

TAX REFORM ACT OF 1969
H.R. 13270

**PART A—TESTIMONY TO BE RECEIVED WEDNESDAY,
OCTOBER 1, 1969**

PART B—ADDITIONAL STATEMENTS

**(Topic: Natural Resources: Depletion Allowances,
Exploration Expenses, Production Payments—Oil
and Gas)**



COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

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(II)

CONTENTS

PART A—WITNESSES

	Page
Honorable John G. Tower, United States Senator, State of Texas.....	1

Natural Resources: Depletion Allowances, Exploration Expenses, Production Payments—Oil and Gas

COORDINATED TESTIMONY OF:

American Petroleum Institute;
Mid-Continent Oil and Gas Association;
Western Oil and Gas Association; and
Rocky Mountain Oil and Gas Association.

PRESENTED BY:

Emilio G. Collado, Executive Vice President, Standard Oil Company (New Jersey).....	8
Robert G. Dunlop, President, Sun Oil Company.....	41
William I. Spencer, Executive Vice President, First National City Bank, New York, N.Y.....	77
George V. Myers, Executive Vice President, Standard Oil Company (Indiana)	97

COORDINATED TESTIMONY OF INDEPENDENT PRODUCERS:

Independent Petroleum Association of America;
Independent Oil and Gas Producers of California;
Independent Oil Producers and Land Owners Association, Tri-State
Inc. ;
Kansas Independent Oil and Gas Association;
Oklahoma Independent Petroleum Association;
Panhandle Producers and Royalty Owners Association;
Texas Independent Producers and Royalty Owners Association; and
West Central Texas Oil and Gas Association.

PRESENTED BY:

H. A. True, Jr., True Oil Company.....	181
Clinton Engstrand, Chairman, Liaison Committee of Cooperating Oil and Gas Associations.....	101
Stark Fox, Executive Vice President, Independent Oil and Gas Producers of California.....	109
D. F. McKeithan, Jr., President, Independent Oil Producers and Land Owners Association, Tri-State, Inc.....	175
Tom Schwinn, B.S., L.L.D., J.D., Executive Vice President and Counsel, Kansas Independent Oil and Gas Association.....	181
William B. Cleary, President, Oklahoma Independent Petroleum Associa- tion	190
C. H. Hinton, Petroleum Consultant, Panhandle Producers and Royalty Owners Association.....	213
William J. Murray, Jr., President, Texas Independent Producers and Royalty Owners Association.....	235
A. V. Jones, Jr., President, West Central Texas Oil and Gas Association...	255

	Page
Eberhard P. Deutsch, Permian Basin Petroleum Association.....	263
Joseph R. Rensch, on behalf of the American Gas Association and the Pacific Lighting System.....	277
Walter E. Rogers, President, Independent Natural Gas Association of America	289
William Jackman, President, Investors League, Inc.....	305
Morton M. Winston, Executive Vice President, the Oil Shale Corporation..	313
B. P. Huddleston, P.E., Citronelle-Mobile Gathering System Company, Inc..	319
Harold D. Rogers, North Texas Oil and Gas Association.....	345
Arthur W. Wright, Assistant Professor of Economics, University of Massachusetts	347

PART B—ADDITIONAL STATEMENTS

Robert V. Moss, Jr., President, United Church of Christ, submitted by Tilford E. Dudley, Director, Washington Office, Council for Christian Social Action.....	369
David W. Richmond, Miller & Chevallier, Washington, D.C.....	379

Senator John Tower

October 1, 1969

Testimony before Senate Finance Committee

Mr. Chairman:

I have asked to come before this distinguished committee this morning because I am fearful that proposed changes in our tax laws, as set forth in H.R. 13270, will strike a particularly heavy blow to the oil and gas industry of this country, and in turn to our nation's defense capability.

As a member of the Senate Armed Services Committee, I am well aware of the vital role a healthy oil and gas industry plays in maintaining a strong defense posture.

In Southeast Asia today, for example, one half of the military tonnage imported from the free world consists of petroleum products. About 10 per cent of the petroleum required to support the military effort there is supplied by the United States, with about 65 per cent imported from the Arabian Gulf and 25 per cent from the Caribbean and other localities.

I believe it is crucial for our nation's defense that there be maintained in this country the capability to supply our own petroleum needs in case foreign oil resources are denied as they were for a short time during the Middle East crisis of 1967. Even within the past 30 days we have heard threats of boycott from the Arab nations.

Mobilization studies of the Defense Department show that any type of extended emergency involving the United States and its allies could not be adequately fueled by the United States alone. Therefore, reliance must be placed upon other free world sources in the Western Hemisphere such as Canada and the Caribbean area. The target date for any appreciable amount of oil production from the Northern Slope of Alaska is estimated to be 1972, so we cannot depend on that resource now.

Our national security dictates that we have in existence petroleum resources capable of satisfying our needs. Petroleum cannot be stockpiled like hardware. The only way of insuring an adequate domestic petroleum supply is through a healthy domestic oil and gas industry. A healthy oil and gas industry requires continual exploration, continual employment of a labor force and continual access to risk capital.

The Defense mobilization studies to which I just referred indicate that we need a petroleum industry in our own country which is capable of producing even more oil and gas than it is now. I am fearful that if Congress approves the tax changes now proposed for the petroleum industry, it will gravely reduce the industry's production capability precisely at a time when there is need for even greater production.

It is imperative that our domestic oil industry be capable of sustaining this country's requirements under any conditions. This strategic material is one of the items absolutely essential to defense and thus it is foremost in the minds of military commanders. The difference between military success or failure could easily hinge on the availability of enough petroleum products at a given particular time.

In the petroleum industry, production hinges on the availability of capital. The importance of capital to our oil industry and in turn to our defense posture, our national economy and the well-being of all Americans, cannot be over-emphasized.

Over 90 per cent of all the work done in this country is done by machinery. This machinery is lubricated and often powered by petroleum products. The use of machinery has contributed heavily to the high wages and high standard of living possible for the people of this country.

The accumulation of capital to finance growth in our business economy has been historically successful in promoting and maintaining our position as the greatest industrial nation of the world.

In order for our private enterprise system to function successfully, it must have a steady and continuous supply of new private capital. One of the world's serious problems today is the shortage of investment capital. In spite of the great benefits our American system has brought us, I fear it is in danger of being severely damaged through an unreasonable system of taxation.

There is a great difference between capital and income. Our federal tax system is based on income and should remain so. Taxation of capital results in a draining away of that capital and in turn less and less income for all.

As you know, I have firmly advocated the continuation of the 27 1/2 per cent depletion allowance for oil. I continue to do so. This allowance, together with the ability to deduct intangible drilling costs and associated exploration expenses from oil and gas income, is the prime source of generating new capital within the oil and gas industry itself. That generation of new capital must be maintained in order to encourage continued health in our petroleum industry and continued overall economic benefits for all Americans.

Today, you will hear excellent testimony of a highly technical nature to substantiate the vital importance of finding and using our domestic oil and gas reserves. Various forms of production payments have been successful in the past as a means of consolidating and transferring newly discovered reserves to skilled oil and gas operators, resulting in greater efficiency in production. I urge you to consider carefully, ways of updating and refining the methods of sale and purchase of these unproduced natural resources, not eliminating this avenue of financing.

In summary, I would stress the need for a system of taxation of our oil and gas industry which will encourage continued health within that industry. I urge this because of our nation's dependency on the industry economically and because of its dependency for an adequate defense operation. I know you are anxious to hear other witnesses who are capable of providing more expert testimony and so I have tried to keep my remarks brief.

Thank you for your kind attention.

STATEMENT OF

EMILIO G. COLLADO
Executive Vice President
Standard Oil Company (New Jersey)
New York, New York

before the

COMMITTEE ON FINANCE
UNITED STATES SENATE
Washington, D.C.

in behalf of

American Petroleum Institute
Mid-Continent Oil & Gas Association
Rocky Mountain Oil and Gas Association
Western Oil and Gas Association

October 1, 1969



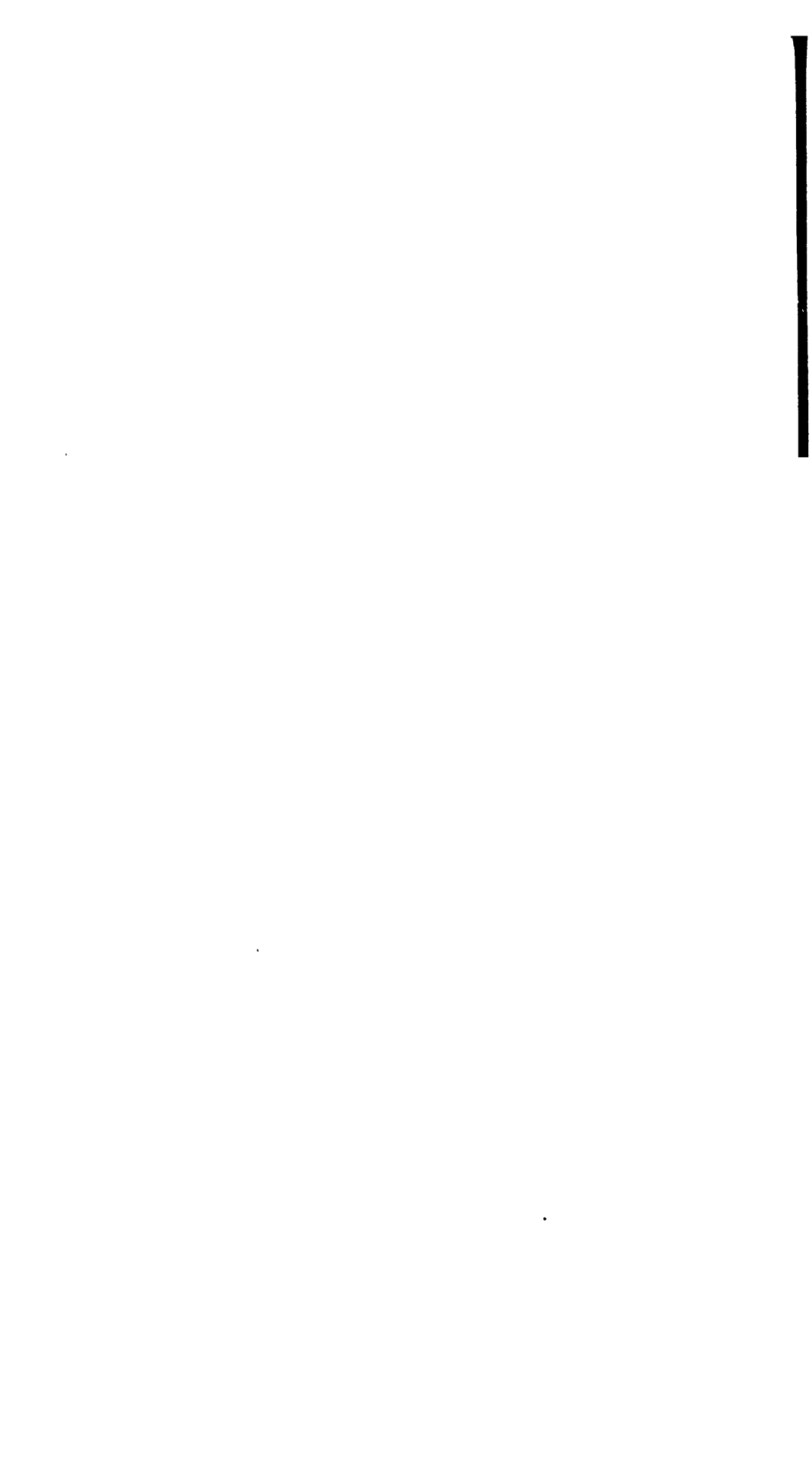
SUMMARY OF PRINCIPAL POINTS IN STATEMENT OF EMILIO G. COLLADO

We strongly urge that Sections 431 and 432, and Section 501(a) of H. R. 13270, applying to the foreign activities of U. S. petroleum companies, be rejected. By increasing the tax burden on U. S. petroleum companies' operations abroad, these provisions would seriously weaken the ability of U. S. companies to compete effectively with foreign oil companies, many of which receive substantial tax benefits and, in some cases, cash subsidies from their home governments. This adverse impact is likely to be felt particularly on the ability of U. S. petroleum companies to obtain concession rights in new producing areas, and thus the provisions would place important obstacles in the way of U. S. companies' participation in the future growth of the international oil industry. These measures must be assessed in the light of the contribution which U. S. petroleum investments abroad make to important U. S. national objectives.

Our national security requires that we maintain adequate and assured sources of oil to meet our growing economic and military needs for energy. Despite the high rate of growth expected in our domestic oil producing capacity in the future, the United States will have to rely increasingly on foreign-source oil to meet our growing requirements. The best way to provide that our country will have access to sufficient foreign-source petroleum is to encourage U. S. companies to continue to search for and develop these resources in diverse foreign areas.

The foreign oil investments of U. S. companies also make a substantial positive contribution each year to our balance of payments, and last year contributed about \$2.5 billion to U. S. receipts of income and royalties and fees from abroad. Moreover, these investments have enhanced our economic welfare and have promoted economic progress in the developing countries.

Sections 431, 432, and 501(a) would also seriously undermine valid and long-standing principles of tax equity and of preventing international double taxation, which United States tax laws have traditionally sought to achieve. Section 501(a) would discriminate against the foreign activities of U. S. petroleum companies by denying them tax treatment comparable to petroleum operations conducted in the United States. Section 431 would double-tax individual parts of a taxpayer's income, while Section 432 would introduce international double taxation on the integrated petroleum industry operations abroad by denying to the mineral industry alone the effective use of the overall basis for applying the foreign tax credit. Such discrimination against foreign-source income, and against the mineral industry in particular, seems unjust and unwarranted. Moreover, enactment of these provisions seems unlikely to produce a significant amount of revenue for the United States. The Treasury has offered recommendations which would alleviate some of these problems.



STATEMENT OF EMILIO G. COLLADO

My name is Emilio G. Collado. I am a Director and Executive Vice President of the Standard Oil Company (N.J.), and my statement is submitted on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. My statement concerns the major provisions of H.R. 13270 relating to U.S. taxation of the petroleum industry's operations abroad. I fully concur with the views expressed in the statements submitted by Messrs. Dunlop, Spencer and Myers.

In our opinion, the changes in U.S. tax laws contained in H.R. 13270 applying to the foreign activities of U.S. petroleum companies ought to be rejected. The specific provisions that we urge be rejected are: Sections 431 and 432, which would change the foreign tax credit provisions of existing law; and Section 501(a) which, in addition to reducing percentage depletion on domestic production, would eliminate percentage depletion entirely for foreign oil and gas production.

We have three principal reasons why we believe these provisions should be rejected. First, after careful analysis we have concluded that the provisions would be harmful to the national security interest of the United States and our foreign allies in maintaining adequate and growing foreign sources of oil. Second, we believe the provisions would be detrimental to the U.S. balance of international payments and general economic welfare. Finally, their enactment would seriously undermine long-established and accepted principles of tax equity and of preventing international double taxation.

National Security of the United States and the Free World

U.S. tax policy pertaining to the foreign activities of U.S. petroleum companies must, above all, be assessed in the light of the importance of these activities to the national interest of the United States in maintaining adequate and secure sources of oil to meet our growing economic and military needs for energy.

Today the United States consumes nearly 40 per cent of the oil consumed in the entire Free World, yet less than 10 per cent of the Free World's petroleum reserves are in this country. In the future we will have to rely increasingly on foreign-source oil to meet our growing requirements. The estimates vary, but considering currently known reserves and with reasonable assumptions about the future with respect to new discoveries and the development of synthetics, and assuming continuation of existing domestic tax incentives and import policy, the coverage of domestic demand for petroleum (including residual fuel oil) by domestic producing capacity is expected to decline from 93 per cent currently, to 83 per cent in 1975 and 76 per cent in 1985. These expectations do not rely on pessimistic assumptions of a lower rate of discovery of petroleum resources in the United States in the future than in the past, nor even on a simple projection of past trends. On the contrary, average annual discoveries in the United States, including Alaska and offshore, are expected to be considerably greater in the future than the recent past, provided that existing domestic tax incentives and import policy are continued.

Foreign-source oil is also of substantial strategic importance to our country. As the U.S. Department of Defense stated in its submission

to the Task Force on Oil Import Control:

"In carrying out our treaty commitments, we, as a nation, face a variety of threats on many fronts. Despite the enormous and costly effort of our nation's intelligence organizations and resources, it is impossible to predict the place, time, scope, and contestants in any future emergency; hence, our logistics planners face a continuing challenge. It, therefore, follows that our national security extends far beyond the shores of the United States. The Department of Defense reaffirms that it is in the best interests of the United States and, in fact, our national security dictates that we have in existence dependable, capable, and willing overseas sources to satisfy our petroleum needs on a global basis.

"In summary, the DoD is primarily concerned with an assured adequate source of supply in close proximity to the area of need and at the lowest possible cost to the taxpayer. One fact is clear and that is the U.S. alone cannot realistically plan to fuel any Free World type of an emergency, therefore, we believe that no drastic action should be taken which would jeopardize our other Free World sources of supply. The interest of the DoD in expanding oil development by areas in order of priority is first the Continental U.S., secondly the Western Hemisphere and, thirdly other Free World areas. This order of priority includes, but is not limited to, the maintenance of a domestic production and refining capability to meet military and essential civilian requirements." (Emphasis added.)

Thus, the future availability of growing quantities of foreign oil is of great economic and strategic importance to the United States to meet our growing needs, both in the United States and for use in our military installations abroad. In the future, we will have to rely increasingly on sources elsewhere in the world -- both our traditional sources of supply and new producing areas of the future.

Our allies, with more limited potential for developing domestic producing capacity, must rely to a much greater degree on foreign oil to meet their needs. For example, Western Europe currently imports 96 per cent of its petroleum requirements. Moreover, energy consumption abroad is growing much faster than in the United States, and petroleum is supplying an

increasing share. In the future, the United States will not be in a position to meet Europe's needs in the event of an interruption of supplies from the Middle East without impinging on U.S. consumption, as we were able to do during the last two Suez crises.

It seems clear that the future security of the United States and the Free World will depend on ready access to diverse and growing foreign sources of oil. In the case of the United States, the best way to provide future access to sufficient foreign-source petroleum is to encourage U.S. companies to continue to search for and develop these resources in diverse foreign areas.

What does this mean in terms of the provisions in H.R. 13270? Primarily, we think it means that the Congress ought to avoid making changes in U.S. tax laws relating to foreign income which would place obstacles in the way of U.S. companies participating in the growth of petroleum industry activities abroad. We are convinced that the changes in the House Bill would seriously impede the efforts of U.S. oil companies to participate fully in this growth.

Impact of U.S. Tax System on Competitiveness of U.S. Oil Operations Abroad

Today the international oil industry is highly competitive. U.S. companies are continuously vying for position relative to foreign companies in all phases of activity -- all the way from acquiring new producing concessions, up through refining and selling in final product markets. In this intense competition, cost advantages of particular companies are readily reflected in competitive bidding for new concession rights and in aggressive marketing tactics.

As confirmed by Assistant Secretary Cohen when he appeared before the Committee, foreign companies generally receive more favorable tax

treatment from their home governments on their operations abroad than do American companies, and in many cases are totally exempt from taxation on their foreign income. In addition, many foreign oil companies also receive outright subsidies and other favored treatment from their home governments for foreign and domestic operations. Many of these benefits substantially reduce the costs of doing business and the associated risks, and are unavailable to American companies which compete with foreign companies receiving such benefits. For example, several foreign countries actually eliminate the risks of unsuccessful exploration by providing outright subsidies.

The significance and widespread use of incentives and cash subsidies for oil exploration by countries such as Australia, Germany, Japan, and the United Kingdom are described in Attachment I, "Summary of Incentives Granted by Foreign Governments in Regard to the Production of Oil and Gas Under Petroleum and/or Tax Laws." Germany has already adopted a system of interest-free loans to German nationals to finance the costs of foreign exploration, and if such exploration is unsuccessful, the loans need not be repaid. In addition, overseas losses can be offset against taxable income in Germany. The U.K. grants cash incentives for both domestic and overseas oil and gas exploration and development. The French government permits its national companies to deduct overseas exploration expenses against income derived within France. Japan, in addition to financial aid to Japanese companies exploring overseas, grants bonus exploration deductions and has committed itself to support exploration in Alaska, Southeast Asia, Africa, and the Persian Gulf. Many other consuming countries are intensifying efforts to encourage local ownership of foreign oil reserves, and additional

incentives are now being contemplated. For example, the countries of the European Common Market are considering extending uniform tax incentives to national companies for foreign exploration. Also, government-owned or controlled companies from various foreign countries have entered the industry in increasing numbers and have proven to be aggressive competitors. Such state-owned or controlled companies frequently have political and monopoly advantages in their home markets and their actions are not necessarily determined by economic considerations.

Despite these differences, American oil companies have successfully achieved a leading position in the international oil industry. U.S. companies currently hold more than half of the world's known oil reserves outside the United States, account for roughly 60 per cent of Free World oil production, and own more than half of Free World refining facilities. It would be unfortunate if the Government of the United States took steps which in themselves could tip the scales in favor of our foreign competitors.

Foreign Oil Investments' Contribution to Balance of Payments and Other U.S. Goals

Our country's national interest in providing for access to diverse and growing foreign sources of oil is sufficient reason, in itself, to reject the current tax proposals. However, there are other important reasons why these proposals should be rejected.

One is the importance which these investments have for our balance of payments. The earnings generated by the more than \$17 billion which U.S. companies have invested in foreign petroleum operations make a substantial positive contribution each year to the U.S. balance of payments and strength of the dollar. Last year, U.S. receipts in the form of income remitted from petroleum direct investments and royalties and fees related to these investments

amounted to about \$2.5 billion. In addition, these investments have directly resulted in substantial U.S. exports of capital equipment and other merchandise.

U.S. foreign investments in petroleum activities have also yielded a better-than-average contribution to our balance of payments. Petroleum investments have in each of the last three years contributed at least 44 per cent of the income remitted to the U.S. from all direct investments abroad, while these investments represent a considerably smaller proportion -- about 30 per cent -- of the book value of all U.S. direct investments. Various estimates made by experts outside the petroleum industry suggest that, on the average, U.S. direct investments in foreign petroleum operations are fully returned in the balance of payments in from three to five years and result in substantial additional contributions to our payments position in subsequent years.

At a time of continuing international monetary uncertainties, with our balance of payments made weaker by the impact of persistent inflation in the United States on the competitiveness of U.S. production, it seems clearly unwise to take measures which would discourage the contribution U.S. petroleum investments abroad can make to our international payments strength.

The foreign petroleum investments of U.S. companies have not only served our national interest in securing foreign oil resources and benefited our international payments position, but also have contributed to other national objectives. Our economic welfare has been enhanced by the annual returns these investments have brought to the United States and by the substantial annual exports of U.S. goods and services they have generated. Moreover, the annual income received from these investments abroad has resulted

in substantial additional U.S. tax revenues as this income is distributed to U.S. individual shareholders.

Another prominent U.S. objective in the postwar period has been to promote economic progress in the developing countries. U.S. petroleum companies have made a substantial contribution to progress in these areas by directly creating income and employment, and by providing host governments with substantial annual revenues which can be used to finance their countries' development. Moreover, American petroleum companies have frequently taken it upon themselves to build roads, hospitals, and schools, and to provide other facilities and services not directly related to their commercial operations.

In considering the provisions in the House Bill, we must recognize that a significant increase in the costs of doing business abroad -- which could well result from the various proposed tax changes -- would inevitably restrict the future contribution American oil companies could make to U.S. national security, to the balance of payments, and to other U.S. goals. A substantial impact is likely to be felt in the process of bidding for new concession rights abroad. Cost disadvantages for U.S. companies such as those which are entailed in the provisions of H.R. 13270 could have the effect of closing the door on U.S. companies' participation in future promising areas for petroleum production. These provisions would not only tend to discourage new U.S. petroleum investments abroad and thereby retard future growth in earnings for our balance of payments and economy, but could also have a depressing effect on the earnings of existing petroleum investments. In today's competitive world, an investment, once it is made, cannot be expected to continue to earn the same returns year after year without additional investment in expansion and modernization. Companies must keep

roughly in line with the industry's growth and technological advances. In addition, of course, the foreign petroleum investments of U.S. companies must continue to be competitive with foreign petroleum companies and to earn returns at least commensurate with other U.S. investments abroad in order to continue to attract the capital which is required for their growth.

Principles of U.S. Taxation on Foreign-Source Income

Concerning foreign-source income, United States tax laws have traditionally sought to achieve equity among taxpayers and to prevent international double taxation. As noted earlier, many countries prevent international double taxation simply by imposing no taxes at all on the foreign income of their corporations which has already been subjected to foreign taxes. The United States, while recognizing the primary claim of the country of source to tax, has traditionally taxed the worldwide income of its citizens and corporations. Since 1918, the United States has sought to avoid international double taxation by means of the foreign tax credit. Thus, the United States has allowed credit against the U.S. tax liability on foreign-source income for income taxes paid to foreign governments on such income. In electing this method of avoiding international double taxation, the United States has long recognized that foreign income tax laws might very well differ in rate and method of computation from those of the United States. In arriving at the allowable credit, U.S. taxing concepts have been applied even if the foreign country does not necessarily follow such concepts in imposing its income taxes. That is, in taxing worldwide income, the same rules for determining income subject to tax have generally applied whether the business operations were conducted in the United States or abroad. While this approach has ensured that at least the U.S. income tax rate would apply, U.S. taxpayers

have also been allowed the choice of computing their foreign tax credit on the basis of the per-country or the overall method of calculation. The general result has been that the burden of income taxes on foreign-source income has been either the foreign or U.S. tax rate, whichever is higher. Under this method, the foreign tax credit cannot exceed the U.S. tax which would be due on the foreign income. These concepts are basically sound and equitable, and should be continued.

To do otherwise could effectively shut off further U.S. foreign investment. As former Assistant Secretary of the Treasury Stanley S. Surrey has said:

"American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the overall burden of two taxes would be so great that international investment would practically cease."^{1/}

Sections 431 and 432 and Section 501(a) of H.R. 13270, if enacted, would violate the traditional principles followed by the United States of achieving tax equity and of avoiding international double taxation. A more detailed discussion of these provisions follows.

Section 501(a)

While Section 501(a) would reduce percentage depletion for oil and gas production in the United States, it would eliminate the allowance entirely for foreign production. Of course, this provision involves outright discrimination against foreign versus domestic operations by U.S. petroleum companies. This contrasts to the existing equitable situation in which the U.S. generally

^{1/} Source: Hearings before The Committee on Foreign Relations, United States Senate, 90th Congress, 1st Session, on Tax Convention with Brazil, Executive Journal, 1967, pp. 19-20.

does not require business operations abroad to pay more income taxes than the same operations would pay if they were conducted entirely in the United States. It would be particularly harsh on U.S. companies operating in Canada, whose oil industry is closely linked to the U.S. industry.

The various incentives and subsidies which foreign governments give to their petroleum companies for foreign production have already been noted and are described in Attachment I. In view of such practices on the part of foreign governments, the elimination of foreign depletion for U.S. companies could substantially reduce the ability of U.S. companies to compete with foreign companies in seeking to acquire new concession rights in foreign producing areas. In considering this provision we must recognize this fact, and all its implications for the United States national interest.

Moreover, Assistant Secretary of the Treasury Cohen, in his appearance before the Committee, has already pointed out that enactment of Section 501(a) would do nothing more than penalize U.S. companies, with virtually no benefit to the U.S. Treasury:

"...Our analysis of this provision indicates, in the light of our foreign tax credit provisions, that after a brief period it will probably result in foreign countries increasing their effective tax rates on income from oil and gas production to 'sponge up' any additional tax revenue otherwise accruing to the United States. Thus the denial of foreign depletion will increase the effective U.S. rate of tax on such income, which tax the foreign governments will then offset by increasing their rates. The end result will be that the U.S. taxpayer will pay additional tax to those countries, but no additional tax to the United States.

"For these reasons, the elimination of percentage depletion on foreign deposits of oil and gas is unlikely to increase U.S. revenues significantly, and will merely increase the burden of foreign taxes on U.S. businesses..."

Similar statements have been made in the past to the Congress by former Secretary of the Treasury C. Douglas Dillon^{2/} and former Deputy to the Secretary of the Treasury Dan Throop Smith.^{3/}

Thus, any increased tax revenues would be lost to the U.S. Treasury and U.S. balance of payments. In addition, the likely impact of the higher tax burden on U.S. oil companies' foreign activities would be to reduce earnings available for distribution to U.S. stockholders and thus would tend further to reduce Treasury tax revenues, owing to the reduction in taxable dividend income. This impact would tend to increase over time, as new investments were deterred by the greater burden of taxation.

The Treasury has recommended deleting the provision in Section 501(a) which would eliminate depletion on foreign oil and gas production. We strongly support the Treasury's recommendation.

Section 431

For companies which have elected the per-country basis for calculating their foreign tax credits, Section 431, in contrast to existing law, would not always allow full credit for foreign income taxes paid up to the amount of U.S. taxes which would otherwise be due on such income. In so doing, this provision would introduce new discrimination in U.S. tax laws affecting foreign-source income and would in some circumstances result in double taxation of foreign income. Therefore, we recommend that Section 431 be rejected.

^{2/} "Statement of Hon. C. Douglas Dillon," Hearings before the Committee on Ways and Means on the President's 1963 Tax Message, 88th Congress, 1st Session, Feb. 7, 1963, p. 606.

^{3/} Dan Throop Smith, Letter dated May 6, 1958 to Harry F. Byrd, Chairman, Senate Finance Committee, on H.R. 8381, Congressional Record, August 11, 1958, p. 16923.

In attempts to justify Section 431, it has been argued in the Ways and Means Committee report on H.R. 13270 that the current law provides a so-called "double tax benefit" to companies which incur initial losses in foreign activities and are able under the per-country foreign tax credit provision to reduce their U.S. taxable income in that year by the amount of such foreign losses. The first so-called tax "benefit" is that the taxpaying company is able to combine profits earned in the United States and abroad with losses incurred in the United States and abroad in determining taxable income. The reasonableness and appropriateness of combining profits and losses for tax purposes is accepted in the House-passed Bill, as it should be. This is a long-accepted and valid principle of taxation. The ability to combine profits and losses in the case of foreign and domestic operations is simply consistent with the U.S. principle of taxing the worldwide income of its citizens.

The second part of the so-called "double tax benefit," so the argument goes, is said to occur when operations turn profitable in the country in which the losses were incurred and the U.S. taxpayer is then allowed credit for the foreign taxes he actually pays on such income. This, of course, reflects the operation of the foreign tax credit, which is required in order to prevent international double taxation. Far from being a "double tax benefit," the credit for foreign taxes paid avoids the inequitable situation in which the taxpayer's income would be taxed twice.

Section 431 would deny to the taxpayer up to half of the credits currently allowable for foreign taxes actually paid until the Treasury effectively "recaptured" in actual U.S. tax revenues the amount of U.S. taxes which would be due on income equivalent to the earlier losses if no foreign income taxes had been paid. The point is, of course, that when

foreign taxes are paid, any further taxation of income which has already been taxed at the U.S. rate, or higher, is double taxation which U.S. law has traditionally sought to avoid. The proposal would not eliminate a "double tax benefit," because there is no double tax benefit.

The following examples compare the results which occur under existing law with the results which would occur if Section 431 of the House-passed bill is enacted. The first example illustrates the results if the foreign country allows the taxpayer to carryover his losses and the second example if the foreign country does not allow any loss carryover.

Example I - LOSS CARRYOVER ALLOWED BY COUNTRY A

For simplicity, assume that the taxpayer elects to claim the foreign tax credit in the year he incurs a foreign loss, that the U.S. and foreign tax rates are each 50%, and that foreign country A allows a loss carryover. The following example shows what would occur under both present law and section 431, assuming the financial results shown in Column 1:

	<u>Income or (Loss)</u> (1)	<u>Foreign Tax</u> (2)	<u>U.S. Tax - Present Law</u> (3)	<u>U.S. Tax - Sec. 431</u> (4)
1970:				
U. S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	(200)	- 0 -	(100)	(100)
Business in Country B	1000	\$500	500	500
	<u>\$1800</u>	<u>\$500</u>	\$900	\$900
Foreign Tax Credit - Country B			(500)	(500)
Net U. S. tax			<u>\$400</u>	<u>\$400</u>
1971:				
U. S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	200	- 0 -	100	100
Business in Country B	1000	\$500	500	500
	<u>\$2200</u>	<u>\$500</u>	\$1100	\$1100
Foreign Tax Credit - Country B			(500)	(500)
Net U. S. Tax			<u>\$600</u>	<u>\$600</u>
1972:				
U. S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	400	\$200	200	200
Business in Country B	1000	500	500	500
	<u>\$2400</u>	<u>\$700</u>	\$1200	\$1200
Foreign Tax Credit:				
For Country A tax			(200)	(150)*
For Country B tax			(500)	(500)
Net U. S. tax			<u>\$500</u>	<u>\$550</u>

* Note: This result occurs because Section 431 would reduce the amount of the allowable foreign tax credit in 1972 by 25% (limitation fraction of \$300/2400 instead of \$400/2400 times the U.S. tax of \$1200) which has the effect of doubling-up on the taxation of the foreign source income in 1972. Although not clear from the Committee Report, statutory construction of Section 431 appears to require a partial recapture of the 1970 loss incurred in Country A in 1971 in the amount of \$100 (not to exceed 50% of taxable income from Country A in 1971 of \$200) even though no tax was paid to Country A in 1971. If this partial "recapture" is not made in 1971 the inequitable tax result shown here as occurring in 1972 would become twice as great, resulting in a \$100 additional U.S. tax instead of \$50 as shown in the example.

Under present law, shown in column (3), the \$200 loss in Country A in 1970 reduces the taxpayer's U.S. tax in 1970 by \$100. In 1971, when \$200 of income is earned in Country A, present law results in a U.S. tax of \$100. Since Country A imposed no tax on this income, no foreign tax credit is available to satisfy the U.S. tax on this income. Thus, in countries which allow loss carryovers, when sufficient income is earned to offset the prior loss, the taxpayer automatically bears a U.S. tax liability equal to the earlier reduction in his U.S. taxes resulting from the loss. In 1972, when the taxpayer earns \$400 of income in Country A and pays \$200 of foreign income taxes, he owes no further U.S. taxes because of the foreign tax credit.

Under Section 431, shown in column (4), identical results occur in 1970 and 1971. However, in contrast to present law, in 1972 Section 431 would impose a further U.S. tax of \$50 on the \$400 income from Country A, thereby resulting in double taxation. As a result of this double taxation, the U.S. taxpayer in the example bears an effective income tax rate of 62.5 per cent on his 1972 income in Country A. Of course, the effective rate of tax which would result from the double taxation imposed by Section 431 can be much higher, or slightly lower than occurs in the example, depending on the amount of income earned in the year concerned. The point is that the inequitable result of double taxation occurs. Moreover, this occurs despite the fact that the earlier reduction in U.S. tax revenue resulting from the original loss was, in effect, "recaptured" by the United States when sufficient income was earned to offset the earlier loss.

Example II - LOSS CARRYOVER NOT ALLOWED BY COUNTRY A

Assume the same facts as in Example I except that Country A does not allow a loss carryover.

	<u>Income or (Loss)</u>	<u>Foreign Tax</u>	<u>U.S. Tax - Present Law</u>	<u>U.S. Tax - Sec. 431</u>
1970:				
U.S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	(200)	- 0 -	(100)	(100)
Business in Country B	<u>1000</u>	<u>\$500</u>	<u>500</u>	<u>500</u>
	<u>\$1800</u>	<u>\$500</u>	\$900	\$900
Foreign Tax Credit - Country B			(500)	(500)
Net U.S. Tax			<u>\$400</u>	<u>\$400</u>
1971:				
U.S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	200	\$100	100	100
Business in Country B	<u>1000</u>	<u>500</u>	<u>500</u>	<u>500</u>
	<u>\$2200</u>	<u>\$600</u>	\$1100	\$1100
Foreign Tax Credit - Country A			(100)	(50)
Foreign Tax Credit - Country B			(500)	(500)
Net U.S. Tax			<u>\$500</u>	<u>\$550</u>
1972:				
U.S. Business	\$1000	- 0 -	\$500	\$500
Business in Country A	400	\$200	200	200
Business in Country B	<u>1000</u>	<u>500</u>	<u>500</u>	<u>500</u>
	<u>\$2400</u>	<u>\$700</u>	\$1200	\$1200
Foreign Tax Credit:				
For Country A tax			(200)	(150)
For Country B tax			(500)	(500)
Net U.S. Tax			<u>\$500</u>	<u>\$550</u>

The results in 1970 are identical to that in the first example, in which Country A allowed a foreign loss carryover. However, in 1971, since no loss carryover is allowed in Country A, the taxpayer pays a \$100 tax to Country A. Present law permits the taxpayer to claim a tax credit for the taxes paid to Country A to the extent that the U.S. would have imposed a tax on such income had it been earned in the United States. Thus, the taxpayer is allowed a tax

credit of \$100 against his U.S. tax liability on the income from Country A. Also, in 1972, present law allows the taxpayer a \$200 credit for income taxes paid on the \$400 of income earned in Country A.

In contrast to the situation under present law, in which the taxpayer pays a tax rate of 50 per cent on his worldwide income, Section 431 would impose additional taxes in 1971 and 1972. Thus, under Section 431 the taxpayer would owe a U.S. tax of \$50 in both 1971 and 1972 on the income from Country A, despite the fact that such income had already been taxed by Country A at the U.S. rate. As a result, in 1971 the taxpayer would bear an effective income tax rate of 75 per cent, and in 1972 a tax rate of 62.5 per cent on his income from Country A. As in Example I, the effective rates of the tax burden on this income in the years following the loss will depend on the amount of income earned in those years, and can be higher or lower than the rates shown.

Proponents of Section 431 would argue that the impact of double taxation such as occurs in 1971 and 1972 is justifiable because the taxpayer's loss in 1970 reduced his worldwide taxable income and, thus, his U.S. tax in 1970. Without the additional tax imposed by Section 431, the taxpayer would have a so-called "double benefit": (1) the recognition of the loss incurred in 1970 in determining total taxable income; and (2) the allowance of a tax credit for income taxes paid to a foreign government on subsequent income from that country.

It is difficult to see how taking a loss into account in determining worldwide taxable income can be considered to be an undue "benefit" to the taxpayer. Without recognition of the loss, taxable income would be overstated. In subsequent years, recognition of income taxes actually paid

to a foreign country as legitimate credits against U.S. taxes imposed on the same foreign-source income is just, equitable, and essential to avoid the inequity of double taxation of the taxpayer's income.

In addition to the results described in the examples, if Section 431 is enacted unrelated projects in a country in which losses were incurred by a taxpayer could be burdened with double taxation as a result of the "re-capture provisions" relating to losses incurred on earlier projects which never earned subsequent profits sufficient to offset those losses. This could affect completely unrelated projects undertaken many years later. For example, suppose a taxpayer initiated unsuccessful drilling activity in Country A in 1970, incurring substantial losses in the early years of the decade. Suppose that in 1980, while continuing to carry on small-scale exploration activity, the taxpayer decides that it would be economically attractive to establish a fertilizer plant in Country A, and expects during the first year of operations to earn profits. Under Section 431, even if the taxpayer would pay foreign taxes on his profit at the U.S. rate, he would nevertheless owe additional taxes to the U.S. Government on such income because of the prior losses from his drilling activities. The prospect of an additional tax burden on the fertilizer project, owing to losses on unrelated earlier operations, could well make an otherwise attractive investment uneconomic for the taxpayer.

Moreover, Section 431 would create tax liabilities relating to earlier losses even if the property which had given rise to the loss was subsequently expropriated by a foreign government without compensation. To illustrate, suppose a taxpayer experienced an operating loss of \$50,000 in his branch operation in Country A in 1971, and in 1972 the government

in Country A expropriated without providing any compensation for the \$200,000 worth of property involved. Although the taxpayer would be allowed a tax deduction based on the cost of the property expropriated, Section 431 would require him to include in taxable income in 1971 an amount equal to the prior operating loss. Similarly, Section 431 would require the creation of taxable income equal to prior losses in cases in which property which gave rise to a foreign loss is subsequently abandoned or sold off at a loss. That is, while the taxpayer would be allowed to deduct the amount of the loss of property, he would also incur a tax liability for income equivalent to the prior loss.

Thus, the operation of Section 431 leads to the strange result that when a taxpayer incurs an operating loss followed by a loss of property, taxable income is somehow created out of thin air. In these situations it would have been advantageous if the properties had instead been destroyed by fire or windstorm, or some other casualty, since in such cases Section 431 would not require the creation of income subject to tax.

The operation of Section 431 would in some cases so severely discriminate against foreign activities as to preclude many new foreign ventures for U.S. companies. Particularly risky foreign projects -- such as exploratory activities for foreign oil resources -- would be most seriously discouraged by this provision. Indeed, Section 431 would, over time, have the effect of denying existing deductions for intangible drilling costs to the extent these deductions resulted in a loss in a foreign country. Section 431 substantially adds to the deterrents in H.R. 13270 to the continued effective participation by U.S. oil companies in the international oil industry.

The Treasury supports this provision and recommends that it be extended to apply to situations in which there has been an overall foreign loss for a company which calculates its tax credit on the basis of the overall limitation. The proponents of Section 431 argue that the provision will increase revenues to the U.S. Treasury. It should be noted, however, that those who make this argument generally fail to take into account the impact these provisions would have on tax revenues resulting from taxes on U.S. dividend income. Profits from foreign ventures contribute significantly to the income and dividends of the companies involved, and such dividends are taxed in the hands of individual shareholders. To the extent U.S. companies find their ability to compete abroad impaired by the increased tax burden imposed by Section 431 they will lose investment opportunities to foreign competitors. Thus, U.S. corporate dividends will tend to diminish and, accordingly, U.S. tax revenues from dividend income will tend to decline.

For all the reasons outlined above, we urge that Section 431 be deleted from the House Bill.

Section 432

Section 432 would introduce a special limitation on the amount of credits allowed for foreign income taxes paid in connection with foreign mineral producing activities. This provision is highly discriminatory against extractive industries and apparently reflects faulty analysis of the taxes incurred on petroleum operations abroad as well as a failure to recognize the integrated nature of these operations. We recommend that it be rejected.

It has been suggested that the income taxes paid by U.S. petroleum companies in some foreign producing countries must contain an element of "royalty" in them, since the income tax rates in such countries are sometimes higher than the U.S. rate, or higher than the rate applying to other industries in that country. However, those who have argued that income taxes in petroleum-producing countries contain an element of royalty (for which credits against U.S. taxes are not allowed) are apparently not aware that royalty payments in these countries are generally as high as, and in some cases considerably higher than, royalties paid on production in the United States. For example, in the case of Venezuela, the effective rate of royalty on gross producing income exceeds 25 per cent, compared to the 12-1/2 to 16-2/3 per cent the U.S. industry generally pays on gross producing income in the United States.

Moreover, the fact that both royalties and income taxes are paid to the same government -- on the one hand as the owner of the property from which the minerals are produced, and, on the other hand, as the authority levying a tax on the income resulting from such production -- does not alter the nature of either payment. Both royalties and income taxes relating to petroleum production are paid to the Federal and State governments in the United States, and to foreign governments, including Canada, Australia, the United Kingdom, and the Netherlands, as well as countries in Asia and Africa. It is clearly possible to distinguish between royalties and income tax payments to these countries.

As Assistant Secretary Cohen expressed the Treasury's view, in discussing Section 432:

"The Administration supports, in part, the effect of this second provision. However, while we recognize the hidden royalty problem at which the House Bill is directed, we do not feel that the bill provides an equitable solution to that problem. On further examination of the tax and royalty structure applicable to the international minerals industry, we do not feel that it is proper to characterize all foreign taxes on mineral income in excess of U.S. taxes on such income as disguised royalties. It is impossible to ascertain the extent to which income taxes in any particular country are a substitute for royalties, and in many cases the foreign country receives royalty payments which are even greater than royalties customarily paid in the United States. Also, foreign countries frequently impose income tax on non-mineral income, as well as on mineral income, at a rate in excess of the U.S. rate.

"If, then, this separate limitation in the bill regarding mineral income is not justified on the ground that any foreign tax in excess of the effective U.S. tax on mineral income is a royalty, it works unfairly for mineral companies as compared to all other U.S. taxpayers with foreign operations. It completely denies mineral companies the opportunity, available to other taxpayers, to average the excess of foreign tax over U.S. tax on mineral income against any excess of U.S. tax over foreign tax on their other foreign income. This result occurs even though the foreign tax on the mineral income is at a reasonable rate judged by world standards and even though such averaging is precisely the purpose of the over-all limitation."

In our opinion, the Treasury is correct in urging rejection of Section 432 as it now stands, since it would, in effect, unfairly deny the use of the overall credit to the mineral industry. The Treasury has recommended in lieu of Section 432 that excess credits for foreign taxes paid on mineral income resulting from the allowance of U.S. percentage depletion -- which Treasury has recommended be reinstated on foreign production -- not be available to be applied against other income. The Treasury has also said that a similar rule now applies in the case of Western Hemisphere Trade Corporations. We believe that this proposal should be studied carefully.

The Treasury has also expressed a broader concern about high foreign tax rates and noted that, apart from percentage depletion, it could be provided for the mineral industry that excess credits resulting from foreign income tax rates higher than 60 per cent not be available to be used against other income. However, as the Treasury has stated, such singling out of the mineral industry cannot be justified on the grounds that high foreign tax rates contain disguised royalties. Therefore, Treasury has decided to study the question of high foreign tax rates in a general context, as they apply to all industries. We agree with the Treasury that there is no justification for singling out the mineral industry for discriminatory treatment in this area. However, in our opinion, there is also no justification for invading the overall foreign tax credit limitation as it applies to all industries, such as a generalized limitation with respect to credits resulting from foreign tax rates in excess of 60 per cent would do.

Section 432 of H.R. 13270 would go much further than this for the mineral industry by preventing mineral companies on the overall foreign tax credit limitation basis from using any excess tax credits from mineral producing activities abroad. Thus, Section 432 would separate for U.S. tax purposes a part of the foreign petroleum industry -- production -- which is economically inseparable from activities such as refining, transporting and marketing this production. Investments in foreign oil producing activities are closely linked to investments in refineries, pipelines, tankers, and other distribution facilities. For example, since the beginning of 1960 my Company alone has spent about \$1.5 billion to add to crude oil producing capacity abroad. This oil was, and is, destined primarily

for markets outside the United States -- in Western Europe, Latin America, Asia, Africa, and the Far East. But without heavy further investments by Jersey Standard in refineries, pipelines, tankers, and other distribution facilities to serve these markets, we simply could not have justified such large investments in additional producing capacity. An international oil company is a closely tied network of oil trade which simply cannot be untied or separated into segments. To attempt to do so contradicts economic fact.

In enacting the overall limitation for purposes of the foreign tax credit in 1960, the Congress stated in House Report No. 1358, 86th Congress, 2nd Session, page 866:

"In most cases American firms operating abroad think of their foreign business as a single operation and in fact it is understood that many of them set up their organizations on this basis. It appears appropriate in such cases to permit the taxpayer to treat his domestic business as one operation and all of his foreign business as another and to average together the high and low taxes of the various countries in which he may be operating by using the overall limitation."

Thus, the existing option available to U.S. companies to elect the "overall" basis for determining the credit for foreign taxes paid results from deliberate Congressional action, in which the Treasury concurred. In this connection, it may be recalled that former Assistant Secretary of the Treasury for Tax Policy Stanley S. Surrey praised such action by the Congress in the 1962 Revenue Act, by noting that the Act:

"...sets a precedent for looking at the foreign activities of a U.S. corporation on a consolidated basis, as if together they comprised a single entity. In this respect the tax law is beginning to recognize the 'international corporation' and to grapple with the technical tax problems which it involves.^{4/}

^{4/} Remarks by the Honorable Stanley S. Surrey, Assistant Secretary of the Treasury, before the Tax Institute Symposium, Washington, D.C., October 25, 1962.

As noted in the House Report cited above the introduction of the overall limitation was based on the fact that many U.S. companies regard their foreign activities as an integrated operation outside the United States. Accordingly, in such cases it is appropriate, and would reflect economic reality, to permit such companies to compute the foreign tax credit on the basis of income from all sources outside the United States rather than a country-by-country basis. As explained previously, the integrated nature of the international oil industry makes it particularly appropriate to allow U.S. oil companies to elect the overall foreign tax credit limitation, and thereby average together the high and low rates of tax paid on operations in all foreign areas. Notwithstanding this fact, Section 432 effectively would deny the use of the overall concept to the mineral industry. As was noted by Secretary Cohen before this Committee early last month, to introduce a separate limitation for tax credits on income from mineral production would effectively deny to mineral companies the option under existing law for companies to elect to calculate their foreign tax credit on the basis of the overall limitation, while permitting all other industries to continue to elect the overall basis. Such discrimination is clearly unjust and unwarranted.

Moreover, the proposed limitation in Section 432 would have the effect of double taxation of the income from integrated petroleum activities abroad. Rather than allowing the averaging of the high and low tax rates, Section 432 would seek out individual parts of a taxpayer's income in low-tax countries and increase the tax to the U.S. level. In so doing, this provision would effectively require mineral business operations abroad to pay more income taxes than the same operations would pay if conducted wholly

within the United States. However, the end result would be a net gain for the treasuries of foreign governments with no significant increase in revenues for the United States. This would occur because foreign governments with lower income tax rates would recognize that if they increased their taxes on the American mineral industry abroad, such taxes would be creditable against U.S. taxes on the same foreign income.

Conclusions

In our opinion, Sections 501(a), 431, and 432 of H.R. 13270 ought to be rejected. By increasing the tax burden on U.S. petroleum companies' operations abroad, the provisions contained in these sections could seriously impair the ability of U.S. companies to compete effectively with foreign companies in the international oil industry. This could affect U.S. companies' participation in all phases of the industry, but the most severe impact is likely to be felt on the ability of U.S. companies to obtain concession rights in new producing areas.

The national security interest of the United States requires that our country have ready access to growing and diverse foreign sources of oil to meet our expanding economic and military needs for energy. The provisions in H.R. 13270 relating to the foreign activities of U.S. petroleum companies would place new obstacles in the way of U.S. companies participating in the future growth of the industry abroad, and thus would run counter to our national security interest. Moreover, by discouraging the foreign investments of U.S. petroleum companies and delivering investment opportunities to foreign competitors, the provisions would be detrimental to our balance of payments and general economic welfare. Finally,

the provisions are inequitable, would result in double taxation, and are unlikely to produce a significant amount of revenue for the United States.

Sections 501(a), 431, and 432 all would discriminate against foreign-source income, and would unfairly increase the tax burden on U.S. investors who have made substantial foreign investments on the basis of existing tax law. Section 501(a) would discriminate against the foreign activities of U.S. petroleum companies by denying them comparable tax treatment to operations conducted in the United States. Section 431 would double-tax individual parts of a taxpayer's income, while Section 432 would introduce international double taxation on the integrated petroleum industry operations abroad by denying to the mineral industry alone the effective use of the overall basis for applying the foreign tax credit. All these provisions would seriously depart from valid and long-standing principles of tax equity. We strongly urge that they be rejected.

October 1, 1969

**SUMMARY OF INCENTIVES GRANTED BY FOREIGN GOVERNMENTS
IN REGARD TO THE PRODUCTION OF OIL AND GAS
UNDER PETROLEUM AND/OR TAX LAWS**

Argentina

Immediate deduction is allowed for exploration costs as well as amortization thereof. An option is available to deduct exploration expenses and normal depreciation on capital assets against non-petroleum activities.

Australia

Recovery of Expenditures

A taxpayer is permitted to recover allowable capital expenditures in regard to exploration and producing activities before any production income becomes subject to income tax. This provision accumulates expenditures for formation, exploration/development and production as deductions against future income from the sale of petroleum production. Income tax is thus postponed until the deductions have been fully offset against producing sales. A petroleum exploration company is allowed to transfer the tax deduction for any producing or exploration expenditures from itself to its shareholders. In this way, the shareholder can claim the deduction for the stock investment in a petroleum exploration company against current taxable income and the deferred deduction of the exploration company is correspondingly reduced.

Partial Additional Deduction for Investment

A deduction for 1/3 of the "calls" on shares to the stockholder investing in the exploration venture is allowed. Since the exploration company may claim a tax deduction for its expenditures, this will result in an aggregate deduction of 133-1/3% between the company and its shareholders.

Direct Subsidies

Subsidies are also used to create favorable conditions for petroleum exploration activities. Originally limited to a subsidy of 1/2 the cost of a company's approved-stratigraphic drilling program; now extended to include off structure drilling, detailed structure drilling, borehole surveys, and geophysical surveys employing magnetic, seismic, gravimetric or other physical methods of obtaining petroleum exploration information. Both past and future subsidies are not taxable, but the taxpayer's deduction for exploration expenditures has to be reduced by the amount of subsidy received. The government now pays up to 30% of the cost of all geophysical surveys and test drilling operations. In the case of stratigraphic drilling the limit is 40%.

Belgium

Allows producers a tax-free reserve limited to 50% of the taxable profits from production. Such reserves must be reinvested within 5 years.

British Honduras

Allows percentage depletion of 27-1/2% of gross income limited to 50% of net petroleum income after royalties but before depletion. Intangible drilling costs are deductible when incurred, limited to 50% of net petroleum income after royalties but before depletion.

Canada

Allows percentage depletion at 33-1/3% of overall profits. All drilling, exploration and general operating costs on a company-wide basis must be deducted before depletion is computed.

Colombia

Allows normal percentage depletion of 10% of the gross value of production less any royalties or participations, limited to 35% of net income before depletion. In addition, a special depletion allowance, computed on the same base, of 18% in the East and Southeast Region, and 15% in the rest of the country, is also allowed. The total of normal and special depletion is limited to 50% of net taxable income in the East and Southeast Region and to 43% in the rest of the country. Amounts allowed as special depletion must be reinvested within three years in petroleum related facilities. Failure to reinvest results in their restoration to taxable income, but over-investment may be carried forward to apply against future reinvestment obligations.

France

Allows producers a reserve equal to 27-1/2% of the gross value at the wellhead of the crude oil extracted. This reserve is limited to 50% of the net profit from production and from the first stage of processing in the producer's own refineries. For the tax exemption to be retained such amounts must be reinvested within 5 years, either in the way of fixed assets or research work for new discoveries of oil or gas, or by making investments in certain companies approved by the government. If not reinvested within this time limit, the reserve is required to be restored to the taxable profits of the fiscal year during which such 5-year period expires, and taxed as ordinary income.

Germany

German (domestic) oil companies operating outside Germany could obtain through December 31, 1968 low interest loans in amounts of up to 75% of the costs of exploration. Such loans were repayable only when commercial production was obtained. Exploration for or production of oil during the years 1959 to 1962 was a prerequisite. There is a new government incentive for foreign operations which was signed on July 7, 1969, effective for the years 1969 through 1974. Under the new proposal a total of DM 575 million will be allocated under a loan scheme. Loans will be granted up to 75% of exploration expenditures and if there is no discovery, no repayment will be required. Even with discovery, up to 50% of the loan can be waived under certain circumstances. If the financial situation warrants it, the plan contemplates a non-repayable contribution of up to 30% of the costs of acquiring a productive field or share in a producing company. To be eligible under this new plan, the company must be domiciled in Germany and have produced petroleum in Germany or been processing petroleum within Germany prior to January 1, 1969. Loans will not be granted if the enterprise can reasonably be expected to finance itself. However, it is expected that if a group of the major German-controlled companies form a new company to explore overseas, this new company will not be considered able to finance itself. Until January 1, 1970, oil and gas companies are permitted to write off drilling costs, geological and geophysical expenditures, dry holes, etc.

Germany
Cost. immediately against other income, whether a branch or subsidiary is used. An oil company can also write down its investment in a foreign subsidiary. When production is achieved the investment must be restored, but this restoration can be written off on a very liberal basis. Presumably this legislation will be extended.

Guatemala Allows percentage depletion of 27-1/2% of gross income, limited to 50% of net income. Exploration and intangible drilling costs can be expensed. Losses can be carried forward indefinitely.

GUYANA Allows percentage depletion and deduction of intangible drilling costs at a "reasonable" level as established by the Commissioner.

Honduras Allows percentage depletion of 25% of gross production, limited to 50% of net taxable profits. Exploration expenses as well as intangible drilling costs can be expensed. Losses can be carried forward for ten years.

Israel Allows percentage depletion of 27-1/2% of gross income, limited to 50% of net income.

JAPAN Allows percentage depletion for companies conducting petroleum exploration, subject to a recapture to the extent that, within a 3-year period, an amount equivalent to the deduction has not been invested in further exploration. The amount is 15% of sales revenue, limited to 50% of net income. A current deduction of intangible drilling and development costs for unsuccessful wells is also provided. These incentives apply to both domestic and overseas exploration.

Overseas Incentives

The government has organized the Petroleum Development Public Corporation (PDPC) as a government-owned entity for the purpose of channeling government funds into exploration and production in order to promote the development of petroleum resources and to ensure stabilized supplies of petroleum.

The PDPC accomplishes these objectives by:

- (1) Making investments and loans necessary for petroleum exploration in overseas areas,
- (2) Guaranteeing debt resulting from loans necessary for overseas petroleum exploration and production,
- (3) Leasing equipment required for oil exploration, and
- (4) Giving technological guidance on oil exploration and production.

The loans referred to in (1) are extended on favorable terms and repayment is required only if the venture financed is successful. Loans amounts may be as high as 50% of the cost of the undertaking, and joint exploration ventures by Japanese and foreign companies, in which the Japanese interest is at least 50%, may also receive these benefits. To date, the PDPC has committed itself to extend financial support to exploration ventures in Alaska, Southeast Asia, and the Persian Gulf.

Domestic Incentives

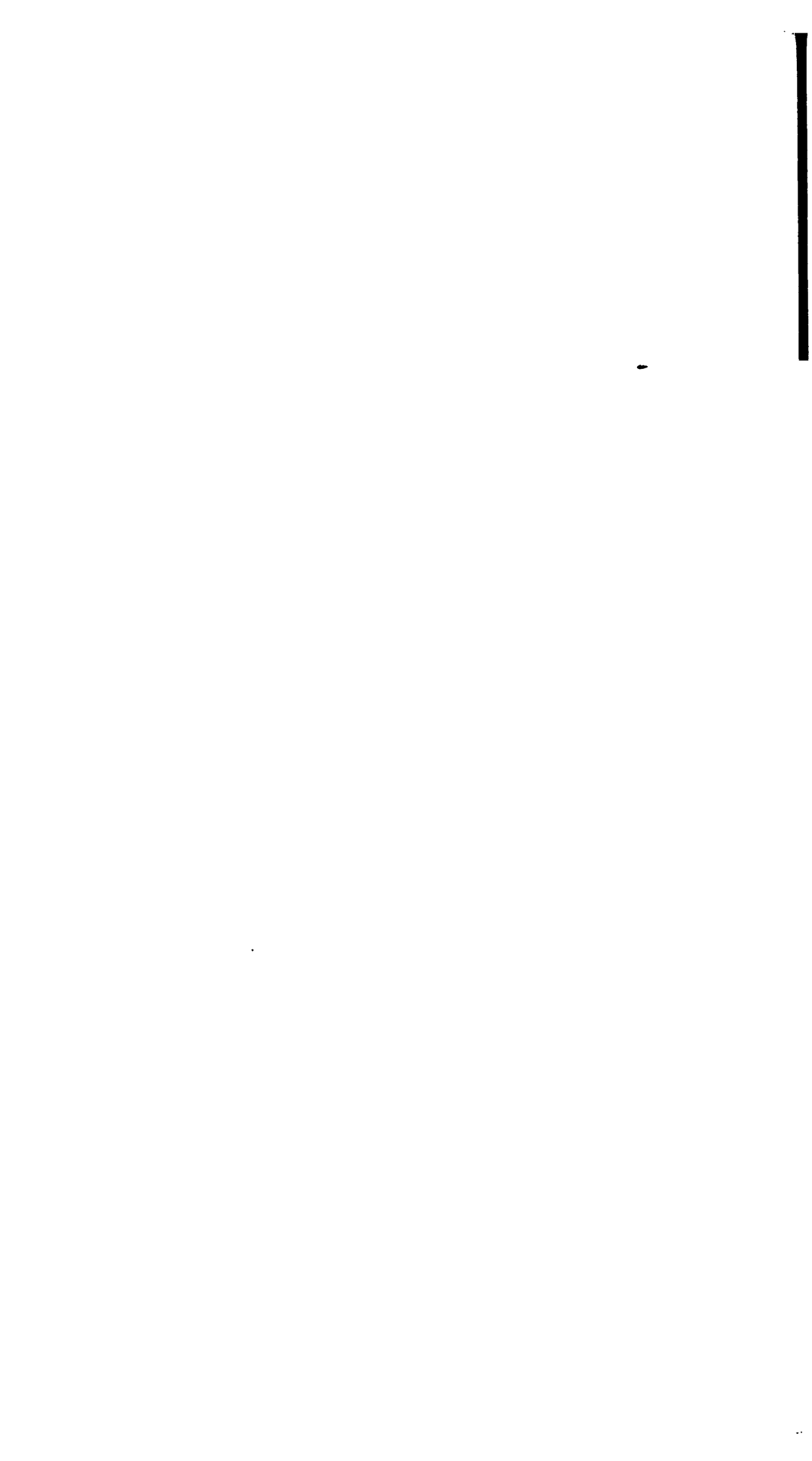
Presently, the government is in the process of developing a policy to actively encourage development of domestic oil and gas reserves. There is in effect a duty rebate system for certain off-takers of indigenous crude. There has been pressure on the government to extend the above PDPC incentives to domestic production, consequently, the government is now reviewing this possibility.

- Nicaragua Allows percentage depletion of 27-1/2% of wellhead value less royalties, limited to 50% of net taxable income before depletion. Intangible drilling costs and dry hole costs are deductible once production is attained. Losses may be carried forward ten years.
- Nigeria Exploration losses, intangible drilling costs and dry holes can be expensed. Losses may be carried forward indefinitely.
- Norway The government may grant companies engaged in the exploration and exploitation of offshore oil and gas deposits the right to carry losses forward over a 15-year period rather than the normal 10-year period.
- Pakistan Allows percentage depletion at the rate of 15% of the wellhead value, subject to a maximum of 50% of net income.
- Peru Allows percentage depletion from 15% to 27-1/2% of the gross value of production (adjusted for transportation in certain areas) depending on whether a national or foreign company is involved and the region in which production is located. A foreign company with production in the Coastal Region is limited to 50% of net profit after deducting depletion and the 20% minimum advance payment of income tax. All others are limited to 50% of net profit before deduction of depletion and the advance payment of income tax. Deduction for intangible drilling costs is also allowable.
- Philippine Republic Allows percentage depletion of 27-1/2% based on gross income, after an amount equal to any rents or royalties paid or incurred in respect to the property has been deducted.
- Sabah Allows percentage depletion at rates deemed reasonable by the Commissioner.
- Spain Allows percentage depletion of 25% of the field value of production less royalties, but limited to 40% of the net profit before deducting depletion. Similar rules apply in the Spanish Sahara.
- St. Maarten Allows percentage depletion at rates deemed reasonable by the Commissioner.
- Trinidad and Tobago Allows percentage depletion of 20% of the gross value of production of submarine wells limited to 40% of income without the deduction of certain specified allowances.
- Turkey Allows percentage depletion of 27-1/2% of the gross income from production after deducting rentals and royalties, limited to 50% of net income before deduction of depletion.

United Kingdom Cash grants of 20% (40% in certain onshore areas) for oil and gas operations onshore and offshore are available generally as follows:

- (1) Geological and geophysical expenses are usually eligible for grant except for the cost of general surveys to determine whether or not to begin exploration in an area.
- (2) Lease acquisition costs are not eligible.
- (3) Exploration, evaluation and production drilling costs qualify.
- (4) Production equipment, certain pipelines and drilling platforms including overheads qualify.

In effect all exploration and drilling expenses (not in excess of investment grants) incurred prior to proving reserves may be expensed. Thereafter until production is achieved, both tangible and intangible drilling costs are capitalized and amortized on a unit of production basis. After production is achieved, tangible costs are still capitalized and amortized, but intangible costs are expensed. Losses may be carried forward for an unlimited number of years. All of the foregoing items that require capitalization must be so treated because only an item that is capitalized is eligible for an investment grant. If for any reason an investment grant is not received, such items may be expensed.



STATEMENT OF

**ROBERT G. DUNLOP
President
Sun Oil Company
Philadelphia, Pennsylvania**

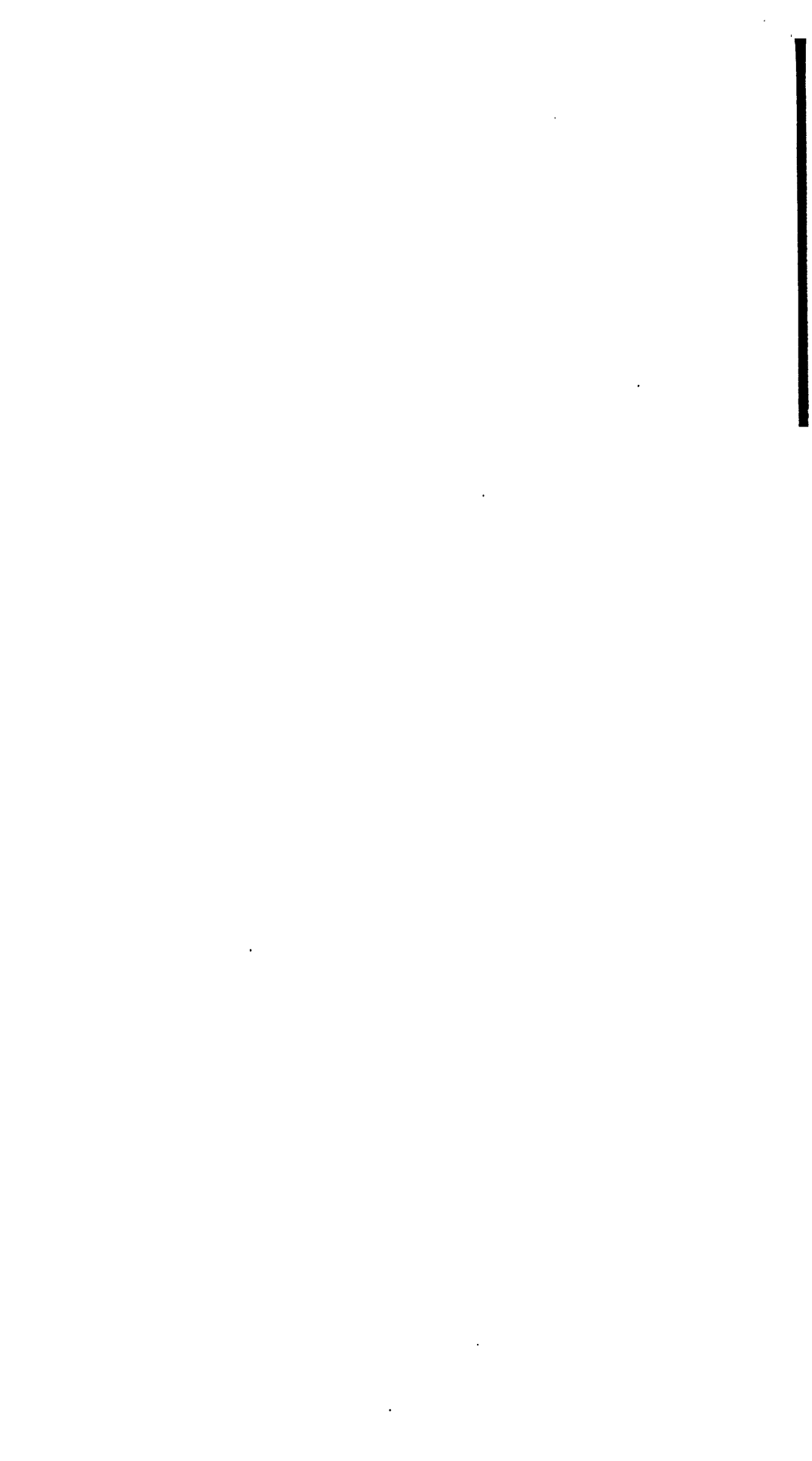
before the

**COMMITTEE ON FINANCE
UNITED STATES SENATE
Washington, D.C.**

in behalf of

**American Petroleum Institute
Mid-Continent Oil & Gas Association
Rocky Mountain Oil and Gas Association
Western Oil and Gas Association**

October 1, 1969



SUMMARY OF PRINCIPAL POINTS IN STATEMENT OF ROBERT G. DUNLOP

1. The United States economy is heavily dependent upon petroleum energy; oil and gas today provide nearly three-fourths of all energy consumed in this country.
2. Assured supplies of petroleum are vital to the national security of the United States.
3. With present tax incentives, the domestic petroleum industry has met this country's essential petroleum needs.
4. Present tax and other incentives have enabled the industry to develop a reserve producing capacity amounting to 3,000,000 barrels daily in 1968.
5. Similarly, the United States today has a spare producing capacity -- producible and deliverable with existing facilities -- of 1,000,000 barrels daily, which is available to meet emergency needs of this country and its Allies.
6. With existing tax incentives, the industry has made oil and gas available to consumers at reasonable prices.
7. Since it is based on production, the depletion provision is a particularly effective incentive for research leading to technological improvement; as such it has contributed significantly to broadening the nation's petroleum resource base.
8. Existing tax incentives have contributed significantly to improving the international payments balance of the United States and to world economic progress.
9. Tax incentives have contributed to the conservation of natural resources by encouraging the use of marginal oil.

10. The petroleum industry earns only average profits on investment.
11. The petroleum industry carries an overall tax burden equivalent to or exceeding that borne by other industries.
12. The combination of sharply rising costs and modestly rising prices is limiting funds available for investment; reserves of oil and gas declined both relatively and absolutely in 1968.
13. Federal control of natural gas well-head prices is partially offsetting the effect of tax incentives and creating a serious supply problem for the future.
14. Increased taxes would likely result either in higher petroleum prices or in reduced investment; neither alternative is desirable.
15. Complete elimination of tax incentives would make the United States heavily dependent on foreign oil; that dependency would range up to 48 to 58 per cent of supplies.
16. This dependency could very well involve this country in a Middle East conflict, through our attempting to insure stability in the area.
17. Contrary to popular notions today, the United States is not running out of oil. Neither is it indicated that Alaska will produce enough additional oil to meet our future needs.

**STATEMENT OF
ROBERT G. DUNLOP, PRESIDENT
SUN OIL COMPANY
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
OCTOBER 1, 1969**

I am Robert G. Dunlop, president of Sun Oil Company, Philadelphia, Pa. My appearance today is on behalf of the American Petroleum Institute, the Mid-Continent Oil and Gas Association, the Rocky Mountain Oil and Gas Association and the Western Oil and Gas Association.

I will attempt to give you an over-view of the present petroleum situation in the United States and of the likely impact of proposed tax changes on that situation. Appearing with me are Mr. William Spencer, executive vice president of the First National City Bank of New York, who will discuss future petroleum requirements and capital investment needs; Mr. George V. Myers, executive vice president, Standard Oil Company (Indiana), who will evaluate the impact of the proposed tax changes on domestic operations; and Mr. Emilio G. Collado, executive vice president of Standard Oil Company (New Jersey) who will close our presentation with a discussion of the tax treatment of foreign petroleum operations.

My colleagues and I appreciate this opportunity to present the petroleum industry's views on proposed tax changes for oil and natural gas. We feel strongly that this Committee's decisions on petroleum tax policies will significantly affect the Nation's future economic progress and its security.

Accordingly, we feel that it is vitally important that the Committee's decisions be based on a comprehensive review of the effect of the proposed changes on our Nation and all of its citizens. It is our intent to contribute to this review by providing you with pertinent background information on the present petroleum situation and how it would be affected by the tax changes now under consideration.

In providing an over-view, I will attempt to define the role of tax incentives in the Nation's petroleum progress; to place the industry's tax payments, prices and profits into perspective; to discuss the relevance of petroleum tax policy to national security; to describe the present status of the industry; and to look at the impact of the tax proposals on the United States petroleum supply position.

First, however, I would like to state the industry's basic position on proposed changes in tax policy. It is this. Our experience as oil men demonstrates that tax incentives provided by the Congress in present law have very effectively achieved the purpose for which they were created: to provide an incentive for development of our petroleum resources. That our resources have, in fact, been effectively developed is a matter of record -- a record of which we in the industry are indeed proud.

We observe two kinds of pressure being applied for a reduction in petroleum tax incentives. One is the pressure of emotional argument for boosting taxes on oil companies,

come what may. The second is a more reasoned approach, recognizing the need for incentives but questioning whether the present level is necessary.

The facts of the situation appear to be of little interest to those who have been advancing the emotional arguments. But we are hopeful that the facts will be of paramount importance to those who are sincerely interested in reaching tax policy decisions that will be in the long-run best interests of the people of the United States.

We seek to be open-minded. We are not blindly opposed to change. If petroleum tax policy changes can be demonstrated to be in the best interests of the American public, we will surely not oppose them. But we strongly oppose change based on emotion rather than reason -- change which is inimical to the progress of this Nation and to its security.

Petroleum Energy in the United States

Against that background, I want first to look with you at the role of petroleum energy in the United States today. I submit that it would not be overstating the case to say that petroleum is the virtual lifeblood of this country. The Department of the Interior has aptly summed up the Nation's heavy dependence upon oil and natural gas in these words:

"The importance of petroleum to the national life of the United States at this particular moment in history is abundantly in evidence. It supplies nearly three-fourths of all energy consumed. Virtually all movement of goods and people depend on it. The Armed Forces would be immobilized without it. Countless industrial processes employ it exclusively, and nine-tenths

of all space-heating is provided by it. And quite apart from its use as a fuel, petroleum forms the base for 88 per cent of all organic chemicals manufactured in the United States."

I have taken a moment to include that quotation because I feel that it points up sharply why we are here today. Petroleum is vital to our country -- so vital that the Nation could not exist today as we know it without adequate supplies of oil and natural gas.

The industrial revolution which is at the base of our prosperity could just as accurately be characterized as an energy revolution. Our ability to substitute inanimate energy for muscle power has made possible the tremendous increase in per capita production which is the essential measure of economic development.

The correlation between energy consumption and income is one of the significant facts of modern life. (See Exhibit I.)

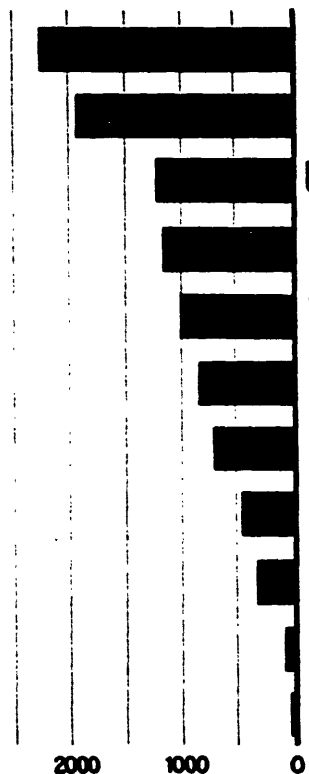
Petroleum is also essential to our defense capability, although in this age of nuclear weapons some observers seriously challenge this view. I would remind those challengers that, fortunately, the nations of the world have so far avoided nuclear war as a means of solving differences. And we all live in the hope that they will continue to do so. Conventional warfare, on the other hand, is likely to be with us for the foreseeable future. So petroleum is now, and will continue to be, vital to our national security.

Exhibit I

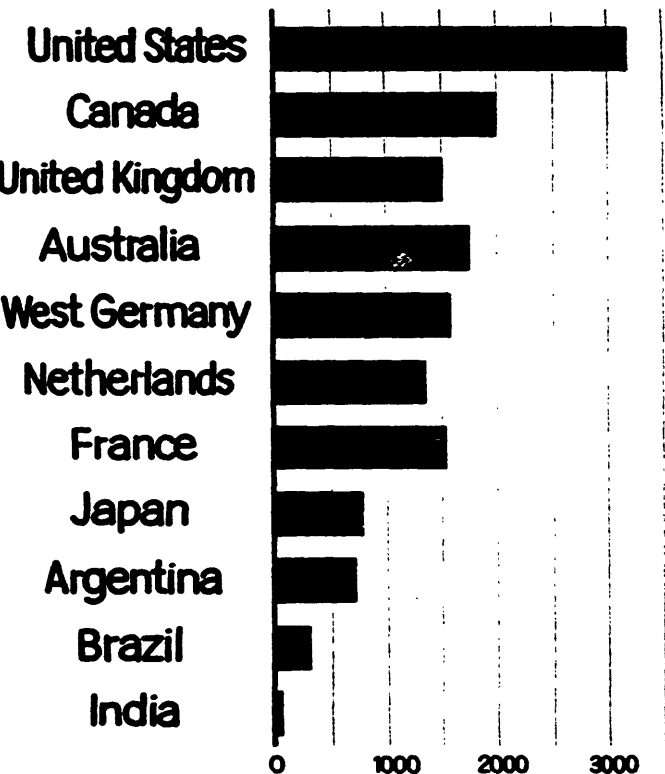
**Energy
consumption
and
income
are
closely
related**

49

1966 Energy Consumption
(Per Capita Equivalent in Gallons of Oil)



1966 Income
(Per Capita in U.S. Dollars)



Source United Nations

Although surprising to many, the truth is that petroleum is becoming increasingly important to our defense capability. In 1968, defense procurement of petroleum per man under arms was twice the peak World War II level -- even though the fighting in progress last year was restricted to a very limited geographic area.

The Department of Defense has put it this way:

"The part that oil plays in the defense posture of the United States is vitally important. It is a strategic material and one of the few items that is absolutely essential and foremost in the minds of military commanders. Along with weapons and ammunition, the needs of petroleum get the most attention."

In my view, these facts add to an inescapable conclusion: The future of the United States as we know it is vitally dependent upon assured supplies of oil. Realistically, we have only two routes to travel in obtaining oil:

- (1) maintaining a strong domestic industry capable of meeting our essential needs, or
- (2) turning increasingly to foreign supplies and, ultimately, becoming dependent upon those less secure foreign sources.

Petroleum Developments Under Existing Tax Policies

Up through the present day we have chosen to travel the first route, seeking to provide the incentives necessary to assure the continuance of a strong domestic petroleum industry capable of meeting the essential oil and gas needs of the Nation.

Was this a wise course of action?

Petroleum Needs Fully Met

The record affirms that it was. For under past and present policies the United States petroleum industry has historically met the petroleum supply needs of this Nation and at the same time contributed immeasurably to the needs of our friends and allies. I need not recount to this Committee the major supply crises we have successfully met in the past.

It would perhaps be of interest and value, however, to show by example how petroleum tax incentives, working in conjunction with other incentives, have contributed to the development of our petroleum resources.

At the close of World War II, the heavy war-time drain on United States petroleum supplies had resulted in a situation where productive capacity was barely equal to demand.

The tax incentives, together with the thrust of rising prices during the late 1940's, enabled the industry steadily to improve the supply situation. By 1955, as shown in Exhibit II, we had reserve capacity of more than 2,000,000 barrels daily. In 1968, reserve capacity was 3,000,000 barrels daily.

I suggest that this is a dramatic demonstration of the role played by the depletion provision and other incentives in helping to assure adequate supplies of petroleum for the United States.

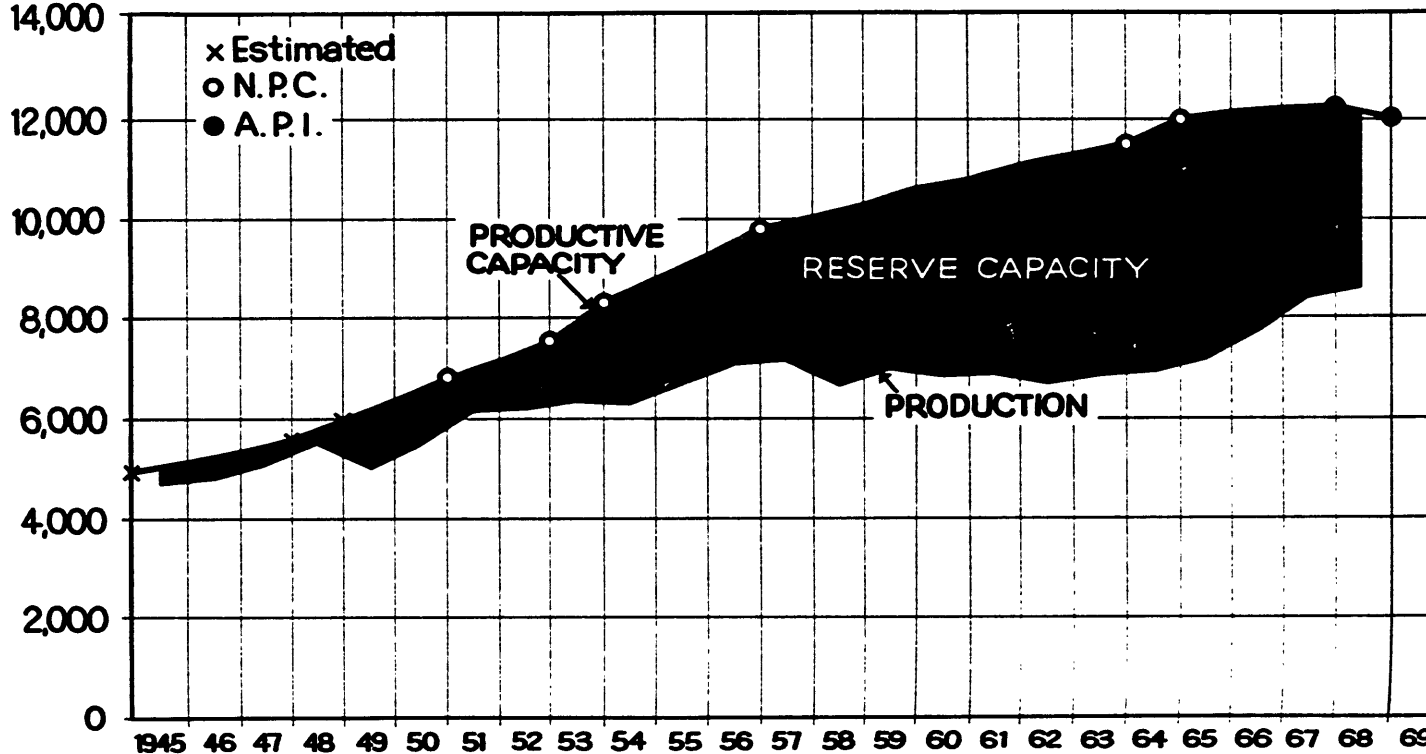
To carry the discussion one step further, we might with profit examine our present available spare producing capacity in the light of potential requirements. I am referring now

Exhibit II

RESERVE CRUDE OIL PRODUCTIVE CAPACITY 1945-1968

Thousands of
Barrels Daily

52



to deliverable capacity--that capacity which can be produced and transported with existing facilities.

I can best demonstrate this by posing a hypothetical situation. Assume for a moment a Middle East war in which the United States, Canada, Western Europe and Japan would be denied Arab bloc oil--that is, all oil from North Africa and the Middle East with the exception of Iran.

Assume also that the United States, Canada, Latin America and Iran choose to supply oil to the maximum of their ability to Western Europe and Japan, which are heavily dependent on Arab bloc oil.

First, what would be the oil supply position of the United States and Canada in this hypothetical situation? And, second, what would be the combined position of the United States, Canada, Western Europe and Japan?

A table demonstrating the supplies that could be made available in relation to requirements is attached as Exhibit III.

In response to question one, the figures show that the United States and Canada would lose 400,000 barrels daily of supply from the Arab Bloc. However, our country and Canada have a combined spare capacity of some 1,200,000 barrels daily, and could cover that loss.

In regard to question two, by making the best possible use of existing pipeline connections between the U.S. and Canada, we would have, together, remaining spare capacity of only 800,000 barrels daily. Assuming that we made this oil available, and that Latin America and Iran similarly

EXHIBIT III

EFFECT OF LOSS OF ARAB BLOCK SOURCES OF
CRUDE OIL FOR THE UNITED STATES,
WESTERN EUROPE, AND JAPAN

	<u>United States and Canada</u>	+ <u>Western Europe and Japan</u>	= <u>Combined</u>
	-----Thousand Barrels per Day-----		
1968 Requirements	<u>14,700</u>	<u>12,700</u>	<u>27,400</u>
<u>Available From</u>			
Domestic Production	11,700	400	12,100
Present Production from Non-Arab Sources	2,600	3,000	5,600
<u>Spare Capacity</u>			
United States	200	800	1,000
Canada	200	--	200
Iran and Latin America	<u>--</u>	<u>1,100</u>	<u>1,100</u>
Total Available Sources	14,700	5,300	20,000
Shortage	<u>--</u>	<u>7,400*</u>	<u>7,400</u>
Total	14,700	12,700	27,400
<u>Memo:</u> 1968 Imports from Arab Sources	400	9,300	9,700

Note: * -- If the United States were to share the burden, there would be a shortage in the United States and a correspondingly lower shortage in Western Europe and Japan.

made their spare capacity available, Western Europe and Japan would then be short 7,400,000 barrels daily, or 58 per cent of their needs. If the U.S. were to share this burden, there would then be a shortage in the U.S. and a correspondingly smaller shortage in Western Europe and Japan.

This example clearly demonstrates two important points. First, the United States, with its total deliverable capacity of 10,000,000 barrels daily, is the bulwark of Western oil supply. And, second, even with the spare capacity now available in the United States, there is a significant gap between oil supply and normal requirements in the West. We can permit that gap to continue to grow only at our peril.

Petroleum Provided at Reasonable Prices

In addition to stimulating the development of adequate supplies of petroleum to meet our domestic needs, existing tax policies have helped to make that oil and gas available at reasonable prices to consumers. In terms of real purchasing power, the average price of crude oil has declined in the neighborhood of 20 per cent since 1926. Price comparisons over a more recent period show that since 1957-59 the wholesale price index for crude oil has risen just five per cent while the index for all commodities has increased by 13 per cent.

Gasoline prices, excluding direct taxes, are up only 10 per cent, or approximately two cents per gallon, since 1926. Over the same period, the consumer price index has doubled. Again, over a

more recent period, the price of gasoline has advanced approximately 10 per cent since 1957-59 while consumer prices generally went up some 28 per cent. (See Exhibit IV.)

Technological Advances Benefit the Nation

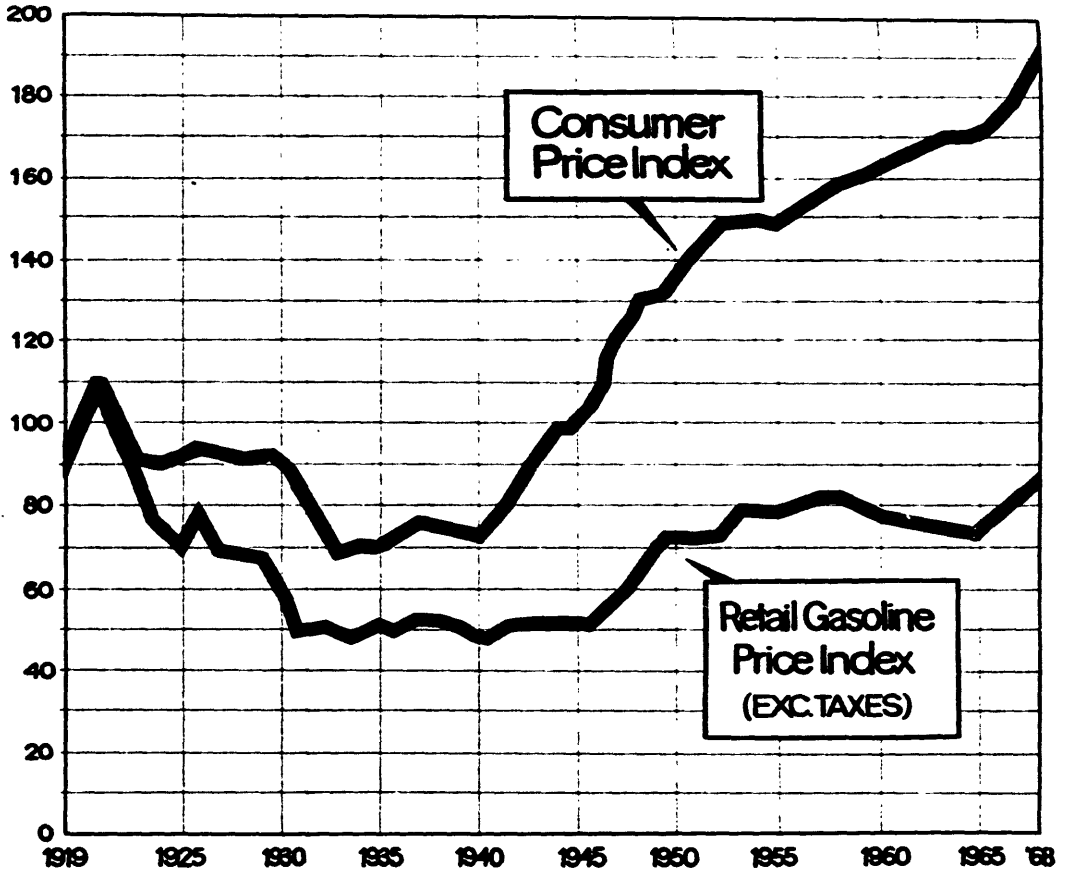
I also want to point out that tax incentives have helped to create benefits for the Nation over and above the development of adequate supplies of petroleum at favorable prices.

The depletion provision, for example, through encouraging investment in the industry and helping to keep it strong, has spurred technological advances in finding and recovering America's oil and gas. The economic impact of these advances has been substantial.

It should be emphasized that percentage depletion is a particularly effective incentive for research leading to technological improvement, since it is based on production. A direct subsidy to exploratory drilling might stimulate that activity, but percentage depletion stimulates both exploration and technological advance after discovery. Percentage depletion rewards the successful explorer in proportion to the amount of oil he finds and produces -- and hence in proportion to his contribution to the national interest. After successful exploration, it rewards successful research designed to increase producibility of the reserves discovered. It applies in neither case in the event of failure because

Price of gasoline is low

57



SOURCE: Price Index: Bureau of Labor Statistics Gasoline Prices: Tax Economics Bulletin of AFI

it becomes effective only when oil is produced. In contrast, a subsidy applies regardless of failure or success.

In exploration technology, improved drilling capabilities have enabled the industry to recover oil and gas at depths that were formerly impossible to drill. In 1930, the deepest well yet drilled went down only slightly more than 9,200 feet. Today the industry is drilling below 25,000 feet.

On another front, offshore drilling in the United States was negligible until the latter half of the 1940's. Today, in contrast, offshore production accounts for some 10 per cent of oil output and 12 per cent of gas output, and the offshore search is one of our brightest prospects for the future. Again, improved technology was the key.

To cite one more example, improved exploratory and drilling know-how is playing an important role in tapping the tremendous reserves of the Alaskan Arctic.

Technological advance is also opening many new horizons in older fields once thought to be nearly-depleted. Before World War II, production was limited to primary recovery--pumping out the oil until the flow became so small as to be uneconomic. This procedure left five or six times more oil in the ground than was recovered, with only 15 to 20 per cent of the oil in place actually produced.

The development of waterflood and other secondary stimulants changed this picture sharply. By upping recovery to 30 to 35 percent of the oil in place, the new techniques have essentially doubled the Nation's recoverable reserves.

I repeat, technology has doubled recoverable reserves. It has increased the estimated ultimate recovery of crude oil from proved reservoirs by almost 60 billion barrels-- 20 times current annual production.

In the future, the industry should continue to increase cumulative recoverability through broader application of existing techniques and the development of new techniques.

In brief, invention and innovation encouraged in part by tax incentives have substantially augmented our recoverable reserves and in doing so have contributed importantly to the goal of strengthening the domestic supply position of the United States.

Other Economic Benefits Attributable to Tax Incentives

Finally, existing petroleum tax policies have contributed significantly to improving the international payments balance of the United States and to world economic progress which has in turn been beneficial to this country.

In regard to international payments, the key plus factor has been the substantial inflow of earnings from past investments abroad.

Those same investments have also played a major role in the economic progress of developing nations. Revenues generated by petroleum development projects have provided these nations with the foreign exchange so essential to economic development, and have contributed to secondary benefits such as the creation of modern transportation and communication systems.

Tax incentives have likewise made a contribution to the conservation of natural resources by encouraging the use of marginal oil rather than abandoning this oil. To leave oil of marginal value in the ground is an inexcusable waste of an exhaustible, non-replaceable natural resource. If a marginal well is shut down, the likelihood of its again producing is remote. If it is reopened, it will only be at a considerably higher price for its output. If the production is lost, the country is the poorer.

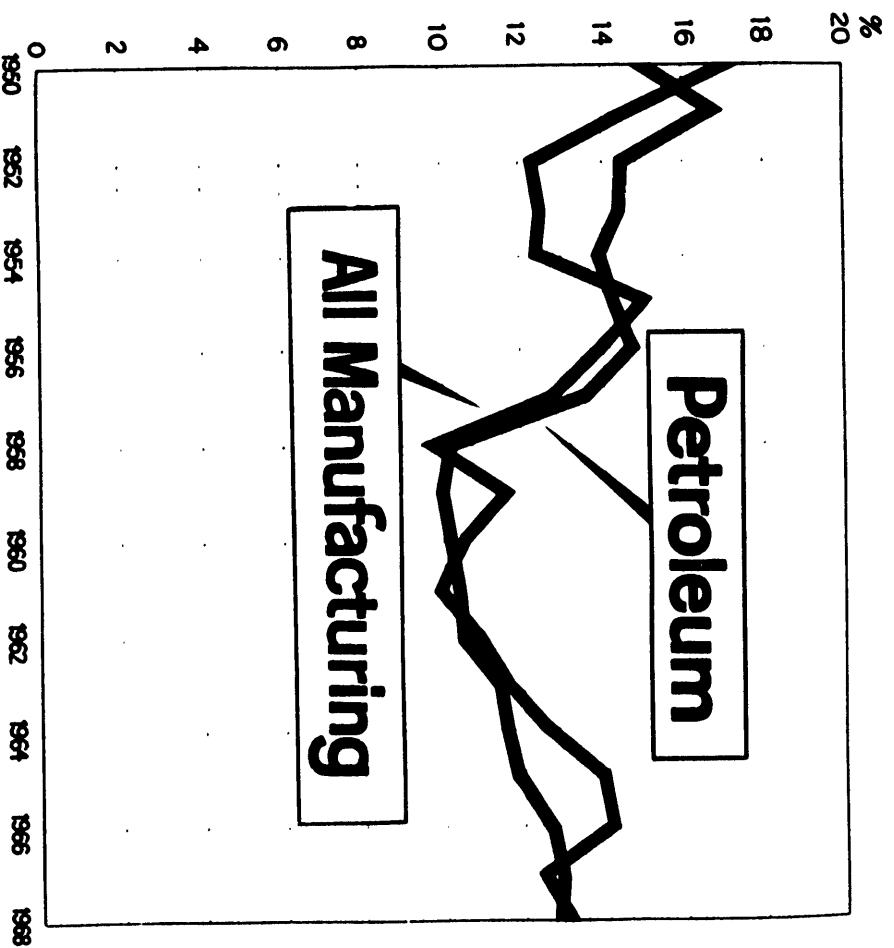
Incentives Provided are not Excessive

All of these benefits -- adequate oil supplies, favorable oil prices, technological progress -- have been achieved with the aid of incentives which are not excessive.

If the percentage depletion rate were excessive, for example, this should be reflected in petroleum industry profit performance considerably better than that of other industries. This is not the case. Rather, figures compiled by the First National City Bank of New York demonstrate that the petroleum industry earns only average profits. In 1968, 99 petroleum producing and refining companies earned a 12.9 per cent return on net assets compared with an average return of 13.1 per cent for all manufacturing companies. In fact, the rate of return on net assets for the petroleum industry was higher than the average for all manufacturing companies in only two of the last 10 years. (See Exhibit V).

Exhibit V

Return on net assets Petroleum Industry and all manufacturing after Taxes



SOURCE First National City Bank

The May 15, 1969 issue of Fortune magazine published 1968 financial data of the 500 largest industrial companies in the United States. These data show that, of the 25 largest companies (determined on the basis of sales), seven were oil companies. From a profitability standpoint, however, the record is quite different. Only one of those seven oil companies that rank in the top 25 on the basis of sales was even in the top 100 when ranked on the basis of return on invested capital -- and that company ranked only 99th. The companies in the Fortune study included 27 oil companies, whose weighted average rate of return on invested capital was 12.0 per cent compared to 12.3 per cent for the other companies.

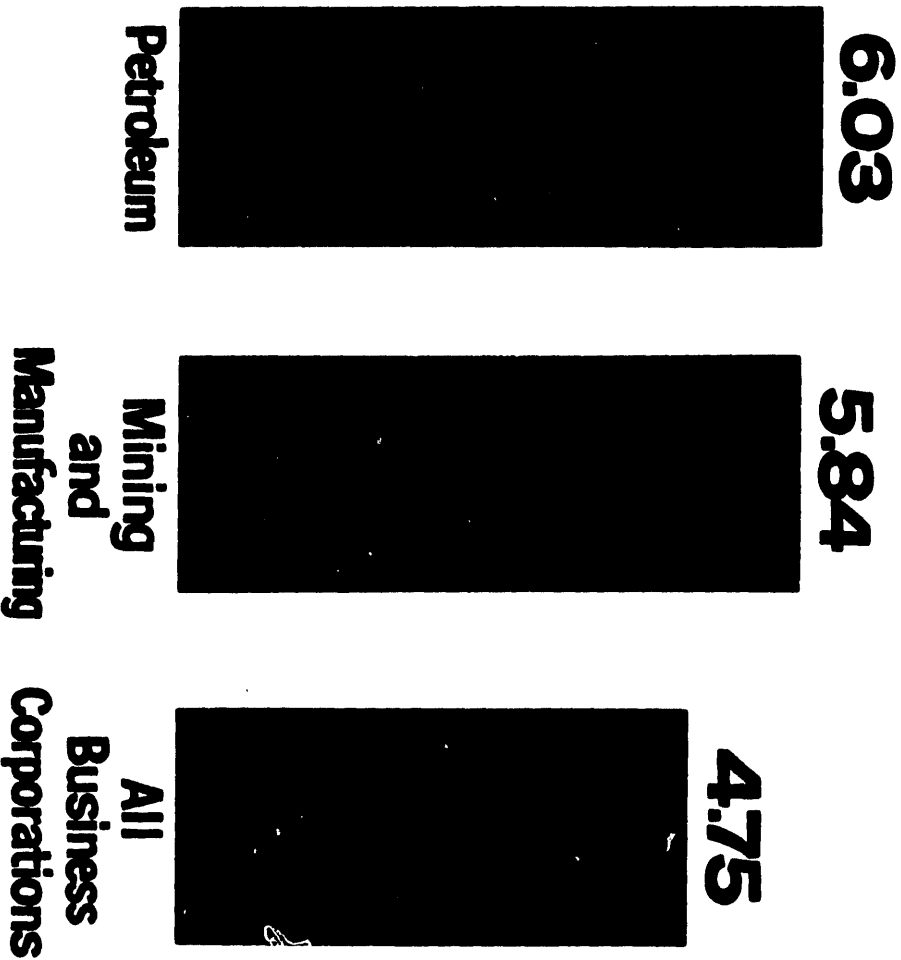
Similarly, the petroleum industry carries an overall direct tax burden exceeding that borne by other industries, even though its federal income tax bill is reduced by the depletion provision. Lower income taxes are offset by the heavier burden of other direct taxes such as severance and property taxes. As a result, studies have shown that total taxes paid by the petroleum industry, exclusive of motor fuel and excise taxes, in 1966 were equivalent to 6.0 per cent of revenues. (See Exhibit VI). Mining and manufacturing corporations paid direct taxes equivalent to 5.8 per cent of revenues in that year, and all business corporations paid taxes equal to 4.8 per cent of revenues.

Current Problems and Future Prospects

Against that background of past experience, I would like now to direct your attention to the petroleum industry's present situation and to its future prospects.

**The
domestic
tax burden
-1966
exclusive
of excise
taxes**
(cents per doll. \sqrt
of gross revenue)

63



Very frankly, the industry today is eyeball to eyeball with some very serious problems. Steady and substantial increases in petroleum demand have collided head-on with sharply-rising oil finding and development costs, with the result that reserves relative to requirements have been declining. Last year the decline was not only relative, but absolute. Proved petroleum reserves dropped across-the-board during 1968, with the life index of crude oil reserves falling to under 10 years and that of natural gas reserves decreasing to less than 15 years. This does not include the now Alaska reserves which are still being evaluated.

The industry's capability to respond successfully to this challenge could well be determined by the decisions made by this Committee. For this reason I will take a few moments to delineate our major difficulties.

First, the domestic industry is caught squarely between sharply rising costs and moderately rising prices. As I noted earlier, the price of crude oil has risen considerably less than the wholesale price index over the past decade. On the other hand, inflation has boosted exploration costs sharply, and, more significantly, unit costs have been rising because fewer giant fields are being discovered. This upward trend in unit costs is likely to continue since the major new successes are occurring in offshore areas and in Alaska where per well costs are several times higher than onshore ventures in the "lower 48." Parenthetically, it should be recognized that in the long run the cost of crude from Alaska's

North Slope will likely average substantially above the unit cost of the enormous field initially discovered.

While improvements in exploration technology have helped to offset rising unit costs a gap continues to exist, particularly in onshore areas where economic exploration ventures are becoming increasingly scarce. A similar problem exists in regard to recovery technology. The most attractive opportunities have already been developed, and further expansion will be dependent upon improved economics based on new technology and the continuance of effective tax incentives.

The natural gas problem differs somewhat from that of crude oil in that the federal government has provided incentives with one hand and taken them away with the other. In other words, the positive effect of tax incentives has been offset by Federal Power Commission regulation of well-head natural gas prices. Under regulation, natural gas sold in interstate commerce is priced below its free market value. In carrying out its gas regulatory responsibilities, the Commission has unfortunately focused its efforts on costs at the expense of supply. It has attempted to apply regulatory techniques developed for public utilities to an intensely competitive industry where survival depends on not investing in low or negative return areas. As a result, only the most favorable natural gas prospects warrant investment in an exploratory venture today.

The serious nature of the present situation was pointed up recently by Federal Power Commissioner Albert B. Brooke, Jr., who declared that the gas industry today faces a "crisis situation." He said that the most obvious, urgent and pressing problem is that of gas supply, and that the next five years "may well prove to be the crucial years." Estimating that demand would grow at a 5 to 7 per cent annual rate, he added that it was unquestionably certain that eliminating or modifying any of the provisions of the tax incentive package would lead to higher consumer prices or more restricted supplies.

In spite of the gas industry experience, it appears that some observers would like to see the crude producing sector of the petroleum business follow the same course as that mandated for gas -- to produce at minimum short-run costs regardless of the effect on supply and long-run costs to consumers. If we had followed this advice in the past, the giant fields, where our reserve productive capacity is concentrated would be largely depleted, and encouraging new discoveries offshore and in Alaska would probably not have been made. As a result, we would have no reserve capacity today and we would be unduly dependent on foreign oil. In contrast, I believe that proposals for modification of the incentive structure should be directed toward increasing the efficiency of resource development in the long run.

Problems exist also for United States oil companies operating abroad. First, economic factors have led to a deterioration in return on investment. Second, host governments, to further improve their positions, are establishing national oil companies and demanding participatory shares in the development and sale of their crude oil. At the same time, crude deficient countries are establishing their own oil companies to discover and develop new supplies. As a result, United States firms find the going increasingly difficult. They must compete with nationally supported companies to obtain the right to explore and develop new areas, and then, having done so, must compete with national producing companies in selling their crude in foreign markets.

In the financial area, sharply increased capital requirements pose additional problems for the industry. I will mention just two points for your consideration. First, there has been a substantial increase in the debt to equity ratio of the larger oil companies. Since this trend cannot, of course, continue indefinitely, any further reduction in internally generated funds must necessarily lead to reduced expenditures on petroleum exploration. And, second, present tax proposals that would reduce the availability of funds to independent operators will immediately and directly reduce their exploratory activities.

As I noted earlier, the petroleum industry is not excessively profitable. To the extent that tax change proposals are geared to the assumption that it is, they are off base, indeed.

In brief, our present petroleum situation suggests that the industry today requires increased rather than reduced incentives.

The Impact of Higher Taxes on Petroleum

Now, in the light of the current petroleum situation and the problems faced, what would be the impact of higher taxes on the industry?

Increased taxes, in the absence of any remedial action, must affect either profits and investment or prices. The alternative effects would be (1) reduced earnings and consequent reduction in capital invested in petroleum exploration and development; (2) increased product prices; or (3) some combination of the two.

Since the petroleum industry at present earns only average profits, a decline in profitability due to higher taxes would impair its earnings position relative to that of other industries. Since added tax costs cannot reasonably be expected to be absorbed, a tax increase would mean a reduction in the rate of investment by the industry. However, decreased investment in the face of a declining reserve trend and a steady increase in petroleum requirements is an unacceptable alternative if we are to continue our present policy of maintaining a strong domestic industry capable of meeting essential petroleum requirements.

The second alternative would be to shift the increased tax costs to consumers through product price increases. Because of the relative price of competitive fuels for other uses, price increases would probably be limited to fuels

supplying transportation energy, such as jet fuel, diesel fuel and gasoline.

To the extent these products are used in business endeavors, the added cost would simply shift the deduction from one industry to another with no net gain to the Federal revenues, or shift the impact further along the line through succeeding price increases. The Federal Government, as the largest single consumer of petroleum products, would bear a significant portion of any price increase. Only to the extent such additional costs were borne by individuals in non-business pursuits can it be assumed that, in the short run, the federal revenues would benefit.

An examination of this phenomenon discloses the effect to be regressive. A recent study indicates expenditures for gasoline per dollar of income are greater for the low income group than for middle and high income groups. The lowest income group, with earnings of less than \$3,000 annually, spends an average of 6.2 cents of every dollar of income on gasoline, compared to only 1.5 cents per dollar in the group earning \$15,000 or more. Because much of the driving of the low income group is work-oriented, their demand is relatively fixed, according to this study. Hence, the impact of an increase in gasoline prices would be four times greater on the lowest income group than on the highest income group.

Thus, a price increase to offset a tax increase would bear most heavily on the federal government and on low income

households. It is by no means clear to me that this would be a net social gain.

Before leaving this topic, I would like to present some background information indicating the effect on the industry of complete elimination of tax incentives. In my view, these data point up very sharply the importance of present petroleum tax provisions to our national security.

Elimination of all petroleum tax incentives would have approximately the same impact on the domestic industry as the elimination of import controls, which would reduce revenues per barrel by about one-third. In the view of most industry respondents to the questionnaire issued by the Cabinet Task Force on Oil Import Control, the key effect of a one-third drop in revenue per barrel would be the "virtual cessation" of exploratory drilling. According to one company, elimination of the import control program or an equivalent decrease in revenue would result in an 85 per cent drop in the volume of exploratory drilling. According to another, the resulting reduction in industry cash flow would mean a "sharply curtailed" exploration program with a resultant permanent loss of "supporting industries, technology and trained people."

What this reduction in exploratory drilling might mean for future reserves was examined by another respondent. According to this estimate, "the amount of oil not discovered

-- which otherwise would be discovered -- might approximate 1 to 2 billion barrels each year in the established older exploration provinces." This would amount to some 10 to 20 billion barrels lost over the next decade, not including the unknown amount which "otherwise would be discovered" in newer or future geologic provinces. The same respondent estimated the loss in reserves in existing developed fields at 6 to 10 billion barrels. The loss in reserves in fields which have been discovered but not developed was estimated at 5 billion barrels.

Six companies estimated that by 1980 the United States would be dependent on foreign sources for one-half to two-thirds of its petroleum supplies if oil import controls were eliminated. (See Exhibit VII). The average of these forecasts was 57 per cent dependency on foreign oil. And this allows for remaining production from reserves already discovered today, including the prolific discovery on the North Slope of Alaska, which has not yet been produced. The estimates made by these companies are in close agreement with projections made by the United States Department of the Interior, which predicted 48 per cent (optimistic) to 58 per cent (pessimistic) dependency on foreign oil by 1980 if oil import controls were eliminated.

Earlier, I indicated that the only alternative to maintaining a strong domestic industry was increased reliance on foreign oil. The above data clearly indicate how heavy that reliance would be if all petroleum tax incentives were eliminated.

EXHIBIT VII

1980 PERCENTAGE DEPENDENCY ON FOREIGN OIL IN THE
ABSENCE OF OIL IMPORT CONTROLS DURING THE 1970'S

<u>Respondent</u>	
Cities Service	68%
Gulf	54
Humble	49
Marathon	61
Phillips	57
Sohio	<u>54</u>
Average	57%
Department of the Interior	48 to 58%

Source: Computed from data in submissions in July, 1969, to the Cabinet Task Force on Oil Import Control.

In respect to the security aspect of these foreign supplies, I would like to quote from the summary of a recent API statement on this subject:

"Interference with foreign petroleum supplies can come from any of three sources: (1) military action during war; (2) shutdown (or sabotage) for political reasons; or (3) shutdown for economic reasons. The first of these is most important in general wars. Even in the absence of general war, however, there can be serious petroleum security problems in all three categories. Since World War II, there have been eight noteworthy interruptions of overseas petroleum supply -- all in the prolific Middle East and African producing areas.

"None of these interruptions has succeeded in obtaining economic or political concessions from the United States or its allies -- primarily because there has been a large, viable North American oil industry on which to rely in the event of emergency.

"If the United States were to adopt public policies which would make further exploration in North America generally unattractive, the United States would then have to turn to the Middle East-North Africa region for the bulk of its petroleum supplies because 86 per cent of overseas reserves are concentrated in this area (Venezuela currently accounts for 17 per cent of production but has only 4 per cent of reserves--See Exhibit VIII.) While no single overseas producing country has a sufficiently large share of reserves to be able to dominate the international oil market, groups of countries having common interests do have large shares.

"Certain groups have, in fact, demonstrated an intent to operate as economic units for certain objectives. In the absence of a viable North American industry to counter the potential market power of these groups, there is every reason to anticipate that they would act as monopolistic entities for economic and political gains at the expense of consuming countries. The potential danger of this situation to the security of Free World energy supplies is compounded by increasing Russian adventures in the Middle East and North Africa, the principal overseas producing areas."

While we would gain a short-run benefit from foreign oil in temporarily lower prices, we would bear a long-run cost

EXHIBIT VIII

SHARE OF 1968 FREE WORLD CRUDE OIL
RESERVES OUTSIDE NORTH AMERICA

Areas

Persian Gulf Countries	75%
North African Countries	<u>11</u>
Subtotal	86%
Venezuela	4
Indonesia	3
All Other	<u>7</u>
Total	100%

Groups

OPEC*	85%
Arab Nations	71%

Note: * -- Organization of Petroleum Exporting Countries.

that cannot be measured in monetary terms. If we became dependent upon that oil, we might well be drawn into any conflict that occurred in the Middle East in order to insure stability. This position would be analogous to our present role in Southeast Asia, except that here the military and economic reasons for intervention would be compelling.

Furthermore, given the Soviet Union's support of the Arab world, any increased United States role in the Middle East could lead to a direct confrontation between the two nuclear superpowers. In any event, our options in international affairs would be severely limited and our military commitments would be increased at a time when we seek to limit them.

In summary, I would like to leave these five salient points with you.

- (1) Present petroleum tax incentives have served the national interest by providing adequate, secure supplies of oil and gas, efficiently produced.
- (2) Petroleum industry profits have been less than average.
- (3) Petroleum industry total taxes have been more than average.
- (4) Petroleum industry prices have risen less than average.
- (5) Petroleum industry supply problems over the next decade will be enormous, since we must produce 40 per cent more oil than in the 1960's.

Before closing, I should like to dispel two contradictory notions which are prevalent today. The first is that the United States is running out of oil. The second is that we have found enough oil in Alaska to meet our needs forever. Neither of these notions is true. In my view, recent experience indicates that it is reasonable to expect a substantial uptrend in new oil found in the United States during the next decade. Crude oil reserves in Alaska could very well be as large as the present total in the continental United States -- 31 billion barrels. However, that would only be 55 per cent of estimated required additions to reserves during the 1970's (and all of the Alaskan oil will probably not be found and developed during that period). We need, therefore, more discoveries in the "lower 48" states. I am convinced that a realistic national petroleum policy continuing to provide reasonable tax incentives for investment will enable us to find and develop the oil we need, to the benefit of this Nation and all of its people.

In conclusion, I urge the Committee to give careful consideration to the future outlook for the United States petroleum situation in reaching its decision about petroleum tax policy. The continued existence of the United States as we know it could well rest on the decisions you reach.

STATEMENT OF

**WILLIAM I. SPENCER
Executive Vice President
First National City Bank
New York, New York**

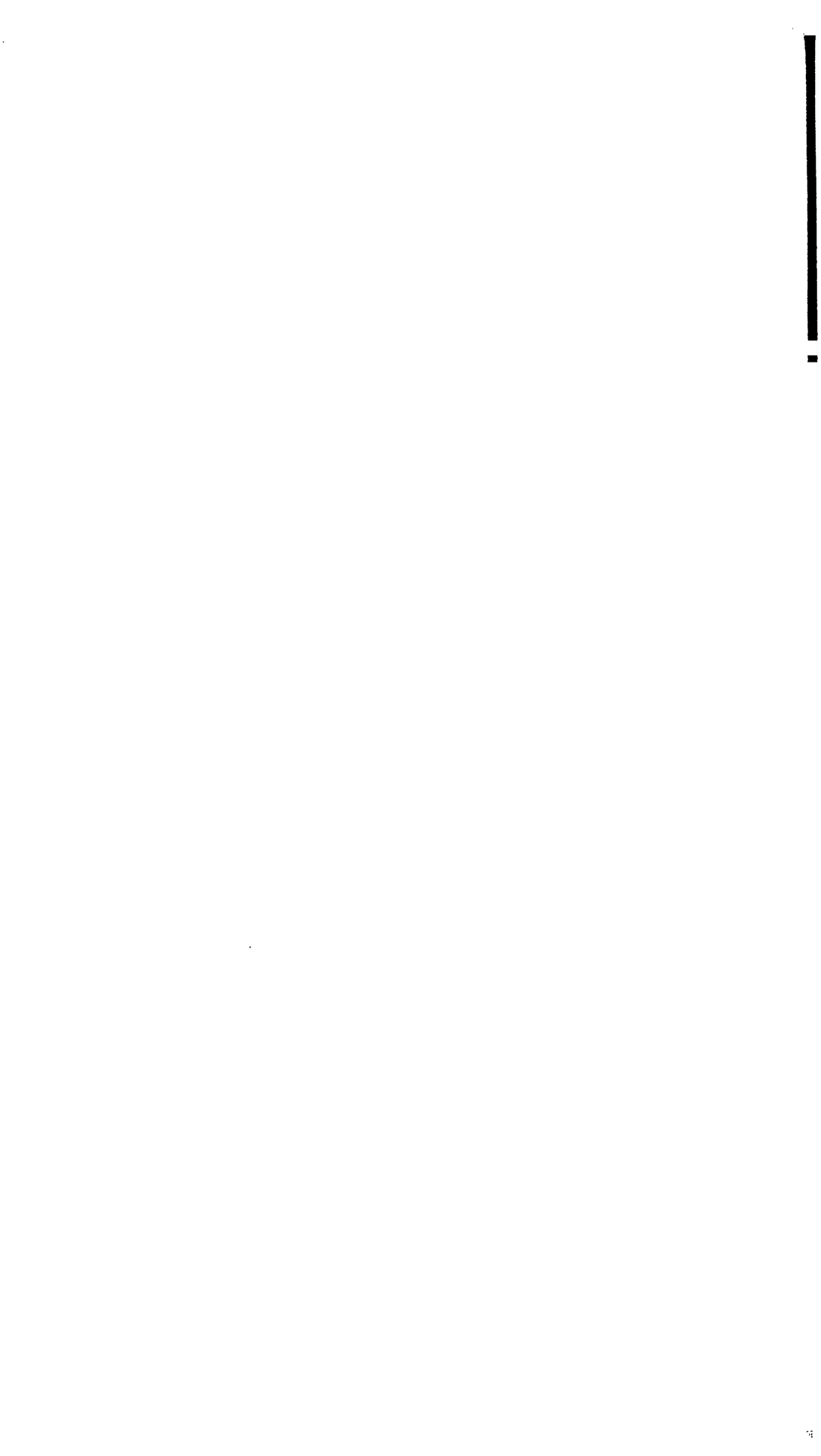
before the

**COMMITTEE ON FINANCE
UNITED STATES SENATE
Washington, D.C.**

in behalf of

**American Petroleum Institute
Mid-Continent Oil & Gas Association
Rocky Mountain Oil and Gas Association
Western Oil and Gas Association**

October 1, 1969



**SUMMARY OF PRINCIPAL POINTS INCLUDED IN
MR. WILLIAM I. SPENCER'S TESTIMONY**

1. Changes in the tax treatment of minerals, as existing for many years, could endanger both the international payments position and the energy supplies of the United States. They could thus have serious, long-term consequences for the welfare of the nation as a whole.
2. The petroleum industry has been responsible for the largest share of United States direct investments abroad, and for those showing the highest return on book value. Helped by a flow of almost \$2 billion (1967) in earnings remitted back to parent companies, the industry has made a major and sustained contribution to the strength of the dollar. Most of the funds required to make this possible come from sources outside the United States.
3. The national need for energy will grow by more than 50% by 1980. Two-thirds of the supply will come from oil and gas, supplemented by other capital-intensive sources such as shale oil. If this petroleum supply is to be made available, and if there is to be no increase in dependence on imports, the annual rate of additions to proved reserves in the ground will have to be 57% higher in the 1970's than in the 1960's.
4. Making conservative assumptions concerning the cost of raising the rate of discoveries to this extent, the petroleum industry will have to attract, for domestic exploration and development alone, as much as \$70 billion for the 10-year period through 1980.
5. In attracting capital on this scale, the industry will be hampered by the likely continuance of monetary stringency in the economy as a whole; also, by the fact that the liquidity of leading petroleum companies has been declining, while their dependence on long-term debt has been rising sharply.
6. The ability of the industry to finance its greatly-increased exploration and development will depend upon its future ability to maintain and improve its profitability. When related to investments, its profits are at best average and significantly below those of other industries facing a lesser degree of risk.
7. The tax structure should be designed to enable the industry to meet our national energy goals. The proposals before the Committee do not meet this test. They are not simple; they are not stable; and they are not in tune with long-term needs.

October 1, 1969



STATEMENT OF WILLIAM I. SPENCER

I am William I. Spencer, Executive Vice President of First National City Bank, New York. My appearance today is on behalf of the American Petroleum Institute, the Mid-Continent Oil & Gas Association, the Rocky Mountain Oil and Gas Association and the Western Oil and Gas Association. For many years I was directly associated with the petroleum and mineral activities of our Bank. I therefore feel honored to appear at these important hearings, and to discuss with you a few of the basic problems presented by some of the proposals now being examined by this Committee.

Since the importance of energy to the national economy has already been so clearly set out by Mr. Dunlop, I shall confine my remarks to two broad areas. In the first place, I shall briefly discuss the importance of petroleum in strengthening the United States position in international trade and payments. Secondly, I shall urge you to consider most carefully the industry's capital needs.

On the first point, let me make it clear that I have no doubt of the advantages to the United States of a growing flow of international trade and payments. I have just returned from a visit to Africa where I was struck by the extent to which American people, American capital and American ideas are not only working to increase our income but also to strengthen our image in the most remote places. To forget the interdependence of the United States and its trading partners abroad would be a little like trying to run Manhattan without the tunnels and bridges connecting the island to the mainland.

Yet the balance of payments problem will remain with us for years to come. International liquidity and the strength of the dollar are likely to be matters of great concern for policy-makers here in Washington throughout the 1970's. In this international context, the importance of petroleum is well known. It occupies first place in sea-borne trade and foreign earnings. No changes in the tax treatment of this and other

mineral industries should be attempted before carefully weighing the impact on international payments.

Our Bank has often expressed concern over the policy of restricting capital outflows by the system of controls introduced early in 1965. Similar objections would apply to tax changes likely to interfere with earnings from direct investments abroad. Over the years, petroleum investments abroad have shown their ability to earn a return on book value appreciably better than that of other investments abroad.

The net effect of the foreign investment activity of the petroleum industry has been an inflow of funds of nearly \$1 billion annually. Not only has this been most important in supporting the national balance of payments; but it has also greatly strengthened the economies of developing countries. In key countries in Asia and Africa, as well as in international shipping, more than half of United States direct investment abroad has been channeled into oil and gas ventures.

Needless to say, an exact accounting for these benefits is difficult to make. On the minus side is the outflow of capital and the cost of tanker and other foreign services. But the capital invested abroad gives rise to far larger plus items. There are exports of services such as fees and royalties, and exports of merchandise such as products, equipment and petrochemicals. There is also the sizable return flow of earnings remitted back to parent companies. In 1967 (the latest available year), this amounted to almost \$2 billion. Without these earnings, the United States balance of payments deficit would have been half as large again as that actually recorded. This seems a good reward for the outflow of \$1.1 billion that took place in 1967 in order to support investments abroad. Indeed, most of the capital now required for this purpose is not drawn from sources in the United States, but from earnings made and reinvested abroad and from sums raised from investors abroad.

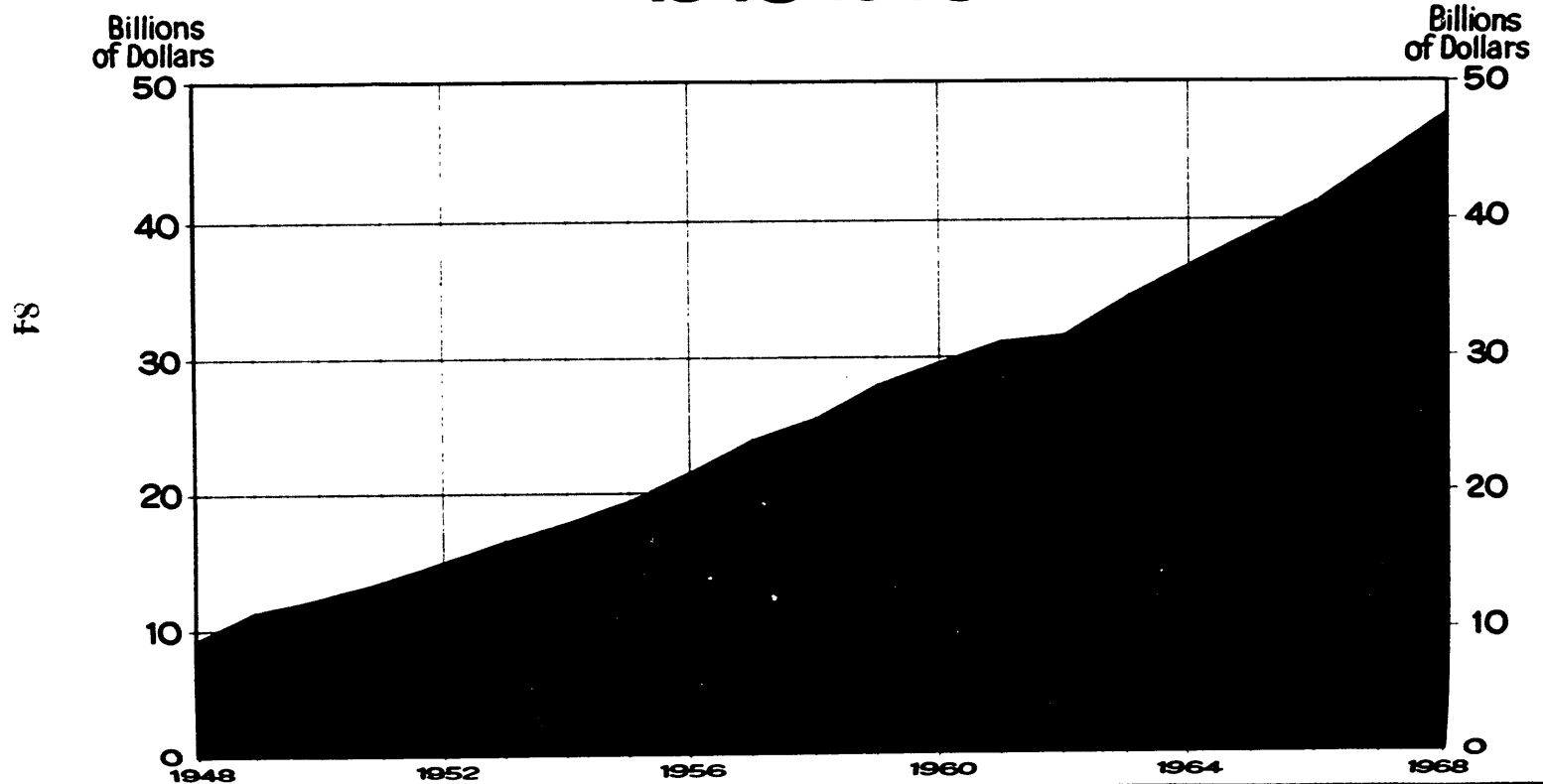
Now, gentlemen, I should like to turn to the capital outlook. Specifically on petroleum, I should like you to look at Exhibit I. We have prepared it to show the trend of capital investment in the petroleum industry over the past 20 years. You will note that the net assets of United States petroleum companies have grown from \$9.2 billion in 1948 to \$47.5 billion in 1968. The reason investors have been willing to risk their money in this business is, of course, that they were anticipating an adequate return on their money. Tax incentives played an important role in attracting investors to this industry. At the same time, the industry's profits have not been excessive, as Mr. Dunlop has demonstrated.

There seems to be an impression, expressed during the hearings early in September, that these tax incentives are expendable. I support the case for sharing the tax burden as equitably as possible. As the President himself has pointed out, taxes can be made fair - but not popular. Reducing the mineral tax incentives, as now under discussion by this Committee, might be popular today. But will it be popular 10 years from now? In the long run, because of the danger of an energy shortage, I do not think it would be wise or fair. In fact, during the 1970's, tax incentives for mineral production will be even more essential than during the 1960's.

I am not saying that the tax system should be left unchanged. But any tax system should meet the tests of being simple, stable and in tune with long-term economic needs. Insofar as the mineral provisions are concerned, I do not find that the proposed measures meet any of these tests. The proposals now before the Committee appear to make the system even more complex. They appear to undermine the stability so vital to productive investment. And they conflict with long-term needs by adding a bias in favor of consumption and unfavorable to investment at a time when the nation is struggling to rein in an inflation that threatens to run away.

Exhibit I

CAPITAL INVESTED IN THE PETROLEUM INDUSTRY 1948-1968



My concern extends across the whole range of minerals. Coal, uranium, copper, and other basic resources will be essential to our economy in the future even more than they have been in the past. Oil shale will one day come into its own as a major source of the nation's energy. But, in the rest of what I say, I shall be focusing on oil and gas. These provide the foundation for the largest industry in the mineral group. Moreover, the added petroleum tax load proposed in the mineral provisions of H.R. 13270 - over \$500 million out of a total of about \$600 million for all minerals -- is far larger than for any of the other minerals.

Looking at the petroleum industry from a banker's viewpoint, I see no reason for overconfidence that this country can successfully cope with the petroleum demands of the 1970's. I see no justification for a crack-down on the petroleum industry. Instead, I think the industry will need all the cooperation it can get from this nation. Let me tell you why.

As a banker, I am uneasy about the petroleum industry's capital outlook -- how much capital it will require and how much it can obtain. I see all too little basis for the confidence that was expressed by Administration spokesmen before this Committee concerning the adequacy of the capital supply.

In the first place, there is the shortage of capital in the economy as a whole. With the big corporations -- and even the Federal Government -- having to pay 8% or more on recent bond and note issues, the present stringency is clear for all to see. So do we expect any early relief. In a recent 5-year forecast, we came up with the prospect of a sharp increase in the need for both short and long-term borrowing by leading United States industries. For petroleum, we expect to see a drastic increase in the use of outside funds, with the total of short-term borrowing being doubled by 1974.

This trend has already set in. Over the past 10 years, the call for outside financing has obliged the five largest international oil companies based in the United

States to step up the long-term debt component in their total capitalization. Their long-term debt has risen sharply - from about \$2 billion in 1958 (9% of the total) to \$6 billion (17%) last year. There comes a point beyond which even the strongest company cannot continue to depend on borrowing to finance its expansion plans.

In the second place, the needs of the energy sector as a whole are bound to mount rapidly. By 1980, we expect the United States to be consuming nearly 95 quadrillion British thermal units of energy (see Exhibit II). This would represent an increase of more than 50% over the present total of 62 quadrillion.

The expected demand for energy in 1980 represents some 45 million barrels a day of crude oil equivalent (see Exhibit III). Some 42% of it will actually come from oil - including a small contribution from synthetic fuels, such as shale oil. Over 25% will come from gas. But this leaves some 33% to come from other sources. One of these will continue to be coal, which will contribute nearly 18%. Other sources may include 12% from nuclear power and 3% from water power. The new energy sources are likely to prove quite as capital-intensive as petroleum. To an unparalleled extent, oil companies will be competing with other companies for the capital needed to secure the nation's energy supply.

Let us next look to the future, and try to apply a yardstick to the capital requirements of the industry in the years ahead. At the outset and very broadly, let me say that, over the 10-year period 1970 to 1980, the petroleum industry may require at least \$70 billion for domestic exploration and development expenditures alone. This average expenditure of \$7 billion a year would be more than half as high again as the average for the last 10 years.

Even this figure may prove to be a low estimate rather than a high one. It does not include at least \$5 billion for transportation investment. Further, it makes no allowance for the possible impact of inflation or for the cost increases due to exploration at greater depths and in less accessible areas. Here is how we arrive at our projection.

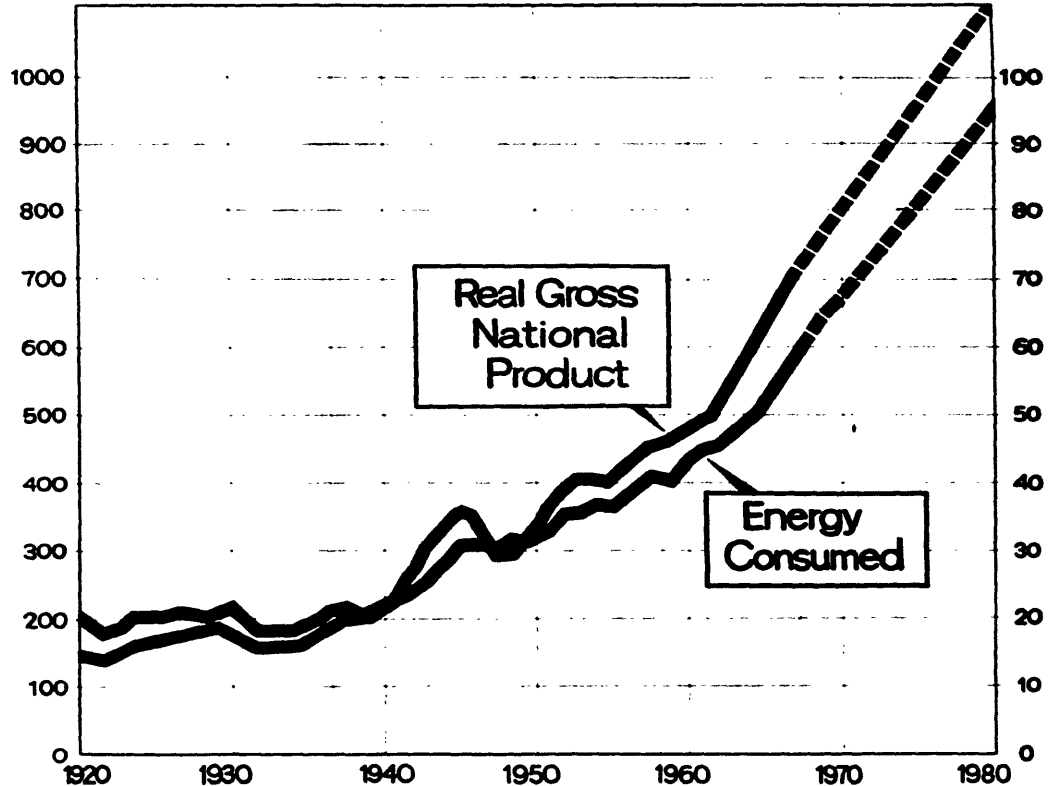
Exhibit II

**U.S. energy
use and
gross
national
product
are
closely
related**

87

BILLIONS OF \$ 1958

QUADRILLION BTU



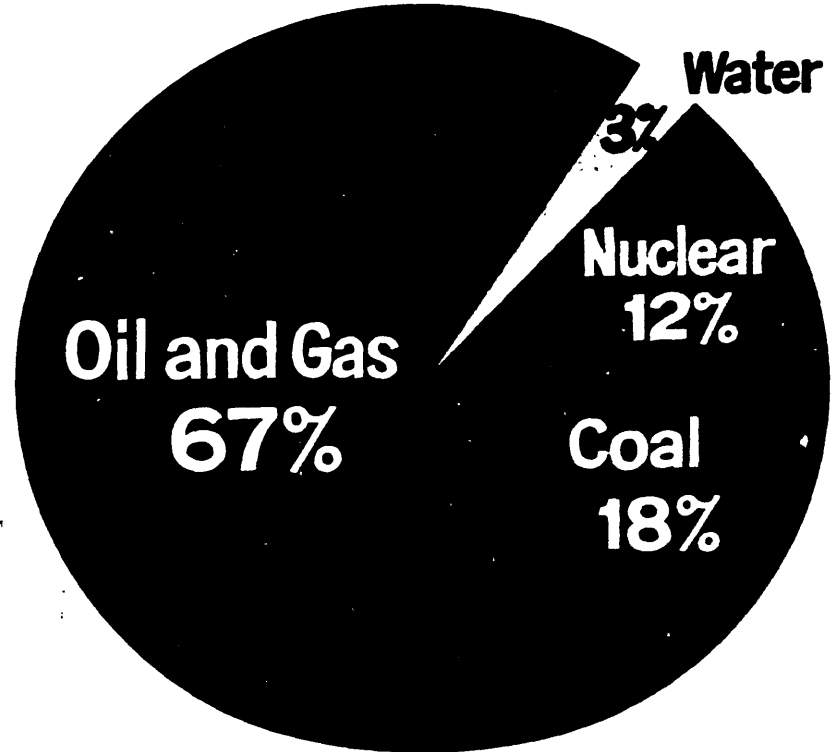
SOURCES: 1920-1988: GNP: Dept. of Commerce, Office of Business Economics
ENERGY: Bureau of Mines

SOURCE: 1968-1980: First National City Bank

Exhibit III

**Distribution
of Total
Energy
Consumption
in 1980**

32



We estimate that energy consumption in the United States will grow at nearly 4% a year during the 10-year period 1970 to 1980. We believe that, through 1980 -- and for a good many years thereafter -- petroleum liquids will continue to furnish the energy for almost all our transportation. This market, together with petrochemical feedstocks, will provide a strong springboard for the growth of total consumer requirements for petroleum products.

In 1980, according to our estimate, United States consumption of petroleum liquids will reach 19 million barrels daily, nearly 6 million barrels daily more than we consumed last year. (This forecast, incidentally, falls within the same general range as a number of estimates prepared by other groups.) Assuming that imports continue to provide 22% of domestic demand (as in 1968), this would mean that the domestic industry will be called upon to supply some 41% more petroleum liquids in 1980 than in 1968 - if the country is to attempt to avoid becoming relatively more dependent on imports.

Shown in Exhibit IV is an indication of the scale of the exploration effort that will be required to meet a growth in demand of this magnitude. The industry would have to produce 46 billion barrels of liquid hydrocarbons during the 1970's. By comparison, total production during the 1960's was only 33 billion barrels.

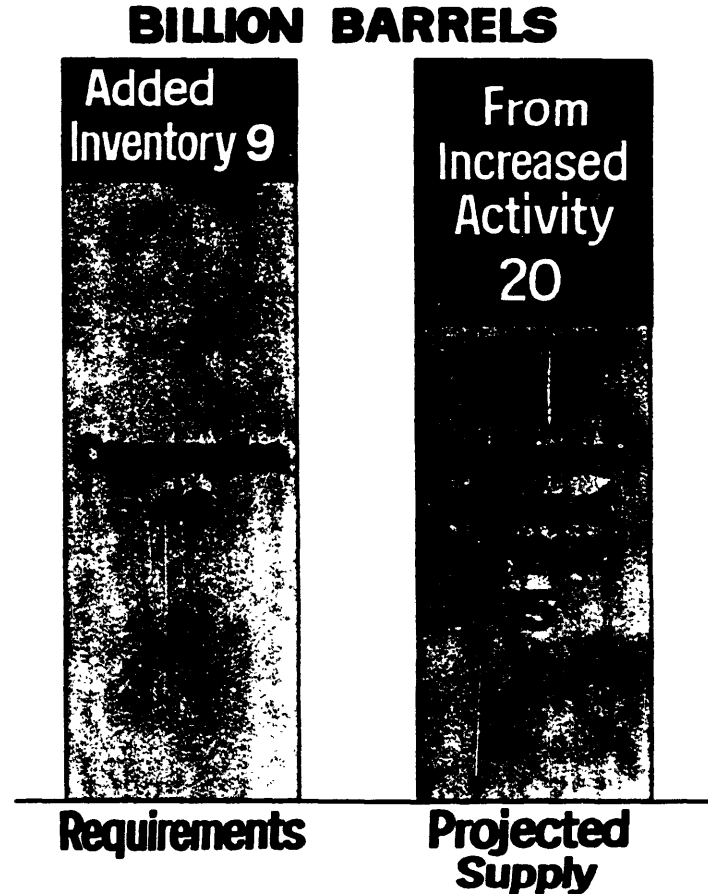
In addition to this need for 46 billion barrels, if the industry is to meet the full requirement in 1980, another 9 billion barrels will probably have to be added to the inventory of proved reserves. The reason for this is the technological limit on the percentage of reserves that can be produced from any reservoir during a given year.

Thus, gross additions to reserves required during the 1970's total 55 billion barrels: 46 billion for consumption and 9 billion for inventory. This total - an average of 5.5 billion barrels per year - is 57% more than the annual average of 3.5 billion barrels that the industry added during the 1960's. Continuation of additions at the 1960's rate during the 1970's would leave the country 20 billion barrels short by 1980.

Exhibit IV

**55 billion
barrels
required
gross
additions
to liquid
hydrocarbon
reserves
during the
1970's**

06



These figures are based on the assumption that the nation will continue its reliance on petroleum imports at today's 22% level. Our own estimate is that this dependence will increase to around 24% by 1980. This would decrease, but not by a sizable amount, the need for additions to domestic reserves.

Nor must we forget the demands of the gas consumer. Our estimates suggest that potential demand for this fuel is now entering a new period of growth. For reasons of convenience, domestic and commercial users are turning increasingly to gas. Nearly half of the industrial energy needs of the United States are already supplied by gas. More than one-fifth of the nation's electric power supply also depends on this fuel.

Yet, it is clear to us that the future availability of gas is becoming a matter of grave concern. By 1980, we expect demand to have grown to 66 billion cubic feet a day -- more than 20% above the present level. This comparatively modest growth takes account of the fact that gross additions to gas reserves are no longer growing as fast as the market potential. More funds will have to be earmarked for gas exploration if the consumer is not to be forced to resort to higher-cost synthetic sources, or to substantial dependence on gas imports. These imports would have to come both by pipeline from Canada and by tanker, in more costly liquefied form, from overseas.

Returning to petroleum liquids, what is likely to be the cost of obtaining the required 5.5 billion barrels a year? During the last 10 years, the industry spent an estimated \$4.5 billion annually to obtain the annual increments of 3.5 billion barrels, mentioned above. If average gross additions to reserves must increase 57%, recent levels of capital expenditures cannot be expected to meet the needs of the future.

Yet there is no neat relationship between capital expenditures and gross additions to reserves. The additions include not only new discoveries, but extensions and revisions. They also include the result of improvements in recovery processes, and the liquids to be derived from gas wells. At the same time, gas-oil ratios will vary, thus

altering the capital requirement. There is no guarantee whatever that changes on these various fronts will allow the industry to hold its overall rate of expenditures per barrel at the average achieved in recent years.

There is the further complication that the industry is having to pioneer into more and more difficult areas in order to meet the nation's needs. Wells are getting deeper. More of them have to be located offshore. Average costs per well in Alaska are likely to be at least five times those in the Lower Forty-eight. Other oil frontiers are also having to be opened up.

Some figures drawn from recent history will help to illustrate my point. For example, the cost of drilling and equipping an average producing well in 1953 was \$54,000. It had increased to \$81,000 by 1967, and as high as \$913,000 for a productive well over 15,000 feet deep. Compare the 1967 average, however, with 1967 costs of \$550,000 for a typical productive offshore well, and \$1,250,000 for a productive well in Alaska. The higher of these figures are more representative of drilling costs in the areas and at the depths that will require a major exploratory effort, if we are to meet our future requirements for oil and gas reserves.

As I have already mentioned, there is also the onward march of inflation. I am not one of those who believes that a price increase automatically generates additional earnings and attracts the necessary supply of capital. As has been demonstrated by Mr. Dunlop, the industry has been in a cost-price squeeze. Wellhead and refined product prices have clearly failed to keep up with the rise in the price level as a whole.

Merely for the sake of illustration, however, we have assumed that capital expenditures will increase by the same percentage as the necessary additions to petroleum liquid reserves. Using the 57% estimated increase, the average annual expenditures will grow from \$4.5 billion to \$7 billion. That is how we arrived at our total of \$70 billion for the decade 1970 to 1980.

Let us now consider the prospect of attracting this stepped-up capital inflow into the petroleum industry.

As I have already indicated, I see no evidence whatever that there is a surplus of available capital in the country today. Nor is there the prospect of one in the years ahead. Is there a surplus of capital in the petroleum industry itself? The answer is clearly negative. As I have just demonstrated, there are certainly not enough proved reserves in the ground to get the industry through the 1970's. Similarly, there is no excess cash within the industry.

For a representative group of companies that we analyzed, the ratio of current assets to current liabilities at the end of last year was only 1.8 to 1. This is less than the 2 to 1 ratio that is often taken as the desirable minimum. The petroleum ratio compares with an average of 2.2 to 1 for other manufacturing industries, and with even higher ratios for steel, chemicals and so on. At a time when these other industries have been maintaining their liquidity at reasonable levels, it is ironic that petroleum, one of the most vital of all, has not fared so well.

Are the industry's profits high enough to attract the huge sums of capital likely to be needed? Although large in absolute terms, when related to investments, the profits are at best average. Industries which do not have to face the risks and uncertainties borne by petroleum have in recent years been earning up to some 20% in relation to their assets against oil's ratio of less than 13%. Among the more fortunate group in 1968 were office equipment, instruments, pharmaceuticals, toiletries and soft drinks. Hardware and tools earned more than 16%, as did the automobile industry. The petroleum industry is only likely to attract the stepped-up capital needs of the 1970's if its profit performance is maintained and improved.

What is the petroleum industry's profit outlook for the future? An adequate answer to this question requires, as one most important condition, a clearer view than we now

possess of the tax prospect. I shall not try to go into the detail of the tax bill prepared in the House of Representatives. But I must frankly confess that I am struck by the negative emphasis in some of the proposals now being considered by this Committee.

You, yourself, Mr. Chairman have referred to recent proposals as "anti-oil" I note, in this connection, that there are the proposed changes in the depletion allowance, reducing the rate for domestic production and eliminating it for foreign production. There is the new concept of the limit on tax preferences, restricting the use of percentage depletion and intangible drilling-cost expensing. There are the further complexities in the application of foreign tax credits; the proposed restrictions could introduce a new element of double taxation, thereby breaching one of the most fundamental principles of fairness in taxation.

Petroleum industry profits emerge as a main target of this array of tax proposals. If the Congress adopts part of all of this package, an investor must expect to earn less from his petroleum outlays.

Some people argue that the impact will be slight. In the report of the Committee on Ways and Means, I read the surmise that the proposed reduction in percentage depletion rates "should have only a minimal effect on efforts to discover new reserves"

Judging by the Treasury's figures, I find this statement hard to support. Moreover, there is the psychological impact. Once the gate to change has been opened, investors become increasingly nervous. These tax changes are not only retroactive; they cast shadows before them. Any undermining of the existing tax structure will inevitably have a more than proportionate effect on investor expectations, and therefore on capital availability.

At the same time, lower profits mean a smaller flow of internal funds available for reinvestment in the industry. In the past, over 70% of the capital spending of the leading oil companies has been provided from internal sources. In the future, under an impaired system of tax incentives, these internal funds could be deeply eroded.

I think it is unfortunate that there is so much eagerness to place obstacles in the industry's path at a time when its capital needs are so great, and when the country's petroleum requirements are on such a steady rise. I am, indeed, puzzled by the timing, not by the sense of haste during some of the hearings on the complex and varied tax proposals now being considered by this Committee. I think there is a danger that perspective will be lost. With the Treasury expecting to raise almost \$200 billion in revenues during the current fiscal year, budgetary savings and tax simplifications are more desirable than ever before -- but only if they do not backfire on the economy. Tax savings that might risk the future energy supplies of the nation could be just that.

I fully agree with those around the nation who feel the need to "do something" about our mammoth and ever-mounting budget. Yet let us not underestimate the gravity of the problem, nor the need for cautious study before far-reaching actions are taken.

To sum up, a reduction in established tax incentives could reduce petroleum industry profitability to something well below that of other industries, thereby endangering the future capital supply. This could have serious -- and insufficiently understood -- long-term consequences for our balance of payments, our economic stability, and the welfare of the nation as a whole.



STATEMENT OF

**GEORGE V. MYERS
Executive Vice President
Standard Oil Company (Indiana)
Chicago, Illinois**

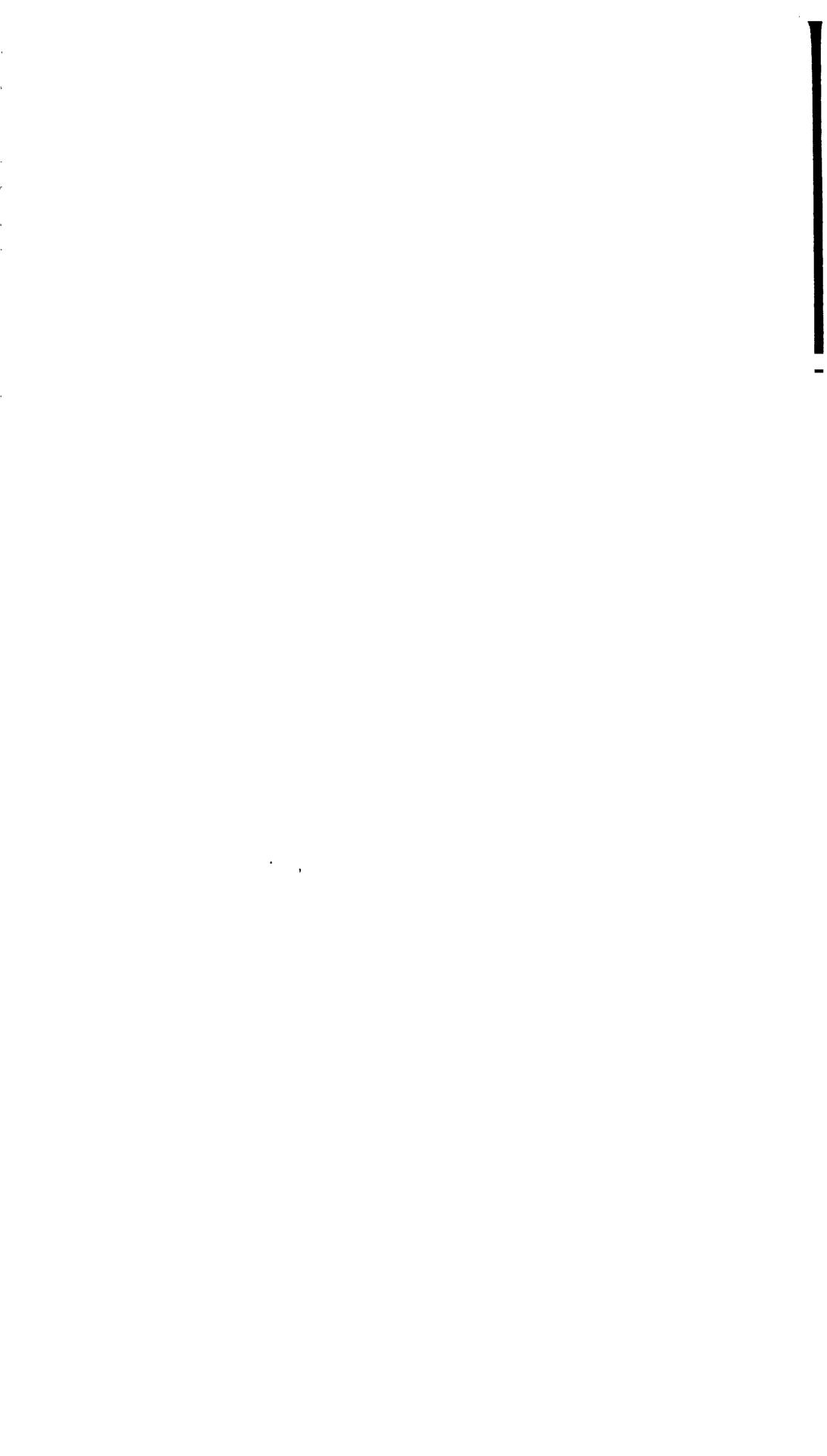
before the

**COMMITTEE ON FINANCE
UNITED STATES SENATE
Washington, D.C.**

in behalf of

**American Petroleum Institute
Mid-Continent Oil & Gas Association
Rocky Mountain Oil and Gas Association
Western Oil and Gas Association**

October 1, 1969



SUMMARY OF PRINCIPAL POINTS IN STATEMENT OF GEORGE V. MYERS

1. Risks in Finding

- a. Significant discoveries, one well out of 50.
- b. Unpredictability of success for individual prospectors.
- c. Past averages may mean little in view of the increased costs of deeper wells and wells offshore and in remote areas.

2. H. R. 13270

a. Effect of Reducing Domestic Depletion Rate

- i. Curtailment in exploration and development leading to an undue reliance on foreign oil.
- ii. Apprehensions of investors that further reductions may follow.
- iii. Investments made on assumption that long-standing depletion deductions would continue.

b. Treating production payments as loans will reduce value of producing properties and restrict borrowing power for financing exploration.

c. Allocation of deductions discriminate against independent individual operator by reducing the effectiveness of his percentage depletion and intangible drilling costs.

d. Oil Shale

- i. House version should be adopted.
- ii. Retorting is a mining process and is proper cut-off point for depletion.

3. Comments on Treasury Department Proposals

a. Inclusion of percentage depletion and intangible drilling costs in LTP computation.

- i. Percentage depletion not categorized by Treasury Department study of 154 individuals as a "major tax reducing factor". Amounted to less than 1 percent of total deductions claimed by 154 individuals.

- ii. Sixty percent rule for intangible drilling costs is arbitrary and discriminatory and will dry up sources of risk capital for independent operators.

b. Taxation as ordinary income of gains from sale of properties to extent of previously allowed intangible drilling costs will lower incentives for investment in exploration.

4. Other Proposals

a. Flow-back of depletion deductions.

- i. Depletion a reward for past success. Flow-back locks in investors.
- ii. Encourages the drilling of inferior prospects.
- iii. Industry will become concentrated in fewer producers.
- iv. Producers who have borrowed against future production will lose part of their depletion unless they can repay their loan and flow-back.

b. Capitalization of intangible drilling costs of development wells.

- i. Will not ultimately increase tax revenues.
- ii. Will seriously disrupt available funds.

c. Percentage depletion at graduated rates

- i. Industry not concentrated.
- ii. Effect of proposal is to reduce the industry to a rate a little higher than 15 percent.
- iii. Risks same for all.

5. Conclusion

- a. High risks are deterrent in attracting capital under present economic conditions.
- b. Proposals to reduce depletion rate, and to eliminate capital incentives in form of production payment sales and ABC transactions will adversely affect the capital raising abilities of the independent operator.
- c. The discriminatory proposals of the Treasury with respect to depletion and intangible drilling costs in the LTP and allocation of deductions computations will seriously affect the capital raising potential of independent operators.
- d. In view of the high risks involved, the proposals in the House bill and in the Treasury testimony, if enacted, would drive capital out of the search for petroleum.

STATEMENT OF GEORGE V. MYERS

My name is George V. Myers. I am Executive Vice President and a Director of the Standard Oil Company (Indiana) of Chicago, Illinois. I am appearing today on behalf of the American Petroleum Institute, the Mid-Continent Oil & Gas Association, the Rocky Mountain Oil and Gas Association, and the Western Oil and Gas Association. I will discuss, first, the risks inherent in exploring for oil. Then I will review the provisions of H. R. 13270, the proposals made by the Treasury, and a few other proposals that would reduce economic incentives for domestic petroleum exploration and development.

Risks in Finding Oil

Unique and heavy risks are involved in finding and producing oil and gas. These risks are just as real today as they were 10, 20, or 50 years ago. In spite of all of our scientific progress and new exploration tools, there is still only one way to establish the presence of oil and gas in the ground; and that is to drill a hole. Recent experience shows that, on the average, only about one out of 50 exploratory wells will find oil and gas in significant quantities; that is, the equivalent of at least one million barrels of oil.

There is still a common belief that one of every nine wildcats will succeed. It is true that, for many years, about 11 percent of wildcats produced some oil or gas, but that figure can be misleading. (Exhibit I) The top line of Exhibit I shows that about 11 percent of wildcats drilled during the period 1953-1967 were originally reported to be producers. In 1968, this rate dropped to 8.5 percent. However, this line is misleading because many of the wells that find oil or gas do not find profitable quantities.

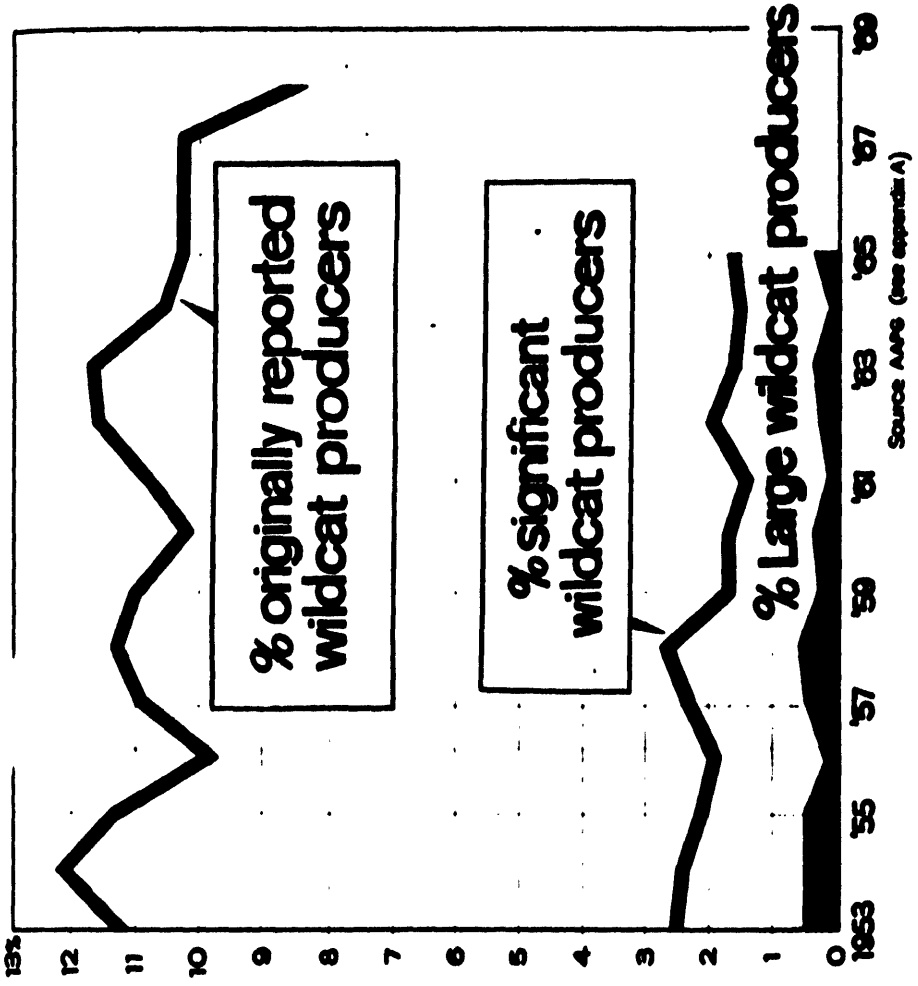
The next line on the chart shows the percentage of wildcats which found fields having more than one million barrels of oil (or the equivalent amount of gas). You will note that the highest percentage is almost twice as great as the lowest, with an average of about 2 percent. Therefore, about one well in 50 is a better measure of the industry's average success rate.

The bottom line on the chart represents discoveries of 10 million barrels or more. The odds here are about one out of 250, or a four-tenths of a percent success ratio.

The search for oil and gas is one of high risk, and the degree of industry success is unpredictable, as shown by extreme year-to-year fluctuations of the industry averages. It follows that the degree of success for any one company is completely unpredictable, since no one

Exhibit I

Productive fields per wildcat well drilled 1953-68



company is large enough to have "average" characteristics. In any event, wildcats are drilled on the basis of the geological outlook for individual prospects, not on the basis of industry average.

Furthermore, past averages and ratios may well mean little for the future; witness the decline in the wildcat success rate in 1968. Since costs increase as we drill deeper and explore in the more remote areas, million-barrel fields which were significant at shallower depths in mature areas may well be unprofitable at greater depths or in frontier areas. Increased costs effectively decrease the success rate since the average profitable field must be larger in order to offset higher costs. This certainly indicates that the incentives for finding oil and gas should be at least maintained at present levels. Risk capital will be forthcoming only if potential rewards are sufficiently attractive. Past rewards have not been excessive, as indicated by the average rate of return for the industry, which Mr. Dunlop discussed. Adequate rewards were the primary consideration underlying Congress' adoption and continuation of percentage depletion and related incentive provisions in our income tax law.

H. R. 13270

As passed by the House, H. R. 13270 would cut back on the existing incentives to explore for and develop domestic oil and

gas reserves by:

1. Reducing the percentage depletion rate on domestic oil and gas wells from 27½ percent to 20 percent.
2. Effectively eliminating the use of production payments.
3. Reducing deductions allowed for interest, charitable contributions, state and local taxes, and other non-business expenses incurred by individual oil and gas operators.

The Treasury Department estimates that the proposed reduction in the percentage depletion rate on domestic oil and gas production would increase the industry's annual tax burden by some \$350 million. The elimination of the use of production payments would impose an additional \$200 million burden.

Although there is no Treasury estimate of the monetary effect of the third proposal, it is a change that would have a serious impact on the independent segment of the business.

Prior to discussing these proposals in greater detail, I think it is important to point out that their adoption in conjunction with other proposals in H. R. 13270, such as the extension of the surtax, the repeal of the 7 percent investment tax credit,

and the capital gains tax changes would siphon a tremendous amount of cash out of the already strained financial resources of our industry. Mr. Spencer has pointed out that our industry will need more, not less, funds if it is to keep up with the demand for ever-increasing volumes of oil and gas required by our economy. This, to me, points up the need for at least maintaining present tax incentives, particularly in view of the increases in future petroleum requirements as outlined by Mr. Spencer.

Reduction in Domestic Depletion Rate

Turning now to the specific provisions of H. R. 13270, I believe that the proposed reduction in the domestic percentage depletion rate from 27½ percent to 20 percent contravenes our national interest. Last year, the Department of the Interior report, "United States Petroleum Through 1980," recognized the importance of existing tax provisions to the development of sufficient new reserves to serve increasing demands. The following statement from this report summarizes the conclusions reached:

"Both intangible expensing provisions and percentage depletion have been long-standing and durable features of the tax treatment of the petroleum industry, despite repeated efforts to change, reduce or eliminate them.

"They are an integral part of the petroleum industry's structure of income and expense, and the available evidence suggests that any substantial change in them would have a direct and significant effect upon the future availability and cost of oil and natural gas."

In the capital-intensive petroleum industry, any impairment of existing tax incentives would inescapably cause a restriction in future exploration and development expenditures. Unless compensating product prices could be realized, our economic progress would be dampened and our military and economic security weakened. As my colleagues on this panel have pointed out, the projected increases in consumer demand, supply requirements, and capital needs clearly demonstrate that now is not the time to experiment with the depletion rate.

Under Secretary Walker has observed that the proposed change relating to income from tax exempt securities has made investors in that market "skittish," with the result of market impact out of all proportion to the proposed change. He said,

"...it can be viewed as a direct taxation for the first time of state and local government securities, which would cause investors to worry that greater taxation, full taxation, might take place at a later date. So that in purchasing securities today they would be skittish about the possibility of the rug being pulled out from under them later. It is the toe in the door argument, and it has its effect on markets, there is no doubt about it."

The proposed reduction of the rate to 20 percent would similarly have a more dampening effect on the industry's exploration efforts. It should be recognized that the psychological impact of such a

reduction would cause oil and gas producers to be apprehensive about further reductions later, and these apprehensions would be reflected in greater reductions in expenditures for exploration and development.

Mr. Dunlop has pointed out that industry submissions to the Cabinet Task Force on oil import controls indicate that a one dollar per barrel reduction in the price of crude oil would make virtually all exploration in the United States uneconomic. Reduction of the depletion allowance to 20 percent would be equivalent to a price reduction of about 20 cents per barrel. If we were to make a simple interpolation between the effect of a 20 cent price cut and a one dollar cut which eliminated exploration, one might anticipate that the proposed reduction in depletion would reduce exploration by one fifth ($20¢ \div 100¢ = 1/5$) -- assuming that the rate decrease were not offset by a price increase.

I feel certain that this is a conservative estimate of the importance of the rate decrease provided in H. R. 13270. Petroleum explorers would find themselves in precisely the same position as the municipal bond buyers referred to by Under Secretary Walker. The toe would be in the door of change in petroleum tax incentives. And a half century of faith in stable tax treatment of the industry

would have been breached. Under these conditions, we can only predict that explorers' expectations about future tax treatment would be gravely and adversely affected. They would ask, "What tax increase next?"

The result would be a reduction in exploration greater than any decrease indicated by a direct evaluation of prospects which would appear uneconomic with a 20 cent lower price. Furthermore, other reductions in petroleum tax incentives -- added to a 7½ point depletion rate reduction--would make exploration still less attractive.

This Committee was told by the Secretary of the Treasury that reducing the depletion rate to 20 percent probably would not make a substantial change in exploratory drilling activity. The Treasury Department of the previous Administration expressed a similar view which was based primarily on a study made by CONSAD Research Corporation.

The principal conclusion of the CONSAD study is that elimination of percentage depletion and of the option to expense intangibles would result in a maximum petroleum reserve reduction of only 7 percent. From this the Treasury concluded that annual exploratory and drilling expenditures would be reduced by only \$150 million per year, even though the tax increase to the petroleum industry would be \$1.6

billion per year. Simply on the grounds of common sense, it is obvious that reducing profits of oil companies by \$ 1.6 billion would have a far greater impact on new expenditures.

There are many flaws in the COMSAD study. These are outlined in Attachment A. The principal error which makes the study irrelevant is that the economic model used in the study assumes that there is no relationship between the level of crude oil production and industry profitability. This is, of course, nonsense and no credence can be given to the study.

Many billions of dollars have been invested in the oil business in good faith reliance on the tax incentives that have been provided in the tax law for over a half century. To arbitrarily reduce the percentage depletion on past discoveries at this time would raise a question of the government's good faith. For example, the oil industry has paid \$ 3 billion to the Federal and state governments for mineral leases in the waters of the Gulf of Mexico and in addition has spent more than twice that amount in exploration and development in this offshore area during the past 23 years. Total industry expenditures for domestic exploration and development have averaged about \$4.5 billion annually during the past decade. All these expenditures have been based on the assumption that long-standing tax provisions would be continued.

The percentage depletion deduction is designed to recover the capital value of oil in the ground. At today's price of crude oil, this deduction provided by the full 27½ percent falls short of the value of net reserves as measured by the sales price of proven properties.

Production Payments

The second provision of H. R. 13270 is the proposal to treat production payments as loans. Oil and gas operators have to rely primarily on producing properties to provide the security needed to obtain additional financing. The treatment of reserved production payments as loans will cause a reduction in value of 15 percent to 20 percent. This reduction decreases the funds available to independents thus impairing their ability to continue in the business of exploring for and developing oil and gas reserves.

According to Treasury estimates, this proposal will initially generate additional tax revenues; but these estimates may not take into account the loss of revenues that would result from discouraging sales of producing properties.

Allocation of Deductions

The third provision of H. R. 13270 that will hurt the individual independent operator in his efforts to obtain needed capital is the one which would reduce his otherwise allowable nonbusiness deductions solely because he claims legitimate business deductions

for his intangible drilling costs and percentage depletion. Examples of these nonbusiness deductions are interest, taxes, casualty losses, charitable contributions, and medical expenses. This proposal would tend to restrict the effectiveness of percentage depletion and intangible drilling cost deductions as incentives to invest the huge amounts of money needed to supply our petroleum needs. It would be a back-door subversion of such incentives.

Tax Treatment of Oil Shale

H. R. 13270 retains the present rate of depletion for shale oil. It also recognizes that retorting of oil shale is a mining process. This properly takes into account the fact that the retorting of oil shale is essentially a process that separates the kerogen from the rock waste. The kerogen, which represents about 11 percent of the total volume of rock shale, must then be upgraded by coking and hydrogenation to process it into a crude petroleum.

This provision clarifies existing tax law and is desirable because depletion on the kerogen extracted from the rock shale is necessary if this important natural resource is to be developed.

Treasury Department Proposals

On September 4 and 5 the Treasury Department made two recommendations to your committee which would impose additional taxes on

oil and gas producers. These recommendations would:

1. Include percentage depletion in determining the "limit on tax preferences" in all cases and include intangible drilling costs where less than 60 percent of the taxpayer's gross income is from the sale of oil and gas.
2. Tax as ordinary income gains on sales of mineral properties to the extent of intangible drilling costs previously deducted.

Limit on Tax Preferences

The Treasury Department's recommendation to include percentage depletion and intangible drilling costs in computing the "limit on tax preferences" (LTP) should be rejected.

On first examination, the idea of LTP may have some appeal as a means of preventing escape from Federal income taxes by wealthy individuals. But on mature consideration it is questionable whether the basic concept of LTP is sound. The provisions for (1) exemption of municipal bond interest (included in LTP in the House bill but not in the Treasury proposal), (2) treatment of capital gains, (3) percentage depletion and (4) intangible drilling costs were written into the tax law after thorough analysis and evaluation by the Congress. They have been frequently reconsidered by many different

Congresses and have been retained because there is good reason for them. The LTP approach, in effect, disallows almost 50 percent of these deductions for a limited number of taxpayers without consideration of the merits of the respective deductions. Actually, the proposal hurts those most who respond best to the incentives.

The Treasury Department's proposal, with its 60 percent rule, would be especially burdensome on the small independent producer even though he may not be personally subject to the rule. Many small producers depend heavily on suppliers of outside risk capital who would be affected by the proposal. If an investor cannot deduct all of his intangible drilling costs, his investments will obviously be curtailed. This would dry up an important source of capital for independent operators.

The Treasury Department stated last January that 154 individuals with adjusted gross incomes of more than \$200,000 paid no Federal income tax in 1966. This statement has been given wide publicity and has been used to imply that percentage depletion was an important factor in these 154 individuals escaping taxation. On April 22, 1969, the Treasury Department revealed, however, that percentage depletion amounted to less than 1 percent of the total deductions which resulted in their paying no tax. Percentage

depletion was so insignificant that the Treasury Department did not categorize it as a "major tax reducing factor."

Taxation of Gains on Sales of Mineral Properties

The Treasury Department has proposed that gains on sales of mineral producing properties be taxed as ordinary income to the extent of intangible drilling costs which have been allowed as deductions.

Adoption of this proposal would substantially reduce the real value of mineral properties. Consequently, it would make investment in exploration and development ventures less attractive at a time when there is a vital national need to make it more attractive.

This new proposal to tax gains on sales of properties as ordinary income is even more damaging to the industry's property values than is the proposal to treat production payments in ABC deals as loans. The combination of eliminating ABC deals and also imposing ordinary tax rates on gains from property sales would apply an "over-kill" technique which would create almost impossible obstacles to sales of mineral properties.

Other Proposals

Other changes have been proposed that would reduce tax incentives for oil and gas producers. Three of these changes are (1) "plow-back" of depletion deductions, (2) capitalization of intangible drilling costs of development wells, and (3) graduated depletion rates. Each would reduce the incentive to develop domestic mineral reserves; hence, each is a threat to national security.

Plow-Back Proposal

Under this proposal, producers would be permitted a 27½ percent depletion rate if they spend an equal amount in domestic exploration and development. The proposal is based on the false assumption that exploration and development expenditures are less than the industry's depletion deduction. The industry spent about \$4.5 billion annually during the last ten years on exploration and development -- almost twice the amount claimed for depletion. In addition to this false basis, the proposal has other defects:

1. The prospect of percentage depletion is, in part, what motivated the producers to explore for and develop the oil properties that are being depleted. Assistant Secretary Cohen correctly characterized depletion as a reward. He said, "If you are attracting capital for exploration, and a lot of capital is needed for exploration

in oil and gas ... it is difficult to get it from people if the incentive is given only so long as they keep their money invested constantly in exploration. If they cannot withdraw it, if the capital is not mobile, it will be difficult to raise."

2. If the depletion deduction is to be based on future exploration and development, then inevitably a producer's expenditures for exploration and development will be influenced by and scheduled according to the amount of depletion that needs vesting. He may not be inclined to spend any more in a particular year than is necessary to cover the year's depletion even though he has attractive prospects. On the other hand, a producer who has not invested enough could make additional expenditures at no after-tax cost and would probably make additional expenditures even though his prospects were inferior. Thus, the "plow-back" requirement could induce one producer to spend money on inferior prospects and at the same time delay another producer from drilling prospects more likely to be productive. These are the dangers inherent in any subsidy approach.

3. Diluting the depletion incentive will deter others from entering the natural resource business, especially since those already in the business who have excess depletion would have lower costs of exploration and development through the vesting of past depletion. The natural resource industry in the United States, as a result, could become concentrated in fewer producers.

Many mineral producers have borrowed substantial amounts of money and have made firm and binding commitments for repayment. Some of these producers would be unable to repay these loans and also to maintain exploration and development expenditures high enough to satisfy "plow-back" requirements. As a result, those producers would lose a part of their depletion deductions; their tax payments would increase; and their ability to repay their present loans or to borrow money in the future would be impaired.

Capitalization of Intangible Drilling Costs of Development Wells

The proposal to remove the current option to either capitalize or expense the intangible costs of drilling oil and gas wells is apparently based on the false assumption that taxes will be increased. Capitalization of these intangible costs will not ultimately increase taxes. It will merely change the timing of

deductions. Deductions that can now be taken in the current year will instead be taken piecemeal over a period of years -- the total deduction does not change.

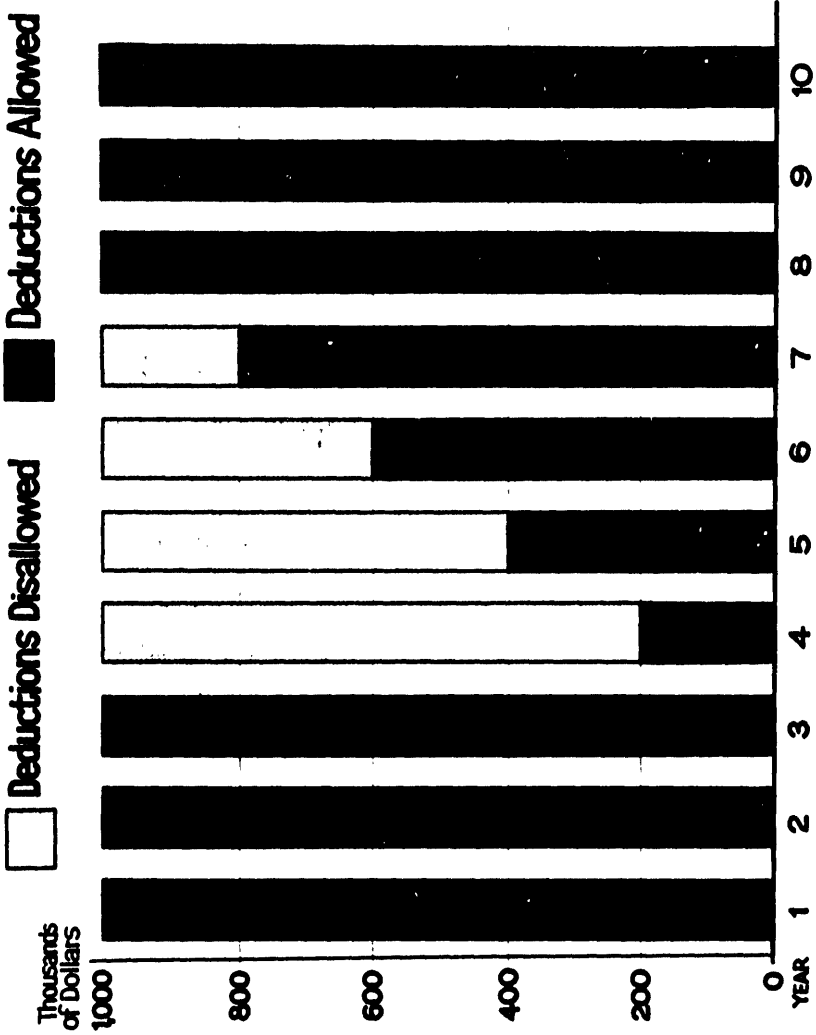
The result of the proposal will be a serious disruption in funds available for exploration and development. The consequence will be a serious discontinuity in the finding and development of petroleum reserves in relation to the discontinuity of available deductions as shown by the example in Exhibit II. The resulting reduction in available funds would force small independent producers to withdraw from the industry. Using Exhibit II as an example, allowable deductions would be reduced \$2 million over four years which, at a 50 percent tax rate, would reduce available funds by \$1 million.

Percentage Depletion at Graduated Rates

Proposals which advocate percentage depletion rates on a graduated scale according to the taxpayer's gross income are based on the false assumption that the industry is dominated by a few large companies. The industry actually consists of some 12,000 business firms with the four largest accounting for only about 24 percent of net domestic production, and twenty-three largest for only about one-half. This is a low degree of concentration when compared to other basic industries in the country.

Exhibit II

Deductions disallowed if intangible drilling costs are capitalized



ASSUMPTIONS: 1. Annual Expenditures of \$1 million
2. Capitalization Beginning in 4th year
3. Amortization over Five years

One such proposal would change the depletion rates as follows:

<u>Gross Income</u>	<u>Depletion Rate</u>
\$1 million or less	27½%
\$1 million - \$5 million	21%
over \$5 million	15%

The net effect of such a proposal would be to reduce percentage depletion for the industry as a whole to an effective rate of little more than 15 percent. Such a proposal would "punish" those who furnish the bulk of the nation's energy supply. Such a proposal would also reduce the incentive for a small company to grow larger. Penalizing success will not sustain the strong and viable petroleum industry needed to supply the energy requirements of our country.

The present tax law grants an exemption from the surtax for all corporations on the first \$25,000 of taxable income. Large individual operators already are burdened by a progressive system of tax rates. To impose progressive depletion rates would double up on progressivity in a most inequitable manner.

In fact, the inequity of the graduated depletion type of progression is most obvious in the case of property owned jointly by a large company and a small independent producer. There is no more reason for this proposal than there would be for disallowing half of a large company's depreciation charges while allowing smaller operators the full deduction. After all, the value of oil in the ground is the same for all producers, regardless of size.

Moreover, the inherent risks in exploration are the same for large and small operators, all of whom have essential roles in the

search for new petroleum deposits. No company is large enough to avoid these risks because: (1) they cannot participate in enough exploration ventures to be sure of achieving a success ratio equal to that of the entire industry; and (2) the size of any discovery in relation to its cost is unpredictable. Furthermore, we should not forget that while a corporation may be large, the ultimate taxpayers, in effect, are the many stockholders who in many cases hold relatively small amounts of stock in these large corporations.

Summary and Conclusions

While we know that the origin of the 27.5 percent oil depletion rate was one of compromise, we also know that Congress, in compromising at a level higher than any other extractive rate, recognized the unusual financial risks associated with oil exploration. These risks have not diminished. To the contrary, current conditions of exploration, offshore operations, and now the Artic ventures all reaffirm, if not magnify, the risks.

As the financial risk associated with oil exploration has, if anything, increased, so has our national dependency upon oil, in terms of security. Through the years, the Congress, in continuing established incentives, has reaffirmed that the oil industry must supply the requirements of the nation under all conditions. The financial community has responded to the rewards offered, and the oil industry has utilized the capital effectively, as evidenced by

our present national self-sufficiency in oil. This Committee must realize fully that an about-face in exploration activity and national security would occur if the various proposals discussed were implemented.

One other aspect of these proposed actions also troubles me. In preparing for this panel, in reviewing the proposed tax law changes and the published commentary and debate concerning them, I have detected something that cannot be analyzed or discussed in terms of economics or barrels of petroleum supply. Whatever it may be called, it is to me something completely alien to our form of government and our free enterprise system.

As applied to the oil industry, it indicates a desire on the part of many to "punish" the industry for being successful. It does not regard the success of the oil industry as the aggregate success of millions of employees, stockholders and property owners. It seems to disregard the success of the industry in enabling the United States to have the highest per capita consumption of energy in the world.

I believe that our industry is fulfilling its obligation to supply energy for this country at a price which has led to 75 percent reliance upon oil and gas and, concurrent with it, the greatest degree of industrialization of any country in the world.

THE CONSAD REPORT ON THE INFLUENCE OF U.S.
PETROLEUM TAXATION ON THE LEVEL OF RESERVES

SUMMARY

The conclusions of the CONSAD report can be given no credence because:

- I. The mathematical formula (an "economic model") from which the conclusions are drawn is conceptually inappropriate for the purpose.
- II. CONSAD, itself, issues repeated warnings about the pitfalls of its model-building. The combined impact of these cautions is a clear signal that CONSAD should have rejected this model, as it did two other models--and as it did this one for natural gas.
- III. The quality of the data used in the formula is questionable, as is the method of manipulation.
- IV. There are factual errors in the report.
- V. The study proceeds from a number of doubtful premises about the economics of the petroleum industry.

I. Inappropriateness of the CONSAD Formula

The CONSAD study employed mathematical methods to predict the change in petroleum reserves that would result from elimination of percentage depletion. A fundamental error was made by using a formula that cannot answer this question. It was assumed that production would not change in the event of an increase in petroleum taxation, and the formula was designed to determine the level of reserves that would be required to accommodate the assumed fixed level of production.

Once it made the assumption that output is fixed regardless of

profitability, it was inevitable that CONSAD would find that there would be little change in the desired level of reserves, since the required level of reserves is technologically determined by the level of production. It is indisputable, owing to the nature of petroleum deposits, that any given level of production requires a supporting amount of reserves which is a multiple of production -- as CONSAD acknowledges on page 7.3 of the report. (To produce one barrel of oil annually, there must be about ten barrels of supporting reserves in the ground.)

CONSAD actually ignored the real problem, which is how the long-run level of output would change in reaction to a decrease in profitability resulting from increased taxation. Instead, CONSAD indefensibly assumed that the desired level of production is independent of the level of profitability of the industry.

Indeed, the CONSAD model makes no provision for unprofitability (except at a zero price of crude oil). The mathematical model is so formulated that it tells us that the industry would find and develop reserves even if price were less than cost. Any model which states that businessmen desire to invest when price is less than cost is indefensible because no firm desires to invest at a loss.

II. CONSAD Cautions

CONSAD raised such an extended and serious list of objections to its own procedures that the reader should be convinced of the mathematical formula's lack of merit without further independent

inquiry.

The formula was developed for use in describing the behavior of individual firms in manufacturing. CONSAD questioned whether the formula would be reliable if extended to the petroleum industry -- see page 6.31.

CONSAD also questioned whether the historical data employed can be used to predict the future -- see pages 6.12 and 6.13. In the report, it was said that "If the quantity of reserves necessary to support a certain level of output has changed during the period of the study, it will cause errors" in the estimates -- page 6.13. (In fact, the ratio of proved reserves to production actually has declined steadily since 1960.)

CONSAD warns that reliable economic models require reliable data. In addition to the problem of finding reliable figures, it was recognized that there are massive problems in using the data. Perhaps the best example is finding costs, "the most ambiguous area in the data in this study" -- page 6.16. Computing industry finding costs involves multiple difficulties, e.g., (a) the impossibility of determining from industry data when the exploration dollars for a given year's discoveries were actually spent; (b) the difficulty of estimating how much has been found until a number of years after discovery; and (c) the random variability of the amount spent per barrel found from year to year.

III. Statistical Problems

The CONSAD report points out that there are "many missing links" in the quantitative data available for making a reliable economic study -- page B.1. It nevertheless proceeded with the study on the basis of estimated data and often relied on doubtful stand-in data to estimate the effects of important items for which it could not obtain direct information. Moreover, the data were used to predict the effect of a change in industry taxation for which there is no historical precedent. Such an extrapolation beyond the range of historical experience violates fundamental statistical principles.

IV. Incorrect Information

The report contains factually incorrect statements. Some involve data -- even matters as basic as the current level of U. S. crude oil production. Others refer to petroleum tax provisions which do not exist.

If a research company is so unfamiliar with the petroleum industry as to err on basic data and tax provisions, it is unlikely to have sufficient knowledge of the industry to be able to develop accurate complex mathematical models for analyzing industry behavior.

V. Doubtful Petroleum Economics

Some of the premises of the CONSAD study are, in our opinion, based on unreliable assumptions about the economics of the industry. A notable example of these propositions asserts that Canadian crude

reserves can "substitute" for United States reserves. However, the amount of crude oil imports from Canada is limited by agreement between the two governments. Since crude oil imports from Canada are controlled, Canadian reserves -- like overseas reserves -- are not substitutes for U.S. reserves. Thus, CONSAD should not have aggregated Canadian and U.S. reserves in its economic model. And drawing conclusions from this model entailed the error of assuming that changes in the U.S. tax law would have the same effect on Canadian reserves as on domestic reserves.

Conclusion

No useful conclusions can be drawn from the CONSAD study because the mathematical model and the data are defective and because some of the basic premises are not appropriate. Indeed, it was predestined that CONSAD's exercise would be futile because CONSAD assumed that production would not change in the event of an increase in petroleum taxation.

Furthermore, we firmly believe that no aggregative mathematical model of the oil industry -- no matter how sophisticated -- can be used as a guide to estimating the effects of eliminating percentage depletion. Two of the most important reasons for this are:

- (1) Part of the period upon which such a model must be based (the 1950's and 1960's) was one of industry readjustment to excess capacity, a readjustment now well on the way to completion.

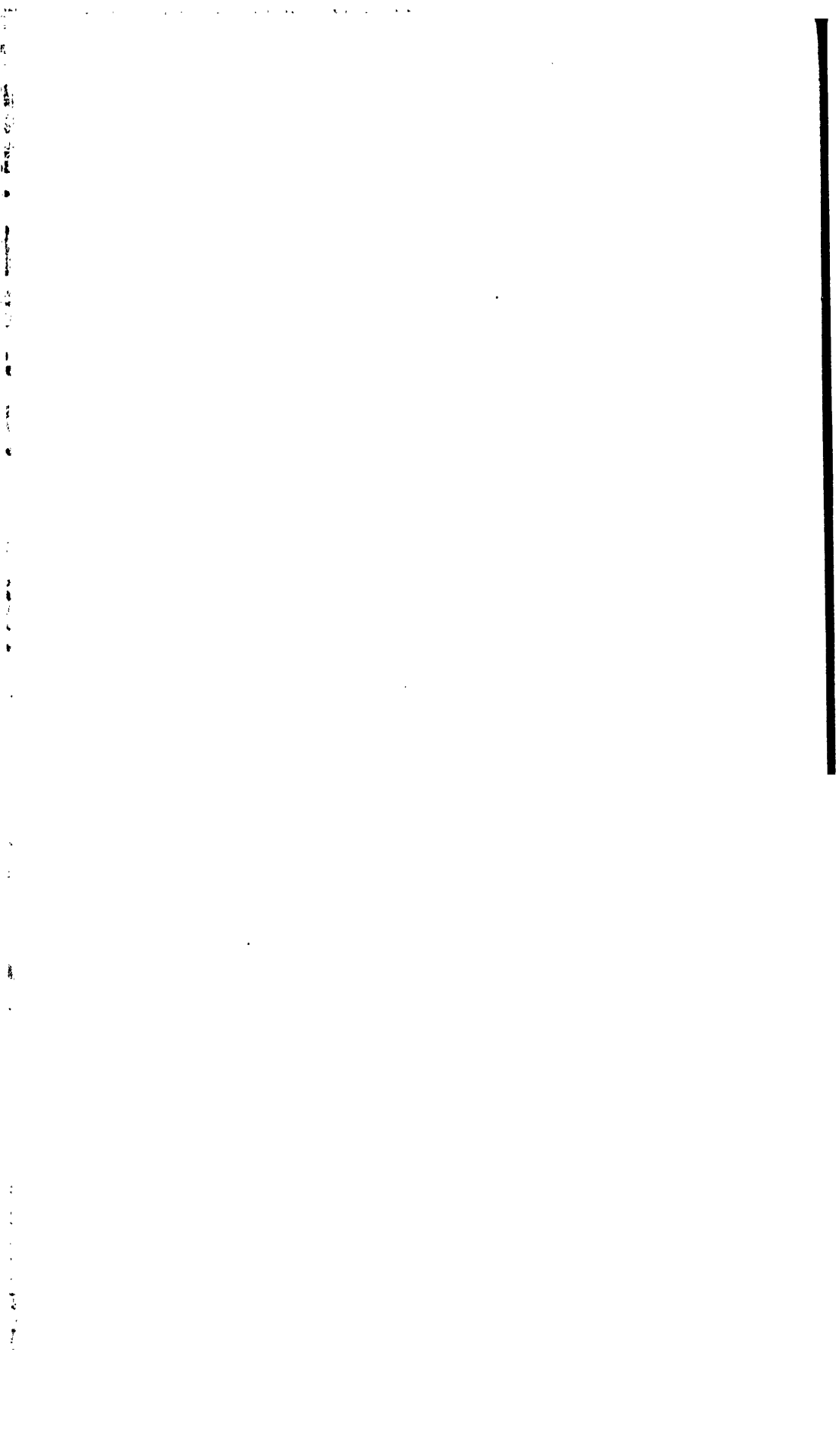
Sound statistical theory holds that projection of a past period assumes that any changes that occurred in the base period will be repeated in the future. Since further significant adjustment to excess capacity is not likely, the 1950's and 1960's cannot be used as a base period for forecasting the future.

- (2) The largest year-to-year crude oil price change since 1950 was +30¢ per barrel (1956 to 1957). Elimination of percentage depletion would be equivalent to a price reduction of about 75¢ per barrel. Thus, any prediction of the results of such a tax change based on a model reflecting the 1950's and 1960's would require extrapolation far beyond the limits of the base period data.

Sound statistical theory holds that such extrapolation is invalid because there is simply no historical basis for evaluating how firms would react to changes so far beyond the range of experience.

CONSAD admitted the existence of these problems, but it proceeded undeterred.

Our criticism is not so much that CONSAD's exercise predictably proved futile, as that CONSAD drew serious public policy conclusions from its mathematical model despite the obvious and admitted statistical problems involved in constructing any such model. The model used is especially subject to criticism because it is based on the improper assumption that industry exploration and development expenditures are not dependent on an adequate rate of return.



STATEMENT

BY

**H. A. TRUE, JR., TRUE OIL COMPANY
CASPER, WYOMING**

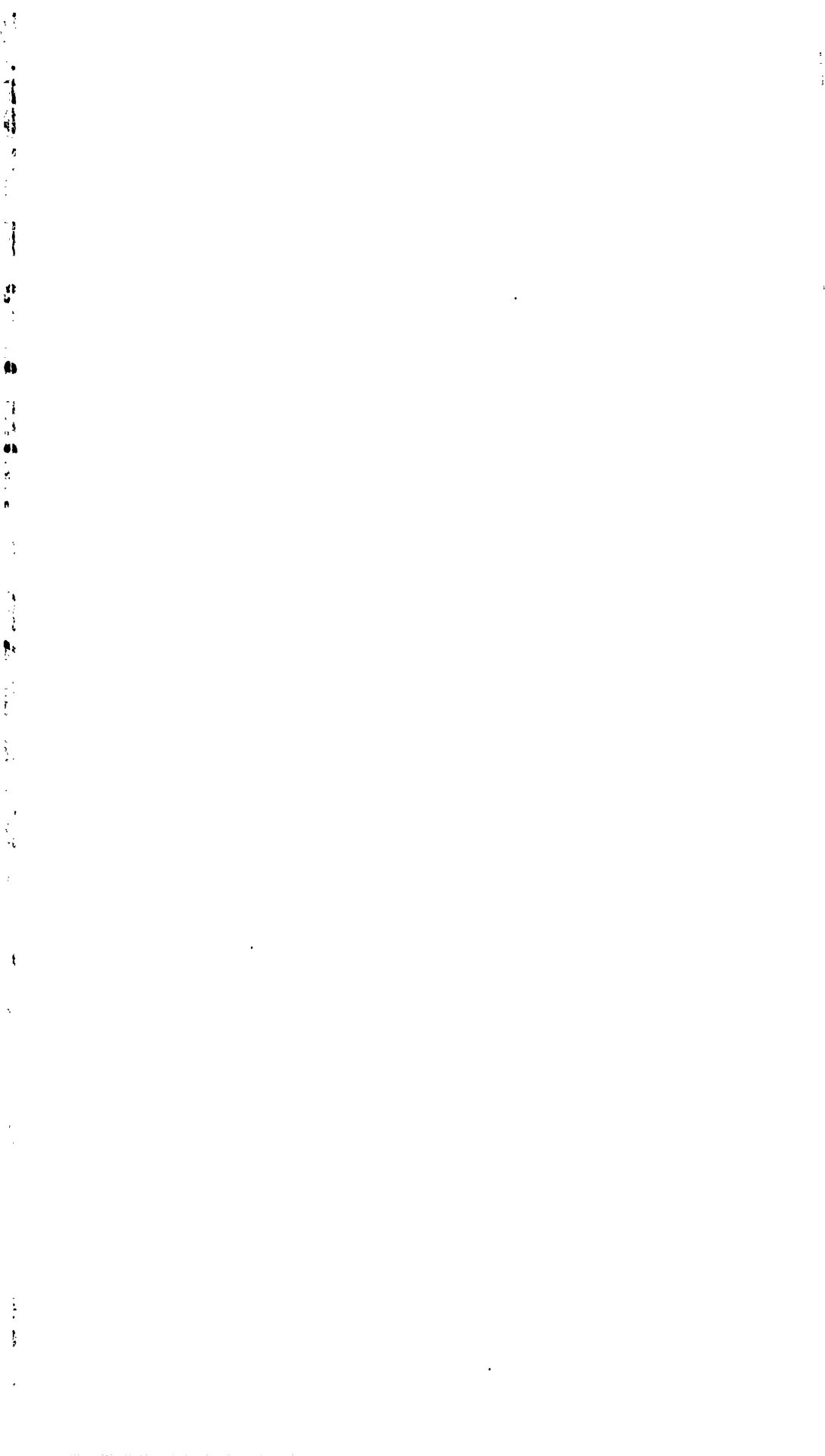
ON BEHALF OF THE

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

BEFORE THE

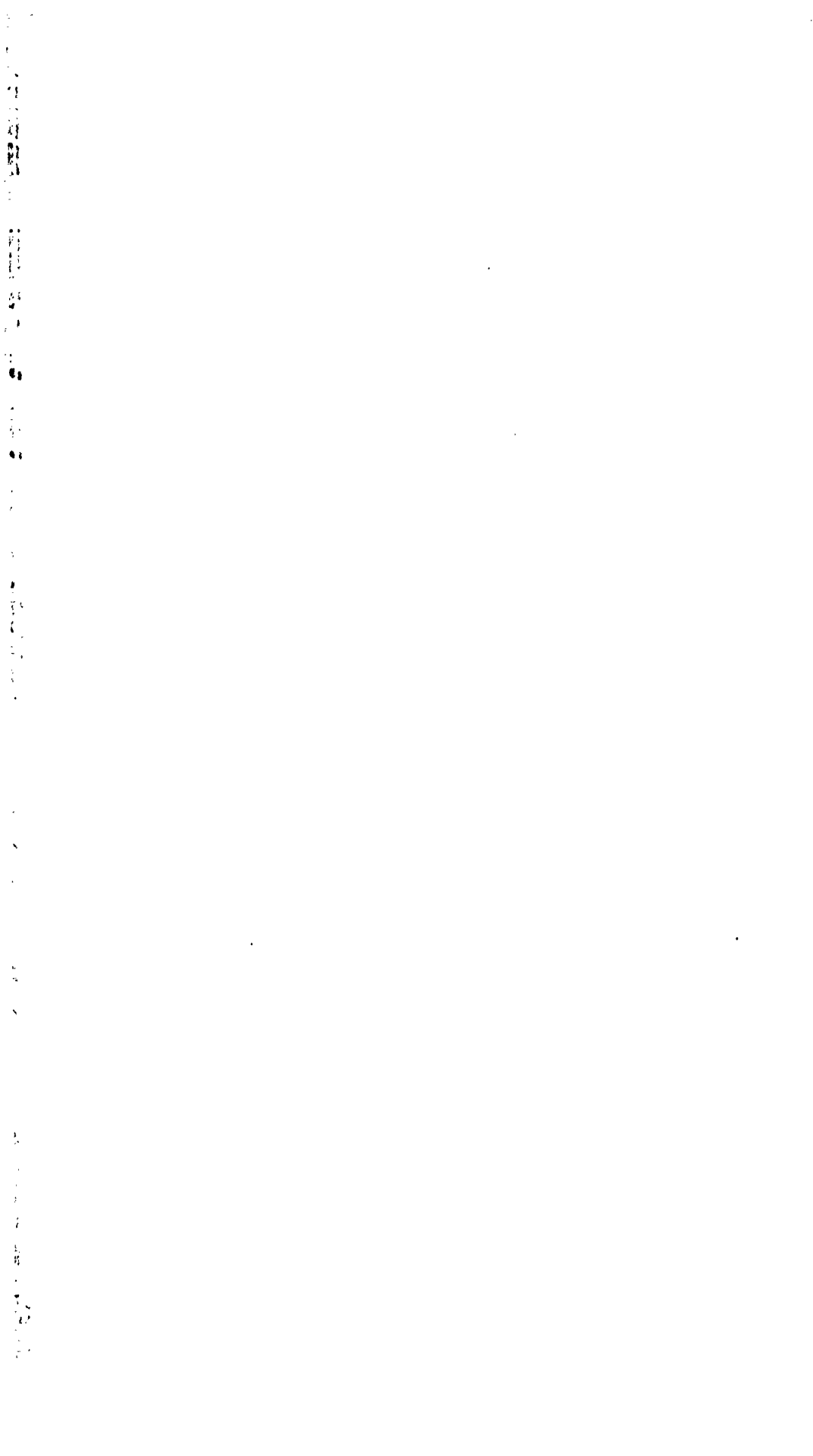
**COMMITTEE ON FINANCE
UNITED STATES SENATE**

OCTOBER 1, 1969



SUMMARY OF STATEMENT BY H. A. TRUE, JR.

1. A healthy, expanding domestic industry has provided the assurance of adequate supplies of both oil and natural gas, and this would be the best assurance for the future.
2. The efficiency of the domestic industry has provided petroleum energy (the producer's average price of both oil and natural gas combined) at a cost of less than \$1.90 per barrel as compared with over \$2.00 per barrel for imported oil.
3. The domestic industry's activities in searching for and developing U. S. petroleum resources have declined to inadequate levels, imperiling the Nation's economic progress and future security. Assurance of adequate oil and gas supplies to meet future requirements requires much more - not less - domestic exploration and drilling.
4. Proposed changes in petroleum tax provisions would decrease substantially the funds available for exploration and drilling, and sharply reduce the incentive to invest capital in this high-risk business.
5. If proposed tax changes were approved, total expenditures for U. S. exploration and development would decline to only \$2.4 billion by 1980, compared with a required expenditure of \$8.3 billion - a deficiency of \$5.9 billion yearly or more than 70 percent.
6. These tax changes would have a devastating effect on independent producers, many if not most of whom would be forced to liquidate their properties and discontinue exploration and drilling. Competition and the multiplicity of effort that has been a key factor in discovery of new reserves would be seriously lessened.
7. The resulting 1980 deficiency in U. S. crude oil production would result in the U. S. being dependent on foreign sources for over 50 percent of the Nation's requirements - an intolerable situation from the standpoint of national security.
8. The search for new reserves of oil and natural gas is interrelated and inseparable. Natural gas is already in short supply and the proposed changes in tax provisions would aggravate and intensify the existing critical situation as to gas supplies.
9. To offset the effect of proposed tax changes and assure adequate supplies of both oil and gas, the alternative would be increased prices that would cost the consuming public in the order of \$10 billion yearly by 1980.
10. Governmental decisions as to federal tax provisions and import policies will determine whether the historical position of U. S. self-sufficiency in indispensable petroleum supplies will be preserved; or whether the U. S. will embark on a course knowingly leading to insufficiency and dangerous dependency on foreign sources.



STATEMENT BY H. A. TRUE, JR.
on Behalf of the
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
Before the
SENATE COMMITTEE ON FINANCE
October 1, 1969

My name is H. A. True, Jr., and I am an independent producer, operating the True Oil Company, a partnership in Casper, Wyoming. I am a former President of the Independent Petroleum Association of America, and my testimony is presented on behalf of that Association.

The IPAA is composed of some 5,000 members whose business interests are primarily, and in most cases, exclusively, the domestic petroleum producing industry throughout the 32 producing states of this Nation. I appear before your Committee, therefore, to discuss proposed tax changes and their effect on the domestic industry in general, and the independent producer in particular.

Consideration of this matter should be predicated on the following fundamental premises:

- (1) Adequate and steadily increasing supplies of both oil and natural gas, from assured sources, are indispensable in meeting the needs of the consuming public, the country's economic progress and the survival of not only the United States but also the Free World.
- (2) A healthy, expanding domestic industry has provided the assurance that adequate supplies are available in both peacetime and times of emergency; and must continue to do so in the future.

Existing tax provisions and other sound governmental policies, such as the Mandatory Oil Import Program, have served the public interest well. The domestic

industry has supplied sufficient petroleum at relatively low prices to meet consumer peacetime requirements; to fuel two World Wars; to block aggression in several lesser wars; and to prevent wars that might have exploded during such times as the 1956-57 Suez Crisis and the 1967 Middle East dispute.

For the foreseeable future, there is no practical, dependable or economic alternative to an expanding domestic industry. The life of our country could not tolerate the denial of petroleum energy any more than the lives of our citizens could survive the denial of food.

Trends in recent years, unfortunately, imperil the Nation's strength as to oil and gas supplies. These changing conditions are set forth in the memorandum attached to my testimony. These facts must be taken into account in considering petroleum tax provisions. They show that the industry's activities in searching for and developing the petroleum resources of the United States have declined to inadequate levels.

These trends are reason for concern, but not pessimism. They can and must be reversed in order to assure adequate U. S. petroleum supplies. A healthy economic climate, in which adequate incentives exist for vigorous and expanding petroleum exploration and development, can and must be restored. During the past two years, there has been some upturn in the industry and, under sound governmental policies, domestic producers can and will continue to supply the oil and gas requirements of this Nation.

However, we are now at the cross roads. The Congress is considering major changes of the industry's tax treatment and the Executive Branch of government is currently making an extensive study of the Mandatory Oil Import Program. Decisions with respect to both of these matters will determine, to a very large degree, whether our nation will continue to be self-sufficient in petroleum. Or whether, for the

first time in our history, we will knowingly embark on a course leading to a position of insufficiency and greater dependency on foreign sources.

Proposed Tax Changes

Petroleum tax provisions should be looked upon first as a resource policy and secondarily as a tax issue. We have, therefore, made an evaluation of the long-range impacts of proposed changes in tax policy on the development of domestic petroleum resources, in the hope that such an analysis will be helpful to your deliberations.

Certain tax proposals (such as extension of the surtax, repeal of the investment tax credit, and the change in the treatment of capital gains) would adversely affect all businesses, including the petroleum industry. Additional proposed changes in federal tax provisions directly affecting U. S. oil and gas supplies include:

- (1) The changes incorporated in the "Tax Reform Act of 1969," as passed by the House: the reduction in percentage depletion from 27½ to 20 percent which would reduce substantially the funds and incentives for the entire industry; the treatment of production payments as loans which would have the practical effect of eliminating the use of this method of financing for independent producers; and the allocation of deductions which could make percentage depletion and intangible drilling cost deductions less effective for individuals.
- (2) The additional changes recommended to your Committee by the Treasury Department: the further reduction in percentage depletion for individual operators by inclusion of depletion

as a "tax preference"; the limitation on expensing of intangible, or non-recoverable, expenditures by inclusion as a "tax preference" for individual operators that obtain less than 60 percent of gross income from "the sale of oil and gas"; and the taxation as ordinary income, under a "recapture rule," on the sale of oil or gas properties to the extent of intangible drilling costs previously deducted. Individual, independent producers would bear the primary and damaging burden of these changes.

The above tax changes would substantially decrease the funds actually available for domestic exploration and development. In addition, and perhaps of equal or greater significance, these tax changes unquestionably would have the psychological effect of further substantial reductions in the incentive to invest capital in the high-risk business of oil and gas exploration. I am convinced that the mere consideration of these changes has already had the psychological effect of discouraging investments. In my own case, their adoption would put me out of the business of exploration and development.

Including depletion and/or intangible expenses in any "Limitation on Tax Preferences" (LTP) would have a crippling impact on the operations of independent producers. For example, we made a study of the effects of the Treasury Department's LTP proposals to the House Ways and Means Committee, covering the operations of 56 independent producers. This study revealed that the proposed tax change would have had the effect of reducing the drilling expenditures of these producers by 75 percent. The resulting loss in oil and gas supplies would far outweigh any temporary gains in tax revenues.

The LTP proposal, the allocation of deductions, or any other form of the minimum tax concept, should not treat "Intangible Drilling Costs" (IDC) as a "preference." Intangible drilling costs are ordinary business expenses, paid in cash by the oil producer. The current expensing of IDC, does not permit a taxpayer to conclude the year with untaxed funds on hand. To the contrary, it merely permits the taxpayer to make a deduction for money actually spent - not income. It is entirely inappropriate, therefore, to include this item in any type of minimum tax proposal.

Likewise, with respect to depletion, it is submitted that it is also inappropriate for this item to be included in the LTP proposal or any other minimum tax proposal. Percentage depletion cannot exceed 50 percent of net income from any property. The present law, therefore, already has embedded within it the minimum tax concept.

In addition to the tax changes approved by the House and recommended to your Committee by the Treasury Department, there are other proposals which are of great concern to the domestic petroleum industry. These include a graduated scale for depletion based on the amount of gross income; a limitation on depletion based on the amount "plowed-back" into exploration and development; and a requirement that intangible drilling costs be capitalized and written off over a period of years. Each of these proposals would have serious adverse impacts on U. S. oil and gas supplies, and would compound the unhealthy effects of the other proposed changes.

It should be recognized that the changes in tax provisions affecting U. S. oil and gas production, now being considered by your Committee, are in conflict with the recently-announced national security position of the Department of Defense that "U. S. domestic petroleum capability must be available to meet military needs in case normal foreign sources are denied." (underscoring added)

They are in conflict with the statements by the Interior Department and the Federal Power Commission that there are already actual shortages of natural gas and a real danger of inadequate U. S. supplies of oil.

They prejudge the findings of a study now in progress by a special Cabinet Task Force which has not yet determined our security needs as to oil supplies.

They are in conflict with the interests of the consuming public because the inevitable result would be less oil and gas, or higher prices, or both.

They are in conflict with the welfare of thousands of communities in 32 producing states, whose tax revenues and economic structure are dependent on oil and gas production.

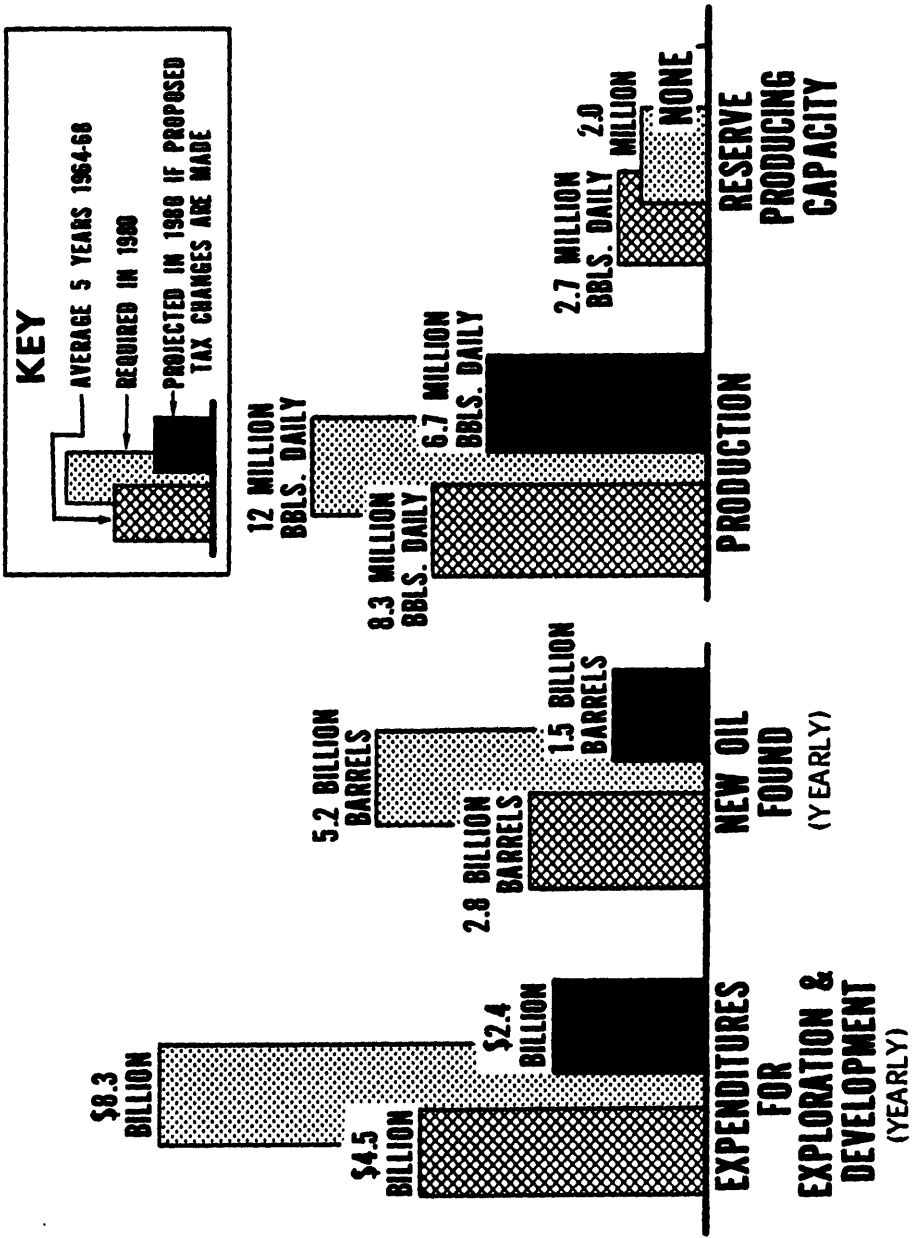
National security, economic progress and the interests of U. S. consumers would be served best by rejecting all proposed adverse changes in oil and gas tax provisions.

Effect of Tax Proposals on Future U. S. Crude Oil Supply

In assessing the effect of the House-approved and Treasury-proposed tax changes on domestic crude oil supplies, we have used the findings of a comprehensive study submitted by the IPAA on July 15, 1969, to the Cabinet Task Force on Oil Import Control. That study showed that total U. S. requirements for petroleum liquids would increase from an average of 12,100,000 barrels daily during the past five years to 18,200,000 barrels per day in 1980, an increase of 50 percent. Imports of foreign oil now supply more than one-fifth of total U. S. oil consumption. To assure adequate domestic supplies, without dangerous increased dependency on foreign sources, the IPAA estimates of oil supplies in 1980 are as follows:

	<u>1980 Supply (barrels daily)</u>
U. S. crude oil production	12,000,000
U. S. natural gas liquid production	2,500,000
Imports of crude and products	<u>3,700,000</u>
Total Required Supply	<u>18,200,000</u>

U. S. CRUDE OIL SUPPLY



This analysis shows that, if these tax provisions were changed, expenditures and supplies would be reduced substantially below current levels, and drastically less than required to provide assurance of adequate supplies to meet the needs of the consuming public, economic growth and national security. A few comments on these figures are in order.

First, total expenditures for U. S. exploration and development would decline by about \$2 billion or 47 percent from the level of the past five years. Expenditures in 1980 would total only \$2.4 billion, compared with a required expenditure of \$8.3 billion; a deficiency of \$5.9 billion or more than 70 percent.

Second, and not shown on the table or chart, it is significant to note that, during the latest five year period 1964 through 1968, exploration and development expenditures by independent producers averaged \$1.3 billion annually, or about 30 percent of the \$4.5 billion expended by the domestic industry. Expenditures by independent producers in 1980 are estimated at less than \$500 million, a decrease of 70 percent from the average expenditures during the last five years - a far greater decline than the 47 percent decrease in total industry expenditures. This results from the fact, which should be re-emphasized, that the primary impact of the tax proposals would be on independent producers.

Many, if not most, independent producers would be forced to liquidate their properties and discontinue exploration and development activities. Competition in the domestic producing industry, and the multiplicity of effort that has been a key factor in the discovery of new reserves, would be seriously reduced.

Third, the 1980 deficiency in crude oil production of 5,300,000 barrels daily would have to be imported. Under these conditions, imports would supply about 50 percent of total U. S. oil requirements, with no U. S. reserve producing capacity.

This would be an intolerable situation from the standpoint of both national security and the maintenance of peace in the Free World. Russia would be the only major world power in a position of self-sufficiency as to essential petroleum supplies. The United States would have lost its posture of strength in petroleum, and would become subject to the political pressures and demands of producing countries in the Eastern Hemisphere.

In this connection, the September 8, 1969 editorial in The Financial Times of London, England is highly pertinent. That editorial deals with the change in government in Libya and includes the following conclusions:

"The oil has also continued to flow. It is to be hoped that this state of affairs continues. However, the coup has once again demonstrated the fundamental instability and political unreliability of the countries on which Britain and most of the rest of the industrialised world, apart from the U. S., depend for their oil." (underlining added)

"Security of supply should be given a higher priority than cheapness. In the short run this means that no one country should be allowed to secure a dominant position among Britain's suppliers. In the longer run it may mean that if relatively expensive oil is discovered either in Europe's offshore water or elsewhere -- the Canadian Arctic, for instance -- in a politically secure country, it should be exploited to our advantage if at all possible, even if it is more expensive than oil from the Middle East and North Africa."

This statement is evidence of the fact that all industrialized foreign countries, including Russia, are directing their policies toward greater assurance of access to essential petroleum supplies. It would be ironic and tragic, indeed, if the United States were to adopt policies that would undermine our capacity to produce crude oil and natural gas.

In discussing petroleum policies, natural gas is too often overlooked. Gas accounts for over 50 percent of the total energy supplied by the domestic petroleum industry. The function of finding oil and natural gas is interrelated and generally inseparable. A reduction in exploration means less oil and less gas.

Unfortunately, unrealistic and short-sighted regulation by the Federal Power Commission has already created a gas shortage. The ratio of proved reserves to production has been declining steadily and substantially. Last year, production outstripped additions to reserves for the first time. Large distributors are already informing customers that supplies are inadequate. Recently, the Federal Power Commission Chairman warned that the nation faces a "critical" supply situation, and the F.P.C.'s "overriding priority" is "to resolve the natural gas supply problem on both a short- and long-term basis."

Adverse tax changes would have only one result: aggravation and intensification of the already critical supply situation as to U. S. supplies of natural gas. In this connection, it should be noted that the domestic producer's price of crude oil and natural gas, converting gas to oil equivalent on a Btu basis, averaged \$1.86 per barrel in 1968. This compares with a cost of over \$2.00 per barrel for imported oil. The domestic industry, therefore, provides petroleum energy to the American consumer efficiently and at relatively low prices. Aside from the factor of national security - and the term is used in the broadest sense to include economic and political as well as military security - there would be no saving to the U. S. consumer from the importation of foreign petroleum energy.

The consumer would be the ultimate victim of the proposed tax changes. To offset these tax changes and assure adequate domestic supplies of both oil and gas,

the alternative would be increased prices. The cost to the consuming public could be in the order of \$10 billion yearly by 1980.

Other Effects of Proposed Tax Changes on U. S. Economy

The projected decreases in U. S. expenditures for oil and gas exploration and development and the resulting decreases in U. S. petroleum reserves and production, have far-reaching implications extending throughout the U. S. economy. Some of the more important of these include:

- (1) Losses in local and state production taxes
- (2) Losses in royalties to Federal and State governments and private landowners
- (3) Losses in wages to employees in the domestic producing industry
- (4) Losses in income to manufacturers, suppliers, servicing companies and other allied businesses
- (5) Losses in federal income taxes from the above reductions in activity

These losses would aggregate several billion dollars annually. In addition, the increase in imports by 1980 would result in an additional outflow of dollars amounting to over \$5 billion annually, thereby seriously aggravating our balance of payments problem.

Conclusions

In conclusion, your Committee is respectfully urged to consider the following:

- A. The assurance of adequate U. S. supplies of oil and natural gas requires much more - not less - exploration and drilling by the domestic producing industry.

- B. The encouragement and effectiveness of national petroleum policies, particularly federal tax provisions and the Mandatory Oil Import Program, should be improved - not weakened.
- C. Under sound national policies, the consumer has enjoyed the benefits of the domestic industry's established record of efficient performance, as evidenced by the fact that the price of U. S. petroleum energy (the average producer's price of crude oil and natural gas combined) is less than the cost of imported oil.
- D. Unless prices were increased very substantially, proposed tax changes would result in greatly reduced U. S. oil and gas exploration, development, production, reserves and producing capacity. Resulting dependency on foreign sources would increase to intolerable and dangerous levels, with no reserve domestic capabilities.
- E. The independent producer, who has played a vital role in discovering new domestic oil and gas supplies, would become a negligible factor in the U. S. producing industry's operations.

The Nation's posture as to petroleum supplies is at a cross roads. Governmental decisions as to tax provisions and import policies will determine whether the historical position of self-sufficiency will be preserved; or whether we pursue a course leading to insufficiency and dependency on unreliable foreign sources of supply.

MEMORANDUM ON TRENDS IN U. S. PETROLEUM PRODUCING INDUSTRY

(Supplement to Statement by H. A. True, Jr.
on behalf of the Independent Petroleum Association
of America before the Senate Committee on Finance
October 1, 1969)

The purpose of this memorandum is to present briefly certain facts, relating to economic conditions in the U. S. petroleum producing industry, that should be considered in reviewing national tax policies as to oil and gas.

Trends in recent years, unfortunately, imperil the Nation's strength as to oil and gas supplies. It is these changing conditions that should be taken into account in considering petroleum tax provisions. The changes in economic conditions are summarized in the form of graphic charts. The charts picture trends in the domestic producing industry since 1956. The industry's activities in searching for and developing the petroleum resources of the United States reached a peak in 1956. The subsequent years have been characterized by:

1. A sharp decline in the search for new U. S. reserves
2. A substantial drop in total drilling activity and employment
3. A steady deterioration in economic conditions affecting domestic producers
4. A weakening of our security posture as to U. S. oil supplies to meet emergencies in the future.

These trends are reason for concern, but not pessimism. They can and must be reversed in order to assure adequate U. S. petroleum supplies. A healthy economic climate, in which adequate incentives will exist for vigorous and expanding petroleum exploration and development, can and must be restored. Under sound governmental policies and favorable economic conditions, domestic producers can and will continue to supply the oil and gas requirements of this Nation.

DECLINING SEARCH FOR U. S. OIL AND GAS RESERVES

The discovery of new reserves, to replace those being consumed, is the foremost and all-important function of the producing industry. Development wells, pipelines, refineries and distribution facilities depend on sufficient new petroleum discoveries to meet increasing requirements.

First Chart

The three sections of the first chart portray essential elements in the search for new reserves: first, the scientific techniques used as guides to possible future producing provinces (as indicated on the chart by the activity of geophysical crews); second, the leasing of acreage not yet productive; and third, the final drilling of wildcat tests, which is the only known method of actually determining whether or not a productive deposit of oil or gas exists.

Obviously, there has been a persistent and sizeable decline in all these exploratory activities which has been offset, but only in part, by advances in scientific and technological methods and increased expenditures in such new high-cost provinces as the continental shelf.

Geophysical work, expressed in terms of crew months, has dropped from 7,846 in 1956 to 3,479 in 1967 (the latest year for which data are available). This is a decline of more than 50 percent.

The decrease in advance scientific testing has been followed by a 22 percent decrease in the total non-productive acres under lease in the United States. Almost 80,000,000 fewer acres were under lease in 1968 as compared with 1956.

The effect of declining geophysical activity and reduced leasing are shown in the third section of the chart. The number of wildcat tests drilled in the United States fell from over 8,700 in 1956 to 5,200 in 1968, a drastic reduction of 40 percent.

The search for new reserves — declining

149

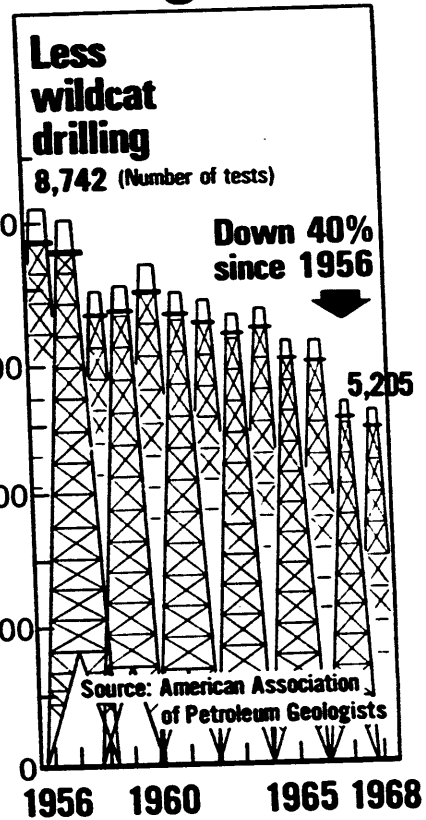
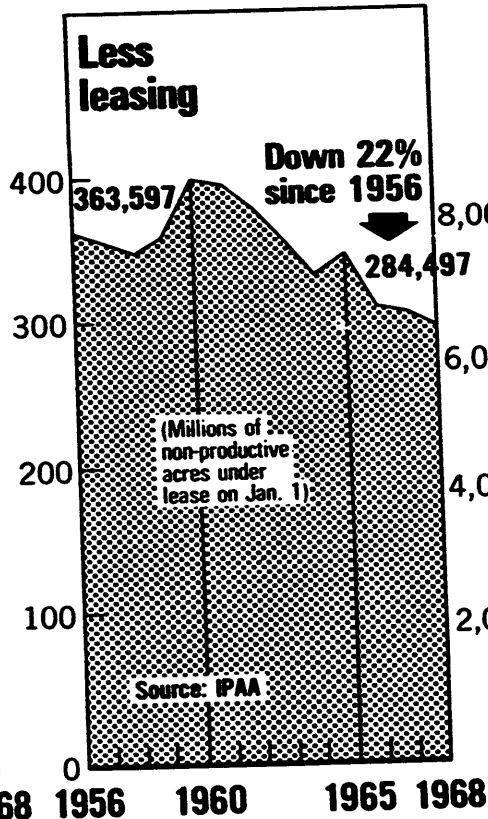
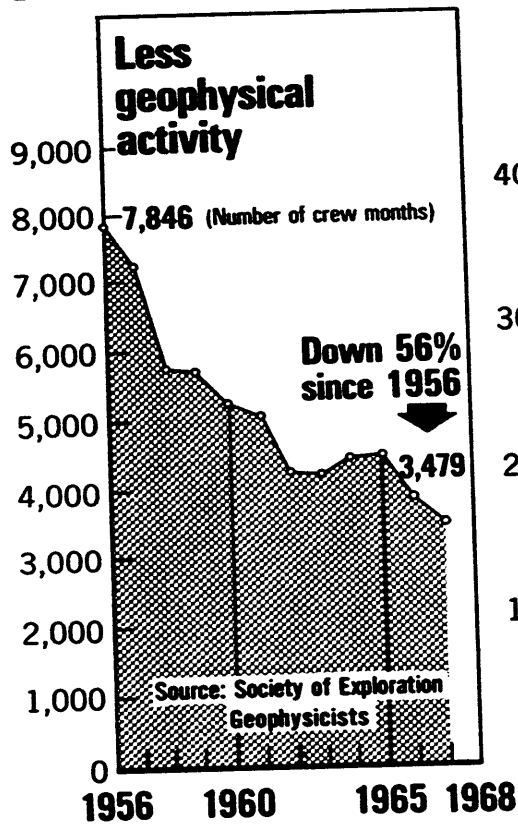


Exhibit IV

**55 billion
barrels
required
gross
additions
to liquid
hydrocarbon
reserves
during the
1970's**

06

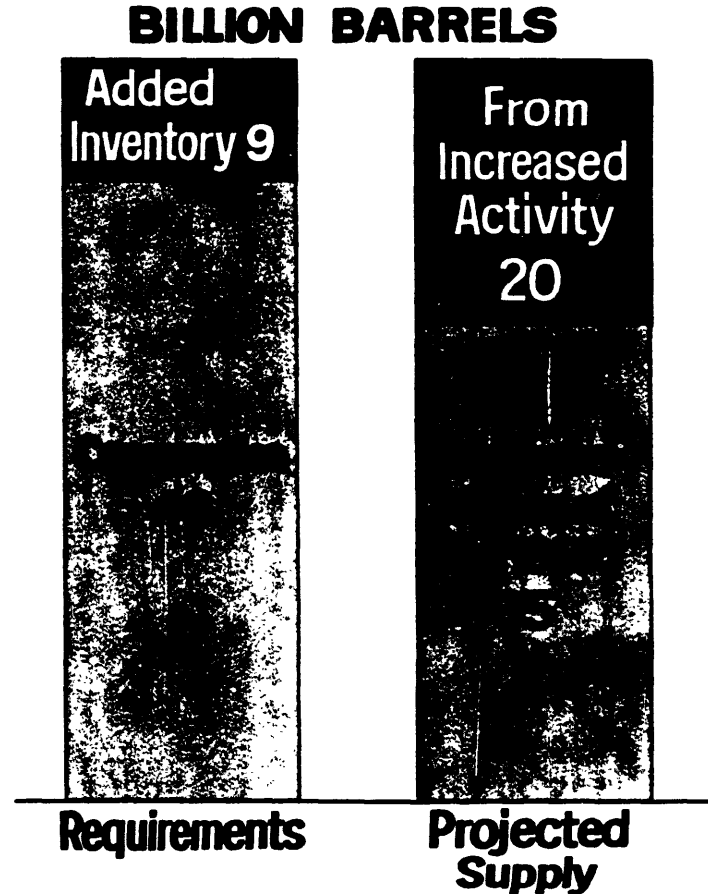
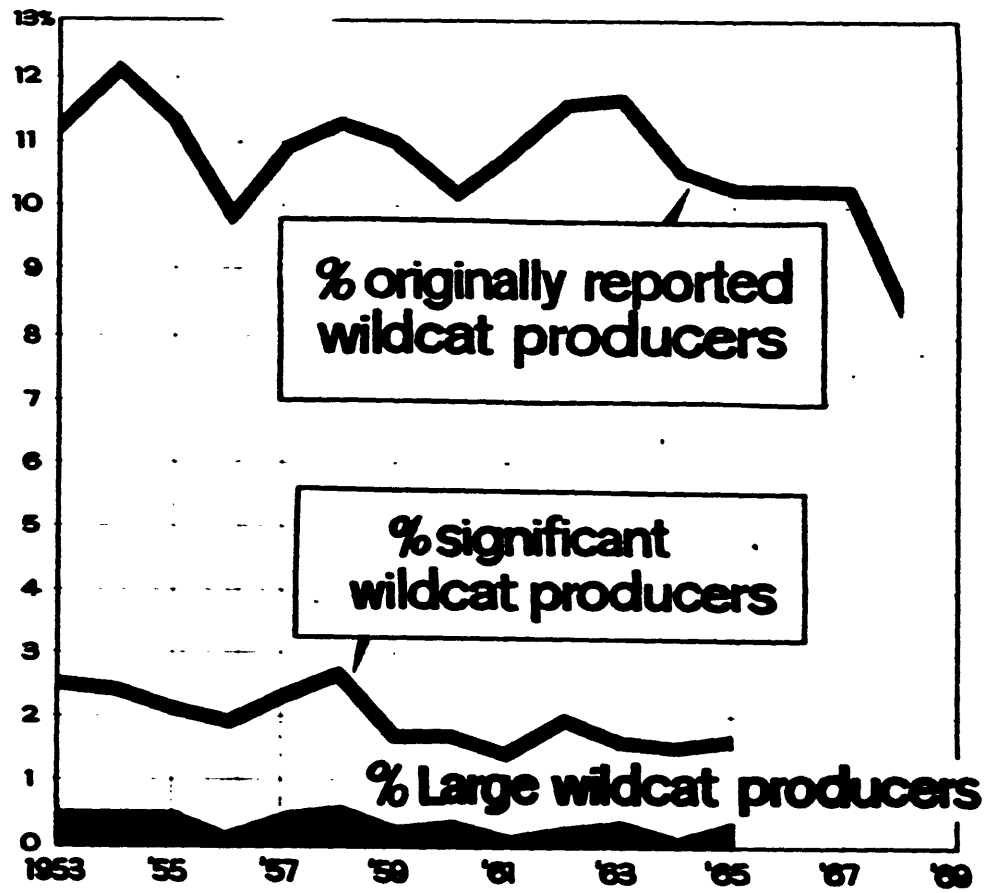


Exhibit I

Productive fields per wildcat well drilled 1953-68

103



Source AAPG (see appendix A)

Exhibit II

Deductions disallowed if intangible drilling costs are capitalized

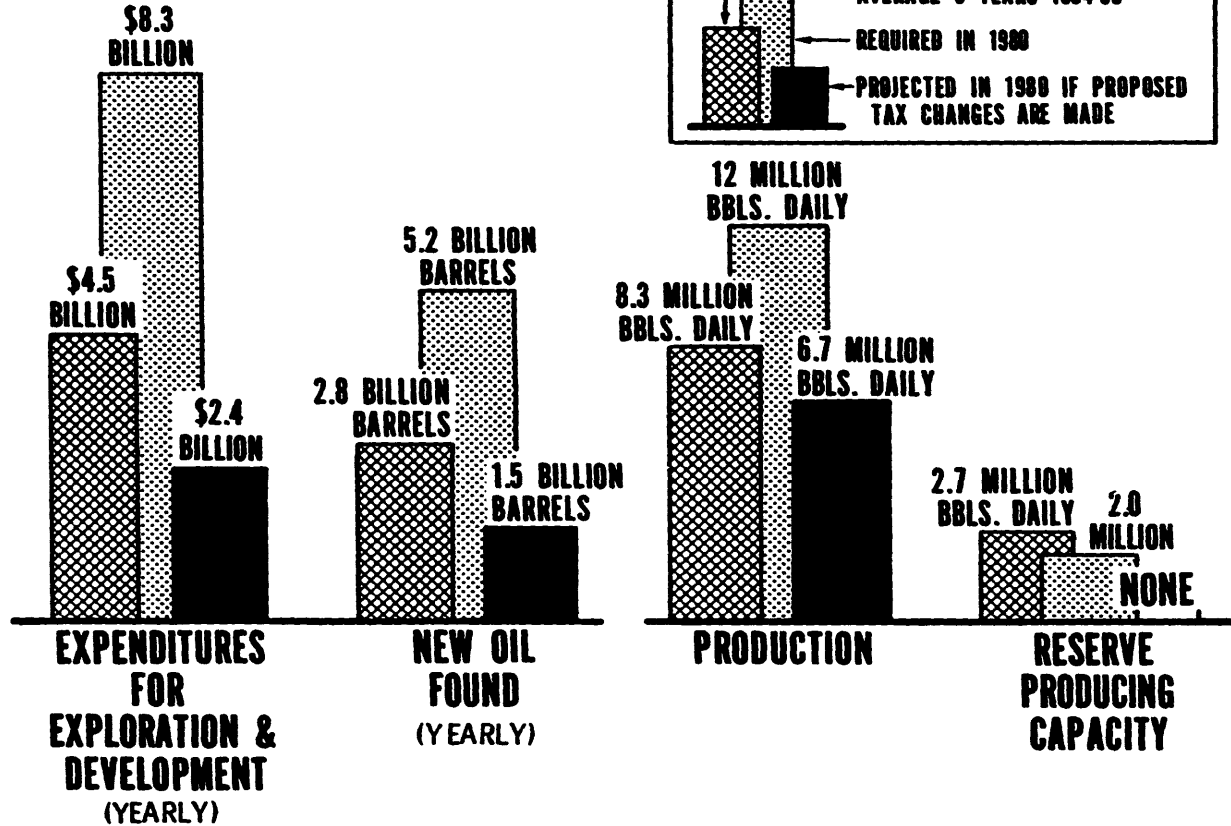
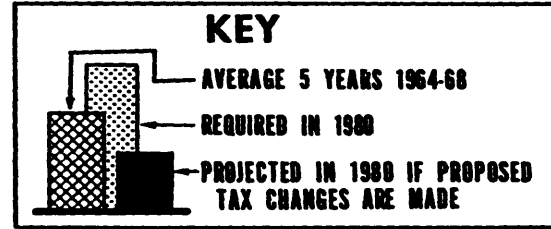
120



ASSUMPTIONS: 1. Annual Expenditures of \$1 million
2. Capitalization Beginning in 4th year
3. Amortization over Five years

U. S. CRUDE OIL SUPPLY

141



DECLINING ACTIVITY IN DOMESTIC PRODUCING INDUSTRY

The deteriorating economic conditions responsible for the declining search for new reserves have also been a factor in the shrinkage in the overall activities of the domestic producing industry, as pictured on the next chart.

Second Chart

The total number of active rotary drilling rigs has been more than cut in half - from 2,600 in 1956 to less than 1,200 in 1968. These figures tell only a part of the story. More important than the statistics, equipment has been cannibalized and highly trained employees have left the industry for better opportunities. Today, there is a very critical manpower shortage in the drilling segment of the industry. It is real, and it must be corrected.

The decrease in active rotary rigs has been accompanied by fewer total wells drilled - a drop of more than 25,000 wells, or over 40 percent since 1956.

Reference has already been made to the critical manpower shortage in trained employees operating drilling rigs. For the producing industry as a whole, total employment has suffered a decrease of more than 60,000 workers, or almost 20 percent since 1956.

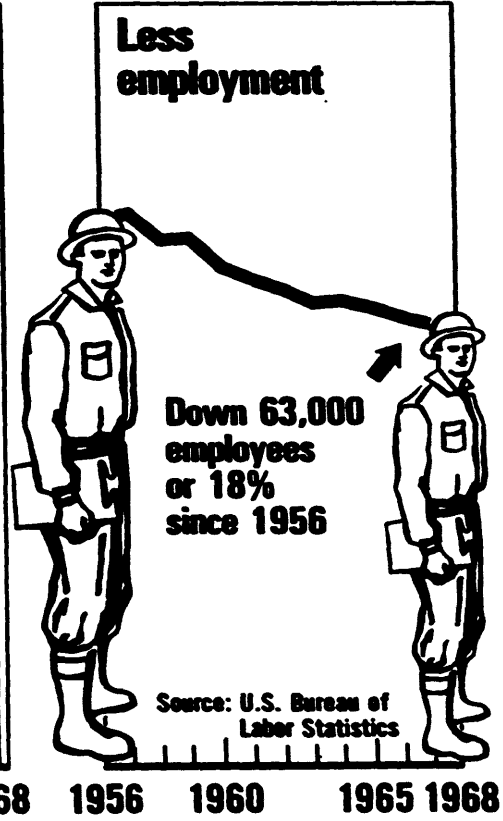
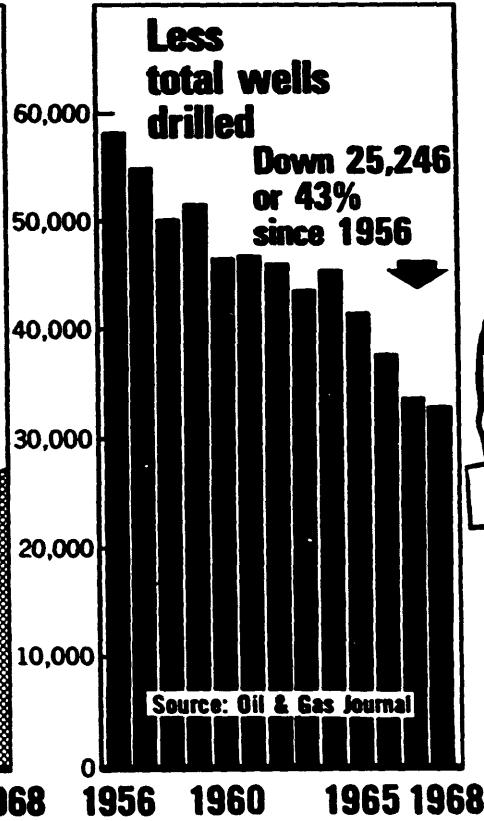
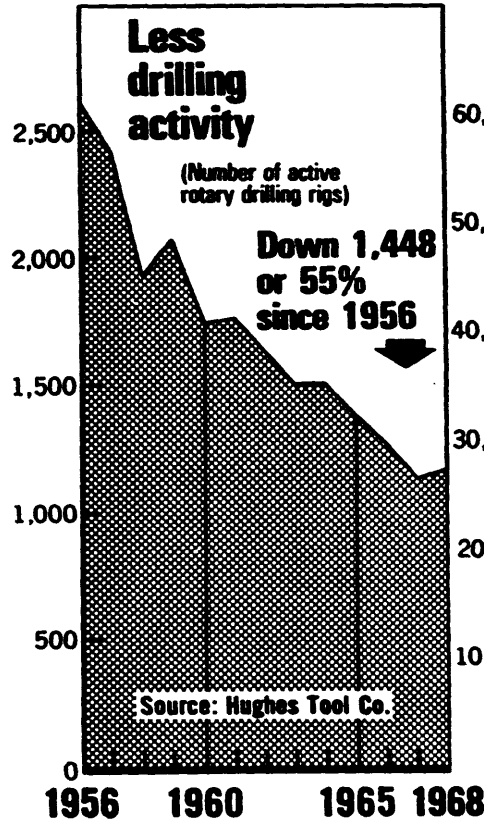
It should be recognized that part of these decreases can be attributed to wider well spacing and increased efficiencies in all phases of drilling and producing operations.

DECLINING INCENTIVES FOR DOMESTIC PRODUCERS

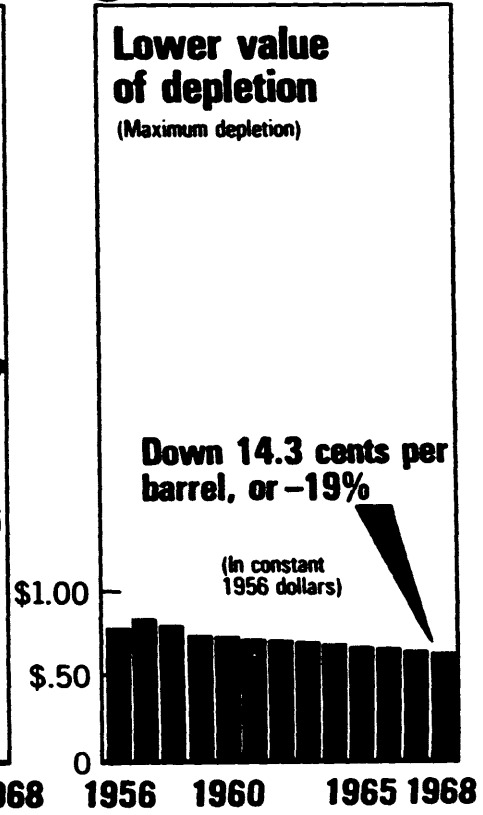
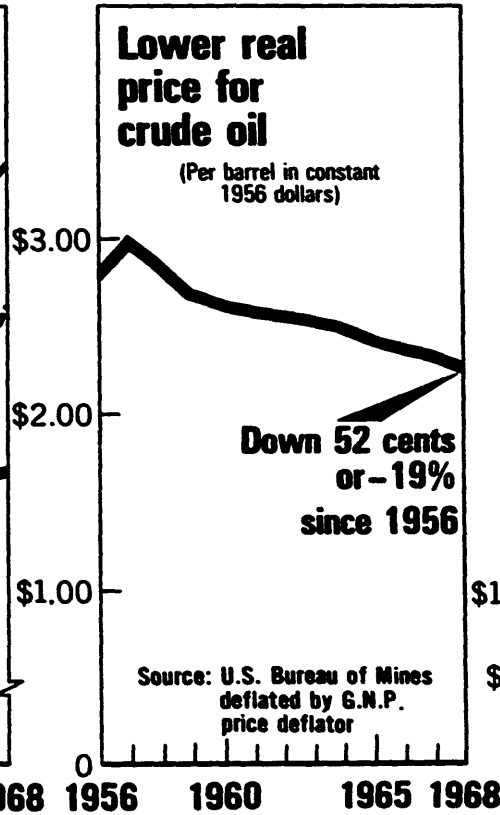
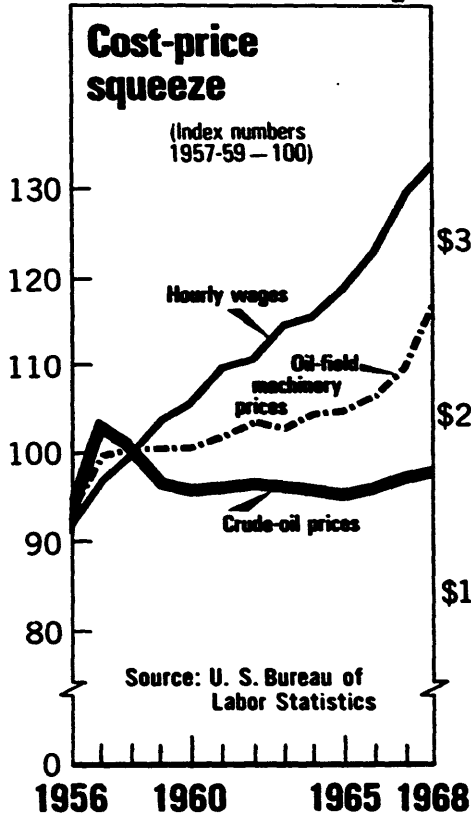
Third Chart

The declining search for U. S. oil and gas reserves and the declining overall activities of the domestic producing industry, set forth in the first two charts, can be attributed to decreasing attractiveness of capital investments in these unusually high-risk ventures. To re-emphasize the degree of risk, only 2

Domestic producing activity — declining



Incentives for producers — declining



out of every 100 new field wildcats drilled are likely to find a field large enough to be profitable.

The industry has been caught in a closing vise known as the cost-price squeeze. Since the base period 1957-59, used by the Government in measuring price and cost trends, hourly wages in the industry have increased by more than 30 percent. The cost of oil field machinery has risen by over 15 percent. The average cost of drilling and equipping new wells (not shown on the chart) increased by almost 20 percent in the short period from 1964 to 1967. Inexorably the search for and development of new reserves grows deeper, more difficult and more costly - despite technological advances that have moderated, but not offset these increased costs.

In contrast, the price of crude oil has remained below the 1957-59 level. The average price in 1968 was 2 percent less than the 1957-59 price, as compared with the above-mentioned increases in costs and an increase of 8.7 percent in the level of wholesale prices for all commodities.

The result of the cost-price squeeze and the inroads of inflation are demonstrated by the center section of the chart which shows the trend of crude oil prices in constant 1956 dollars. In terms of real purchasing power, the producer has lost 52 cents per barrel since 1956, or almost 20 cents out of every dollar.

The relatively low prices for crude oil have a double-barrel effect. In addition to the cost-price squeeze, the decline in the real price for crude oil results in a lessening in the value and effectiveness of percentage depletion.

Maximum depletion at 27-1/2 percent has declined by 14.3 cents per barrel, or 19 percent, in constant dollars since 1956. Not only, therefore, has the price of crude oil become increasingly inadequate in relation to replacement costs, but also the depletion provision has become correspondingly less adequate as a measure of the capital value of the crude oil being depleted. A maximum percentage depletion rate

of 34 percent in 1968 would have been required to prevent the loss in the real value of maximum depletion since 1956. Today, many producers find it more advantageous to sell properties under the capital gains treatment, rather than to continue to operate.

To sum up the situation as to incentives for petroleum exploration and development in the United States, there is an obvious need for more - not less - economic stimuli. A comprehensive study by the National Petroleum Council (the official industry advisory group to the Government, appointed by the Secretary of the Interior) concluded that declining U. S. exploration and development could be attributed to "decreasing profit prospects for new investments."

Further declines in economic incentives and further decreases in prospective profitability for new investments would result from any adverse change in petroleum tax provisions. The adverse change that would have the greatest immediate and disruptive effect on drilling, particularly for independent producers, would be any lessening in the effectiveness of the present treatment of intangible drilling expenses.

DECLINING SECURITY IN U. S. OIL SUPPLIES

The foregoing discussion has dealt briefly with deteriorating conditions in the domestic petroleum producing industry. The resulting threat to national security is illustrated by the next and final chart.

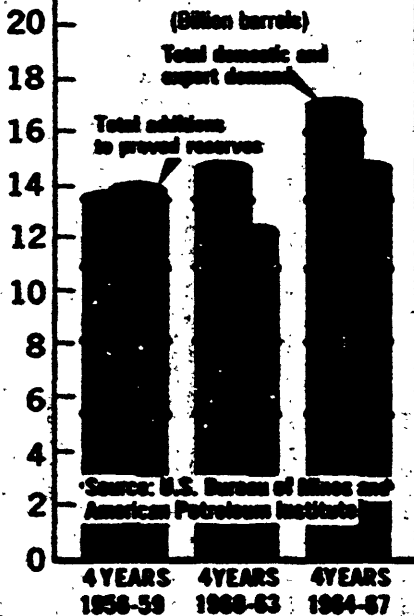
Fourth Chart

Total additions to U. S. proved reserves of liquid hydrocarbons have been falling progressively behind our national requirements for petroleum products. In the four year period 1956-59, additions to reserves were larger than total U. S. consumption. In the latest four year period, total consumption had out-run additions

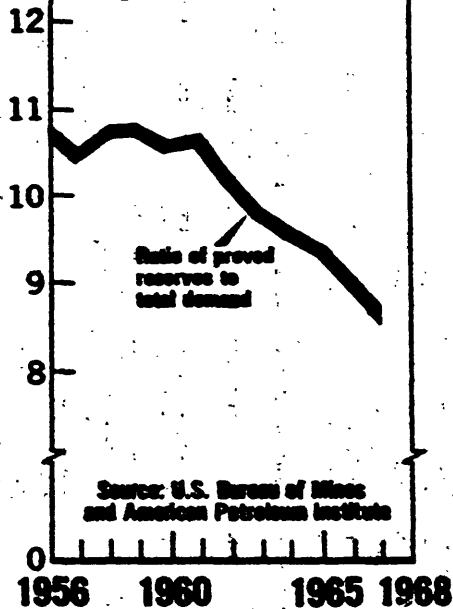
Security in U.S. oil supplies — declining

155

U.S. consumption outpaces additions to reserves

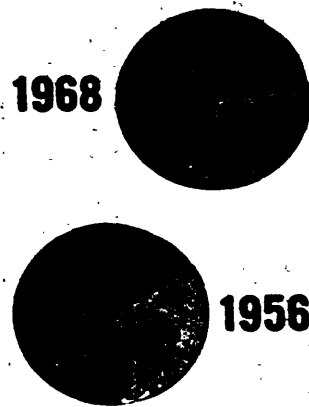


Reserve-consumption ratio drops



Imports increase

(Percent of U.S. consumption supplied by imported oil)



to reserves by almost 2.5 billion barrels. As a result, the ratio of proved reserves to total consumption dropped steadily from 10.8 in 1956 to 8.7. Meanwhile, imports of foreign oil rose from 16 percent of 1956 domestic requirements to 22 percent in 1968.

A statement by the late President John F. Kennedy concluded that, "The depletion allowances which affect over 100 items should be considered primarily as a matter of resources policy and only secondarily as a tax issue." He went on to say that, "Its purpose and its value are first of all to provide a rate of exploration, development and production adequate to our national security and the requirements of our economy...The oil depletion allowance has served us well by this test."

More recently, a comprehensive study by the U. S. Department of the Interior entitled "United States Petroleum Through 1980", published in July 1968, concluded:

"Both intangible expensing provisions and percentage depletion have been long standing and durable features of the tax treatment of the petroleum industry, despite repeated efforts to change, reduce or eliminate them. They are an integral part of the petroleum industry's structure of income and expense, and the available evidence suggests that any substantial change in them would have a direct and significant effect upon the future availability and cost of oil and natural gas."

Percentage depletion and related tax provisions have been ingrained for many years in the economic and financial processes of the petroleum industry. Any adverse change in these provisions would have repercussions of vast proportion, including the following:

1. The flight of capital from the industry and disruption of investments, with a chaotic adjustment in industry financial processes.
2. Sellouts and mergers among smaller industry units, already a concern, would be greatly accelerated with a resulting increase in corporate concentration in the production and control of petroleum.

3. Contraction of the industry would result in a reduction in the multiplicity of independent effort that has been so important in the exploration for new reserves.
4. Severe impairment would occur in the economies of the thousands of oil communities throughout 32 producing states.
5. Reduced petroleum activities would be followed by reduced markets for steel, other basic materials, and hundreds of supplying and servicing organizations sustained by petroleum production.
6. Unquestionably there would be less crude oil and gas found and developed in the United States. The alternatives would be either a more concentrated industry at greater cost and much higher prices to consumers, or greater dependence on foreign oil. Neither of these alternatives would be in the interests of the consuming public or, most important, the security of this Nation and the rest of the Free World.

CONCLUSION

Any change in percentage depletion, the treatment of intangible drilling expenses or related federal income tax provisions - designed for the purpose of increasing tax revenues from oil and gas production - would result in less oil and gas and/or higher prices. This fact has been recognized even by academic critics of depletion who have acknowledged that the effect of these tax provisions is to expand investment and output - thus bringing down mineral prices.

Because of the depressing and widespread repercussions of adverse changes in petroleum tax provisions, it is unlikely that such changes would increase federal

tax revenues in the long run. The public interest would not be served by weakening the Nation's posture as to petroleum supplies essential to national security, in exchange for the uncertain hope of additional tax dollars.

In conclusion, it should be re-emphasized that the declining trends in the domestic producing industry, as presented in this memorandum, are cause for concern, rather than a lack of confidence in the industry's future abilities. Geologists confirm that there are huge undiscovered deposits of oil and gas in the United States. Advancing research and technology can provide the tools for discovery, development and improved recovery methods. With adequate incentives restored by healthy economic conditions, sufficient domestic petroleum supplies will continue to be available for the consuming public and the security of our country.

**TRENDS IN THE U. S. PETROLEUM PRODUCING INDUSTRY
1956-1968**

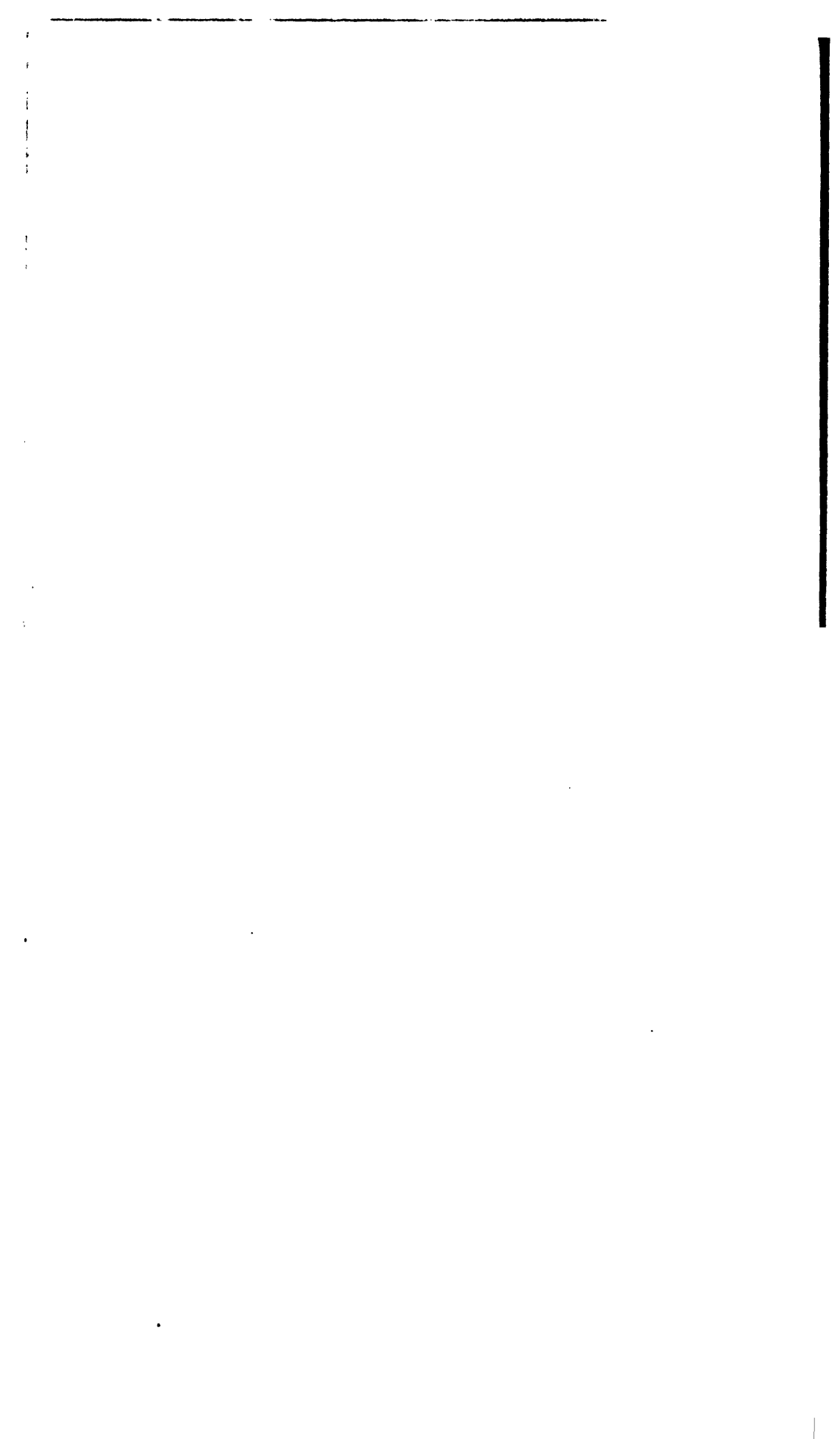
	Geophysical Activity (Crew Months)	Non-Prod. Acreage Under Lease * (Thous.)	New Field Wildcat Wells	Rotary Rigs Active	Total Wells Drilled	Number of Employees
1956	7,846	363,597	8,742	2,618	58,160	340,100
1957	7,242	" A.	8,014	2,429	55,024	344,000
1958	5,731	347,650	6,950	1,923	50,039	327,500
1959	5,696	358,476	7,031	2,074	51,764	329,500
1960	5,207	364,880	7,320	1,746	46,751	309,200
1961	5,024	362,560	6,909	1,763	46,962	303,100
1962	4,231	351,262	6,794	1,637	46,179	298,000
1963	4,174	333,653	6,570	1,501	43,653	289,500
1964	4,406	315,400	6,632	1,502	45,236	291,100
1965	4,471	332,486	6,182	1,388	41,432	287,100
1966	3,835	295,073	6,158	1,270	37,881	281,800
1967	3,496	292,127	5,271	1,134	33,818	276,800
1968	3,390	284,497	5,205	1,170	32,914	277,500

	Hourly Wages	Oil Field Machinery Prices	Crude Oil Prices	Real Price for Crude Oil (Constant 1956 \$) (Per Barrel)	Maximum Value of Depletion Per Bbl.	U. S. Consump. tion (Mil Bbls)	Additions to Reserves (Mil Bbls)	Ratio Reserves to Consump. (Percent)
	(Index Numbers 1957-59 = 100)			(Constant 1956 \$) (Per Barrel)				
1956	92.0	93.2	93.0	\$2.79	\$.767			
1957	96.7	99.6	103.0	2.98	.820	10.5		
1958	99.5	100.1	100.3	2.83	.778	10.8		
1959	103.8	100.2	96.7	2.68	.737	10.8		
1960	105.4	100.3	96.0	2.62	.721	14,975	12,410	10.6
1961	109.7	101.8	96.3	2.60	.715			10.7
1962	110.8	103.2	96.7	2.58	.710			10.2
1963	114.4	102.6	96.3	2.54	.699			9.8
1964	115.5	104.4	96.0	2.49	.685	17,215	14,900	9.6
1965	118.7	104.7	95.3	2.42	.666			9.4
1966	123.0	106.1	96.0	2.38	.655			9.0
1967	129.6	109.8	97.3	2.34	.644			8.7
1968	132.4	116.5	98.0	2.27	.624	4,873	3,140	8.1

* Excludes Alaska for which comparable figures are not available for the entire period. Acreage under lease in Alaska declined from 34,265,000 acres on Jan. 1, 1960 to 10,675,000 acres on Jan. 1, 1968, a decrease of 69 percent.

SOURCES OF DATA:

Geophysical Activity from Society of Exploration Geophysicists. Acreage under lease on Jan. 1 from IPAA. New Field Wildcats drilled from American Association of Petroleum Geologists. Rotary rigs active from Hughes Tool Co. Total Wells Drilled from Oil & Gas Journal and American Association of Petroleum Geologists. Number of employees, hourly wages and Oil Field Machinery Prices from U. S. Bureau of Labor Statistics. Crude Oil Price Index based on U. S. Bureau of Mines data. Real Price of crude oil and Value of Depletion calculated by IPAA. U. S. consumption from U. S. Bureau of Mines. Additions to reserves from API. Ratio reserves to consumption calculated by IPAA.



**LIAISON COMMITTEE OF
COOPERATING OIL AND GAS ASSOCIATIONS**

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EASTERN: Richard Veibel
Newark, Ohio

Statement on U. S. Oil Tax Policy

Submitted to

The U. S. Senate Committee on Finance

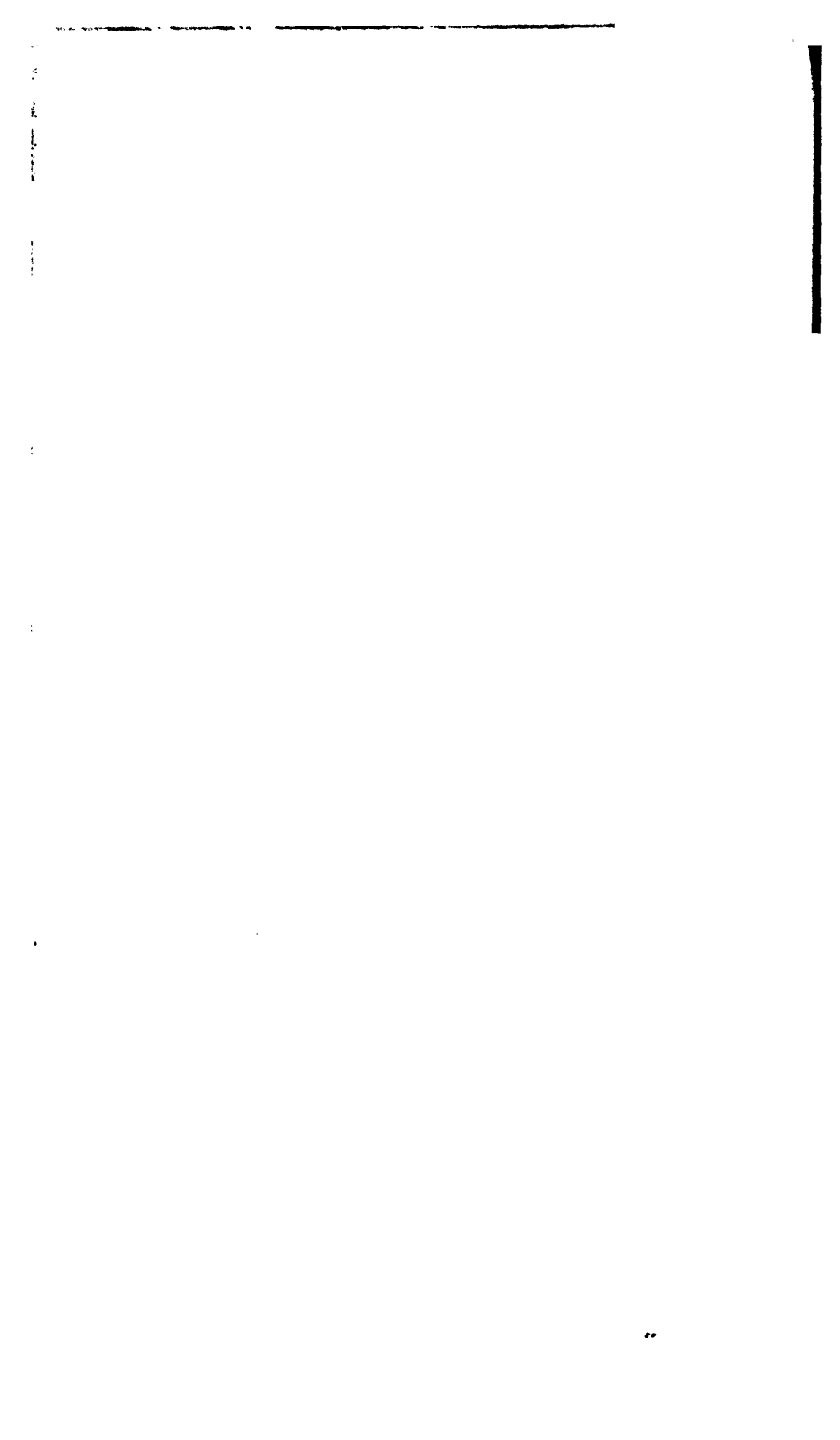
Washington, D. C.

by

Clinton Engstrand, Chairman

Liaison Committee of Cooperating Oil and Gas Associations

October 1, 1969



**LIAISON COMMITTEE OF
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Newark, Ohio

SUMMARY SHEET

The Liaison Committee of Cooperating Oil & Gas Associations contends that in order to accomplish the drilling job required by the nation we must at least have -- in addition to adequate crude prices and opportunity to produce -- the following provisions in our nation's oil tax policy:

1. Expensing of non-recoverable drilling costs. This current tax provision is universally cited by domestic producers as the most important existing tax incentive to encourage exploratory drilling. Even the present low rate of drilling would drop precipitously, should independents be required to capitalize such costs or include such costs in computing income tax liability.

2. The "loss carry forward" tax provision. This current provision is vital in the extremely high risk oil exploration business. Drilling costs approximate an average of \$50,000 per well. This cost burden becomes significant in exploratory drilling since only one well in nine finds oil and only one well in each 33 drilled results in a commercial discovery.

3. Liberalization of the 50 percent net income limitation on percentage depletion application. Only by this positive change can the percentage depletion provision more effectively assist in the desired result of increasing domestic oil and gas drilling to levels needed. Without such adjustment domestic independent wildcatters cannot receive the maximum tax incentive authorized under the depletion provision. Even more damaging to the independent would be the Administration's new proposal requiring non-incorporated individuals to include income derived from percentage depletion application in computation of income tax liability.

4. Retention of capital gains tax treatment for total value of oil and gas property sales. Independents must maintain at least the current economic incentive to sell discovered petroleum so that they can be in position to conduct expensive exploration activities. Otherwise, further reduction in already inadequate drilling effort will result causing further reduction in secure domestic reserves.

5. A positive tax incentive program applied directly to domestic exploration efforts. Recognized even by authors of the percentage depletion study submitted by the Treasury Department to this Committee is the increasing need for further attention to the problem of strengthening economic incentive to search for domestic oil reserves. It is in the best interest of the consuming public and the nation's security, as well as the domestic oil producing industry, to seek the most plausible means for achieving this objective. Governmental oil policies can play an important role in this effort.

Mr. Chairman and Members of the Committee:

My name is Clint Engstrand. I am authorized to appear here as Chairman of the Liaison Committee of Cooperating Oil and Gas Associations, an organization consisting of representatives from 21 independent producer, royalty owner and service associations located throughout the nation. Our groups range geographically from Alaska to the Gulf Coast and from California to Pennsylvania.

The producers we represent operate almost exclusively in the inland areas of the United States and concentrate their activity in the exploration, development and production segment of the domestic oil industry. Consequently, we seek national tax policy that encourages rather than discourages development of domestic oil reserves.

To emphasize this position, the Liaison Committee unanimously adopted the following resolution at its meeting in Wichita, Kansas, on September 8th:

"Be it resolved that Liaison endorse any tax legislation (1) which recognizes the dangerous pending energy gap in this nation and the very significant role of the domestic independent in providing for national security and consumer welfare; (2) which recognizes the important, disproportionate role of the independent petroleum producer in exploring for and developing the domestic reserves so vital to national welfare; (3) which supports as necessary to domestic development the continued expensing of

non-recoverable costs of drilling; and (4) which returns to the maximum extent necessary incentives for domestic exploration and development."

More than 85 percent of the nation's effort to search for home oil reserves is conducted by independent producers. This high risk, security-vital function constitutes the independents' primary role in the U.S. oil and gas industry. Consequently, if the nation's petroleum discovery effort is in trouble, then so is the independent producer.

The serious decline in U.S. oil and gas exploration activity over the past 12 years submitted in evidence before this Committee by other witnesses here today can only mean, then, a serious decline in independent producer activity. It is equally apparent that if the nation desires restoration of exploration activity to adequate levels, then the incentive for the independent to do so must also be adequate, whether it be in terms of higher prices for oil and gas discovered or revision in national petroleum policy.

Despite this inescapable need, however, the tax reform movement, insofar as it relates to the petroleum industry, has concentrated on ways and means to reduce rather than increase the economic incentive of the independent producer. Attention has been focused on tax changes that would impede independent producer decisions to borrow and/or spend the staggering amounts of funds necessary to drill wells.

Independents operate as individuals, small partnerships or in venture combinations. They rarely incorporate, thereby maintaining the freedom required for well drilling decisions -- subject of course to veto by their bankers or investor partners. They are, therefore, highly vulnerable to any

adjustment in current tax laws that offer them the incentive needed to drill.

A small business operation in the oil and gas producing industry relies heavily, for example, on the right to expense non-recoverable costs of drilling. Without it, there would be no way to afford the expense of developing discovered oil and gas properties for the simple reason that the independent and his banker must be in position to cope with the non-discovery years in his drilling history that inevitably arise between petroleum discoveries.

The severe ups and downs experienced by small business in this high risk industrial activity also require the incentive aid that comes from other tax features under attack, including domestic percentage depletion, the ABC payment method, carved-out production payments and capital gains sales of mineral properties. Eliminate or reduce any of these long-standing tax features for either the independent producer or those who help finance his ventures and further reduction in the nation's vital petroleum drilling effort is bound to follow.

Several member Associations of Liaison have representatives here today who have all submitted individual testimony for the record on behalf of their individual Associations. In addition, they are prepared to participate in this oral presentation of the case for the independent producer and royalty owner. With the Committee's permission, I shall introduce each of them and call on them to cover specific aspects of tax reform proposals as passed by the House, as presented by Administration officials before this Committee and as currently being considered by members of the Senate. When they have concluded their remarks, I would like to summarize briefly our position.

In summary it appears obvious to us that regardless of the political necessity to review U. S. oil tax policy, constructive measures must be considered to assure the even more important objective of adequate search for domestic oil reserves. Our consultations involving hundreds of domestic independent producers support our contention that in order to accomplish the drilling job required by the nation we must at least have -- in addition to adequate crude prices and opportunity to produce -- the following provisions in our nation's oil tax policy:

1. Expensing of non-recoverable drilling costs. This current tax provision is universally cited by domestic producers as the most important existing tax incentive to encourage exploratory drilling. Even the present low rate of drilling would drop precipitously, should independents be required to capitalize such costs or include such costs in computing income tax liability.

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to the independent would be the Administration's new proposal requiring non-incorporated individuals to include income derived from percentage depletion application in computation of income tax liability.

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5. A positive tax incentive program applied directly to domestic exploration efforts. Recognized even by authors of the percentage depletion study submitted by the Treasury Department to this Committee is the increasing need for further attention to the problem of strengthening economic incentive to search for domestic oil reserves. It is in the best interest of the consuming public and the nation's security, as well as the domestic oil producing industry, to seek the most plausible means for achieving this objective. Governmental oil policies can play an important role in this effort.

STATEMENT C
INDEPENDENT OIL AND GAS PRODUCERS OF CALIFORNIA
BEFORE THE
SENATE COMMITTEE ON FINANCE
WASHINGTON, D.C.
OCT. 1, 1969

Mr. Chairman and Members of the Committee:

My name is Stark Fox. I am executive vice president of Independent Oil and Gas Producers of California, a consolidation of two independent oil and gas producer associations both of which dated back to the early thirties. We are the only statewide association of producers in California.

At the outset, let me say that we join in the statement of the Independent Petroleum Association of America and will, therefore, confine our remarks to a description of conditions among California independents, and the impact the proposed changes in oil tax policy will have upon them.

Let me further say that we are opposed to all the proposed changes. Their sum total effect is to lessen oil industry incentives to find and develop the more than 80 billion barrels of oil needed between now and 1980, according to the Chase Manhattan Bank and the Department of the Interior. The Congress - and the Administration - should be considering ways to add to those incentives, rather than reduce them.

Conditions In the California Oil Industry

A 10-year record, 1957-1967, of the California oil industry unveils a gloomy picture, particularly for the smaller independent. The reason we use a 10-year period ended 1967 is that complete statistics for the succeeding period are unavailable. We believe that no significant changes in trends occurred during 1968 or thus far in 1969.

Here are some of the facts:

The total number of companies in the state in 1957 was 1465; in 1967 it was 1044, according to the Annual Review of California Oil and Gas Production compiled by the Conservation Committee of California Oil Producers. The net loss in number of companies was 421, a drop of 29%.

Total employment in oil and gas extraction dropped from 26,000 in December, 1957 to 21,800 in December, 1967, the California Department of Industrial Relations reports in its Labor Statistics Bulletin. The Bulletin also reports that average weekly earnings in the same months of the same years were \$111.07 and \$146.64, respectively. (Currently, they are \$173.43).

The State Franchise Tax Board reports that 1039 companies filed Bank and Corporation Franchise (state income) Tax returns for calendar 1957; only 658 did so for 1967.

Of the 1039 filing companies in 1957, 428 reported taxable income, on which they were assessed \$8,263,214.00. Of the 658 filing companies in 1967, 330 reported taxable income, on which they were assessed \$16,074,343.00. (Production in 1957 was 928,971 B/D; in 1967 it was 984,722 B/D. Thus the state income tax per barrel of oil produced nearly doubled).

Conditions Among Independent Producers

The foregoing data apply to the California industry as a whole, but there is one group, the smaller independent producer, who was hardest hit during the period.

Conservation Committee tabulations show the varying patterns within the industry.

Between 1957 and 1967, the major companies increased their share of total California production from 45% to 53%; the 43 principal minor companies slightly, from 28% to 29%; the independents dropped from 9% to 3.7%. These percentages do not include production from unit operations, in which the small companies have little or no interest.

Figures covering oilfield development show the same trends. In 1957, the majors completed 44.6% of all wells; in 1967, they completed 53.8%. Principal minor companies increased their completions from 24.5% to 37.0%; independents dropped from 30.0% to 8.3%. Again, unit operations are excluded.

In 1957, major companies were credited with 45.5% of all wells; this figure had increased to 53.4% by 1967.

Principal minor companies increased their share of all wells from 25.0% in 1957 to 27.4% in 1967; independents dropped from 22.7% to 10.3%.

Disincentives

In spite of this obvious deterioration in the independent's position, and in spite of the fact that District V (Alaska, Arizona, California, Hawaii, Nevada, Oregon, and Washington) does not produce enough oil to fill its own needs, there are those who would further dampen the incentive to explore for and produce oil. They are the ones who would eliminate, reduce, or otherwise "adjust" the depletion provision in the Internal Revenue Code, as well as change other industry tax provisions. Up to this point they have succeeded in doing so. According to press reports, the so-called Tax Reform Bill passed by the House, coupled with the recommendations of the Treasury Department, would burden the oil industry with additional annual Federal taxes of \$600 million.

We do not pretend that the ratio of oil production to taxes is direct; however, using that ratio as a rough guide, the District V producing industry's share of that added annual tax load would approximate \$84 million, based upon its current 14% share of total production.

We make no effort to determine how much of the added tax burden would fall upon independent and principal minor companies. It would be a significant sum, however, because together they account for 47% of total California oil production.

And whatever the amount, it would come directly out of their pockets.

Producers Have No "Ultimate Consumer"

They cannot pass it on; they are not integrated companies; they cannot offset a tax increase by charging the ultimate consumer higher prices for their product. They have no "ultimate consumer" in the classical sense. It is common knowledge that, in the oil producing industry, the buyer, not the seller, determines the price that will be paid for crude oil. Hence, the producer has no way of shifting the burden of any added expense, be it taxes, higher wages, or any other.

The impact of such added expenses is particularly severe for the California producer. California is the only oil producing region in the nation where average crude prices are less than they were in 1959 - 10 years ago. According to the current Statistical Release of the Independent Petroleum Association of America, crude oil prices east of the Rockies average \$3.17 per barrel today; in 1959 they averaged \$2.95 per barrel.

California crude prices, on the other hand, average \$2.51 per barrel today, whereas in 1959, the average was \$2.55.

Thus, compared with 10 years ago, producers in the rest of the nation have had per barrel price increases totalling 22 cents; California producers have suffered a loss of four cents per barrel.

This is disincentive enough for the California producer, but the "tax reform" bill passed by the House and the Treasury Department's recommendations would further curtail his ability to maintain his present none-too-enviable position.

And why did all this come about?

"Pressures"

Because of "pressures"; Treasury Secretary Kennedy is reported as saying.

The Chairman of the House Committee on Ways and Means was quoted to a similar effect, during that Committee's deliberations on the bill.

It seems to us that, in saying that the recommended changes in Federal oil tax policy - and particularly in the depletion provision - were brought about by pressures, those who sponsor them (or acquiesce in them) tacitly admit that no thought has been given to the merits of the case.

The Wall Street Journal - no "friend" of the oil industry, as witness its frequent highly critical editorials about the oil import program - supports that opinion.

In speaking of the House action on the so-called Tax Reform Act, it had this to say:

"Everyone is in favor of reform, and after more than four decades it's likely that oil taxes could use some of it. Both the nation and the industry would benefit, though, from one thoughtful study of the change and its possible impact.

"But no. Here, as elsewhere, the tax reformers have simply slashed away, and the House has pushed through the whole package without bothering to give it more than a passing glance."

We have tried to give you some idea of the impact of the proposed changes upon the California producer. Our petition to you is simple. We reiterate our opposition to all the proposals and ask only that, before you junk - because of "pressures", not the merits of the case - an oil tax policy that has served this nation well for some 43 years, you make "one thoughtful study of the change and its possible impact."

Thank you.

Los Angeles, California
September 25, 1969

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**INDEPENDENT
OIL PRODUCERS and
LAND OWNERS ASSOCIATION**

TRI-STATE, INC. INDIANA • ILLINOIS • KENTUCKY
116 MULBERRY STREET • EVANSVILLE, INDIANA 47713

STATEMENT

OF

INDEPENDENT OIL PRODUCERS AND LAND OWNERS ASSOCIATION

TRI-STATE, INC.

(INDIANA - ILLINOIS - KENTUCKY)

BEFORE THE

COMMITTEE ON FINANCE

OCTOBER 1, 1969

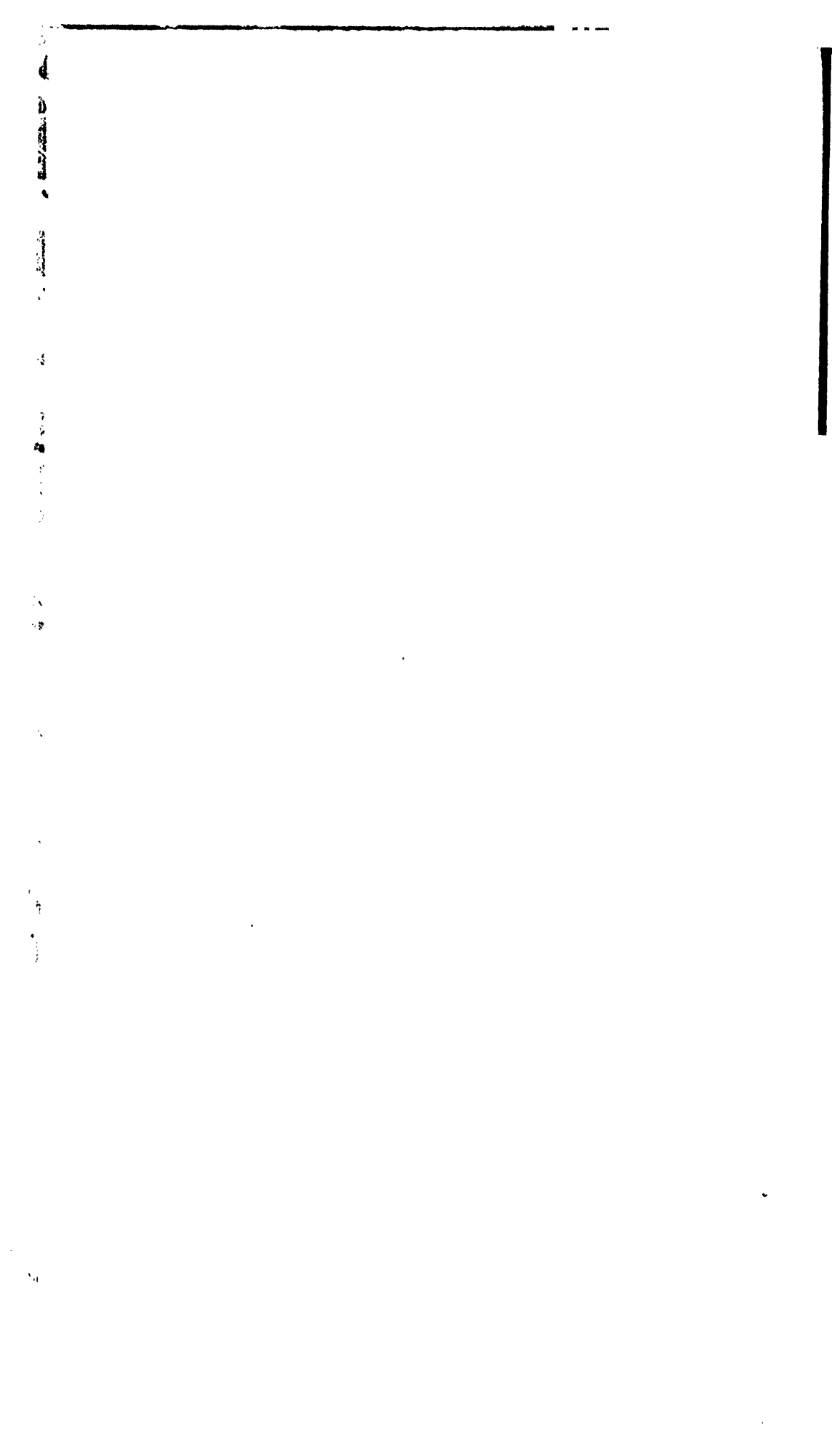
WASHINGTON, D. C.

**ADDRESSED TO
TAX REFORM ACT OF 1969**

(H. R. 13270)

BY

D. F. McKEITHAN, JR., PRESIDENT



Mr. Chairman:

My name is D. F. McKeithan, Jr., and my home is in Evansville, Indiana. I am an independent oil producer and the President of the Independent Oil Producers and Land Owners Association, Tri-State, Inc., which association I have the privilege to represent today. The membership of IOPLOA consists solely of small independent oil producers and land owners located in the Tri-State area of Illinois, Indiana and Kentucky.

Before proceeding, I wish to go on record on behalf of IOPLOA as supporting fully the other testimony received today from those independent petroleum associations from other parts of our country, which recognize the role of the independent oil man and the necessity to preserve, as well as to stimulate, his continued contribution to the domestic oil and gas industry. Their remarks are in our judgment sound and well stated. I am, however, here today to tell you about Illinois, Indiana and Kentucky because I know that you, and all the members of this committee, are well versed with the intricacies of the domestic oil business; that you are aware of the serious nature of the proposed tax revisions as they would affect oil. But, you may not know, or be aware of the fact that dependent upon your action an entire industry hangs in jeopardy in my home area. Thus, I will confine my remarks to the three-state area of Illinois, Indiana and Kentucky.

The oil industry to which I refer is almost exclusively composed of small

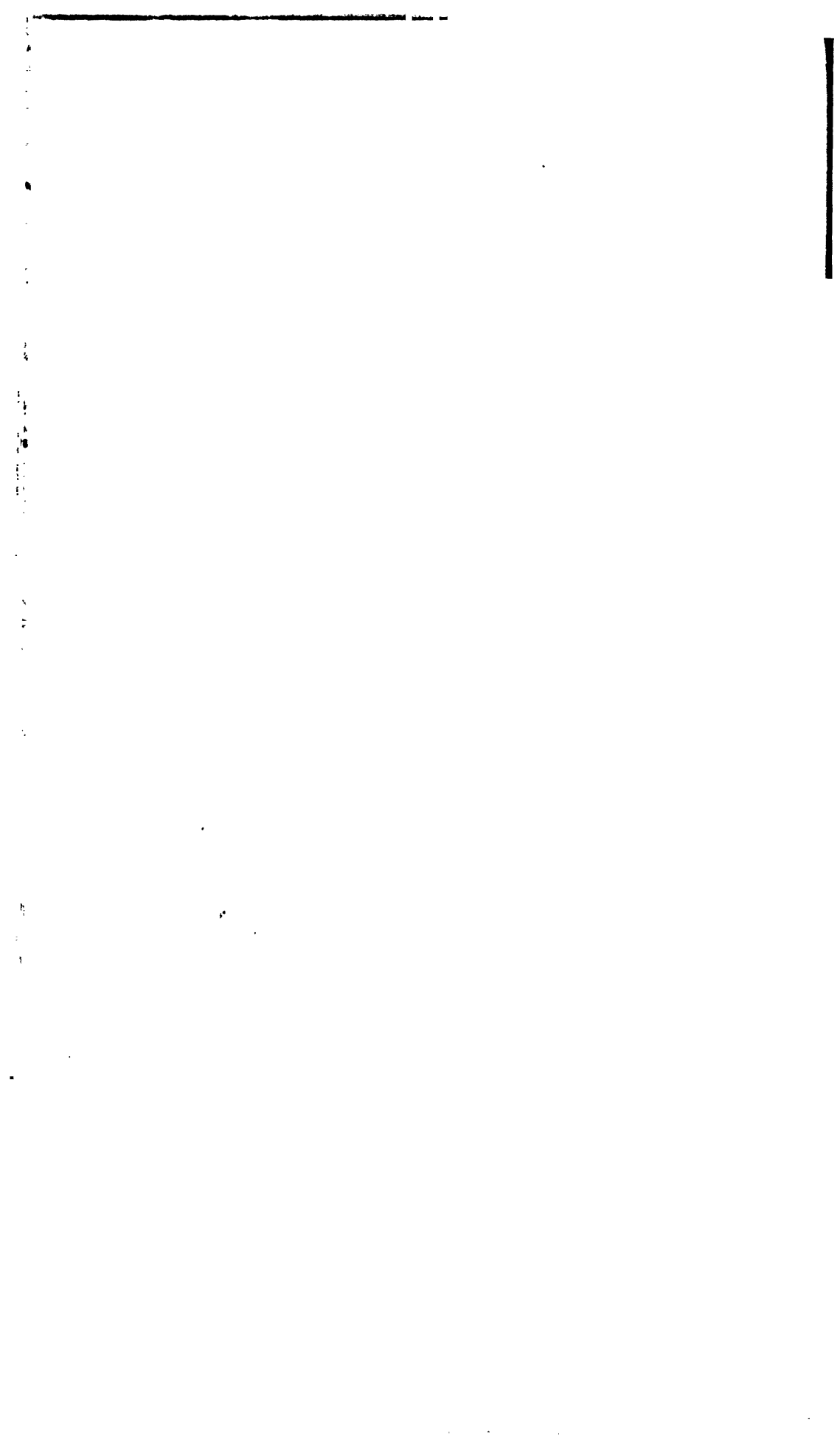
independent producers, suppliers, and drillers. They are the same type of independent who has historically found 80% of our domestic reserves. His usual operation is long on guts and short on capital but, nevertheless, he continues to drill and search for oil. Normally, his exploration capital is raised from investors outside of the oil business, from men and women who can afford to risk capital on the 1 in 15 chance that oil will be discovered. Ironically, these same investors who provide the funds necessary to the small independent, are now a primary target of this Congress in its effort to revise the present tax structure.

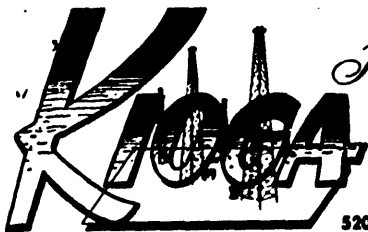
The proposed tax revisions, if adopted, can only affect adversely those individuals and firms now engaged in the oil and gas industry. This consideration alone is not necessarily a valid reason for avoiding a change. However, all the consequences of any tax change must be measured not only in terms of the immediate revenues expected to be realized but, more importantly, in the long range effects to be expected and the overall impact on the economy and security of our nation. In our Tri-State area, a reduced depletion rate will seriously cripple our segment of the domestic oil industry. This would result in the obvious curtailment of employment with the resulting loss in payrolls and taxes as well as a loss in oil production and, consequently, royalties to the land owners and taxes to the counties.

If it can be recognized that a cut in the present depletion schedule would seriously cripple the Tri-State oil industry, then it is even more apparent that a change in the manner of deduction of intangibles will literally, and without exception, destroy the domestic oil business in our area. Because the principle sources of capital funds relied upon by our operators are derived from outside investors, any required capitalization of such funds will shut off completely this flow of money and force our operators out of business.

Over 1500 small businessmen employing approximately 30,000 men and women in our Tri-State area annually contribute about 400 million dollars to the economy, which includes 30 million dollars annually paid to land owners in royalties and over 6 million dollars in taxes to the counties. As noted, the proposed tax change will not merely work a temporary hardship upon these independents, such changes will virtually eliminate them as a contributing segment of our economy. Our local economy would be unable to compensate for such a loss. More importantly, we maintain that our country cannot afford to lose this segment of its domestic oil industry. Once it is lost, it is doubtful that either the reserves or the skilled technicians could ever be replaced.

In conclusion therefore, I submit that the action of this committee will very definitely determine the future course of the independent oil man in the states of Illinois, Indiana and Kentucky. Unfortunately, the choice is not one of compromise. Our very livelihood depends upon the decisions you will make.





Kansas Independent Oil & Gas Association

INFORMATION SERVICE

520 UNION CENTER • PO Box 3-7297 • WICHITA, KANSAS 67202

For Release: Morning Papers, Wednesday, October 1, 1969

**STATEMENT BY TOM L. SCHWINN, B.S., L.L.D., J.D.,
EXECUTIVE VICE-PRESIDENT AND COUNSEL**

Accompanied by: V. Richard Hoover, President
Carl W. Sebits, Vice-President
David Tripp, C.P.A.
Wayne Sundling, C.P.A.

ON BEHALF OF THE

KANSAS INDEPENDENT OIL & GAS ASSOCIATION

BEFORE THE

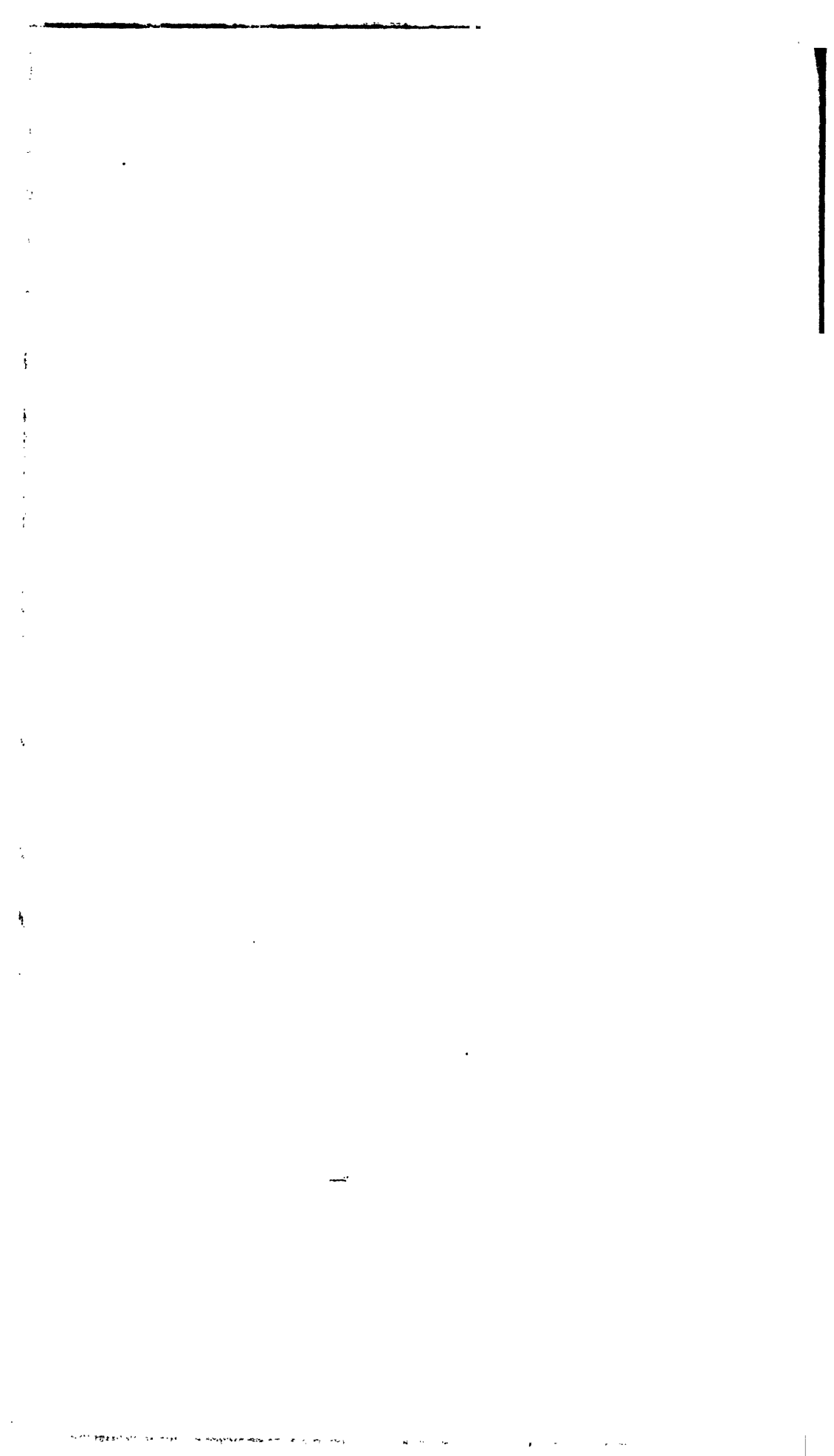
COMMITTEE ON FINANCE, UNITED STATES SENATE

ON

H.R. 13270, The Tax Reform Act of 1969.

Washington, D.C.

October 1, 1969





TOM L. SCHWINN
EXECUTIVE VICE-PRESIDENT

KANSAS INDEPENDENT OIL & GAS ASSOCIATION

520 UNION CENTER

FORMER 3-7297

WICHITA, KANSAS 67202

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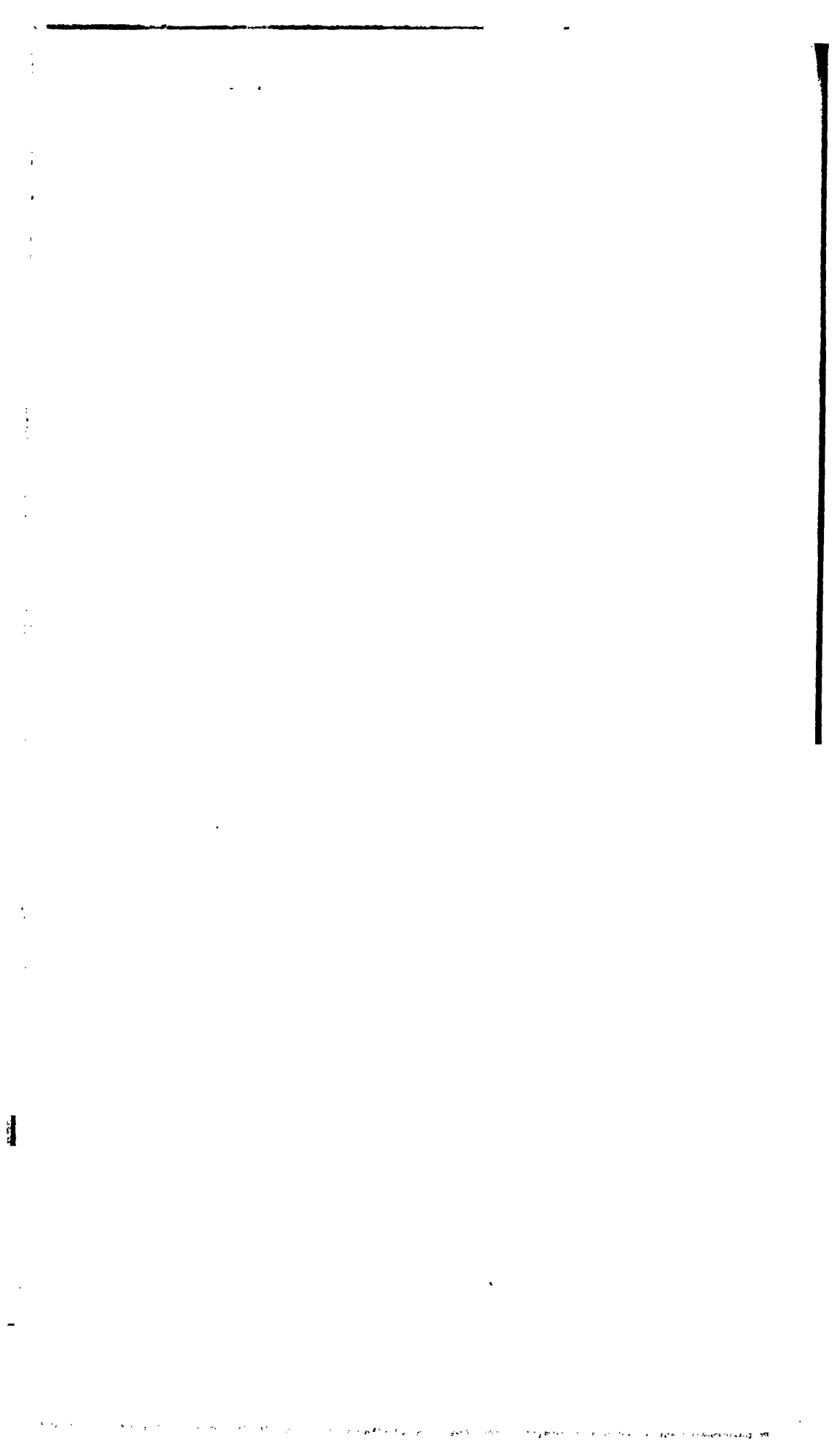
*** EXECUTIVE COMMITTEE**

SUMMARY OF PRINCIPLE POINTS

Drilling, reserves, and productive capacity of both oil and gas, are down in Kansas and in the United States.

1. Intangibles must be preserved at all costs.
2. Depletion and other incentives are also vital.
3. The independent segment deserve special consideration because of its unique and perilous position when pitted competitively against the major international companies.
4. Treasury proposals are an indirect attempt to gut the domestic petroleum industry under the guise of tax reform.
5. The domestic industry is vital to the economic well-being of the producing states and the nation.

"KioGa Leads the Fight for Independents"



STATEMENT

Mr. Chairman, Members of the Committee:

The Kansas Independent Oil & Gas Association (Kioga), now in the thirty-fourth (34th) year of its existence, is a petroleum trade association comprised of approximately thirteen hundred (1300) members. It has no major company members. It is producer-oriented.

We are grateful for the opportunity of appearing before this distinguished committee today. We are here to underscore the importance of maintaining and improving current provisions of mineral tax law as they relate to oil & gas. We deem these provisions to be vital to the survival of the domestic independent producer. Collaterally, we shall have something to say about adverse proposals, formal or otherwise, that would do grave damage to the petroleum industry and the energy position of the nation.

Whereas, there are many facets to the Kansas petroleum economy, the independent oil and gas producer continues to be one of its mainstays. Historically, both the major companies and the independents explored and developed the obvious and major petroleum provinces of the state and were the harbingers of the development that occurred throughout the great mid-continent area of the United States. Following discovery and development of these obvious and easily identifiable features, the major companies began to withdraw from Kansas. The hard business of finding elusive oil and gas was left to imaginative independent operators. The state remains one of the principal

gas and oil producing states in the nation.

In 1968 more than 96% of all exploratory and development wells were drilled by independent operators in the state of Kansas. Their share of total daily oil production now exceeds 65% and is growing annually. Only in the vast reaches of the Hugoton gas field do the major companies play a significant role in the development and production of the state's petroleum resources. Thus, as will be true in all of the great historic oil provinces of this nation, Kansas' present and future depends increasingly upon the independent oil operator.

The Senate Committee on Finance has the hard task and must assume the responsibility for deciding whether or not this nation shall have an important and viable domestic industry. Tax policies, which are the peculiar function of this committee, have a significant role in determining the level at which this industry will participate economically. It should be no mystery to members of this committee that historically, independent oil men raise the capital necessary for exploration from sources outside of the industry. A modest amount is generated internally. Everyone knows that the search for oil & gas is one of the most highly speculative businesses this side of Monte Carlo. Major companies, because of their sprawling and diversified nature, generate their funds internally, through the sale of products and other items. It is for this reason that the privilege of expensing intangibles during the year in which the item is incurred is so vital to independent operators and not necessarily so important to major companies. Corporate

structures, being broad-based, could withstand a period in which intangibles must be capitalized and thereafter be re-captured through amortization; yet there is scarcely an independent in the United States who could sustain a period of more than one (1) year during which his investor would have to capitalize the speculative dollars he spends in the risky business of oil finding.

The world of oil has historically been pictured as a single monolithic industry. This is not true. The world of oil is composed of two segments: independent domestic producers and the major international oil companies. This nation must depend in the foreseeable future upon the independent operator to explore and develop the country's petroleum resources. Because of the relative profitability of foreign oil, the major international companies are spending ever-increasing percentages of their exploration dollar in foreign countries.

Crude oil and natural gas reserves are declining at an alarming rate in Kansas. Already, available supplies of natural gas, so essential for dwelling heat and industrial development, are non-existent. These facts are depicted in the attachment to this statement. The reasons for this decline in reserves (and productive capacity) are two-fold. Numbers of independents are dwindling and fewer wells are being drilled. Both of these trends must be reversed if a genuine energy crisis is to be averted.

Tax policy of the federal government is the hand maiden of a healthy domestic petroleum industry. Incorporated in federal tax policies have been a series of tax incentives which are undeniably vital if the industry is to prosper and meet demands made upon it. The thirist requirements of the nation are growing at an astonishing rate. Tax Incentives in descending order of importance are:

1. The privilege of expensing non-recoverable business expenses, (intanqibles). This privilege is of overriding importance.

2. Percentage depletion -- Long considered by some to be a loophole, this provision nevertheless permits a return of capital and pays in part for the many dry holes that all wild-catters encounter. Contrary to much opinion, producers seldom realize the full 27½%. A recent survey by this association in Kansas disclosed that we are realizing an average net effective depletion rate of only 20.4%. Included in this result were the scattered good leases on which higher depletion rates are realized.

3. 50% net income limitation on percentage depletion--- This severely limits depletion and should be liberalized. If this were done, not only more exploration would result, but the ends of conservation would be served, as marginal wells would enjoy a longer life.

4. Loss Carry Forward Tax provision - This is covered in more detail later in this statement. Suffice it to say that even the prudent operator may experience unexpected losses in any particular tax period. If denied the right to carry these

losses forward to the next period, his ability to continue his exploratory efforts will be drastically impaired.

5. Retention of Capital Gains Treatment

This is covered at length later in the statement.

H. R. 13270 has already reduced percentage depletion to 20%. This will reduce the average net effective rate in Kansas to below 15%. Complicating our task has been the efforts of the Department of the Treasury to do by indirection what the Department has not succeeded in doing directly. A special KIOGA Task Force on these limited tax preference proposals has just concluded a study of these matters, which is herewith incorporated as a part of this statement:

The independent segment of the oil and gas industry is in real sympathy with the Treasury's efforts to close and eliminate the so-called tax loopholes which have permitted certain taxpayers to use tax avoidance devices to escape income tax liability altogether or to pay only a minimal amount. However, we submit that the methods proposed in both the House bill and by the Treasury to correct this situation, do not justify the drastic changes and penalties imposed upon the majority of legitimate oil and gas operators who are now paying a fair share of the necessary burden of the cost of government.

In properly analyzing Treasury Department proposals relating to the mineral tax section under Limited Tax Preferences, it was deemed appropriate to note other tax changes, formal or informal, that had been suggested elsewhere or incorporated in a bill. Following passage of the House version of the tax

reform law, called by some "the most incredibly complicated tax law in U. S. history," containing categories of proposals which overlap to the extent that the result is grotesque, the Treasury Department now has suggested to the Senate Finance Committee a widened series of proposals that add more complexities:

ANALYSIS OF TREASURY LTP PROPOSALS

1. Capitalization of intangibles (non-recoverable business expenses), even on development wells, which was not proposed formally, but was mentioned, would have the most adverse effect upon the domestic independent petroleum industry.

2. The House-passed cut in depletion from 27½% to 20% was found to be next in severity in its adverse impact upon the domestic independent. Studies disclosed that this change would add approximately 15% to the adjusted gross income of the established investor.

3. (a) LTP provisions would have a nominal effect on the established oil operator or high income investor.

(b) For the young operator with minimal oil and gas income, or for the investor, with small outside income, the reverse is true. Using some reliable assumptions, the adjusted gross income of these two classes of taxpayers was increased by 124%. The reason for this is that the young man started in the oil business, either as an operator or as an investor, is spending a greater proportion of his total income on LTP items than is the older, wealthier individual, operator or major oil

company. Please note that the latter category of taxpayer, being incorporated, is not subject to the provisions of LTP.

4. We strongly disagree with the inclusion of the intangible drilling cost deduction in the Allocation of Deductions provision. Moreover, we urge that the 60% limitation for the application of ADR be derived from oil and gas operations, including, but not limited to, all phases of exploration, development, drilling and producing, as suggested by Secretary Kennedy, rather than from the sale of oil and gas as recommended by Mr. Cohen. There are a number of legitimate related activities for fully qualified oil and gas operators.

5. Intangible drilling costs in any case should be excluded from the Allocation of Deductions Rule. IDC is not truly an LTP item. The theory of ADR is that no cash is expended. IDC involve direct cash outlays in a legitimate search for oil and gas. Inclusion of IDC in the ADR provision is discriminatory against the investor of the independent operator. Therefore, the 60% limitation would be a disincentive to the independent segment and have no direct affect on the major oil companies. This provision would give a direct competitive advantage to the extremely large operator over the independent segment that historically has discovered more than 75% of our domestic reserves.

6. The suggested recapture rule for intangible drilling costs, upon the sale of the property, would have its most adverse effect upon the small operator who periodically may be forced to

sell a discovered lease to retire bank loans and other obligations incurred in drilling and developing the lease. Even Treasury has labeled IDC as "an annual expense" and has always required that IDC be used to reduce depletion allowance in prior years under the net income provision.

7. We object to the retroactive provisions in this regard too, because it is suggested that IDC be recaptured for each year it was claimed as an annual expense since the discovery of the property. This could apply in retrospect for as long as 43 years (Percentage depletion enacted, then). Record retention, sensibility, and any fair Statute of Limitations makes this requirement ridiculous. Having changed the maximum 25% capital gains treatment accorded a transaction involved in the sale of a property, we deem it improper to impose additional tax by use of the recapture feature.

8. The proposed 50% top marginal rate on earned income coupled with other proposed tax changes which affect the investor will work to eliminate him as an oil and gas speculator. The point here is that traditionally, the independent oil and gas operator generates his capital from outside the industry. Major companies generate their capital internally from the sale of products, etc. Looked at in this light, the reduction in the tax rate is a disincentive to investment in oil and gas exploration. Lack of investors will hasten the disappearance of the independent oil man from the scene.

9. Treasury proposals take little note of the fact that commitments beyond the control of the prudent independent may cause an unplanned, heavy, financial investment in any year, thereby turning a profit into a loss for a particular year. Examples are: Offset obligations, farm-out commitments, production problems and expensive completion problems in deep holes.

10. The latter pages of Treasury testimony are an undisguised and lengthy attempt to justify continuation of foreign tax credits, which are actually nothing more than royalty payments in most cases.

11. In addition to the increased tax burden which would be imposed by many of the proposals, the complexities of trying to interpret regulations and filing a tax return would be worse confounded. Some of the proposals would require computation, re-computations and comparisons of computations that would be vexatiously time-consuming and expensive and would leave the taxpayer with no certainty whatever that he had properly interpreted the regulations and properly filed his return.

Rather than simplification, which should be one principal goal of tax reform, Treasury proposals, in our judgment, will create mass confusion in the business community. It will be years before the true impact is fully known. In the meantime, all of us will face enormously increased costs of accounting, appeals and litigation.

All current incentives available to the domestic petroleum industry need to be maintained and improved. Of all of these, the privilege of expensing intangibles is of overriding importance to the domestic segment. But depletion and all the rest are each important---and in different ways and at different times.

We respectfully submit that adverse changes in mineral tax policy will literally devastate the basic economy of our state.*

Although it might be considered slightly academic there is merit in assessing the effect of the decline and even the possible virtual disappearance of the Kansas petroleum industry. What are the plausible impacts of such a situation?

Such a state of affairs can probably be most realistically visualized in terms of the estimated current dollar values generated by the Kansas petroleum industry. Suppose for sake of emphasis, the entire oil industry were to cease; what would this mean in direct and side effects, measured in dollars?

MEASUREMENT METHOD OF POTENTIAL LOSSES

In order to do this we turn to the system of social accounting known as input-output (I-O) analysis. Because

* Ronald G. Hardy, Chief
Mineral Resources Section
State Geological Survey of Kansas

Acknowledgment: Input-output data for this report has been furnished by Dr. Jarvin Emerson, State Economic Analyst, Manhattan, Kansas

the petroleum industry is a major one in the economy of many regions in Kansas, the impact of changes is significant. Instability in this industry will effect numerous parameters in the private as well as public sectors of the region's economy; in particular it will affect personal incomes and sales and employment in other industries. The demand for land and for local government services and the magnitude of tax receipts will be affected.

The (I-0) analysis simulates these relationships and is therefore a valuable tool with which to measure the impact that changes in any economic activity will have on all other activities, not only after the fact but also for assessing proposed changes.

The data of I-0 analysis are the flows of goods and services inside the economy that underlie summary statistics by which economic activity is conventionally measured. This technique is essentially a system of double-entry bookkeeping which shows for each sector of the economy purchases from and sales to each of the other sectors during a given period.

POTENTIAL LOSS ESTIMATES

In the light of the foregoing, the Kansas 1965 I-0 analysis shows the following interindustry effects, assuming the Kansas petroleum industry was removed from the economy.

(1) The effect on all other Kansas industry outlays.

- (a) The crude oil and natural gas production industry has an output of \$441 million. If this were to cease it would result in a loss of \$660 million in

the output of the remainder of the state's industry.

(b) Oil field services now has an output of \$46 million; removal of this industry would be reflected in a \$68 million loss in the remaining state's industries output.

(c) The present Kansas petroleum refining industry has an output valued at \$580 million. If this were to cease it would create a \$1 billion loss in the remaining state's industry sectors output.

(2) The effect on wages and salaries.

(a) The crude oil and natural gas production industry now pays wages and salaries of \$37 million. If this industry were to disappear it would create a loss of wages and salaries in all of the remaining industries of \$169 million.

(b) Salaries and wages in the oil field services industry now total \$25 million. Loss of this industry would cause a loss of \$45 million in all of the remaining state's industries.

(c) The refining industry now has a wage and salary payroll of \$38 million. Should this be eliminated, there would be a loss of \$191 million created in the remainder of the state's industries.

(3) State and local taxes.

(a) The impact on taxes of the removal of the Kansas petroleum industry would be a loss amounting to \$43 million. About half of this, or \$20 million,

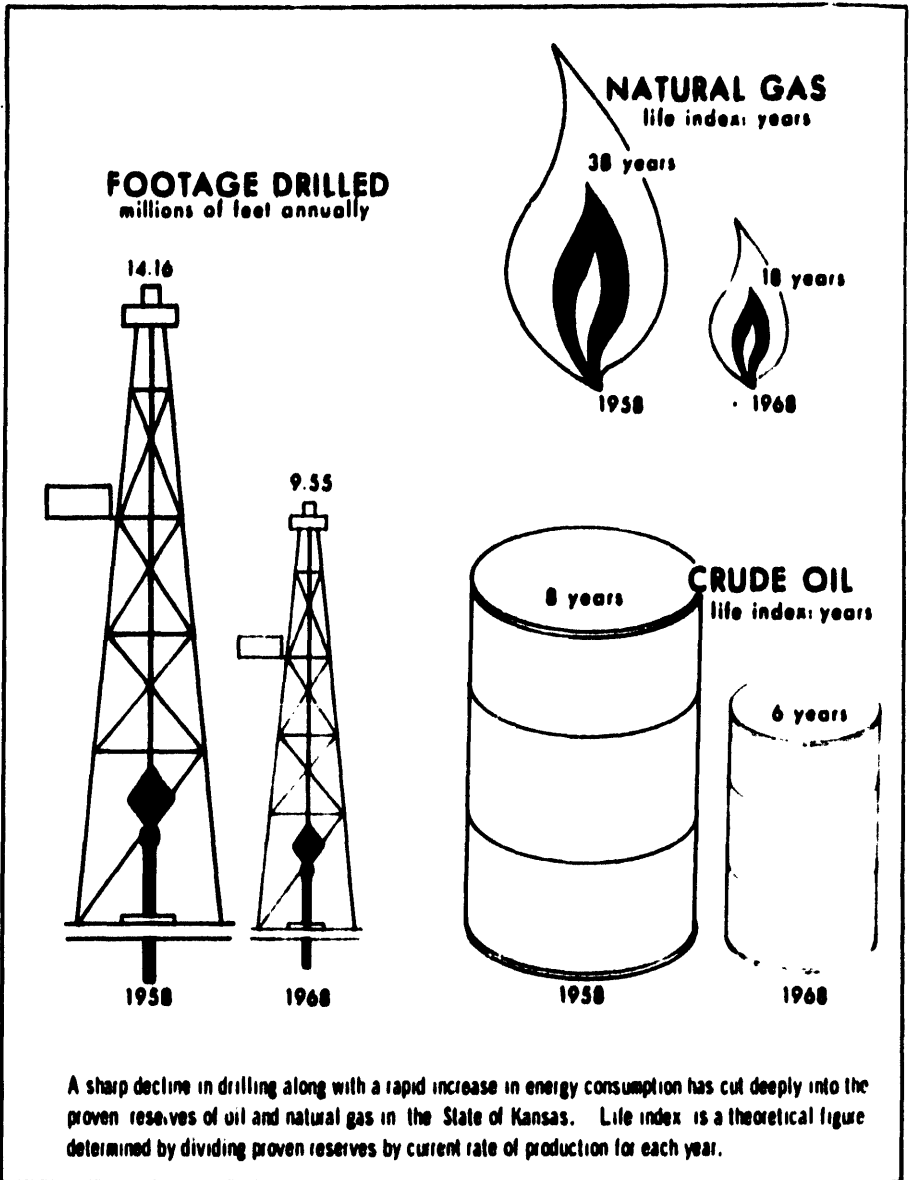
represents income taxes and since total state income taxes is currently about \$10 million this is a loss of 20%

Summing all of the losses that could occur with the cessation of a Kansas petroleum industry amounts to approximately \$3 1/3 billion. Total Kansas output for 1965 was close to 25 1/3 billion dollars, thus the loss is very close to 13% of this total. The impact of this would result in very serious dislocations in many Kansas regions for a long period of time. The foregoing social cost loss would seem to be a heavy one that in the long run would be less costly to prevent.

Respectfully submitted,

The Kansas Independent Oil
and Gas Association

KANSAS Oil and Gas Reserves Shrink as Drilling Declines



KANSAS INDEPENDENT
OIL & GAS ASSOCIATION

September, 1969

SUMMARY OF
STATEMENT OF
WILLIAM J. CLARY,
PRESIDENT,
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
BEFORE THE
CLARY PETROLEUM CORPORATION, OKLAHOMA CITY

10

THE
UNITED STATES
SENATE
COMMITTEE
ON
FINANCE



Oklahoma now produces about 100,000 barrels of oil per day which is about 4 percent of total U. S. production. We produce 7 percent of the Nation's gas production and our operating area has about 12 percent of the probable undiscovered U. S. gas reserves in the lower 48. Independents now drill more than 85 percent of the exploratory tests in our state and well over half of the exploratory tests in this country. We expect the major companies to do even less drilling in our area as budgets are shifted more and more to offshore areas and Alaska. So the danger of finding new domestic reserves of oil and (particularly of natural gas) falls squarely on us. In Oklahoma we have not been able to produce enough oil to meet demand for nearly two years and the gap gets larger. The Nation's natural gas supply is dropping at an alarming rate, a fact that is well documented.

Oil and gas exploration is a speculative business. In order to attract capital, return must justify risk. Present prices and tax provisions do not provide enough incentive to have supply meet consumer demand. Available risk capital has dried up appreciably in the past two months because of present uncertainty over the tax laws. The effect of the present tax handling of non-recoverable so-called intangible costs will be covered by other witnesses. Percentage depletion, the principal subject of this testimony, serves a vital function on the return side of the risk return formula.

The percentage depletion concept is sound. We deplete our capital assets when we produce our oil and gas. An oilman can be likened to an apple farmer who cuts off a limb with each apple so that when his crop is harvested he has no more tree, no crop next year. Depletion acknowledges this depleting asset concept and says that a portion of the apple crop should be set aside before tax liability so that new land can be bought and new trees planted. The risk of crop failure for oilmen is extremely high. The tax climate for oil and gas has a very considerable effect on whether our crops will flourish or wither and die.

Current tax laws provide an artificial limitation on that depletion which renders it largely ineffective when it is most needed. This 50 percent net income limitation accounts for the fact that Oklahoma producers do have savings but about 24 percent actual percentage depletion rather than 27.12 percent. We therefore urge that this 50 percent net income limitation on any percentage depletion be eliminated.

The consumer's domestic expenditures are outrunning our supply capability, particularly in natural gas. If present trends continue, the consumer won't have anything to consume. Any politically feasible change in the present tax laws which will help rather than hurt incentive to find new reserves should be carefully considered. We strongly recommend removal of the 50 percent net income limitation on depletion.

OCTOBER 1, 1969

STATEMENT OF
WILLIAM B. CLEARY
PRESIDENT
OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION
PRESIDENT
CLEARY PETROLEUM CORPORATION, OKLAHOMA CITY

TO

THE
UNITED STATES
SENATE
COMMITTEE
ON
FINANCE



I am William B. Cleary, President of Oklahoma Independent Petroleum Association representing more than 800 independent oilmen in Oklahoma. I'm also President of Cleary Petroleum Corporation, Oklahoma City. Our company drills about fifty wells a year. Our state has significant oil and gas reserves both producing and undeveloped. We currently produce about 600,000 barrels of oil per day which represents about 6 percent of total U.S. production. We produced about 1.5 trillion cubic feet of gas last year which represented about 7 percent of the Nation's gas production. The area we operate in has about 12 percent of the probable undiscovered U.S. gas reserves according to a study by the Colorado School of Mines Mineral Resources Institute, Potential Gas Agency Branch. (See attached map, Exhibit A).

Oklahoma independents do about 85 percent of the drilling in the state and are directly responsible for about 40,000 jobs in the state. Under present prices and existing tax provisions we have not been able to keep up with growing demand for new oil and gas reserves in our area and this situation is now approaching a critical stage. For more than 20 months demand for Oklahoma crude has exceeded supply, and the gap gets larger (Exhibit B). The supply situation in natural gas is even more critical. Mr. John O'Leary, head of the Bureau of Mines, has warned of the approaching critical shortage of natural gas. Mr. John Nassikas, head of the Federal Power Commission has also expressed his concern about our dwindling supplies as have other members of the FPC (see Exhibit C). Every gas well my company has which sells to interstate pipelines is selling at more than contract rates where the well is capable of producing additional gas. Three years ago the FPC staff spoke of fifteen to seventeen years of natural gas supply. The head of the FPC stated earlier this month that a new study indicates we may now have a ten years supply. My own experience tells me the figure is likely to be considerably lower than that.

Independents have been drilling more than 85 percent of the new oil and more important new gas wells drilled in our state. With major oil company budgets being committed to the North Slope and Offshore, I expect that percentage to increase, if we independents are still in business when the new tax law becomes effective. I can honestly say that if we don't do the exploring I don't know who will.

Ours is a speculative business and in order to attract risk capital (and more than 70 percent of our risk capital comes from outside the oil business) cost, risk and ultimate return must be balanced. If incentives are too great supply exceeds demand. If incentives are not great enough demand exceeds supply and that is the condition now.

Others here will testify as to the effect of the present tax handling of non recoverable costs on the cost side of this tester-totter.

I would like to tell you of the importance of depletion on the ultimate return side and make a suggestion regarding depletion. Risk capital for oil and gas exploration is a fragile flower and it withers easily. We have already seen a marked decline in availability of risk capital as a result of the present tax deliberations. If producers after tax costs are increased our ultimate return is reduced and supply must suffer. The consumers cannot force producers to take unjustified risks.

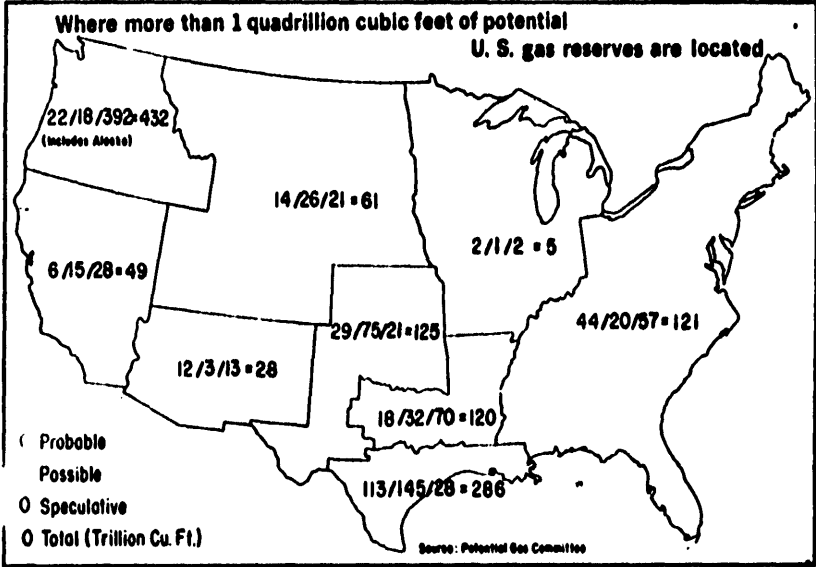
The percentage depletion concept is a sound one. Oil and gas in the ground is a capital asset and when it is produced it should be taxed as a depleting capital asset rather than as an asset which can produce continuing income. An apple farmer pays an income tax on the sale of his apples because he can produce them year after year. An oilman depletes his total asset with each barrel he removed from the ground. If he were an apple farmer you could think of him as cutting off a bit of the tree with each apple he harvests so that when his harvest is complete he not only has no more apples but he has

no more tree. Rather than tax the whole crop as income, a portion of this crop has wisely been set aside to be free of tax so that he can plant another tree and try again. I can assure you the risk of crop failure is extremely high, and changes that have been proposed in the tax climate will make the attrition even higher.

Where does depletion come into the picture? It of course affects the amount of money an investor in oil eventually has in his pocket, after paying all the bills. It controls his ability to try again. We have all heard a great deal about the perhaps unfortunate symbol of 27-1/2 percent depletion. The symbol is an unfortunate one particularly for Oklahoma producers, because an Oklahoma University Bureau of Research survey conducted earlier this year showed that independents in our state average around 21 percent depletion rather than 27-1/2 percent. This difference comes about because of the limiting factor in the present law which is virtually unknown to most tax payers outside the oil business. It says that percentage depletion shall be limited to 50 percent of the net income from a given property. Let's see how this works. In Oklahoma our average per well production last year was a little over 7 barrels of oil per day. The national average, because of flush new production in Montana, Texas and Louisiana, averages about 12 barrels per day. This is marginal production but it is production the Nation can ill afford to lose. It costs as much to produce a 7 barrel well as it does a 100 barrel well, and frequently costs more. For the producer who has \$100,000 a year in oil and gas sales with production like this, costs of production might easily be \$80,000 leaving him a net income of \$20,000. Percentage depletion on his \$100,000 sale would say that he should have \$27,500 available for replacement of reserves before incurring tax liability. The 50 percent net income limitation however says that his depletion cannot exceed half of his net income. His net income was \$20,000, so his percentage depletion would be \$10,000 and he'd pay tax on the other \$10,000. This restriction puts a

particular penalty on the independent producer and the penalty is most burdensome in the marginal years of production when the producer has the greatest need for reinvesting his money in the search for more oil and gas.

Our Nation's domestic energy needs are outrunning our supply capability at increasing rates. When you consider the incentives the producing segment of the industry needs in order to fulfill the consumers demands at the stove and the gasoline pump I urge you to consider removal of the net income restriction on percentage depletion. It would help offset the adverse effects on incentive of any reduction in percentage depletion. It is politically feasible. It would be particularly beneficial to the independent segment of the industry.



Undiscovered U.S. gas reserves total 1,227 trillion cubic feet

THE POTENTIAL GAS COMMITTEE estimates undiscovered natural gas reserves in the United States total 1,227 trillion cubic feet—nearly double the Committee's estimate of 690 trillion cubic feet two years ago.

Reasons for the increase: Alaska's reserves are included for the first time (400 trillion cubic feet); water depths for offshore reserves were increased from 600 feet to 1,500 feet; well depths were increased from 25,000 feet to 30,000 feet.

The new PGC report explains that nearly one-third of the total undiscovered natural gas supply is in Alaska, and will not be available to markets in the "lower 48 states" until pipe lines are built, or until gas can be liquefied and moved south in tankers. The increases in water and well depths add several hundred trillion more cubic feet to the total.

The Committee estimate is divided into the following categories: probable supply—260 trillion cubic feet; possible supply—335 trillion; and speculative supply—632 trillion. These totals are in addition to 287 trillion cubic feet of proved recoverable reserves, as of December 31, 1968.

For the first time, the PGC reports U.S. potential natural gas supply by nine supply areas (See map). Boundaries of each region coincide with the boundaries used by the American Gas Association Proved Reserves Committee. Two years ago the report was divided into estimates for three areas: East, Central and West U.S. Offshore Gulf Coast undiscovered supply for Louisiana and Texas is separated from the onshore supply for the first time.

The 150-member Potential Gas Committee is sponsored by the Colo-

rado School of Mines' Mineral Resources Institute, Potential Gas Agency branch. The Agency's activities are financed by the American Gas Association, Inc.; the American Petroleum Institute; and the Independent Natural Gas Association of America.

The report emphasizes that huge gas reserves remain to be found, but "economic incentives must be provided to encourage people to go get it."

In recent years, fewer and fewer wells have been drilled in search of new reserves. As a result, the American Gas Association reports that in 1968, for the first time since World War II, the U.S. used more gas than it discovered—by 3.5 trillion cubic feet. Reserves were increased by 13.5 trillion cubic feet, but consumers used 19 trillion cubic feet.

18 Wed., Sept. 24, 1969 THE DAILY OKLAHOMAN

Oklahoma Crude Demand Still Outpaces Production

By Deacon New

Demand for Oklahoma crude oil continues firm, outstripping the state's productive capacity.

Crude purchasers told the state Corporation Commission Tuesday they need 631,090 barrels daily next month, an 11,267-barrel jump over September requests.

The nominations totaling 631,090 barrels a day compares with pipeline runs during August averaging 607,468 barrels a day. Output the first 13 days of September is running about the same rate, 606,954 barrels daily.

Most purchasers testify-

ing at the commission's market-demand hearing recommended continuation of the current 100 per cent factor applied to the basic depth-acreage allowable table.

Dan R. Dunnitt, director of the commission's oil and gas conservation department, also favored holding the allowable at the same rate.

Dunnitt said the Bureau of Mines forecast of demand for Oklahoma crude during October at 620,000 barrels a day, the same as the September estimate.

Wilburn Cartwright, commission vice chairman, presided at the hear-

ing in the absence of the chairman, Charles Nesbitt. Nesbitt is in Alaska attending an Interstate Oil Compact Commission executive committee meeting.

Cartwright and Ray C. Jones, who heard the purchasers' testimony, said the October allowable will be set later this week.

The increase in the total nominations was more than accounted for by a boost in the request of Mobil Oil Corp. Mobil increased its nomination 12,500 barrels to 48,200 barrels a day. The company's purchases totaled 35,899 barrels a day during

August.

George Stricker, representing Mobil, told the commission the increased nomination represented a firm demand for Oklahoma crude.

The purchasers, reporting on company-wide stocks, said total inventories as of September 1 were 9,570,844 barrels above desired level. That compares with a surplus of 17,023,597 barrels.

A breakdown showed crude stocks at 7,493,428 barrels on the plus side, while products in storage were 2,077,418 above desired level.

	ACTUAL PRODUCTION BOPD	CRUDE BUYERS NOMINATIONS BOPD
1968		
January	604,000	644,000
February	618,000	650,000
March	620,000	643,000
April	628,000	636,000
May	613,000	634,000
June	610,000	630,000
July	614,000	628,000
August	614,000	628,000
September	610,000	628,000
October	606,000	626,000
November	610,000	619,000
December	612,000	616,000
1969		
January	615,000	615,000
February	619,000	634,000
March	609,000	635,000
April	626,000	628,000
May	610,000	642,000
June	617,000	637,000
July	608,000	619,000
August	607,000	619,000

NOTE: State allowable was at 65% of Table "A" maximum January, 1968 through May, 1968. From then through the end of 1968 it was 75% and finally in 1969 went to 90%. It has been at 100% since March and production is declining.

Nassikas means business on gas supply

New FPC chairman sees no lack of evidence that gas is in short supply and fast getting shorter, says he doesn't need national survey to precede action. If higher price is solution, he'll likely buy that.

GENE T. KINNEY
Washington Editor

THE NEW chairman of the Federal Power Commission doesn't intend to wait for a national gas survey before doing something about a growing supply problem.

This presumably means raising well-head prices, if it appears this is the likely solution.

John N. Nassikas, who took office Aug. 1, expresses confidence FPC has the flexibility to help turn supply trends around.

Named by President Nixon to succeed Lee C. White, Nassikas revealed his attitude in an interview last week. It contrasts sharply with that of his Democratic predecessor.

White never really conceded there was a supply problem, in spite of a 5½-trillion-cu-ft decline in reserves last year. He led the commission in a deep slash of rates in South Louisiana, the most important producing area in the nation — a move hardly calculated to boost reserves. Moreover, he contended a study of some kind, such as the survey he pushed unsuccessfully, was necessary to establish the facts.

Nassikas, the 52-year-old Republican lawyer from Manchester, N.H., has found plenty of evidence of declining supply. He cites studies by industry groups and FPC's own staff.

In his view, past FPC decisions — notably in the Permian basin and South Louisiana — and rulings of the Supreme Court have not frozen present producer rates. Quite the opposite, he says. In Permian, he stresses, the high court affirmed FPC's wide discretion in using varying price levels to bring forth adequate supply.

FPC study. Nassikas, after 6 weeks on the job, considers the evidence of supply trouble to be "rather convincing."

He cites the annual report of proved reserves by the American Gas Association and other studies, including one by the FPC staff.

"All confirm an increasing problem with gas supply," he says.



FPC Chief Nassikas finds evidence of gas-supply trouble "convincing."

The FPC study, to be published soon, shows a deliverability life from present reserves of only 10 years, the chairman discloses.

In view of increasing demand and recent declines in reserves, Nassikas believes the supply-demand curves will intersect much sooner than 10 years from now, unless the supply trend is reversed.

"When you have that close a margin," he declares, "a critical supply situation exists."

Top priority given. In view of this situation, the FPC chairman says, the "overriding priority of FPC is to make sure to resolve on a practical, expeditious basis the gas-supply problem in the United States."

Unless this is done on a short term and long-term basis, FPC is not doing justice to a \$30-billion industry, its investors, and the consumers who rely on it.

Nassikas says he became somewhat familiar with FPC issues during the past year as counsel to the minority on the Senate Commerce Committee, which has legislative oversight of the agency. Also, he took a cram course

beginning last April, when he became aware of the President's intention to install him as chairman of FPC.

Since that time, he says, he has become convinced that the supply issue deserves priority attention. He rejects any thought of "rationing scarcity" as a solution, preferring instead to "share abundance."

A national gas survey may be desirable, he says. "But absence of a survey is no excuse for delay in meeting a problem that is manifest."

Problem cause. Nassikas refuses to attribute the reserves decline directly or solely to FPC's policies of keeping the lid on producer prices.

But he does quote with approval an economic axiom stated by Milton Friedman. The surest way to achieve a shortage in a commodity, according to the economist, is for the Government to impose a price ceiling that is too low.

The new chairman plans first to determine what has caused the decline in drilling, the slide in the reserves-production ratio and deliverability life, and, last year, the absolute drop in proved reserves.

If FPC finds that its price policies have been responsible, he says, then these policies should be reversed.

He says FPC must ascertain whether price alone offers adequate incentive or disincentive to control the supply of gas. And he suggests that assurance of a firm price once approved may be almost as important as the price level itself.

The industry has drafted proposed contract-sanctity legislation that would prevent future FPC rollbacks of prices once approved. But no drive has been mounted to push the legislation.

The cure. Once the cause of present supply trends is established, Nassikas says, the policy actions should be fairly clear.

He expresses confidence FPC machinery is not so cumbersome it cannot deal with the situation. He says the commission has several possibilities, without commenting on any of them.

He acknowledges that the commission has set "permanent" rates in the Permian basin and South Louisiana. The first case was upheld 100% by the Supreme Court, and the second is before the Fifth Circuit Court of Appeals with oral argument set for Oct. 6.

FPC and the courts are bound to decide these cases on the facts and circumstances in the record.

But, Nassikas points out, the FPC and the courts can set new rates, or adopt new formulas, in subsequent cases, if the facts or circumstances change.

This is the principal argument of producers, pipelines, and a large group of distributors — that circumstances have changed, requiring higher rates to avoid a threatened shortage.

Nassikas says FPC is already making "policy decisions" aimed at dealing with the question.

Last week the commission set oral argument on two pending area rate cases for Oct. 31. These deal with producer prices in the big Texas Gulf Coast and Hugoton-Anadarko regions, pending before FPC on examiner's decisions since Sept. 16, 1969.

The commission also has before it a reopened proceeding embracing the federal offshore portion of South Louisiana, and a settlement proposal for Hugoton-Anadarko. There are also motions to expand the offshore proceeding to include onshore Louisiana as well, and even motions to consider a national proceeding.

Nassikas believes FPC has wide dis-

cretion in dealing with supply, and even the contract sanctity question.

Favors regulation. FPC is duty-bound to act so that the industry will be able to meet future gas demand, Nassikas believes.

If it finds itself impotent to solve the problem, then he feels the commission should recommend appropriate legislation.

But decontrol — or regulation within narrowly defined limits under legislation — is not the best approach, as far as he is concerned.

Under present statutes and court rulings, FPC ought to be able to respond to particular problems, he says. He declines to lay the blame for any current troubles on restrictive court decisions. The courts, he emphasizes, have not put FPC in a strait jacket.

"We should improve the concept of producer regulation, not discard it because we happen to have a problem."

He also opposes the Burleson bill, which would require regulatory agencies to gear rate of return to inflationary trends. Pipelines have sought this legislation as a solution to their rate-of-return problems.

But this approach, the chairman warns, would only lead in the long run to broader problems than the narrow one the legislation is designed to solve.

"The regulatory process itself," he declares, "is the appropriate forum to resolve inflation problems or any other pressures to erode rate of return, rather than use the legislative approach

when FPC may in the past have failed to resolve the problem."

New staff appointments. Nassikas promises to begin announcing, perhaps in less than a month, new appointments to the Office of Executive Director, chief of the Bureau of Natural Gas, and deputy chief of the bureau.

He declines to say whether he will replace the present general counsel, Richard Solomon.

Nassikas says he is seeking qualified men of integrity, familiar with the regulatory process and the problems of industry, consumers, and investors. Top staff members also should be aware of the impact of FPC decisions on regulated industries, he adds.

Action, not talk. Nassikas gives the impression of a man who is not at all intimidated by the immensity of the problems facing FPC.

He shows signs of becoming an activist chairman willing to take initiative where departures from present policies seem called for. And the initiative won't be long in coming, if his present plans are realized.

"I am talking about a series of regulatory decisions which we will be in the process of making this year," he says. "We will start soon. I am not talking about a thinking process of a couple of years. We have gone through that process and are formulating policies designed to deal with the gas supply and deliverability problems."

Two jurists picked in Algeria fuss

ATLANTIC RICHFIELD Co. last week said that two of the three judges on an arbitration court to rule on its dispute with Algeria have been appointed.

Under the rules, one judge is to be named by the International Court of Justice at the Hague, and one by each of the dissenting parties.

The International Court of Justice named Prof. Giorgio Balladore Pallieri of Milan, Italy, a judge at the European Court of the Rights of Man, as president of the arbitration court.

ARCO then announced its appointment of Prof. Francois Luchaire of the University of Paris, a member of the French Constitutional Council, as the second member.

So far, the Algerian Government has not announced its appointment of the third judge, and there's no guar-

antee it will deign to do so.

A spokesman for Sinclair Mediterranean Petroleum Co., the ARCO subsidiary whose Algerian properties are at stake, said that Dr. Jose Luis Bustamante y Rivero, president of the International Court, had advised the company of Pallieri's appointment and said the Italian barrister had accepted.

Sinclair Mediterranean announced last May 13 that it was initiating the arbitration proceedings to protest the forfeiture of its properties to the Algerian Government. Principal of these is a 28% interest in Rhourde el Baguet oil field, where Sinclair's share of production was 22,981 b/d in 1968. There was no return to the company, however, since it has been under Algerian Government control since June 1967.

STATEMENT
of
**THE PANHANDLE PRODUCERS AND ROYALTY OWNERS
ASSOCIATION**

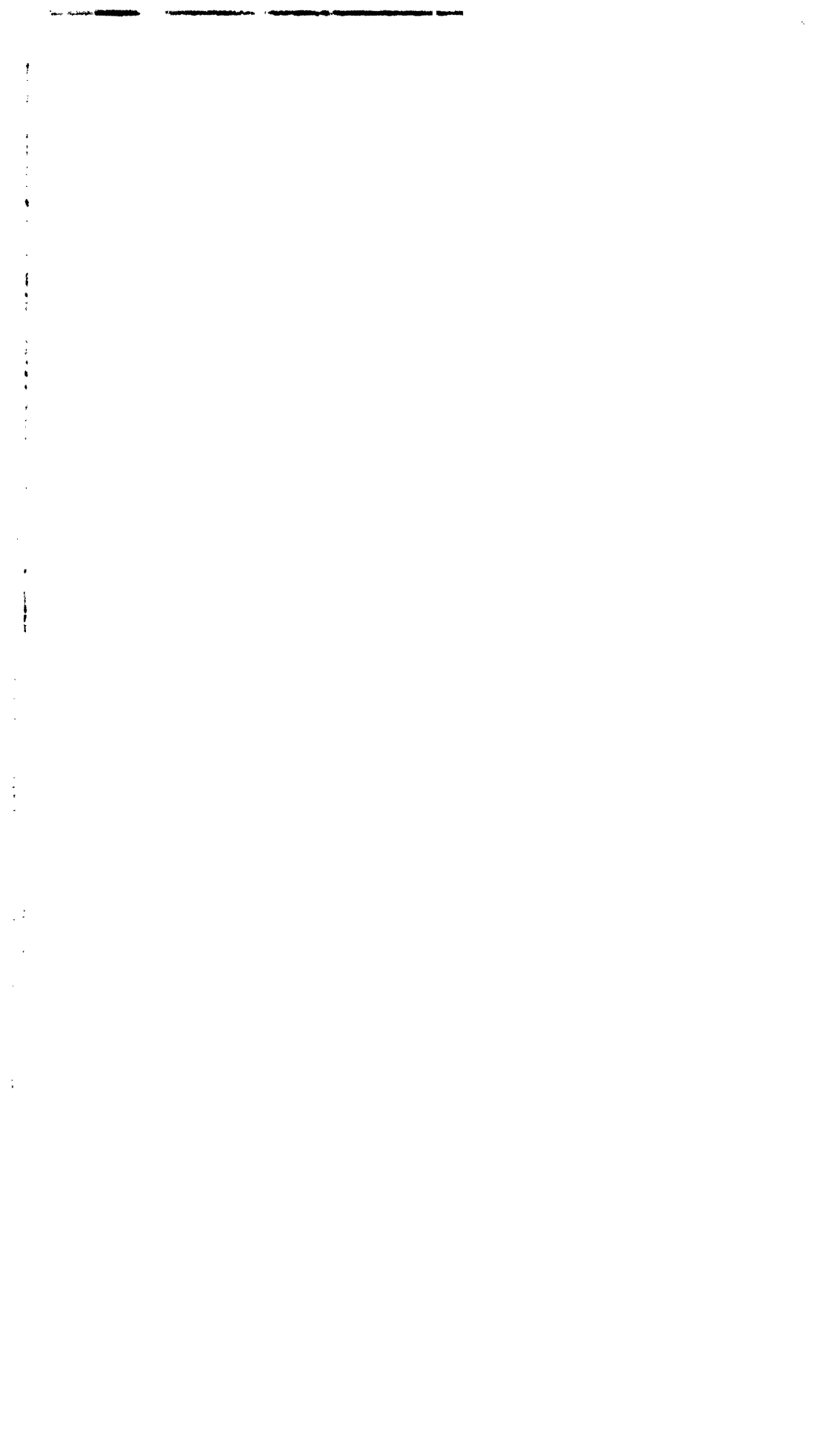
**P. O. Box 2226
Amarillo, Texas**

**BEFORE THE
SENATE FINANCE COMMITTEE
TAX REFORM HEARINGS
WASHINGTON, D. C.**

October 1, 1969

PRESENTED BY:

**C. H. HINTON
PETROLEUM CONSULTANT**



SUMMARY

The scope of my statement covers statistics on the recoverable natural gas reserves for the period ending each year from 1955 through 1968. It also shows the annual production for the same period and the number of well completions in the United States extending over the same period. This is shown in graphic and schedule form.

My statement also covers the estimated gas requirements for the future up to 1990.

I have made an effort to point out why there has been a decline in the number of wells drilled in the United States; why it is essential for the number of wells to be increased to a level of twice the 1968 number; and why the removal of any existing tax deductions would have an adverse effect on drying up drilling funds that would cause a further reduction in the number of well completions.

I have discussed the reserve life index or the ratio of production to reserves and explained that the use of such reserve life index as a yardstick for the life of natural gas reserves furnishes the most optimistic picture of the availability of natural gas for the future.

The producers have been classified as the pipeline producers, large independent producers, and the small independent producers, with the contribution that each makes to the natural gas supply.

My entire statement has been reduced to four Conclusions which are of importance in the action which this committee might take with respect to reducing statutory depletion, or removing intangible drilling costs as income tax benefits.

Conclusions:

1. It is an indisputable fact which must be faced - that there is a very serious shortage of natural gas being developed in the United States.

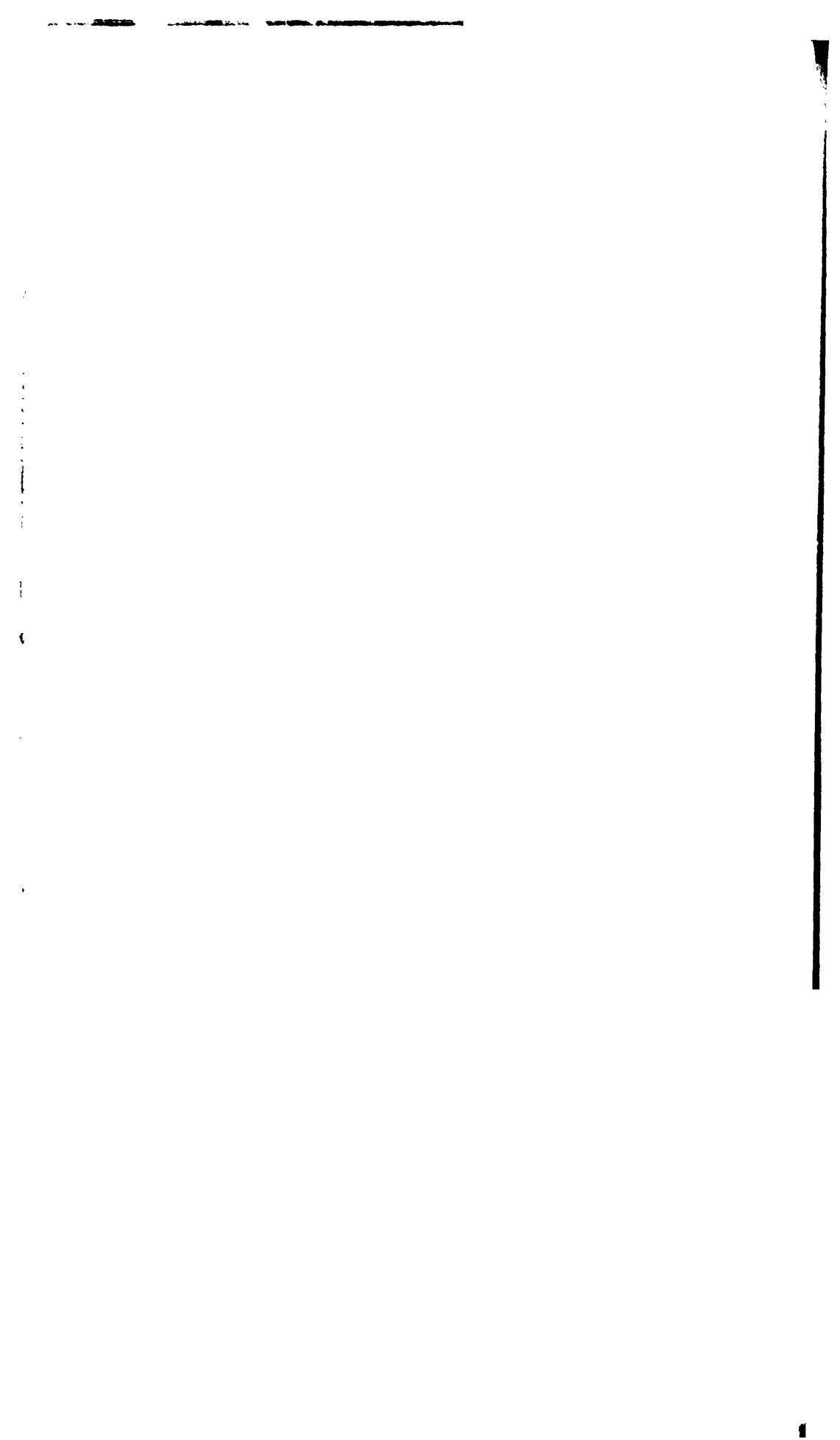
2. If future requirements are to be supplied, the number of well completions must be doubled over the 1968 level in the shortest possible time.

3. There are thousands of yards of sediments which are estimated to be productive of natural gas that have not been tested by the drilling of wells.

4. Any downward reduction in statutory depletion, or any reduction in intangible drilling costs as a tax reduction will cause a further decline in the number of well completions.

TABLE OF CONTENTS

	<u>Page</u>
The Gas Supply Situation From 1955 through 1968	1- 2
History of the Number of Wells Drilled in the United States	3- 5
Reserve Life Index	5- 6
Analysis of Future Gas Requirements	6- 7
Producer Classification	7- 9
Impact of a Lessened Incentive for the Producer to Drill	9
Example of How Statutory Depletion and Intangible Drilling Costs Really Work	9-10
Conclusions	10-11
Summary	
Schedule 1a - United States Natural Gas Reserves and Net Production History Reduced to Reserve Life Index	
Schedule 2a - United States Number of Well Completions (Excluding Service Wells) Shown by Oil Wells- Gas Wells - Dry Holes	
Graph 1 - United States Natural Gas Reserves and Net Production History Reduced to Reserve Life Index	
Graph 2 - United States Number of Well Completions Excluding Service Wells 1955-1968	
Graph 3 - United States Annual Natural Gas Production	



**STATEMENT OF
PANHANDLE PRODUCERS AND ROYALTY OWNERS ASSOCIATION**

My name is C. H. Hinton. I reside in Amarillo, Texas. My office address is 1012 West Tenth Street. I am a petroleum consultant and President of Consulting Services, Inc.

For the past 33 years I have spent a major part of my time on problems related to natural gas supply and the requirements for natural gas.

I am a member of the National Society of Professional Engineers; the Society of Petroleum Engineers of the American Institute of Mining and Metallurgical Engineers; the Texas Professional Engineers; and I am a registered professional engineer.

I am appearing here today as a member of, and in behalf of, the Panhandle Producers and Royalty Owners Association.

**The Gas Supply Situation
From 1955 through 1968:**

In order to present a clear picture of gas supply trends and the increase in the annual requirements to supply markets, I have prepared three graphs which are attached to the back of this statement.

Graph No. 1 shows the recoverable natural gas reserves for the 14 year period 1955-1968. At the top of each bar the reserve is shown as of the end of the year in trillions of cubic feet. Immediately to the right of the recoverable reserve is a bar which shows the gross additions to reserves for each of the years. Your attention is called to the fact that back in the mid-50's the gross additions to reserves were more than twice

the annual volume of gas produced. In 1968, for the first time in the history of the natural gas industry, production was greater than the additions to reserves. To the extreme right is a bar which shows the annual production. It can be noted that annual production has almost doubled from 10.1 trillion cubic feet in 1955 to 19.4 trillion in 1968.

The reserve life index is shown by years for the period and has declined from 22.1 years in 1955 to 14.8 years in 1968. The reserve life index is obtained by dividing the annual production into the year-end recoverable reserves.

The American Gas Association has caused to be formed a Gas Industry Committee to study the future gas requirements of the United States. It is estimated that the requirements will increase to 25.5 trillion for the year 1975 and 36 trillion by the year 1990. In order to present the upward trend in natural gas requirements, Graph No. 3 was prepared and is attached hereto, which shows the annual increase in natural gas requirements.

The interstate pipeline companies have been unable to contract the full volume required to meet present and estimated future requirements for the past few years. The reasons that there are inadequate volumes for interstate transportation to supply the United States requirements are:

- (1) the reduction in the number of well completions, and
- (2) the gas requirements in the producing states, particularly Texas and Louisiana, have increased at a very substantial rate.

A schedule which shows gas volumes and reserve life index in

more detail is attached to this report and is shown as Schedule 1(a).

**History of the Number of Wells
Drilled in the United States :**

The downward decline in the number of well completions in the United States is shown on Graph No. 2 with the detailed numbers on the schedule numbered 2(a) which both appear at the back of this report.

The largest number of wells ever completed in the United States in any one year occurred during the year 1956. That year 57,111 wells were drilled in the United States, of which 35,273 were productive of oil or gas and 21,838 were dry. There has been a decline in the number of wells drilled since 1956 down to a low since World War II of 30,599, of which 17,612 were productive of either oil or gas and 12,987 were completed as dry holes or non-producers.

The question arises as to why there has been such a drastic reduction in the number of wells drilled in the United States over the past 13 years. I will set out the principal reasons which have caused this reduction:

1. The method of Federal Power Commission regulation as applied to wells which were drilled by the pipeline producer. A pipeline producer is a company engaged in the finding and development of gas reserves and is also engaged in the interstate transportation of natural gas. Since 1941, as a result of a Federal Power Commission decision in the Hope Natural Gas rate case, all pipeline producers were placed under the regulation of the Federal Power Commission and the price

- 3 -

which was permitted to be charged for natural gas was based on a utility cost of service concept. The impact of this type of regulation on producing properties caused the pipeline to reduce its production activities as this type of risk capital investment cannot be expended where the regulation is determined on a cost of service basis. The incentive for the pipeline producer to continue to look for and develop gas reserves was further retarded when the Federal Power Commission took the position that all statutory depletion should pass directly to the consumer as a reduction in the amount of income tax that is to be paid and included as a part of the cost of service.

2. The Supreme Court decision in the Phillips case, handed down in June 1954, placed the non-pipeline producer under the jurisdiction of the Federal Power Commission as to the price which might be paid for natural gas that was contracted to be sold in interstate commerce.

After years of lengthy hearings the Federal Power Commission proceeded to regulate the price of natural gas by putting into effect area guideline prices and would not accept contracts for filing which provided for prices higher than the area guideline prices. Even after all of the hearings, which cost the producer and the government millions of dollars, the area guideline prices correspond very closely to prices which were being paid for gas on contracts made prior to 1960 and contracts which were entered into after 1960. Thus, the industry has lived for nine years under prices which were determined at the 1960 level.

During the period 1960 through 1968 you will note that there has been a very alarming decline in the number of wells drilled in the United States.

3. Each year during this period there has been an increase in the barrels of oil which have been imported into the United States. Imported oil does not add to the natural gas reserves. For many years the natural gas which was produced in conjunction with the production of oil supplied approximately 1/3rd of the total natural gas consumed in the United States. The reduction in the number of well completions in the United States in the face of the increased gas requirements has lowered this percentage and for 1968 only approximately 20% of the total gas was supplied from oil-well gas.

4. The oil industry is concentrating on obtaining an increasing percentage of the domestic production through secondary recovery operations. This secondary recovery oil is obtained by methods of driving oil to the well bore by water flooding, gas injection, and utilization of other liquids by injecting materials into a reservoir which will no longer produce economic amounts of oil.

Secondary recovery operations make very little contribution to the gas supply as the primary production of oil generally utilizes both gas-cap gas and solution gas.

Reserve Life Index :

I have explained that the reserve life index is an arithmetic computation which shows the number of years of life that the recoverable

reserve would last if produced at an annual rate which is equivalent to the annual volume produced during any year. Reserve life index, however, does not give consideration to any increase in future requirements or any additions to recoverable reserves.

A natural gas well loses a portion of its physical ability to produce gas with each one thousand cubic feet produced, and, in general, natural gas wells will be depleted to the extent that the wells will have very little peak producing ability after about the first 12 years of production where the gas is produced in accordance with the contract provisions determining the quantity which may be produced. There is normally a lag of two to three years from the completion of wells in a new reservoir to the date of first production and sale. Thus, the portion of the recoverable reserve available for the consumer supply is narrowed down to 11 to 12 years.

Cycling operations which are carried on in the United States tie up approximately the equivalent of 20 trillion cubic feet, which further reduces the volume available to the consumer.

Therefore, when the reserve life index is determined on the gas connected to the pipelines it is from three to four years less than is shown by the simple computation of dividing the annual current production into the recoverable reserves.

Analysis of Future Gas Requirements :

The estimated demand for natural gas required in the future should

receive the complete attention of Congress, the consuming public, and the transporter and producer of natural gas. The drastic reduction in the number of well completions and the historical annual increases in the gas requirements, coupled with the estimated future requirements, create a problem which cannot be ignored.

If present and future customers are to be served a continuing supply of natural gas, there must be a broad change in regulatory bodies having jurisdiction over price. Please bear in mind that of the total amount of money which has been invested by interstate pipeline companies and distributors who receive the major portion of the gas from interstate companies, approximately 71% of such investment remains to be depreciated. Unless there is an increase in the gross additions to reserves much greater than has been experienced over the past few years, new depreciation rates will have to be placed in effect in order for the investor to recoup his money. This means a higher cost to the consumer for the same limited supply of natural gas.

Producer Classification:

The producers of natural gas fall into three general classifications:

1. The pipeline producer who can no longer be classed as a major contributor to the production of natural gas. The pipeline producer volumes have declined from more than 50% of the total requirements during the early life of the long distance interstate pipeline companies to approximately 8% of the total gas produced.

2. The major producer of natural gas is usually an integrated company that carries on manufacturing activities requiring hydrocarbons and this group has, over the past few years, drilled from 30 to 35% of the total wells drilled.
3. The most important contributor to oil and gas discoveries and development is the smaller independent producer whose principal business is the drilling of oil and gas wells and the production therefrom.

The small independent drills from 65 to 70% of the total number of wells drilled in the United States. While the big acreage sales are bid in by the major oil companies, in most cases such companies have adequate collateral and income from sources other than production to make the financing of the major acquisitions possible, but the small independent producer group makes the greatest contribution to domestic gas reserves.

In the majority of projects the small independent producer receives the money utilized in the drilling wells from independent investors who invest risk capital solely from the standpoint of the reduction in federal income taxes which would otherwise be paid. The removal of intangible drilling costs as a tax deductible item would promptly dry up drilling funds received from such investors. The lowering of statutory depletion from 27-1/2% to 20% would likewise contribute to a lack of drilling funds from investor sources.

Natural gas has established itself as a highly desirable heat energy source which has been supplied in the desired volumes at a price which has

been lower than other competitive sources of energy. The finding and development costs have gradually increased to a level where greater incentives must be provided for continuing development.

**Impact of a Lessened Incentive
For the Producer to Drill** :

If tax incentives for the drilling of oil and gas wells should be adjusted downward, it removes a source of funds that have been available for such drilling.

The question has often been asked - why the number of well completions have declined with the present tax deductions. The answer is relatively simple.

Under the present price structures which cover the cost of finding and development and the income which is generated at current oil and gas prices, the margin of profit is inadequate to induce the expenditure of risk capital and the drilling of wells in the search of oil and gas is certainly of a high risk nature. It is evident that a higher price must be paid for oil and for gas in order to have the number of wells drilled which will supply current and future requirements. Any downward adjustment in the existing statutory depletion, or the allowance of intangible drilling costs, can only cause a higher price to be paid for the oil and gas which will be produced.

**Example of How Statutory Depletion and
Intangible Drilling Costs Really Work** :

The existing tax regulations are applied to an investor who advances \$1,000,000 for the search and development of natural gas. Based on statistics, approximately 50% of the \$1,000,000 will be spent on

non-productive drilling. This amount will be totally deductible for income tax purposes. The other 50% of the drilling fund would be required to drill 4 wells to a depth of approximately 8,000 feet. The average reserve per well drilled to that depth has averaged out approximately 5 billion cubic feet per well. The gross income from such a well under existing contract terms used in the industry would amount to \$37,168.00 per year. Gross production taxes range from 5.4% to 7.5%. Ad valorem taxes amount to approximately 20% of the investment and operating costs range from 5% to 10% of the gross income. The taxable income after the application of the statutory depletion amounts to approximately \$10,000 and the income tax for the private investor would amount to about \$7,000 per well.

If the investor did not advance these funds on the basis of obtaining the tax deductions, the wells would not have been drilled and the local community would not have the benefit of the industry employing personnel to drill and operate the wells; the state would not have the benefit of the gross production and ad valorem taxes; and the federal government would not have the benefit of the income tax.

The same million dollars could be invested in tax-exempt bonds and make approximately 50% of the same amount of money without taking a risk of losing the entire amount.

Conclusions :

1. It is an indisputable fact which must be faced - that there is a very serious shortage of natural gas being developed in the United States.

2. If future requirements are to be supplied, the number of well completions must be doubled over the 1968 level in the shortest possible time.

3. There are thousands of yards of sediments which are estimated to be productive of natural gas that have not been tested by the drilling of wells.

4. Any downward reduction in statutory depletion, or any reduction in intangible drilling costs as a tax reduction will cause a further decline in the number of well completions.

**UNITED STATES
NATURAL GAS RESERVES AND NET PRODUCTION HISTORY
REDUCED TO RESERVE LIFE INDEX**

(All Volumes in Millions of Cubic Feet @ 14.73 Psia and 60°F.)

<u>Year</u> A	<u>Total Reserves End of Year</u> B	<u>Net Additions To Reserves</u> C	<u>Net Production During Year</u> D	<u>Gross Additions To Reserves</u> E	<u>Reserve Life Index</u> F
1954	210,560,931	-	-	-	22.4
1955	222,482,544	11,921,613	10,063,167	21,948,780	22.1
1956	236,483,215	14,000,671	10,848,685	24,849,356	21.8
1957	245,230,137	8,746,922	11,439,890	20,186,812	21.4
1958	252,761,792	7,531,655	11,422,651	18,954,306	22.1
1959	261,170,431	8,408,639	12,373,063	20,781,702	21.1
1960	262,326,326	1,155,895	13,019,356	14,175,251	20.1
1961	266,273,642	3,947,316	13,378,649	17,325,965	19.9
1962	272,278,858	6,005,216	13,637,973	19,643,189	20.0
1963	276,151,233	3,872,375	14,546,025	18,418,400	19.0
1964	281,251,454	5,100,221	15,347,028	20,447,249	18.3
1965	286,468,923	5,217,469	16,312,852	21,530,321	17.6
1966	289,332,805	2,863,882	17,458,527	20,322,409	16.6
1967	292,907,703	3,574,898	19,064,779	22,639,677	15.4
1968	287,349,852	(5,557,851)	19,373,428(1)	13,815,577	14.8

Source: Reserves of Crude Oil, Natural Gas Liquids, and Natural Gas in the United States and Canada as of December 31, 1968. Pages 120 and 126. Historical Statistics of the Gas Industry.

(1) 1968 Net Production - Preliminary Number.

Note: Includes Alaska (Reserve as of 12/31/68 - 5,252,324 MMCF; 1968 production - 41,681 MMCF).

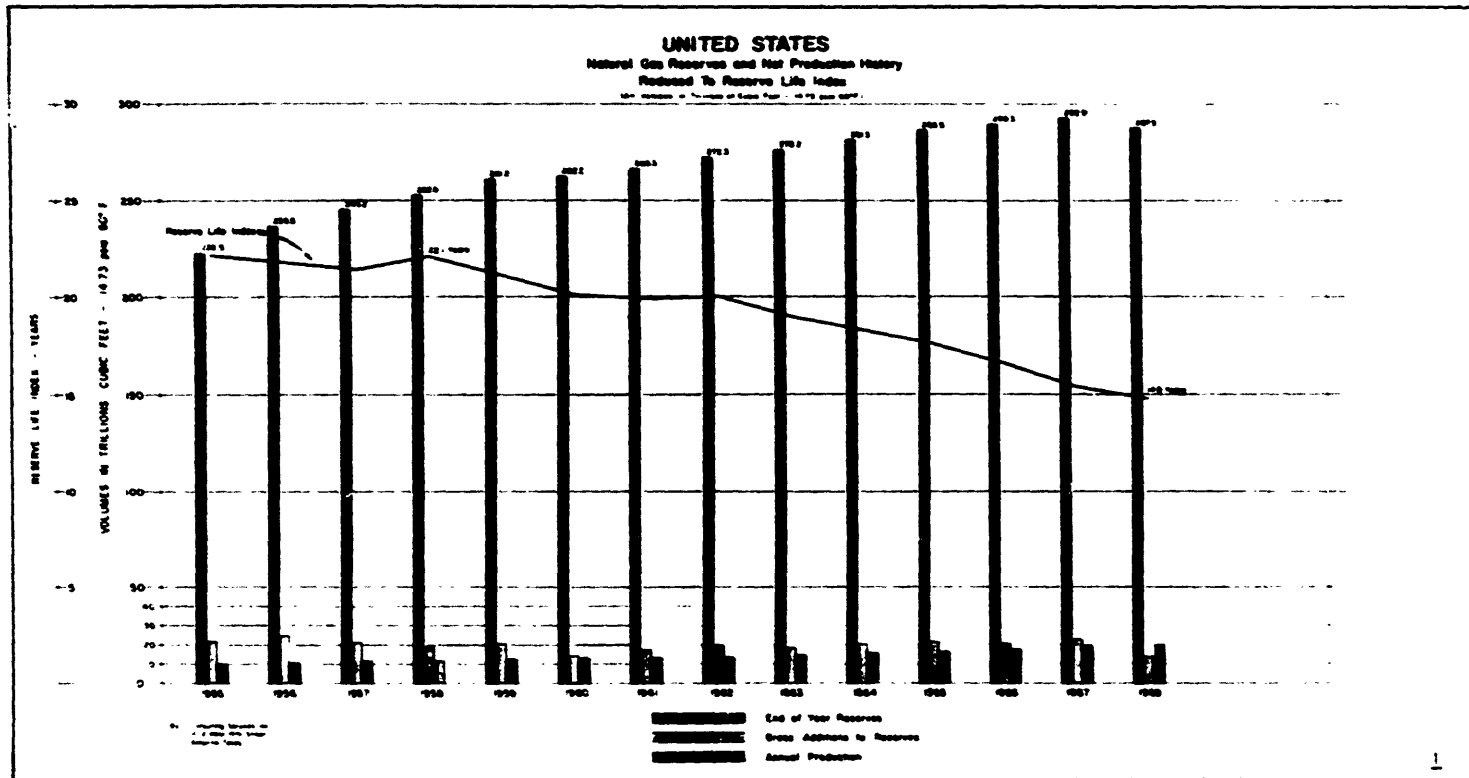
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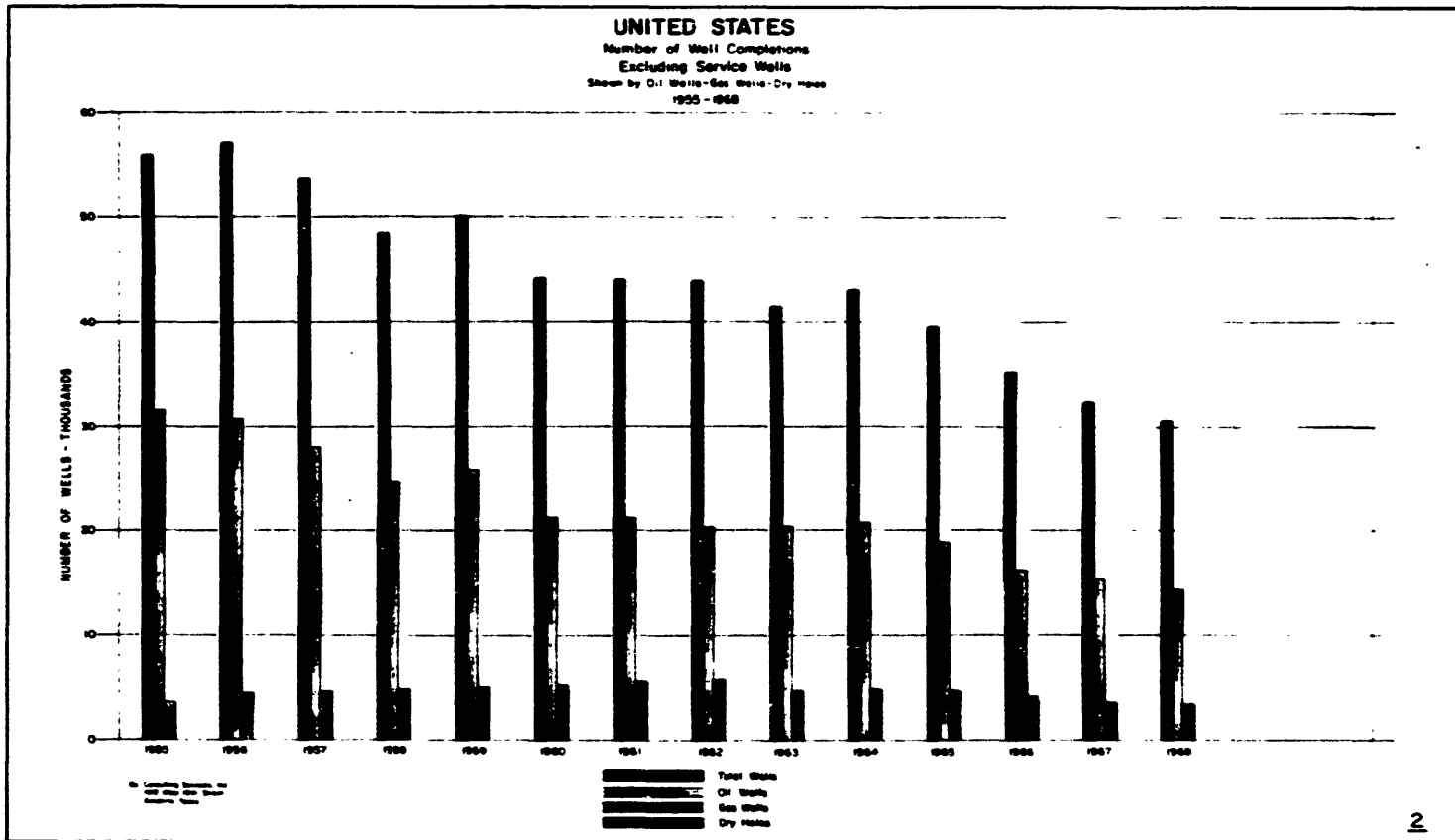
**UNITED STATES
NUMBER OF WELL COMPLETIONS (EXCLUDING SERVICE WELLS)
SHOWN BY OIL WELLS - GAS WELLS - DRY HOLES**

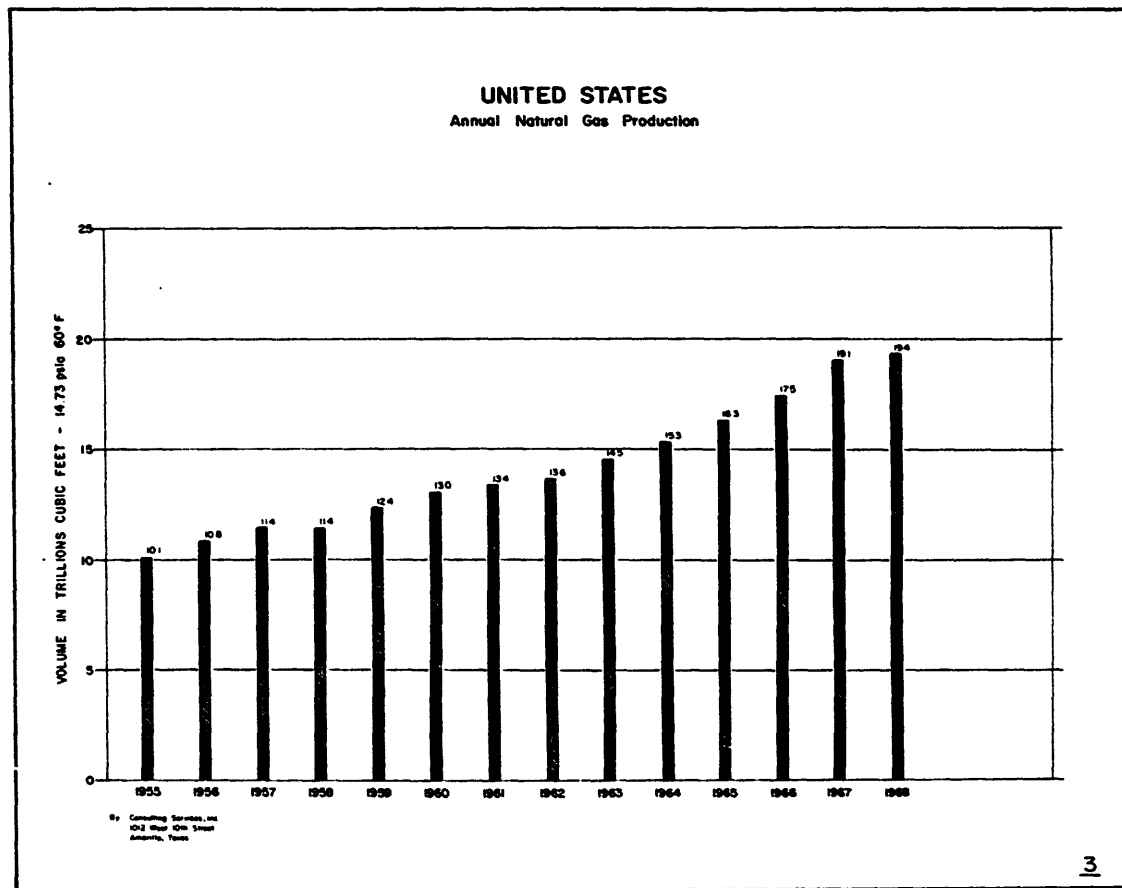
<u>Year</u>	<u>Type Of Well</u>				<u>Total</u>
	<u>Oil</u>	<u>Gas</u>	<u>Producers</u>	<u>Dry</u>	
1955	31,567	3,613	35,180	20,742	55,922
1956	30,730	4,543	35,273	21,838	57,111
1957	28,012	4,620	32,632	20,983	53,615
1958	24,578	4,803	29,381	19,043	48,424
1959	25,800	5,029	30,829	19,265	50,094
1960	21,186	5,258	26,444	17,574	44,018
1961	21,101	5,664	26,765	17,106	43,871
1962	21,249	5,848	27,097	16,682	43,779
1963	20,288	4,751	25,039	16,347	41,386
1964	20,620	4,855	25,475	17,488	42,963
1965	18,761	4,724	23,485	16,025	39,510
1966	16,076	4,191	20,267	14,891	35,158
1967	15,203	3,556	18,759	13,538	32,297
1968	14,227	3,385	17,612	12,987	30,599

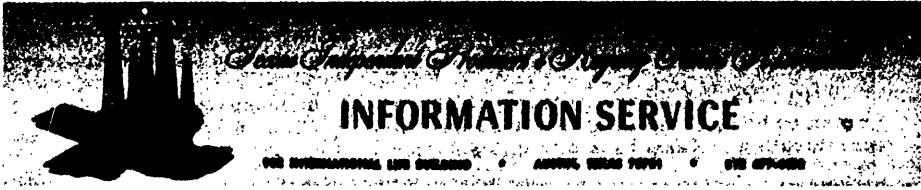
Source: 1955 through 1966 from GAS FACTS, Table 31, Page 37.
1967 through 1968 from International Oil Scouts Assn.
Yearbooks, Pages 531, 538 (1967); Pages 482, 490 (1968).

No. 2a









**Recap
Statement of
William J. Murray, Jr.
Texas Independent Producers & Royalty Owners Association
before the
Senate Finance Committee
October 1, 1969**

I. The nation is running out of oil and natural gas -- not for lack of adequate domestic resources but rather for lack of adequate incentive for domestic exploration and drilling.

--Reserve productive capacity has been grossly overestimated, and some degree of consumer rationing might prove necessary in any future foreign-supply curtailment.

--There is growing recognition within both industry and government that an energy gap looms just ahead, unless domestic drilling rates are restored at least to former levels.

--"End use controls," a form of consumer rationing, may soon be required for natural gas because of diminishing supply; a new FPC study, revealed by Chairman Nassikas, indicates that the supply of deliverable gas is already down to 10 years, and continuing a sharp decline.

--To attempt to fill the emerging energy gap by increasing imports would not only endanger national security but would thwart all efforts to close the nation's payments gap.

--Paradoxically, the proposals before the Committee, labeled tax reform, would further depress domestic exploration and drilling at the very time when an increase is required to avert a supply crisis.

II. The expensing of non-recoverable costs is absolutely vital to the domestic wildcatter, and to require that these costs be capitalized would render it impossible for most small operators to look for oil and gas.

--The independent producer is not trying to escape his fair share of the nation's tax burden; he is quite willing to pay taxes on oil and gas produced and sold, but cannot be expected to drill for oil if denied the privilege of expensing intangibles.

--The intangible charge-off privilege does not allow the producer to retain or pocket one cent of his income, but rather serves to encourage him to go into debt or seek outside risk capital in order to remain in the business of searching for reserves to produce.

--Denying the intangible expensing privilege would be particularly injurious to independents trying to get started, while having relatively far less effect upon the large integrated companies and larger independent producers.

III. The 27.5 percent factor is supportable on numerous bases. Fundamentally, if the rate were too high, there would be disproportionate concentration of resources into this enterprise, when the contrary is true.

IV. The 50 percent of net limitation works a particular hardship upon the smaller operator and upon the caretakers of the nation's marginal or stripper wells so essential to America's relative self-sufficiency in energy resources.

--Because of the 50 percent of net limitation, few domestic independent producers enjoy anything approaching the full 27.5 percent depletion.

--An increase in the net limitation would enable all operators to realize a more nearly uniform depletion percentage factor and serve to encourage domestic independents to become more active in the search for oil.

V. Particularly injurious to independents would be the proposal to require individual producers and outside investors who derive less than 60 percent of their income from oil and gas operations to include intangible expensing and depletion income in computing their tax liability.

--The LTP plan, while excluding large corporations, seems aimed directly at the independent producers, upon whom the nation historically has relied for 75 percent of domestic discoveries.

--It is the independent who is aggressively searching for oil and spending every cent he takes in and can borrow who would be the principal victim of the LTP provision.

VI. The mineral interest holder, or land and royalty owners, more than a half million in number, would be particularly affected by the LTP and percentage reduction proposals.

--Proposals denying land and royalty owners full participation in depletion would undermine the foundation upon which America has built her great energy industry, and would further depress domestic exploration and drilling by denying a primary investment stimulus to this nation's drilling efforts.

VII. Elimination of the ABC method of financing development, elimination of carved-out production payments, and the proposed recapture rule that would require treating as ordinary income any gain or sale of mineral properties to the extent of intangible drilling costs previously deducted, all would hit hardest at the domestic wildcatter.

VIII. The time is at hand to increase, not decrease, incentives to domestic independent oil and gas producers, if we are to avoid a dangerous energy gap.

--Any increase in the tax burden upon the domestic producing segment of the petroleum industry will result either in curtailed drilling or an increase in consumer prices.



Texas Independent Producers & Royalty Owners Association

INFORMATION SERVICE

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STATEMENT

before the

U. S. Senate Committee on Finance

Washington, D. C.

Submitted by

William J. Murray, Jr., President

Texas Independent Producers & Royalty Owners Association

October 1, 1969

Mr. Chairman and Members of the Committee:

My name is William J. Murray, Jr., and I am President of the Texas Independent Producers and Royalty Owners Association. Our membership approximates 3,500 independents who have oil or gas operations in the State of Texas.

TIPRO welcomes this review of oil tax policy, recognizing that the extremely serious problem of inadequate domestic oil and gas supply to meet projected needs must be the central consideration in governmental deliberation of the oil tax program. Independent producers and royalty owners across the nation share a deep concern over the failure of national oil policy to ensure adequate search for domestic reserves.

In considering tax reform proposals as they affect the domestic oil and gas producer, there is first the need for a realistic appraisal of the actual condition of the domestic petroleum industry today.

Bluntly speaking, the nation is running out of oil and natural gas -- not for lack of adequate domestic resources but rather for lack of adequate incentive for domestic exploration and drilling.

There are some who realize that this is true but fear that such a statement will harm the industry and worsen the already-alarming situation. Others fail to speak out because of vast undeveloped reserves of petroleum

both on land and offshore, tremendous quantities of secondary recovery oil which may become available, and potential liquid hydrocarbons which can be produced from oil shale. However great our potential, the hard-boiled statistical fact is that these potentials are not being realized.

The U. S. has grossly inadequate proved recoverable reserves of oil and natural gas to meet the increased demands of the future. Annual additions to reserves are less than consumption; and the method of reporting reserves probably obscures an even darker picture.

This Committee is surely aware of the importance of surplus domestic producing capacity to national security and to a dependable consumer supply. In view of this, it is important to realize capacity has been unintentionally but almost always overstated in the past, and in my opinion is being overstated today -- to the extent that surplus capacity is almost non-existent.

All of the states in this nation, other than Texas and Louisiana, are admittedly producing at capacity. Texas and Louisiana do have some fields that could produce more than they are currently producing but they also have hundreds of fields that cannot long efficiently sustain their current rates. It is probable that the natural decline both in efficiency and in actual productive capacity of these older fields will about offset the remaining efficient surplus capacity of a few other fields. (Even the most conservative estimates indicate that by 1972 Texas, for example, will have run out of surplus producing capacity.)

According to Texas Railroad Commission reports during the first half of 1969, Texas underproduced its oil allowable by nearly 520,000 barrels per day. State oil production has dropped steadily per producing day

authorized during the past five years. In 1969, the State produced one-third less than it did in 1965 per producing day authorized. For Texas -- the state which produced more than two-thirds of all the oil used by the nation's military during World War II and which largely met the sudden needs occasioned by the Korean conflict and the various Mideast crises -- to now be so underproducing its allowable in a relatively normal period is a very sobering fact.

The situation regarding natural gas is fully as bad -- probably worse when it is realized that it is technically difficult and economically unsound to import natural gas from overseas. The reported situation on proved reserves and discovery rates in themselves reveal inadequate supplies to meet future increased demand. But these reserve estimates, like estimates of oil producing capacity, are based on out-of-date studies and are understandably but dangerously optimistic.

Only in recent days the new chairman of the Federal Power Commission, John Nassikas, revealed that a staff study now nearing completion indicates a 10 year supply of deliverable gas. This finding, coupled with available government and industry information, clearly constitutes a warning that unless present trends are reversed soon this nation will face a critical gas supply problem.

We say to you without fear of contradiction that all responsible studies in recent months have concluded that we face a critical oil and gas supply problem -- a domestic energy gap, so to speak. Further, we charge that this energy gap is wholly unnecessary, the result entirely of the denial of adequate incentives for domestic exploration and development. For a great many reasons, our nation cannot and must not tolerate this situation.

At stake not only is consumer discomfort. If rationing of our prime energy resources were the only danger, maybe that would be tolerable. The day we become helplessly dependent upon foreign energy sources, not only will the American consumer be gouged mercilessly in the price he pays but may quite easily find himself denied adequate energy at any price. Quite obviously, this situation would threaten our survival in a hostile world. Our national security and our economic stability are very much imperiled by the present trend.

This, then, is hardly the time to be talking about proposals which would further curtail home exploration and drilling. Yet that is precisely what is before us in the guise of tax reform.

Role of the Independent Explorer

Unquestionably, the most important factor behind the nation's petroleum supply crisis is the decline in independent producer activity. Historically, the independent has been responsible for more than 75 percent of the nation's exploration for domestic oil reserves. It is he who in the past has been willing to assume the substantial risk of drilling wildcat wells.

Since the mid-1950's, however, declining economic incentive has cut the independent's well drilling activity by more than half. This is reflected in the attached chart which shows the sharp decline in the number of wells drilled annually in the nation's largest producing state, Texas. A total of 18,526 wells were drilled in 1959, while a total of only 8,750 is anticipated for 1969, a drop of 52.8 percent.

While the growing demand-supply squeeze has alleviated one of the independent's former economic problems -- severely restricted opportunity

to produce -- several others remain to assure inadequate exploration and development activity on his part. Among them are: an inadequate price for domestic crude oil that still remains below decade-ago levels; sharply increasing costs, which continue to rise in the extended inflationary era now being experienced; ineffective oil import regulation which not only failed to restrict import growth in reasonable proportion to domestic production but also apportioned import quota privileges in a manner which served special interests without due regard for the objective of ensuring adequate domestic exploration and drilling; a steady increase in state and local tax burdens; seriously inadequate natural gas prices depressed by an unrealistic area pricing policy administered by the Federal Power Commission; and federal economic policies which have discouraged outside investment in drilling activity. These drilling-incentive depressants virtually guarantee inadequate home drilling in the critical decade ahead, even without the tax proposals currently being aimed at the independent.

There is growing awareness in the Federal Government that a supply crisis exists and that something must be done to assure an adequate domestic drilling program. Yet, paradoxically, serious consideration is now being given by both the Administration and Congress to tax proposals which would further reduce drilling incentives for domestic independent producers in particular.

Current and Proposed Tax Provisions

To emphasize the seriousness of this paradox there is need to discuss current tax provisions and the way in which a typically small but aggressive independent producer operates.

Expensing of Non-Recoverable Costs. First and most important to the independent is the right to expense the non-recoverable costs. These, usually referred to as "intangibles," include the cost of drilling the hole, the cost of mud, cement and chemicals used in drilling and the cost of various services such as electric logging, gun perforating, acidizing or fracturing. Tangibles include casing, tubing, rods, underground pump equipment, surface pump jacks and motors, stock tanks, separator heater treaters and all other surface equipment. Under the present tax law all operators must capitalize their tangible costs but have the option of either capitalizing or expensing the intangibles. It is my understanding that most oil producers currently elect to expense intangibles. However, it has been suggested that the large corporations who are reasonably certain of continuous income for the next ten or more years would not be seriously penalized by the requirement that intangible costs be capitalized and depreciated over a ten-year or longer period.

On the other hand, capitalization of intangibles would so adversely affect the independent explorer and producer as to cause almost complete cessation on his part of further exploration and development expenditures. This we contend would be extremely harmful to the national welfare.

Furthermore, the privilege of expensing intangibles cannot be considered a tax loophole because it does not permit retaining tax-free income. Actually, the typical aggressive independent who has been criticized for escaping income tax does so only because he spends his total income on intangibles and dips into capital or more usually borrows an approximately equal amount to pay for the tangible costs.

The ratio of tangible to intangible costs varies, but on the average well are approximately equal. It should be emphasized that statements early attributed to Treasury officials must have resulted from misquotation or misunderstanding because no producer is allowed to charge off the entire cost of a producing well. He is currently permitted to expense only the intangible costs but must capitalize the approximately equal tangible costs.

The privilege of expensing intangibles does allow the aggressive independent to escape taxation for a period of time if he uses all of his income on intangible development costs and goes into debt for an approximately equal amount of tangible costs. But during this period when he "escapes" taxes there are no loopholes involved, because he is actually keeping no money -- but rather he is continuously going deeper into debt. The incentive for doing this is the anticipation that some day he will be able to enjoy the fruits of his occasionally-successful ventures, either by statutory depletion or by capital gains sales. These incentives must be retained. The immediate point is that intangible expensing can not correctly be described as a loophole but rather a very important tax option if domestic exploration and development are not to be severely retarded.

This is particularly important to young men or young companies who are trying to get started in the oil business. Intangible expensing is vital to them and the proposed "60 percent of income from oil" requirement

would never allow them to get started. In effect, it would give a monopoly to existing oil companies and no opportunity for newcomers.

27.5 Percent Depletion Allowance. We firmly agree with the other industry witnesses who have presented to this Committee sound arguments supporting the economic justification of at least the current percentage depletion allowance. There remains the basic fact that percentage depletion is an incentive to drill in a high-risk industry. Unfortunately the odds are against those who will explore for petroleum in the United States. But the fact that some do hit and because of depletion can keep a significant portion of their income encourages a great many others to continue year after year to invest more in exploration than they ever receive.

The logic of the 27.5 percent factor is supportable on numerous bases. For one thing, if it were too high, as some charge, there would be disproportionate concentration of resources into this enterprise. The opposite is true, quite obviously, today. But in terms of the objective of avoiding taxes upon that portion of gross income which represents a return of capital, it can likewise be more than justified. A test of the formula to see whether 27.5 is indeed too high can be conducted simply by asking whether the depletion rate times the gross selling price of a unit of production equals the price at which a similar unit of production

can be purchased in the ground. Stated another way, a producer should be entitled to end up the year with the same reserves he started with before he has taxable income.

In the case of oil, assuming the average price at lease tanks of \$3.00 per barrel, when 27.5 percent is taken, a producer deducts 82.5 cents from his net income. But he currently must pay \$1 to \$1.25 per barrel for reserves to replace the barrel produced. The point is that a producer should have a depletion rate which will give him enough money tax free to replace that year's production by buying reserves. He may of course decide instead to gamble that he can replace them more cheaply by finding them himself and this is his decision and his risk. If a producer can take only 82.5 cents tax free out of a barrel of oil, he is much more inclined to sell his reserves for \$1.25 per barrel than if his depletion is \$1.25 per barrel. The fact that the 27.5 percent factor is not returning his capital holding accounts for the persistent stream of sellouts with its monopoly implications.

With this in mind, we believe the primary concern of this Committee should be whether or not percentage depletion is performing its intended

function both as an incentive to drill and a means of returning capital investment. Since the facts at hand support the contention that the economic and military survival of this country require a greater exploratory effort than is taking place, Congress should be looking for ways to increase rather than retard the incentive for the risk-takers.

The 50 Percent of Net Limitation. One of the main reasons the current depletion provision has failed to provide adequate incentive is the companion restriction of its application to 50 percent net income. This hits hardest the independent producer who does virtually all the domestic exploring. Few domestic independent operators are able to enjoy the full 27.5 percent depletion, whereas such may not be the case with international companies. To illustrate how effective the 50 percent net limitation decreases percentage depletion taken by small operators, this Association sampled its membership. Of 70 operators sampled the average depletion taken was only 19.09 percent. One of these, a reasonably typical independent in Texas with a great many years of exploration experience, and a demonstrated capacity as a competent oil finder and producer, has failed to achieve the full 27.5 percent depletion on all but three leases since 1952. Even on these three leases, the full application was short lived in each case.

Internal Revenue studies, we believe, do not properly reflect the true picture for typical independent producers. The examples most often cited are anything but typical, and have almost no relation to the operations of domestic non-integrated independent producers -- the nation's wildcatters.

There are several reasons independents are unable to enjoy full depletion. As a rule, they have little or no low-production-cost holdings,

more typical of foreign reservoirs, on which attainment of the full rate is normal. Independents are badly hurt by the inflation squeeze on operations, since crude prices have failed to keep pace with higher wages, material and administrative costs of operation, thereby triggering the 50 percent net income limitation. Most independents are "caretakers" of the nation's defense-vital marginal or "stripper" production operations, protecting some 6.3 billion barrels of oil reserves, which reduce net income levels. Finally, few independents are fortunate enough to discover production sufficiently flush to command full depletion after the waiting period during development when percentage depletion does not apply.

It is our position, in short, that present depletion provisions are anything but excessive to the purposes for which percentage depletion was provided, insofar as domestic operations are concerned. To repeat, the 50 percent of net profit limitation serves unnecessarily to prevent its functioning effectively as an incentive to adequate drilling at home.

Other Tax Provisions. We most strenuously object to the proposal to require individual producers and outside investors who earn less than 60 percent of their income from oil and gas operations to include income derived from application of intangible expensing and percentage depletion in computation of their income tax liability. This would have precisely the same adverse effect on incentive to drill, in principle if not in degree, as the elimination of intangible expensing or reduction in percentage depletion would have. This proposal, commonly referred to as a plank of the Limitation on Tax Preferences plan, would, moreover, be aimed directly at the independent producer as opposed to the major oil corporation.

The independent who is truly aggressive in development is not only spending all of his income but borrowing a substantially equal additional amount. He is building for the future in the hopes then that he can develop production on which to pay full taxes. It is this very sort of independent upon whom the nation must depend to do the exploration and development which the country now so desperately needs. It is the independent who is spending every cent he takes in and every cent he can borrow who would be the victim of the LTP provision.

The mineral interest owner, the land and royalty owners of this nation, more than a half million in number, would be particularly affected by this and other proposed changes. At stake quite literally may be the foundation upon which America has built its great energy industry. If the land and royalty owners are denied any part of the present depletion provision, the result can only be a further depressant upon domestic exploration and drilling. For it is this source which provides a primary stimulus -- in the form of risk capital and encouragement -- to the exploration and drilling efforts which have so often proved vital to our national survival.

Other proposals either passed already by the House of Representatives or proposed by the Administration which hit hardest at the small independent include elimination of the ABC method of financing development of discoveries, elimination of carved-out production payments, and the proposed recapture rule that would require treating as ordinary income any gain on sale of mineral properties to the extent of intangible drilling costs previously deducted. While independents favor elimination of abuses or inequities under the Internal Revenue Code, they view these current provisions as vital incentives for

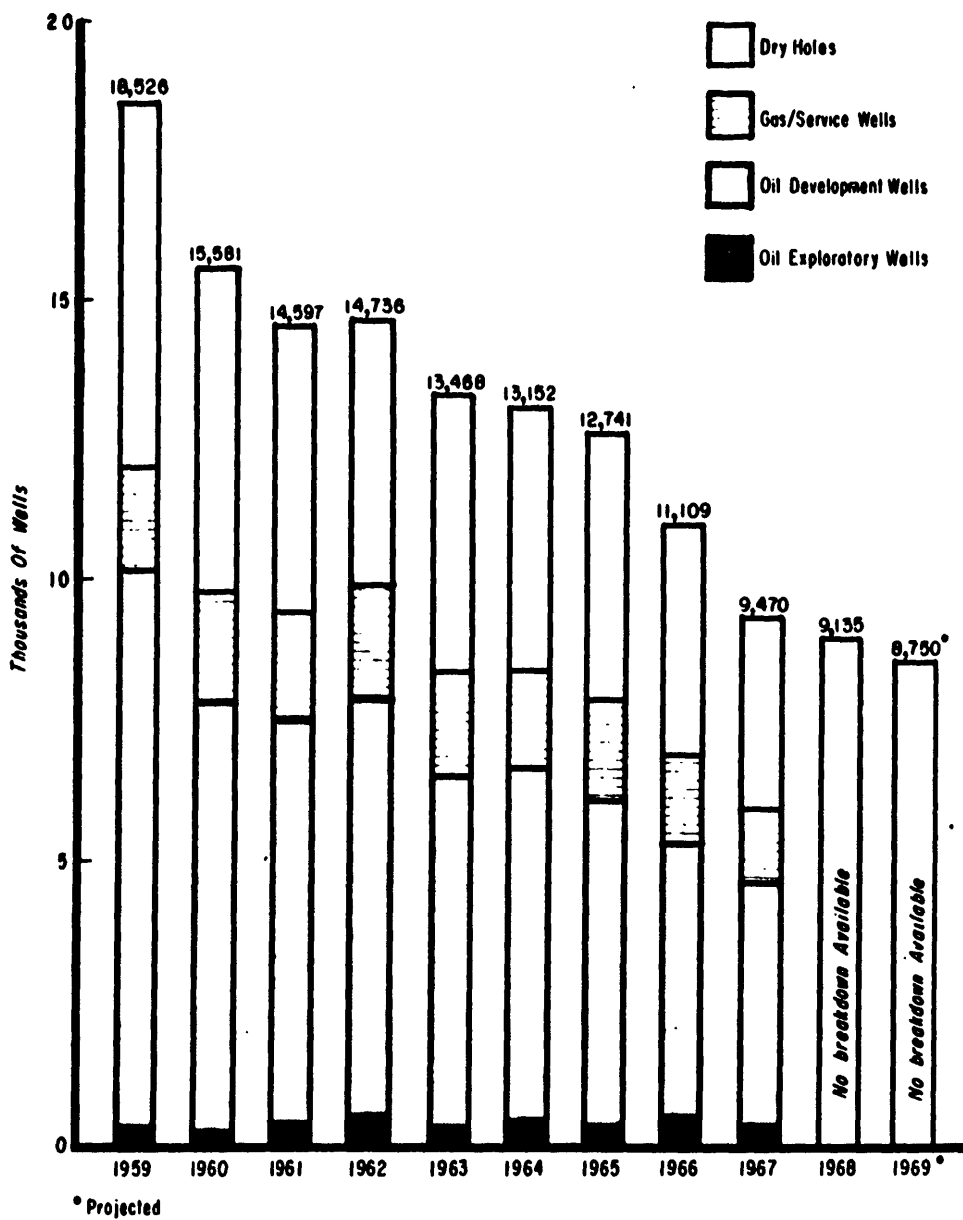
further exploration. Their elimination or revision would be a devastating economic blow for most independents, necessitating a further sharp curtailment in their drilling programs.

Conclusion

If this Committee concurs in the conclusions that the nation is already facing an energy gap which could soon threaten its very survival, then surely it concurs also that the time is at hand to devise means of revitalizing the domestic producing industry. The future of the industry will literally be determined by what government oil policy emerges in the next few months. Time is about to run out for a relatively self-sufficient energy industry in this nation under present policy. If it is agreed this is vital, then incentives must be improved, not lessened, for the domestic oil and gas producing segment of the industry. If the proper changes are not made, then investments will increasingly be channeled abroad, with consequent impairment of the domestic industry -- and with dire consequences to the nation's security and payments balance.

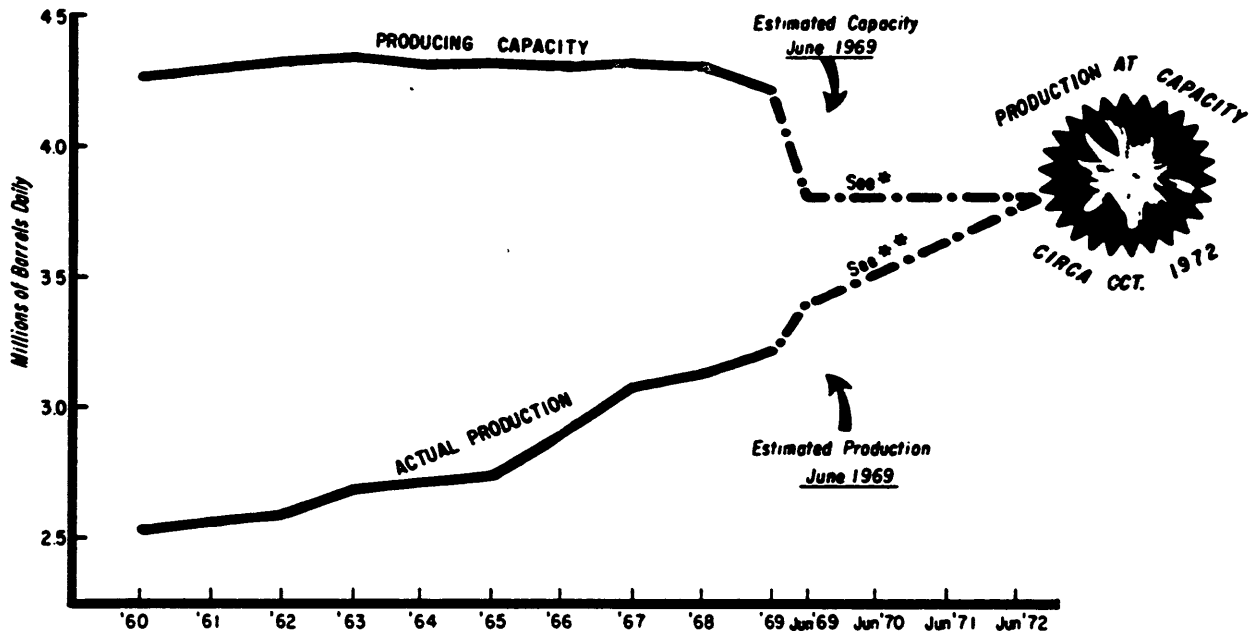
It seems not improper or presumptuous under these circumstances, to say frankly that responsibility for what happens should be clearly assumed by those in a policy-making position of government. If this Committee does not want this nation helplessly dependent upon foreign sources for its energy resources, then any changes in federal taxation of the domestic oil and gas producing industry should be in the direction of increasing incentives for the domestic independent producing segment of the industry.

TRENDS IN TEXAS WELL DRILLING DURING 1959-69 DECADE



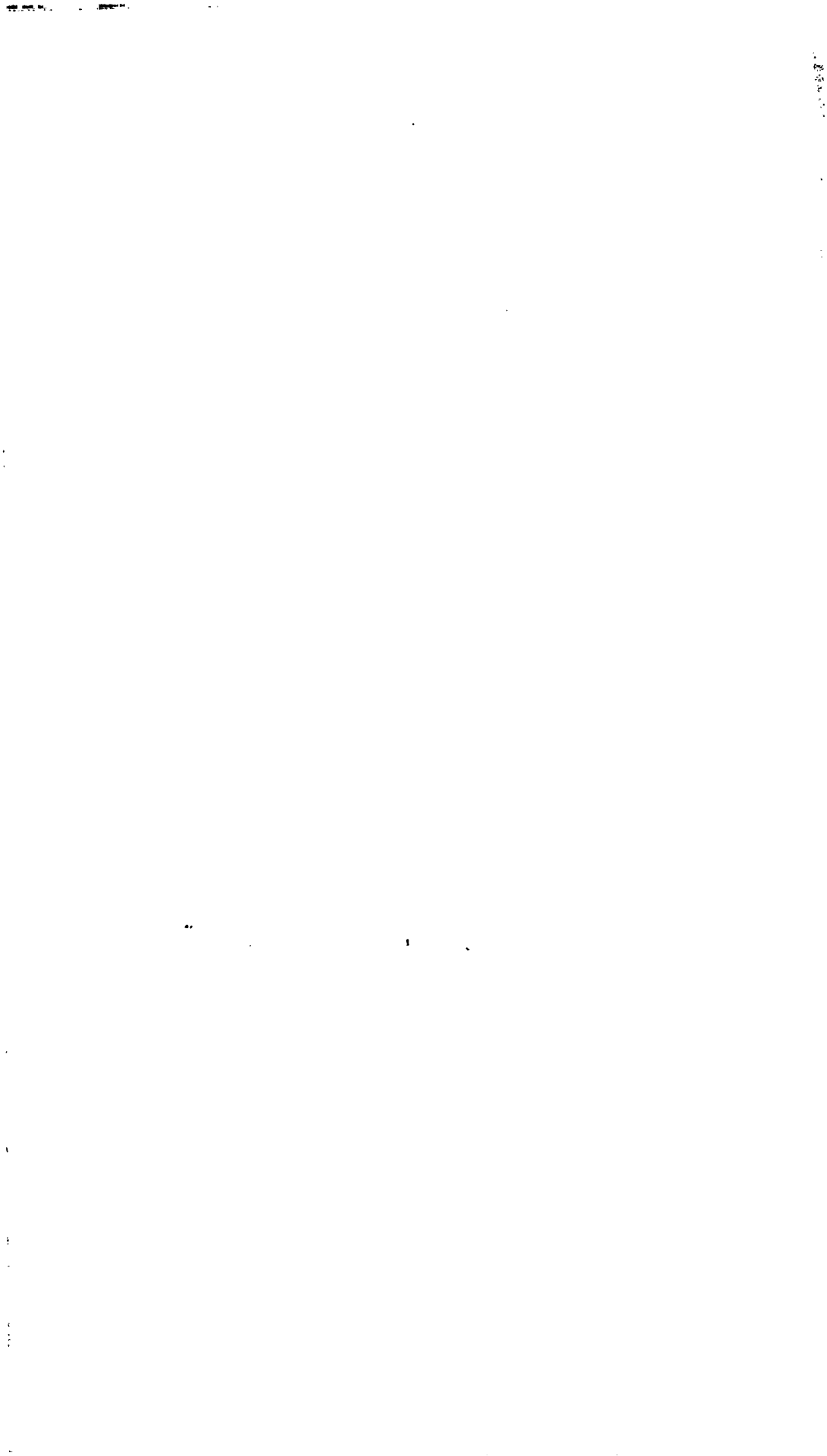
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ACTUAL AND PROJECTED COMPARISON BETWEEN TEXAS OIL PRODUCTION AND PRODUCTIVE CAPACITY: 1960-1972



* Experts close to the situation estimate maximum capacity of 3.8 million barrels daily now and for the foreseeable future, assuming little improvement in drilling rates, upward revision of field NERS and allowable limits where feasible, and continued secondary recovery activity at current levels.

* * Assuming an annual growth rate in demand for Texas crude of 3.5%. May be higher due to lack of surplus capacity in other states between now and 1972.





W.C.TOGA

**WEST CENTRAL TEXAS
OIL & GAS ASSOCIATION**

(815) 677-2469 • P O BOX 2332 • 337 PETROLEUM BLDG • ABILENE TEXAS 79604

TESTIMONY

of

A. V. JONES, JR., PRESIDENT

**WEST CENTRAL TEXAS OIL & GAS ASSOCIATION
P. O. BOX 2332, ABILENE, TEXAS**

Before the

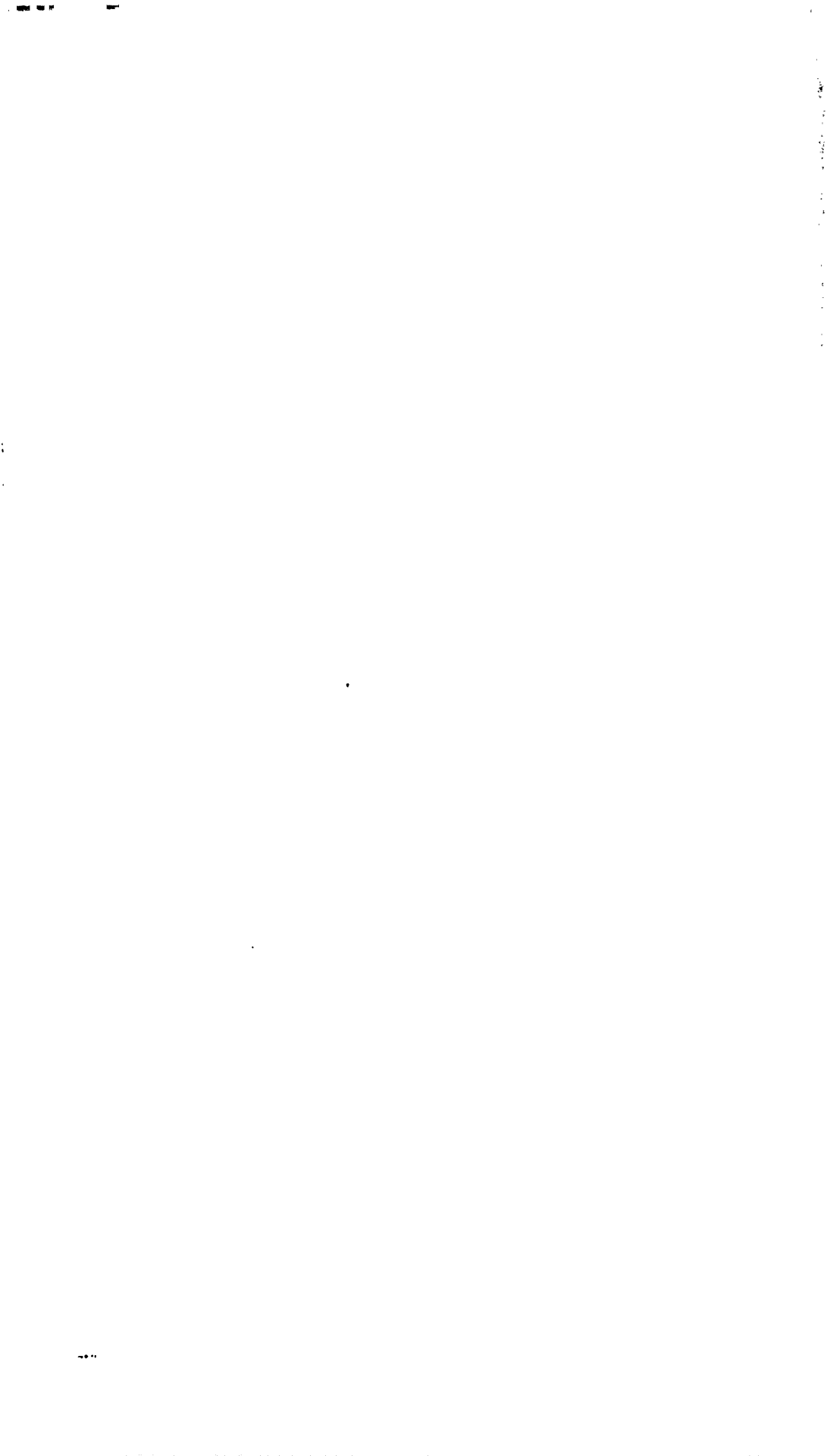
COMMITTEE ON FINANCE

**UNITED STATES SENATE
WASHINGTON, D. C.**

in re:

**H. R. 13270 Tax Reform Act
1969**

September 30, 1969





WEST CENTRAL TEXAS OIL & GAS ASSOCIATION

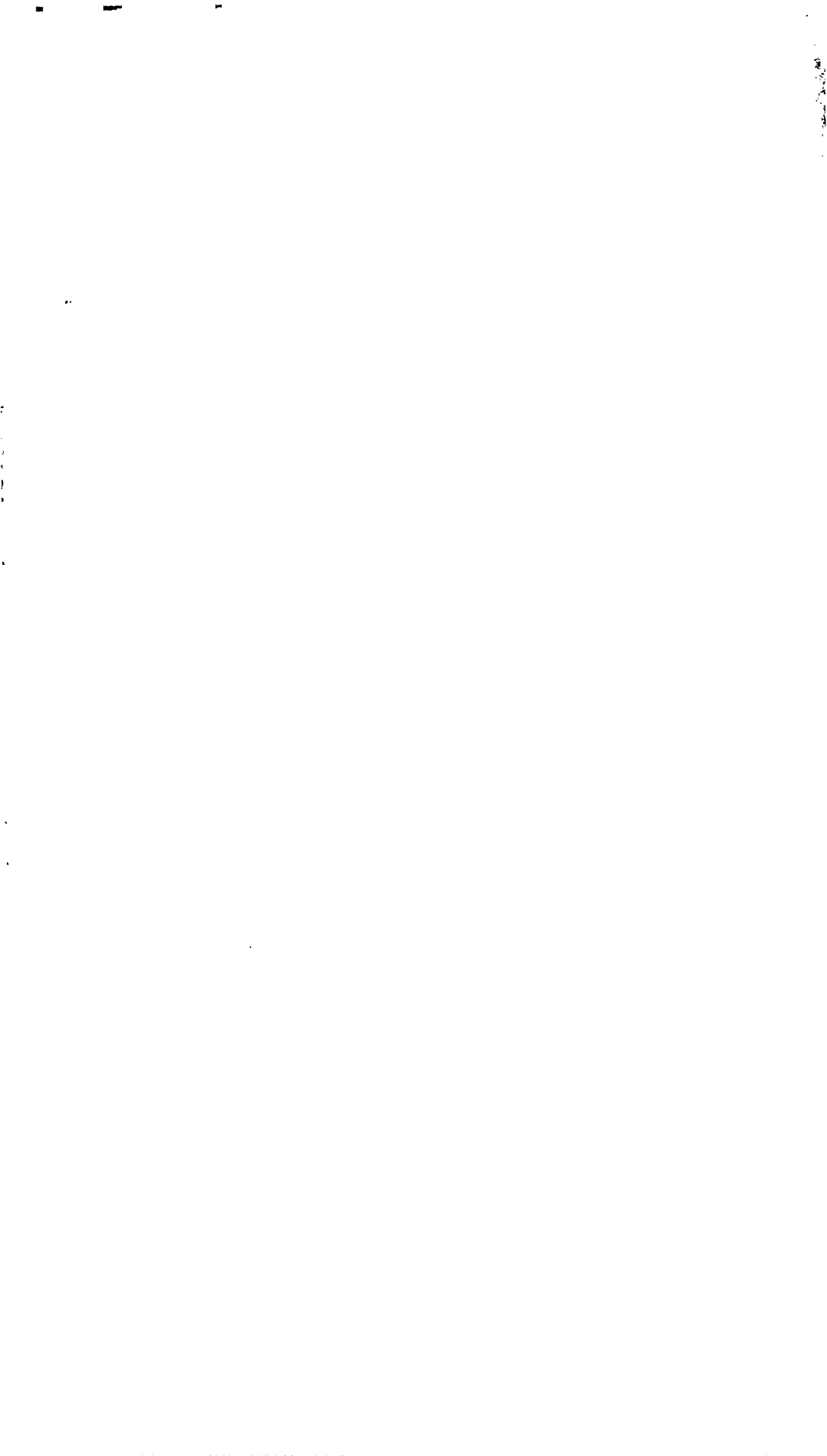
(818) 677-2488 • P O BOX 2332 • 337 PETROLEUM BLDG • ABILENE TEXAS 79604

SUMMARY

TESTIMONY OF A. V. JONES, JR., PRESIDENT WEST CENTRAL TEXAS
OIL & GAS ASSOCIATION ABILENE, TEXAS BEFORE THE COMMITTEE
ON FINANCE IN THE U. S. SENATE, WASHINGTON, D. C.,
RECOMMENDING:

1. THE PETROLEUM INDUSTRY SERVES THE CONSUMING PUBLIC
AND SERVES IT WELL.
2. PETROLEUM EXPLORATION MUST BE INCREASED AND SINCE
IT IS RISKY ALL COSTS SHOULD BE DEDUCTIBLE WHEN
INCURRED.
3. RULES ON STATUTORY DEPLETION AND PRODUCTION PAYMENTS
SHOULD BE RETAINED.
4. THE LIMIT ON TAX PREFERENCE (LTP) IS DIRECTED EXCLUSIVELY
TOWARDS THE SMALL BUSINESSMAN AND IT WILL DESTROY HIM.
IF THIS PROVISION BECOMES LAW, IT WILL FOSTER A MAJOR
COMPANY MONOPOLY IN THE PETROLEUM INDUSTRY.
5. RECOMMENDATION THAT THE PRESENT OIL AND GAS TAX STRUCTURE
BE LEFT UNCHANGED.

September 30, 1969



MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS A. V. JONES, JR. I AM AN INDEPENDENT OIL AND GAS PRODUCER AND LIVE IN ALBANY, TEXAS. I APPEAR HERE TODAY AS PRESIDENT OF THE WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION AND AM REPRESENTING THE MEMBERS WHO BELONG TO THIS ASSOCIATION AND ALSO AS AN INDIVIDUAL SMALL BUSINESSMAN WIDELY EXPERIENCED IN OIL EXPLORATION AND DEVELOPMENT.

I APPRECIATE THE PRIVILEGE OF BEING ALLOWED TO APPEAR HERE TODAY BEFORE THE SENATES' COMMITTEE ON FINANCE BECAUSE THE TAX PROPOSALS YOU ARE CONSIDERING ARE OF GRAVE CONCERN TO ME INDIVIDUALLY, THE MEMBERS OF MY ASSOCIATION, AND ALL WHO PARTICIPATE WITH US FINANCIALLY, ALSO VITALLY CONCERNED ARE THE HUNDREDS OF THOUSANDS OF PEOPLE IN ALL OF 32 OIL AND GAS PRODUCING STATES WHO ARE DIRECTLY INVOLVED IN THE DOMESTIC PETROLEUM INDUSTRY.

THE CONSUMING PUBLIC, ALL THE PEOPLE OF THIS NATION, HAS BEEN WELL SERVED BY THE PETROLEUM INDUSTRY. FEW INDUSTRIES HAVE SUPPLIED THE CONSUMING PUBLIC WITH CONTINUALLY IMPROVING PRODUCTS AT ESSENTIALLY THE SAME REAL PRICE. ANY ADVERSE LEGISLATION WILL DIRECTLY AFFECT ALL CONSUMERS.

TO SUPPLY THE ENERGY NEEDS OF THIS NATION, MOST GOVERNMENTAL AND INDUSTRY REPORTS EMPHASIZE THE FACT THAT PETROLEUM EXPLORATION MUST BE INCREASED SUBSTANTIALLY OVER THE NEXT FEW YEARS. HISTORICALLY THE INDEPENDENT SEGMENT OF THE PETROLEUM INDUSTRY EXPLORED FOR AND FOUND MOST OF THE DOMESTIC PRODUCTION. IN ORDER TO CONTINUE THE NECESSARY DOMESTIC EXPLORATORY EFFORT,

THE COST OF EXPLORATION AND DRILLING -- KNOWN AS INTANGIBLES -- MUST CONTINUE TO BE RECOGNIZED AS ESSENTIAL BUSINESS EXPENSE FOR ALL PARTICIPANTS IN THE OIL AND GAS INDUSTRY. THERE MUST BE NO 50% OR ANY OTHER LIMITATION -- ALL COSTS SHOULD BE DEDUCTIBLE WHEN THEY ARE INCURRED.

PETROLEUM EXPLORATION IS A VERY RISKY ENTERPRISE AND CORRESPONDINGLY THERE MUST BE SUBSTANTIAL PROFITS TO BALANCE THE EXTENSIVE LOSSES. THE PUBLIC HEARS ABOUT THE FEW WINNERS -- BUT NEVER HEARS ABOUT THE LARGE NUMBER OF LOSERS. THESE LOSERS ARE A NECESSARY PART OF THE INDUSTRY. SOME MAKE IT BIG AND SOME LOSE -- THIS BUSINESS IS UNAVOIDABLY DIFFERENT FROM FARMING OR MANUFACTURING OR MERCHANDISING -- IT IS A HIGH RISK OPERATION. LEGISLATIVE PROPOSALS HAVE OFTEN QUESTIONED THE NEED FOR DEDUCTING INTANGIBLES FROM TAXABLE INCOME. INTANGIBLES ARE THE COST OF FINDING PETROLEUM AND DRILLING WELLS NECESSARY TO PRODUCE THE OIL OR GAS. THEY ARE ROUTINE, NORMAL, LEGITIMATE COSTS OF DOING BUSINESS. THERE SHOULD BE NO LIMITATION WHATSOEVER ON WHAT CAN BE INVESTED OR REINVESTED IN THE BUSINESS OF OIL AND GAS EXPLORATION TO PROVIDE FOR OUR NATION'S NEEDS.

STATUTORY PERCENTAGE DEPLETION HAS BEEN WIDELY MISUNDERSTOOD. WHEN OIL AND GAS ARE SOLD THE RECEIPTS ARE PARTLY CAPITAL AND PARTLY INCOME. OUR NATIONAL TAX POLICY HAS ALWAYS RECOGNIZED THAT THE SALE OF A CAPITAL ASSET SHOULD BE GIVEN SPECIAL TREATMENT. THIS ACCOUNTS FOR THE FACT THAT MORE THAN ONE HUNDRED MINERAL PRODUCTS ARE SUBJECT TO A DEPLETION ALLOWANCE AND RIGHTLY SO. CURRENTLY PERCENTAGE DEPLETION IS LIMITED TO 50% OF NET INCOME. DUE TO

THE EXTREME RISKS OF THE PETROLEUM INDUSTRY, HOWEVER, THIS LIMITATION SHOULD BE RAISED TO 75% OR MORE.

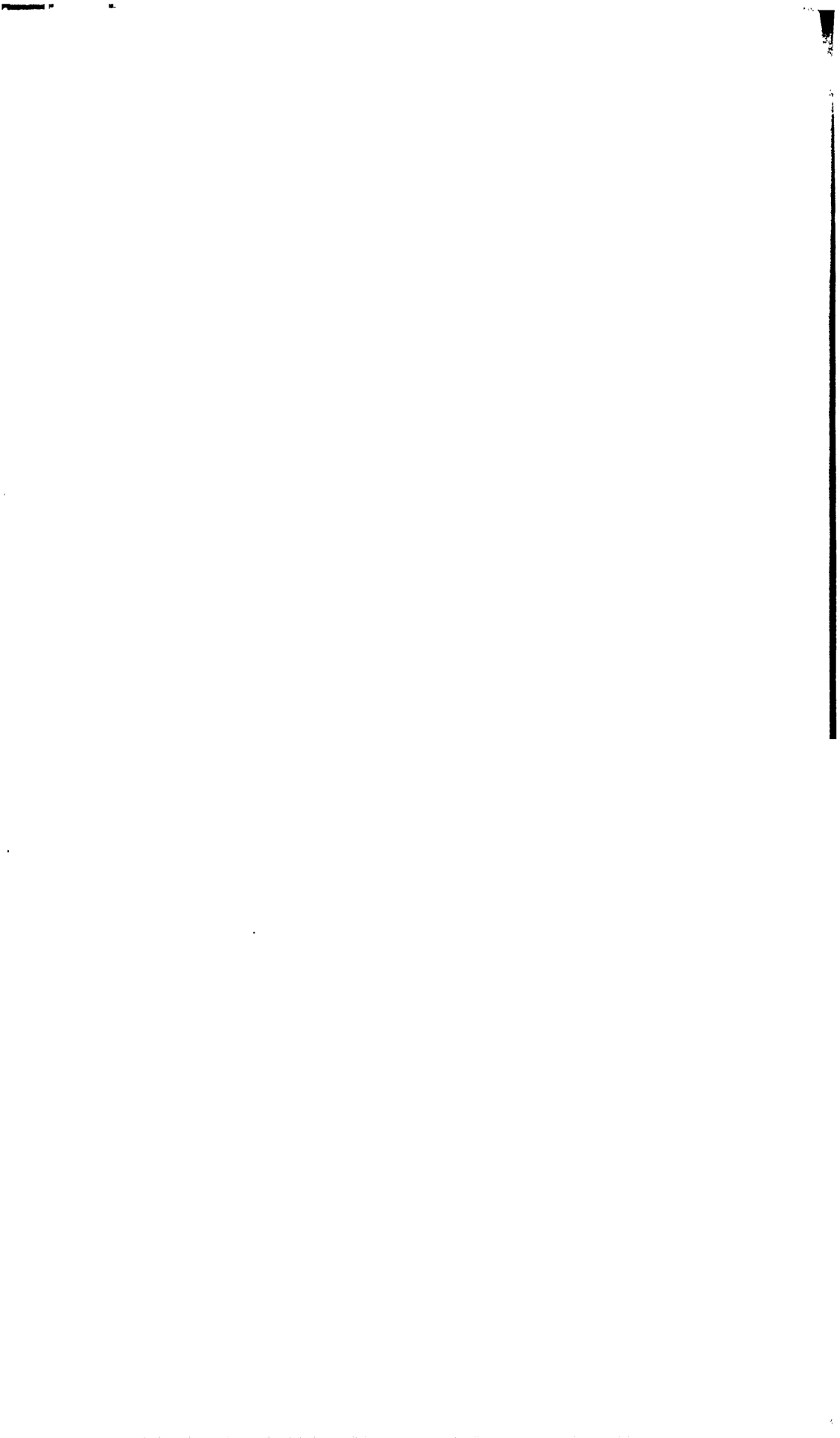
PRODUCTION PAYMENTS AND THEIR USES HAVE BEEN THE SOURCE OF CONSIDERABLE CONFUSION. IT IS OUR BELIEF THAT PRESENT TAX TREATMENT OF BOTH ABC AND CARVEOUT TYPE OIL AND GAS PAYMENTS SHOULD BE CONTINUED.

MOST OF THE CURRENTLY PROPOSED OIL INDUSTRY TAX REFORMS ARE DIRECTED AGAINST THE SMALL BUSINESSMAN ENGAGED IN OIL EXPLORATION AND DEVELOPMENT. TO BE SPECIFIC, THE SO-CALLED LIMIT ON TAX PREFERENCES (LTP) IS APPLICABLE ONLY TO INDIVIDUALS, PARTNERSHIPS, TRUSTS AND SMALL CORPORATIONS. THIS IS A PUNITIVE PROPOSAL, WHICH IF IT BECOMES TAX LAW WILL PRACTICALLY WIPE OUT THE INDEPENDENT SEGMENT OF THE INDUSTRY WHEN THE NEED FOR OUR EFFORTS HAS NEVER BEEN GREATER. NOT ONLY WILL THIS SO-CALLED LIMIT ON TAX PREFERENCES (LTP) PROVISION WIPE OUT THE INDEPENDENTS IN OIL AND GAS EXPLORATION, BUT ULTIMATELY IT WILL CREATE A MAJOR COMPANY MONOPOLY BY DESTROYING SMALL BUSINESSMEN. IT DOES NOT SEEM LIKELY THAT IT IS THE INTENT OF TAX REFORM TO FOSTER ANY MONOPOLY, BUT IT WILL BE THE INEVITABLE RESULT OF THIS LIMIT ON TAX PREFERENCES (LTP) TO CREATE JUST SUCH A MAJOR COMPANY MONOPOLY IN THE PETROLEUM INDUSTRY.

THE BASIC ECONOMIC FACTS OF FUNDAMENTAL IMPORTANCE TO OUR INDUSTRY AND NATIONAL SECURITY HAVE BECOME OBSCURED AND CONFUSED. IT APPEARS THAT THE EMOTIONAL AND POLITICAL ASPECTS OF TAX REFORM PROPOSALS HAVE SHAPED THEM INTO A DISCRIMINATORY PROGRAM -- NOT INTO A SOUNDLY CONSIDERED PIECE OF TAX LEGISLATION.

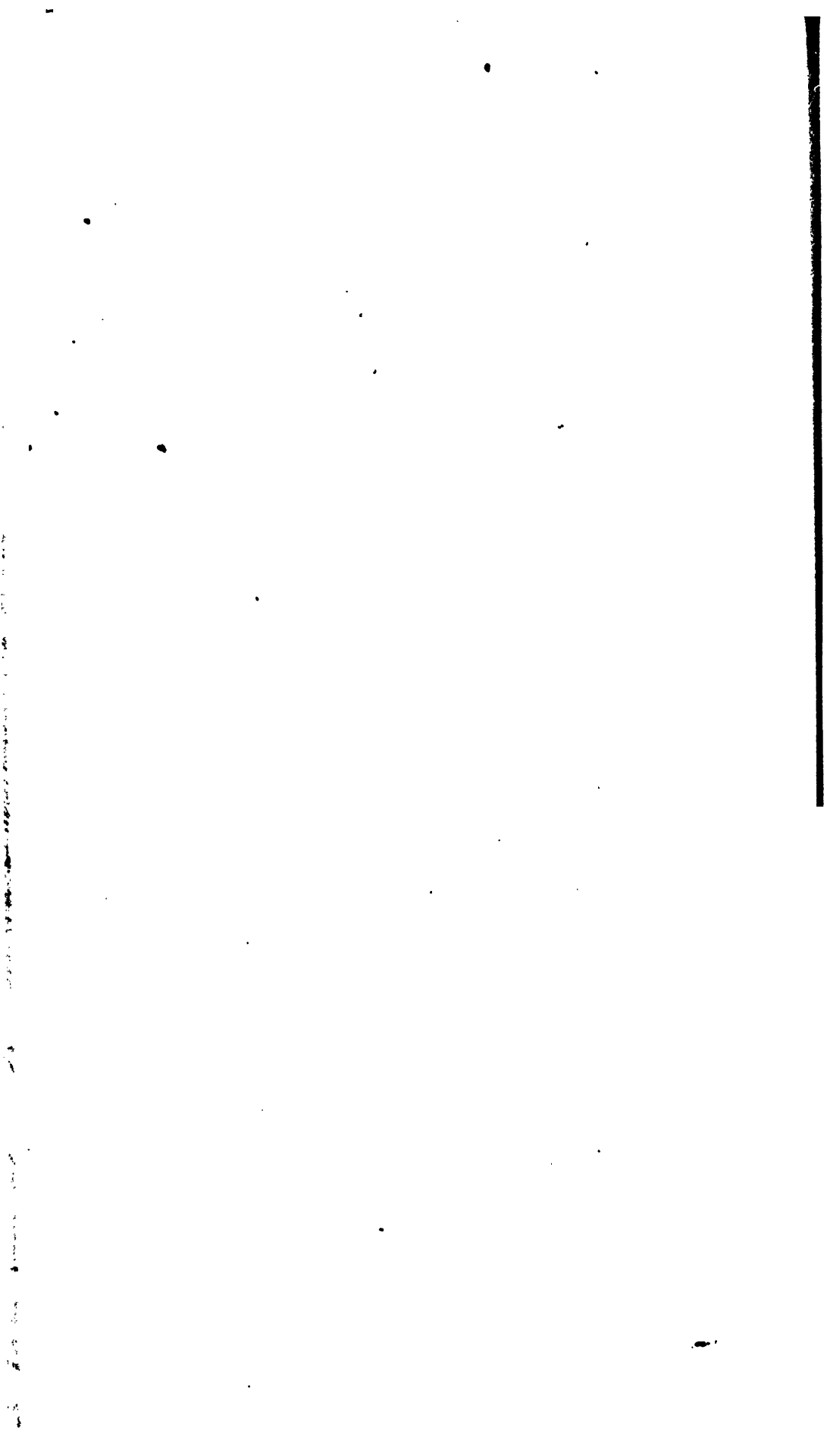
INSTEAD OF CREATING THE NECESSARY ECONOMIC CLIMATE FOR THE EXPANSION REQUIRED, THE PROPOSALS BEFORE YOU WOULD DESTROY MOST OF THE INCENTIVE FOR PETROLEUM EXPLORATION.

GENTLEMEN, IT IS MY RECOMMENDATION THAT THE TAX STRUCTURE OF THE DOMESTIC PETROLEUM INDUSTRY BE LEFT UNCHANGED.



STATEMENT
by
Eberhard P. Deutsch
of
New Orleans
before the
Senate Finance Committee,
Washington,
on
October 1, 1969,
on
Production Payments
under HR 13270,
the
Tax Reform Act of 1969.

DEUTSCH, KERRIGAN & STILES
COUNSELLORS AT LAW
HIBERNIA BANK BUILDING
NEW ORLEANS 70112



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SUMMARY

1 - The independent petroleum producers of the United States oppose any reduction in the present oil-depletion allowance under the income-tax laws, on the ground that this allowance is a vital incentive to stimulate the search for new sources of oil and gas.

2 - Exploration and development of oil and gas reserves have grown increasingly expensive in recent years. The independent producer has had to meet these ever-increasing costs, in large measure, from carved-out production payments.

3 - The present advantageous tax treatment of such payments was accorded to the petroleum industry to encourage the search for oil and gas, and to stimulate its production.

4 - It is accordingly tremendously important, especially

DEUTSCH, KERRIGAN & STILES

to the independent petroleum producer who has limited means at his disposal, that the present tax treatment accorded to carved-out production payments be retained.

5 - Drilling budgets for one year are always prepared during the preceding year, and land-lease acquisitions are ordinarily worked out and committed two or three years in advance; and it is contemplated that carved-out production payments are to bear most of the exploration and development expense in the year in which that work is done.

6 - If it is deemed necessary, for reasons beyond the crying needs of the independent oil producer, to discontinue the present tax treatment of carved-out production payments, that should under no circumstances be done retroactively.

7 - Such retroactive repeal would deprive the independent producer of venture and short-term operating capital, after he is committed and already in debt, at a time when it is virtually impossible to borrow money, and may well drive him out of business.

8 - The rules of the game should not be changed after play has already entered the second half. Carved-out production payments have had special tax treatment for more than thirty years.

9 - The present treatment of carved-out production pay-

ments should be left undisturbed; but if it must now be changed for supervening reasons, it should at least be permitted to remain in effect for the taxable year in which new legislation is enacted.

- - - 0 - - -

My name is Eberhard P. Deutsch. I am a New Orleans lawyer, and appear here in behalf of the Permian Basin Petroleum Association of Midland, Texas - an association of some 650 independent producers of petroleum, and individuals and firms affiliated with them, primarily in West Texas.

The Association opposes strongly any reduction at all in the present oil-depletion percentage allowance under the income tax laws of the United States, which its members submit is necessary to provide adequate incentive to stimulate the search for new sources of oil and gas.

The share of petroleum in the United States energy market has shown a steady growth for many years. The increased demand has been equivalent to an annual average advance of 5.5 per cent. since 1920. Demand has increased to such an extent that, today, the Department of the Interior estimates that seventy per cent. of the energy consumption in this country is provided by crude oil and natural gas. The oil industry must meet this petroleum demand in the United States. There can be no doubt that greater oil production is imperative to our national security.

From the time that oil was first discovered in commercial quantities in 1859 at Titusville, Pennsylvania, the United States became an exporter of both crude oil and its derivatives. But in 1948 the United States became a net importer. Since then, foreign oils have gradually increased until now some 21.1% of the United States crude oil supply is imported.

The international petroleum industry is today experiencing a supply-demand race for world markets. In 1964, for the first time, production in Middle East fields equalled that of the United States. Because the expense of discovering and developing foreign production has been lower than that for domestic exploration and development, American oil companies are participating increasingly in foreign operations to the detriment of domestic production. To obtain an advantage of \$1 per barrel in discovery-production cost below that in the United States, American producers are willing to absorb the high initial costs of establishing foreign production and markets.

Oil and gas is the only depletive-resource industry which spends a major share of its earnings on the finding and development of new reserves. Nearly one-quarter of the industry's gross revenues is spent on exploration alone, most of which fails to locate any oil. Eighty per cent. of new wells are development wells, drilled to sustain existing production in order to compensate for the continuous depletion of older wells whose pro-

ductivity is tapering off.

The domestic petroleum industry has encountered increasing difficulty in locating new crude oil reserves to meet the ever-increasing demand, in spite of a major increase in its effort to find oil. Drillers must bore deeper into the earth than ever before to find new reserves; and this increases their cost, as does also the constantly rising cost of leasing land.

The capital required to finance these increased costs and efforts inevitably strains the industry's capacity to generate such funds; and the small independent producer must obtain this money from carved-out production payments to meet the cost of its drilling program.

A "carved-out production payment" is created by the sale, by the owner of a mineral property, of a portion, but not all, of the future production attributable to his property. A "reserved production payment" comes into being, by the mineral-property owner's reservation to himself, of a portion of the future production attributable to his property, and his sale of the remainder to another person.

The money received by the seller of the carved-out production payment is generally classified as ordinary income subject to depletion during the year in which it is received. The money received by the owner of the retained production payment is subject to percentage depletion during the payout period.

That portion of the production income, in either a retained or carved-out production payment situation, used to pay off the amount of the production payment, is excluded from the income of the mineral-property owner during the payout period. Any money received by the mineral-property owner, not applied to the production payment, constitutes ordinary income to such owner, subject to cost or percentage depletion depending on his cost basis for the mineral property.

In a carved-out-production-payment situation, expenses attributable to producing the minerals subject to the production payment are deductible during the year in which they are incurred.

The present advantageous tax treatment of carved-out production payments was accorded to the oil industry more than thirty years ago to encourage the search for oil and gas, and to stimulate the increased production thereof.

Oil companies, both large and small, prepare their drilling budgets about six months in advance of the beginning of their fiscal years. The drilling program is planned: so many wildcat wells, so many development wells, so much geophysical work and so many leases to buy. Contracts are made in advance with drilling contractors, so that when the time comes for a well to be drilled, a rig is available. The current year's budget was accordingly prepared during the preceding year, and in the case of

the small independents, cost is almost always tied to monies received from, and the tax treatment afforded, production payments.

As stated, independent oil producers normally make extensive use of short-term debt capital, from loans which are usually secured by all, or substantially all, of their producing properties. They have access to only very limited amounts of additional borrowing. To implement the financing of their operations, the independent producers have had to rely heavily on various types of sharing arrangements.

Short-term operating credit can literally disappear overnight as a result of some change in the industry's economic environment. The over-all effect of even a minor change in a long-standing oil-tax provision will seriously limit, if not take away entirely, a small producer's short-term fund-raising ability. Because of the risks inherent in this activity, exploration cannot ordinarily be financed directly with normal loan proceeds, unless the loans are secured by other assets.

As any wise investor will attest, it is the height of business folly to finance exploration for mineral resources with funds borrowed in the ordinary course. An operator who borrows money for use in exploration runs the double risk of losing the funds in unrewarding ventures, and the possible loss of his producing properties, through foreclosure or by forced liquidation to retire debt.

In addition, the petroleum industry must remain competitive in the capital market, particularly in times of rapid economic growth, and, as now, during periods of tight money.

For the reasons stated, the Congress is urged to retain the present tax treatment of carved-out oil and gas production payments. If, however, it is found to be imperative, for reasons beyond the crying needs of the independent oil producer, to discontinue that tax treatment of such payments, the members of the Association for whom I speak will make every effort to work out, for the future, some new practicable means, through possible long-term financing, of carrying on their exploratory operations.

But, in that unhappy event, they request that their present methods be not cut off retroactively as proposed in HR 13270, already passed by the House of Representatives.

Any adverse change, without time to prepare for such change, would immediately affect the collateral securing existing loans, and would drastically restrict the ability of the independent producers to finance their operations with the proceeds of new loans until some new means of fund-raising can be worked out.

It should be emphasized that a sale of a carved-out production payment is not consummated overnight. In the first place, land-lease commitments must normally be made at least

two to three years in advance. Months of preparation are spent thereafter finding a buyer for a carved-out production payment on producing property, arranging the financing, gathering the necessary geological and engineering data as a basis on which to evaluate the oil and/or gas in place, and to predict the income. One can be sure that almost every sale of a production payment made in the Fall was initiated in the Spring.

A large percentage of wildcat drilling is done by the smaller independent producers. No banker will finance wildcat drilling ventures without substantial collateral. The money to stay in business must come from discoveries already made. Retro-active repeal of the present tax treatment of production payments, added to the financial problems which the independent producer already faces, will deprive him of the availability of venture and short-term operating capital, and may well drive him out of business.

Unless the effective date of the proposed legislation is postponed until the end of the taxable year in which the legislation is enacted, many small oil companies will be unable to meet their short-term bank loans, to honor their contracts, or even to pay for their current year's drilling programs; or, at best, they will be unable to drill any wells at all during the following year; all because funds allocated for such costs will not be forthcoming.

Another reason for giving the industry time to adjust to

a sudden change in its tax treatment, is to preserve its right to sell an oil payment for income to offset a loss carry-forward. Suppose that a company, which may have had a loss five years ago, has attempted unsuccessfully to earn profits in the course of its normal business transactions over the past four years. The company now performs plans to sell a production payment to make up its loss. Making the effective date of the proposed change in the production-payment tax allowance retroactive, would penalize the company which had endeavored to avoid selling a production payment in prior years in the futile hope of other profits which had failed to materialize. There should be no difference between this situation, and that of a company in any other industry which sells assets at a profit to offset a loss carry-forward.

If the carved-out-production-payment tax treatment is taken away retroactively on the effective date proposed by the House of Representatives, it will leave an important segment of the oil industry without capital at a time when it is virtually impossible to borrow money, whereas, if the effective date is deferred until the end of the taxable year of enactment, the independent can at least try to devise some other means - however difficult he may find that to be - to meet his expected financial needs.

No company - and especially no independent oil producer - can operate without capital. If one source of exploratory and

development capital is abrogated retroactively, and without adequate time to endeavor to arrange other sources, the industry may be driven to the wall. If it can find no other source of funds, it may well have to look to the consumer for finances in the form of higher prices. Concededly, it is not sound economics to raise capital by raising prices in an inflationary cycle; but if there is no other plan, that becomes the only way.

It is respectfully submitted that the rules of the game should not be changed after play has started, and has, in fact, entered its second half. As stated at the outset, the members of the Permian Basin Petroleum Association, whom it is my privilege to represent before you, will make every effort if they must, to find new ways and means to finance their future exploratory programs in place of the production-payment method which has heretofore worked so well for all concerned.

They urge, however, that the present method be permitted to stand; but if for reasons beyond their own imperative needs, this system, which has been in effect for more than thirty years, must now be abandoned, they earnestly request that the present tax treatment of carved-out production payments be permitted at least to remain effective for the whole of the taxable year in which the new legislation is enacted.

Eberhard P. Deutsch

New Orleans,
September 18, 1969.



**BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE**

**THE TAX REFORM ACT OF 1969
H. R. 13270**

**STATEMENT OF JOSEPH R. RENSCH
ON BEHALF OF THE
AMERICAN GAS ASSOCIATION, INC.
and the
PACIFIC LIGHTING SYSTEM**

October 1, 1969



SUMMARY OF PRINCIPLE POINTS

1. A disturbing paradox exists currently: Estimates of potential gas supplies have increased substantially; estimates of proved recoverable reserves declined last year.
2. Since 1946, the Nation's gas Reserve/Production ratio has declined from over 32 to less than 15.
3. Additions of new proved reserves are lagging because drilling activity has declined sharply since 1956.
4. At the very time Congress is considering a reduction in the incentives to drill, the temporary supply problem is most critical.
5. The long-term outlook for adequate gas supplies is bright because domestic supplies will be supplemented by imports and synthetic pipeline gas, but maximum domestic supplies must be developed now because there will be a time lag before these supplemental supplies become available in significant volumes.
6. Reduction of the depletion allowance and other tax incentives would impose added and unnecessary costs on the consumer.
 - a. An increase in the producers' tax expense would flow through to the consumer.
 - b. Shortage of domestic natural gas supplies would hasten the dependence on higher cost imported supplies and synthetic pipeline gas.
 - c. If gas supplies should become inadequate to continue service to the load balancing industrial market, the cost of serving the small household consumer will be increased.
7. The current lag in exploration and development of new domestic gas supplies can be attributed basically to lack of available capital and incentive to drill for gas.
8. Reducing tax incentives at this time would further reduce cash available for drilling and would be a severe blow to the gas industry's efforts to develop gas supplies that are available and badly needed now. Such a reduction could not come at a worse time.

I am President of Pacific Lighting Service Company, headquartered in Los Angeles, California, and I am appearing on behalf of the American Gas Association and the Pacific Lighting System.

THE AMERICAN GAS ASSOCIATION

The American Gas Association is comprised of 271 gas distribution companies, 67 gas and electric distribution companies, 31 gas pipeline companies and several thousand individual members. Over 40 million homes, businesses and industries in this country are served with natural gas; the distribution companies in this Association serve over 90% of these customers.

This Nation has become highly dependent on this clean, efficient and economic source of energy. Over one-third of the country's total energy requirements are now provided by natural gas. This dependency is reflected by the gas industry's \$35 billion investment in facilities and many more billions of dollars of consumer investment in appliances and other equipment.

THE PACIFIC LIGHTING SYSTEM

The Pacific Lighting companies serve the country's largest and fastest growing gas distribution system. Our two large distribution companies, Southern California Gas Company and Southern Counties Gas Company, serve approximately 3,100,000 retail customers and wholesale natural gas to supply another 470,000 customers in Southern California. Over 12 million people depend on our companies for a reliable supply of natural gas at a regulated reasonable price. Our gas operations trace back over 100 years and, for over 40 years, Southern Californians have been heavily dependent on natural gas as an energy source.

THE CURRENT NATIONAL GAS SUPPLY OUTLOOK

A disturbing paradox exists currently in the natural gas industry. Estimates of potential natural gas supplies--waiting to be searched for, discovered and developed--have been increased substantially due to recognition of new provinces and improved technology. Consumer demand for this clean, economic energy source is climbing sharply. Yet, the finding and development of proved gas reserves are sagging simply because the producers are not devoting the necessary drilling capital in the continental United States.

I have reviewed 36 estimates of potential supplies prepared since 1950. During this period, as new provinces were discovered and technological improvements emerged, these estimates of potential supplies have

increased substantially. The Potential Gas Committee, which acts under the objective guidance of the Colorado School of Mines and relies on the input of a large number of the most technically qualified people in the industry, increased its estimates of future potential gas reserves from 690 trillion cubic feet in 1967 to 1230 trillion cubic feet in 1969, due primarily to the new provinces in Alaska and the technological developments that permit deeper drilling both onshore and offshore. But all of these potential supplies are of no value to the consumer until they are drilled for and put on production.

Paradoxically, this year the American Gas Association Reserves Committee reported a decline in the Nation's proved recoverable gas reserves for the first time since this nationally accepted Committee commenced publishing annual reserve statistics 23 years ago. During the year 1968, 19.4 trillion cubic feet were produced while only 13.8 trillion cubic feet of new gas reserves were added, so that the Nation's proved reserve inventory declined from 292.9 trillion cubic feet to 287.3 trillion.

The chart in Appendix A compares the yearly reserve additions with the net annual production totals since the end of World War II and graphically illustrates the recent disparity between increases in supply and demand for gas. During this period, the Nation's ratio of proved reserves of natural gas to annual production has declined from over 32 to less than 15 by 1968. (See Appendix B) The sharp downward trend in the Nation's Reserve/Production ratio must be arrested by the development of new domestic reserves so that the inventory does not get too low before large scale production of synthetic pipeline gas becomes available.

The tabulations of certain key statistics included in Appendix C demonstrate why the addition of new proved gas reserves is lagging. Total new well drilling reached a peak in 1956 and has been declining ever since. Since that year, the following decreases have been recorded:

Total exploratory wells:	down 45%
Gas discoveries :	down 48%
All new wells :	down 47%
Gas producers :	down 26%
Active drilling rigs :	down 57%

This tabulation also shows that the total number of producing gas wells has declined in each of the past two years.

Now, at the very time Congress is considering a reduction in the incentives to drill, the industry's temporary supply problem has reached its most critical stage. Many of the gas pipeline companies have been unable to acquire the gas supplies to meet the normal growth requirements of the gas distributors this year. Every effort must be made to turn this situation around and accelerate drilling for gas to higher rates of activity than ever before. Time is of the essence because there is a time lag between the resumption of accelerated drilling activity and the proving up of the gas reserves to deliver to the pipelines.

FUTURE SUPPLIES

The long-term outlook for adequate gas supplies is bright not only because our growing recognition of the large volume of potential supplies and our ability to supplement future supplies with imported volumes (delivered by pipeline or by tanker in the form of liquefied natural gas) but, most important in terms of the next century, because of the outlook for production of synthetic gas from the Nation's abundant supply of coal.

This raises another reason for developing the maximum volumes of gas supply in the continental United States at this time. These important future supplemental supplies will be higher priced. The maximum early development of the lower-cost, domestic natural gas supplies will postpone the blending in of these supplemental sources to the benefit of the consumer's pocketbook. Furthermore, although the gas industry's goal is to attain an annual supplemental gas production rate of 20 trillion cubic feet of synthetic gas by the year 2000, further time is needed for pilot plant and development work and the first large scale production facility cannot be expected to be in service much before the mid-1970's.

To fill this time gap, the current rapid decline in the Nation's gas Reserve/Production ratio must be arrested by giving the producers the maximum immediate incentive and access to funds to accelerate the level of drilling activity. Any elimination of the present tax incentives--which, in turn, are a key source of exploration capital--will severely impair the gas industry's effort to solve the immediate supply problem.

THE COST IMPACT ON THE CONSUMER

The American consumer--feeling the need for tax reform--is under the natural impression that he would be benefited by a reduction of the symbolic depletion allowance and other tax incentives now available to the oil and gas producers. Actually, the consumer will not only bear the cost burden of

the additional tax revenue but, in addition, will fall heir to other unnecessary costs if the incentive to explore for gas is further reduced by limitations on the tax incentives.

The price of gas flowing in interstate commerce is regulated on the basis of cost, and it can be assumed that any increase in the producer's tax expense will flow through to the consumer. Unfortunately, the cost impact on the consumer would not stop here. First, as indicated above, the certain adverse impact on exploration for domestic gas supplies would hasten the dependence on higher-cost, imported supplies and synthetic gas. Of even greater important, if gas supplies are inadequate to continue service to the important load-balancing industrial market, gas pipeline and distribution companies will operate their high capital cost facilities at reduced load factors, and this automatically increases the cost of serving their customers. This unnecessary economic penalty on the small household consumer will result if the producers do not proceed to develop adequate domestic supplies now.

THE RELATIONSHIP OF TAX INCENTIVES TO DRILLING

The current lag in exploration and development of new domestic gas supplies can be attributed basically to lack of available capital and incentive to drill for gas. Both of these factors would be worsened by a reduction in percentage depletion and elimination of other tax incentives.

There are other factors currently dampening exploration activity and the gas industry is working hard on those that are subject to alleviation. Unit drilling costs and average well depths are increasing while exploratory success ratios are declining. Shallow, easy-to-find fields have already been found. Many in the industry feel that past Federal regulatory policies have stifled the incentive to explore for gas.

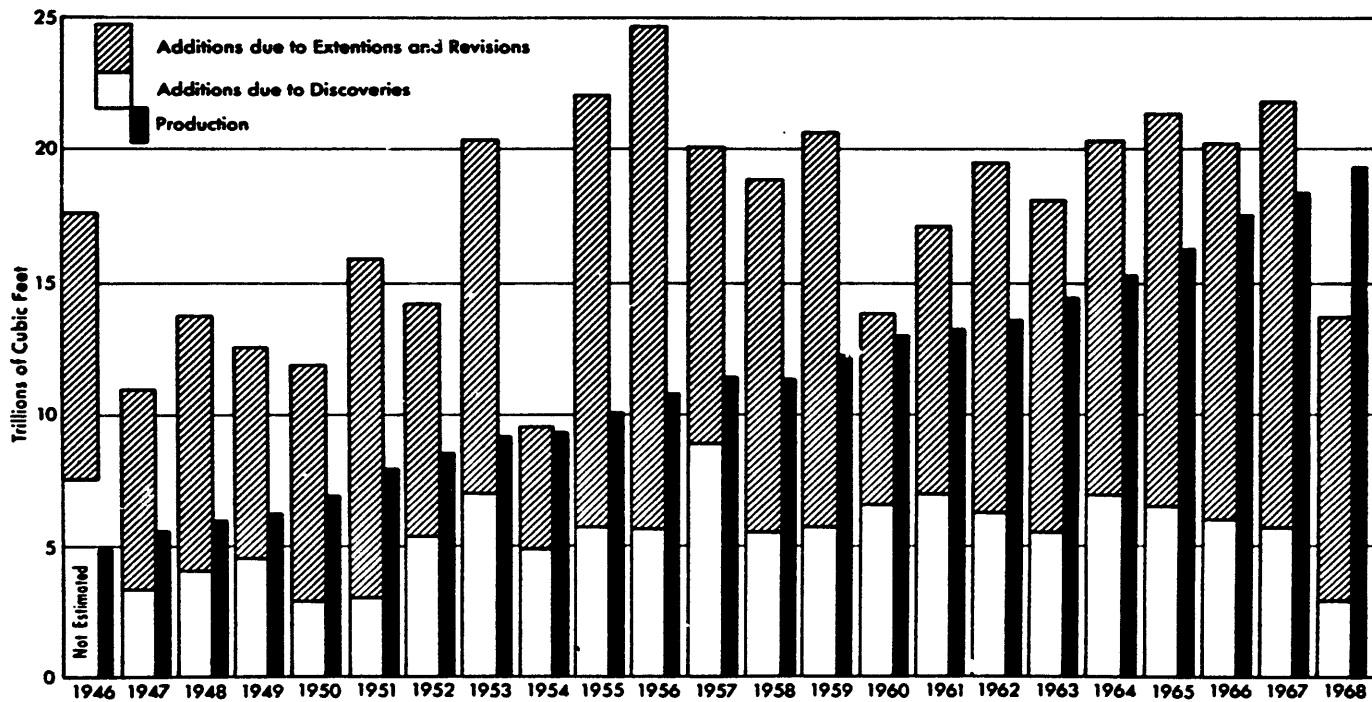
The tight money situation is certainly having its impact. Historically, the producing industry has relied heavily on internally generated funds, but increasing capital requirements have forced much more extensive use of debt capital. And the capital demands on the producers are intensifying further. Recent high bonuses paid for offshore and Alaska North Slope leases have drained exploration budgets. All of these factors combine to make it difficult to attract exploration capital into badly needed domestic gas drilling.

Adding the reduction of tax incentives at this time will decrease the cash which would otherwise be available for exploration and development work and will be a severe blow to our efforts to bring forth the valuable domestic gas supplies that are available to be developed and so badly needed now.

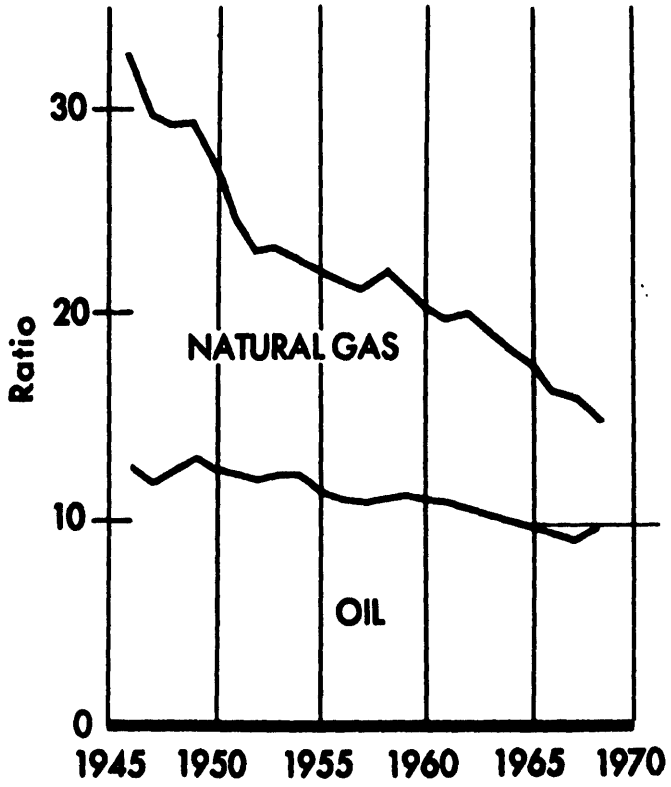
CONCLUSION

The gas industry is seriously concerned that the urgent need of the natural gas consumers has been obscured. It cannot be emphasized strongly enough that any reduction in the tax incentive to drill for gas could not come at a worse time. An all-out effort must be made to increase--not decrease--the incentive to explore for and develop critically needed gas supplies.

AGA ESTIMATE OF YEARLY ADDITIONS vs. NET PRODUCTION



U. S. RESERVES/PRODUCTION RATIO

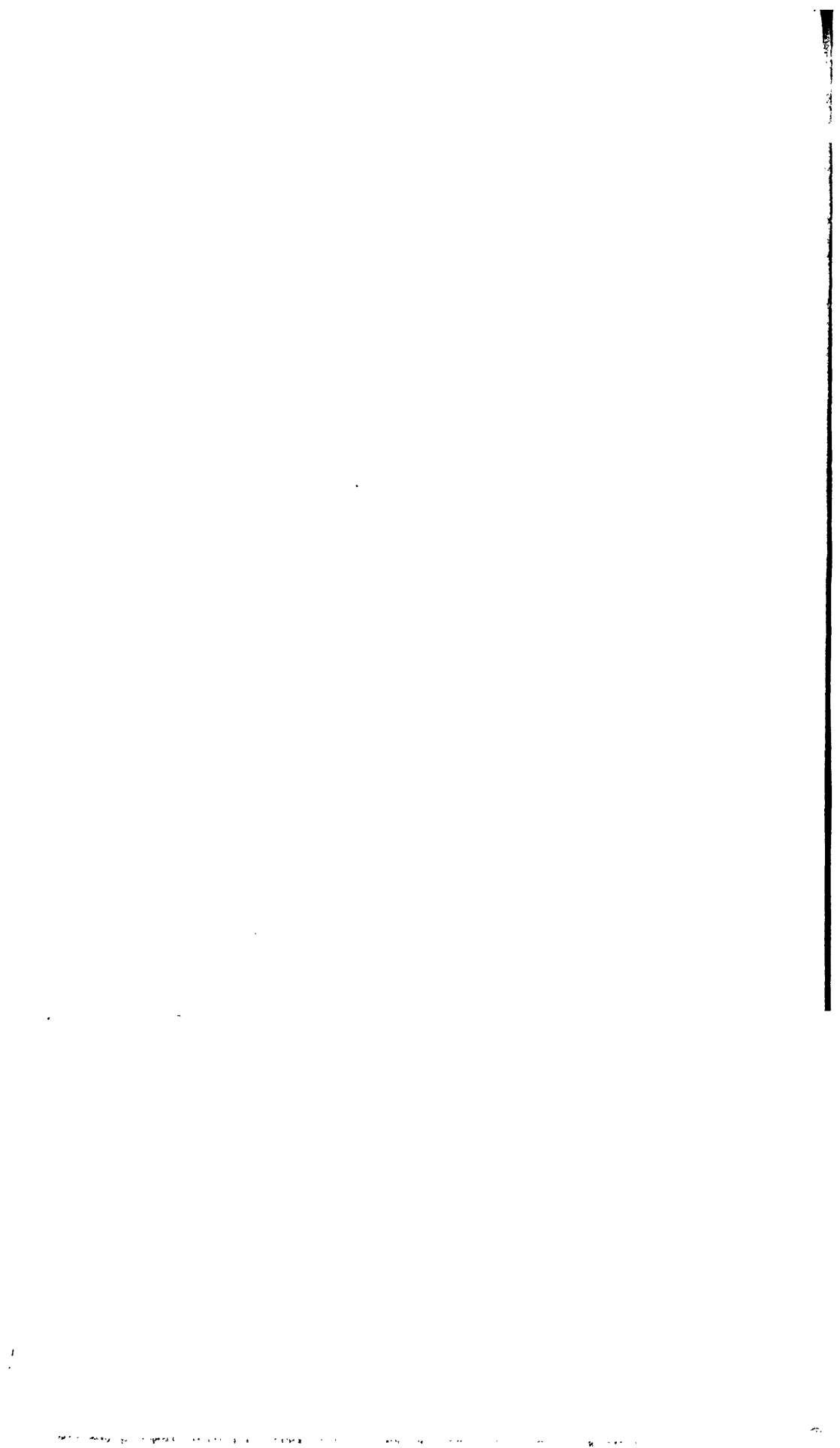


Year	<u>Total Exploratory Wells drilled during each year ^{1/}</u>			<u>All New Wells Completed during each year ^{2/}</u>			<u>Total Gas^{3/} Wells Producing at year end</u>	<u>Average Number of Drilling Rigs during year ^{2/}</u>
	<u>Total</u>	<u>Discoveries</u>		<u>Total</u>	<u>Producers</u>			
		<u>Oil</u>	<u>Gas</u>		<u>Oil</u>	<u>Gas</u>		
1946	5,759	762	375	30,230	16,087	3,562	62,740	4,353
1947	6,775	982	396	33,147	17,613	3,720	63,676	4,741
1948	8,013	1,098	365	39,477	22,197	3,312	64,212	4,950
1949	9,058	1,406	424	38,962	21,415	3,499	63,346	4,290
1950	10,306	1,583	431	43,307	23,775	3,480	64,900	4,517
1951	11,756	1,763	454	45,996	23,532	3,542	65,100	4,844
1952	12,425	1,776	559	46,509	23,371	3,693	65,450	4,857
1953	13,313	1,981	699	49,480	25,251	4,232	68,223	4,784
1954	13,100	1,985	726	52,197	28,063	4,219	70,192	4,635
1955	14,942	2,236	874	55,879	30,474	4,169	71,475	4,867
1956	16,207	2,267	822	58,418	30,641	4,495	74,261	4,845
1957	14,714	1,945	865	53,783	27,519	4,622	77,041	4,791
1958	13,199	1,745	822	49,101	24,311	5,029	80,400	4,114
1959	13,191	1,702	912	50,179	25,532	4,870	83,225	3,991
1960	11,704	1,321	868	46,831	22,258	5,149	90,761	3,543
1961	10,992	1,157	813	45,644	21,437	5,486	96,809	3,464
1962	10,797	1,211	771	45,997	21,727	5,353	100,267	3,089
1963	10,664	1,314	664	43,126	20,135	4,570	102,966	2,952
1964	10,747	1,219	577	44,149	19,905	4,694	112,895 ^{2/}	3,066
1965	9,466	946	515	40,374	18,065	4,482	115,834 ^{2/}	2,800
1966	10,313	1,030	578	36,883	16,216	4,321	124,092 ^{2/}	2,514
1967	9,059	1,039	556	32,473	15,073	3,602	121,758 ^{2/}	2,208
1968	8,879	863	430	30,939	13,982	3,329	119,528 ^{2/}	2,095

Sources:

^{1/} American Association of Petroleum Geologists^{2/} World Oil^{3/} except as noted Bureau of Mines

DEH:jl 9/22/69



TESTIMONY OF
WALTER E. ROGERS, PRESIDENT
INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA
BEFORE THE
UNITED STATES SENATE COMMITTEE ON FINANCE
ON
H. R. 13270 - A BILL TO REFORM THE INCOME TAX LAWS
WEDNESDAY, OCTOBER 1, 1969

My name is Walter E. Rogers. I am President of the Independent Natural Gas Association of America, which is frequently referred to as INGAA. INGAA is a non-profit national trade association representing virtually all of the major interstate natural gas transmission companies subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act of 1938. Our member companies account for over ninety percent of the natural gas transported and sold for resale in interstate commerce. These companies have a total gross transmission storage and production plant investment of over \$15 billion. Natural gas transmitted through these facilities reaches every state of the Union with the exception of Alaska and Hawaii. The Association also includes a substantial group of producers and distributors of natural gas in its membership.

My testimony today will be directed principally to two features of the tax reform bill, both of which are of great concern to our industry. It is the studied opinion of INGAA that if these two features are adopted as presently written in the bill, they could result in serious adverse effect on the industry, the general economy, and the welfare of the nation.

The two features referred to are:

1. Accelerated depreciation allowed regulated industries, and
2. Reduction in the depletion allowance for oil and gas.

These two items will be discussed in the order named.

**ACCELERATED DEPRECIATION ALLOWED
FOR REGULATED INDUSTRIES**

In 1954 the Congress amended Section 167 of the Internal Revenue Code with respect to the depreciation methods and rates available to taxpayers in computing depreciation on tangible property used in trade or business. The taxpayer was given the right by that amendment to elect, from the methods available, to use either straight line depreciation or accelerated depreciation in computing his income tax, and to discontinue its use at any time, both as to new and old property.

The legislative history of the amendment to Section 167 clearly indicates that it was the intent of Congress in providing the depreciation methods described in Section 167 (b) (2), (3) and (4) of the Code to allow all taxpayers the free exercise of business judgment in the selection, from among those methods authorized, of the appropriate method of allocating the depreciable cost of property over the years of service, without restriction by regulatory agencies in the case of taxpayers subject to regulation. The Code further permits the use of accelerated depreciation for tax purposes and straight line depreciation for book purposes. Normalization is defined generally as the computation of tax expense, for cost of service purposes, by using a method of

depreciation which is different from the method actually used for computing Federal income taxes and adjusting a reserve for deferred taxes to reflect the deferral of taxes resulting therefrom.

Despite the clear intent of Congress that regulated industries be permitted the same elections and the same benefits regarding depreciation of their business property as non-regulated taxpayers, several of the regulatory agencies took the position that those regulated companies within their jurisdiction, using accelerated depreciation for tax purposes, would be required to "flow through" currently to the companies' customers any and all tax benefits or reductions in income taxes. Such policy is presently being pursued by the regulatory agencies referred to, and unless corrections are made in this legislation, they may continue to do so.

The consequence of such action is rank discrimination against the regulated industry, in that the very purpose and reason for accelerated depreciation is defeated, and the Treasury of the United States is deprived of substantial tax revenues. The latter point being expressly pointed out by Assistant Secretary of the Treasury Edwin S. Cohen in his testimony to the Congress.

It should also be pointed out that the former Chairman of the Federal Power Commission, the Honorable Lee C. White, told the Ways and Means Committee of the House of Representatives on March 25, 1969, that the taxes payable by natural gas pipeline companies in 1967 were reduced by about \$72 million due to the use of the "flow through" policy referred to. Such policy

also operates to deny to the regulated industry the much needed funds intended by the Congress to be available to industry for investment in new plant and equipment. Hence, the natural gas pipeline industry, as one of the regulated industries, is forced to go into the highly competitive money markets of the nation in order to acquire the funds necessary to carry out its responsibilities in providing and furnishing gas to meet the rapidly expanding demands throughout the nation, especially in the metropolitan areas. In order to get these funds, the natural gas pipeline industry, a highly debt-structured industry (perhaps the highest with the exception of the housing industry), must compete with all others seeking additional funds. The result has been constantly increasing interest rates, which are now in excess of 8-1/2% and may be expected to continue to climb in the absence of a realistic approach to such problems as those outlined in this presentation. Thus, the present policy of the F. P. C. obviously contributes measurably to the inflation spiral and also to the increased cost to the consumer. It is the opinion and view of INGAA that the "flow through" policy of the regulatory agencies is in violation of the clear intent of Congress, results in discrimination against the regulated industry, is a disservice to the consumers of products and services subject to regulation, deprives the United States Treasury of much needed revenue, and is not in the best interest of the general economy of the country.

It is the further opinion of INGAA that Section 451 of H. R. 13270, which would amend Section 167 of the Internal Revenue Code, does not cure the

problems outlined nor afford the remedy so badly needed.

We believe that the taxpayer, whether regulated or non-regulated, should, in the exercise of his best business judgment, have the freedom of electing that method of depreciation authorized in Section 167 which is best suited to his needs; and that such election should be completely free of any interference from regulatory agencies. We firmly believe that no regulatory agency with authority to establish or approve the rates of any taxpayer should, without the consent of the taxpayer, specify or prevent a change of the method or rate of depreciation allowable under the Code used or proposed to be used by such taxpayer in computing the amount of its Federal income tax. We further believe that no regulatory agency, in determining the taxpayer's expense for Federal income tax, should be allowed to utilize any other method of depreciation other than that used or proposed to be used by the taxpayer in computing its Federal income tax nor be permitted to exclude from such tax expense, either directly or indirectly, the amount of any reduction in Federal income tax payable for any period utilized by the regulatory agency in establishing the taxpayer's cost of service.

In short, it is the strong opinion of INGAA that the choice of the method of depreciation to be used by the taxpayer from among those methods authorized by law should be solely the choice of the taxpayer, and that such choice be inviolate for all purposes.

We fully appreciate the dilemma faced by this Administration with relation to Treasury revenues because of the trend toward the "flow through" of accelerated depreciation tax benefits. However, we would hasten to point out that the change over by many of the regulated industries has been the result of implied threats by the regulatory agency having jurisdiction to impute to such industries the "flow through" theory in fixing "cost of service" for rate making purposes. In short, the change over has been involuntary. It is like telling a man that unless he moves he will be "snake bit." The chances are he would move. Such has been the case in many instances of natural gas pipeline companies in moving over to the flow through method of accounting. Some of them would like to return immediately to either straight line depreciation or to accelerated depreciation with normalization. Some of them find that they cannot immediately make such change because their programs have been worked out over a period of several years using the flow through method which was virtually forced upon them.

Under the circumstances the proper solution to the problem faced by the Treasury and also by the companies, would seem to be an authorization for those companies to return to a slower method of depreciation but not allowed to go to a faster depreciation. In other words, if Section 167 of the Internal Revenue Code could be amended to provide the election to the taxpayer to remain on the method of depreciation being used as of July 22, 1969, or to return to a slower depreciation, any moves from flow through to normalization or straight line would result in additional revenues to the Treasury on an

early basis and substantial increases on a long range basis. It would also enable the regulated companies to have flexibility in meeting their capital needs for expansion requirements, and would be a contribution toward the solution of the inflationary problem.

This could be done as to both old and new property, as defined in H. R. 13270, and the result would be additional revenues to the Treasury. A suggested amendment is attached hereto and made a part of this statement for all purposes, which in the opinion of INGAA, will accomplish the results sought. Unless such an amendment or one of a similar nature accomplishing the purposes outlined, is adopted, there will result rank discrimination and unfairness as between regulated and non-regulated industries and also as between regulated industries. It should be noted that as the "flow through" policy was developing in the minds of the regulatory agencies, some of those agencies moved faster than others in indicating to those companies under their jurisdiction, the intention to adopt flow through policies for rate making purposes. Hence, many of the companies that moved to "flow through" before July 22, 1969, because of such indications or implied threats as the case may be, find themselves frozen into "flow through" on both old and new property, under the provisions of the language adopted by the House of Representatives (Section 451 of H. R. 13270) unless permitted by the regulatory agency to change. Other companies which had not moved into the flow through method but had continued to use straight line depreciation may remain on straight line depreciation both as to old and new property. The taxpayer using accelerated depreciation on or before July 22, 1969, and

normalising, would be allowed to continue to use accelerated depreciation and to normalize with respect to old property. If the taxpayer was using accelerated depreciation and flowing through, he would be required to continue to use such practice in the absence of permission by the regulatory agency to go to a slower depreciation. In other words, he would be frozen into the "flow through" method, even though he had adopted such method against his best business judgment and only because of the insistence of the jurisdictional regulatory agency.

With relation to new property (property completed or acquired after December 31, 1969), a taxpayer on straight line or on accelerated depreciation with normalization would be permitted to take accelerated depreciation and normalize. If the taxpayer was on flow through as of July 22, 1969, he would have no choice but to stay on flow through unless he could get the permission of the regulatory agency having jurisdiction, to return to a slower method of depreciation. A PERMISSION THAT COULD NOT BE OBTAINED UNDER ANY CIRCUMSTANCES INSOFAR AS THE FEDERAL POWER COMMISSION IS CONCERNED UNLESS THE SAID FEDERAL POWER COMMISSION CHANGES THE POLICY IT HAS PURSUED TO THIS DATE.

The unfairness with relation to regulated industries forced into the flow through method of accounting is quite obvious, and in the opinion of INGAA should be changed.

INGAA respectfully submits to this Honorable Committee and the Congress that fairness in the application of tax requirements or benefits demands uniformity in the law as applicable to both regulated and non-regulated industries, and especially is this true with regard to the several industries falling within the category of the "regulated" field. It is the position of INGAA that all regulated industries now using the "flow through" method of accounting for depreciation purposes should be given the right and option as to both old and new property to change such accounting method to a slower method of depreciation, to wit, "straight line" or "accelerated depreciation with normalization," but not be required to. All companies presently using accelerated depreciation and normalizing should be allowed to continue such accounting practice as to both old and new property, or to go to a slower depreciation on either type of property or both types, but not be required to. Those companies presently using the straight line method of accounting for depreciation purposes should be permitted to use accelerated depreciation with normalization on new property.

If the Congress will adopt such policy, it is the opinion of INGAA that the best interests of the country will be served.

REDUCTION IN THE DEPLETION ALLOWANCE
FOR OIL AND GAS

INGAA respectfully submits that it is unqualifiedly opposed to any reduction in the 27-1/2% depletion allowance on oil and gas which has been in effect for more than forty years.

A review of history will reveal that at the time of the adoption of the percentage depletion formula in 1926, the Treasury of the United States, having made a thorough and complete study of the issue, recommended more than 30% as an appropriate and fair figure. The 27-1/2% was the result of a compromise. It has been attacked annually for many years and has always withstood the onslaughts directed against it, because it is reasonable, just, fair, and has served to produce the incentive for the tremendous progress enjoyed by this country in the development of oil and gas. That incentive made it possible for this country to move to the forefront in the exploration, discovery and development of great petroleum resources in our nation. Resources, without which this country could well have been the loser in armed conflict that has challenged free man constantly during this century. Resources that not only provided the major difference in our defense posture, but served as the basis for the greatest advancement of mankind in contributions to the needs and requirements of the individual during peace time. There is no area of human need or endeavor in which petroleum does not play some substantial

role. I have often wondered in my own mind what the picture would be today had there not been an incentive to promote and foster the search for oil and gas, such as the 27-1/2% depletion allowance. Would there have been a North Slope of Alaska? Would there have been a Texas Panhandle field? Would there have been an East Texas field? Would there have been many of the discoveries on foreign soil? Would America have won World War II? What would be the situation in the field of medicine, to which petroleum products have so measurably contributed? What would have happened to our automobile industry or to the labor groups? This same question could be asked about every phase of American life since the original discovery of oil in Pennsylvania.

Some may say that there is no relationship between the 27-1/2% depletion allowance and the great strides that we as a nation have made, both collectively and individually. However, the facts of history simply do not bear out such an allegation. It has been the hope of reward that has spurred on the single wildcatter, the small partnership, the corporations and combinations of these entities to risk their time, their energies and their worldly goods in the quest for petroleum products. It has been the product of that quest that has made this country the world's leading producer of petroleum products over the years and the world's greatest consumer of those products. In 1967 the records reflect that there were 5,260 new-field wildcat wells drilled, 4,700 of which were dry holes. This reflected a productive percentage of only 10.6%. Had it not been for depletion allowance and the expensing of

intangible drilling costs, no one would be naive enough to suggest that such a drilling program could have been mounted. If either or both of these incentives are measurably reduced or destroyed, it is almost certain to follow that there will be a substantial reduction in wildcat wells drilled and in new-field wildcat wells drilled. Even under present circumstances, records reflect that there has been a constant reduction in wildcat wells drilled from 12,000 plus in 1956 to 6,026 in 1967. In new-field wildcat wells drilled, the reduction has been constant since 1956 from 8,709 to only 5,260 in 1967.

INGAA realizes that this Honorable Committee has received a great and varied amount of statistics on this subject. It is not our purpose to indulge in repetition, but we do hope that the gravity of the situation has been made clear and that this Committee will conclude that the true value of the depletion allowance has been proven many, many times.

One might ask why the gas pipeline industry would have an interest in a matter that should be of greatest concern to the oil industry. The answer is quite obvious. Gas for many years was looked upon as a by-product of the oil business, without any great value. Wells were drilled for oil, not gas. Gas was discovered while the search was being made for the oil. It was during World War II that the great need for energy opened the door for the large interstate pipelines to be constructed and provided the opportunity for gas to assume its proper role in the energy requirements of this nation. Today gas provides one-third of the energy requirements of our country, and the

demand for additional service and supplies is constantly rising. Hence, natural gas is the lifeblood of the pipeline industry. Unless it is available in appropriate quantities, the industry itself will suffer measurably, the serious effects on the industries utilizing it cannot be over emphasized, and cold homes and apartments would not be an idle thought. As before mentioned, the demands for natural gas are on the constant increase. It is estimated at the present time that such requirements will increase at the rate of about 4% per annum. New gas discoveries are not keeping pace with demand. For the first time since 1946 the records reflect that natural gas production in 1968 exceeded new discoveries. Total reserves showed a decline over the previous year of 1967. Additions to reserves were approximately 6 trillion cubic feet less than the amount produced in 1968. The Federal Power Commission in July of this year reported that domestic natural gas reserves of 64 major pipeline companies dropped during 1968. In recent months pipelines and distributors have experienced difficulties in contracting for anticipated requirements, and in a number of instances have not been able to obtain the needed gas. These declines, if allowed to continue, coupled with the population explosion in this country, could signal the beginning of a most critical stage in the ability of this country to meet its energy requirements.

It would appear that the logical, the sensible, and the realistic approach at this time would be for the Administration and the Congress to be searching for new ways to promote the exploration and discovery of petroleum products. Certainly it is not the time to reduce the incentives presently available and

thereby create a risk that this country cannot afford to take. If there was ever a time in the history of this country when we need to search out every possible source of energy in the continental United States, it is now. We are well aware that much has been said about the potential reserves of oil and gas in this country. The Potential Gas Committee, which has done an admirable job in association with the Colorado School of Mines, has estimated future potential gas reserves of 1,230 trillion cubic feet, both on shore and off shore in the continental United States. This all sounds wonderful, but the word "potential" cannot be associated with "known reserves." If these potential estimates are to be realized, there must be a measurably stepped-up exploratory effort resulting in new discoveries. Results that will not come about unless proper incentive is present.

It is the opinion of INGAA that the most sensible investment this country could make at this time would be to retain the incentives presently available in the oil and gas industry, and if necessary, to add thereto rather than subtract therefrom. If such a course is followed, the average American citizen will be the beneficiary, both from a personal and a national standpoint.

AMENDMENTS PROPOSED BY THE
INDEPENDENT NATURAL GAS ASSOCIATION OF AMERICA
TO H. R. 13270

On page 266, strike out lines 14 and 15 and insert in lieu thereof the following:

"(B) the requirements of paragraph (2), to the extent applicable, are met with respect to such property."

On page 266, line 16, strike out the phrase "CONTINUATION OF NORMALIZATION" and insert in lieu thereof "ELECTIONS."

On page 266, after line 25, add the following new paragraphs:

"In the case of public utility property described in paragraph (1) with respect to which (or with respect to property of the same kind) the taxpayer as of July 22, 1969, used a method of accounting other than normalization, the taxpayer may continue to use a method other than the straight line method with respect to such property for the purposes of computing taxable income, or such taxpayer may elect to utilize a straight line method of depreciation for computing taxable income with respect to such property.

"In the case of public utility property described in paragraph (1) with respect to which (or with respect to property of the same kind)

the taxpayer as of July 22, 1969, used a method of accounting other than normalization, the taxpayer may adopt the normalization method of accounting with respect to such property.

"No agency or instrumentality, commission, or other similar body with authority to establish or approve the rates of any taxpayer shall, either directly or indirectly, limit the elections of such taxpayer as herein described."

On page 267, line 18, after the period, insert the word "or," and add a new paragraph to be designated (C) to read as follows:

"(C) the taxpayer referred to in (B) above elects to use the normalization method of accounting with respect to such property. No agency or instrumentality, commission, or other similar body with authority to establish or approve the rates of any taxpayer shall, either directly or indirectly, limit the election of such taxpayer as herein described."

STATEMENT OF INVESTORS LEAGUE, INC.
By William Jackman, President
Submitted to
THE SENATE FINANCE COMMITTEE ON H.R. 13,270
September 16, 1969

My name is William Jackman. I am president of Investors League, Inc., 84 Fifth Avenue, New York, N.Y. and a voting resident of East Orange, N. J. The Investors League is a non-profit, non-partisan voluntary membership organization of thousands of businessmen and investors, large and small, residing in all of the fifty states of the nation.

Mr. Chairman and members of the Committee:

I wish to thank you for the privilege of presenting this statement before your committee on behalf of America's many millions of tax-paying voting investors (who are also consumers) on H.R. 13,270 the Tax Reform Bill of 1969 now before you.

This Bill passed the House by a majority of 394 to 30 which was utterly ridiculous. It was conceived and enacted in astonishing haste without giving the legislators sufficient time to study and digest it and there was no opportunity for amendments from the floor of the House. It was found irresistible also because it promised low-income and middle-income taxpayers about \$9.2 billion in tax-relief. As Assistant Secretary of the Treasury, Edwin S. Cohen, ruefully put it, the House Tax "reform" bill might better be known as "the lawyers and accountants relief act of 1969".

Another stinging rebuke to those who favorably reported the Tax Reform Act out of the Ways and Means Committee was offered by Congressman James B. Utt, an important member of this Committee. Said Mr. Utt: "This tax reform bill follows past practices in enacting patchwork provisions to the code - - History shows that this approach adds untold additional pages to the Internal Revenue Code, greatly magnifying the complexity of existing provisions. The more complex the law becomes the greater the number of inequities we face".

"It is time for the Congress to realize that true tax reform can be achieved only through simplification. Tax simplification can be achieved by a broadening of the base and a reduction of

the rates. By achieving this goal, the incentive for avoiding taxes through a variety of sophisticated devices diminishes".

Since many of the bills provisions of the Act were announced piecemeal, at least in principle, there was a general understanding that the bill would help the low income taxpayer and soak the wealthy taxpayer; but since many of the provisions had not been put into precise language, and no committee report was available, there was considerable confusion as to what had actually been done. In a tax bill, the exact words are more important than the generalities.

Even Chairman Mills of the House Ways and Means Committee, had to confess himself confused. He had to reassemble his Committee to amend the rate schedules for low income taxpayers because of what he called a "misunderstanding". As it turned out, a \$2.4 billion misunderstanding. A summary of the bill was finally made available, but it takes time to digest 226 pages of tax-prose and another 143 pages of "technical explanation" even if you're a Philadelphia lawyer.

As a clear indication of the haste with which the legislation was considered even by the Ways and Means Committee, Rep. Peter H. B. Frelinghuysen (N.J.) and others have pointed to the extraordinary noon session called by the committee on the day before the bill was scheduled for action on the floor because it had somehow "overlooked" seven million potential beneficiaries.

Even more astounding was the fact that these seven million persons were in the \$7,000 to \$12,000 annual income group, the so-called "middle-income" taxpayer. This oversight was quickly "corrected" by the committee, although the action cost the government \$2.4 billion in anticipated lost revenue.

In a separate statement of his views in the Ways and Means Committee report, Rep. James B. Utt (R.-Calif.) one of the committee members, made some telling criticisms. The committee, he said, simply did another patchwork job. By trying to "delineate tax equity with needle-like precision", it made the law immensely more complex and onerous for the individual taxpayer than it already was. Tax simplification, he insisted, which should have been given No. 1 priority, was forgotten.

"It is certainly anomalous", added Mr. Utt, "to recommend passage of the surtax for a full year on the theory that we need additional revenues to reduce present severe inflationary problems while at the same time providing a tax decrease of nearly \$2 billion. But this is precisely what the committee has done... The revenue reductions in this bill will grow from nearly \$2 billion in fiscal 1970 to nearly \$7 billion in fiscal 1975, and this is bound to aggravate our problems with inflation... Since any surplus we will realize is due to an excess of trust funds receipts over disbursements, the federal budget on a federal funds basis will continue to be in deficit".

The statement did not mention that even since the tax cuts were passed by the House, the President had not yet put forward his guaranteed income proposal which would add from \$4 billion to perhaps \$10 billion a year of government outlays and increase the inflation probability all the more.

In the Tax Reform Bill of 1969 before your Committee to increase the maximum tax on long term capital gains from 25% to 30% indicating that the Treasury would gain \$300 million of new revenue from this source if this were accomplished. Who on earth has arrived at this assumption. I would like one of you gentlemen to explain it to me. The facts are contradictory. The Treasury would lose money if the Senate Finance Committee allowed this provision to remain in this Bill.

Congressman Mr. Utt, on August 6, 1969 made the following observation: "The last item and, to me, the most deadly to the American free enterprise system, is the tax treatment given to capital gains. Some one has convinced the majority of our committee that there is no difference between capital and earned income. That is a deadly assumption. Capital is the thing that makes possible creative risk investments, and is entitled to separate and preferred treatment. The history of the great economic progress in America has been based on the willingness of millions of individuals to risk their hard-earned cash for research, development, expansion and production of goods in America. We stand today on the threshold of the greatest opportunity in our history to perfect and produce gadgets of every sort and description at cheaper and cheaper prices in order

to give America a still higher standard of living than we have now. We must not destroy that incentive; that creative imagination which can give us the greatest progress in our history. Here, again, we are stymied by the Marxian doctrine of social reform through taxation. When capital gains taxes were under discussion a few years ago, and Mr. George Meany was on the stand, I (Congressman James B. Utt) asked him if he believed in taxation for revenue or punitive purposes. He quickly replied "for revenue". Then, I said, "Mr. Meany, studies have been made by The Brookings Institute which showed that if you reduced the capital gains alternative tax and reduced the holding period, there would be more than a trillion dollars worth of real estate and stocks which would become unfrozen and would double the amount of revenue from the capital gains sector. He replied, "Yes, Mr. Utt, but that would be socially unjust". In that statement alone is the fallacy of this whole reform legislation".

A recent survey conducted for the New York Stock Exchange by Louis Harris and Associates, Inc. (See Exhibit "A" attached) showed that if the long term capital gains tax were reduced from 25% to 12-1/2%, the Treasury would receive an estimated \$2.5 billion in revenue - over \$2 billion more than the \$500,000 million they now receive under the present rates.

A similar survey recently conducted by the Investors League of its own members substantiated these figures.

When the government needs revenue and can get it from a tax decrease why shouldn't they do so?

The one-sidedness of the new bill is particularly glaring in its harsh treatment of capital gains.

The bill increases from six months to 12 months the period during which an asset must be held if the receipts from its sale are to be treated only as long-term gains subject to lower tax rates. But the highest tax even on long-term capital gains is no longer to be 25 per cent; it will be one-half the tax rate on regular income, and so can rise to 35 per cent to taxpayers in the highest brackets.

The attitude of successive Administrations and Congresses toward capital gains has been hypocritical, a cynical heads-I-win tails-you-lose treatment of the taxpayer. If Congress really believed, as it professes to, that net short-term capital gains are justly treated as a full addition to ordinary income, then it should agree that net short-term capital losses should be deductible in full against the same year's ordinary income.

Or if it is right that half of all net long-term capital gains in a given year should be added to that year's ordinary income and taxed as such, as they are, then half of all net long-term capital losses in a given year should be deductible against that year's ordinary income. But no members of Congress even mentions any such even-handed treatment.

As a result of the inflation of the last 36 years, people have been paying taxes on "capital gains" that are in fact non-existent.

For instance, suppose you bought stock or real estate for \$10,000 in 1939 and sold it for \$26,400 today. You would be taxed for a capital gain of \$16,400. Actually, as the cost of living has also risen 164 percent in this period, you would have achieved no real capital gain at all. Your \$26,400 would buy no more than \$10,000 bought in 1939.

There are at least a dozen different possible reforms of the capital gains tax, any one of which would make it less one-sided. I suggest we begin with this one: When a taxpayer sells shares or a piece of property held over a long period, he should be permitted to calculate his real gain (or loss) by reducing his nominal money gain against the increase in the official price index since the year in which he originally acquired the property.

To expect this is probably utopian. But is it even utopian to hope that at least a few of the abuses in the House tax bill can be corrected in the Senate by this Committee?

CAPITAL GAINS TAX AT DEATH

We are opposed to the imposition of a tax at capital gains rates on all net gains accrued on capital assets at the time of transfer at death or gift. We are equally opposed to carrying over the decedent's basis for property included in his estate.

A tax on appreciation at death would lead to substantial shift of equity investment to sheltered investments. If done on a large scale, this could have a serious effect on the investment markets and attitudes of investors. The use of substituted bases is completely unworkable from a record keeping standpoint. The problem of trying to establish fair market values for all properties as of the date a new tax reform bill becomes law would be fantastic. It would parallel the problem we had for decades in determining the value of property as of March 1, 1913.

A tax on appreciated property not sold or exchanged would constitute a new capital levy on death. In effect, it would be an additional estate tax imposed specifically on those persons who have been successful in taking the investment risks which are a most important part of our economic system.

Gentlemen, I thank you.

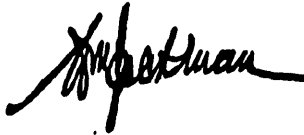


TABLE I		
STOCKHOLDINGS OF 1494 INDIVIDUALS		
Value of Stock Held (At Price Levels of Dec. 31, 1964) ..	\$66,268,000	
Market Value of Stock When Purchased	29,813,000	
Unrealized Capital Appreciation	36,455,000	
AT CURRENT CAPITAL GAINS TAX RATE (25% Maximum)		
Would Sell in 1965	\$ 1,515,000	
Capital Appreciation Realized		\$ 490,000
WITH 50% CUT IN CAPITAL GAINS TAX (12½% Maximum)		
Would Sell in 1965	11,526,000	
Capital Appreciation Realized		5,714,000

**IF THE PRESENT CAPITAL GAINS TAX RATE REMAINS UNCHANGED
—MAXIMUM TAX OF 25%:**

The indicated annual market value of sales of stock by all individual investors would total about \$10.3 billion—of which some \$3 billion would represent capital appreciation subject to the capital gains tax.

In terms of revenue, the Treasury would receive an estimated \$440 million.

*All tax implications described in the survey assume an expanding economy which will follow the same basic growth patterns evident in recent years. Were the price level of the market to drop appreciably, the net gain could be substantially less than is indicated in this report.

311

TABLE II			
TOTAL INDIVIDUAL SHAREHOLDINGS IN PUBLICLY OWNED CORPORATIONS ESTIMATES OF AMOUNT OF UNLOCKED CAPITAL AND IMPACT ON FEDERAL REVENUES UNDER THREE ASSUMED CAPITAL GAINS TAX SITUATIONS			
Estimated Value of Stock Held (Dec. 31, 1964) .. \$386,980,000,000			
Estimated Unrealized Capital Appreciation .. . 208,300,000,000			
AT CURRENT CAPITAL GAINS TAX RATE (25% Maximum)			
Would Sell in 1965	\$10,340,000,000		
Capital Appreciation Realized		\$ 2,970,000,000	
Tax To Treasury			\$ 440,000,000
WITH 50% CUT IN CAPITAL GAINS TAX (12½% Maximum)			
Would Sell in 1965	67,320,000,000		
Capital Appreciation Realized		29,220,000,000	
Tax To Treasury			
Initial Sales			2,490,000,000
Annually After Leveling Off			760,000,000

**IF THE CAPITAL GAINS TAX RATE WERE REDUCED TO A
MAXIMUM OF 12½%:**

The market value of sales by all individual investors would soar from \$10.3 billion to \$67.3 billion. Total capital appreciation of \$29.2 billion would become subject to the lower capital gains tax rate. Thus:

Nearly seven times as much stock would be sold.

Nearly ten times as much capital appreciation would be unlocked and thus become subject to the lower capital gains tax rate.

IN TERMS OF DOLLARS ..

\$57 billion more of capital would be freed for reinvestment than under the present rates.

AND

The Treasury would receive an estimated \$2.5 billion in revenue—over \$2 billion more than under the present rates.

October 1, 1969

STATEMENT OF MORTON M. WINSTON
EXECUTIVE VICE PRESIDENT
THE OIL SHALE CORPORATION
BEFORE THE SENATE FINANCE COMMITTEE
ON THE TAX REFORM ACT OF 1969

I am here today representing The Oil Shale Corporation, a publicly-held company, which -- together with Atlantic Richfield Company, Sohio Petroleum Company, and The Cleveland-Cliffs Iron Company, as joint venturers -- is now completing the development stages of the first commercial petroleum production complex from oil shale in North America.

As you know, "oil shale" is a marlstone containing a hydrocarbonaceous substance, finely distributed through the rock matrix, called "kerogen". The large oil shale deposits of Colorado, Utah and Wyoming have been estimated to contain some 800 billion barrels of petroleum reserves of good quality.

We and our joint venture partners have spent more than \$50 million to establish reserves for, and the technical and economic feasibility of, commercial-production facilities for oil-shale mining, crushing, and retorting -- that is, for the extraction of oil from the shale by heating. Oil-shale retorting is not a refining process; it is a separation process for the separation of the kerogen, as shale oil, from the rock by heat.

We have made this investment because we are convinced that without shale oil even the best efforts of the skillful American petroleum industry cannot keep pace with the tremendous growth of demand for liquid and gaseous petroleum and maintain safe reserve levels in the United States.

Petroleum demand is now approximately 13 million barrels per day. By 1980, it will be -- conservatively -- 17 million barrels per day. As Director David Freeman of the President's Energy Policy Staff told the Senate Interior Committee this summer, "In view of the tremendous future demand for energy facing this nation, it would seem prudent that we develop a policy that would at least determine whether the shale resource can compete with other forms of energy. Otherwise this vast source of potential energy cannot be called upon to play its rightful role in meeting the nation's energy needs."

We and our joint venture partners are now demonstrating in field operations our conclusion that shale oil is an economic supplement to domestic petroleum supplies. But the present Internal Revenue Code is frustrating shale oil development.

Oil and gas produced from oil shale are subject to two competitive injuries in the depletion calculation under current interpretations by the Internal Revenue Service:

1. The I.R.S. ruled in 1957 that oil shale "mined solely for its kerogen content" was in the category of "all other minerals" (now section 613(b) (7) of the Code), and therefore entitled to a depletion allowance of 15%.
2. The point of application for the depletion allowance must be, according to the I.R.S., the value of the crushed oil shale rock before retorting.

Stated another way, there is no specific depletion allowance on shale oil under existing interpretation of the present tax code. There is only a 15% depletion on the supposed value of the unmarketable shale rock from which the oil is separated. Yet, shale oil must compete with crude oil from wells. That oil is allowed depletion at its full value at the wellhead, and the present rate is 27-1/2%.

This depletion discrimination against shale oil production is as plain as it is indefensible. It mitigates against the flow of capital into shale oil development, and it places shale oil at a competitive disadvantage in the market place.

To remove this inequity and to encourage the development of the nation's oil shale reserves, the House Ways and Means Committee and the full House of Representatives voted to change the existing tax code as to the depletion allowance on shale oil.

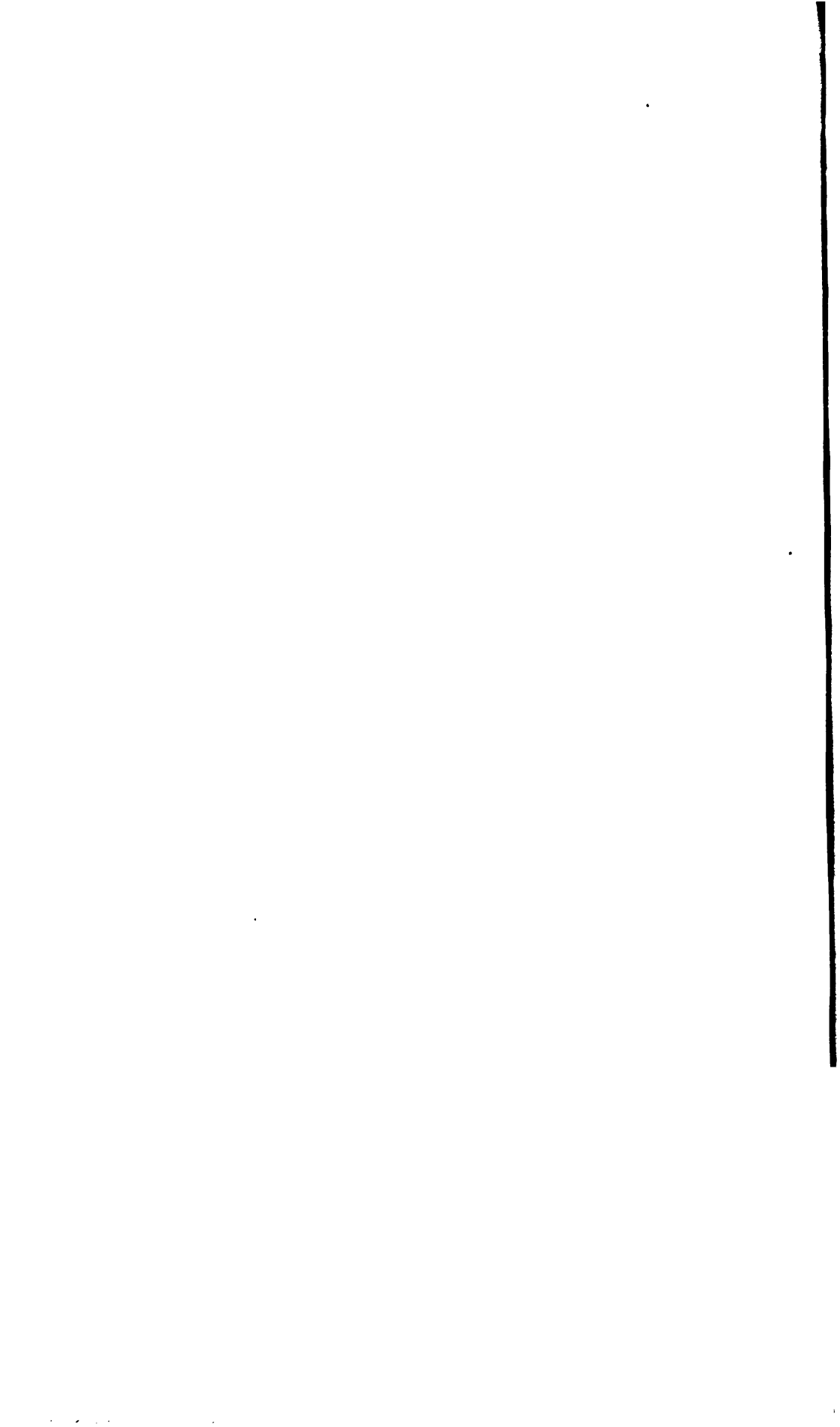
H.R. 13270, now pending before this Committee, sets up separate provisions for shale oil, expressly fixes the depletion rate at 15%, and fixes the point of application as the value of the oil after retorting, that is, after the separation process but before any refining.

As the Secretary of the Interior wrote in a letter to Chairman Aspinall of the House Interior Committee in 1965 commenting on a bill to apply the depletion allowance at the end of the retort:

"Application of the depletion allowance on the gross value of crude shale oil as it comes from the retort provides a fair comparison with natural petroleum at the well-head. Crude shale oil is a product which is easily measurable and it is physically similar enough to natural petroleum to be handled in oil pipelines and sold to refineries equipped to process it further."

Oil shale retorting is not a manufacturing or refining process. It is a separation process, the only known method to separate kerogen from the shale. Shale itself has no value per se. It is the kerogen, which is a small part of oil shale, which has a value; and the logical point for applying depletion is after kerogen is first recovered by the separation process, and before any further processing.

This simple change in the tax code, applying shale oil depletion to the value of the oil instead of the rock, will not affect present tax receipts one iota. There is no taxable income from the shale oil industry today. To launch this industry requires large amounts of capital and entrepreneurs willing to assume the substantial risks involved, both technical and financial. If you approve the change made by H.R. 13270, it will be a significant step toward making it possible for the new industry to come alive and to grow. When that occurs, there will be taxable revenue and our vast shale oil resources will be contributing to meeting America's enormous demands for liquid fuel. This is why we urgently ask that this Committee help remove the tax discrimination against shale oil and to approve the change made by the House.



CASE HISTORY
THE EFFECTS OF REDUCING THE OIL DEPLETION
ALLOWANCE AND THE ELIMINATION OF THE ABC
TRANSACTION AS PROPOSED IN
HR 13270, SECTIONS 501(a) AND (b)

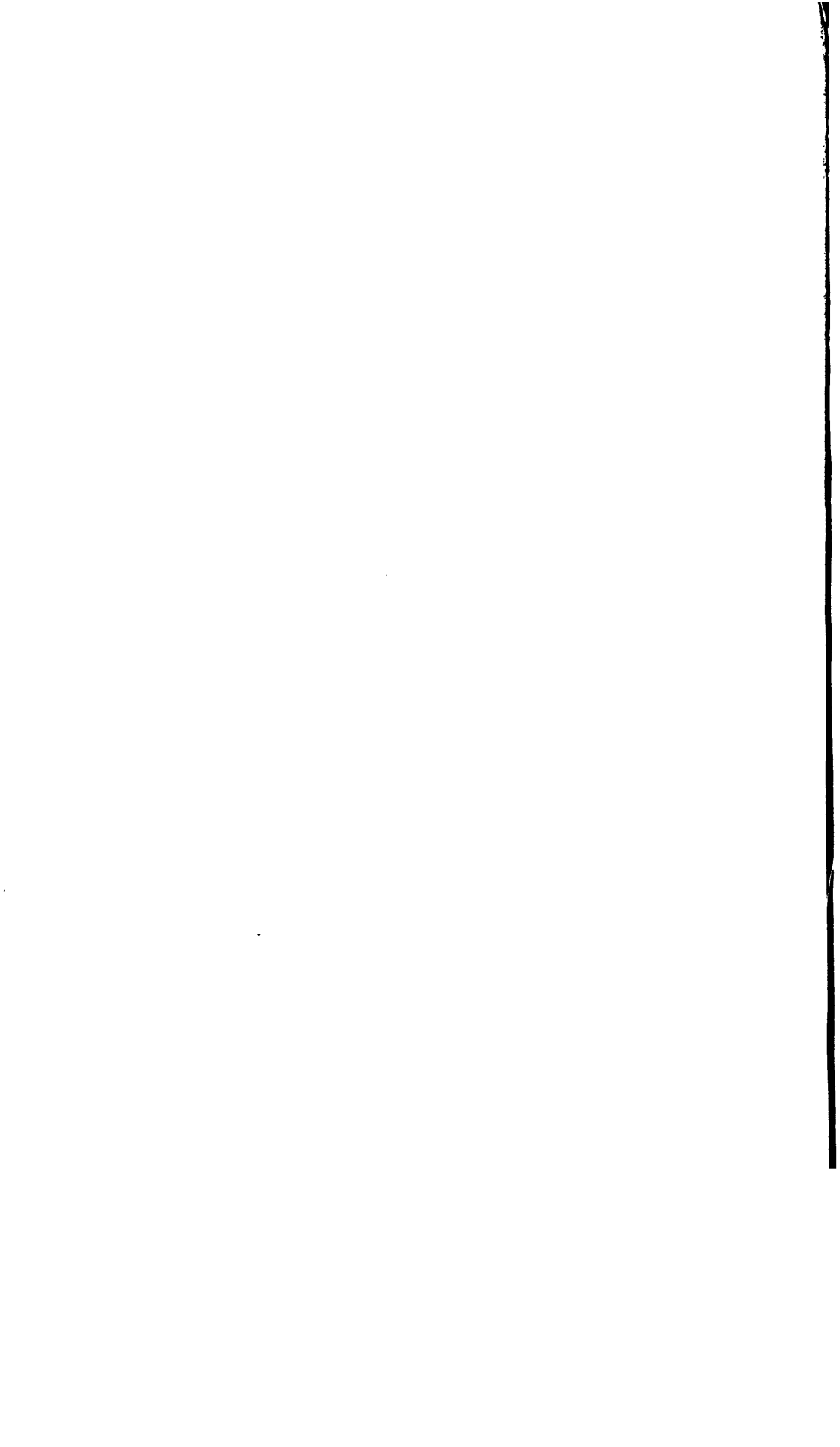
by
B. P. Huddleston, P. E.
Petroleum Reservoir Engineer
Houston, Texas

SUMMARY

This study illustrates the effect of the proposed changes in the Federal Income Tax Law relating to the percentage depletion allowance and the ABC transaction on the independent oil operator. The illustration is based on a series of cases developed from Citronelle Field, Alabama. Citronelle Field is uniquely representative of a significant oil reserve with diverse operating ownership of over 500 individuals and corporations. Major oil companies own less than 20% of the total operating interest ownership. In addition, over 1000 individuals receive royalty income from Citronelle production.

The examples herein show that the Federal income tax burden of the Citronelle operators would be increased by 19.5% if the percentage depletion rate is reduced from 27.5% to 20%. The combination of the reduction in the depletion rate and the elimination of the ABC transaction reduces the market value of the Citronelle owners' operating interests (the price that would be paid by a willing purchaser) by 34%. Independents are differentiated from major integrated oil companies since the major company can be expected to pass on these drastic effects to the ultimate consumer.

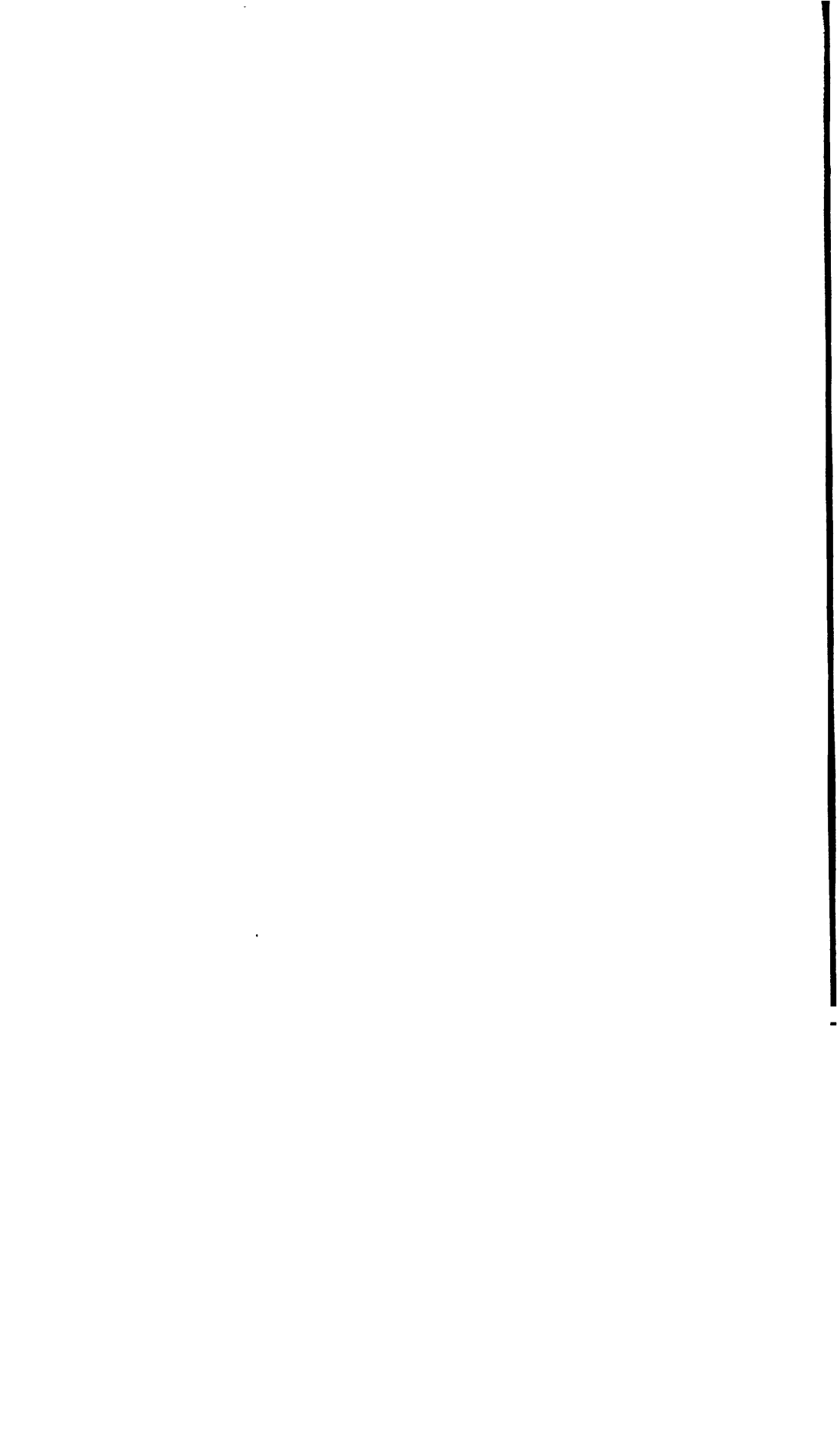
Prepared For
The United States Senate Finance Committee Hearing
Scheduled October 1, 1969



CASE HISTORY
THE EFFECTS OF REDUCING THE OIL DEPLETION
ALLOWANCE AND THE ELIMINATION OF THE ABC
TRANSACTION AS PROPOSED IN
HR 13270, SECTIONS 501(a) AND (b)

by
B. P. Huddleston, P. E.
Petroleum Reservoir Engineer
Houston, Texas

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The United States Senate Finance Committee Hearing
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INTRODUCTION

A careful study of the proposed changes in oil and gas taxation, as described in HR 13270, Sections 501(a) and 501(b), shows that the ultimate payor will be the independent oil operators and finally the consumer. The far reaching effects of the proposed changes on the future of exploratory drilling for oil and gas reserves have been adequately described by articulate spokesmen for the petroleum industry and therefore are not treated here. Nor do we offer the oft repeated arguments for depletion or for justification for the ABC transaction. The case history described herein illustrates that the tax changes would drastically increase the tax burden of the independent oil operator and reduce the value of his properties.

CASE HISTORY

Citronelle Field, Alabama, one of the most prolific producers in the Southeastern United States, was discovered by independent oil operators in 1955 and subsequently developed primarily by independents with the drilling of over 400 wells. Only one major company made a significant contribution to the field and relatively early in the producing life this company chose to sell out rather than risk the complexity of initiating secondary recovery operations.

Through August, 1969, Citronelle Field has produced over 80 million barrels of oil. Had high-risk water flood operations been unsuccessful, the field would be uneconomical today. Rather, the field is producing approximately 500,000 barrels of oil per month. Ultimate recoverable oil from the field is estimated to be in excess of 150 million barrels with existing tax laws.

The effects of proposed changes in the tax laws on operating interest owners in Citronelle Field are shown in summary for eight different cases on Exhibit 1. Appendix A shows the complete calculations for two cases. Future project life is estimated to be 25 years. The average royalty burden is assumed to be 25% although some operators' royalty burden is considerably greater due to overriding royalties being paid to major companies.

The following two cases illustrate the increase in Federal income taxes for Citronelle operators resulting from the proposed reduction in the depletion rate from 27.5% to 20%. These calculations are for the 100% operating ownership so that the examples may not represent any particular corporation or individual.

	----- Stated in \$1,000's -----		
	<u>Net Revenue After FIT</u>	<u>Federal Income Tax</u>	<u>Actual Effective Depletion, %</u>
Case 3* - 27.5% depletion - Property is held throughout economic life subject to existing tax laws	70,072	27,017	25.6
Case 4* - 20% depletion - Property is held throughout economic life with statutory depletion rate reduced to 20% of gross income, but otherwise subject to existing tax laws	64,807	32,252	19.3

The increase in Federal income taxes is a significant 19.5%. The percentage increases in taxes is the same for all owners, regardless of their tax bracket. Furthermore, the vast majority of the Citronelle owners do not have the opportunity to recover the added tax cost as do the major oil companies.

The two cases shown below illustrate the effect on the value of Citronelle oil properties considering that the depletion rate is reduced and the ABC transaction is eliminated.

	----- Stated in \$1,000's -----		
	<u>Net Revenue After FIT</u>	<u>Federal Income Tax</u>	<u>Market Value</u>
Case 7* - Property is sold to purchaser corporation in ABC transaction using \$30,000,000 production payment subject to existing tax laws -			
Seller	31,875	10,625	
Purchaser	30,681	15,604	
Holder of production payment	<u>4,152</u>	<u>4,152</u>	
Total	<u>66,708</u>	<u>30,381</u>	<u>42,500</u>
Case 4* - Property is sold to purchaser corporation without ABC method and with statutory depletion rate reduced to 20%, otherwise subject to existing tax laws -			
Seller	21,000	7,000	
Purchaser	<u>36,807</u>	<u>32,282</u>	
Total	<u>57,807</u>	<u>39,282</u>	<u>28,000</u>

*Case numbers refer to cases listed in Exhibit 1.

The ABC transaction example is based on the assumption that sixty percent of the gross revenue is dedicated to retirement of the production payment. Market value is calculated to be that sum that will provide the purchaser a rate of return of 15% on his invested capital. These computations show that proposed changes in the tax laws would reduce Citronelle market values by 34%.

In all cases, the calculations show that the effective depletion allowance is less than either 27.5% or 20% of gross revenue, whichever applies, since the deduction for allowable depletion is limited to 50% of net income computed on a property-by-property basis.

THE MAJOR COMPANY ADVANTAGE

Most major companies generally are engaged in exploration, production, transportation, refining and finally marketing of petroleum products on both a domestic and international level. In the total development and sale of products, the composite of these companies, while subject to fierce individual competition, dominate the market and can thereby expect a fair return on investment. Exhibit 2 shows that the oil companies' return on invested capital is about 12.5%, or about the mid point of the spectrum for all industries in the United States. It is reasonable to anticipate that the stockholders of the major companies will not be willing to accept an increased tax burden at the expense of lower profits.

Exhibit 3 shows the concentration of sales by oil companies. The top thirty companies represented 68% of petroleum sales in 1963 compared to 48% in 1939. Obviously, the percentage of sales contributed by smaller companies has continued to decline and the independent oil producer is being phased out of business.[†] Most of the thirty largest companies are fully integrated and therefore in a position to stabilize profits by controlling all phases of their budgets from exploration to marketing.

The point is simply that the major companies can pass any increase in taxes on to the consumer. If the price of gasoline is increased the traditional one cent per gallon, the consumer costs will be increased over \$800 million per year. Treasury Department estimates show that proposed change in the depletion allowance will generate \$425 in tax revenues.

[†]Herbert F. Poyner, Jr., The Future of the Independent Oil Producer in the United States and Its Banking Implications, thesis, Southwestern Graduate School of Banking, Dallas, Texas, July, 1958.

REMAINING OIL RESERVES IN THE UNITED STATES

In a comprehensive three phase treatment, M. King Hubbert[†] concluded that ultimate United States oil production would be approximately 160 billion barrels of which over 85 billion barrels have already been produced. Based on API estimates, cumulative discoveries to date would ultimately yield 136 billion barrels of oil leaving 24 billion barrels to be discovered. An approximate median of several other estimates place ultimate reserves at approximately 260 billion barrels. In any event, we have either produced or discovered over one half of the estimated ultimate production. Tax reform which increases materially the tax burden of an industry earning only average profits on depleting assets must be illogical by any yardstick.

The economics related to any depleting industry obviously deteriorate with continued production. The petroleum industry continues to cite irrefutable statistics to show the average well is now drilled deeper than ever before, the discovery ratio is lower, the volume of reserves for each new discovery is smaller, and finally, that only an average of 38 barrels of oil is discovered per foot of hole drilled compared to 160 barrels of oil per foot of hole drilled from 1929-35. While these data are presented, no comprehensive study by objective knowledgeable persons familiar with the petroleum industry is offered to show that the proposed tax changes will benefit the American people. At best, the argument is that the proposed changes in the tax laws may not be detrimental to our prime energy source.

If remaining domestic reserves of 100 billion barrels are reduced by only 10 percent or 10 billion barrels by poor tax planning now, the claimed but improbable increased tax revenue will be wiped out over threefold by the value of energy lost to the United States.

EFFECTIVE DATES OF PROPOSED LEGISLATION

Most retroactive tax legislation is discriminatory, even that legislation which can be truly called "tax reform." The present tax bill was assembled and presented with such haste and is of such magnitude that the thought that it could be enacted in its present form with its many different effective dates makes one shudder. Business plans are not made overnight. Most important transactions in all industries require lengthy periods of time for negotiation and agreement, the oil and gas industry being no exception.

The present bill provides for an exception to the effective date provisions relating to the creation of production payments if the parties had entered into a binding contract before April 22, 1969. If two taxpayers were negotiating for an

[†]M. King Hubbert, "Degree of Advancement of Petroleum Exploration in the United States," Economics and the Petroleum Geologists, (Midland West Texas Geological Society, Publication No. 66-53, 19 1966.)

ABC sale of properties to the same purchaser, one closing his transaction on April 21 and the other closing his on April 23, the former would meet this exception while the latter would not, even though the proposed law change governing the transaction was not even presented to the House of Representatives until more than three months later and was not enacted until the following year.

It is strongly urged that, if enacted in its present form, the provisions of the bill not be effective before taxable years beginning after date of enactment or at the very earliest for events occurring after date of enactment.

CONCLUSIONS

1. The reduction in the depletion allowance from 27-1/2% to 20% will increase the tax load of the operators by 19.5% in the examples calculated herein.
2. Elimination of the ABC transaction combined with the reduction in the depletion rate will result in a loss in market value of 34% for the oil property in the attached example. This loss will effect over 500 property owners.
3. The integrated major oil companies will probably pass any increase in taxes on to the consumer in order to maintain their present rate of return on invested capital. The independent oil operator will not have the means available to maintain such return on investment. Thus, the proposed changes in oil and gas taxation would unquely penalize the independent oil operator.
4. The effective date of enactment of changes in the tax law should not be effected before the beginning of the first taxable year following the changes.

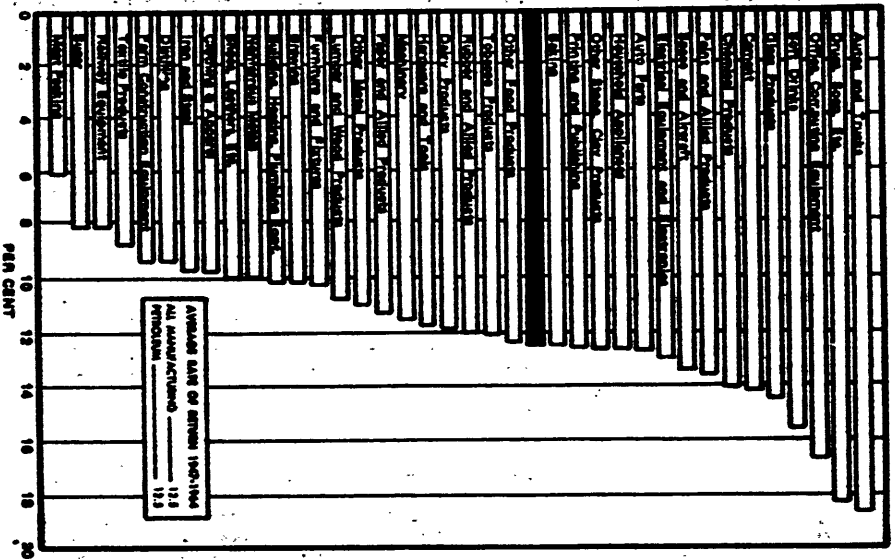
**EFFECTS OF PROPOSED CHANGES IN FEDERAL INCOME TAX
SUMMARY OF EIGHT CASES
CITRONELLE FIELD, ALABAMA
STATED IN \$1,000'S**

Case Number	Federal Income Tax Rate, %	Maximum Allowed Depreciation, %	Actual Effective Depreciation, %	Adjusted Gross Income \$	Operating Costs \$	Depreciation Allowance \$	Federal Income Tax, \$	Future Net Revenue, After \$	Net Revenue Discounted @ 9%, \$	Production Payment \$	Estimated Market Value, \$
1	28	27.5	25.6	167,742	70,663	43,064	13,509	83,580	51,143	0	38,000
2	28	20.0	18.3	167,742	70,663	32,825	16,141	80,948	48,463	0	36,000
3	60	27.5	25.6	167,742	70,663	43,064	27,017	70,072	42,712	0	31,000
4	60	20.0	18.3	167,742	70,663	32,825	32,282	64,807	38,332	0	28,000
5	28	27.5	21.7	138,983	68,208	27,576	7,902	80,983	24,080	30,000	45,000
6	28	20.0	17.6	138,983	68,208	22,283	9,123	48,662	23,963	30,000	44,500
7	60	27.5	21.7	138,983	68,208	27,576	16,804	43,181	20,803	30,000	42,500
8	60	20.0	17.6	138,983	68,208	22,283	18,248	40,538	19,548	30,000	41,500

Notes:

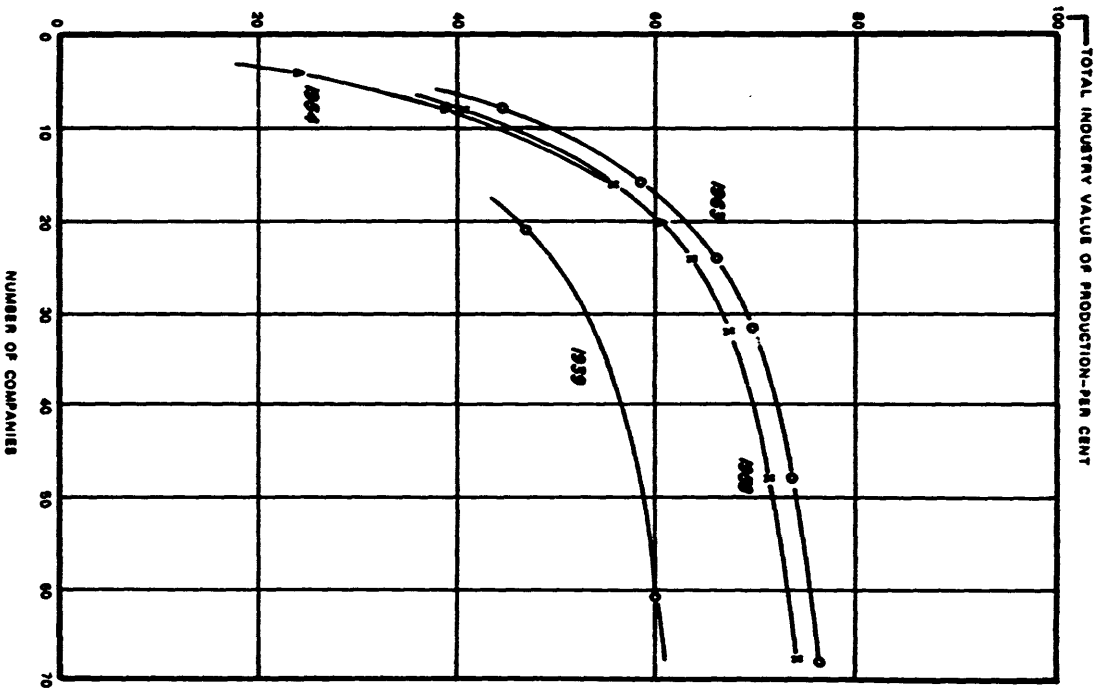
- 1) Comparison of Case 1 through 4 shows effects of reducing the Depreciation Allowance.
- 2) Comparison of Case 5 through 8 shows effects of reducing the Depreciation Allowance if properties are subject to production payment.
- 3) Comparison of Case 2 to 5 and Case 4 to 7 show combined effect of reducing the Depreciation Allowance and eliminating the production payment.
- 4) Market value is equal to sum of the production payment and the amount that will yield equity 10% annual rate of return on invested capital.

329



Source: 1944-1964 OH & Co. Association, Proceedings,
Division Economic Research and National Research,
based on United Nations data.

EXHIBIT 2 - RATE OF RETURN ON BOOK NET ASSETS, 1947-1964.



Source: U. S. Bureau of the Census

EXHIBIT 3 . . CONCENTRATION OF SALES IN AMERICAN PETROLEUM PRODUCTION,
1939, 1954, 1958, and 1963.

APPENDIX A

EXAMPLE CALCULATIONS
FOR CASES 4 AND 7

EFFECT OF PROPOSED TAX CHANGES - CITRGNELLE FIELD, ALABAMA CASE 4

STARTING DATE IS 1/ 1/70
WELL TYPE IS OIL
DISCOUNT RATE FOR REPAINDER IS 0.2021
NUMBER OF MONTHS IN LAST YEAR 48
PRESENT WORTH FACTOR IS 0.090
TIMES/YEAR PW FACTOR AND CF REINV. ARE COMPOUNDED 2.
LIFE OF PROJECT IN YEARS 26
LIFTING COST, \$PER WELL/MONTH 500.
EXPENSE, FRACTION OF GROSS REVENUE 0.0600
OPERATING COST (DOLLARS/BBL) 0.500
INCOME TAX RATE 0.500
DEPRECIATION PERIOD, IN YEARS 0.
PERCENT 1ST YR TANG INV INCLUDED IN DISC TOT INV 0.000
SALVAGE VALUE, FRACTION OF TANGIBLE INVESTMENT 0.000
DISCOUNT RATE FOR INVESTMENT 0.000
PERCENT OF TANG. INV. SUBJECT TO TAX CREDIT 0.000
AREAS 1 AND 2 WILL BE CLEARED AND THE RESULTS ADDED TO 1
UNDEPRECIATED TAN INV IS NOT ADDED TO C F OF LAST YR.
DEPRECIATION IS BYPASSED
CASH FLOW IS CALCULATED WITHOUT REINVESTMENT
TAX CREDIT IS BYPASSED
NEGATIVE TAXES ARE SET TO 0 AND CREDITED TO NEXT YEAR
CALCULATION WILL INCLUDE 20.0 PERCENT DEPLETION

Appendix A - Exhibit 1 - Page 1 of 6

333

YEAR	**** PRODUCTION OIL/COND	*** GAS	***** TANGIBLE	INVESTMENTS NON-DEPL	***** DEPL	EXTRA EXPENSES	*** PRICE OIL/CON	**** GAS	NO OF WELLS	***** NET	***** WORKING
1970	5710000.	0.	0.	0.	0.	0.	3.05	0.000	285	0.7500000	1.0000000
1971	6580000.	0.	0.	0.	0.	0.	3.05	0.000	285	0.7500000	1.0000000
1972	6390000.	0.	0.	0.	0.	0.	3.05	0.000	285	0.7500000	1.0000000
1973	6610000.	0.	0.	0.	0.	0.	3.05	0.000	280	0.7500000	1.0000000
1974	5280000.	0.	0.	0.	0.	0.	3.05	0.000	275	0.7500000	1.0000000
1975	4860000.	0.	0.	0.	0.	0.	3.05	0.000	265	0.7500000	1.0000000
1976	4510000.	0.	0.	0.	0.	0.	3.05	0.000	260	0.7500000	1.0000000
1977	4280000.	0.	0.	0.	0.	0.	3.05	0.000	255	0.7500000	1.0000000
1978	4020000.	0.	0.	0.	0.	0.	3.05	0.000	250	0.7500000	1.0000000
1979	3680000.	0.	0.	0.	0.	0.	3.05	0.000	245	0.7500000	1.0000000
1980	3250000.	0.	0.	0.	0.	0.	3.05	0.000	240	0.7500000	1.0000000
1981	2710000.	0.	0.	0.	0.	0.	3.05	0.000	235	0.7500000	1.0000000
1982	2330000.	0.	0.	0.	0.	0.	3.05	0.000	230	0.7500000	1.0000000
1983	2010000.	0.	0.	0.	0.	0.	3.05	0.000	225	0.7500000	1.0000000
1984	1750000.	0.	0.	0.	0.	0.	3.05	0.000	220	0.7500000	1.0000000
1985	1520000.	0.	0.	0.	0.	0.	3.05	0.000	215	0.7500000	1.0000000
1986	1370000.	0.	0.	0.	0.	0.	3.05	0.000	210	0.7500000	1.0000000
1987	1220000.	0.	0.	0.	0.	0.	3.05	0.000	205	0.7500000	1.0000000
1988	1100000.	0.	0.	0.	0.	0.	3.05	0.000	200	0.7500000	1.0000000
1989	980000.	0.	0.	0.	0.	0.	3.05	0.000	190	0.7500000	1.0000000
1990	0.	0.	0.	0.	0.	0.	3.05	0.000	0	0.7500000	1.0000000
1991	0.	0.	0.	0.	0.	0.	3.05	0.000	0	0.7500000	1.0000000
1992	0.	0.	0.	0.	0.	0.	3.05	0.000	0	0.7500000	1.0000000
1993	0.	0.	0.	0.	0.	0.	3.05	0.000	0	0.7500000	1.0000000
1994	0.	0.	0.	0.	0.	0.	3.05	0.000	0	0.7500000	1.0000000
1995	3170000.	0.	0.	0.	0.	0.	3.05	0.000	165	0.7500000	1.0000000

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 4

YEAR	** GROSS PRODUCTION ** OIL/COND (BBLS)	GAS (MMCF)	*** NET PRODUCTION *** OIL/COND (BBLS)	GAS (MCF)	***** PRODUCTION ***** OIL/COND (BBLS)	PAYMENT GAS ACTUAL (DOLLARS)	***** INTEREST ***** (DOLLARS)
1970	5710000.	0.	4282500.	0.	0.	0.	0.
1971	6580000.	0.	4935000.	0.	0.	0.	0.
1972	6390000.	0.	4792500.	0.	0.	0.	0.
1973	6610000.	0.	4957500.	0.	0.	0.	0.
1974	5280000.	0.	3960000.	0.	0.	0.	0.
1975	4860000.	0.	3645000.	0.	0.	0.	0.
1976	4510000.	0.	3382500.	0.	0.	0.	0.
1977	4280000.	0.	3210000.	0.	0.	0.	0.
1978	4020000.	0.	3015000.	0.	0.	0.	0.
1979	3680000.	0.	2760000.	0.	0.	0.	0.
1980	3250000.	0.	2437500.	0.	0.	0.	0.
1981	2710000.	0.	2032500.	0.	0.	0.	0.
1982	2330000.	0.	1747500.	0.	0.	0.	0.
1983	2010000.	0.	1507500.	0.	0.	0.	0.
1984	1750000.	0.	1312500.	0.	0.	0.	0.
1985	1520000.	0.	1140000.	0.	0.	0.	0.
1986	1370000.	0.	1027500.	0.	0.	0.	0.
1987	1220000.	0.	915000.	0.	0.	0.	0.
1988	1100000.	0.	825000.	0.	0.	0.	0.
1989	980000.	0.	735000.	0.	0.	0.	0.
1990	0.	0.	0.	0.	0.	0.	0.
1991	0.	0.	0.	0.	0.	0.	0.
1992	0.	0.	0.	0.	0.	0.	0.
1993	0.	0.	0.	0.	0.	0.	0.
1994	0.	0.	0.	0.	0.	0.	0.
SUB	70160000.	0.	52620000.	0.	0.	0.	0.
REM	3170000.	0.	2377500.	0.	0.	0.	0.
TCT	73390000.	0.	54997500.	0.	0.	0.	0.

Appendix A - Exhibit 1 - Page 2 of 6

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 4

YEAR	EXPENSES-COSTS					INVESTMENT DATA		
	LIFTING	REVENUE	OPERATING	EXTRA	TOTAL	TANGIBLE	INTANGIBLE	DEPRECIATION
1970	1710000.	783697.	2141250.	0.	4634947.	0.	0.	0.
1971	1710000.	903105.	2467500.	0.	5080605.	0.	0.	0.
1972	1710000.	877027.	2396250.	0.	4983277.	0.	0.	0.
1973	1680000.	907222.	2478750.	0.	5065972.	0.	0.	0.
1974	1650000.	724680.	1980000.	0.	4354680.	0.	0.	0.
1975	1590000.	667035.	1822500.	0.	4079535.	0.	0.	0.
1976	1560000.	618997.	1691250.	0.	3870247.	0.	0.	0.
1977	1530000.	587430.	1605000.	0.	3722430.	0.	0.	0.
1978	1500000.	551745.	1507500.	0.	3559245.	0.	0.	0.
1979	1470000.	505080.	1380000.	0.	3355080.	0.	0.	0.
1980	1440000.	446062.	1218750.	0.	3104812.	0.	0.	0.
1981	1410000.	371947.	1016250.	0.	2798197.	0.	0.	0.
1982	1380000.	319792.	873750.	0.	2573542.	0.	0.	0.
1983	1350000.	275872.	753750.	0.	2379622.	0.	0.	0.
1984	1320000.	240187.	656250.	0.	2216437.	0.	0.	0.
1985	1290000.	208620.	570000.	0.	2068620.	0.	0.	0.
1986	1260000.	188032.	513750.	0.	1961782.	0.	0.	0.
1987	1230000.	167445.	457500.	0.	1854945.	0.	0.	0.
1988	1200000.	150975.	412500.	0.	1763475.	0.	0.	0.
1989	1140000.	134505.	367500.	0.	1642005.	0.	0.	0.
1990	0.	0.	0.	0.	0.	0.	0.	0.
1991	0.	0.	0.	0.	0.	0.	0.	0.
1992	0.	0.	0.	0.	0.	0.	0.	0.
1993	0.	0.	0.	0.	0.	0.	0.	0.
1994	0.	0.	0.	0.	0.	0.	0.	0.
SUB	29130000.	9629455.	26310000.	0.	65069455.	0.	0.	0.
REP	3960000.	435082.	1188750.	0.	5583832.	0.	0.	0.
TOT	33090000.	10064537.	27498750.	0.	70653287.	0.	0.	0.

Appendix A - Exhibit 1 - Page 3 of 6

385

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 4

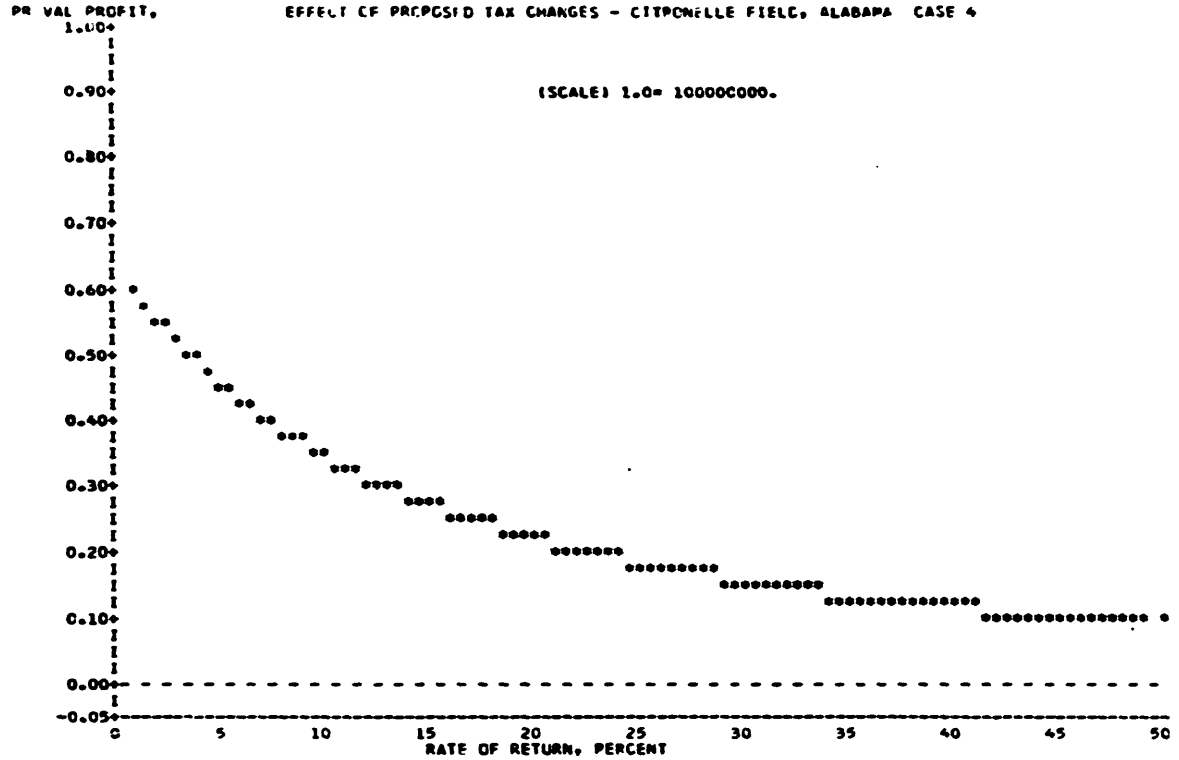
YEAR	DEPLETION TAKEN	INCOME TAX PAYMENT	TAX CREDIT TAKEN	ADJUSTED GROSS INCOME	**** NET CASH FLOW **** ANNUAL CUMULATIVE	* REINVESTED CASH FLOW * ANNUAL CUMULATIVE		
1970	2612325.	2907176.	0.	13061625.	5519501.	5519501.	0.	0.
1971	3010350.	3480397.	0.	15051750.	6490747.	12010249.	0.	0.
1972	2923425.	3355211.	0.	14617125.	6278636.	18288885.	0.	0.
1973	3024075.	3515164.	0.	15120375.	6539239.	24828124.	0.	0.
1974	2415600.	2653860.	0.	12078000.	5069459.	29897584.	0.	0.
1975	2223450.	2407132.	0.	11117250.	4630582.	34528167.	0.	0.
1976	2063325.	2191526.	0.	10316625.	4254851.	38783018.	0.	0.
1977	1958100.	2054985.	0.	9790500.	4013085.	42796103.	0.	0.
1978	1839150.	1898677.	0.	9195750.	3737827.	46533931.	0.	0.
1979	1683600.	1689660.	0.	8418000.	3373260.	49907191.	0.	0.
1980	1486875.	1421344.	0.	7434375.	2908219.	52815410.	0.	0.
1981	1239825.	1080551.	0.	6199125.	2320376.	55135786.	0.	0.
1982	1065975.	845179.	0.	5329875.	1911154.	57046940.	0.	0.
1983	919575.	649339.	0.	4597875.	1568914.	58615854.	0.	0.
1984	800625.	493031.	0.	4003125.	1293657.	59909511.	0.	0.
1985	695400.	56490.	0.	3477000.	1051890.	60961401.	0.	0.
1986	586046.	293023.	0.	3133875.	879070.	61840471.	0.	0.
1987	467902.	233951.	0.	2790750.	701854.	62542325.	0.	0.
1988	376387.	188194.	0.	2516250.	564581.	63106906.	0.	0.
1989	299872.	149936.	0.	2241750.	449809.	63556715.	0.	0.
1990	0.	0.	0.	0.	0.	63556715.	0.	0.
1991	0.	0.	0.	0.	0.	63556715.	0.	0.
1992	0.	0.	0.	0.	0.	63556715.	0.	0.
1993	0.	0.	0.	0.	0.	63556715.	0.	0.
1994	0.	0.	0.	0.	0.	63556715.	0.	0.
SUB	31691881.	31864829.	0.	167742374.	63556715.		0.	
REM	833771.	416886.	0.	7251375.	1250657.	64807372.	0.	0.
TOT	32525652.	32281715.	0.	167742374.	64807372.		0.	

Appendix A - Exhibit 1 - Page 4 of 6

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 4

YEAR	P.W. FACTOR	***** ADJUSTED GROSS INCOME	PRESENT WORTH OF NET INCOME	***** NET CASH FLOW	DISCOUNTED TOTAL INVESTMENT	* PRESENT WORTH ANNUAL	PROFIT * CUMULATIVE	RATE OF RETURN
1970	0.95705	12500670.	8064779.	5282456.	0.	5282456.	5282456.	*****
1971	0.87650	13192979.	8739788.	5689192.	0.	5689192.	10971648.	*****
1972	0.80264	11732356.	7732556.	5039513.	0.	5039513.	16011162.	*****
1973	0.73500	11113561.	7390043.	4806378.	0.	4806378.	20817540.	*****
1974	0.67306	8129300.	5198309.	3412084.	0.	3412084.	24229625.	*****
1975	0.61634	6852087.	4337677.	2854047.	0.	2854047.	27083672.	*****
1976	0.56440	5822783.	3638385.	2401471.	0.	2401471.	29485143.	*****
1977	0.51684	5060171.	3136252.	2074143.	0.	2074143.	31559287.	*****
1978	0.47329	4352261.	2667704.	1769078.	0.	1769078.	33328365.	*****
1979	0.43340	3648414.	2194301.	1461992.	0.	1461992.	34790357.	*****
1980	0.39688	2950578.	1718330.	1154223.	0.	1154223.	35944580.	*****
1981	0.36343	2252996.	1236025.	843312.	0.	843312.	36787892.	*****
1982	0.33281	1773840.	917338.	636053.	0.	636053.	37423945.	*****
1983	0.30476	1401270.	676046.	478150.	0.	478150.	37902095.	*****
1984	0.27908	1117201.	498633.	361037.	0.	361037.	38263132.	*****
1985	0.25556	888596.	359931.	268825.	0.	268825.	38531957.	*****
1986	0.23402	733413.	274302.	205727.	0.	205727.	38737684.	*****
1987	0.21430	598075.	200549.	150412.	0.	150412.	38888096.	*****
1988	0.19624	493805.	147729.	110797.	0.	110797.	38998893.	*****
1989	0.17970	402862.	107779.	80835.	0.	80835.	39079728.	*****
1990	0.16456	0.	0.	0.	0.	0.	39079728.	*****
1991	0.15069	0.	0.	0.	0.	0.	39079728.	*****
1992	0.13799	0.	0.	0.	0.	0.	39079728.	*****
1993	0.12636	0.	0.	0.	0.	0.	39079728.	*****
1994	0.11571	0.	0.	0.	0.	0.	39079728.	*****
SUB		95017223.	59236461.	39079728.	0.	39079728.		
REM	0.20210	1465502.	337010.	252758.	0.	252758.	39332486.	*****
TOT		96482726.	59573471.	39332486.	0.	39332486.		

337



EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 7

STARTING DATE IS 1/ 1/76
WELL TYPE IS CIL
DISCOUNT RATE FOR REMAINDER IS 0.2021
NUMBER OF MONTHS IN LAST YEAR 48
PRESENT WORTH FACTOR IS 0.090
TIMES/YEAR PM FACTOR AND CF REINV. ARE COMPOUNDED 2.
LIFE OF PROJECT IN YEARS 26
LIFTING COST, \$PER WELL/MONTH 500.
EXPENSE, FRACTION OF GROSS REVENUE 0.0600
OPERATING COST (DOLLARS/BBL) 0.500
INCCPE TAX RATE 0.500
DEPRECIATION PERIOD, IN YEARS 0.
PERCENT 1ST YR TANG INV INCLUDED IN DISC TCT INV 0.000
SALVAGE VALUE, FRACTION OF TANGIBLE INVESTMENT 0.000
DISCOUNT RATE FOR INVESTMENT 0.000
PRODUCTION PAYMENT 30000000.
INTEREST RATE ON PRODUCTION PAYMENT 0.090
PERCENTAGE OF PRODUCTION APPLIED TO PAYMENT 0.600
PERCENT OF TANG. INV. SUBJECT TO TAX CREDIT 0.000
AREAS 1 AND 2 WILL BE CLEARED AND THE RESULTS ADDED TO 1
UNDEPRECIATED TAN INV IS NOT ADDED TO C F OF LAST YR.
DEPRECIATION IS BYPASSED
CASH FLOW IS CALCULATED WITHOUT REINVESTMENT
TAX CREDIT IS BYPASSED
NEGATIVE TAXES ARE SET TO 0 AND CREDITED TO NEXT YEAR
CALCULATION WILL INCLUDE 27.5 PERCENT DEPLETION

Appendix A - Exhibit 2 - Page 1 of 6

339

YEAR	**** PRODUCTION ***	GAS	***** INVESTMENTS *****	TANGIBLE	NON-DEPL	***** DEPL	EXTRA EXPENSES	*** PRICE ***	OIL/CCN	GAS	NO OF WELLS	***** INTEREST *****	NET	WORKING
1970	5710000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	285	0.7500000	1.0000000	1.0000000
1971	6580000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	285	0.7500000	1.0000000	1.0000000
1972	6390000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	285	0.7500000	1.0000000	1.0000000
1973	6410000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	280	0.7500000	1.0000000	1.0000000
1974	5280000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	275	0.7500000	1.0000000	1.0000000
1975	4860000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	265	0.7500000	1.0000000	1.0000000
1976	4510000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	260	0.7500000	1.0000000	1.0000000
1977	4280000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	255	0.7500000	1.0000000	1.0000000
1978	4020000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	250	0.7500000	1.0000000	1.0000000
1979	3680000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	245	0.7500000	1.0000000	1.0000000
1980	3250000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	240	0.7500000	1.0000000	1.0000000
1981	2710000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	235	0.7500000	1.0000000	1.0000000
1982	2330000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	230	0.7500000	1.0000000	1.0000000
1983	2010000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	225	0.7500000	1.0000000	1.0000000
1984	1750000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	220	0.7500000	1.0000000	1.0000000
1985	1520000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	215	0.7500000	1.0000000	1.0000000
1986	1370000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	210	0.7500000	1.0000000	1.0000000
1987	1220000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	205	0.7500000	1.0000000	1.0000000
1988	1100000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	200	0.7500000	1.0000000	1.0000000
1989	980000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	190	0.7500000	1.0000000	1.0000000
1990	0.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	0	0.7500000	1.0000000	1.0000000
1991	0.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	0	0.7500000	1.0000000	1.0000000
1992	0.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	0	0.7500000	1.0000000	1.0000000
1993	0.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	0	0.7500000	1.0000000	1.0000000
1994	0.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	0	0.7500000	1.0000000	1.0000000
1995	5170000.	0.	0.	0.	0.	0.	0.	3.05	0.000	0.000	165	0.7500000	1.0000000	1.0000000

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 7

YEAR	** GROSS OIL/CCMC (BBLS)	PRODUCTION ** GAS (MCF)	*** NET PRODUCTION *** OIL/CCMC (BBLS)	GAS (MCF)	***** OIL/CCMC (BBLS)	PRODUCTION GAS (MCF)	PAYMENT ACTUAL (DOLLARS)	INTEREST (DOLLARS)
1970	5710000.	0.	4282500.	0.	2569500.	0.	7366756.	2700000.
1971	6580000.	0.	4935000.	0.	2961000.	0.	8489187.	2279991.
1972	6390000.	0.	4792500.	0.	2875500.	0.	8244058.	1721164.
1973	6610000.	0.	4957500.	0.	2974500.	0.	8527891.	1134103.
1974	5280000.	0.	3960000.	0.	1979780.	0.	5676029.	468663.
1975	4860000.	0.	3645000.	0.	0.	0.	0.	0.
1976	4510000.	0.	3382500.	0.	0.	0.	0.	0.
1977	4280000.	0.	3210000.	0.	0.	0.	0.	0.
1978	4020000.	0.	3015000.	0.	0.	0.	0.	0.
1979	3680000.	0.	2760000.	0.	0.	0.	0.	0.
1980	3250000.	0.	2437500.	0.	0.	0.	0.	0.
1981	2710000.	0.	2032500.	0.	0.	0.	0.	0.
1982	2330000.	0.	1747500.	0.	0.	0.	0.	0.
1983	2010000.	0.	1507500.	0.	0.	0.	0.	0.
1984	1750000.	0.	1312500.	0.	0.	0.	0.	0.
1985	1520000.	0.	1140000.	0.	0.	0.	0.	0.
1986	1370000.	0.	1027500.	0.	0.	0.	0.	0.
1987	1220000.	0.	915000.	0.	0.	0.	0.	0.
1988	1100000.	0.	823000.	0.	0.	0.	0.	0.
1989	980000.	0.	735000.	0.	0.	0.	0.	0.
1990	0.	0.	0.	0.	0.	0.	0.	0.
1991	0.	0.	0.	0.	0.	0.	0.	0.
1992	0.	0.	0.	0.	0.	0.	0.	0.
1993	0.	0.	0.	0.	0.	0.	0.	0.
1994	0.	0.	0.	0.	0.	0.	0.	0.
SUB	70160000.	0.	52620000.	0.	13360280.	0.	38303923.	8303923.
REP	3170000.	0.	2377500.	0.	0.	0.	0.	0.
TOT	73330000.	0.	54997500.	0.	13360280.	0.	38303923.	8303923.

Appendix A - Exhibit 2 - Page 2 of 6

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 7

YEAR	***** LIFTING	REVENUE	EXPENSES--CCSTS OPERATING	***** EXTRA	TOTAL	***** TANGIBLE	INVESTMENT DATA INTANGIBLE	***** DEPRECIATION
1970	1710000.	313479.	2141250.	0.	4164729.	0.	0.	0.
1971	1710000.	361242.	2467500.	0.	4538742.	0.	0.	0.
1972	1710000.	350811.	2396250.	0.	4457061.	0.	0.	0.
1973	1680000.	362889.	2478750.	0.	4521639.	0.	0.	0.
1974	1650000.	362380.	1980000.	0.	3992380.	0.	0.	0.
1975	1590000.	667035.	1822500.	0.	4079535.	0.	0.	0.
1976	1560000.	618997.	1691250.	0.	3870247.	0.	0.	0.
1977	1530000.	587430.	1605000.	0.	3722430.	0.	0.	0.
1978	1500000.	551745.	1507500.	0.	3559245.	0.	0.	0.
1979	1470000.	505080.	1380000.	0.	3355080.	0.	0.	0.
1980	1440000.	446062.	1218750.	0.	3104812.	0.	0.	0.
1981	1410000.	371947.	1016250.	0.	2798197.	0.	0.	0.
1982	1380000.	319792.	873750.	0.	2573542.	0.	0.	0.
1983	1350000.	275872.	753750.	0.	2379622.	0.	0.	0.
1984	1320000.	240187.	654250.	0.	2216437.	0.	0.	0.
1985	1290000.	208620.	570000.	0.	2068620.	0.	0.	0.
1986	1260000.	188032.	513750.	0.	1961782.	0.	0.	0.
1987	1230000.	167445.	457500.	0.	1854945.	0.	0.	0.
1988	1200000.	150975.	412500.	0.	1763475.	0.	0.	0.
1989	1140000.	134505.	367500.	0.	1642005.	0.	0.	0.
1990	0.	0.	0.	0.	0.	0.	0.	0.
1991	0.	0.	0.	0.	0.	0.	0.	0.
1992	0.	0.	0.	0.	0.	0.	0.	0.
1993	0.	0.	0.	0.	0.	0.	0.	0.
1994	0.	0.	0.	0.	0.	0.	0.	0.
SUB	29130000.	7194525.	26310000.	0.	62624525.	0.	0.	0.
REM	3960000.	435082.	1188750.	0.	5583832.	0.	0.	0.
TOT	33090000.	7619607.	27498750.	0.	68208357.	0.	0.	0.

Appendix A - Exhibit 2 - Page 3 of 6

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 7

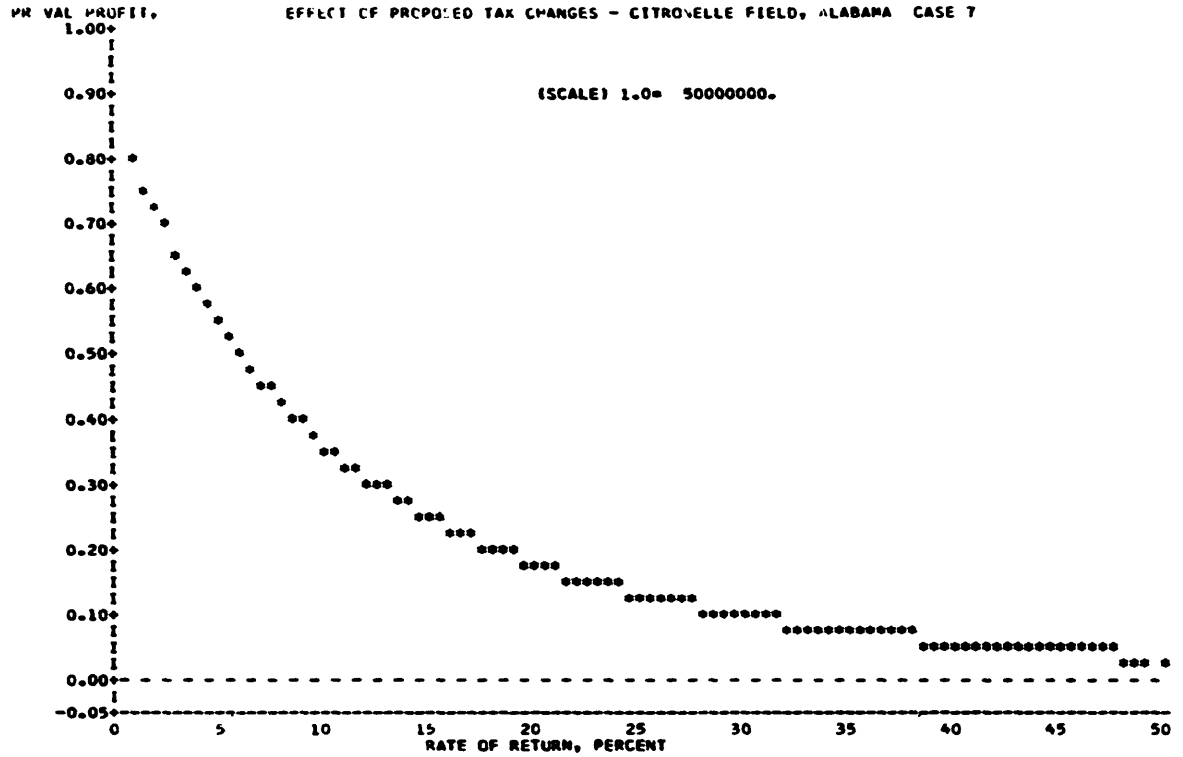
YEAR	DEPLETION TAKEN	INCOME TAX PAYMENT	TAX CREDIT TAKEN	ADJUSTED GROSS INCOME	*** NET CASH FLOW *** ANNUAL	*** NET CASH FLOW *** CUMULATIVE	* REINVESTED CASH FLOW * ANNUAL	* REINVESTED CASH FLOW * CUMULATIVE
1970	529960.	264980.	0.	5224650.	794941.	794941.	0.	0.
1971	740979.	370489.	0.	6020700.	1111468.	1906409.	0.	0.
1972	694894.	347447.	0.	5846850.	1042341.	2948751.	0.	0.
1973	763255.	381626.	0.	6048150.	1144882.	4093634.	0.	0.
1974	1023645.	511823.	0.	6039670.	1535467.	5629102.	0.	0.
1975	3057243.	1990235.	0.	11117250.	5047479.	10676581.	0.	0.
1976	2837071.	1804653.	0.	10316625.	4641724.	15318306.	0.	0.
1977	2692387.	1687841.	0.	9790500.	4380228.	19698535.	0.	0.
1978	2528831.	1553836.	0.	9195750.	4082668.	23781203.	0.	0.
1979	2314950.	1373985.	0.	8418000.	3688935.	27470138.	0.	0.
1980	2044453.	1142554.	0.	7434375.	3187008.	30657146.	0.	0.
1981	1700463.	850232.	0.	6199125.	2550695.	33207842.	0.	0.
1982	1378166.	689083.	0.	5329875.	2067250.	35275092.	0.	0.
1983	1109126.	554563.	0.	4597875.	1663690.	36938782.	0.	0.
1984	893344.	446672.	0.	4003125.	1340016.	38278798.	0.	0.
1985	704190.	352095.	0.	3477000.	1056285.	39335083.	0.	0.
1986	566046.	293023.	0.	3133875.	879070.	40214153.	0.	0.
1987	467902.	233951.	0.	2790750.	701854.	40916007.	0.	0.
1988	376387.	188194.	0.	2516250.	564581.	41480588.	0.	0.
1989	299872.	149936.	0.	2241750.	449809.	41930397.	0.	0.
1990	0.	0.	0.	0.	0.	41930397.	0.	0.
1991	0.	0.	0.	0.	0.	41930397.	0.	0.
1992	0.	0.	0.	0.	0.	41930397.	0.	0.
1993	0.	0.	0.	0.	0.	41930397.	0.	0.
1994	0.	0.	0.	0.	0.	41930397.	0.	0.
SUB	26743168.	15187222.	0.	126993520.	41930397.		0.	
REM	833771.	416886.	0.	7251375.	1250657.	43181054.	0.	0.
TOT	27576939.	15604108.	0.	126993520.	43181054.		0.	

Appendix A - Exhibit 2 - Page 4 of 6

EFFECT OF PROPOSED TAX CHANGES - CITRONELLE FIELD, ALABAMA CASE 7

YEAR	P.W. FACTOR	***** PRESENT NORTH OF ***** ADJUSTED NET GROSS INCOME INCME	***** NET CASH FLOW	DISCOUNTED TOTAL INVESTMENT	* PRESENT WORTH PROFIT * ANNUAL CUMULATIVE	RATE OF RETURN		
1970	0.95705	5000268.	1014400.	760801.	0.	760801.	760801.	*****
1971	0.87650	5277191.	1298948.	974211.	0.	974211.	1735012.	*****
1972	0.80264	4692942.	1115506.	836630.	0.	836630.	2571642.	*****
1973	0.73500	4445424.	1121994.	841496.	0.	841496.	3413138.	*****
1974	0.67306	4065101.	1377963.	1033472.	0.	1033472.	4446610.	*****
1975	0.61634	6852087.	4337677.	3111000.	0.	3111000.	7557610.	*****
1976	0.56440	5822783.	3638385.	2619825.	0.	2619825.	10177436.	*****
1977	0.51684	5060171.	3136252.	2263899.	0.	2263899.	12441336.	*****
1978	0.47329	4352261.	2667704.	1932288.	0.	1932288.	14375624.	*****
1979	0.43340	3648414.	2194301.	1598807.	0.	1598807.	15972431.	*****
1980	0.39688	2950578.	1718330.	1264869.	0.	1264869.	17237301.	*****
1981	0.36343	2252996.	1256025.	927019.	0.	927019.	18164320.	*****
1982	0.33281	1773840.	917338.	688003.	0.	688003.	18852323.	*****
1983	0.30476	1401270.	676046.	507034.	0.	507034.	19559357.	*****
1984	0.27908	1117201.	498633.	373975.	0.	373975.	19733332.	*****
1985	0.25356	888596.	359931.	269948.	0.	269948.	20003280.	*****
1986	0.23402	733413.	274302.	205727.	0.	205727.	20209007.	*****
1987	0.21430	598075.	200549.	150412.	0.	150412.	20359419.	*****
1988	0.19624	493805.	147729.	110797.	0.	110797.	20470216.	*****
1989	0.17970	402862.	107779.	80835.	0.	80835.	20551051.	*****
1990	0.16456	0.	0.	0.	0.	0.	20551051.	*****
1991	0.15069	0.	0.	0.	0.	0.	20551051.	*****
1992	0.13799	0.	0.	0.	0.	0.	20551051.	*****
1993	0.12636	0.	0.	0.	0.	0.	20551051.	*****
1994	0.11571	0.	0.	0.	0.	0.	20551051.	*****
SUB		61829284.	28039797.	20551051.	0.	20551051.		
REM	0.20210	1465502.	337010.	252758.	0.	252758.	20803809.	*****
TOT		63294787.	28376807.	20803809.	0.	20803809.		

Appendix A - Exhibit 2 - Page 5 of 6



Mr. Chairman and members of the Senate Finance Committee, my name is Harold D. Rogers and I am an attorney practicing law in the law firm of Sherill Pace & Rogers, Wichita Falls, Tex. I am here representing the North Texas Oil & Gas Association, Wichita Falls, Tex.

I appreciate the opportunity to appear before you to present to you the position that section 501(B) of the proposed Tax Reform Act of 1969 is unconstitutional. The position stated herein has the approval and concurrence of Mr. Leland Fishe, chairman of the Natural Resources Committee, Taxation Section, American Bar Association.

The taxation of production payments as proposed by section 501(B) is unconstitutional.

FACTS

Section 501 (B) in title V of the Tax Reform Act of 1969 (H.R. 13270) provides that income from mineral production payments whether carved out or retained be taxes to the owner of the mineral property not to the owner of the production payment.

QUESTION PRESENTED

Whether Congress would be violating the U.S. Constitution by enacting legislation which would require taxpayer B in the following two examples to include in his taxable income the amounts received by taxpayer A from a production payment owned by A:

(1) A, the owner of a producing oil lease (sometimes called mineral property or \$10,000 reserving unto himself a \$15,000 production payment (plus a sum equal to interest at the rate of 8 percent, per annum, payable out of 50 percent of the gross sales price of all of the oil produced from the lease.

Section 501 (B) (designated as section 636 (B) of the Internal Revenue Code) relating to retained production payments proposes to tax to B the \$15,000 received by even though A owns the production payment and will receive the entire \$15,000 as paid from oil sales made from the lease.

(2) B, the owner of a producing oil lease, sells A \$25,000 production payment to A. The production payment is payable out of 50 percent of the gross sales price of all of the oil sold from the lease plus a sum equal to interest on said \$25,000 at 8 percent per annum.

Section 501 (B) (designated as section 636 (A) of the International Revenue Code) relating to carved-out production payments proposes to tax to B the \$25,000 as received by A even though A owns the production payment and will receive the entire \$25,000 as paid from oil sales made from the lease.

LAW AND DISCUSSION

The proposed law as set forth in section 501 (B) to tax the income of A to B as outlined in examples (1) and (2) above is clearly unconstitutional. The Supreme Court held in *Hooper v. Tax Commission of Wisconsin* (1931) 284 U.S. 206, that due process is denied where one person is taxed upon the income from the property owned by another. In that case the State of Wisconsin had attempted by statute to tax a husband on income earned by his wife from her separate property. The U.S. Supreme Court held that an attempt by the State of Wisconsin to measure tax on a person's property or income by reference to another's property or income is contrary to the due process clause of the 14th amendment.

The Court stated at page 215: "That which is not in fact the taxpayer's income cannot be made such by calling it income."

Proposed section 501 (B) as quoted above constitutes a denial of due process under the 5th admendment to the constitution. These proposals attempt to tax the income of A to B. In example (1) above A is the owner of the production payment since he retained the production payment from his conveyance to B and he is the only person entitled to receive the income from the production payment. B has no legal rights in the production payment nor does he have any command over the income from the property.

It has been settled law for many years that property rights depend upon the law of the State where the property is located. The Supreme Court has held that State law controls in determining the nature of the legal interest that a taxpayer has in property. *Tyler v. United States* (1930) 281 U.S. 497; *Blair v. Commissioner* (1937) 300 U.S. 5. The various States have unanimously held that the owner of a production payment is the owner of a vested property right. Furthermore, the Supreme Court has held that the owner of a production payment, not the owner of the mineral property, is taxable on the amounts received from the production payment. *Thomas v. Perkins* (1937) 301 U.S. 655.

The proposed statute is unconstitutional because it taxes to B the income from property owned by A. Moreover, the proposed statute attempts to create a mortgage when no mortgage exists. In example (1) above the proposed statute provides that B purchased the lease for \$25,000—\$10,000 cash and a \$15,000 purchase money mortgage. But B did not sign a promissory note in the amount of \$15,000 in favor of A nor did he execute a mortgage granting to A a lien of \$15,000 against the property.

If the oil produced is insufficient to pay \$15,000 to A, then A's interest is terminated. A has no rights against B for the failure of the production payment to pay the full \$15,000.

The factual situation in example (1) above is no different than the sale of real property by A to B with A reserving a life estate in the property. During A's lifetime the income from the property is taxable to A, not to B. This is true because A owns the life estate (a vested property right) and has the legal right to receive the income from the property. Any attempt by congress to tax such income to B would be unconstitutional. *Hooper v. Tax Commission of Wisconsin*, supra. Also, the factual situation in example (2) above is no different than the sale of any property interest for a term certain. For example, if B owned an apartment house and sold it to A for a 3-year term certain, the income from the apartment is taxable to A during such 3-year period, not to B.

It follows then that a congressional attempt to tax income from a mineral production payment to a person who does not own the production payment represents a denial of due process of law. The mere fact that Congress designates certain transactions as a loan (purchase money mortgage) will not result in creating taxable income when, in fact, the income from the property is not the taxpayer's income.

These proposed statutes remind me of a story attributed to Mr. Lincoln. It is told that in the course of cross examination he asked, "How many legs does a dog have?" The adverse witness replied, "Four". Mr. Lincoln then said, "If you call a tail a leg, how many legs does the dog have?" to which the witness replied, "Five". Mr. Lincoln then said, "No sir, you are wrong, calling the tail a leg don't make it a leg."

HAROLD D. ROGERS.

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Summary of Oral Testimony
before
Senate Finance Committee

October 1, 1969

ARTHUR W. WRIGHT, Assistant Professor of Economics, University of Massachusetts, Amherst, Massachusetts:

States that the present tax treatment of natural resources is an important source of unfairness in the Federal tax system. Points out that the present tax rules for natural resources make it possible for many extremely wealthy individuals to pay less Federal taxes than persons living in poverty and enable corporations engaged in mineral production to pay far less Federal taxes than do other corporations.

Condemns the present tax treatment of natural resources as a wasteful and inefficient form of subsidy, the need for which has not been demonstrated. Suggests that the beneficiaries of mineral tax subsidies should have more faith in the ability of the American free market economy to produce minerals and fuels without Federal aid.

Points out that the present system of mineral tax subsidies creates severe administrative burdens for government and business alike. Indicates that the areas of greatest administrative difficulty concern "economic interest" questions, depletion rate determinations, cut-off point questions, unit price computations, and the fifty percent net income limitation on percentage depletion.

Points out that the Treasury's CONSAD Report, published in March 1969 by the House Ways and Means Committee, constitutes the only thorough study, to date, of the effects of the present system of tax subsidies for mineral producers. States that the CONSAD Report shows the inefficiency of these tax subsidies. Also states that the CONSAD Report has withstood the criticisms leveled at it by the petroleum industry, and suggests that the industry should commission studies of equivalent stature and thoroughness rather than merely criticizing the CONSAD Report.

Rejects claims that natural resource producers pay their fair share of Federal taxes. States that claims of this sort often use misleading bases for comparison (such as gross income instead of taxable income) and inconsistently lump together foreign taxes, Federal taxes, local taxes, and user charges when computing the industry tax burden.

Also rejects claims that the present tax treatment of natural resources is needed to let natural resource producers recover their capital investment in mineral properties. Points out that this recovery can be accomplished through cost depletion and that the present tax treatment is defective because it permits tax free recovery of amounts far greater than a mineral producer's original capital investment. States that this tax treatment discriminates against other industries that also must attract substantial amounts of capital investment.

Also rejects the claim that percentage depletion helps keep gasoline prices down. Points out that the Treasury recently estimated there would be a change in the price of gasoline of less than one half cent per gallon if the percentage depletion rate were reduced to 20 percent. States that retail prices of gasoline could be reduced by several cents per gallon by removing import restrictions and Federal support for market prorationing.

Also rejects mineral industry arguments that their tax benefits should be continued because industry rates of return on capital are low. Questions whether mineral industry rates of return are in fact low. Further states that rates of return, in the American free market economy, tend to equalize in all industries after taking into account the tax benefits granted each industry. Suggests that mineral tax benefits are often dissipated in the form of higher royalty payments to property owners.

Describes the present program of tax assistance to the natural resource industries as an inequitable, wasteful, problem-ridden government aid program. Urges the Committee to scrap the existing aid program and substitute depletion computed on the basis of actual cost, together with capitalization of intangible drilling costs and recovery of such costs over the useful life of the property like business investment in other industries.

Praises the natural resources provisions in the House-passed tax reform bill as a step in the right direction, but criticizes both the House bill and the Administration's proposals for failing to eliminate percentage depletion entirely, and, most particularly, for failing to require full capitalization of intangible drilling and development costs.

**WRITTEN STATEMENT ON TAX REFORM: DEPLETABLE NATURAL RESOURCES
SUBMITTED TO THE COMMITTEE ON FINANCE, U.S. SENATE**

by

**Arthur W. Wright
Assistant Professor of Economics
University of Massachusetts**

Mr. Chairman and Members of the Finance Committee:

Thank you for receiving this statement on tax reform in the area of depletable natural resources. This is an important subject, because changes in present federal tax treatment of natural resources ought to be part of any meaningful tax reform package. To facilitate my presentation, I have prepared a separate analysis in which my views on this subject are developed in more detail.* I would like to ask the Committee's permission to insert this analysis in the record following my written statement.

I represent no organization or interest group. Rather, I am writing as an economist and concerned citizen who has studied natural resource problems, including their tax treatment, for about a decade. As a result of my work, I have become increasingly worried about present federal tax policies in this area. Let me summarize the reasons for my concern.

*** The analysis referred to will be printed in the record compiled of the hearing.**

1. Lack of tax fairness: Present tax policies towards natural resources provide a major route by which wealthy individuals and corporations escape liability for federal income taxes. As a result, our tax system, judged by publicly accepted standards, is less fair than it should be. Understandably, the American public has become concerned about this situation.

2. Waste of tax monies: The present tax treatment of natural resources leads to a serious waste of public funds, because we are receiving very little benefit in return for substantial tax expenditures. Moreover, our present tax policies make it harder to attain other worthwhile public goals, such as greater public confidence in our tax system.

3. Administrative difficulties: Serious problems have arisen in administering the present tax provisions for natural resources. These problems have been unduly neglected in past studies of natural resource taxation. After forty years of court decisions, regulations, and rulings, these problems are now more serious than they were when the special tax benefits for mineral producers were first introduced.

I will discuss each of these points in turn.

1. Lack of Tax Fairness

There are two standards by which to judge the fairness of the federal tax system.

First, taxpayers with similar incomes should bear similar tax burdens. The effective tax rate should not depend on the source of one's income: earnings from minerals and earnings from other sources should be taxed alike. Yet earnings from natural resources are now taxed at lower rates -- in many cases substantially lower rates -- than earnings from most other sources. Under present tax rules, natural resource incomes are shielded by percentage depletion deductions in excess of cost depletion, by accelerated write-offs of exploration and development expenditures -- including, for petroleum and natural gas, immediate expensing of intangible drilling and development costs -- and by inflated foreign tax credits.

A family with an income of \$50,000 from (e.g.) oil production should, in fairness, pay about the same tax as a family with \$50,000 in income from ordinary salary and wages, but the Internal Revenue Code's special provisions for natural resources make this impossible. Similarly, an oil firm should pay more than a tiny fraction of the

corporate tax which is paid by a chemical firm with similar receipts and profits. Yet our present tax rules permit the oil firm and other natural resource firms to avoid payment of their fair share of federal taxes.

The second standard of tax fairness is progressivity of tax rates. This means that persons with higher incomes should be taxed more heavily than persons with lower incomes. But the present tax provisions for natural resources, by providing high income groups with an easy way to reduce their effective tax rates, make it very difficult to attain this goal. So broad is the avenue of escape that a significant number of wealthy individuals, including some with incomes in excess of \$1 million per year, pay less federal taxes than do individuals living in poverty. The public is understandably concerned about such unfairness. If we fail to correct this situation, we run the risk of undermining the faith of the American people in their self-assessment tax system. In order to operate well, such a system must have public confidence.

These considerations of tax fairness argue for putting an end to the special tax privileges currently enjoyed by

the natural resource industries. Unless this is done, it will not be possible to produce a tax system which, because it treats all taxpayers fairly, is entitled to widespread public support.

2. Waste of Tax Monies.

In the United States, it is our policy to rely primarily on market forces to achieve our economic goals. Government intervention in the marketplace is not favored unless it is found to be absolutely necessary. At present, however, the federal government actively intervenes in our market economy by exempting the natural resource industries from taxes they would otherwise have to pay. Is this government intervention necessary?

A number of traditional arguments have been advanced in support of the existing interventionist tax treatment of natural resources. Most of these arguments lack substance. For example, we are told that our present tax policies are needed to foster "a strong mineral industry." But why should we benefit the mineral industries at the expense of everyone else? The expansion and success of all our industries are important, and the mineral industries

should have no special claim to government favor.

We are also told that natural resource production requires advantageous tax treatment because it is highly "risky". But those who have studied the petroleum industry -- supposedly the most risky of all the natural resource industries -- have pointed repeatedly to the ingenious techniques developed by oil and gas producers to spread risks within the market mechanism. Most pleas from oil and mineral producers for tax assistance show a disturbing lack of faith in the ability of market processes to adapt to risks. What is needed is more faith in the American market economy, and less reliance on public expenditures through the tax system.

The only possibly valid argument for retaining existing tax aid to natural resource producers is the so-called "national security argument." The heart of this argument is the claim that extra productive capacity -- referred to as "reserves" -- is needed for use in the event of war or other emergency, and that special tax benefits are needed to encourage the creation of such reserves. However, the national security argument is open to serious doubt on several counts.

In the first place, we do not really know whether the national security requires greater reserves than market processes, if left to themselves, would provide; or if there is a need, how great it is in quantitative terms. Secondly, we have no proof, beyond tub-thumping assertions by industry spokesmen, that present natural resource tax provisions actually do create significant additional reserves. The evidence we do have, from several non-industry sources, indicates that the net impact of our tax policies on reserves is rather small.

The most recent evidence on this subject was provided in the Treasury report prepared by the CONSAD Research Corporation and released in March 1969. The results of this report, which in my opinion remain essentially valid in spite of attacks by the Mid-Continent Oil and Gas Association and other industry groups, suggest that our present tax policies result in additions to petroleum reserves worth, at most, \$150 million per year, in return for annual tax expenditures for petroleum exceeding \$1.3 billion. Spending \$1.3 billion through the tax system to achieve public benefits worth \$150 million is a wasteful extravagance.

It is significant that during 1969, petroleum industry publicists have begun to de-emphasize the national security argument, and to play up the notion that special tax treatment of petroleum helps maintain low prices to consumers. This notion, and its implied corollary that removing such tax treatment would cause sizable price increases, have simply not been convincingly demonstrated. Nor has the industry explained why we should use the tax system to manipulate oil prices and not the prices of such other "vital" products as milk or clothing. Nor has the industry explained why we should bother to tax consumers of oil products more heavily in order to attempt to give them lower product prices.

If the industry were serious about reducing prices to consumers, they would be asking Congress to remove or greatly relax the present restrictions on oil imports, and seeking to do away with the various state prorationing schemes -- just the opposite of their stands on these programs. Clearly the "low price" justification for special tax treatment of natural resource producers can be dismissed as merely another example of the cynical scare tactics employed so often in past industry publicity.

The Honorable Wilbur Mills, Chairman of the House Ways and Means Committee, in a speech to the House in December 1967, aptly labelled tax expenditures -- that is, expenditures on the revenue side of the budget -- as "back door spending." In this speech, Mr. Mills pointed out several defects of tax expenditures as opposed to outright appropriations: tax expenditures are seldom reviewed by the Executive Branch or by Congress to determine whether they are still necessary; accurate data on their costs and benefits are often difficult to obtain; and too frequently they are wasted on firms which would have undertaken the intended activity without them.

These defects obviously characterize our present system of tax expenditures on the natural resource industries. The basic philosophy of the system -- that is, the long-term objectives, the need for tax benefits, and the rationale of the existing set of depletion rates and cut-off points -- has escaped serious examination for 40 years. Furthermore, no line items in the Administration's budget reflect our tax expenditures on natural resources. And, as the recent CONSAD study suggests, most of these expenditures are wasted.

It is important to recognize the relative magnitude of our back door spending on natural resources. According to a statement on January 17, 1969, by former Secretary of the Treasury Joseph W. Barr, the United States currently spends -- through the back door -- at least \$1.7 billion annually to aid oil producers and other segments of the extractive industries. This sum is just \$200 million short of what the federal government appropriates directly, under close scrutiny, for the same purpose.

The \$1.7 billion in back door spending on natural resources is three times what was budgeted during fiscal 1969 for federal law enforcement; fifteen times as much as the cost of running our federal judicial system; three times the budgeted amount for school lunch and food stamp programs; five times as much as is budgeted for low-rent public housing; and four times the allotment for the Alliance for Progress. This \$1.7 billion in back door spending rivals in size such carefully scrutinized areas as the foreign aid program, the Apollo moon program, the programs of the Office of Economic Opportunity, and federal aid for elementary schools. Tax expenditures of this magnitude should be halted in the

absence of solid proof that these huge expenditures actually produce public benefits commensurate with their size.

3. Administrative Difficulties

Too little attention has been paid to the serious practical problems encountered in administering our present system of special tax benefits for the natural resource industries. In part, these difficulties arise from taxpayers' natural desire to expand their tax benefits to the greatest degree possible, and the equally natural desire of tax administrators to limit revenue losses. Difficulties also arise from the vagueness of the existing statute, which frequently fails to identify clearly the natural resources for which tax benefits may be claimed, or the rules to be used in computing the dollar amount of the tax benefit.

These problems are not simply a matter of percentage depletion rates, as is sometimes thought. The problems actually fall into five major areas. The first of these areas involves the taxpayer's possession of an "economic interest" in a natural resource property. An economic

interest is a necessary prerequisite to a depletion claim, but there is much confusion regarding the legal meaning of this vague term.

The second problem area involves the appropriate percentage rate of depletion for a particular natural resource deposit. Different ores and minerals are entitled to sharply different depletion rates under the Code. However, because the Code's definitions are vague, and because deposits vary in physical and chemical composition, it is not always clear which rate applies to a particular deposit.

Third, many difficulties arise concerning the "cut-off point," which determines the amount of processing which a taxpayer may include in his depletion base. In general, the inclusion of more processing in the depletion base increases the depletion deduction. The principles to be used in determining an appropriate cut-off point are not clear, and disputes therefore abound.

Fourth, there is the problem of determining the unit price to be used in computing gross income from a natural resource property. For instance, I understand that the

Internal Revenue Service has recently encountered major difficulties in determining the price for crude oil produced by U.S. firms operating out of the Persian Gulf. Similar pricing problems affect many other natural resources.

Finally, there are rather serious problems connected with the computation of the statutory fifty percent net income limitation on percentage depletion. Allocating costs between extractive and fabricating activities, and the carryover of losses from one accounting period to another, are particularly vexing problems in this area.

Today, after 40 years of court decisions, regulations, and rulings, the practical problems in administering the tax provisions for natural resources are more serious than they were in the 1920's when these provisions were first introduced. The accounting and legal costs incurred in trying to cope with these problems are substantial, for government and taxpayer alike. It has been necessary to create an elaborate government bureaucracy to handle these matters, and businessmen are induced to spend time and

energy in protracted disputes rather than in productive endeavors. Moreover, as technology and costs change, and as new types of natural resources come into use, new problems continually arise. The complexities involved in trying to settle these administrative problems further increase the waste and inefficiency associated with the percentage depletion mechanism.

Summary and Recommendations

In short, our present program of tax assistance to the natural resource industries is an inequitable, wasteful, problem-ridden government aid program. Only one responsible recommendation can be made: this program should be scrapped. Depletion on natural resource properties should be computed on the basis of actual cost, under rules similar to those set forth under section 611 of the Internal Revenue Code. Future investments in natural resource production facilities should be capitalized, and, like business investment in other industries, recovered over the useful life of the property.

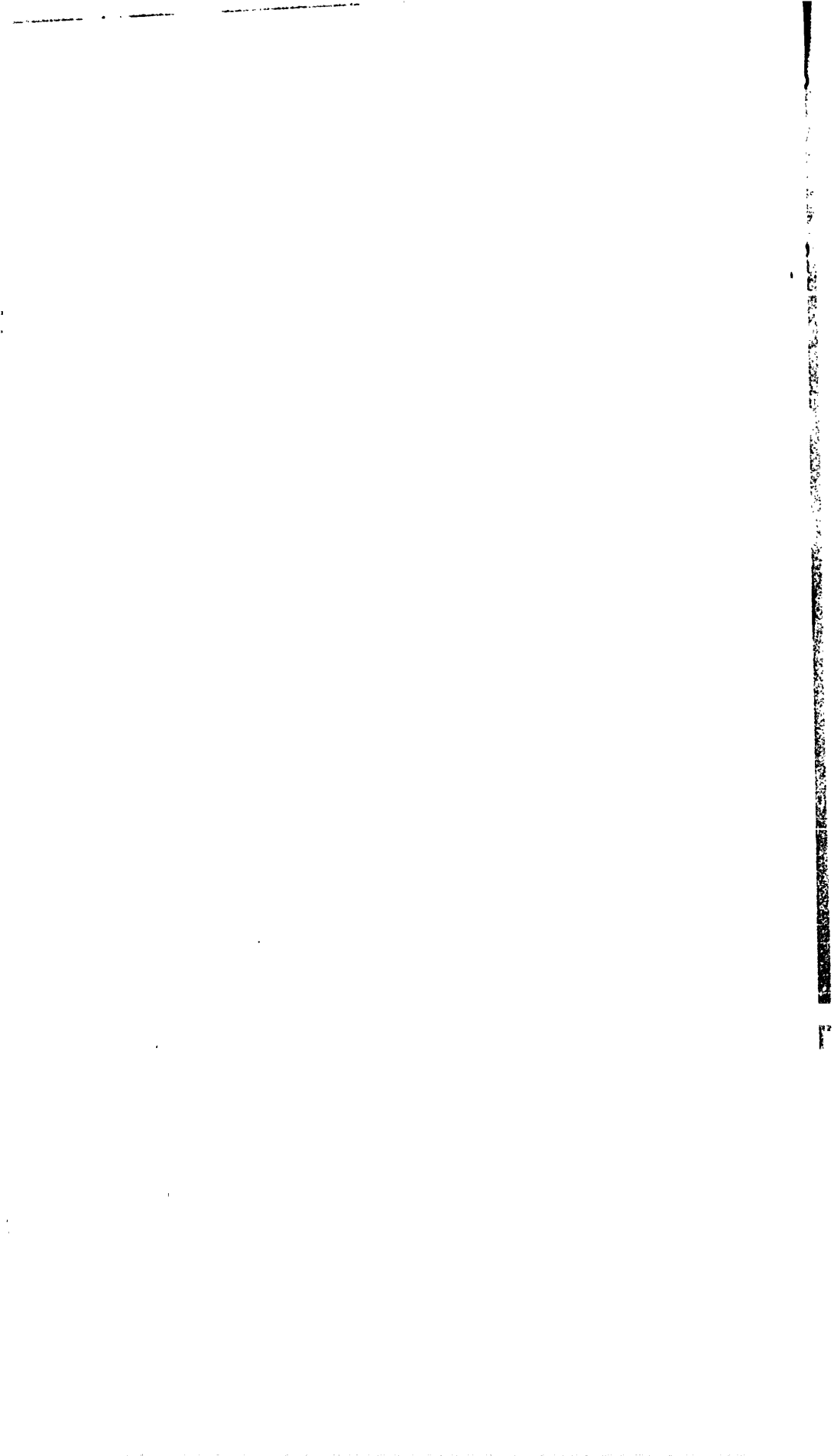
Recent action by the House Ways and Means Committee, recommending reductions in percentage rates of depletion and restricting the uses of several ploys that widen the tax loopholes on natural resource incomes, constitutes a step in the right direction. In my view, however, the Committee did not go far enough; moreover, they did nothing about the unnecessary and unparalleled provisions for immediate expensing of so-called "intangible" drilling costs -- a glaring omission from what is otherwise a promising package of tax reforms.

If natural resource producers actually need government aid -- and this need has not been satisfactorily demonstrated -- there are cheaper, more effective means of giving such aid which would avoid the inequities and administrative difficulties of the present aid system. Specifically, direct appropriations, which are more easily scrutinized and more directly tied to performance, are a superior method of granting government aid.

In conclusion, I appeal to this Committee to scrutinize carefully the arguments advanced by natural resource producers in support of the back door spending now authorized by the special mineral resource provisions of the Internal Revenue Code. It is important to remember in making this examination that all of the available evidence indicates we are wasting tax money -- huge amounts of tax money each year -- through these special tax provisions. We are spending big sums but receiving little in the way of public benefits. Until these wasteful back door expenditures are brought to a halt, I believe that the public will be justified in regarding much of the talk about "tax reform" and "economy in government" as empty rhetoric.

Thank you.

PART B – ADDITIONAL STATEMENTS





UNITED CHURCH OF CHRIST

COUNCIL FOR CHRISTIAN SOCIAL ACTION

September 29, 1969

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Mr. Thomas Vail
Chief Counsel
Senate Committee on Finance
N.S.O.B. Room 2227
Washington, D. C. 20510

Dear Mr. Vail:

I hereby file with you fifty copies of the testimony of Robert V. Moss, Jr, submitted on behalf of the United Church of Christ on the subject of tax reform.

Since one of the major points of the statement deals with the oil-gas depletion allowance, we ask that the statement go in your records for Wednesday, October 1, when that subject is considered. I understand that from the fifty copies, your office makes the distribution to the members of your committee and to the press.

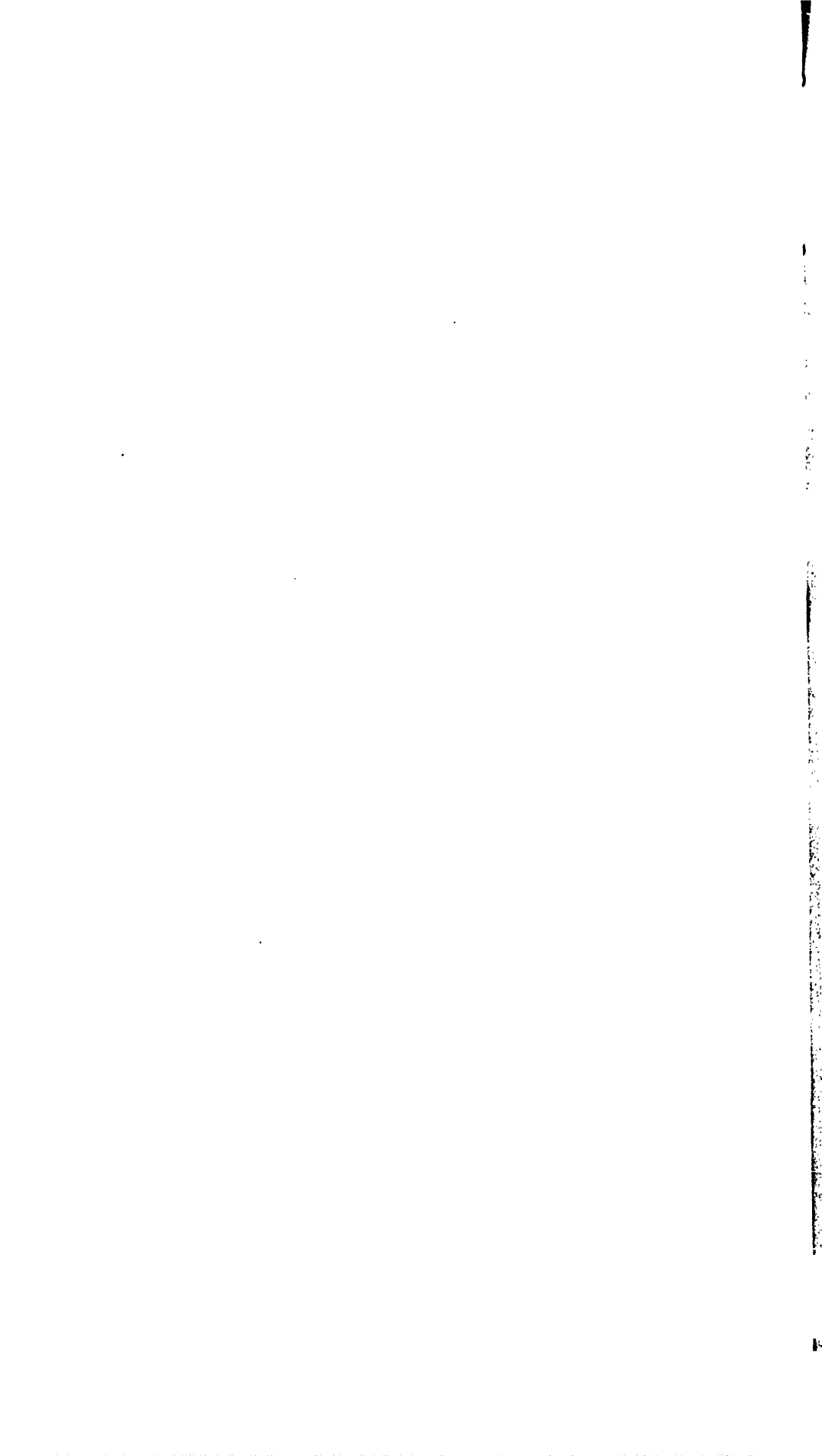
We thank you for your cooperation in this matter.

Sincerely yours,

Tilford E. Dudley

Tilford E. Dudley
Director, Washington Office

TED/raj
Encl:



TESTIMONY OF ROBERT V. MOSS, JR.
for the
UNITED CHURCH OF CHRIST
before the
U. S. SENATE COMMITTEE ON FINANCE
Oct. 1, 1969

I am Robert V. Moss, Jr., President of the United Church of Christ. Our national office is at 297 Park Ave. South, New York, New York, 10010 and our Washington office is at 110 Maryland Ave. N. E., Washington, D. C. 20002.

The United Church of Christ was formed on June 25, 1957 by the merger of two of America's oldest denominations, the Congregational Christian Churches and the Evangelical and Reformed Church. It has approximately 7,000 local churches, with slightly over two million members. The representative body of the United Church is the General Synod, which meets biennially.

The Seventh General Synod met this June 25 to July 2, 1969. Its 744 delegates from across the nation, among other things, adopted a pronouncement on tax reform, entitled **SHARING THE COST OF GOVERNMENT FAIRLY**, which I am privileged to file with you today.

I should note for you the participation by the local churches in the preparation of this statement. During the last seven years, the Church circulated two study documents on tax reform among the local churches for their reaction and comment. From those comments a specific proposal was prepared and circulated this spring. Three-fourths of the bodies responding voted to support the statement or something close to it. The final drafting and adoption at the Synod thus reflect attitudes back home as well as at the convention itself.

Significant Aspects of Statement

There are three aspects of this pronouncement which strike me as especially significant.

- 1) This is surely one of the most non-self serving statements to be filed with this Committee. We ask nothing for ourselves. In fact, we recommend the closing of one loophole favoring churches, i. e. the taxing of church owned properties and businesses not related to normal religious pursuits. Our primary concern has been for the welfare of the general community of which we are a part. We are even studying taxation of church property per se and some local churches contribute to local governments in lieu of tax payments.

- 2) Our recommendations for the closing of loopholes are generally tougher than the provisions enacted by the House of Representatives. For example, we recommend that the preferential treatment afforded capital gains be "eliminated"-not merely reduced by lengthening the waiting period to one year - and that the preferences extended to the oil and gas investors should be "ended" - not merely reduced from 27½% to 20%.
- 3) We did not put in a plea for tax reduction. Although we have previously called for a reduction in national armaments and are gravely concerned over the high military expenditures, we realize that there are vast human needs which require large government funding. Thus we have not dealt in this pronouncement with the amount of taxes needed but only with the obligation of each person to pay his share. Our title, SHARING THE COST OF GOVERNMENT FAIRLY, is accurate.

Summary of Statement

After general statements of principles and tax criteria, our statement proposes the following tax reforms:

- a) interest paid on state and local government bonds should be taxed like other income, with federal government grants or loans to offset any increased interest costs;
- b) corporations should be allowed to deduct dividend payments as a business expense, as they now deduct interest payments;
- c) preferential treatment afforded capital gains "should be eliminated" with provisions for averaging the gains over the years involved;
- d) provisions for averaging income generally should be simplified and extended;
- e) preferential treatment extended to oil, gas and mineral industries should be ended and only depreciation deductions allowed;
- f) estate and gift taxes should not be levied on transfers to the surviving spouse;
- g) the inheritor of property of increased value should take the decedent's cost base for the property;

- h) spurious foundations should not confer benefits of tax deduction;
- i) businesses and property of churches, etc. unrelated to their normal religious pursuits should be taxed at the standard rates;
- j) there should not be a minimum threshold limiting deductions for small contributions;
- k) persons under or near the poverty line should not be taxed;
- l) increases in Social Security should come from general revenues rather than increased taxes on workers' wages.

And now, Mr. Chairman, I file with you our entire statement.

SHARING THE COST OF GOVERNMENT FAIRLY
A pronouncement of the United Church of Christ
Adopted July 1, 1969

Christians recognize that government has an important place in the providence of God in meeting His purposes and human needs. Christian stewardship regards the payment of taxes, levied through the democratic process, as a public duty, and their responsible use as a public trust. In the interest of justice, we insist that the revenues necessary to meet the expenses of government must be apportioned with utmost fairness.

TAX CRITERIA

Taxes, while primarily a source of governmental revenue, intentionally or unintentionally also affect the economic and social process. Tax policy, therefore, requires difficult choices to be made in accordance with the relative weight given to diverse, sometimes contradictory, norms. The following criteria, however, are basic in a just system:

1. **Adequacy.** Taxes should provide adequate revenue for the government.
2. **Simplicity.** The law should be understandable to the taxpayer and relatively easy for both taxpayer and government to administer.
3. **Distributive Justice.** Taxes should fall on taxpayers in accordance with their ability to pay. While income

is not the only element in a measure of ability to pay, it is proper for individuals with higher incomes to be taxed at successively higher rates, other things being equal. Regressive taxes - which take a larger share of income from the poorer taxpayer than from the richer - should be used sparingly and avoided entirely whenever possible.

4. Neutrality. Taxes should not create artificial incentives for making economic decisions except where explicitly intended as a matter of public policy. Even then, the end sought may be more effectively and forthrightly achieved through properly designed controls and incentives.
5. Vitality. Both the nature and extent of taxation should be designed to enhance rather than inhibit economic efficiency, healthy non-inflationary growth, and productivity in a socially constructive manner.
6. Encouraging voluntary agencies. The tax structure should continue to stimulate the use and development of voluntary agencies for their salutary contributions to our life.

SHORTCOMINGS OF OUR TAX SYSTEM

In the light of these principles, we believe that major reliance should be placed on the income tax. But we call attention to certain shortcomings in present United States tax policy.

1. The Tax System Does Not Meet the Test of Equity. Since 1913 the United States has accepted the principle that a person's income tax should be related to his ability to pay, and that those enjoying greater income should contribute a larger percentage in taxes than those with a smaller income. Nevertheless, this rule is inequitably applied in practice. The mass of our citizens, who work for wages and salaries, pay full tax on their incomes. Yet in 1965 individuals reporting incomes over \$1 million paid, in the aggregate, income taxes amounting to less than 31% of the net taxable income which they actually reported. They paid far less than this percentage of their total income, although the nominal rate scale called for a tax of at least 67%.

In 1967, there were 155 Americans with incomes in excess of \$200,000 who paid no federal income tax at all. (Testimony of former Secretary of the Treasury Joseph Barr before the Joint Economic Committee of the Congress.) At the other end of the income scale there are persons who pay income tax on annual incomes of less than \$2,000, in addition to Social Security payroll

taxes and a host of state and local taxes.

These disparities are not due to dishonesty in reporting. In great measure they are the result of legal "loopholes" which favor certain forms of income as over against others or apply inconsistent criteria in defining the (untaxed) cost of earning income.

These inequities were intensified by the 10% surtax of 1968. This measure taxes at a still higher level those of moderate income who already pay taxes. It taxes at a minimum rate, or not at all, those who are able to escape a full share of the tax burden.

Tax reform, largely deferred when taxes were reduced in 1964 and substantially denied when taxes were increased in 1968, is important to counteract the prevailing bitterness and sense of injustice. It would assure that the burden will fall fairly on all the American people, not just on those powerless to secure preferential tax immunity or relief.

2. The Tax Base Does Not Meet the Test of Adequacy. The federal tax base has been eroded by many provisions that permit vast amounts of real income legally to avoid inclusion in net taxable income. As a result, those who can benefit are too much concerned with the technicalities of tax avoidance; and a high rate scale is applied to those forms of income which are fully taxed. Our direction must be toward a broader tax base involving fewer tax preferences, with a consequent reduction in rates.

3. Tax Inequities Prevent Counterbalancing Fiscal Policies. In order to carry out its responsibilities to eliminate unemployment and inflation, the government needs effective tools and techniques. One of the most important ways of achieving these objectives is by adjusting income tax rates to counteract adverse economic trends. To be most useful, however, these changes must be enacted as soon as such problems appear. So long as our tax law is laden with complexities and inequities, Congress will be reluctant to alter tax rates to meet national economic requirements.

4. The Inequities of the Federal Law Become Inequities in State Taxation. Many states compute their own income taxes on a base that is identical with that for the federal tax, except for minor modification. As a result, the state income tax heightens the inequities of the federal tax. This inequity is intensified by state reliance on property, sales, and other taxes that have undesirable impacts on economic efficiency, urban development, housing, and the living standards of the poor. States cannot take the lead in tax reform without increasing the compliance

burden of taxpayers. Reform at the federal level, therefore, is essential for the improvement of state fiscal systems.

PROPOSED REFORMS

We recognize that a revision of the federal tax structure involves many technical questions. Nevertheless, we ask for correction of certain glaring and obvious deficiencies.

1. All personal income, whatever its source, should for tax purposes be treated on essentially the same basis, and be subjected to a graduated rate of taxation which is progressively heavier as the total amount increases. Any exceptions must be fully justified by a vital social or economic purpose, and must be scrutinized particularly as to their effect upon the less affluent members of society.

2. In the interest of greater equity and adequacy, the following steps should be taken to correct existing preferences and inconsistencies:

a) Interest paid on bonds hereafter issued by state and local governments should be taxed like income from other investments. In order to make this change financially feasible for state and local governments, federal grants and/or low interest loans to such governments must be provided to offset the otherwise increased interest costs. This would be preferable and cheaper than the present hidden subsidy by tax exemption, which is no longer required by constitutional interpretations.

b) Corporations should be allowed to deduct cash dividends as a business expense in determining their taxes, just as interest payments are now deducted. This would eliminate "double taxation" and tend to encourage the sale of new stock.

c) The present preferential treatment afforded most capital gains should be eliminated and such gains should be taxed at the same rates as any other income. Provisions should be made for averaging the gains over the years involved to prevent unduly high rates for a single year. It is contrary to most notions of fairness that capital gains income should be taxed at lower rates than income earned as wages or salaries. Such preference also injects an artificial influence into business decisions. There are better ways to improve the vitality of our economy.

d) Provisions for averaging income for tax purposes should be simplified and extended to taxpayers not presently enjoying this advantage. Persons who receive the bulk of their income in a relatively short period of their working life tend to

pay higher income taxes over their lifetimes than those receiving their income more evenly throughout their productive years.

e) The preferential treatment extended to taxpayers who invest in oil, gas and mineral properties should be ended. Depletion deductions, like depreciation deductions available to taxpayers in other fields, should be limited to the amount of the taxpayer's actual investment.

f) Federal estate and gift taxes should be revised to permit a husband or wife to receive property from the spouse tax free; but the law should not permit wealthy families to avoid estate taxes for generations by the use of long term trust arrangements.

g) Provisions permitting profits on property appreciated in value to escape tax free at the owner's death should be changed so that where no inheritance tax is paid, the recipient of the inherited property takes the decedent's basis for the property.

h) Property contributed to spurious, tax-haven foundations which do not significantly serve social purposes should no longer confer the benefits of tax deduction on the individuals who created them.

i) Businesses and property of churches, foundations, educational and charitable organizations, but unrelated to their normal religious, educational and humanitarian pursuits, should be taxed at the standard rates applicable to business and property not so owned.

j) We oppose use of a threshold principle below which charitable gifts would not be deductible.

3. The income tax should be completely eliminated for those below the poverty line, and should not fall so heavily upon those immediately above the poverty line that they are thereby brought below it. Millions of citizens living below the subsistence level already pay unduly large portions of their income in income, sales, Social Security, and other taxes.

4. Any future increases needed to augment our Social Security trust funds for higher benefits to persons below or near the poverty level, should come from general revenues, principally the graduated income tax, rather than from increased taxes on the low-income worker's take-home pay. (How best to assure a reasonable minimum income to those living in poverty is not the subject of this pronouncement. Better Social Security,

an improved welfare system and the use of a negative income tax for these purposes are still under review by the C.C.S.A.)

We recognize that these initial efforts will not eliminate all inequities, but they will provide a worthy beginning. We must remove any ground for the cynicism which results when the tax system favors the citizen who can afford a lobbyist or a high priced tax advisor, and places a disproportionate share of the cost of maintaining the peace or eliminating want upon those who are below, at, or immediately above the poverty level. The sense of shared enterprise and purpose will be real and deep only when each person who is required to help finance the national effort knows that each of his fellow citizens is sharing the burden as he is, and that all income is given equal treatment.

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September 26, 1969

Honorable Russell B. Long
Chairman, Committee on Finance
United States Senate
Washington, D. C. 20510

STATEMENT IN SUPPORT OF PROPOSAL TO
RESTORE THE PERCENTAGE DEPLETION
ALLOWANCE TO CANADIAN GAS PRODUCTION

Dear Mr. Chairman:

The tax reform bill as passed by the House (H.R. 13270, §501) provides that percentage depletion will not be allowed for foreign oil and gas wells and that for domestic oil and gas wells the present rate of 27-1/2% is to be reduced to 20%. This statement does not deal with the question of the level of the depletion rate, but only with the question whether the same depletion benefits should be extended to gas wells in Canada as in the United States.

Except for an infant industry in liquified natural gas, the economics of which are not yet well established, gas consumers in the United States are dependent on supplies which can be delivered by pipeline. As a practical matter, therefore, deficits in meeting United States requirements for natural gas must be made up, and are now being made up, primarily from Canadian production. If the total of domestic (contiguous United States) and Canadian supplies are inadequate for the United States market, the result will be a

shortage in meeting market requirements with serious impact on both price and availability of gas within the United States.

Large-scale imports of gas from Canada began more than a decade ago. They have grown from year to year as demand increased without comparable growth in United States reserves. In 1967 imports of natural gas into the United States from Canada (513.3 billion cubic feet) increased 18.9% over the prior year and were 42.2% of Canada's net production. Imports from Canada amounted to 3.07% of total United States production as compared to .4% ten years earlier. An even greater acceleration in the growth of imports will be required in the future. In 1968 for the first time in the history of the natural gas industry, consumption of United States gas reserves was greater than newly-discovered reserves in the United States. The growth in demand, now at a rate in excess of 6% a year, will continue to mount with increases in population, industry and income. Irrespective of short-term changes in the ratio of reserves to requirements, over the long term the shortage in domestic production is bound to increase. It bears emphasis that gas is not a renewable resource and that each year a substantial part of finite reserves is withdrawn from natural storage for use within the United States. The long-range resource strategy therefore must be to encourage the greatest possible development of the

large Canadian gas resources to serve the United States and Canadian markets, so that the United States may continue to benefit from Canadian supplies in excess of Canadian needs. A continental approach to natural gas resources is essential in the interest of the United States. This approach is also in the interests of the Canadians, whose resources are far greater than those of the United States in relation to population and demand.

The retention by the Congress of the percentage depletion allowance for domestic production, although at a reduced rate, can only signify Congressional recognition of the need for the depletion allowance as an incentive for exploration for new petroleum supplies. The explanation of the House Committee on Ways and Means, in recommending elimination of percentage depletion for foreign oil and gas wells was that its action would permit "percentage depletion for these items to be confined to areas where it will achieve its objective of stimulating exploration and discovery of domestic reserves" (Report of the Committee, p. 138). The Committee's reasoning--that percentage depletion would encourage exploration and discovery of new wells (Report, p. 137)--is entirely sound, but its finding that "the granting of percentage depletion to income from foreign deposits results in a large loss of revenue without commensurate advantages" (Report, p. 137) misses the mark with respect to Canadian gas. As United States gas markets grow, there is substantially the same advantage in the assurance of supplies from

Canadian sources as from domestic sources. In effect, United States consumers are already drawing on a common pool to meet United States requirements. It would be little short of disaster to shrink the pool to the reserves within the boundaries of the 48 states. Yet such a result would be implicit in withdrawing the benefits of the depletion allowance for Canadian gas production.

The fact that the United States can rely on Canadian commitments almost to the same extent as for its domestic supplies in itself argues strongly in favor of extending equal encouragement to United States taxpayers producing gas in Canada by the allowance of percentage depletion on the Canadian production.

We note that Assistant Secretary Cohen, in his statement to your Committee on September 4, 1969, recommends the deletion of the provision in the House bill which would deny percentage depletion to United States taxpayers on foreign mineral production. We urge your Committee to accept this recommendation.

Respectfully,

MILLER & CHEVALIER

By *David W. Palmer*