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HOW CONGRESS CAN STRENGTHEN U.S. ENERGY SECURITY

INTRODUCTION

The tax "reform" measure meandering through Congress would affect many industries. Oil is among the most important. A series of federal actions in the past 17 years has eliminated tax code provisions essential to the long-term health of the U.S. oil and gas industry. Although the effects of these changes were masked partially by the high oil prices that prevailed since the middle 1970s, under recent market conditions of collapsing oil prices, they are being felt with a vengeance. In combination with other federal regulations, the tax code in two years could decimate the independent U.S. oil sector--those entrepreneurs who find 90 percent of the nation's new oil and gas supplies. As a result, by 1990, the U.S. could lose 750,000 barrels per day of domestic oil production and 450,000 jobs in oil exploration, production, and related industries.

Among the provisions in the current tax code contributing to the potential problem are:

1) The continued erosion of the depletion allowance, which now is available only to a handful of domestic producers.

2) The imposition of a 10 percent tax on so-called Intangible Drilling Costs (IDCs) for producers who have insufficient revenues to pay income taxes.

3) The continued imposition of the Windfall Profits Tax (WPT) on domestic oil.

Regulations that compound the difficulties emanating from the tax code include:

4) Production requirements under the so-called due diligence rules that lead to the early abandonment of oil wells.

5) The continued regulation of certain categories of natural gas.

6) The *de facto* ban on the export of U.S. crude oil and refined products.

7) The ban on sales of domestic oil to the Strategic Petroleum Reserve.

The growth of these restrictions on the operation of a free market over more than a decade and a half has restricted severely the process of capital formation for oil exploration and reduced the flexibility of oil and gas companies to respond to changing market conditions. They have increased the risks in what is already a high-risk endeavor by restricting the potential rewards for firms that assume the risks involved in searching for new oil and gas supplies.

The tax reform measures currently before Congress offer a welcome vehicle for addressing the tax problems of the oil industry in the context of a complete restructuring of the tax system. Unfortunately, this opportunity is being ignored. Both Congress and the Administration are considering tax legislation that would mean new and even more onerous taxes and market impediments for the oil industry, just at the moment when such actions would have the most dangerous effect on the health of the industry and the nation's long-term energy security. Lawmakers, instead, should move swiftly to make key changes in the tax and regulatory framework governing domestic oil producers that would enable them to adapt quickly to the fluctuations of the world market.

THE OIL INDUSTRY AND TAXES

A persistent misconception plaguing the oil industry is that it is undertaxed. During the current tax reform debate, both the press and some members of Congress have spotlighted the alleged "special tax breaks" the oil industry enjoys. Yet comparing oil companies' tax rates with those of non-oil firms reveals just how fallacious is the notion that oil firms receive advantageous treatment. During the five-year period between 1980 and 1984, oil companies paid an average of 43 percent of their U.S. net income in federal taxes. By contrast, the tax burden for non-oil firms for the same period averaged 22 percent. In short, the effective federal tax rate for oil companies

over the five years in question was roughly double that of non-oil counterparts.

The Windfall Profits Tax

A major reason for the large difference between the taxes paid by oil and non-oil firms is the 1980 so-called Windfall Profits Tax (WPT) on crude oil. Designed to capture part of the "windfall" benefits enjoyed by the domestic petroleum industry as a result of the world price rise engineered by OPEC, the WPT taxed away 90 percent of the money firms received for a barrel of oil over a base price. The WPT, ironically, has been an indirect subsidy to the OPEC producers by reducing the cash flow to U.S. producers, thereby restricting the capital they had available to invest in the development of new domestic oil and natural gas supplies. This impediment to the expansion of the domestic reserve base increased the U.S. import requirements while simultaneously pushing up prices.

To be sure, oil prices have fallen so low that the WPT is not levied. Yet WPT reporting requirements remain a significant financial burden, particularly for the smaller entrepreneurial drilling firms. Especially hard hit are those firms that have a large proportion of their production in the form of "stripper wells," those producing fewer than ten barrels per day.

Stripper wells are normally those in the last stages of production. In many cases they have been in production for so long that the ownership of the royalty interest has been divided among a large number of individuals, either through inheritance or successive sales of the property. Thus a firm can find itself required to fill out dozens of individual sets of forms (one for each owner, no matter how small the interest) for each of hundreds of wells producing less than ten barrels per day. The result is that tens of millions of forms are filed, at a cost of countless man-hours of expensive accounting time--all for a tax that is no longer collected.

Even in the absence of the WPT, the oil industry still bears a tax burden significantly higher than its non-oil counterparts. Without the WPT, the 1980-1984 tax burden for oil firms still would have been 29 percent of U.S. net income or one-third higher than for non-oil firms.

Fairness alone would suggest that the clear anti-oil bias of the tax code should be eliminated in any tax reform package. And there are practical reasons to correct the inequities as well. Among the most important is that the operations of firms exploring for new domestic oil reserves are especially sensitive to changes in cash flow. The reason for this is that, unlike other forms of business activity, oil exploration cannot normally be financed by borrowing from banks--there is simply too much uncertainty involved to permit a bank to risk its depositors' savings. Thus exploration must be

financed either through internally generated cash or by equity investment--usually from individuals. By siphoning off a significant proportion of the revenues generated by successful wells, the WPT reduced the internal cash available for new exploration, and it restricted the ability of firms to attract outside risk capital by sharply reducing the investors' potential return on their investment. This in turn hindered the search for new domestic oil and gas reserves. In short, the WPT unjustly diverted needed capital from exploration to fill federal coffers, delaying the achievement of security.

Neither the House nor the Senate tax reform proposals would eliminate the WPT.

The Depletion Allowance

Given the current world price of oil, the WPT is now only a paperwork burden--albeit a very heavy one for small producers. But the domestic oil industry still bears heavier taxes than other sectors of the economy. This is largely the result of the steady erosion of tax provisions originally enacted in recognition of the special conditions associated with extractive industries in general, and with oil and gas in particular.

One of the most important, and perhaps least understood, tax provisions the industry has lost is the "depletion allowance." Its purpose was to give firms engaged in mineral extraction a means of recovering their capital at approximately the same pace as that at which other industries recover capital through depreciation. The "percentage depletion" provision was necessary because the main capital assets of a firm involved in mineral extraction are actually the deposits being mined. In other industries, by contrast, the main capital assets are the plant and equipment. Therefore, just as capital is consumed when a machine or a building is being used, the capital of a mining or oil firm is consumed as a resource is extracted.

There is a key difference. In conventional depreciation, an asset "written off" for tax purposes normally will still function. A fully depreciated asset could even be worth more than when first purchased--for example, a building that has increased in value. This residual, or "salvage" value would be taxed if the asset were sold. In most cases, of course, an increase in value would be treated as a "capital gain," if sold, but the gain would be subject to a tax rate substantially lower than that imposed on regular income.

With mineral deposits such as oil, however, there is no prospect of retaining any residual value. Once a resource is depleted, it is gone forever.

"Percentage depletion" was an attempt to recognize these facts. It allowed oil companies to "depreciate" their mineral deposit in a manner similar to an industrial firm depreciating machinery. Just as a firm would be able to deduct a portion of the value of a machine from its taxable income, an oil producer was allowed to deduct a portion of the value of the oil he produced from taxable income. Many Members of Congress, however, criticized depletion as a special benefit, and in response, Congress in 1969 restricted its use to small firms. And now the oil depletion allowance is limited to firms producing less than 1,000 barrels of oil per day. The percentage of the value of their output they are allowed to take has been reduced from 27.5 percent of revenues to just 15 percent.

To make matters worse, the tax reform measure passed by the House calls for the immediate elimination of the depletion allowance. This would impair severely the oil exploration industry's ability to attract new capital. Even the Senate committee proposal, however, would do nothing to restore the depletion allowance to appropriate levels. It merely leaves current law in place.

Intangible Drilling Costs

Another tax provision constraining capital formation in the oil industry is the 10 percent minimum tax on Intangible Drilling Costs. IDCs include such items as the cost of labor used to drill an exploratory oil well, the cost of access roads built to reach the drilling site, and the cost of energy used to run equipment at the site. Under current law, these are subject to a 10 percent tax. In other words, at the very earliest stages of developing an oil well, before a profit is realized and when cash flow is most important, the Treasury levies a 10 percent tax on the operator's expenses. In other businesses, such expenditures would be considered normal expenses and deducted from taxable income in the year they were incurred. The Internal Revenue Service, however, insists that drillers only be allowed to treat up to 80 percent of IDCs as an expense (and thus deductible as they are incurred), and Congress levied a 10 percent tax on IDCs deducted in this manner. As a result, firms drilling exploration wells were faced with the choice: either forgo the option of deducting IDCs as an expense or pay a 10 percent tax on their value. Since IDCs represent the bulk of the cost involved in drilling a well, the tax implications have been considerable, leading to a large reduction in the cash available for new exploration.

The House bill would drastically curtail the ability of producers to deduct IDCs as an expense by forcing producers to treat them as a capital expense--to be deducted over a 26-month period. The so-called 10 percent preference tax would remain in force. In the Senate tax reform proposal, current law would be left in place.

The Investment Tax Credit

An additional tax provision of importance not only to the oil and gas industry, but to other forms of mining such as coal, is the Investment Tax Credit. The ITC allows a firm to deduct from its tax liability 10 percent of the value of new equipment purchased. By reducing the cost of new equipment, the credit makes it easier for firms to keep the most advanced equipment on hand and to maximize efficiency. In addition, ITCs increase the cash flow for oil exploration, thereby expediting the search for new supplies.

Both the House and Senate committee tax reform measures would abolish the Investment Tax Credit. In the Senate version, however, firms that earned ITCs in years prior to the tax bill's effective date, but did not have sufficient tax liabilities to take them, would receive a tax refund equal to their value.

REGULATORY IMPEDIMENTS

Tax provisions are not the only market impediments endangering a healthy U.S. energy sector. Regulations and laws also hinder the search for new oil and gas supplies and contribute to the premature depletion of existing sources.

Due Diligence Rules

One of the most damaging regulations, especially in current market conditions, are the so-called due diligence rules. These rules were originally intended to serve the useful purpose of preventing speculators from buying leases and failing to develop them. Diligence rules are a problem at both the state and federal level. The current rules require that any oil lease holder who stops production from a well for more than 60 days may be considered to have "abandoned" the lease, and be required to "reclaim" the property. Reclamation entails the removal of pipe lining the wellshaft and plugging the hole with concrete. Once this is done, a new well must be drilled if any oil is to be produced from the deposit.

The diligence requirement may be well-intentioned and, in some instances, justified. Under current market conditions, however, it is prompting drillers to abandon prematurely tens of thousands of "stripper wells." These oil wells producing less than 10 barrels per day have production costs that often range as high as $15 per barrel. With the current oil price below $14 per barrel, stripper production is uneconomic. However, the operators of such leases cannot temporarily cap their wells and wait for prices to rise to the point that production once again becomes profitable. Instead they face the choice of operating at a loss or having their lease declared

"abandoned" under the diligence rules. While individual stripper wells do not produce very much oil, total stripper well production accounts for nearly 14 percent of the U.S. total. As a result, the diligence rules could result in the permanent loss of as much as 1.3 million barrels per day of U.S. oil production. This would be the rough equivalent of losing all of Alaska's oil production capacity.

The answer to the stripper problem is a simple one. The Secretary of the Interior should waive the diligence rules until it is clear what sort of long-term pattern of oil prices will emerge out of the current turbulent market. The Secretary also should urge the states to follow the example of Texas and Oklahoma, which have waived the diligence requirement on state-controlled leases.

The Strategic Petroleum Reserve

Another unwise restriction is the ban on using domestic oil to fill the Strategic Petroleum Reserve. The SPR is an oil stockpile maintained by the federal government for use in times of shortage, which currently contains close to 500 millon barrels of oil. The rationale for the ban was that Congress did not want domestic reserves depleted when foreign oil was available. Under current market conditions, however, allowing domestic producers to bid on the SPR would help to expand their market and improve their cash flow.

Exports of Domestic Oil

A related move would be to eliminate the *de facto* ban on exports of domestic oil. Instituted during the height of the "energy crisis," the ban was prompted by fears that the world was in imminent danger of exhausting its oil reserves. As such, went the argument, domestic supplies should be restricted to domestic use. But under current market conditions, this ban imposes an unreasonable limitation on oil producers' ability to respond to market fluctuations. Example: it may be possible to sell some of Alaska's production to Japan and replace it with less expensive Mexican crude oil, thus benefiting both Japanese and American oil consumers.

Decontrol of Natural Gas

A final needed reform is completion of the process of natural gas decontrol. In January 1985, price controls on about half of all U.S. natural gas supplies were eliminated. Despite claims by opponents that this would escalate prices sharply, the result was quite the opposite. Prices for natural gas have been declining and supplies have increased. A number of studies indicate that, if all controls were lifted, as much as 50 trillion cubic feet of gas, which are now uneconomic to produce, would enter the market. Much of the gas currently subject to controls is owned by independent oil producers, and is a by-product of oil wells. Eliminating the rules that make its production uneconomic would permit these companies to market their gas

and would increase their cash flow, creating new capital to finance exploration.

CONCLUSION

Federal tax policy and federal regulatory impediments on the free functioning of the energy market are making it needlessly difficult for the oil industry to respond to changing market conditions. Worse, these unwarranted restrictions could turn the current short-term benefits of low oil prices into long-term problems for domestic oil production. If the restrictions are not removed, U.S. imports could skyrocket in the near future, and the permanent shutdown of a significant part of the domestic oil industry could once again make the nation perilously dependent on oil from an unstable Middle East. Saudi Arabia already has increased its exports to the U.S. by nearly 2,500 percent in just a few months. Other OPEC producers could follow suit.

If Congress recognizes the mistakes of the past, it should take advantage of the tax reform bill to provide the U.S. with a very different energy future. The domestic petroleum industry could retain its flexibility and grow, if the anti-oil bias were eliminated from the tax code and market-hampering regulations repealed. Should this happen, the benefits of inexpensive energy could be maintained for decades.

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