TAX INCREASE PROPOSALS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

ON

VARIOUS PENDING TAX INCREASE PROPOSALS

JUNE 5, 6, 10, AND 11, 1974

PART 1

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TAX INCREASE PROPOSALS

WEDNESDAY, JUNE 5, 1974

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Ribicoff, Byrd Jr., of Virginia, Mondale, Gravel, Bennett, Curtis, Fannin, Hansen, and Dole.

The CHAIRMAN. This hearing will come to order. Other Senators will be along shortly.

I am going to read my prepared statement, and I hope by the time the Secretary is into his statement, the other Senators will be here.

OPENING STATEMENT OF THE CHAIRMAN

Today the committee begins hearings on a number of proposals to increase taxes. These measures have been introduced as amendments to H.R. 8217, a minor tariff bill now pending on the Senate Calendar, and which we expect will soon be considered by the Senate. Among other things, the amendments include measures to:

(1) Repeal the percentage depletion allowance for oil and gas production;

(2) Eliminate the more rapid depreciation of machinery and equipment permitted under the Asset Depreciation Range, the so-called ADR system;

(3) Phase out the 7 percent investment tax credit for property costing more than $100,000;

(4) Limit the use of the foreign tax credit;

(5) Repeal the tax provisions allowing deferred reporting of part of the overseas income of a domestic international sales corporation (DISC); and

(6) Increase the present minimum tax.

These are all major amendments. Most of them cost anywhere from several hundred million dollars to several billion dollars. If all of them were enacted, these various proposals would amount to a tax increase for corporations and individuals of some $8 billion in the current tax year.

It has been the practice of the Committee on Finance, when proposals are made to increase taxes, to allow taxpayers an opportunity to present testimony before the Senate acts on a proposal. In the present case also, the taxpayers affected should have the chance to tell us what will happen before Senators vote on measures to increase their tax liabilities by hundreds of millions and perhaps billions of dollars. Senators should have an opportunity to learn the effect of the tax increase proposals, and to understand who, in the last analysis, will have to bear the cost of these various tax increase proposals.

[The committee's press release announcing these hearings, follows:]

PRESS RELEASE

FOR IMMEDIATE RELEASE
May 31, 1974

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 Dirksen Senate Office Bldg.

FINANCE COMMITTEE SCHEDULES HEARINGS ON TAX INCREASE PROPOSALS

The Honorable Russell B. Long (D., La.), Chairman of the Senate Committee on Finance, announced today that the Committee would begin hearings on various pending tax increase proposals beginning Wednesday, June 5, at 10:00 A.M. in Room 2221 of the Dirksen Senate Office Building. The leadoff witness will be Treasury Secretary William Simon, who will present the Administration's position on these proposals.

Senator Long stated: "A number of tax increase measures have been proposed as amendments to H.R. 8217, a minor tariff measure now on the Senate Calendar and soon to be considered by the Senate. These various proposals would: (1) repeal the percentage depletion allowances for oil and gas production; (2) eliminate the more rapid depreciation of machinery and equipment permitted under the Asset Depreciation Range (ADR) system; (3) phase out the 7 percent investment tax credit for property costing more than $100,000; (4) limit the use of the foreign tax credit; (5) repeal the tax provisions allowing deferred reporting of part of the overseas income of a domestic international sales corporation (DISC); and (6) increase the present minimum tax. If enacted, these various suggestions would amount to a tax increase for corporations and individuals of about $7 to $8 billion in the current tax year.

"The Committee realizes that ordinarily, measures involving tax increases running into the billions of dollars would be accorded extensive Committee hearings in both House and Senate before being advanced to the Senate Floor for debate. However, these amendments have already been introduced and will in all likelihood be offered on the Senate floor in the near future. An affirmative vote by a Senator on a measure of this sort usually implies a commitment on his part to vote for the same proposal again if it comes up subsequently. In view of this, the Committee feels that persons affected by the measures proposed should be accorded an opportunity, to the extent that it can be arranged within the time available, to explain the advantages, disadvantages, and problems these proposals would present.

"In addition, I would hope that the witnesses would endeavor to explain where in their view the ultimate incidence of these tax increases would fall if they were enacted--whether on business or on consumers."

In the case of the depletion allowance, the Chairman asked that witnesses testify both on the effect of a complete elimination of the percentage depletion allowance, and also on the effect of an alternative proposal under which the depletion allowance would be retained with respect to the first 3000 barrels of oil per day produced.

Requests to Testify. -- Senator Long advised that witnesses desiring to testify during this hearing must make their request to testify to Michael Stern, Staff Director, Committee on Finance, 2227 Dirksen Senate Office Building, Washington, D. C., not later than Friday, June 7, 1974.

The Chairman said that because an unusually large number of requests to testify are anticipated, the Committee will not be able to schedule all those who request to testify. Those persons who are not scheduled to appear in person to present oral testimony are invited to submit written statements. The Chairman emphasized that the views presented in such written statements will be as carefully considered by the Committee as if they were presented orally.

All parties who are scheduled to testify orally are urged to comply with the guidelines below:

Notification of Witnesses. -- Parties who have submitted written requests to testify will be notified as soon as possible as to the time and date they are scheduled to appear. Once a witness has been advised of the time and date of his appearance, rescheduling will not be allowed. If a witness is unable to testify at the time he is scheduled to appear, he may file a written statement for the record of the hearing.

Consolidated Testimony. -- The Chairman also stated that the Committee urges all witnesses who have a common position or with the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views on the total bill than it might otherwise obtain. The Chairman praised witnesses who in the past have combined their statements in order to conserve the time of the Committee.

Legislative Reorganization Act. --The Chairman observed that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress--

> "--to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

The statute also directs the staff of each Committee to prepare digests of all testimony for the use of Committee Members.

Chairman Long stated that in light of this statute and in view of the large number of witnesses who desire to appear before the Committee in the limited time available for the hearing, all witnesses who are scheduled to testify must comply with the following rules:

(1) All statements must be filed with the Committee at least one day in advance of the day on which the witness is to appear. If a witness is scheduled to testify on a Monday or Tuesday, he must file his written statement with the Committee by the Friday preceding his appearance.

(2) All witnesses must include with their written statements a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted to the Committee.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their ten-minute oral presentations to a summary of the points included in the statement.

(5) Not more than ten minutes will be allowed for the oral summary.

Witnesses who fail to comply with these rules will forfeit their privilege to testify.

Written Statements.--Witnesses who are not scheduled for oral presentation, and others who desire to present a statement to the Committee, are urged to prepare a written position of their views for submission and inclusion in the printed record of the hearings. He emphasized that these written statements would also be digested by the staff for presentation to the Committee during its executive sessions, and that they would receive the same careful consideration by the Committee as though they had been delivered orally. These written statements should be submitted to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, no later than June 14, 1974.

PR #73

The CHAIRMAN. The first witness at these hearings will be the Honorable William Simon, Secretary of the Treasury.

Mr. Secretary, we are very pleased to have you before the committee this morning.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY OF THE UNITED STATES, ACCOMPANIED BY FREDERIC W. HICKMAN, ASSISTANT SECRETARY FOR TAX POLICY

Secretary SIMON. Thank you, Mr. Chairman. I am delighted to be here, as always, to appear before this very able and distinguished committee.

At the same time, I must express concern that I am here because major tax measures have been proposed for floor action, before the careful committee consideration and staff work which such measures need.

Many of the measures proposed would alter provisions that are fundamental in the present structure for taxing business income. Fundamental changes are not necessarily bad. But when they are made, it is important that they be made carefully and that they not be made in a manner so abrupt that taxpayers are unable to digest them. Abrupt dislocations cause economic slowdowns from which no one benefits. Uncertainty alone can cause those major dislocations. When the ground rules become uncertain and the future becomes clouded, businessmen postpone decisions and wait for the outlook to become clearer and more favorable. A chain reaction follows: Modernization and expansion are held in abeyance. Purchases are not made. Sellers, faced with lesser sales, cut back in their operations. Workers are laid off, and so on. Taxes are a very major cost and changes in taxes create very major uncertainties. They must be approached with care.

The administration strongly supports tax reforms. Over a year ago, we proposed a carefully designed package of changes. Those proposals were presented originally to the Ways and Means Committee of the House. In December, we made additional proposals to tax the windfall profits earned by domestic oil producers on the sale of oil to their fellow Americans.

The Ways and Means Committee has now worked carefully through the windfall profits proposals and has ordered a bill reported. It is now in the midst of considering a wide range of additional tax reform measures a .d expects to report a major bill by the end of this month. Weeks of committee time and thousands of man-hours of staff time have gone into those efforts in order to produce balanced and technically sound legislation. In normal course these measures should be out of the House and before your committee and the Senate in a matter of weeks, so that you may consider and adopt legislation for final passage in this Congress. That is the way major tax measures have proceeded in the past, because it is the best way to assure thoughtful and responsible tax legislation.

In 1969, the revisions in our tax laws took nearly a year, while the tax writing committees explored the changes proposed with their professional staffs, with the Treasury staff and with affected members of the public. Tax revision is a complicated and critical task and we need to work together and do it in a thoughtful way.

The amendments to H.R. 8217 proposed in the Senate include a wide array of proposals for fundamental changes in the existing system. I could not possibly cover with you today all of the pros and cons of the proposals. Many involve technical problems which you ought to explore with members of your own staffs and the Treasury's staff, who are more versed in the intricacies of the tax law than I. I should like, however, to make a few general comments concerning the proposals.

Proposed Amendments of the Minimum Tax

The proposals with respect to the minimum tax are poor amendments to a poor provision of existing law. They would do more to thwart tax reform than to further it.

The present minimum tax was enacted in 1969. It was supposed to prevent persons with large economic incomes from using tax preferences to eliminate or unduly reduce their tax liabilities. The intent was that they should pay some "minimum tax."

The problem with the present minimum tax is that it does not work. A large number of persons with high incomes still pay little or no tax. It is pertinent to note that this ineffectual provision was the product of Senate floor action.

The problem with the proposed amendments to the minimum tax is that they will not work either. The amendments proposed are (a) to reduce the $30,000 exemption to $10,000, and (b) to eliminate the offset of taxes paid against tax preferences. These amendments would collect more tax, but they would not get at the problem of the high income taxpayer who pays no tax. The principal effect of the proposals would be to increase, in a somewhat haphazard way, the tax on capital gains. Your committee may well conclude that some change in the taxation of capital gains is desirable, but that is a different problem from assuring that people with high incomes pay some minimum amount of tax.

Not only do these amendments not do the job, they create new problems and would be objectionable for that reason alone:

Reducing the $30,000 exemption to $10,000 causes the minimum tax to apply to middle-income persons who are already paying substantial income tax and play no part in the high income—low tax problem.

Eliminating the offset for income taxes paid converts the so-called minimum tax into an additional tax. Under the present minimum tax, taxes paid are deducted from total preferences, which tends in a rough way not to impose further tax on persons who are already paying more than a "minimum" amount. The proposed change would render irrelevant the amount of tax already paid and would thus impose a "minimum" tax even on persons already paying large amounts of tax. Paradoxically, the proposed change would have little or no effect on persons who now pay little or no tax, but would penalize most those who already pay the most.

I urge your committee, as strongly as I can, to approve—when you receive the tax reform bill from the House—the two proposals which the Treasury has developed to replace the present ineffectual minimum tax. The first of these proposals is a "minimum taxable income" provision. It would require high income individuals to pay a reasonable

and fair share of income tax. The second is a proposal for a limitation on artificial accounting losses. It would limit so-called "tax shelters," which permit economically profitable ventures to report tax losses which can offset other taxable income.

I shall not attempt here to explain how those proposals work, except to say that they focus more carefully on a wider range of items than the present minimum tax. The 1974 Report of the Joint Economic Committee compared the present minimum tax with the Treasury approach and concluded as follows:

The Administration's minimum income tax proposal should be given priority in the interest of improving tax equity, of restoring taxpayer confidence in the tax system and of raising additional revenue.

The following comparisons illustrate the greater effectiveness of the Treasury's proposals over the present minimum tax and the proposed Senate amendments:

I commend, Mr. Chairman, you and your committee to look at the numbers very carefully, and the effects of the present minimum tax, the proposed amended minimum tax, and the Treasury's MTI and LAL proposals.

[The information referred to follows:]

	Treasury's MTI/LAL	Present minimum tax	Proposed [1] amended minimum tax
Revenue gain from individuals (billions)	$1.15	$0.2	$0.7.
Average tax increase for high income, low tax individuals above $100,000 AGI.	$33,000	$9,400	$11,000.
Effect on 92 taxpayers in 1972 who had AGI of $200,000 or more but paid no tax.	69 out of 92 required to pay tax (average tax of $61,600).	No effect	Only 12 out of 92 required to pay tax (average tax of $9,700).
Effect on "tax shelters" in oil, real estate, etc., which are a major source of the high income, low tax problem.	Eliminates tax shelters.	No significant effect.	No significant effect.
Rates of tax	Regular graduated rates from 14 to 70 percent.	Flat rate of 10 percent.	Flat rate of 10 percent.

[1] Would also raise about $800,000,000 to $900,000,000 from corporations (an additional $300 to $400,000,000 over present law) if percentage depletion is not repealed but would raise much smaller amounts if percentage depletion is repealed. The Treasury would retain the present minimum tax on corporations.

Proposals To Revise Taxation of Income From Business Capital

Secretary Simon. Two of the proposed amendments would drastically change the terms on which business investment decisions are made. One would lengthen the cost recovery periods permitted under the ADR depreciation system, the other would greatly diminish the scope of the investment credit. Before reviewing each of these proposals which would amend portions of the Revenue Act of 1971, I would like to discuss the aims of the legislation of that time.

The year 1971 was not a good year: unemployment ran at a rate of nearly 6 percent for the year; industrial production was stagnant, running at a rate nearly 4 percent below the peak of 2 years before; and capacity utilization was fully 12 percent lower. In considerable part, this condition of the economy could be attributed to the overall effects of the Tax Reform Act of 1969 which had repealed the 7 percent investment credit and otherwise increased the tax burden on business capital while reducing taxes on personal income. Just as Secre-

tary Kennedy warned this committee, the House-passed bill was imbalanced in its effect on consumption and saving, and we are still suffering the consequences.

In response to the need to stimulate business investment, the administration proposed two steps in 1971: a radically new depreciation procedure designed to reduce uncertainty faced by investors, and reinstitution of the investment credit. The record shows these were successful:

Unemployment declined steadily to a rate well below 5 percent before the decline was interrupted by the energy crisis last winter.

Investment increased by 9 percent in 1972 and 13 percent in 1973.

Industrial production increased by nearly 19 percent in 2 years, and capacity utilization rose substantially, by 10 percent.

But the need for a high rate of capital formation has not terminated. Now, even more clearly than in 1971, we see the need for additional investment:

Since 1971, additional demands for capital investment by U.S. industry have been imposed by the drive to achieve improvements in the environment. Just to stand still and employ no more workers or produce no more goods and services than presently, U.S. industry will have to invest more in order to achieve the required reduction in air- and water-polluting emissions.

Although currency revaluation has appreciably improved the competitive position of U.S. industry, the fact remains that, as compared with its major foreign competitors, U.S. industry is less modern. If we are not to fritter away the opportunity to maintain and increase our share of world markets, we must continue to foster a high rate of investment in manufacturing, one of the sectors in which we possess a comparative advantage.

Having been rudely reminded of the importance of maintaining a higher degree of energy self-sufficiency, especially in oil, we have launched Project Independence. This will call for vast additional investment in coal mining, coal and oil shale processing plants and a new logistical network to bring these resources to market.

Many of our basic materials producing industries have found their existing plants inadequate to supply the growth in demand—for domestic use as well as exports. Order backlogs for durable goods are up by more than 40 percent over 1973. Textile, paper and pulp, chemicals and metals producers have been operating at near capacity, with backlogs and bottlenecks, notwithstanding increases in capacity of nearly 13 percent since 1971.

Proposals To Cut Back ADR

One of the proposed amendments would lengthen the cost recovery periods permitted under the ADR depreciation system, thus decreasing depreciation deductions. The result would be to discourage investment in new productive capacity, to decrease productivity and to increase inflationary pressures. That would be absolutely the wrong direction in which to move, and today would be absolutely the worst time to move in that wrong direction.

The ADR system specifies an average life for each asset class and permits taxpayers to select an appropriate life within a range above

and below that average. The system recognizes the plain fact that there is no way to know today just how many years into the future an asset—especially a long-lived asset—will be used. At best, we can achieve rough approximations. In a world of rapidly changing technology and obsolescence, the past is apt to be a poor guide to the future. Latitude for human error and difference of opinion must be allowed. The inescapable fact is that investors must be convinced that they will be able to recover their costs over reasonable periods or they will not invest. The higher the rate of inflation and the longer the life is expected to be, the more critical is this problem.

The ADR system was enacted in 1971 and is a structural reform of great importance in dealing with the tax aspects of investment in machinery and equipment. It permits business to make investment decisions with certainty about the depreciation deductions which will be allowed. In addition it provides for a reasonable degree of uniformity in cost recovery practices within given industries. Neither certainty nor uniformity was available under the previous system. Both facilitate investment in productive capacity.

The ADR system provided flexibility and updated guideline lives which were 10 years old at the time the system was adopted. The lives and the system are under continuing study by the Office of Industrial Economics, set up in the Treasury in 1971. We believe that the system has functioned well, that it provides reasonable cost recovery periods, and that it has encouraged needed moderization and expansion.

Postenactment experience with ADR data indicates that the amount by which cost recovery periods were shortened was less than half the amount originally expected. Nearly 40 percent of the depreciation base is even now accounted for on a "facts and circumstances" basis, thus indicating that ADR cost recovery periods are in fact in a reasonable middle range. To now lengthen the periods would simply return the bulk of taxpayers to a facts and circumstances system, in which they would be required to haggle with individual revenue agents. Many, if not most, would reach nearly the same result provided by ADR, but would lose the uniformity and certainty which the ADR system now provides. It should be noted in this connection that the first year revenue gain which would follow from the proposed amendment is about $400 million, rather than the $800 million figure cited by proponents of the amendment.

No doubt the ADR system can be improved and no doubt adjustments in particular lives can and will be made. But they should be made after analysis of the experience since 1971 and after consideration of the facts of particular industries. Enactment of arbitrary, blanket changes in the system would be extremely unfortunate and would further cloud the climate for the investment and increased productivity required to dampen inflation.

Phase-Out of the Investment Tax Credit

The other pending proposal is to phase out the investment tax credit as the cost of the qualifying property increases. We believe that proposal to be unsound from both a tax policy and tax administration standpoint. We strongly oppose it.

I have already recounted the increase in investment which followed reinstitution of the credit in 1971. Now, even more clearly than in 1971, we see the growing need for additional investment to increase our basic capacity and to effect changes we all wish to bring about in our environment. To suspend or repeal the investment credit even in part would simply compound the difficulties we must overcome.

The proposal to graft on to the investment credit an exception for property costing in excess of $50,000 or $100,000 is unwise because:

The exception is not a small business exception. A large business could obtain a full credit on millions of dollars of property so long as each piece of property had a cost basis of $50,000 or less.

Under the exception there will be an economic incentive for purchase of property which is sold for less than $50,000 and none for purchase of property which is sold for more than $100,000. Why?

The exception will repeal the investment credit or retain it in a completely haphazard fashion. Some businesses will be unaffected by the repeal of the investment credit because they buy many pieces of equipment each costing less than $50,000. Others will get very little investment credit because most of the equipment they buy costs more than $100,000.

The exception would be a very difficult rule to administer. What standards are to be used by taxpayers and the IRS in determining whether two pieces of machinery, each costing $50,000 and sitting side by side on the factory floor, should be considered as one piece of investment credit property, in which case there is not credit, or as two pieces of investment credit property, in which case there is a $7,000 investment credit?

As the Treasury has consistently stated, the investment credit is a fiscal device for reducing the cost of capital investment in order to stimulate that investment. It will only serve this function if investors can count on it. If investors believe that Congress will forever be taking it on and off, on some assets or all assets, the investment credit will become too uncertain, investors will not rely on it and the stimulus effect will be greatly diluted or lost entirely.

The investment credit should therefore be left alone.

Proposals To Repeal Percentage Depletion

We estimate that at current price levels the elimination of percentage depletion for oil and gas would raise revenues $2 billion per year. Revenue effects of various phaseout plans vary with the number of years included in the phaseout and the number and type of exemptions from phaseout. For example, the Ways and Means Committee phaseout plan would produce revenues of $130 million in 1974, $860 million in 1975 and so on, until it reaches $3 billion in 1979, by their staff estimate.

The additional tax revenues will come from tax payments by oil producers and, in the short run, will lessen their profits. In the longer run, however, if we maintain some given degree of self-sufficiency, removal of percentage depletion will result in higher prices to consumers. The principal beneficiaries of the percentage depletion deductions have not been the shareholders of the oil companies, but rather

the consumers of oil and gas who have enjoyed larger supplies and lower prices than would otherwise have been the case.

The Treasury is opposed to change in the percentage depletion allowance at this time. Our oil and gas shortage is critical and this is the wrong time to make a fundamental change in the economics of the oil and gas industry by eliminating percentage depletion. The oil and gas industry has relied on percentage depletion for 48 years in making billions of dollars of investments and in formulating billions of dollars of investment plans to move the United States toward energy self-sufficiency. Capital investment that is available to go into oil and gas exploration and development will be discouraged by fundamental tax law changes at this time. The extent of this harm to the industry cannot now be safely predicted and we simply cannot afford to be wrong.

Another consideration is that the adverse effects on capital investment from elimination of percentage depletion may fall more heavily on the independent oil producers than on the major oil companies because the present depletion allowance is worth more to individual taxpayers in brackets above 50 percent than it is to corporations in 48-percent brackets. Many independents rely on that fact in raising capital. Even if the aggregate present benefits of depletion were translated dollar for dollar into higher prices, the industry as a whole would be unaffected. However, high bracket producers to whom the deduction was worth more than the price increase would be somewhat disadvantaged, and lower bracket producers to whom the price increase was worth more than the deduction would be somewhat advantaged.

Elimination of percentage depletion imposes a further penalty on owners of controlled oil. Controlled oil already bears a price penalty of over $4 per barrel compared with the $9 and $10 per barrel prices we pay to Canadian, Indonesian, Middle Eastern, and South American suppliers. The removal of percentage depletion would be equivalent to a rollback of 55 cents a barrel to $4.70 from the present average of $5.25. That rollback would apply to roughly two-thirds of the oil produced in the United States and could eliminate some production we are now getting.

Elimination of percentage depletion for natural gas is even more difficult to justify. Most, if not all, of the proposals to eliminate percentage depletion for natural gas recognize that most gas prices are controlled at low levels already by the Federal Power Commission and by long-term gas sale contracts. Therefore, these proposals exempt controlled gas from the depletion phaseout. Our present system of pricing natural gas is illogical and wrong, and widespread gas shortages have been caused as a result. We are certainly not going to encourage the finding of any additional natural gas supplies by eliminating percentage depletion on a major fraction of the gas produced today. The prospect is that such action will further discourage the drilling of gas wells when we already have a major shortage in this area.

You have asked that we address specifically the 3,000-barrel-per-day exemption from the phaseout of percentage depletion. I have already indicated that we do not favor elimination of percentage de-

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pletion. If it is to be eliminated, however, it is difficult to justify nonuniformity in treatment of producers, except perhaps on a transitional basis. Further, to make the 3,000-barrel-per-day exemption meaningful, there have to be complex rules which prevent the same economic unit from having the benefit of more than one 3,000-barrel-per-day exemption. These rules can never work perfectly and some people are not penalized who should be and, what is even worse, others who should not be affected at all are penalized.

In addition, if a barrel of oil is worth $5.20 after tax, in the hands of producer A, who has no depletion, but is worth $5.92 after tax to producer B, who still has 15-percent depletion, producer A will tend to sell his oil property to producer B, since the oil is worth more to producer B than A. The price A receives from B tends to reflect the higher value of the oil in the hands of B—for example, it tends to reflect the 15-percent depletion allowance. The result is that A gets a higher price and B gets percentage depletion and thus both tend to have the benefit of the 15-percent depletion allowance but a lot of transfers of property for no sound, underlying economic reason will have occurred. We should avoid creating problems like this with the tax laws wherever possible.

In summary, we believe it would be a mistake to eliminate percentage depletion, but if it were to be done, we believe that generous transition periods are an absolute essential.

Foreign Mineral Income and the Foreign Tax Credit

Amendments have been proposed which would repeal foreign percentage depletion and the current deduction for foreign intangible drilling costs, require a separate foreign tax credit limitation for foreign mineral income and direct the Secretary of the Treasury to establish criteria to prevent oil royalties from being treated as creditable income taxes.

Although the administration opposes repeal of percentage depletion for domestic oil and gas, we have proposed that foreign percentage depletion be eliminated, and the Ways and Means Committee has incorporated this proposal in the Oil and Gas Energy Tax Act of 1974. We have no objection to the Senate acting on this provision independently, although it would seem more appropriate to deal with it in connection with the Energy Tax Act.

We oppose the elimination of the deduction for foreign intangible drilling expenses. Unlike depletion, intangible drilling expenses represent actual current cash outlays. Present law permits current deduction of such expenditures, whether at home or abroad. The proposed amendment would require such expenses to be capitalized and recovered through ordinary depreciation deductions. The present treatment is far simpler and does not make foreign operations more attractive than domestic operations.

On the other hand, we do not believe our tax laws should encourage foreign exploration more than domestic exploration. Net foreign losses can be and have been used to reduce U.S. tax on U.S. source income. A loss recapture provision, recommended by the administration in April of 1973 and included in the Energy Tax Act, is an effective

means of equalizing the tax treatment of domestic and foreign oil production. Under our proposal, foreign losses which are deducted against U.S. income would be recaptured in later years when foreign income is realized. The mechanism for the recapture would be to reduce the allowable foreign tax credit in those later years. The effect of our proposal would be to prevent the interaction of the U.S. foreign tax credit and the often somewhat arbitrary tax laws of foreign oil-producing countries from unjustifiably reducing U.S. tax revenue on foreign source oil income.

Another proposed amendment would establish a separate foreign tax credit limitation for foreign taxes imposed on mineral income, including oil production. The objective of this amendment is to prevent a foreign tax credit attributable to mineral income from reducing U.S. taxes on other foreign income.

In February 1974, the administration proposed the elimination of excess credits arising from foreign taxes on oil production income. We believe that our approach is preferable.

The Energy Tax Act as reported by the Ways and Means Committee contains still another approach to this problem. It would limit the available amount of excess credits attributable to foreign oil production income to 10 percent of the U.S. tax on that income. It would also restrict the use of those excess credits to "foreign oil-related income." We believe that our approach is preferable, but we recognize that the issue is complex, and intelligent decisions can be made only after considering all of the ramifications of the problem and the several alternatives.

The last proposed amendment in the mineral area would direct the Secretary of the Treasury to establish criteria to determine what portion, if any, of payments made to foreign countries in connection with oil or gas income is in fact a royalty payment. The effect of characterizing a payment as a royalty rather than a tax is that a royalty is only deductible from gross income while tax may be creditable.

There is a problem in this area. But the amendment provides no standards for reaching a solution. Many foreign countries which have petroleum reserves have substantial latitude in structuring their tax laws so that payments will qualify as creditable taxes rather than deductible royalties. This latitude also makes it virtually impossible and certainly self-defeating to establish the types of criteria the proposed amendment demands. As soon as criteria were established, those foreign countries would change their tax systems to qualify.

The administration's February proposal limited the available foreign tax credit on oil production income to the present U.S. statutory rate. This insured that the oil companies would not be subjected to double taxation, but it also insured that these foreign levies would not be used to reduce U.S. tax on other foreign income.

Foreign Losses

The proposed amendment on recapture of foreign losses would reduce the allowable foreign tax credit where a previously incurred loss has reduced U.S. income. As I mentioned earlier, the Treasury Department made a similar proposal in April of 1973. This spring the

Ways and Means Committee applied this proposal to oil companies in the Energy Tax Act and has tentatively decided in the pending tax reform legislation to extend it to all companies.

Here again we have no objection in principle to the proposed amendment. But we do have various technical problems with the specific language proposed. We are now working on these problems with the Ways and Means Committee, and expect to be working closely with your committee in due course.

Income of Foreign Subsidiaries

In general, the foreign income of foreign corporations controlled by U.S. owners is not taxed by the United States until repatriation in the form of dividends. This is an extension of the basic tax principle that shareholders are not taxed on dividends until they receive them. Another proposed amendment would end this system by taxing the shareholders of all U.S.-controlled foreign corporations as if they had received the income of the foreign corporations even though it was not distributed to them.

The Treasury Department opposes this approach. We believe it would make our industries less competitive with those of other countries. No other country imposes its tax in such a manner.

A primary effect of the proposed amendment may be to increase the amount of tax paid to foreign countries. Since the parent corporation would be subjected to U.S. tax on subsidiary's profits, it is likely to cause the subsidiary to remit those profits. As actual dividends, these profits would in most countries be subjected to foreign withholding tax, thereby increasing the foreign tax revenue and increasing the foreign tax credit applied to reduce U.S. taxes. The after-tax profits could then be returned to the foreign subsidiaries as working capital.

Although we oppose the complete elimination of deferral, we believe there are certain situations where deferral is not justified. In April 1973, the Treasury Department proposed legislation which would eliminate deferral where the foreign subsidiary receives a "tax holiday" from the foreign country as an inducement to locate these or where the domestic parent decides to manufacture abroad products it intends to sell in the United States. We believe these proposals are sufficient to limit unjustified deferral of taxation. The Ways and Means Committee is presently considering action in this area and we hope will eventually adopt an approach similar to our April 1973 suggestion.

DISC

The Domestic International Sales Corp., the DISC, legislation was adopted in late 1971 as an incentive to exporting U.S. products. It was also designed to encourage the retention and modernization of domestic production facilities and to allow smaller domestic corporations to receive tax benefits equivalent to those available to larger corporations which could locate production facilities abroad. One of the proposed amendments would repeal this legislation.

The Treasury Department opposes elimination of the DISC provisions.

While it is difficult to measure the magnitude of DISC's effect on exports, it was anticipated that its incentive value would be felt only over time as U.S. manufacturers became more export conscious and the tax benefits of DISC were actually understood and realized. Thus, while there were only approximately 2,000 DISC's by the end of 1972, there are now over 5,000 DISC corporations in existence, many of which are owned by medium or small parent corporations. At the present time, only the relatively incomplete statistics for 1972 are available on the effects of the DISC legislation. However, as the April report issued by the Treasury Department demonstrates, the available information does indicate that DISC did increase the level of U.S. exports. While the revenue cost was larger than estimated, we believe this was primarily attributable to the unexpectedly large profits realized on exports in 1972.

U.S. exports have increased drastically in the past 2 years. However, so have imports, and there is no assurance that the surplus experienced in 1973 will continue. Therefore, we believe it unwise to eliminate this export incentive after so brief a trial period, especially when other industrialized nations are making substantial efforts to increase their share of world export markets. It should be noted that the Ways and Means Committee did not adopt the suggestion of some of its members to repeal DISC in its recent review of the legislation. It did, however, tentatively decide to limit its benefits by excluding agricultural and natural resource exports.

Altogether, the pending amendments, if enacted, would effect a fundamental transformation of many aspects of our existing system of taxation. We must realize that these proposals will have very profound effects on our already highly strained economy. Jobs are at stake. Our ability to control inflation is at stake. It is a time for exceedingly careful deliberation and careful change.

The basic decisions involved in the pending amendments affect billions of dollars of investment and profits. I have recounted for you above the major surge of investment and new productive capacity which followed the Revenue Act of 1971 which enacted ADR and reinstated the investment credit. I could also recount for you the decline in investment following the Revenue Act of 1969, which repealed the investment credit.

In closing, I would emphasize that changes in our tax laws such as those discussed with you today should only be made after careful committee consideration of the full impact they would have on our economy. Satisfactory economic growth depends to a significant extent on public confidence that our system for making major changes in our economic policy will be allowed to work. Let us all work together to restructure our tax system carefully. We must consider all proposals for tax reform fully and fairly and to shape our tax policy in coordination with the long-range objectives or our total economic policy. We stand ready and willing to cooperate with you in that effort.

Mr. Chairman, Fred Hickman, our Assistant Secretary for Tax Policy, and I would be delighted to respond to any questions.

The CHAIRMAN. I would like to ask that each member confine himself to 10 minutes, and that staff set the timer during this first round of questions.

1969 Tax Act

Mr. Secretary, I have now forgotten a few of the things I learned in law school about the law of evidence, one of them being historically a purely self-serving statement was not admissible, but if someone cared to make a statement or a confession, that was admissible, on the theory that people tend to say that which is to their advantage. But if they want to admit something, that you could use it without proving it has probative value. And I think everyone that was in Congress at the time we passed that 1969 Tax Act ought to search his own conscience to see to what extent he did a statesmanlike thing and to what extent he was expeded in that measure.

Now, as I recall it, back at that time the administration was trying to extend the surtax that had been passed under President Johnson, at least for a while or at least in part, and the Democratic leadership took the attitude that there would be no extension of that surtax without tax reform. Now, of course tax reform is something that everybody can have a different opinion on.

But I for one thought that we ought to repeal the investment tax credit at that time. It looked to me, as it looked to Chairman Mills and others, that was attracting the capital that was needed for building homes ıway from that market, running up interest rates and making it difficult for people to borrow money to buy homes, while were were placing too much incentive on building new plants and equipment.

But look at what happened when we repealed the investment tax credit, reduced the depreciation advantages, increased the taxes on capital gains, put $700 million of additional taxes on the oil industry, and struck in about every other area that we could find where somebody seemed to be getting an advantage. A minimum tax was passed, the way you stated, with whole varieties of ideas having been offered in haste and the committee substituting a floor amendment for its own version even on the floor.

That act was on balance a ıax cut. It raised taxes by $7 billion in the reform area, and it reduced taxes by $9 billion, so on balance it was a $2 billion tax cut. And yet, there is no doubt in my mind that that measure, tax cut though it may have been, was the key factor that proceeded to tax us right into a recession by the middle of the year, because in fairly short order President Nixon, who had signed that bill and who had gone along with us in recommending that we repeal the investment tax credit frantically urged us to restore the investment tax credit to get things going again.

Now, on the theory that honest confession is good for the soul, I am saying that all of that tax reforming we did at that time had the effect of putting this Nation into a recession. I am pleased to see that your statement tends to say that. Back at that time the Democratic leadership could not afford to say that, since we had advocated the bill, and it would have been politically unwise to say that. The administration, in fact, did not say so. The President had signed the bill and took the view that on balance this was good legislation.

But look what happened.

Were we not in a recession by August of that year?

Secretary Simon. Yes, sir.

The Chairman. I personally feel that the Tax Reform Act played major part in it.

1969 Revenue Act Taxing the Oil Companies

I have read statements by some persons studying the energy crisis indicating that the $700 million a year of additional taxes that we put on the domestic oil industry under the Tax Reform Act, if it had been used to provide more energy, would have brought us in 10 percent more energy by the time the Arabs put the oil boycott on us. Certainly, that would have made a major contribution toward helping us be self-sufficient, I would assume, if the $700 million had been put into drilling for more energy.

Oil and Gas Prices--Domestic versus Foreign

Now, can you tell me at this time about how much we are paying on the average for energy produced in this country, if you include natural gas as well as oil and average it out on a per barrel basis?

Secretary Simon. Well, on a per barrel basis for oil we pay on the controlled barrel an average of $5.25 a barrel, and the last number I saw, Mr. Chairman, was $9.50 average on the uncontrolled barrel. The uncontrolled barrel is between 30 and 35 percent of our domestic production.

The Chairman. I was informed the last time I asked the question that we were averaging on oil about $6.25 a barrel, because most of our domestic oil is $5.25 oil.

Secretary Simon. Yes, sir. I did not average it. I gave you the two prices.

The Chairman. Right. But if you are thinking only in terms of domestic oil, when you take the gas that is being produced and average that in at the price to which it is being held by the Federal Power Commission and which is selling intrastate—that brings the average price down for energy, if you are looking at oil and gas, down to about $4 a barrel.

Does that sound somewhere in the ball park?

Secretary Simon. That would be a ball park number, Mr. Chairman, yes, sir.

The Chairman. All right, then, how much are we paying for oil that we are importing in the country right now?

Secretary Simon. An average of $9.50 per barrel. It goes as high as $10.50 per barrel for oil from longer distance destinations.

The Chairman. That means the energy we are producing here is saving the taxpayer at least 50 cents on every dollar that he pays for energy, to the extent we are able to produce it domestically at this moment.

Secretary Simon. More important, Mr. Chairman, is that the one-third we are forced to import at these much higher prices could be produced domestically at much cheaper prices.

Oil Industry Encouraged To Go Overseas

The Chairman. Well now, there is one further problem that concerns me. The tax and trade policies of this country during the last 20 years have in effect told the oil industry that they ought to go overseas, because the economics of it were such that they could make a lot more money producing oil overseas than they could here.

Now, is that still true?

Secretary SIMON. Yes, sir, the economics are better overseas. All of the cheap and easy oil and gas has been found in this country. Where it cost $50,000 to $75,000, perhaps $100,000, to drill a well in the early 1960's, we now have to go to the more hostile climes of the Outer Continental Shelf, the North Slope in Alaska, as well as use the more expensive secondary and tertiary recovery methods to get oil.

So obviously an industry is going to respond by exploring where they can get greater production much easier and much cheaper.

INDEPENDENT OIL PRODUCERS FORCED OUT OF BUSINESS

The CHAIRMAN. During the last 20 years, 50 percent of the independent oil producers have been forced out of business. I know that was the case in Louisiana, and I am confident that was the case in Oklahoma and Texas. Some of those people are asking me right now, does the Government want me in this business or do they want me to get out?

One of the larger independent producers asked me just a few days ago, Senator, do you people want me to get out of the oil business? If it will help matters, I can get out of it. I can put my land to something else.

When we continue to adopt policies that look like we want these people out of business, just like we liquidated half of their friends, what conclusion would you expect them to draw from it?

Secretary SIMON. Well, you can illustrate that rather dramatically, Mr. Chairman; 1956 was the year oil and gas exploration peaked in this country, and the actual number of wells drilled in the late 1960's versus 1956 had declined by 50 percent. It created today's shortage of rigs because nobody is going to manufacture rigs and tubular steel if indeed there is no demand for it. Then, when the price of oil went up slightly for domestic oil last year, after the two-tier, incentive price system was put in, we had an explosion of demand for tubular steel as well as rigs, and it has resulted in a 40-percent increase in drilling this year over last, and that is good.

The CHAIRMAN. Well, Mr. Secretary, we still have our rigs going overseas. People down my way say they are fabricating away on drilling rigs for the North Seas or where it is more attractive financially to make their investments. They are still exporting to go elsewhere.

Secretary SIMON. Yes, and it will continue until our Outer Continental Shelf program is stepped up, as it is being stepped up right now. I think you are going to see greatly increased activity in the Outer Continental Shelf as a result of the improved leasing program.

The CHAIRMAN. My time has expired. Senator Bennett?

OIL INDUSTRY PROFITABILITY

Senator BENNETT. In your confirmation hearings before the committee, Mr. Secretary, you stated that you were conducting a study on the profitability of the oil industry.

Do you have any preliminary results of that study?

Secretary SIMON. We, Senator Bennett, are finalizing and attempting to bring that study up to date and calculate the foreign and domes-

tic proportion of the income of the oil companies. Our resutls from September 1973 to now are not conclusive yet. But it does show that the oil industry made a significantly larger amount from foreign operations, those outfits that operate overseas, than they did from their domestic operations. But they still made significant domestic profits, and that, of course, is because the price of domestic oil increased. Then again, one can say that nearly all industry in 1973 in the United States had a very good year.

I will, as I promised in my confirmation, when that study is completed and gone over very carefully by the accountants—and we had a private accounting firm do the first portion of the study, and I would expect that we would do the same thing with the update—I will submit it to you for the record, sir.

Request for Comparison of Profitability of Major Oil Companies With Independents

Senator Bennett. The staff of the committee asked you, as a supplementary study, to compare the profitability of the majors with the independents.

Have you been able to move along on that one?

Secretary Simon. Boy, that is proving to be hard, because there are so many independents in the United States. As you know, they drill a majority of the holes in this country. 75 percent approximately of the wells drilled are drilled by the independent segment. To get a handle on all of these small outfits, and get their profit statements is extraordinarily difficult, because most of them are smaller operations and are not reporting the way the larger corporations are.

Senator Bennett. Well, have you made any progress or are you continuing the study?

Secretary Simon. Yes, we are working with the Independent Petroleum Association to attempt to get the figures that you requested.

Elimination of Foreign Tax Credit for the Oil Industry—Effect on Balance of Payments

Senator Bennett. Have you compiled any data on the possible effect of the ending of the foreign tax credit on oil income upon our balance of payments?

Secretary Simon. Do we have the numbers on that, Fred?

Mr. Hickman. I do not believe we have any numbers in just that form, Senator Bennett.

Senator Bennett. Can you put them together in such a way, even if they are a ball park rather than very specific and exact figures?

I think we are very interested.

Mr. Hickman. You are talking about the total elimination of the foreign tax credit and its effect on the oil industry?

Senator Bennett. Well, its effect on our balance of payments.

If we eliminate it from the oil industry, what will the effect be on our balance of payments?

[The following information was subsequently supplied for the record:]

The effect on the United State balance of payments from eliminating the foreign tax credit for foreign oil income is not susceptible of a precise dollar and cents answer. The principal reasons are that we cannot accurately predict taxpayers' responses to such a major shift in the taxation of such income nor can we predict the effect of such responses on currency exchange rates. We are certain, however, that a significant change in taxpayers' activities would occur over some time period to attempt to avoid a double taxation of foreign income.

According to Commerce Department figures for 1972, the balance of payment inflows from the foreign petroleum sector were about $4.2 billion, comprised of $2.6 billion in branch earnings, $1.1 billion in dividends, $0.2 billion in interest and $0.3 billion in royalties and fees. These figures would be higher now due to increases in oil prices and profitability.

The elimination of the foreign tax credit would tend to reduce first the $1.1 billion inflows from dividends. If the dividends could not be repatriated without double tax, they would tend not to be repatriated. We would also expect the foreign branch operations which produce inflows of $2.6 billion, to become organized instead as subsidiaries so that those foreign earnings too could be protected against double taxation. Of course, if these earnings were not being repatriated in full, there might be some reduction in outflows of U.S. capital to finance future investments.

Overall, while we cannot predict the amount of reduction in inflows from foreign petroleum operations, we can predict that there would be a significant reduction.

Reduction or Elimination of the Depletion Allowance

And another question, Mr. Secretary:

To what extent do you believe that any of the amendments proposed to reduce or eliminate the depletion allowance would have in causing companies to move their operations abroad to avoid the tax change?

Secretary Simon. I really do not think—and—although we have no complete study of this—that it would cause many companies to move overseas. A lot of the independents obviously do not have the wherewithal.

Senator Bennett. They cannot move overseas.

Secretary Simon. They cannot move overseas. They just do what comes naturally. They give up the depletion allowance and they pass it on to the consumer. So their net benefit would be the same and the consumer would end up paying the bill. That is always the way it has been.

Every economist I talk to—and I am, as you know, not an economist—presents very compelling arguments that the depletion allowance for years has been passed along to the consumer.

Senator Bennett. I have no other questions, Mr. Chairman.

The Chairman. Senator Ribicoff?

Oil Company Profits

Senator Ribicoff. Mr. Secretary, I think we have got a basic question of how much incentive must major oil companies get from the United States in order to get a fair return and be fair with the public. Now, even with the immediate repeal of oil depletion the oil industry will have a $7 billion aftertax profits.

Now, this is an increase of $3 billion over 1973 profits with depletion. How much incentive must they have?

Is not $3 billion more this year than last a pretty good rise?

Let us take Exxon, up 39 percent, although I have read in the press that many people questioned the legitimacy of that 39 percent, with

some of the credits they have taken. I am assuming that the Internal Revenue Service is looking into the legitimacy of those deductions.

Secretary SIMON. Basically, they set aside a reserve because they still have not made their deal in the OPEC nations as to what price they are going to pay for lifting the oil, Senator Ribicoff, and the IRS looks very carefully at reserves to make sure that——

Senator RIBICOFF. They will look before they accept it?

Secretary SIMON. Yes, sir.

Senator RIBICOFF. Now Texaco, up 123 percent; Skelly, up 97 percent; Occidental, up 817 percent; Gulf up 75 percent; Standard of Indiana, up 75 percent.

How much more incentive must the major oil companies get?

Secretary SIMON. Well, their profitability, 1974 over 1973, will be up, although our initial study running 15 years clearly demonstrated, their profitability was average. The 300-percent increase that we had in world crude oil prices last year is a one-time phenomenon—I do not think anyone would suggest it was going to go up again this year; indeed, I feel it is going to start declining in the near future. You recognize that world oil has gone up slightly in excess of 500 percent since 1971.

Now, any time you have a price explosion caused by what I would call artificial factors—there were certainly no free market factors involved in the price going up 300 percent last year due to the OPEC nations control of 67 percent of the world's reserves—you are going to have windfall profits. That is the reason the administration proposed the so-called windfall profits tax bill.

To get specific about your question, what is adequate profitability: The windfall profits tax takes care of the windfall profits that perhaps one could argue they do not deserve. It is a one-time phenomenon.

We think the world price is going to decline. I can remember testifying some months ago when emotions were running rather high, and one of the most noted economists in the United States was saying that the oil industry in 1974 is going to make between $18 and $22 billion of additional profits. Well, now they are down to $7 billion dollars. I do not know where they are going to end up.

We can do all sorts of things with numbers. But I will say that a year from now, as sure as we are sitting here, you will find the oil industry's profits back exactly where they were over the last 15 years. The oil industry, out of basically the 29 or 30 average manufacturing groups in this country, ranked 11th on return on equity, and on average compounded growth they ranked 23rd or 24th, and their average compounded growth rate was 6.6 percent.

Senator RIBICOFF. You are not suggesting that the American people pass the hat for the American oil companies, are you, Mr. Simon?

Secretary SIMON. No. I also realize what I am saying is not terribly popular, because all the American people understand is that we are paying an exhorbitant amount for gasoline and for our heating oil and for the basic feedstock of our industry. All I am trying to say, Senator Ribicoff, is that I agree, this has been an extraordinary blow to the consumer in our country to have all of this occur in just 1 year. But in order to inject something a little more rational into the discussion, recognizing what has to be done in the future

in this industry, the capital-intensive industry that it is, you have to go back and say, well, have they always had these profits, what some people call a boondoggle?

No they have not. They have been in the middle range of industrial profitability in our country. And I am not saying either that just because of the capital intensity of this industry, as many studies have stated, that these industries should average after tax 18-percent or 20-percent return, because I do not, frankly, buy that.

They ought to have just sufficient return on capital to enable them to attract the investment, not all internally generated to do what has to be done here in the United States.

Incentives Needed for Alternate Sources of Energy

Senator Ribicoff. You had a big role in formulating the President's Project Indedendence. I believe in that. As you know, that ERDA bill is a bill that I have been pushing for the administration.

Secretary Simon. Yes, sir. I do. Thank you.

Senator Ribicoff. We must rush alternate sources of energy. But with the oil depletion allowance factor, you really discourage the production of alternative energy sources by subsidizing only the raw material extraction of oil. There is no comparable break for solar, wind energy technologies, and these new technologies. So if someone is going to put in the capital they are going to put the capital in where you are going to get the break—oil—instead of the new types of alternate sources of energy.

Is that not so?

Secretary Simon. Well, of course, they do get the break on the investment tax credit, the building of the new facilities and what have you, perhaps——

Oil Depletion Allowance and Independent Producers

Senator Ribicoff. But the oil companies get that in addition to oil depletion allowance. Now, what worries me in your statement, this oil depletion allowance is a bad break for the consumers and the poor independents are going to be very badly hit.

Now, do the independents really need this break?

As I understand the situation, three-quarters of the independent production is not subject to price control.

Secretary Simon. I have not seen that number, Senator Ribicoff.

Senator Ribicoff. Well, is not a pretty substantial proportion of the independent production against the major companies not done under price control?

Secretary Simon. Well, the calculation of the free and matched barrel, as far as price controls are concerned, is based on the level of production during the 1972 base period. And if you produce in excess of that, meaning if you have new production, the incentive is the freedom from price controls. But of course, production continues to decline each year on existing reserves. I just have never done the study and I do not know, but I have not seen the numbers that would suggest that your figures for independents versus the majors are correct.

Senator RIBICOFF. But how much uncontrolled oil are we getting?

How much of the oil being produced in the United States is the uncontrolled capacity and the so-called $9 a barrel as against the so-called $5.25 a barrel?

Secretary SIMON. It is between 30 and 35 percent, Senator Ribicoff. Part of that is new reserves and part of that is stripper wells.

Senator RIBICOFF. So much of that would be the independent, the uncontrolled?

Secretary SIMON. Well, there again I would hesitate to make a blanket statement. The stripper well is probably owned by the independent. I would say that that is undoubtedly true in general. We use that example that Senator Buckley has used so often about the 5,400 wells in New York State that pump a half a barrel a day on average. Some say, well, is not $9.50 or $10 a barrel for that oil unconscionable?

Well, I do not know what the right price is for a barrel of oil from Onandaga County, a well that is producing a half a barrel a day. But I would hate to take a real chance of cutting the price on that to the point of having the well shut down.

What is our alternative?

We are paying the Arabs $9.50 or $10 a barrel.

Why not pay the same to the guy in New York State or Colorado or any place else?

Senator RIBICOFF. Well, the FEO in production as of 1974 showed the independents control 56 percent of uncontrolled oil. That is the figures from FEO, your former agency.

So will you take those figures as correct?

Secretary SIMON. I certainly will. They have always been very accurate. [General laughter.]

UNRELIABILITY OF STATISTICS

Senator RIBICOFF. I wish they were, really, with no reflection on you or your Agency. I think this is one of the great problems we have, is the unreliability of the figures and statistics that come from industry and come from Government agencies, which makes in impossible for us to try to formulate policy, because we do not really know the facts upon which policy is being made.

Secretary SIMON. Well, you know, Senator——

Senator RIBICOFF. And this is causing a lot of the trouble that we have because of the inaccuracy of statistics and the lag of statistics to be applied to current problems.

Secretary SIMON. We never hesitated to agree with you on that, Senator Ribicoff, and that is why we put in the reporting system that will be able to provide you with those statistics so you can make sound policy.

EFFECTIVENESS OF DISC

Senator RIBICOFF. We have spent a lot of time on this. Let me get a few minutes on DISC.

The General Accounting Office has expressed some doubt as to the effectiveness of stimulating export by DISC provisions of the Tax Code. In trying to make a detailed study of the effects of DISC, the GAO was denied access to Treasury statistics this year. This was before you were Secretary.

Mr. HICKMAN. That is not correct, Senator.

Senator RIBICOFF. The GAO is incorrect?

Mr. HICKMAN. Well, I think it is misstated there. What did happen was that GAO wanted to come in and look at numbers and we said, we do not yet have numbers and when we do, and when we have things sorted out, we would be happy to have you come. And when we got to that point we did invite them and they did come. And we have, as you know, submitted the report.

Senator RIBICOFF. Well, my time is up. I cannot pursue that question.

The CHAIRMAN. We will come back to you later if you wish.

Senator Curtis?

INVESTMENT TAX CREDIT

Senator CURTIS. Mr. Secretary, I want to commend you on your statement. I think it is sound. I think it is good for our economy. I think that it would be far better for the consumer than to follow the course that is being advocated in opposition thereto.

I opposed the investment credit when it was first enacted back in the Kennedy administration. I felt that it probably would be unfair to the business that could not buy new equipment. I have changed my mind, but I have also learned that this, having the investment credit on, then repealing it, then reinstating it, is not a good thing for anybody.

Would you agree to that, that it should be constant?

Secretary SIMON. Yes, sir, I would. Business needs certainty to make its plans for investment. The minute you inject uncertainty in an area the investment money that would go into that area immediately moves somewhere else.

Senator CURTIS. Yes, I think the investment credit is a very good instrument for promoting jobs through plant expansion and that sort of thing. But in addition to the uncertainty that it creates, when we follow a policy of having a tax provision and then eliminating it and then restoring it, it is also very unfair to taxpayers.

The individual who for other economic reasons buys new equipment during the gap when it is not in force may have an unfair situation compared with his competitors.

Is that not correct?

Secretary SIMON. Yes, sir. And it is also unfair to the board or the company, whatever the size, that sits there and makes exhaustive studies on expansion or new equipment and spends a great deal of money on these studies to see if they can expand and produce more in this country, if the Congress eliminates it after they have made an affirmative decision. They just say, well, the hell with it.

INCENTIVES NEEDED FOR DOMESTIC OIL INDUSTRY

Senator CURTIS. I feel very strongly that we must encourage our domestic oil industry to the maximum. I do not thing that we discharge our responsibility for anything less than an all-out effort for self-sufficiency. No foreign nation or group of nations should be able to tie up our economy, transportation, industrial production, and our national defense by shutting off oil.

I would like to call attention for the record to our experience in Nebraska. We are not a large oil producing State. Our oil activity is confined to about four counties, three of which are adjacent. Unlike the Alaskan fields and these other places, it is not a costly operation to drill the holes. But the oil, it is not a high grade field at all, and I have some figures based upon the last 3 years. At the time that the price of oil was about $3.70 a barrel we had a great many wells abandoned in this small three-county area. I know of one individual who had two oil wells. They were down producing six barrels a day. They had to be abandoned.

The price of oil went up about $5. He spent $20,000 on the wells treating them with acid and other things. They are now producing 20 barrels a day. But 40 barrels is just less than a drop in the bucket, but 40 barrels of oil is much better than 12 barrels. And in this small area there are 100 wells producing now that were not before the price increase.

I also asked, What is the cost of drilling? The average cost of drilling a well there over the last 3 years, $32,000 if they get a dry hole. If they strike oil, the pipe, the pumps getting into the pipeline runs at about $100,000. And also, in the last 3 years there have been 13 dry holes drilled for every 1 that produced oil.

Now, this is small production. It is low cost in the drilling. But if we talk about whether we do it or not, if we talk about rolling back the price, if we talk about eliminating and phasing out the depletion allowance, what promises to be a new and growing industry in my State is just going to fade out.

Do you believe that the exploration and discovery of new sources in this country is dependent upon the present tax incentives?

Secretary SIMON. I believe they have been of tremendous assistance in attracting the capital necessary to drill the wells. They have been useful for the independent segment of the industry which raises its money from thousands of individuals around this country. Tax incentives are certainly a carrot.

Senator CURTIS. I do not think there is any question about it. Now, there are a few people with funds in my State who, in a stable situation where they can rely on the tax incentive, will continue to invest in these oil wells. But if all of the so-called reforms go through, it just is not going to be there.

DISC PROVISION

Now, on another matter, I feel that the DISC proposal has not had a long enough time to really be tested.

About how long has it?

Secretary SIMON. It has been about 2 years and a half, Senator Curtis, and we would agree with your statement.

Senator CURTIS. Since it was enacted?

Secretary SIMON. Yes, sir.

Senator CURTIS. But people had to make plans for it, did they not?

Secretary SIMON. Yes. We saw in 1972 slightly under 2,000 DISC corporations, and now we have in excess of 5,000. It involves the same principle as the investment credit. If you put it on, you take it off, you

put it on some products, you take it off for other products drive people away with ad hoc decisions. They begin to feel if they invest money on this basis they're crazy.

Senator CURTIS. If the company views a potential market in a foreign country, and goes over there to build a factory and produce it, the U.S. Treasury does not get any revenue from that until dividends are brought back.

Is that not correct?

Secretary SIMON. That is correct, yes, sir.

Senator CURTIS. And we have no payroll.

Secretary SIMON. But, if I can interrupt. As far as our dollar investment abroad, which sometimes comes under what I consider false attack, it has been well demonstrated, I think, on many occasions that foreign investment is very healthy for this economy. For every $2 that is invested abroad, we get $4 back in repatriation, which is very salutary to our balance of payments.

Senator CURTIS. Yes, but some of those new factories are built by other countries, and what the DISC does, it enables the American producer to compete for those foreign markets and still keep his major operation at home.

Is that not the whole idea of the DISC?

Secretary SIMON. That is correct. A stimulus to our exports, to be able to compete; and also it has got the safety valve where, if the President determines something is in short supply, he can suspend DISC for the particular product that is deemed in short supply.

Senator CURTIS. I think it would be helpful, if there is time in my 10 minutes, if you would just concisely tell us for the record and to refresh our memories on how the DISC works, not a technical explanation, but a practical one in layman's language.

Secretary SIMON. Fred, why do you not answer that one?

Mr. HICKMAN. The basic concept is that you may use for export purposes a corporation which is a domestically incorporated corporation. That is the DISC, Domestic-International Sales Corp. One half of the total profits from sales is then attributed to the DISC. That gives an allocation rule as to what the profit is and who gets what part of it.

Of the one half that the DISC retains, it is permitted to defer the tax on half, so there is a 25 percent tax deferral of the total. Now, that is not an indefinite deferral, because the money has to be used for export purposes. There are a variety of things the DISC can do. But the idea is that so long as the one-half of the profit attributed to DISC continues to be used in export activity, it will not be currently taxable.

The overall intent was to leave the DISC in roughly the same situation as if the manufacturer had gone abroad and had invested in plant equipment abroad. It would normally have been reinvesting in that, and the reinvested portion would not come back and would not have been taxed currently in the United States. So it was an attempt to put American exporters on a basis technically comparable to—not precisely the same, but comparable to—what they would be on if they had gone abroad and financed operations there. Thus the DISC help to keep their operations in this country.

Senator CURTIS. Thank you.

The CHAIRMAN. Senator Byrd.
Senator BYRD. Thank you, Mr. Chairman.

THE BUDGET

Mr. Secretary, first I want to congratulate you and commend you for your statement citing the importance of a balanced budget if this severe inflation is to be brought under control. I know it takes a lot of courage for you to stress that point, but I think it is a vitally important one.

Secretary SIMON. I want to commend you for the legislation that I believe you coauthored the other day in this regard. I will probably get shot for saying it.

Senator BYRD. Thank you.

WRITING TAX LEGISLATION ON THE SENATE FLOOR

Your testimony this morning brings out that this matter of taxation is very complex. I cannot imagine a more inopportune or a more undesirable place to attempt to write tax legislation than on the floor of the Senate. But I assume that that attempt will be made.

WINDFALL PROFITS

I am not clear, Mr. Secretary, as to the administration's position on the huge profits which the oil companies made in 1973 and will make apparently in 1974. The administration opposes, I gather, most of the amendments which have been or are likely to be presented dealing with this subject.

Does the administration recommend a one-time windfall profit tax?

Secretary SIMON. We recommended a windfall profits tax which would phase out as the market forces took over later in this decade. We also proposed an elimination of foreign depletion. We also proposed a solution to the inequity that was created due to the excessive increase in the foreign price of oil that enabled the companies to deduct as a tax credit the taxes and royalties that are being charged by the countries. We suggested that the deduction could not be greater than our tax rate here domestically to remove this abuse. And we testified at great length about this proposal in the Ways and Means Committee.

Mr. HICKMAN. I think I ought just to clear that up slightly for the record. Technically, there is no credit for royalties as such. The technical proposal that we made was to, in effect, deny the use of credits in excess of our tax rate but otherwise it is as the Secretary said. It is a complicated thing that there is a good deal of confusion about it.

Secretary SIMON. Our proposal deals with the windfall side of the problem. We directed ourselves at the windfall itself, which was the explosion in the world price of oil rather than proposing, as some suggested, an excess profits tax. When one sees excessive demand and then an embargo-induced shortage, every time that occurs in any commodity, the price is going to be puched up to extraordinary levels.

And that affected not only the tanker rates, which exploded from world scale 100 to world scale 450 last year, but refineries which were operating at 100 percent capacity until, of course, the embargo. Profit-

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ability was all across the board, including exchange rate gains when the dollar strengthened.

Senator BYRD. I assume the Treasury's position in regard to excess profits tax is based somewhat on the experience of World War II. It did not prove very feasible.

Secretary SIMON. Yes, that is correct, Senator Byrd.

GOLD PRICES

Senator BYRD. Mr. Secretary, you spoke last night, I believe it was, in regard to gold. And without getting into specifics as to what the Government may or may not recommend with regard to changing the price of gold, could you outline for the committee the advantages and disadvantages of changing the price of gold?

Secretary SIMON. Well, I read that in the newspaper. Strange that they would just pick that that is what I meant by the broad allusion to the commodity of gold.

As you know, the position in the Treasury Department, the position of our administration, is basically to remove gold from the center of the monetary system, that it would be replaced by the special drawing like the SDR, and that gold should be treated as any other commodity, silver and lead, and traded, and, indeed, ultimately be allowed to be owned by citizens in the United States.

Now, there are problems in moving immediately to a free world system. Obviously, when one frees up and marks up—if that were, in deed, one thing that occurred—all of the nations, the gold-holding nations, of this world were allowed to mark up their reserves, one could argue very strongly that this would be very inflationary. It would inflate their reserves fourfold, because they are today priced at $42.22, which is the controlled price under the agreement. Also, perhaps, in the other countries of the world, that this new-found wealth would encourage some countries to improve fiscal policies and monetary policies, which would fuel inflation.

What I was attempting to do is to show to the other countries of the world who are coming here this weekend for our week-long International Monetary Conference, the Ministers' C-Twenty meeting, that we were, indeed, prepared to be forthcoming and cooperative in discussions of gold, to once and for all attempt to sit down and discuss the thing together and attempt to begin to arrive at a conclusion on this very emotional subject.

Senator BYRD. Thank you, sir.

LIQUID LIABILITIES OF FOREIGNERS

Do you happen to have available the liquid liabilities of foreigners at the present time, or as of March 31 or April 30?

Secretary SIMON. I can supply that for the record, Senator Byrd.

Senator BYRD. Would you do that?

Thank you.

(The Department of the Treasury subsequently supplied the following information:)

At the end of March 1974, U.S. liquid liabilities to all foreigners (official institutions, banks, and other foreigners) were 91.1 billion dollars.

At the same date, U.S. liquid claims on foreigners amounted to 6.7 billion dollars.

Investment Tax Credit

Senator Byrd. You mentioned the need to leave the investment tax credit alone. And you say, "If investors believe that Congress will forever be taking it on and off, then the investment credit will become too uncertain, and a great deal of its value will be lost."

I think you are right. It was recommended in 1962 by President Kennedy and then in 1966, it was not the Congress but it was President Johnson who recommended taking it off. Congress went along with him. I happened to vote against it. But then 6 months later President Johnson asked that it be put back. And then in 1969, President Nixon asked that it be taken off and then in 1971, President Nixon asked that it be put back. So I think we have got to decide whether we want to have an investment tax credit or not have one and leave it alone.

Secretary Simon. It is enough to make you dizzy, is it not?

Senator Byrd. Yes. I started out in opposition to it when President Kennedy first proposed it. And since then I think it has been helpful overall to our economy, helping in providing jobs. And I think that unless we are going to take it off entirely and forget about it, we had better leave it alone, just as you recommend today.

Secretary Simon. Well, you know, Senator, a lot of the conversation this morning, a lot of the dialog, has been focused on the oil and gas industry and the critical area of energy. But, many of our basic material producing industries have found their existing plants inadequate to supply the growth in demand for both their domestic use and our exporting use to maintain the strength of our dollar.

We have to look at steel and paper and chemicals and the bottlenecks and the backlogs of orders. We have a supply problem in our economy right now, and it is not going to be cured in the near term. It is necessary to bring these commodities to our consumers ultimately at the lowest prices, so we will not be dependent on foreign sources to bring in so many of our basic needs.

We should be sure these things provide true, useful incentives and make sure that they are doing exactly what we intended them to do. But we really ought to leave them alone. It is really the answer, or one of the answers, to our inflation problem, creating a supply in our country to meet the demand. Today the demand exceeds supply in most of our industries significantly.

Senator Byrd. I think you are right. And the point I am suggesting in regard to the investment tax credit is that it is not just the Congress that has been taking it on and off, but it is two administrations which have recommended that it be taken on and off. So I think both the administration and the Congress were to blame for this yoyo proposition.

Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

The Chairman. Senator Fannin.

Senator Fannin. Thank you, Mr. Chairman.

Mr. Secretary, we are certainly pleased to have you with us here today and very proud that you hold this very important position.

You have certainly been forthright in your statement and also in answering your questions. I am very proud that you have placed the priorities in proper perspective.

Tax Reform?

I would like to read a statement that I think states the case that I feel exists today. Tax reform will not serve the public interest if the results in terms of short-term gains in tax revenues are bought at the expense of long run costs in terms of employment, national income, social welfare, economic security, and building for the United States to exert its influence in international affairs in support of peace and freedom.

Mr. Secretary, do you not agree that the only reforms of serious consideration will be those that will strengthen this Nation by providing long-run public benefits?

Secretary Simon. Yes, I do, Senator Fannin.

Overtaxing Industry

Senator Fannin. What I am concerned about is that many people think we can tax industry more and individuals less, and it will be very popular, and it will operate to the benefit of the country. Here we have employment so dependent upon what business is able to do, and I fear we are unable to emphasize this perspective.

And, Mr. Secretary, our current capital recovery allowances do not compensate for the confiscation of capital by inflation. You have talked about the tremendous need for additional revenues to furnish the capital. You have used figures, I think, of $1.3 trillion—$1,300 trillion will be needed just in the energy industries.

Is it not true that accelerated depreciation rates combined with investment credits have narrowed the gap between the U.S. and foreign capital recovery allowances, but our taxes are still behind those of other industrialized nations?

Secretary Simon. Yes, I would say that is accurate overall, though it varies on comparison from country to country. But certainly the first portion of your statement, I just could not agree with you more, whether the figure is $1 trillion, or $1.3 trillion, or ends up at $1.5 trillion over the next decade that is needed for the energy industry.

And we seem to focus on that because of our recent experience and neglect to think about the other two-thirds of our capital investment that is needed in this country in our other basic industries. We seem to move from one crisis to the next and attempt to react to the crisis just passed until the next one is upon us. I am just suggesting we ought to look a little ahead at this $3 trillion or so that must be raised over the next decade, and refrain from in any way inhibiting the attraction of this capital that is going to continue to bring the greatest standard of living to this country at reasonable prices.

Senator Fannin. The chairman very forcefully brought out the issues at hand. And if we do not follow what was advocated by the chairman, we will be confiscating capital that we require. We certainly will not be able to do what you feel is so necessary, not only in the energy picture but in the overall needs of our country. We

have a short supply of many commodities, and if we are going to meet the challenge that is with us today and that is almost worldwide as far as the non-oil-producing countries of the world, we certainly are going to need additional capital.

The first quarter results show many American companies with recordbreaking profits. Is it not true though, Mr. Secretary, that many companies' profits were bolstered by underappreciation, which ignores soaring replacement costs?

Secretary SIMON. Yes, that is correct. Inflation contributed a great deal to profitability, unfortunately.

Senator FANNIN. So when we are using many of these figures, we are really misleading the public as to what is happening?

Secretary SIMON. If you look back, and we are really just starting that, for the true profitability of all businesses in our country over the last few years, you will see some of the root causes of some of our problems. Our shortages in productivity are due to the heavy capital-intensiveness that is required, to labor factors and other extraneous factors. We have to turn this about a little bit.

What I am suggesting is not the big banker approach, which sometimes I have been, I think, falsely accused of, because if I was taking the big banker approach, I would be back up there with the big bankers. Basically, what I am doing is honestly—and I could be wrong—but honestly trying to recommend what I think is in the best long-term interest of this country and to continue all of the things that our great free enterprise system has provided us with in the past.

Senator FANNIN. Well, I assure you that I agree with you in that respect. And this off-again, on-again basis of handling our different tax credits and tax programs—it is always easy to talk about what you can do to see that everyone pays their fair share of the taxes, but there are many complications involved when we are speaking of tax incentives.

Advocates of repeal of the foreign tax credit question why foreign income tax should be allowed as a direct credit—and that has been discussed here before—against U.S. tax liability when State and local taxes are allowed only as a deduction in arriving at taxable income. Accordingly, they believe foreign taxes should not be given more preferential treatment than State and local taxes. That is one of the problems we have, is explaining exactly why this exists.

Secretary SIMON. Well, there are two things that sort of stick in my craw on that, Senator Fannin. One is that State taxes are certainly significantly below what the foreign taxes are. Too, sister States have all sorts of arrangements that enable you to set one tax off against the other.

Basically, what we are talking about is whether our industries and our companies that wish to go into other foreign countries and compete with the other countries of this world and the other industries from those countries should be allowed to compete on an equal basis. And our present tax system, which we constantly work on to make sure it is equitable, works in that direction. Our system is opposed to the concept of double taxation or even permitting a deduction instead of a tax credit, because the cost would be prohibitive. It would move companies from a 48-percent bracket, if that is what they are paying in

one of the foreign countries, to roughly a 72-percent bracket. And that clearly would force them to sell out.

Senator FANNIN. In other words, the return we now receive and you spoke about that is so beneficial to this country would just be a thing of the past?

Secretary SIMON. Yes, and would it have a very deleterious effect on our balance of payments.

BENEFITS OF U.S. CAPITAL INVESTMENTS THROUGHOUT THE WORLD

Senator FANNIN. We have done so much in many of the countries in helping to build their economies, if this were discontinued, then we would not be in a position to render the same service that has been so valuable to these other countries.

Is that not true?

Secretary SIMON. Yes.

Senator FANNIN. We forget about the quid pro quo that has been forthcoming because we have been willing to make the capital investments and take the risks in so many countries in the world. And I know we have criticism of the oil industry for having made these tremendous investments. And, still, if we look at the overall world picture, we see that this world as a whole would not have progressed nearly as rapidly in their developments if it had not been for the industries of this country going abroad and helping them with the development of the resources, furnishing the technology.

Secretary SIMON. And that in turn redounds to our benefit. We are going to be having the first negotiations with the Saudi Arabians who arrived today. They will be here through the balance of this week, and they have great plans for industrialization and diversification of their country, which is going to promote jobs in this United States and exports and all of the things that world trade means to everyone in this, today, one world.

Senator FANNIN. At this time it would be so very critical if we discontinued some of these programs that have been beneficial in these developments. And here we have an opportunity as you say, with the Arab countries, Saudi Arabia and other countries, that if we discontinue the incentives for carrying forward on these programs, it would work very detrimentally to our economy.

Secretary SIMON. If I could say one thing: We have to look at incentives on a case-by-case basis, but we also must look at removing the impediments. We have a withholding and a State tax today for foreign investments in this country. It raises—oh, gosh—the number I believe is $50 million a year in revenues, a really insignificant amount when one compares that to our total revenues.

Now, this is a real as well as an imagined constraint on foreign investments, especially when one deals with the very conservative investment practices in these countries. And it would be very positive if we could remove that and do it quickly to enable the funds to flow over here, which of course would be positive for our balance of payments.

We have enough restraints that we need not be concerned about countries coming in and buying up massive industries and buying up massive companies. We have got the Defense Department and many rules and regulations under our antitrust laws that are adequate safe-

guards to protect us against that. We should remove these inhibitions and remove them quickly.

Senator FANNIN. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Mondale.

STUDY OF TAX INCENTIVES FOR BUSINESS

Senator MONDALE. Mr. Secretary, the President the other evening in his economic message indicated that there is a highlevel committee or commission working on studies of tax incentives for business and business investment.

Who is on that high-level committee?

Secretary SIMON. Basically, the tax department in the U.S. Government is the Treasury Department, and one might say that we are always studying taxes and tax reform.

Senator MONDALE. He indicated there is a special effort.

Who is on that?

Secretary SIMON. Fred Hickman, who is our Assistant Secretary for Tax Policy, has been working on these areas to assess the feasibility of various incentives for savings and investment.

Senator MONDALE. Who else is on the committee?

Secretary SIMON. Oh, to study the capital needs of the future. That is the Council of Economic Advisers, Senator Mondale.

Senator MONDALE. Is that what he was referring to, just the Council of Economic Advisers?

Did he not say there was a high-level committee?

Secretary SIMON. That would be the economic mechanism of Government. It would include the Treasury Department and the OMB. The Federal Reserve, where appropriate, is part of the quadriad, as well as the Council of Economic Policy.

Senator MONDALE. Has this committee met yet?

Secretary SIMON. Not to the best of my knowledge, no, sir. But this work——

Senator MONDALE. When is it going to meet?

Secretary SIMON. I would defer that to Chairman Herb Stein. But this work is ongoing as far as the Treasury Department is concerned. We have for a long time done these studies independently, Senator Mondale.

Senator MONDALE. I am talking about the Presidential message, in which he referred to a high-level committee that was working on this capital problem. I want to know who is on it, when you are meeting, and what you are considering.

Will you answer that?

Secretary SIMON. It has not, to the best of my knowledge, met yet, Senator.

Senator MONDALE. When is it scheduled to meet?

Secretary SIMON. I would have to ask Herb Stein that question.

STATE OF THE ECONOMY

Senator MONDALE. As I see the present economic policy, we have the highest interest rates since the Civil War. We have got a restrictive budget, something like a $12 billion surplus on a full employment

basis. We have no incomes policy left except in very few limited fields. We have no policy to stimulate demand in terms of tax relief for the average consumer. So that, basically, what we have is a policy of stepping on the brakes very hard, and I gather you think that is going to restrain inflation.

How do you review the results of that policy over the next year in terms of unemployment, in terms of the average workweek, in terms of the inflation rate?

Where are we going?

Secretary SIMON. Senator, I do not happen to believe we are, as you said, stomping on the brakes very hard. Monetary policy has been exerting significant influence over the last few months, which has sent interest rates to these peak levels; there is no doubt about that. Each time in the last 10 years we have seen interest rates rise in response to monetary policy, and, I might add, in the absence of fiscal policy restraints which would enable the Federal Reserve to be more moderate in the utilization of monetary policy. As you know, I do not consider a budget deficit of $11½ billion in 1975 as one of restraint.

Senator MONDALE. What do you think it should be?

Secretary SIMON. I think that our direction should be pare our 1975 budget wherever we can pare it and move to a balanced budget in 1976. I recognize the fact that it is extremely difficult and I have never, as I have been accused of saying, suggested that we go right to a balanced budget in 1975. While some people say that 73.5 percent of the budget is uncontrollable, I do not agree with that and I do not think any of you Senators would agree with that, either.

Senator MONDALE. I only have 10 minutes. I want to stay on my questions.

INFLATION

Where do you think the economy is going this year in terms of inflation?

Secretary SIMON. I think the problem in our economy today is one of demand, and it is a very pervasive demand throughout our entire economy. Now, the inflation rate at the present double-digit inflation that we are experiencing right now is going to decline as the year goes on.

Senator MONDALE. Where do you think it will be by the end of the year.

Secretary SIMON. By the end of the year, my judgment is that it will be 7½ to 8 percent, Senator.

UNEMPLOYMENT

Senator MONDALE. Where do you estimate we will be in terms of unemployment?

Secretary SIMON. Unemployment will certainly move up slightly from the 5 percent level that it is presently. But we do not expect that it will reach 6 percent.

Senator MONDALE. You do not think it will reach 6 percent?

Secretary SIMON. No, sir.

RELIEF NEEDED FOR AVERAGE TAXPAYER

Senator MONDALE. As I listened to your testimony today, it seemed to me that your policy focuses entirely upon the pleas of businessmen to continue or expand what they call investment incentives. I did not hear any discussion of the demand problems which I think exist in our society, and I wonder how this policy looks to the average American. He is being asked to pay the highest interest rates in American history. Their tax bills are rising under inflation as they get into higher tax brackets. The payroll tax is rising dramatically, with no exemptions or loopholes for them at all.

He is being asked to pay in terms of unemployment, in terms of a reduced work week. He is being asked to pay in terms of an inflated dollar, which has substantially eroded his purchasing power. He is being asked to pay in terms of a cutback in social programs that are directed toward him and his family—education, health—housing is a dramatic example. And the policy of the Government is that he should enjoy it, it is good for him, that in the long run if you just keep responding to the claims of the major industries such as the oil industry for higher profit, that is good for him.

Now, I think there is a problem of balance here. When I think in terms of how Government and economic policy looks to the average American, it is terrible. I sense today that the average American hears this and it sounds like Alice in Wonderland.

Secretary SIMON. Senator, we are just dealing with one part of it. To say that that is our total enunciated economic policy is really not correct. I do not believe you have heard me enunciate on a proper balance between fiscal and monetary policy, which most certainly acts to reduce the demand.

Senator MONDALE. Well, let us just take DISC for example. Here is a case where many economists claim it is not buying us anything. More than that, it may be encouraging shortages. And we have a situation now where export policy is being stimulated dramatically with the change in monetary values.

This might be a good place where we could save a little money, and maybe bring some relief to the average person. Your position is, it is very complicated, we do not have the figures yet, so let us leave it the way it is.

Secretary SIMON. It just has not been in long enough. Our exports are what keep our dollars strong, and that is extremely important, is it not, and where we have removed the set-asides—and that is the other side of the picture——

Senator MONDALE. But you say you do not have the figures to justify that.

Secretary SIMON. Well, the operation is slightly over 2 years old, the DISC corporations. We have allowed these DISC corporations to grow where today we have in excess of 5,000 corporations. We think it is too early to assess the entire economic impact of the DISC program that was legislated. Now, recognizing the fact that there are areas of shortages, with the President can suspend the DISC treatment if he deems that there are shortages in special areas.

Senator MONDALE. It just seems to me, every time there is a tough economic problem—say the oil crisis—the answer of this administration is high oil prices. Every time we have got an inflation problem, the answer is higher interest rates or more tax incentives for big business.

Secretary SIMON. I was not advocating——

Senator MONDALE. It may satisfy you, but I think when the average American looks at the present tax structure, looks at the present economic policies, he sees a policy that is loaded in favor of big business and a policy which does not give a damn about him and his family, and I do not think they are going to let you or me get away with it.

Secretary SIMON. Senator, what in the world did we have to do with the OPEC nations trebling the price of oil in December?

Senator MONDALE. Why did you let 40 percent of the production in the United States bring the Arab boycott price?

You once said yourself that seven bucks was plenty. It is now $10.

Secretary SIMON. Seven dollars was our estimated long-term supply price in the Treasury, and that is, as I have said, a judgmental price. When we bring in the alternate sources of energy and have this ability for self-sufficiency, that is our judgment of what it will cost.

Senator MONDALE. In what substantial area have you once disagreed with the major oil companies?

Secretary SIMON. Oh, I would say the mandatory oil import policy. You can start there. I changed the mandatory oil import program as chairman of the Oil Policy Committee long before the embargo recognizing that this was a bad idea. And I am sure there are lots of others. I agree——

Senator MONDALE. Can you think of one other?

Secretary SIMON. Pardon me?

Senator MONDALE. Can you think of one other area?

Secretary SIMON. The windfall profit tax would certainly be very controversial for the oil companies. I think our tax proposals are punitive for the oil companies as far as the majors overseas are concerned. I am not a captive of big oil or big anything else, as far as that goes. I do not think we are that far apart when we talk about what happens when all of a sudden there is a shortage and the spurt in prices that occurs when demand so far exceeds supply.

The thing you have to do is look back and see what caused it—all of the bad government policies running back to 1956 that brought this shortage into being. That ought to be fair warning for the other industries where we are looking for the same kind of trouble. We have to deal with the incentives carefully on a case by case basis. We have to deal with supply, Senator Mondale, in agriculture and our other commodities. We have to deal with the fundamentals, and that is fiscal policy, to make sure that government just does not continue to spend, spend, as it has in particular in the last 20 years. Then you will begin to wring the inflationary expectations out of our economy, that are going to bring interest rates back down to moderate levels where our people can afford them.

Senator MONDALE. My time is up.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Thank you, Mr. Chairman.

Five Day Experts on the Oil Industry

Mr. Chairman, I was once Governor of Wyoming, and along with nine other Governors we visited Japan for a couple of weeks, and then Southeast Asia for 5 days, and I became a 5-day expert on Vietnam. It occurs to me that there are some of us around here who have become 5-day experts on the oil industry. Not many years ago some of the eastern representatives were saying that we ought to do away with domestic production. We ought to close down stripper wells, because we were paying too much for that oil and that we ought to go abroad where we could buy it cheaply. It is interesting that some of these same critics of a few years ago are now damning the international oil companies and saying, "put them out of business." I guess it will not be hard to put them out of business.

I wonder, though, if the American public will conclude that we are better off when we have done that.

Senator Ribicoff is not here. I wish he were because I am going to say that when he criticizes the figures that you have submitted, Mr. Secretary, that he too may not understand as completely as you.

He says the oil industry figures cannot be relied upon. I have heard him and others speak about the amount of reserves. Reserves, I ask you, are the estimate of what can be recovered from the known deposits at a specific price level with a specific cost incident to that production. Is that right, is that what is meant by reserves?

Secretary Simon. That is correct, Senator.

Senator Hansen. And if the price goes up and the other costs do not rise proportionately, would it follow that reserves could become greater simply because of the mechanism of price?

Secretary Simon. They necessarily will, because you can drill deeper, use secondary and tertiary recovery, explore the more expensive climes that I spoke of before. Of course they will go up.

Senator Hansen. And without doing any drilling, without taking a single thing, is it not a fact that when the price of stripper well oil went from about $3 a barrel to $10.30 a barrel, we do have wells that are pumping now simply because it is profitable to pump that oil?

You spoke about Senator Buckley from New York with 5,300 wells in his State, the average production of which it about half a barrel a day. If that oil were selling for $3 a barrel, my guess is not a single one of them would be pumping a single barrel of oil.

Is that right?

Secretary Simon. Yes, and this is a nifty lifebelt, at this time, from from our balance of payments and our economy point of view. As we drill the Outer Continental Shelf and bring on the alternate sources of energy that we so abundantly have in this country, and subsequently the price begins to come down, these strippers are going to shut down. And in the interim it is a good idea that we have them because our alternative is to pay the Arab producers this price and maybe even a higher price.

Senator Hansen. Senator Mondale asked when you disagreed with the oil companies. I think your response certainly was a good one. I recall what Winston Churchill once said. He said, the inherent vice of capitalism is the unequal sharing of blessings, and the inherent virtue of socialism is the equal sharing of misery.

Now, all I can say is that maybe there is a better way. Maybe you have not disagreed with business too much. I have not observed Senator Mondale disagreeing with George Meany too much. But I do not think George Meany wants to socialize this country because he knows pretty well that the workers in this country are far better off than the coal miners are in England. If that is a better way of getting along than the way we are doing over here it must be different than it appeared to me in January when I was in England, and the hotel in which I stayed in London shut the heat off. They had very dimly lighted hallways. Crime was up because that was practically a darkened city.

Do you think that, despite all of the things wrong with capitalism that socialism is as good an answer as capitalism?

Secretary SIMON. Nobody has ever had a system that is better or fairer to people than our system here in the United States, and we have got millions of medium- and small-sized businessmen that will attest to that fact. I wish those people who ask me questions about, when was it that you last agreed with big this or big that, would call in the independent petroleum people, whether it is the drillers, whether your marketers or the jobbers, and ask them which way our policies leaned to make sure that this very competitive force remained operative during a very extraordinarily difficult period. And they will respond for the record.

Senator HANSEN. Well, Senator Ribicoff asked, what is an adequate return, and he mentioned what the returns were for Occidental Petroleum. He quoted a figure, I think, in excess of 800-percent increase in profits of 1973 over 1972, according to Time magazine, which is not always my best source of information. I would say that they said that Occidental's profits went up in 1973 718 percent over what they were in 1972.

They did not bother to point out that Occidental had a very disastrous year in 1971, that it actually lost money, that the dividends it paid in 1972 were 1.3 percent on the stockholders investors investment. And it is true that when they paid 9 percent in 1973, if you figure out all of the fractions that were in those figures, they did go up 718 percent. I would ask you, do you think that Congress ought to decide what is an adequate rate of return, or do you believe that maybe the American investor might be relied upon to make the best decision in this case?

Secretary SIMON. Why, of course, the American investor is the only one that can determine what is an adequate—adequate, I said—rate of return. An adequate rate of return is one that will attract the needed investment for expansion and provide a reasonable rate of return to the investor, and that is the way it should be. And we can use all sorts of numbers. Somebody wrote a book when I was very early in the investment business, 'How To Lie with Statistics', and you know, recent periods have taught me some new tricks with that, I will tell you.

Senator HANSEN. Senator Ribicoff is a lawyer, I am a cattle rancher. If I were living in the east I suppose I would be called a farmer. I do not suppose he would think that my idea of what is a reasonable lawyer's fee would necessarily square with what he might think is one, nor

do I expect that the average physician would believe that it would serve society well if I were to determine what doctors charge rather than let them make this decision.

Do you think that the fact that the number of drillers, independents in this country, declined from 1956 to 1972 by more than half indicates that the return that they were getting was adequate to bring about the kind of activity necessary to sustain the degree of self-sufficiency we had back in 1956?

Secretary SIMON. No. Everyone warned what would happen, starting with the Phillips decision and continuing through all of the other actions and inactions on the part of the Government, to drilling and exploration, and to our basic energy self-sufficiency which we enjoyed. It was predictable.

Senator HANSEN. There has been some criticism of the profits that American-investor oil companies have made in other parts of the world. It has been contended by people in the industry and a number of the others that the United States needs imported oil and U.S. companies operating abroad need foreign tax credits to remain competive wtih non-U.S. companies. My question is:

Would we be better off if this Congress enacts legislation that will indeed get American dollars out of foreign investments?

I think the foreigners are doing a pretty good job through expropriation of American properties to get us out anyway.

But should we accelerate this tendency already clearly in evidence to put American businessmen out of business in the oil operations throughout the rest of the world?

Would we be better, in other words, if the Japanese or the Russians or whoever were doing in instead of Americans.

Secretary SIMON. Senator, you have had on several occasions testimony this year and last year on the role of the multinationals and their beneficial effects as far as the U.S. economy on jobs, exports and strengthening our balance of payments. Just the very statistic that I gave before, that we bring back to this country through repatriation twice as much as is invested abroad each year, is a great demonstration of that effect, and we should not discourage this. We should encourage it prudently.

Senator HANSEN. Thank you, Mr. Secretary.

Secretary SIMON. We are not asking that our companies overseas have a leg up on their competitors. All we want them to do is to have a fair chance to compete on an even basis.

The CHAIRMAN. Senator Gravel?

EFFECTS ON PRICE OF PERCENTAGE DEPLETION ALLOWANCE

Senator GRAVEL. Mr. Secretary, in your statement you talked about the effect of the depletion as being a 55-cent rollback in price on a $5.25 barrel of oil. Now, the companies have an obvious choice. They can absorb that or they can, as is normal, try to maintain profits, the supposedly exorbitant profits of the day or the not so exorbitant profits of a year and a half ago.

If they do not absorb that, then obviously it is going to be translated to the consumer.

What would the congressional action in repealing depletion mean right at the gas tank, for the person who rolls up to the gas station?

What is going to be his increase?

What is going to be the inflationary push that he is going to experience as a result of this congressional action?

Secretary SIMON. It is about a penny a gallon.

Senator GRAVEL. It would be about a penny a gallon increase for the rollback?

Secretary SIMON. Every dollar in a barrel of crude oil translates to about 2.3 cents. That is at the current price. If you go to a long-run price, obviously it is going to be higher. But at current prices.

Senator GRAVEL. That is at the $5 price, so if you are talking about $9 a barrel, it is going to be higher than that. And you would expect maybe 2 cents.

Now, on the unregulated oil the market forces will operate, but on the regulated oil they have got to come back to the Government and ask for a price increase, right?

Would you guess that the Government would grant that price increase?

Secretary SIMON. I would doubt it.

Senator GRAVEL. Then what is going to happen?

You are going to have a compression that will take place.

Secretary SIMON. You are going to have wells shut down.

Senator GRAVEL. Well, would you assume that you might have a flight of capital that would take the money elsewhere to invest in oil or energy products?

Secretary SIMON. Oh, there is no doubt about that, or just move to other industries to invest.

Senator GRAVEL. Move to steel or soft drinks where the return on capital is much more attractive than it has been in oil?

Secretary SIMON. Yes.

Senator GRAVEL. I would like to focus on one major problem right now, Mr. Secretary, one I am deeply concerned with, and I do not think the American public is yet concerned with. It will be in 5 years.

The CHAIRMAN. Could I just interrupt you one moment on that point?

Senator GRAVEL. Sure, if also, Mr. Chairman, you grant me the same courtesy as we continue on with the questions.

The CHAIRMAN. I would also ask this not be on the Senator's time. I will just use some of my time.

I do not see quite how you arrive at that figure, and I wish you would just take a pencil and see if you arrive at the same conclusion that I do. Let us assume that your pricing is correct when you are averaging out $6.25 on oil, which at the moment is being depleted at 22 percent. Now, that comes down to about $1.37 a barrel, on which you are being taxed at a rate of roughly 50 percent. But to get that back it seems to me they would have to raise that price by about $1.35.

Secretary SIMON. On a barrel of crude?

The CHAIRMAN. On a barrel of crude. And you estimate that it is worth 2.5 cents a gallon at the pump.

Senator GRAVEL. One cent was the increase.

The CHAIRMAN. Well, no, that $1 increase in a barrel of oil means 2.5 cents at the pump. I heard you use that figure on television.

Secretary SIMON. 2.3 cents, that is what our calculations are.

The CHAIRMAN. Well, you say 2.3 cents, but if you multiply it by 1.3 or 1.35, to me that comes out just about 3 cents.

Secretary SIMON. I have all my number jockeys here figuring feverishly.

The CHAIRMAN. In other words, it seems to me that that answer you are giving is not taking into account the fact that when a person makes it back he has to make it back against a 48 percent tax rate.

Secretary SIMON. That is correct.

The CHAIRMAN. All right.

Now, so if you take all that into account it looks to me as though my mathematics would put it much higher than that 1 cent.

Mr. HICKMAN. He has got to get $1.37 a barrel back.

The CHAIRMAN. Right, and he has got to get it back against a 48 percent tax rate.

Mr. HICKMAN. That is right.

The CHAIRMAN. Now, I wish you would have one of your people calculate that through, because that means to me that he has got to raise his price by $1.35. Assuming you are letting him make about what you think he should be permitted to make at this point, he is going to have to raise the price by almost 3 cents a gallon.

Senator GRAVEL. I wonder if, Mr. Chairman, if they could not supply that for the record, because we will need this on the floor in debate?

Mr. HICKMAN. It is about 3 cents a gallon on the $6.25 barrel.

The CHAIRMAN. I sat down at night and calculated, and I have sat down in the morning and calculated it, and I have run it past the majors and I have run it past independents, and it sounds to me as though you are talking about roughly 3 cents a gallon. Now, that is what the consumer is raising the devil about right now.

It is costing too much at the pump. Now, if this increase has to be passed on through, I think you ought to tell him that this tax increase means that when he drives up to that pump where he is raising the devil about the 61 cents, it will mean 64 cents.

Secretary SIMON. It is going to take $3 billion out of the economy. Every penny is about a billion dollars.

FINDING MONEY IN ENERGY R. & D.

Senator GRAVEL. That is the point I want to get to. It is going to take $3 billion in potential productive capacity in a critical area, what we recognize as a critical area today—energy.

There are two approaches to the problem. One is, of course, the financing of the public effort which is going to be ERDA, and if the Government chooses to get into this legislation, to guarantee loans to refineries and a whole host of others. That is one cost. Now, since you are recommending going toward—and I accept that—going toward a balanced budget, where are we going to get the money to finance this increased cost, the minimum of which under Senator Jackson and President Nixon's proposal, is about $2 billion a year?

We are only spending a billion at present. I think it is less than that because of some impoundments. So that means we have to come up with a billion, plus additional moneys that are not presently being spent on governmental efforts for energy.

Now, where is that money going to come from?

Secretary SIMON. No. 1, we must succeed in cueting back our demands on the capital markets. Today in the debt markets alone the U.S. Government, the Treasury and federally sponsored agencies preempt 62 percent of our capital markets. If we reduce our demands on these markets—obviously, there are other people trying to raise capital who become disadvantaged. Our securities are the highest rated securities in the world, and they preempt the people at the bottom of the ladder—the mortgage moneys, the Xeroxes of tomorrow, the needed investment.

But many industries need the funds. So this is a reduction in demand. A reduction in demand also reduces interest rates.

Senator GRAVEL. I think what I was asking—I do not want to touch the private sector yet. I want to find out the role of the Government—because we are making a lot of speeches in Congress about what we are going to do to solve the energy crisis and make this Nation independent. You know, next year we are going to be facing the balance-of-payments loss of $15 billion, plus or minus.

What I would like to know is, if we are going to deal honestly with the American people, where are we going to get the money to finance ERDA?

Where is it going to come from?

Do you know of any plans?

You are the Treasury, you are the administration.

Where is the money going to come from for us to finance this great R. & D. thrust to create these jobs and these alternate sources of energy or known sources of energy?

Where is that money going to come from?

Secretary SIMON. Unless, Senator, we wish to increase taxes, which we are not suggesting that we do, or indeed create a larger budget to finance the $2 billion a year for the next 5 years, as the R. & D. proposal of the President stated, we have to reorder our priorities in this country.

Senator GRAVEL. Right, we do.

Now, if we win, so that there is no increase in taxes, there is going to be no money there. If we then go the route of additional debt financing, we know that really what we are doing is robbing other sectors of our private economy which you just talked of, because the Government is going to have to go out and get that money to do it.

Secretary SIMON. Not only that, but you are levying a tax through inflation on every American citizen.

Senator GRAVEL. Right, there would be no increase in jobs out there in that productive area of society. So, unless we go into more debt or raise taxes, the Government is not going to do one single thing to increase our potential independence with respect to energy.

Is that a fair statement?

Secretary SIMON. Well, there again you leave out the reordering of budget priorities.

Senator GRAVEL. Well, in your experience with the Government and with the Congress, is it fair to expect, with the crunch we have on today, that we are going to see an appreciable reordering to the tune of $1 billion plus, to satisfy this new energy area?

Secretary SIMON. I must admit, Senator, that I am for the first time—and I do not think I am politically naive—becoming optimistic that double-digit inflation has frightened the American people, and that they are going to be willing to focus in on the real long-range problem of Federal spending. The budget bill that is going to the Congress right now is a step in that direction, where the administration and the Congress are going to work together to bring our spending into proper perspective.

Senator GRAVEL. So what you are saying is, probably the only avenue of intelligent action in the energy crisis is taxation?

Secretary SIMON. I am talking about cutting the Federal budget.

Senator GRAVEL. Well, when you cut the Federal budget you are compounding the lack of funds in this Project Independence. So my question is, going back to your other answer, it is going to have to happen through taxes, right?

Secretary SIMON. We get higher revenues each year. Part of it, obviously, comes through the inflation process, and part of it through the increase in revenues and earnings of these corporations, and that enables us to grow at reasonable rates.

Senator GRAVEL. Well, we have not even touched the private sector. I am still trying to focus on where we are going to get the money to do the governmental activities. I do not think we have pinned that down.

Secretary SIMON. Part of it is going to come from the private sector. Part of it is going to come from increased savings in this economy.

Senator GRAVEL. Do you think that will be enough to handle the governmental thrust?

Secretary SIMON. Yes, sir. Indeed, I do. If we do our fiscal job properly here.

Senator GRAVEL. The point I am driving at is, I have offered a proposal to create an energy trust fund to take some money from our society and focus it on the problem area.

You do not think that would be necessary at this point in time?

Secretary SIMON. The trust fund proposal we continue to study downtown, Senator Gravel. There is a fundamental bias on trust funds. They seem to have stayed long after their useful life. We are looking at all sorts of alternatives, such as trigger mechanisms, et cetera. But we have at this point reached no conclusion on them, although we think it could be done from the regular appropriations and budget process.

Senator GRAVEL. Well then, I think you can join the congressional club that exists in this country today—that is, that nobody has come up, including the administration, with a meaningful proposal to raise the significant money in the public area to do something about Project Independence. Thus far it is all rhetoric.

Now, let us move to the private sector. We received estimates in testimony before the committee that the private sector is going to need about $500 billion to approach independence. $500 billion.

Now, where is that money going to come from?

Secretary SIMON. Well, when one looks at the makeup of our capital market, I think the figure is probably closer to three-quarters of a

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trillion and it might even approach a trillion dollars, over the next decade.

Senator GRAVEL. Well, the world requirement is about $1.3 trillion. But ours could be as high as three-quarters?

Secretary SIMON. Sure. I think that is——

Senator GRAVEL. And being conservative as to what our need would be.

Secretary SIMON. If one looks at the past decade, the energy industry basically has demanded from our capital sector about 22 percent of the total capital invested in our industries in this country, and this is going to rise to about 30 to 31 percent in the next decade.

Well, this is a significant increase certainly.

Senator GRAVEL. What numbers are you talking about there, Mr. Secretary?

Secretary SIMON. You are talking about somewhere between $2.25 and $3 trillion domestically, if one wants to take all of the variables as far as total capital investment in this country—and remember, that is judgmental—that one has to crank in lots of economic forecasts in that growth. But that is a ballpark number.

Now, we have succeeded in the past during noninflationary periods, where profitability is adequate in industries—and this is an important point in it, that if we begin to restrict the profitability of any sector of our industrial complex, investment funds flow to other sectors and they become——

Senator GRAVEL. Mr. Secretary, moving out of the theoretical areas——

Secretary SIMON. I am not being theoretical: I am being actual.

Senator GRAVEL. But there has been no profitability worthwhile in oil for the last 15 years except for this last year, and everybody has panicked. Everybody thinks it is excess windfall profits, the administration included. Otherwise they would not even have come up with the windfall profits tax.

Secretary SIMON. Senator, they basically have been able to, up to this time, attract sufficient capital to perform the functions worldwide that they were performing.

Senator GRAVEL. Worldwide—we are talking about Project Independence, not Project Arabia.

Secretary SIMON. Now that is what we talk about. What is needed if you believe that the free enterprise system——

Senator GRAVEL. But the last 15 years has seen a flight of capital from this country in energy, and we look to investment tax credits and all of these other, what I think are really red herrings in the issue. But look at the fundamentals—it has not been a problem to invest in oil and gas in the United States.

Secretary SIMON. The fundamentals are it has been a hell of a lot more profitable to invest overseas.

Senator GRAVEL. Right, or in Pepsi-Cola or in Coca-Cola.

Secretary SIMON. Yes.

Senator GRAVEL. Right. So since there is a flight of capital, what is being done to enable the private area to raise this $500 billion?

And that is why I was saying that your earlier statement was theoretical. I want to know how much money is going to be raised this

year to meet this increment of the private sector's responsibility for the next 10 years?

The figure I have is somewhere between $5 and $8 billion which is going into plant expansions to meet these independent needs.

Secretary SIMON. Senator, I think what is going on in the marketplace right now as far as our energy industry domestically is concerned speaks for itself. We have controlled oil at $5.25 versus controlled oil at $3.40 a year and a half ago, and the new and matched barrel, trading around $10, which have acted as the incentive to attract needed investment in this area. Drilling is up 40 percent this year.

Look at the prices we are getting for our leases.

Senator GRAVEL. That is because of the deregulation of oil. That is because of $9-a-barrel oil. That is why they are drilling more, is that not right?

Secretary SIMON. And also the $5.25, to a slight degree. But basically, for the free market price, I agree with you.

Senator GRAVEL. But in quantitative terms, I go back to the figure I just gave you, between $5 and $8 billion going into this area. You just multiply it out by 10 years, it is $80 billion. That is $420 billion shy of what the private sector needs to do the job.

Secretary SIMON. Well, there again you are using estimates. We do not know whether it is $8 billion or $7 or even $10 billion in the overall industry, because one cannot get the total handle on what the independents are making as far as these small partnerships, et cetera.

Senator GRAVEL. Well, I am not off that much—give or take $2 billion. We are still $400 billion shy.

Where is that money going to come from?

Secretary SIMON. I do not have the numbers of the independent sector because I guess we would have to go through every tax return of every oil owner, of which there are hundreds of thousands in this country, to assess the independents. They raise a significant amount in this country, and if we allow profitability in that industry they are going to continue to be able to attract this investment.

Senator GRAVEL. The Congress has not indicated any disposition toward that. In fact, we passed a law to roll back the price of oil.

Now, how can we, as public officials, sit here and talk about incentives to industry when the Nation cries out for exactly the opposite policy?

Secretary SIMON. The President vetoed that law and they are still attracting this investment, enabling them to have a market for this new investment.

Senator GRAVEL. That is the point I am making, that investment is somewhere between $5 and $8 billion, and that is not even near enough to do the job. I just point that out.

SENATOR GRAVEL'S BONUS BIDDING AND SOLAR ENERGY AMENDMENT

Let me not use up any more time, but give you, Mr. Secretary, two amendments that I have prepared. One is to discontinue the present practice of bonus bidding, and I would like Treasury's comments on that because I think it is ridiculous to rob Peter to pay Paul. We don't want the oil companies to make excessive profits, but we want

them to do a job. So I see no point in taking money from them, putting it in the Treasury Department, then finding another way to get it to them. Let us let them put that money into the ground and find new oil so the American people can get that oil. That is one of the amendments I have.

The other is for solar energy. Now, I think Senator Ribicoff or others brought up the problem, how do we get people moving in the solar direction? I do not mean just mirrors on your roof. I am talking about hydrogen cells and that whole gamut of areas. I have an amendment here which would permit Mr. John Q. Public, who owns a home or who lives in an apartment, to take a $3,000 tax deduction if he transfers his heating and cooling system into a solar system.

Now, I think this would create a whole new industry in this country, create jobs and get us moving in an alternate method. I would like the comments of Treasury, because I intend to offer this amendment the first opportunity on the floor of the Senate. It will be a step in getting this Nation moving in an intelligent direction.

Secretary SIMON. I would be delighted to look at that. I am especially interested in——

Senator GRAVEL. Well, I will give you these amendments, because these comments will be used in the course of debate. If they are negative comments, well, fine, I think we will continue even if they are negative. I want to caution you in this regard: We are in danger of continuing in the do-nothing policy that exists in the Congress and in the administration with respect to energy. The words of Project Independence will be nothing but rhetoric and the American people will find this out as we go deeper and deeper into the fiscal problems of the balance of payments, which I think you truly recognize.

Thank you, Mr. Secretary.

Secretary SIMON. Thank you, Senator.

The CHAIRMAN. Senator Dole?

Senator DOLE. I do not have any questions. I had to be absent for about 50 minutes, and you probably covered most of the questions anyway with respect to independent producers and also the minimum tax. I think the administration's minimum tax proposals are much more effective than those we have now, and even the proposed changes, and I think it indicates a commitment on the part of the administration and the Secretary to do something about it, something meaningful, not based on emotion but based on the proper approach. And it is now 12:30, and I will forgo any questioning.

NEED FOR ENERGY INDEPENDENCE

The CHAIRMAN. Mr. Secretary, I would just like to come back to one or two things that have not been covered so far. I for one have been making speeches for about 20 years trying to tell people that if we did not have the capacity to produce our requirements of energy in this country it could lead to some very unsatisfactory results, to say the least. When the Suez Canal was closed at the time of the first Israeli-Arab fight, we had enough surplus capacity on hand that the public did not even know that foreign oil had been shut off. In fact, we had enough surplus to go to the aid of friendly countries around the world.

Then we had another case or two of that sort of thing while we still had enough capacity that we could make it. But when the industry continued to operate on the economics that made it far more profitable to produce overseas than produce here, and a lot of good economists with good credentials were saying that we ought to be buying our oil in the world market because it could be produced there more cheaply, we found out what it means when these foregin countries were able to impose a national cartel, not a company cartel but a national cartel, price on world oil. And we really did not feel the full bite of it even then because we still had about one-third of those foreign imports coming in, did we not?

Secretary SIMON. Yes, sir.

The CHAIRMAN. Now, to cut off the other two-thirds, those lines 4 blocks long would have been nothing compared with what we would have had to contend with when we struggled through that situation last winter.

Is that a fair statement?

Secretary SIMON. Yes, sir.

RESIDENTIAL VETO OF OIL PRICE ROLLBACK BILL

The CHAIRMAN. Now, you were the Energy Administrator and you tried to move toward an independence in this country during that period of time. The popular conception, including, I think, even the majority of people in Louisiana, still thought that this was something that the oil companies had contrived in order to find a way to impose a price increase on the public. That in turn led to the Congress voting through a rollback on the price of oil, which the President vetoed.

Why did you recommend that he veto the price rollback?

Secretary SIMON. Because it would have created longer lines and I had enough troubles at that time anyway.

The CHAIRMAN. Was it not a fact that you simply were looking at what it would take to attract capital to find more energy, and if you rolled back the price that would mean less energy here in the United States rather than more energy?

EFFECT OF REMOVAL OF THE DEPLETION ALLOWANCE

Is it not true that the depletion allowance has been discounted in the marketplace a long time ago?

Secretary SIMON. There is no doubt about that, and I think that the very fact that some of your major oil companies today are calling for the removal of the depletion allowance is very illustrative of that fact. It has been a millstone around their neck and they do not get any benefit from it. So remove it.

The CHAIRMAN. But look at who said that, Atlantic Richfield, and look at their big developmental costs in Alaska and look at what their foreign tax credit was worth to them in their overseas operations.

Would you mind taking a look at their tax return and see whether it really would have cost them any money to repeal that depletion allowance, if yon look at their overall operation?

Do I have to get a request from this entire committee for you to take a look at that tax return?

Secretary SIMON. No, sir. I promise you I will.
It has not been used in the foreign countries, has it Fred?
Mr. HICKMAN. You are talking about the domestic depletion?
Secretary SIMON. And foreign, overall.
The CHAIRMAN. If you had just repealed the depletion as far as Atlantic Richfield is concerned, would that have made a substantial difference in the taxes they paid?
Mr. HICKMAN. I cannot answer the question.
Why do you not pull the tax returns and try to make a study of it?
The CHAIRMAN. My guess is it would not have meant much of a tax increase for them, and it would have had the advantage of putting out of business a lot of their independent competitors. Now, I am told by the independent producers that that type of a tax increase on them which they are in no position to pass along unless the majors raise their prices, means that 50 percent of them will have to go out of business.
So it might very well serve Atlantic Richfield's purpose to reduce the competition in the industry, while at the same time repealing a provision of the tax law that does not mean very much to them.
Mr. HICKMAN. It is hard to see, Senator, how they could fail to have their taxes go up if domestic depletion were eliminated. The credit does not really do anything with respect to the U.S. source income. But maybe.
The CHAIRMAN. Well, if you take a look at their developmental expenses and you take a look at their foreign tax credits and their overseas operations——
Mr. HICKMAN. That would not affect the domestic situation. That would affect other foreign operations, but not domestic.
The CHAIRMAN. Well, if they have enough developmental expense, enough depreciation on their filling stations, enough depreciation on their pipelines and the refineries, it just might not make any substantial difference to them, especially if they can anticipate an increase in the price of oil to go along with it.
Mr. HICKMAN. That is right, any time you get a price increase in lieu of a subsidy you are all right.

MAJOR OIL COMPANY PROFITS SEEN HURTING INDEPENDENTS

The CHAIRMAN. Well, so far the independents say that what has been happening here is that the majors are reporting windfall profits on their foreign oil. A lot of those so-called windfall profits are a mere bookkeeping profit resulting from devaluation of the dollar.
Is that not correct?
Mr. HICKMAN. Yes, that is correct. There is a substantial amount of that in the foreign earnings of large companies.
The CHAIRMAN. Because the dollar is worth less they collect more dollars and the result then makes them appear to have made more money.
You are familiar with that?
Mr. HICKMAN. Yes.
The CHAIRMAN. In addition to that, they had inventory in the pipelines, oil at sea, oil in their tank farms, oil in their refineries, even

oil in the filling station tanks that had not yet been sold, so the price increase caused a great deal of profits by the increase in the value of the inventory when the Arabs increased their price.

Is that not correct?

Mr. HICKMAN. That is right.

The CHAIRMAN. All right.

Now, the independents will be saying to us that here were unexpected profits that the major companies achieved, especially in their foreign oil. But the proposed response to that is to punish somebody, and that the people about to be punished are the independents who are not making the windfall profits.

You are familiar with that problem?

Mr. HICKMAN. Yes. I think it is true that the large companies have a major portion of the increase in their profits attributable to what has happened abroad. It is also true that most—some 70 to 80 percent—of what they produce abroad they sell abroad. They sell to the Japanese, the Germans, and so forth. So we do not have in that situation—to the extent that it is sold abroad—the American consumer paying the price of these additional profits. The windfall tax that the administration proposed was based on the premise that the American consumer was footing the bill for the increased price of domestic production, which had risen to abnormally high levels, and that in fairness to the American consumer we should return part of that to the Government.

We did not apply the tax or did not propose to apply the tax aboard, because the American consumer was not bearing the brunt of that. There really was no reason why we should penalize American companies if they made profits selling to the Japanese and the Germans at the same price that the German and Japanese companies sold to their own nations. In addition to that the OPEC nations were exacting their own windfall profits taxes in the form of higher prices as fast as they could figure out what they should be. And as Mr. Simon referred to earlier, they still do not know retroactively for the last year what the price to some of the foreign governments will be for some of the oil that they produced. So the foreign situation is clearly a different one. But the windfall tax that we were directed to was on production here, because that is what the American consumer was footing the bill for. It was on the prices of domestic production, and both the large companies and the small were getting the prices and would pay the tax.

The CHAIRMAN. Gulf Oil Co. bought an ad in the Washington newspapers in which they said that if you separated out the profits made from foreign oil from their income, and then you separate out the profits they made in their chemical operations and their refinery operations, and with their filling stations, and then took a look at how much they made with their oil production operations, they made less money producing oil in this country this year than they did the year before.

Are you familiar with that?

Mr. HICKMAN. Yes, I am familiar with that, and I think their position is that they really had some very large losses. They did not do well domestically.

SEPARATING FOREIGN OIL PROFITS FROM DOMESTIC PROFITS

The CHAIRMAN. Now, have I asked that you make some effort to separate the profits in domestic oil from those in foreign oil?

Are you making any headway with that?

Secretary SIMON. Yes, sir. We are getting those numbers from the companies. We have to call each one, and their accounting system is very intricate, and it is broken down into refineries, tankers, and all the rest of it. So we are compiling that now. That is going to be part of our study.

The CHAIRMAN. I think that the Congress ought to know when it votes on this matter what the best information is on that subject. It is my understanding that there have been large profits in tanker rates and shipment of oil on the high seas, because there has been a scarcity of tankers. There have been large profits because of devaluation of the dollar. There have been large profits because the Arabs insisted on a tremendous increase in the national take of their countries. And there have been profits because of the increase of the value of inventories resulting from all of that.

But it would seem to me that to punish the domestic producer who is the one that we can control and the one who is holding the price of energy down domestically to the equivalent of four dollars a barrel, when you average oil in for gas, is a very unfair thing to do just because somebody over whom he has no control and with whom he has no business to do is charging $9.50 for a barrel of oil produced in Saudi Arabia.

Do you agree with that?

Mr. HICKMAN. Well, I think so far as our tax is concerned, we were not attempting to penalize anyone. What we were attempting to do was to collect back for the government a part of the windfall that resulted from abnormally high prices on oil sold to American consumers.

Secretary SIMON. Without removing the incentive for drilling. A year and a half ago prices were controlled at $3.40. and if the windfall tax came into play after 3 years, which we estimated to be the long-term supply price, that appeared to be very adequate.

The CHAIRMAN. But that is not what I am addressing myself to. I am looking at a situation such as an oil man told me about where he had committed to him $12 million to go out and drill for more oil, and when all of the legislative proposals came in—to remove the depletion allowance, roll back the price of the oil, to do these various and sundry things to punish the domestic producer for the sins of somebody in Saudi Arabia somewhere, where has has never been and never expects to go—that his whole $12 million dried up.

Secretary SIMON. I can believe that. Everyone in that industry back in January and February at the height of the emotion, with all of the proposals, as you say, being put forward, they had no idea what was going to happen to the industry. It seems that it is a shame, but the word "profitability" has become a dirty word today in our country in many industries. If we do not allow our companies, big, small, and medium, to earn an adequate rate of return, the consumer is just going to pay the price in the final analysis.

The CHAIRMAN. That man further told me that he went to a chemical company that does not have much oil production, if any, and they agreed that they would find him $12 million to go drill for oil, provided that this man would provide the oil that he would find to the chemical company. Now, he tells me that with the allocation law he will not be able to do that. So his $12 million is gone all over again, and his only hope is that the allocation law would expire next year.

What advice can I give him?

Secretary SIMON. We hope you will let it expire.

The CHAIRMAN. Well, thank you very much, Mr. Secretary. I think you have made a very fine presentation before us. I apologize for imposing on you. I know you are a very busy man.

Secretary SIMON. It is always a pleasure, sir.

[Whereupon, at 12:40 p.m., the hearing recessed, to reconvene at 10 a.m., June 6, 1974.]

TAX INCREASE PROPOSALS

THURSDAY, JUNE 6, 1974

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 10:10 a.m., in room 2221, Dirksen Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Byrd, Jr., of Virginia, Mondale, Gravel, Bentsen, Bennett, Fannin, Hansen, and Dole.

The CHAIRMAN. This hearing will come to order.

Is Senator Dewey Bartlett in the room?

Senator, we would be very pleased to hear from you today on the various tax reform proposals that we are in the prospect of voting on in the near future.

STATEMENT OF HON. DEWEY F. BARTLETT, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

DEPLETION ALLOWANCE

Senator BARTLETT. Mr. Chairman, members of the committee, I am pleased to have the opportunity to address the members of this committee on the subject that is all-important to the consumers of the United States if they are to have adequate energy supplies at a reasonable price.

As you well know, the depletion allowance was devised as a method of fair income tax treatment towards the extractive industries, and has been in effect since the first income tax law was enacted under the 16th amendment to the Constitution in 1913.

I suppose if you refer to the depletion allowance as a loophole, you could also refer to the income tax as a loophole in the taxpayers pocket.

Although the method of calculation of the depletion allowance has been revised and lengthy debate over the merits of the depletion allowance has occurred through the years, the basic concept of fair and equitable tax treatment for a depletable asset has continued for over 60 years.

Aside from the fair tax treatment issue, the committee will also through testimony be able to determine the effects of the depletion allowance to judge whether they are desirable or undesirable—if they are in the consumer's best interest or not. I know that the committee is seeking information from all interested parties—independent producers, major oil companies, as well as consumers. I hope the list of witnesses will also include representatives of the royalty owners.

There is one inescapable fact—reducing the depletion allowance would increase energy prices for consumers in the United States. If the higher costs of operation reflected by the increase in taxes are not passed on to the consumer in the form of an increase in the price of domestic crude oil, then all exploration activity will be sharply reduced. If oil field activity is reduced, then we must depend upon importing more unreliable and high-priced foreign oil. So it is inescapable etiher way—the consumer will be faced with higher prices.

The last 9 months have been very emotional. For the first time Americans have been faced with a shortage of energy supplies which have been taken for granted during prior years. Constructive action is needed to overcome our energy deficiency. This is no time for punitive action aimed verbally at the major oil companies but actually hitting the independent producers and consumers. The recent increases in major oil company profits have been earned overseas—not from the depletion allowance.

This is a time for incentives, not disincentives. The uncertainty created by Congress with proposed rollbacks and tax revisions can only serve to delay the domestic activity that could further relieve our dependence upon unreliable and high priced foreign oil. The petroleum industry should be given the green light, not a blinking orange light.

Any reduction in the depletion allowance would be far more disastrous to the exploratory activities of the independent producer than it would be to those of the major oil company. I am sure subsequent testimony by independent producers will bear that out.

Reducing the depletion allowance would definitely decrease competition in the petroleum producing industry. The independent operator drills about 80 percent of all domestic wells. He depends to a great extent upon outside capital to finance these high risk, oil finding ventures.

A reduction in the depletion allowance would severely hamper an independent's ability to acquire this outside capital, and I say this, even if the additional costs were passed on to the consumer. This is because of the tax advantages to a prospective investor in a high risk venture.

Also, the independent operator produces an estimated 80 percent of the domestic stripper well production—those wells which are marginally economic. A small reduction in the cash flow of this marginal production could mean the difference between continued production and abandonment of many of these leases.

This committee should attempt to define the effects of lowering the depletion allowance from 27.5 to 22 percent in 1969. My information is that domestic expenditures decreased about $500 million because of this decrease in the depletion allowance, which had the effect of reducing the value of crude oil by approximately 17 cents a barrel.

This was the final blow to many independents, whose numbers were reduced from 20,000 to 10,000 over a 15-year period ending in the early seventies by low profits resulting from the Government policies during that period.

Another important fact is that the average tax benefit to an oil company is well below the 22 percent of gross income. This is especially

true of the independent operators because the depletion allowance is either 22 percent of the gross income or 50 percent of the net income, whichever is the lesser.

In the latter stage of the life of a producing lease, the operating expenses approach the gross income. The net income becomes small and therefore 50 percent of net income is far less than the 22 percent of gross income. For that reason, several smaller operators in my State estimate that their overall benefits from the depletion allowance average anywhere from 12 to 18 percent—far below the 22 percent figure.

At this time I would like to suggest that the committee consider eliminating or revising the 50 percent of net income limitation on the depletion allowance to allow the continued production of marginally economic production.

During the World War II energy shortage a substantial Federal subsidy of from 20 to 35 cents per barrel of crude oil was paid to producers in order to prolong the life of marginal oil wells, to encourage workovers and infill drillings.

As I have said, the reduction of the depletion allowance has a relatively more severe effect on the independent producer than it would have on the major oil company because the major oil company could partially make up for the decrease in cash flow by raising the prices of refined products. But to the extent that the major oil companies' cash flow would be reduced, capital and therefore investment to increase oil and gas and alternate energy supplies would be restricted.

Energy Self-Sufficiency and Oil Company Profits

This Nation is not going to develop domestic energy self-sufficiency unless the necessary capital commitments are made. The capital requirements, as I am sure the chairman knows, are staggering. These capital requirements can only be filled if there is adequate cash flow to sustain equity commitments and debt service.

In other words, the borrowing ability of the industry depends upon its cash flow. Therefore, the ability of the petroleum industry to respond to our energy needs depends upon the combination of factors that make up cash flow—net profits, depletion allowance, intangible charge-offs, and return of capital through depreciation.

It is important to note that major oil company profits, which appear to be the general stimulus to criticism of the petroleum industry, have not occurred because of the depletion allowance. John Winger of the Chase Manhattan Bank has explained very aptly in a paper entitled "The Profit Situation" that the major oil company profits have in general occurred on foreign operations because of factors over which the major oil companies had no control—principally devaluation of the dollar and price increases established by the OPEC countries.

Foreign tax credits are much more important than the depletion allowance to enable the major American oil companies to compete successfully with foreign oil companies on a worldwide basis.

Mr. Chairman, I request that the article I mentioned by John Winger, "The Profit Situation", and a recent study by the Petroleum Information Research Foundation Inc. on foreign tax credits be inserted into the record at the conclusion of my remarks.

The CHAIRMAN. Without objection, that will be done.

Senator BARTLETT. In 1973 more than 85 percent of the increase in profits of the 30 largest oil companies resulted from profits realized

outside the United States. The 30 major multinational oil companies earned in 1973 $4.354 billion in the United States and $7.368 billion in the rest of the world. Compared to 1972, that was only a 19.1 percent increase domestically and a substantial 130 percent increase in profits from the rest of the world.

Much of the profit from foreign operations is being reinvested in domestic operations. Over the past 5 years expenditures domestically have exceeded domestic profits by 80.6 percent. The same companies expended on foreign investments 47.7 percent more than their foreign profits. It can readily be seen that the ratio of expenditures to profits demonstrates that the major petroleum companies are committed to increasing domestic production. It can be seen that profits from foreign operations are to a significant extent subsidizing domestic investments.

Tax Treatment of Royalty Owners

Mr. Chairman, last but not least, I would hope that the committee will address itself to the interests of the royalty owners—these, of course, mostly are landowners, as you know—to make sure that they receive fair and equitable tax treatment upon the selling of their irreplaceable assets. The rights of the royalty owners, the original mineral interest owners, are often overshadowed by the interests of the producers and consumers.

Mr. Chairman, I am sure that this committee intends to investigate fully the effects of changes in the existing tax treatment for all concerned.

Mr. Chairman, I might add, as far as royalty owners are concerned, there are an estimated 500,000 in the country.

The average price of domestic crude oil has increased substantially—but the principal cost of oil and gas exploration has skyrocketed, too. The prices of steel tubular goods, oil and gas leases and contract drilling have more than doubled for many operators in recent months.

The rate of drilling oil and gas wells has increased substantially this year. There is a real momentum and confidence developing in an industry which has been squeezed dry by 20 years of direct and indirect price controls.

The stability of any industry is important to maximizing its capital investment. This is particularly true of a high risk industry.

Reducing the depletion allowance will continue the instability of this oil industry and jeopardize the increasing momentum of the current exploratory effort.

In order to achieve energy self-sufficiency, the oil and gas industry needs a consensus of support from the Congress, not a consensus of punishment.

If the goal of legislation to lower or eliminate the depletion allowance is to punish the multinational oil companies, the sponsors of this legislation may as well forget it. The effect will be like trying to sink a battleship with a bow and arrow.

But there would be an effect—which I believe would be disastrous—the major oil companies would end up with a larger share of the oil industry and the independents a smaller share. There would be many less independents. There would be decreasing competition in the petroleum industry.

Mr. Chairman, I appreciate this opportunity to address the committee.

The CHAIRMAN. Thank you very much for a good, well-reasoned statement, Senator.

DEPLETION ALLOWANCE

I find it unfortunate that there is so much misunderstanding about percentage depletion. I hear some people speaking of it who still do not know what it is, debating against it without knowing what it is. They say it has been shown that somebody depleted a well two or three or four or five times over. When one says that, of course, he without realizing it confesses he does not know what percentage depletion is, because, if you are working on the concept that you should be permitted to deplete the well, then you are talking about 100 percent depletion. You are not talking about 22 percent, because if it is the well you are depleting you are entitled to deplete your entire cost.

Is that not right?

And out on the continental shelf, as I understand it, where these companies are paying as much as $200 million for a lease, it is to their advantage in many cases to take cost depletion, is that not correct?

Senator BARTLETT. That is correct.

The CHAIRMAN. Cost depletion in those cases is to their advantage. But percentage depletion is taken against the resource. It is for the mineral that is in the ground, and it is based on the theory that you need to set aside something to go out and find more, because you are going to be out of business when you have taken out of the ground what is there. Now, no one has argued that there should not be cost depletion.

Do you know of anybody that contends that you should not have cost depletion?

That is all agreed, is it not?

Senator BARTLETT. Yes, sir.

The CHAIRMAN. I have not seen anybody dispute that, thank the Lord. They do seem to understand what cost depletion is.

Now, with regard to percentage depletion, if you are going to totally repeal percentage depletion allowances you will see a lot more cost depletion, obviously. What would happen is that someone who has some oil would sell it to someone else and take a capital gain, since on balance, if he could sell it for what it is really worth, he would actually have more favorable tax treatment than he would with a depletion allowance.

But you and I know what the difficulty there is, do we not? It is that when a geologist estimates what is there he is invariably going to estimate far less than is actually down there because if he ever estimated on the high side nobody would ever hire him again.

Is that not about the size of it?

Senator BARTLETT. That is right.

The CHAIRMAN. No bank would ever trust him to make a loan and no purchaser would ever hire him. So that if a person sells for capital gain he just leaves a great deal of money on the table. The estimate does not include a great deal of oil that can be recovered, and furthermore it gives him nothing for the possibility that if you drill down deeply you might find more oil in the same structure.

That is correct too, is it not?

Senator BARTLETT. It very definitely is, and I think this would result, Mr. Chairman, as you indicated, in the selling of production,

which undoubtedly would add to the production of the major oil companies and reduce that of the independents. So I think it would be a concentration of more of the production in the hands of the bigger companies.

The CHAIRMAN. If percentage depletion is repealed, would that not necessarily force the independents to sell off a great deal more of their production if they find something, rather than to pay a 70 percent tax on it?

Senator BARTLETT. Yes.

The CHAIRMAN. And that, of course, brings about the concentration in the industry that a lot of people would like to avoid. I for one think it is bad to keep moving toward greater and greater concentration in the industry. That is not good for the consumer or anybody else, is it?

Senator BARTLETT. That is right, and the oil industry as it is presently constituted has a very low concentration factor. We have just been having hearings on the divestiture problem, and the facts we have show that it ranks very low among the major industries.

The CHAIRMAN. Now, as far as that landowner is concerned, if he owns enough land to where he can call the terms and write his own lease on his own terms—in other words, he has enough resources so he can either pay somebody to drill it for him or else write the lease just exactly the way he wants it, rather than signing up on somebody else's lease, if he is not going to have his percentage depletion, is it not to his advantage, then, to string out the production over a long, long period of time rather than to produce it in a hurry?

Senator BARTLETT. Yes, sir. It would be, very definitely.

The CHAIRMAN. The longer he spreads it out, the more he would tend to hold down his tax bracket for tax purposes.

The CHAIRMAN. And of course, if he wanted to borrow a lot of money during all of that time, I do think he could borrow money against the resource, and the interest expense would be deductible.

Senator BARTLETT. Yes, correct.

The CHAIRMAN. Now, it has occurred to me that as far as that landowner is concerned, if he is not going to have a percentage depletion allowance, recognizing the fact that when his oil is gone it is all gone, that he ought to be given the same consideration he is given under the law if he is selling land by the acre. He should just be permitted to sell the oil by the barrel and take his capital gain on it, rather than be forced to sell a fractional interest to get capital gain, because when he sells a fractional interest he takes that very horrible beating that you and I have been discussing. And you do not think that is fair and neither do I that he would be forced to make a sale where he is only being paid for about half of what he is really selling.

Senator BARTLETT. I agree, and I think it is significant that the landowner cannot pass it on. He cannot pass the increase in his taxes on to anybody else. He just pays Uncle Sam that much more.

The CHAIRMAN. Well now, is there any doubt at all that if the tax increase is passed on through, there will have to be an increase in the price at the pump, and the housewife who is using fuel oil will have to pay more, and the Federal Power Commission will have no choice but to permit the people producing gas to raise the price of gas?

Senator BARTLETT. Absolutely, because if the price was not passed on directly, as it probably would not, but if it was not then there would

be less exploratory activity and we would have to import more higher-priced oil. So either way the price will rise to the consumer, and either way there would probably be reduced activity, so we would have that much more dependency on foreign oil.

The CHAIRMAN. If you are doing that as a corporation in the 48-percent tax bracket, it would appear to me that means that the price is going to have to go up by around $1.35 a barrel in order for the companies to make back what they are losing by increasing the price. Now, some people think that is a good thing. But I think that the consumer ought to be advised that he is the one who is going to have to pay this tax.

Senator BARTLETT. Absolutely.

The CHAIRMAN. It seems to me if you assume the Federal Power Commission is doing the job that it feels that the court assigned it to regulate gas at the price that would permit a fair return, then if there is going to be a big tax increase the Commission has no choice. They have to permit the companies to raise the price. And I would think the same thing is true if FEO is regulating the price of oil where it ought to be for the industry to survive: they have no choice but to raise that price when the tax goes up.

Senator BARTLETT. I agree, and I think that the 30 percent that is free market at the present time would respond also, and go up.

The CHAIRMAN. Now, I have talked to some very good economists who say that if it had never been for the depletion allowance, then it all would have gone to the price of oil. Now, if that had been the case I think they should advertise, look, Ms. Housewife, Mr. Automobile Owner, when Congress votes this they are voting to raise the price of gasoline 3 cents a gallon at a minimum at the pump. And Ms. Housewife up there in New England, when you buy your heating oil, that Congress is voting to give you a 3-cent-a-gallon increase on the heating oil for next winter.

So for those economists who find it no problem to just raise the price, that is what it means. The price goes up, and Congress votes to raise the price when they vote to raise the tax.

Senator BARTLETT. That is absolutely correct.

The CHAIRMAN. Senator Bennett?

Senator BENNETT. I did not hear Senator Bartlett, so I have no questions. I actually have no questions anyhow.

The CHAIRMAN. Senator Fannin?

I want to commend Senator Bartlett for an excellent statement and bringing in perspective just what we are up against. I know of his expertise in this field, and when he says this is the time for incentive and not disincentive I agree wholeheartedly. And we can look back to 1969 when we did pass the Tax Reform Act and we had the cutback that he referred to, and I notice that the figures on oil and gas production, that the taxes that would raise more than 4 percent of the gross revenue have an effect on profits equivalent to a cut of 9 percent on prices.

Now, is not one of the great problems we face the uncertainty that exists today as to just what is going to be done by the Congress?

Consequently, many of the companies are not going forward with developments. If a man is going to invest his money he has to have pretty good assurance he has a chance for return. If you are going to

cut off that chance of return by more than just the risk of drilling the well and being able to benefit by what he finds, and especially considering that 90 percent of the exploratory wells are dry holes, then is not this quite a factor now that we must overcome?

Senator BARTLETT. Yes, I think particularly in a high-risk industry. I think a lot of oil people have described the current conditions as the best of times and the worst of times for them.

The price certainly has been good in the last several months compared to what it has been in the last 20 years. But on the other hand there has been no consensus of the Congress supporting the status quo of the $5.25 price per barrel of old oil, and the free market of about 30 percent of the domestic production—there are all kinds of threats in Congress such as the depletion allowance cut or reduction or elimination that creates this uncertainty. And I think until we go get a consensus of support and in a specific direction, the ability of the oil industry to function at a maximum efficient rate will be hampered.

Senator FANNIN. Well, when we are talking about the risk capital, I know that in the State the Senator very capably represents they have had pretty good luck so far as oil wells are concerned. But, still, your percentages are as you have stated. In my State of Arizona, I could quote percentages that would be much more devastating, because we have had oil wells drilled over the years and they were cut back just about in ratio to the depletion allowance change from 27.5 to 22 percent. Our exploration, our new well drillings were cut back, and of course all we have had is dry holes so far, and the only oil is what has leaked over from New Mexico across the Navajo Reservation. I felt sorry for the Navajoes.

But we do have a very serious problem in getting new exploration and getting the risk capital invested.

Do you not think that if we continue to cut down or cut back on depletion allowances, that we risk the possibility, that the independents are going to cut back in their drilling operations?

Senator BARTLETT. Yes; and I think we will see the demise of many independents because they rely on outside capital for the lion's share of the capital used. Outside investors, because of the depletion allowance and other tax advantages, find it attractive to invest in a high-risk industry, and even if the prices, the costs, were passed on with price increases, there would be a reduction in the exploratory effort because of the inability of independents to raise the necessary capital, and the reduction of the independents would reduce the overall number of wells drilled.

As you well know, the number of wells drilled by independents in this country approaches about 82 percent of the total. So I think it is one thing to say, "pass it on and let us remove this loophole." But this is based on what was considered to be equitable treatment for taxation at the very beginning of the income tax. It recognizes a depletable asset, and I think it has worked out to the advantage of the citizen and the consumer in this country of having available plentiful supplies of energy at reasonable prices.

Senator FANNIN. I agree with you, Senator. The established procedure for encouraging investment capital, risk capital, and every time we change we interfere with that procedure would mean there would have to be a readjustment period. So when we need it the most we would have the least chance of being able to go forward with the energy independence program.

But I certainly commend the Senator for his statement and for the very diligent efforts he is making in trying to overcome this problem.

Senator BARTLETT. Thank you.

The CHAIRMAN. Senator Mondale?

Senator MONDALE. Thank you, Mr. Chairman.

OIL PRICES

I think we would all agree that we want a healthy domestic oil industry and we want enough incentive to that industry to make it profitable and to encourage exploration, to help lead toward further national self-sufficiency in energy. The question that many of us have had who have been urging price rollbacks—and because that failed perhaps reduction in the tax preferences—is the question of, when is enough enough. Now, about 1½ years ago, I believe domestic oil was bringing a price of $3.50, somewhere in there.

Today so-called old oil is bringing $5.25 and deregulated oil, new oil, is bringing $9, $10, something like that.

Where is the line at which the industry has enough money and the consumer might at that point be entitled to a price break or the taxpayer be entitled to some reduction of preferences?

Senator BARTLETT. Well, I think the question of when is enough enough is a very good one, and I think the economists agree almost unanimously that it cannot be determined precisely, and therefore a free market is essential. I think it is significant at the present time that we do not have a free market in this one area, and it is the only area where we have a controlled price in our entire economy. We could see the results of the controlled price on natural gas and then the indirect control on oil for a period of 20 years, showing a very steady decline in drilling, a steady decline in reserves, a steady decline in the available capital. Then, right after 13 years of a constant price or less for oil, the depletion allowance was lowered in 1969, and what did that do? That just made a big further drop in drilling activity, a further drop in the number of wells drilled and found, and necessitated a price increase at that point to try to compensate.

So I think the history of the 1969 reduction, which was a small reduction compared to what some people have in mind, shows what will happen. The prices will go up. The activity will go down, and the consumer, in my opinion, is not going to be well off. I think the consumer has two interests, the one which you stated, which is a fair price, a low price—I think the other is for the consumer to have an available supply. So I feel the proper goal is an available supply at a reasonable price.

Now, only 30 percent of the domestic oil today is in a free market. The rest is controlled at $5.25.

Senator MONDALE. Now, when you talk about price rollbacks, Senator Hansen on page S. 13438 introduced into the record a letter by John Miller, president of the National Stripper Well Association, dated May 1972, in which he said, "substantial, prolonged results would be gained from a realistic crude price increase to $5 a barrel." We are now at $10, because stripper wells are deregulated.

Is that not a statement by the industry itself that indicates that the price now is well above what they themselves expected would be neces-

sary to bring forth the incentives needed to sustain increased production?

Senator BARTLETT. Well, I think it is like the wheat producer in Oklahoma, and I would imagine Minnesota. When wheat was $1.30 just a short time ago, he thought $1.80 sounded pretty good. Then when it got to be $5, he was quite surprised, but nonetheless that was the result of thousands and thousands of transactions, and of course. particularly the sale in Russia had an effect on it.

Meat in the same way. The price of cattle went up, and I think the cattle producers, ranchers, in our State at least, were surprised how the price of cattle went. They were also surprised when it went down.

I think the important thing is that——

Senator MONDALE. That is to say that people would like more rather than less. I think we all know that is true of human nature. But what I am trying to get through is, what is the point at which enough is enough?

Senator BARTLETT. Well, I think the point that your example makes is that it takes the thousands and thousands of transactions in the free market to establish the price, and when a few people take it upon their own shoulders to establish one, they invariably establish it too low to produce a market clearing price in their interest to serve the consumer.

Senator MONDALE. Does that not bring us, though, to the second complication, and that is that OPEC is a classic cartel. It has nothing to do with the free market. They have rigged the international price of oil far beyond anything that free market forces would dictate. They have done it for political purposes and practically say so. And in our own country the Federal Trade Commission has charged the major oil companies with monopolistic concentration.

Would you say that our oil industry can be fairly characterized as a free and independent industry?

Senator Bartlett. Oh, absolutely. The Supreme Court, which I think is the proper judge, ruled very recently, or stated in a ruling very recently, that the oil industry is competitive. The concentration of the oil industry——

Senator MONDALE. What case was that?

Senator BARTLETT. I will furnish it for the record.

Senator MONDALE. You are not talking about the Standard Oil case of 1906?

Senator BARTLETT. We will provide that for the record. The chairman may be familiar with that. It is a Louisiana case.

Senator MONDALE. I, too, think the free market is a better determinant of price than the Government or anybody else if you have a free market. But I am not convinced that that is what we have. Now I think we have a very tight market situation. The OPEC countries have put the screws to us and it is a critical commodity. Energy is like air and water. People have to have it. It is the kind of area which is traditionally considered for the possibility of utility regulation for that reason, and I think the price performance in light of OPEC sustains that position. Its delivered price to the oil industry on the deregulated

portion of domestic production was double what their own industry said they needed 2 years ago.

Now, what have we gotten for these higher prices?

The figures I see show that production in this country has dropped. A recent story in the New York Times says that the policy introduced last summer to spur greater production of domestic crude oil by allowing its price to rise has failed to provide more oil. It has enabled the Nation's big oil companies to raise the prices of their own crude oil supply and pass those higher prices along to consumers of gasoline and fuel oil. It has provided soaring profits for oil companies.

They also point out that domestic crude oil production has dropped almost 2 percent in the last 9 weeks, even though the price of domestic crude oil has almost tripled in those same 8 months. Now, for the week ending May 17, U.S. crude oil production totaled 8.9 million barrels compared to 9.3 million barrels on May 18, 1973, a drop of 400,000 barrels per day.

So is it true that these higher prices are bringing forth increased production?

Senator BARTLETT. You bet.

Senator MONDALE. Are these figures wrong?

Senator BARTLETT. No. I am sure they are correct. I cannot attest to them, but I accept them.

First, let me comment on your statement again about the member of the industry who estimated the price of $5 oil would be sufficient.

We had testimony before the Interior Committee from five economists, one of whom was there via a telegram, and there was not one of them who supported the rollback in price. All of them thought it would be counterproductive.

Let me try to put this in perspective for you, if I may. If you go back to the year 1954, that was when price controls started for natural gas——

Senator MONDALE. I think natural gas is a different issue. I would like to stay on oil, if we could. We have got regulation there; it has been a different issue.

Senator BARTLETT. Well, it is intertwined with oil, if I may say so. At least that is my opinion. And the price of oil was kept low because the price of gas was kept low, because gas is the superior fuel and the cheapest by one-third the price. So it had a big effect on the price of oil.

The price of oil in 1957 was $3.09 a barrel, and then went down. In 1969 it got back up to $3.09 when the Congress lowered the depletion allowance, which affected it adversely by about 17 cents a barrel. In 1956 the rate of drilling peaked out and then dropped almost regularly every year, to the extent that in 1971 it bottomed out. And there were half as many wells drilled in 1971 as were drilled in 1956. There were roughly half the reserves found.

The demand, though, today compared to 1956 is double. So if you are going to drill today at the rate compared to demand that we drilled in 1956, we would have to increase 400 percent. So you say, what have we done?

Well, in the short time that there has been a reasonable price in the oil industry after a dry period of 20 years, and with the number of

independents being reduced from 20,000 to 10,000, there has been a turnaround in a number of States where individual States' production has increased. In our State, we were in a horrible decline period. We have had a lot of secondary recovery projects, and when those are plugged out, they are high-cost production. Sometimes the leases are making fair amounts; it affects the control of production adversely.

The first thing you have got to do when you are having a rapidly declining production, you have got to stop the decline.

Senator MONDALE. Well, let me just——

Senator BARTLETT. Let me also say, if I may, now, it takes a long leadtime. It is estimated on the average well that it takes 18 months from the time you decide you want to drill a well until you actually complete that well and get it on production. That could be on the short side. So the rate of drilling is up.

We have ample evidence to show that the success of finding oil is tied directly into the number of wells we drill. So there is no question that we are finding more oil because we are drilling more wells, and we are going to keep drilling more wells as long as it is attractive to do so.

Now, it is counterproductive to lower depletion; it is counterproductive to roll back the prices. So if we want to deter the effort that is going, then that is the way to do it. But if we want to help the effort that is going, let us at least keep the status quo.

Senator MONDALE. I understand the theory, but the figures show that we are going in the other direction. In Oklahoma in the weekly figures from May 25, 1973, to May 24, 1974, dropped from 546,000 barrels a day to 521,000 barrels a day.

What explains that?

Senator BARTLETT. Well, when you produce all of the wells in the country today, there is going to be less oil tomorrow. So unless you find some more oil wells to produce by tomorrow, then the production is going to drop. So it takes a certain addition of new production every day just to stay where you are. Or, if you are not finding it a fast enough rate, you will be on a decline curve, as we have been, because of very shortsighted practices over a long period of time. And this is going to continue unless we reverse it.

Now, my feeling is, you know, we are fighting all of the brush fires here, one thing or another, FOGCO, and chartering the foreign corporations, all these different things. I am not convinced that if we just go as we are now that we are going to be coming anywhere near close to raising sufficient capital to do the job that people want the oil industry to do, and I know that you want them to do. But certainly——

Senator MONDALE. But the trouble is, there seems to be a relationship. I do not understand it; that is why I asked for an answer. Why, as prices go up, does production go down?

Senator BARTLETT. The rate of drilling has increased.

Senator MONDALE. I understand that drilling is up. What about the production?

Senator BARTLETT. Obviously, you do not seem to understand it at all.

Senator MONDALE. Try me once more. I have got a limited ability, but I will try to listen. You go ahead. Give it to me once more.

Senator BARTLETT. When an industry has been squeezed as dry as the oil industry has by actions of Congress over a period of time, 20

years, and the action of the courts, then the ability to drill enough wells to take care of the withdrawals from the reservoirs, to take care of depletion of the reservoirs, is not there. And we have to have a certain rate of drilling to just maintain production.

We have to have a higher rate of drilling to increase production. It takes a long leadtime in order to take the capital that has increased in cash flow and convert that into footage drilled and completed wells and oil in tanks and marketed oil. Therefore, you are going to have a delay in the time from the short time we have had the higher prices.

The stripper well amendment, I might remind the Senator, became law on the 16th of November. And yet there were Senators saying in January, why has there not been some increase in stripper production?

Well, you know, you have got to give people a little bit of time to take the decisive actions that are necessary. But nonetheless, it is very interesting in that one area that in 1973 there were the least number of stripper wells plugged in 14 years, showing that there was an immediate response, because people could maintain those wells.

Now, if you did not provide for stripper wells, the free market price, which is close to that of the OPEC price, then we would be plugging out wells that were—whose oil was bringing $6 or $5.25 a barrel domestically, and we would be replacing those barrels with foreign oil at $10.25.

Is that a good exchange? I do not think so.

So I think there is plenty of justification for the stripper well amendment. I think there are plenty of facts and figures to show that the activity is there, that there will be more reserves brought on. But I think there is a big question as to whether the present situation of available capital under the present conditions, the economic conditions, the oil conditions, are sufficient to bring about self-sufficiency.

Senator MONDALE. Are you in the oil industry?

Senator BARTLETT. No. Jack Anderson said I did not sell enough of my interests when I sold everything I owned.

Senator MONDALE. No. I really do not know.

Senator BARTLETT. Well, I used to be.

Senator MONDALE. Why is it that you say 80 percent of the new wells are drilled by independents and not by the majors?

What explains the higher activity by independents?

Senator BARTLETT. Well, the majors during the 20-year period I described, in order to maximize their profits, moved overseas to a greater extent, and, of course, helped to develop cheap foreign oil. The independents stayed in this country and operated but decreased in number. There are 10,000 estimated, 10,000 independents. They drill very shallow wells to very deep wells; some of them are on the Outer Continental Shelf. But the industry is a very competitive industry.

Senator MONDALE. Can you define what is the difference between major oil companies and the independents?

Senator BARTLETT. Oh, yes. There are several definitions. I think any one of them works reasonably well. I define the independents as the non-30-largest. The 30 largest, the multinationals, the major multinationals, and the others are the independents.

Senator MONDALE. Would it make sense, if we wish to have a more competitive oil industry, to try to draw up a distinction in tax treatment between the majors and the independents?

Senator BARTLETT. Well, I think if you did that, and if you are talking about depletion allowance to the extent that the majors have the depletion allowance, would increase their costs and the consumers' costs.

Senator MONDALE. Why is it inevitable that an increased cost to the industry must inevitably be reflected at this point in increased prices, when the profits are so high?

Could there not be some give on the part of the oil companies?

Senator BARTLETT. Well, you say the profits are too high. The large increase, as I point out in my testimony, came from foreign operations. The profits in this country, as the Senator knows, have gone up very definitely. And the oil industry has not had the opportunities it had for 20 years that it has today, but it is also being plagued by threats today that it has not been plagued with during that 20-year period.

But let me try to put the profit picture in perspective, if I may. The profits for the multinationals and the foreign operations, particularly, have gone up rather substantially. But in the first quarter of this year, General Motors profits went down 87 percent, or 85 percent; let us accept that. And view General Motors, say that happened for a year. And let us say next year they got back where they were last year. In other words, they went back just where they were—no higher. There would be a headline in every paper in the country because their increase would be 567 percent.

So what we have had here, comparing the increased profits of the majors and the independents' profits are up on the one hand, and the decrease by General Motors, is the action of the marketplace. I think, on the one hand, it shows that crude oil is in short supply and that there needs to be more capital to develop more crude oil and refined products, refineries and reserves, bring on the oil and fuel.

On the other hand, there is not a need for more automobiles to be produced in Detroit. There is a need for model changes, and so on. So we see the marketplace mechanism operating.

Senator MONDALE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dole has been here for quite a while. If Senator Hansen does not object, I am going to call on Senator Dole next.

Senator HANSEN. Yes, fine.

Senator DOLE. I appreciate very much the testimony from the Senator from Oklahoma, but we have a great number of witnesses, and I am afraid they are never going to get on if I ask questions. So I will wait for some other victim.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. With that sort of statement, I have no choice, Mr. Chairman.

The CHAIRMAN. Well, I was going to ask the witness a number of questions, also. But with that sort leadership, I think I will go along.

Senator BARTLETT. Mr. Chiarman, I thank you very much, and I thank the members of the committee.

The Chairman,

The CHAIRMAN. Thank you.

[The following material was submitted for the record by Senator Bartlett.]

THE PROFIT SITUATION

A Special Petroleum Report

APRIL, 1974

Profits and the Ordinary Man

Ask any man what he would need first if he wanted to get into the petroleum business. He would be virtually certain to say money. He would know he could not start the business without money. And he would also know he would need more money to keep the business going and still more to make it grow.

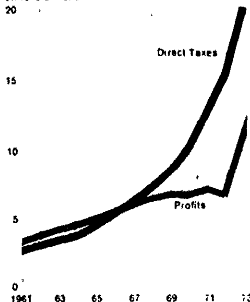
Ask him where he would get the money. And he would be likely to say that he would have to provide most of it himself from his accumulated earnings. He would probably know he could borrow some – but only if he could prove to the lender his ability to repay the loan out of future profits.

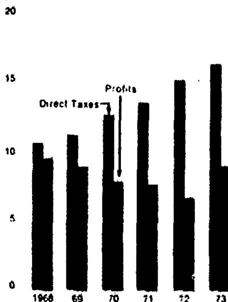
Because he obviously must depend upon them so much, ask him to define profits. Again, he would be likely to respond correctly. He would know that, of the money he took in from the sale of petroleum, only the amount remaining after paying all the costs of doing business, including taxes, would represent his profit. He would be likely to understand that he could expand his business only if his profits were large enough. **And he would also recognize that his business would fail if his profits were too small.**

Despite the fact that most people readily understand their own needs for an adequate income, whether it be salary or profits, many fail to recognize the equal needs of others. Indeed, the extent of the failure to understand the vital importance of the role played by profits in the free enterprise system is appalling. **Because that lack of understanding is now so great, it constitutes a significant threat to the continued existence of the economic system that has served the people of the United States so well in the past.**

The Free Enterprise System

The American economy has been called the eighth wonder of the world because it is based on a historically revolutionary idea: that a society can function, prosper and grow on the basis of free economic choices by individuals. The market place – not government planning – regulates the economy. The desire for private gain and fulfillment, not decree or coercion, is the motivating force. It is a system that has brought to the American people the highest standard of living anywhere on earth. It has worked well because for the most part it has been permitted to function with a minimum of intervention by government. **Yet, despite the demonstrated merits of the system, disturbing changes are being introduced.** With increasing frequency governmental intervention is being substituted for the free choice of individuals in the market place.





Economic Illiteracy

If asked, a vast majority of the people of this nation would doubtless say they believed in the free enterprise system. But how many really understand how it functions? Only a small proportion of all high school and college graduates have ever taken a course that explains the free enterprise system in a meaningful fashion. Former Secretary of Commerce Luther Hodges once said, "If ignorance paid dividends, most Americans could make a fortune out of what they don't know about economics."

Among the most disturbing effects of economic illiteracy is the widespread misunderstanding of the role profit plays in the free enterprise system. In the minds of far too many, unfortunately, profit is a dirty word. There is the strong tendency to think of profits as funds left over from the operations of a business – money to be utilized for any unrelated purpose. Profits, therefore, are regarded as something a business does not really need, or at least something that can be reduced without serious consequences. Many, though they endorse the free enterprise system, nevertheless reject profits. Apparently, their lack of knowledge of economics leaves them unprepared to understand that the American economy cannot function without capital – and there can be no capital without profits. **Indeed, there is the shocking evidence that some are not even able to distinguish between gross revenue and profits.**

How Much Profit?

Even among those who understand the need for profits, there is often the failure to recognize that profits must also grow. With each passing year, our needs for goods and services rise. And if they are to be satisfied in full, our economy must also grow. **But it cannot if profits do not expand too.** Yet, from sources not truly qualified to judge, we frequently hear that profits are too high.

How should the adequacy of profits be judged? There is no simple or permanent benchmark. Under one set of circumstances, profits of a certain size could be judged sufficient. But, given changed circumstances, the same amount of profit could be either too little or too large. No meaningful conclusion can be drawn from a mere measurement of an organization's profits for a limited period of time or the amount of increase over the preceding period. Nor is the rate of return on invested capital by itself a sufficient guide. A knowledgeable management, thoroughly acquainted with every facet of a company's operations and with a carefully planned and detailed projection of future capital expenditures, knows what level of profits will be necessary. **But the casual observer cannot possibly know.** If the profits have been sufficient to provide and attract all the capital required for an extended period of time, they may be deemed to have been adequate – for that period. But, if the company's business is growing, the same amount of profit would be inadequate to serve future needs.

A Dangerous Situation

The inability to judge the adequacy of profits fairly with only a superficial examination has never been more apparent than at present. The public attitude in respect to the profits of the petroleum industry reveals clearly how dangerous a small amount of information can be. Usually, the earnings of the petroleum industry go largely unnoticed. Brief reports appearing in the business section of newspapers attract mainly the attention of investors and are ignored by most other readers. But, a combination of abnormal factors in 1973 caused earnings to be much larger than in 1972. Because the news media and many politicians have focused a great deal of attention on the size of individual petroleum company profits, public awareness is much greater than usual. And there is no doubt that much of the public now considers the earnings excessive. Coupled with the current shortages of petroleum products, all the publicity relative to earnings has created the impression that petroleum companies are engaged in profiteering. That belief is doubtless shared by many representatives of government. And many obviously believe punitive actions against the industry are therefore necessary.

Considering the widespread failure to understand the true function of profits in the free enterprise system, the attitude of the public is not surprising. **But the American people are entitled to a much greater insight on the part of their elected and appointed representatives in government.** Unless they fully understand the nation's chosen economic system and unless they ascertain all the facts before they act, these officials run the risk of setting in motion forces that are likely to prove highly detrimental in the longer run. Because its economic and social well-being is so highly dependent upon an adequate supply of petroleum, the nation can no longer tolerate political blunders that jeopardize that supply.

There is, therefore, an urgent need to publicize the underlying factors responsible for the unusual level of earnings experienced by petroleum companies in 1973. For that reason, this special report is presented in the hope that the information it contains will contribute to a more accurate and broader understanding of all that is involved. The information is drawn from a financial survey of a large group of petroleum companies conducted continuously by this bank for nearly four decades. Currently, the group is comprised of 30 companies of various size. Together, they represent a major proportion of the entire petroleum industry throughout the non-Communist world. Not all of the companies have completed the auditing of their books nor have they all reported to their shareholders. Therefore, the figures cited in this report are necessarily of a preliminary nature. Although the final data may prove to be slightly different, the variation is not likely to be sufficient to alter the conclusions presented here.

The Factors

It is important to recognize at the outset that the group of companies does business throughout the entire non-Communist world and that the operating conditions in 1973 outside the United States were vastly different than within. The growth of demand for petroleum was strong in the United States – but it was much stronger in the rest of the world. Market needs in the United States increased by nearly a million barrels per day and elsewhere they rose by more than two million a day. **Gains of that magnitude, of course, could alone produce a substantial increase in earnings without any change in the price of petroleum.**

But, for several reasons – mostly abnormal – there were price increases also. A gradually evolving shortage of petroleum has been apparent for many years. For the most part, that development has been regarded with complacency in the United States. In most of the rest of the world, however, the degree of awareness has been much greater. And mounting apprehension about the scarcity of supply caused prices to advance in many of the world's markets during 1973.

Largely because of governmental restraints on the generation of capital over the past two decades, it has not been possible to increase the production of petroleum in the United States in recent years. And all of the expansion of market needs, therefore, has had to be satisfied with imported oil. **That means the United States has recently started to compete much more aggressively with other importing nations for available foreign supplies.** And that competition in 1973 gave rise to even greater concern within other nations about the ade-

rest of the world. Indeed, taxes have increased more than profits for many years. The following table illustrates the degree of increase over the past five years:

	1973	1968	Change from 1968	
	Million Dollars		Mill. $	Percent
Profits	11,722	6,664	+ 5,058	+ 75.9
Direct Taxes	20,845	7,276	+13,569	+186.5

Clearly, governments are benefiting far more from the operations of the companies than the companies themselves. In the United States alone, total direct taxes rose by 33.1 percent in 1973 compared with the 19.1 percent gain in profits. Income taxes were up 72.9 percent. Over the past five years direct taxes in the United States increased by 1,343 million dollars or 65.2 percent compared with the profit gain of 441 million dollars or 11.3 percent. Income taxes alone increased by 804 million dollars or 97.2 percent during that period.

In addition to the direct taxes they pay, the companies transfer to governments an enormous amount of money in the form of excise taxes. In 1973 the excise taxes amounted to 26.4 billion dollars – 10.1 billion in the United States and 16.3 billion in the rest of the world. The total taxes taken in by governments as a result of the group's operations in 1973 amounted to 47.2 billion dollars – 13.5 billion in the United States and 33.7 billion in the rest of the world. Of the total taxes paid, the major portion went to the governments of the petroleum importing nations. Indeed, the tax receipts of government in the United States alone exceeded those of all the major producing countries together. Compared with the the year before, the tax revenue of governments increased by 9.4 billion dollars. Over the past five years governments took in 172.7 billion dollars in taxes. The profits of the companies over the same period amounted to 39.2 billion dollars. By any **test, governments have fared exceedingly well.**

It should be readily apparent that the more money governments take from the companies in the form of taxes the less there is available for capital investment. When governments increase taxes they reduce profits and thereby create an immediate need for the companies to offset the loss by raising petroleum prices in an effort to restore their profits. But, if governments apply price controls or otherwise limit profits, the companies cannot offset the loss of capital funds caused by the tax increase and they are then forced to curtail their capital investment. **Obviously, the companies cannot invest money they do not have.**

They Spend More Than They Earn

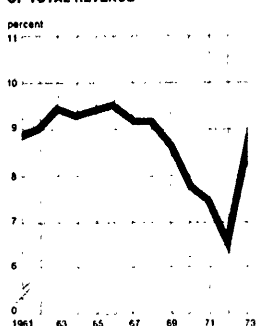
Historically, there has always been a very close relationship between capital expenditures and profits. As one of the charts in this report clearly reveals, capital expenditures rise and fall with net income. Also indicated is the fact that the group's capital expenditures are much larger than its profits. The following table compares the actual amount of profits and capital expenditures over the past five years:

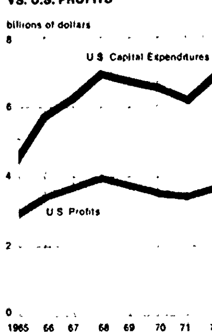
	Profits	Capital Expenditures	Expenditures over Profits	
	Million Dollars		Mill. $	Percent
United States	18,883	34,102	+15,219	+80.6
Rest of World	20,308	30,000	+ 9,692	+47.7
Worldwide	39,191	64,102	+24,911	+63.6

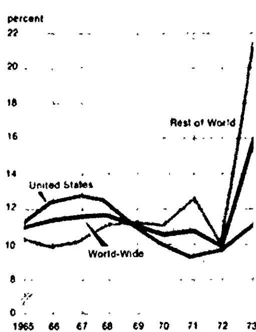
As the table reveals, the companies invested nearly two-thirds more money in the past five years than they generated in profits. And in the United States they spent nearly twice as much as they earned. **In fact, well over half of their worldwide investment was made in the United States even though their profits were larger in the rest of the world.** The companies were able to invest more than they earned only because they could obtain part of the money they needed through the mechanism of capital recovery and another part by borrowing.

The Importance of Petroleum

The satisfaction of virtually all needs for goods and services throughout the world depends upon the use of energy. Without a sufficient supply of energy, the developed nations of the world cannot maintain their existing standard of living and the less developed nations will not be able to achieve the economic and social gains they so urgently need. The liquid form of oil makes it by far the most versatile of all energy







of income taxes. The payment amounted to 14.8 billion dollars – 4.5 billion more than in 1972.

Petroleum companies do in fact pay additional taxes that are not imposed on most other businesses. They include such levies as production, severance, and ad valorum taxes. In 1973, these additional taxes amounted to 6.0 billion dollars for the group of companies. Their total tax payment in 1973, therefore, came to 20.8 billion dollars – 5.4 billion more than in the previous year.

Of the total 1973 operating revenue, 75.3 percent was required to pay day-to-day operating costs. Taxes took 15.8 percent. And the remaining 8.9 percent represented the group's profits. Each of these elements increased in 1973 as indicated in the following table:

	United States	Rest of World	World-wide
	Million Dollars		
Gross Operating Revenue	+8,171	+19,725	+27,896
Operating Costs	+6,627	+11,001	+17,628
Direct Taxes	+ 846	+ 4,560	+ 5,406
Profits	+ 698	+ 4,164	+ 4,862

Obviously, higher operating costs absorbed a major portion of the revenue increase both within and outside the United States. Also, taxes increased more than profits in both areas. **And, of the total growth in profits, the great bulk – more than 85 percent – occurred outside the United States.** The next table compares the actual amount of profits in both areas in 1973 with the net earnings in the year before:

Profits	1973	1972	Change from 1972 Mill. $	Change from 1972 Percent
	Million Dollars			
United States	4,354	3,656	+ 698	+ 19.1
Rest of World	7,368	3,204	+4,164	+130.0
Worldwide	11,722	6,860	+4,862	+ 70.9

The average changes shown in the table reflect widely varied results for the individual companies ranging from very large gains to very large declines.

Why Profits Increased So Much

In 1972, more than half of the group's over-all profits – 53 percent – were earned in the United States. But, in 1973, the proportion dropped to only 37 percent. For the most part, that major shift reflected the impact of the various abnormal forces operating in 1973.

Devaluation of the dollar had the single greatest effect. Indeed, nearly one-fourth of the worldwide increase in profits can be attributed to devaluation alone. About one-sixth of the profit gain was brought about by the increase in the value of inventories following the progressive firming of petroleum prices in most of the world's markets throughout the year. As explained earlier, the price changes were the result of both economic and political forces. Historically, the profitability of both the petrochemical and tanker operations of the companies has ranged from extremely poor to extremely good. It is unusual, however, for both operations to stage a strong recovery in the same year, as was the case in 1973. Because these activities did recover at the same time, they also contributed substantially to the expansion of the group's profits.

Four of the thirty companies in the group are European rather than American organizations. Their earnings have fluctuated widely in recent years and in 1972 they were severely depressed. **Because of the unusual developments in 1973, the earnings of these four companies were much improved and that recovery alone accounted for more than one-third of the profit gain for the entire 30 company group.**

The growth of demand for oil continued unabated in 1973. Worldwide needs were 3.2 million barrels per day larger than in the year before. And, with that much additional oil moving to market at price levels that averaged higher than in the previous year, a substantial increase in profits was a perfectly normal consequence.

When considered superficially, a 71 percent increase in profits appears excessive. But, an analysis that is limited solely to the change for a single year is not only foolish and grossly misleading but can also be dishonest. If petroleum companies are to serve the expanding needs of consumers, they must make long range investment plans. And those plans must necessarily be based upon the average growth of profits over a long period of time – not just the increase in a single year. For the past five years, including 1973, the group of companies achieved an average annual growth in earnings of 12.0 percent. For the past ten years, the annual growth has averaged 9.9 percent. In both cases, the average increase fell far short of the growth required to provide the capital funds needed to keep pace with the expansion of petroleum demand.

Within the United States alone the longer term growth of profits has been even less favorable. Although the group's earnings in 1973 were 19.1 percent higher than in the year before, they were only 11.3 percent higher than five years earlier. And the average annual growth for the past five years has been only 2.2 percent. Over the past ten years the average growth has amounted to no more than 6.2 percent. **Clearly, the United States cannot possibly achieve the higher degree of petroleum self-sufficiency it so urgently needs if profits continue to grow at such slow rates.** Not nearly enough capital can be generated internally nor will capital from outside sources be attracted. There are many opportunities for investment in the United States that are much more attractive.

A Risky Business

A high degree of risk has always been a characteristic of the petroleum business. There is the continuous risk of spending vast amounts of money on the search for petroleum without finding any. And there are also the political risks which take various forms. The most obvious is the outright confiscation of assets by government. More subtle but no less damaging are those actions of government that interfere with the highly essential process of capital formation. Both kinds of political risk continue to exist right up to the moment. Because of these risks, petroleum companies need to achieve a higher return on their investment than most other industries. For many years, however, the return on average invested capital for the group of companies has been too low relative to their risk element. In 1972 it was only 9.7 percent and substantially below the return for many other industries with much less risk. The higher level of profits in 1973 brought the group's worldwide return up to 15.6 percent. At that level it was within the range considered necessary to generate the required capital funds.

In the United States, however, the rate of return remained too low. It increased from 9.6 percent the year before to 11 percent in 1973. At that level it was still substantially below the return for most other industries with a lower degree of risk. For the most part, the poor return in the United States in 1973 and in the past was the direct result of governmental interference with the operations of the nation's chosen economic system.

About Those Taxes

As noted earlier, the group's taxes increased more in 1973 than its profits – both in the United States and in the

PROFITS

billions of dollars

8 7 6 5 4 3 2 1 0

Foreign

United States

1961 62 63 64 65 66 67 68 69 70 71 72 73

U.S. PROFITS
AS A PERCENT OF TOTAL

percent

70 60 50 40 30 0

1961 63 65 67 69 71 73

quacy of their oil supply. They reacted by increasing their stockpiles of oil and bidding up prices further in the process.

Governments of several major oil producing nations were also responsible for higher oil prices in 1973. To varying degrees and in several stages they enlarged their ownership of the petroleum operations within their borders and in the process dictated very large increases in the price of crude oil. Under the terms of the varied and complicated formulas that establish the relationship of the governments and the operating petroleum companies, most of the benefits of the price changes went to the governments, but some accrued to the companies too.

During 1973, governments of some of the oil producing countries made threats to cut off the flow of oil. Such warnings, of course, contributed to the apprehension within the importing nations about the continuity of their oil supply. And, as a consequence, the governments of the importing nations compelled petroleum companies to maintain exceptionally large inventories. As the price of oil progressively rose in the world's major markets in response to both the forces of supply and demand and the unilateral actions of government, the value of inventories increased too. And that development was naturally reflected in the gross revenue of the petroleum companies involved.

Early in 1973 the dollar was devalued. And, in the process of the necessary conversion from various other currencies, dollars were automatically increased on the books of many petroleum companies. **Thus, an action of the United States Government contributed directly and significantly to the growth of earnings of those companies.**

The strong worldwide growth in the demand for petroleum in 1973 caused tanker rates to soar to record highs after being at subnormal levels the year before. Consequently, the transportation operations of many of the petroleum companies became substantially more profitable than they had been.

After being in the doldrums for several years, the petrochemical operations of the petroleum companies staged a strong recovery in 1973. And the earnings from those operations, therefore, were significantly better than in the previous year. The impetus for the recovery was provided by both a strong demand for chemical products and a shortage of supply.

More Money and Where It Went

As the foregoing commentary reveals, there were several unusual developments in 1973 which together led to a larger than usual increase in the gross operating revenue of the group of petroleum companies. The actual size of that increase is measured in the following table:

	1973	1972	Change from 1972	
Gross Operating Revenue	Million Dollars		Mill. $	Percent
United States	55,810	47,639	+ 8,171	+17.2
Rest of World	76,245	56,520	+19,725	+34.9
Total	132,055	104,159	+27,896	+26.8

The table reveals that the companies received much more revenue outside the United States than within. And, **because of the abnormal developments cited earlier, nearly three-fourths of the increase in revenue occurred outside the United States.**

Normally, as the scope of their business expands, the operating costs of the companies rise too. In 1973, however, the increase of 21 percent was proportionately larger than the growth of their business operations. But, even so, the rise in costs was still not as great as the expansion of operating revenue. Consequently, the group's pre-tax income was 54 percent larger than in 1972.

Unfortunately, there is a widespread failure to recognize that taxes are one of the costs of doing business. But they are, of course. And, like all other costs, they must be recovered in the price paid by the consumers of petroleum. Otherwise, the business operations simply cannot remain viable for long. **Therefore, whenever governments impose higher taxes on petroleum companies, they are actually imposing those taxes indirectly on consumers.** And, if consumers had a better understanding of this, they would doubtless protest vigorously.

When pre-tax income increases, income taxes go up too, of course. And income taxes also rise as a result of governmental actions. For the latter reason, income taxes have been the fastest growing cost of doing business for the petroleum companies. And, in 1973, the group turned over as much as 56 percent of its pre-tax income to governments in the form

sources. Our studies reveal that the world will depend upon oil alone to satisfy well over half of its energy needs between 1970 and 1985. The world's requirements for petroleum in that time will be nearly three times greater than in the preceding fifteen years. Even if the demand for oil stopped growing, the consumption would still be almost twice as large as in the preceding fifteen years.

All of the existing proved reserves of oil throughout the entire non-Communist world are not now sufficient to satisfy the worldwide needs between 1970 and 1985. If those needs are to be satisfied and a realistic level of underground inventories maintained, the petroleum industry will have to find twice as much oil between 1970 and 1985 as it discovered in the preceding fifteen years. The estimated cost of finding that much oil and providing all the additional facilities required to satisfy the world's expanding markets plus the other essential financial needs of a viable business operation will amount to well over a trillion dollars. That is about four times the amount of money the industry utilized in the preceding fifteen years. **In the United States alone, the petroleum industry's financial needs will exceed half a trillion dollars.**

Raising that much money will represent an enormous task. Part of it can be borrowed but at least three-fourths will have to be generated internally from profits and capital recovery. Nearly half must be obtained from profits alone and, profits will have to grow much faster than in the past. The rate of return on invested capital will need to range between 15 and 20 percent.

The Role of Government

But, if obstacles are raised by governments, and the petroleum industry is therefore prevented from generating all the capital funds it needs, it will be unable to serve the world's markets – a progressively worsening shortage of petroleum will surely evolve. The United States is now faced with a shortage of all forms of energy and the blame for that condition must be laid almost entirely at the doorstep of government. For nearly four decades, government has broken economic laws repeatedly and has compiled an appalling record of interference with the normal operations of the free enterprise system. **Yet, against that background, many representatives of government are currently exhibiting an incredible determination to take further actions that are certain to prove highly detrimental to the nation.**

The temper of the times is dangerous. And government should be acting with utmost care. It ought to be making a thorough, well-reasoned, and open-minded assessment of all the abnormal forces at work in 1973. In addition, it should be conducting an equally honest examination of its own role in bringing about the energy shortage. Good government demands nothing less. But we are not witnessing actions of that nature. Instead, there appears to be an impulsive rush to take punitive actions – actions apparently motivated primarily by the growth of petroleum company profits in 1973. There are few signs of a truly meaningful effort to seek the facts. Hearings abound. But the politically charged, theatrical atmosphere of the typical Congressional hearing does not provide an opportunity for the effective development of factual and relevant information. **Sincere and earnest efforts to gain information can be accommodated far better with other methods.**

Among the punitive actions proposed are limitations on both capital recovery and profits. Government appears unmindful of the serious consequences of restricting the petroleum industry's ability to generate capital funds. Apparently, there is little understanding that a worsening shortage of petroleum would be the inevitable outcome. Nor does it seem to be understood that the nation's economy would surely suffer as a result of the petroleum shortfall and that tax receipts would then decline, leaving government less able to carry on its legitimate functions.

The sequence of events in prospect are cause for much alarm. And, if government acts to set them in motion, the nation will be faced with a prolonged period of hardship. That is not to say, however, that the ultimate result would be doom. As the problems worsen, the seeds of correction will begin to grow. Consumers will not tolerate shortages of petroleum, or other forms of energy, indefinitely. They will insist that their needs be satisfied. At the present time, they are angry at the petroleum companies, as well as the electric and gas utilities because of shortages and rising prices. And the punitive actions being considered by government appear to manifest in part a desire to cater to the public attitude for reasons of political expediency. But the punitive actions will not solve the problems -- they will only make them worse. And, when conditions do not improve, consumers will seek a new villain. By then, the only one available, of course, will be government.

By resorting to their most potent weapon – their votes – consumers can bring about change; they can set in motion powerful forces of correction. In response to their needs and demands, men and women with a more positive attitude toward the free enterprise system and the needs for capital can be attracted to government service. And, in time, the United States can stage a gradual recovery and again achieve a high degree of self-sufficiency relative to the supply of petroleum and other forms of energy. The nation does not lack basic energy resources to be developed – all that is required is sufficient capital funds and freedom to act.

But the time required to attain that goal will be long and painful. Favorable results could be achieved sooner if only government would recognize immediately the urgent need to work constructively with all the energy industries for the over-all good of the nation rather than continuing in an adversary posture.

John G. Winger, Vice President
Richard C. Sparling, Energy Economist
Richard S. Dobias, Financial Analyst
Norma J. Anderson, Assistant Financial Analyst

THE FOREIGN TAX CREDIT AND THE U.S. OIL INDUSTRY

(Ed. Note: Due to the significance and timeliness of the report just issued by the Petroleum Industry Research Foundation on the effects of foreign tax credits on the U.S. oil industry, Oil Daily has decided to reproduce the report in full. The first part of the report appears below. It will be continued in tomorrow's paper. The report is the property of Petroleum Industry Research Foundation Inc., 122 East 42nd Street, New York, N.Y. 10017.)

INTRODUCTION

The 5 month political embargo on Arab oil shipments to the U.S. and the sharp and unexpected increases in world oil prices unilaterally imposed by the Organization of Petroleum Export countries have brought home to most Americans the risks and costs of depending on foreign sources for a significant share of domestic oil requirements. This situation is quite new. Until 1972 our dependence on foreign oil was such that the kind of embargo that existed from October 1973 to March 1974 would have had relatively little effect on our supplies. In fact, throughout the embargo period we received more foreign oil than during the comparable period of 1972. Likewise, world oil prices prior to 1973 had always been below U.S. prices so that in the past imports had the effect of lowering our average oil cost.

It is not surprising that under the shock effect of these radical changes, legislators and policy makers are asking for a return to the pre-1973 period and, in fact, are looking for self-sufficiency in energy by about 1980. Whether this is a realistically achievable goal has been questioned by many experts in government and industry. The National Petroleum Council in its major study, "The Outlook for Energy," released in December 1972, projected that by 1980 our dependency on foreign oil would range from 30% to 66% with 48% as the most likely number. Even if we assume the National Petroleum Council's most optimistic domestic supply projection (which the Report termed "difficult to attain") and the smallest demand projection, we will still have to bring in a minimum of about 6 million barrels daily of foreign oil by 1980.

Thus, it is reasonable to assume that regardless of what energy policy we pursue, foreign oil will play a significant part in supplying our demand for the next ten years at least. It is therefore essential that we do not embark on policies which will reduce our access to foreign oil during this period without having an offsetting effect on domestic supplies.

The various current proposals to alter or abolish the Foreign Tax Credit on income from U.S. oil operations abroad must be examined from this point of view. The acknowledged principal purpose of these proposals is not to raise additional tax revenue but to create a tax disincentive to U.S. investment in foreign oil production on the assumption that this would lead to increased investment in domestic oil production. If the assumption is correct, a reduction in the Foreign Tax Credit may be justified. If it is not, the effect of the removal is likely to be counter-producitve.

Thus, before we go into the technical aspects of how the Foreign Tax Credit works and what the consequences of the various proposals to reduce or eliminate it would be, we must determine why U.S. oil companies ventured abroad, what would have been the consequences if past government policy had prevented them from doing so and what the role of foreign oil will be in supplying our future energy needs.

TAX POLICIES AND OIL INVESTMENT—U.S. VERSUS FOREIGN

American oil companies have been investing substantially in foreign countries before the turn of the century, well before the adoption of the modern income tax law in the United States in 1913. Their historic reasons for doing so are well covered in other studies. Here we are concerned with the question of what role, if any, taxes have played in the continuation of such investments, particularly since the end of World War II.

The fact is that from the tax point of view it was better throughout this period to produce oil in the U.S. than in almost any major foreign producing country. Prior to 1970, when the Tax Reform Act of 1969 became operative, the average federal income tax payment of integrated U.S. oil companies amounted to not

quite 20% of their total U.S. book earnings and less on their earnings from domestic crude oil production alone.

The principal reason for this relatively low rate were two special tax provisions applying to oil and gas production: the depletion allowance and the expensing of intangible drilling costs. The rationale for these two provisions on which a vast literature exists lies outside the scope of this report. But with the exception of Canada, no major foreign oil producing country has granted oil companies such preferential tax treatment.

As a result, since the introduction of the so-called 50/50 principle in foreign oil taxation (which consisted of a 50% income tax rate minus a tax credit for royalties and other payments made to the state), in 1948 in Venezuela and two years later in the Middle East, U.S. oil companies operating in the major foreign producing countries have consistently paid a higher tax rate there than at home. Over the years the differential has grown dramatically. Until about 1960 the income tax rate on oil operations in the Middle East and Venezuela was approximately 36% or nearly twice as high as the effective tax rate in the U.S.

In the early 1960's increasing competition forced the oil companies abroad to introduce discounts off their posted prices. However, OPEC did not allow these discounts to be used for the purpose of calculating taxable income. As a result, the effective tax rate on real income was further increased. Then in the second half of the 1960's OPEC required that royalties be treated as a deduction instead of a tax credit. This together with the discounts raised the effective tax rate to 54–56% of real earnings.

In 1971, statutory income tax rates were raised to 55% in the Middle East and African producing countries and to 60% in Venezuela. In addition, a series of sharp increases in posted prices were imposed by the producing country governments culminating in the current postings which range from $11.44 to $15.77 per barrel, about four times the level of a year ago. As a result, the current effective tax rate in the Middle East is about 87% of the real earnings on a company's own (equity) crude oil production (see page 5), assuming a market price of $9.70 f.o.b. Persian Gulf.

By comparison, the total U.S. tax burden on crude oil production including state income and production taxes, is probably less than half of this rate. In other words, U.S. oil companies have gone abroad despite the fact that U.S. tax treatment of their earnings has been consistently more favorable than that of major foreign producing countries. Over the years, this difference has steadily increased as the foreign countries raised their tax bases and rates while the U.S. limited such general tax incentives as the Investment Credit and Accelerated Depreciation largely or wholly to domestic investments.

Reasons for U.S. Foreign Oil Investments

The principal reason why, despite this disparity, American companies have apparently increased their investments in foreign exploration and production much more than those at home in the last 12–14 years lies of course in the resource base differential. The opportunity to find very large deposits of very low cost oil abroad at a time when domestic deposits were beginning to show signs of decline and finding costs were rising was sufficient to overcome the foreign tax disadvantage. The results bear out the correctness of this choice. Production costs in the OPEC nations range from 10¢ to 60¢ per barrel while in the U.S. they average in excess of $1.00 per barrel. Even more dramatically, while in 1971 the drilling of a total of 11,858 oil wells in the U.S. did not prevent a production decline of about 100,000 b/d from the previous year, in the Middle East where a production increase of 3 million barrels daily (b/d) was achieved only 160 wells were drilled.

Suppose the U.S. government through prohibitive tax measures or other means had succeeded in preventing or hampering U.S. companies from developing the petroleum resources abroad?

Would such a policy have resulted in higher investment in petroleum production at home? Probably not. There is clear evidence that the decline in U.S.

oil production investments did not reflect lack of funds but lack of opportunity to employ the funds profitably. The great bulk of domestic oil investment had occurred on-shore in the Southwestern and West Coast regions.

There is now general agreement among geologists that the bulk of the recoverable reserves in these areas have been located and that the only way to extract more oil from these reserves is to introduce secondary or tertiary recovery methods. This is a direct function of the existing or expected wellhead price of oil rather than the availability of capital.

INVESTMENT OPPORTUNITIES IN THE UNITED STATES

The principal areas for major new oil finds in the U.S. will be the offshore regions along our coastlines and the offshore and onshore areas of Northern Alaska. The American petroleum industry has shown every sign that it wants to develop these areas at the most rapid rate and has the capital to do so. The Alaskan North Slope discoveries which, together with the pipeline to the warm water port of Valdez will have cost a total of well over $10 billion by the time commercial production gets under way, were found and developed when domestic crude prices were at one-third and landed foreign prices at one-fifth of their present levels.

The only thing that held up the commercial development of the North Slope reserves were court and government actions, never lack of capital. The eagerness of additional companies to join in the Alaskan oil search was clearly demonstrated at the lease auction in September 1969 when $1 billion was payed in bids to the Alaskan state government for the right to search for oil.

There is every indication that if the state or federal government were to open more areas with promising geological indications for oil search in Alaska on any profitable basis, the American oil industry would be willing and financially capable to undertake this search without any change in existing tax or other legislation.

Similarly, every lease sale in federal off-shore lands in the Gulf Coast in the last several years has brought in over a billion dollars in bonuses. In the two latest sales, held early in 1974, the industry paid $1.8 billion and $2.2 billion, respectively, in cash bonuses to acquire leases. In fact, the petroleum industry's position is that more federal off-shore leases should be offered for bidding than the 3% of the total area that has been opened up so far. The industry has also urged the opening up of the East Coast for oil exploration and the removal of some of the restrictions put on oil search and production in the Pacific off-shore areas.

Without going into the specific positions of the industry and the government on the question of off-shore drilling, it is clear that American oil companies are willing to invest considerably more money in search for oil and gas in the major remaining potential oil bearing areas in this country than they have been permitted to do so far. The reason for the decline in domestic production and reserves in the last several years is therefore not lack of funds but lack of opportunity.

If a change in U.S. government policy were to make it more difficult for U.S. oil companies to invest funds abroad, it would not follow that these funds would be invested in U.S. oil production ventures which are currently considered not profitably enough. The basic criterion for any business investment decision is to maximize the return on the investment. If opportunities outside the oil producing sector promise a higher rate of return this is where the funds would go. Thus, one result of discouraging past foreign oil investments would probably have been increasing domestic diversification of oil companies into other lines of business. The same thing can be expected if such a policy were to be adopted now.

BALANCE OF PAYMENTS CONSIDERATIONS

It is sometimes argued that if U.S. companies had not been able to develop foreign production they would have had to develop more production at home even

if the profitability were less, since integrated oil companies cannot stay in business without adequate crude oil supplies. This assumes that any oil not found by American oil companies abroad would stay unfound.

Actually, international competition between U.S. and non U.S. oil companies is very keen. Three of the world's biggest and oldest oil companies—Royal Dutch Shell, British Petroleum and Compagnie Francaise des Petroles—are headquartered in Europe. There are also large oil companies in Germany, Italy, Belgium and Japan. Some of these have access to government funds for their foreign exploration ventures.

Furthermore, the national oil companies of all the major producing countries have by now acquired enough knowledge and skill to produce and sell their own oil. In the future their role as international oil marketers will in fact be greatly expanded.

Thus, the amount of oil available for sale abroad would not necessarily be less in the absence of American oil companies. U.S. companies could therefore import the same volume of oil as they do now by purchasing it from foreign producers. The only difference would be that the profits abroad from the sale of this oil would accrue entirely to the foreign producers. In turn, this would have a negative effect on our balance of payments.

The importance of foreign oil earnings in our balance of payments is shown in the table on page 5. It should be pointed out that most of these earnings are not the result of imports into the U.S. but into other markets—mainly Europe and Japan. In 1972, U.S. oil companies produced a total of about 18 million b/d abroad while oil imports into the U.S. amounted to less than 5 million b/d and not all imports came from U.S. controlled companies.

In previous years, the share of U.S. controlled foreign oil going into third countries was even larger. Had there been effective interdiction of U.S. investments in foreign oil production, we might have lost up to a cumulative maximum of $10 billion of foreign earnings inflow since 1965 without necessarily reducing our dollar outflow for oil imports by any relatively significant amount.

Investment in Down-Steam Facilities

In the future, the role of U.S. oil companies in the main foreign producing areas will clearly decline while that of the national oil companies will rise. U.S. earnings from oil production abroad can therefore be expected to diminish. But the same is not likely to hold for the role of U.S. companies in the importing countries abroad. In fact, as their earnings from upstream profits dwindle, the companies will try to shift their profit center to refining and marketing operations.

If U.S. companies were handicapped vis-a-vis their foreign competitors in participating in these operations, the inflow of foreign earnings would of course be diminished. There would be no compensating increase in domestic investment and earnings. An international oil company blocked by U.S. tax policy from building a refinery in Europe to supply the local market will not build one in the United States instead.

Refinery building is a function of market demand and availability of crude oil. The reason for the insufficient U.S. refining capacity is not lack of domestic capital. Rather, a variety of other factors such as our former oil import policy, environmental opposition to refinery location and the existence of excess refining capacity until 1972 came together to create this situation.

Some of these factors are no longer prevalent or have been mitigated. As a result, almost every large refining company has announced plans within the last ten months to expand its capacity. If all these plans are carried out it will mean an increase in U.S. refining capacity of about 3 million b/d by 1977/78, enough to raise our self-sufficiency in refined products above the level of recent years.

How many of the announced expansions of new constructions will actually take place depends primarily on one factor—secure access to foreign crude oil. Any attempt to hinder U.S. companies from finding more oil overseas could therefore have a negative side effect on U.S. refinery construction in the next few years.

FOREIGN OIL AND U.S. NATIONAL SECURITY

Self-sufficiency in petroleum in the next ten years is not a realistically achievable goal for the U.S., official statements to the contrary notwithstanding. It would require a reduction of 50% in our historic energy growth rate from 1974 on. This is clearly unrealistic. It would result in an economic recession of major proportions.

We can, however, reduce our dependency on foreign oil considerably over the next ten years from what it would be in the absence of a concerted effort to do so. Thus, by 1980 our domestic petroleum production under the stimulation of higher prices and a more liberal government policy on off-shore leasing might be as high as 14 million b/d, compared to 11 million barrels in 1974.

At the same time, our oil demand which had been projected to reach 24 million b/d in 1980 by various authoritative studies made prior to the major changes in world oil demand and supply conditions which occurred last year, may be reduced through conservation measures and substitution of coal to an absolute minimum of 20 million b/d. This would imply an annual growth rate of 1.8%, about one-third of our recent historic rate.

Even these spactacular achievements in increasing domestic supplies and decreasing the growth in demand would require imports of at least 6 million b/d in 1980, or 30% of total demand. If we further assume that all increases in oil demand between 1980 and 1984 can be made from domestic sources and that at the same time oil imports can be reduced by another 10% from their 1980 levels, we will still have to bring in 5.4 million b/d of foreign oil ten years from now.

Thus, even under these clearly optimistic assumptions we will continue to be substantial importers of oil for the next decade and very probably beyond. The question of access to foreign oil will therefore continue to be of major national significance.

One thing we have learned from the present oil crisis is the need for maximum diversification of supply sources. Without the existence of major producing areas in Canada, South America, West Africa and Southeast Asia the effect of the Arab oil embargo on the U.S. would have been far more serious than it was.

Some of these areas were developed only within the last ten years. Nigeria, for instance, produced only 75,000 b/d in 1963 compared to 2.2 million b/d in 1974. Ecuador which had virtually no exports prior to 1973 now sells over 250,000 b/d abroad. In Indonesia production has increased from 450,000 b/d ten years ago to the current level of 1.4 million b/d. Canadian production has nearly doubled in the last five years to its present level of 2.1 million b/d. In all these cases, U.S. companies were involved in finding and developing this oil.

All major oil, importing countries other than the U.S. are officially encouraging the search for new deposits throughout the world in order to diversify their supply sources. At the same time the national oil companies of existing or potential producing countries are looking for minority partners or subcontractors to help them develop their resources. If American companies were to be prevented from participating in this search the security of supply of our required imports would clearly be weakened.

The Arab oil embargo has demonstrated that during a physical shortage the global allocation of available supplies is in the final analysis in the hands of the international oil companies. To the extent to which these companies are American our government has some means of influencing the allocation. True, during the embargo U.S. companies operating in Arab countries were specifically prohibited from supplying their own country and had no choice but to respect this prohibition.

However, by increasing shipments from non-Arab sources and by importing finished products from refineries in countries which continue to have access to Arab crude oil, the shortfall of imports into the U.S. throughout the five months of the embargo was kept below the level that would have prevailed if the embargo had been fully effective and no offsetting shipments from non-embargoed sources had come in.

Given the present constellation of world policies it is questionable that such remedial action would have been taken if most of the oil shipped to the U.S. had been controlled by private or government companies of other countries.

Thus, as long as the U.S. remains a major importer of oil it would seem to be in the national interest to encourage U.S. companies to participate in as many foreign oil ventures as possible.

CONCEPT AND CALCULATION OF THE FOREIGN TAX

Looking at the role the Foreign Tax Credit plays in U.S. foreign oil operations. One of the most concise as well as authoritative explanations of the principle of this tax provision was given by the then Secretary of the Treasury, George P. Shultz, before the House Ways & Means Committee on February 4, 1974 which is quoted below:

"The basic concept of a tax credit system is that the country in which the business activity is carried on has the first right to tax the income from it even though the activity is carried on by a foreigner. The foreigner's home country also taxes the income, but only to the extent the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by a foreign tax credit.

"For example, if a U.S. corporation were taxed at a 30% rate in country X on its income from operations in country X, the U.S. would not duplicate country X's 30% tax on that income. But since the U.S. corporate income tax rate is at 48%, the U.S. would collect—i.e. "pick-up" the 18% which remained over and above the 30% collected by country X. Technically the result is achieved by imposing a hypothetical 48% U.S. tax on the income earned in country X, with the first 30 percentage points rebated by a credit. However, if the foreign rate were 48% or more, there would be nothing left for the U.S. to pick up and thus no tax payable to the U.S. on that foreign income.

"Note that the foreign tax credit only affects income earned in some foreign country through activities conducted in that country. Income arising out of operations conducted in the U.S. and the taxes on that income are totally unaffected by the credit."

The Foreign Tax Credit is, of course, not limited to the oil industry. It applies to all U.S. controlled business enterprises abroad. However, the oil industry's foreign tax credit is the largest of any U.S. industry. But the same applies to the foreign earnings of the U.S. oil industry. Table A on page 2 shows the foreign earnings, and tax credits of all U.S. industries and of the petroleum industry in the years 1969–72.

THE TWO METHODS OF COMPUTING THE FOREIGN TAX CREDIT

The allowable Foreign Tax Credit can be determined in two ways. The "per country" method treats the income and taxes from each foreign country separately in determining the Foreign Tax Credit. The "over-all" method treats all foreign net income and all foreign taxes as a whole. Tax payers may elect either method. But if they elect the over-all method they are not free to change to the per-country method in subsequent years unless they receive special permission from the Treasury.

The principal attraction of the over-all method is that it permits a company operating in several foreign countries to average differential tax rates. Thus, excess foreign tax credits accumulated in countries with tax rates higher than in the U.S. may be used to offset U.S. tax liabilities arising in countries with tax rates below the U.S. level.

The advantage of the per country method is that it permits losses in a foreign country to be deducted from U.S. income taxes on domestic earnings, independent of the accumulation of excess tax credits in other foreign countries. This is based on the principle in our tax law that if the foreign income of U.S. businesses is subject to U.S. taxes, foreign losses must be deductible from U.S. taxes. In the case of foreign income a Foreign Tax Credit is allowed to avoid double taxation.

In the case of a foreign loss there is no conceivable-counterpart to the Foreign Tax Credit. A taxpayer on the per country basis may therefore deduct the loss directly from his total earnings which include of course his domestic earnings.

The Case of Aramco

An illustration of a limitation on the use of the excess foreign tax credit, regardless of the method used to compute it, is provided by the Arabian American Oil Company (Aramco)—the world's largest crude oil producer. Aramco's own operations are limited almost entirely to Saudi Arabia. But its four U.S. owners—Exxon, Texaco, Standard of California and M[illegible]—operate of course in many foreign countries. However, since none of them controls a large enough share of Aramco to treat it as a subsidiary for U.S. tax purposes, they can not make use Aramco's accumulated excess foreign tax credit.

According to recently released figures by the Senate Foreign Relations Committee, Aramco paid nearly $2 billion in income taxes in Saudi Arabia in 1972 and an estimated $3.9 billion in 1973. On the basis of these figures it can be estimated that the company received U.S. tax credits of approximately $1.4 billion in 1972 which gave it an excess Foreign Tax Credit of about $600 million in that year.

In 1973, the excess tax credit was probably some-what above $1 billion, according to preliminary figures. For the reasons pointed out, no part of the excess tax credit generated by Aramco can be used to reduce the U.S. tax liability of its owners in any other country. It was therefore no value for the four companies.

Some Misconceptions of the Foreign Tax Credit

Much of the controversy over the oil industry's use of the Foreign Tax Credit arises out of misunderstandings over how the credit works and what its limitations are. In the following paragraphs the most common of these misconceptions are discussed.

(1) The foreign tax credit as an offset against U.S. income taxes: In the public discussions about the Foreign Tax Credit it is sometimes claimed that U.S. oil companies can offset increases in foreign tax liabilities by a corresponding lowering in tax payments to the U.S. Treasury through the Foreign Tax Credit device. It is important to understand that this credit is available only up to the point where foreign tax rates equal U.S. rates.

Since, by and large, foreign tax rates for the oil industry have exceeded U.S. tax rates since the mid-1960's, increases in foreign tax-payments since then have had very little effect on tax payments to the U.S. Treasury.

In other words, the U.S. oil industry has paid very little domestic income taxes on its foreign earnings for a number of years and since tax liabilities arising out of domestic earnings can never be reduced by a foreign tax credit, there has simply been nothing to write off against the many increases in foreign tax payments in recent years. As a result, all U.S. oil companies with substantial foreign producing operations have built up increasing amounts of unusable excess Foreign Tax Credits.

Table "B" illustrates this point. It shows the composite foreign income tax liabilities and U.S. foreign tax credits of 18 major oil corporations which report their earnings and taxes regularly to the public accounting firm Price, Waterhouse and Co. As can be seen, foreign tax liabilities have risen by $2.3 billion during the four-year period but the Foreign Tax Credit has gone up by only $0.4 billion. Similarly, in 1972 the Foreign Tax Credit covered only 37% of total foreign income tax payments, compared to 58% in 1969—an indication of the growth in excess foreign tax credits, that is tax credits in excess of those required to offset U.S. tax liability. In 1973 the ratio dropped still further.

Since at least part of the increase in the Foreign Tax Credit since 1969 was due to higher earnings in oil importing countries, some of whose tax rates are below the comparable U.S. level, virtually none of the sharp increases in tax liabilities to the oil producing countries during this period were passed on to the U.S. Treasury through higher Foreign Tax Credits.

(2) The question of royalty payments: It is sometimes charged that the income tax paid by oil companies in the major foreign producing countries is only a disguised form of royalty payment and should be treated as such in the computation of the U.S. income tax liability on these earnings. The difference would be quite significant, since a royalty under U.S. tax law is in effect treated as a deduction rather than a tax credit. Thus, under a hypothetical 50% U.S. tax rate one dollar paid in foreign income tax would reduce U.S. tax liability on that income by one dollar while one dollar paid in royalties would reduce U.S. tax liability by only 50¢

The dispute over whether the payments to foreign oil producing governments are taxes on royalties arises in part out of the confusion as to the kind of payments made to these countries and in part out of the historic origin of these payments. For the past 20 years at least foreign oil producing companies have paid both an income tax and a royalty to their host governments.

The latter ranges from 12.5% to 16.6% of the posted or tax reference price of the crude oil. It currently amounts to about $1.46/bbl in Saudi Arabia and about $1.25 a barrel in Venezuela. The royalty is treated as a regular business deduction for U.S. income tax purposes and thus does not figure in the computation of the Foreign Tax Credit.

The foreign producing countries also treat royalty payments as a tax deduction, although prior to 1965 most of these countries treated them as a tax credit in calculating the 50% income tax rate then in effect. Some of the confusion might arise from this previous differential treatment of oil royalty payments in the producing countries.

Another reason for the confusion is that at one time all payments to foreign producing countries were in the form of fixed royalties per barrel. In Venezuela an income tax law applicable to foreign oil companies was passed in 1943 and in Saudi Arabia it was introduced in 1950 as part of the 50/50 principle in sharing profits between the government and the company. Shortly thereafter all remaining major oil producing countries adopted income tax legislation. The system in most of these countries is similar to that in effect in the U.S. for oil operations on federal territories. Oil companies producing on public lands or offshore areas must pay a royalty to the government, in addition to which they are of course subject to an income tax on their earnings.

The argument has been made that since a major reason for the change over from a pure royalty to a combination income tax and royalty in Saudi Arabia was to take advantage of the U.S. Foreign Tax Credit. Saudi Arabian and other Middle East income taxes are really converted royalties and as such should not be given Foreign Tax Credit status. The argument ignores several points.

(a) It is only common sense for any country to try to minimize within the framework of existing laws and conventions, the tax payments to other countries from profits earnings within its borders. The long-standing provision in the tax codes of the U.S. and the U.K. the two largest investors in Middle East oil, of a Foreign Tax Credit was a clear invitation to reduce the outflow of tax payments. The fact that under the royalty system the U.S. Treasury received a much larger income from Saudi Arabian and other Middle East oil operations than the treasuries of these countries provided a strong additional incentive to take corrective action.

(b) It is now generally recognized that the income tax is a superior form of governmental revenue collection than a fixed royalty, both because it has greater flexibility and because it makes the government a partner in the profits and losses of the enterprise. The move from a royalty to an income tax system must therefore be regarded as a normal development in fiscal sophistication on the part of the less developed countries which would have come about even in the absence of Foreign Tax Credits in U.S. and other tax legislation.

(c) It would be extremely arbitrary for the U.S. to insist on treating all tax payments to foreign oil producing countries forever as royalties because at one time some of these countries (none where the first oil discovery was made after 1950) collected their oil revenues in the form of royalties.

TABLE A
U.S. CORPORATE FOREIGN EARNINGS AND TAX CREDITS
($ million)

	Foreign Earnings			Foreign Tax Credit		
	All Corp's	Petrol	Petrol's Share Of All Corp's	All Corp's	Petrol	Petrol's Share Of All Corp's
1969	8,128	2,452	% 30.2	3,988	1,779	% 44.6
1970	8,789	2,935	33.4	4,549	1,820	40.0
1971	10,299	3,856	37.4	5,486	2,444	44.5
1972	12,386	4,552	36.7	n.a.	n.a.	n.a.

Source: Dept. of Commerce Survey of Current Business and Internal Revenue Service, Corporate Income Tax Returns.

TABLE B
Foreign Income Tax Payments And Tax Credits Of 18 Major U.S. Oil Companies
($ million)

	Foreign Tax Credit	Foreign Income Taxes	Ratio of Column (1) to Column (2)
1969	1,176.5	2,027.0	58.0
1970	1,181.6	2,366.6	49.9
1971	1,676.2	3,808.4	44.0
1972	1,616.2	4,315.0	37.5
Increase 1969-72	37%	113%	

Source: Reports by Price Waterhouse & Co. to the General Committee on Taxation of the American Petroleum Institute.

Note: The figures shown are those reported in the published financial statements of the companies. They exclude two major U.S. foreign oil companies — Aramco and Caltex — the income taxes of which are not included in the consolidated reports of their shareholders whereas the earnings are

TABLE C
Hypothetical U.S. Income Tax Liability And Foreign Tax Credit On Equity Kuwait Crude Oil, March, 1974 - (Posted Price $11.55)

	Present Law		Present Law Without Depletion Allow.		No Foreign Tax Credit No Depletion Allow.	
Recent Market Price		9.70		9.70		9.70
Depletion Allow. Computation:						
Rollback to Wellhead	0.08					
Royalty (12.5% of Posted Price)	1.44					
		-1.52				
Gross Depletable Revenue		8.18				
Depletion Allow. (22% of above)		1.80				
U.S. Income Tax Computation:						
Gross Income		9.70		9.70		9.70
Less:						
Royalty	1.44		1.44		1.44	
Operating Cost	0.07		0.07		0.07	
Depletion Allow.	1.80		-		-	
Kuwait Tax	-		-		5.52	
		3.31		1.51		7.03
Taxable Income		6.39		8.19		2.67
U.S. Tax @ 48%		3.07		3.93		1.28
Kuwait Income Tax (see p. 29)		5.52		5.52		5.52
U.S. Foreign Tax Credit		3.07		3.93		-
Excess of Kuwait Tax Over Foreign Tax Credit		2.45		1.59		-
Total U.S.-Kuwait Tax Cost		5.52		5.52		6.80

(3) Posted vs. market prices: Another criticism of the U.S. Foreign Tax Credit provision as it applies to foreign oil is that the credit is permitted on the artificially inflated earnings based on posted prices. Posted prices were originally the market prices at which oil companies were willing to sell to third parties. In the early 1960's, the setting of these prices was taken over—at first informally and now officially—by the governments of the producing countries and were set above actual market values. For instance, the current posted price for light Saudi Arabian crude oil is $11.65 per barrel. But the actual market value of this oil is $1.50–$2.00 less. Since company profits for tax purposes are calculated on the basis of posted prices by the producing countries, it is argued that the profits are overstated as are the resulting tax payments to the foreign governments and the ensuing U.S. Foreign Tax Credit.

The problem is that some countries such as Saudi Arabia and Iran require the producing companies to use only posted prices for accounting and operating purposes. If these companies grant discounts off the posted prices to meet market competition they must do so outside the producing countries. In some other countries such as Venezuela, it is only necessary to pay taxes on the basis of "tax export values." For export purposes the foreign companies in Venezuela are free to use actual market prices. They take therefore a Foreign Tax Credit only on that portion of their foreign tax payments which is based on market prices. The balance is treated as an expense.

Since the U.S. Treasury takes the position that profits or losses for tax purposes should be based on transactions at real market values, it has argued that the Foreign Tax Credit should be based universally on foreign earnings arising out of market prices rather than government-imposed posted prices. The change would not bring about additional tax payments to the U.S. Treasury because all producing country tax rates are above comparable U.S. tax rates. The only effect would be a reduction in excess Foreign Tax Credits.

Table "C" illustrates the workings of the Foreign Tax Credit, based on the estimated recent market price of one type of crude oil at the Persian Gulf. The table shows that the allowable Foreign Tax Credit equals slightly more than half the actual tax paid to the producing country. As pointed out earlier, the resulting excess tax credit may under certain conditions be used to reduce U.S. tax liability on earnings in other foreign countries.

The table also shows that removal of the depletion allowance on foreign production earnings which is currently under consideration by Congress, would reduce the excess tax credit but would not result in the payment of any U.S. income tax in the case shown. However, the reduction of the excess tax credit could bring about an increase in U.S. tax liabilities from earnings in some other countries for companies using the overall method of determining their Foreign Tax Credit. The Treasury has estimated that removal of the depletion allowance on foreign oil production earnings would increase U.S. tax liabilities by $40 to $50 million a year.

The removal of both the Foreign Tax Credit and the depletion allowance would in the specific case shown create a U.S. liability of $1.28/bbl in addition to the $5.52/bbl liability to the producing country. This would cut the existing net profit of $2.67 on equity crude oil nearly in half.

(4) The real point margin on foreign oil: Tables "C" and "D" show that crude oil with an fob market value of $9.70 bbl at the Persian Gulf has a total tax-paid cost to the producing company of $7.03/bbl, resulting in a profit margin of $2.67 bbl. This is substantially higher than the historic profit margin on foreign crude oil for most international oil companies. The sharp increase in the margin has created the impression that higher posted prices and tax payments, in the foreign producing countries have moved in tandem with higher after-tax profits for the oil companies.

However, the profit margin shown in the two tables applies only to "equity" crude oil, that is crude oil owned by a priavte company and produced for its own account. Until 1973, virtually all crude oil (except royalty crude) produced in the Middle East and North Africa could be considered equity oil. Since then government companies in the producing countries have progressively taken over varying shares of the oil companies equity.

TABLE D
Income Tax, Tax-Paid Cost And Effective
Tax Rate On Kuwait Equity Crude Oil
($/bbl)

I) Income Tax Calculation		b) Tax-Paid Cost to Companies
Posted Price	11.55	—
Production Cost	-0 07	0 07
Royalty (12.5% of posted price)	-1.44	1.44
Taxable Income	10.04	—
55% Income Tax	5.52	5 52
Tax-Paid Cost to Companies		7 03
c) Effective Income Tax Rate		
Market Price		9 70
Cost:		
Production	0.07	
Royalty	1.44	1.51
Pre-tax Profit		8.19
Income Tax Payment		5.52
Ratio of Tax to Profit		67.4%

In Kuwait and Qatar, equity crude will account for only 40% of total production. In Saudi Arabia, a similar share is being negotiated, probably retroactive to January 1, 1974, while in Libya the companies share seems to have been set at 49% of total production.

Since all of the established international oil companies need considerably more oil than their equity share entitlement to meet their internal and external market requirements, they must buy the balance back from the producing country government at prices imposed by the latter. While the level of many of these "buy back" prices has not yet been determined, will probably be near the current market price.

Thus, under the new system the profit on a company's equity crude must now be viewed in conjunction with the possible loss—or, at the very least, absence or profit—on its buy-back crude. Taken together the overall profit margin per barrel of crude oil is therefore considerably smaller than that on a company's equity crude alone.

For instance, a company with 40% equity crude, having to obtain the balance of its crude requirements under buy-back provisions or in the open market, could under our assumption, have an overall per-barrel profit of less than half of that received on its equity crude.

(5) Differential treatment of state and foreign taxes: The question is sometimes asked why foreign income taxes are treated differently from U.S. state income taxes. A state income tax can only be deducted as an expense in computing federal income tax liability while a foreign income tax can either be deducted or be treated as a tax credit for federal income tax purposes.

The question is only superficially meaningful. State income taxes and foreign income taxes are simply not comparable. Since U.S. tax legislation treats all state taxes alike, the problem of competitive advantage or disadvantage does not enter into consideration in the federal treatment of state taxes. In the treatment of foreign tax liabilities of U.S. firms, however, this consideration is of major importance. If the U.S. practice were to be more severe, that is create a greater total tax burden, than that of other nations, American firms abroad would of course be at a competitive disadvantage

Treating foreign income taxes as a deduction for U.S. tax purposes would result in partial double taxation—taxation of the same income at the foreign source and at home. According to a calculation of the National Foreign Trade Council, this would increase the total tax burden for U.S. companies as follows in a number of selected countries:

EFFECTIVE INCOME TAX RATE FOR U.S. COMPANIES

Local tax jurisdiction of subsidiary	Treating foreign taxes as a deduction	Under present law	Percentage increase
Canada	77.2	56.2	37.3
France	74.6	51.2	45.7
Germany	71.8	45.8	56.8
Italy	76.0	53.9	41.0
Japan	72.9	47.8	52.5
Mexico	73.2	48.5	50.9
Netherlands	73.3	48.6	50.8
United Kingdom	71.4	45.0	58.0

Source: "Economic Implications Of Proposed Changes In The Taxation Of U.S. Investments Abroad, National Foreign Trade Council, Inc.," June 1972.

The increases would apply only to U.S. companies. Domestic companies in those countries would of course not be affected by it. Nor would firms of third countries other than the U.S., since most countries either do not tax the foreign earnings of their business enterprises at all or allow a tax credit for such earnings.

Most other home countries of international oil companies treat taxation on foreign-source earnings at least as favorably as the U.S. Any weakening of the Foreign Tax Credit provision in our law would therefore create a disparity between the tax burden of U.S. and foreign oil companies. The U.K., the Netherlands, France, Italy, Germany, Belgium, Sweden and Japan, all home countries for companies with foreign oil operations, either exempt foreign earnings from taxation or grant full tax credits on such earnings.

Most of these countries—the U.K. Netherlands, Italy, Germany, Belgium and Japan—also permit the deduction of foreign losses. This indicates that U.S. tax legislation in this regard is in line with international tax practice.

A proposed change in this particular tax provision, requiring the recovery of these losses out of future earnings for U.S. tax purposes, would weaken the international competitive position of U.S. oil companies primarily in the one activity of most interest to the U.S.—the exploration and developemnt of new areas. Most oil company losses abroad are incurred during the search for new oil deposits and the early development years of such deposits and are deductible either currently (with loss carry-over provisions) or are amortized over a period of years.

However, any U.S. tax benefits that may be realized in the exploratory stage through deduction of losses are partly or wholly offset by the reduction of creditable foreign taxes during the pay-out period because most foreign producing countries also permit the deduction of such losses from future earnings.

If U.S. oil companies were required to refund the loss deductions to the Treasury out of subsequent earnings they would find it more difficult to bid competitively with non-U.S. companies in the ever faster race for access to the remaining petroleum resources around the world.

The national interest would seem to indicate just the opposite stance on the part of the U.S. government. Certainly, no other country is putting these or other restraints on the foreign activities of its oil companies—not even countries, such as the U.K. and the Netherlands, which have recently found substantial oil and gas reserves in their own home territories.

The CHAIRMAN. Next we will call Mr. John Miller, president of the Independent Petroleum Association of America. I believe he would like to have some of the members of his association appear with him at this time.

Who would you like to have accompany you on this panel, Mr. Miller? I think that would speed this testimony.

Mr. MILLER. Senator, if we might, we would like to have Mr. Bob Mead, Mr. John Franks, Mr. Warren Tomlinson, Mr. Karney Cochran, Mr. John Phillips, Mr. Bill Myler, and Mr. Ken McWilliams join me at this time for testimony, if that is agreeable with you.

The CHAIRMAN. I would ask that those witnesses be identified in in connection with the companies with whom they are associated.

Mr. MILLER. Senator Long, we thank you and the members of the committee very much for this opportunity to appear before you and to bring testimony on this very important matter.

Each of the speakers that follow will identify themselves and their connection in their statement, if that meets with your approval, sir.

STATEMENT OF C. JOHN MILLER, PRESIDENT, PETROLEUM ASSOCIATION OF AMERICA, ACCOMPANIED BY ROBERT E. MEAD, PRESIDENT, MACDONALD OIL CORP.; JOHN FRANKS, PRESIDENT, FRANKS PETROLEUM, INC.; WARREN E. TOMLINSON, PRESIDENT AND CHAIRMAN OF THE BOARD, TOMLINSON OIL CO., INC.; KARNEY R. COCHRAN, PRESIDENT, PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION, AND REPRESENTING THE NEW YORK STATE OIL PRODUCERS ASSOCIATION; JOHN G. PHILLIPS, CHAIRMAN OF THE BOARD, THE LOUISIANA LAND & EXPLORATION CO.; WILLIAM C. MYLER, PRESIDENT, MUSKEGON DEVELOPMENT CO., AND REPRESENTING THE MICHIGAN OIL & GAS ASSOCIATION; AND W. K. McWILLIAMS, JR., CHAIRMAN AND CHIEF EXECUTIVE OFFICER, McMORAN EXPLORATION CO.

STATEMENT OF JOHN C. MILLER

My name is C. John Miller. I am a partner in Miller Bros., an independent oil and natural gas exploration and production firm at Allegan, Mich. I appear here as president of the Independent Petroleum Association of America, a national organization of independent petroleum producers representing some 4,000 members in every producing area in the United States.

PROPOSED TAX CHANGES AND DOMESTIC OIL PRODUCTION

The purpose of this presentation is to discuss the changes in mineral tax provisions affecting oil and natural gas that are pending or proposed in Congress, particularily with respect to phasing out or retroactively terminating percentage depletion on oil and natural gas.

If enacted, these proposals would achieve, in effect, an undesirable tradeoff of decreased energy supplies for more tax dollars. Because the United States already has a very large and growing deficit in its domestic supplies of both crude oil and natural gas, it is our firm conviction that adoption of these proposals would so aggravate our supply position as to cause intolerable balance of payments and security of supply problems.

Mr. Chairman, I would like to discuss the proposition of terminating the 22 percent depletion provisions in terms of a number of considerations and realities that I believe mérit close examination by the Congress. They can be summarized briefly as follows.

No. 1, the independent segment of the domestic petroleum producing industry would be critically affected by termination of depletion to the extent that thousands may be forced to liquidate their businesses. This would preclude development of needed domestic oil and gas supplies in the future because the 10,000 independents in the industry conduct

more than 85 percent of exploratory drilling to find and develop new petroleum reserves.

Two, any reduction in or removal of tax incentives ought to be viewed in light of the fact that the domestic petroleum producing industry has just gone through a 17-year period of declining exploration, drilling, and development. This has resulted in sharply reduced reserves in the face of a 90-percent gain in demand for oil and a 138-percent rise in demand for natural gas.

Three, a great deal of uncertainty exists in the industry because of the fact that Congress is actively considering punitive legislation which would have a debilitating impact on domestic producers.

The Nation faces energy shortages. This is just not the proper time to consider substantial alterations in the tax laws which have been embedded in the economics of this industry for nearly 50 years.

If the Congress deems it in the national interest to alter the tax laws, these changes should be carried out only after careful, deliberate consideration of the likely effects.

Four, unless Government tax and economic policy reflects not just a willingness but a determination to encourage massive expenditures in domestic exploration and development of all energy resources, and oil and gas in particular, the downtrend in our energy supply will not only continue but accelerate. The results will be an increasing dependence on foreign energy and a cost in terms of our balance of payments that will be intolerable.

Five, the Nation will continue to be primarily dependent on oil and natural gas to meet its energy needs at least through the 1980's. There are vast potential domestic oil and gas reserves remaining to be found, enough certainly to greatly reduce our dependence on insecure foreign supplies. The surest, quickest, lowest cost means of maximizing our supplies of petroleum fuels is to reactivate and encourage the 10,000 independent producers to explore the vast, promising sedimentary basins onshore in the lower 48 States.

Six, because of recent improvements in economic conditions, there are indication that the 17-year decline in domestic exploration and development activity that had its onset in 1956 is being arrested in 1974. As a result, the decline in domestic crude oil production that began in 1970 will bottom out this year. Production will increase in 1975, and subsequent years, unless the resurgence now taking place in drilling and development is killed by punitive, counterproductive actions such as the proposed retroactive repeal or phaseout of percentage depletion.

The elimination of depletion now proposed by some in both the Senate and House reflects the apparent conclusion of its sponsors that (a) our energy problems are over, (b) increased levels of exploration for and development of oil and gas supplies are not essential to meet our energy needs, or (c) that removal of $3 billion plus per year from the domestic industry through the elimination of depletion would have no effect on levels of expenditures for exploration, or on future discovery, development, and recovery of additional oil and natural gas resources. It is my considered opinion based on the facts that none of these conclusions is correct.

It is highly important that Congress and the American people fully understand the dangerous and growing inadequacy of U.S. supplies

of oil and natural gas, and our accelerating dependence on remote and insecure foreign supplies. Petroleum fuels, oil and gas, are relied upon by the American people to fill 75 percent of their energy needs. In future years, the role of conventional oil and gas will undoubtedly change, but no significant change will occur before the late 1980's. In the interim, the Nation has no practical alternative except to move ahead with maximum development of its petroleum resources. To do less is to invite the unacceptable economic costs and the insecurity of supply that are inherent in overdependence on foreign oil.

To examine where we must go, it is useful to look at where we have been and were we are at the moment. A good starting point is 1956, the year that the United States peaked in exploration and drilling for oil and natural gas. Since that time, the demand for liquid petroleum fuels has increased 90 percent, and the consumption of natural gas has risen 138 percent. These demands have been increasingly met out of the reserves found through past discovery efforts and increased imports. Not since 1966 have we found as much crude oil as we have produced in any one year; discoveries of natural gas have not equaled production since 1967.

Why our oil and gas supply situation has eroded should not be a mystery to anyone. A few figures comparing the domestic industry's exploration activity in 1956 as it translated into available petroleum reserves compared to 1973 provides a graphic explanation.

Geophysical activity during this period is down 60 percent. Wildcat wells drilled are down 54 percent. Total wells drilled, down 53 percent; rotary rigs active, down 54 percent; proved reserves, except the North Slope, crude oil is down 16 percent, and natural gas is down 5 percent.

The root cause of these substantial downward changes can be seen in the decrease by 15 percent in the price of crude oil expressed in constant 1973 dollars from $4.57 to $3.89 per barrel. In late 1973, crude oil prices began to increase providing an improved economic climate which will reverse these declining trends if the industry is not thwarted by adverse governmental policies.

I should mention that in the 1956–73 period, the average price of gasoline, excluding Federal and State taxes, increased 25 percent. And during this time, the Government's consumer price index measuring the retail cost of all items increased 70 percent, and the wholesale price index for all commodities rose 49 percent.

The most ominous statistic, and one which should be kept in mind by Congress as it weighs energy tax policy as well as all energy policy, is the fact that our dependence on foreign oil from 1956 to 1973 increased 332 percent, from 1,436,000 barrels daily to 6,201,000 barrels a day. Until the United States halts and effectively reverses the erosion in its productive capacity of oil and gas, the incremental increase in our demands for both oil and gas must be met by higher imports of Eastern Hemisphere oil. To meet this incremental increase, imports must rise on the order of 1 million barrels daily per year.

The Federal Energy Administration recently computed the composite cost of our imports at $10.42 per barrel. At this price, the Nation's bill for imported oil will exceed $23 billion in 1974, and each million-barrel increase in future years will raise that import bill by approximately $4 billion. If the U.S. requirement for imported oil

reaches 10 million barrels daily by 1980, as some have forecast, our import bill as present prices would equate to more than $38 billion yearly. We are already in a precarious balance-of-payments position.

For economic reasons alone, not to mention security reasons, this Nation has no practical alternative except to maximize production of its energy resources within the United States, and its development and production of its oil and natural gas in particular. It is significant that the combined price of domestic oil and natural gas today—expressing our gas production in crude oil equivalent—is less than $4 a barrel. Nowhere on Earth can we obtain a comparable energy bargain.

There is strong evidence that the domestic independent oil and gas producing industry has set in motion a resurgence of effort that will halt our decline in crude oil production their year and which promises increased production in future years. In terms of what must be done, however, in recognition of the long leadtimes required to significantly increase output, we have barely made a start. In terms of capital requirements needed to reverse the Nation's energy supply position, we have not begun to generate sufficient funds.

Senator, I will cut on through this statement a bit and condense this in order to save some time.

I would like to point out, though, that the capital requirements for all facilities needed to achieve maximum oil and gas supply by 1985 are projected to be in the range of from $16 to $20 billion yearly. It is interesting to note that the total wellhead value of domestic oil and natural gas in 1973 came to only $17.2 billion.

The question of whether it is desirable to move ahead with development of our energy resources clearly is a public policy question, and therefore, a political question. Government policy, including tax policy, can be directed to either encourage or discourage the search for and development of oil and natural gas.

This fact was never more clearly illustrated that in the unmistakable results of the changes in oil and gas tax treatment incorporated in the Tax Reform Act of 1969, the principal item being a reduction in the rate of percentage depletion on oil and gas from 27½ to 22 percent. The reduction in depletion, together with other changes, increased the tax take from domestic producers by about $600 million annually. In the next year, 1970, exploratory drilling in the United States dropped by 2,008 wells, a 21-percent decline from 1969. This was the biggest drop in exploratory drilling in a single year in the history of the industry. We still have not regained the 1969 level of exploration.

However, we are on the road toward the 1969 level and above if Congress does not act precipitously to undermine the improved economic incentives that are now generating greatly increased exploration and development.

The role of the independent producer has been set forth in testimony before this committee before, and I would again just reiterate that the independent is the one responsible for drilling in excess of some 85 percent of the exploratory wells drilled in this country. And if we are going to ever be successful in a drive for energy self-sufficiency, this segment of the industry is going to have to become motivated, such as it has not been for the last 20 years.

I would like now to speak briefly to the fallacy that percentage depletion is no longer justified or needed because of "high oil prices."

Natural gas, the price of which is rigidly regulated by the Federal Power Commission, constitutes 56 percent of the energy, measured in British thermal units, produced by the domestic petroleum industry at the wellhead; the other 44 percent is in the form of crude oil. As I have pointed out, the combined price of domestic crude oil and natural gas is about $4 a barrel. The price of domestic crude oil averages about $7 a barrel. In the combined price, or for crude oil alone, the domestic industry is selling the lowest cost energy available to Americans today.

There is an erroneous assumption that price improvements simply result in "windfall" or "excess" profits. Those who believe this simply do not understand the function of price or the economics of petroleum exploration. The improved prices authorized by Government were for the purpose of stimulating exploration and recovery programs that were not being undertaken and would never have been undertaken at the lower prices.

About 30 percent of domestic crude oil is selling at the free market price of approximately $10 a barrel. About an eighth of total production, included in this 30 percent, is from stripper wells producing less than 10 barrels daily. This price will stimulate programs to increase recovery from marginal and idle wells by hundreds of millions, and ultimately, billions of additional barrels of oil. Some of the innovative recovery programs that will be forthcoming will entail costs of $8 or more a barrel. The oil thus recovered will be that which never would have been recovered at lower prices. Secondary and tertiary reserves are a known quantity, already discovered with the pipe in place.

Likewise, free market prices for new oil will stimulate deep and much more costly drilling ventures to develop production that would never have been sought at lower prices. This is the only hope of finding the substantial additional oil that is available, because the easy and the cheap oil has long since been found.

Mr. Chairman, it is hoped that Congress is not willing to foreclose all chance of restoring energy self-sufficiency through punitive tax changes that would be counterproductive to the basic and pressing need to increase U.S. supplies of oil and gas.

Thank you.

OIL PRODUCTION

The CHAIRMAN. While Senator Mondale is here, I would like to see if I can get an answer for him from you that you might know.

What can you tell us about the fact that the production seems to be going down while the price is going up? Why is it we are producing less oil, even though the price has gone up?

Mr. MILLER. I would say that we are not producing less oil in the overall sense. We feel at this time that the figures this year will indicate that our continual decline has been arrested. Those numbers do not translate into the immediacy of a weekly or a monthly reporting series. We feel that within the four quarters that it will indicate that this leadtime that we have experienced over a year has, in fact, been arrested by the stripper wells that were off production, no longer economic, having been placed back on production by remedial work on existing, other stripper wells having been undertaken, and by the increase in drilling activity with some of those wells coming onstream. It is the time lag involved that Senator Bartlett addressed himself to. We do feel we can state the decline has been arrested.

AVAILABILITY OF STEEL FOR WELL DRILLING

The CHAIRMAN. It does not take nearly as much steel to drill those 6,000-barrel-a-day wells over there in Saudi Arabia; that is, it does not take any more steel to drill one of those 6,000 barrel wells over there than it does to drill a 50-barrel-a-day well here, does it? It is about the same thing.

Mr. MILLER. I guess it could be true.

The CHAIRMAN. And it is my understanding that the industry had geared itself to going overseas and, frankly, your fellows were gearing themselves for going out of business at the time all this happened, were they not?

Mr. MILLER. We basically have been phased out of business. Over half of our people are no longer actively engaged in the oil and gas industry.

The CHAIRMAN. When the price went up and it looked as though there was going to be something for the independents to do after all, but when you found that the steel companies had not made the pipe and the casing that you would need, and you could not get the rigs that you needed because they had not planned on you fellows being in business this long anyhow, so that when you went back to drill a lot more wells, was there not a shortage of steel to contend with?

They had steel; it just was not made in the shapes you needed?

Mr. MILLER. Yes, sir; that is correct. We determined by our study that the steel mills are capable of rolling sufficient tonnage to fuel the available working rigs now operating in the United States. There is no capacity to build inventory, but if that steel flows through to the active operating rigs, we can maintain a rig count that would be approximately 25 percent greater than that which was actively working last year and would allow us to be about this business of regaining a position of some degree of energy sufficiency.

The CHAIRMAN. Furthermore, the British and others had enough good judgment to draft their leases in such a way that required immediate drilling on those leases. And the companies that achieved those leases have a firm commitment to drill them immediately. So we had rigs being fabricated over here that are being sent over there to drill even though those wells over there are not doing us any good.

That is part of the overall problem, is it not?

Mr. MILLER. Yes, sir, it is. I think perhaps a graph indicating what happened at the conclusion of World War II would probably be the most dramatic testimony to what can be achieved if there is a commitment on the part of this country to achieve the goal of energy sufficiency. And that is at the end of World War II, with a dramatic increase of oil and gas, we did find that the steel companies did address themselves, and the manufacturing companies, immediately addressed themselves to the manufacture of drilling rigs and of tubular goods, and we saw a tremendous surge in the rate of drilling.

And, in fact, Senator, what occurred was a complete dedication of effort there that eventually placed us in a position where we actually had surplus producing capacity. We were that successful in achieving that goal. Under the same guidelines, the same opportunities, I would think that we might have at least a reasonable possibility of working towards a like goal.

REASONS FOR INDEPENDENTS DRILLING 80 PERCENT OF EXPLORING WELLS

The CHAIRMAN. Now, can you tell me why it is that the independents seem to be drilling 80 percent of the exploratory wells?

Mr. MILLER. Yes, sir. It is their area of operation. This is the area that the independent can operate in. Most independents are precluded from operating to a great deal offshore, and most of them are precluded from operating in foreign operations because of the cost and the size of that operation. So we have found that the domestic, the lower 48, has been primarily the province of the independents, and they have addressed themselves to the problem of operating, and I think have done a tremendous job of maintaining a reasonable operation in the face of some extremely distressing circumstances.

The CHAIRMAN. Thank you.

Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

TURN OF EVENTS AFFECTING OIL PRICES

I just want to commend you for an excellent coverage of the problems that are facing us today in trying to meet the energy crisis and the tremendous need that we have for petroleum products.

Is it not true that there are many other factors that enter into the problems that have come about in the last few months, in the last couple of years?

We hear so many references as to what was stated by you or others in the industry about what price oil would be sufficient for you to go forward with your exploration and development. But has there been cost increase because of inflation that has affected you to some extent?

And, also, I understand that another 20 percent of the company profits are affected by the adherence to old depreciation schedules where ignored replacement costs are taken into consideration. Are there not many factors there?

I think this is something we should clarify, because there is quite a misunderstanding brought about by some of the statements that were made by you or other leaders in the industry at a time that was vastly different than what we face today.

Mr. MILLER. Thank you, Senator.

I did learn a lesson in that, I guess, that what you say may come back to haunt you. I assume you are all very familiar with that. I did not have that experience.

Let me say that that letter, I believe, was written—and I do not have a copy of that letter, Senator Mondale—but the letter came about after a study had been undertaken to try to determine how much additional oil could be recovered at various incremental rates.

Now, the letter may have been a summary-type letter and may not address itself to all of those things. But the National Stripper Well Association at that time had attempted to develop some scheduling here that would say, if oil is raised 50 cents a barrel, then x number of wells could be placed onstream and that their new economic limitation would then be thus if it were $1 a barrel and if it were something else. And at that time we had used a schedule trying to set forth what would happen if $5 oil were in existence, and of course it was stated in the context of the existing cost of that time, which of course we are very much aware has changed this picture greatly.

Senator FANNIN. That is what I was saying, the times have changed. What we are up against has changed greatly. Your capital, your money, everything else has been tremendously affected with the turn of events.

Mr. MILLER. Yes, sir.

Senator FANNIN. So I think it is unfair for us to place you in a position of having projected something back when conditions were entirely different, and try to hold you responsible for it today and say that, well, look, we are taking your own figures. You know this is often done, and I know as far as the foreign oil operations, the change as far as the currency is concerned has made a great difference.

I think it has been estimated that 20 percent of the profits increase was due to currency exchange. Now, this is in foreign commerce, but when we are talking about oil prices, there are so many other considerations that must be reflected.

Mr. MILLER. Yes, I think very quickly we can grab just one particular isolated number and say what the basic rate was for borrowing money at that particular time and what it is now, and if we crank that in alone, we measurably change that number and every other area of costs that we would address ourselves to will also reflect itself in that number.

But again, that study could as well have been addressed to $7 oil, $8 oil, or $10 oil, and we could have as well demonstrated that an increase in price does make each of those wells a new economic entity for an additional period of time, recovering a greatly increased amount of oil.

EFFECT OF REPEALING DEPLETION ALLOWANCE

Senator FANNIN. I know that in my State of Arizona, I will just speak about the change that came about when the depletion allowance went from 27½ to 22, and we did reflect just about that percentage of decrease. Now, I am not saying that if we did away with the depletion allowance entirely that you would go out of business, but it would certainly make a tremendous change in your operations and your risk capital is quite dependent upon depletion allowance, as I understand it.

Mr. MILLER. It certainly is, Senator, and the removal or reduction of depletion will dramatically affect the number of wells drilled in this country, dramatically. There will be some specific testimony offered to that point.

Senator FANNIN. Very good.

And I thank you very much.

The CHAIRMAN. Senator Mondale?

INDEPENDENTS' INVOLVEMENT IN FOREIGN OIL, OFFSHORE OIL, AND FEDERAL LANDS

Senator MONDALE. You indicated that independents could not really participate in the development of oil resources in other nations, and you said that independents found it difficult to engage in the more costly offshore oil developments.

Is that correct?

Mr. MILLER. Yes, because of the size of their operation. I do not say that they are not involved, Senator. I say that you take the 10,000 independents, those that are involved in offshore and foreign operations are a relatively small number.

Senator MONDALE. What about independents' involvement in oil resources on the Federal lands? We have heard criticism that with the present policy which requires bidding with the price up front, the cost of the lease to produce oil on Federal lands culls out many of those small producers that might be able to participate if they could spread

the cost of the lease over the production period—maybe represented by a percentage of oil or in some other way—so that it would not take all of that money to get involved.

Is that a matter that affects independent involvement in Federal reserves?

Mr. MILLER. I am sure that the front money has to be a contributing factor to preclude an independent from operating out there, but there are other factors that are also very important, the unlimited liability aspect and the cost of doing business out there alone is rather terrific. I can answer you specifically as far as the front money on an illustration that happened in my home State the day before yesterday at an auction of State leases, where one 80-acre tract went for $1,800,000, which is in the offshore category per acre. Fortunately it was a small tract, but I can feel rather confident, although that was bid in a broker's name, that no independent bought that particular tract. That is a pretty high risk to attach on one spot where you are going to drill a hole and you either win or lose; one time at bat is all you get.

DEPLETION ALLOWANCE—ADVANTAGE PER BARREL

Senator MONDALE. What do you estimate the advantage of the present oil depletion allowance is worth per barrel? Do you have a standard? The allowance is now 22 percent.

About how much does that work out to per barrel in terms of tax relief? Is there a standard?

I have heard the figure 60 cents a barrel.

Mr. MILLER. Of course, 22 percent of the $10 would start in at $2.20, but the depletion is set up, of course, to where it is limited. It is expressed 22 percent of the gross or 50 percent of the net. So as you have the lower producing wells, then you in effect have a lower effective depletion rate, and I do not know that I could state what it is across the country at this moment.

Senator MONDALE. There is not a sort of rule of thumb of what that preference is worth in oil per barrel?

Mr. MILLER. I have not heard it expressed that way. We tried to determine one time what the effective rate of depletion actually was, and it was below the 22 percent, of course, because of the net limitation.

Senator MONDALE. Mr. Chairman, I do not have any questions. I would like to ask some questions of one of the independents when we get around to it.

The CHAIRMAN. Well, go right ahead, Senator. That is perfectly all right.

DEPLETION OIL PRODUCTION DESCRIBED

Senator MONDALE. All right, I wanted to ask, how about Mr. Cochran.

STATEMENT OF KARNEY R. COCHRAN

Mr. COCHRAN. Right here, sir.

Senator MONDALE. You are from Pennsylvania. Are you an independent oil producer?

Mr. COCHRAN. I am an independent oil producer.

Senator MONDALE. And are all of your operations in Pennsylvania?

Mr. COCHRAN. Mine are all in New York State.

Senator MONDALE. I see.

Now, what were you getting for oil you were producing say a year ago, approximately?

Mr. COCHRAN. A year ago now we were getting I think it was $5.40 some.

Senator MONDALE. Well, let me go back 2 years, then.

Mr. COCHRAN. Two years ago, probably $4.35,

Senator MONDALE. What are you getting for that oil now?

Mr. COCHRAN. $10.65, the highest in the Nation.

Senator MONDALE. Is all of your oil deregulated?

Mr. COCHRAN. Yes, well, for all practical purposes.

Senator MONDALE. Why would you have such a high percentage of so-called new oil or deregulated——

Mr. COCHRAN. Well, we are classified as stripper operators.

Senator MONDALE. Oh, I see, you are all strippers.

Mr. COCHRAN. I produce or own and operate about 225 wells. That sounds like a big number, but I produce only 140 barrels per day.

Senator MONDALE. Do your wells all come within the stripper definition?

Mr. COCHRAN. All of my wells come within the stripper definition.

Senator MONDALE. All right, now, how many barrels per day were you producing say 2 years ago on the average?

Mr. COCHRAN. Two years ago I was producing 130 barrels a day. My production, if I can anticipate what you want to get at, I had estimated my production to be this year 110 barrels per day on an average, but due to the price increase and additional drilling I had, I am now estimating that to average about 130 barrels a day. In other words, I am drilling more than enough wells to offset the normal decline in my production.

Senator MONDALE. But right now your average is about 110 barrels per day?

Mr. COCHRAN. No, it is 140 barrels per day. It was projected to average 110 before I determined to drill more wells as a result of the price increase.

Senator MONDALE. So your production is up some.

Mr. COCHRAN. My production is up some, and I can testify that the production in our little backyard here has increased about 15 percent where it had been projected to decline about 8 percent.

Senator MONDALE. What was the net profit on your operation 2 years ago, if you can remember?

Mr. COCHRAN. I would guess that it was about $20,000.

Senator MONDALE. And what was it last year?

Mr. COCHRAN. Last year it was about $30,000.

Senator MONDALE. And what about your investment in your efforts last year?

How much new investment did you make in your oil operation?

Mr. COCHRAN. Well, last year I drilled 2½ wells. In other words I drilled a joint well. These wells cost $12,000 to $14,000 apiece. This year I have already drilled four. I had planned to drill six more. I hope to get them all drilled. We do have a problem of shortages. Frankly I doubt if we will get them drilled for the simple reason that we do not know what the economic climate is going to be.

In our industry, we are so small that $10.65 which seems an enormous price to the American public, and yet they are willing to pay that much for imported oil, we just do not see why we have to shut

down our operations and quit if they are going to go through with this so-called windfall profits tax, which is based on the price of oil alone, and it would roll our price back to say $7.50 per barrel.

Now, the reason I feel we are justified in a $10.65 figure is this: I have several leases on which I am quite confident, that is, I do not think there is a big risk factor because we have a great deal of information on the reservoir, that I can drill a well and get 3,000 barrels out of it in probably the next 7 years.

Now, that would bring me in a gross income of $30,000. I will pay $12,000 to $14,000 to drill the well and equip it. I will probably have another $10,000 to $12,000 in operating it, and it just makes a little bit better return on my investment than I can get CD's, and that is the basis on which most of our operations are.

Senator MONDALE. Now, your price per barrel at which you sell oil has risen from, if I understood you correctly, from about $4.35 a barrel 2 years ago to $10.65 a barrel for an increase of $6.30 a barrel. I think that works out to about 150-percent increase in price.

Mr. COCHRAN. That is correct.

Senator MONDALE. Would it have to go that high—would the increase have had to go that high in order to encourage this new activity and investment on your part?

Mr. COCHRAN. To encourage the new activity, there again, to drill the 3,000-barrel recovery well, it would have to go that high.

We also have some areas where we can get 4,000 to even 5,000 barrels, so that would obviously have been accomplished at a lesser price.

Senator MONDALE. Thank you, Mr. Chairman.

Senator BENNETT. May I ask a question?

Mr. COCHRAN. I would like to make one additional comment here; $10.65 is even more than we are paying for the Arabian oil, and you cannot say that we have a cartel there. Our little old region up in the Pennsylvania area produces one-third of 1 percent of the domestic oil produced in the United States. We produce 18, around 18 percent of the lubricants produced in the United States, and they are in very tight supply, and I actually believe that the refineries that purchase our oil would pay us more if it wasn't for the jawboning that has been done, because lubricants are in tight supply.

Senator MONDALE. Thank you.

Senator BENNETT. Mr. Chairman, I just have a curiosity.

How deep do you have to go down to get your oil?

Mr. COCHRAN. Our wells range from a minimum of 300 feet to a maximum of 2,000 feet. And the range in which my personal drilling is done is about 1,400 feet.

Senator BENNETT. That is all I have, Mr. Chairman.

The CHAIRMAN. If you would like to ask more questions, Senator Mondale, please go right ahead.

Senator MONDALE. Is your oil a special quality or difference which bears the higher prices?

Mr. COCHRAN. Yes. Our oil contains about 30 percent of lubriating fraction, 30-percent gasoline, and 30 percent other fuel oil and that sort of thing. The average crude oil produced in the midcontinent area, and I am not so sure of these numbers, is around 2½ percent of the lube fraction, so it is the lube fraction that makes our oil. There is practically no sulfur. It is easily refined, makes high grade lubricants.

Senator MONDALE. Thank you, Mr. Chairman.

Senator BENNETT. As a man who used to be in the retail oil business we always used to boast of the fact that we had Pennsylvania lubricating oil to sell.

The CHAIRMAN. Senator Bentsen?

DIFFICULTIES IN PUBLICIZING DIFFERENCE BETWEEN INDEPENDENTS AND MAJOR OIL COMPANIES

Senator BENTSEN. Thank you very much, Mr. Chairman.

Gentlemen, it is interesting to see how few members of the press we have here today. This is particularly true for those of us who have been concerned a long time about trying to show the difference in the role of the independent oilman and the major oil companies. Recently we had a hearing in Congress where the major oil companies were here, and we had a great TV extravaganza. The room was filled with cameras and the press was crowding that table, and I am sure these two representatives here are very capable members of the press, but they are pretty lonesome over there. And that is the problem of getting the story across.

EFFECT OF REPEAL OF PERCENTAGE DEPLETION ON INDEPENDENTS

Now, you gave a number as to percentage of exploratory wells drilled. I have a number that is a little higher than yours for the first quarter that shows that almost 90 percent drilled by independents, and in Texas alone, 1,384 wildcat wells were built by independents, 141 by the majors.

If you look at these annual statements of the major oil companies, almost without exception their great increase in profits has been overseas, but you cannot get at those sheiks here, so some folks are moving against the domestic situation.

Now, that necessarily hits the independents, and depletion plays a pretty big role for the independents than any others.

I cannot help but remember going to some of the association meetings of independents years ago, and they were very crowded, and then in recent years, very few, most of them there reminiscing about the old days, and then I understand now that we have a bunch of new folks coming in, and I am delighted to see it. But I do not want to see the independent become an endangered species.

And I really believe—and I want to check some economics with you—if we are talking about phasing out depletion as the House bill talks about doing, and doing it over a period of 4½ years, does it make any sense under that kind of a situation for the independent to be buying leases in unproven territory, to be drilling the exploratory wells, to be committing his rigs and his pipe to that, or is it better for him to use wells on proven areas to build up his production on those and not bringing in new reserves, and at the end of 4½ years selling out to the majors on an appreciated cost basis where he can take cost depletion?

Now, is that not about what would happen to the independent, and then he would take his money and put it into things he could make more out of?

Mr. MILLER. Senator, I think that is very correct, and in addition I think that because of that uncertainty, that is the reason we are not seeing a greater increase in domestic production now because of the people standing on the edge wondering what the temperature of the water is going to be. They are just precluded from making any type of plan, going ahead with these things because of these various things that you are enumerating.

Increased Costs of Drilling Wells

Senator Bentsen. I have been given numbers on increases of costs and drilling of wells that in west Texas, to drill a 5,000-foot well, the increase in cost of drilling that well in the last 10 years has increased by 450 percent.

Is that reasonable?

Now, are those the figures——

Mr. Miller. But, as the old cliché goes, it is not real, but it is probably true.

Senator Bentsen. Is it also true that they are not drilling much deeper wells because a good number of the easy-to-find and larger reserves have already been found?

Mr. Miller. That is absolutely true.

Senator Bentsen. And that the cost increase is more than just an arithmetic increase as you go to deeper wells.

Mr. Miller. It certainly does.

STATEMENT OF JOHN FRANKS

Mr. Franks. I am John Franks, president of Franks Petroleum Inc., in Shreveport. We recently drilled a well in St. Mary's Parish, La. It is 1,500 feet at a cost of $400,000, and we had a dry hole and decided to drill the well 1,000 feet deeper. To drill the additional 1,000 feet, which we never really got to due to losing the hole to high pressure, it cost us another $140,000, just to illustrate your point very well.

Forty-Three Other Minerals Have a 22-Percent Depletion Rate

Senator Bentsen. Mr. Chairman, it is pretty difficult for me to understand a policy, where we have probably 43 other minerals that have an average depletion rate of about 22 percent.

How many do we have?

Mr. Miller. I understand that the list is about 115, involving 82 separate, identifiable minerals, but they are broken into 115 categories.

Senator Bentsen. I understand that, but we are talking about 22 percent now.

Mr. Miller. Excuse me. That is correct.

Senator Bentsen. Twenty-two percent is in the area of 43, is it not?

Mr. Miller. I think that is correct.

Senator Bentsen. Have you had some substantial increases in prices of some of those minerals?

Mr. Miller. We certainly have; yes, sir.

Senator Bentsen. But there appears to be a singling out for this particular industry.

Mr. Miller. Yes. We feel without question or doubt that there has been a singling out of this industry, and that we are being subjected to a punitive-type situation that defies a logical answer.

We are in a position where we are extremely short of domestic oil and gas. We are in an intolerable position regarding imports where the only way of reversing that is to maximize our domestic oil and gas exploration effort, and then we are seeing legislation proposed that will absolutely prohibit that domestic effort. It defies an answer.

Drilling Capital Raised By Depletion Allowance

Senator Bentsen. Is it fair to state that a great deal of the capital that is raised for the drilling of these exploratory wells is raised because of the depletion allowance?

Mr. Miller. Yes, sir, it certainly is.

Senator BENTSEN. Is it fair to state a great deal of the capital not had a substantial production increase so for resulting from an increase in price is because there is an actual delay in the accumulation of that capital as the price goes up, and there has been a delay and difficulty in obtaining the goods, the drilling pipe, and the rigs?

Mr. MILLER. Yes, and it goes further back than that. It goes back to the acquisition of the leasehold for the prospect and then the necessary geological and geophysical work, and each of these things mobilizing and getting this thing ready to go. We were in a shutdown position, and to get into an accelerated, active position means that we have to bring all of these things on, and then, after we have the prospect, the rig, the pipe, the whole thing, and the money right along with it.

SEVENTY-FOUR PERCENT OF AVAILABLE TUBULAR GOODS CONTROLLED BY SEVEN COMPANIES

Senator BENTSEN. Is it fair to state that the major companies have been accumulating rigs and accumulating pipe at a much more rapid pace than the independents in this situation?

Mr. MILLER. Our records indicate that 74 percent of the available tubular goods are controlled by seven companies.

Senator BENTSEN. Thank you very much, Mr. Chairman.

That's all I have at the moment.

The CHAIRMAN. Senator Dole?

Senator BENNETT. Senator Dole, would you let me ask one question?

Senator DOLE. Fine.

LENGTH OF TIME FOR DRILLING A WELL

Senator BENNETT. It is along this line.

What do you consider to be the lead time necessary from the time you decide to start a well until you go through all of these necessary steps and reach the point where the drill rig can start to operate?

Mr. MILLER. In some cases it could be accomplished in a matter of some let us say few months, perhaps even in a few weeks, depending on how far along you were and where you were at in that particular area.

In other areas we are going out into a wildcat exploratory, far removed from any other production, you are talking then of a year's time or more, and we have situations, Senator, where we are dealing with a year and a half in my State at the present time, and in fact, we have 200 wells up there that are drilled and completed that are not now on production because the gas lines have not yet been extended on our to pick up the product.

STATEMENT OF ROBERT MEAD

Mr. MEAD. May I make a comment in that regard?

My name is Robert Mead from Dallas, Tex. I think the best example of the time lag is domestic production and for our area we could point out today is Alaska, where we found commercial production 9 years ago and we haven't got a barrel yet.

Senator BENNETT. But the independents are not drilling up in Alaska.

Mr. MEAD. No, but that is a good example.

Senator BENNETT. I wanted a normal, natural, average kind of lead-time pattern.

Mr. MILLER. Well, we are representing, of course, here, Senator, across the country, so there would be a variety of answers, but I am sure that you are dealing in the year area before you accomplish all of this.

Senator BENNETT. All right, thank you very much.

Senator DOLE. Mr. Chairman?

The CHAIRMAN. Please go ahead.

Senator DOLE. As I understand, you are all here as a panel. Or are you each going to be quizzed separately?

The CHAIRMAN. Just go ahead and ask whatever question you wish.

Senator DOLE. Well, I have some questions and do not want to monopolize Mr. Miller's time. I would wait for someone else, but if they are there as a panel, maybe it would save the committee's time if the questions were put, generally.

The CHAIRMAN. Well, you ask any questions you want to. I am going to hear all the witnesses in any event.

REASONS FOR PRODUCTION DECLINE AFTER PRICE INCREASE

Senator DOLE. Well, Senator Mondale raised with Senator Bartlett the question about the increase in price and decline in production. I think there is an easy answer to that and I would like someone to respond to it. I do not think it is difficult at all. Yes?

Mr. COCHRAN. I am Karney Cochran. I will respond.

Senator DOLE. From which State?

Mr. COCHRAN. From New York State, Pennsylvania grade crude oil.

Senator DOLE. Right.

Mr. COCHRAN. At the rate we were drilling, up until 1974 we just were not drilling enough wells to develop the reserves and the production to even maintain a level rate of production. Now, if we drill—for instance, that rate was 27,000 wells, I believe. If it had been, say, 35,000, I do not know exactly what that number is, but if we had drilled some 35,000 we would have stopped the decline. If we drill 40,000 wells, we will get a small increase. If we drill to 60,000 and 70,000 wells, we feel are required to be drilled every year in this country if we are going to attain any degree of self-sufficiency, it is going to require those sort of numbers.

Now, if we drill no wells, the decline is going to be steep. So we could still be drilling wells and still have a decline if we are just not drilling enough wells.

Senator DOLE. Well, Mr. Tomlinson agreed. I do not know what the figures are in Kansas in the last 10 years, but it has been going down. Finally—I am not certain it has been totally arrested, but the intentions to drill have been almost double in our State, just the way the ball bounces. I mean, you do not produce at the same level every year. It drops and it drops and it drops, and if you do not have any incentive for exploration, it is going to continue to drop, and I think that has turned around to some extent in Kansas, has it not, Warren?

STATEMENT OF WARREN E. TOMLINSON

Mr. TOMLINSON. Very much so, and the price increase is really what has done it. We were down to someplace between 15 and 25 rigs running last year. We are running between 40, 45, and 50 rigs now. We, I think, have the capability of maybe putting 10 more rigs to work if we had the casing.

We are starting to see our rigs shutting down now because we have run out of the casing we have been using.

Senator DOLE. Well, the chairman made a reference to casing earlier There has been some evidence of a great deal of it stockpiled by the majors and not available to independents. And that is another problem.

Mr. TOMLINSON. This is one thing that really holds down the increase in production that we could have; if we had the casing to drill development wells while we are working on our exploration programs we could greatly add to our daily production, I think, but right now, if most of us independents that want to drill a new well can only drill wildcats, because that is the only pipe that is available. That is through two or three steel companies who have a wildcatting rig program, and you make application and they try to furnish pipe for a new well each day, but right now that is all we can drill. I am practically out of pipe. I will be out of pipe in another month.

Senator DOLE. Is that true in all the States represented here: Michigan, Louisiana, Texas, New York?

Mr. TOMLINSON. You can go out in west Texas and look at some of those pipe racks, and as far as you can see it is pipe line. They have the money. Most of us independents have to work from hand to mouth. We get ready to drill a well, if we get a producer; we order pipe from the mill.

Senator BENTSEN. Mr. Chairman, would the witness speak into that microphone?

Mr. TOMLINSON. I am sorry.

I say that most of us in the past—and the reason we do not have historical allocations like the majors is that we have never been able to afford to stockpile pipe, so when we get ready to drill a well and if we get a producer, normally we call to the mill and they ship it out there to us. But like I say, most of us that have partners, most of us probably do not control more than a quarter of the well that we are drilling. You cannot afford to stockpile pipe for strangers.

KILLING INCENTIVES FOR INCREASED PRODUCTION

Senator DOLE. Some of us do not understand why we talk about the energy crisis and the need for more production and then turn right around in less than 2 or 3 months and talk about taking away, if not all, most of the incentives.

It is easy to talk about the major companies and separate those from the independents, but it seems the independents always somehow suffer.

What is the worst thing Congress can do to the independents, just in case it happens?

Mr. MILLER. I think if we go ahead and adopt those things that are now proposed in the Congress, that you have severely damaged this country and you have completely put the independents out of business.

REVENUE AND JOBS PROVIDED BY OIL COMPANIES

Senator DOLE. I have often said that most people have the idea that, of course, that there are only very few people in the oil business and they are all rich. Does anybody work for you people in oil? Do you provide any jobs in this country? Do you pay taxes and otherwise have an input into the economy? Do you not?

Mr. MILLER. We certainly do. Warren, why do you not comment on that?

Mr. TOMLINSON. Very much so. As you know, Senator, oil is probably No. 2 in the State of Kansas, and we do employ directly and indirectly thousands and thousands of people. We are very large taxpayers in each of the counties that we are involved in. I think we are all quite aware . the fact right now that we are faced with a very large increase in valuations, much larger than any other industry in our State, anyway.

Mr. MILLER. Senator, perhaps John Frank or Ken McWilliams could comment on the tax implications in their areas?

Senator DOLE. It is important. I think there is always a stress on, you mentioned oil, that means money. And to the average voter and the average person in every State, including my own, there is a sharp separation of anybody in the oil business and anybody in any other business. Somehow you are set apart as a special group with great influence and great wealth. And I find that not to be the case most of the time.

In addition, it is important to our economy in Kansas, and perhaps it has never been fully understood—that may be our fault or maybe the independents'—but I am certain it is true in Louisiana; right?

Mr. FRANKS. Right.

Senator DOLE. As far as the economy is concerned, how many jobs do you provide in that State directly and indirectly?

Mr. FRANKS. Well, in Louisiana, the oil and gas industry for the State undoubtedly is now up to 60 percent of the State revenue, directly and indirectly, with the new tax they put on us there recently. And that is—I do not know the number of jobs.

I myself, as a small independent, am responsible for 27 families that are worried about this situation. They are wondering whether or not we are going to continue. Only one person is happy about it, my wife, who has been trying to get me to quit for 5 years; and I told her there may be a farmer up here who may accomplish that.

Senator DOLE. Well, it seems to me, maybe that is the way it goes. We are sometimes always on the defensive, if you are in politics or in the oil business. Maybe the best defense is a good offense. And if people in America understood how many people are working in the oil industry and what the taxes were and what it meant to the economies of the oil and gas producing States, it might be helpful.

IMPORTANCE OF DEPLETION ALLOWANCE AND INTANGIBLE DRILLING COST WRITEOFF

Do you consider the depletion allowance or the intangible drilling cost writeoff the most important, as independents?

Mr. TOMLINSON. I think you have to have them both, Senator. I would not want to give one up before the other. If you really had to—I think you have got to keep the intangibles.

Senator DOLE. With the depletion allowance, if you are assured of getting a good price for your oil, it would not be quite as important.

Mr. TOMLINSON. Well, it would not be quite as important; it is still important though, and it is still the fact that whether we like it or not at least 80 percent of our money comes from outside the oil business. And you have to have incentives to get people to take these kinds of

risks, because you can go out there and throw your money out the window and you have got just about as good a chance as you have drilling a wildcat. So, you have to have some kind of incentives if you are going to entice a new investor into the oil business. And believe me, they are hard to find and hard to train.

EMPLOYMENT AND THE OIL INDUSTRY

Mr. MEAD. Senator Dole, I am Bob Mead.

I would like to retreat back to your previous question, if you would allow me.

I think that the people in the United States do not have any conception of the rollback effect of money spent in the oil business.

First of all, half of our money goes for steel, and there are a lot of people who work in steel mills. A lot of it goes for automobiles. There are a lot of people who make automobiles tires—I could go on for an hour. But when we talk about the people we employ—we also indirectly employ hundreds of thousands of people in other industries in other areas, and I do not believe we have ever told that story to the public effectively.

Senator DOLE. It is a very positive story they are telling.

REPEAL OF DEPLETION ALLOWANCE ON ROYALTY INTEREST

And finally, gentlemen, I would just ask a question: There has been some talk that perhaps the depletion allowance would remain as far as working interests, but not as far as the royalty interest. Do you have any comment on that? Because they talk about the landowner and others who have nonworking interests, but they do not have any capital invested. Is there any justification for that?

STATEMENT OF JOHN PHILLIPS

Mr. PHILLIPS. My name is John Phillips, chairman of the Louisiana Land Exploration Co. in New Orleans, and we do have royalty interests as well as working interests. And I feel that if you remove the depletion allowance for royalty owners, you will force him to sell his capital assets at ordinary income. The recognition of the depletion allowance as a portion of his income is really recognizing the fact that he is selling an irreplaceable asset under his land over a period of years. And if you remove the depletion allowance, he should be allowed some portion of capital gain on that, as it is sold on a per-unit basis. The capital gain, of course, is not recognized on a per-unit basis.

Senator DOLE. Well, I do not think that is touched on by the testimony. You raised a good point. It is a resource. Where the other seven-eighths might be attracting the capital, this would be a resource.

STATEMENT OF W. K. McWILLIAMS

IMPORTANCE OF TAX INCENTIVES TO THE OIL INDUSTRY

Mr. McWILLIAMS. Senator, my name is W. K. McWilliams, and I am chairman of the board of McMoRan Exploration Co. We have spent a total of approximately $25 million of outside capital, which is all of the capital that we have spent since 1969, since becoming a public exploration company. And I would venture to say that the incentives, the tax incentives, including the depletion allowance and

intangible writeoffs, have been sole reason that we have had the $25 million to work with over the past 4 or 5 years.

Mr. MILLER. Ken, excuse me.

Would you comment as to some of the findings of the investment of that money? I think the Senators would be interested in that.

Mr. McWILLIAMS. Well, we act, as many independents do, we work and invest outside capital and we get a position in our own exploration efforts by actually selling our expertise to the outside capital provided. Now, in the years since we went public in 1969—and it was December 1969—by outside calculated engineering reserve figures, we have found domestically some 260 billion cubic feet of gas and some 15 million barrels of liquid hydrocarbons.

McMoRan, for its expertise in handling the placement of this money in the proper places, has ended up, by these same outside engineering figures, with approximately $45 million worth of future net production income.

We think that if the depletion allowance or the intangible drilling cost is removed, that we will be hard put to find capital to back our exploration effort.

Now, as an example, I would like to give you an example of last year, and what happened to McMoRan Exploration Co.

We had been working with outside money raisers over the past several years and we had a verbal understanding with those money raisers to support our exploration effort to the tune of $10 million in 1973. In May of 1973, the President made his energy speech, in which he encouraged in every manner exploration in the continental United States. We thought that we would have the backing of everyone in the effort to get this thing turned around. Within a matter of, either the next day or two after the President's speech, Secretary Shultz announced a proposal to do away with the intangible drilling writeoff. We had already spent company funds to acquire drilling prospects to the tune of nearly a half a million dollars, and we had already taken drilling commitments of almost $3 million in drilling commitments. based on our past experience with the money source. Just on the proposal of Secretary Shultz's to limit the incentive, our money was withdrawn.

Senator DOLE. So was his proposal.

Mr. McWILLIAMS. So was his proposal.

Mr. TOMLINSON. It was too late, though, Senator.

Mr. McWILLIAMS. But it was too late. And so McMoRan had to try to solve their problem by a complete revamping in mode of operations. And we decided to go, to try to tie up with an end user of product to back our exploration effort. And we ended up tying up on a very fine arrangement with the Dow Chemical Co. to back our efforts in exploration.

I can go into the particulars with the Dow Chemical Co., but suffice it to say that Dow has worked out with us to pay us for our expertise in helping them find products as an end user.

Now, this one proposal by Secretary Shultz not only caused several months of loss in exploration, it caused a good bit of money to be spent and a complete revamping of approach to our exploration efforts.

Tax Proposals Before Congress Causing Uncertainty in the Oil Business

Senator Bentsen. Let me interrupt at that point to tell you that I am not sure that you are aware that yesterday Secreary Simon reemphasized the administration's position, saying that they would prevent drilling expenses being deducted against nonoil income. That adds up to the same thing; that is what it does to you, it denies you the outside capital. Now, they try to call that artificial accounting losses. And let me say, I have put up money for wells that were dry, and I did not find anything artificial about the losses.

Senator Dole. The point was, I do not know how the oil man really knows what he should do. I do not imagine all these proposals floating around the Congress stimulate your business either, do they?

Mr. McWilliams. No, sir. As a matter of fact, in my statement today I say with Government regulations by many agencies, oilfield shortages of tubular goods and drilling rigs, the confusing uncertainties of Federal controls and the many proposals in Congress relative to the oil and gas industry make future planning and projections next to impossible. And we are desperately in need of a measure of stability.

Mr. Miller. Senator, I would like to just say here that there is a point right here that I hope we can focus on, that here has been a successful oil and gas finding company and 9 months of productivity for that company was set aside by one proposal that did not become fact. But that proposal took that oil and gas finder and put him on the shelf. And that, multiplied by the 10,000 independents, is the very place we find ourselves today.

Mr. McWilliams. Now Senator, if I might expand on John's statement——

Senator Dole. Well, I do not want to take all the time, but we have had a good discussion here; and I think it is probably more helpful than reading the statements, which we can all read. There are already half of you gone out of business, and I hope the Congress does not put the other half out of business. The facts are there, as far as the input of the independents, and what the future might be if we talk about the incentives and what the independents can do as far as the energy sources are concerned.

Two-Price System

I would like to just finally ask about the two-price system. Are you not a little nervous about how long that will be in existence?

Mr. Miller. We understand that that is being addressed at this time. I do not know—we have not been advised as to what the final outcome is proposed to be.

Senator Dole. Do you have any suggestions?

Mr. Miller. No, I do not think I have one right at this immediate time. We had said, you know, a number of times that the market conditions prevail, but as far as a regulation into a free price, no sir, we certainly do not.

Mr. Phillips. Senator, I think it should at least be maintained in constant dollars. The average price that you have today, which is around $6.75 or $7, which would of course require an increase as inflation goes up——

Senator DOLE. Well, the reason I raised that—it seems to me what we could be doing here is sooner or later get you back in the free market, after taking away the depletion allowance and maybe changing the intangible drilling cost provisions. And then you really would be in a pickle, if the price was down and you lost all the incentives. I do not think we would have too many hearings like this unless it would be on bankruptcy or disaster loans for the independent oil men.

Mr. TOMLINSON. You would be talking only to the majors, because they would own us all.

The CHAIRMAN. I would like to ask about one other matter that has not been covered by the statements, so far as I have read them. I think it ought to be reflected for the record if it is correct.

TAX INCENTIVES REASONS FOR INDEPENDENTS DRILLING MAJORITY OF EXPLORATORY WELLS

It is my impression that one of the reasons that the independents drill so many more exploratory wells than the majors drill has to do with the tax structure. If someone is in a high tax bracket, he gets a deduction for intangible drilling costs. If he takes a chance but finds a dry hole, well, of course, he has lost everything. But at least, if he is in a 70-percent bracket, for example, he has only lost 30 cents on the dollar, because the Government would have taken 70 cents anyway. If he has the good fortune of finding something, then that depletion allowance, against a 70-percent tax rate, would make it worth his while to have taken all of that risk. If he did not have the depletion allowance, it just would not be worth his while to invest his money in that type of very risky speculative activity.

Does that not have a lot to do with the fact that independents tend to drill a lot of prospects that a major company probably would pass by?

Mr. MEAD. Absolutely.

The CHAIRMAN. And so, a major company, with a 48-percent tax rate, would tend to pass over a lot of marginal prospects that an independent, looking at a 70-percent tax rate, might feel, well, if he has to pay that much tax, it might be worth taking a chance.

Now, that same person in the 70-percent bracket could do a lot of other things; he would buy tax-exempt bonds or he could borrow money to invest in something and have an interest expense that could be deductible. He could build a plant and get an investment tax credit. He could buy some equipment and take an accelerated depreciation writeoff. There are a lot of other things he could do with his money, but right now, with the Nation critically in need of energy, I do not know of anything he could do to advance the Government's interests any more than trying to find some energy with it, do you? It seems to me that if someone wanted to repeal the depletion allowance, now would be the worst time to repeal it, when the Nation is critically short of oil and it needs energy the worst kind of way, and it needs to encourage people to go out there and drill.

CREDIT ADVANTAGES FOR MAJOR OIL COMPANIES

Now, some of the things we are doing I do not understand at all. I mean, if a man wants to go drill himself a well in the North Sea or in Saudi Arabia, my understanding is that he is eligible for a loan from

the Export-Import Bank to buy himself a rig and go over there and drill it. Now, those rigs are very expensive. If he wants to drill it here, he cannot get the credit to do that unless he is a major company; is that not correct, Mr. Miller?

Mr. MILLER. And if he did arrange the credit, the cost of it would be enough to change his mind.

The CHAIRMAN. Now that is something that a steel company man told me. He said it does not make any sense at all. If you want to get some oil in this country, you ought to fix it up so that someone who would like to buy our equipment could buy it to produce oil in this country. If it is a major company they can do that, but if it is a person who would drill a well out on the Continental Shelf for a large independent, he cannot get the rig because he cannot get the credit.

I see you nod your head that you agree with that.

So, some of the things that are being done do not make any sense at all, and I for the life of me do not see why the depletion allowance should now be terminated.

It might be that some of you might want to read your statement in the record. If you would like to, I will be glad to hear them.

HIGHER OIL PRICES PROVIDING MORE INCENTIVES

Mr. McWILLIAMS. Senator Long, I would like to make one remark, that was pretty interesting to me. I read an article in a magazine yesterday that quoted a large oil company, the personnel of a large oil company, saying that the higher prices had made them revamp their look at what they could do, and they now figured that they could probably drill a prospect that would have as little as 10 million barrels of oil in it; when before, they were looking at the prospects that they thought should have at least 20 million barrels to warrant their exploration.

Well, to confirm your point. McMoRan would be glad to find 500,000 or a million barrels in our exploration effort. And, as many other independent exploration efforts, all the way down to the stripper people, we are always first into an area with risk capital, and we are always last out of an area doing the cleanup job that the majors cannot do because it is uneconomical for them to do, with the drilling of a smaller prospect and the less pronounced things, the more subtle things; and all the way down to fighting, like our friend over here, for a couple of barrels a day out of a well. And all I have got to say is that there are millions of barrels of oil that we are finding and have proven that we can find, that do not measure up to the standards that a big company could afford to look for.

The CHAIRMAN. Thank you.

Mr. Tomlinson, why do you not read your statement into the record? I think for the benefit of your Senator, you ought to have your entire statement in the record at this point.

Mr. TOMLINSON. I will be glad to do it. I think we covered——

Senator DOLE. He has covered a lot of it, Mr. Chairman, while you were out of the room, so he could probably summarize it.

Mr. TOMLINSON. Johnny and I were just visiting about the fact that the group of us up here have had a very nice discussion with

everybody and had a good question-and-answer session. We have a lot more people to hear, and I would just as soon have mine entered into the record, unless you would like to hear it, Bob.

Senator DOLE. Well, I have read it, Mr. Chairman. I think it is particularly of interest—the attachments from the Joint Committee of the State Legislature, which is made a part of the record and part of your statement. The other matters have been touched upon. The importance, of course, to the economy of Kansas, where we rank in oil and gas and things of that kind, I think, are helpful. But it has been pretty well demonstrated across the board that everybody has about the same problem, whether you are from Texas, Louisiana, or Kansas: if you cannot get pipe, you cannot drill an oil well. And the actions of the administration and the proposed actions of the Congress, at least, are certainly unsettling, to say the least.

The CHAIRMAN. Mr. John Phillips is here. You have a very well-prepared statement here, Mr. Phillips. Would you care to read the entire statement, or summarize it? I do not want any of it to be lost, without being considered.

Senator DOLE. His statement will be made a part of the record.

INDEPENDENT OIL COMPANIES' PROFIT PICTURE

Mr. PHILLIPS. If it is made a part of the record—there is one thing, and I am sorry that Senator Mondale left, and that is the part that is related to profits. And I wanted to make that statement.

Louisiana land profits for 1973 were up 11 percent, and even if our profits were to double this year, which we certainly do not think is achievable, our average profit increase for the past 10 years would be 11 percent. So, the people in the independent segment of the industry are not getting rich; we are not participating in these foreign profits that he was referring to.

The other thing is the tremendous impact on us of the depletion allowance. We spent our entire net income, since 1972, in exploration activities. The depletion allowance represents about 25 percent of our profits. And we estimate that if it is eliminated, we will have to cut it by at least 50 percent, our exploration effort, at a time it is desperately needed to find oil and gas for the United States.

Those are the only points I wanted to make, and have this made part of the record, Senator.

The CHAIRMAN. Thank you, sir.

Now, I have read your statement, Mr. Mead. Shall I just include that in the record at this point?

Mr. MEAD. Yes, sir. I would like to state that this is not the first time you have heard from me on the same subject. It was about 4½ years ago I came up here and said the same thing practically.

The CHAIRMAN. It is a good statement and it will be printed just exactly the way you have it.

Mr. MEAD. You paid close attention, and I know you will again. I do not think we have to tell you anything about depletion.

The CHAIRMAN. You can teach me a lot that I do not know about it, I can promise you that, because you are out there day by day trying to find some energy for this country.

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The CHAIRMAN. Mr. Franks, I have read your statement. Perhaps you would like to add something to that. We will print it in the record at this point.

PLOWING PROFITS INTO EXPLORATION

Mr. FRANKS. Senator, since we lost our prospect, and time is running on past, since it is in the record, I would say one thing on profits—it reflects in my record. Perhaps you would find that we have been plowing back about 150 percent more each year in exploration that we have actually made. We are betting on the future, and are in debt $4,800,000 that is going to have to be paid back. And all of that went into exploration on a very successful program.

The CHAIRMAN. Mr. McWilliams, would you care to add something to your prepared statement?

Mr. MCWILLIAMS. Senator Long, very little; but I would like to say that McMoRan Exploration Co.'s philosophy and approach to this thing is to plow back as much money as we have coming in, for runs or for tax advantage and all, back into exploration to increase our size of participation in our own efforts. And the philosophy behind that is to build our equity in oil and gas reserves.

And so, if depletion allowance is eliminated, then we have got just that much less money to figure to plow back into our own effort.

We also are pledged to plow back as much of our production runs as we can into an exploration effort.

The CHAIRMAN. Thank you very much, sir.

Mr. Cochran, would you care to add something to your prepared statement?

Mr. COCHRAN. No, sir. I have said enough.

The CHAIRMAN. It is a very well prepared statement, sir, and I think that you have been very helpful to the committee here.

Mr. Wlliam Myler from Michigan, would you like to add something to the statement you have given?

DEPLETION ALLOWANCE VITAL TO STRIPPER OPERATORS

Mr. MYLER. Just to reemphasize, Senator, how vital depletion is to the stripper operator. I think that is the whole tone of my statement. I just want to reemphasize, it is really vital to our company and I think all of the operators in the State of Michigan.

The CHAIRMAN. Mr. McConnell.

Mr. MYLER. He will be on next, sir.

The CHAIRMAN. Well, gentlemen, thank you very much for the presentation you have made to the committee. I think you have brought us a very fine amount of information that will be helpful to the committee. I know sometimes you are disappointed, just as many times I am disappointed when a good witness appears before the committee and it is important to him that he be heard, and he looks around and sees only a few Senators there to hear it.

Might I suggest that before you go home you go by and look up your Senator and be sure he knows about your views on this matter?

Mr. MYLER. Thank you, sir.

The CHAIRMAN. Thank you very much.

[The prepared statements of Messrs. Miller, Mead, Franks, Tomlinson, Cochran, Phillips, McWilliams follow:]

Statement of C. John Miller, President
Independent Petroleum Association of America
Before the Finance Committee
United States Senate
Washington, D. C.
June 6, 1974

My name is C. John Miller. I am a partner in Miller Brothers, an independent oil and natural gas exploration and production firm at Allegan, Michigan. I appear here as President of the Independent Petroleum Association of America, a national organization of independent petroleum producers representing some 4,000 members in every producing area in the United States.

The purpose of this presentation is to discuss the changes in mineral tax provisions affecting oil and natural gas that are pending or proposed in Congress, particularly with respect to phasing out or retroactively terminating percentage depletion on oil and natural gas.

If enacted, those proposals would achieve, in effect, an undesirable tradeoff of decreased energy supplies for more tax dollars. Because the United States already has a very large and growing deficit in its domestic supplies of both crude oil and natural gas, it is our firm conviction that adoption of these proposals would so aggravate our supply position as to cause intolerable balance of payments and security of supply problems.

Mr. Chairman, I would like to discuss the proposition of terminating the 22 percent depletion provisions in terms of a number of considerations and realities that I believe merit close examination by the Congress. They can be summarized briefly as follows:

1. The independent segment of the domestic petroleum producing industry would be critically affected by termination of depletion to the extent that thousands

may be forced to liquidate their businesses. This would preclude development of needed domestic oil and gas supplies in the future because the 10,000 independents in the industry conduct more than 85 percent of exploratory drilling to find and develop new petroleum reserves.

2. Any reduction in or removal of tax incentives ought to be viewed in light of the fact that the domestic petroleum producing industry has just gone through a 17-year period of declining exploration, drilling and development. This has resulted in sharply reduced reserves in the face of a 90 percent gain in demand for oil and a 138 percent rise in demand for natural gas.

3. A great deal of uncertainty exists in the industry because of the fact that Congress is actively considering punitive legislation which would have a debilitating impact on domestic producers.

The nation faces energy shortages. This is just not the proper time to consider substantial alterations in the tax laws which have been embedded in the economics of this industry for nearly 50 years.

If the Congress deems it in the national interest to alter the tax laws, those changes should be carried out only after careful, deliberate consideration of the likely effects.

4. Unless Government tax and economic policy reflects not just a willingness, but a determination, to encourage massive expenditures in domestic exploration and development of all energy resources, and oil and gas in particular, the downtrend in our energy supply will not only continue but accelerate. The result will be an increasing dependence on foreign energy and a cost in terms of our balance of payments that will be intolerable.

5. The nation will continue to be primarily dependent on oil and natural gas to meet its energy needs at least through the 1980's. There are vast potential domestic oil and gas reserves remaining to be found, enough certainly to greatly reduce our dependence on insecure foreign supplies. The surest, quickest, lowest cost means of maximizing our supplies of petroleum fuels is to reactivate and encourage the 10,000 independent producers to explore the vast, promising sedimentary basins onshore in the lower 48 states.

6. Because of recent improvements in economic conditions, there are indications that the 17-year decline in domestic exploration and development activity that had its onset in 1956 is being arrested in 1974. As a result, the decline in domestic crude oil production that began in 1970 will bottom out this year. Production will increase in 1975, and subsequent years, unless the resurgence now taking place in drilling and development is killed by punitive, counter-productive actions such as the proposed retroactive repeal or phase-out of percentage depletion.

The elimination of depletion now proposed by some in both the Senate and House reflects the apparent conclusion of its sponsors that (a) our energy problems are over, (b) increased levels of exploration for and development of oil and gas supplies are not essential to meet our energy needs, or (c) that removal of $3-billion-plus per year from the domestic industry through the elimination of depletion would have no effect on levels of expenditures for exploration, or on future discovery, development and recovery of additional oil and natural gas resources. It is my considered opinion based on the facts that none of these conclusions is correct.

U. S. Oil & Gas Supply Position

It is highly important that Congress and the American people fully understand

the dangerous and growing inadequacy of U. S. supplies of oil and natural gas, and our accelerating dependence on remote and insecure foreign supplies. Petroleum fuels, oil and gas, are relied upon by the American people to fill 75 percent of their energy needs. In future years, the role of conventional oil and gas will undoubtedly change, but no significant change will occur before the late 1980's. In the interim, the nation has no practical alternative except to move ahead with maximum development of its petroleum resources. To do less is to invite the unacceptable economic costs and the insecurity of supply that are inherent in over-dependence on foreign oil.

To examine where we must go, it is useful to look at where we have been and where we are at the moment. A good starting point is 1956, the year that the United States peaked in exploration and drilling for oil and natural gas. Since that time, the demand for liquid petroleum fuels has increased 90 percent, and the consumption of natural gas has risen 138 percent. These demands have been increasingly met out of the reserves found through past discovery efforts and increased imports. Not since 1966 have we found as much crude oil as we have produced in any one year; discoveries of natural gas have not equalled production since 1967.

Why our oil and gas supply situation has eroded should not be a mystery to anyone. A few figures comparing the domestic industry's exploration activity in 1956 as it translated into available petroleum reserves compared to 1973 provides a graphic explanation.

	1956	1973	Change
Geophysical Activity (crew months)	7,857	3,140*	DOWN 60%
Wildcat Wells Drilled	16,207	7,466	DOWN 54%
Total Wells Drilled	58,160	27,602	DOWN 53%
Rotary Rigs Active	2,619	1,194	DOWN 54%
Proved Reserves (Ex. N. Slope):			
Crude Oil (Billion of Recoverable bbls.)	30.4	25.7	DOWN 16%
Natural Gas (Trillion Cu. ft.)	236.5	224.0	DOWN 5%

*1972

The root cause of these substantial downward changes can be seen in the decrease by 15 percent in the price of crude oil expressed in constant 1973 dollars from $4.57 to $3.89 per barrel. In late 1973, crude oil prices began to increase providing an improved economic climate which will reverse these declining trends if the industry is not thwarted by adverse governmental policies.

I should mention that in the 1956-73 period, the average price of gasoline, excluding federal and state taxes, increased 25 percent. And during this time, the Government's consumer price index measuring the retail cost of all items increased 70 percent, and the wholesale price index for all commodities rose 49 percent.

The most ominous statistic, and one which should be kept in mind by Congress as it weighs energy tax policy as well as all energy policy, is the fact that our dependence on foreign oil from 1956 to 1973 increased 332 percent--from 1,436,000 barrels daily, to 6,201,000 barrels a day. Until the United States halts and effectively reverses the erosion in its productive capacity of oil and gas, the incremental increase in our demands for both oil and gas must be met by higher imports of Eastern Hemisphere oil. To meet this incremental increase, imports must rise on the order of 1,000,000 barrels daily per year.

The Federal Energy Administration recently computed the composite cost of our imports at $10.42 per barrel. At this price, the nation's bill for imported oil will exceed $23 billion in 1974, and each million barrel increase in future years will raise that import bill by approximately $4 billion. If the U. S. requirement for imported oil reaches 10 million barrels daily by 1980, as some have forecast, our import bill at present prices would equate to more than $38 billion yearly. We are already in a precarious balance of payments position.

For economic reasons alone, not to mention security reasons, this nation has no practical alternative except to maximize production of its energy resources within the U. S., and its development and production of its oil and natural gas in particular. It is significant that the combined price of domestic oil and natural gas today--expressing our gas production in crude oil equivalent--is less than $4 a barrel. Nowhere on earth can we obtain a comparable energy bargain.

The Challenge of the Future

There is strong evidence that the domestic independent oil and gas producing industry has set in motion a resurgence of effort that will halt our decline in crude oil production this year, and which promises increased production in future years. In terms of what must be done, however, in recognition of the long lead-times required to significantly increase output, we have barely made a start. In terms of capital requirements needed to reverse the nation's energy supply position, we have not begun to generate sufficent funds.

I would call the committee's attention to a very informative assessment of what must be done with respect to future domestic oil and gas development, set forth in a study entitled "U. S. Energy Prospects," just completed by a Task Force of the National Academy of Engineering. The Task Force attempted to assess what must be done in each energy area to maximize energy availability to meet demands in 1985, after allowing for reductions in consumption through improved efficiency and conservation. The Task Force stated with respect to domestic petroleum development:

> "A variety of estimates have been made of future import requirements, and most of these indicate that unless substantial additional effort is put into development of domestic sources, imports will grow to 10 MBPD and beyond within a few years. This oil will almost certainly come from the Middle East where the

world's spare capacity, whatever it may be, is likely to be concentrated. The Task Force believes that the United States has the resources and the technology to reverse this importation trend and to reduce imports by 1985 to a practical minimum that will be consistent with national policy if it is desired to do so." (emphasis added)

With respect to petroleum, the Task Force forsaw an achievable production increase of 25 percent by 1985, for a combined oil and gas increase to 27 million barrels daily from the 1973 production of 22 million barrels a day. To reach this level of production, it estimated the industry would be required to increase drilling to 58,000 wells per year, compared to a total of over 27,000 in 1973, increase employment by 65,000 over and above the 266,000 directly employed in the domestic petroleum producing industry at this time, and increase its steel consumption to 7.5 million tons by 1985, up from 4.1 million tons last year. The prospect embraces all known and potential techniques of exploration and recovery, including accelerated tertiary recovery and recovery of natural gas from low permiability sands.

The capital requirements for all facilities needed to achieve maximum oil and gas supply by 1985 were projected to be in the range of from $16 to $20 billion yearly. It is interesting to note that the total wellhead value of domestic oil and natural gas in 1973 came to only $17.2 billion.

I have chosen to dwell on the findings of this significant study for two reasons. First, it is a practical assessment of the technology, manpower and capital requirements involved in achieving relative energy-sufficiency. Secondly, it is predicated on a big "IF," that being whether it is desirable to undertake to achieve self-sufficiency. At a number of points, the report refers to this goal in terms of whether it is a desirable one--leaving no question that it is a feasible one.

The question of whether it is desirable to move ahead with development of our energy resources clearly is a public policy question, and therefore a political question. Government policy, including tax policy, can be directed to either encourage or discourage the search for and development of oil and natural gas.

This fact was never more clearly illustrated than in the unmistakable results of the changes in oil and gas tax treatment incorporated in the Tax Reform Act of 1969, the principal item being a reduction in the rate of percentage depletion on oil and gas from 27 1/2 to 22 percent. The reduction in depletion together with other changes increased the tax take from domestic producers by about $600 million annually. In the next year, 1970, exploratory drilling in the United States dropped by 2,008 wells, a 21 percent decline from 1969. This was the biggest drop in exploratory drilling in a single year in the history of the industry. We still have not regained the 1969 level of exploration.

However, we are on the road toward the 1969 level and above if Congress does not act precipitously to undermine the improved economic incentives that are now generating greatly increased exploration and development.

Role of Independent Producers

If the federal Government decides it is in the public interest to encourage full development of our remaining large potential of oil and gas resources, then independent explorers and producers must be encouraged in their indispensable role. Historically, independents have drilled the great bulk (in excess of 80 percent in 1972) of exploratory wells to find new domestic reserves of oil and gas, and have accounted for about three-fourths of total wells drilled in the United States.

The United States became the largest oil and gas producing and consuming country largely because of the multiplicity of effort made possible only by the participation of thousands of independent explorers onshore in the lower 48 states.

During the period since the mid-1950's, however, the persistent decline in domestic exploration and development, with the resulting erosion in our petroleum reserve and productive capacities, has been accompanied by a thinning of the ranks of independents by about one-half. From a total of some 20,000 independents participating in domestic exploration and development in 1956, only about 10,000 remain active today.

It is not just happenstance that the 50 percent drop in the number of independents corresponds almost precisely with the drop of more than 50 percent in exploratory drilling since 1956. Expenditures for exploration and development by independents also dropped by one-third in this period--from $2.45 billion in 1956 to an average of $1.64 billion in the next 16 years.

This flight of explorers and capital from domestic oil and gas-finding activity occurred for one reason: A steadily worsening economic climate caused by direct and indirect Government efforts to control unreasonably the wellhead prices of both crude oil and natural gas. Gas prices were controlled directly, crude oil prices indirectly by coercion and "jawboning" as a condition of the oil import quota program. Because prices were controlled without regard to accelerating costs, oil and gas discovered sold for less than the expense of its finding. That, in a nutshell, is why the United States faces monumental energy supply problems today.

There are some in Congress today who are saying, "we gave the oil producers percentage depletion and this was supposed to assure adequate petroleum supplies. It did not. So we will take it away." But sound tax policy alone cannot assure production of any product which, by requirement of the Government, must sell below its

replacement cost. During long periods when oil and gas prices equated with prices in the economy generally, the percentage depletion provision served a vital function of encouraging venture capital into the high-risk exploration process, particularly the risk capital made available to independent producers.

Independents rely heavily on venture capital from outside the industry to share the risk of oil and gas exploration. At today's costs, there are few producers who have sufficient capital to conduct exploration without such risk sharing. The percentage depletion provision has been a primary incentive for investors to share in such high risk ventures. Its removal would immediately reduce funds available for exploration and development by hundreds of millions of dollars per year.

All investment in exploration and development to establish current production of oil and gas was made in the expectation of the continuance of percentage depletion. Thousands of independent producers have arranged their capital formation, including debt funding of exploration and development programs, on this expectation. They have sought and attracted billions of dollars of risk capital from private investors based on this expectation. The foundation and liquidity of their enterprises rest on this expectation. It is clear that retroactive repeal of percentage depletion would have repercussions that would shake the very foundations of the independent sector of the domestic industry. It would simply cause the liquidation of many hundreds of producers.

Such wholesale liquidation of independent producers would result in a greater degree of concentration of domestic production in the hands of fewer and fewer companies. The loss of competition and the loss of the great multiplicity of effort in the discovery and development of oil and gas that has been provided by the independent sector would not serve the public's interest in adequate fuel supplies.

I would like now to speak briefly to the fallacy that percentage depletion is no longer justified or needed because of "high oil prices." Natural gas, the price of which is rigidly regulated by the Federal Power Commission, constitutes 56 percent of the energy (measured in British thermal units) produced by the domestic petroleum industry at the wellhead; the other 44 percent is in the form of crude oil. As I have pointed out, the combined price of domestic crude oil and natural gas is about $4 a barrel. The price of domestic crude oil averages about $7 a barrel. In the combined price, or for crude oil alone, the domestic industry is selling the lowest cost energy available to Americans today.

There is an erroneous assumption that price improvements simply result in "windfall" or "excess" profits. Those who believe this simply do not understand the function of price or the economics of petroleum exploration. The improved prices authorized by Government were for the purpose of stimulating exploration and recovery programs that were not being undertaken and would never have been undertaken at the lower prices.

About 30 percent of domestic crude oil is selling at the free market price of approximately $10 a barrel. About an eighth of total production, included in this 30 percent, is from stripper wells producing less than 10 barrels daily. This price will stimulate programs to increase recovery from marginal and idle wells by hundreds of millions, and ultimately, billions of additional barrels of oil. Some of the innovative recovery programs that will be forthcoming will entail costs of $8 or more a barrel. The oil thus recovered will be that which never would have been recovered at lower prices. Secondary and tertiary reserves are a known quantity, already discovered with the pipe in place.

Likewise, free market prices for "new" oil will stimulate deep and much more costly drilling ventures to develop production that would never have been sought at lower prices. This is the only hope of finding the substantial additional oil that is available, because the "easy" and the "cheap" oil has long since been found.

The prospect of increases in multiple means of increased recovery and production, in response to improved economic conditions, was discussed in the report of the National Academy of Engineering Energy Task Force, to which earlier reference was made. The Task Force study had this to say, in part:

> "One key to accelerating production of oil using known technology is the establishment of a better economic climate that leads the producer to expect to recover higher costs caused by taking greater risks or operating in a more expensive manner or area. If domestic oil and gas were to closely approach price parity with imported crude, the incentives would stimulate industry to accelerate production efforts, and substantial production increases could be achieved by 1985.
>
> "In such an economic climate, increased cash flow and improved prospects for profitable discoveries would cause exploration efforts to be substantially expanded. The drilling of outpost and development wells in mature producing areas would be strongly stimulated.
>
> "Wells that were not drilled because of marginal economics would be attractive with higher prices to offset higher drilling and operating costs. Production from known but presently non-commercial reservoirs (e.g. tight or thin formations) would become feasible. Workover of wells to increase rates of production would be stimulated, although this would not change reserves or eventual production. However, it would accelerate production in the decade ahead. Abandonment of stripper wells would be delayed as a result of reducing the lowest rate at which production is economically feasible. Also, more secondary recovery projects would be initiated, thereby increasing recoverahle reserves and accelerating production."

The Academy Task Force thus set forth succinctly the broad range of initiatives that will be undertaken only under improved economic conditions. The recent price improvement that has been permitted will make thousands of such ventures possible. The costs of such ventures will relate closely to existing prices.

It appears from the statements of some sponsors of the proposal to repeal percentage depletion retroactively that this clearly is intended as a punitive action, designed to "punish" the industry for long-overdue price improvements that will make possible a strengthening of our long-term energy supply position. Termination of depletion would simply obliterate the economic improvements resulting from higher prices. Those that survived would, from an economic standpoint, be back where they were before prices improved.

The result would be to halt immediately the newly initiated programs that promise to substantially improve the nation's petroleum fuels supplies and reduce its dependence on higher cost foreign oil in years to come.

The Basic Concept of the Depletion Allowance Remains Sound

Percentage depletion as a tax policy has proved sound in principle and effective in practice, and should be continued irrespective of and apart from considerations of price.

The Congress enacted the depletion provision in its present form in 1926 in recognition of a basic economic principle. That principle is simply that when a government taxes capital, the government will soon own all the capital. Rather, the government should only tax income and allow the recovery of invested capital. This basic principle is followed in other industries through depreciation allowances on capital investments.

A part of the revenue derived from a producing oil or gas well represents a recovery of capital and should not be taxed.

After several attempts at ascertaining an equitable formula for determining the part of the revenue from an oil or gas well which represents capital, the Congress finally compromised at 27 1/2 percent.

There is no justification for disallowing the petroleum producing industry the benefit of a longstanding, sound economic principle especially in view of the energy shortages which are currently facing the nation.

In evaluating the benefits of this long-standing tax policy, the late President John F. Kennedy said:

> "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. 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."

In testimony to this committee in 1969, one of my predecessors as president of IPAA and the present chairman of the National Petroleum Council, Mr. H. A. (Dave) True, began his statement with this observation: "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." During the recent Arab embargo, we experienced a foretaste of the peril that Dave True warned about.

It should be hoped that memories are not so short, Mr. Chairman, that Congress is now willing to foreclose all chance of restoring energy self-sufficiency through punitive tax changes that would be counter-productive to the basic and pressing need to increase U. S. supplies of oil and gas.

SENATE FINANCE COMMITTEE
JUNE 6, 1974

I AM ROBERT E. MEAD, PRESIDENT OF MACDONALD OIL CORPORATION, A DOMESTIC INDEPENDENT OIL AND GAS PRODUCING COMPANY BASED IN DALLAS, TEXAS.

OVER FOUR AND ONE-HALF YEARS AGO I CAME TO WASHINGTON AS PRESIDENT OF THE IPAA AT A TIME WHEN THERE WAS A GREAT CLAMOR TO ABOLISH DEPLETION AND IMPORT VAST QUANTITIES OF "CHEAP" FOREIGN OIL.

AT THAT TIME, I WARNED THE GOVERNMENT REPEATEDLY THAT SUCH ACTIONS WOULD RESULT IN DEPENDENCE ON INSECURE FOREIGN SOURCES FOR OUR ENERGY AND WOULD ACT TO DISMANTLE THE DOMESTIC INDUSTRY.

THE CHICKENS CAME HOME TO ROOST. OUR DOMESTIC EXPLORATION INDUSTRY HAS BEEN STEADILY DECLINING AND OUR FOREIGN SUPPLY SOURCES DID THE OBVIOUS--EMBARGO AND PRICE INCREASES.

I BEG YOU GENTLEMEN TO DO NOTHING FURTHER TO IMPAIR OUR DOMESTIC INDUSTRY AT THIS TIME OF CRITICAL DEPENDENCE ON FOREIGN SOURCES OF ENERGY.

NOW, AS TO DEPLETION, MY ACCOUNTANTS TELL ME THAT COMPLETE ABOLITION OF THIS TAX ALLOWANCE WOULD LEAVE OUR COMPANY 16-1/2% LESS MONEY TO DRILL WITH THAN WOULD OTHERWISE BE THE CASE. IT'S THAT SIMPLE. I HAVE 16-1/2% LESS MONEY SO I DRILL 16-1/2% LESS WELLS. MULTIPLY THAT BY THE ENTIRE INDEPENDENT DOMESTIC INDUSTRY AND YOU GET FAR LESS ENERGY DEVELOPMENT THAN UNDER THE CURRENT RULES.

A SECONDARY EFFECT WOULD BE A REDUCTION IN VALUE OF OUR PROPERTIES AND A CONSEQUENT REDUCTION IN BORROWING POWER OF THE COMPANY, FURTHER CUTTING OUR POWER TO EXPAND ENERGY RESOURCES.

OUR COSTS ARE GOING UP UNBELIEVABLY. LAST MONTH I DRILLED A WELL FOR $72,000 WHICH WOULD HAVE COST $46,000 TWO YEARS AGO.

FOR YEARS I HAVE TRIED TO STRESS THE NEED FOR LONG TERM PLANNING IN THE OIL INDUSTRY. FOR THE SAKE OF OUR COUNTRY, PLEASE GIVE US STABLE RULES TO LIVE WITH SO THAT WE CAN GET ON ABOUT OUR BUSINESS OF FINDING OIL AND GAS INSTEAD OF READING SCARE HEADLINES AND NOT BEING ABLE TO PLAN EVEN A SIX MONTHS BUDGET. WE SHOULD BE PLANNING YEARS AHEAD.

34-639 O - 74 - 9

FRANKS PETROLEUM INC.

244 MONTGOMERY ST.
P. O. BOX 7665
SHREVEPORT, LOUISIANA 71107

TELEPHONE 221-2666

TO: U. S. Senate Finance Committee
Washington, D. C.
Thursday, June 6, 1974

FROM: John Franks, President
Franks Petroleum Inc.
Shreveport, Louisiana

1. Statement of Position on Oil Depletion Allowance
2. Franks Petroleum Inc. Production Impact - Related to People
3. General Information on Franks Petroleum Inc.
4. Franks Petroleum Inc Exploration Activity Summary - 1968-1974

STATEMENT OF POSITION ON STATUTORY
OIL DEPLETION ALLOWANCE OF 22%

By: John Franks, President, Franks Petroleum Inc., Shreveport, Louisiana
To: Senate Finance Committee

We have always considered the oil depletion allowance as our main means of cash replacement of our inventory cost.

As a small independent business man (27 employees) who owns and operates his own family-owned oil and gas exploration company, I consider the oil and gas leases that we purchase as our inventory.

It is basic in my business that if you don't buy oil and gas leases, you can't drill wells. However, we can't "buy" oil and gas leases on other than a short term basis, generally for a term of three (3) to five (5) years. In the absence of production these leases must be kept in force by the payment of an annual "rental". Even with the rental payments the leases "expire" (revert to the landowner) at the end of their primary contract term, unless during the term, oil and gas are discovered and produced from the property.

Needless to say, many leases do not produce at all and many prove to be non-commercial or at the best marginal producers. We are in a high risk business whose inventory is expensive, often worthless and we are constantly having to spend additional money to evaluate its worth.

Though a small company, we are the most active exploration company in the North Louisiana area and have been for the past 6 1/4 years. Our exploration efforts have been successful and the depletion allowance has played a vital role in our success in two (2) ways.

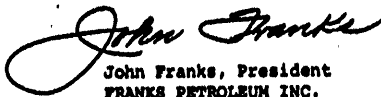
First, we have had the money to replace our inventory with new drilling prospects. Second, it has materially aided us in raising the necessary capital from sources outside the oil and gas business to enable us to carry on an exploration program that far exceeds our internally generated capital.

We are not an integrated oil company. As such, we make a profit only on the oil and gas we find and that is sold "at the wellhead." We have no way of passing along through a "pipeline profit," "refinery profit" or to the ultimate "end user" any increase in taxes. The elimination of the depletion allowance would have the same effect on us and all our royalty owners as would a 22% increase in taxes.

In my judgment, the elimination of the depletion allowance from domestic production would result in less domestic exploration by all explorationists. It would reduce Franks Petroleum's activity immediately by at least 50% as I believe it would all other independents...who, as you know, drill 80% of all domestic exploration wells.

At this time, when our country needs every barrel of oil and every cubic foot of gas it can possibly produce "at home," safe from foreign embargoes or blackmail, I sincerely urge you to make every effort to encourage rather than discourage domestic exploration.

Sincerely,



John Franks, President
FRANKS PETROLEUM INC.

FRANKS PETROLEUM INC.

PRODUCTION IMPACT - RELATED TO PEOPLE

FRANKS PETROLEUM INC. OPERATED PRODUCTION AS OF APRIL 1, 1974

	Oil/Barrels	Gas/MCF
Monthly	67,700	3,456,500
Daily	2,180	111,500

Franks Petroleum Inc.'s daily oil production is an amount of oil, when converted to gasoline to furnish daily transportation to an estimated 55,000 people.

Franks Petroleum Inc.'s daily natural gas production is an amount of natural gas sufficient to furnish natural gas daily to 271,950 homes housing an estimated 1,000,000 people.

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(2180 bbls) (42 gallons) ÷ (5 gallons per day)	=	18,312 cars
(18,312) x (3 people)	=	54,936 people
(11,500,000) ÷ (410)	=	271,950 homes
(271,950) x (4 people)	=	1,087,800 people

FRANKS PETROLEUM INC.- SHREVEPORT, LOUISIANA

GENERAL INFORMATION

1974 PROJECTIONS

Twenty-Seven (27) full time employees in office -

1.	Annual Payroll	$ 363,166
2.	Payroll Taxes	18,800
3.	Inventory Replacement (new leases)	500,000
	Outside Services Utilized -	
	Petroleum Engineering Firms:	
4.	Well Completions	25,000
5.	Annual Reserve Determinations	15,000
6.	Geological Consultants	10,000
7.	Auditors & Tax Consultants	15,000
8.	Attorneys, Title Work, etc.	30,000
9.	Independent Landmen & Leasing	50,000
10.	Contract Well Switchers & Pumpers (130 wells)	210,000
11.	Independent Drilling Contractors	5,000,000
12.	Oil Field Service Companies (Halliburton, etc.)	5,000,000
		$ 11,236,966

Items (1) thru (9) are 100% Franks Petroleum Inc. expenditures ($913,696 annual). Items (10)thru (12) paid for by Franks Petroleum Inc. and joint owners ($10,323,270).

Franks Petroleum Inc. depletion 1973 - $485,764.30, (from tax return) or about $15,000 below inventory replacement cost.

In 1973 lease rentals totalled additional $73,253.09, and is part of lease inventory cost for rentals required to keep unexpired leases in force.

1973 income from oil and gas, net to Franks Petroleum Inc.-$3,000,000. Debt against future oil and gas income as of January 1, 1974 - $4,838,598. Franks Petroleum Inc. reinvesting in exploration yearly in excess of 100% of its profits from oil and gas.

John Franks salary as President-Owner - $40,000 per year.

ADDITIONAL GENERAL INFORMATION

Taxes Paid - 1973:	
Income taxes - State and Federal	$ 49,950.56
Severance & Ad Valorem taxes	227,961.20
Payroll taxes	18,800.00
Total business taxes -	$ 296,711.76
Interest paid on business loans - 1973 -	$ 190,831.22

FRANKS PETROLEUM INC. WELLS DRILLED

RECAPITULATION OF RESULTS

Year	Number of Wells Spudded	Production Completions		D & A	
1968	41	23/41	.560976	18/41	.439024
1969	44	23/44	.522727	21/44	.477273
1970	46	31/46	.673913	15/46	.326087
1971	64	45/64	.703125	19/64	.296875
1972	45	30/45	.666667	15/45	.333333
1973	55	38/55	.690909	17/55	.309091
1974 (1st quarter)	13	10/13	.769231	3/13	.230769
Total	308	200/308 .649351**		108/308 .350649**	

* NOTE: These figures exclude the W. H. Reeves Well which has not been completed or abandoned.

** NOTE: Weighted average.

1968-1973 (6 years) - averaged 49 wells per year.

1974 - 1st Quarter - (13) (4) - projected for year - 52.

6 1/4 years - 308 wells drilled - 200 producers - 108 dry holes.

Average depth of wells - 9000'.
Average cost - completed well - $250,000 (200) - total completed wells $50,000,000.
Average cost - dry hole - $150,000 (108) - total dry holes $16,200,000.

SENATE FINANCE COMMITTEE
JUNE 6, 1974

MY NAME IS WARREN E. TOMLINSON. I AM PRESIDENT AND CHAIRMAN OF THE BOARD OF TOMLINSON OIL COMPANY, INC., A PUBLICLY OWNED INDEPENDENT EXPLORATION AND PRODUCTION COMPANY.

THIS TESTIMONY IS PRESENTED ON BEHALF OF THE KANSAS INDEPENDENT OIL AND GAS ASSOCIATION WHICH I CURRENTLY SERVE AS PRESIDENT. THE ASSOCIATION IS COMPOSED OF SOME 1,000 SMALL INDEPENDENT OIL AND GAS PRODUCERS AND OPERATORS.

WE ARE ATTACHING TO THIS TESTIMONY, FOR THE RECORD, A COPY OF THE POSITION RECENTLY TAKEN BY THE JOINT SENATE-HOUSE COMMITTEE ON CONSERVATION AND NATURAL RESOURCES OF THE KANSAS LEGISLATURE OPPOSING THE ELIMINATION OF DEPLETION ALLOWANCES.

WE WOULD LIKE TO PREFACE OUR MAIN REMARKS WITH A FEW QUICK BACKGROUND COMMENTS.

FIRST, WE BRING TO MIND THE IMPORTANCE OF MOUNTING A VASTLY INCREASED EXPLORATION EFFORT IN THE UNITED STATES. WE MUST FIND AND DEVELOP NEW RESERVES OF CRUDE OIL AND NATURAL GAS.

SECOND, IT IS GENERALLY RECOGNIZED BY MOST GEOLOGISTS THAT THE UNITED STATES HAS THE NEEDED PETROLEUM RESOURCES IN THE GROUND, WAITING TO BE DISCOVERED. WE REITERATE, THE SEDIMENTARY BASINS IN THE UNITED STATES ARE ADEQUATE TO MAKE THIS NATION 85 TO 90 PERCENT SELF-SUFFICIENT IN ENERGY WITHIN THE NEXT TEN YEARS, GRANTING THE NATION SUFFICIENT TIME TO DEVELOP ALTERNATE SOURCES OF FUELS.

THIRD, SUCH DOMESTIC RESERVES WILL BE MORE DIFFICULT AND MUCH MORE EXPENSIVE TO FIND AND DEVELOP. WE HAVE PICKED THE APPLES FROM THE LOWER BRANCHES OF THE TREE AND WE MUST NOW CLIMB THE STEPLADDER TO GET TO THE RESOURCES MORE DIFFICULT TO REACH.

FOURTH, IF WE ARE TO AVERT A NATIONAL DISASTER IN ENERGY FUELS, PARTICULARLY HYDROCARBONS; IF WE ARE TO PREVENT CONTINUED AND INCREASING RELIANCE UPON UNSTABLE FOREIGN SOURCES OF OIL AND GAS; AND IF WE ARE TO AVOID SKYROCKETING AND POTENTIALLY BANKRUPTING INCREASES IN OUR BALANCE OF PAYMENTS THROUGH IMPORTATION OF EXPENSIVE FOREIGN FUELS, WE MUST IMMEDIATELY UNDERTAKE A CRASH PROGRAM TO DEVELOP OUR OWN DOMESTIC RESOURCES.

FIFTH, WE ARE TALKING ABOUT DRILLING AT LEAST 60,000 WELLS A YEAR, COMPARED TO LESS THAN 30,000 ANNUALLY IN RECENT YEARS, WE ANTICIPATE EXPENDITURES EXCEEDING 10 BILLION DOLLARS A YEAR, COMPARED TO CURRENT OUTLAYS OF 5 BILLION DOLLARS.

WE ARE TALKING ABOUT A REAL CRASH PROGRAM. DOUBLING THE EFFORT. TRIPLING THE MONEY SPENT.

NOW, TWO QUESTIONS, WHERE IS THIS MONEY TO COME FROM? AND WHO IS GOING TO ASSUME THE HIGH RISK SEARCH FOR THESE NEW RESERVES?

TO ANSWER THE SECOND QUESTION WE MUST TURN TO THE INDEPENDENT PRODUCERS AND OPERATORS WHO HISTORICALLY HAVE COMPLETED OVER 75% OF THE NEW WELLS IN THE UNITED STATES.

IT WILL HAVE TO BE THE INDEPENDENTS BECAUSE OF THE VERY SIZE AND HIGH RISK OF THE VENTURE. IT WILL TAKE THE HUNDREDS AND THOUSANDS OF INDIVIDUAL OPERATORS AND SMALL INDEPENDENT COMPANIES, WORKING WITH RISK OR VENTURE CAPITAL FROM OUTSIDE THE INDUSTRY, TO SUCCESSFULLY ACCOMPLISH THE TASK. THE VERY SIZE AND CORPORATE RETICENCE OF THE MAJOR INTEGRATED COMPANY DISCOURAGES SUCH HIGH RISK ACTIVITY FOR MOST DOMESTIC PROSPECTS...AND ONLY THROUGH THE COMBINED KNOWLEDGE AND EXPERTISE OF THE THOUSANDS OF EXPERIENCED INDEPENDENTS CAN THE JOB POSSIBLY BE SUCCESSFULLY ACCOMPLISHED.

WE THEREFORE SUGGEST A CLOSE LOOK AT THE DOMESTIC INDEPENDENT PRODUCER/OPERATORS UPON WHOSE SHOULDERS THE VERY EXISTENCE OF THIS NATION MAY QUITE LIKELY REST IN THE NEXT FEW YEARS.

THE INDEPENDENT OILMAN SITS ON A THREE LEGGED FINANCIAL STOOL, AND MY APPEARANCE HERE BEFORE THIS HEARING IS TO URGE THAT THIS CONGRESS REFRAIN FROM YANKING THAT STOOL OUT FROM UNDER HIM.

THE THREE FINANCIAL LEGS ARE DEPLETION, INTANGIBLE DRILLING COSTS, AND PROPER MARKET PRICES FOR OIL AND GAS, PRICES WHICH ARE COMMENSURATE WITH THE DEGREE OF RISK INVOLVED IN FINDING SUCH RESERVES.

WE NOW GIVE OUR MAIN ATTENTION TO THE HISTORIC DEPLETION ALLOWANCE SINCE IT IS THE SUBJECT OF ATTACK. DEPLETION FUNCTIONS IN A TWO-FOLD MANNER FOR THE INDEPENDENT. IT PROVIDES HIM WITH WORKING CAPITAL FOR THE FUTURE. IT ALSO HELPS ATTRACT THE OUTSIDE RISK CAPITAL WHICH IS SO NECESSARY FOR EXPLORATION, AND WHICH SIMPLY CANNOT BE RAISED FROM INTERNALLY CREATED CASH FLOWS, OR FROM OTHER NORMAL CORPORATE FUNDING SOURCES.

WE REFER TO THE THREE LEGGED STOOL BECAUSE IT IS OF UTMOST IMPORTANCE THAT THE CONGRESS AND THE PUBLIC UNDERSTAND THAT ALL THREE FINANCIAL LEGS ARE NECESSARY IF THE INDEPENDENT IS TO PROPERLY FUNCTION.

TAKE MY FIRM FOR INSTANCE. AT PRESENT MARKET PRICES AND OPERATIONAL COSTS WE ARE IN A SOUND POSITION REGARDING OUR PRESENT PRODUCTION, AND FOR FUTURE DEVELOPMENT DRILLING OF OUR COMPANY'S RESERVES.

BUT THIS WILL NOT ALLOW FOR EXPLORATION.

OUR COMPANY, AND MOST INDEPENDENTS, MUST TURN TO OUTSIDE RISK CAPITAL IN A HIGHLY COMPETITIVE MONEY MARKET FOR MOST OF OUR EXPLORATION FUNDS. WE SIMPLY DO NOT HAVE SUFFICIENT CORPORATE REVENUE FOR THIS PURPOSE. NOR WOULD IT BE WISE FOR US TO ABSORB 100% OF SUCH A HIGH RISK VENTURE ANYWAY.

SO TWO THINGS FORCE US TO OUTSIDE VENTURE CAPITAL. FIRST, THE VERY VOLUME OF MONEY WHICH WILL BE NECESSARY. AND SECOND, THE RISK ITSELF MUST BE SPREAD. IT IS THE ONLY WAY IT WILL WORK.

GIVEN AN EXTREMELY COMPETITIVE AND TIGHT MONEY MARKET, WHAT WILL ATTRACT SUFFICIENT FUNDS TO VENTURE INTO SUCH A HIGH RISK ENDEAVOR? WHAT WOULD IT TAKE TO ATTRACT YOUR INVESTMENT DOLLARS INTO OIL AND GAS EXPLORATION? THIS IS A FAIR QUESTION. AND ONE WHICH EVERY LEGISLATOR SHOULD WEIGH PERSONALLY FOR HIMSELF BEFORE TAMPERING WITH AN INDUSTRY AS CAPITAL INTENSIVE AND AS FRAUGHT WITH RISK AS IS THE EXPLORATION FOR NEW RESERVES OF OIL AND GAS.

WE SUBMIT THAT ONLY TWO THINGS WILL ATTRACT SUFFICIENT RISK CAPITAL. A MARKET PRICE FOR CRUDE OIL AND NATURAL GAS WHICH IS COMMENSURATE WITH THE HIGH RISK INVOLVED; AND A FAVORABLE LEGISLATIVE AND TAXING CLIMATE WITHIN WHICH TO OPERATE. THIS MEANS INTANGIBLE DRILLING COSTS, AND INCREASED MINERAL DEPLETION.

YES, WE SAID INCREASED DEPLETION ALLOWANCES. AND IT TIES TO OUR NEED FOR EXPLORATION. PRIOR TO 1926 DEPLETION WAS BASED UPON DISCOVERY-VALUE, BUT SO MANY TECHNICAL DIFFICULTIES AROSE IN APPLYING THIS METHOD FAIRLY THAT CONGRESS REPLACED IT WITH A PERCENTAGE WHICH WOULD REALIZE ABOUT THE SAME TAX RESULTS AS DISCOVERY-VALUE DEPLETION. IF THIS WISE COURSE IS TO BE FOLLOWED, IT NOW MEANS DEPLETION ALLOWANCES SHOULD AGAIN BE INCREASED.

DEPLETION LIKE DEPRECIATION IS A DEEPLY ROOTED, SOUND ECONOMIC CONCEPT RECOGNIZED IN STANDARD ACCOUNTING PRACTICE AND SANCTIONED OVER A LONG PERIOD OF TIME BY THE NATION'S COURTS. IN THE CASE OF WASTING ASSETS SUCH AS THE PRODUCTS OF MINES, WELLS AND MORE THAN 80 OTHER EXTRACTIVE MINERALS, DEPLETION IS USED TO MEAN THE VALUE OF THE ASSETS EXTRACTED.

THE INDEPENDENT OIL AND GAS OPERATOR, LIKE MERCHANTS UNABLE TO OBTAIN INVENTORY TO REPLACE GOODS SOLD FROM THE SHELF, MUST GO OUT OF BUSINESS IF HE CANNOT FIND OIL AND GAS TO REPLACE THAT WHICH HAS BEEN TAKEN OUT OF THE GROUND THROUGH PRODUCTION AND SOLD IN THE MARKETPLACE.

TO ALLOW AS DEPLETION MERELY THE COST OF FINDING THE SEVERED, OR PRODUCED OIL, AND NOT THE FULL MARKET VALUE OF SUCH OIL SEVERLY HANDICAPS THE PRODUCER IN HIS EFFORTS TO REPLACE THE WASTING ASSET.

ECONOMISTS AND ACCOUNTANTS RECOGNIZE THAT.THE INCREMENT IN THE VALUE OF THE PROPERTY DUE TO DISCOVERY OF MINERALS, OIL OR GAS CAN IN NO WAY BE DIFFERENTIATED IN PRINCIPLE FROM THE INCREMENT IN VALUE OF REAL ESTATE, STOCKS, BONDS OR OTHER PROPERTY.

IF CONGRESS REMOVES THE PERCENTAGE DEPLETION, IT IS THEREFORE SUGGESTED BY THE PRINCIPLE ABOVE THAT MANY OWNERS OF OIL AND GAS IN PLACE WILL BE SELLING THEIR PROPERTY AND TAKING A CAPITAL GAIN.

THE BUYER WILL THEN DEPLETE THE OIL SEVERED ON THE BASIS OF HIS COST, AND THIS PORTENDS A GREATLY ACCELERATED MOVE TOWARDS FURTHER CONSOLIDATION AND MONOPOLY OF OWNERSHIP WITHIN THE PETROLEUM INDUSTRY BY THE MAJOR INTEGRATED COMPANIES.

OUR POINT IS THAT CONGRESS IS MISSING ITS TARGET AND HITTING THE WRONG END OF THE HORSE. ONE THING SEEMS CERTAIN, REMOVAL OF PERCENTAGE DEPLETION WILL NOT HURT THE LARGE MAJOR INTEGRATED OIL COMPANIES SO MUCH, BUT IT MAY VERY WELL DESTROY A LARGE NUMBER OF INDEPENDENTS, AND IT WILL CERTAINLY DELIVER GRAVE HARM TO ROYALTY OWNERS AND LANDOWNERS.

HIGH CORPORATE PROFITS NOT WITHSTANDING, IF THIS NATION IS TO MOUNT A MAJOR EFFORT TO DEVELOP NEW RESERVES OF CRUDE OIL AND NATURAL GAS, THE PETROLEUM INDUSTRY'S FINANCIAL POSITION MUST BE STRENGTHENED INSTEAD OF WEAKENED THROUGH LEGISLATIVE EFFORTS.

AFTER ALL, BASICALLY SPEAKING, A CORPORATION CAN DO ONLY THREE THINGS WITH PROFIT. IT CAN PAY INCREASED SALARIES, PAY INCREASED DIVIDENDS TO ITS STOCKHOLDERS, OR RE-INVEST ITS FUNDS IN JOB CREATING, ENERGY PROVIDING ACTIVITIES. ALL THREE STRENGTHEN AN ECONOMY.

WE SUBMIT THAT THE DEBATE ON PERCENTAGE DEPLETION IS IN THE WRONG DIRECTION. WE SHOULD BE DISCUSSING HOW MUCH IT SHOULD BE INCREASED IN ORDER TO ELICIT THE MASSIVE INVESTMENT IN THE HIGH RISK VENTURE OF LOOKING FOR NEW DOMESTIC OIL AND GAS RESERVES. RESERVES WHICH MAY VERY WELL DETERMINE THE FUTURE OF THIS GREAT NATION WHICH WE ALL LOVE SO MUCH.

THANK YOU!

[illegible] MOU[illegible]
SENATOR TWENTY-SEVENTH DISTRICT
SEDGWICK COUNTY
1316 ARROWHEAD
WICHITA, KANSAS 67203

TOPEKA

SENATE CHAMBER

COMMITTEE ASSIGNMENTS
CHAIRMAN: CONSERVATION AND NATURAL RESOURCES
MEMBER: ASSESSMENT AND TAXATION
TRANSPORTATION AND UTILITIES
LEGISLATIVE, CONGRESSIONAL AND JUDICIAL APPORTIONMENT
SPECIAL COMMITTEES:
ASSESSMENT AND TAXATION
ENERGY CRISIS, CHR.
NATIONAL LEGISLATIVE CONFERENCE:
SPECIAL COMMITTEE ON ENERGY

May 24, 1974

Honorable William Green
Honorable Charles Vanik
House of Representatives
Washington, D. C. 20515

Subject: Opposing the Elimination of Depletion Allowances

Copies to:
Honorable Wilbur D. Mills, Chm. of House Ways and Means Committee
Honorable President Richard M. Nixon
Honorable John Sawhill, Administrator, Federal Energy Administration
Honorable Kansas Senate and House Delegation
[illegible]

Dear Mr. Green and Mr. Vanik:

The Joint Senate-House (bipartisan) Committee on Conservation and Natural Resources of the Kansas Legislature in meeting at Topeka, Kansas, voted unanimously to express its opposition to any action further reducing the depletion allowance on domestic oil and gas production. Our Committee further suggests that the economics of your proposed actions is most counter productive to encouraging domestic expansion of exploration for, and production of, oil and gas needed to span the gap in the near-term broad spectrum energy crunch facing this nation. The United States must depend most heavily on oil and gas until we can expand nuclear and coal power production in order to reserve oil and gas for mobile transportation needs.

Both independent operators and national oil companies should be given every incentive possible to provide the huge amount of capital needed to explore for and develop (hopefully) new production just to offset the declining reserves of this nation.

We are particularly alarmed at the serious impact of your proposed action on Kansas and Mid-continent production for the following reasons.

You may know that Kansas currently ranks fifth in gas production and eleventh in oil production and that oil and gas is the second largest revenue source to the State of Kansas.

What you probably don't know is that of the 41,000 producing oil wells in Kansas, 35,000 of them are classed as "stripper" wells which produce ten barrels or less per day, with the average about four barrels per day--and yet these wells are producing two-thirds of the Kansas production.

The point is that these are marginal wells and the production from a substantial portion of them would be wiped out if the depletion allowance is lost because of your efforts.

The Kansas Geological survey, a department of Kansas University, testified before the Committee that only one of eleven wells drilled in Kansas is a producer. This means that the one producing well has to pay for the cost of the other ten wells plus the recovery of cost of the producer. You will find similar high risk ratios in other midwestern states. So if you think it's all gravy, why don't you put some of your money in midwestern oil and gas exploration?

Most of the exploration in Kansas is by independent operators who operate under obviously high risk conditions. Historically the depletion allowance has been maintained as a tax incentive to encourage the exploration for more oil and gas. Now, more than ever before, the nation needs the independent operator. And you propose to kill the goose that lays the golden egg.

In 1973, this nation depended on imports for 35% of her needs. At $2.00 a barrel, which the "big" oil companies were providing to U. S. consumers, this was a real bargain. But our balance of payments can't stand a six-fold increase in cost that we now face at the 35% level of import--much less at 50% as some predict, as we become more dependent on foreign oil. In the scramble to stem the balance of payment deficit, we are exporting grain, much needed fertilizer and other critical materials, thus driving up the inflationary spiral of costs at home.

We suggest that the National Congress should take into consideration the "grass roots" consensus of the state legislatures. This would be a good place to start in order to avoid some of the precipitous unsound actions advocated by some members of Congress.

We are sending a copy of this letter to President Nixon, requesting him to veto your action if Congress eliminates the present depletion allowances.

We hope the combined economic judgment of the House is better than the understanding you have demonstrated.

Respectfully submitted,

As authorized by the Joint Senate-House
Committee on Conservation and Natural
Resources of the Kansas Legislature

By____________________________
Sen. Vincent Moore, Chairman

Statement of

KARNEY R. COCHRAN

PRESIDENT, PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION

AND REPRESENTING THE NEW YORK STATE OIL PRODUCERS ASSOCIATION

Before the

SENATE FINANCE COMMITTEE

June 6, 1974

My name is Karney Cochran. I represent the Pennsylvania Grade Crude Oil Association and the New York State Oil Producers Association. This is the region where it all started.

For thirty-five years, I worked for a small independent company that had its beginning in 1860. In 1969, they liquidated a major portion of their oil holdings, including all their operated properties solely because other investments were more attractive than producing oil.

I am an independent producer. I own and operate over two hundred and fifty wells which produce one hundred and forty barrels per day.

We are all small producers, we are at the very bottom of the producing scale.

I know your first reaction is "why take up our time with this drop in the bucket?"

The Pennsylvania Grade region produces less than one-third of one percent of our domestic production. However, it furnishes approximately eighteen percent of its lubricants, and lubricants too are in tight supply.

It's typical of the highly specialized nature of this industry.

Our crude has always been a premium oil. We have normally been paid a price 50 percent higher than the rest of the country. Our costs, as you might expect from these small wells, are also higher.

You may further ask, at what point should we cease production from these wells? When do they reach their economic limit? We feel we should be able to produce them in competition with foreign crude, without a burdensome excise tax based on price. We don't understand why we should have to plug our wells as long as the country is importing oil at higher prices. We are important to the economy of our area. The industry pays more taxes in New York State in those townships it operates than any other industry.

Our industry is undergoing a resurgence as a result of the higher prices we now receive. All available rigs are busy. Our production is increasing. We have pipe shortages and people shortages. The average age of the cable tool drillers we employ is over 63 years. They don't grow them anymore.

Our problems are many, and money is one of them. We are opposed to any action by the government which would remove one dollar from the industry. Consider for a moment the capital needs of the domestic segment of the petroleum industry in the next few years. The best estimate I have seen is from five hundred billion to one trillion dollars, about twice our national debt. This makes the 'obscene' profits of the industry look like peanuts. The industry will be hard pressed to meet this challenge.

This is no time to penalize us with punitive measures just because it's politically expedient.

The depletion allowance has always been an important part of our capital structure. It was created almost fifty years ago after very serious deliberation as an inducement to producers to stay in business and accept the unusual risks inherent in it. Being in a high cost area, practically all of our operators are limited to fifty percent of net income for depletion purposes.

The late President Kennedy said on the subject of depletion in 1960, "The depletion allowances which affect over 100 items should be considered primarily as a matter of resource policy and only secondarily as a tax issue."

If depletion is eliminated, as proposed, then every independent producer must re-assess his position and determine if he should sell out. A portion of his selling price then becomes the basis for cost depletion by the purchaser. What has been gained, other than to eliminate a producer?

The proposed "windfall" profits tax based solely on price would have the effect of cutting the price we receive for oil by about three dollars per barrel. This tax, which does not take costs into account, would result in a loss of domestic crude. At the same time, it would have no effect on the higher priced foreign crudes imported to replace it.

We in the Pennsylvania Grade region are most concerned about the lack of understanding of the seriousness of the energy problem. We feel it is here to stay. There will never again be an abundant supply of inexpensive energy. World demand is too great and the sources of energy too limited.

Almost everyone pays lip service to project independence, but little has been done by the government to achieve it. We need definite helpful policies by the government. We need them so that we can plan our operations. We need them now.

Gentlemen, I make no apologies for our industry. I'm proud of it. It has furnished this country with energy so cheap, few people ever gave it a thought until last fall. The problem now lies in getting enought at any price, and getting it quick. We do not have an indefinite time to solve this problem. We need your cooperation, not your coercion.

I thank you on behalf of those I represent and myself for the opportunity to present these views.

PREPARED TESTIMONY BEFORE

THE SENATE FINANCE COMMITTEE

JUNE 6, 1974

by

JOHN G. PHILLIPS

CHAIRMAN OF THE BOARD

THE LOUISIANA LAND AND EXPLORATION COMPANY

IMPORTANCE OF THE OIL DEPLETION ALLOWANCE TO THE UNITED STATES

The potential changes in the depletion allowance should be viewed within the framework of the United States and world energy outlook, the resulting objectives that the United States should pursue, and the valuable perspective of history; these subjects are discussed below.

The Outlook

Our recent evaluation of the energy outlook has taken into account a rapid movement toward economic conservation in the use of energy and a resulting drop in the growth rate of total energy demand, as well as the revitalization of the coal industry (Table 1). Recognizing these developments and assuming that the present price of U.S. crude oil will be maintained in constant dollars and the depletion allowance will be maintained at the present rate, we nevertheless foresee the need for further increases in oil imports through this decade at least (Table 2). While the level of imports forecast for 1978 and 1980 are well below that which appeared likely in pre-embargo days, they do increase from the 6 million barrels per day level of last year to about 9 million barrels per day by 1978-80.

The outlook for the free world petroleum supply and demand in total (Table 3) has also changed rather drastically from pre-embargo days, but even with slowed economic growth in many parts of the world, we still foresee a growth in oil demand from 48 million barrels per day currently to 60 million barrels per day by 1980. If demand can be held to this level and if United States and other non-Arab sources expand as may be possible, it is conceivable that Middle East output can be held close to the present level.

Restraining our demands on Middle East oil can be of great economic significance to the free world. OPEC has amply demonstrated its power;

control of the international price of crude oil rests fully in their hands. They could lower their price voluntarily or competitive conditions could force them to lower their price. But it is more probable that the price will increase with inflation if Middle East output does not expand significantly. If the world demands an appreciable expansion in Middle East output, the price on all OPEC output will probably rise more rapidly than inflation. For every 1 million barrels per day expansion, we estimate an increase in price of $1 a barrel; on U. S. imports alone, the annual cost would be $3 billion.

National Objectives

A national goal of striving toward energy self-sufficiency is critical to our long term economic security even though there is no hope of achieving it for a decade or even longer. There are benefits during this interim period because to the extent that domestic energy production is increased, oil imports from the Middle East will be that much less; the cost of all oil imports will also be reduced.

Today, the average price of crude oil produced in the United States is more than $3 a barrel below the delivered price of foreign crude oil. There is almost no chance, short of a depression, that the price of foreign crude will drop below the present price of U. S. crude, in constant dollars, and will probably be higher. By increasing U. S. self-sufficiency, we gain from a lower average price of energy as well as in improvement in balance of payments. Finally, if a rapid increase in Middle East production is relied upon, we may well discover that the increased output simply will not be made available, and U. S. economic activity would be unable to expand. Literally hundreds of billions of dollars in Gross National Product can be lost in this manner. The proof is lost economic activity during the embargo.

Another national objective that has long been pursued is the maintenance of the competitive structure of the petroleum industry. There is competition and we hope that all proposed future government policies will be tested to determine their potential effect on the structure of the industry.

Historical Perspective

If we assume that in 1959 the Oil Import Control Program had not been instituted and the depletion allowance on oil had been withdrawn, domestic production of oil and gas would have declined because of the devasting effect on U.S. exploration. Oil imports in 1973 would have been 12 million barrels per day instead of 6 million barrels per day with all of that increased magnitude coming from Arab oil production in the Middle East. This, after all, would have been the objective--turning to the low cost and "inexhaustible" source of oil in the Middle East. The consequences would have been:

1. Eight billion dollars of additional oil imports in 1973 alone. Over $100 billion of additional oil imports between 1973 and 1980.
2. Loss of GNP in excess of $100 billion during Arab oil embargo. Much tighter future energy supply, perhaps insufficient to permit continued economic growth; potential loss in the hundreds of billions of dollars.

Against these staggering costs, the contention has been that the cost of energy to U.S. consumers would have been reduced by $5 to $7 billion a year, because of the lower price of crude oil, but this ignores the fact that the finding rate and output of low-priced natural gas would also have been reduced.

Taking all the changes into account, U.S. consumers would have paid at least as much for energy even if oil imports had been completely unrestricted--thus, the short term benefits would have been zero while the long-term costs would have been over $100 billion.

Present Perspective

If the oil depletion allowance were to be withdrawn in 1974, we need to think of the long term consequences. The post-embargo situation is quite different; the consequences are perhaps less obvious.

One consideration is the eventual effect on all other minerals. It is presumed that the depletion allowance on all minerals would eventually be withdrawn. Loss of depletion allowance would have an adverse effect on the relative attractiveness of U.S. production of many minerals, yet more than ever we need to encourage U.S. production in order to minimize the degree of success of foreign countries in cartelization of minerals production.

As for the direct economic significance to the oil industry, there are a number of factors. First, what would happen if the price of foreign oil were to drop back to $3 or $4 a barrel? We do not think this will happen, but some analysts do. Obviously, the old trend of declining oil production would continue and the loss of depletion benefits would accelerate the decline.

Second, were the price of oil to remain high, there will still be an effect on the development of domestic oil resources if depletion is withdrawn. Exploration and development expenditures would be 15% to 30% lower than

with continuance of the depletion allowance at 22%. The full effect would be felt by about 1980; we estimate 1 million barrels per day less U. S. production in that year without depletion than with depletion. There are three potential consequences:

1. The higher level of required oil imports adds that much more to the balance of payments problem, probably over $5 billion a year.
2. The added import level would create greater demand pressure on Middle East oil supplies, and lead to a still higher price for international oil. Our imports in 1980 could cost an additional $3 billion or more for this reason.
3. The lower domestic energy supply than under optimum conditions increases the chance of insufficient energy supply to maintain economic growth up to our potential. The effect of 1 million barrels per day shortfall is some $30 billion a year in GNP.

The above effects are for one year only (1980). The effect in earlier years gradually increases to the 1980 level, and continues to increase thereafter. Cumulative effect over many years is of course quite appreciable, and will certainly more than offset any financial gain to the U. S. Government from higher tax payments.

The above analysis is based on industry wide impacts, which would apply to LL&E as a specific entity in the industry. Let me describe briefly our own situation. In 1973 our earnings increased 11 percent over 1972, far below the increase for the total industry, which was primarily influenced.

by foreign earnings that LL&E did not participate in. Even if our earnings increase is 50 percent this year, which we do not think is achievable, the rate of increase in earnings through 1974 would average only 11 percent per year for the past 10 years. With the present level of earnings and a domestic oil price that is maintained in constant dollars, we believe we can achieve an increase in domestic production. Our wildcat drilling in 1974 is up 50 percent in number of wells and 100 percent in dollar expenditures. Our dividends as a percent of net profits has been trending downward; we do not expect the dividends percentage to increase with the higher level of earnings. Beginning in 1972, we have been plowing back into exploration an amount equal to our total earnings and total reinvestment has been equal to 135 percent of earnings. Obviously, this was accomplished only by increasing the debt burden. Loss of depletion would reduce LL&E's earnings by one-quarter and would force us to reduce our wildcatting expenditures by roughly 50 percent. Our U. S. oil production would probably decline rather sharply.

Returning to the industry-wide picture, loss of depletion works hardest on the independent producer. There is an adverse impact on the large integrated oil companies, but the effect on the independent is still greater. The oil industry is not monolithic; there is a great diversity of interests which makes for a highly competitive industry. Withdrawal of the depletion allowance further weakens the domestic producer, whose ranks have already been thinned in the past 15 years.

Conclusion

In the broad perspective, U. S. energy production must catch up to our demands as quickly as possible, which even requires a reversal of recent trends. This task is tremendous; to accomplish it, the oil industry must realize a high price on domestic crude oil and must maintain the depletion allowance at the present rate.

Table 1

DEMAND FOR ENERGY IN THE UNITED STATES, BY FORM OF ENERGY
1972-1980

	1972	1973	1974 Normal	1974 Probable	1975 Normal	1975 Probable	1976	1978	1980
A. All forms of energy (millions of barrels per day equivalent)									
Coal (see B below)*	6.0	6.3	6.7	6.7	7.1	7.1	7.4	8.0	8.5
Oil	16.4	17.2	18.5	17.5	19.5	18.6	20.0	21.7	21.7
Gas (see C below)	10.9	10.9	10.5	10.5	10.2	10.2	10.2	10.4	10.6
Hydroelectric	1.3	1.3	1.5	1.5	1.4	1.4	1.4	1.5	1.5
Nuclear	0.3	0.5	0.6	0.6	0.9	0.9	1.2	1.7	3.5
Total	34.9	36.2	37.8	36.8	39.1	38.2	40.2	43.3	45.8
B. Total coal production (millions of tons per year)									
Used as such	580	600	660	660	700	700	735	800	900
Converted to gas	0	0	0	0	0	0	12	24	60
Exports	56	60	60	60	60	60	60	60	60
Total	636	660	720	720	760	760	807	884	1,020
C. Gas sources (in trillions of cubic feet per year)									
Natural gas, 48-State	23.1	22.9	22.6	22.6	22.0	22.0	22.0	22.0	22.0
Natural gas, Western Canada	1.0	1.0	1.0	1.0	0.9	0.9	0.8	0.5	0.5
Arctic gas	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Oil gasification	0.0	0.0	0.0	0.0	0.2	0.2	0.3	0.5	0.5
Coal gasification	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.6
LNG	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.3	0.5
Total	24.1	23.9	23.6	23.6	23.1	23.1	23.3	23.6	24.1

* Coal used as such.

Source: S. H. Clark Associates.

Table 2

TOTAL PETROLEUM DEMAND/SUPPLY BALANCE IN THE UNITED STATES
(Thousands of Barrels per Day)
1972-1980

	1972	1973	1974 1st Qtr.	1974 2nd Qtr.	1974 3rd Qtr.	1974 4th Qtr.	1974 2nd-4th Qtr.	1974 Year	1975	1976	1978	1980
Total domestic demand	16,367	17,251	16,681	16,910	17,270	18,470	17,560	17,340	18,620	19,970	21,670	21,770
Supply												
Indigenous production												
Crude oil	9,015	8,768										
Lease condensate	426	419										
NGL	1,714	1,738										
Subtotal	11,185	10,925	10,870	10,800	10,700	10,700	10,730	10,770	11,000	11,500	12,500	13,700
Imports												
Crude oil	2,216	3,244	2,307	3,310	3,740	3,990	3,675	3,335	3,930	4,390	4,270	4,040
Unfinished oils	125	137	150	110	110	110	110	140	150	150	150	150
Plant condensate	86	103	110	110	110	110	110	110	120	130	140	150
Refined products	2,314	2,718	2,500	2,370	2,720	3,200	2,765	2,750	3,070	3,420	4,170	3,270
Other hydrocarbons	27	30	30	30	30	30	30	30	30	30	30	30
Total new supply	15,953	17,157	15,967	16,760	17,410	18,170	17,453	17,135	18,300	19,620	21,260	21,340
Unaccounted for crude oil	28	23	20	20	20	20	20	20	20	20	20	20
Processing gain	389	453	410	420	470	490	460	435	510	540	600	620
Total supply	16,370	17,633	16,397	17,200	17,940	18,680	17,935	17,600	18,830	20,180	21,880	21,980
Stock change, all oils	(232)	135	(500)	50	-450	0	165	50	0	0	0	0
Total	16,602	17,498	16,897	17,150	17,480	18,680	17,770	17,550	18,830	20,180	21,880	21,960
Exports												
Crude oil	--	2	0	0	0	0	0	0	0	0	0	0
Products	222	229	200	200	200	200	200	200	200	200	200	200
Subtotal	222	231	200	200	200	200	200	200	200	200	200	200
Crude losses	13	13	13	10	10	10	10	10	10	10	10	10
Total domestic supply	16,367	17,254	16,684	16,940	17,270	18,470	17,560	17,340	18,620	19,970	21,670	21,770

Source: Developed by S. H. Clark Associates.

Table 3

ESTIMATED OIL PRODUCTION BY REGION OF THE FREE WORLD
(Millions of Barrels per Day)
1972-1980

	1972	1973	1974 1st Qtr.	1974 2nd Qtr.	1974 3rd Qtr.	1974 4th Qtr.	1974 Year	1975	1976	1978	1980
United States*	11.2	10.9	10.8	10.8	10.7	10.7	10.8	11.0	11.5	12.4	13.7
Canada*	1.8	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9	2.0	2.1
Western Europe	0.4	0.4	0.4	0.4	0.4	0.5	0.4	0.9	1.5	2.2	3.0
Venezuela	3.2	3.4	3.3	3.1	3.1	3.1	3.2	3.1	3.1	3.0	3.0
Other South America	1.5	1.8	1.8	1.8	1.8	1.8	1.8	1.9	2.0	2.2	2.4
Total Latin America	4.7	5.2	5.1	4.9	4.9	4.9	5.0	5.1	5.1	5.2	5.4
Libya	2.2	2.1	2.0	1.9	1.8	1.8	1.9	1.8	1.8	1.8	1.8
Algeria	1.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Nigeria	1.8	2.0	2.2	2.2	2.3	2.3	2.2	2.4	2.6	3.0	3.2
Other Africa	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.5	0.6	0.9	1.2
Total Africa	5.7	5.7	5.7	5.7	5.7	5.7	5.7	5.7	6.0	6.7	7.2
Saudi Arabia	6.3	7.4	7.9	8.5	9.0	9.0	8.6	7.8	9.4	10.3	10.0
Iran	4.9	6.0	6.1	6.2	6.2	6.2	6.2	6.0	6.5	6.7	6.7
Kuwait	2.8	2.9	2.8	2.7	2.7	2.7	2.7	2.5	2.5	2.5	2.5
Iraq	1.5	1.9	1.8	1.8	1.8	1.8	1.8	1.8	1.8	2.0	2.0
Other Middle East	2.7	3.2	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.7	2.7
Total Middle East	18.2	21.4	21.0	21.7	22.2	22.2	21.8	20.6	22.7	24.2	23.9
Indonesia	1.0	1.3	1.5	1.5	1.6	1.6	1.5	1.7	1.9	2.3	2.7
Other Pacific Basin	0.8	0.9	1.0	1.0	1.0	1.0	1.0	1.1	1.2	1.5	1.8
Total Pacific Basin	1.8	2.2	2.5	2.5	2.5	2.5	2.5	2.8	3.1	3.8	4.5
Total Free World	43.8	47.8	47.5	48.0	48.3	48.4	48.1	48.0	51.8	56.5	59.8

Note: Totals may not add due to rounding.
* Includes gas liquids.

Source: Developed by S. H. Clark Associates.

Statement of
William C. Myler, President
Muskegon Development Company

and representing
The Michigan Oil and Gas Association

Before the
Finance Committee
United States Senate
June 6, 1974

My name is William C. Myler, and I am president of Muskegon Development Company, Mt. Pleasant, Michigan. Our company is typical of the small Michigan independent producer and has been in business since 1928, having drilled and operated one of the first producing wells in the state.

It is my purpose to discuss the importance of percentage depletion in terms of enabling expansion of operations, both through exploratory drilling and secondary recovery operations, to increase both oil and natural gas reserves and production in the United States. So far as our company is concerned, the funds retained through depletion have been our operational lifeline. This is true because we consistently have reinvested our depletion funds, plus the great bulk of our profits, in programs to expand production.

Primarily, Muskegon Development is an operator of stripper wells in the true sense of the word. Throughout the state of Michigan, we operate 300 producing oil wells with a total output of 700 to 800 barrels daily. Our average production approximates 2-1/2 barrels per day per well. Because of the varying costs among our different producing properties, it is noteworthy that of 179 separate leases operated by our company, we were able to claim depletion on only 56 leases in our latest tax year. Of these 56 leases, the 22 percent depletion rate applied on only 21. Overall, on our gross sales of $885,424, our total depletion amounted to $130,602, or an overall average of only 15 percent.

Because our company always has plowed back its depletion funds in exploration, secondary recovery, and maintenance work on its producing properties, our company would not have been in existence today except for this incentive. Since 1962, primarily with funds retained through depletion, we have helped develop two new natural gas fields in Michigan with combined reserves of some 29 billion cubic feet. Both of these fields have been sold to public utilities in Michigan which will produce them and then use them for much-needed natural gas storage.

In addition to these natural gas discoveries, Muskegon has in the same time period helped develop two water floods which will increase ultimate recovery of oil from the flooded fields by 2,500,000 barrels. Also in this period, we have approximately doubled our production and increased our gross sales from $435,000 to $885,000 in 1973.

In the last five years we have retained through percentage depletion a total of $593,000, or approximately $120,000 per year, all of which was reinvested to enable the additions to the oil and gas energy production in Michigan that I have just described. Except for percentage depletion, I wish to reemphasize, our cash flow would not have been sufficient to underwrite this expansion and the increased production that has resulted.

Muskegon Development Company admittedly is not a major economic entity whose survival is of tremendous importance to many people. It has only 26 employes, which means it provides a livelihood for approximately 100 people. But it is typical, I feel, of some 200 small producers who operate some 4,000 producing wells in the State of Michigan, and typical of many of the 10,000 independents who do most of the exploration for oil and gas in the United States.

The average daily production of all the wells in Michigan is only nine barrels daily, and the overwhelming majority - some 82 percent - are stripper wells

producing far less than the average. It is my conviction that except for percentage depletion, many of these wells would be abandoned and lost permanently. With the depletion provision, many are subject to secondary recovery programs that would significantly increase the ultimate production of oil from existing fields.

We have used and will continue to use depletion funds to (1) engage in exploratory drilling ventures, (2) buy new leases for further development, (3) buy stripper production which shows promise for secondary recovery operations. Should the Congress choose to terminate the depletion provision, we will be forced to terminate our efforts to expand our production by the means just mentioned.

It is my conviction that hundreds if not thousands of small producers would likewise sharply curtail if not terminate their exploration and costly secondary operations. I cannot believe, Mr. Chairman, that the Congress wants to bring about such a result, and for this reason, I hope serious and more complete thought will be given to the proposals to phase out or repeal the depletion provision - and that the Congress in its wisdom will reject these proposals.

STATEMENT OF W. K. McWILLIAMS, JR.

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

McMoRan EXPLORATION CO.

Before the

SENATE FINANCE COMMITTEE

JUNE 6, 1974

McMoRan Exploration Company, relatively new as a publicly owned company (since December, 1969) is a true domestic independent "wildcatter" and explores solely for oil and gas reserves, building equity in the company by selling "expertise" for a participation in its own exploration activity.

McMoRan's income depends upon receipts from sale of crude oil and natural gas at the wellhead.

Like many of the independent operators, McMoRan, privately before 1969 and since as a public company, has depended on outside capital to support its exploration programs, but is responsible for expenditures for its proportionate interest in development and operational costs.

Risk capital backing domestic exploration by many independents has largely resulted from favorable tax incentives such as the depletion allowance and charge-off of intangible drilling costs.

EXAMPLE OF IMPORTANCE OF TAX INCENTIVES

McMoRan had a verbal understanding for backing in 1973 for $10,000,000 and had spent over half a million assembling drilling prospects which totaled $3,000,000 in drilling commitments, when Secretary Shultz proposed doing away with charge-off of intangible drilling costs. This proposal came only a day or so after the President's Energy Message where Operation Independence was spawned. The message sounded every encouragement to increase domestic exploration. The commitment to us

for risk capital was withdrawn and it was necessary for McMoRan to completely change its mode of operations by making arrangements to be backed by an end user of products, the Dow Chemical Company. These negotiations necessitated several months of delay in exploration.

The present domestic price of oil and gas at the wellhead accounts for very little of the high prices of petroleum products to the consumer. The blame must be placed on the high prices paid for foreign oil and the higher cost for refining, etc.

Statistics will show that few, if any, so called "windfall profits" have resulted in the domestic oil and vas industry, and certainly not for the independent depending on receipts of sales at the wellhead.

Thousands of independents have left the industry since the federal control of gas prices at the wellhead in the mid-Fifties, but a marked increase in domestic activity is clearly demonstrated since the adjustment upward of prices in 1973. Proposals in the Congress at the present time are sure to reverse this trend and force many qualified people out of the industry at a time when they are desperately needed.

Government regulations by many agencies, oil field shortages of tubular goods and drilling rigs, the confusing uncertainties of federal controls and the many proposals in Congress relative to the oil and gas industry make future planning and projections next to impossible, and we are desperately in need of a measure of stability.

Being a relatively new entity as a private company with production runs of only $60,000 in 1969, statutory depletion at first was not a major factor, but with 1973 production at $2,759,000 and projected to exceed 4 million in 1974, statutory depletion has become a major consideration in plans to plow back capital

to increase our participation in our own exploration effort, and is vital as an incentive to attract outside risk capital to McMoRan's exploration ventures.

Since 1969 through the 1972-73 program McMoRan has drilled 189 total exploratory wells being 139 dry holes and fifty discoveries, and in addition, has drilled 88 development wells resulting in fifty completions. Total footage drilled has been approximately 1,936,022 feet of which 1,437,371 has been exploratory. These operations have resulted in participation in the discovery of some fifteen million barrels of liquid hydrocarbon and some 260 billion cubic feet of natural gas as calculated by third party reservoir engineers. Total risk capital of investors spent in this interim was approximately $25,000,000.

It is our conviction that most if not all of this venture capital would have been unavailable to us without present tax incentives, including percentage depletion.

McMoRan in 1974 has a 12 million dollar exploration program with Dow Chemical Company, an end user of product, as the principal backer, and has exploration operations under the program either in progress or planned for Coastal Louisiana and Texas, South Texas, West Texas, New Mexico, Colorado, Wyoming, Montana, Michigan, Mississippi, Alabama, North Dakota, and possibly Utah, Florida and Arkansas.

Through the first nine months of fiscal '74 McMoRan has shown a loss due to high interest rates and the necessity to change format for exploration backing, and has been forced to sell 20 percent of its reserves for cash to partially satisfy banking loans to finance development operations. Third party engineering calculations show McMoRan to own some $45,000,000 in future net production income for its proportionate part of reserves found and has spent approximately $15,000,000 for its part of exploration, development and operations.

McMoRan has never paid a dividend nor is one anticipated in the foreseeable future inasmuch as McMoRan's philosophy is to plow back the revenues from production

runs toward increasing its interest in its own exploration programs.

With a 12-1/2 million dollar program completed in 1973, McMoRan drilled some 88 exploratory wells, many of which were relatively deep ventures in Coastal Louisiana and Texas. This number of operations exceeded, considerably, the domestic effort of most of the large companies. In fact, quoting Fortune Magazine, Exxon, the largest oil company in the world, drilled only 35 domestic exploratory wells in the lower 48 states last year.

Gentlemen, I submit to you that McMoRan, like hundreds of other qualified domestic independents, is not worried about their ability to find oil and gas reserves given the incentives, and allowing us to operate under our proven system of free enterprise and competition. The oil industry has a remarkable record of achievement and has met every road-block in technology head-on and solved them. Without undue controls and intervention by government (where history teaches us this practice has met with disaster on nearly every occasion) we will solve the present energy problem.

The domestic industry needs, as never before, the involvement of the thousands of independents who are first into new areas with risk capital, and last out after performing the clean-up work and stripper well operations which are uneconomical for the large companies, but are essential to find and recover millions of barrels which would never be produced.

McMoRan EXPLORATION CO.
History of Drilling Programs - 1969 - 1972

YEAR	NO. OF EXPLORATORY WELLS DRILLED	DRY HOLES	DISCOVERIES	NO. OF DEVELOPMENT WELLS DRILLED	DRY HOLES	COMPLETIONS	TOTAL FOOTAGE DRILLED*	(EXPLORATORY*	- COMPLETION)*
1969	13	8	5	12	6 1 SWD	5	249,850'	135,750'	114,100'
1970	27	22	5	8	2	6	327,711'	256,665'	71,046'
1971	61	43	18	44	15	29	650,268'	424,582'	225,686'
1972	88	66	22	24	14	10	708,193'	620,374'	87,819'

189 TOTAL EXPLORATORY WELLS
139 dry holes
50 DISCOVERIES

88 DEVELOPMENT WELLS
38 dry holes
50 COMPLETIONS

1,936,022' TOTAL FOOTAGE*
1,437,371' EXPLORATORY FOOTAGE*
498,651' DEVELOPMENT FOOTAGE*

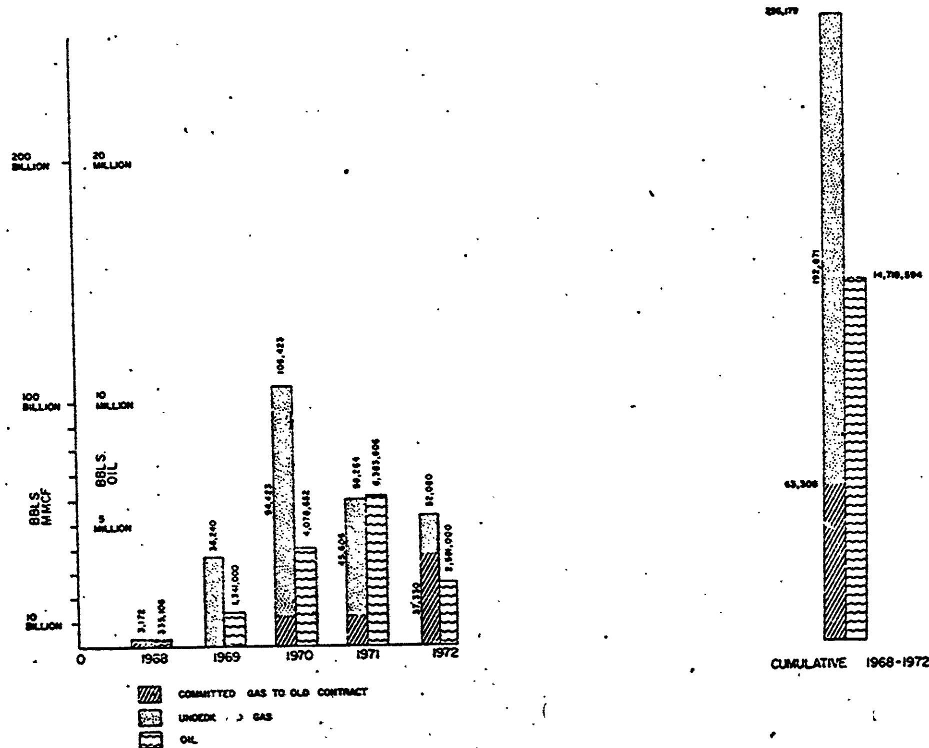
All wells are program wells proper except for 1970 Program, which includes The GeoDynamics year end deals.

* Approximate numbers

Cindy

McMoRan EXPLORATION CO.

U.S. Reserves Discovered 1968 - 1972



The CHAIRMAN. Now, I would suggest that at this point, before we hear any more witnesses on oil and gas, I would like to accommodate those who came to testify on other subjects.

Is Mr. Charles I. Derr, senior vice president of the Machinery and Allied Products Institute here?

Mr. DERR. Right here, sir.

The CHAIRMAN. Would you please take the stand, sir?

STATEMENT OF CHARLES I. DERR, SENIOR VICE PRESIDENT, MACHINERY & ALLIED PRODUCTS INSTITUTE, ACCOMPANIED BY RICHARD R. MacNABB, VICE PRESIDENT AND SECRETARY, AND WILLIAM J. HEALEY, JR., STAFF COUNSEL

Mr. DERR. Mr. Chairman, members of the committee, my name is Charles Derr. I am senior vice president of the Machinery & Allied Products Institute, which as you may know is a national organization of capital goods and allied industrial equipment manufacturers.

My associates are immediately on my right, Mr. Richard R. MacNabb, vice president and secretary of the institute, and on his right, Mr. William J. Healey, Jr., who is the institute's staff counsel.

In accordance with the rules of the committee, Mr. Chairman, I intend to summarize my statement. But I do ask leave of the Chair that the full statement be included in the printed record.

The CHAIRMAN. That we will do, sir.

Mr. DERR. Thank you, sir.

CAPITAL FORMATION AND INVESTMENT

I would like to speak briefly about some of the problems of capital formation and investment which we thing are critically involved in the tax proposals now before this committee. Directly or indirectly, most of these so-called tax reform proposals would adversely affect capital formation and investment. Capital requirements in the United States are very high and rising.

As a current measure of those requirements, business capital investment in 1973 was running at the rate of about $100 billion annually, with a 12-percent increase in current dollars projected by the Commerce Department for 1974 over last year's expenditures.

Besides the continuing growth of normal investment, there are very substantial new capital requirements necessitated by our national commitment to achieving independence in energy resources. It has been estimated that capital requirements for this purpose alone would amount to $600 billion or more from 1974 through 1985, or roughly $56 billion per year for energy alone. A part of the surging demand for capital investment is occasioned by new environmental and safety and health requirements. McGraw-Hill has estimated this element of current capital spending, largely nonproductive in character, at some 8.5 percent of the total.

The steel industry, to take a single industry as an example, anticipates annual capital expenditures of $3 to $4 billion for the period 1974 through 1980, which is an amount almost exactly twice that spent by the industry during the period 1963 through 1972.

To some degree, the impending shortage of capital is concealed by the illusory character of business profits. As the result of inflation, profits are now grossly overstated by conventional financial reporting. A recent institute study of this problem entitled "Inflation and Profits" reaches some starting conclusions. The study uses Department of Com-

merce figures and adjusts profits reported for: (1), the underdepreciation of fixed assets; and (2), the conversion of inventory consumption charges from historical cost to their current cost equivalents.

Over the period 1965 through 1973, some remarkable changes, all bad, have occurred in the quality of business profits. In 1965 reported after-tax profits of nonfinancial corporations were $38.2 billion, the adjusted figure is $36.1 billion—the difference is slight. In 1973, reported after-tax profits were $49.8 billion—the adjusted figure is $23.4 billion. In the latter case, the difference of $26.4 billion is accounted for by $9.1 billion in underdepreciation of fixed assets and a whopping $17.3 billion in the form of an inventory valuation adjustment.

Now, bad as those numbers are, the real story is worse. The adjusted earnings are stated in current, not constant, dollars. If we deflate by use of constant 1965 dollars, the adjusted after-tax earnings in 1973 were slightly less than one-half of those in 1965.

Moreover, because real profits are so much lower than reported profits, the effective tax rate on real profits over the past 5 years has averaged 60 percent, and in 1973 reached 66.5 percent.

I am supplying the staff a copy of this study, Mr. Chairman, and I ask leave that it be included in the record of the hearings.

The CHAIRMAN. Yes, sir.

Mr. DERR. Thank you, sir.

Other recent institute research analyzes business capital formation over an extended period of time and concludes that we have only recently reached what may be considered a normal stock of business capital goods, quantity and quality considered.

However, having in mind some of these new and growing demands for capital, to which I have already adverted, the study concludes that we must anticipate new and higher norms, and since the enlargement of business investment depends primarily on an increased flow of funds available, there is a pressing need to assure that tax policy encourages private saving and capital formation.

That study, entitled "Business Capital Formation—Putting It in Perspective (1925–1970)," is also being given to the committee staff, and with the Chair's permission, I would ask that it be included in the record.

The CHAIRMAN. Without objection, so ordered.

Mr. DERR. I thank you, sir.

Permit me to emphasize one further general point. Our present tax system is biased against savings and investment in favor of consumption. This bias is especially evident in the taxation of savings, and the taxation of the earnings of savings. The bias continues through the taxation of capital gains, estate and gift taxes, and so on.

At a time when the prospective requirements for capital—the product of savings are so high, the imposition of a massive new tax burden on business, as proposed by these amendments, would greatly accentuate the already existing bias against private savings and investment.

I conclude this portion of my remarks by observing that, given a shortage-induced inflation and the inescapable necessity of greater capital investment to enlarge and modernize our national productive plant, this would seem to be very nearly the worst possible time to impose a major new tax burden on business.

WHERE THE ULTIMATE INCIDENCE OF TAX INCREASES WOULD FALL

The chairman has asked of witnesses before this committee to endeavor to explain where, in their view, the ultimate incidence of tax

increases would fall if they were enacted, whether on business or on the consumer. This is an excellent question, for which there is no single agreed answer, although many, if not most, theorists now believe that corporate income taxes are shifted rather than absorbed.

In general, we would say that any such tax increase will be shifted as much and as fast as the market will permit. Whatever the answer in the individual case, it presents a dilemma for tax policy. To the extent such taxes are shifted, they would represent a concealed general sales tax, an increase in costs, and more fuel for inflation. To the extent that the market delays or limits shifting, the profits of corporations involved, which are already overstated, will be further reduced and the process of capital formation and investment further impaired.

Investment Credit and ADR

Now, for some brief comments, Mr. Chairman, on certain of the specific proposals before this committee. Considering the investment tax credit and ADR depreciation together, we strongly support the continuation of both in their present form. As explained more fully in our written statement, both are essential to provide the wherewithal and incentive to continued growth of the Nation's productive capacity and for the modernization and replacement of its existing equipment. Their continuation will make it possible for our economy to: One, provide the goods necessary to meet its domestic needs, civilian and defense, and in so doing combat inflation; two, provide the additional jobs and equipment required by a rapidly expanding labor force; three, provide wage increases based on increasing productivity without inducing price increases; four, fulfill our international obligations; five, meet the competition for world markets.

Referring specifically to ADR, we recommend that authority for a variation of 20 percent—up or down—from the 1962 guidelines be continued without change. Both ADR and the investment credit are necessary in our judgment to assist in providing the funds and the incentive needed to satisfy the massive capital investment requirements now so readily foreseeable. It is significant and worthy of note that before this combination of capital consumption allowances was approved by Congress in 1971, the United States had the highest capital costs among 10 leading industrial nations, including in addition to the United States the United Kingdom, Japan, Italy, West Germany, Sweden, Belgium, France, the Netherlands, and Canada.

We think this fact is not unrelated to another fact of importance to this discussion. The U.S. productivity gains since 1950 have been the lowest of any major non-Communist country.

We have recommended in our principal statement certain technical amendments to ADR but this system of depreciation and the investment credit should be retained as permanent parts of the Internal Revenue Code in our judgment, Mr. Chairman.

DISC

Several of the pending proposals call for the repeal of authority for so-called DISC's, Domestic International Sales Corporations. Authority for DISC was granted in 1971 as an incentive to increase exports at a time when our balance of payments was in deficit. Today our position has improved as exports have increased, although we are certainly not out of the woods with the prospect of enormous expenditures for the importation of oil and other basic commodities facing us. The contribution of DISC to improving our trade balance defies

exact quantification, but we agree with Treasury's recent report that it has made some contribution.

With a clear need for increased exports to pay for increased imports, this is hardly the time to remove such an incentive. Moreover, it has been in actual use for only 2 years and it should, at the very least, be given a further period of test in our judgment.

Taxation of Undistributed Earnings of Controlled Foreign Corporations

Now, as for the taxation of undistributed earnings of controlled foreign corporations, we oppose the current taxation of all earnings of controlled foreign corporations. In fact, we opposed the original adoption of subpart F or the Code and we still think it was a mistake. There are several reasons for our present position:

First, the elimination of deferral will result in new costs for U.S. companies doing business in low-tax countries which tend to be less developed and the result could be to slow the pace of U.S. investment in those areas most in need of economic assistance.

Second, Government estimates suggest that the overall revenue increase from elimination of deferral would be relatively small.

Finally, U.S.-based companies doing business through CFC's abroad will be immediately handicapped in competition with foreign-based companies if the U.S. income tax deferral is eliminated.

Minimum Tax

We recommend the continuation of the present WHTC provisions.

Finally, a comment on the minimum tax. Since its enactment, the minimum tax has contributed to the erosion of tax incentives which are very important to capital formation, many of the so-called tax preferences such as accelerated depreciation and the lower income tax rate on capital gains were consciously designed by the Congress as desirable incentives for capital formation. We believe the need for such incentives is now even greater than the undoubted need which existed at the time of their enactment. The proposal to tighten the minimum tax would simply tend to increase this impairment of capital formation.

We oppose the proposal.

That concludes my oral statement, Mr. Chairman. If you have any questions we will endeavor to answer them, sir.

Arriving at True Economic Profitability

The Chairman. I would like to ask you this: Do I understand that you are saying that an accounting system that reports profits for a corporation or for individuals should try to take into effect the inflation, particularly on inventories, in order to arrive at true economic profitability?

Mr. Derr. Well, sir, that is just about right. What I am saying is that accounting, conventional accounting and reporting, is necessarily tied to historical costs. In thus being tied to historical costs, particularly if the company is on a so-called FIFO—first-in, first-out—inventory basis, and is charging to current production, inventory which it cannot replace at the cost it paid for the inventory in the first place. The company's profits are overstated by conventional reporting. These inventory valuation adjustments are made regularly by Commerce in its figures. I think I indicated that in 1973 it ran as high as $17 billion as a proper inventory valuation adjustment for all business profits.

Actually, there has been quite a bit written about this in the financial press recently. But for some strange reason, it has been ignored.

There is a lesser, but still very significant, loss or reduction in profits in the case of underdepreciation of physical assets, fixed assets which cannot be replaced in current dollars for what it cost to put them in place in the first place. It is a matter of purchasing power and what is happening to the purchasing power of the dollar.

The CHAIRMAN. We have seen it suggested that someone should be charged a lot more taxes or denied a tax consideration that he has had heretofore because it appears that he has made a lot of money. And then when you go to analyze the profit he was supposed to have made, you may find that a lot of it is because this Government devalued the dollar. Well, when the Government devalued the dollar it meant that the Government had decided that with what was going in world trade, it was going to make its dollar worth a lot less.

Now, the taxpayer had nothing whatever to do with that decision and was not benefited by it. But since the dollar is worth less, his inventory is worth more money in terms of dollars. But he had not made anything; the dollar just went down in value.

Mr. DERR. But his market price increased in dollars.

The CHAIRMAN. Yes.

Mr. DERR. Which is to say the dollar is worth less today than it was yesterday.

The CHAIRMAN. A lot of times what we have done on the capital gains tax on citizens is just to assess a penalty on him by virtue of the fact that the Government failed to maintain the purchasing power of its money, a fact about which he had nothing whatever to say one way or the other. But you and I are so familiar with those situations where some stock or a piece of property or a piece of machinery or a plant is sold for a great deal more than one paid for it, though in terms of constant dollars he did not make any profit at all.

Mr. DERR. Precisely, sir.

The CHAIRMAN. But on that transaction, the Government proceeds to charge him the tax, and someone contends that that tax was not enough and that the minimum tax ought to be raised to make him pay more, when in the last analysis the man did not make anything anyway. All that happened was that the Government failed to maintain the purchasing power of his money and the Government is assessing a penalty on him for something he had nothing whatever to do with.

Mr. DERR. That is right, sir.

The CHAIRMAN. And in some cases these so-called large profits that someone was supposed to have made were due to the Federal Government devaluing its dollar or inflating its currency or failing to do something that he had a right to expect better of his Government doing.

Mr. DERR. I think, Mr. Chairman, that this study which, as I said, I will give the staff, is very pertinent to some of the discussions that occurred in this morning's earlier hearings, because profits were discussed, and the illusory character of today's profits was not, I think, sufficiently ventilated. It deserves to be.

The CHAIRMAN. Thank you very much, gentlemen. That was a very fine statement, and I will try to see that the Senate carefully considers it in voting on an amendment of this sort.

Mr. DERR. Thank you, sir.

[The prepared statement of Mr. Derr and material referred to follows:]

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
Before the
Committee on Finance, United States Senate
on
Certain Proposals to Amend H.R. 8217

Presented by
Charles I. Derr, Senior Vice President

June 6, 1974

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Statement of the
Machinery and Allied Products Institute
Before the
Committee on Finance, United States Senate
on
Certain Proposals to Amend H.R. 8217

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Tax Increases vs. a National Shortage of Capital

Directly or indirectly, most of the "tax reform" proposals here in question would adversely affect capital formation and investment.

1. Capital investment requirements in the United States are high and rising.

2. Business profits--from which a large share of capital requirements must come--are overstated by reason of inflation and capital itself is being taxed.

3. We have only recently achieved normalization of our national capital goods stock; in the future a higher ratio of capital formation to national product must be considered normal.

4. The present tax code contains a severe bias against private savings and investment; enactment of these proposals would accentuate that bias.

5. Given the existence of serious inflation largely induced by supply shortages together with those considerations noted above, this would be very nearly the worst possible time to impair the process of capital formation and investment and the enlargement and modernization of our productive plant by the imposition of a major new tax burden on business.

Capital Investment--The Role of the Investment Credit and Class Life ADR Depreciation

The Need To Equip a Rapidly Expanding Labor Force

The Need To Improve the U.S. International Competitive Position

1. Higher rate of productivity gains in foreign nations.

2. More favorable treatment of capital investment in Western European countries and Japan.

Unsuitability of Investment Tax Credit as a Contracyclical Control Device

MAPI Recommends:

Retain the present form and structure of the investment tax credit but extend its availability to industrial real property.

Retain ADR depreciation with the present 20 percent range but with modifications relating to:

1. Subsidiary assets
2. Leased assets
3. Repair allowances
4. Industrial real property

Taxation of Foreign Income

Domestic International Sales Corporations.--DISC provisions should be continued. We suggest that a case can be made for elimination of the 50 percent limitation on tax deferral of DISC income.

Tax deferral of foreign subsidiary income.--All earnings of controlled foreign corporations should not be subject to current taxation; indeed, there are strong reasons for repealing the present Subpart F of the Code.

Western Hemisphere Trade Corporations.--Present WHTC provisions should be continued.

Minimum Tax on Tax Preferences

We urge rejection of the proposal to expand the minimum tax concept. Indeed, we believe the entire rationalization of the minimum tax concept is specious and we recommend its repeal.

Statement of the
Machinery and Allied Products Institute
Before the
Committee on Finance, United States Senate
on
Certain Proposals to Amend H.R. 8217
June 6, 1974

The Machinery and Allied Products Institute appreciates this opportunity of commenting on certain tax increase proposals now pending before the Senate. As you may know, the Institute is a national organization of capital goods and allied industrial equipment manufacturers. It has long engaged in an extensive program of economic and management research, with much of its research directed to questions of capital formation and investment. Such questions are critical to the consideration of certain of the proposals for amendment of H.R. 8217 which form the subject of these hearings.

Because of the form in which these proposals have been offered, we acknowledge a special sense of appreciation for the calling of these hearings./1 Although legislation by floor amendment is rarely, if ever, desirable in our opinion, it seems to us especially inappropriate for tax legislation which, as this Committee knows so well, is a subject of surpassing complexity. This being true, it is our hope that these hearings may be extended to permit the presentation of testimony by witnesses representing all the many taxpayers who would be affected by these proposals. This is suggested, if for no other reasons, by considerations of fairness and equity. Beyond that, in the absence of such hearings, there would exist the possibility of legislating upon the basis of an incomplete or one-sided body of information. Finally, we applaud the calling of these hearings because we believe that amendments adopted on the floor tend to derogate the orderly and deliberate process of Committee consideration.

Our statement is divided into two principal parts. First, and as a prelude to our discussion of specific legislative proposals, we consider some broader questions of capital formation and investment which are raised by such proposals. In introducing one of the measures on which we shall comment, Senator Nelson characterized the economy as ". . . a 'seamless web' where each aspect affects each other and the whole."/2 It is an apt simile and it can, we think, be applied equally to the relationship existing among the numerous parts of the Internal Revenue Code. Adopting Senator Nelson's theory of the "seamless web,"

1/ Current press reports suggest that these same amendments may be offered as riders to other pending legislation.

2/ Congressional Record, May 14, 1974, p. S.7946.

we are convinced that capital formation problems, which are already bad enough, would be measurably worsened by adoption of certain amendatory proposals now pending before this Committee.

The second major part of our statement consists of specific comments on six proposals to amend the Internal Revenue Code. Inasmuch as certain of the proposed amendments to H.R. 8217 appear in more than one of the numbered amendments proposed for adoption, we have chosen to identify and discuss them by subject matter rather than by specific amendment number.

Those proposed amendments upon which we have commented hereafter are those most directly affecting the tax status of the Institute's membership and concerning which we think that experience and Institute research equip us to offer useful testimony. Specifically, we have commented on proposals that would:

1. Effect substantial repeal of the investment tax credit;

2. Repeal the Class Life Asset Depreciation Range (ADR) system of depreciation;

3. Repeal those Code provisions authorizing creation of Domestic International Sales Corporations (DISCs);

4. Provide for current taxation of earnings of controlled foreign corporations;

5. Repeal those Code provisions which authorize Western Hemisphere Trade Corporations; and

6. "Strengthen" the minimum tax.

Some Problems of Capital Formation and Investment

Directly or indirectly most of the "tax reform" proposals here in question would adversely affect capital formation and investment. Accordingly, we have thought it useful to consider briefly some of the more important circumstances currently affecting capital formation in the United States before taking up individually the several amendatory proposals identified above.

Proposals now before the Committee may be categorized broadly in two classes:

1. Proposals to mitigate the effects of inflation on lower- and middle-income taxpayers by reducing their personal tax load; and

2. Proposals to offset revenue thus lost by increases in taxes on business such as those noted above plus the imposition of new taxes on the oil industry. (Lacking special-expertise in this latter field, we offer no comment thereon except to observe that the inescapable necessity for increased capital formation and investment would be badly served by such proposals.)

One might assume from statements offered in support of these amendments that only lower- and middle-income taxpayers are adversely affected by inflation. Unquestionably--and regrettably--they are. But, so is everyone else--including business. Economic growth requires substantial and increasing capital formation. That process, which is a matter of importance to all Americans, is seriously affected by inflation.

Business capital investment was running at the rate of about $100 billion annually in 1973 and a 12 percent increase in current dollars is projected for 1974 over last year's expenditures. What of the future? What are our national goals and what will it cost to achieve them?

It is difficult, of course, to express national goals in terms of specific dollar costs. However, the National Planning Association (NPA) undertook such an effort./1 In estimating the costs of attaining "national goal standards" in 1980 for such areas as private consumption, urban development, national defense, social welfare, health, education, transportation, etc., NPA included a figure for the amount of fixed investment that would be required to meet all of these goals. It was $208.8 billion (in 1969 dollars) or an increase of 112 percent over 1969. However, NPA's figure for projected expenditures in 1980 under circumstances existing prior to the energy crisis was $156.1 billion, an increase of 58 percent over 1969. This is not to suggest, nor does NPA, that we will come close to attaining all the national goal standards. However, it does point up the magnitude of the problem in terms of the resources required to meet our explosive social goals.

Consider another aspect of this impending crisis of capital formation. The NPA figures just cited do not take into account additional capital requirements necessary to achieve American independence in energy resources. Capital requirements of this character are conservatively estimated to reach some $600 billion from 1974 to 1985, or roughly $56 billion per year for energy alone.

A significant part of the surging demand for capital investment is occasioned by new environmental and safety and health requirements. This element of current capital spending is estimated by McGraw-Hill to be some 8-1/2 percent of the total.

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1 Goals, Priorities and Dollars--The Next Decade, Leonard A. Lecht, The Free Press, New York, 1966. More recent data beyond that cited in the published work were subsequently presented informally by Mr. Lecht recently at a meeting of the National Economists' Club.

Perhaps no better example of the accelerating demand for capital investment can be cited than the prospect faced by the steel industry. The American Iron and Steel Institute says:

> For the period 1974 through 1980, capital expenditures for the industry are estimated at $3.5 billion per year [in 1973 dollars] to maintain present productive capacity; to add additional productive capacity to meet additional demand; to meet environmental requirements; and for other miscellaneous items. Since future estimates can vary, an estimated range of $3-4 billion annually has been used by industry spokesmen. The best estimate is double the annual average of $1.7 billion which the industry spent during the period 1963-1972./1

I repeat that business, too, is damaged by inflation. Recent MAPI research documents some of the more important elements of that damage.

Inflation and Profits

In January of this year the Institute published a memorandum entitled "Inflation and Profits" by George Terborgh, Economic Consultant to the Institute and its former Research Director. Using Department of Commerce figures and with adjustments to profits reported for (1) the underdepreciation of fixed assets, and (2) the conversion of inventory consumption charges from historical cost to their current cost equivalents, the study arrives at some startling conclusions which are very pertinent to this discussion of capital problems. Whereas in 1965 after-tax profits adjusted to account for the understatement of costs by reason of inflation were only a little less than after-tax profits actually reported, by 1973 adjusted after-tax profits were less than half the after-tax profit figures reported--and on which taxes were actually paid. Perhaps even more startling is the conclusion that adjusted after-tax profits in 1973 were only 65 percent of the 1965 figure in absolute amount.

Let me emphasize this point with actual numbers. In 1965 reported after-tax profits of nonfinancial corporations were $38.2 billion--the adjusted figure $36.1 billion. In 1973 reported after-tax profits were $49.8 billion--the adjusted figure $23.4 billion. In the latter case, the difference of $26.4 billion is accounted for by $9.1 billion in underdepreciation of fixed assets and a whopping $17.3 billion inventory valuation adjustment in 1973 alone.

But the whole story is actually worse. The adjusted earnings are stated in current--not constant--dollars. If we deflate by use of

1/ Steel Industry Economics and Federal Tax Policy, The American Iron and Steel Institute, February 1974.

constant 1965 dollars, the adjusted after-tax earnings in 1973 were slightly less than half of those for 1965. Moreover, because real profits are so much lower than reported profits, the effective tax rate on real profits over the past five years has averaged 60 percent, and in 1973 reached 66.5 percent.

One point deserves emphasis. With both prices and reported profits rising in absolute terms in response to inflationary stimuli and with, as we have seen, the very serious understatement of real costs, the income taxation of profits thus reported rises correspondingly. The profits are in part illusory; the taxes are real. And this increased taxation not only prevents saving and the accumulation of new capital but represents the taxation of capital itself.

Permit me to close this discussion by quoting a portion of the conclusion to "Inflation and Profits" cited above:

> Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is vital that they be large enough not only to motivate the expansion of productive investment, but to finance a substantial part of it. It is frightening from the public-policy standpoint that the reinvestment of corporate earnings, realistically measured, has almost ceased. If this continues it will cost the country dearly.

Business Capital Formation--
The Past and the Future

Another product of Institute research, Capital Goods Review No. 94, December 1973, entitled "Business Capital Formation--Putting It In Perspective (1925-1970)" reaches another conclusion pertinent to this discussion--that ". . . higher ratios of capital formation to national product [are needed] than we have heretofore considered normal." The study is an updating of earlier Institute research in the field. The measurements employed both in the current study and its predecessor included the following:

1. The record of business capital expenditures by years.

2. Business capital expenditures as a percentage of the privately produced gross national product.

3. Gross investment in the stock of business capital goods.

4. National output per dollar of gross investment.

5. Gross investment per worker in the private labor force.

6. The ratio of the net to the gross investment in the capital stock.

The study was confined to business capital goods defined as plant and equipment privately held and is based on U.S. Department of Commerce estimates. Capital goods held by governments and consumers are excluded. Subject to the caveat that data reported in the study permit the drawing of only the broadest and most general inferences, this latest Institute study of business capital formation in the United States reaches the following general conclusion.

Normalization

The period prior to the great depression saw a vigorous and persistent expansion of capital goods activity. The next 15 years was a period of contraction and stagnation in this area. The early part of the postwar era, now 25 years in length, was devoted in large part to normalizing the situation--to repairing the damage left by depression and war.

By normalizing we do not mean restoring the situation to what it would have been if the depression and the war had not occurred. These two calamities have doubtless left permanent scars on the economy, and on capital goods in consequence. We mean restoring a normal relation, both qualitative and quantitative, between capital goods and contemporary economic activity--actual activity, not what would have been without the misfortunes of 1930-1945.

By this test, the normalization appears to be well along, if not virtually complete. Output per dollar of gross investment in capital goods has substantially exceeded the 1925-29 average. The ratio of net to gross investment has attained a new high. This means that the capital goods industries have been living recently, and will have to live hereafter, on currently accruing needs, without benefit of the restoration or normalization process. This should not be too disturbing a thought; apparently it is years since they have derived any major benefit from this process. The adjustment has already been made.

Beyond Normalization

Normalization of the quality and quantity of the capital goods stock does not imply that the present situation is satisfactory, or that current levels of capital expenditure are adequate. There are several important considerations that argue to the contrary:

the increase in the growth rate of the labor force; the forced expenditures for antipollution equipment; the essential expenditures for energy; the present high percentage utilization of capacity; and the economic competition worldwide. All of these considerations argue for higher ratios of capital formation to national product than we have heretofore considered normal.

To assure adequate performance in the future, government must maintain and even increase measures to augment the flow of funds as a means of stimulating business capital investment. This means, of course, that the present realistic depreciation allowance and the investment tax credit should remain a permanent part of our tax law. Beyond this, it is essential that we eliminate or reduce the present bias in our tax structure against private saving and capital formation. Finally, because of the recent rapid rate of inflation, it is more than ever necessary that the government adopt an alternative to historical cost depreciation.

The moral is clear. If we are at all right in predicting higher levels of demand for plant and equipment, since the enlargement of business investment depends primarily on an increased flow of funds available for the purpose, there is a pressing need to assure that tax policy encourages private saving and capital formation. This is the surest way to achieve and maintain the higher rate of economic growth which is essential to our national well-being.

The Bias of Our Tax System Against Private Savings

Finally, I should reemphasize that our present income tax system contains a severe bias against savings and investment and in favor of consumption. This bias is analyzed in detail in a very useful study entitled "Tax Policy, Capital Formation and Productivity" prepared by Norman B. Ture for the Committee on Taxation of the National Association of Manufacturers. A brief but pertinent excerpt from the author's summary of findings and conclusions is quoted as follows:

> Examination of a number of the major features of the existing tax structure in the United States reveals an enormous bias in these taxes against private saving. This bias is inherent in the income tax treatment of saving and is accentuated by the corporation income tax, the taxation of capital

gains, state and local property taxation, and estate and gift taxes as well as by numerous other tax provisions of narrow applicability. Examined against the criterion of neutral tax treatment of saving and consumption, a number of tax provisions popularly labeled "loopholes" turn out to be instead very modest moderations of the tax bias against saving.

Tax policy should give top priority to reducing the existing bias against private saving and capital formation. When one amasses the taxes and tax provisions which disproportionately increase the cost of saving relative to consumption, it appears that saving and capital accumulation rank in society's preference scale somewhat below cigarettes and alcoholic beverages.

Compared with the tax bias against saving, the conventional list of loopholes appears to be of secondary importance at most. Existing tax policy commits grand larceny in robbing the economy as a whole of the additional production capacity it might enjoy under more nearly neutral taxation; at the same time, tax policy exhausts its energies in attempts to reduce petty thefts.

Rather clearly the enactment of tax increases here under study would accentuate the present "enormous bias in [our tax structure] against private saving" and thus tend further to inhibit necessary capital investment.

<u>The Incidence of Proposed Tax Increases</u>

In the announcement of these hearings, the Chairman has expressed the hope that ". . . the witnesses [will] endeavor to explain where in their view the ultimate incidence of tax increases would fall if they were enacted --whether on business or on consumers."

This is an excellent question. It is also a difficult one to which there appears to be no single answer. The ultimate incidence of corporate income tax was considered by Institute research some years ago in a pamphlet entitled "Effect of Corporate Income Tax on Investment."/1 The specific question of shifting is considered at page 5 of the pamphlet in this language:

1/ Capital Goods Review No. 37, Machinery and Allied Products Institute, March 1959.

> It is impossible to get very far in this analysis without raising the question of the incidence of the tax. Who ultimately pays it? A generation ago it was widely assumed by economists and students of fiscal policy that the corporate income tax is "absorbed," hence that it represents substantially a dollar-for-dollar reduction of profits. More recently there has developed a substantial body of opinion that the tax is partially, if not largely, "passed on" to the market. Certainly "shifting" theory appears to be gaining on "absorption" theory.

Although these words were written in 1959, it is our opinion that the situation has not materially changed since then, and we continue to believe that the theory of shifting is still gaining on the theory of absorption.

The reason that it is impossible to supply a clear, single answer to this very important question is the fact that the tax will be shifted only so much and so fast as the market will permit it to be shifted. In a seller's market, it may be shifted and rather promptly. In a buyer's market, the shifting may be deferred indefinitely. In either case it may be less than complete.

Whatever the answer in the individual case, it presents a dilemma for those charged with the determination of tax policy. To the extent that tax increases here proposed are in fact shifted to consumers, they would represent a concealed general sales tax. To the extent that market conditions delay or limit the shifting, the profits of corporations involved--which as we have already noted are very considerably overstated in terms of real purchasing power--will be further reduced and the process of capital formation and investment further impaired.

The Continuing Need for the Investment Credit and the Class Life ADR Depreciation System

We strongly support the continuation of both the investment credit and the Class Life Asset Depreciation Range (ADR) system, not only on the grounds that they are justifiable supports to business investment, but also because they are essential to the economic health and well-being of this nation. Although we do have certain suggestions with respect to structural improvement, these suggestions should not be construed to diminish our general support of both the credit and ADR depreciation. Our reasons for this support follow at this point.

Tax Policy and Capital Investment

In the name of tax reform, Senator Haskell proposes the elimination of the investment tax credit except for investments of $100,000 or less with

the full credit available only to investments of $50,000 or less. A number of "tax reformers" call for elimination of ADR depreciation. We are in fundamental disagreement with these proposals.

The investment tax credit and ADR depreciation are vital to our economic health in that they help to provide the wherewithal and incentive to continued growth of the nation's productive capacity and the modernization and replacement of its existing equipment. In so doing they help to assure that the economy can:

1. Provide the goods necessary to meet its domestic needs--civilian and defense--and, in so doing, combat inflation;

2. Provide the additional jobs and equipment required by an expanding labor force;

3. Provide wage increases based on increasing productivity without inducing price increases;

4. Fulfill our international obligations; and

5. Meet the competition for world markets and thus contribute to the solution of our balance-of-payments problem.

<u>The need to equip a rapidly expanding labor force</u>.--In analyzing the problems of economic growth, we turn first to the matter of equipping the American worker. There are a number of factors which are likely to generate a requirement for strongly rising investment over the next several years, including an increase in the tempo of technological change, the need to offset rapidly rising labor costs by making the worker more productive, and the need to equip a work force which is expected to show rapid growth over the next several years.

The private labor force is expected to rise from some 75 million persons in 1973 to roughly 86 million persons in 1980.

This would represent an average annual increase of more than 1-1/2 million workers to be equipped during this period. If one assumes an increase in investment per worker at the same rate that occurred between 1948 and 1973 as business attempts to continue providing higher quality equipment (at higher prices) in order to generate further gains in productivity, this would require an increase of 5.9 percent per annum in investment per worker to $34,600 by 1980. The rise in the number of workers together with the increase in investment per worker would lead to a gross stock level of plant and equipment totaling $2,990 billion in 1980 as compared with $1,740 billion in 1973, or an increase in gross stocks of 8.0 percent per annum. This represents a 12-1/2 percent <u>acceleration</u> in the growth rate from the 7.1 percent rate experienced between 1948 and 1973.

Need to improve the U.S. international competitive position.--The competitive position of the United States vis-a-vis its major competitor countries in Europe and Japan has become a matter of vital importance. Productivity gains in the United States have lagged behind those of other major industrial powers during most of the post-World War II period.

1. Available data from the U.S. Bureau of Labor Statistics (BLS) indicates that U.S. productivity gains since 1950 have been the lowest of any major non-Communist industrial country./1 A more recent study covering the period 1960-73/2 shows that the U.S. has continued to rank last. Figures for 12 industrial countries/3 show that the average annual percent increase in output per man-hour in manufacturing in the United States grew by only 3.3 percent per annum during 1960-73. No other country experienced this low a growth rate. Other gains ranged from 4.2 percent in the United Kingdom to 7.0 percent in Denmark to 10.7 percent in Japan.

2. The greater importance of fixed investment in Europe and Japan relative to the U.S. is understandable when consideration is given to the more favorable tax treatment of capital investment in those countries. 1971 Treasury figures for the U.S. and the following nine countries--United Kingdom, Japan, Italy, West Germany, Sweden, Belgium, France, The Netherlands, and Canada--show that, absent ADR depreciation and the investment tax credit, capital costs in the U.S. would exceed those in every other country listed./4 It is our understanding that a similar situation would prevail today in the absence of ADR and the investment credit.

Unsuitability of the investment tax credit as a contracyclical control device.--There have been suggestions that the investment credit should not be considered a permanent provision in tax law, but instead it should be available only when the economy is in a recession and needs a stimulant. From the time the investment tax credit was initially considered by the Congress in 1961, MAPI has taken the position that the tax credit

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1/ Monthly Labor Review, July 1972.
2/ Monthly Labor Review, November 1973.
3/ Belgium, Canada, Denmark, France, Germany, Italy, Japan, The Netherlands, Sweden, Switzerland and the United Kingdom, in addition to the United States.
4/ Office of the Secretary of the Treasury, Office of Tax Analysis (The Revenue Act of 1971, Hearings Before the Senate Finance Committee, 92nd Congress, 1st Session, on H.R. 10947, Part 1, p. 8.).

should not be manipulated for purposes of economic control, but should be included as a permanent feature of the tax system.

A central problem in attempting to use the investment tax credit as a contracyclical device relates to the matter of timing. A MAPI Capital Goods Review/1, in discussing this problem in some detail, documents the nearly insuperable problems in this respect. Any suspension of the credit would almost inevitably be late and in response to current, not anticipated, conditions. A proposed suspension date would be subject to change before final enactment, and industry would no doubt take anticipatory action even before a proposed suspension were announced. And finally, with respect to a restoration of the credit, these same problems would tend to repeat themselves. The historical record concerning the credit since its initial adoption in 1962--including the abortive suspension in 1966 and repeal in 1969--amply document this analysis.

Investment Credit

The economic rationalization outlined above, in our judgment, clearly indicates the desirability of continuing in effect a substantial and permanent investment credit, and we so recommend. Indeed, we think that the Committee should seriously consider broadening the classification of property which is eligible for the credit.

Industrial real property.--Unfortunately, when the investment credit was first enacted, it was made available only for "Section 38" property--tangible personal property with certain very narrowly limited application to other forms of property. Buildings and structural components of buildings were specifically excluded from credit eligibility. This meant, generally speaking, that with respect to industrial property, the credit could be utilized for the purchase or acquisition of productive equipment but not for the construction or purchase of the plant housing that equipment. This discrimination against industrial real property was continued in the Depreciation Guidelines promulgated by the Treasury in 1962 in which there was no general reduction in useful lives for buildings comparable to that provided for machinery and equipment. For example, useful lives for productive machinery and equipment listed in Bulletin F were reduced by 33-1/3 percent, while the life for factory buildings was reduced by only 10 percent. This discrimination against industrial real property has been continued in ADR.

We urge that the Committee instruct the staff of the Joint Committee on Internal Revenue Taxation to investigate what we think to be the obvious discrimination against industrial realty. In this connection, the Committee should bear in mind that modern buildings and buildings components are essential to a dynamic technology.

1/ "The Investment Credit as an Economic Control Device," Capital Goods Review No. 67, September 1966.

ADR Depreciation

We urge the Committee not to repeal or narrow the Code provisions relating to the Asset Depreciation Range (ADR) system of depreciation originally put into effect administratively by President Nixon in January 1971 and approved later that year by Congress in the Revenue Act of 1971. It seems to us that the administrative convenience resulting from the end of both service life audits (made possible by the 1962 Depreciation Guidelines) and the abolition of the reserve-ratio test included in the ADR system, and the resulting savings in costs for both taxpayers and the government, argue strongly for taxpayers being encouraged to elect the ADR system through improvements to it rather than restrictions.

We are aware of the suggestions that the existing 20 percent range--which permits taxpayers to reduce the 1962 Guideline lives by as much as 20 percent--should either be eliminated or reduced. We think that the argument against the elimination or reduction of the 20 percent reduction was best stated by John S. Nolan, former Deputy Assistant Secretary of the Treasury for Tax Policy, in his excellent paper on tax treatment for capital recovery presented to the House Ways and Means Committee during the panel session on that topic on February 7, 1973. We agree completely with Mr. Nolan's reasoning on this point. It is clear that it is in the best interests of the government to have taxpayers adopt ADR depreciation. However, it is frequently overlooked, as Mr. Nolan indicated, that there are certain disadvantages and difficulties which, in the absence of the 20 percent reduction in Guideline lives, might well discourage a taxpayer from electing to use the ADR system. These include, for example, the fact that losses on asset dispositions before the end of the depreciation period cannot be recognized. Also, the allowable depreciation lives for assets cannot be later reduced even though it is clear that their use will not extend to the full period of years originally specified. In addition, there are very substantial record-keeping requirements that must be faced by taxpayers who elect the ADR system.

ADR modifications.--To be more useful, the ADR system requires at least three modifications.

Government must soon come up with some system of handling the problem of subsidiary assets, which results from the fact that under the "all or nothing" election in the ADR system a taxpayer is required to include all his subsidiary assets (e.g., jigs, tools, dies, and fixtures) in the class account for the principal assets to which the subsidiary assets relate. Where subsidiary assets are a significant part of the taxpayer's capital, the "stretch-out" of subsidiary assets occasioned by this requirement may substantially eliminate the benefits of ADR depreciation for many companies.

A similar problem resulting from the ADR election requirements exists for depreciable real property such as industrial buildings. Under

the guideline system of tax depreciation predating ADR, taxpayers could demonstrate to IRS that their tax lives of depreciable real property were shorter than those specified in the guidelines and do so without prejudice to use of the guidelines for other purposes. This is not so under ADR, and the rather long ADR life which must be used is inappropriate for many taxpayers and a detraction from use of the system.

In addition, we believe there is a need under the ADR system for some special treatment of leased assets to recognize that leased assets in many cases have a shorter useful life than "owned" assets. Further, government should find some means to overcome the anomaly in present ADR regulations which require that a leased asset take the guideline life of the lessee. Where identical items are leased by the same taxpayer to lessees with differing guideline lives, the taxpayer-lessor finds himself depreciating identical items over quite different periods of time. Also, there are considerable record-keeping problems for the lessor in this approach.

Finally, provision should also be made for more liberal repair allowances than are currently included in Revenue Procedure 72-10 which implements the ADR system.

We understand, of course, to make these and other such modifications in the ADR system has already been given by Congress to the Secretary of the Treasury who has formed an Office of Industrial Economics to deal with these matters. Our only purpose in raising these subjects at this time is to suggest that it may be desirable for Congress to extend interim relief provisions which expired on December 31, 1973, or at least to be alert to taxpayer declinations to use the ADR system because of any of the shortcomings mentioned.

Tax Reform Arguments

Repeal of DISC

In December of 1971, only 2-1/2 years ago, Congress enacted the Domestic International Sales Corporation export tax incentive. Generally speaking, it allows deferral of federal income tax on 50 percent of the income derived from exports by special domestic corporations meeting certain qualification requirements specified in the statute. It will be recalled that the DISC concept became law only after careful consideration by the Administration and the Congress, and it was part of a fiscal and monetary package intended to deal with a worsening U.S. balance of payments and a relatively slack state of domestic economic growth. Now, with only one full year of DISC experience to serve as a gauge, certain Senators propose the repeal of this provision of tax law. We think this proposal ill-advised.

If Congress could act carefully and decisively to enact DISC in December of 1971, then we think it should not, in the absence of a

convincing demonstration that DISC has been unsuccessful, simply do away with DISC as an expedient to obtain federal revenue for another purpose. We strongly doubt that any such demonstration has been or can be made.

In support of repeal it is suggested that: (1) the revenue losses are running higher than was expected; (2) it cannot clearly be demonstrated that DISC is encouraging exports; (3) DISC may be a violation of GATT; (4) the trade accounts have recently been in a surplus condition rather than a deficit condition; and (5) DISC is encouraging the export of some commodities in short supply. Each of these contentions deserves comment.

First, as to the revenue losses, we are aware of the magnitudes, but question whether they should be considered significant in view of the importance ascribed by Congress to the export purposes for which DISC was created. The numbers suggest--I should add--that DISC is working even better than Treasury thought it would. If the numbers had fallen below estimate, some tax "reform" advocates presumably would be arguing for repeal of DISC on grounds that that fact proved DISC was not encouraging exports.

Second, it may be true that DISC's beneficial effects cannot be clearly and conclusively demonstrated apart from those of exchange rate changes and other tax, trade, and monetary influences. However, we find it paradoxical that the same people who advance this argument for repeal also are worried about revenue losses exceeding expectations and seem to feel that DISC is "encouraging" exports of items in short supply--positions which necessarily assume that the incentive really is working. Exports have, in fact, been decidedly on the increase since enactment of DISC; the trade deficit has been overcome--at least for now; and Treasury believes DISC has been beneficial in the export picture. In this light, and given the very brief existence of DISC, the burden of proof that DISC is not serving its purpose rests, we think, with the doubters.

Third, on the matter of DISC and GATT, Treasury undoubtedly could reveal to anyone interested many GATT violations which signatories to that agreement have perpetrated over time at the expense of this country. Such actions contributed in no small way, it will be recalled, to two devaluations of the U.S. dollar, temporary imposition of a U.S. import surcharge, and the creation of DISC itself. In our view, DISC is demonstrably an important factor in this picture. As the Committee knows, the Special Representative for Trade Negotiations could use DISC as a bargaining "chip" in international trade talks if Congress would only leave DISC in effect and provide the Administration with a "clean" authority to negotiate. We commend the Committee for moving ahead with its work on the trade measure.

Fourth, in favor of repealing DISC it is argued that the trade accounts have moved into black ink and that DISC no longer is needed. A disturbing assumption which seems to underlie this argument is that DISC

can be turned on and off based on the ebb and flow of the trade figures. After all, DISC authority became available in 1972 when the figures were adverse. Now it is 1974 and the complexion of things has turned for the better. Why not just turn DISC off? One answer is that there is very considerable expense and disturbance to business activity associated with Congress' offering and then suddenly abandoning an economic mechanism of DISC's importance and complexity. Exporters and others in the business community from whom government increasingly expects more employment, more social involvement, and more revenues deserve a more certain environment in which to plan than is implied by actions of this sort. The history of the "off-again, on-again" treatment of the investment tax credit is instructive in this respect.

Perhaps more important than this technical issue, Congress should be aware that the trade surplus we now enjoy is fragile indeed with the oil situation, with other commodity cartels forming, with purchasing countries seemingly more concerned to fend for themselves rather than to cooperate with one another, and with U.S. trade negotiating authority bottled up in Congress. At a time when trade barriers and export incentives could be expected to proliferate absent some restraining influence or new mutual agreements to limit them, it would seem wise for Congress to retain DISC. The fact that the Special Negotiator could use DISC in the multilateral trade talks, which one hopes will commence before long, attests to its value in this respect.

Finally, as to the issue of DISC's encouraging the export of commodities in short supply, we think it illogical on this ground alone to conclude that DISC in its entirety should be repealed. If the contention were accurate and the consequences of such exports were adverse to the public interest, there might be merit in curtailing the DISC incentive in some way. However, the mechanism to deal with short supply problems already exists in the law and it has been the Administration's judgment thus far not to exercise its authority in this area. Also, Congress has --to date, as we understand it--objected to the Administration's handling of this question in only fragmentary ways. The power to negotiate new trade arrangements will repose in the Executive Branch, and, in our opinion, that is where authority to curtail DISC should remain to handle such short supply or other problems as may arise.

To summarize, no compelling case to support repeal of DISC has come to our attention, and we even consider it premature to entertain the question under present circumstances. Obviously, there may be ways that Congress could refine or simplify DISC through amendments to the underlying statute at this time. Although constructive modification of the DISC mechanism--which would warrant careful and deliberate study--is not yet under consideration, and we choose to reserve comment on that matter, we observe in conclusion that a case can be made for elimination of the present 50 percent limitation on the deferral of tax on DISC income.

Taxation of Undistributed Earnings of CFCs

Of all the issues studied by Congress from time to time in connection with tax reform, the current taxation of undistributed earnings of controlled foreign corporations seems the item most doggedly pursued by persons interested in radical reform. Prolonged consideration was given by Congress to the current taxation concept when it was proposed by President Kennedy in 1961 and the reasons which turned Congress against the idea then are equally persuasive now. Furthermore, this issue has been reexamined more recently by two distinguished "outside" advisory groups--the President's Task Force on Business Taxation in 1970 and the President's Commission on International Trade and Investment Policy in 1971--and both rejected the idea. Also, the vast preponderance of testimony before the House Ways and Means Committee during the spring of 1973 was opposed. One wonders whether it would ever be possible to satisfy the supporters of current taxation of foreign subsidiary earnings that the issue should be laid to rest.

Congress cannot ignore that most other nations do not engage in the extraterritorial extension of their taxing jurisdiction which is involved in current taxation of undistributed earnings of controlled foreign corporations. Subpart F caused no little consternation in this matter of overreaching when it was put into effect, and one might think that current taxation not even linked to so-called tax haven situations would be considered a rather serious infringement of other nations' sovereignty. Obviously, the Committee must decide whether it would be wise to set this precedent which goes so far beyond domestic fiscal affairs into the realm of foreign relations. We believe that it would not be wise, and urge once again that Congress abandon the idea--including such alternatives as the Administration proposals of April 1973 in this area and the plans likely to be offered with respect to partial elimination of U.S. tax deferral on unrepatriated CFC income.

The record is replete with well-reasoned argument in opposition to this shopworn tax reform proposal. Therefore, we will limit ourselves to a brief cataloging of key items. First, the elimination of deferral would result in new costs for U.S. companies doing business in low-tax countries. These countries tend to be less developed, and business investment in them is generally riskier and less desirable than in other areas of the world, which fact accounts, in part, for the lower tax rate. It would seem, therefore, that elimination of deferral might over time slow the pace of U.S. investment in those nations most in need of economic assistance.

Second, government estimates suggest that the overall revenue increase from elimination of deferral would be relatively small. Where revenue is raised, it would, of course, be derived from income of CFCs in low tax rate countries, as previously noted. If a foreign country's

low tax rate incentive to U.S. investors were to be nullified by a U.S. decision to tax CFC income currently, could it not be expected that the foreign country would want to raise such applicable taxes as would eliminate the residual amounts that this country otherwise would collect? We only raise this point to suggest that the revenues from elimination of deferral would seem likely to be not only a small overall amount to begin with, but also a diminishing sum over time.

A final point which gives rise to subsidiary issues is that U.S.-based companies doing business through CFCs abroad will be immediately handicapped in competition with foreign-based companies if U.S. income tax deferral is eliminated. There is no reason we know of to think that other nations plan to abandon deferral simultaneously with the United States (or ever). To approve elimination of deferral is to saddle U.S.-owned companies abroad with a new expense. It is not unreasonable to expect that such an expense would lead to declining market shares abroad for U.S.-owned companies; slower growth; less foreign-income for CFCs to reinvest or distribute; less U.S. business activity and employment resulting from exports to CFCs; less U.S. tax revenues in the long run; a worsened balance-of-payments position; and further depression in the value of securities of U.S. businesses with such adversely affected foreign operations.

We suggest that anyone who would pile such a sizable new expense on CFCs must bear the burden of rebutting decisively these presumptions as to the consequences which normally could be expected to follow.

Indeed, in our view, there are very strong reasons for the complete repeal of Subpart F so that foreign subsidiary income would not be subject to U.S. taxation until it is repatriated to U.S. parent companies in the form of dividends.

<u>Western Hemisphere Trade Corporations</u>

Since 1942 the Code has provided for what amounts to a 14 percent rate reduction in the corporate tax for a Western Hemisphere Trade Corporation (WHTC) which is generally defined as a domestic corporation doing business within North, Central, or South America, the West Indies, or in Newfoundland. In addition, at least 95 percent of the WHTC's gross income for the preceding three years must be derived from sources without the U.S., and at least 90 percent of its gross income for that period must be derived from the active conduct of a trade or business.

We favor the retention of the WHTC provisions. During the period of slightly over 30 years following the enactment of the WHTC provisions, there has been a significant increase in general economic activity in Latin America and also in U.S. exports to the Latin American countries. The precise contribution of WHTCs to this result is impossible to measure, but there seems little doubt that their repeal at this time would do much to reverse these trends.

The Minimum Tax

One tax reform proposal now before this Committee is a tightening of the minimum tax on "tax preferences." We emphatically disagree with those who advocate restrictive change in this area. The minimum tax became law some five years ago as a consequence of public concern that a small number of taxpayers were not bearing their fair share of the fiscal burden. In fact, they were beneficiaries of tax provisions which Congress previously had defined as being in the public interest. Since enactment, the minimum tax has contributed to the erosion of tax incentives which are very important to capital formation. Perhaps most serious, the minimum tax has attracted the interest of those who style themselves "tax reformers" who would like to reduce or eliminate existing "tax preferences" and bring other incentives within the scope of the minimum tax for the same purpose.

To be more specific, the Committee is considering, through tightening of the minimum tax, the impairment of certain capital formation incentives associated with the write-off of real property and of personal property subject to a net lease; the amortization of certified air or water pollution control facilities and qualified railroad rolling stock; stock options; depletion; and capital gains. Ironically, this "reform" is being entertained at a time when inflationary forces make accelerated depreciation imperative for the good of the economy; when the burden of pollution control has steadily increased; when new railroad rolling stock will be needed more than ever for the transportation of people, goods, and energy resources; when incentives are needed for the exploration and extraction of natural resources; and when capital is expensive and capital markets are depressed. The logic of reducing tax incentives in these areas, especially at this time, completely escapes us.

For a variety of reasons well known to this Committee--enlargement of industrial capacity to lessen inflationary pressures, the longer-range reaction to energy shortages, pollution control, mass transportation, to name only a few--we face unprecedented requirements for capital in the immediate, and for the foreseeable, future. Many so-called "tax preferences," such as accelerated depreciation and the lower income tax rate on capital gains, were consciously designed by Congress as desirable incentives for capital formation. We believe the need for such incentives is now even greater than the undoubted need which existed at the time of their enactment. It is the possibility of an indirect--almost surreptitious--attack on such incentives via an extension of the minimum tax principle with which we are now concerned. We urge that the Committee reject the proposed further expansion of the minimum tax concept. Indeed, we believe that the entire rationalization for the minimum tax is specious, and we recommend its repeal.

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MEMORANDUM

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INFLATION AND PROFITS

by
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MACHINERY AND ALLIED PRODUCTS INSTITUTE
AND
COUNCIL FOR TECHNOLOGICAL ADVANCEMENT

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION COMMUNICATION AND COMMERCE), IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

INFLATION AND PROFITS

The effect of rising price levels on the accounting of profits is not a new subject. During the sharp postwar inflation of 1946-48 it generated a lively discussion in accounting and management circles. This was revived, on a lesser scale, by the price run-ups of 1950-51 and 1956-57. But under the relatively stable price level of 1958-64 interest waned. It was widely believed that inflation was a thing of the past, that the after-effects of earlier inflation would gradually wear off, and that no corrective action was needed. This proved to be an illusion. By 1965 inflation was under way once more, and it has continued at a distressing pace ever since. It is now high time to take another look at the problem.

The Principle

The overstatement of profits during and after a period of inflation arises from the practice of charging only the historical cost of physical asset consumption (fixed assets and inventory). When the purchasing power of the dollar is shrinking, the charging of historical costs--reflecting earlier, and hence lower, price levels--is insufficient for the restoration of the real assets used up in production. A proper reckoning requires the restatement of previously incurred costs in the dollars of realization, that is to say, in the revenue dollars against which they are charged. Only when costs and revenue are measured in the same dollars can the difference between them (profit) be correctly determined.

It follows that when the real cost of physical asset consumption is undercharged the shortfall is accounted as profit. It follows also that this much of the reported profit is fictitious, representing simply the understatement of costs.

The Project

What we intend to do is to translate into current-dollar equivalents (equivalents in the dollars of revenue) the costs of physical asset consumption now accounted on an historical basis. We can then see what difference the conversion makes in the profit figures. The study is limited to the corporate system because profit as such is not available for the unincorporated sector, and more specifically to nonfinancial corporations, the category principally concerned with physical asset consumption. It is limited also to the inflation of 1965-73.

In doing this we rely for both fixed assets and inventory on data compiled by the Department of Commerce--in the case of fixed assets, on its computations of current-cost depreciation; in the case of inventory, on its "Inventory Valuation Adjustment."/1

1/ In both its depreciation and its inventory adjustments the Department uses specific price indexes to compute the current-dollar equivalents of historical costs. While we prefer a general index of the purchasing power of the dollar for this conversion, its use would not alter the results fundamentally. For a discussion of this issue see Realistic Depreciation Policy, MAPI 1954, Chapter 12.

I. FIXED ASSETS

The Department computes annually current-cost depreciation on the fixed assets of nonfinancial corporations, using two writeoff methods (straight-line and double-declining-balance) and a variety of service-life assumptions./1 It is noncommittal on the choice of depreciation methods, but does have a preference on service-life assumptions (85 percent of Bulletin F lives). We shall use that assumption in conjunction with the double-declining-balance writeoff.

A word on the choice of writeoff. Notwithstanding the Department's neutrality on the issue, we entertain no doubt that the straight-line writeoff is in most applications a grievously retarded measure of capital consumption, and that the double-declining-balance method is in general more realistic. This is not the place to argue the issue, which we have done at length elsewhere./2 Suffice it to say that this writeoff conforms quite well to both theoretical and empirical evidence on the typical course of capital consumption, especially for capital <u>equipment</u> (as distinguished from structures), which accounts for around five-sixths of corporate depreciation.

The following table compares the Department's computation of current-cost double-declining-balance depreciation with its estimate of the depreciation allowed for income tax purposes.

Table 1

Comparison of the Current-Cost Double-Declining-Balance Depreciation of Nonfinancial Corporations With the Depreciation Allowed Them for Income Tax Purposes

	(1) Current Cost DDB/a	(2) Income Tax Depreciation	(3) Excess of (1) over (2)/b
	(Billions of Dollars)		
1965	$ 35.8	$ 35.4	$ 0.4
1966	39.7	38.4	1.4
1967	44.4	41.7	2.7
1968	49.0	45.4	3.6
1969	54.7	50.1	4.6
1970	60.6	54.0	6.6
1971	65.7	58.1	7.6
1972	70.6	63.2	7.4
1973	~~75.8/c~~ 77.4	~~68.1/d~~ 68.3	~~7.5~~ 9.1

a/ The Department's "Current-Cost 2." This employs a more conservative index of construction costs than "Current-Cost 1."
b/ Differences may not check exactly because of rounding.
~~c/ Our estimate.~~
~~d/ Average of second and third quarters at annual rate.~~

1/ Both writeoffs are extended over estimated full service lives. The double-declining-balance method is applied with a straight-line switch.
2/ <u>Realistic Depreciation Policy</u>, MAPI 1954, Chapters 3, 4, and 5.

Note that the excess of current-cost DDB over tax depreciation has grown from a negligible amount in 1965 to ~~[illegible]~~ $9.1 billion in 1973.[1]

II. INVENTORY

As indicated earlier, the conversion of inventory consumption charges from historical cost to their current-cost equivalent is computed by the Department of Commerce as the "Inventory Valuation Adjustment" (IVA). The calculation allows for inventory consumption presently charged for income tax purposes by LIFO and similar current-costing procedures, and converts only the balance under historical-costing systems. The results follow.

Table 2

Inventory Valuation Adjustment for Nonfinancial Corporations

(Billions of Dollars)

Year	
1965	$ 1.7
1966	1.8
1967	1.1
1968	3.3
1969	5.1
1970	4.8
1971	4.9
1972	6.9
1973	~~19.0/a~~

~~a/ Average of second and third quarters at annual rate.~~

Here again we have a gradual rise in the excess of current-cost over historical-cost charges, culminating in this case in a sudden surge to ~~$19~~ $[illegible] billion in 1973.

III. ADJUSTMENT OF PROFITS

We are now ready to put the pieces together and adjust profits as reported for income tax purposes.

1/ The stability of this margin ~~over the last three years~~ in 1971-72 reflects the introduction in 1971 of the Asset Depreciation Range system for tax depreciation.

Table 3

Adjustment of Reported Profits of Nonfinancial Corporations/a

	(1) Profits Before Tax as Reported	(2) Income Tax Liability	(3) Profits After Tax as Reported (1) - (2)	(4) Under-Statement of Costs/b	(5) Profits Before Tax as Adjusted (1) - (4)	(6) Profits After Tax as Adjusted/c (3) - (4)
	(Billions of Dollars)					
1965	$ 65.8	$ 27.6	$ 38.2	$ 2.1	$ 63.7	$ 36.1
1966	71.2	30.1	41.2	3.2	68.0	38.0
1967	66.2	28.4	37.8	3.8	62.4	34.0
1968	72.4	34.0	38.3	6.9	65.5	31.4
1969	68.0	33.7	34.3	9.7	58.3	24.6
1970	55.7	27.6	28.2	11.4	44.3	16.8
1971	64.1	29.7	34.4	12.5	51.6	21.9
1972	74.3	35.0	39.2	14.3	60.0	24.9
1973	~~99.8/d~~ 96.5	~~48.2/d~~ 46.6	~~51.6/d~~ 49.9	~~26.5~~ 26.4	~~73.3~~ 70.1	~~25.1~~ 23.5

a/ Figures may not check exactly because of rounding.
b/ The sum of the excesses of current costs over historical costs shown in Tables 1 and 2.
c/ Since this is a retrospective recomputation of profits, it takes as given the corporate income taxes actually paid. If tax liabilities had been figured on the adjusted pre-tax profits, the after-tax effect of the adjustment would, of course, have been reduced by the tax saving resulting therefrom. But since they were actually figured on the reported profits throughout, there were no such tax savings. Adjusted after-tax profits are simply adjusted pre-tax profits minus actual taxes on reported profits.
~~d/ Averages of second and third quarters at annual rate.~~

Here is a startling picture. Adjusted after-tax profits started out in 1965 not far below the reported figure. They wound up in 1973 less than half as large as reported. They were, moreover, only 65 percent of the 1965 figure in absolute amount.

Restatement of Retained Earnings

An even more startling picture emerges when we subtract dividend payments from adjusted after-tax profits to derive adjusted retained earnings.

Table 4

Adjusted Retained Earnings of Nonfinancial Corporations

	(1) Adjusted After-Tax Profits	(2) Dividend Payments	(3) Adjusted Retained Earnings
		(Billions of Dollars)	
1965	$ 36.1	$ 16.9	$ 19.2
1966	38.0	18.2	19.8
1967	34.0	18.9	15.1
1968	31.4	20.9	10.5
1969	24.6	20.7	3.9
1970	16.8	20.0	-3.2
1971	21.9	20.3	1.6
1972	24.9	21.2	3.7
1973	~~25.1~~ 23.5	~~22.3/a~~ 22.3	~~2.8~~ 1.2

~~a/ Average of second and third quarters at annual rate.~~

Over the past five years adjusted retained earnings have been negligible (in one case negative). Nonfinancial corporations have been distributing practically all of their adjusted earnings, their reported savings representing little more than the amount required to cover the understatement of costs.

Adjusted Profits and Retained Earnings in Constant Dollars

To make the horror story even worse, the dollar has been shrinking over the interval and it is necessary to adjust for this by stating the results in constant dollars. We use for this purpose the private GNP deflator (1965 = 100).

Table 5

Adjusted Profits and Retained Earnings of Nonfinancial Corporations in 1965 Dollars

	(1) Adjusted After-Tax Profits	(2) Adjusted Retained Earnings
	(Billions of Dollars)	
1965	$ 36.1	$ 19.2
1966	37.3	19.4
1967	32.1	14.2
1968	28.8	9.6
1969	21.6	3.4
1970	14.0	-2.7
1971	17.5	1.3
1972	19.5	2.9
1973	~~18.6~~ 17.4	~~2.1~~ 0.9

In constant dollars the adjusted earnings of 1973 were ~~slightly over~~ less than half of 1965. As for retained earnings, the 1973 figure was down by ~~nearly~~ more than 90 percent.

IV. EFFECTIVE INCOME TAX RATES ON ADJUSTED PROFITS

Since the income tax liability (federal and state) is computed on overstated historical-cost profits it is obvious that the effective rate on profits adjusted for the overstatement is higher than the rate reported. The following table shows the difference.

Table 6

Effective Tax Rates on the Pre-Tax Profits of Nonfinancial Corporations as Reported and as Adjusted/a

	(1) On Profits As Reported (Percent)	(2) On Profits As Adjusted (Percent)
1965	41.9	43.3
1966	42.3	44.3
1967	42.9	45.5
1968	47.1	55.3
1969	49.4	57.7
1970	49.6	62.3
1971	46.3	57.6
1972	47.1	58.3
1973	48.3	~~[illegible]~~ 66.5

a/ Column (2) of Table 3 as percentage of Columns (1) and (5), respectively.

It is obvious at a glance that effective tax rates on real profits have moved away from those on reported profits. Over the past five years they have averaged 60 percent against 48 percent. In 1973 the rate reached ~~66~~ 66.5 percent.

V. WHAT DOES IT MEAN?

It is clear that American business has not yet learned how to protect itself against inflation. Overall, it has been unable to maintain normal margins even in the overstated profits of conventional accounting. In terms of *real* profits, the shrinkage has been drastic.

It is extremely difficult to protect even *nominal* profit margins in the face of inflation, owing to the tendency of unit costs to move up faster than realized prices. Under prevailing practice prices are often fixed for substantial periods ahead. Catalogs may be issued only annually or semiannually; seasonal merchandise may be priced months in advance of delivery; long-cycle production may be quoted before work is started; etc. But even where prices are more quickly adjustable there is a general tendency to lag behind the march of costs.

If it is difficult to protect *nominal* profit margins it is still more so to protect *real* margins. Since the latter are more adversely affected by inflation their maintenance requires even bolder and more aggressive action, not to mention their restoration after they have been allowed to decline.

The core of this action is of course pricing policy. Management must learn how to price its products in an inflationary economy. This means first of all *anticipatory* pricing--pricing in anticipation of cost increases prior to sale. It means secondly a proper accounting of costs themselves, especially the cost of physical asset consumption.

It must be acknowledged of course that such a pricing policy may be impracticable for an individual company in a market where the competition is pricing on understated costs. The real remedy lies in the reform of policy *across the board*. If all competitors are targeting their prices on fully stated costs, there is a better chance that they can make them stick.

Obviously these exhortations assume the absence of price controls. Given such controls, the efforts of management to maintain real profit margins are likely to be frustrated by bureaucratic action. Since the authorities deal with nominal margins only, and conceive it their mission to squeeze even these, real margins suffer an amplified crunch. There can be no doubt that the controls prevailing since August 1971 have contributed to the subsequent erosion of these margins, but it is easy to exaggerate their impact. It is clear that the erosion was going on before controls entered the picture, and that the basic problem is much deeper. It will be with us after they are gone.

Let us add in closing that the present situation is bad not only for business, but for the nation as a whole. Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is vital that they be large enough not only to motivate the expansion of productive investment, but to finance a substantial part of it. It is frightening from the public-policy standpoint that the reinvestment of corporate earnings, realistically measured, has almost ceased. If this continues it will cost the country dearly.

Let us add further that the Alice-in-Wonderland accounting of costs and profits that now passes for orthodoxy is a problem not only for business management, but for the accounting profession, the regulatory agencies of the government, and, not least, for the tax authorities. It is high time for concerted action by all concerned.

It is gratifying in this connection that the accounting profession appears at last to be grappling with the problem. In Britain, the Institute of Chartered Accountants is studying a full-scale restructuring of accounts to reflect inflation. In this country, the Financial Accounting Standards Board may soon consider the subject (its Advisory Council has recommended that it be placed on the agenda). Another straw in the wind is a recent statement of the Securities and Exchange Commission urging its reporting companies to disclose to stockholders the amount of their earnings representing "inventory profits" (but not, unfortunately, the amount reflecting underdepreciation).

These are hesitant first steps, to be sure, but we may hope that others will follow. We may hope also, and even more fervently, that the tax authorities will not be far behind. For the evils of undercosting are compounded by the present practice of taxing capital consumption as income. No reform of costing procedures can be more than partially successful so long as this practice continues.

Capital Goods Review

MACHINERY and ALLIED PRODUCTS INSTITUTE

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BUSINESS CAPITAL FORMATION —PUTTING IT IN PERSPECTIVE

(1925 - 1970)

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION COMMUNICATION AND COMMERCE), IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

BUSINESS CAPITAL FORMATION--PUTTING IT IN PERSPECTIVE (1925-1970)

Introduction

It has been a decade since the Institute last reviewed in detail the record of business capital formation./1 The sixties was a decade characterized by real economic expansion, save for the mini-recession of 1960-61 and the significant increase in the rate of inflation after the mid-point of the decade. In a climate of real economic expansion it is not surprising that the capital goods industries turned in an excellent performance.

The Measurements Employed

To gain perspective, we intend to review the record from 1925 to 1970, employing the same measurements used in the earlier Institute study. These are as follows:

1. The record of business capital expenditures by years.
2. Business capital expenditures as a percentage of the privately produced gross national product.
3. Gross investment in the stock of business capital goods.
4. National output per dollar of gross investment.
5. Gross investment per worker in the private labor force.
6. The ratio of the net to the gross investment in the capital stock.

Coverage

The study is confined to business capital goods, defined as plant and equipment privately held, and is based on U.S. Department of Commerce estimates. Capital goods held by governments and consumers are excluded.

A caveat is in order. Because of the highly aggregative nature of the data and the great diversity of situation among the wide range of

1/ Sixty Years of Business Capital Formation, George Terborgh, MAPI, 1960.

product lines subsumed under the heading of capital goods, a good deal of care should be used in applying the findings of the study to individual sectors of the economy.

I. Record of Capital Expenditures

The basic data from which all subsequent calculations are derived are the estimates of domestic business capital expenditures by years. These are shown in Chart 1 for plant, equipment, and the combination of the two, both in the actual dollars of investment (current dollars) and at their equivalent in the dollars of 1958 (constant dollars).

It is obvious that both plant and equipment expenditures experienced a broad upsweep over the period covered, interrupted only by the downturns reflecting the effect of the great depression and World War II. The slower rise of the constant-dollar line in the years prior to 1960 and the leveling off since 1966 reflect, of course, the persistent and, recently, more rapid rise in capital goods prices due to inflationary forces. While at an all-time high, capital expenditures leveled off in real terms from 1965-1970.

As to the components, a new relationship has been established. Equipment expenditures have risen more rapidly than those for plant since World War II. When combined with the overall higher levels of expenditures for plant and equipment, this obviously bodes well for equipment producers should these trends continue.

II. Share of Business Plant and Equipment Expenditures in the Privately Produced Gross National Product

As we have seen, plant and equipment expenditures in current dollars are at all-time-high levels. But how high is high? For this we turn to a relative, as contrasted with absolute, measure; namely, business capital expenditures as a share of the privately produced gross national product. This is shown in Chart 2 on page 4, the comparison being in current (actual) dollars.

While the percentages fluctuate widely from year to year, in large part reflecting changes in general business conditions, several points stand out:

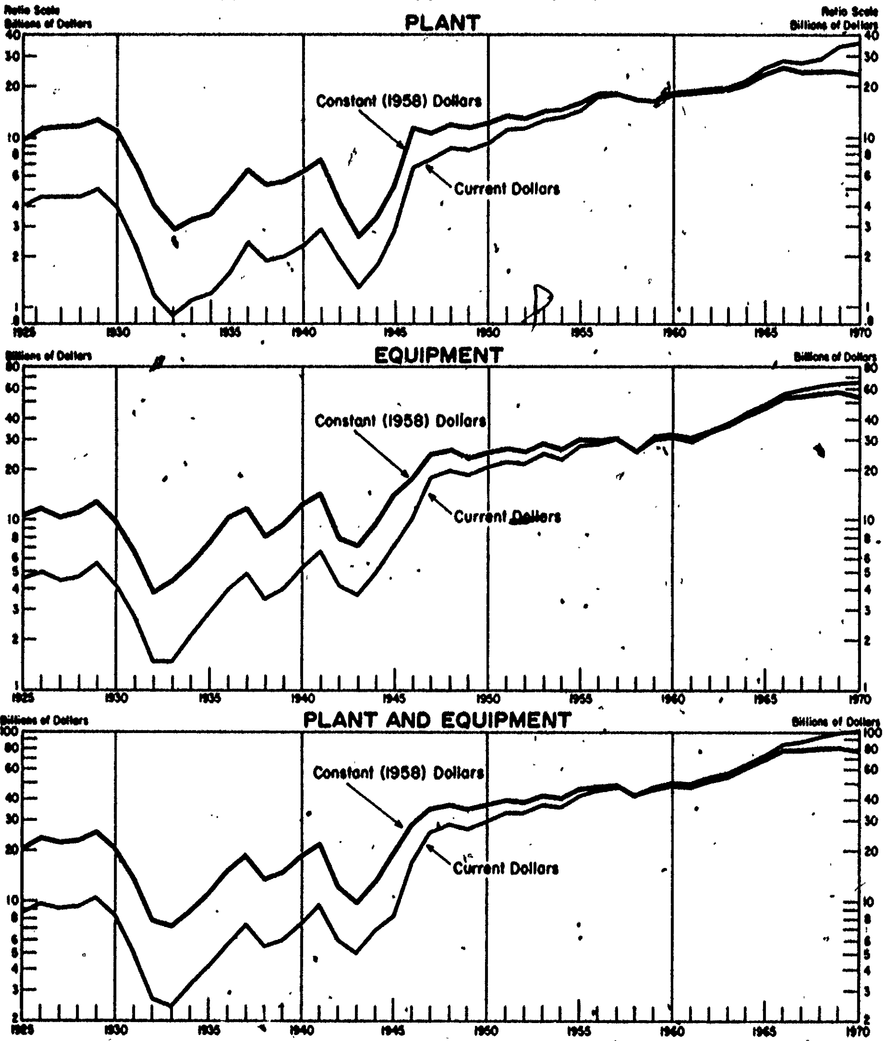
1. The plant ratio, while below the 1925-29 levels/1 of 4.4 to 5.1 percent, rose above its depression

1/ The figures for the period 1925-28 underlying Charts 2, 4 and 5 are extrapolative, based on data underlying the charts in Sixty Years of Business Capital Formation.

CHART 1

Expenditures for Business Plant and Equipment:

(1) in Current Dollars; (2) in Constant (1958) Dollars

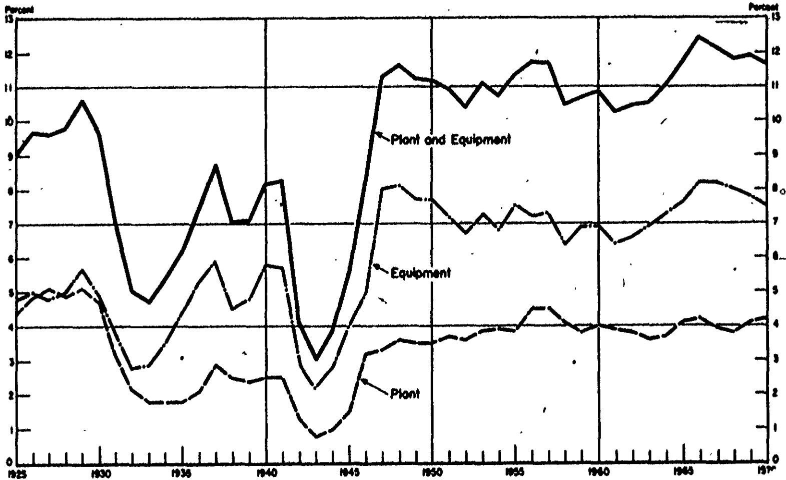


Source. U.S. Department of Commerce

CHART 2

Expenditures for Business Plant and Equipment as a Percentage of the Privately Produced Gross National Product

(Current Dollars)



Source: U.S. Department of Commerce

and wartime lows and since 1960 has remained relatively stable, ranging between 3.6 and 4.2 percent of the gross private product.

2. The equipment ratio, by way of contrast, rose <u>sharply</u> to 8 percent in 1948 and since then has fluctuated between 6.4 and 8.2 percent. It is significantly above the 1925-29 levels of 4.8 to 5.7 percent.

3. There has been a notable change in the relationship between the plant and equipment ratios. The gap between them has become substantially wider as compared with the predepression period. It narrowed somewhat during the 1950s but has widened again since 1961.

4. For plant and equipment expenditures combined, postwar ratios have run significantly higher than those

in the 1925-29 period. In only one year (1929) prior to the war did the ratio reach 10 percent; since 1947 every year has been above 10 percent.

5. Since the early part of the postwar era the combined ratio has remained on a new high plateau. The figure for 1970 of 11.7 percent is only slightly below the peak of 12.4 in 1966 and is higher than any year in the predepression period.

Further Comment

The relatively long period of higher ratios during the postwar period for plant, equipment, and the combination of the two no doubt is in some part an offset to the deficiency accumulated during the period of low installations (1930-1945). This higher level of demand was made effective through a combination of improved financial availability, due in large part to more realistic depreciation allowances and since 1962 the investment tax credit.

III. Gross Investment in the Stock of Business Capital Goods

Still another measure of business capital expenditures is the investment in the existing stock of capital goods in place. Here we are concerned with the gross investment before allowance for the accrued depreciation of the stock.

The Commerce Department's capital goods stock estimates assume a consistent application of double declining balance depreciation (with straight-line switch) to the historical-cost installations of prior years at service lives equal to 85 percent of Bulletin F lives. In order to state the capital goods estimates in constant (1958) dollars, it was necessary to value identical assets at the same (1958) price regardless of their actual price in the year of acquisition.

This measure is shown in Chart 3.

A number of conclusions seem obvious.

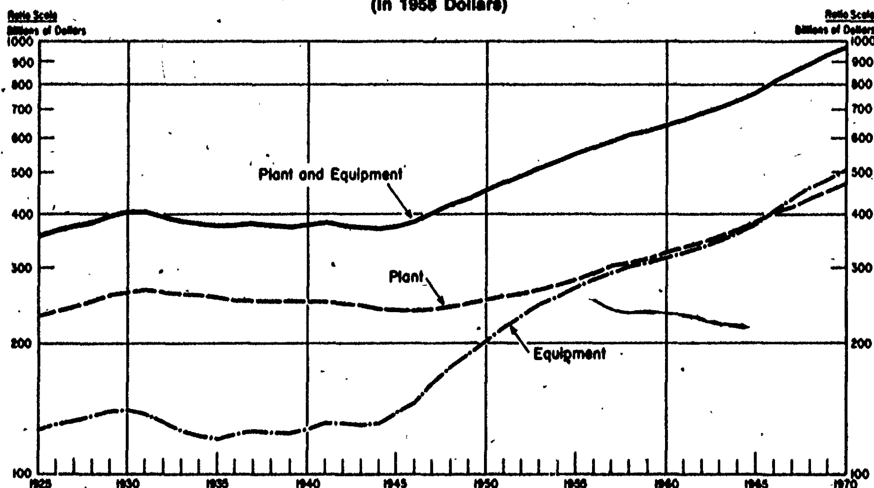
1. From 1925 to 1945, the stock of plant, equipment, and the combination of the two was generally stable.

2. Since 1945 both plant and equipment have grown. However, investment in the stock of equipment has risen far faster than plant investment (265 percent against 100 percent).

CHART 3

Gross Investment in the Stocks of Business Plant and Equipment

(In 1958 Dollars)



Source: U.S. Department of Commerce

3. Because of this differential growth rate, the investment in equipment has exceeded that in plant in recent years. Both are in the general vicinity of $500 billion.

4. Investment in the combined stocks is more than two and one-half times its 1945 level.

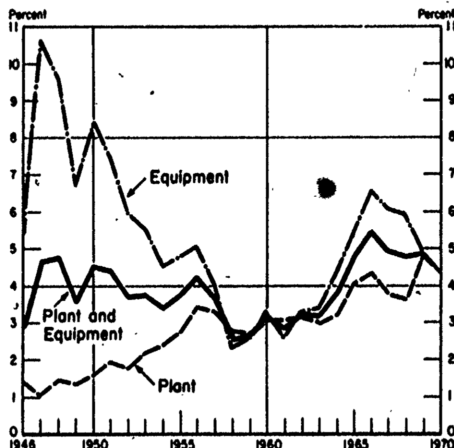
Annual Growth Rates

While the equipment series has grown more rapidly in the postwar era than the plant series, its growth has been significantly slower than its peak years of 1947-48. In fact, the two growth rates in the two most recent years covered are about the same. As can be seen from a glance at Chart 3A, however, this has happened in the past only to have the two rates diverge. Perhaps the most pertinent observation that can be made is that the two rates once again seem to be approaching rates more in line with the long-run growth rate of the economy, i.e., roughly 4 percent.

CHART 3A

Annual Percentage Increases in Gross Investment in the Stocks of Business Plant and Equipment

(In 1958 Dollars)



Source: U.S. Department of Commerce

IV. Output per Dollar of Gross Investment

In Section II we related business capital expenditures to the privately produced gross national product of the same year. Now that we have computed the investment in the stocks of capital goods, it is possible to relate the product to this investment. This is shown in Chart 4 on page 8.

Here, too, a few points are worthy of comment.

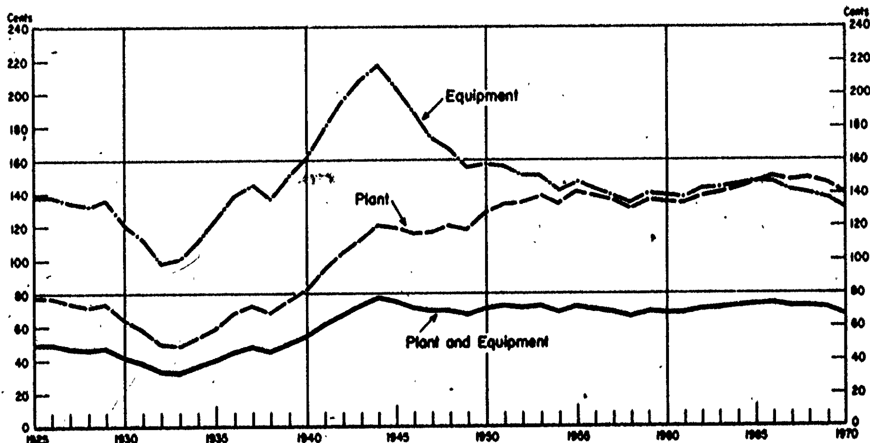
1. Over the postwar period, annual output per dollar of investment in plant has moved more or less sideways in the $1.20 to the $1.50 range.

2. Interestingly, after following a significantly different pattern from that for plant from 1925 to the

CHART 4

Privately Produced Gross National Product Per Dollar of Gross Investment in the Stocks of Business Plant and Equipment

(In 1958 Dollars)



Source: U.S. Department of Commerce

mid-50s, <u>equipment</u> has followed a similar pattern. In fact, there is now little difference between the two.

3. The result for the combination of plant and equipment is that the two combined have been on a plateau since 1945, ranging between 66.4 cents and 75.6 cents. This is significantly higher than the predepression period average of 48.2 cents.

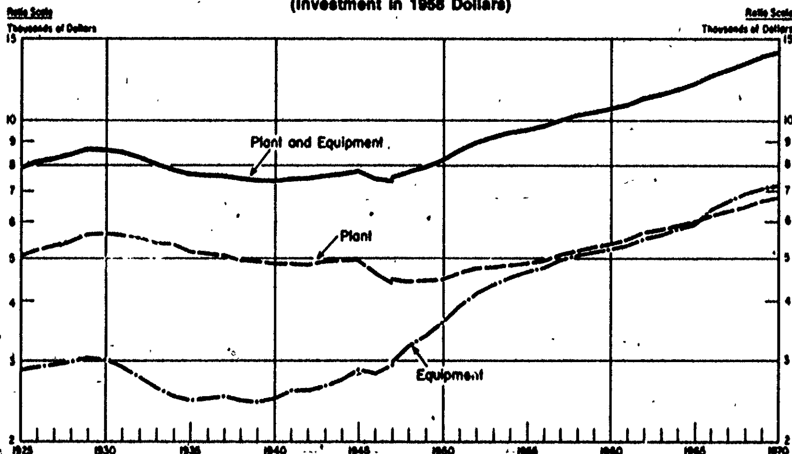
V. Gross Investment per Worker

Still another measure of interest is the amount of investment per worker. To arrive at this estimate we will use the number of workers in the private labor force. This is shown in Chart 5 on page 9.

CHART 5

Gross Investment in the Stock of Business Plant and Equipment Per Worker in the Private Labor Force

(Investment in 1958 Dollars)



a/ Labor Force includes persons over 14 years of age prior to 1947 and persons over 16 thereafter. The 1947 figures are shown on both bases.

Source: U.S. Department of Commerce

Here too, the picture is rather clear. Investment per worker rose in the period 1925 to 1930; it then declined until 1940, when it leveled off during the war. It has climbed since then to new highs. However, as to the components, equipment per worker has grown much faster to the point where the investment per worker in 1970 was slightly greater for equipment, $7,191 against $6,741 for plant. The combined investment is $13,932, in 1958 dollars, and $18,698 in current dollars.

A Look Forward

The amount of capital that is required to maintain the same rate of increase in investment per worker is of course dependent on the size of the labor force. Since the projected growth rate is now around 1.8 percent as compared with an earlier figure of 1 percent, if expenditures are not increased, the tempo of progress will be slowed up. The moral is that public policies should encourage the higher volume of saving and capital formation required to equip the added workers without detriment to the rate of economic improvement.

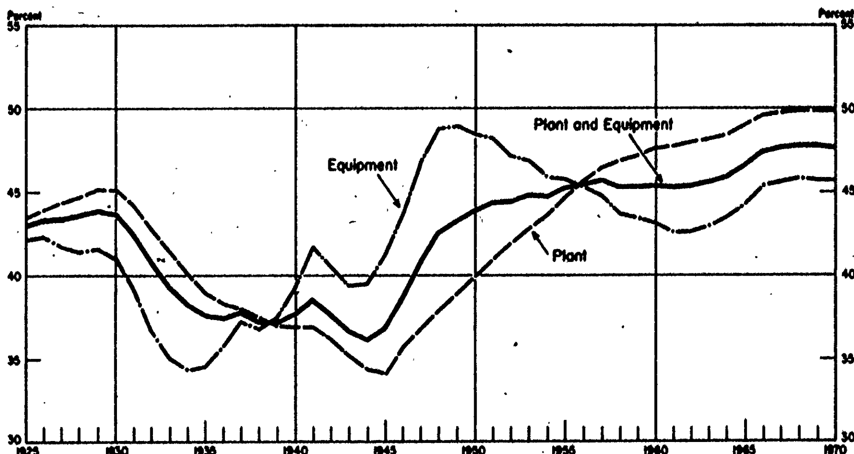
VI. Ratio of Net to Gross Investment

As a final measure of capital expenditures we turn to the ratio of net to gross investment, the net being, of course, the gross minus accrued depreciation. This is shown in Chart 6.

CHART 6

Net Investment in Stocks of Business Plant and Equipment as a Percentage of Gross Investment

(In 1958 Dollars)



Source: U.S. Department of Commerce

In the case of plant investment, the net-to-gross ratio declined continuously from 1929 to 1945. Since then it has risen to a present level well above that prevailing before the depression. The equipment ratio has had a more irregular history, declining during the depression, rising a little in the late thirties, and declining again during the war. Thereafter it rose to a very high level during the late 1940s, and has since receded to a point still notably above its predepression position. The combined ratio has risen slightly since the early 1950s to a level well above 1925-29. This is the result of a more rapid growth of installations.

Conclusion

No one with an appreciation of the fallibility of these measures will wish to draw any but the broadest and most general inferences from their use. A few such inferences are worth noting in conclusion.

Normalization

The period prior to the great depression saw a vigorous and persistent expansion of capital goods activity. The next 15 years was a period of contraction and stagnation in this area. The early part of the postwar era, now 25 years in length, was devoted in large part to normalizing the situation--to repairing the damage left by depression and war.

By normalizing we do not mean restoring the situation to what it would have been if the depression and the war had not occurred. These two calamities have doubtless left permanent scars on the economy, and on capital goods in consequence. We mean restoring a normal relation, both qualitative and quantitative, between capital goods and contemporary economic activity--actual activity, not what would have been without the misfortunes of 1930-1945.

By this test, the normalization appears to be well along, if not virtually complete. Output per dollar of gross investment in capital goods has substantially exceeded the 1925-29 average. The ratio of net to gross investment has attained a new high. This means that the capital goods industries have been living recently, and will have to live hereafter, on currently accruing needs, without benefit of the restoration or normalization process. This should not be too disturbing a thought; apparently it is years since they have derived any major benefit from this process. The adjustment has already been made.

Beyond Normalization

Normalization of the quality and quantity of the capital goods stock does not imply that the present situation is satisfactory, or that current levels of capital expenditure are adequate. There are several important considerations that argue to the contrary: the increase in the growth rate of the labor force; the forced expenditures for antipollution equipment; the essential expenditures for energy; the present high percentage utilization of capacity; and the economic competition worldwide. All of these considerations argue for higher ratios of capital formation to national product than we have heretofore considered normal.

To assure adequate performance in the future, government must maintain and even increase measures to augment the flow of funds as a means of stimulating business capital investment. This means, of course,

that the present realistic depreciation allowance and the investment tax credit should remain a permanent part of our tax law. Beyond this, it is essential that we eliminate or reduce the present bias in our tax structure against private saving and capital formation. Finally, because of the recent rapid rate of inflation, it is more than ever necessary that the government adopt an alternative to historical cost depreciation.

The moral is clear. If we are at all right in predicting higher levels of demand for plant and equipment, since the enlargement of business investment depends primarily on an increased flow of funds available for the purpose; there is a pressing need to assure that tax policy encourages private saving and capital formation. This is the surest way to achieve and maintain the higher rate of economic growth which is essential to our national well-being.

The CHAIRMAN. Now next I would like to call Mr. John Davidson of the Tax Council.

We are happy to have you, Mr. Davidson. We will be pleased to have your statement.

STATEMENT OF JOHN C. DAVIDSON, PRESIDENT AND A DIRECTOR OF THE TAX COUNCIL

Mr. DAVIDSON. Thank you, Mr. Chairman.

My name is John C. Davidson. I appear here in behalf of the Tax Council, of which I am president and a director. The council is a nonprofit, tax policy organization supported by business.

From its inception 8 years ago, the council has stressed the importance in the public interest of a tax policy which reflects recognition of the good which capital does.

Naturally, we of the council have been concerned and worried about the tendency of some prominent Senators to disregard the importance of capital in their expressions and actions on tax policy. We therefore were especially pleased, Mr. Chairman, that you would schedule these hearings at this time.

TAX PROPOSALS SEEN HARMFUL TO PUBLIC INTEREST

The proposals you have listed as the subject of the hearings are next listed, and I hardly need to repeat those. Even if not enacted, these proposals, collectively and individually, are harmful to the public interest because their advocacy tends to befog the national problem of scarce capital and divert attention from the tax bias against capital which contributes so substantially to that scarcity. If enacted, these proposals would be steps in the wrong direction.

What is needed at this stage in history is a legislative program to undo some of the economic damage of the present tax law, not to add to that damage. Unfortunately, an anticapital approach has always characterized the tax reform movement. Everyone benefits from the increase of capital, not just the primary accumulators and users. Instead of taking up time here to discourse on the public interest in capital, there is appended to this statement a piece entitled "Capital and the Public Interest," which is excerpted from our "A Program for a Capital Conscious Federal Tax Policy," and may that be accepted?

The CHAIRMAN. That will be printed at the conclusion of your statement.

Mr. DAVIDSON. Thank you, sir.

The areas in which the Federal tax law is biased against capital and, in the process, against companies and people with the greatest potential for creating new capital, include: first, double taxation of dividends; and in the case of intercorporate dividends, when dividends subject to a penalty tax on intercorporate dividends are paid out to stockholders by the receiving corporation there is a triple taxation.

Top rate of tax on corporate profits. Because retained earnings of corporations are overwhelmingly the major source of growth capital, a top tax rate on corporate income as high as 48 percent obviously is biased against capital.

And then there is double taxation of capital. When realized capital gains are taxed first to the owner during life, and then as part of his estate at death, there is double taxation of capital.

Then the rates of tax on capital: the bias of double taxation of capital is compounded by confiscatory rates. When realized gains are first subject to the regular top tax rate of 35 percent, and then to the top estate tax rate of 77 percent, there is a tax take of $850 out of each $1,000 of affected capital.

Then the minimum tax in income: although termed a minimum tax on income, this enactment treats capital gains which are not income as an income tax preference. Under present law, this increases the effective top rate on affected gains 36.5 percent.

There have been some proposals before Congress—I do not think they are amendments before this committee—which would take that up to around 52 percent. This would be a maximum tax.

While capital gains are subject to the disadvantages of income tax treatment, equality of treatment is not provided in the case of capital losses.

A home represents the major capital investment of the average person. While gains on sales of homes and other properties used for personal purposes are taxed, there is no provision for deduction of losses.

The steep progression and high rates of tax through and above the middle-income brackets obviously are biased against the development of new capital.

The bias is greater in the case of investment income which is taxed at higher rates than earned income.

With deductions for depreciation and inventory in computing taxable income based on original cost, the erosion of capital by taxation increases during periods of inflation. That is what is happening right now.

In considering the proposals before you, it is relevant to recall the atmosphere which prevailed when reinstatement of the investment credit and approval of the ADR system were the issues in late 1971. At the time, the opponents of these moves tended to rest their case on a single point, namely, the amount of idle plant capacity.

Proponents stressed the reasons why complacency about the need for new facilities was not warranted, and brought in the matter of economic balance. They noted there was no experience which indicated the Nation could have a fully operating, balanced economy without business capital spending holding up its end, and capital formation in itself would make the economy flourish. Some of us stressed that scarce capital was already a major problem of the 1970's and that, while the

new investment credit and ADR system might get us back on the track of strong economic growth, further easing of the tax impact on capital could be very much in order within a couple of years.

Less than 2 years later, the talk of idle plant capacity was forgotten lore. Even before the oil embargo, capacity was being pressed to the limit and shortages were showing up in many areas of the economy. Since then, the Nation has committed itself to an all-out drive for self-sufficiency in energy. The needs for evermore capital grow apace in other areas. Economists and financial authorities are genuinely bewildered as to where the required capital will come from. And yet, the same people who opposed the credit and the ADR in 1971 are now asking for their repeal and other tax changes, which would increase the tax burden on capital.

Are they blind, or what is their problem?

It is understandable why these people could have been so wrong in 1971, but it is not understandable how they could be so wrong at this time. The shortage which overshadows all other shortages today is of capital. It is a shortage which is well known to the rest of the world, but one which has not been so apparent here.

This is no time for pretention that it cannot happen here. It not only can, but it has happened. And in some part, the Federal tax laws are responsible for the happening. Those who introduced and are advocating the pending proposals directed at capital would do better to turn their attention and influence toward removing the tax bias against capital in the Federal tax law. That is where the public interest lies.

Because these hearings have not been designed to develop a record of policy proposals relating to the tax impact on capital, we have not included the Council's recommendations in this statement. They, of course, are included in the program from which the appendix is excerpted, and if it served the purposes of the committee we would be happy to have the entire program included in the printed hearings. We look forward to the opportunity to appear when hearings on comprehensive legislation are held.

In conclusion, if it is not practical to legislate tax steps in the right direction at this time, the economy should at least be spared any more steps in the wrong direction. It is people generally who pay the price in more inflation and less improvement in living standards when existing or potential capital is converted into Government spending.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much for your statement, Mr. Davidson, and the statement "Capital and the Public Interest" will also be printed at this point in the record.

Mr. DAVIDSON. Thank you.

(The prepared statement of Mr. Davidson and information referred to follows:)

Tax Steps in the Wrong Direction

Statement of John C. Davidson
in behalf of The Tax Council
before the
Committee on Finance, United States Senate
June 6, 1974

My name is John C. Davidson. I appear before you in behalf of The Tax Council of which I am President and a Director.

The Council is a nonprofit, tax policy orgainzation supported by business. Our membership includes large, medium-size and small companies. Our Board of Directors is a working group drawn largely from our membership but including some distinguished people in the field of taxation without membership connections.

From its inception eight years ago, the Council has stressed the importance in the public interest of a tax policy which reflects recognition of the good which capital does.

Naturally, we of the Council have been concerned and worried about the tendency of some prominent Senators to disregard the importance of capital in their expressions and actions on tax policy. We therefore were especially pleased, Mr. Chairman, that you would schedule these hearings at this time.

The proposals you have listed as the subject of the hearings would --

- Repeal the percentage depletion allowances for oil and gas production
- Eliminate the more rapid depreciation permitted under the Asset Depreciation Range (ADR) system
- Phase out the 7 percent investment credit for all property costing more than $100,000.

- Limit the use of the foreign tax credit
- Eliminate the tax savings under the DISC program
- Greatly increase the burden of the minimum income tax

Even if not enacted, these proposals, collectively and individually, are harmful to the public interest because their advocacy tends to befog the national problem of scarce capital and divert attention from the tax bias against capital which contributes so substantially to that scarcity. If enacted, these proposals would be steps in the wrong direction.

What is needed at this stage in history is a legislative program to undo some of the economic damage of present tax law; not to add to that damage. Unfortunately, an anti-capital approach has always characterized the tax reform movement. Everyone benefits from the increase of capital, not just the primary accumulators and users. Instead of taking up time here to discourse on the public interest in capital, there is appended to this statement a piece entitled "Capital and the public interest" excerpted from the Council's "A Program for a Capital Conscious Federal Tax Policy".

Tax Bias Against Capital

The areas in which the federal tax law is biased against capital and, in the process, against companies and people with the greatest potential for creating new capital, include:

1. Double taxation of dividends. Corporate income paid out as dividends is doubly taxed above the small exemption now provided.

2. <u>Triple taxation of intercorporate dividends.</u> When dividends subject to a penalty tax on intercorporate dividends are paid out to stockholders by the receiving corporation, there is triple taxation.

3. <u>Top rate of tax on corporate profits</u>. Because retained earnings of corporation are overwhelmingly the major source of growth capital, a top tax rate on corporate income as high as 48 percent obviously is biased against capital.

4. <u>Double taxation of capital</u>. When realized capital gains are taxed first to the owner during life, and then as part of his estate at death, there is double taxation of capital.

5. <u>Rates of tax on capital</u>. The bias of double taxation of capital is compounded by confiscatory rates. When realized gains are first subject to the regular top rate of 35 percent, and then to the top estate tax rate of 77 percent, there is a tax take of $850 out of each $1,000 of affected capital.

6. <u>Minimum tax on income</u>. Although termed a minimum tax on income, this enactment treats capital gains which are not income as an income tax preference. Under present law, this increases the effective top rate on affected gains to 36 1/2 percent.

7. <u>Capital losses</u>. While capital gains are subject to the disadvantages of income tax treatment, equality of treatment is not provided in the case of capital losses.

8. <u>Sales of homes</u>. A home represents the major capital investment of the average person. While gains on sales of homes and other properties used for personal purposes are

taxed, there is no provision for deduction of losses.

9. Rates of personal tax. The steep progression and high rates of tax through and above the middle income brackets obviously are biased against the development of new capital.

10. Rates on investment income. The bias is greater in the case of investment income which is taxed at higher rates than earned income.

11. Capital recovery. With deductions for depreciation and inventory in computing taxable income based on original cost, the erosion of capital by taxation increases during periods of inflation.

Perspective

In considering the proposals before you, it is relevent to recall the atmosphere which prevailed when reinstatement of the investment credit and approval of the ADR system were the issues in late 1971. At the time, the opponents of these moves tended to rest their case on a single point, namely, the amount of idle plant capacity. Proponents stressed the reasons why complacency about the need for new facilities was not warranted, and brought in the matter of economic balance. They noted there was no experience which indicated the nation could have a fully operating, balanced economy without business capital spending holding up its end, and emphasized that when capital formation flourishes, so does the economy, and when the economy flourishes, it needs all the capital formation it can get in order to improve productivity and counter inflationary forces.

Some of us stressed that scarce capital was already a major problem of the 1970's and that, while the new investment credit and ADR system might get us back on the track of strong economic growth, further easing of the tax impact on capital could be very much in order within a couple of years.

Less than two years later, the talk of idle plant capacity was forgotten lore. Even before the oil embargo, capacity was being pressed to the limit and shortages were showing up in many areas of the economy. Since then, the nation has committed itself to an allout drive for self sufficiency in energy. The needs for ever more capital grow apace in other areas. Economists and financial authorities are genuinely bewildered as to where the required capital will come from. And, yet, the same people who opposed the credit and the ADR in 1971 are now asking for their repeal and other tax changes which would increase the tax burden on capital. Are they blind, or what is their problem?

It is understandable why these people could have been so wrong in 1971, but it is not understandable how they could be so wrong at this time. The shortage which overshadows all other shortages today is of capital. It is a shortage which is well known to the rest of the world but one which has not been so apparent here. This is no time for pretension that it can't happen here. It not only can, but it has happened. And, in some part, the federal tax laws are responsible for the happening. Those who introduced and are advocating the pending proposals directed at capital would do better to turn their attention and influence towards removing the tax bias against capital in the federal tax law. That is where the public interest lies.

Constructive Policy Proposals

Because these hearings have not been designed to develop a record of policy proposals relating to the tax impact on capital, we have not included the Council's recommendations in this statement. They of course are included in the program from which the appendix is excerpted, and if it served the purposes of the Committee we would be happy to have the entire program included in the printed hearings. We look forward to the opportunity to appear when hearings on comprehensive legislation are held.

Conclusion

If it is not practical to legislate tax steps in the right direction at this time, the economy should at least be spared any more steps in the wrong direction. It is people generally who pay the price in more inflation and less improvement in living standards when existing or potential capital is converted into government spending.

APPENDIX

Capital and the public interest. Capital, created by man, is the servant of mankind. The service rendered by capital is the most important known to the human race. The societies which have accumulated the least capital are all too aware of this fact, while those which have accumulated the most are most prone to forget it. There are neither substitutes for nor shortcuts to the accumulation of capital in advancing human well-being in any nation. Capital accumulation comes hard, and is most efficiently accomplished under the discipline and incentives of free market economies. After using anti-capitalism as a means for gaining power, the over-riding problem of every socialist or communist regime becomes one of accumulating capital.

The socialist experience discloses what free enterprise economists have always known: more capital means advancing standards of living in any society. The much higher average of real incomes in America as compared with other countries derives from the much higher average of capital per worker here. Despite all the efforts to portray a fundamental conflict in tax policy between the interests of the people generally and the interests of the accumulators, owners and users of capital, the American experience provides the ultimate proof of the confluence of those interests.

But, ignoring this proof, there is a troublesome indifference among political and other opinion leaders in America to the importance of safeguarding the capital formation process. To a large extent, this indifference may be attributed to the larger-than-life roles claimed for unions and humanistic government in advancing real incomes of workers and others. But union power and government concern for citizen welfare are not peculiar to America. Where our nation has and still stands way out ahead of the rest of the world is in the level of capital investment per worker and in related phenomena for maintaining and increasing the level of real incomes. As a matter of fact, whatever the case for or against unions, and whatever the needs with which the government is concerned, when their policies and actions contribute to an anti-capital tax policy, they are shortchanging the very interests they profess to serve.

It should not be forgotten that older people and other nonworkers are just as dependent on capital for their economic wellbeing as are those in the active labor force. Just as real incomes of workers here are double or more the real incomes of workers in most other nations, so is the level of real incomes of disadvantaged people and others who wholly or largely live on payments under government programs.

Even more than attributing economic progress to the wrong sources, however, indifference to the tax impact on capital seems to reflect a widespread failure to understand or be influenced by a fundamental but simple economic fact-of-life, namely, there is no such thing as surplus or idle capital. A pervasive thought among political leaders and other opinion-moulders is that there always is plenty of capital around; the problem is to decide what to do with it. In the recent Presidential campaign, for example, Senator McGovern talked of employing idle capital for specific purposes.

The problem, however, is just the opposite. It always is where to find the capital, not what to do with it. While the truth never varies, the fact is more evident in some eras than others and this is one of the eras where the evidence abounds. Look at the matters which receive so much priority in public attention—home building, community facilities of all kinds, pollution abatement and control, the location and development of new sources of energy, communications and transportation facilities, greater productivity to improve living standards here and compete more effectively with foreign producers, improvement of conditions in the least developed areas of the country, and more new and better jobs to serve the needs of disadvantaged people, the unemployed and partially employed and young people just joining the nation's work force—all are dependent on finding the capital. Look at interest rates.

The myth of idle capital may exist in part on misunderstanding as regards capital movements or the mobility of capital. Capital is moving around all the time, but from one use to another. In the economic sense, existing capital always is employed. When capital moves from one investment to another, other capital moves in where the dis-investment occurred. Thus, while old capital may be used for new ventures, and new capital may replace capital in old ventures, net increase in the total of investment in any period is dependent on the net generation of capital in that period.

Yesterday's capital will not be available to meet tomorrow's needs.

Tomorrow's capital will never be enough to meet all the needs which would serve the public interest.

Source: A Program for a Stable Capital Conscious Federal Tax Policy. Tax Policy Committee, The Tax Council, November 1972. pages 9-11.

The CHAIRMAN. Next we will call on Mr. Walker Winter and Mr. Walter A. Slowinski of the Chamber of Commerce of the United States, accompanied by Mr. Robert Statham.

Gentlemen, we are happy to have you. I am sorry that this hearing puts you at this point where we do not have as much attendance as I would like to have for you. But I would like to see that the entire Senate knows of your views.

STATEMENT OF WALKER WINTER, A MEMBER OF THE FIRM OF ROSS, HARDIES, O'KEEFE, BABCOCK & PARSONS, MEMBER OF THE BOARD OF DIRECTORS OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, CHAIRMAN OF THE CHAMBER'S TAXATION COMMITTEE; AND WALTER A. SLOWINSKI, A MEMBER OF THE FIRM OF BAKER & McKENZIE, MEMBER OF THE TAXATION AND INTERNATIONAL COMMITTEES OF THE CHAMBER OF COMMERCE OF THE UNITED STATES, ACCOMPANIED BY ROBERT R. STATHAM, DIRECTOR OF THE TAXATION AND FINANCE SECTION OF THE NATIONAL CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. WINTER. Mr. Chairman, we are very pleased to be here. My name is Walker Winter. I am a member of the board of directors of the Chamber of Commerce of the United States and chairman of its taxation committee, and I am a partner in the Chicago law firm of Ross, Hardies, O'Keefe, Babcock & Parsons.

I am accompanied by Walter A. Slowinski, a member of the chamber's taxation and international committees, and a partner in the Washington, D.C., law firm of Baker & McKenzie, and Robert R. Statham, director of the taxation and finance section of the national chamber.

Mr. Slowinski will present the views of the national chamber with regard to those amendments affecting the taxation of foreign source income, and I will present the views of the chamber with regard to the other proposals.

Mr. Chairman, as I said, we very much appreciate the opportunity to give our views on the tax increase measures that have been proposed as amendments to H.R. 8217. I will review it very briefly if I may, Mr. Chairman, and have it included in the record as if read.

OPPOSITION TO TAX INCREASES ON INDIVIDUALS AND CORPORATIONS

Mr. WINTER. Let me give you a summary of the chamber's position. The national chamber is opposed to an increase in taxes on individuals and corporations. The chamber supports the full retention of the investment tax credit, favors liberalizing the asset depreciation range system, favors the retention of adequate depletion allowances, recommends complete elimination of the minimum tax, supports the concept of the domestic international sales corporation DISC, supports retention of the deduction allowed to Western Hemisphere trade corporations, supports full retention of the foreign tax credit, opposes elimination or fragmentation of either the overall liimtation method or the per-country limitation method of computing the foreign tax

credit, and opposes any legislation that would increase the tax burden and undermine the ability of American businessmen to operate in world markets. For this reason, the national chamber, as detailed in this testimony, is opposed to most of the tax measures proposed as amendments to H.R. 8217.

The overall impact of these amendments would be to fan the fires of inflation, send the country into a deeper recession, heap more tax burdens on individual and corporation taxpayers, add to the shortages facing the American consumer, destroy jobs, weaken our competitive enterprise system, and sap the ability of American companies to compete in world markets.

A word on the procedural aspects of the amendments. We wish to commend the committee for holding these hearings. The tax revision amendments that are the subject of these hearings are of such magnitude and so fundamental to the tax structure that they should have the benefit of public hearings and very careful committee consideration.

The Ways and Means Committee in the House has held extensive public hearings on tax revision with testimony from over 250 witnesses covering over 7,000 pages. That committee is currently engaged in 2 months of markup sessions in drafting tax revision legislation.

The far-reaching and complex tax proposals contained in these amendments should receive extensive public hearings before being finally considered by this committee and the entire Senate. Amendments that have such a direct impact on the Nation's caiptal cost recovery system, energy supply, investment abroad, and the Federal taxing system as a whole deserve far more deliberation than floor debate alone.

If I may, I will review very briefly these issues.

The investment tax credit was restored in the 1971 act. We reaffirm our support for the credit and urge that it be retained in full as a permanent part of our tax laws. Our economy cannot afford the on-again, off-again approach to the investment tax credit absent a modern capital cost recovery system equal to our foreign competitors'. It is exceedingly important that the United States' tax policy not discourage modernization and expansion of its productive facilities. In the light of historical high interest rates and the low esteem of equity investments, everything should be done to augment the cash flow business needs to maintain an increased capacity.

Now, I will turn to the asset depreciation range. We supported the asset depreciation range when it was first instituted by Treasury regulation in June of 1971, and again when it was ratified in the Revenue Act of 1971. We continue to support the full retention of the ADR system. At the same time we also reaffirm our long-standing preference for a permanent and flexible capital cost recovery allowance system along the lines set forth in the 1970 Report of the President's Task Force on Business Taxation.

Turning to the minimum tax for tax preferences, amendment 1350 of the bill would increase the so-called minimum tax for tax preferences by reducing the $30,000 exclusion to $10,000 and eliminate

the deduction for other taxes paid. Not only are we opposed to these two amendments, but we are also opposed to the minimum tax and urge its repeal.

With respect to depletion and intangible drilling costs, I think that has had complete coverage today. We would certainly associate ourselves with that. We support and have supported adequate depletion allowances, and we certainly support the retention of the intangible drilling costs.

In conclusion, Mr. Chairman, the real answer is cutting expenditures. Most of those who are offering amendments to this bill are seeking a way to provide tax relief because Federal tax rates are too high and are a great burden on those at every level of the economy. We think the solution would be to bring Federal spending under control. Huge Federal deficits have been a primary reason for the devastating inflation that is the No. 1 problem facing this country. No reshuffling of tax burdens will make that problem go away.

Legislation has already passed both Houses of Congress to provide improved procedures for bringing spending under control. That legislation should be finally enacted and used by the Congress to bring about a system of priorities and reduce unnecessary Federal expenditures. Spending reduction can mean an end to rampant inflation and can make it possible to reduce taxes across the board for all taxpayers.

In conclusion I would like to again compliment the committee for holding these hearings. We urge the rejection of these amendments which would place additional tax burdens on individuals and corporations. These proposals should be given the benefit of extensive public hearings and the careful consideration of this committee.

Mr. SLOWINSKI. Mr. Chairman, I am Walter Slowski, and I will be very brief. I am liaison between the international committee and the taxation committee and will present the views of the national chamber with regard to amendments affecting the taxation of foreign source income, and our summary is very brief.

OPPOSITION TO TAX INCREASES ON BUSINESSES DOING BUSINESS ABROAD

The chamber opposes any legislation that would increase the tax burden of U.S. businesses doing business abroad either directly or indirectly, including the current taxation of earnings and profits of controlled foreign corporations. We support the concept of the domestic international sales corporations and retention of the deduction allowed to Western Hemisphere trade corporations.

We support the full retention of the foreign tax credit currently allowed to U.S. corporations for the payment of foreign taxes paid both by the U.S. parent corporations and their foreign subsidiaries. We oppose elimination or fragmentation of either the overall limitation method or the per country limitation method of computing the foreign tax credit.

Any proposal to tax on a current basis the earnings of foreign subsidiaries of U.S. companies referred to as controlled foreign corporations should be rejected. The national chamber opposes any changes in the tax law that would permit taxing earnings of foreign manufacturing subsidiaries of U.S. companies in the year in which they are

earned rather than in the year in which they are paid. There are sound reasons for the present tax law and any change almost certainly would result in curtailing American foreign operations, with an attendant loss of jobs both here and abroad.

As a matter of tax policy, it would be unsound to tax the income currently because dividend income should not be taxed until it is received. A foreign subsidiary of a U.S. corporation is a separate corporation incorporated in that country. It is subject to the laws of the foreign country and must pay taxes to the host country. The earnings of the subsidiary are not a part of the earnings of the parent until they are distributed and therefore should not be taxed until received.

Increasing the total tax burden of U.S. companies operating abroad would put them at a disadvantage with foreign competitors who are not taxed by the mother country on the earnings of their subsidiaries overseas. In fact, there are at least 25 countries that do not tax these earnings of foreign subsidiaries regardless of whether or not they are distributed. In the long run, the only beneficiaries of a U.S. tax on current earnings of foreign subsidiaries would be our foreign competitors.

An underlying premise held by those who advocate the current taxation of subsidiary income is that multinational corporations are threatening domestic employment opportunities by manufacturing products abroad. Those who support this view do not take a look at the other side. The facts indicate that an increase in foreign investment raises total employment both here and abroad.

Not only does new foreign investment directly create jobs abroad, it also increases the demand for domestic jobs by increasing the need for U.S. materials equipment, and know-how. In a survey of multinational corporations conducted by the national chamber, we found that U.S. employment in 121 firms increased from 2.5 million in 1960 to 3.3 million in 1970. We also found that the trade surplus of 81 responding companies increased from $1.7 billion in 1960 to $5.1 billion in 1970.

For a variety of reasons, the United States will continue to experience a balance-of-payments problem. Unfavorable tax consequences could only further aggravate the situation. Repatriation of earnings by American industry has now become a positive contributor to the solution of the balances-of-payments problem, as can be seen by the fact that $2.3 billion of earnings repatriated in 1960 grew to over $7.3 billion in 1971.

On the other hand, very few manufactured goods abroad are shipped back to the United States by foreign affiliates of American corporations. In 1957, only 6 percent, and in 1968, only 8 percent of all affiliate sales became U.S. imports. These figures include the imports under the Canadian auto pact.

Deferral of taxation on dividends is necessary to maintain equality with foreign competition. The current taxation of income not yet received by American business will only have an adverse effect on U.S.

employment, substantially increase the balance-of-payments deficit in the long run, and severely weaken our competitive position abroad.

Now, with regard to DISC, as Mr. Winters said, the chamber supported the DISC in 1971 and certainly still does. Besides promoting domestic employment and helping to improve our balance-of-payments position, the DISC is intended to overcome two major disadvantages that faced U.S. domiciled exporters. First, they were not receiving the tax deferral benefits available to foreign subsidiaries of U.S. corporations. Second, domestic exporters were often competing against exporters based in foreign countries, who were given far more liberal tax benefits by their own governments. These disadvantages would exist today were it not for the DISC.

Western Hemisphere trade corporations: In 1942 the Western Hemisphere trade corporation provision was inserted in the revenue code. It followed a precedent beginning in 1918 of special treatment afforded certain companies to encourage the use of domestic U.S. corporations for operations in the Western Hemisphere and especially in Latin America. Retention of the existing provisions is necessary to continue the established avenues of trade with countries in the Western Hemisphere. It is essential to our economy and to the implementation of international policies. Without some special consideration, there could be little incentive to compensate for the special risks attendant upon investment today in Latin America, where political instability creates special hazards such as expropriation of foreign investment.

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

Regarding the separate limitation on the foreign tax credit with respect to foreign mineral income, which was the subject of this morning's discussion—we would like to note the distinction between foreign oil and foreign mineral income if we may in this juncture. Amendment 1320 should be rejected. It requires the use of a separate per-country limitation in computing the foreign tax credit with respect to income derived from foreign mineral production where the foreign government to which the taxes are paid also holds the rights to, or receives royalties relating to the minerals with respect to which the income is derived, or where the foreign country imposes a higher effective tax rate on mineral income than on other types of income. We believe a separate per-country limitation should not be mandatory.

In conclusion, Mr. Chairman, we urge the rejection of these amendments, which would increase the tax burden on U.S. businesses doing business abroad, either directly or indirectly. These proposals also should be given the benefit of extensive public hearings and the careful consideration of this committee.

Thank you very much.

Mr. WINTER. May I conclude, also, just by thanking you, Mr. Chairman, for having us here. We very much enjoyed being here to give you our views. We would be glad to answer any questions.

Minimum Tax—Lack of Consideration of Deductions for State Taxes Paid

The Chairman. I did want to ask one question. In the debate on the 1969 Tax Reform Act concerning the minimum tax provisions, are you aware of any consideration given to deductions for State income taxes paid, real estate and State taxes paid, or personal property taxes paid?

Mr. Winter. I am not quite sure I understand you.

The disallowance of those items?

The Chairman. Well, are you aware of any consideration that was given to the possibility or the desirability of providing a deduction from the minimum income tax provisions for taxes paid to the State and local governments?

That is what I am talking about.

Mr. Winter. I am not sure I know.

Mr. Statham. I do not recall that discussion in any of the hearings. I think there were some discussions in some of the meetings around the country with regard to this point. But it has been quite a while ago, about 5 years ago, since that discussion was held. So I do not remember very much about it. But I think there was some discussion along that line.

The Chairman. Well, you are against the minimum income tax. I understand that. But if we are going to have one, it seems to me that it might be well to give consideration to more than just the Federal income tax that is paid. In other words, some people might be paying a great deal of taxes to government. In the last analysis, as far as the businessman is concerned, a tax is an expense.

Mr. Winter. No question about that.

The Chairman. It is no less of an expense whether he is paying it to the State government, the Federal Government, or the city government, and so it would seem to me that if we are ging to have a minimum income tax, if it appears that these people have not paid more taxes, we ought to take a look at how much they have paid the State and local governments as well as how much they have paid the Federal Government.

Mr. Winter. There certainly should be an overall look at the tax burden. We tried to make that point through the years.

The Chairman. Thank you very much, gentlemen.

Mr. Winter. Thank you.

[The prepared statements of Messrs. Winter and Slovinski follow:]

STATEMENT
on
PENDING TAX INCREASE PROPOSALS
before the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
WALKER WINTER and WALTER A. SLOWINSKI
June 6, 1974

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

I am accompanied by Walter A. Slowinski, a member of the Chamber's Taxation and International Committees and a partner in the Washington, D. C. law firm of Baker and McKenzie, and Robert R. Statham, Director of the Taxation and Finance Section of the National Chamber.

Mr. Slowinski will present the views of the National Chamber with regard to those amendments affecting the taxation of foreign source income, and I will present the views of the Chamber with regard to the other proposals.

Mr. Chairman, the National Chamber appreciates this opportunity to present its views on the tax increase measures that have been proposed as amendments to H.R. 8217, a tariff measure now on the Senate Calendar and soon to be considered by the Senate.

Summary of Chamber's Position

The National Chamber is opposed to an increase in taxes on individuals and corporations. The Chamber supports the full retention of the investment tax credit, favors liberalizing the Asset Depreciation Range system, favors the retention of adequate depletion allowances, recommends complete elimination of the minimum tax, supports the concept of the Domestic International Sales Corporation (DISC), supports retention of the deduction allowed to Western Hemisphere Trade Corporations, supports full retention of the foreign tax credit, opposes elimination or fragmentation of either the overall limitation method or the per-country limitation method of computing the foreign tax credit, and opposes any legislation that would increase the tax burden and undermine the ability of American businessmen to operate in world markets. For this reason the National Chamber, as detailed in this testimony, is opposed to most of the tax measures proposed as amendments to H.R. 8217.

The overall impact of these amendments would be to fan the fires of inflation, send the country into a deeper recession, heap more tax burdens on individual and corporate taxpayers, add to the shortages facing the American consumer, destroy jobs, weaken our competitive enterprise system, and sap the ability of American companies to compete in world markets.

Procedural Aspects of the Amendments

We commend the Committee for holding these hearings. The tax revision amendments that are the subject of these hearings are of such magnitude and so fundamental to the tax structure that they should have the benefit of public hearings and very careful Committee consideration. The Ways and Means Committee in the House has held extensive public hearings on tax revision with testimony from over 250 witnesses covering over 7,000 pages. That Committee is currently engaged in two months of mark-up sessions in drafting tax revision legislation.

The far-reaching and complex tax proposals contained in these amendments should receive extensive public hearings before being finally considered by this Committee and the entire Senate. Amendments that have such a direct impact on the nation's capital cost recovery system, energy supply, investment abroad, and the federal taxing system as a whole deserve far more deliberation than floor debate alone.

Investment Tax Credit

We are opposed to amendment 1247 introduced by Senators Haskell and Chiles. This amendment would limit the investment tax credit to assets with a cost basis of $100,000 or less. The credit would be applicable up to a cost basis of $50,000 and then would be incrementally phased out from $50,000 to $100,000.

The Revenue Act of 1971 restored the investment tax credit to the Internal Revenue Code. We reaffirm our support for the credit and urge that it be retained in full as a permanent part of our tax law. Our economy cannot afford the on-again, off-again approach to the investment tax credit absent a modern capital cost recovery system equal to our foreign competitors'. It is exceedingly important that the United States' tax policy not discourage modernization and expansion of its productive facilities. We must continue to stimulate, rather than stifle, the productive forces of American industry in order that we may fight inflation, provide more jobs, and pull this country out of its present recessionary difficulties.

At a time when the Department of Commerce and the Federal Reserve system are in agreement that capacity pressures are forcing manufacturers to increase outlays, it appears incongruous for Congress to consider adopting policies that restrict investment. Capacity utilization estimates for major materials industries were 95% in the fourth quarter of 1973 compared to 92½% at the end of 1972, an almost unsustainable rate.

The Bureau of Economic Analysis of the U.S. Department of Commerce recently stated:

> BEA data on the evaluation of capacity by manufacturers confirm the need for additional facilities in the basic materials industries. Capacity pressures are also reported to exist in other lines such as small cars, converted paper products and machine tools. Pollution abatement requirements have also been a factor affecting outlays in some industries; . . . substantial amounts of the spending in primary metals and paper industries are attributable to this factor.

In addition, the Department of Commerce reported that as of December 31, 1973, companies owning over 54% of all fixed assets in manufacturing reported that their plant and equipment were inadequate, while 43% deemed their facilities adequate with only 3% stating that their capacity exceeded their needs. This is a substantial reversal from two years ago when in March of 1972 only 31% reported they needed more capacity with over 60% reporting adequate plant capacity and 7% reporting excess capacity. Industries involved in the production of basic materials such as lumber, primary metals, chemicals, petroleum and rubber companies accounting for 62% of total assets in materials industries, were in need of more capacity.

Failure to encourage these industries to expand will result in greater inflationary pressure on the entire economy. Business is already faced with unprecedented high interest rates which increase the cost of capital. It also finds it difficult to raise capital through equity markets due to the unpopularity of the stock market in recent years.

In light of historically high interest rates and the low esteem of equity investments, everything should be done to augment the cash flow business needs to maintain and increase capacity.

Increased environmental controls and the age of much of the capacity in U.S. industries are important factors that should be taken into account in devising any system of tax reform. A proper understanding of the impact of inflation on the need for investment capital is necessary. For example, assuming a 20-year life

expectancy for plant and equipment, we find a considerable capital shortfall on the part of industry as it seeks to replace plant and equipment. In the past twenty years the cost of producers durable equipment has risen by 69% and the cost of nonresidential structures has increased by over 111%.

In looking at our tax laws as they relate to investment the overriding considerations should therefore be:

1. The shortage of capacity in basic industries, and
2. The increasing cost of replacing worn-out plant and equipment at present prices compared to historic prices and the shortage of capital that results from this disparity.

We believe that the investment tax credit and the Asset Depreciation Range system have been significant factors in encouraging investment in new plant and equipment. A recent McGraw-Hill survey just released in May 1974, indicates that American business plans to spend $119 billion for new plants and equipment this year. Business spending on new plants and equipment shows that the incentive measures in the Revenue Act of 1971 are working. These new outlays for plant and equipment stimulate construction, increase orders for materials, and will result in increased employment.

An example of how the investment credit can affect productivity in the United States can be seen from the apparent impact of the previous credit on new orders for domestically produced machine tools. These orders are viewed as an important indicator of the future capital spending plans of business. After a slight decline in machine tool orders in 1964, new orders increased strongly until October of 1966, when the old 7% investment credit was temporarily suspended. During the period of the suspension, orders dropped more than 25%. When the investment credit was restored in 1967, orders began increasing, reaching a peak in April of 1969, when the credit was terminated. After the termination, new orders for machine tools decreased markedly. In the first quarter of 1971, orders were over 70% less than their all-time high in 1969. The investment credit was reinstated in August of 1971, and total orders rose 67%, from $747.3 million in 1971, to $1.25 billion in 1972.

The ability of this country to create jobs and reduce unemployment depends on the ability to equip workers with the tools of production. To equip new workers requires new investment in machinery and equipment. According to the 1974 Fortune survey of the "First 500," some of the industry medians of assets per employee are:

Petroleum refining	$149,197
Metal manufacturing	43,078
Pharmaceuticals	34,171
Metal products	21,924
Apparel	13,306

The median for all industries was $28,639.

As the labor force in the country increases in the coming years, we are going to have to meet employment needs with huge investments in the capital base. Projections of the Bureau of Labor Statistics show that during this decade the total labor force will expand by 15.9 million, with the labor force reaching 101.8 million by 1980. Only with the investment of many thousands of dollars can a job be created for even one worker. Well-paying jobs will require tremendous investments in capital.

We cannot expect to improve the economic well-being of all Americans in the years ahead unless we are able to produce more goods at lower prices and provide for the employment needs of our society. To turn off the stimulants to capital investment in this country can only retard our efforts to meet our national goal of prosperity and a high standard of living for all our citizens.

If we are to be effective in our fight against inflation, we must attempt to increase productivity. Any attempt to discourage investment in new plants and equipment will discourage productivity and contribute to the inflationary spiral by discouraging increases in supplies of scarce commodities. Increasing supplies and reducing demands is the proper way to fight inflation. Increasing productivity is the effective weapon against this worst "tax" of them all. At a time when the country is faced with a huge inflation we must not discourage productivity.

An amendment, such as 1247, creates uncertainties in the tax law. It creates instability. It creates fear in the minds of businessmen who are considering long-term investment that another shift in tax policy will upset reasonably developed programs. This instability tends to discourage business from making major investments in new job-producing ventures. The investment tax credit has been subjected to two suspensions in the past eight years. Another modification at this time would not be in the interests of good tax policy.

Amendment 1247 would discourage modernization and expansion of the nation's productive facilities, increase unemployment, create uncertainties in the law, and retard efforts to fight inflation.

Asset Depreciation Range System

Amendment 1316 sponsored by Senator Nelson, amendment 1247 sponsored by

Senators Haskell and Chiles, and amendment 1350 sponsored by Senators Bayh, Clark, Hart, Humphrey, Kennedy, Mondale and Muskie to repeal the Asset Depreciation Range system should be rejected.

We supported the Asset Depreciation Range (ADR) system when it was first instituted by Treasury regulation in June of 1971, and again when it was codified in the Revenue Act of 1971. We continue to support the full retention of the ADR system. At the same time, we also reaffirm our long-standing preference for a permanent and flexible capital cost recovery allowance system along the lines set forth in the 1970 Report of the President's Task Force on Business Taxation.

The present depreciation practices in this country are grossly inadequate. Although the codification of the Asset Depreciation Range system has eased the situation, it is far from being corrected. The recommendations of the President's Task Force on Business Taxation with regard to capital cost recovery should be enacted into law. These recommendations include substituting a capital cost recovery allowance system for the present system of deductions based on the useful life of property, and allowing full recovery of cost, unreduced by salvage value, in a period 40% shorter than would be allowed under the 1962 Treasury guidelines for determining useful lives. While ADR is having an immediate effect on the economy, the full Task Force recommendations should be adopted for their long-range, permanent effect.

Termination of the ADR system would handicap American business at a time when modernization and expansion of production facilities are essential to the achievement of national goals.

As we previously stated, any sound program designed to fight inflation, provide higher wages, and encourage economic growth must contain as a key element an increase in productivity. This requires that an adequate capital recovery system be permanently worked into our tax structure. By using more modern and efficient production facilities, more goods can be produced at a lower cost per unit. By encouraging American industry to invest in the most modern machinery and equipment available, an effort can be made to reduce inflation.

American business has been paying taxes on its capital. In order to lessen the effects of inflation on replacement costs, a shorter period for computing depreciation should be permitted. Because of inflation, American business has, in effect, underdepreciated its assets. This underdepreciation has led to an overstatement of profits and an overpayment of taxes based on those profits. Typically

a piece of equipment is depreciated at its cost over a long period of time. When replacement is necessary, the cost of replacement has greatly increased due to inflation. This increased cost of replacement must be paid for primarily from earnings.

Those who advocate the repeal of ADR frequently refer to the system as "interest-free loans of taxes." The fact is that a number of businesses in this country have been sending to Treasury what purports to be a tax on earnings but what in reality is a contribution of business capital. In addition to taxing the product of capital, government also is taking some of the capital itself.

It is important that the Congress adopt a tax policy that encourages the replacement of obsolete and inefficient plant machinery and equipment so that American enterprise can increase productivity, provide jobs at the highest wages in the world, and maintain American leadership in the world markets. Amendments 1247, 1316 and 1350 would do the opposite and should be rejected.

Minimum Tax for Tax Preferences

Amendment 1350 proposed by Senators Bayh, Clark, Hart, Humphrey, Kennedy, Mondale and Muskie, and amendment 1324 proposed by Senator Nelson, would increase the so-called minimum tax for tax preferences by reducing the $30,000 exclusion to $10,000, and eliminate the deduction for other taxes paid. Not only are we opposed to these two amendments, but we are also opposed to the minimum tax and urge its repeal.

The Tax Reform Act of 1969 instituted the minimum tax. Generally, this is a flat-rate 10% tax on "tax preferred" items in excess of $30,000 per year and the income taxes imposed for the tax year. This tax applies to corporations as well as individuals.

In 1969, we opposed the adoption of a "minimum tax." We acknowledged the problem that some individuals may avoid taxes, but urged review of those specific provisions deemed improper, rather than adoption of a minimum tax. Tax deductions, credits, and exclusions should not have as their purpose the granting of special privileges to any class. If there are instances where this occurs, the particular deduction, credit or exclusion should be modified.

New taxes, such as a minimum tax, often gain popular acceptance by being directed initially at the wealthy; but, in the long run, there is a temptation to increase the burden and scope of a new tax until it applies to virtually all taxpayers. These amendments tend to validate our concern. Reducing the $30,000 ex-

emption to $10,000 would place the minimum tax on middle income taxpayers and eliminating the deduction for income taxes paid penalizes those who are already paying taxes.

Sound tax policy should not penalize a corporation for vigorously conducting its trade or business, but that is exactly what the present minimum tax does. The proposed amendments could only compound this result. The amendments could deal a severe blow to private capital formation and development of essential energy resources -- the worst thing that could happen during a national energy crisis.

Proponents advocate the minimum tax because certain persons in higher income brackets selectively carry on personal and business activities for which the tax laws provide deductions, exclusions and exemptions available to all taxpayers. Those provisions were placed in the tax laws by Congress because they were considered to be needed for reasons of fairness, because they were in the best interests of the nation, or because there was a constitutional question involved. If Congress determines certain of those provisions to be improper, they should be modified. But, a penalty tax should not be imposed on those who are properly conforming with the provisions of those laws. These amendments could completely undermine the deductions granted and destroy their effectiveness without any real consideration of their merits.

The minimum tax, in considering only the federal income tax paid, ignores an individual's or corporation's total tax burden and contributions to all levels of government. The additional tax liability has complicated the tax law and increased the complexity of filing income tax forms. The amendments, if adopted, would make a bad tax substantially worse. The "Minimum Tax for Tax Preferences" would no longer retain even a semblance of being a so-called minimum tax. It would in effect be an "additional" tax applied to an arbitrarily selected list of tax provisions contained in the Internal Revenue Code. The long-range effect of a minimum tax is to increase inequities and provide disincentives for particular activities already endorsed by Congress.

Instead of increasing the tax burden through the minimum tax as is proposed in amendments 1324 and 1350, we urge that the minimum tax be repealed in its entirety.

<u>Depletion and Intangible Drilling and Development Costs</u>

Amendment 1321 sponsored by Senator Nelson would repeal oil depletion rates

on oil wells, and amendment 1322, also sponsored by Senator Nelson, would repeal the intangible drilling and development costs for foreign exploration of oil and gas wells. Amendment 1326 sponsored by Senators Ribicoff, Magnuson and Jackson, and amendment 1350 sponsored by Senators Bayh, Clark, Hart, Humphrey, Kennedy, Mondale and Muskie would repeal the percentage depletion allowance for oil and gas with certain exceptions.

We are opposed to these amendments. Our energy situation is critical. Any adverse changes made in the tax laws with regard to natural resources could seriously impair the competitive position of American companies engaged in the search for domestic and foreign energy sources.

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

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

Tax laws must recognize that rising energy demands in this nation require the constant development and maintenance of a healthy energy industry. As exploration and development of energy resources grow more difficult, more costly, and financially more hazardous, venture capital will continue to be attracted to this field only if the reward for success is commensurate with the risks involved. Therefore, to meet national needs and to assure replacement of exhausted mineral assets, the tax laws should provide that all nonrenewable natural resource industries be granted adequate depletion allowances.

The Real Answer to Cutting Taxes

Let us face up to the real problem. Most of those who are offering these amendments are seeking a way to provide tax relief because federal tax rates are too high and are a great burden on those at every level of the economy.

Why not face up to the real solution -- bring federal spending under control. Huge federal deficits have been a primary reason for the devasting inflation that is the number one problem facing this country. No reshuffling of tax burdens will make that problem go away.

Legislation has already passed both houses of Congress to provide improved procedures for bringing spending under control. That legislation should be finally enacted and used by the Congress to bring about a system of priorities and reduce unnecessary federal expenditures. Spending reduction can mean an end to rampant inflation and can make it possible to reduce taxes across the board for all taxpayers.

Conclusion

In conclusion I would like to again compliment the Committee for holding these hearings. We urge the rejection of these amendments which would place additional tax burdens on individuals and corporations. These proposals should be given the benefit of extensive public hearings and the careful consideration of this Committee.

STATEMENT
on
PENDING TAX INCREASE PROPOSALS
before the
SENATE COMMITTEE ON FINANCE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
WALTER A. SLOWINSKI
June 6, 1974

I am Walter A. Slowinski, a member of the Taxation and International Committees of the Chamber. I will present the views of the National Chamber with regard to those amendments affecting the taxation of foreign source income.

Summary of Chamber's Position

The National Chamber opposes any legislation that would increase the tax burden on United States businesses doing business abroad either directly or indirectly, including the current taxation of earnings and profits of controlled foreign corporations. We support the concept of the Domestic International Sales Corporations and retention of the deduction allowed to Western Hemisphere Trade Corporations. We support the full retention of the foreign tax credit currently allowed to United States corporations for the payment of foreign taxes paid both by the United States parent corporations and their foreign subsidiaries. We oppose elimination or fragmentation of either the overall limitation method or the per-country limitation method of computing the foreign tax credit.

Taxation of Earnings and Profits of Controlled Foreign Corporations

Amendment 1323 proposed by Senator Nelson to tax on a current basis the earnings of certain foreign subsidiaries of United States companies referred to as controlled foreign corporations should be rejected. The National Chamber opposes any changes in the tax law that would permit taxing earnings of foreign manufacturing subsidiaries of United States corporations in the year in which they are earned, rather than when they are paid to the parent company as dividends, as at present. There are sound reasons for the present tax law and any change almost certainly would result in curtailing American foreign operations, with an attendant loss of jobs both here and abroad.

Prior to 1962, foreign source income of a foreign subsidiary was not subjected to United States tax until the earnings were repatriated, that is, transmitted to the United States in the form of dividends. In 1962, the concept

of current taxation of Subpart F income of controlled foreign corporations was introduced into the federal tax laws. This concept provided that those profits derived from certain categories of foreign income must be reported pro rata by the corporation's United States' shareholders, even though not distributed to them.

Certain exceptions to the current taxation of Subpart F income were made partly because other countries did not tax their domestic subsidiaries on foreign earnings until such earnings were repatriated as dividends. If foreign subsidiaries were to be taxed on a current basis as provided for in amendment 1323, it would require either the United States parent to pay a tax on dividends it has not received or force the foreign subsidiary to pay dividends to its United States parent to help finance the tax the parent has to pay. The effect of either of these would be highly detrimental to the financing of American operations abroad.

As a matter of tax policy, it would be unsound to tax the income currently because dividend income should not be taxed until it is received. A foreign subsidiary of a United States corporation is a separate corporation incorporated in that country. It is subject to the laws of the foreign country and must pay taxes to the host country. The earnings of the subsidiary are not a part of the earnings of the parent until they are distributed and therefore should not be taxed until received. This is in contrast to the recognized policy that a domestic corporation with branch operations abroad is taxed currently on the income received.

Increasing the total tax burden of United States companies operating abroad would put them at a disadvantage with foreign competitors who are not taxed by the mother country on the earnings of their subsidiaries overseas. In fact, there are at least 25 countries that do not tax these earnings of foreign subsidiaries regardless of whether they are distributed. In the long run, the only beneficiaries of a United States tax on current earnings of foreign subsidiaries would be our foreign competitors.

An underlying premise held by those who advocate the current taxation of subsidiary income is that multinational corporations are threatening domestic employment opportunities by manufacturing products abroad. Those who support this view do not take a look at the other side. The facts indicate that an increase in foreign investment raises total employment both here and abroad. Not

only does new foreign investment directly create jobs abroad, it also increases the demand for domestic jobs by increasing the need for United States materials, equipment and know-how. In a survey of multinational corporations conducted by the National Chamber, we found that United States employment in 121 firms increased from 2.5 million in 1960 to 3.3 million in 1970. We also found that the trade surplus of 81 responding companies increased from $1.7 billion in 1960 to $5.1 billion in 1970.

The United States will continue to experience a balance-of-payments problem. Unfavorable tax consequences could only further aggravate the situation. Repatriation of earnings by American industry has now become a positive contributor to the solution of the the balance-of-payments problem as can be seen by the fact that $2.3 billion of earnings repatriated in 1960 grew to over $7.3 billion in 1971. On the other hand, very few manufactured goods abroad are shipped to the United States by foreign affiliates of American corporations. In 1957, only 6% and in 1968, only 8% of all affiliate sales became United States imports.

Deferral of taxation on dividends is necessary to maintain equality with foreign competition. The current taxation of income not yet received by American business will only have an adverse effect on United States employment, substantially increase the balance-of-payments deficit in the long run, and severely weaken our competitive position abroad.

Domestic International Sales Corporation (DISC)

Those amendments providing for the outright repeal or curtailment of DISC benefits as contained in amendment 1318 sponsored by Senator Nelson, and amendment 1247 sponsored by Senators Haskell and Chiles, amendment 1350 sponsored by Senators Bayh, Clark, Hart, Humphrey, Kennedy, Mondale and Muskie, and amendment 1302 sponsored by Senator Tunney should be rejected. We expressed support to this Committee in 1971, and again express our support for the concept of a Domestic International Sales Corporation.

The DISC provisions were codified in the Revenue Act of 1971. A DISC is a special type of United States corporation engaged in the business of export sales. It is not subject to income taxes, although its shareholders are treated as receiving 50% of the DISC's income. The other half may be retained by the DISC and reinvested in its export business, generally without liability for federal income tax.

Besides promoting domestic employment and helping to improve our balance-of-payments position, the DISC is intended to overcome two major disadvantages that faced United States domiciled exporters. First, they were not receiving the tax deferral benefits available to foreign subsidiaries of United States corporations. Second, domestic exporters were often competing against exporters based in foreign countries, who were given more liberal tax benefits by their governments. These disadvantages would exist today, were it not for the DISC provisions.

The DISC provisions now provide tax deferral opportunities for domestic exporters where previously they were available just to American exporters using foreign subsidiaries. Also, the DISC allows firms that are too small to operate through foreign subsidiaries to enter the export field. It is now estimated that over 5,000 elections have been made to become a DISC. The tax deferral may not be large in many cases, but the cumulative benefit will provide a substantial increase of working capital for further export development.

DISC places the American exporter in a more competitive position in world trade and in the search for world markets. Foreign countries have a variety of incentives to encourage foreign trade such as the European Common Market's requirement of the use of the value-added tax which permits member countries to rebate taxes paid the exporter at the time of the export, and to impose a tax on importers. On the other hand, because the United States uses an income tax, it is precluded from giving a tax rebate on American exports and imposing border taxation on imports.

In 1971, the United States experienced a $2.7 billion trade deficit, its first since 1893. During 1972, the trade deficit increased to $6.9 billion, while during 1973, our balance of trade showed a surplus of only $0.7 billion. Prospects for this year are not encouraging and although a trade deficit is expected there are few estimates of its probable size, because of uncertainties surrounding the nation's soaring oil-import bill. It is extremely important that the DISC provisions be retained to permit expansion in major export markets.

Coupled with the investment tax credit and the Asset Depreciation Range system, DISC helps our unemployment problem. DISC provides an incentive to American businessmen to build up export sales and provide export facilities by using the undistributed DISC income. It prompts American manufacturers to expand in

the United States, rather than abroad, thereby increasing employment opportunities in this country.

DISC can play a major role toward economic recovery. An increase in exports will help lessen the balance-of-payments deficit. Many states have enacted parallel laws for deferment of state income taxes similar to DISC provisions to further encourage exports. It has been reported that some foreign firms are manufacturing in the United States in order to take advantage of DISC provisions. It is still too early for a thorough evaluation of the DISC provisions. Any adverse change in the law at this time casting doubt over DISC's could severely inhibit those businesses who currently use the provisions or those who intend to operate as DISC's in the future.

Western Hemisphere Trade Corporations

It would be inadvisable to eliminate the deduction allowed to Western Hemisphere Trade Corporations as provided for in amendment 1317 proposed by Senator Nelson. A Western Hemisphere Trade Corporation is a domestic corporation which does all of its business in North, Central, or South America, or the West Indies, and has at least 95% of its gross income from sources outside the United States and has at least 90% of its income from the active conduct of a trade or business.

The special treatment afforded these companies is necessary to encourage the use of domestic corporations for operations in the Western Hemisphere. Beginning with the Revenue Act of 1918, which provided for credits for foreign income taxes paid by domestic corporations, there is a long history of special tax treatment for income received by domestic corporations from sources outside the United States. Special treatment for Western Hemisphere Trade Corporations was granted in 1942, to allow United States corporations to compete effectively with foreign local corporations and third-country foreign corporations doing business in the Western Hemisphere.

Today, Western Hemisphere Trade Corporations engage in export activities that provide a positive stimulus to our balance of trade. Domestic International Sales Corporation status is denied to such corporations to preclude a double benefit.

Retention of the existing provisions is necessary in order to continue the established avenues of trade with countries in the Western Hemisphere. It

is essential to our domestic economy and implementation of international policies. Without some special consideration, there could be little incentive to compensate for the special risks attendant upon investment in South America, where political instability creates special hazards such as expropriation of foreign investment.

Foreign Tax Credit - Reduction In Case of Foreign Losses

It would be unwise to adopt amendment 1319 proposed by Senator Nelson which provides in effect that if a United States taxpayer uses the per-country limitation in computing the foreign tax credit and reduces his tax on domestic income by reason of a loss from a foreign country, a portion of the foreign tax credit will be reduced when he subsequently receives income from that country. We are opposed to elimination or fragmentation of either the overall limitation method or the per-country limitation method of computing the foreign tax credit. Both methods must be retained for American business to compete with foreign-owned competition.

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

Since the 1960 Act to amend the Internal Revenue Code, taxpayers have had the option of electing either the per-country or overall limitation. The availability of both an overall and a per-country limitation is basically a recognition of different foreign operating patterns among American taxpayers. In many instances, foreign operations of a United States business will be compartmentalized according to national boundaries and the per-country limitation is therefore more meaningful. In other instances, operations in different foreign countries may be fully integrated with each other, in which case it is the overall income tax burden of the operation which is most significant.

Amendment 1319, by requiring a recapture of losses, would tend to discourage smaller and less economically integrated companies from entering into

foreign ventures in less developed, relatively high-risk countries. These countries present potentially rapidly growing markets of the future. This discouragement would result in yielding a part of these potential markets to companies which are based in countries that encourage such foreign investment.

This limitation on the foreign tax credit would make it more difficult for many companies, especially the smaller and less fully integrated companies, to engage in overseas mineral exploration and development. At a time of increasing awareness of the limitations of the currently producible mineral wealth of the United States, and at a time when the nation is experiencing serious energy shortages, it seems especially unwise to adopt this amendment.

Separate Limitation on Foreign Tax Credit with Respect to Foreign Mineral Income

We believe amendment 1320 proposed by Senator Nelson should be rejected. Amendment 1320 requires the use of a separate per-country limitation in computing the foreign tax credit with respect to income derived from foreign mineral production where the foreign government to which the taxes are paid also holds the rights to, or receives royalties relating to the minerals with respect to which the income is derived, or where the foreign country imposes a higher effective tax rate on mineral income than on other types of income. We believe a separate per-country limitation should not be made mandatory.

Amendment 1320 would discriminate against American companies competing for world mineral resources that are so vital to meet the demands of an energy crisis and assure an adequate supply of minerals for our national defense. The tax laws must recognize that exploration for, and discovery and development of, new mining deposits has continually grown more difficult, more costly and financially more hazardous. To compete with growing demands by foreign countries for minerals, it is essential that the tax laws encourage mining investment to promote and maintain the free-enterprise economy.

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

Conclusion

In conclusion I would like to compliment the Committee for holding these hearings. We urge the rejection of these amendments which would increase the tax burden on United States businesses doing business abroad either directly or indirectly. These proposals also should be given the benefit of extensive public hearings and the careful consideration of this Committee.

The CHAIRMAN. Next we will hear from Mr. Robert McNeill, executive vice president of the Emergency Committee for American Trade.
Mr. McNEILL. Mr. Chairman, it is very late. I shall take about 30

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE PRESIDENT OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

SUPPORT FOR FOREIGN TAX CREDIT AND FOREIGN TAX DEFERRAL PROVISIONS

Mr. McNEILL. Mr. Chairman, it is very late. I shall tabe about 30 seconds and simply say that the group that I represent, the Emergency Committee for American Trade, is supportive of the foreign tax credit and the foreign tax deferral provisions in the Internal Revenue Code. My statement is addressed to those. We hope that they are not changed. We think it would be bad for the country.

And that completes my statement, sir.

The CHAIRMAN. We will print your entire statement in the record at this point, Mr. McNeill, and I will try to see to it that it is considered by the Senate if and when the amendment is offered that would repeal this.

Thank you so much.

Mr. McNEILL. Thank you, sir.

The CHAIRMAN. I am going to recess the hearings at this point and suggest that we resume our hearing at 2:15 this afternoon. That will give us a chance to have a bite to eat and do some other things and be back here at 2:15.

Thank you very much.

[The prepared statement of Mr. McNeill follows:]

STATEMENT BY ROBERT L. McNEILL

ON BEHALF OF THE

EMERGENCY COMMITTEE FOR AMERICAN TRADE

BEFORE THE

COMMITTEE ON FINANCE

HEARING ON TAX REFORM

June 6, 1974

SUMMARY OF ECAT JUNE 6, 1974 TESTIMONY ON THE TAXATION OF FOREIGN SOURCE INCOME BEFORE THE COMMITTEE ON FINANCE

GENERAL

U.S. direct foreign investment contributes substantially to the American economy. Public and private studies clearly demonstrate that the operations of U.S. multinational firms produce net balance of trade surpluses of several billion dollars each year; that overseas investments do not lower but rather raise their U.S. exports and that repatriated profits earned from overseas investments contribute many billions of dollars to the U.S. balance of payments.

ECAT strongly urges the retention of the foreign tax credit and the so-called "tax deferral" provisions of the Internal Revenue Code.

FOREIGN TAX CREDIT

The United States imposes income tax on the world-wide income of its citizens and corporations. To avoid double taxation, the foreign tax credit provides that a tax dollar paid a foreign government offsets a tax dollar owed the U.S. government on the same overseas income. The tax credit further ensures that income earned abroad by U.S. firms shall pay the higher of either the U.S. or the foreign tax rate.

Elimination of the credit system would lead to double taxation and to effective rates of taxation on foreign source income of close to 75% in most of the industrial countries of the world. U.S. firms could not pay such rates and compete with firms of other countries who would be paying the lower national rates of about 50%. There would thus be a substantial economic retrenchment. U.S. companies would be financially poorer. Domestic jobs would suffer.

CURRENT U.S. TAXATION OF FOREIGN SOURCE INCOME

The present system taxes foreign source income when repatriated to the parent firm. Repatriated profits from overseas investments totaled $10.3 billion in 1972. Elimination of the present system -- referred to as "tax deferral" -- would tax overseas earnings in the year earned. This would be so whether the monies were distributed to the U.S. corporate shareholder or not so that U.S. corporate taxpayers could be taxed on profits not received.

"Tax deferral" is meaningful only in those cases where the foreign rate of taxation is less than the 48% U.S. rate. Since most industrial countries have corporate income tax rates close to the U.S. rate, so-called "tax deferral" has economic meaning mainly in regard to profits earned in the developing regions of the world.

Because of the tax withholding system on profit remittances leaving countries, it is unlikely that forcing repatriation of the overseas profits of U.S. subsidiaries would benefit the U.S. Treasury. Forced repatriation would harm the overseas competitiveness of U.S. firms.

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STATEMENT BY ROBERT L. McNEILL ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE BEFORE THE COMMITTEE ON FINANCE HEARING ON TAX REFORM

June 6, 1974

Chairman Long and members of the Committee on Finance, I am Robert L. McNeill, Executive Vice Chairman of the Emergency Committee for American Trade. I am pleased to be here today on behalf of ECAT to testify on the subject of the taxation of foreign source income. The members of ECAT are the heads of 63 large companies with extensive trading and investment activities throughout the world. They believe with me that private foreign investment benefits the American economy and that the trade and investment activities of multinational companies constitute vital contributions to the well-being of the United States and other nations.

I will limit my statement today to: (1) the tax-credit provision whereby taxes paid abroad are credited against the U.S. tax obligation, i.e., a tax dollar paid a foreign government offsets a tax dollar owed the U.S. government on the same foreign income* and (2) the so-called "tax deferral" provision whereby the U.S. tax is not levied until overseas profits have actually been distributed to the United States parent.

Our Chairman, Donald M. Kendall, testified before the House Ways and Means Committee in April of 1973 on both the foreign tax credit and "tax deferral". The remainder of my statement is simply a restatement of Mr. Kendall's remarks.

ECAT strongly urges the retention of these two provisions as features of U.S. tax policy. They are designed to achieve the desirable objectives of avoiding international double taxation and avoiding penalties or benefits on

* It is important to note that the foreign tax credit system does not permit foreign taxes to be credited against U.S. taxes imposed on income derived within the United States. It allows the credit only against income earned abroad.

foreign versus domestic source income.

Tax credit and "deferral" are not peculiar to the United States system of taxing foreign income. So-called "tax deferral" is a universal practice and the tax credit mechanism is nearly so. The few countries that do not utilize the tax credit -- for example, France and the Netherlands -- do not do so since they levy no tax whatsoever on income earned abroad by their nationals. (A credit mechanism, therefore, is for them totally unnecessary.) Thus, the existing United States system of taxing foreign source income is in complete harmony with the practices and rules of all our trading partners.

FOREIGN TAX CREDIT

The tax credit simply ensures that income earned abroad by U.S. firms shall pay the higher of either the U.S. or foreign tax rates. If the latter rate is the same or higher than the U.S. rate, then nothing is owed the U.S. Treasury. If the foreign tax rate is lower, then the U.S. Treasury is owed the difference between the foreign and the U.S. rate of 48%. In this manner double taxation is avoided and the higher of the two tax rates is charged.

Legislation before your Committee would change this to provide that taxes paid foreign governments would be treated as normal business deductions, regardless of the rate of foreign taxation. This would amount to taxing the same foreign source income twice and would lead to effective rates of taxation on such income of about 75% in most of the industrial countries of the world.

To illustrate:

Illustration involving a hypothetical U.S. corporation doing business in Country A

		Under Current Tax Credit Provision
Pre-tax Country A source income		$100
Country A tax (rate of 50%)		50
Pre-credit U.S. tax (rate of 48%)	48	
U.S. foreign tax credit	48	
Net U.S. tax (48-48)		0
Total U.S. and Country A tax (0 + 50)		50

		Under Legislative Provisions That Would Abolish the Tax Credit
Pre-tax Country A source income		$100
Country A tax (rate of 50%)		50
U.S. deduction for Country A tax	50	
Pre-U.S. tax Country A source income (100 - 50)		
Net U.S. tax (rate of 48%)		50
Total U.S. and Country A tax		24
(24 + 50)		74

With foreign profits of American subsidiaries subject to tax rates of about 75%, there undoubtedly would be substantial U.S. business withdrawal from abroad, leaving foreign markets to the enterprises of other nations. The consequences to the U.S. balance of payments and to the economic health of the U.S. economy could be disastrous. This would be so since both U.S. government and private studies clearly demonstrate that the operations of U.S. multinational firms produce net balance of trade surpluses of several billion dollars each year. Their overseas investments do not lower but instead raise their U.S. exports. In addition to their trade surpluses, U.S. multinational firms contribute many billions of additional dollars to the U.S. balance of payments through the repatriation of profits earned from their overseas investments. In

1972 these repatriated profits are estimated by the Department of Commerce to have totalled $10.3 billion. The Commerce Department also estimates that for 1972 there was an outflow of $3.3 billion for direct investment abroad, leaving a net surplus on private direct investment account of $7.0 billion to the U.S. balance of payments. Without these profit remittances and balance of trade surpluses, the U.S. balance of payments would be in terrible shape.

The U.S. economy would further lose since these same firms gain substantial revenues from their overseas operations. To lose all or part of these revenues would hurt their domestic operations. Total revenues would be smaller as would profits and funds for new U.S. investment. Employment would suffer as would the U.S. economy.

IMMEDIATE TAXATION OF FOREIGN INCOME

The second major area of contention concerning taxation of income earned abroad is that of so-called "tax deferral", which would be eliminated by the same tax reform bills. Elimination would mean that a U.S. tax would effectively be levied on all monies earned abroad in the year earned by the subsidiary. This would be so whether the monies were distributed to the U.S. corporate shareholder or not. In other words, U.S. corporate taxpayers could be taxed on profits never received. This would be analogous to requiring individual shareholders of American corporations to pay personal income taxes on that portion of undistributed corporate profits used to retire corporate debt or to invest in plants and equipment.

As a practical matter, "tax deferral" is applicable or meaningful only in those cases where the foreign rate of taxation is less than the 48% U.S. rate. Where the foreign rate is equal to or higher than the U.S. rate, there is no tax payment

due the U.S. Treasury. Where the rates are below the U.S. rate, there is, of course, the obligation to pay the U.S. the difference between the foreign and the U.S. rate.

Most industrial countries have corporate income tax rates close to the U.S. rate. Most less-developed countries have income tax rates lower than those of the U.S. and the other advanced countries. Consequently, tax deferral has economic meaning mainly in regard to profits earned in the developing regions of the world.

Direct investments in the less-developed countries tend to be more risky than in the industrial countries of Europe and Canada. Nearly 75% of U.S. manufacturing investments are located in Europe and Canada where the income tax rates approximate the U.S. level. In addition to greater commercial risks in less-developed countries there are also greater risks of losses from domestic disorder, nationalization, exchange controls, license restrictions and other possible government restrictions. It is precisely because of these risks that such countries set their tax rates at relatively low levels in order to help compensate for such risks.

Elimination of deferral would make it difficult for American-owned companies to compete effectively with European, Japanese, or other foreign-owned firms operating in the lower tax countries. Non-American firms would not be required to pay an immediate tax to their home countries on the difference between the local rate of tax and the higher rate in their home country. Thus, profits of U.S. firms would be taxed at rates higher than their competitors in such countries. The ability of American companies to compete in these

countries would be considerably diminished at a time when there is vigorous competition for the growing markets of the developing nations. From the viewpoint of U.S. competitiveness in the less-developed and other relatively low-tax countries, the deferral elimination would, therefore, be most harmful.

While this might sound somewhat strange, it is unlikely that elimination of deferral would provide significant U.S. tax revenues. This is so for several reasons. One is that the great bulk of U.S. direct investment is in industrial countries with tax rates at or near the U.S. level, as mentioned earlier. In those countries, therefore, not many U.S. tax obligations are being deferred. Another reason is that the countries affected would most likely increase their taxes on profit remittances leaving their borders. Then, the ironic result of the U.S. eliminating deferral would be higher revenues for foreign treasuries and not our own.

Most countries of the world levy, in addition to income and other taxes, a special tax on profits that leave their borders. This is usually referred to as a withholding tax on profit remittances. These "withholding" taxes average 25-30% of the amount being remitted but are held to much lower levels of 5-15% by virtue of bilateral tax treaties with the United States. The U.S. has such treaties with 23 of our trading partners. Such treaties have many purposes but basically they are designed to deal with national taxation measures that could impede the international flow of goods and capital, or artificially attract foreign investment.

Should the U.S. eliminate "tax deferral", it is reasonable to assume that companies would be forced to make dividend remittances to the U.S. parent to provide funds to pay the additional U.S. income tax. Foreign governments

might view this as an extra territorial application of U.S. tax laws to the profits of their corporate nationals -- which foreign subsidiaries of U.S. firms are -- and take retaliatory actions. One such action could be to allow the profit remittance "withholding" tax to snap up from the lower treaty rate levels to the higher non-treaty levels. For those countries with whom we do not have treaties there would be similar incentives to simply raise their withholding rates. The consequence, of course, would be significantly higher withholding tax payments to the foreign government. These, coupled with the foreign government's own income tax rate, could bring the total tax levy up to or near the U.S. 48% rate, depending, of course, on the relative rate structures. Assuming existence of the foreign tax credit, the U.S. could gain but little or nothing whereas the foreign government would have collected more and the American subsidiary would be placed at a serious competitive disadvantage vis-a-vis its Japanese, European and other national competitors, since it would have paid substantially higher taxes and have less cash available for investment and other essential business purposes.

To illustrate:

Assuming the foreign tax credit with a foreign income tax rate of 36% and a statutory "withholding" tax on profit remittances of 30% that is lowered to 15% by a tax treaty with the U.S., and a dividend distribution of $40 from the overseas subsidiary to the U.S. parent, the following two illustrations would pertain:

ILLUSTRATION A
Under Profit Remittance Withholding Tax of 15%

Taxable Income	$100
Tentative U.S. Tax at 48%	48
Credit for foreign income and "withholding" tax at 15% rate ($36 + $6)	(42)
U.S. Tax	6

ILLUSTRATION B
Under Profit Remittance Witholding Tax of 30%

Taxable Income	$100
Tentative U.S. Tax at 48%	48
Credit for foreign income and "withholding" tax at 30% rate ($36 + $12)	(48)
U.S. Tax	0

I believe this kind of eventuality is likely since many governments would do all within their means to see that they were the recipients of any tax payments to be made by their corporate citizens.

Aside from the disadvantageous economic consequences that are likely to flow from deferral elimination, I think it worth observing that it would discriminate against U.S. shareholders of foreign corporations as contrasted with shareholders of domestic corporations rather than remove a preference as some allege. Unlike domestic shareholders, U.S. shareholders of foreign subsidiaries would be taxed on income which they had not realized and which, because of devaluation, expropriations and exchange controls, they may never realize.

Other witnesses before this Committee have and will detail for you the positive benefits of investment overseas by American companies. While I do not want to take the time to recite the conclusions of a major survey

of 74 large U.S. multinational companies that was undertaken and published last year by ECAT, I do request that these conclusions, which are given in the centerfold of the attached brochure, Plain Words, be made an addendum to this statement. As can quickly be seen from the conclusions, the multinational company is a major contributor to the well being of the United States and its economy. I fear that elimination of the tax credit and deferral provisions respecting taxation of foreign income would severely cripple that contribution.

(Whereupon, at 1:20 p.m., the committee recessed, to reconvene at 2:15 p.m. on the same day.)

AFTERNOON SESSION

The CHAIRMAN. This hearing will come to order, please.

We will now hear from the additional independent oil and gas producers who were unable to appear this morning.

STATEMENT OF DAN JONES, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, ACCOMPANIED BY KENNER McCONNELL, PRESIDENT, OHIO OIL & GAS ASSOCIATION; CHARLES FRASER, SENIOR VICE PRESIDENT, FIRST NATIONAL BANK OF MIDLAND, MIDLAND, TEX.; A. W. RUTTER, JR., TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.; GLENN C. FERGUSON, PRESIDENT, INDEPENDENT OIL & GAS PRODUCERS OF CALIFORNIA, LOS ANGELES, CALIF.; LOYD G. WHITLEY, PERMIAN BASIN PETROLEUM ASSOCIATION, MIDLAND, TEX.; DANNY H. CONKLIN, PRESIDENT, PANHANDLE PRODUCERS & ROYALTY OWNERS ASSOCIATION, AMARILLO, TEX.; EDWARD N. LITMAN, INDEPENDENT PETROLEUM ASSOCIATION OF THE MOUNTAIN STATES, DENVER, COLO.; EDWARD E. RUE, ILLINOIS OIL & GAS ASSOCIATION, MOUNT VERNON, ILL.; L. M. YOUNG, WEST CENTRAL TEXAS OIL & GAS ASSOCIATION, ABILENE, TEX.; AND BURT H. MURPHY, NEW MEXICO OIL & GAS ASSOCIATION, SANTA FE, N. MEX.

STATEMENT OF DAN JONES

Mr. JONES. Mr. Chairman, my name is Dan Jones, executive vice president of the Independent Petroleum Association of America. Mr. Miller, because of a prior commitment, had to leave. As you see, we have several additional witnesses. In the interest of time, we would like to submit their statements for the record, and then ask each of the witnesses to make a comment on some portion of the problem here that was not touched upon this morning.

The CHAIRMAN. Thank you very much. We will print in the record each one of these statements by the witnesses, and at the conclusion of their statements we will add the additional statement that they might make at this point, so that the record will have it all. Would you care to designate who should be called on first, Mr. Jones?

Mr. JONES. Mr. Charles Fraser; he is a banker from Midland, Tex. He has a different viewpoint than was covered this morning. I would like to call on him first.

The CHAIRMAN. All right, please proceed sir.

Mr. Fraser.

Mr. FRASER. Thank you, Mr. Chairman.

STATEMENT OF CHARLES D. FRASER

I am Charles D. Fraser, from Midland, Tex.; and I work with the First National Bank of Midland in the capacity of senior vice presi-

dent, loan officer, and petroleum engineer in charge of our oil and gas department. I have worked in the Permian Basin since 1958, and I am a petroleum engineer, having a bachelor and master's degree from the University of Texas.

As Dan suggested, I am going to skip to some of the points I would like to make out of my written testimony.

First of all, the Permian Basin still provides almost one-fourth of this Nation's daily domestic supply of crude oil. And the Permian Basin is located in West Texas and southeastern New Mexico, and is a geologic definition relating to the sedimentary sequence.

INCREASED OIL PRODUCTION IN 1974

Addressing myself to Mr. Mondale's comments, I would like to point out that comparing May of 1974 with May of 1973, the Permian Basin was producing 39,000 barrels a day more than it did last year. We have about 50 to 60 rigs more running this year than we had last year. We are running about 246 or 247 rigs.

Now, we have had an activity explosion. Our bank keeps activity indexes, and for the sake of time we will not try to cover all of these. I would note the airline boards in Midland, Tex., are up 3,000 per month over this time last year, from what we feel to be a good indication of the efforts of the industry. Our business is the oil business.

EFFECTS OF REDUCING DEPLETION ALLOWANCES

Now, we have recognized that for the past 15 years we have had a continuing deterioration in our economy, and most of the reasons for this deterioration have been pointed out. I would like to address the punitive legislation—or as we saw it, punitive—in the 1969 Tax Reform Act, where the depletion allowance was cut, and the carved out and ABC means of raising capital, were eliminated. And I would like to address those from the standpoint that we saw immediately thereafter an increase in the price of oil by about 25 cents a barrel. And also, the value of our loan collateral dropped. I have my percentage figures. But each producer's property value dropped. The royalty owner's property value dropped. Our area definitely suffered immediately after that bill was enacted.

EVALUATION OF A SMALL OIL LOAN

Skipping on over, and in preparation for coming here, I hurriedly extracted from our files an evaluation of a small oil loan made to an individual independent oil man. I looked at the line of credit that earlier this year, about 3 or 4 months ago, we increased to a total loan of $110,000. I made some quick calculations as to the effect of eliminating the depletion allowance total on this one individual. Our bank strives to get its oil loans repaid, or at least turn that loan over every 36 months, and we do this by requiring monthly payments. In this particular case, our loan exceeded our normal guidelines by about 1 year. In other words, we had a 48-month loan, under existing law, compared to what we normally want; we were a little stretched. The effect of eliminating depletion allowance was to increase this loan paid outf rom 4 out to 5½ years.

In addition, we are well aware that our engineering and geological techniques for forecasting future production are, to say the least, imperfect. And therefore, we try to be cautious in our lending, but not in our estimation of what wells or properties will produce.

However, if we were unfortunate enough in this particular loan to have overestimated the customer's production and underestimated his operating costs, say, 3, 4, and 5 years out in the future; and if we suffered a loss of depletion allowance and maybe some other things, we could be into a situation of what we call "work-out loan," considering this man could not borrow any more money.

I also viewed these figures as if a man were coming in today to borrow that $110,000, and whether or not we might lend him that money on this same property.

Considering the fact that we are faced, as bankers, with trying to understand the windfall profits tax, cutting depletion allowance, and other such measures, we have already become more conservative in our lending.

For instance, we do not use a $10-per-barrel price in any loan appraisal. The most we use is about $6; and whatever comes out in the windfall profits tax proposal, we do not feel we would be safe in lending at the $10 price. That is not to say we do not think it is justified; we just do not feel it is prudent banking at this time.

In this customer's account, the effect of eliminating the depletion allowance would have caused us to tell him that we could not lend him any more than $80,000, compared to the $110,000 line of credit he already has. In other words, his ability to borrow has been cut by roughly $30,000, or some 27 percent.

Now, we looked at that as money that has gone out of our economy, and it will not be there. This fellow has promoted no less than five drilling fields a year for the last 7 years, and I know that all of his money goes back in the ground. And from the banker's view, we are faced with terrible uncertainty. We would hope that—well, we would like to point out that this sort of thing mushrooms. You have got 10,000 independents, and if they are all faced with sort of a drop in their borrowing ability, then the whole system is in trouble and, in fact, our bank may well be in trouble.

To more or less summarize, my feelings and the feelings of our board—and by the way, our bank board feels very strongly about this situation, and it is hopeful that we can avoid undue problems in legislation—however, we prefer no legislation and pray for good legislation.

That is about all I have to say.

The CHAIRMAN. Thank you very much.

POSSIBLE EFFECTS OF RETAINING DEPLETION ALLOWANCE FOR SMALL PRODUCERS

Let me ask you, how much would it help matters if we would repeal the depletion allowance, but retain it for producers who have 3,000 barrels per day production or less?

Mr. FRASER. Well, Senator, my view of that is, I think we are addressing ourselves to two questions. For the industry and the country as a whole, I cannot subscribe to such a provision. I think that is wrong. In fact, I have prepared an explanation of depletion allowance that has been kicked around. I believe the theory of depletion is proper. I think the percentage is questionable.

In the sense of your asking, it would be better for my bank and its customers if everybody that had 3,000 barrels a day or less production had depletion, well, yes, it would help us a great deal, because most of my—I have very few customers who have more than 3,000 barrels a day production.

But I am opposed to the idea of eliminating depletion allowance for anyone.

The CHAIRMAN. Thank you very much, sir.

Mr. JONES. Mr. Ken McConnell.

STATEMENT OF KEN McCONNELL

Mr. McCONNELL. Mr. Chairman, I am Ken McConnell, president of the Ohio Oil & Gas Association. Our assocation is made up of hundreds of small independent producing companies, who have several thousand employees, plus hundreds of royalty owners.

TAX PROPOSALS COULD ELIMINATE OHIO AS AN INDEPENDENT PRODUCER

We have already submitted my testimony, which you have, and in the interest of time I would just like to make a few very brief remarks.

I have spelled out in my testimony what our actual percentage depletion was in 1972 and 1973. In 1972, it was 11.8 percent; in 1973, it was 9.81 percent. The purpose of saying this is that even though you get 22 percent, unless you have got some very large wells, you have a limitation of 50 percent of your net; and you do not realize the full 22 percent. You may on a few wells, but a lot of wells you do not get any depletion on.

Second, we in Ohio just feel that the removal of either intangible drilling or the excise tax, which is a very nebulous thing, or the removal of depletion would absolutely remove Ohio as an independent producer, because we need the intangible and the tax incentives in order to stay in business.

Thank you very much.

Mr. JONES. Ed.

STATEMENT OF EDWARD LITMAN

Mr. LITMAN. Senator, my name is Edward Litman. I am executive vice president of the Echo Oil Corp., Casper, Wyo., which is a small public-owned corporation which was formed in 1968. We are engaged solely in exploration and production of oil and gas.

It is also my privilege today to represent the Independent Petroleum Association of Mountain States, headquartered in Denver. Colo. I am on the executive committee and a past vice president of the Rocky Mountain Oil & Gas Association, and a past president of the American Association of Petroleum Landmen.

I want to just touch on a couple of points that I think may have been touched on briefly here today, Senator.

EFFECT OF OIL INDUSTRY ON WYOMING

First, there was some mention made earlier of the impact on our industry of the various States, and I would like to point out, even to those that are not in attendance, that one out of eight people in Wyoming depend on the oil and gas business for their livelihood. The State of Wyoming as a total entity receives approximately 60 percent of its total revenue from the oil and gas industry in the form of taxes and royalties, et cetera.

One incredible myth that I would also like to explode today is the media image that our industry pays no taxes. Our industry is one of

very few that pays State taxes on the basis of gross income. Perhaps the best example is our own small company.

Our oil and gas sales are presently running at the rate of approximately $800,000 per year, primarily in Wyoming and Montana, where the tax rate varies from 8.5 to 14 percent. Our gross production taxes to those two States are presently running at over $84,000 per year. This amounts to more than 10 percent of our gross income from oil and gas revenues. These taxes are also paid during the years of corporate losses.

Another point I would like to make is our company has suffered modest annual corporate losses during the past 4 out of the past 5 years, and only in this current year—partly because of increased product prices and partly due to successful exploration and secondary recovery projects and increase in production actually, we are beginning to show corporate profits.

We, like many others, have continued to play the hand we have been dealt. We have continued to stay fully invested in our industry, including our borrowings and equity financing.

We have touched here several times today on the venture capital for the drilling of wells. I think it is also significant that a great deal of venture capital goes into corporate equity financing, and this needs to be available.

Our company has just under 1,000 shareholders who must, as the commercial goes, be bullish on America, at least to some degree. In any event, not all of their money is in CD's. Corporate investment and venture investment must be designed as a reasonable alternative to CD's in my view. Certificates of deposit do not make products; they do not run cars; they do not heat homes; and they do not make payrolls. CD's, excluding those of the elderly and certain other instances, represent decadence, slothfulness, and laziness, in my view, all of which are contrary to America's work ethic and economic history of the Nation.

I think those are the primary points I would like to leave with you today.

Thank you.

The CHAIRMAN. Thank you very much for your statement.

STATEMENT OF LOYD G. WHITLEY

Mr. WHITLEY. I am Loyd Whitley of Midland, and I am employed by Adobe Oil & Gas Corp. in the capacity of vice president of finance. I am also a director of the corporation, a publicly held company.

PERCENTAGE DEPLETION AND THE INDEPENDENT

The point I would like to make this afternoon is that I took the percentage depletion that was allowed by our small company and tried to apply that to the whole independent force, and see what reduction we would have in exploration as a result of the elimination of percentage depletion.

Adobe's income for the year, 1972 and 1973, would have been reduced by $503,000 and $669,000, if percentage depletion had been eliminated. In other words, our tax bill would have been that much greater. Since our small company does reinvest all of its cash flow, over and above debt service, in the oil business, it would be logical to assume that we would have done that much less drilling if we had had to pay that much more income tax.

The average well costs, over these 2 years, were $178,000 and $142,000 per well produced in the year. On this basis, Adobe would have completed 2.83 less wells in 1972, and 4.7 less wells in 1973, if percentage depletion had not been available.

Since the average independent is approximately one-twelfth the size of Adobe—and I made that computation by taking the so-called majors' production from the total production of the 9,200,000 per day, and came up with approximately 25 percent of the production as attributable to independents, and applying this to the 10,000 independents throughout the United States—and this is assuming there is no reduction in the number of independents—as a result of depletion elimination, this would have the effect of reducing the number of wells drilled by roughly 4,000 per year in the United States.

During 1973, some 28,000 were completed, so, thus, we could expect an approximate reduction of 15 percent as a result. If this logic is correct, we can expect a reduction in drilling of approximately 15 percent.

Thank you.

Reinvesting Cash Flow Back in the Oil Business

The Chairman. Do I understand that it is a practice followed by a lot of other people in the oil industry to invest all their cash flow back in the oil business?

Mr. Whitley. It is in our case, sir. We have publicly made that statement through the years, and we are a growing organization. We went public in 1970, and each year our production was increased. And that has only been accomplished by reinvesting all of our cash flow, plus borrowings. We now have considerable indebtedness for a company our size.

Mr. Fraser. Senator, I am Charles Fraser from First National of Midland, and I would like to comment also on that subject of reinvestment.

My experience—and we are the largest oil bank in the Permian Basin. We are not a big bank compared to Chase, but we are about a $280 or $290 million total assets bank, and have maybe $40 or $50 million in direct oil loans.

The Chairman. How much in oil loans?

Mr. Fraser. Around $40 or $50 million in what we call direct oil loans.

The Chairman. Yes.

Mr. Fraser. Virtually all of our loans end up related to the oil business, but we try and segregate about that much in the oil business directly. Now, that would not include loans to drilling contractors or well-servicing contractors or other people; just oil and gas production loans.

Our experience with these people is that we not only receive their depletion allowance, but also their depreciation; and all of their cash flow will flow on our desks. And we do not find them able to build substantial deposits, CD's, if you will. The cash flow from our customers' business goes to bank debt, and we are continually asked to lend out into the future. And we count on that money to repay this debt, as a generality.

The Chairman. Thank you very much.

Mr. Jones. Mr. Chairman, Mr. McConnell here to my right has a plane he would like to catch; if you do not have any further questions of him, may he be excused?

The CHAIRMAN. Yes. Thank you very much.
Mr. McCONNELL. Thank you very much, sir.
Mr. JONES. Glenn.

STATEMENT OF GLENN FERGUSON

Mr. FERGUSON. My name is Glenn Ferguson. I am an independent oil and gas producer headquartered in Bakersfield, Calif. I am also president of Independent Oil and Gas Producers of California, although I speak here primarily for our own operations.

What affects me, however, will affect the rest of the independent producers in my State.

As I understand it, this printed page will become of record.

The CHAIRMAN. Yes, it will.

Mr. FERGUSON. All right, I will try and just hit the highlights.

The CHAIRMAN. We will print it just exactly as if you read every word of it, and then we will add anything that you put in addition to it.

Mr. FERGUSON. Thank you very much.

PERCENTAGE DEPLETION SHOULD BE INCREASED

On general statement, percentage depletion—a subsidy or a method of recovering capital?

Now, I have a little story here to tell. When I was a boy, my father owned a few beehives. During the spring and summer months, the bees were always busily engaged gathering nectar from the flowers which they then somehow made into honey and stored in their hives. In the fall, my father would always relieve the bees of a good portion of their honey, a sort of tax for providing them their hives. I asked him once, "Why do you leave so much honey; why do you not take it all?" Whereupon he answered, "I am being nice to those bees since they worked so hard for so long. I leave them enough honey to get them through the winter and they will be able to gather more honey next spring and summer."

As I reflect upon that memory, I realize he was subsidizing those bees in accordance with present day political concepts of the word "subsidy." There was a time, of course, when political concepts were somewhat different. I realize there are a number of Congressmen who still have those concepts, and I am sure that you are fully aware of how the depletion allowance came into existence and its relation to recovery of capital; so I will not recite that. However, if this country is ever again to become self-sufficient, a depletion allowance in absolutely essential for domestically produced oil—and the percentages should be increased, not lowered or eliminated.

If you will but stop and reflect for a moment, you will realize that far more oil can be developed for the expended exploration dollar in foreign lands than in the lower 48 States of the United States of America. And I think that is a very important point. In the absence of an added incentive to help balance this differential, the oil industry will simply continue to gravitate to foreign territory—at least the larger independents and the major oil companies.

Now, as has been testified to here earlier, the average independent, of course, does not have the wherewithal to move into foreign territory. Of course, all of the easily found oil in this country, with the exception of offshore oil, has been discovered, while in large areas of

foreign land the surface has hardly been touched. I would like to give you an example that should drive home what I am talking about.

Well, let us take a situation, for example. If we were to place 100,000 needles in each of several haystacks and you were to ask a group of youngsters to sift through the hay in one of the stacks to find those needles, I am certain that the first several thousand would be easily and quickly found. As time wears on, the remaining ones will become more difficult to find and much more time consuming. If in the beginning the children were rewarded a penny for each needle, or if you had larger needles, perhaps you could reward them with a nickel or a dime, their enthusiasm would remain high until the needles became scarce. They would then become disenchanted and would no longer search for the needles unless greater rewards were offered. Otherwise, they would begin to search for a new haystack where they might find the needles more easily. The new haystack would be comparable to foreign territory and the search for oil there.

Now, those youngsters who found the most needles, if there was a charge for searching in the new haystack, would be the only ones that would be able to search in the new haystack. You are either going to have to have some additional incentives, then, to continue the search in the first haystack or the youngsters will all move to the new haystack if they have the money to do so.

Now, instead of offering an additional incentive to look for the remaining needles in the first stack, you decide to take away some of the pennies as they find the needles—you can imagine the result. I cannot help wondering why that imagination cannot be applied to the oil industry. As a geologist, I am fully aware that most of the needles—oil fields if you please—have been found in this haystack of ours, and since I am one of those relegated to continue looking, I am not about to look for additional needles under circumstances less rewarding to me than those that were most easily found. When I speak of rewards, I speak of the amount I have left over for myself after all taxes have been paid.

Now, a great deal has been said about $10 oil. Very little of our oil qualifies for new oil prices—as a matter of fact, only about 5 percent—not in California; I am speaking of my personal oil—most of it is selling for $5.21, all old oil. Incidentally, the average price for old oil in California is about $4.10 per barrel, still well below the cost of replacement under today's higher well costs. Our average price for old oil there is almost $1 a barrel below the average of the rest of the country; and the reason for this, of course, is for the gravity differential in the pricing structure.

The CHAIRMAN. If you will pardon me, I have to go to vote. Those five lights there mean that we have only a few minutes to go vote and get back. But I will come back just as soon as I can, if you gentlemen will just please stay where you are.

Also at this time, I believe I will ask that we put into the record your prepared statements, and then continue with your individual testimony when we return.

Thank you.

[A brief recess was taken.]

The CHAIRMAN. Let us resume this hearing, gentlemen.

Mr. JONES. Shall Mr. Ferguson continue?

The CHAIRMAN. Yes, go ahead.

Mr. FERGUSON. In the interest of time, Senator, I will conclude by saying that if the Congress passes punitive legislation, they will definitely be acting as a tool of major oil companies, particularly if it results in the elimination of a large segment of independent operators. I am convinced that this is what will happen in the long run. And the independents, of course, are the only competitors the majors have in the domestic production scene. The only alternative to selling is simply conserve what we have, conduct no further exploration and simply produce ourselves out of business, using our production as an old-age annuity.

Why in the name of logic should we risk what we now have under circumstances less rewarding to us than they have been while the risk and cost is constantly increasing? And I might ask, what would you do if our positions were reversed.

Thank you for listening.

The CHAIRMAN. Thank you very much, sir.

STATEMENT OF L. M. YOUNG

INCREASED PIPE COSTS FOR STRIPPER OPERATORS

Mr. YOUNG. I am L. M. Young, representing West Central Texas Oil & Gas Association, Abilene, Tex. We have 800 members and I would say that most of us are strippers, stripper operators.

About the only thing I would like to touch on that is not in my printed statement is our added cost of pipe and so forth. We, of course, cannot stockpile the pipe. Very few of us ever use new pipe in the first place, because we are shallow well drillers, 5,000 and up. And this pipe has skyrocketed. It has been going from $4.50 to $6 a foot, compared to new pipe, if it would be delivered to us, at about $2.06, tubing at about 97 cents for new, $3 for used.

So these are some of the costs that really take up the slack of even $10 oil, and they are reaching a proportion of where you cannot even pay these prices and search for $10 oil. So the profit margin is not there right now, and all of our services have done the same, and I think everything else has been touched on pretty well.

Thank you very much.

The CHAIRMAN. Thank you very much.

STATEMENT OF A. W. RUTTER, JR.

Mr. RUTTER. I am A. W. Rutter, Jr. I represent TIPRO, Texas Independent Producers & Royalty Owners Association.

I have a written statement and I would just like to summarize it. I won't take your time reading it.

UNCERTAINTIES OF THE OIL BUSINESS

I am one of the people who should be among the 2,500 who are no longer members of TIPRO because I got to the point of producing 1 million barrels a year in 1956 and 1957, and along about 1959 I got to thinking this maybe wasn't such a good business, and so I sold out. I am virtually not in the oil business any more, but it is still a business I would like to be in.

I have a degree in geology and a degree in economics. I suppose I am a better economist than I am a geologist, but I have always made my living, or up until 1959, in the oil business. Since then I have been in a lot of other businesses. I operate four hotels presently, two

restaurants, two bars. I have served on the board of directors of three life insurance companies. I am the agent for the city of Midland. I am agent for the Schoolchildren's Health Insurance in Midland. I'm in a lot of other businesses, but I would go back in the oil business if I could ever figure out what the oil business is going to be like.

We took back three wells that we can deepen about 1,000 feet, and it costs about $100,000 each to deepen. The reserves are questionable, but I think they would make a profit at $10. I am pretty sure they would not make a profit at $5. Before I deepen those wells, I need to know what the price is going to be.

Reinvesting Cash Flow in the Oil Industry

I would like to comment on your previous question about people putting—the typical independent putting his cash flow all back in. I do not—I must say, I do not know anybody that does not put 100 percent back in, and as Charles Fraser indicated, most of us go to the bank and try to borrow more.

If you are in the oil business, you are in debt. I do not know anybody that is not in debt in the oil business.

I have written at the end of this statement a second——

The Chairman. Frankly, my impression about the average independent oil producer is that when he comes to the end of the road he has to borrow money from some friend in order to get out of the oil business.

Formula for Figuring the Depletion Rate

Mr. Rutter. I have a formula for figuring what the property depletion rate is, and this has come from my background as an economist. The formula is on page 4 of my statement. The depletion rate times the gross selling price of a unit of production should equal the price at which a similar unit of production can be purchased in the ground.

When this formula is in balance, the producer of cubes of X material can replace however many cubes he has produced from his reserves by paying some other producer the amount of depletion claimed.

Or stated another way, a producer should be entitled to end up the year with the same reserves he started with before he has any taxable income.

Now, this applies to sand and it applies to gravel, it applies to every mineral that is an extractive mineral. I do not know anything about a lot of those businesses, but I know enough about the oil business. There is a large number of trades made at arm's length so that there is a going price for reserves in the ground, and I—if the 5 percent, if that is what it is on sand, times the gross selling price, if the gross selling price is a dollar, then a cube of that sand or that much sand should be bought in the ground for a nickel, and if it is not, then we either have the wrong depletion rate, or if the price—the variables, the depletion rate is fixed by Congress, the variable is the fixed selling price, and the price of the reserves.

I do not know much about what reserves would sell for in Saudi Arabia, but I dare say they would probably sell for less in the ground than reserves here, or maybe the depletion rate is too high in Saudi Arabia. I can tell you this, it is too low here because under present conditions, 22 percent times $10 even, the $10, is only $2.20, and reserves are presently selling in the ground for $3 or $4, and that is a much wider spread than normal, but there is much greater uncertainty than normal at the present time.

You can look at what the proper depletion rate is on any mineral by applying that formula.

The CHAIRMAN. I just want to supplement your statement to say this, that if a person is only getting $5.20—

Mr. RUTTER. He is only getting $1.10 maximum.

The CHAIRMAN. Then he would only be getting about $1.10 to find another barrel of oil, and you say that it costs somewhere between $3 and $4 to find another barrel.

Mr. RUTTER. Well, the cost of finding oil is one of the things that purchasers will look at when they decide whether they are going to buy oil. That is one of the ingredients that goes into making up the market price of oil. We know where all the sand is, we know where all the coal is, we know where most all of the vein type of minerals are. No exploration expense; it is strictly production and capital outlay and putting the mine into production.

But there is a going price for coal reserves, you see, and the price is lower because there is no exploration expense, discovery expense. And sand, we know where all the sand is; the whole State of New Hampshire is covered with it.

OIL PRODUCTION INCREASES—BOYLE'S LAW

I am sorry I did not get a chance to answer Senator Mondale's question about why our production has not increased with the increase in price. Gas reservoirs act as under Boyle's Law; they are a perfect gas, if they were not compounded by some problems of liquid expansions.

But he could perhaps understand the problem. He knows if you take an inner tube and you pump it up to 30 or 40 pounds and pull the stem, the air escapes, and that inner tube goes down all the time. But what he possibly does not know is that the rate at which it escapes goes down all the time, and it is a straight line function according to Boyle's Law.

Now, gas reservoirs act in perfection on this. Oil reservoirs act imperfectly, not in a straight line, in a parabola, so that there is no way that you can—when you secondary recover oil reserves, what we do is we stand on the sides of the tube to make the air go out faster. We are repressuring. That is exactly what you do when you stand on the side of that inner tube to make it go out faster.

We have got, let us say, 10,000 inner tubes, each putting out a little, you see. They are all old and depleted. We throw out four or five new ones, or percentagewise a small percentage of new ones, and, sure, they are producing fast, ut they are not going to overcome those thousands of old tires.

I sold some production just recently. We were producing wells that were drilled in 1917, 57 years old, and that is a pretty tired field.

Thank you.

The CHAIRMAN. I have to leave for an appointment in a few minutes, so I wish you would summarize the additional statements, if you would, please.

Thank you very much, sir.

STATEMENT OF DANNY CONKLIN

Mr. CONKLIN. My name is Danny Conklin. I am a partner in Philcon Development Co., located in Amarillo, Tex.

We have heard how unfavorable Federal actions have and can affect our business. The Federal Power Commission, since the Texas Panhandle is primarily a gas province, provides an example. The Federal Power Commission exempted the small producer. In my statement there is a chart which shows active rigs and annual footage which followed that action.

You will note that the Federal Power Commission promulgated the exemption on March 18, 1971, and our activity, of course, came up in 1972 and is continuing in 1973. So we see what favorable-type actions can do. With the independents drilling 88 percent of the wells in our area, we do need depletion.

The CHAIRMAN. Thank you very much.

I will ask that the chart be printed in the record in connection with the statement, as well.

Thank you.

STATEMENT OF EDWARD E. RUE

Mr. RUE. My name is Edward E. Rue. I am an independent geologist and oil producer from Mt. Vernon, Ill.

I have a rather lengthly statement, but I will summarize the summary here in the interest of time.

DECLINE IN NUMBER OF INDEPENDENTS

I think it has been clearly established that the domestic oil business is 85 percent independents, and I do not think anything further needs to be said about that, except that I have some figures that in 1952 there were 35,000 independent companies, and now there are only around 10,000.

And that is an important point, because you have got a hard core of lucky oil finders that can well do the job that needs to be done in this country today, and that is to find and produce more crude oil.

PERCENTAGE DEPLETION AND DOMESTIC EXPLORATION

One of the questions that you asked a while ago was why there were no majors—or why the majors were so sparsely represented in domestic exploration. And I think the single answer to that is that it is not profitable. If you are spending your own money, it is not profitable to be in the exploration business. Most of the independents use outside capital in their ventures to find new oil, and many invest their own funds, as has been reported here today.

Both sources are used because of the percentage depletion allowance. Without it, the risks are not worth taking. Few oil operators like to admit it, but overall that is the whole domestic picture. More money goes into the ground than is ever brought out of the ground.

This is particularly true in oil and gas. The investors know this and try to find a smart, lucky oil operator. The point is, without depletion you will dry up the independent oil operator who is 83.5 percent of the domestic exploration business.

We have talked about the other industries that have depletion allowances. I am amazed that they want to strike out oil, because it is one of the most strategic minerals we have today. If it is profits you are after, look to where the profits are. In any mineral industry the profits are in transportation, processing, and marketing. They are not in exploration.

John D. Rockefeller told his bankers after visiting the Young fields

in Pennsylvania words to this effect: I would not drill those wells with your money. The bigger profits and safer investments are in transportation, refining, and marketing. Exploration overall is a losing proposition.

To be in it, you have to be lucky and you have to have percentage depletion and all of the encouragement you can get. Without all of these, you are dead.

It has already been said how much of a drop has been made in the drilling activities with the decrease in percentage depletion heretofore. I firmly believe that if you even tamper with the oil depletion allowance, you will ruin 75 percent of the domestic exploration business. We can be materially helpful to solving the energy problem. Why kill off this highly seasoned and lucky group of oil finders?

Thank you, sir.

Mr. JONES. Mr. Murphy is our last witness.

STATEMENT OF BURT MURPHY

Mr. MURPHY. I am the anchorman, I guess, Senator Long.

I am Burt Murphy from Roswell, N. Mex., and I am representing not only myself here today but two other independents from southeastern New Mexico.

We will put this into the record. They are letters. So I will just brief them for you. I know you are short of time.

PROFIT PICTURE FOR TWO INDEPENDENTS

The first is Reed & Stephens, who ranked as the 38th company in New Mexico of the 228 oil and gas operators. And they show that on a capital investment, where they started their company 3½ years ago, of $717,000, they returned an average of 7 percent over the last 3½ years. They had a—this has been an erratic return, and a loss of 29.54 percent in 1972, and a gain of 44 percent in 1973. And for the first 5 months of 1974, a 20-percent—I am sorry, a 20-percent gain.

They say that, based on—that they are putting in 44 percent more dollars into exploration than their depletion amounts to. And if the depletion is cut, it would cut their exploration by 61 percent.

The rest of the information is in their statements, which have beeen given to you.

The CHAIRMAN. I was going to ask a question, but go right ahead. I will ask you later.

Mr. MURPHY. The other company is Franklin, Aston & Fair, and they have drilled or participated in 58 wells. Last year they drilled a little over, they say, over 67 miles of holes, 353,000 feet of hole.

Their firm employs 12 people. They operate in 10 States. Their daily production is 1,676 barrels of oil in 1974, and in 1973 it was 1,354, an increase of 322 barrels per day. The gas production is 195 million cubic feet gas per day, an increase of 7,858,000 cubic feet during the 1-year period. They operate 56 wells, and 23 of these are in the stripper area, St. Andrews production and Toddfield, averaging 36 barrels a day for 23 wells, or approximately a barrel and half a day, which was at the economic limit and now is above the economic limit, but would be plugged out if the price would roll back, or probably if the depletion was lost.

They also operate another 6 wells in a different St. Andrews field averaging 27 barrels of oil per day in 1973, down to 17.55 barrels of oil

per day in 1974. Gas production for the same period dropped by 2,805 million cubic feet of gas per day.

They made one major discovery in the last year. And the past year's operations for the corporation found them with exploration and drilling expenses of $885,000 to discover 209 gross barrels of new oil per day and 4,573,000 cubic feet of gas per day.

They feel that the loss of the depletion allowance will materially reduce their activity in the business.

Increased Oil Production in 1974

Before I get into my operations, I think Bob Mead may have submitted this graph to you, which shows the Permian Basin operations. It is a graph against time on the bottom, starting in 1962 and going into May of 1974. It graphs two parameters, the price of oil at the wellhead for new oil, and the exploratory activities of the Permian Basin, which is one of our largest oil and gas basins in the United States.

It shows a steady decline from a little over 300 operations a month to 200 operations a month, bottoming out in 1970, when the price of oil came up from around $2.90 to $3.09, and finally $3.56 in 1970. That flattened the curve but did not bring it up.

Starting in 1973 when the price went up to over $10, around $10.16, operations increased sharply, exploratory operations, from the 200 to 240 operation a month level to almost 500 operations a month.

Talk of Tax Proposals Hurting Oil Production

A very significant thing on the graph is the fact that just the conversation here in Washington concerning the rollback in January dropped our operations by 100 operations a month in February. This was down from around 430 operations a month to about 350 operations a month, just due to the conversation.

Now, I do not know how others reacted out there, but I know I was preparing to order pipe, planning operations for the year, and I just stopped everything during those conversations. And I think that is reflected in this graph.

My operations are very much like these other gentlemen's, and I think everything has been said. I have done the same thing. I raise outside money. Depletion will certainly cut back any funds that I might have available for exploring.

Lack of Capital for Independents

In addition, one of the weak things the independents have traditionally had is a lack of capital dollars, while the major companies have a capital structure that allows them to hold large blocks of acreage and land; so that when we find a field, if we control an eighth to a quarter of it, we are normally very lucky.

Starting about 3 years ago, I started trying to provide capital dollars indirectly to some of my associates that are independents by raising outside capital dollars and buying prospects, acreage and so on, on a basis of, in effect, stockpiling them for 2 or 3 years, then turning to them to recoup my capital and to then take an override or carried interest or what have you.

Now, in essence, this is a tax-watch on these dollars. They are hard dollars; they are not expense dollars. You put them in, you get them out. There are no tax consequences. The only thing that is attractive to anyone that puts that kind of money into the independent scheme is the depletion allowance. These dollars will certainly dry up, certainly be reduced if depletion is reduced.

My educational background is as a petroleum engineer. I worked for the majors in the late 1940's and large independents in the early 1950's and became an independent in 1957. I went out of business once because things were so bad. I went in and built a water company up.

The CHAIRMAN. You went into what?

Mr. MURPHY. A water company, water pipeline company, in New Mexico, to supply water to water flood projects. We built a couple of hundred miles of pipelines and that type of thing.

In the late 1960's I almost went out of business again because of the general condition of the oil business and went into some other water projects but did stay in.

I think the country needs the independent action. I think we need all of the incentives we get. Thank you very much.

The CHAIRMAN. Thank you very much, gentlemen.

Senator Fannin might want to ask a question.

I appreciate the fine testimony you have given us here today.

Senator FANNIN. Thank you, Mr. Chairman.

RATE OF RETURN ON EQUITY FOR INDEPENDENTS

The CHAIRMAN. Oh, let me ask one quick question before I leave.

I just want to ask this: Can you give me some idea as to what the rate of return on equity is on any basis whatever, a cross-sample of your members or of those that you invited to come here, or of those who have been members of your association the longest, on just any basis at all?

Mr. JONES. Senator, we will undertake to do that. That is a difficult matter to do, because most independents do not issue annual reports. But I think we can come up with some guidelines on that.

Mr. RUTTER. I think the answer to that is there is probably no meaningful statistic, because a guy who is very lucky will have, in one year, let us say, will have a very high return, and he may have several very lean years. Even the major oil companies have this problem.

The CHAIRMAN. I know that. But if you can give us anything to go by, it would be helpful.

Mr. MURPHY. Well, you have the one figure on Reed and Stephens. Their return average over three and a half years has been a little over 7 percent on the capital investment. They had one year when they were 29 percent in the hole and one year when they were 44 percent in the black.

The CHAIRMAN. Thank you very much.

[The following information was subsequently received for the the record:]

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
Washington, D.C., June 12, 1974.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: During the hearing last Thursday, June 6, 1974, you inquired on page 280 of transcript, if we could provide information on the rate of return on equity of independent producers. Most independent producers do not

prepare annual reports and therefore we do not have access to information with which to provide you with documented information showing the rate of return on equity. As a matter of fact, most independents, in order to stay in business, must reinvest what might otherwise be profits and in addition must often go into debt so as to maintain an ongoing operation that is not self-liquidating. In other words, profits are deferred on the hope that if their exploratory efforts are successful they will be able to build up reserves of oil or natural gas that will provide a return in the future.

A recent survey of members of the Association shows that independents do not enjoy large profits, through depletion or otherwise, and usually drill themselves into a loss position. If depletion were eliminated, the survey also shows that there would be a substantial reduction in funds available for drilling. A summary of the survey is set forth in the enclosed letter dated June 6, 1974, from the President of our Association to Secretary Simon.

A recent study of the First National City Bank of New York does provide an indication as to the overall profitability of domestic operations. This is an analysis of the profits of the seven largest international oil companies. It is summarized in the enclosed table. You will note that these seven companies, comparing 1973 with 1972, realized an increase in profits on foreign operations of 136.8 percent but on U.S. operations only 6.4 percent.

In a recent report, the Gulf Oil Corporation showed that in the first quarter of 1974 it realized an increase in profits of 76 percent above the 1973 first quarter but that domestic operations actually declined 4 percent.

In considering the profitability of independent producers it is important to recognize that the international and integrated companies have downstream operations such as refining and marketing through which they have additional opportunity for the generation of profits. In contrast the independent producer has a single source for the generation of profits, namely, the sale of crude oil and natural gas at the wellhead.

Very truly yours,

L. DAN JONES.

Enclosure.

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA,
Washington, D.C., June 6, 1974.

Hon. WILLIAM E. SIMON,
Secretary of the Treasury,
Washington, D.C.

DEAR MR. SECRETARY:

SURVEY RELATING TO IMPACT OF ELIMINATION OF PERCENTAGE DEPLETION DEDUCTION FOR INDEPENDENT OIL AND GAS PRODUCERS

The Independent Petroleum Association of America ("IPAA") is a national trade association with some 4,000 members engaged in the exploration, development and production of oil and gas in all producing areas of the United States.

The purpose of this letter is to summarize certain statistical data relating to the percentage depletion deduction gathered from a confidential sample of the members of the IPAA. The data summarized below represents information taken directly from the latest tax returns filed by 30 non-corporate taxpayers and 93 corporate taxpayers. The taxpayers included in the sample had gross income from oil and gas properties (including income from both operating and nonoperating interests) for the particular taxable year included in the survey varying from $17,114 to $60,669,657. The data was accumulated by IPAA from September 1973, to February 1974, therefore, in most cases, the data is for calendar year 1972 or for fiscal years ending early in 1973 or during 1972.

The information secured from the sample may be sumarized as follows:

Gross income from oil and gas operations (including income from both operating and nonoperating interests)	$625, 460, 367
Percentage depletion in excess of cost depletion	90, 817, 686
Cost depletion	28, 074, 697
Intangible drilling and development costs ("IDC") (excluding dry hole costs)	126, 061, 626
Dry hole costs	76, 939, 394
Cancelled and surrendered leases	41, 221, 977
Depreciation on lease and well equipment	52, 345, 328
Taxable loss per returns as filed	(84, 569, 999)

It is a common misconception that oil and gas operators drill only to the extent that they reduce their taxable income to the amount of their percentage depletion deduction and that the percentage depletion deduction eliminates the balance of their taxable income. The above survey clearly refutes such a suggestion since the 123 taxpayers in the survey drilled themselves into a loss of ($84,569,-999). In other words, they drilled up all but approximately $6,000,000 of their percentage depletion deduction.

The cash flow of the 123 taxpayers comprising the above sample may be estimated as follows:

Taxable loss per returns as filed above	$(84, 569, 999)
Add noncash deductions[1]:	
Percentage depletion in excess of cost depletion	90, 817, 686
Cost depletion	28, 074, 697
Cancelled and surrendered leases	41, 221, 977
Depreciation on lease and well equipment	52, 354, 328
Estimated cash flow	127, 889, 689

[1] Does not consider depreciation on assets other than lease and well equipment or other noncash deductions, since such deductions are not identifiable from available data.

If the $90,817,686 percentage depletion deduction were eliminated, the estimated cash flow would be reduced by Federal income tax of approximately $45,408,843 computed as follows (assuming that (1) a 50 percent Federal income tax rate applies and (2) the $(84,569,999) loss could have been otherwise used as a net operating loss carryback or carryforward to offset taxable income in prior or future taxable years):

Percentage depletion in excess of cost depletion cost	$90, 817, 686
Assumer tax rate: 50 percent.	
Approximate Federal income tax cost resulting from elimination of percentage depletion	45, 408, 843

Hence, cash flow would be reduced to $82,480,846 ($127,889,689—$45,408,843).

Since the purpose of percentage depletion is to allow an oil and gas operator to generate capital in the form of pre-tax dollars to replace his depleting assets (i.e., oil and/or gas reserves and related equipment); one might initially conclude that the sole impact of elimination of percentage depletion for the taxpayers in the sample would be to eliminate the availability of $45,408,843 of capital for (1) investment in capital expenditures (i.e., additional leases, geological and geophysical costs, and equipment), (2) repayment of debt, or (3) payment of dividends. Such a conclusion alone is disastrous in view of the current domestic energy shortage. However, further analysis demonstrates an even more devastating result.

It is estimated that at the present time at least 50 percent of the total cost of each new well is equipment cost (i.e., nondeductible capital cost) and the balance of such total cost is IDC. The foregoing ratios do not take into account additional capital costs for leasehold acquisition and geological and geophysical costs since such costs may vary substantially from property to property. Assuming that equipment, on the average, represents 50 percent of the cost of a successful well and that IDC represents 50 percent of such cost, the taxpayers in the above sample required capital of approximately $126,061,626 to equip the new wells discovered by the expenditure of $126,061,626 of IDC. Hence, virtually all of the estimated cash flow would be required for equipment on new wells. If only $82,480,846 of cash flow, rather than $127,889,689 were available, no internally generated funds would remain after equipping the new wells for (1) acquisition of new leases, (2) geological and geophysical costs, (3) equipment other than lease and well equipment, (4) repayment of debt, or (5) payment of dividends. In fact, substantial borrowing or reduction in drilling would be required merely to equip the new wells.

If $45,408,843 is required for Federal income tax because of elimination of percentage depletion, the above taxpayers would have no alternatives for raising the needed capital other than by additional borrowings or by reducing funds ex-

pended for drilling wells. Most oil and gas producers would be reluctant to borrow substantial sums for drilling (assuming financing were available which it normally would not be for exploratory drilling). Hence, the only logical alternative for most oil and gas operators would be to curtail drilling, pay tax on the funds available because of reduced drilling, and use the net funds for other capital expenditures in their oil and gas business or make alternative investments outside the oil and gas industry.

It is clear that elimination (or even a reduction) of percentage depletion would have a dramatic impact on the level of domestic drilling. That a reduction of percentage depletion has a direct impact on the level of domestic drilling is illustrated by the following table which compares the number of wells completed through 1969 with the number of wells completed since 1969:

Year:[2]	*Total domestic well completions*[2]
1966	37,881
1967	33,818
1968	32,914
1969	34,053
1970	29,467
1971	27,300
1972	28,755
1973	27,375

[2] Source: 1974 United States Petroleum Statistics, published by the Independent Petroleum Association of America.

The reduction of the rate of percentage depletion from 27.5 percent to 22 percent became effective for taxable years beginning after October 9, 1969, by virtue of Section 501(a) of Public Law 91-172. The effective date of the reduction of the percentage depletion rate ties directly to an approximate 14 percent decrease in the total number of wells completed in 1970 as compared to 1969. Slight decreases have continued since that time. Certainly, an elimination of percentage depletion (or even a further reduction thereof) would cause a substantially more dramatic decrease in number of wells completed.

Independent oil and gas operators drilled 82.5 percent of all oil and gas wells drilled in the United States in calendar year 1972. Since the percentage depletion allowance has been a major factor in generating the capital which independent oil and gas operators have used to drill in the past, any reduction of the availability of such capital will necessarily reduce their drilling activity. If, in fact, it is in the nation's interest for independent oil and gas operators to increase their drilling activity, a return of the rate of percentage depletion to 27.5 percent should provide substantial incentive for increased drilling.

We trust that the foregoing demonstrates the need for continuance of percentage depletion at least at the present level Should you have any additional questions or require any additional information, please contact us.

Very truly yours,

C. JOHN MILLER.

Senator FANNIN (presiding). Thank you, Mr. Chairman.

You may respond.

Mr. WHITLEY. I would like to give my company's experience. Our average is up to 15 percent for 1973 and 1972 return on equity capital.

Senator FANNIN. I realize this is a very difficult problem, because others can tell about how much money you are making, whether you know it or not, and it is very hard for us to not be able to present factual information. That is why we are so appreciative of your being here today.

Mr. RUE. Sir, my name is Edward E. Rue from Mount Vernon, Ill. Many of my friends in the independent ranks of the oil exploration business simply do their business out of a checkbook, and when that

money is gone, they are out of business. And any figures that you got today would reflect those 10,000 people that are left in this business, and it should be a significant part of it. To add those many people that are out of business now, that would bring our figures, I am sure, way down below and prove the point that there is no real profit in the overall exploration business in this country today for any kind of mineral.

Senator FANNIN. Well, of course, we are very hopeful that there will be a profit, that it will be beneficial for you to have greater exploration, because, after all, you in the petroleum business are in the best position to solve the energy problems we have facing us for the next few years. Because, as you know, when we are depending upon petroleum products for 75 percent, or approximately 75 percent, of our energy requirements, then we are dependent upon you in the petroleum industry for that assistance.

I regret very much that I was not here to hear the full testimony. I have talked to many of you, and I have heard you before, previously, on this subject.

I certainly commend you for what you are doing, and I know the great effort you are making. And I sympathize with you for not knowing what is going to happen as far as legislation is concerned.

Now, I hope we can settle down and arrive at legislation that will be an encentive for you to go forward rather than to be detrimental to your activities.

I imagine you have covered most of the questions I might ask of you. I know you have been here quite a while. I did have another assignment and could not be with you.

I just want to express the appreciation of the committee for your testimony and for your help in getting factual information by which we can make decisions, by which the Congress can make decisions. I certainly realize the problems you have, and it is very difficult with the inflationary trends that have been going forward in the recent months, and the shortage of materials, that it is difficult to stay above board. The number of independents that have gone out of the business, as you stated, reflects the problems that you have had.

So I hope that we can arrive at legislation that is fair and equitable, both to the consumer and to you gentlemen—the ones that are exploring for this product and that would be, in many instances, the producers we are depending upon.

I do not know if there is anything further that you have to say or not. If you do have any further information, the record will be held open, because we will be holding additional hearings.

But I do again express the appreciation of the committee and my personal appreciation to you for being here today.

Mr. JONES. Thank you, Senator Fannin.

Senator FANNIN. The committee will now stand in recess until Monday, when the hearings will be resumed.

[The prepared statements of Messrs. Fraser, McConnell, Litman, Whitley, Ferguson, Rue, Young, Rutter, and Conklin, and material supplied for the record follow:]

Statement of Charles D. Fraser
Senior Vice President
The First National Bank, of Midland, Texas
Before the Finance Committee
United States Senate
Washington, D. C.
June 6, 1974

I am Charles D. Fraser from Midland, Texas. I am employed by The First National Bank of Midland in the capacities of Senior Vice President, Loan Officer, and Petroleum Engineer in charge of our Oil and Gas Department. My experience in the oil industry began upon graduation from the University of Texas in June 1958. I hold Bachelor and Master of Science degrees in Petroleum Engineering. For seven years, I worked for a major oil corporation. I was a petroleum consultant for two years and have been in banking for seven years. I serve on the Executive Committee of the Permian Basin Petroleum Association (PBPA). Today, I will testify on behalf of PBPA and on behalf of our bank.

The Permian Basin

Midland, Texas, is the focal community for oil and gas activities in the geologic province known as The Permian Basin of West Texas and New Mexico. Beginning in about 1958, our local economy, which is the oil and gas business, deteriorated rapidly because of:

1. Unrealistically low crude oil prices caused by cheap (?) foreign sources.
2. Ridiculously low wellhead gas prices dictated by the Federal Power Commission.
3. Diversion of major company capital to more lucrative foreign prospects.

4. Punitive legislation epitomized by the Tax Reform Act of 1969 which:
   a. Reduced statutory depletion from a maximum of 27.5% to an arbitrarily lower level of 22% of gross income.
   b. Eliminated the carved-out and ABC production payment methods of generating badly needed investment capital.

Today, The Permian Basin still provides almost one-fourth of this Nation's daily, domestic, supply of crude oil and lease condensate. Reference to API figures reported in the Oil and Gas Journal of June 3, 1974, will reveal the following:

Production of Crude Oil and Condensate

	Permian Basin*	Total United States
5-24-74	2,132,000 Bbl/day	8,978,000 Bbl/day
5-25-73	2,093,000 Bbl/day	9,372,000 Bbl/day
Change--	UP 39,000 Bbl/day	DOWN 394,000 Bbl/day

The very existence of a viable oil industry in this region, today, results from incentives contained in existing tax laws plus the stubborn efforts of oil operators. These laws provided the incentive for flow of investor capital into the area when the major companies diverted the majority of their capital to foreign endeavors. The independent in The Permian Basin has sustained a level of activity by virtue of his ability to raise this investor capital, generate oil income, retain that oil income for reinvestment, or retain that income for dedication to the repayment of his sizeable borrowings for development activities. Contrary to the statements of some

*Texas Railroad Commission District 7-C and 8 plus Southeast New Mexico

Congressmen that existing incentives have not been successful in stimulating domestic development, any knowledgeable student of The Permian Basin industry knows that only because of these incentives are we now able to muster some 240 active drilling rigs, the necessary service organizations to support the accelerating activity emphasized by our shortage of petroleum products, qualified personnel, and the capital to finance this business. For fifteen years at least, The Permian Basin has been depressed by unrealistically low domestic oil prices caused by cheap (?) foreign sources. Existing tax laws have helped keep us alive, and we are now involved in our activity explosion.

Unfortunately, it appears that punitive legislation apparently directed at the major oil companies but potentially much more adverse to the independent could, if enacted, bring this explosion to a halt and result in the demise of the independent operator. Specifically, we are here today to fight against unwarranted attacks on our part of the free enterprise system and efforts to cripple our industry by elimination of the much maligned depletion allowance.

The Depletion Allowance

The concept of permitting recovery of capital from depleting assets before imposition of taxes, commonly referred to as the depletion allowance, will go down in history as being criticized by many and understood by few. I am totally dedicated to the defense of this concept and its preservation in our tax laws both for the benefit of the domestic oil industry and for the Nation as a whole. My arguments will be both practical and philosophical.

From the practical view, our Nation must dedicate itself to minimizing its dependence on foreign sources of energy; therefore, I believe in Project Independence! Suppose, as advocated by many well intentioned but hopefully misinformed

people, the depletion allowance on domestic crude oil was eliminated effective January 1, 1974. What would happen? The answers are simple: capital is taken out of the domestic industry, the domestic independent is crucified, and I have some greatly over-extended loans. Punitive legislation is contradictory to the goal of maximizing our self-sufficiency.

To demonstrate the practical effect of eliminating the statutory depletion allowance, I have made a simplified analysis of one oil loan account handled by my department. A customer increased his bank debt to about $110,000.00 earlier this year. The loan is secured by a mortgage on his interests in twenty different oil and gas properties. This man is the epitome of a small, domestic independent oil operator; however, during each of the seven years I have handled his banking, this man has initiated no less than five new drilling ventures each year. He has contributed to the domestic energy supply and he has helped maintain a viable industry in The Permian Basin.

Now, consider the effect of elimination of percentage depletion on this man and on our bank. We strive for a 36-month payout on oil loans and normally require monthly repayment ~~from oil~~ and gas sales. Crude oil purchasers make payment to the bank for the customer's account; we apply 70% to 85% of the money to the man's note; and the difference is deposited in his account for use in paying operating costs and local taxes. The percentage split varies from loan to loan, but the procedure is standard.

I have calculated the approximate effect of losing percentage depletion on this loan. Details of the calculation are available. First, under existing prices and tax law, forecast loan payout is four years. We have already exceeded our guideline

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by one year. Elimination of depletion allowance extends payment to five and one-half years.

Stated differently, we have already exceeded our desired loan by $16,000. Eliminating depletion will increase the overage to about $30,000. We have now been forced from rating this as a reasonable loan to reclassification as an over-extended credit. Let me assure you that our examiners will agree with this conclusion. It is imperative to note that geological and engineering techniques for predicting future levels of oil and gas production are much less than precise. Contrary to popular belief, our bank does not bias its engineering predictions under the guise of conservatism. We take care of analytical risk by using conservative guidelines such as a three-year loan payout. Suppose that, in this case, we sustain unanticipated punitive legislation, have underestimated future operating costs, and have overestimated the customer's future oil and gas production. If this combination occurs, a reasonable loan will become very sick.

Suppose the customer was applying for his loan, today. Would pending Congressional action influence our lending decision? Considering threatened price rollbacks, excise or "windfall profits" taxes on oil, threats to the depletion allowance and expensing of intangible drilling costs for tax purposes, etc., our bank has already taken a much more conservative approach to oil loans than we have in the past. Today, I estimate that we would only lend $80,000 against a $110,000 request on this customer's properties; thus, his borrowing capacity has dropped by $30,000 or about 27%. This would, in turn, take $30,000 out of our local exploration and development effort.

We have been duscussing one small independent and a man who does not fall in the high end of the Federal Income Tax scale. Multiply this man's situation by 10,000 independents, consider the exponentially more severe impact on a higher "bracket" taxpayer, and recognize the compound effect of taking depletion money out of the industry each year for the next ten. How could elimination of the depletion allowance be compatible with project independence?

Addressing the problem from a different view, many speakers on the subject of tax treatment for the domestic oil industry argue that the depletion allowance ends up in the hip pocket of the oil producer and that each oil producer gears his activities to take maximum advantage of the tax law for personal gain. Based upon experience with many oil producers of all sizes, the general utilization of depletion allowance has been for the repayment of bank indebtedness rather than for the purchase of Certificates of Deposit, race horses, yachts, etc. The oil operator cannot gear his activities solely to the tax equation because many other constraints are imposed. It is very common for the oil operator to grant a continuous development clause as part of the consideration for an oil and gas lease. It is also a well known precept of oil and gas law that an operator must either meet the development activities of his competitor on adjoining properties to prevent drainage of oil from his lease or give the lease up. These two constraints alone result in the operator being forced to make investments at a rate which cannot be sustained out of internally generated funds; therefore, the oil man traditionally stretches his bank credit to the limit and commits himself to a repayment schedule which includes not only depletion but also depreciation allowances. Any reduction in these allowances will merely inhibit his ability to repay debt and therefore limit his availability of capital.

Now for the philosophy. I refer you to the Washington Post of April 29, 1974. On page A-3, an interview with the Shah of Iran is quoted. Asked if the price of foreign oil will go up even after the embargo is lifted, the Shah states:

> "Why not? The Europeans buy oil--we buy other things from Europe, and from you. The prices of the things we must buy are going up, always up....Do you know that for one ton of wheat you can buy four tons of oil? Every year the United States can sow and produce new crops of wheat. EVERY YEAR OUR RESERVES OF OIL ARE DEPLETED BY THE AMOUNT OF OIL WE EXPORTED. WE CANNOT GROW NEW OIL."

I consider the Shah's analysis to be an excellent explanation of the need for percentage depletion.

The entire concept of depletion allowances for income from depleting assets is to permit re-stocking of the inventory net of taxation. As the cost of replacing a barrel of crude oil goes up, the tax free allowance permitted a producer should go up rather than down.

Conclusion

Neither our bank nor the domestic independent oil producer can possibly continue to function effectively without making an immediate estimate of the probable constraints to be applied to the domestic oil industry by the Congress. Even before final actions are known, we must make pragmatic business decisions based on what the ground rules are and what they may be. We dedicate ourselves to the depiction of misunderstandings in these areas, hoping to prevent errors in legislation which might ultimately work to the grave detriment of the consuming public. We must be able to make an estimate of the probable rules of the game if we are to avoid potentially disastrous loans and investments, continue to support accelerating oil activities in our area, and ultimately make a maximum contribution to the goal of placing

new volumes of oil and gas into the domestic market place at minimum cost. We trust in your judgment each day by making investment decisions which will be disastrous if you inadvertently legislate profit out of the oil business.

I represent the largest oil bank in the Permian Basin. Our customers range from major oil corporations through every known phase of the business. Our loan volume and the bulk of our deposits are, in the main, generated by the independent oil and gas operator and those who are engaged in supporting activities both for major companies and independents. We have long recognized and tried to encourage the vitally needed contributions of the major oil corporations to the economy of our area. We hope for their continued participation in the ultimate development of the Permian Basin Area. In no way are we trying to divide the industry; however, my efforts as expressed herein are directed principally to the independent sector of the business.

The independent oil man and his investors have traditionally been willing to push the profit indicators on a given prospect to thinner margins than has the major company counterpart. This is not fundamentally wrong, but, as a result, the independent operator has ended up with a large percentage of marginal properties. Fortunately, his willingness to stretch the profit indicators has also resulted in discovery of unexpected but substantial reserves of oil in the less obvious types of reservoirs such as stratigraphic traps. The oil game is played and oil is discovered by drilling holes. No one can play on paper, and the most eminent scientists, economists, and forecasters have been proven wrong again and again by THE OIL MAN.

Our arguments are a plea for his preservation and the ultimate good of our nation. We urge you to recognize that the independent is much more vulnerable to adverse legislation or regulation than his multi-national, integrated competitors. Please consider our argument, objectively. We prefer no legislation while praying for good legislation if legislation is inevitable.

Testimony

by

KENNER McCONNELL

President of the

OHIO OIL AND GAS ASSOCIATION

Before the
SENATE FINANCE COMMITTEE

June 6, 1974

Mr. Chairman, Members of the Senate Finance Committee

I am Kenner McConnell, President of the Ohio Oil and Gas Association. Our Association is made up of hundreds of small independent producing companies, who have several thousand employees plus hundreds of royalty owners.

I am also Executive Secretary and Treasurer of Clinton Oil Company, a small Ohio independent oil and gas developer and producer. We have been actively drilling and producing crude oil and natural gas in Ohio for the past 28 years.

In discussion with our membership we are very concerned, and indeed alarmed, that this legislation would remove depletion.

In 1973, our company had a gross income of $379,600.00 and we were allowed a percentage depletion of $44,890.00 or 11.82 percent. In 1972 on a gross sale of $420,172.00 we received $41,216.00 or 9.81 percent. Clinton Oil drilled 24 wells in 1972 and 20 in 1973 and we invested $340,000 in 1972 and $240,000 in 1973. To my knowledge, the Ohio producer would average somewhere between 9 and 13 percent depletion. So you can see we do not get 22 percent depletion.

What would happen to the Ohio oil and gas industry if depletion were eliminated? -

The results to Ohio would be:

1. Loss of incentive
2. Oil would not attract investors
3. Drain away capital from exploration to taxes
4. Tax land royalty - heavy
5. Slow down development
6. Reduce funds available to rework wells
7. Reduce investment

8. Reduction in employees

9. Lower profits

10. Remove or reduce money available to repay bank capital loans

11. Remove competition

Ohio has approximately 25,000 wells - 10,000 are gas wells, 15,000 are oil wells. The oil wells are of the "stripper" type, and 98 percent must be pumped to produce, the average per day production is approximately 1.5 barrels. This is a daily average of 25,568 barrels or 9,332,000 barrels of oil per year. My point in reciting these statistics is to show the accumulative value of small wells - yet this is vital in order to help supply this country's petroleum requirements.

Ohio is a marginal state in regards to large oil and gas reserves, however, when all of these small wells are added together we do help to heat and fuel. Without our gas contribution last winter and our oil during the Middle East embargo, more homes would have been without heat and many industries in Ohio would have been forced to shut their operations down.

During the first quarter of 1974, Ohio ranked fourth in the U. S. in the number of wells drilled and fifth in the total footage drilled. All of these wells were drilled by small independent producers. There is not one major producer actively drilling in Ohio.

The elimination of depletion could possibly remove the small independent producer from the oil and gas industry in Ohio and possibly elsewhere.

It will drain badly needed investment capital away from the oil industry and will certainly not entice outside, or venture, capital in.

We feel that capital investments are vital to our industry - stimulation of consumption without encouragement of investment will lead to loss of job opportunities not to mention the loss of domestic crude oil products.

Profits and retained earnings are a must if we are to encourage the oil industry. Profits are a must if we are to be able to invest.

Every cost incurred in drilling and equipping an oil and/or gas well has increased between 65 percent to 80 percent in the last two years. True we now receive more per barrel and per Mcf. If the cost continues increasing, our source capital is taxed away and incentive removed, the price received for our products will of necessity increase substantially.

Who will pay the ultimate price for elimination of depletion? The purchasing public - for depletion has been a subsidy to the public and has helped to spur development by operators.

We have a very real and serious shortage of oil and natural gas. We cannot be lulled to sleep because foreign oil can be imported. We are now 36 percent dependent on foreign crude oil and any action taken by the Congress of the United States to ask this Nation to become more dependent would weaken this country and I cannot understand this position.

Whatever happened to the idea that Government could assist and industry, are we not dependent on each other? We need either more incentive by increasing depletion or eliminate the 50 percent limitations to spur the energy producers.

Any action to shut an industry down, is not telling the people of this Nation the real hard facts. We cannot afford tunnel vision - I firmly believe that a healthy oil and gas industry needs depletion - needs incentive - needs governmental action to increase not decrease development.

Mr. Chairman, members of this Committee, I thank you for allowing me to appear here. If you have questions, I will be happy to answer them to the best of my ability.

ECHO OIL CORPORATION

P. O. BOX 2038 CASPER, WYOMING 82601 PHONE 307 234-6995

Senator Russell B. Long, Chairman
Senate Finance Committee

Testimony of Edward N. Litman
before the Senate Finance
Committee June 6, 1974

My name is Edward N. Litman - Executive Vice-President of ECHO Oil Corporation - Casper, Wyoming, which is a small Public owned corporation formed in 1968, engaged solely in Exploration and Production of Oil and Gas. It is also my privilege to represent today the Independent Petroleum Association of Mountain States. I am on the Executive Committee and a past Vice-President of the Rocky Mountain Oil and Gas Association and a past President of the American Association of Petroleum Landmen.

In the foregoing capacities, I strongly urge retention of the historical concept surrounding the depletion allowance at or above the current level. In the past five years, our company has been involved, directly or indirectly, in the drilling of 108 wells, 73% of which were dry and only approximately 10% of which really made any money. At the present time, the bulk of our exploration operations are carried on as Operator and Manager of a Joint Venture involving the participation of two Oil and Gas Companies and four Independent Oil Operators not otherwise operating in the Rocky Mountain States. Their investment and our investment depends exclusively on internally generated funds from Oil and Gas operations. Any Legislative tax changes, which would reduce the internally generated funds

of our company and our Joint Venture Partners (such as reducing the depletion allowance) would correspondingly reduce our individual and Joint capacity to carry on our Exploration Program, currently approaching $2,000,000 annually, which, albeit modest, is a vital part of our National resolve toward energy independence. Speaking as a citizen, it is totally abhorent to me that our Nation's Legislative Leaders, somehow appear to be having trouble scratching up the fortitude to maintain our position of pre-eminence in the world and seem more inclined toward abdicating our energy leadership. I take no pleasure in being minipulated as a monkey on a string by those foreign powers to whom we have gradually given this privilege.

One incredible myth I would like very much to explode today is the media image that our industry pays no taxes. Our industry is one of very few that pays state taxes on on the basis of gross income. Perhaps the best example is our own small company. Gentlemen, our oil and gas sales are presently running at the rate of approximately $800,000 per year, primarily in Wyoming and Montana. Our gross production taxes to those two states are presently running at over $84,000 per year. This amounts to more than 10% of our <u>gross income</u> from oil and gas sales. Those taxes were also being paid during years of corporate losses. It is far past the time that various taxing authorities should perhaps indulge in a little collusion as to just how they might want to cut us up, otherwise their separate zeal may well kill each other's goose.

Our company has suffered modest annual corporate losses during the past four years and only in this current year, partly because of increased

product prices and partly due to successful Exploration and Secondary Recovery Projects, are we beginning to show Corporate Profits. We, like many others, have continued to play the hand we were dealt. That is, we have continued to stay fully invested in our Industry including our borrowings and funds from equity sales. Our company has just under 1,000 shareholders who must, as the commercial goes, be Bullish on America. In any event, not all of their money is in CD's. Corporate Investment and Venture Investment must be designed as a reasonable alternative to CD's. Certificates of Deposit don't make products, run cars, heat homes, or make payrolls. CD's (excluding those of the elderly) in my view, represent to a large degree, decadence, slothfulness, and laziness, all of which are contrary to America's work ethic and econmic history. If we are going to embrace zero growth, then two of my three children will wind up at the Public trough. It is time to put aside past vindictive attitudes and allow Industry to grow and prosper. I have no more shame in the desire for profits than I have in my love of an America where healthy economic and industrial growth allowed my Father, with a third grade education and a lifetime on drilling rigs, to provide me with the background and desire to attain a modest middle class position and work in an Industry of which I am immensely proud and one which just happens to be our most basic Industry.

This business, gentlemen, is our discipline; this is where our expertise lies and this is where we can best serve our stockholders and our Nation. By some degree of plurality, you gentlemen were chosen to represent our people and utilize your best judgment in exercising the stewardship of that mandate. I respectfully trust that you will stay open and objective

in your consideration of these matters as I really don't think our people are ready to assume a secondary role in the World which unfortunately could be the end product of bad energy decisions, including tax policy. I have great respect for the intelligence of our Nation's Le lers, and it is out of this respect that I know you must understand and appreciate what you are hearing today. Frankly, gentlemen, I consider it a joint responsibility of ours and yours to advise the Public they can't retain world Leadership and continue to use the Oil Industry as a whipping boy. A lot of us go through life wearing a smile and a clean shirt telling "The Man" only what we think he wants to hear. The only real Kudos I ever got from an employer came from telling him what I thought he ought to know. I cannot conceive of anyone who could in good conscience tell the people of America that all the ECHO Oil Corporations of the country are big, bad robber barons. Unfortunately, the big paint brushes that get flung around all too often cover us as well. I honestly urge your help in bringing the message of the Industry, and in particular, the message of the small producer to the people of this country and help them to understand. We sincerely regret the technical complexities of Exploration; but if we must blame someone, we must blame the creator for as one oil man put it, "Science might show us the structure but only God can provide the porous sand."

Thank you,

Edward N. Litman
Casper, Wyoming

Statement of
Loyd G. Whitley
Representing the Permian Basin Petroleum Association

before the
Senate Finance Committee
June 6, 1974

I, Loyd G. Whitley, Midland, Texas, am employed by Adobe Oil and Gas Corporation in the capacity of Vice-President-Finance. I am also a director of the Corporation, a publicly held company.

I graduated from Texas Christian University in 1943 with a degree in accounting and received a C.P.A. certificate in 1947. For a period of twenty-six years I was engaged in the practice of public accountancy and during the last ten years of that period as a partner in the tax department of Peat, Marwick, Mitchell & Co.'s office in Midland, Texas. Approximately 90 percent of Peat, Marwick, Mitchell & Company's Midland office clients during this period were engaged in the production of oil and gas.

In 1972 I left Peat, Marwick, Mitchell & Co. to become employed by Adobe. My present duties include financial budgeting, tax planning, and financial reporting.

Presently I am a member of the American Institute of Certified Public Accountants, Texas Society of Certified Public Accountants, the Permian Basin Petroleum Association and the Independent Petroleum Association of America.

Percentage depletion was adopted, initially in 1926, to permit taxpayers the opportunity to recover for tax purposes deductions in excess of cost of the properties. Stimulation of exploration for discovery of new reserves is essential to replace the depleted oil and gas. Congress in 1969 in a committee report stated "the percentage depletion rate provided for oil and gas wells is higher at the present time than is needed to achieve the desired increase in reserves".(1) The rate was reduced at that time by 20 percent or to 22 percent. The current energy crisis emphasizes that the depletion rate should have been increased rather than decreased.

(1) Senate Committee Reports on P.L. 91-172

Congress in enacting the various revenue laws over the years has declared that percentage depletion is a stimulus for expanded exploration for discovery of new oil and gas reserves. Presently and for several years the United States is and will be suffering from an acute energy shortage of oil and gas. Why then would anyone advocate the elimination or the phase out of the percentage depletion provision?

Atlantic Richfield (ARCO), a large oil company, has reportedly advanced the idea of a gradual phase out of percentage depletion. This endorsement is being used incorrectly by those proponents who wish to eliminate depletion. ARCO, as a matter of record, has only advocated the phase out of depletion if the following conditions are met:

1. Phase out of crude oil price controls,
2. Control of well head price of gas must be eliminated
3. Consideration of an overall tax policy of the Federal Government.[2]

ARCO's position, though a qualified one, on this matter has brought a storm of protest from within the industry. Rightfully this protest has been extremely vocal from small independent oil companies who in 1972 drilled approximately 82 percent of the domestic wells and 89 percent of the domestic wildcats. This percentage depletion incentive is needed if these small companies are to continue the search for oil and gas reserves.[3] Larger oil companies have virtually abandoned domestic onshore exploration during the past ten years simply because onshore exploration has not been profitable for these companies. The importance of the independents who drilled most of the domestic wells should be recognized by retaining depletion -- not impaired by the elimination or reduction of the depletion rate.

(2) Oil & Gas Journal, January 7, 1974, Page 24
(3) Petroleum Information Corporation - Computer Study

Independent oil producers, who historically are responsible for discovering 75 to 80 percent of the oil and gas in the United States, need tax incentives that make the risk of exploration justifiable.

To combat the energy shortage in the United States every stimulus available should be used to encourage more exploration and development drilling. In 1973 crude oil production in the United States dropped 2.9 percent to an average of 9,203,000 barrels a day compared with 1972's mark of 9,477,000 barrels per day. The highest point of the United States crude production was in 1970 when 9,637,000 barrels per day were produced.[4]

To illustrate the part that percentage depletion plays in finding and producing oil, permit us to utilize Adobe Oil & Gas Corporation's figures for 1972 and 1973. During 1972 and 1973, Adobe's percentage depletion amounted to $1,047,000 and $1,394,000 respectively. Upon reducing these figures to the actual reduction in income, in other words without depletion income, Adobe's income would have been reduced by $503,000 and $669,000 respectively during these two years. Since Adobe does reinvest all of its cash flow, over and above debt service, in the oil business, we can surmise how many additional wells were drilled as a result of depletion. During 1972 and 1973, Adobe drilled and completed 71 and 78 gross wells resulting in 28.5 and 28.7 net wells respectively. The average well costs were approximately $178,000 and $142,000 per well for those two years. On this basis, Adobe would have completed 2.83 less wells in 1972 and 4.7 less wells in 1973 if percentage depletion had not been available. Since the average independent is approximately 1/12th the size of Adobe, we can surmise that their drilling would be reduced by approximately .40 of a well. On applying this to 10,000 independents throughtout the United States, (assuming there is no reduction in number of independents as a result of depletion phaseout) this would have the effect of reducing the number of wells drilled in the

(4) Oil & Gas Journal, January 28, 1974, Page 111

search and production of oil by 4,000 per year. During 1973, some 28,000 wells were completed thus we can expect a reduction in drilling of approximately 15%, if, in fact, percentage depletion is phased out. The independent, the oil finder in the United States, has no means whereby he can pass on additional costs. Upon considering the fact that drilling and completion costs have risen from 50-80% since mid-1973, it is reasonable to assume that the actual reduction in number of wells drilled could conceivably exceed the 4,000 figure derived in this exercise, the cumulative effect of the abolition of depletion during years 2, 3, 4 and 5 could be disastrous for the domestic producing industry, the only safe oil supply available to America.

Summary:

Other industries have certain tax advantages which were instituted to foster research, development and expansion. Examples - percentage depletion applicable to numerous hard minerals; expensing of research and development expense; rapid amortization of pollution control facilities; bad debt write-offs of financial institutions; capital gains applicable to cutting of timber; capital gains applicable to coal and iron ore disposed with a retained economic interest; and expensing of conservation expenses in the agriculture industry. There has not been a public outcry to eliminate any of these tax breaks.

As pointed out United States crude oil production is declining and demands for petroleum products are increasing resulting in an acute shortage which will become more severe if such yearly trends are allowed to continue. The time lag between now and when substitute energy sources can be developed to meet the needs of the nation have not been accurately estimated. Surely, in the interim period every incentive available and within reason should be employed to stimulate United States domestic production. Two beneficial tax incentives that have worked in the

years past and acknowledged as necessary by Congress are percentage depletion and write-off of intangible drilling and development costs. Any tampering with these provisions will hamper the independent oil people's efforts and will prove to be a very sad mistake.

Testimony

by

GLENN C. FERGUSON

President

INDEPENDENT OIL & GAS PRODUCERS
of CALIFORNIA

Before

THE SENATE FINANCE COMMITTEE

June 6, 1974

INTRODUCTION

Mr. Chairman and members of the Committee, my name is Glenn C. Ferguson. I am an independent oil and gas producer located in Bakersfield, California. My partner, I. W. Bosworth, and I operate as a partnership on all exploration activity. Our producing properties are operated by a wholly owned company, Laymac Corporation. I am a geologist by profession, and I am almost solely responsible for the production we have developed, as well as the dry holes we have drilled. As a result, I am fully aware of the risks involved in the drilling of wildcat wells. I would like, however, to take this opportunity to thank you for the privilege of testifying before your Committee, and I hope that what I have to say will be helpful in your deliberation concerning the retention or elimination of percentage depletion for oil, the most speculative of all the 115 or so extractive industries.

I might preface my remarks by stating that I have always hoped that I could someday reach a stage in life where I could spend most of my time on the golf course. Judging from the tone of conversations with a number of Congressmen and Senators while visiting here last week, I think that time has about arrived provided, of course, enough gasoline is available for me to reach the golf links and home again. If the majority of independent operators should follow the same pattern that we intend, in the event of the elimination of the depletion allowance, there likely will not be gasoline available, but then we will not be alone in our dilemma.

GENERAL STATEMENT

Percentage depletion, a subsidy or a method of recovering capital? When I was a boy, my father owned a few beehives. During the spring and summer months, the bees were always busily engaged gathering nectar from the flowers which they then somehow made into honey and stored in their hives. In the fall, my father would always relieve the bees of a good portion of their honey, a sort of tax for providing them with their hives. I asked him once, "Why do you leave so much honey"

"Why don't you take it all?" Whereupon he answered, "I am being nice to those bees since they worked so hard for so long. I leave them enough honey to get them through the winter and they will be able to gather more honey next spring and summer." As I reflect upon that memory, I realize he was subsidizing those bees in accordance with present day political concepts of the word subsidy.

There was a time, of course, a few years back when political concepts were somewhat different, at least as related to percentage depletion. Shortly after the income tax laws were first placed into effect and with the sale of a great many developed oil properties, it soon became recognized that proven quantities of oil in the ground had value and represented capital. The purchaser of an oil producing property obviously had the right to recover his capital outlay on some kind of tax free basis and cost depletion was established. It rapidly became apparent that all oil production would soon be concentrated in the hands of a very few companies and true monopolies would develop. The Congress at that time reasoned, and rightfully so, that the finder and developer of oil properties needed some added incentive in order to encourage him to continue in business and to search for more oil. They further reasoned that if a purchaser has a right to cost deplete his capital outlay, the developer of the property should be afforded the same sort of privilege as an added inducement to take the risks in finding more oil. That same concept holds true today and even more so, for the risks involved in finding domestic production are greater than ever particularly on land where most independent producers are relegated. Certainly in the case of our own operations, in the absence of a depletion allowance and regardless of price, unless domestic prices become considerably higher than world prices, we will be uninterested in conducting further domestic exploration. In the future, the price of foreign oil will be governed not only by the law of supply and demand but by taxes as well. Since taxes must be considered as a part of the cost of doing business, it must be reflected in the price of the product. Otherwise, there will soon be no product.

If this country is ever again to become self-sufficient, a depletion allowance is absolutely essential for domestically produced oil and the percentage should be increased, not lowered or eliminated. If you will but stop and reflect for a moment, you will realize that far more oil can be developed for the expended exploration dollar in foreign lands than in the lower 48 states of the United States of America. In the absence of an added incentive to help balance this differential, the oil industry will simply continue to gravitate to foreign territory. All the easily found oil in this country with the exception of offshore oil has been discovered while in large areas of foreign land the surface has hardly been touched. I would like to give you an example that should drive home what I am talking about. If you were to place 100,000 needles in each of several haystacks and you were to ask a group of youngsters to sift through the hay in one of the stacks to find those needles, I am certain that the first several thousand would be easily and quickly found. As time wears on, the remaining ones will become more difficult to find and much more time consuming. If in the beginning the children were rewarded a penny for each needle, their enthusiasm would remain high until the needles became scarce. They would then become disenchanted and would no longer search for the needles unless greater rewards were offered. Otherwise, they would begin to search for a new haystack where they might find the needles more easily. The new haystack would be comparable to foreign territory and the search for oil there. You either are going to have to have some additional incentives to continue the search in the first haystack or the youngsters will all move to the new stack. Now, instead of offering an additional incentive to look for the remaining needles in the first stack, you decide to take away some of the pennies as they find the needles, you can imagine the result. I can't help wondering why that imagination can't be applied to the oil industry. As a geologist, I am fully aware that most of the needles (oil fields, if you please) have been found in this haystack of ours, and since I am one of those relegated to continue looking, I am not about to look for

additional needles under circumstances less rewarding to me than those that were most easily found. When I speak of rewards, I speak of the amount I have left over for myself after all taxes have been paid.

A great deal has been said about $10 oil. Very little of our oil qualifies for new oil prices. Most of it is selling for $5.21, all old oil. Incidentally, the average price for old oil in California is about $4.10 per barrel, still well below the cost of replacement under today's higher well costs.

We are currently compiling figures to determine our total cost of the new reserves we have been able to develop since 1959. These figures are not yet available but I think it is safe to say that it will figure to be in excess of $10 per barrel. Our earlier track record was good, but the needles are now getting scarce and to beat the odds, you have to be in the right place at the right time. I can personally see no reason to continue our efforts if current attitudes in Washington prevail. Unquestionably, we would be better off financially if we were to sell out to some major oil company. However, in going all out, so to speak, the past few years in an effort to find new reserves and in anticipation of price increases, we established substantial tax losses which need to be carried forward and applied against future production. The carry backs were used up some time ago. If the idea of imposing an excise tax prevails, it will be more difficult to carry those losses forward. Those who have tried the hardest to find new domestic reserves, it would appear, are going to be penalized the most. The Government has argued that with increased prices, the industry does not need a depletion allowance. Yet many in Government would like nothing better than to tax away the increase and eliminate the depletion allowance as well. If a knock-out is eminent, it is time to throw in the towel.

SPECIFICS

In order to give you some idea as to the size of our operation, we can be considered a small to medium size independent oil company. Our share of production of joint operations with others, less royalties, amounts to approximately 1,000 B/D. In addition we have some minor gas production. Our gross income is on the order of $2,000,000 per year although we generate far more wildcat ventures than we can afford to drill ourselves. After obtaining geological leads, we generally lease the land and conduct seismic surveys if necessary, and then usually try to interest others on some kind of equitable basis to do the actual drilling. We sometimes act as the operator ourselves during the drilling of the initial well and then turn operations over to our operating company. Last year we were involved in the drilling of 19 exploratory wells, several of which were quite deep. Our tax loss for the year exceeded $268,000. Of the 19 wells, 4 were completed, only one of which actually developed anything that can be remotely considered as significant. A second well can be considered profitable, but there will be no follow up wells. The other two simply will not return our investment. While we were instrumental in the drilling of more wells in 1972, the average depth was not as great, but with only two successful completions, neither of which were significant. I suspect our operations are representative of the average independent, no one of which can be considered important in the over-all activity, but when all our efforts are added together, they become significant and something the nation can ill afford to lose.

The Congress in passing punitive legislation will definitely be acting as a tool of the major oil companies if it results in the elimination of a large segment of independent operators, the only competitors the majors have in the domestic production scene. The only alternative to selling is to simply conserve what we have, conduct no further exploration and simply produce ourselves out of

business, using our production as an old age annuity. Why in the name of logic should we risk what we now have under circumstances less rewarding to us than they have been while the risk and cost is constantly increasing? What would you do if our positions were reversed?

Thank you for listening.

Senate Finance Committee Hearings
June 6, 1974

Percentage Depletion

My name is Edward E. Rue, Mt. Vernon, Illinois. I graduated with a masters degree in geological engineering and was employed by Magnolia Petroleum Company, now Mobil in 1949. After four years as a geologist, I left that firm and have been an independent geologist and oil producer since then.

You have been charged in part with solving the energy problem, and from what I have read and heard of your actions in that regard, I am convinced that you have been fed such a forest of facts that it is difficult to see the trees. This is not to be critical of you. Almost anyone reviewing this much data would be in the same boat.

There is only one way out of this problem insofar as the oil industry is concerned and that is to produce more domestic crude oil. As a geologist, believe me, this can be done. The oil is here. The technology is here. And the talent is here. The job would have been done long ago, except for the last twenty-five years the imports of cheap foreign oil have blunted the economic incentives to find domestic oil. In fact, those people left in the domestic oil exploration business who survived this economic pressure for the last twenty-five years are well qualified to do the job.

According to IPAA statistics, there were 35,000 independent producers in 1952. In 1973, there were only 8,100. These remaining few

are hard core, efficient oil finders, which is one of the things we need most in this country today. They want nothing from you except to be left alone so that they can do the job.

Now it appears to me that most of your data tells you that the energy problem is all caused by the oil companies, and therefore we should whip those companies into line, and not let anyone make any windfall profits. Anyone who thinks he is going to solve the problem this way doesn't know how mineral exploration operates. The only kind of profits in mineral exploration are windfall profits. Take that away, and you will do without.

One noticeable fallacy with this whole idea is that the proposed windfall profits tax is only a name to sell to the public. It is not a tax on profits at all. It is an excise tax on crude oil at the wellhead. It is a tax that the major integrated oil companies can pass on to the consumer, and one which the independent producer cannot pass on.

A long time ago Herbert Hoover the mining engineer, not the President, said words to this effect: "Never will the value of the minerals taken out of the ground be equal to the money spent to find and extract them." This is still true today, and particularly in oil and gas exploration. Another famous or infamous American, John D. Rockefeller, when investigating the young oil fields in Pennsylvania, reported back to his bankers words to this effect: "I wouldn't drill wells with your money. You never can tell what you are going to get back. The real profits, and safer investments will be in transportation, refining, processing and marketing." And gentlemen, that is still true today.

There are two points to be made here: (1) It takes romance money to explore for any minerals, particularly oil and gas, and (2) Both major companies and independents in their own way use this source of capital. The dry holes they leave behind are the necessary data used to find new oil reserves. So even the dropouts of the oil industry help find crude oil.

One of the most pertinent statistics that seems to elude people investigating the energy problem, is that 75% of the domestic exploratory wells in untested areas are drilled by the independent operators. According to Petroleum Information, an independent industry statistics gathering company, the independent oil operators drilled 83.5% of the exploratory wells in 1972. And yet all the proposed governmental plans hurt the independent operator far more than the major oil companies who many people seem to be after.

It's the independent operators who drill the rank wildcats and who are not involved in transportation, refining and marketing that the proposed governmental controls shackle the most. He sells his crude to the major pipeliners, refiners, and marketers who want cheap domestic crude to balance the cost of the now high-priced foreign crude oil. The independent operator finds two-thirds of the domestic crude, and produces only about one-third of the domestic supply. Why? Because many times the place he wants to drill is held by long term leases owned by major companies, and he is given a small part of the acreage to drill his dream prospect with the help of outside romance money. This is how the major companies use the independent's risk capital to find oil and gas.

Now this might give the impression that I too am against the major oil companies. Not so. Both majors and independents have contributed to the half-price fuel oil, gasoline and hundreds of other products that the American public has had for thirty years or more. As anyone who has visited Europe, Africa, Asia or the Far East in the last thirty years will attest, gasoline and fuel oil was, and still is, twice as costly there as in America. Much of this was delivered by American oil companies, and the profits came back to this country and were taxed twice before the American shareholder got to spend his share.

The independent made his contribution just by staying in business during the last twenty-five years, while imports of cheap foreign crude kept the price of domestic crude almost level, and while his exploration and development costs doubled and tripled. During that same period, domestic fluorspar mining was virtually ruined on account of fluorspar imports. Because the independent oil operator stayed in business, we are only 15 to 20 percent dependent on foreign oil. Whereas, the rest of the free world is from 50 to 100 percent dependent on imported crude, which is now coming in to this country at prices as high as $17.50 per barrel.

The real Ogre in this problem is the OAPEC nations, the oil exporting nations, and you have to include our old buddy Canada. For years they imported $1.25 to $1.50 crude from Venezuela, while exporting to us crude oil at $3.00 to $3.50. Now their government has slapped their producers with a $6.50 per barrel ceiling price and a $5.20 export tax, which means we

pay them $11.70 per barrel. Their domestic exploration business will collapse if that situation is not changed. And so will the American domestic crude oil exploration business if you take away the normal economic incentives for exploration and development.

There are already several examples of what will happen when the price of a natural resource is held down below the price made by supply and demand. For a short while the products from that resource are cheap, but then suddenly you have a crisis shortage in the raw material. Prices of the raw material go up and final products skyrocket in price. You will not solve the energy problem by rolling back crude oil prices. In fact, that is really why we have one today. In effect, we learned to waste the most valuable mineral resource we have today.

The only other "statistic" that I will burden you with, is that after reducing the percentage depletion on oil and gas in 1969 from 27½ to 22, there were 21 percent fewer exploratory wells drilled in 1970. This represented the largest decline in exploratory drilling in a single year in the history of the domestic industry. Percentage depletion does affect the amount of exploratory drilling. Exploration has still not recovered to the 1969 level.

Since my only business is the exploration and development of crude oil and gas, and because that is the one phase of the petroleum industry that can help solve the energy problem, then your problem in that regard is the same as mine - find more domestic crude oil! The average independent is

not in transportation, refining and marketing. And these phases do not affect our tremendous imbalance of payments that is killing our economy. These imbalances are a direct result of the huge quantities of imported oil. This is not to say that these other phases are not relevant to the whole problem. But, nothing will be solved without materially increasing our domestic crude production, and that takes exploration, and that takes romance money, and that takes a depletion allowance. A depletion allowance that is there for good, not brandished around like a whip on the very group of people that can help solve the energy problem.

OIL & GAS JOURNAL

EDITORIAL

Decision of independents to fight good news for oil

THE EVIDENCE IS growing that if the domestic petroleum industry escapes political disaster this year, the independent oilman must play a larger role than in the past. It could be a decisive role.

This is based on solid facts: Independents have many friends in Congress that majors don't have. Independents do not suffer the image currently created by large profits from operations abroad, from inventory appreciation, and from dollar devaluation. But they may suffer the same political consequences.

For the truth is that there is no refuge from punitive legislation for large or small. All segments must work with those members of Congress with whom they have credibility.

The shoestring operation of the Independent Petroleum Association of America has benefited all industry far out of proportion to its meager financing. But this effort is ridiculously low in light of current stakes in pending legislation.

So it is a vitally interesting development when enraged independents during IPAA's Denver midyear gathering kicked off an instant campaign to let their voices be heard louder in Congress.

WHAT has the independents up in arms?

They realize that punitive measures aimed by the politicians at the major oil firms are going to hit independents even harder. Witness the ways and means bill taxing windfall profits and phasing out percentage depletion. While claiming to tilt incentives from foreign to domestic production, the committee actually hits domestic producers for $11.4 billion in higher taxes compared to only $1.5 billion for foreign operations during 1974-79.

Other bills calling for chartering oil corporations, putting federal agents on their boards, and forming a national oil company are also unpopular with independents. They correctly see them as distinct perils to everyone in the industry and to the free-enterprise system itself.

The IPAA isn't falling for divide-and-conquer techniques. The independents have observed that even those legislators who praise the virtues of small business are writing legislation that would make it impossible for independents to perform the job Congress is asking them to perform.

THE INDEPENDENTS' anger and their constructive response represent a reaction at the grass-roots of the oil business.

Smaller operators feel that a successful fight still can be mounted to forestall political disaster. In this, they are supported by many government leaders who urged them in Denver to make their voices heard. It's quite possible that if Congress becomes convinced that the hundreds of small operators who form the industry's backbone and do most of the oil finding will go down the drain, it probably will relax the torture treatment.

The IPAA campaign is welcomed as beneficial to the entire domestic industry and to the nation. This country needs the unhampered efforts of both independents and majors in restoring its energy position.

OIL AND GAS DEPLETION: Facts versus Fallacies

Fallacy: Percentage depletion in the tax laws is no longer justified because of the industry's "high profits."

Fact: The domestic petroleum industry, over many years time, has had earnings consistently below the average earnings of industry generally. In 1972, U. S. oil company earnings averaged 9.6 percent rate of return on investment, compared with 10.6 percent for all manufacturers. In the 20 years 1953-72, domestic oil companies earned an average of 10.1 percent; manufacturers generally earned 10.8 percent.

Moreover, the much-publicized profits of the seven largest international oil companies in 1973 were earned primarily on their foreign operations. A First City National Bank study shows the domestic earnings of these companies increased an average of only six percent.

Fallacy: Percentage depletion is no longer needed when producers are selling "ten dollar oil."

Fact: The composite price of domestic crude oil, according to the Federal Energy Administration, is about $7.00 a barrel - not $10.00. At $7.00 or $10.00 for new oil, prospects will be drilled that would never have been drilled at $3.00 or $5.00...... deeper prospects where aggregate costs are five times the average drilling outlay, and marginal prospects that would have been uneconomic at lower prices. In drilling these prospects, the economic rewards at $10.00 are relatively no greater than are the more promising prospects that producers may be willing to drill at $5.00. Percentage depletion has been proven sound in principle and in practice, and should be continued irrespective of "the price of oil."

Fallacy: Percentage depletion is not an inducement to exploration, but only encourages drilling in known fields.

Fact: In the 1969 Tax Reform Act, Congress reduced the percentage depletion rate from 27-1/2 to 22 percent and made other changes which increased the tax burden on the domestic industry by more than $600 million annually. This precipitated a drop in 1970 of 2,008 wildcat wells, down 21 percent from the 1969 level, and the largest decline in exploratory drilling in a single year in the history of the domestic industry. Exploration still has not recovered to the 1969 level.

Fallacy: The consuming public has not benefited from depletion as evidenced by current "high" prices for gasoline.

Fact: The average price of domestic crude oil has increased about 7-1/2 cents a gallon in the past year. In 1972, regular grade gasoline prices averaged 35 cents. Clearly, the increase in domestic crude prices cannot be the cause of 60 and 70-cent gasoline. The fact that the cost of imported oil has quadrupled since 1972, plus increased refining and marketing charges, are the primary reasons for today's high gasoline prices.

Despite our large dependence on foreign oil (35%), however, it is noteworthy that gasoline prices (excluding taxes) in March, 1974, averaged 39.59 cents per gallon - among the lowest in the world. This March price reflects an increase of 89 percent from the average gasoline price in 1926 when percentage depletion was adopted, but the consumer price index for all items since 1926 has risen 170 percent!

Independent Petroleum Association of America
May 1974

Fact Sheet on Crude Oil Prices

Various proposals pending in Congress to roll back domestic crude oil prices to levels as low as $3.62 per barrel would result in less U.S. oil and gas supplies, increased dependency on higher cost foreign oil and higher prices for oil products to consumers.

During 1973 the government permitted the price of U.S. crude oil to rise. According to the Federal Energy Office, the average price of controlled domestic crude oil is $5.25 per barrel; the average price of uncontrolled crude oil, which include new and stripper production, is $10.00 per barrel; and the average price of all domestic crude oil is $7.06 per barrel.

The increased prices have brought forth an acceleration in the activities related to domestic petroleum exploration. The number of active rotary rigs at the end of April 1974, for example, was more than 40 percent over the same date in 1973. Although there is a time lag between increased exploration and production, there is evidence already that the decline in domestic production that began in 1970 will bottom out in 1974.

A price rollback would hurt the independent producer to a far greater degree than the major oil company. This is so because independents drill 80 percent of exploratory wells, and it is estimated that they operate 80 percent of the stripper wells. Most of the oil which the major oil company sells is "old" or controlled oil. But most price rollback proposals would only apply to new and stripper well oil. An exception is Sen. Abourezk's proposal to roll all prices back to the levels of May 15, 1973.

The professed reason for the rollbacks is to save money for the consumer through lower product prices. However, the rollback would apply to less than 20 percent of total supply (domestic and foreign) and could only result in temporary savings to consumers of less than 2 cents per gallon on all oil products.

There has been understandable concern as to increases in price of oil products to the consumer and speculation that we may be facing gasoline prices of 75 cents or even $1.00. In this regard, it is pertinent to keep in mind that the current average price of domestic crude oil is only 7½ cents a gallon over the 1972 price. Obviously, since the average price of gasoline in 1972 was 36 cents, domestic crude oil prices have not been, and will not be, the cause for 60-cent or 75-cent prices for gasoline. Sharply higher gasoline prices can be attributed to high prices of imported foreign crude oil ranging in price from $10.00 to $17.00, and higher charges for refining and marketing.

A rollback of domestic crude oil prices would not solve the problem of increased prices for gasoline, home-heating oil, jet fuel and industrial fuels. By reducing domestic supplies of crude oil, the rollback would result in increased dependency on foreign oil and higher prices for oil products to consumers.

Independent Petroleum
Association of America
May 1974

PERCENTAGE DEPLETION AND THE INDEPENDENT OILMAN

By the most conservative estimates, expenditures for U. S. oil and natural gas exploration and development ought to be immediately doubled, and progressively increased. In a detailed study released May 15, the National Academy of Engineering called for efforts to increase domestic oil and gas production by 25 percent by 1985, declaring this to be essential in restoring energy self-sufficiency. To achieve this, the Academy said expenditures for petroleum development would have to be increased to a range of $160 to $200 billion in the period between now and the mid-80's.

This projection by the Academy, an affiliate of the National Academy of Science, anticipates capital requirements of $16 to $20 billion a year for domestic petroleum exploration, development, production and recovery. Those anticipated expenditures equate to or exceed the total wellhead value - $17.2 billion - of domestic oil and natural gas produced in 1973.

It is clear that phase-out or repeal of percentage depletion (combined with the "windfall profits" tax) would have a crippling effect on domestic petroleum exploration and development at a time when expenditures for these activities ought to be doubled and tripled, not discouraged or reduced.

Percentage depletion has been and is particularly vital to independent oil and natural gas producers who drill 85 percent of domestic exploratory wells. At today's costs, the ability to attract outside capital to share the risk of exploration is increasingly important. Percentage depletion has been a primary and indispensable incentive for investors to provide risk capital. Its removal would immediately reduce funds available for exploration and development by hundreds of millions of dollars per year.

Most independent producers incur long-term debt to conduct development programs, and thousands depend on funds retained through percentage depletion to retire such debt. Phase-out or repeal of depletion would therefore put many producers in a liquidation position, forced to sell out to meet debt obligations. As a result, many independents would quit permanently, and their contribution to the overall industry effort to expand the nation's petroleum supplies would be lost.

In its recent report, "Concentration Levels and Trends in the Energy Sector of the U. S. Economy," the Federal Trade Commission concluded that "concentration ratios in crude oil production appear to be relatively low compared to many other industries, although they have risen significantly since 1955." Removal of percentage depletion for the independent would accelerate this concentration trend.

The quickest, surest and lowest cost means of securing additional supplies of energy is to reactivate the 10,000 independent producers to explore for and develop the vast oil and gas potential onshore in the lower 48 states.

The shrinkage in the great multiplicity of effort by thousands of independents in the exploration for and development of the nation's oil and natural gas would be a loss the nation could ill afford if it is to again achieve a position of energy self-sufficiency.

Independent Petroleum Association of America
May 1974

REPEALING PERCENTAGE DEPLETION: THE ECONOMIC IMPACT

Phaseout or repeal of percentage depletion for oil and gas, as contemplated in proposals pending in Congress would increase the tax burden of the domestic petroleum industry by more than $3 billion yearly. It would cancel a tax provision that has been ingrained in the industry's economic and financial processes for 48 years. It would have repercussions of vast proportion, detrimental to the nation's energy supplies.

These adverse results could be set forth in great detail, but they can be summarized as follows:

1. A flight of capital from oil and gas exploration and drilling, and disruption of capital investments on an almost panic scale. Chaos would follow during the period of unprecedented adjustment to and evaluation of the industry's changed financial outlook.

2. Widespread sellouts and mergers would occur among 10,000 independent explorers and producers who drill 85 percent of U. S. exploratory wells, and would result in increased concentration in the production and control of petroleum.

3. Contraction of the industry would result in reduced levels of exploration, drilling and development with an inevitable drop in our already inadequate domestic petroleum reserves and production.

4. Precipitate large-scale unemployment among 275,000 petroleum production employes in 32 producing states.

5. Shrinkage of the nation's largest mineral producing industry would be accelerated and would precipitate a reduction in the overall base for local, state and federal tax revenues.

6. Reduced oil exploration activities would be followed by curtailed markets for steel, other basic materials, and hundreds of supply and service organizations sustained by petroleum production.

7. Capital expenditures would be diverted in increased scale to foreign areas. This would compound our tenuous dependence on foreign energy and aggravate the already serious adverse impact on our balance of payments situation.

8. With economic growth directly related to energy use, and domestic oil and natural gas supplying the lowest cost energy available today, economic expansion would be impeded.

9. In short, the nation would be increasingly dependent on foreign oil supplied by a more concentrated industry at far higher costs.

These are fundamental considerations that the pending proposals ignore. Some of these results would come immediately, others gradually, if percentage depletion is phased out. Certainly, precipitation of such an upheaval in the domestic oil and gas producing industry would be inconsistent with and counter-productive to the national priority and urgency of re-building U. S. energy-sufficiency.

Independent Petroleum Association of America
May 1974

PETROLEUM INFORMATION CORPORATION *A Subsidiary of A. C. Nielsen Company*
P.O. BOX 2612, DENVER, COLORADO 80201 • PHONE 303-825-2181

DRILLING STATISTICS ... AND HOW THEY ARE COMPILED

In this issue, Energy Information presents the basic results of a review of operator-of-record data for U.S. drilling during 1972. Statistics were accumulated with respect to the sole or first-listed operator only. Thus, other working interests in specific wells are not represented, nor is non-operating economic support visible in the many cases to which it applies.

But operator-of-record identification reaches to the limits of established industry statistical practice.

To measure with absolute accuracy the amount of drilling activity for which a specific category of operators is economically responsible would require application of exact working interest to the wells in which each operator within the category participated. The sum of the net wells thus calculated for all operators would then be equal to total drilling.

This degree of statistical refinement is not available. The operator-of-record analysis is the most significant appraisal of activity by operator categories. It is an acceptable statistical criterion since the industry leans heavily on joint ventures in which companies may be operator-of-record about as often as they are non-operating working interest participants so that statistical aberrations tend to be compensating.

And, current and timely operator-of-record statistics are available only through timely coverage of all U.S. drilling activity, a function unique to Petroleum Information.

An Energy Information Exclusive

NEW STUDY SHOWS "SMALL" COMPANIES DRILL MORE THAN 80% OF U.S. WELLS

An operator-of-record survey of 1972 drilling in the United States shows that the larger companies in the petroleum industry were operators on only 17.50 per cent of United States drilling in 1972.

Smaller companies were operators of record on 82.50 per cent of all 1972 wells.

These figures emerged at the completion of a study by Petroleum Information of all domestic drilling during 1972. Earlier this year ... on June 6 ... Energy Information published operator of record analysis of about 60 per cent of domestic drilling. The study has been extended to cover the areas not included in the earlier study, notably most of Texas, Louisiana and the southeastern United States.

Operators were classified according to their inclusion in the Chase Manhattan Bank's 30 company group of "larger operators". Members of this group accounted for 17.50 per cent of drilling. All others accounted for 82.50 per cent.

Figures for the entire United States did not differ materially from the partial study completed in June. While some of the areas not then surveyed are prone to deep drilling and would be expected to show a preponderance of large company activity, there has been a steady growth in activity by companies not members of the Chase Group. In addition, inclusion of several active, shallow areas tended to weight statistics in the direction of smaller operators.

However, it should be noted that in terms of footage drilled, the Chase Manhattan Group accounted for 22.39 per cent while all other operators accounted for 77.61 per cent. This points up the involvement of the larger companies in the deeper drilling in many parts of the country. Such involvement, of course, reduces the number of wells completed in a given period of time.

Nevertheless, the extent of dominance of domestic drilling by operators of record not members of the Chase Manhattan Group is, perhaps, surprising.

A substantial portion of the funding of companies not members of the Chase Group was attracted from non-oil-related sources. The statistics on drilling point up the importance of incentives as a means of attracting the capital responsible for so large a portion of total domestic drilling.

The study shows that the smaller companies drilled more discoveries of both oil and gas ... and far more dry holes ... than members of the Chase Group.

But, there was surprisingly little difference

in exploratory success ratios between the two groups. The Chase Group risked exploratory failure 1,000 times. The result was 272 productive wells, or a record of 27.2 per cent success. All other companies drilled 8,024 exploratory wells, completed 1,972 as producers, for a success ratio of 24.57 per cent.

The larger companies widened the comparative margin of success when it came to development wells. This may reflect a substantial amount of ... control on the part of this group and the justified tendency to reserve for internal development locations of obviously lower risk.

The Chase Group successfully completed 3,328 development wells of a total of 3,833 drilled. The success ratio is 87.08 per cent. All other companies drilled 14,758 development wells, completed 72.70 per cent, or 10,730 wells, as producers.

The statistics are set out below. Totals include drilling offshore Louisiana and Texas. The Chase Manhattan Group accounted for 398 of 628 wells drilled off Louisiana. Others completed 230. Of 40 wells drilled offshore Texas, the Chase Group completed 23, other companies, 17.

All U.S. Drilling

	Total Wells	Percentage	Total Footage	Percentage
Chase Group	4,833	17.50%	30,598,231	22.39%
All Others	22,782	82.50	106,038,006	77.61
	27,615		136,636,237	

All Exploratory Wells

Chase Group	1,000	11.08	8,823,474	16.46
All Others	8,024	88.92	44,756,402	83.54
	9,024		53,579,876	

All Development Wells

Chase Group	3,833	20.62	21,774,737	26.22
All Others	14,758	79.38	61,281,604	73.78
	18,591		83,056,361	

Analysis of Exploratory and Development Success

		Exploratory		Development	
		Wells	% of Category	Wells	% of Category
C-M Group	Oil	142	12.86	2,655	26.00
Others	Oil	962	87.14	7,560	74.00
C-M Group	Gas	130	11.40	683	17.73
Others	Gas	1,010	88.60	3,170	82.27
C-M Group	Dry	728	10.74	495	10.94
Others	Dry	6,052	89.26	4,028	89.06

FIRST NATIONAL CITY BANK

EDWARD SYMONDS
VICE PRESIDENT

399 PARK AVENUE, NEW YORK, N. Y. 10022

IN REPLY PLEASE QUOTE

May 8, 1974

Mr. Frank Jordan,
Executive Secretary
IPAA
1101 Sixteenth Street, N.W.
Washington, D.C. 20036

Dear Frank:

It was good seeing you and participating in your various committee meetings in Denver.

Attached is a tabulation showing 1973 vs. 1972 major oil company earnings by region. As soon as possible, we shall let you have may preliminary findings concerning 1974 results.

We are glad to know that you plan to make these data widely available to your membership and on The Hill. Please make sure the members of the Accounting Principles Committee, where such pleasant things were said about Citibank's efforts, are provided with the data. This will, I believe, be a most constructive follow-up to the Denver meetings, particularly since you omitted any reference to our figures from your Cost Study Committee Report.

Sincerely,

FIRST NATIONAL CITY BANK
PROFITS OF 7 LARGEST INTERNATIONAL OIL COMPANIES

	1972 (bil. $)	1973 (bil. $)	Increase	%
Total	$4.865	8.7	3.906	80%
Western Hemisphere (not U.S.)	.772	1.330		
Eastern Hemisphere	1.984	5.197		
Total Foreign	2.756	6.527	3.771	136.8
U. S.	2.109	2.244	.135	6.4

Competition from independents helps keep them in line

The above table shows earnings of the seven largest international oil companies divided between domestic and foreign operations, with a separate line showing profits attributable to Western Hemisphere operations outside this country.

These figures by the First National City Bank show that profits of these companies on their total foreign operations increased 136.8 percent, while domestic profits rose only 6.4 percent. Of the total increase of $3.9 billion, the $135 million attributable to U. S. operations represents only 3.5 percent.

For many companies, this trend in which foreign earnings represent by far the dominant factor in their profits picture continued in the first quarter of 1974. Gulf Oil Corporation, for example, earned $200 million in the first quarter, 76 percent above the 1973 first quarter. But Gulf's earnings on its U.S. petroleum operations actually declined four percent.

Mobil Oil Corporation reported a 66 percent increase in profits in the fourth quarter, but only 16 percent of this increase was attributable to its domestic operations. Of Texaco's first quarter profits, 73 percent came from its foreign operations, only 27 percent from U.S. operations.

Clearly, these figures make it apparent that price rollbacks on domestic oil would not materially change the earnings picture for these international companies. Such a rollback would, however, severely dampen domestic exploration and development--and accelerate investments in foreign areas.

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FIVE U.S. BASED INTERNATIONAL OIL COMPANIES
RETURN ON NET WORTH BY GEOGRAPHIC AREAS - 1972 to 1974

1972	Net Worth - 1/1 ($ Million)	% Chge.	Net Income ($ Million)	% Chge.	Return on Net Worth (%)
United States	18,342		1,910		10.4
Foreign	15,268		2,079		13.6
TOTAL	33,610		3,989		11.9
1973					
United States	18,854	+2.8	2,048	+7.2	10.9
Foreign	16,365	+7.2	4,180	+101.1	25.5
TOTAL	35,219	+4.8	6,228	+ 56.1	17.7
1974 (Estimated)					
United States	19,284	+2.3	2,543*	+24.1	13.2
Foreign	19,516	+19.3	6,003*	+43.6	30.8
TOTAL	38,800	+10.2	8,546*	+37.2	22.0

*Annualized First Quarter Net Income

Companies Included Exxon Corporation, Gulf Oil Corporation, Mobil Oil Corporation, Standard Oil Company of California, Texaco Inc.

OIL & GAS JOURNAL
MAY 20, 1974

Another pipeline development: Texoma Pipe Line Co. will start laying 30-in. line next week on its $96.5-million, 472-mile system to move crude from the Gulf Coast to the Mid-Continent. First work will be on 45 miles of line northwest of Longview, Tex., by H. B. Zachary Co., San Antonio.

There's also transportation news in plans to make the Mississippi accessible to deep-draft ships as far north as Natchez, Miss., which would be a deepwater port.
The Corps of Engineers is studying the plans and will hold a public hearing May 28 at Natchez. Besides the port at Natchez, plans involve industrialization of the river bank between Baton Rouge and Natchez.

Price of Alberta crude will be held at a maximum $6.50/bbl, according to Wayne Minnion, chairman of the provincial petroleum-marketing board. The price follows an agreement with the federal government which was brought down recently by a no-confidence vote in the Parliament.
Meanwhile, federal Energy Minister Donald Macdonald is asking the industry to continue collecting for Ottawa the export tax on oil, raised to $5.20/bbl for June (see p. 39). Macdonald also wants the industry to limit retail-price increases on products to about 9¢/gal in western Canada and 3¢/gal in the eastern region.

Canada's National Energy Board will hold full-scale hearings, probably this fall, on natural-gas supply for domestic and exports needs.
Interested parties must submit briefs by Sept. 3. The submissions must deal with natural-gas requirements in Canada for each year from 1973 to 1995.

LOOKING ABROAD. Financial sharpies, lured by reports of $54 billion oil income this year, are moving into the Middle East. And this has prompted Shaikh Naji B. Almuddin, chairman of Middle East Airlines, to urge that western experts should advise Arab countries on best use of their oil revenues.
"There's now an urgent need," he told an audience in London, "for serious and reliable investment advice for the Arab world from the experienced and knowledgeable financial institutions of the West."

Danish Government says plans are under way for leasing areas off the west coast of Greenland. Negotiations with some 20 companies that have run seismic surveys in the area will start soon.
Drilling probably won't start before 1976. Plans call for putting up 25,000 sq miles south of the 72nd parallel for bids. Terms will be stiff. They include cash leasing fee, 12.5% royalties, 55% tax, and up to 50% carried inter-

DEPLETION ALLOWANCES PRESENTLY AUTHORIZED

Title 26 - Internal Revenue code

22% - Antimony ore
22% - Anorthosite
22% - Asbestos
10% - Asbestos (not from deposits in U. S.)
22% - Bauxite
14% - Bauxite (if not from U. S. deposits)
22% - Beryllium
22% - Bismuth
22% - Block steatite talc
22% - Cadmium
22% - Celestite
22% - Chromite
22% - Clay
7½% - Clay (used for manufacture of sewer pipe or brick)
5% - Clay (used for drainage and roofing tile, flower pots and kindred products)
22% - Cobalt
22% - Corundum
22% - Fluorspar
14% - Fluorspar (if not from U. S. deposits)
22% - Graphite
14% - Flake graphite (if not from U. S. deposits)
22% - Ilmenite
22% - Kyanite
22% - Laterite
22% - Lead
22% - Lithium
22% - Manganese
22% - Mercury
22% - Mica
22% - Molybdenum
22% - Nickel
22% - Oil and gas wells
22% - Olivine
22% - Platinum
22% - Platinum group metals
22% - Quartz crystals (radio grade)
22% - Rutile
22% - Sulphur
22% - Tantalum
22% - Thorium
22% - Tin
22% - Titanium
22% - Uranium
22% - Vanadium
22% - Zinc
22% - Zircon

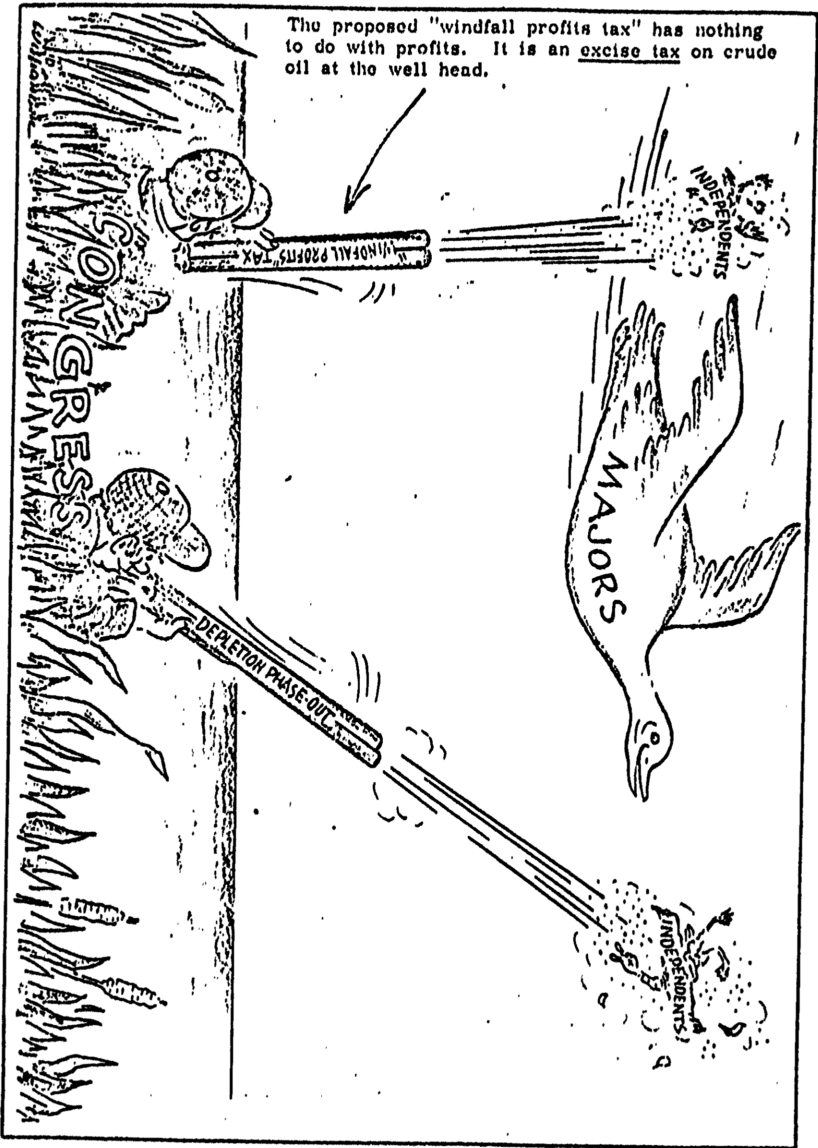
15% - Copper
15% - Gold
15% - Iron ore
15% - Oil shale
15% - Silver

14% - Aplite
14% - Ball clay
14% - Barite
14% - Bentonite
14% - Borax
14% - Calcium carbonates
14% - China clay
14% - Marble
14% - Mollusk shells (including clam and oyster shells)
14% - Phosphate rock
14% - Potash
14% - Quartzite
14% - Rock asphalt
14% - Sagger clay
14% - Slate
14% - Soapstone
14% - Stone used as dimension or ornamental stone
5% - Stone
14% - Thenardite
14% - Tripoli
14% - Trona
14% - Vermiculite

10% - Brucite
10% - Coal
10% - Lignite
10% - Perlite
10% - Sodium chloride
10% - Wollastonite

7½% - Slate (for use as sintered or lightweight aggregates)

5% - Bromine (from brine wells)
5% - Calcium chloride (from brine wells)
5% - Gravel
5% - Magnesium chloride
5% - Peat
5% - Pumice
5% - Sand
5% - Scoria
5% - Shale


The proposed "windfall profits tax" has nothing to do with profits. It is an excise tax on crude oil at the well head.
INDEPENDENTS
MAJORS
INDEPENDENTS
"WINDFALL PROFITS" TAX
DEPLETION PHASE-OUT
CONGRESS

[illegible]CTOGA

WEST CENTRAL TEXAS
OIL & GAS ASSOCIATION

(915) 677-2469 • P O BOX 2332 • 355 PETROLEUM BLDG • ABILENE TEXAS 79604

TESTIMONY

OF

L. M. YOUNG FOR
WEST CENTRAL TEXAS OIL & GAS ASSOCIATION
ABILENE, TEXAS

BEFORE THE

SENATE FINANCE COMMITTEE
UNITED STATES SENATE

<u>IN OPPOSITION TO PROPOSED CHANGES
IN OIL & GAS TAX POLICY</u>

JUNE 6, 1974

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, MY NAME IS L. M. YOUNG. I RESIDE IN ABILENE, TEXAS, AND I APPEAR HERE TODAY FOR MYSELF AND THE WEST CENTRAL TEXAS OIL AND GAS ASSOCIATION. OUR OIL & GAS ASSOCIATION IS COMPRISED OF 800 SMALL BUSINESSMEN OIL OPERATORS WHO ARE LOCATED PRINCIPALLY IN THE 35 WEST CENTRAL TEXAS COUNTIES AROUND ABILENE, TEXAS.

MY PURPOSE HERE TODAY IS TO OPPOSE ANY CUT IN THE DEPLETION ALLOWANCE WHICH IS SO VITAL TO THE INDEPENDENT OIL OPERATORS OF THIS NATION. THERE SEEMS TO BE SOME DOUBT IN THE CONGRESS AS TO JUST WHAT AN INDEPENDENT OIL OPERATOR IS. THE INDEPENDENT OPERATORS I'M REPRESENTING ARE INDIVIDUALS WHO PRODUCE 2 BARRELS OF OIL PER DAY UP TO MANY HUNDREDS OF BARRELS PER DAY. MANY OF OUR OPERATORS ARE STRIPPER WELL OPERATORS PRODUCING LESS THAN 10 BARRELS OF OIL PER WELL PER DAY. THEY HAVE NO REVENUE FOR DRILLING AND PRODUCING OIL & GAS WELLS FROM EITHER REFINING, TRANSPORTATION, PETROCHEMICAL PLANTS AND NEITHER DO THEY SELL ONE SINGLE GALLON OF GASOLINE AT THE RETAIL GASOLINE PUMP, YET WE ARE EXPECTED TO OPERATE AND SURVIVE UNDER THE SAME TAX PROVISIONS AS THOSE WHO OPERATE IN ALL SEGMENTS OF INDUSTRY. THE REVENUE WE USE TO DRILL AND PRODUCE MUST COME FROM THE BARREL OF OIL AND THE NATURAL GAS WE PRODUCE. WE HAVE NO OTHER SOURCE OF REVENUE EXCEPT THE RISK CAPITAL WE ARE ABLE TO ATTRACT TO HELP US CARRY ON OUR EXPLORATION EFFORT. I BELIEVE THE INDEPENDENT OIL OPERATOR'S EXPLORATION EFFORT HAS BEEN WELL DOCUMENTED SINCE WE CONTINUE TO DRILL SOMETHING OVER 75% OF THE EXPLORATORY WELLS AS WE HAVE OVER THE PAST DECADE OR MORE.

IN 1969, OUR ASSOCIATION APPEARED BEFORE THE HOUSE WAYS AND MEANS COMMITTEE IN AN EFFORT TO KEEP THE CONGRESS FROM CUTTING THE DEPLETION ALLOWANCE. WE EXPRESSED OUR BELIEF, AT THAT TIME, THAT A DEPLETION CUT WOULD FURTHER SLOW

DOWN THE OVERALL EXPLORATION EFFORT FOR ALL OF INDUSTRY, AND PARTICULARLY THE INDEPENDENT SEGMENT OF THE INDUSTRY. THE DEPLETION WAS CUT 5½%, AND THE CONGRESS ELIMINATED TWO ADDITIONAL TAX PROVISIONS THAT HAD HELPED THE INDEPENDENTS SURVIVE WHAT, BY THEN, WAS ALMOST A PATHETIC SITUATION IN THE INDEPENDENT RANKS. IN 1969, THE NATION HAD 1,195 ACTIVE ROTARY RIGS MAKING HOLE IN THE CONTINENTAL LIMITS OF THE UNITED STATES. THE TAX REFORM ACT WENT INTO EFFECT IN 1970, AND BY 1971 WE ONLY HAD 975 ACTIVE ROTARY RIGS, A DECREASE OF 220 ACTIVE DRILLING RIGS. I DON'T BELIEVE IT TAKES TOO MUCH MOXY TO SEE THAT ANOTHER CUT OR COMPLETE ELIMINATION OF THE DEPLETION PROVISION WILL ALL BUT PARALYZE THE EXPLORATION EFFORTS OF INDEPENDENT OIL AND GAS PRODUCERS.

LAST, AND CERTAINLY NOT THE LEAST OF OUR PROBLEMS, IS THE FACT THAT SOME PEOPLE IN GOVERNMENT THINK THAT THE RECENT UPWARD TREND IN OIL PRICES HAVE PUT THE INDEPENDENTS ON EASY STREET. NOTHING COULD BE FURTHER FROM THE TRUTH. THE INCREASED COST OF DOING BUSINESS IN THE LAST 6 MONTHS HAS TAKEN MUCH OF THE PROFIT OUT OF A BARREL OF CRUDE OIL. THIS, ADDED TO A PROPOSED CUT IN DEPLETION, WOULD CERTAINLY BRING THE INDEPENDENTS BACK TO OR BELOW THE 1971 LEVEL OF ACTIVITY WHICH I MENTIONED EARLIER IN THIS STATEMENT. IN THIS REGARD, I WOULD BE MOST HAPPY TO DISCUSS THIS ASPECT OF OUR BUSINESS WITH ANY MEMBER OF THIS COMMITTEE.

MEMBERS OF THIS COMMITTEE, WHAT THIS NATION AND OUR INDUSTRY NEEDS TODAY IS MORE INCENTIVE, NOT DISINCENTIVES, AND AN ECONOMIC CLIMATE WHERE WE CAN CONTINUE OUR SEARCH FOR THE ENERGY RESERVES THAT THIS NATION IS SO VITALLY SHORT OF TODAY. UNLESS YOU CAN PROVIDE THOSE INCENTIVES HERE IN THE CONGRESS, CONTROL OF OUR ENERGY RESOURCE POLICIES WON'T BE SET BY THIS CONGRESS, BUT WILL BE SET BY THOSE NATIONS WHO CONTROL 55% OF THE FREE WORLD'S CRUDE OIL RESERVES AND

NATURAL GAS, NAMELY THE NATIONS OF THE MIDDLE EAST. I THINK IT'S TIME WE STOP AND TAKE STOCK OF OUR ENERGY POSITION BEFORE WE MAKE ANY JUDGEMENT ON CHANGING OUR TAX POLICIES FOR AN INDUSTRY THAT IS AS VITAL TO THE NATION AS OUR IS.

THANK YOU FOR LETTING ME APPEAR HERE TODAY.

LAVON M. YOUNG

Statement of A. W. Rutter, Jr.
Before the Finance Committee
United States Senate
Washington, D. C.
June 6, 1974

My name is A. W. Rutter, Jr. I live in Midland, Texas, and I appear here on behalf of the Texas Independent Producers and Royalty Owners Association. Our Association has approximately 3,500 members, down 2,500 from the high point of about 6,000 in the 1956-58 period. I happen to be one of the few who remained active in our Association even though my economic interest in the industry materially changed.

I would like to tell you of my business history since receiving a Bachelor of Arts degree in economics in 1948 and a Bachelor of Science degree in geology in 1949. I went to work for a consulting petroleum geologist in Midland in 1949 and two years later joined my father, a small independent West Texas producer. Our company grew from about 150,000 barrels of oil per year production in 1951 to a million barrels of operated production in both 1956 and 1957. During these two years, we also operated 2 billion feet of natural gas production annually.

Starting in 1958 and culminating in 1961, a series of disturbing events caused us to reappraise our then complete economic involvement in the oil and gas business. Briefly, these included being forced to file with the Federal Power Commission as a public utility when in fact we never intended to be in business for anyone's convenience and necessity except our own. The rising tide of imports threatened to wipe us out and allowable production in Texas was cut back month after month in order to prevent waste. Small price erosions were taking place even though costs were increasing. We had three wildcat discoveries in 1958, each capable of producing the

5,000 barrels per month allowance assigned and we spent about six weeks of intensive effort to find a purchaser. Each nearby pipeline said it was the responsibility of another to take our oil. We finally trucked the oil to market at a discount.

In 1960 and 1961 we sold a substantial portion of our production and for once in my life I didn't owe the bank anything. Since 1961, we have diversified into many other fields, including shopping centers, rental property and motel operations. I presently operate 4 motels containing 532 rooms and have in the past operated 10 motels with over 1,000 rooms. I am a founding director of the National Innkeeping Association. Diversification even extended to the life insurance business, where I have served on the boards of three life insurance companies.

From 1961 until 1973 we essentially drilled no wells. The obvious shortages of gas domestically led us to become involved in a wildcat drilling program in Alberta where we have had some success. The Alberta government has recently mandated an increase in the price paid to producers which further heightens our interest in Canadian exploration. We will continue exploring there until it becomes equally profitable domestically or until the Canadian government deters us by enacting the punitive legislation that has been proposed.

I can tell you with complete candor that there is a boom in the oil patch in West Texas right now. People are working nights, no rigs are available, crews working for service companies often have a six-month "veteran" as the most experienced man, and any half way reasonable prospect can be turned.

I submit exhibits 1, 2 and 3 to show the telephone connections, bank deposits and employment in Midland in 1973 and 1974. It is obvious that the increase in the price of domestic crude which started in the summer of 1973 had a dramatic effect. The

number of rotary rigs operating in Texas increased to 499 on May 20 from 355 a year earlier and nationwide 610 more wells were drilled in the first quarter of 1974 than 1973, about a 9% increase. I would suggest that all evidence indicates that the response to unfavorable factors can be just as swift as the response has been to the favorable factor.

We have all heard of shortages and certainly we have many in oil field materials. These can be overcome in due course with better distribution, higher incentives, etc. A longer range shortage is in our skilled personnel. Oil exploration is extremely complex, requiring the talents of many diverse sciences and skills. Cable tool drillers are a dying breed and experienced rig personnel have disappeared during the same period I sat on the sidelines. As an example, my exhibit 4 shows the number of graduating seniors majoring in Petroleum Engineering and in Geology at the University of Texas at Austin. This has been one of the nations largest schools, and I feel sure the experience has been duplicated at all universities offering these degrees. The recent upturn in Graduates is probably accounted for by job openings in foreign exploration. If the job is ever to be done, our young people must see a future in oil exploration and production so that they will pursue the proper degree plans to fill our needs.

We would like to get back into domestic oil exploration. We recently re-acquired three well bores that can be deepened to a lower pay zone. These wells are definitely uneconomic at $5.00 for oil and almost surely profitable at $10.00. These wells will cost $100,000 each to deepen. We have postponed this endeavor month to month hoping to get a final answer on what the Congress is going to do. I can't tell

you how many similar projects are sitting on the shelves while politicians argue and make wild accusations and threats against the oil business. No doubt there are many thousands of such examples. We therefore urge you to come to a final decision soon. If depletion is to be removed, then this fact will be taken into account in investment decisions. The stock market hates uncertainty and so do oil producers. The main difference is that oil producers are by nature optimistic. Everytime a well is drilled, the oil hunter is betting 5 inches against the world.

I would like to turn my attention to the economic principle involved in the statutory depletion allowance. No income tax law since passage of the 16th Amendment to the Constitution has contemplated a tax on that portion of gross income which represents a return of capital. Nor do our opponents at this time admit that they contemplate such a tax. I submit that a formula to test the adequacy of a depletion rate and to explain the depletion principle is readily available.

This formula is: The depletion rate times the gross selling price of a unit of production should equal the price at which a similar unit of production can be purchased in the ground. When this formula is in balance, a producer of cubes of "X" material can replace however many cubes he has produced from his reserves by paying some other producer the amount of depletion claimed. Or 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 the oil business, let us assume that the price of oil at lease tanks is $10.00 per barrel. When 22.0% depletion is taken, a producer deducts $2.20 from his net income, but he currently has to pay $3.00 to $4.05 per barrel for reserves to replace the barrel produced.

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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 from others. He may decide instead to gamble that he can replace them more cheaply by finding them himself and this is his decision and his risk. And the risks inherent in finding reserves and all of the other factors usually cited as the basis for depletion rates will be averaged and weighed by a free marketplace in arriving at the going price for reserves in the ground.

While the formula suggested does not balance at the present time, I submit that historically it has and that, if out of balance for any extended period of time, will result in dire consequences. In the middle thirties, for instance, West Texas sour crude brought 90¢ to $1.00 and good reserves old for 20¢ to 25¢ per barrel. Similarly in the late forties and early fifties, top grade crude was $3.10 and reserves could be purchased for 90¢ to $1.00. The properness of the depletion rate for any extractive industry, including foreign production, can be checked by this formula. And probably most will stand up.

In the formula, the depletion rate is fixed and the two variables should be competitively set in the marketplace. If the variables are so arrived at, any imbalance is due to the wrong depletion rate. In today's instance in crude, the increased costs and risks of finding new reserves has pushed up the price for proven reserves.

The present rate of depletion is too low because purchasers are willing to pay more than the depletion rate times the gross selling price. Perhaps you are not aware that there is a large freely competitive market for reserves. Even the majors, on occasion,have been on the selling side and the large banks all have engineers to appraise properties for loans. There are hundreds, even thousands, of potential buyers and sellers and there are lots of brokers working to bring the two together.

If a producer can only take $2.20 tax free out of a barrel of oil, he is much more inclined to sell his reserves for $3-$4.00 per barrel than if his depletion is $3-$4.00 per barrel. I firmly believe this accounts for the persistent stream of sell-outs of independent producers with its monopoly implications.

If we had $14.00 crude, the depletion rate times sales price would equal the going market for reserves. With $10.00 crude, we need about a 35% depletion rate to equal the market price for good reserves.

I believe all extractive industries should justify and explain their depletion rate using this formula. If a serious imbalance results, the rate should be raised or lowered accordingly, unless one of the two variables is not freely arrived at in the competitive market.

Thank you for the opportunity to be heard. I will welcome any questions you may have with respect to my testimony.

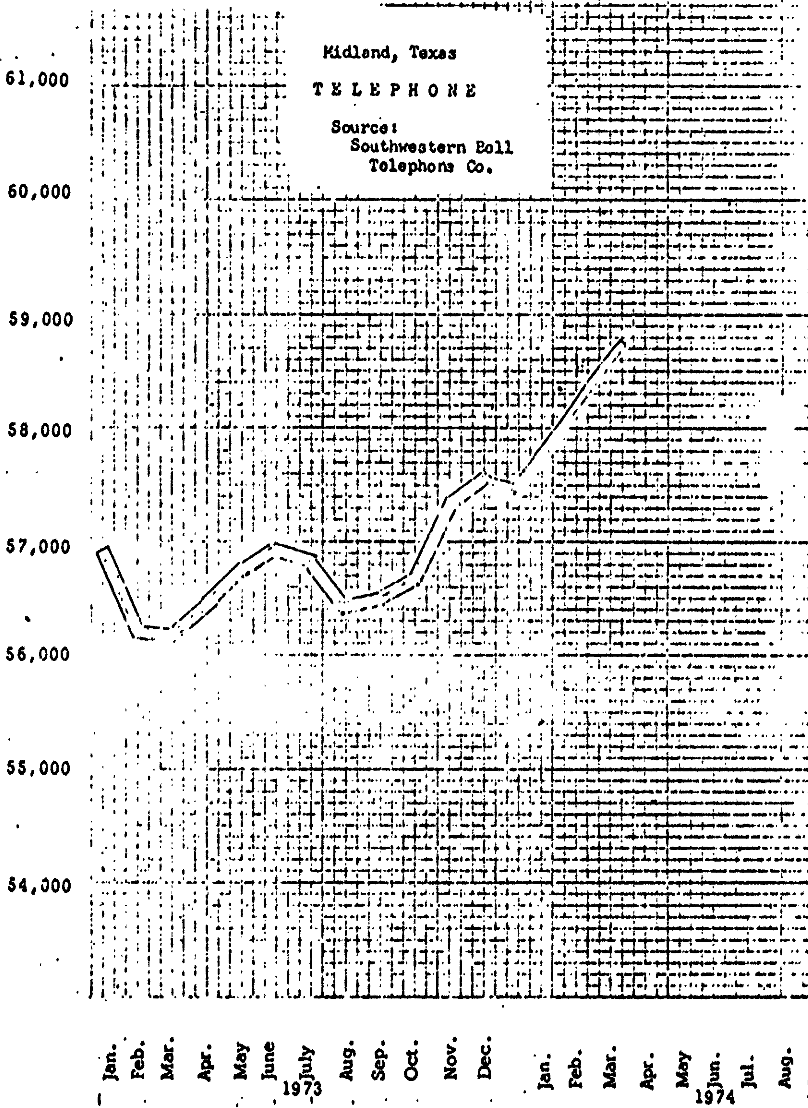
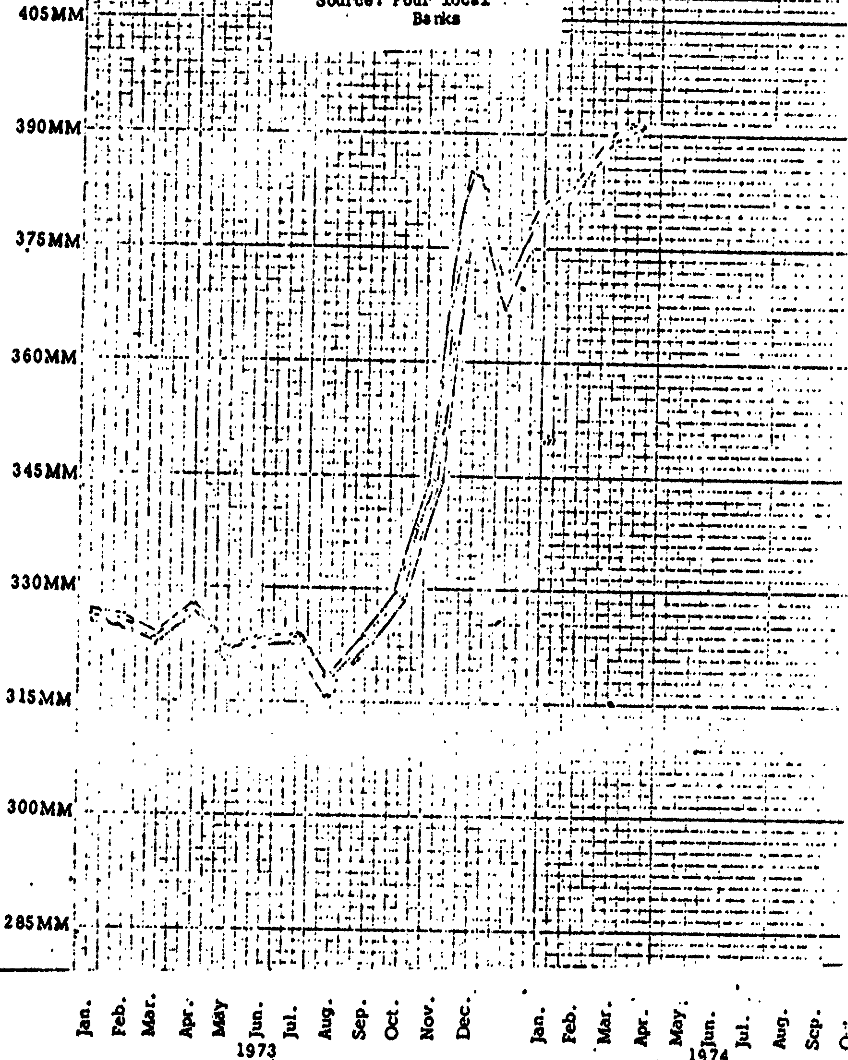


EXHIBIT 1


Midland, Texas
BANK DEPOSITS
Source: Four local Banks
405MM
390MM
375MM
360MM
345MM
330MM
315MM
300MM
285MM
Jan.
Feb.
Mar.
Apr.
May
Jun.
Jul.
Aug.
Sep.
Oct.
Nov.
Dec.
1973
Jan.
Feb.
Mar.
Apr.
May
Jun.
Jul.
Aug.
Sep.
1974

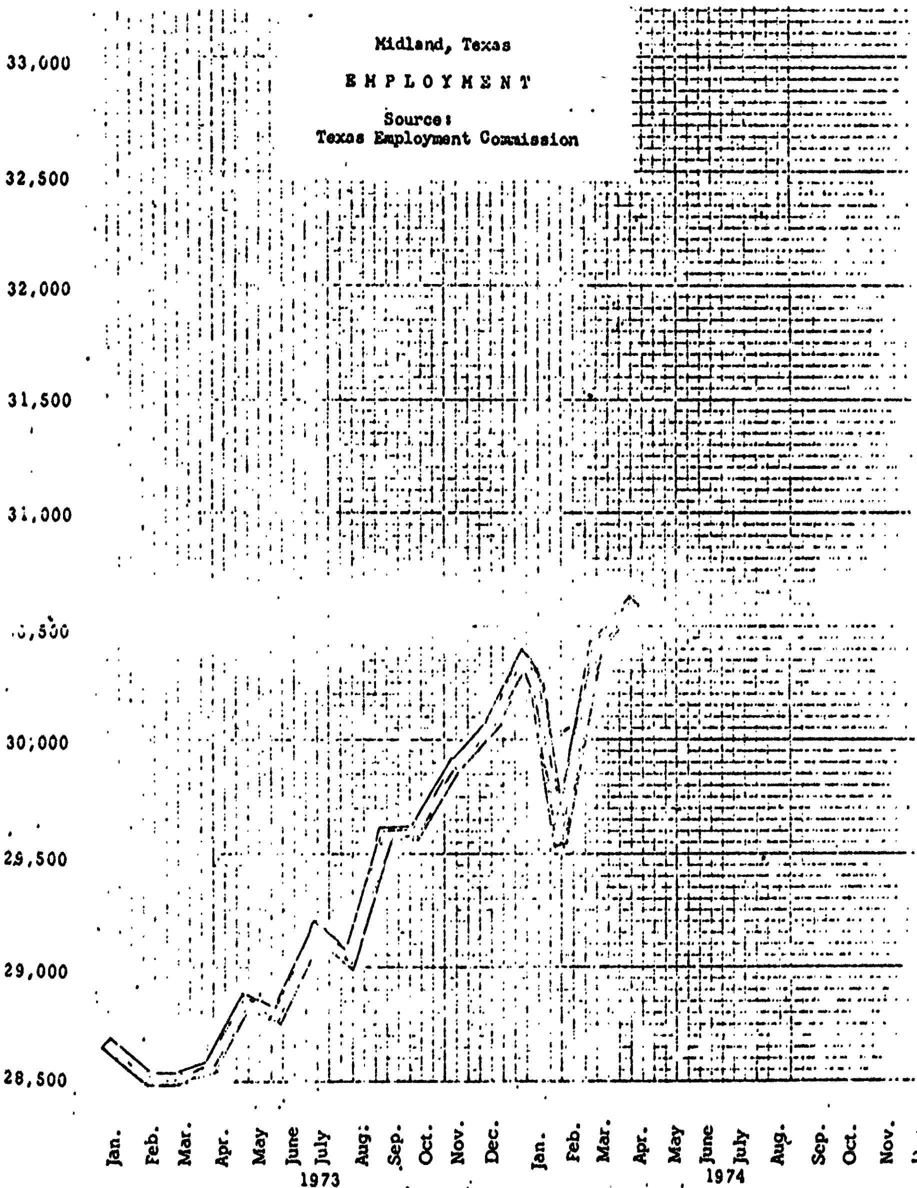


EXHIBIT 3

Graduating seniors from the University of Texas at Austin, Texas with majors in Petroleum Engineering or Geology

	Petroleum Engineering	Geology
1957-58	109	121
1964-65	19	7
1965-66	9	9
1966-67	9	8
1972-73	27	33

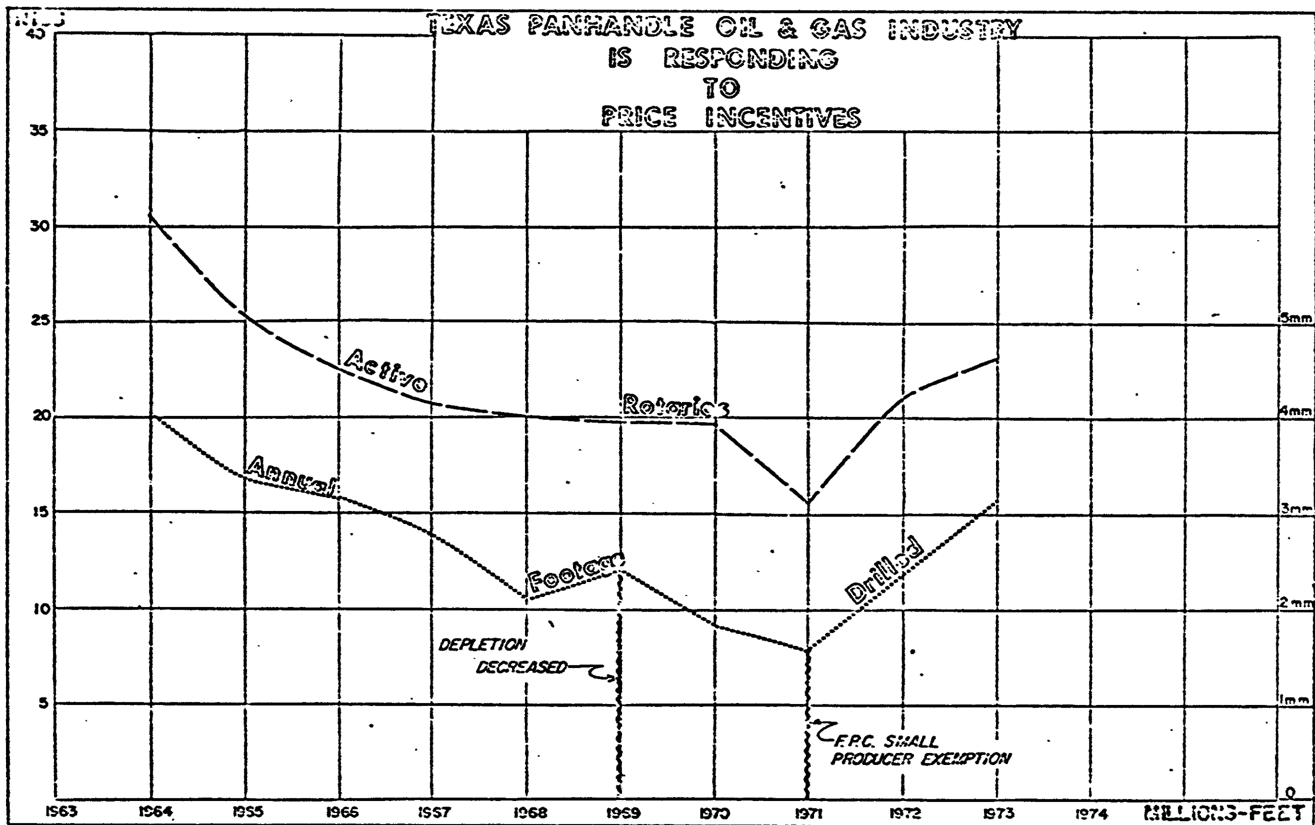
Statement of Danny H. Conklin
Philcon Development Co.
Before the Finance Committee
United States Senate
Washington, D. C.
June 6, 1974

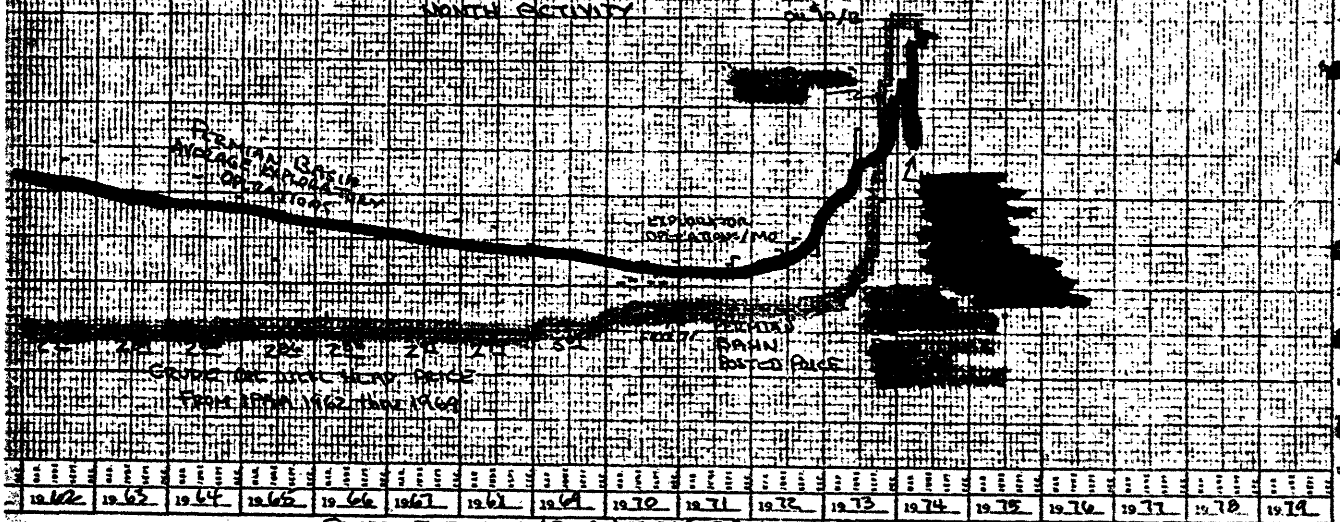
My name is Danny H. Conklin. I am a partner in Philcon Development Co., an independent oil and natural gas exploration and producing firm. I appear here as president of Panhandle Producers and Royalty Owners Association, a regional association with 438 members composed of independent oil and gas producers, royalty owners and service related companies of the Texas Panhandle.

The data presented in graph form is based on the annual footage drilled and active rotary rigs in the Texas Railroad Commission District #10 covering the top 26 counties in the Texas Panhandle. The response to Federal action, favorable or unfavorable, is obvious by tracking the peaks and valleys in the activity curve. The Tax Reform Act of 1969 decreased depletion from 27 1/2% to 22% effective October 9, 1969. You will note the decrease in the annual footage in 1970 with rigs and footage continuing to decrease in 1971. It was my experience this activity decline was due to the decrease in the percentage depletion and improper price structure. The outside investor had placed capital in high risk oil and gas ventures with the depletion allowance program in his return on investment. The unfavorable Federal action immediately changed the economic picture for the investor; consequently, he turned to other investment opportunities with much less risk. This graph enables you to foresee the possible effect the proposals to phase-out or eliminate the percentage depletion will have on the exploration for petroleum reserves.

The dramatic reversal of the downward activity trend was in direct response to the Federal Power Commission's exemption of the small natural gas producer effective March 18, 1971. This exemption was later held to be invalid by the Court of Appeals in the District of Columbia and is currently on appeal to the U. S. Supreme Court. The FPC action of releasing price controls for the small independent stimulated natural gas exploration in the Texas portion of the Anadarko Basin. Gas well completions increased from 49 in 1971 to 105 in 1972. A 114% increase. The increase continued in 1973 with 149 gas completions. A 42% increase over 1972. This graphic picture of the Texas Panhandle Oil and Gas explorers' response to price incentives and less Federal regulations suggests the cource that will generate exploration for additional petroleum reserves. My company and investors spent $1,300,000 exploring for oil and gas in 1973. We drilled 9 wells ranging in depths from 3200 feet to 10,600 feet and purchased oil and gas leases on approximately 12,000 acres. Philcon and Partners oil and gas income for 1973 was $1,250,000.

The percentage depletion allowance is extremely important to my company since 86% of our exploration program is financed with outside investment capital. This incentive, along with the proper price structures, helps us compete for this capital. If depletion is eliminated, it is possible Philcon Development Co. will have to stop drilling for petroleum reserves because our capital will turn to investments with much less risk. In closing, our Association supports the testimony given by the Independent Petroleum Association of America. I thank you Mr. Chairman for this opportunity to appear before this committee.


TEXAS PANHANDLE OIL & GAS INDUSTRY
IS RESPONDING
TO
PRICE INCENTIVES
Active Rotaries
Annual Footage Drilled
DEPLETION DECREASED
F.P.C. SMALL PRODUCER EXEMPTION
40
35
30
25
20
15
10
5
0
1mm
2mm
3mm
4mm
5mm
1963
1964
1966
1968
1969
1970
1971
1972
1973
1974
MILLIONS-FEET


EXAMPLE
NOV 1973 MAP
62 COMPLETIONS
NOTE OPERATIONAL PLOT
REFLECTS PREVIOUS
MONTH ACTIVITY
EXPLORATORY OPERATIONS
FROM MIDLAND MAP CO
MONTHLY PERMIAN
BASIN WILDCAT MAP
PERMIAN BASIN
WEST TEXAS & NEW MEXICO
EXPLORATION ACTIVITY
PERMIAN BASIN
EXPLORATION
OPERATIONS/MO
BASIN
POSTED PRICE
1962
1963
1964
1965
1966
1967
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
PLOT OF TOTAL EXPLORATORY OPERATIONS,
PERMIAN BASIN & POSTED PRICE NEW &
RELEASED CRUDE OIL
MURPHY MINERALS CORPORATION
POST OFFICE DRAWER
ROSWELL, NEW MEXICO

S/k c 7

554 SECURITY NATIONAL BANK BUILDING

PHONE 622-3770

CHARLES B. READ
PRESIDENT

NORMAN L. STEVENS, JR.
VICE-PRESIDENT

JOHN L. ANDERSON, JR.
EXPLORATION MANAGER

Read & Stevens, Inc.
Oil Producers
P. O. Box 2126
Roswell, New Mexico 88201

June 4, 1974

The Honorable Russell B. Long
Chairman
Finance Committee
United States Senate
Washington, D. C.

Dear Senator Long:

Read & Stevens, Inc., an independent oil and gas producer located at Roswell, New Mexico, submits for consideration of your committee a report of our operations for the 3 1/2 year period ending March 30, 1974. We are a domestic nonintegrated company primarily engaged in the exploration, drilling and production of oil and gas. We presently produce 43,945 barrels of oil per month and rank 38th, based on production, out of a total of 228 oil and gas operators in the State of New Mexico.

We own an undivided interest in 596 undeveloped oil and gas leases comprising 223,396 gross acres or 100,682 net acres situated in New Mexico, Texas, Arizona, Colorado, Utah and Montana. We operate 48 producing oil and gas wells located on a total of 6280 acres. Our producing properties are only 3% of our total oil and gas lease inventory. We have 13 employees in our company.

Attached is Summary Of Operations Of Read & Stevens, Inc. for the 3 1/2 year period ending March 30, 1974 shown as Exhibit "A". During this period, our statutory depletion allowance has averaged only 19.6%. Our depletion allowance has amounted to only 66% of our total drilling, exploration and dry hole expenditures. We have plowed back more than we have received in depletion allowance tax credits. Based on an original investment of $717,471.00, the average annual yield on our investment, after taxes, during the 3 1/2 year period is 7.06%. Because of recent price increases in the sale of oil and gas products, we have increased our drilling and exploration budget for the first six months of 1974 by 68%. Corporate earnings for the same six months comparative period have decreased 87% in 1974 as compared to 1973.

The depletion allowance is the most important incentive that the independent oil and gas producer has to continue in business. If the depletion allowance were eliminated in its entirety, it would necessitate a reduction in our drilling and exploration budget by 61%. In order for our nation to achieve energy independence, I strongly urge you not to reduce the depletion allowance. In fact, it should be increased rather than decreased to provide the incentive for the independent oil and gas producers who drill more than 75% of the wells in the United States.

Yours very truly,

READ & STEVENS, INC.

Charles B. Read
President

CBR:at

Encl.

EXHIBIT "A"

Read & Stevens, Inc.
Summary of Operations
3 1/2 Year Period Ending March 30, 1974

Total Oil & Gas	1971		1972		1973		1974 First 6 months		Total 3 1/2 Yr. Period
Production in Barrels	653,147		576,829		642,266		262,256		2,134,498 bbl.
R&S Net Oil & Gas Sales		$1,121,777		$728,059		$746,859		$418,791	$3,015,486
Expired & Condemned leases	$ 20,313		$ 92,069		$ 56,317		$ 1,842		
Intangible Drilling Costs	$154,765	$ 175,078	$140,177	$232,246	$231,641	$287,958	$194,271	$196,113	$ 891,395
Statutory Depletion		$ 228,716		$111,834		$163,592		$ 88,005	$ 592,147
Return on Investment based on Stockholders equity and net profit after taxes		10.04%		(29.54)%		44.0 %		0.20%	

SUMMARY

(1) Statutory Depletion over 3 1/2 year period average is 19.6%

(2) Depletion accounted for only 66% of total Drilling & Exploration Expenditures.

(3) Based on original investment of $717,471.00 (original book value of Read & Stevens, Inc. in January 1, 1971) the average annual yield on investment, after taxes is 7.06%.

(5) If Depletion Allowance is eliminated completely then drilling & exploration would be reduced by an average of 61.4%

PICKRELL DRILLING COMPANY

DRILLING CONTRACTORS • OIL PRODUCERS
705 FOURTH NATIONAL BANK BLDG.
WICHITA, KANSAS 67202

June 1, 1974

Senator Russell B. Long, Chairman
Committee on Finance
United States Senate
Senate Office Building
Washington, D. C. 20515

Dear Senator Long:

We are writing to inform you of the effect of the proposed repeal of the 22% statutory depletion allowance for oil production on our own small independent oil operations. We are also requesting your consideration of the effect of this proposal on oil and gas exploration efforts of the independent segment of the industry, and requesting your support in preventing such a drastic step by Congress.

The attached schedule reflects projected oil sales for 1974 for two individual taxpayers associated with our company, the operating expenses, depreciation and depletion applicable to this income and the resulting Federal income taxes thereon, together with the Federal income taxes which would be due if the 22% statutory depletion rate were removed as of January 1, 1974. This projected information is next assembled to disclose the cash flow available to these taxpayers from oil production and the effect on cash flow of the removal of the 22% depletion provision.

Inasmuch as these taxpayers are each in the 70% Federal income tax bracket, the reduction in cash flow available for exploration and equipment is 70% of 21% (effective depletion rate) of oil production.

The schedule also shows the effect on all interests in our oil operations, including Taxpayers B and S, assuming other associates in our production and exploration program also are in the 70% Federal income tax bracket and also receive an effective 21% rate of depletion.

If the 22% statutory depletion provision were removed from the Federal income tax laws and a windfall profits tax (excise tax on production) were also to be imposed on the independent oil and gas industry, our cash flow

problems would be compounded. Our own funds for exploration would be curtailed, our associates would withdraw from or materially reduce their oil and gas exploration expenditures, and we independent explorationists would, of necessity, be required to drastically reduce our oil and gas seeking efforts.

In our own case, Pickrell Drilling Company has been able to drill 60 to 70 wells per year with its two rotary rigs. With an average well cost of approximately $25,000 for dry holes, $50,000 for successful wells, and a weighted average cost of $27,777, the reduction of $1,149,338 in cash flow would translate to approximately 41 wells which we would not be able to drill(which is approximately two thirds of our potential drilling capacity).

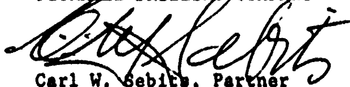
Exploration is heavily financed by the independent producer through the cash flow which is provided by the depletion allowance. The above effects on cash flow vividly show, for one small independent operator, how significant is depletion to its exploration program.

We believe we are typical of the small independent operators in the oil and gas industry, which are currently responsible for 85% of domestic exploration activity. If other independent operators are as adversely affected by the removal of depletion as are we, and we see no reason why they will not be similarly affected, it is dramatically evident that this important segment of the energy industry will be unable to continue any agressive exploration program, let alone develop an expansion which is sorely needed.

We respectfully request your assistance, Senator Long, for our industry and for the nation.

Yours very truly

PICKRELL DRILLING COMPANY



Carl W. Sebits, Partner

CWSrs
Encl.

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PICKRELL DRILLING COMPANY
EFFECT OF REPEAL OF 22% DEPLETION

	Taxpayer B	Taxpayer S	100% of Pickrell Interests (Including Taxpayers B and S)
Cash Flow:			
Cash Generatedfrom Oil Sales	$1,219,350	$1,034,600	$7,818,620
Cash Requirements for Operating Expense	341,418	289,688	2,189,214
Cash Requirements for Income Taxes With Above Depletion Allowance	392,630	333,141	2,517,595
Total Cash Requirements With Present Depletion	734,048	622,829	4,706,809
Cash Available for Exploration and Lease Equipment With Continued Present Depletion Allowance	485,302	411,771	3,111,811
Cash Available for Exploration and Lease Equipment Without Depletion	306,057	259,685	1,962,473
Reduction in Cash Available for Exploration and Lease Equipment	$ 179,245	$ 152,086	$1,149,338
Actual 1973 Expenditures:			
Equipment Costs, Leases	$ 75,950	$ 67,177	$ 383,869
Development Costs, Leases	148,190	154,207	881,183
Dry Hole and Exploration Costs	279,247	225,135	1,286,486
Total 1973 Expenditures	$ 503,387	$ 446,519	$2,551,538

PICKRELL DRILLING COMPANY

EFFECT OF REPEAL OF 22% DEPLETION

	Taxpayer B	Taxpayer S	100% of Pickrell Interests (Including Taxpayers B and S)
1974 Projected Oil Sales:			
165,000 Bbls. at $7.39 (average Price)	$1,219,350		
140,000 Bbls. at 7.39 (Average Price)		$1,034,600	
1,058,000 Bbls. at 7.39 (Average Price)			$7,818,620
Total Oil Sales	1,219,350	1,034,600	7,818,620
1974 Projected Deductions:			
Operating Expenses Projected at 28% of Sales	341,418	289,688	2,189,214
Depreciation Projected at 5% of Sales	60,968	51,730	390,931
Depletion Projected at Effective Rate of 21%	256,064	217,266	1,641,910
Total Deductions	658,450	558,684	4,222,055
Taxable Income from Producing Properties	560,900	475,916	3,596,565
Tax at 70% With Above Depletion Allowance	392,630	333,141	2,517,595
Tax at 70% Without Depletion Allowance	571,875	485,227	3,666,933
Increase in Taxes Resulting From Removal of Statutory Depletion	$ 179,245	$ 152,086	$1,149,338

G. L. JERRY VINSON
OIL AND GAS PRODUCER
600 CITY NATIONAL BUILDING
WICHITA FALLS, TEXAS 76301

June 4, 1974

The Honorable Russell B. Long, Chairman
Senate Finance Committee
Old Senate Office Building
Washington, D. C. 20510

Dear Senator Long:

I wish to describe to you the effect which the loss of the depletion allowance would have on our oil and gas operations.

As the law now stands, if an individual spends $100,000 to drill and complete an oil or gas well, he will be able to deduct 70% or 75% of that $100,000 from his current taxable income because that is about the normal amount of intangibles involved in an average well. However, he will not be able to deduct the remaining 25% or 30% which goes into tangibles such as casing, surface equipment, etc. If, at the same time, he had a matching $100,000 worth of income from oil and gas, the depletion allowance would provide him with 22%, or $22,000, of the required money to pay for the tangibles, leaving him still short by 3% to 8%. Lacking the depletion allowance, he would be forced to borrow the money to pay for his tangibles and that would present him with a difficult repayment problem, since any income above about $44,000 a year for a husband and wife is taxed at more than 50% and that rate climbs rapidly up to a maximum, counting the minimum tax, of about 75%.

Just how does he live, pay for the seven or eight dry holes he probably must drill before he gets his producer, attract any outside investors, and leave any room for growth. The problem is much more compound and almost impossible if he be a young man trying to start out in the oil business without any substantial income to begin with.

To be more specific, I will give you the figures of our own operations last year, 1973:

Total income from oil and gas production	$ 471,110.82
Total expenditures in drilling operations, acquiring leases, paying lease rentals, geological and geophysical expenditures, lease equipment, producing costs, severance taxes and general and administrative overhead	1,300,871.35
CASH DEFICIT	$ 829,760.53

Obviously, this difference must be made up from:

1. Our own income outside of the oil and gas industry.

2. Outside investors who were attracted to the oil industry principally by the depletion allowance.

3. Borrowings (at current interest rates - a real burden).

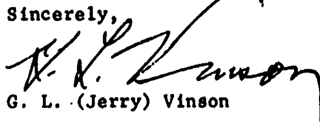
It can be seen that the depletion allowance falls somewhere between 3% and 8% short of being enough to cover the tangible equipment used for our typical well.

This industry is going to need vast infusions of outside capital in order to do the job of producing energy which the country needs and expects. It will be hard to attract without the depletion allowance.

As to the price of oil, every single thing we must buy from labor, trucking, materials, office overhead, or any other item you could name just goes up constantly. For example, a well drilled in this vicinity recently for $3.75 per foot contract price went to the lowest bidder 60 days later at $6.00 per foot. This was for a comparatively shallow well of about 3400 feet depth. The 20,000 ft. ones in which we often participate present an even more inflated picture.

I trust this information will prove to be useful and that you can, by its use, make some few of the complications involved in the oil business better understood by those who make the laws which can destroy us all overnight because I fear that the elimination of the independent from the oil industry would place us still further at the mercy of foreign producers; thus rendering us more incapable of defending ourselves, lowering our living standards, and giving our country an impossible balance of payments shortage.

Sincerely,



G. L. (Jerry) Vinson

GLV:me

THE WISER OIL COMPANY
P.O. BOX 192 SISTERSVILLE, W. VA. 26175

John C Wright President
Milton G Bailes Secretary

June 3, 1974

Mr. John Miller, President
Independent Petroleum Association of America
1101 Sixteenth Street, N. W.
Washington, D. C. 20036

Re: Depletion

Dear John:

The Wiser Oil Company, with oil and gas production in fourteen states and Canada, located in Sistersville, West Virginia, has a long history of exploring for and providing energy in the form of oil and gas for refining and consumption in the United States. Our history as a small non-integrated domestic exploration and producing company dates back almost to the turn of the century. Our company participates in the drilling of over 100 wells per year and in 1973 had capital expenditures for company activities approximating $4,129,000. Net oil production presently is running at 4,100 barrels per day.

I would suggest that Wiser is a typical small independent company in this highly competitive business competing with all of the other independents and the majors for acreage and drilling opportunities. We are too small to risk the very deepest drilling in the country or to bid and drill in the offshore areas.

The new oil and gas prices have stimulated our 1974 program so that to date in the current year, exclusive of shallow Kentucky waterflood wells, we have participated in 49 wells, either drilling or completed, in nine states. Included in that list of wells, already completed are 26 dry holes. Our capital expenditure program was slated to increase as much as 50% over the preceding year. We are now reviewing very carefully our exploratory and expenditure program for the remainder of the year in light of legislative events in Washington.

I need not recite to you the part that the domestic independent producer has played and continues to play in doing most of the U. S. A. exploring for and drilling and producing. The independent has always been willing to take the risks, gather forth the funds and drill the wells, while the majors stood by or looked elsewhere for their oil supplies. Due to artifically low oil and gas prices, generally caused by our government, we have lost over one-half of our independent sector in the past thirty years. Under current legislative proposals, we will lose many more.

The Wiser Oil Company is greatly concerned over proposals to eliminate depletion, rollback the price of crude oil and place an added burden of excise or windfall profits taxes on the producer. We hear lip service from our Senators and Congressmen that they want to maintain a healthy, viable independent oil business and get after the majors. The very rules they are proposing will serve to sustain the majors and phase the "oil finders" out of business.

The recent Arabian embargo should have frightened and aroused our electorate to positive action, but instead, we see most of them playing politics and attempting to punish all of the oil companies for something we have been warning of for years. Their "helter-skelter" actions arouses in me a deep alarm for the future of this nation. Someone had better wake up to the facts of the situation.

First quarter 1974 company profits need examining. Alarmingly rapid increased costs have not caught up to increased product prices yet, (they will), no real account has been given to replacement costs, and inventory adjustments have made figures misleading.

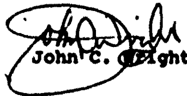
As a small independent oil company, we view the legislative proposals as punitive, self-defeating and regressive. If they should all or a part of them go through, you will see a great exodus of small producers. You don't make new independent domestic oil men overnight - in fact you won't make them again once they leave. They have played a big part in providing this country with cheap energy and plenty of it, and I'm proud to be one of them!

Looking at one of these proposals, the elimination of statutory depletion, will give you an idea of the effect on The Wiser Oil Company. Due to having many old wells that are fully cost depleted, we have over $1,600,000 per year in statutory depletion. Should this be eliminated, our company would have approximately $768,000 of added tax burden. Our company paid in Federal and State taxes in 1973, $1,910,000. The addition of the $768,000 would simply make that much money not available for our prime purpose - finding or acquiring new oil and gas reserves. Multiply this by the other independents and you take a lot of money away from exploration and development domestically. Such legislation as this and the other proposals, will require all of us to reassess our future plans and programs carefully. This business is hard and risky enough without confiscatory interference by the government.

However, we have great faith in our system of government and in those of the electorate who are statesmen, men of vision and integrity. We believe that reason will prevail and that ultimately, we will get encouragement rather than discouragement to move forward in broadened exploratory and drilling programs that will ultimately increase this country's self-sufficiency to a comfortable point. To reach this stage will require greatly increased expenditures and, consequently, sizably increased earnings. The independent oil man has historically put most of his income and cash flow back in the ground hunting for new production.

In conclusion, I'm proud to be an independent oil man representing an independent oil company, and I do not apologize for depletion. I believe what is good for the independent oil man is good for the country.

Very truly yours,



John C. Wright

JCW/hma

cc: Senator Robert C. Byrd
Senator Jennings Randolph
Congressman Robert H. Mollohan
Congressman Harley O. Staggers
Congressman John M. Slack
Congressman Ken Hechler

ROTARY RIGS ACTIVE

	1972 November	1972 December	1973 January	1973 February	1973 March	
Florida	7.8	8.0	8.2	7.5	8.8	
New York	1.5	1.0	0.2	0	0	
Pennsylvania	8.8	9.5	10.4	7.8	8.8	
Virginia	1.8	0.5	0.6	0.5	0	
West Virginia	19.8	21.3	13.8	15.8	17.3	
Other	1.8	2.0	[illegible]	1.0	0	
DISTRICT I	41.5	42.3	34.0	32.6	34.9	
Illinois	12.5	10.5	7.2	5.0	5.0	
Indiana	1.3	1.5	1.0	0.5	0.5	
Kansas	23.3	33.3	38.8	28.5	19.5	
Kentucky	2.8	2.3	0.8	1.8	1.8	
Michigan	21.5	20.8	22.6	20.3	16.3	
Nebraska	5.8	5.5	4.8	3.0	5.0	
North Dakota	11.0	8.8	9.0	7.0	7.0	
Ohio	28.0	30.3	31.6	29.0	24.8	
Oklahoma	93.8	94.0	96.6	92.5	102.0	
South Dakota	0.5	1.0	0.2	0	0	
Other	2.0	2.0	0.4	0.5	1.0	
DISTRICT II	[illegible]2.5	210.0	213.0	188.1	182.9	
Alabama	18.8	16.0	12.8	13.5	13.8	
Arkansas	11.8	12.3	13.4	17.0	18.0	
Louisiana	235.8	[illegible]	244.6	228.8	197.3	
Gulf						
Other						
Mississippi	40.8	42.0	42.4	34.0	28.8	
New Mexico	62.5	73.3	62.0	44.5	43.0	
Texas	342.0	362.5	371.0	363.3	344.3	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	701.7	743.8	746.2	695.1	645.2	
Colorado	45.5	43.8	39.6	38.0	28.5	
Montana	23.3	22.8	20.0	19.0	13.3	
Utah	38.8	42.8	47.0	45.8	42.5	
Wyoming	79.0	83.0	69.8	59.5	55.0	
Other	0.5	1.0	0.6	0	0.8	
DISTRICT IV	187.1	193.4	177.0	162.3	140.1	
Alaska	3.5	2.5	3.2	5.0	8.3	
Arizona	1.5	1.5	0.2	2.0	2.0	
California	48.5	47.3	45.4	41.3	35.8	
Nevada	1.0	0.5	0	0	0	
Orher	0		0	0	0	
DISTRICT V	54.5	51.8	48.8	48.3	46.1	
TOTAL U.S.	1186.5	1241.0	1219.0	1126.0	1049.0	

Source: Hughes Tool Co.

ROTARY RIGS ACTIVE

	1973 November	1973 December	1974 January	1974 February	1974 March	
Florida	9.5	8.4	6.5	8.3	7.5	
New York	5.3	5.4	5.0	5.0	5.8	
Pennsylvania	15.3	17.2	14.8	13.8	17.5	
Virginia	2.0	1.2	0.5	2.5	2.0	
West Virginia	24.8	28.8	26.0	20.7	15.7	
Other						
DISTRICT I	59.2	63.2	55.3	52.1	49.5	
Illinois	4.0	2.6	2.8	4.0	5.0	
Indiana	0	0.2	0	0.5	0.3	
Kansas	34.0	39.6	41.0	37.0	38.5	
Kentucky	1.0	2.0	3.0	3.0	0.3	
Michigan	25.0	24.4	23.0	20.5	18.5	
Nebraska	6.0	5.6	6.0	7.8	7.0	
North Dakota	13.0	9.8	8.3	6.5	8.3	
Ohio	47.0	43.0	37.2	35.2	38.7	
Oklahoma	142.8	133.8	136.5	134.0	129.7	
South Dakota	1.3	1.0	1.0	1.0	0	
Other	2.0	1.2	1.3	1.8	1.3	
DISTRICT II	276.1	263.2	260.1	251.3	247.6	
Alabama	16.8	13.4	11.8	12.8	14.5	
Arkansas	19.5	21.4	18.3	17.3	19.5	
Louisiana	221.3	217.8	218.7	206.2	208.5	
Gulf						
Other						
Mississippi	28.8	30.6	30.7	32.0	27.5	
New Mexico	92.0	83.0	83.2	81.5	79.5	
Texas	418.0	434.4	431.7	443.5	461.0	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	785.4	800.6	794.4	790.3	810.5	
Colorado	50.0	50.8	41.5	43.2	37.2	
Montana	17.0	25.8	23.7	20.0	23.0	
Utah	33.0	30.6	34.7	40.2	40.2	
Wyoming	96.3	102.4	94.0	90.2	90.0	
Other	1.5	1.4	0.8	0	0.8	
DISTRICT IV	197.8	211.0	194.7	193.6	190.4	
Alaska	3.5	0.2	5.0	8.5	10.8	
Arizona	1.0	1.2	1.0	1.0	1.0	
California	65.0	64.0	60.5	57.2	56.5	
Nevada	1.5	1.6	0.8	1.0	1.0	
Other	0.8	0	0	0	0	
DISTRICT V	71.8	67.0	67.3	67.7	69.3	
TOTAL U.S.	1389.8	1405.0	1371.8	1355.0	1367.9	

Source: Hughes Tool Co.

TOTAL WELLS DRILLED

	1972 November	1972 December	1973 January	1973 February	1973 March	
Florida	18 23	38	8	4	7	
New York	12	66	2	4	5	
Pennsylvania	95	91	109	25	154	
Virginia	0	18	0	0	0	
West Virginia	51	70	34	88	67	
Other	0	3	0	0	0	
DISTRICT I	166	275	153	121	233	
Illinois	38	77	60	35	24	
Indiana	24	48	11	21	29	
Kansas	239	255	179	172	141	
Kentucky	61	52	53	41	52	
Michigan	22	55	18	22	30	
Nebraska	20	61	22	5	18	
North Dakota	12	11	14	7	11	
Ohio	162	171	127	115	167	
Oklahoma	161	280	123	177	216	
South Dakota	2	2	4	0	1	
Other	17	20	12	5	6	
DISTRICT II	758	1032	633	600	695	
Alabama	23	11	7	8	19	
Arkansas	40	35	12	24	21	
Louisiana	324	293	266	197	273	
Gulf						
Other						
Mississippi	31	47	33	36	38	
New Mexico	81	71	97	112	93	
Texas	694	584	647	703	741	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	1193	1041	1062	1090	1185	
Colorado	88	101	73	69	69	
Montana	71	118	39	25	49	
Utah	18	16	7	15	10	
Wyoming	100	97	108	64	93	
Other	0	0	1	0	0	
DISTRICT IV	277	232	228	173	221	
Alaska	0	3	0	0	7	
Arizona	1	0	1	0	0	
California	49	200	88	127	107	
Nevada	0	2	0	0	0	
Other	0	0	0	3	0	
DISTRICT V	50	207	89	130	114	
TOTAL U.S.	2,444	2,897	2,165	2,104	2448	

Source: API Monthly Drilling Activity Report

TOTAL WELLS DRILLED

	1973 November	1973 December	1974 January	1974 February	1974 March	
Florida	5	6	0	5	6	
New York	7	66	24	15	17	
Pennsylvania	62	194	54	113	114	
Virginia	0	9	0	10	1	
West Virginia	72	65	85	40	63	
Other	0	1	1	2	12	
DISTRICT I	146	341	164	185	213	
Illinois	22	115	56	46	49	
Indiana	21	40	13	26	29	
Kansas	223	289	178	152	209	
Kentucky	73	60	80	40	41	
Michigan	19	40	24	21	18	
Nebraska	16	18	13	17	17	
North Dakota	13	24	10	6	5	
Ohio	177	177	123	115	127	
Oklahoma	239	295	218	229	192	
South Dakota	2	2	1	1	1	
Other	12	16	11	8	11	
DISTRICT II	827	1076	747	671	709	
Alabama	11	5	3	12	23	
Arkansas	20	33	16	24	24	
Louisiana	242	262	193	212	200	
Gulf						
Other						
Mississippi	37	30	24	38	51	
New Mexico	91	119	102	69	69	
Texas	678	914	707	849	945	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	1079	1363	1045	1204	1422	
Colorado	84	64	63	89	51	
Montana	53	87	43	47	40	
Utah	12	41	8	15	12	
Wyoming	75	84	84	75	67	
Other	0	2	0	0	0	
DISTRICT IV	224	278	198	226	170	
Alaska	1	3	0	0	4	
Arizona	0	0	0	6	2	
California	95	171	55	105	148	
Nevada	0	0	0	0	1	
Other	0	0	0	0	0	
DISTRICT V	96	174	55	113	155	
TOTAL U.S.	2378	3232	2,209	2,399	2,669	

Source: API Monthly Drilling Activities Report

U.S. CRUDE OIL PRODUCTION
(1000's B/d)

	1972 November	1972 December	1973 January	1973 February	1973 March	
Florida	73	83	83	94	94	
New York	2	2	2	2	2	
Pennsylvania	11	10	11	11	10	
Virginia	0	0	0	0	0	
West Virginia	7	7	7	7	7	
Other	0	0	0	0	0	
DISTRICT I	93	102	103	114	113	
Illinois	93	86	87	84	86	
Indiana	16	11	14	15	15	
Kansas	190	184	183	193	181	
Kentucky	26	24	23	24	25	
Michigan	37	35	38	38	33	
Nebraska	23	21	21	21	19	
North Dakota	56	56	55	56	58	
Ohio	24	24	21	20	22	
Oklahoma	549	546	513	610	505	
South Dakota	1	1	1	1	1	
Other	6	0	1	1	1	
DISTRICT II	1,015	991	957	1,068	941	
Alabama	29	28	27	31	34	
Arkansas	50	50	50	51	49	
Louisiana	2,412	2,379	2,355	2,322	2,259	
Gulf						
Other						
Mississippi	163	165	162	154	156	
New Mexico	294	288	280	283	283	
Texas	3,602	3,575	3,494	3,527	3,586	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	6,550	6,485	6,368	6,398	6,367	
Colorado	105	107	92	96	91	
Montana	93	94	92	89	92	
Utah	76	67	74	77	75	
Wyoming	351	362	370	380	386	
Other	0	0	0	0	0	
DISTRICT IV	625	630	628	642	647	
Alaska	198	196	195	217	174	
Arizona	2	2	2	2	2	
California	443	428	425	413	430	
Nevada	1	1	1	1	1	
Other	0	0	0	0	0	
DISTRICT V	1,143	1,127	1,123	1,151	1,107	
TOTAL U.S.	9,426	9,335	9,179	9,373	9,175	

Source: U.S. Bureau of Mines

U.S. CRUDE OIL PRODUCTION
(1000's B/d)

	1973 November	1973 December	1974 January	1974 February	1974 March	
Florida	92	90	91			
New York	2	2	3			
Pennsylvania	11	10	11			
Virginia	0	0	0			
West Virginia	7	7	7			
Other	0	0	0			
DISTRICT I	112	107	112			
Illinois	79	72	75			
Indiana	14	13	13			
Kansas	176	159	165	177	180*	
Kentucky	21	21	22			
Michigan	42	45	44			
Nebraska	19	18	17			
North Dakota	23	43	52			
Ohio	24	23	23			
Oklahoma	296	512	478	552	520*	
South Dakota	1	2	1			
Other	1	0	1			
DISTRICT II	928	918	891			
Alabama	32	32	33			
Arkansas	48	47	44	47	50*	
Louisiana	2,214	2,177	2,163	2,195	2,085*	
Gulf						
Other						
Mississippi	151	149	149			
New Mexico	277	271	236	274	265*	
Texas	3,549	3,529	3,483	3,522	3,630*	
District 1						
District 2						
District 3						
District 4						
District 5						
District 6(East)						
District 6(Oth)						
District 7B						
District 7C						
District 8						
District 8A						
District 9						
District 10						
Other						
DISTRICT III	6,276	6,205	6,108			
Colorado	106	102	100			
Montana	96	96	94			
Utah	95	97	97			
Wyoming	421	405	409			
Other	0	0	0			
DISTRICT IV	718	700	700			
Alaska	195	196	191	190	195*	
Arizona	2	2	2			
California	913	911	903	905	910*	
Nevada	0	0	0			
Other	0	0	0			
DISTRICT V	1,110	1,109	1,096			
TOTAL U.S.	9,144	9,041	8,907	9,156	9,075*	

* Estimated by IPAA. Source: U.S. Bureau of Mines

[Whereupon, at 3:35 p.m., the committee was recessed to reconvene at 10 a.m. on Monday, June 10, 1974.]

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