

INCENTIVES FOR DOMESTIC REFINING

HEARING
BEFORE THE
SUBCOMMITTEE ON
ENERGY AND AGRICULTURAL TAXATION
OF THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
NINETY-SEVENTH CONGRESS
FIRST SESSION

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MARCH 27, 1981
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INCENTIVES FOR DOMESTIC REFINING

FRIDAY, MARCH 27, 1981

**U.S. SENATE,
SENATE SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION OF THE COMMITTEE ON FINANCE,
*Washington, D.C.***

The public hearing was held, pursuant to notice, at 9:42 a.m., in room 2221, Dirksen Senate Office Building, Hon. Malcolm Wallop (subcommittee chairman) presiding.

Present: Senators Dole, Wallop, Durenberger, Symms, Bentsen, Bradley, and Mitchell.

[The committee press release, a description of the proposals, and Senator Wallop's opening statement follow:]

P R E S S R E L E A S E

FOR IMMEDIATE RELEASE
March 11, 1981

UNITED STATES SENATE
COMMITTEE ON FINANCE
Subcommittee on Energy and
Agricultural Taxation
2227 Dirksen Senate Office Building

FINANCE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
SETS HEARING ON TAX INCENTIVES FOR DOMESTIC REFINING

The Honorable Malcolm Wallop (R., Wyo.), Chairman of the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on March 27, 1981 on various tax and tariff proposals to aid the domestic refining industry.

The hearing will begin at 9:30 a.m. in Room 2221 of the Dirksen Senate Office Building.

In announcing the hearing, Senator Wallop stated: "The ingenuity and creativity of the U.S. energy industry have at last been freed for productive purposes, rather than remaining a captive of pricing regulations and rulemaking by the Department of Energy. However, it is my hope that the end of controls will also prompt the Congress and the Executive Branch to thoughtfully examine the problems facing this Nation's domestic refining industry. This hearing will explore the problems that domestic refiners may experience in the decade ahead and consider several tax and tariff-based ideas which have been advanced as possible solutions to these problems. The role of the Energy and Agricultural Subcommittee in this review should be to examine the industry, its particular problems, and the potential solutions which lie within the jurisdiction of the Senate Finance Committee."

The following are among the tax and tariff proposals to be addressed by the hearing:

1. Modification of Foreign Tax Credit Rules

The foreign tax credit rules in the Internal Revenue Code could be modified so that sales of crude oil to small and independent refiners constitutes "foreign source income." A taxpayer could be given an election to treat such sales as either foreign extraction income for purposes of computing the separate tax limitation in Section 907(a) of the Code or as foreign oil-related income for purposes of computing a separate overall limitation under Sections 904 and 907(b).

2. Tariff on Imported Petroleum Products

A substantial tariff or fee could be imposed on the importation of foreign refined petroleum products to encourage refining within the United States.

3. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

In order to encourage capital improvements in the domestic refining industry, the depreciable life for refinery assets could be shortened to five years, an additional 10 percent investment credit could be provided for investments in refinery upgrading or additional investment credits could be offered for the purchase of energy efficient refinery equipment.

4. Crude Oil Purchasing Cooperatives

To assist small and independent refiners to obtain long term foreign crude oil supply contracts, independent refiners could be permitted to set up privately owned tax-exempt crude oil purchasing cooperatives.

These proposals are not intended to be an exhaustive list. The Subcommittee would welcome testimony on any additional proposals within the Finance Committee's jurisdiction.

Witnesses who desire to testify at the hearing on March 27, 1981 must submit a written request to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, to be received by no later than noon on March 23, 1981. Witnesses will be notified as soon as practicable thereafter whether it has been possible to schedule them to present oral testimony.

Legislative Reorganization Act.--Senator Wallop stated 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."

Witnesses scheduled to testify should comply with the following rules:

- (1) A copy of the statement must be filed by noon on Thursday, March 26, 1981.
- (2) All witnesses must include with their written statement 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 by noon on Thursday, March 26, 1981.
- (4) Witnesses should not read their written statements to the Subcommittee, but ought instead to confine their oral presentations to a summary of the points included in the statement.

Written statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record on the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Robert E. Lighthizer, Chief Counsel, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D.C. 20510, not later than Friday, April 10, 1981.

DESCRIPTION OF TAX AND TARIFF PROPOSALS FOR DOMESTIC OIL REFINING

**PREPARED FOR THE USE OF THE
COMMITTEE ON FINANCE
BY THE STAFF OF THE
JOINT COMMITTEE ON TAXATION**

INTRODUCTION

The proposals described in this pamphlet have been scheduled for a public hearing on March 27, 1981, by the Subcommittee on Energy and Agricultural Taxation of the Committee on Finance.

The hearing is on various proposals for tax incentives and tariffs to aid the domestic crude oil refining industry. Four specific proposals are among those to be addressed by the hearing. As announced in the Subcommittee's press release (81-113) March 11, 1981, these relate to (1) a modification of the foreign tax credit rules, (2) a tariff or fee on the importation of foreign refined petroleum products, (3) tax credits and accelerated depreciation for upgrading or retrofitting domestic refineries, and (4) the creation of tax-exempt crude oil purchasing cooperatives.

The first part of this pamphlet is a summary of the specific proposals listed in the Subcommittee's press release. The second part is an overview of the oil refining industry, and the third part is a summary of the government regulations that have affected the oil refining industry. The fourth part of the pamphlet contains a detailed description of present law and an explanation of each proposal.

I. SUMMARY OF PROPOSALS

1. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

Under present law, the cost of an asset with a useful life in excess of one year generally must be capitalized and recovered over its useful life. However, the cost of eligible property may be recovered over the appropriate period specified in the asset depreciation range rules (ADR). Equipment used to refine oil can be depreciated over 18 years under present regulations.

Present law generally allows a 10-percent investment tax credit with respect to expenditures for specified tangible property, including equipment used to refine oil. Present law also allows a 10-percent credit with respect to expenditures for the acquisition of certain energy property, but eligible property does not include many energy-saving investments by oil refiners.

The proposal would establish a five-year depreciable life for refinery assets and would allow an additional 10-percent investment credit for the purchase of qualified refinery equipment to modernize or expand the capacity of an existing facility or to improve its energy efficiency.

2. Petroleum Product Tariff

The statutory import duties and license fees applicable to imported petroleum products have been suspended since April 1979.

Section 232(b) of the Trade Expansion Act of 1962 authorizes the President to adjust imports of an item upon a finding that such imports threaten to impair the national security.

Under the proposal, tariffs would be imposed on refined petroleum products at a level high enough to enable some or all small domestic refiners to compete with imported refined petroleum products.

3. Modification of Foreign Tax Credit Rules

Under present law, most U.S. international oil companies have excess foreign tax credits from their foreign extraction operations. This proposal would allow these oil companies to utilize their excess foreign tax credits by selling oil extracted in the U.S. to certain small and independent U.S. oil refineries. The proposal would treat income from the sale of oil extracted in the U.S. and sold to U.S. independent refiners as foreign source income and would thus raise the oil company's foreign tax credit limitation to allow the use of the excess extraction taxes.

4. Crude Oil Purchasing Cooperatives

Cooperative entities utilized for the business or financial benefit of its members generally are subject to Federal income taxation. However, present law exempts from Federal income taxation certain cooperative organizations and associations that meet specified requirements.

The proposal would exempt from Federal income taxation cooperatives formed by small and independent refiners to purchase crude oil from foreign suppliers under long-term contracts.

II. OVERVIEW OF THE OIL REFINING INDUSTRY

Oil refiners transform crude oil into such usable petroleum products as gasoline, heating oil and jet fuel. As of January 1, 1980, the United States had 303 operating oil refineries with a capacity of 18.8 million barrels per day. Crude oil input to U.S. refineries was 13.5 million barrels per day in 1980, resulting in an average 70-percent utilization rate for all domestic refineries. In 1980, the U.S. imported 1.6 million barrels per day of refined petroleum products, more than half of which was residual fuel oil.

There are many different kinds of oil refiners. Very simple refineries, sometimes called "topping plants," generally are capable only of distilling light and sweet crude oil into certain petroleum products (usually jet fuel, naphtha, and fuel oil). (Light crude oil is oil that is relatively liquid; sweet crude oil is oil with a low sulphur content.) These refineries usually have little or no ability to make gasoline. Because of economics of scale, it is usually uneconomic for simple refineries whose capacity is under about 25,000 barrels per day to install the equipment necessary to produce gasoline.

Large refineries generally are more complex than simple refineries. Because large refineries ordinarily have more sophisticated equipment, they are capable of refining heavy and sour crude oil and producing a wider range of petroleum products (including leaded and unleaded gasoline and petrochemical feedstocks).

Aside from these distinctions among refineries, the Emergency Petroleum Allocation Act of 1973 (EPAA) contains definitions which classify refiners to determine their treatment under price and allocation controls. "Small refiners" are refiners whose total capacity for all refineries owned is less than 175,000 barrels per day. "Independent refiners" are refiners who supplied less than 30 percent of their own crude oil needs in the third quarter of 1973 from their own production and who market substantial volumes of gasoline through independent marketers.

The aggregate capacity of domestic refiners to distill crude oil is large relative to domestic oil consumption, but much of this capacity cannot process heavy and sour crude oil into light petroleum products (such as gasoline) even though these types of crude oil are becoming an increasing fraction of world supply. Thus, new investment is desirable despite apparent excess capacity in the refining industry.

Table 1 lists the companies with over 175,000 barrels/day of total refining capacity. These companies own one-third of operating U.S. refineries but represent over 75 percent of total U.S. refining capacity.

TABLE 1.—COMPANIES WITH OVER 175,000 BBL/D REFINING CAPACITY IN THE UNITED STATES

Name	Number of refineries	Total crude oil capacity (thousand barrels per calendar day)
Exxon.....	5	1, 577
Chevron.....	12	1, 487
Amoco.....	10	1, 238
Shell.....	8	1, 151
Texaco.....	12	1, 059
Gulf.....	7	912
Mobil.....	7	891
Arco.....	4	834
Hess.....	2	728
Marathon.....	4	588
Union Oil.....	4	490
Sun ¹	5	484
Ashland.....	7	462
Phillips.....	5	425
Conoco.....	7	361
Coastal States.....	3	298
Cities Service.....	1	291
Sohio ²	2	288
Champlin.....	3	239
Tosco ¹	3	222
Getty.....	2	221
Kerr-McGee.....	4	195
Total.....	117	³ 14, 421

¹ On Sept. 15, 1980, the pending sale of Sun's, Duncan, Okla., 49,000 bbl/d refinery to Tosco was announced. This refinery is still listed as part of Sun's capacity.

² British Petroleum owns 53 percent of Sohio. B.P. has 1 U.S. refinery with a capacity of 164,000 bbl/d, which is not contained on list.

³ 77 percent of total U.S. capacity.

Prior to 1970, small refineries tended to serve relatively small, isolated or specialized product markets. However, small, simple refineries, typically with capacity under 10,000 barrels/day, were constructed at the rate of one a month between 1974 and 1979. Many of these small refineries were constructed to take advantage of certain Federal Government subsidies (described below) available to small refiners. In addition, some large refiners sold their small refineries to new owners who could take advantage of these subsidies because the new owner's total refinery capacity did not exceed the prescribed limits.

The 56 refineries constructed during this period are listed in Table 2. Excluding the 200,000 barrels/day ECOL refinery (now owned by Marathon Oil), all of these refineries are 40,000 barrels/day capacity or under, and 36 have capacity of 10,000 barrels/day or less. Typically, they are simple refineries capable of processing only sweet crude oil and have little, if any, capacity to make gasoline.

TABLE 2—NEW U.S. REFINERIES COMPLETED BETWEEN JAN. 1, 1974 AND DEC. 31, 1979

Company, city, and State	Initial barrel per day capacity	On-stream date
Quintana/Howell, Corpus Christi, Tex.....	30, 000	1974
A. Johnson and Co., Newington, N.H.....	14, 000	1974
Toro Petroleum Corp., Port Allen, La.....	36, 000	1974
Northland Oil & Refining Co., Dickinson, N. Dak.....	5, 000	1974
Pioneer Refining Co., Nixon, Tex.....	2, 200	1974
Mid-Tex Refinery, Hearne, Tex.....	7, 500	1974
Crown (Western) Refining Co., Woods Cross, Utah.....	9, 000	1974
Giant Industries, Bloomfield, N. Mex.....	5, 600	1974
Saber, Corpus Christi, Tex.....	9, 000	1974
Famariss, Lovington, N. Mex.....	37, 000	1974
Louisiana Land, Mobile, Ala.....	37, 500	1975
United Independent, Tacoma, Wash.....	750	1975
Inger Oil, Darrow, La.....	470	1975
Glenrock Refining Co., Glen Rock Wyo.....	600	1976
U.S.A. Petrochem, Ventura, Calif.....	15, 000	1976
ECOL, Garyville, La.....	200, 000	1976
Glacier Park, Osage, Wyo.....	2, 000	1976
Sigmor, Three Rivers, Tex.....	10, 000	1976
Arizona Fuels, Asphalt Ridge, Utah.....	3, 000	1976
Basin Petroleum, Long Beach, Calif.....	3, 100	1976
Bi-Petro, Pana, Ill.....	960	1976
ECO Petroleum, Signal Hill, Calif.....	3, 000	1976
DeMenno Resources, Compton, Calif.....	5, 000	1976
M. T. Richards, Crossville, Ill.....	100	1976
Trans-Ocean Petroleum, Wilmington, N. C.....	11, 900	1976
Hill Petroleum, Krotz Springs, La.....	3, 000	1976
Dillman Oil Recovery, Oblong, Ill.....	1, 500	1977
Calcasieu Refining, Ltd., Lake Charles, La.....	6, 500	1977
Erickson Refinery Corp., Port Neches, Tex.....	30, 400	1977
Gulf States Refining Co., Corpus Christi, Tex.....	7, 400	1977
Mount Airy Refinery Co. Mount Airy, La.....	11, 600	1977
Mobile Bay Refining Co., Chicasaw, Ala.....	16, 900	1977
Shepherd Oil & Refining Co., Jennings, La.....	5, 000	1977
Sentry Refining Co., Corpus Christi, Tex.....	10, 000	1977
Tipperary Refining Co., Ingleside, Tex.....	6, 000	1977

TABLE 2—NEW U.S. REFINERIES COMPLETED BETWEEN JAN. 1, 1974
AND DEC. 31, 1979—Continued

Company, city, and State	Initial barrel per day capacity	On-stream date
Nevada Refining Co., Tonopah, Nev.....	3, 000	1977
North Pole Refining Co., North Pole, Alaska..	22, 600	1977
Cibro Petroleum Product, Albany, N.Y.....	27, 100	1978
T & S Refining Co., Jennings, La.....	19, 200	1978
Uni Oil, Inc., Ingleside, Tex.....	11, 300	1978
Ergon Refining, Inc., Vicksburg, Miss.....	11, 800	1978
Vicksburg Refining Co., Vicksburg, Miss.....	7, 900	1978
Sierra Anchor, McKittrick, Calif.....	10, 000	1978
Raymal Refining Co., Ingleside, Tex.....	2, 500	1978
Friendswood, Friendswood, Tex.....	10, 500	1978
Port Petroleum, Stonewall, La.....	2, 000	1978
Schulze Processing Co., Talla Bena, La.....	1, 700	1978
Slapco, Mermentau, La.....	10, 000	1978
Quad Refinery Corp., Bakersfield, Calif.....	7, 000	1978
Seaview Petroleum Inc., Paulsboro, N.J.....	37, 500	1979
Gulf Energy Refining, Brownsville, Tex.....	10, 000	1979
Lake Charles Refining Co., Lake Charles, La...	40, 000	1979
Mallard Resources, Inc., Gueydan, La.....	5, 000	1979
Placid Refining Co., Mont Belvieu, Tex.....	12, 000	1979
Sooner Refining, Crowley, La.....	8, 000	1979
Huntway Refining Co., Wilmington, Calif.....	5, 000	1979

III. REGULATORY BACKGROUND

Several of the Federal government's trade and regulatory policies have had a significant impact on the domestic oil refining industry. Often, this impact has been unintentional. These policies include oil import tariffs and quotas, price and allocation controls, and environmental policies.

Oil Import Policy

President Eisenhower established mandatory oil import quotas in 1959 under authority granted to him by the "national security" provisions of the Trade Agreement Extension Act of 1958 (now section 232 of the Trade Expansion Act of 1962). These quotas remained in effect until 1973.

At the time the quota system was established, foreign oil was available at very low prices (less than \$2 per barrel), and the Administration was concerned that overdependence on oil imports would impair national security by permanently damaging the domestic crude oil producing industry. The quotas were intended to prevent this overdependence.

The specific method used by the Interior Department to operate the quotas, however, benefited certain segments of the domestic oil refining industry. Because the quotas raised the price at which oil could be sold in the U.S. above the price of imported oil, a license to import oil was worth about one dollar per barrel. Because import licenses could be transferred through oil swaps, moreover, the owner of an import license could realize this gain without actually importing any oil himself. The government distributed the licenses, free of charge, to persons who had been importing oil prior to the quotas and to all domestic oil refiners. This exclusion of foreign refiners from the allocation of import licenses generally gave domestic refiners some protection against foreign competition. Furthermore, small refiners received a proportionately larger share of the import licenses than larger refiners. Thus, the import quotas generally operated to benefit U.S. oil refiners, particularly small refiners and refiners who had been importing oil prior to the imposition of the quotas.¹

In 1973, President Nixon replaced the quota program with a less cumbersome import fee of 21 cents per barrel on crude oil and 63 cents per barrel on refined petroleum products. The 42-cent differential provided an incentive to import crude oil, rather than refined products; that is, to refine in the United States. Also, because the tariffs initially applied only to imports in excess of prior quota levels (called fee-free allocations), the advantages which small refiners received under the

¹ One aspect of the quotas, however, did work against domestic refiners. There was a more lenient quota on imports of residual fuel oil than on other imports, which discouraged domestic refining of crude oil into residual oil.

quota system carried over into the tariff. The fee-free allocations, however, were scheduled to be phased out by April 1980. These import fees were suspended by President Carter in April 1979 and have not been reinstated.

Price Controls

In 1971, Phase I of the Nixon Administration's wage and price controls froze petroleum product prices at their August 1971 level. The Cost of Living Council then established comprehensive regulations to govern the pricing of petroleum and petroleum products. President Nixon ordered a second freeze in 1974, which was followed by the Phase IV pricing regulations. For oil, the regulations used May 15, 1973, as the base period for prices charged under price controls. Refiners were permitted to increase their prices above this level on a dollar-for-dollar basis to reflect increases in the cost of petroleum they purchased and to reflect increased nonproduct costs subject to a profit margin limitation. The regulations specified how increased costs were to be allocated by product, and retail price ceilings were established for motor gasoline, home heating oil, and diesel fuel.

These regulations served as a basis for the Emergency Petroleum Allocation Act of 1973 (EPAA). The EPAA allowed the President to allocate and to control the price of crude oil and refined petroleum products even after the expiration of the President's general price control authority. Price and allocation controls were extended further by the Energy Policy and Conservation Act of 1975 (EPCA). Under the EPCA, controls were mandatory through May 1979 and could be extended by the President until September 30, 1981. In April 1979 President Carter announced a program of phased decontrol through September 1981. President Reagan eliminated all price and allocation controls in January 1981.

While most public debate on oil price controls focused on crude oil prices, the controls on refiners also had significant economic impact. The price controls on large oil refiners served to discourage investment in new refining capacity because, while the controls allowed a pass-through of refiners' costs of production, they did not provide for any rate of return on new investment. Hence, any refiner who expected price controls at the refinery level to be binding in the future had little incentive to make investments in new or modernized capacity. This lack of incentive came when new investment was needed to make unleaded gasoline (a new product), to meet environmental requirements, and to adapt to the changing mix of available crude oil. Since the phaseout of price controls was announced in 1979, many large refiners have announced major investment programs to upgrade their refineries.

Entitlements

One result of the original price controls, when combined with substantially increased foreign crude oil prices, was to place domestic refiners who depended on foreign oil at a disadvantage when competing with similar refiners buying price-controlled domestic crude oil. In response, the Federal Energy Administration established the "entitlements program" in 1974. This program, in principle, was intended to

equalize crude oil costs by having all domestic refiners pay the "national average" price for crude oil. Refiners with a greater than average amount of price-controlled oil were required to buy an "entitlement;" refiners with foreign oil or oil exempt from price controls were given entitlements to sell.

This relatively simple concept proved difficult to implement, particularly because the entitlements program was modified to achieve a wide variety of objectives other than price equalization between refiners. These exceptions included the items described below:

Strategic petroleum reserves.—Under the Energy Security Act, entitlements were used to reduce the cost of oil acquired for the Strategic Petroleum Reserve.

East Coast residual fuel oil.—Importers of residual fuel oil received 50 percent of an entitlement for each barrel of foreign residual fuel oil imported into the State of Michigan or the United States East Coast. Domestic refiners were subject to a penalty for transporting such oil in a foreign tanker.

Synthetic fuels.—Shale oil, production of ethyl alcohol for use in making gasohol, and the production of municipal garbage into fuel were automatically eligible for partial entitlements. Other liquid synthetic fuels could have been made eligible on a case-by-case basis.

Puerto Rico naphtha.—Importers of naphtha for petrochemical manufacture in Puerto Rico were eligible for entitlements.

California heavy oil.—Refiners of heavy California oil received entitlements according to the weighted average gravity of the oil.

Small refiners.—Refiners with less than 175,000 barrels a day of refining capacity received a greater-than-proportional share of entitlements, determined according to a sliding scale. Refiners with 10,000 barrels or less a day capacity received the greatest number of additional entitlements per barrel. This provision, known as the "small refiner bias," provided small refiners with much larger benefits than they had received under the oil import quotas or tariffs. These preferences for small refiners were structured in such a way that they grew in proportion to the gap between controlled and uncontrolled oil prices and eventually became much larger than was originally intended, at one time exceeding \$500 million per year for about 100 companies.

The entitlements program provided something akin to tariff protection for domestic refiners because importers of crude oil received entitlements and importers of most refined petroleum products did not. This entitlement benefit for domestic refining, instead of foreign refining, varied between one and six dollars per barrel during the period of controls. As a result of price controls on domestic crude oil and the specific structure of the entitlements program, imports of refined petroleum products fell from 3.0 million barrels per day in 1973 to 1.6 million barrels per day in 1980. Also, the domestic refining industry operated at a high level of capacity utilization during most of this period, while foreign refiners had excess capacity. Because the protection against foreign competition provided by the entitlements program was explicitly temporary, however, it did not give large refiners enough of an incentive to make long-term investments to offset the disincentive effect of the price controls.

For small refiners, the preferences built into the entitlements program were large enough to encourage considerable investments despite their temporary nature. As shown in table 2, the period during which the entitlements program was in effect witnessed the birth of a large number of new small domestic refiners.

Mandatory Controls

Between the enactment of the EPAA and decontrol, the Federal Government has assured access to crude oil for certain refiners through the so-called Buy/Sell Program.

There have been three successive crude oil Buy/Sell programs implemented since early 1974. Each has involved the publication of allocation lists requiring certain refiners to offer to sell specified volumes of crude oil to other qualifying refiners. Eligible buyers may decline to purchase their allocations or may have DOE direct another refiner to sell to them if they have been unable to purchase oil voluntarily from an allocation list.

The first Buy/Sell Program (February-May 1974) required refiners with access to crude oil supplies to share them on a quarterly basis with refiners that lacked crude oil, so that all refiners could run at the same percentage of capacity. Sales were made at each seller's weighted average monthly cost for all crude oil plus 6 percent plus transportation and quality adjustments. Since no entitlements program existed at that time to reduce crude oil price disparities, most Buy/Sell crude oil was priced significantly below market price levels and eligible buyers purchased virtually all their allocations. These allocations amounted to slightly more than 1 million barrels/day. Some analysts have blamed this program for aggravating the oil embargo by discouraging U.S. companies from buying oil abroad.

The second Buy/Sell Program (June 1974-September 1977) was implemented after the Arab oil embargo. Fifteen major refiners, who were presumed to have access to large volumes of imported crude oil, were required by DOE to sell crude oil to all small and independent refiners to allow them to operate their refineries at 1972 levels. The pricing provisions of the program were similar to those of the first program, and Buy/Sell crude oil continued to be priced below the market until the entitlements program was introduced late in 1974. At that time, eligible buyers began to purchase less of their allocations, and program sales dropped to less than 200,000 barrels/day by mid-1977.

The third Buy/Sell Program (October 1977—decontrol) was designed to assure crude oil supplies only for refineries that had to depend on allocated crude oil, either on a continuing or an emergency basis. The fifteen major integrated refiners continued to be required to sell all the oil under the program. Sales were made at each seller's weighted average monthly cost of imported crude oil plus 5 cents per barrel plus transportation and quality adjustments. Large independent refiners (over 175,000 barrels/day aggregate refining capacity) were eliminated from the program because they were considered large enough to be self-sufficient but not to control adequate

production to be sellers. Small refiners could receive allocations: (1) on a regular six-month basis, to maintain historical runs level at land-locked refineries if the refiner purchased oil under the program during the period October 1976–September 1977, or (2) on an emergency basis, on a two- or three-month basis, for refineries that lost 25 percent or more of their crude oil supply and whose owners were unable to replace the lost supply. Small refiners could not receive allocations for new refineries or new refining capacity unless the new refinery or increased capacity was designed and 20 percent of its financing was irrevocably committed prior to August 24, 1977, thereby discouraging the construction of refining capacity that might depend on government allocations for its existence. Sales of crude oil under this program dropped to less than 20,000 barrels/day in 1978 but escalated to as much as 300,000 barrels/day after emergency allocations were granted because of the Iranian revolution. Use of the program fluctuated, depending on the world crude oil market situation.

Crude oil allocations also were implemented with respect to Canadian oil. Under the Canadian crude oil allocation program, first priority refiners were those whose crude oil runs during the base period (November 1974 through October 1975) were made up of at least 25 percent Canadian oil and who possessed no current capability to replace Canadian suppliers. Refiners who could not meet the 25 percent level could request priority from the Department of Energy if they can demonstrate dependence upon imports.

Pollution Control Rules

The domestic refinery industry is subject to a variety of Federal, State, and local pollution control laws that contribute to the cost of refining petroleum in the United States. Because some foreign countries do not have comparable pollution control laws, it has been argued that American refiners may be at a cost disadvantage relative to foreign competitors.

Although expenditures for pollution controls required to be used in conjunction with crude oil refining may increase the cost of refining domestically relative to refining petroleum outside of the United States, preferential tax incentives are available with respect to expenditures for such equipment. In addition, small refiners may be exempted from certain pollution control rules by the Environmental Protection Agency.

IV. DESCRIPTION OF PROPOSALS

1. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

Present law

Depreciation

Under present law, the cost of an asset with a useful life in excess of one year generally must be capitalized and recovered over its useful life. Alternatively, an election may be made to use the asset depreciation range (ADR) rules for eligible property. Under these rules, the cost of eligible property may be recovered over a period within a range of 20 percent above or below an established useful life for property within its guideline class. The guideline life for refinery equipment generally is 16 years so that this equipment may be depreciated over a 13-year life.

Investment tax credit

Present law provides a 10-percent investment tax credit for investments in tangible property with a useful life of 7 years or more. Oil refineries are eligible for the credit.

Energy investment credit

Qualified investments in "energy property" generally are eligible for a 10-percent energy investment tax credit if placed in service after September 30, 1978, and before 1983. A special effective date rule extends the expiration date of the credit when certain "affirmative commitments have been undertaken prior to the expiration date.

"Energy property" includes "alternative energy property," and "specially defined energy property."

The term "alternative energy property" includes boilers and burners, as well as related pollution control, handling, and storage equipment, which use an "alternate substance" as a primary fuel. "Alternate substances" include all substances other than oil and natural gas, or a product of oil and natural gas. "Alternative energy property" also includes equipment to convert an alternate substance into a synthetic liquid, gaseous, or solid fuel, equipment to modify existing oil or gas equipment to use an alternate substance (or not less than 25 percent of an alternate substance), and equipment that uses coal or its products as a feedstock.

The term "specially defined energy property" includes specific items of equipment, such as heat wheels and heat exchangers, used to improve the energy efficiency of industrial and commercial facilities and processes in existence on October 1, 1978. The Secretary of the Treasury has the authority to add new items to the list of those eligible as specially defined energy property.

Explanation of proposal

The proposal consists of two amendments to the Internal Revenue Code to encourage investments in domestic refinery assets.

Depreciation

The proposal would establish a 5-year useful life for new refinery assets that are tangible property.

The proposed 5-year capital cost recovery period for refinery assets is essentially the same as that proposed in S. 683, the Administration's tax reduction proposals. The tax reduction bill reported by the Finance Committee in the 96th Congress, H.R. 5829, would have established 7 years as the cost recovery period for refinery assets.

Investment credit

Under the proposal, an additional 10-percent investment credit would be allowed for the purchase of qualified refining equipment. Qualified refining equipment would include new refining equipment that upgrades or retrofits an existing refinery facility. Qualified refining equipment would also include equipment that improves the energy efficiency of an existing domestic refining facility.

2. Petroleum Product Tariff

Present law

Section 232(b) of the Trade Expansion Act of 1962 (19 U.S.C. sec. 1982) grants the President authority to "take such action, and for such time, as he deems necessary to adjust the imports of [an] article and its derivatives so that such imports will not threaten to impair the national security. . . ." This adjustment authority includes both the imposition of quantity restrictions, such as quotas, and import fees. The President's authority, however, is eliminated whenever Congress enacts a joint disapproval resolution.

Currently, existing statutory import duties and license fees on imported petroleum products have been suspended. These tariff rates generally are expressed as specific rates (i.e., x cents per gallon). The existing rates, which have been in effect since at least 1963, are equal to about one percent or less of the current value of the products. For example, the rate for fuel oil is 0.125 to 0.25 cents a gallon, and that gasoline and jet fuel is 1.25 cents a gallon.

In addition to the statutory tariffs, imported petroleum products have been subject to various other trade restrictions. As noted above, from 1955 to 1959, a voluntary quota system was in place. This voluntary system was followed by the mandatory quotas which were in effect from 1959-1973. The mandatory quotas were replaced in May 1973 by import license fees of 21 cents a barrel for crude oil and 63 cents a barrel for refined petroleum products, with supplemental fees in 1975. The import fees were suspended by Presidential Proclamation in April 1979.

The statutory tariff rates on refined petroleum products are "bound" in the General Agreement on Trade and Tariffs (GATT) against increase. As "bound" rates, tariff increases could imply an obligation to pay compensation to foreign countries which are substantial suppliers of the relevant items. Similarly, imposition of such non-tariff measures as quotas or licenses, for reasons other than national security or balance-of-payments, could lead to requests for compensation or retaliation by other GATT countries.

Explanation of proposal

Under the proposal, tariffs would be imposed on refined petroleum products at a level high enough to enable some or all small domestic refiners to compete with imported refined petroleum products. It is not clear what level of tariff would be necessary to accomplish this because each refinery's costs and economics vary.

3. Modification of Foreign Tax Credit Rules

Present law

General

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result.

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the computation of the foreign tax credit contains a limitation to insure that the credit only offsets the U.S. tax on the taxpayer's foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before other tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. Therefore, the limitation is determined by using a simple ratio of foreign source taxable income divided by total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

Historically, the foreign tax credit limitation has been determined based upon either the taxpayer's total foreign income or his foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively. Currently, the foreign tax credit limitation can only be computed under the overall method.

Under the overall method, the taxpayer combines the income and losses from all his foreign operations and allocates the pre-credit U.S. tax based upon this amount. Thus, if a taxpayer has \$100 of income from Country A which bears a \$60 tax, and \$100 of income from Country B which bears a \$40 tax, under the overall limitation the taxpayer is treated as having \$200 of foreign source income on which \$100 of foreign taxes were paid. The taxpayer's overall foreign tax credit limitation is \$92 (i.e., assumed U.S. tax rate of 46 percent times \$200 of foreign source income). The taxpayer can thus fully

offset the \$92 of pre-credit U.S. taxes attributable to its foreign operations and is left with \$8 of excess foreign tax credits.

The overall limitation is generally advantageous to the taxpayer when he has income subject to a high tax (as compared to the U.S. rate) in one foreign country and income subject to a low or zero tax in another country. The use of the overall method allows the taxpayer to use the foreign taxes imposed by the high-tax country to offset the U.S. tax imposed on the foreign income in the low or zero tax country. Thus, in the above example \$6 of the tax paid to Country A is allowed as a foreign tax credit against the income of Country B.

In the case of the international oil companies, the overall foreign tax credit limitation allows them to credit high taxes (up to a 95 percent tax rate) on extraction income against low-taxed income from oil-related activities (e.g., oil trading, shipping, and refining) carried on in other foreign countries. Because of the U.S. source rules, this use of excess foreign extraction tax credits against income from oil-related activities undertaken in other foreign countries occurs even though the ultimate destination of the oil being traded, shipped, or refined is the U.S.; that is, the source of the income from the extraction, shipping, and refining of the oil (for purposes of determining the limitation of the foreign tax credit) is the place where these activities are carried on, not the place where the oil is ultimately used. Thus, if an oil company has available excess credits arising out of its foreign extraction activities, it may use them to offset its U.S. tax liability attributable to its foreign refining operations, even where the oil being refined is destined for the U.S. market.

Special oil and gas rules

Special rules (sec. 907) have been enacted in recent years which apply to foreign tax credits claimed by oil companies. These special oil tax credit rules were adopted largely because of the difficulty in determining whether payments made to foreign governments on oil income are, in substance as well as in form, creditable income taxes or whether they are, instead, noncreditable payments such as royalties or severance taxes. Generally, these special rules limit the credit which may be claimed for foreign taxes on oil and gas extraction income to 46 percent of the company's overall foreign extraction income. However, a foreign tax credit carryover is allowed for excess extraction taxes paid to the extent of 2 percent of foreign oil extraction income.

The taxpayer's extraction income is generally the sum total of the company's income and loss from foreign extraction operations. However, if the extraction activities and sales of the extraction assets in any country result in a net loss for any year (as ordinarily is the case during the exploration and development stage), the loss from the country is not taken into account in the computation of the foreign oil extraction income for the year (the special "per-country extraction loss rule"). This benefits the taxpayer because its oil and gas extraction tax limitation exceeds its pre-credit U.S. tax attributable to its foreign extraction activities (including the loss activities) by 46 percent of the nonincluded loss. Consequently, notwithstanding the 46-percent limitation of section 907(a), the company may have substantial excess

credits attributable to its foreign extraction operations available for use against its low-tax oil-related income.

Present law also provides that a taxpayer is to compute the foreign tax credit limitation (sec. 904 and sec. 907(b)) separately for its foreign oil-related income. (Thus, foreign taxes paid on the taxpayer's foreign oil-related income may not offset its U.S. tax on its other income and vice versa.) Foreign oil-related income includes foreign oil and gas extraction income as well as foreign income from refining, transporting, distributing and selling such foreign production. Importantly, foreign extraction losses are included in computing the foreign oil-related income limitation. In most cases, the combination of these extraction losses with losses from other foreign oil-related activities (notably shipping) has resulted in a limitation that is lower than the amount of the creditable foreign taxes on extraction income and on the other foreign oil-related income. Thus, in computing their foreign tax credit for foreign oil-related income, most oil companies have had excess foreign tax credits.

For a fuller explanation of the U.S. foreign tax credit rules, particularly as they apply to foreign oil taxes, see the Joint Committee staff pamphlet, "Explanation of Foreign Tax Credit Rules Applicable to Petroleum Income and Description of Administration Proposal" (JCS-26-79).

Explanation of proposal

The proposal would allow oil companies to treat income from oil that was extracted in the United States and was sold to certain unrelated domestic small and independent refiners as foreign oil extraction income or foreign oil-related income. This is intended to induce U.S. international oil companies with otherwise unusable excess foreign extraction tax credits to sell U.S. oil to independent U.S. refiners. It would allow these oil companies to utilize their excess extraction foreign tax credits to offset the U.S. tax on the income from the sale to independent oil refiners of oil and gas extracted in the United States.

4. Crude Oil Purchasing Cooperatives

Present law

Cooperative entities utilized for the business or financial benefit of its members generally are subject to Federal income tax. However, present law exempts from Federal income taxation certain cooperative organizations and associations that meet specified requirements. Among those organizations that may be exempt from taxation are certain cooperative insurance associations, mutual ditch or irrigation companies, and telephone companies (sec. 501(c)(12)), crop financing corporations (sec. 501(c)(16)), cooperative hospital service organizations (sec. 501(e)), cooperative educational service organizations (sec. 501(f)), farmers' cooperatives (sec. 521), and homeowners associations (sec. 528). These tax-exempt mutual and cooperative organizations generally are operated to provide goods or services to their members at cost. As such, gross membership revenues in excess of costs ordinarily are viewed as being "overcharges," rather than as income, if refunded promptly to its members. Revenue from non-membership sources, e.g., investments and non-membership dealings, may be taxable.

Under present law, antitrust statutes generally prohibit cooperative business arrangements which may reduce competition. However, Congress has granted U.S. oil companies a limited antitrust defense for participation in the International Energy Agency (IEA). In the absence of such a defense, U.S. oil companies could not share information and, in the event of an emergency, allocate supplies with the IEA's membership.

Explanation of proposal

The proposal would allow small and independent refiners to establish privately owned tax-exempt cooperatives to purchase crude oil from foreign suppliers under long-term contracts.



senator
Malcolm Wallop
 wyoming

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Contact: Karen Delke (202)224-0803

Statement of Senator Malcolm Wallop, Chairman,
 Senate Subcommittee on Energy and Agricultural Taxation
 Public Hearing on Tax and Tariff Incentives for
 The Domestic Refining Industry
 March 27, 1981
 Senate Committee on Finance

Today's hearing is intended to give the Subcommittee on Energy and Agricultural Taxation a better understanding of the economic problems facing the U.S. refining industry and the role that the domestic refining industry will play in the U.S. energy system. It should be absolutely clear that this hearing is not structured to usher in tax or tariff legislation to subsidize those inefficient refiners unable to survive in a competitive free market. Our intent is to determine whether immediate decontrol has created any market dislocations that prevent otherwise efficient refining operations from competing in a true-cost-of-energy environment. The Subcommittee has requested testimony on various tax and tariff proposals recommended by segments of the refining industry which would assist the industry in making a transition to a free market environment.

The problems of the domestic refining industry have been compounded by two changes in its economic environment over the last eight years. In the early 1970's the refining industry was jolted by OPEC induced international price increases. The response of the United States government to higher world oil prices was to insulate even further both the American consumer and the domestic refining industry from the full effects of these oil price shocks. Those policies not only discourage domestic production and conservation efforts, but they also served to discourage investment in new refining capacity or in retrofits needed to process increasing supplies of sour and heavy crude oil.

President Reagan's courageous decision to decontrol crude oil will have a number of beneficial effects in the economy, including increased incentives to produce and conserve energy. However, decontrol has also radically altered the economic environment in which the U.S. refining industry must compete. This hearing will help the committee determine how the competitive environment in the refining industry has changed, and whether it is appropriate to consider any tax or tariff based solutions to the traditional problems that may face the domestic refining industry.

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Our concern is not only with the ability of segments of the refining industry to compete in this new environment, but also make sure that the U.S. refining industry will continue to be able to meet the needs both of the American consumer and national security. It is critical that all markets are adequately served, but especially rural agricultural consumers. Market disruptions in industrial areas can result in an inconvenience and reduced production of goods and services for all consumers. However, these losses can be recovered, unlike the irrevocable loss of a harvest or the inability to proceed with spring plantings due to an energy shortage. A supply disruption or a market imperfection that allows agricultural regions to be cut off can have a formidable impact on agricultural production, consumer food prices, exports and our balance of payments.

The Subcommittee is also concerned with the fact that the domestic refining industry faces the challenge of processing increasingly more sour and heavier crude oil. The domestic refining industry faces a tremendous financial challenge as it makes large new investments to retrofit existing facilities to deal with heavy and sour crude oil. Fortunately, President Reagan's accelerated Cost Recovery Program will provide an unprecedented boost to the refining industry's ability to meet this investment challenge.

Finally, the committee is concerned with the possible national security consequences of increasing U.S. dependence on foreign refined products. The U.S. is already faced with a dangerous degree of dependence on foreign supplies of crude oil, and the committee wishes to determine whether an increase in product imports will increase U.S. strategic vulnerability to energy supply disruptions. If it is determined that the U.S. can now anticipate an increase in petroleum product imports and that such an increase would pose a threat to U.S. strategic interests, then this subcommittee would work closely with the Subcommittee on International Trade to determine that tariff or other trade mechanisms are necessary to enhance U.S. energy security.

Senator WALLOP. Good morning.

Today's hearing is intended to give the Subcommittee on Energy and Agricultural Taxation a better understanding of the economic problems facing the U.S. refining industry, and the role that the domestic refining industry will play in the U.S. energy system.

It should be absolutely clear that this hearing is not structured to usher in tax or tariff legislation to subsidize those inefficient refiners unable to survive in a competitive free market.

Our intent is to determine whether immediate decontrol has created any market dislocations that prevent otherwise efficient refining operations from competing in a true cost-energy environment.

The Subcommittee on Energy and Agricultural Taxation has requested testimony on various tax and tariff proposals recommended by segments of the refining industry, which could assist the industry in making a transition to a free-market environment.

Problems of the domestic refining industry have been compounded by two changes in its economic environment over the last 8 years. In the early 1970's, the refining industry was jolted by OPEC-induced international price increases. The response of the U.S. Government to higher world oil prices was to insulate even further both the American consumer and the domestic refining industry from the full effects of these oil price shocks.

Those policies not only discouraged domestic production and conservation efforts, but they also served to discourage investment in efficient refining capacity, such as retrofits needed to process increasing supplies of sour and heavy crude oil.

President Reagan's courageous decision to decontrol crude oil will have a number of beneficial effects in the economy, including increased incentives to produce and conserve energy.

However, decontrol has also radically altered the economic environment in which the U.S. refining industry must compete.

This hearing will help the committee determine how the competitive environment in the refining industry has changed, and whether it is appropriate to consider any tax or tariff-based solutions to the transitional problem—and I stress transitional—that may face the domestic refining industry.

Our concern is not only with the ability of segments of the refining industry to compete in the new environment, but also to make sure that the U.S. refining industry will continue to be able to meet the needs, both of the American consumer and national security.

It is critical that all markets are adequately served, but especially rural agricultural consumers. Market disruptions in industrial areas can result in an inconvenience and reduce production of goods and services for all consumers.

However, these losses can be recovered, unlike the irrevocable loss of a harvest or the inability to proceed with spring plantings due to an energy shortage.

Supply disruption or a market imperfection that allows agricultural regions to be cut off can have a formidable impact on agricultural production, consumer food prices, exports and our balance of payment.

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Fortunately, President Reagan's accelerated cost-recovery program will provide an unprecedented boost of the refining industry's ability to meet this investment challenge.

Finally, the committee is concerned with the possible national security consequences of increasing U.S. dependence on foreign refined products. The United States is already faced with a dangerous degree of dependence on foreign supplies of crude oil, and the committee wishes to determine whether an increase in product imports will increase U.S. strategic vulnerability.

If it is determined that the United States can anticipate an increase in petroleum product imports, and that such an increase may pose a threat to U.S. strategic interests, then this committee would work closely with the Subcommittee on International Trade to determine what tariff or other trade mechanisms are necessary to assure U.S. energy security.

Senator DOLE. Well, I would just, first of all, commend Senator Wallop for having this hearing. There is a great deal of interest.

I would say, with the change in this committee, we now find Republicans, after 26 years, thinking "It's not such a bad idea." But, in any event, we understand our responsibility to everyone in this audience regardless of politics.

So, I commend the subcommittee chairman. I'm not certain that the answer to some of the problems may lie in this committee. I mean, we can look at tariffs and taxation, but there may be other committees with relevant jurisdiction, and I'm certain you're aware of the ones I mean.

There also, of course, is the basic question of what we should do, or whether we should do anything. There are a number of problems in the industry, and one is the excess of refining capacity. How we address that will depend, for the most part, on the suggestions we have from the industry, plus other suggestions. I'm certain we'll have testimony that maybe the market should solve this problem, and this is an effort by Congress to further involve itself in your business.

We certainly appreciate many attending this morning. Some of us are involved in amendments on the Senate floor, and will be running back and forth.

Senator WALLOP. Thank you very much, Senator Dole.

Senate Dole. Thank you.

I have a statement I would like to present.

[The prepared statement of Senator Dole follows:]

STATEMENT OF SENATOR DOLE: TAX AND TARIFF PROPOSALS FOR DOMESTIC OIL
REFINING

Mr. Chairman, the U.S. oil refining industry faces a number of formidable challenges as we enter the "post control" era. President Reagan's termination of all crude oil price and allocation controls finally removed a variety of burdensome regulatory distortions from the marketplace. Nevertheless, decontrol also eliminated a degree of crude oil supply protection and economic benefit for many refiners.

Even without decontrol, the U.S. refining industry has a number of fundamental problems. For example, the U.S. currently has a significant excess of refining capacity. It is estimated that U.S. refiners are operating only at about 70 percent of capacity. Without a sudden upsurge of demand for refined products, which seems unlikely, one would expect some normal contraction of the industry so that less efficient refineries are phased out.

Despite the general overabundance of refining capacity, the industry needs a substantial amount of new capital investment to process heavy, high sulfur crude oil. I understand that now only about half of the Nation's refineries can process high-sulfur "sour" crude oil, which makes up an ever increasing portion of U.S. produced crude oil. There also is a need for a substantial amount of retrofitting and reconfiguration of existing refineries to meet new product demand, including an increasing demand for quantities of unleaded gasoline.

The U.S. refining industry also faces stiff competition from abroad. Foreign refineries, like those in the U.S., have a substantial amount of excess capacity. The United States is undoubtedly an attractive market for foreign refiners. Moreover, many foreign refiners do not have some of the transportation and environmental costs that the Federal Government has imposed on U.S. refiners. U.S. refiners also face problems of an unpredictable future product demand and considerable uncertainty about the interrupting availability of foreign crude oil.

Mr. Chairman, I believe that a strong U.S. refining industry is vital to the national defense interests of this country. Just as the Nation moves to become less dependent on foreign sources of crude oil, we should not become overly dependent on vulnerable foreign refineries, I also believe that it is important as we review the problems of the refining industry that we insure that all sections of the country, including rural agricultural regions, are adequately supplied with needed petroleum products. It is with those concerns in mind that I approach the issues to be addressed today. I recognize that many of the problems faced by the refining industry cannot be dealt with by this Committee. Nevertheless, I am interested in the testimony on the proposals that do fall within our jurisdiction.

Mr. Chairman, I appreciate your calling this hearing and I look forward to the testimony on this important energy issue.

— Senator WALLOP. Fine.

Senate Dole. Thank you, Mr. Chairman. I want to commend you, Mr. Chairman, for taking the initiative to call this hearing. I am glad to see the witnesses here and see my colleague, formerly from the other side of the Hill here, Bill Thomas, this morning, because I think this is a very important subject that we address. We all know that the small and independent domestic refining industry has played an important role in our total energy needs, and an active domestic refining industry, I think, is something that we should not allow to disappear and take lightly, because it does provide a means of fuel production in this country. It's helpful for our national security and it's also helpful for keeping more competition in the system.

So, I look forward to these hearings and hope that something can be resolved that will be helpful to this problem.

Senator WALLOP. Thank you very much.

I'm delighted to welcome, as our first witness, Congressman Thomas. Would you proceed, please?

STATEMENT OF HON. WILLIAM THOMAS, U.S. REPRESENTATIVE

Congressman THOMAS. Thank you, Mr. Chairman. I also would like to thank the chairman and the subcommittee for beginning hearings in this area, because I would like to outline, very briefly, a problem for you that was created by Government action and could be resolved by Government action, principally in my district in California.

The problem is this: The windfall profits tax has inadvertently caused an inefficient use of fuel in heavy oil production. The tax has destroyed the market for residual fuel oil produced by oil refiners in my district.

Prior to the windfall profits tax, residual fuel oil produced in refineries near the fields was used to power the steam generators in the production of the heavy oil. In this process, the steam is injected into a reservoir to increase the flow of the heavy crude.

However, the windfall profits tax exempted crude oil consumed "in situ" from the tax, so producers, obviously, with economics driving them, began burning the crude oil on heavy oil leases instead of the residual fuel oil.

Consequently, more oil is consumed in the production process, because crude burning yields fewer Btu's per unit than the residual fuel oil. Therefore, more crude than residual fuel oil is required to recover the same amount of heavy crude.

Local refineries are operating at minimal levels, or not at all, because they are unable to sell the residual fuel oil they produce.

Now, the windfall profits tax is adding to the oversupply of west coast heavy fuel oil by making tax-exempt crude more economically attractive than the residual fuel oil.

I have introduced a bill on the House side, H.R. 1974, which would resolve these problems by allowing a barrel-for-barrel exemption for residual fuel oil used in production. It is now allowed for crude oil under the tax.

I would like to emphasize that no loss of tax revenue from the Treasury would result, because crude oil, which has replaced the residual fuel oil, is tax exempt now, anyway.

Actually, the benefits of H.R. 1974 would be threefold: First, would be the energy saved in the production of oil. Conservative estimates by the industry place the savings and, therefore, the oil put into useful production at between 33 million gallons of refined petroleum products, and as high as 84 million gallons annually, assuming about a 5-percent fuel efficiency differential.

Second, additional revenue would actually come into the Treasury because of these additional petroleum products on the market. Revenue increase would be somewhere between \$2.6 million and \$6.5 million, annually.

Finally, of course, jobs would be opened up once again, because there would be a market for residual fuel produced.

I said, initially, that it was a problem centered in my district, but I don't want you to think that I have narrow parochial views because my district happens to contain a county which, if this county, Kern County, was a State among the 50 States, would be No. 4 in the production of oil, behind only Alaska, Texas, and California.

If we can get residual burning once again in the boilers instead of crude and we can put the rest of the crude back in production, we will become more than 50 percent of California's production, and therefore I would like to say we would be the No. 3 State, this one particular county.

In addition, although steam injection is usually identified with heavy oil, just yesterday there was a symposium scheduled to take place in the district in front of the Petroleum Engineers Society,

which shows an economically feasible procedure utilizing steam injection in light oil recovery.

So, we know we have billions of barrels of heavy oil that we're able to recover from steam injection, but the technologies pioneered and developed in Kern County in heavy oil now, apparently, are going to be able to be used economically for even further recovery of billions of barrels of light oil.

It was an inadvertent inadjustment, because of the windfall profits tax. We need to make sure that the kind of technology that has been carried out in Kern County can continue and a slight modification, which blesses the Treasury as well as the refiners in Kern County, I think is appropriate, Mr. Chairman.

Senator WALLOP. Thank you very much, Congressman.

The consequences of congressional and political spite always amaze me. When they go after people intent on punishing them, they generally only punish themselves. I think you have adequately demonstrated that.

Would you say that the lack of a market for residual fuel, therefore, is the most serious problem your California refiners face?

Congressman THOMAS. I think in the short term, the failure to have that locally available market for the residual fuel oil is the most significant problem.

I think, in the long run, the failure to continue the kinds of innovative technology that have allowed us to increase production will be the consequences, and that all of America will suffer, because we will not continue to develop as rapidly the ability to recover the leftover oil.

Senator WALLOP. Do your refiners face any competition from imported products?

Congressman THOMAS. Well, with the residual fuel oil, the market, primarily, is in the oil fields or as bunker oil down into the Los Angeles Harbor area.

The kind of oil that we produce does not have the direct competition. Our problem is that with the heavy crude, we do need to have sufficient light oil for blending purposes in many refineries. This light oil, principally, is now coming from Alaska, for example, and from other oil fields that produce lighter oil. It has, and can, come from other countries.

Senator WALLOP. Thank you.

Senator Dole?

Senator DOLE. No; I have no questions. I appreciate your taking the time to be here this morning. Thank you very much for your statement.

Congressman THOMAS. Thank you very much, sir.

Senator WALLOP. Senator Symms?

Senator SYMMS. Bill, I appreciate your statement, too, and I would like to also compliment you that you had the good sense to vote against the windfall profits tax that brought about this problem when we were in the House together.

Just to make sure that I understand what you're saying is that your bill would allow for every barrel of heavy crude that is used, it would be exempted from the windfall profits tax; is that correct?

Congressman THOMAS. No. The heavy crude is currently exempted. That's the problem. They used to burn residual fuel oil, and you produced the crude on the property and it would be shipped a short distance to a refinery where you just pulled the distillates off and the residual fuel would come back and they would burn that fuel oil in the boilers because it has a higher Btu value.

It was easily done and economically feasible, but once you put a windfall profits tax on any of the crude oil that leaves the property, you wind up burning the crude oil on the property to save the difference, and it is a sizable difference.

The problem is: The crude oil doesn't burn as efficiently. You consume more of it. It dirties up the scrubbers, by the way, and the pollution-control devices have to be cleaned more frequently. It's just a classic example of how everyone on the left hand didn't realize that in trying to do one thing, they produced a very uneconomic relationship on the other.

So, it is an attempt to get a barrel-for-barrel trade for residual fuel rather than the crude. There is no benefit anywhere, except to the Treasury and to the consumer of petroleum products in the United States, because we would be sending less of it up in smoke, and more of it to the marketplace.

Senator SYMMS. So, what you are also saying is, if this happens that some of these refineries go out, there may be some parts of the country that are getting the specialized products, et cetera—

Congressman THOMAS. They have gone out and they will continue to go out, because—

Senator SYMMS. Because they haven't been serviced.

Congressman THOMAS. That's correct.

Senator SYMMS. It's just one more reason why the windfall profits tax—

Congressman THOMAS. I'll second that, Senator.

Senator WALLOP. Thank you very much.

Congressman THOMAS. Thank you.

Senator WALLOP. Bill, thank you very much for taking your time to come over here. Once again, my apologies for holding you up.

Congressman THOMAS. Thank you very much.

[The prepared statement of Hon. William Thomas follows:]

STATEMENT OF REPRESENTATIVE WILLIAM THOMAS

Mr. Chairman, I would like to thank you and the other distinguished Senators on this subcommittee for the opportunity to testify this morning on a problem faced by oil refiners in my state, California.

The problem is this: the windfall profits tax has inadvertently caused an inefficient use of fuel in heavy oil production, and the tax has destroyed the market for residual fuel oil produced by oil refiners in my District.

Prior to the windfall profits tax, residual fuel oil produced in refineries near the heavy oilfields was used to power steam generators in the production of heavy oil. In this process, the steam is injected into a reservoir to increase the flow rate of the heavy crude.

However, the windfall profits tax exempted crude oil consumed "in situ" from the tax, so producers began burning crude oil on heavy oil leases instead of residual fuel oil.

Consequently, more oil is consumed in the production process because crude burning yields less heat than residual fuel oil. Therefore, more crude than residual fuel oil is required to recover the same amount of heavy crude.

Also, local refineries are operating at minimal levels, in part because they are unable to sell residual fuel oil they produce. The windfall profits tax added to the

oversupply of West Coast heavy fuel oil by making tax-exempt crude oil more economically attractive than residual fuel oil.

My bill, H.R. 1974, would solve these problems by allowing a barrel-for-barrel exemption for residual fuel oil used in production, as is now allowed for crude oil under the tax.

No loss of tax revenues to the Treasury would result, because crude oil which has replaced residual fuel oil in the production process is now tax-exempt anyway.

The benefits of H.R. 1974 would be threefold. First, energy would be saved in the production of oil. By using residual fuel oil rather than crude, slightly more fuel efficiency would result, meaning that more crude would be produced and more light-end petroleum products would become available from this increased crude oil production. Conservative industry analyses place the savings at 33 million gallons of refined petroleum products annually, and the savings could run as high as 84 million gallons annually, assuming a 5 percent fuel efficiency difference.

Second, additional revenue for the U.S. Treasury would be generated, because more crude oil would leave the property. Analyses indicate that between \$2.6 million and \$6.5 million in additional tax revenues would result.

Finally, refiners could increase their operating rates and reopen jobs, because H.R. 1974 would help to restore the market for residual fuel oil which the windfall profits tax removed.

Senator WALLOP. The next witness is the Honorable John E. Chapoton, Assistant Secretary of Treasury for Tax Policy.

For the information of you and those that follow you, we absolutely must stick to the 5-minute rule, because we have an incredible list of witnesses. Every testimony will be taken in full, and we hope to get some juice out of all of the witnesses here during the morning.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Mr. CHAPOTON. All right, Mr. Chairman. I do have a shortened version of my statement. I'll have to shorten it even more as we go along. I'll attempt to do that.

Senator WALLOP. Thank you, sir.

Mr. CHAPOTON. I appreciate the opportunity to be here this morning to present the administration's views on four specific tax and tariff proposals relating to domestic refiners.

One is the tax incentives for upgrading or retrofitting domestic refineries; two, the imposition of a tariff or fee on the importation of foreign refined products; three, the modification of the foreign tax credit to encourage sales of crude oil by international oil companies to domestic refiners, and; four, the creation of tax-exempt crude oil purchasing cooperatives.

Before I go into these proposals in any detail, I want to discuss, briefly, the reasons cited in support of these proposals and the problems they attempt to address.

First, it is contended that the termination of the price control system has changed the competitive position of the domestic refining industry. Consequently, small and independent domestic refiners must obtain assistance in order to remain competitive.

Second, it is anticipated that the supply of high quality light low-sulfur crudes will decline as a proportion of the total availability of supply of crude oil. Hence, it is argued that financial assistance in modifying and replacing refinery equipment is required.

As this committee well knows, price controls worked in two ways to maintain the size of the U.S. refining industry. By delaying the adjustment of petroleum product prices to world price levels, con-

trols helped to sustain the higher rate of domestic demand for, and consumption of, petroleum products than otherwise would have occurred.

In addition, the price control system had the effect of discouraging the imports of refinery products and encouraging the import of crude oil.

Consequently, the termination of controls will both shrink the size of the U.S. market for petroleum products, and, indeed, it has already begun to do so, and it is expected to shrink the share of U.S. consumption that is refined domestically.

It is the administration's position that this sorting out process should be determined by market forces. We feel it would be inappropriate for the Federal Government to allocate resources through the tax system, or by other means, to maintain uneconomic domestic refinery facilities.

One additional argument is made for Federal action on behalf of small and independent refiners. It is contended that they are the principal firms that assure competition within the industry and that their continued presence is vital on that score.

We do not believe that Government intervention on behalf of small and independent refiners is warranted on economic policy grounds.

First, the freedom of resource entry into and out of the refining industry is not dependent on the size of refinery installations.

Second, the fact that a refiner is independent; that is, has little or no interest in oil production, has no bearing on either the ability to sell petroleum products or to purchase crude, such that would warrant Government intervention.

The presence in world markets of both independent refiners and independent crude producers suggests that all refiners have access to enough crude oil to meet whatever product demand they wish to satisfy.

Turning to the second justification for Federal assistance, it is argued that in the future, the average quality of crude supplies will deteriorate. Thus, it will require more capital intensive and hence, more costly refinery processes to produce the present mix of refinery products from low quality crude.

The gradual degradation of the quality of crude oil does not present a problem that requires Government action. The technology for processing low quality crudes is well known, is currently in use and is available to any refiner who wishes to install it.

To the extent that the oil refining industry needs assistance to finance future anticipated capital costs, the adoption of the President's tax proposals liberalizing the cost recovery rules, our ACRS proposal, is, we feel, the best way of providing this assistance.

Let me discuss very briefly, because I see the yellow light is going on, Mr. Chairman, the four proposals that we are asked to address.

The first would establish a 5-year useful life for new refinery assets that are tangible property, and would provide an additional 10-percent investment tax credit for new refining equipment that modernizes and expands the capacity of an existing refinery facility.

In brief, we feel that the present proposal on the ACRS system would take care of the first problem. It would drop the present 16-year ADR life for refinery assets to a new 5-year life over an accelerated recovery system, and would give that 5-year life a full 10-percent investment tax credit.

The second proposal would propose a petroleum product tariff or fee.

Senator WALLOP. In this instance, I think it is probably important to have the administration's position laid down on those things that have been discussed in front of the committee, so if you would please just go ahead and read those, please.

Mr. CHAPOTON. I appreciate that indulgence, Mr. Chairman. It will just take about another 5 minutes.

The second proposal would impose a petroleum product tariff or fee on refined products to protect the domestic refining industry.

The administration strongly opposes the imposition of tariffs or fees on imports of petroleum products. The effect of such a measure would be to increase petroleum product prices beyond levels determined by world oil prices solely for the purpose of discouraging importation of refined petroleum products.

It would impose a tax on all product users, which would, in turn, divert scarce capital from economic investments to sustaining uneconomic refinery capacity.

The proposal, therefore, is inflationary on two counts, causing a rise in prices directly, and reducing national productivity. We would therefore oppose.

The third proposal would modify the foreign tax credit limitation rules to expand the definitions of foreign oil and gas extraction income and foreign oil related income. The proposal would also modify the source of income rules applicable to the foreign tax credit limitation to treat sales of domestic and foreign crude oil to small and independent refiners as foreign source income rather than as U.S. source income.

The effect of this would be to substantially distort the historic function of the foreign tax credit limitation. The proposal would allow excess foreign tax credits from OPEC and other foreign oil production to offset U.S. income tax on profits from drilling and production of oil within the United States.

The advocates of the proposal argue that the foreign tax credit limitation rules of existing law contain a bias which favors investment in overseas refining by the international oil companies, and that foreign refinery products produced from such investments displace refining in the United States.

While the special oil extraction foreign tax credit rules may, in fact, be defective, the proposal under discussion would simply broaden the defect; it would not remove it.

It is not clear, in addition, that the proposed change would achieve the intended reduction in oil acquisition costs of small and independent refiners. Multinational oil companies with excess foreign tax credits are currently selling oil to independent and small refiners. It seems that these sales at market prices would continue without reduction in price to qualified refiners, if this foreign tax rule were changed.

We would suggest, Mr. Chairman, that if there is a defect in the foreign tax credit limitation rules encouraging investment in refinery capacity abroad, that that question be directly addressed in the foreign tax credit limitation rules, section 907, rather than by a limited proposal such as this, which would, we think, broaden that defect.

The final proposal would allow small and independent refiners to establish tax-exempt cooperatives to purchase crude oil from foreign suppliers under long-term contracts.

The proposal would call for tax-exempt cooperatives. The present law, allowing taxable cooperatives, allows such entities to provide goods or services to their members at cost. Gross membership revenues in excess of costs are treated as overcharges rather than income to the cooperative if refunded to members either by cash or by retain certificates.

Thus, taxable cooperatives are not generally subject to tax, except to the extent of income from investments or nonmembership dealings. Thus, in fact, they are no different than the so-called tax-exempt cooperatives.

Therefore, in short, Mr. Chairman, we think that what is proposed by the taxes in a cooperative proposal could be accomplished under present law through the use of taxable cooperatives, provided that the gross membership revenues in excess of costs are returned to the members.

So, Mr. Chairman, we are opposing favorable committee action on all four of the proposals that we have been asked to comment on this morning.

Senator WALLOP. Thank you very much, Mr. Chapoton.

Has there been, in addition to the conversations which I can track clearly in your testimony about the free market forces and effects on consumers, but has there been, as well, a discussion of the national security interest, or has there been a conversation with, for example, the Secretary of Energy, as to some kind of ability to monitor any increasing dependence on refined products?

Mr. CHAPOTON. Mr. Chairman, that subject was addressed in the report that was released in January by the Treasury Department under the previous administration.

There has been staff-level contact with the Department of Energy in recent times, and that question has been addressed in the last month or two. There has not been, to my knowledge, direct contact with the new Secretary of Energy.

Senator WALLOP. But you would be, or the administration would be, monitoring future imports of refined products.

Mr. CHAPOTON. Yes, sir.

Senator WALLOP. It bothers me, as it does almost every American who knows about it, the hammerlock that outside forces have on our economy, from the standpoint of crude supplies. Then we get into the business of refined products as well. I realize that we're a long way from overdependence on refined products, but I just would hope that somebody would continue to pay attention to it.

Mr. CHAPOTON. I think that's a very valid comment, Mr. Chairman, and it is something that should be monitored and will be monitored.

Senator WALLOP. Senator Dole?

Senator DOLE. As I understand, you are not in support of any of the four proposals, but you do indicate, in reference to the first proposal, that under the tax package submitted by the President, there will be some relief, some positive impact on refiners.

Mr. CHAPOTON. Yes, Senator Dole. Clearly, there is going to be a market problem here resulting from decontrol, and there will be additional costs in the industry, and we think that the President's proposals, the accelerated cost recovery system, which will greatly benefit major capital outlays in all industries that have long-lived assets such as refineries, will benefit the most. So, they will receive a very significant benefit under the President's proposal, and it is appropriate.

Senator DOLE. It is my understanding that, despite certain pronouncements from some, the administration will still press on with this tax package; is that correct?

Mr. CHAPOTON. I can assure you, Mr. Chairman, in spite of such pronouncements, that the administration is pressing on with this tax package.

Senator DOLE. At this time, you are not looking for—

Mr. CHAPOTON. No, sir, we are not. [Laughter.]

Senator DOLE. I didn't think that was the case, but I have been reading in the paper about General Haig, and I read those items. I read about the demise of the tax package. I thought I had better verify it. [Laughter.]

Mr. CHAPOTON. I think the death of a tax package was prematurely announced, yes, sir.

Senator DOLE. I would suggest that we would act on it probably after the House does. We haven't decided on a burial.

Mr. CHAPOTON. We're ahppy to hear that, Senator.

Senator WALLOP. Senator Symms?

Senator SYMMS. Thank you, Mr. Chairman, and thank you, Buck, for your testimony. I just wanted to ask one question that I'm concerned about.

Isn't it true that most of our military jet fuel is made from independent refiners in the country?

Mr. CHAPOTON. Senator Symms, I cannot state that categorically. I believe I did see that research in one of the materials I read in preparation this morning, but I haven't independently ascertained that.

Senator SYMMS. Well, maybe I have misinformation on it, I don't know. But, it would appear to me that there are certain products that they are making that do add to our ability to provide some security.

Maybe your colleague wants to comment on that question.

If that's the case, it seems to me like something ought to be done to keep these refiners from going out, because there are specialized products that they make in many instances: printing ink, specialized lubricating oils and so forth, and there may not be anybody else producing them.

Mr. CHAPOTON. Well, Senator—

Senator SYMMS. Where, in the case where we even export some things, there is always a hullabaloo about us exporting petroleum, and I know oftentimes there are amendments offered on the floor

to block exporting, and it's really some specialized lubricant that may be exported.

Mr. CHAPOTON. Senator, we have some preliminary 1980 data that might be—we would be happy to supply for the record. I would like to review it more closely myself, indicating who refines the type of products, that type of thing.

But, of course, the market forces tend to adjust to this type of thing, and as the chairman said in his opening statement, we would not, I think, want to adopt a proposal, or we suggest the committee would not want to adopt a proposal that would reward—do anything other than let the market forces operate and reward efficient operations—because if adjustments occur, others will produce that product, of course.

[The information referred to follows:]

The Department of Defense Fuel Supply Center has furnished the following tabulation of bulk fuels under contract as of March, 1981. They show that refiners with a capacity of 50,000 barrels a day or less ("small refiners" under the criterion suggested by the American Petroleum Refiners Association) supply 25.8 percent of bulk fuels to the Defense Department. These quantities supplied include "set asides" under the several small and minority business procurement programs and, therefore, do not represent capacities of the small refinery sector uniquely necessary to meet defense needs.

DISTRIBUTION OF BULK FUELS UNDER CONTRACT, WITH THE DEPARTMENT OF DEFENSE, BY SIZE OF CONTRACTOR; CONTRACTS IN FORCE MARCH 1981

[Amounts in millions of dollars]

Contractor size (barrels per/day of refinery capacity)	Type of fuel											
	All types		JP-4 ¹		JP-5 ²		Diesel ³		Residuals ⁴		Gasolines ⁵	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
All contractors	5,210.0	100.0	3,604.1	100.0	959.9	100.0	545.5	100.0	57.9	100.0	39.5	100.0
10,000 and under	225.5	4.3	225.5	6.3	28.8	3.0	0.5	0.1	3.8	6.5	3.4	8.6
10,001 to 30,000	437.5	8.4	404.4	11.2	103.0	10.7	99.0	18.1	48.0	82.8	36.1	91.4
30,001 to 50,000	681.1	13.1	431.1	12.0	57.6	6.0	4.3	0.8	6.2	10.7	36.1	91.4
50,001 to 100,000	288.5	5.5	223.2	6.2	770.5	80.3	441.6	81.0	6.2	10.7	36.1	91.4
100,001 and over	3,577.4	68.7	2,322.9	64.4	770.5	80.3	441.6	81.0	6.2	10.7	36.1	91.4

¹ U.S. Air Force turbine fuel.

² U.S. Navy high-flash turbine fuel.

³ Marine and automotive diesel fuel.

⁴ Oil burner fuels.

⁵ Automotive and aviation motor fuels.

Note.—Individual items may not sum to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Senator SYMMS. Well, I appreciate that and I appreciate your testimony. I would only say that I think the problem is that the severance tax that the Congress passed last year and was signed into law by the President, is what caused the problem in the first place. The so-called windfall profits tax, I like to call a severance tax because that's really what it is, on crude oil production, and that has caused a tremendous problem, I think, for this industry and maybe there is something we need to do. I want to dig into it further, but thanks very much.

Mr. CHAPOTON. Sure.

Senator WALLOP. Senator Bentsen?

Senator BENTSEN. Thank you very much, Mr. Chairman. I am delighted to welcome back Secretary Chapoton. I have no questions of him, but I would like to make a comment.

First, I want to congratulate you on holding these hearings to express your concern for a very vital part of the production of the energy of this country with the small and the independent refiner, because he does do a good part of it in heating oils, but he does other things, too, such as propane and diesel fuels, which are very important to agriculture in our country.

But, unfortunately, we're faced with a problem that of the crude oil supply that we're developing in this country, more and more is heavy crude and sour crude, and we don't have the kind of refinery capacity that we need to come out with some of the light products such as gasoline, and we do have to have a major concern toward the investment and the retrofitting of these refineries, and I believe accelerated appreciation would do a lot of that, if we go far beyond what we have on the books now, whether it's 1053 or 24710 or some variation of that. We need a way for capital recovery to encourage that kind of investment.

I also know these small refiners are having a problem in having a competitive source of crude oil. So, I'm pleased to study the proposals that they have brought about and, in turn, am interested, obviously, in the comments that you have made concerning them.

Thank you very much, Mr. Chairman.

Senator WALLOP. Thank you, Senator Bentsen and thank you very much, Mr. Chapoton. I really appreciate your being here.

There may well be a question or two from committee members which we might want to submit to you for your response in writing.

Mr. CHAPOTON. We'd be happy to do that, Mr. Chairman.

Senator WALLOP. Thank you.

Mr. CHAPOTON. Thank you.

Senator BENTSEN. Mr. Chairman, I apologize for my lateness in being here but I'm in a competing committee and I'm the head of another one. It seems that the problems of the Democrats may be a little more serious than yours at the moment. [Laughter.]

Senator WALLOP. Well, if it's any consolation, I was late myself, despite a considerable effort to do something better.

[The prepared statement of Hon. John E. Chapoton follows:]

For Release Upon Delivery
Expected at 10:00 a.m.

STATEMENT OF THE HONORABLE JOHN E. CHAPOTON
ASSISTANT SECRETARY (TAX POLICY)
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE COMMITTEE ON FINANCE
MARCH 27, 1981

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the Treasury Department's views on four tax and tariff proposals relating to the domestic oil refining industry. The Treasury Department's primary focus at this time must be the tax proposals that are part of the President's economic program, and our comments on the four proposals under consideration today must be understood in the context of the overriding need for swift action on the proposals in the economic program. As you know, we are requesting that Congressional action with respect to all other tax measures, however meritorious, be deferred until completion of legislative action on the President's economic program.

Proposals for Federal assistance

We have been requested to comment on four specific proposals of interest to domestic refiners. These relate to (1) tax incentives for upgrading or retrofitting domestic refineries, (2) the imposition of a tariff or fee on the importation of foreign refined petroleum products, (3) modification of the foreign tax credit to encourage sales of crude oil by international oil companies to domestic refiners, and (4) the creation of tax-exempt crude oil purchasing cooperatives.

Three of the proposals under consideration here -- a 5-year useful life for new refinery assets, an additional 10-percent investment tax credit, and modification of the foreign tax credit rules -- were the subject of a report prepared by the Department of the Treasury and Department of Energy dated January 16, 1981. The report evaluated the need for tax incentives for the domestic refining industry generally and for domestic independent and small refiners specifically. The report concluded that such incentives were not needed. We have undertaken a fresh examination of these proposals and our independent findings generally reach the same conclusion as was reached by the report. Consequently, we must oppose the adoption of these proposals.

Reasons for proposals

Before I address each of these proposals in detail I will briefly discuss the reasons cited in support of Federal intervention on behalf of the domestic refining industry. First, it is contended that the termination of the price control system has changed the competitive position of the domestic refining industry. Consequently, small and independent domestic refiners must obtain assistance in order to remain competitive. Second, it is anticipated that the supply of high quality light low-sulfur crudes will decline as a proportion of the total available supply of crude oil. Hence, financial assistance in modifying and replacing refinery equipment is required.

Termination of price controls create need for assistance to small and independent refiners if they are to compete

Price controls worked in two ways to maintain the size of the U.S. refining industry. By delaying the adjustment of petroleum product prices to world price levels, controls have helped to sustain higher rates of domestic demand for, and consumption of, petroleum products than otherwise would have occurred. In addition, since lower prices of domestic refinery products were achieved through crude oil and refined product price controls, the price control system had the effect of discouraging the imports of refinery products and encouraging the import of crude instead. Consequently, the termination of controls will both shrink the size of the U.S. market for petroleum products -- and indeed it has already begun to do so -- and is expected to shrink the share of U.S. consumption that is refined domestically.

It is the Administration's position that this sorting out process should be determined by market forces. This reduction in the size of the domestic refining industry will be accomplished by a failure to replace obsolete, high cost and uneconomic operations that have been sustained by the price control system. It would be inappropriate for the Federal government to allocate resources, through the tax system or by other means, to maintain uneconomic domestic refinery facilities.

One additional argument is made for Federal intervention on behalf of small and independent refiners. It is contended that small and independent refiners are the principal firms that assure competition within the industry and that the continued presence of small and independent refiners in the market is essential to maintaining refinery product prices at competitive levels.

We do not believe that government intervention on behalf of small and independent refiners is warranted on economic policy grounds. First, the freedom of resource entry into and out of the refining industry is not dependent

on the size of refinery installations. The optimal size of a refinery is determined by the characteristics of product demand in the markets served and by refining technology. Thus, the number of refineries required to maintain a competitive market is determined by the market itself.

Second, the fact that a refiner is "independent"; that is, has little or no interests in oil production, has no bearing on either the ability to sell petroleum products or to purchase crude that warrant government intervention. The presence in world markets of both large independent refiners and independent crude producers suggests that all refiners have access to enough crude oil to meet whatever product demand they wish to satisfy.

Capital will be needed by refiners for conversion to lower quality crudes

With respect to the second justification for Federal assistance it is argued that the mix of crude oils currently produced are of a higher average quality than proved and probable reserves. Consequently the average quality of future crude supplies will deteriorate. Thus, in order to produce the present mix of refinery products from low quality crude will require more capital intensive and hence more costly refinery processes.

The gradual degradation of the quality of crude oil does not present a problem that requires government intervention. The technology for processing low quality crudes is well known, is currently in use and is available to any refiner who wishes to install it. Refiners, not needing to expand capacity in the eighties and nineties because of reduced demand will be able to modify their existing facilities to process lower grade crudes as part of their regularly scheduled shutdowns for maintenance and repair. Indeed, recent reports indicate that refiners are taking advantage of current low demand for refined products to do just that.

To the extent that the oil refining industry needs assistance to finance future anticipated capital costs, adoption of the President's tax proposals liberalizing the capital cost recovery rules is the best way of providing such assistance. This assistance will be available for all new equipment.

In conclusion, we believe that neither the termination of price controls nor future changes in the characteristics of crude oil justify a special subsidy for investment in domestic petroleum refining in addition to the assistance to be provided by the President's tax-reduction program. If enacted, additional subsidies would have the effect of producing abnormal profits for refiners whose plants and

locations already assure them economic viability and would deter exit from the industry of inefficient plants. This intervention to maintain a flow of capital to refining facilities which cannot otherwise survive wastes scarce resources and reduces productivity.

Four proposals

I will now discuss the four specific proposals under consideration by the committee:

Tax incentives for upgrading or retrofitting domestic refineries

The first proposal would (1) establish a 5-year useful life for new refinery assets that are tangible property, and (2) provide an additional 10-percent investment credit for new refining equipment that modernizes and expands the capacity of an existing refinery facility. An expansion of capacity would include converting from sweet to sour crude processing and installing equipment to handle high sulfur crude oil. Qualified refinery equipment would also include equipment that improves energy efficiency of an existing domestic refining facility.

The 5-year capital cost recovery period proposed for refinery assets is similar to the general cost recovery initiatives proposed by the Administration under its tax reduction proposals. The Administration's tax reduction proposals will reduce the present 16-year ADR life for refinery assets to 5 years. This will significantly assist all refiners in the general upgrading and conversion of refinery equipment and will not be limited to specific equipment as in the proposal.

However, for the reasons discussed earlier we do not believe that the refining industry has established a need for Federal assistance for capital acquisition costs beyond that being provided for all business under the regular investment tax credit provisions of the Code. Refiners, in general, have the financial resources to meet their current and anticipated needs for the modification and upgrading of their refineries. In addition, refiners will make the necessary investments in energy conserving equipment without Federal subsidies. To the extent that energy conservation is achieved it will be in response to the operation of market forces and not because of the availability of an energy investment credit. Enactment of an energy tax credit under such circumstances would not result in any energy conservation and would provide refiners, who will be making these investments in any event, with a windfall.

The adoption of an additional investment credit will reduce tax receipts by \$350-500 million annually for the

next few years. That is a cost that cannot be justified at a time when we are seeking to balance our budget.

Imposition of a petroleum product tariff or fee.

It is proposed that a petroleum product tariff or fee be imposed on refined products to protect the domestic refining industry.

This Administration strongly opposes the imposition of tariffs or fees on imports of petroleum products. The effect of such measures would be to increase petroleum product prices beyond levels determined by world oil prices solely for the purpose of discouraging importation of refined petroleum products. The apparent intent of the proposals are to shield from competition inefficient and uneconomic refineries that were established to take advantage of the "small refiner entitlement bias" that has disappeared with price controls. It would impose a tax on all product users, which would in turn divert scarce capital from more economic investments to sustaining uneconomic refinery capacity. The proposal is therefore inflationary on two counts: it causes a rise in prices directly, and it reduces national productivity. In the event Congress wishes to impose a restraint on petroleum product consumption by means of a tariff calibrated to add a national security premium to the world price of petroleum, it should do this directly by taxing the importation of both the crude and the product so as not to bias the choice between domestic refining and product imports.

Modification of foreign tax credit rules.

The third proposal would modify the foreign tax credit limitation rules to expand the definitions of foreign oil and gas extraction income and foreign oil related income. The proposal would also modify the source of income rules applicable to the foreign tax credit limitation to treat sales of domestic and foreign crude oil to small and independent refiners as foreign source income rather than U.S. source income. The effect of the proposal would be to substantially distort the historic function of the foreign tax credit limitation. The proposal would allow excess foreign tax credits from OPEC and other foreign income taxes on oil production to offset U.S. income tax on profits from drilling and production of oil within the United States. Clearly, that should be deemed unacceptable.

The advocates of the proposal, the American Petroleum Refiners Association, believe it is necessary address "the obvious preferential tax treatment accorded major multinational oil companies under U.S. law". By this they mean that the foreign tax credit limitation rules contain a bias which favors investment in overseas refining and other.

oil related activities by international oil companies and that foreign refinery products produced from such investments displace refining in the United States. While the special oil extraction foreign tax credit rules may, in fact, be defective, the proposal under discussion here today makes no effort to remove the defect. Instead the proposal seeks to broaden the defect in order to provide small and independent refiners with a pool from which to draw a benefit to reduce their cost of acquiring oil.

It is neither clear that the inducement to invest in foreign refining facilities displaces U.S. refining capacity, nor that the proposed change would achieve the intended reduction in oil acquisition costs of small and independent refiners. Multinational oil companies with excess foreign tax credits are currently selling oil to independent and small refiners. These sales at market prices would continue without reduction in price to the qualified refiners but with an unwarranted tax benefit for the international oil companies that have excess foreign tax credits.

We would suggest that if the defect in the foreign tax credit limitation rules for oil income creates an incentive for multinational companies to invest in foreign refineries, this problem should be addressed in the context of an overall examination of the foreign tax credit rules.

Crude oil purchasing cooperatives.

The final proposal would allow small and independent refiners to establish tax exempt cooperatives to purchase crude oil from foreign suppliers under long term contracts.

In general, subchapter T of the Internal Revenue Code of 1954 provides rules for the operation of so-called "taxable" cooperatives. Those rules allow these cooperatives to provide goods or services to their members at cost. Gross membership revenues in excess of costs are treated as overcharges rather than income to the cooperative if refunded to members either by cash or by retain certificates. Thus, taxable cooperatives are not generally subject to tax except to the extent of income from investments or nonmembership dealings. To this extent they are no different than so-called "exempt" cooperatives.

It appears, therefore, that the purpose of establishing privately owned cooperatives to purchase crude oil from foreign suppliers under long term contracts can be achieved under existing law without creating a special tax exemption category. These cooperatives will not be subject to tax to the extent that they deal with their members at cost. We see no need for the adoption of this proposal.

Conclusion

In conclusion, I would repeat the Administration's opposition to the adoption of any of the four proposals under consideration today. The domestic refining industry should be fully capable of financing its current and future capital needs in the favorable business environment that will be created with the adoption of the President's tax program.

Senator WALLOP. The next witness is Prof. George Horwich, department of economics, Purdue University in West Lafayette, Ind. Please proceed.

STATEMENT OF PROF. GEORGE HORWICH, DEPARTMENT OF ECONOMICS, PURDUE UNIVERSITY, WEST LAFAYETTE, IND.

Mr. HORWICH. Thank you, Mr. Chairman. I appreciate the opportunity to testify on this important issue. I have somewhat fuller remarks on the subject that I would like to submit for the record.

Senator WALLOP. Your statement will be included in the record in its entirety.

Mr. HORWICH. I assume the committee has asked me to testify because of my background in this particular area. For 2 years ending last fall, I had a unique opportunity as a senior economist in the Office of Oil Policy of the Department of Energy to study the U.S. refinery industry.

I was particularly concerned with the national security implications of crude oil decontrol. The removal of price controls and the rise of U.S. oil prices to world levels promised, of course, to deprive domestic refiners of an important cost advantage they enjoyed relative to refiners elsewhere in the world.

By computer simulations, we anticipated that decontrol would cause a decline of domestic refinery output of somewhere between 500,000 and 1 million barrels a day. That is about 5 or 6 percent of U.S. refining capacity. In place of that domestic output, we believed that imports of finished petroleum products, mostly from the Caribbean and Western Europe, would rise by roughly an equal amount.

The basic question that our staff and I grappled with was whether this increase in product imports constituted a threat to the national security of the United States. In view of higher petroleum product imports, would the United States be in a generally less secure position and experience higher costs in the face of world oil supply interruptions?

In my view, the possible threat to national security is the only substantive reason for even considering protection of domestic refiners from the rise of petroleum product imports.

Our staff constructed models of the United States and the world economy under decontrol with an increased volume of product imports and then, for comparison, with a reduced volume of product imports brought about by a product import tariff. These models were subjected to a wide variety of simulated petroleum disruptions occurring in many parts of the world.

To summarize this research, we were unable to find any significant general advantages to the United States when it had a lower level of product imports due to a product import fee as compared to higher product imports in the absence of a protective tariff.

There is one fundamental reason for these results. When petroleum product imports increase under decontrol, total petroleum imports—that is, both finished products and crude oil—do not increase. As some of U.S. refinery output is replaced by produce imports, the declining domestic refineries have less need for crude oil. Since the marginal source of crude oil is from foreign countries, crude oil imports tend to fall, barrel for barrel, with the rise of petroleum product imports.

Thus, in response to oil disruptions, the United States is not generally in a more vulnerable position with higher product imports since, under these circumstances, its crude oil imports are lower.

Another reason the product/crude oil mix in our petroleum imports is not generally important to our national security is that under crude oil interruptions, excess refining capacity springs up throughout the world. That will tend to be true in the Caribbean, Eastern Canada, and the United States itself. There will be no problem, for example, of securing refining capacity to process our strategic petroleum reserve or other petroleum stockpiles.

Thus, for the typical kind of petroleum disruption we have experienced in the past and are likely to encounter in the future, crude oil, not refinery capacity, is the scarce resource.

The only circumstance in which a higher volume of product imports increases our vulnerability is if a world disruption involved a significant destruction of refineries themselves, say in the Caribbean. In that event, there would be no simultaneously emerging excess refining capacity. We could conceivably have difficulty refining our strategic reserves.

In this connection I offer the following concluding observations:

In the present world, the probability of a crude oil disturbance in the Middle East would appear to be many times greater than that of a refinery disaster in the Caribbean, Western Europe, or eastern Canada, the likely sources of additional product imports. Granted, however, that the probability of a refinery disaster in these territories is not zero, we must ask whether it is high enough to justify the annual costs of a protective tariff which reduces product imports to predecontrol levels. In 1979 oil prices, these costs were several hundred million dollars in real resources, and entailed transfers exceeding \$6 billion from consumers to producers and Government. Today the outlays would be more than double that.

I have just another comment or two.

Senator WALLOP. Very briefly, if you will. I appreciate what it means to be asked to come all this way. I also appreciate that other people will have the same problem.

Mr. HORWICH. Just a final observation.

I would say if one seriously believes that the probability of a refinery disaster in the Caribbean, eastern Canada, and Western Europe were high enough to justify those annual costs of a tariff, then he would have to consider whether the funds might be spent more effectively in support of those regions by the Department of

Defense, rather than by the American public in an attempt to build additional refineries which the free market itself would not generate.

Thank you.

Senator WALLOP. Thank you very much, Professor Horwich.

Is it a point that you would consider U.S. dependence on foreign-refined products a security risk?

Mr. HORWICH. I would not want to say that there is no such point. I would observe, though, that we are talking about levels of product imports that are not what I would call truly large. We are talking, for 1980, about a level of 1½ million barrels a day out of total petroleum imports of slightly over 6 million.

I cannot see our product imports rising much higher than 2 million barrels. I just think that the general downward trend in world oil consumption, and the substantial excess refinery capacity, both in this country as well as the rest of the world, does not indicate that we are going to be deluged by product imports in the foreseeable future.

Senator WALLOP. Is there a related economic consequence, other than the security? In other words, I agree with what you say, from everything I know, that we're not likely to have importation of oil as an entity, because of the refined product increase, but the price differential will have some payment consequences.

Mr. HORWICH. We found those impacts on the balance of payments to be virtually negligible. By and large, the most important influence on the balance of payments is our relative rate of inflation. It dwarfs every other variable which might affect it. We found very little happening to our balance of payments as a result of increased product imports under decontrol.

Senator WALLOP. Are crude oil prices and refined prices a major portion of the inflationary picture?

Mr. HORWICH. When they rise, and rise rapidly, they do play a role. Actually, there have only been several years, the 1973-74 episode and the 1979-80 episode, during which petroleum prices were rising sharply and thereby caused about one-third of the inflation rates of those two periods.

In general, energy prices have otherwise, in real terms, actually been falling.

Senator WALLOP. Thank you very much, Professor Horwich.

Mr. HORWICH. Thank you.

[The prepared statement of George Horwich follows:]

STATEMENT OF GEORGE HORWICH, PROFESSOR OF ECONOMICS, PURDUE UNIVERSITY

I thank the committee for the opportunity to testify on this important issue of the future of the U.S. refining industry. I assume the committee has asked me to testify because of my background in this particular area. For two years ending last fall, I had a unique opportunity, as a senior economist in the Office of Oil Policy of the Department of Energy, to study the U.S. refinery industry. I was particularly concerned with the national security implications of crude oil decontrol. The removal of price controls and the rise of U.S. oil prices to world levels promised, of course, to deprive domestic refiners of an important cost advantage they enjoyed relative to refiners elsewhere in the world. By various analytical techniques and computer simulations, our refinery policy team anticipated that decontrol would cause a decline of domestic refinery output of somewhere between 500,000 and one million barrels a day. That is about five or six percent of U.S. refining capacity. In place of that domestic output, we believed that imports of finished petroleum products—

mostly from the Caribbean and Western Europe—would rise by roughly an equal amount.

The basic question that our staff and I grappled with was whether this increase in product imports constituted a threat to the national security of the United States. In view of higher petroleum product imports, would the U.S. be in a generally less secure position and experience higher costs in the face of world oil supply interruptions? In my view, the possible threat to national security is the only substantive reason for even considering protection of domestic refiners from the rise of petroleum product imports.

Our team constructed models of the U.S. in the world economy under decontrol with an increased volume of product imports and then, for comparison, with a reduced volume of product imports brought about by a product import tariff. These models were subjected to a wide variety of simulated petroleum disruptions occurring in many parts of the world. To summarize this research, we were unable to find any significant general advantages to the U.S. when it had a lower level of product imports, due to a product import fee, as compared to higher product imports in the absence of a protective tariff.

There is one fundamental reason for these results. When petroleum product imports increase under decontrol, *total* petroleum imports, i.e., both finished products and crude oil, do not increase. As some of U.S. refinery output is replaced by product imports, the declining domestic refineries have less need for crude oil. Since the marginal source of crude is from foreign countries, crude oil imports tend to fall barrel-for-barrel with the rise in petroleum product imports. Thus, in response to world oil disruptions, the U.S. is not generally in a more vulnerable position with higher product imports, since under these circumstances its crude oil imports are lower.

Another reason the product/crude oil mix in our petroleum imports is not generally important to our national security is that under crude oil interruptions, excess refining capacity springs up throughout the world. That will tend to be true in the Caribbean, Eastern Canada, and the U.S. itself. There will be no problem, for example, of securing refinery capacity to process our Strategic Petroleum Reserve or other petroleum stockpiles. Thus, for the typical kind of petroleum disruption we have experienced in the past and are likely to encounter in the future, crude oil, not refinery capacity, is the scarce resource.

The only circumstance in which a higher volume of product imports, as opposed to crude imports, increases our vulnerability is if a world disruption involves a significant destruction of refineries in, say, the Caribbean. In that event there would be no simultaneously emerging excess refining capacity; we could conceivably have difficulty refining our strategic reserves.

In this connection I offer the following observations:

1. In the present world, the probability of a crude oil disturbance in the Middle East would appear to be many times greater than that of a refinery disaster in the Caribbean, Western Europe, or Eastern Canada, the likely sources of additional product imports to the U.S.

2. Granted that the probability of a refinery disaster in these territories is not zero, we must ask whether it is high enough to justify the annual costs of a protective tariff which reduces product imports to pre-decontrol levels. In 1979 oil prices, these costs were several hundred million dollars in real resources, and entailed transfers exceeding \$6 billion from consumers to producers and government. Today those outlays would be more than double that.

3. Suppose one believed that the probability of a refinery disaster in the Caribbean, Eastern Canada, or Western Europe were high enough to justify the annual costs of a tariff. However, we would then have to consider whether the funds might be spent much more effectively on military support for the regions in question by the Department of Defense, rather than by the American public in an attempt to build additional refinery capacity which does not emerge under free market conditions.

4. Petroleum consumption is, of course, falling rapidly throughout the world. With considerable excess refining capacity in virtually every major industrial country, including the U.S., it is hard to imagine our petroleum product imports rising, under free market conditions, to a truly significant degree.

5. In any case, oil supply shortfalls tend, sooner or later, to be spread around the globe in proportion to each region's share of world petroleum consumption. As long as we are importing any products from anywhere in the world, a cutoff of product exports from, say, the Caribbean, will ultimately cost us our proportionate share, even if our imports from that area are initially zero. This outcome will result from powerful market forces. The process unfolds as those experiencing cutoffs bid on existing flows and draw them away from their former recipients.

6. While importing products adds a second link in the transportation of petroleum to the U.S. from OPEC producers, there are real advantages to minimizing our direct economic dealings with OPEC. Thus, while importing product instead of crude may add some additional vulnerability to the security of our petroleum supply, limiting our direct purchases of crude from OPEC may add a degree of latitude to both our foreign policy and domestic stockpiling activities.

An alternative claim is frequently made that increased U.S. petroleum product imports will come not from areas secured by the U.S. military umbrella, but from the Middle East. Arab OPEC producers are in fact said to be building substantially increased export refining capacity. In a report written for Melvin Conant and Associates in 1979, Henry Schuler cited evidence that crude oil producers in the Middle East would have export refining capacity of 5 to 6 million barrels per day by 1985. The U.S., Schuler claimed, would be expected to take a substantial share of these exports at prices which initially will be subsidized by crude oil revenues. Later, prices will be raised as OPEC extends its oil cartel to include refinery operations. In view of all this, Schuler and many others have argued that the U.S. national security would best be served by shutting out additional product imports—from the Middle East and elsewhere—by a protective tariff.

The Department of Energy's surveys of the world refinery industry have failed to substantiate any significant entry by OPEC producers into the refining export market in the 1980's. In its 1979 survey, DOE saw no evidence of additional Middle East refining export capacity before 1983 other than that due to reduced internal consumption by Iran. Beyond 1983, DOE reported 1.4 million barrels per day of export capacity scheduled to come on stream. But this was 0.5 million less than DOE forecast in 1978. And more than half of the 1.4 million total, 0.8 million, was in the "study" stage, compared to only 0.3 million so characterized the year before.

DOE's 1980 survey, the latest evidence on this subject, shows virtually no increase in Middle East net exportable capacity in 1983 and 1984 and only 1.0 million barrels per day (mainly in Saudi Arabia) beyond 1984. However, the survey also notes that the Iranian refinery at Abadan and Iraq's complex at Basrah are both probably damaged beyond repair. If, conservatively, half the capacity of these refineries is assumed to have been exportable, then 0.4 million barrels per day must be subtracted from the 1.0 million post-1984 projected Middle East increase. That leaves only 0.6 million barrels per day of net additional Middle East exportable capacity by the mid-1980's, a negligible amount. Virtually all of Middle East product exports are earmarked for Africa, with some for Europe. There is thus nothing in DOE's surveys to indicate that the Middle East will be in a position to export a great many refined products to the Western Hemisphere before the 1990's, if ever.

Indeed, the picture is one of OPEC generally building refineries to keep pace with its own growth and internal requirements. Beyond that, its near-term attempts to enter the refinery export market appear very tenuous, as one would expect in a world of declining petroleum demand and significant excess refinery capacity. The claims of Arab and other members of OPEC, frequently overstated in the past, can hardly be taken as a basis for U.S. policy in the present.

The argument that a monopolist can extend his power by tying in sales of a good in which he has monopoly power with product sales in which he is a competitor is a common misconception. It is difficult to see what economic advantages would accrue to OPEC producers if they were to tie in refined products with their crude. They would sell more product, but less crude, a larger portion of which would be retained as raw material for their new refineries. Sales of their low cost crude would be replaced by sales of product for which OPEC's comparative advantage is no greater, and probably less, than numerous other countries of the world. OPEC's total sales of petroleum—crude plus product—would be essentially unchanged, its costs higher, its profits lower, and its total leverage over consuming nations no greater than previously.

If, nevertheless, OPEC decides for other reasons to build refinery capacity which would not be to its economic advantage, it will surely not be deterred by U.S. decision to protect its own refinery industry.

The argument, sometimes advanced, that selective embargoes are easier to carry out in petroleum products than in crude oil does not appear to be accurate or particularly relevant. The task of identifying, through chemical analysis, the geographical origin of crude oils is comparatively simple. Tracing refined products to their source is all but impossible.

But oil embargoes in any case tend to be ineffective. The attempt by Arab OPEC countries to embargo supplies to the United States and the Netherlands in 1973-74 did not succeed. Even if a country could enforce stipulations as to the ultimate destination of its exports, no country can prevent the innumerable offsetting substitutions from other sources that the world oil market generates almost spontaneous-

ly. In the United States, at least, the preponderant evidence is that the reduction in our petroleum imports in 1973-74 is entirely explainable by our diminished demand at sharply higher prices. These prices were caused not by the attempted embargo, but by the rapid deceleration of world oil output by OPEC producers which affected all consuming nations.

The further argument that American refiners must be compensated for the higher costs of doing business in America is not a reliable guide to foreign trade policy. The ability of the U.S. to compete in world markets stems from efficiency and productivity levels that yield American industry a comparative advantage, even while paying the world's highest wages. In recent years American workers have received some of their compensation in the form of healthier working conditions—in particular, a cleaner environment. Congress, in its wisdom, has required goods transported between American ports to move in American vessels at U.S. union-determined wage levels (The Jones Act). All of these measures impose higher costs on U.S. refiners which pass the test of democratic consensus, if not, in every instance, economic efficiency in the narrower sense. If indeed inefficiencies in environmental policy or Jones Act requirements deserve to be corrected, they should be attacked directly, not compounded by new inefficiencies of tariff policy.

What we are facing in March 1981 is nothing less than the deregulation our domestic refinery industry for the first time in 22 years. It is no time to panic.

Senator WALLOP. The next witnesses will compose a panel. The panel will be Mr. R. Thomas Van Arsdall, vice president, National Council of Farmer Cooperatives, Washington, D.C.; Mr. Laurence R. Steenberg, chairman of American Petroleum Refiners Association, and president of Laketon Asphalt Refining Inc.; Gary Petersen, spokesman for Independent Refiners' Association of California, and president of the U.S. Oil & Refining Co., Tacoma, Wash.; William H. Bode, general counsel, Emergency Small Independent Refiners' Task Force, Washington, D.C.; Mr. Robert Vinson, chairman of the Tax Committee, Independent Petroleum Association of America, and president of the Sterling Petroleum Co., Wichita Falls, Tex.; and last, Mr. Richard Wilcke, president, Council for a Competitive Economy, Washington, D.C.

Gentlemen, would you proceed and, again, we will follow the 5-minute rule.

Mr. Van Arsdall, would you begin?

STATEMENT OF R. THOMAS VAN ARSDALL, VICE PRESIDENT, NATIONAL COUNCIL OF FARMER COOPERATIVES, WASHINGTON, D.C.

Mr. VAN ARSDALL. Thank you, Mr. Chairman. You have a full statement, for the record.

Senator WALLOP. Each of your statements will be inserted in the record in full, as if delivered.

Mr. VAN ARSDALL. We are here today essentially because farmers must have fuel when they need it to insure full food and fiber production. Many farmers have turned to their own cooperatives to supply this fuel. Cooperatives now have eight efficient refineries with an aggregate production capacity of 460,000 barrels per day, market petroleum products in more than 40 States, and supply about 45 percent of onfarm fuel use and a large portion of rural needs.

We live in a precarious world market in which history shows that crude oil disruptions impact first and hardest upon farmer cooperatives and other independent refiners. These impacts cause product shortages in the agricultural community and disproportionately higher farm fuel costs.

The National Council has consistently supported certain decontrol measures to encourage domestic energy production, but significant barriers remain to a truly free market.

Farmer cooperatives' attempts to obtain more secure supplies in the domestic market have been limited because major refiners own most of the domestic crude production, and exploration and production activities by cooperatives have been restricted by capital availability.

Attempts to purchase foreign crude at competitive prices have also encountered major obstacles, including long-standing preferential treatment of some major oil companies by certain oil-producing nations; and, politically motivated pricing decisions which have no bearing on economically justifiable quality differentials.

Thus, total absence of Government involvement in the crude oil market is likely to have an effect opposite that envisioned by free market proponents. Agricultural communities would become even more vulnerable to supply disruptions and price disparities.

As pointed out by the chairman in his floor statement, the primary problem confronting the responsible small and independent refining segment today is the inability to obtain equitable access to crude oil at competitive prices. Consequently, our comments today are offered in the context of the ability of each proposal to address this fundamental problem.

Foreign tax credits for sales of domestic or foreign crude to independent refiners would appear to be limited for several reasons:

One, the impact on Treasury revenues, whether such action actually assists in the creation of a competitive environment; two, the fact that this approach is a two-edged sword, in that the transaction which enhances the competitive viability of the independent simultaneously increases the financial position of the major seller; and three, it would not appear to provide effective access during supply disruptions.

A permanent product import policy should be established. Domestic refiners now face cost disadvantages resulting from U.S. Government regulations which offshore refiners do not face. For national security reasons, it would be unwise to permit the export of domestic refining capacities. We propose the imposition of a fee system, which would effectively preclude imports above historic levels.

A fee on imported crude oil would not appear to provide equitable access to crude at competitive prices. First, a flat fee would fall hardest upon independents and exacerbate the present crippling foreign price disparities. A variable import fee could be used to equalize these price disparities, but might encourage OPEC to increase its prices.

In addition, domestic crude prices may rise to the import level plus fees. Allocation of import rights, similar to that in the old mandatory oil import program, does not appear to apply in today's far different world petroleum market.

In short, it would appear that a tariff would cause as many problems as it would solve.

We agree with the chairman's observation that President Reagan's business tax cuts would do much to encourage investments.

However, due to the manner in which cooperative income is treated for tax purposes, accelerated depreciation will have the opposite effect for cooperatives.

Therefore, we propose the establishment of an additional 10-percent energy tax credit for cooperatives. In this regard, S. 750 might be appropriate as a vehicle.

Farmer cooperatives have already attempted several approaches similar to crude purchasing cooperatives and have had limited success in that effort. We would like to discuss these experiences with you at your convenience.

Even if successful, such efforts will take some years to yield significant results, and foreign crude oil supplies will remain highly vulnerable to disruptions.

In conclusion, there are a number of beneficial aspects to the proposals today, but they will not assure equitable access to crude oil at competitive prices.

The bottom line is that any such programs are academic to efficient, farmer-owned refiners, unless the key ingredient to capital formation—access to crude oil—exists.

Accordingly, we urge that serious consideration be given to the development of the standby program, which would assure access to crude oil at competitive prices for cooperatives and other efficient refiners. Such a program would do much to assure petroleum supplies for farmers and other high-priority users adversely affected by disruptions.

Thank you.

Senator WALLOP. Thank you, Mr. Van Arsdall.

[The prepared statement of Mr. Van Arsdall follows:]



National Council of Farmer Cooperatives

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Before the
Subcommittee on Energy and Agricultural Taxation
of the
Senate Finance Committee

Statement of
R. Thomas Van Arsdall
Vice President, Energy Resources

March 27, 1981

Statement of
R. Thomas Van Arsdall
Vice President, Energy Resources

Mr. Chairman and Members of the Subcommittee:

My name is R. Thomas Van Arsdall, Vice President, Energy Resources of the National Council of Farmer Cooperatives. The National Council is pleased to have the opportunity to appear today to discuss National petroleum policy and various tax and tariff proposals to address problems facing domestic refining industry.

Mr. Chairman, we would particularly like to compliment you on your sensitivity to those serious problems which remain in the decontrolled marketplace. In your floor statement announcing this hearing, you specifically noted the predominant role played by farmer cooperatives and other independent refiners in serving agricultural markets:

"Small and independent domestic refineries, including cooperative refineries, often provide sparsely populated agricultural areas with the petroleum products such as diesel fuel and propane that are necessary to sustain the farming activities so essential to the economy of these rural regions. In view of such circumstances, it is necessary for Congress to consider the impact that the collapse of these small and independent refining companies would have upon these agricultural regions."

You also identified the access to crude oil by domestic refiners as the "linchpin" which ultimately determines

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the viability of independent refineries and their ability to supply fuel to these rural markets:

"...the primary problem confronting the responsible small and independent refining segment today is the inability to obtain equitable access to crude oil at prices which would enable them to remain competitive with the refineries of major international firms and foreign governments."

This timely hearing is the first opportunity in the Senate to address petroleum policy since the President's decontrol action. Given the imminent expiration of authorities in the Emergency Petroleum Allocation Act of 1973, debate must move forward on an expedited basis to ensure a viable domestic refinery sector and to maintain secure supplies of petroleum products at equitable prices to agriculture and rural America.

In summary, our testimony today (1) describes the genesis and role of the farmer cooperative petroleum system, (2) discusses decontrol and its implications for that system, and (3) addresses tax and tariff proposals before this Subcommittee, with emphasis on the extent to which these alternatives provide access to crude oil at competitive prices for farmer-owned cooperatives and other efficient independent refiners.

ROLE OF THE FARMER COOPERATIVE PETROLEUM SYSTEM

The National Council of Farmer Cooperatives is a nationwide association of cooperative businesses which are owned and controlled by farmers. Its membership includes

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119 regional marketing and farm supply cooperatives, the 37 banks of the cooperative Farm Credit System, and 31 state councils of farmer cooperatives. National Council members handle practically every type of agricultural commodity produced in the United States, market these commodities domestically and around the world, and furnish production supplies and credit to their farmer members and patrons. Two-thirds of United States farmers are affiliated with one or more cooperatives. The National Council represents about 90 percent of the more than 6,700 farmer cooperatives in the nation, with a combined membership of nearly 2 million farmers.

Farmers depend heavily on critical fuel inputs in their business of converting energy from the sun into food and natural fiber. Given the vagaries of nature, timing is critical to farm operations. Even a short disruption in fuel supplies at the wrong time can result in crop losses or reduced yields for that year. Farmers must have fuel in sufficient quantities and at the appropriate time and place to ensure full food and fiber production.

Farmers first entered the petroleum business through their own cooperatives in an effort to achieve secure fuel supplies, better quality service and fairer prices. Farmer cooperatives began marketing petroleum products in the 1920's; the first cooperative refinery was established in 1939; and the co-op role has grown steadily since that time.

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While farmer-owned cooperatives supplied 14 percent of on-farm fuel in 1942, 13 regional farmer cooperatives presently own and operate 8 efficient refineries (Attachment 1) which have an aggregate production capacity of about 460,000 barrels per day, and whose yields of gasoline, diesel fuel and heating oil amount to approximately 85 to 90 percent of their refined products. While this represents only 2.5 percent of United States refining capacity, cooperatives market petroleum products in more than 40 states and currently supply about 45 percent of all on-farm fuel (an additional 25 to 35 percent is supplied by other independent refiners) and a large portion of rural needs. About three-fourths of the petroleum products sold by farmer cooperatives go to farmers, with the remaining volumes sold to other rural customers. This distribution network for petroleum products is unique and irreplaceable.

Cooperative refineries are unique because individual farmers have invested their hard-earned savings in these petroleum operations to enhance the security and viability of their farming operations. Any cost savings from these refineries are distributed back to farmer-owners on the basis of their fuel use. Farmer cooperatives represent the only segment of the petroleum industry in which the consumers of its products are also its owners. This feature carries with it a unique accountability in terms of commitment of supply, service and price.

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The cooperative network's ability to meet farmer-member needs is dependent upon the ability of farmer-owned refiners to obtain adequate supplies of crude oil at competitive prices--an ability that has been compromised by recent developments in international crude oil markets.

IMPACT OF DISRUPTIONS

The United States is now, and will for the foreseeable future be, dependent upon significant amounts of crude oil derived from the world market. There is general agreement that, over the long term, world oil demand and supply will be in close balance. This precarious condition means that even small disruptions will be quickly felt in the world marketplace, and the United States will therefore be vulnerable to the supply and price uncertainties attendant to such dependence.

Crude oil disruptions impact first and hardest upon farmer cooperative and other independent refiners, whether generated by absolute shortfalls in supply or such high prices that the crude oil is unavailable as a practical matter. For example, as a consequence of the Iranian disruption in early 1979, cooperative refiners lost a significant portion of their crude oil supplies and were, therefore, forced to run at 50 percent of capacity (compared to an industry average of 85 percent). Further, crude oil acquired by farmer cooperatives was priced well above the national

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average. The results were predictable. Rural areas experienced serious diesel fuel shortages during the spring planting season, and farmers bore a disproportionate share of OPEC-driven price increases. Although the government tried to deal with the problem by providing an agricultural priority for diesel fuel allocations, there were simply insufficient supplies in the rural distribution network to make up for the losses occasioned by crude oil shortages.

Emergency crude oil allocations (a program dismantled by decontrol) did ultimately move crude oil supplies to cooperative refineries. Although generally too late for spring planting, these allocations did provide much needed relief beyond that time. The painful lessons to be learned from this experience are clear:

- (1) Most importantly, unless farmer cooperatives and other refiners serving rural areas are able to obtain crude oil, product shortages are extremely likely, and
- (2) disproportionately higher crude oil costs mean disproportionately higher farm fuel costs.

DECONTROL AND ITS IMPLICATIONS
FOR THE RURAL PETROLEUM SYSTEM

President Reagan's decontrol of crude oil and refined petroleum product prices and allocation controls on January 28 was designed to correct many of the problems affecting the petroleum market. The National Council has consistently supported certain decontrol measures to encourage domestic

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energy production under our free enterprise system. Government involvement is appropriate only when competitive forces are deficient or consumers' product needs are not met.

It must be understood, however, that there is a difference between a decontrolled market and a free market. Cooperative refiners and their farmer-owners are facing market circumstances that do not reflect the basic free-enterprise environment. In that regard, Senator Wallop indicated in his floor statement that integrated U.S. refiners own or control approximately 70 percent of total domestic production.

Limited Domestic Access:

Because of instabilities in the foreign crude oil market, farmer-owned refiners have tried to obtain more secure supplies in the domestic market. They have attempted to increase their self-sufficiency in crude oil. For example, exploration and production expenditures have expanded from about \$15 million annually in 1973 to more than \$115 million annually in 1980. In spite of these efforts, owned production represents only 7% of the requirements of farmer cooperatives. These efforts have been limited for two reasons:

- (1) First, major refiners own the majority of domestic crude oil production. In 1979, the 16 largest integrated refiners got about 75% of their domestic crude oil supply from

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their own production. They also have access to additional domestic crude oil through their ownership of gathering lines and pipeline connections.

- (2) Second, cooperative domestic exploration and production activities have been restricted by capital availability.

Consequently, cooperative refiners have been forced to look to the international market for a much greater share (approximately 60 percent) of their total crude oil supplies.

Limited Foreign Access:

Attempts by farmer cooperatives to purchase foreign crude oil at competitive prices have also encountered two major obstacles:

- (1) the long-standing preferential treatment of some major oil companies by certain oil producing nations; and
- (2) politically motivated pricing decisions which have no bearing on economically justifiable quality differentials.

First, foreign crude oil production has historically been dominated by a number of international oil companies, whose predominant position was an important element, if not the centerpiece, of United States foreign policy in the oil producing areas of the world. Producing nations have purchased the production interests from these

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international oil companies, and other major integrated refiners and independents have, in recent years, made modest inroads into the international markets. Nevertheless, the majors, particularly the ARAMCO partners, continue to benefit from these historical relationships and thereby continue to control a substantial portion of foreign crude oil. Indeed, small and independent refiners are still unable to obtain crude oil supplies from certain countries. In terms of access, the sixteen integrated refiners obtained, during the first six months of 1979, 55% of their foreign crude oil from captive sources (compared to 14 percent for the large independents and less than 10 percent for farmer cooperatives), with the ARAMCO partners obtaining fully 88% of their foreign crude oil from such sources.

Second, politically motivated, and economically unjustified, differentials in foreign crude oil prices jeopardize the long-term viability of the rural petroleum system and result in disproportionately higher fuel costs for farmers. For example, Saudi Arabian light is presently priced at \$32 per barrel to ARAMCO partners, with similar quality oil elsewhere being priced from \$4 to \$5 per barrel higher. No other companies have access to this Saudi light crude at \$32, although the Saudis are providing crude oil at this price on a government-to-government basis. To the extent that any is available, buyers must pay \$36 or \$37.

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In certain countries, such payment must be accompanied by additional considerations, such as exploration premiums, investment commitments and the like. Moreover, North African and North Sea "sweet" crudes are priced at between \$40 and \$41 per barrel, prior to the imposition of any premiums. The differential between sweet and sour crudes, which reaches \$9 per barrel at the extreme, simply is not justifiable when one considers that the economic differential has historically been in the range of \$2 per barrel.

Compounding these disparities in the OPEC pricing structure is the fact that many former cooperative refiner long-term contracts were terminated during shortages resulting from the Iranian revolution. It has since proven difficult, if not impossible, for cooperative and other independent refiners to enter into long-term foreign crude oil supply contracts at competitive prices. The large majority of crude oils that are offered on a contract basis to co-op refiners are the African sweet crude oils, which, for political reasons, continue to be priced at substantial premiums above the market.

Erosion of Competition:

In the absence of any government involvement, these market circumstances will generate a number of adverse impacts upon cooperative refiners and the agricultural community.

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First, the combined effect of domestic production control by the majors and the OPEC pricing structure could result in the practical elimination of the farmer-owned refiners' role as a competitive presence in the marketplace. This is not to say that cooperative refiners and other efficient independents will necessarily cease to operate. Rather, the more likely prospect is that in many areas the customers of these refiners will ultimately pay disproportionately higher prices for their fuel in order to assure the continued flow of petroleum products.

Generally speaking, the extremes of these price inequities will be found in the more remote rural regions already, or soon to be, abandoned by the majors. Farmer cooperative responsibilities have steadily increased, in large part due to partial and total market withdrawals in these areas by major oil companies. These withdrawals are accelerating as a result of decontrol, as illustrated by recent withdrawal announcements (Attachment 2). The economic forces causing the withdrawal of these companies from rural markets are understandable. However, the responsibility of serving not only farmers but rural communities which support farming falls more heavily to cooperatives. Presently, more than 900 communities are supplied solely by farmer cooperatives, and the total grows each year.

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Second, in rural markets where farmers have turned to their cooperatives as a competitive alternative to those majors that still supply such areas, these continued cost disparities could preclude farmer cooperatives from playing their traditional competitive role. Ultimately, product prices will have to reflect higher raw material costs. Under these circumstances, companies with lower crude oil costs can either choose to follow this "negative price leadership" and enjoy handsome profits or price their product below the farmer cooperative, eventually reducing that cooperative's ability to serve its owners. It is unlikely that remaining volumes in remote rural markets could support a viable rural petroleum system. Thus, with the absence of the farmer cooperative refiner, such areas would be even more vulnerable to supply interruptions.

Third, every time a supply shortage develops, the upward spiral in crude oil costs will continue as farmer cooperatives and other independents are forced to the spot crude oil market. This demand stress forces spot prices upward, with contract prices tending to follow. Not only does the farmer pay more for fuel, but the price of fuel to every consumer rises.

In sum, the total absence of government involvement in the crude oil market is likely to have an effect exactly opposite of that envisioned by "free market" proponents. Rather than the establishment of a competitive market, opportunities for non-competitive activity will increase, and agricultural communities will become even more vulnerable to supply disruptions and price disparities.

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EVALUATION OF TAX AND TARIFF PROPOSALS

As quite properly pointed out by Senator Wallop in his floor statement, "the primary problem confronting the responsible small and independent refining segment today is the inability to obtain equitable access to crude oil at prices which would enable them to remain competitive with the refineries of major international firms and foreign governments." Consequently, our comments on the various tax and tariff programs discussed in that statement and outlined in the notice of today's hearing are offered in the context of our evaluation of a particular program's ability to address this problem in an effective manner.

Foreign Tax Credits:

The first suggestion is that the foreign tax credit rules in the Internal Revenue Code could be amended so as to provide that income from sales of domestic or foreign crude oil to unrelated domestic small and independent refiners be treated as foreign source income, two principal issues are raised. The first is whether, in the present budget-balancing environment, there would be sufficient support for such a program whose ultimate success is, by definition, dependent upon a reduction in the revenue available to the U.S. Treasury.

The second, more important issue raised by this proposal is whether it would assist in the creation of an environment in which small and independent refiners would be competitive--a result which is by no means assured for several reasons. First, in order for such a program to be successful, there would have to be a sufficient number of major international refiners with

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excess crude oil and excess tax credits to provide a competitive market for the sale of such crude oil to small and independent refiners. In this regard, the Departments of Treasury and Energy, in commenting upon a similar proposal, indicated:

"But it is not apparent that the few U.S. multinational oil companies with large amounts of unused foreign tax credits own contracts for delivery of high quality crude, in suitable locations, to assure that competition among them will drive down their selling prices to qualified small refiners by the full amount of the subsidy. It is highly likely, therefore, that a significant portion of the subsidy will be absorbed in higher multinational oil company profits and/or excessive transportation and trading costs to get the oil to small refiner locations."^{1/}

Moreover, given the wide disparity in the average crude oil costs between major, integrated refiners (particularly those with access to Saudi Arabian oil and substantial amounts of domestic crude oil) and, for example, former cooperative refiners, the benefits provided by the program would have to be particularly generous if it were to result in competitive crude oil prices--a generosity that would have a concomitant adverse impact on tax revenues. Any benefits falling short of such a level would not, of course, assure the creation of a competitive environment.

^{1/} "Evaluation of Certain Proposals To Aid Domestic Refiners", Department of Treasury (Office of Tax Analysis) and Department of Energy (Office of Oil, Policy and Evaluation) (January 16, 1981) at 16.

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Furthermore, it is important to recognize that this foreign tax credit approach is a two-edged sword for small and independent refiners. While small and independent refiners may be able to obtain additional amounts of crude oil and may even be able to negotiate so as to obtain a portion of the tax benefit, the very transaction that enhances the competitive viability of a small and independent refiner simultaneously increases the financial wherewithal of the major, integrated refiner that has sold the crude oil to the small and independent refiner.

Finally, and most importantly, past experience indicates that such a program would not be effective during periods of supply disruptions. Thus, even though a refiner may not be directly affected by a disruption, such a refiner has historically been unwilling to engage in, or continue, third party transactions.

For these reasons, we believe that the ability of such a foreign tax credit approach to assure that small and independent refiners have equitable access to crude oil at competitive prices is subject to substantial doubt.

Import Tariffs:

Insofar as product import tariffs are concerned, the National Council believes that a permanent product import policy should be established. With the decontrol of domestic crude oil prices (and their consequent rise to world levels) and the termination of related regulatory programs, the price advantage enjoyed by domestic refiners vis-a-vis foreign

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refiners has come to an end. Indeed, domestic refiners now face cost disadvantages resulting from OSHA and EPA regulations, Jones Act requirements, and taxes. This reversal in relative cost advantage could have an adverse impact on product import levels and, in turn, on the domestic refining industry, particularly refiners with high average crude oil costs. Thus, we believe that it is critically important to develop a product import policy.

Toward that end, the following considerations should be reflected in that policy:

First, with the actual and projected surplus of refining capacity throughout the world and planned construction of export refineries by oil-producing nations, it is particularly important that the United States articulate a clear, permanent product import policy.

Second, in view of historic policies which have recognized, if not encouraged, the importation of certain levels of petroleum products to the United States (particularly residual fuel oil refined in the Caribbean for use in the Northeast), the product import policy should permit such levels of product imports to continue, but not increase. To the extent demand for residual fuel oil decreases over the decade as a consequence of increased use of coal and other energy sources, the levels of imports so treated should be reduced concomitantly. Similarly, because of the historic importance of propane imports to agricultural and rural areas, it is important that such imports not be impeded.

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Third, achievement of this objective should be accomplished through the imposition of a fee system which would effectively preclude imports above historic levels. The ultimate amount of the fee will have to reflect not only the cost disadvantages incurred by domestic refiners but also the impact of inflation and the relative crude oil costs of domestic refineries in comparison to foreign refineries that will be exporting products to the United States (which, in turn, will have to reflect the ultimate content of the domestic refinery policy legislation). Consequently, the National Council does not, at this time, have a recommendation as to the precise level for such a fee.

Finally, the policy should be sufficiently flexible to provide for the waiver of the product import fee during precipitous product shortages.

The establishment of a product import policy is critically important to assuring the viability of all domestic refiners. However, we do not believe that a fee on imported crude oil will ensure equitable access to crude oil at competitive prices for several reasons. First, if a flat fee were to be imposed on each barrel of crude oil imported into the United States, the impact of such a fee system will fall, at least initially, on those small and independent refiners that are heavily dependent on imported crude oil. Second, in light of the significant crude oil cost disparities between major, integrated refiners (especially those with access to Saudi Arabian crude oil) and small, independent refiners

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(particularly those that presently run sweet crude oil imported from Nigeria, Libya and Algeria), the addition of a flat fee on such imports will only exacerbate already crippling price disparities.

While it would be possible to overcome these difficulties by imposing a variable fee on crude oil imports in order to equalize these price disparities in the cost of imported oil, several problems would nevertheless remain. First, any such crude oil import fee system will only encourage OPEC to increase its price at an ever faster rate, since it will signal OPEC that the United States is willing to pay higher prices for its crude oil. With those increases in price and consequent increase in revenues, OPEC countries will also be encouraged to reduce their production levels, with the possibility that such reductions may exceed the actual reductions in demand resulting from higher product prices in the United States.

Second, to the extent that domestic crude oil prices increase to the level of imported crude oil prices (including any fee imposed), domestic producers will enjoy yet another "windfall" (which will not be totally taxed away by the windfall profits tax) and consumers in the United States will be required to pay even higher product prices. Farmers are price takers chronically caught in a cost/price squeeze, and artificially-induced higher energy prices will only further compromise their ability to remain financially viable.

Finally, it is not clear that the allocation of import rights would assure that small and independent refiners would have access to crude oil at competitive prices. The Mandatory Oil Import Program did create incentives that facilitated access to crude oil by small and independent refiners. However, the crude oil environment that refiners face today includes such considerations as declining domestic production, far greater control over production levels by exporting countries, and economically unjustified price differentials for imported crude oil. These factors may not result in the creation of the kinds of incentives that existed under the old import program.

In short, while a tariff on crude oil imports could be crafted so as to address certain aspects of the crude oil access difficulties facing small and independent refiners, it likely would create additional problems and would not assure equitable access to crude oil at competitive prices.

Incentives for Reconfiguration:

Turning to the question of tax incentives for refinery reconfiguration, we agree with Senator Wallop's observation that President Reagan's proposed business tax cuts will do much to encourage this needed investment. As the members of this Subcommittee are aware, however, the manner in which income generated by farmer cooperatives is treated for tax purposes renders certain tax incentives as applied to farmer cooperatives less useful, if not counterproductive. This situation leads us to make two recommendations concerning how much tax incentives should be structured.

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First, while the Administration's accelerated depreciation proposal will, no doubt, encourage reconfiguration by non-co-op refiners, the mandatory application of that proposal to farmer cooperatives would have precisely the opposite effect as that intended. Farmer cooperatives are required to distribute patronage on the basis of taxable, not book, income. This means that a cooperative would be required to depreciate the capital expended on an upgraded refinery on an accelerated basis, and, thus, cause the co-op to distribute the very capital that the program had intended would be accumulated for investment. Consequently, we would urge that accelerated depreciation not be made mandatory for cooperatives.

Second, since accelerated depreciation is not a useful tax incentive for cooperatives, we would urge that the Committee consider establishing an additional 10 percent energy tax credit for cooperative investment in equipment to retrofit their refineries. In this regard, we note that Senator Wallop and three other members of the Finance Committee have introduced S. 750 (which would provide additional non-refundable tax credits for certain investments), and we would request that cooperative refinery investments be made eligible for such credits as well.

In the last analysis, however, the most critical factor in obtaining the necessary financing for reconfiguration is a refiner's access to a secure source of crude oil. Consequently,

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while these tax incentives will encourage such reconfiguration, the financing for that investment will ultimately be dependent upon the lending institution's determination as to the ability of a refiner to obtain adequate crude oil supplies.

Crude Purchasing Cooperatives:

Farmer cooperatives have already attempted several approaches similar to the proposal that would set up privately owned tax-exempt crude oil purchasing cooperatives to assist small and independent refiners to obtain long-term foreign crude oil supply contracts. These attempts have thus far basically met with only limited success for a number of reasons. The foreign market structure, as discussed earlier, sharply limits access to the more secure and favorably priced foreign crude oil sources. There are no clear indications that independents could enjoy a much higher degree of success by "banding together," although larger volumes might induce a more favorable response.

The only thing that independents have to offer for crude oil is dollars. They still do not have the exploration and production expertise that the majors have to offer in dealing with producing countries. Even combining their resources, they are likely to fall well short of being able to offer similar assistance.

Farmer cooperatives do have technical expertise of a different kind to offer--that in agricultural production and in setting up cooperatives. They are working to establish more favorable trading relationships with producing countries by

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offering such assistance, but thus far with negligible results.

The suggested use of the Banks for Cooperatives as a "role model" would appear to offer limited tax advantages in setting up purchasing cooperatives comprised of independent refiners. Our experience is that farmer cooperative refineries, which already have access to the Bank for Cooperatives, have certainly found that their ability to borrow from the Bank for Cooperatives of the Farm Credit System, although of some help, was not an answer to their problem of attaining access to crude oil at competitive prices. However, it could hold more potential for joint ventures in exploration and production. For example, the federal government provided "seed money" to finance these rural lending institutions. These funds were subsequently paid back in full, and the system now stands on its own. Perhaps a similar approach might be used to amass the funds necessary for effective exploration and production.

Farmer cooperatives have also already engaged in several joint ventures in the search for oil. Shortly after the Arab Oil Embargo, the International Energy Cooperative was formed by farmer cooperatives in the petroleum business, and funds were expended in overseas exploration. Unfortunately, this effort was largely unsuccessful, and it became obvious that capital requirements were far too great. Currently, a number of firms are still attempting joint ventures in areas such as exploration and production, the search for foreign crude contracts, and the transportation of crude.

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Obviously, the proper application of cooperative principles to this problem holds some merit and perhaps warrants additional investigation. However, similar attempts thus far have exposed some rather serious limiting factors, and even if successful would take some years to develop secure and equitably-priced supplies.

To draw a parallel, farmer cooperatives have certainly aided the American farmer but have not solved his problems. Even if this approach is cultivated further, it must not be regarded as the only solution to access to crude oil. Foreign crude oil supplies will remain highly vulnerable to disruptions.

CRUDE ACCESS REMAINS FUNDAMENTAL PROBLEM

As we have discussed today, certain of the tax and tariff proposals will be beneficial, but, for a variety of reasons, these proposals will not assure equitable access to crude oil at competitive prices for small and independent refiners. Indeed, the bottom line is that any other programs toward these ends are academic to efficient farmer-owned refiners unless the key ingredient to capital formation, access to crude oil at competitive prices, exists.

Accordingly, the National Council of Farmer Cooperatives urges that serious consideration be given to the following program that can be integrated with these proposals:

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I. Establishment of a standby crude oil access program.

This program would address both supply and price irregularities by assuring access to crude oil at competitive prices. It would assure crude oil availability for cooperatives and other efficient refiners. It would thus assure petroleum supplies for farmers and other high priority users adversely affected by disruptions.

II. Establishment of a standby petroleum product allocation program.

This program would assure that petroleum products would be made available to priority users during a petroleum supply disruption. Agriculture would be assured fuel for planting, growing, and harvesting operations. Other high priority users would also be assured of product to meet critical needs.

Farmer-owned cooperatives are not asking for a subsidy or "free ride." The cooperative petroleum system is efficient and performs its role under truly free market conditions. To the extent the market functions normally, government programs would have no role. However, the realities of the marketplace dictate that all too often access to crude oil at competitive prices is denied due to disruptions and market anomalies. The essential role of cooperatives in supplying fuel at reasonable prices to agriculture and rural America must be maintained during such periods.

In conclusion, we appreciate this opportunity to present our views on this pressing problem. In view of the expiration of the Emergency Petroleum Allocation Act on September 30, we encourage this committee as well as other appropriate committees to continue and expedite this constructive process. Obviously, it is preferable to consider and adopt comprehensive petroleum policy legislation in the present atmosphere rather than under crisis circumstances.

STATEMENT OF LAURENCE R. STEENBERG, CHAIRMAN OF AMERICAN PETROLEUM REFINERS ASSOCIATION, AND PRESIDENT OF LAKETON ASPHALT REFINING INC.

Mr. STEENBERG. Thank you.

We appreciate the opportunity to be here today to express our position on national refining policies.

As early as 9 months ago, our association was wanting of the adverse effects that crude oil decontrol would have on domestic refining industry without a national refining policy in place.

Well, we support an immediate decontrol, we urge that it be accompanied by a credible commitment to the future of a strong domestic refining industry. Decontrol has been accomplished. Regrettably, no national refining policy is in place, and we are now seeing the first signs of the decline in the health of this basic industry.

Our association would stress three desirable components to a comprehensive U.S. refining policy. They are: First, a tariff on imported refined products; second, a tax incentive to free up crude oil for independent refiners who do not have a captive source of supply; and finally, tax incentives to spur investment which will insure that U.S. refineries are more energy efficient and capable of refining heavier, high-sulfur content crude oil.

Let me discuss each of these in turn.

First, the tariff. Mr. Chairman, the United States recently decontrolled the price of crude oil without an adequate tariff in place on imported petroleum products. This sends just the wrong signal before nations who are anxious to use surplus revenues from production to expand their activities to encompass the building of new refineries to process petroleum downstream.

In addition, existing foreign refineries are running at very low utilization rates, primarily processing products for home markets. With the expiration of controls and no adequate tariff in place, it would become profitable for these refineries to increase their runs to still process marginal barrels for export into U.S. markets.

As very little increase in operating costs will be associated with processing these marginal barrels and because their social costs of operation are much lower than our refineries, these products can be exported to the United States at prices below what U.S. refiners

can meet. An adequate tariff on product would prevent this from occurring.

As you are aware, a recent Department of Energy study analyzing the cost and benefits of a tariff on petroleum products reaches the conclusion that such a tariff would pose an unacceptably high cost to the American consumer.

We disagree completely with this conclusion. The study reaches an economic conclusion based upon a theoretical economic model which charts out resource costs of a tariff. No attention is paid to political reality. Political and economic dependency are related, but they should not be confused. The DOE study does not view greater economic dependency as a bad thing, because petroleum products could be purchased by consumers at a lower price in the short run.

However, recent history shows that crude oil and products are employed as political weapons with increasing frequency in today's world. In the effort to free our country from the political dependency on foreign crude oil, we must not fall into the trap of becoming dependent on foreign petroleum products.

Next, let me address our tax incentive program for freeing up crude oil. I'm going to depart from my text here to make sure that I get our point across.

We are proposing that those companies who are multinational oil companies that have bank unuseable foreign tax credits be given the opportunity, under a revision of the tax code, to bring those tax credits home on their tax returns, as a reward for distributing crude oil to the independent refining sector. We feel this is a free market attempt to provide a more free market in crude oil for all of U.S. refiners, and it does not represent a subsidy to anyone, nor does it represent a cost.

The reason it doesn't represent a cost to the Treasury is because the tax rates on the refiners who will get the crude oil are four times, on average, as high as the tax rates on the major oil companies who will sell the crude oil. So, we feel there will not be a decline in revenue associated with this proposal.

Finally, tax incentives for upgrading refineries. We have submitted a detailed proposal which has a three-part program for capital creating tax incentives. They are first, an additional 10-percent investment tax credit for particular items of refining process equipment; second, an accelerated depreciation schedule; and third, a proposal which allows the expensing of Government-mandated investment and pollution control equipment.

Mr. Chairman, I have a detailed statement I would like to submit for the record, and I would like to include with it our comments in rebuttal to the Department of Energy's study on our proposals, which was alluded to earlier.

Senator WALLOP. By all means, that will be made a part of the record.

Thank you, Mr. Steenberg.

[The prepared statement of Mr. Steenberg follows:]



AMERICAN PETROLEUM REFINERS ASSOCIATION

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SYNOPSIS OF PREPARED TESTIMONY
of Larry Steenberg,
President Laketon Asphalt Refining Inc.,
and Chairman of the Board of the
American Petroleum Refiners Association
Before the Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation
March 27, 1981

The American Petroleum Refiners Association is the largest Washington based trade association representing small and independent refiners. Current membership in APRA consists of 58 refiners with an aggregate refining capacity of over one million barrels/day. (See Appendix A.)

Small and independent refiners are truly domestic refiners who have served isolated geographical and special products markets in the United States for over fifty years. They provide an important element of competition to major integrated oil companies. Innovative applications of new refining technology, willingness to serve special markets, and geographic dispersal in many areas of the United States are all advantages smaller independent refiners bring to the nation and the refining industry.

The American Petroleum Refiners Association believes that there are four essential components to a well planned national refining policy. These include:

- (1) Assurance of an equitable supply of crude oil at competitive prices for all domestic refiners;
- (2) The enactment of a tariff on imported petroleum products;
- (3) A specific program of tax benefits designed to assist the entire domestic refining industry in modernizing and upgrading its facilities, to improve efficiency and productivity; and
- (4) A standby federal crude oil allocation program to be activated only under specifically defined circumstances such as a crude oil shortage or a sudden supply interruption.

"FOSTERING THE INTERESTS OF SMALL REFINERS"

The immediate decontrol of crude oil prices has already caused a reduction in the number of smaller refining companies in the U.S. market. Some attrition was to be expected and is likely to continue. These four proposals listed are not designed to encourage the construction of new, unsophisticated small refineries. Rather, the thrust is to establish a strong, well balanced domestic refining industry capable of producing the proper mix of refined products needed by the United States. APRA has taken the lead in proposing a tax based solution to crude oil access because this issue is crucial to the small and independent refiner and because much of the needed investment in refinery modernization and upgrading must be made in smaller refining facilities.

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AMERICAN PETROLEUM REFINERS ASSOCIATION

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Written Testimony of APRA
Before the Senate Finance Committee
Subcommittee on Energy and Agricultural Taxation
March 27, 1981

I. Overview

Throughout history, small and independent refiners have played a vital role in the development of this nation's domestic refining industry. Indeed, many of the current members of the American Petroleum Refiners Association (APRA) have contributed to the development of this nation's domestic refining industry for more than fifty years. It is the small and independent refiner, and not the multi-national integrated oil company which truly represents domestic refining. Congress should recognize that the refining capacity of international oil companies is predominantly foreign in nature. Only one-fourth of both Exxon and Shell's respective refining capability is located in the United States. Mobil and Texaco have only one-third of their respective total refining capacities in this country. APRA is proud that its members are exclusively U.S. refiners. See Appendix A.

For the past twenty years, the federal government has recognized the important contributions of small and independent refiners by attempting to ensure the continued competitive viability of this segment of the industry. Nevertheless, in

the past several years, certain journalists and public policy spokesmen, as well as special interest groups, have unnecessarily criticized and inaccurately characterized small and independent refiners. Much of this criticism has resulted from the size of the small refiner bias program. However, continued criticism of one aspect of a regulatory program which has already been eliminated does a disservice to the majority of small and independent refiners in this country. Such dated and exaggerated criticism ignores both the legacy of service as well as the vital functions performed by smaller refiners in the United States.

Indeed, it is interesting to note that among the ten largest companies that refine crude oil in the United States, 70 percent of the actual refineries that these firms control would qualify as small refiners if they were independent entities. These refineries process 33 percent of the total crude oil run by these major integrated companies. Moreover, a full one-third of the refineries in question would qualify for membership in APRA because their capacities are 50,000 barrels per day (bpd) or less. See Appendix B. In view of this data, it is ironic that it is always the independent small refiner, and never the captive small refinery owned by these major firms, which must reply to allegations that their facilities are inefficient and lack adequate economies of scale.

Any analysis which assesses the need for smaller refiners by comparing them with the refining divisions of major integrated oil companies is misplaced. These refiners have remained competitive and been a vital component of the domestic refining industry because they serve specific and unique markets and perform functions which differ in many cases from those performed by substantially larger refineries.

There are several very specific reasons that the continued competitive viability of smaller refiners must be an important element of any future national energy policy. Small and independent refiners, which are located throughout the different regions of this nation, often serve rural and agricultural markets which are not only difficult to reach, but which, in many instances, have been abandoned by the major oil companies for this very reason. Since the decontrol announcement on January 27, 1981, at least four major oil companies have begun market pullouts in specific regions of the United States in order to concentrate their efforts in more profitable, populated geographic areas. Indeed, consolidation in the markets served by larger refineries initially prompted the formation of agricultural cooperatives to purchase refined petroleum products so that these essential supplies would be provided at reasonable cost to their members located in agricultural areas abandoned or not fully serviced by the major companies. Today, regional

farmer cooperatives own and operate eight efficient refineries with a total production of approximately 460,000 bbls/day or 2.5% of total U.S. refining capacity. These refineries supply about 45 per cent of all on-farm petroleum fuels. In addition to this willingness and ability to serve distinct geographic market areas, it is the smaller refiner which has often displayed the willingness to undertake the risks associated with installing and developing new and innovative refining technology.

Among the revolutionary advances in refining technology that were first installed by small refiners were the first hydrocracker as well as the first alkylation units. See Appendix C. Small refiners have also historically provided highly specialized refined petroleum products which larger integrated refiners are reluctant to produce because of the limited market for such products. For instance, it is the small refining segment of the industry which produces a disproportionate amount of such products as asphalt, military jet fuel, lube oil, printing inks, and speciality chemicals which serve vital functions in the industries in which they are utilized.

Small refiners also play an important role in ensuring our national security. As a matter of fact the PADD districts presently utilized by DOE were originally established during

World War II for security reasons. To allow an overconcentration of domestic refining facilities in very large refining complexes could cripple our national economy if only a few of these facilities were incapacitated. Smaller refiners are dispersed over many geographic regions. The danger associated with centralization, which is inherent in allowing dependence upon a limited number of large refining facilities, has been painfully experienced by the nation of Iran in recent months, which recently imported petroleum products due to the destruction of its Abadan refinery. The destruction of the Abadan complex also prompted a rise in the spot market prices of residual fuel oil in the Western European markets that depended upon that refinery for supply.

Smaller refiners also currently provide the Defense Department with close to 40 percent of our Nation's military jet fuel requirements. To shift this important responsibility to foreign refiners would jeopardize our Nation's security.

Smaller and independent refiners employ many highly skilled individuals. According to labor sources within the industry, it requires 12 refinery workers for each thousand barrels of crude processed daily. Small and independent refiners, which constitute approximately four million bpd of this nation's total domestic refining capacity, therefore directly support

nearly 50,000 workers. In addition, countless other independent employees involved in the production of crude oil used by smaller refiners, as well as the jobbers involved in the transportation and marketing of the petroleum products which result, are dependent on the continued competitive viability of small and independent refiners. Moreover, the state and federal tax revenues generated, and the economic survival of the numerous small communities where these refineries are located, reinforce the need to maintain the competitive viability of this industry segment.

Small refiners also represent an important element of competition for the major oil companies. In the absence of such competition, there is little to prevent these international firms from adding to their foreign facilities if the costs of refining in this country, due to such factors as environmental costs and higher wages, are greater than exist abroad.

APRA believes that there are four necessary and essential components for future national refining policy. These components include the following:

- (1) Assurance of an equitable supply of crude oil at competitive prices for all domestic refiners;
- (2) The enactment of a tariff on imported petroleum products;

- (3) A specific program of tax benefits designed to assist the entire domestic refining industry to modernize and upgrade its facilities in order to improve efficiency and productivity; and
- (4) A standby crude oil allocation program to be activated only under specifically defined circumstances such as a crude oil shortage or a sudden supply interruption.

Decontrol of crude oil prices has already caused a reduction in the number of refining companies serving the U.S. market. Refineries owned by major oil companies as well as independent refining companies are closing at a rapid rate. Yet, the four proposals listed above are the product of careful thought and are not designed to encourage the construction of new, unsophisticated small refineries. Rather, the thrust of these proposals is to establish a strong, well-balanced domestic refining industry capable of producing the type of refined products our country needs. APRA has taken the lead in this regard because much of the needed investment must be made in the smaller (under 175,000 bpd) refinery.

A further explication of each of these separate elements is discussed in Sections III through VII of this testimony.

II. Equitable Access to Crude Oil

Any future legislation regarding the domestic refining industry must signal to existing small and independent refiners that they can be assured of an equal opportunity to purchase crude oil at competitive prices. In the absence of such a foundation, other goals such as upgrading, providing incentives for such capital investments, and encouraging further technological and marketing innovations, become irrelevant. Without equitable access to sufficient volumes of crude oil at competitive prices, no independent and small refiner will be able to survive.

During the past decade crude oil has been available at competitive prices a majority of the time. Nevertheless, it is equally clear that during those periods when the crude oil market has been distorted by aberrations such as the Arab oil embargo in 1973 or the sudden cessation of supplies from Iran, crude oil will not be available to small and independent refiners. Moreover, there can be no doubt that the issue of equitable access to crude oil will persist into the foreseeable future. First, access to domestic crude oil for independent refiners will be increasingly difficult to achieve now that current crude oil allocation regulations have expired, because major international oil companies will retain their own captive domestic production, as well as bid up the price for available crude supplies that do appear on the market by subsidizing their refining operations from

other divisions. While a free market in petroleum products can be expected to develop after the end to price controls, there will be no free market in crude oil for independent refiners. Independent refiners, owning little if any crude production, will be forced to buy crude at very high spot market prices. Independent refiners are unable to command quantity discounts from foreign governments and because of unique historical circumstance, they are unable to lift OPEC oil at official government prices. Secondly, OPEC will undoubtedly continue to restrain output. Furthermore, the price of access to OPEC crude oil can be expected to include additional premiums, such as tie-in agreements requiring firms to also purchase refined petroleum products, and also joint venture efforts with larger oil companies which will in turn assist OPEC in carrying out previously announced plans to expand its own refining capacity. Multi-national oil companies will also severely reduce, if not completely eliminate, third party sales. Finally, the multiple tier price structure for foreign crude oil, which was demonstrated in the Exception Application filed by the Union Oil Company in the summer of 1979, may well persist, resulting in an anti-competitive impact on those small and independent refiners which depend on one or two specific crude producing nations.

Recent events have also taught the small and independent segment of the refining industry that guarantees for access

to available supplies of crude oil at equitable prices, in the form of long-term contracts with either foreign producers or major integrated oil companies, do not constitute guarantees at all. At the time of the Arab oil embargo, small and independent refiners found their long-term supply contracts suddenly abrogated by the majors.

If small and independent refiners are to plan for and obtain the necessary capital financing to increase their efficiency, upgrade their facilities, and continue to serve their existing markets, they must be able to prove to financial institutions in the very near future that they will have an equal opportunity to buy competitively priced crude oil.

III. A Tax Proposal to Free Up Crude Oil for Domestic Independent Refiners

APRA has long believed that the best means to accomplish the equitable distribution of crude oil is to provide an economic incentive for crude sufficient companies to sell to smaller independent refiners.

Summary of Proposal

APRA proposes amending the foreign tax credit rules in the Internal Revenue Code to provide that income from sales of domestic or foreign crude to unrelated domestic small and independent refiners shall be treated as foreign oil related income for purposes of computing the separate overall limitation on foreign-oil related income (Sections 904 and

907(b)) and shall not be reduced by net losses under the "per-country loss rule" (Section 907(c)(4)).

Alternatively, or in addition, an election would be provided whereby income from sales of domestic or foreign crude to unrelated domestic small and independent refiners would be treated as foreign extraction income for purposes of computing the separate extraction tax limitation (Section 907(a)).

Under existing law, the Code favors the foreign refining of crude oil. Major oil companies can increase their utilization of foreign tax credits and avoid a build-up of unusable excess foreign tax credits, which may expire before they can be drawn down, by selling their lowest priced foreign crude--under proper pricing methods--to related foreign refining companies. In effect, this approach allocates income to the related foreign refining company; increases the separate overall limitation on foreign oil related income; makes more foreign tax credits available to offset U.S. tax liability; and increases the major oil companies' profitability.

It is proposed that these provisions be amended to provide that sales by these companies of domestic or foreign crude oil to domestic small and independent refiners will be treated in the same fashion, regardless of where the sale

actually takes place. The new provision might expire in say 7-10 years, after which small and independent refiners would be expected to compete on an equal basis with the major companies.

The amendment would tend to narrow the choice between sales of crude oil to foreign refiners and sales to domestic small and independent refiners. The proposal does not depend upon different crude acquisition costs of major oil companies and small and independent refiners. It does not create a new tax benefit for major oil companies but merely makes available additional foreign tax credits (which in every case represents "out-of-pocket" amounts actually paid by the companies).

The proposal does not deprive the major oil companies of any benefit presently available to them. It is intended simply to make more neutral in their effects certain provisions of the law that presently encourage sales of lower-priced foreign crude to foreign refineries and thereby to increase small and independent refiners' access to crude supplies.

It is understood that some major U.S. oil companies have large amounts of excess foreign tax credits which they cannot use currently to reduce their U.S. tax liability and must carryover and may perhaps lose. Apparently, this situation will continue for the foreseeable future. Thus,

the proposal should free up substantial volumes of crude oil. The degree to which it is effective will depend upon a large number of variables, including the number of major companies which have excess foreign tax credits on foreign oil related income, and which have available crude oil supplies, (2) the number of major companies which have a higher extraction tax limitation (Section 907(a)) than a separate overall limitation on foreign oil related income (Section 904 and 907(b)), and (3) the profitability to the major company of selling a barrel of crude oil to a domestic small or independent refiner, taking into account the proposed foreign tax credit effect, as compared with the profitability of itself refining that barrel. A good deal of additional consideration should be given to these factors before settling on the exact details of this proposal.

Several additional points might be noted. (1) If major companies are limited under Section 907(a), the proposal might be modified to provide an election to treat income from sales to unrelated domestic small and independent refiners as foreign extraction income for purposes of computing the separate extraction tax limitation. (2) The incentive to sell foreign crude to foreign refineries (related or unrelated) may increase after the entitlements program ends. (3) Shipping income of major oil companies--which is generally foreign source income--is apparently down due to the existence of surplus tanker capacity.

Example

The operation of the foreign tax credit rules with and without the proposed changes is illustrated as follows. Assume that a major oil company's foreign income and foreign taxes are as set forth below:

	Extraction			Shipping and Foreign Refining	Domestic Sm. and Indep. Refining
	Country A	Country B	Country C		
Income (loss)	\$200	\$200	(\$100)	\$50	\$20
Foreign Tax	\$170	\$100	-0-	\$ 5	-0-

- (a) Without the proposed change. -- The amount of extraction taxes which the company can claim as credits for the current year are limited to \$184 by the Section 907(a) extraction tax limitation. This is 46% of the sum of \$200 of extraction income from Country A plus the \$200 of extraction income from Country B. In accordance with the "per-country extraction loss rule", the \$100 loss from Country C is not taken into account. However, the company's separate overall limitation on foreign oil related income of \$350 (\$200 each from Countries A and B, plus \$50 of shipping and refining income, less the \$100 extraction loss from Country C) is only \$161, assuming an effective pre-credit U.S. rate of 46%. Accordingly, the total credit it can claim against its total foreign

oil-related income is limited to \$161, its pre-credit U.S. tax on that income.

- (b) With the proposed change. -- Since the Section 907(a) extraction tax limitation -- which is unaffected by the proposed change is higher than the Section 904 separate overall limitation on foreign oil related income, as increased due to the inclusion of taxable income derived from sales to unrelated domestic small and independent refiners, the total foreign tax credit that can be claimed is increased from \$161 to \$170.20. Thus, under these circumstances, the additional benefit is equal to 46% of the taxable income derived from such sales.

IV. Import Tariffs

APRA also feels that an import tariff on petroleum products should be an element of any future domestic refining policy. One common criticism of such an import tariff is that it constitutes protectionism which results in higher costs to the consumer. This Association believes such criticism is short-sighted, and APRA maintains that the long-term interests of the United States weigh heavily in favor of a tariff on imported petroleum products.

The decision to impose such a tariff will not be an easy political choice. Indeed, tariffs are never popular with consumers or with advocates of the theoretical advantages of unfettered world trade. Nevertheless, after all these arguments are carefully considered the case for a tariff remains a compelling one.

A tariff on petroleum products is necessary for several specific reasons. First, a tariff, provided that it is properly structured, will equalize certain cost advantages now held by foreign refiners. These cost advantages are derived from added costs currently borne by domestic refiners which result from compliance with environmental regulations as well as the need to provide higher wages and a safer work place than required abroad. We do not oppose the goals which these social costs were designed to achieve. Congress and the

American people have decided that certain standards and requirements such as those of the Environmental Protection Agency and the Department of Labor are important to the quality of life in the United States. In addition, petroleum products shipped from one region of the United States to another must be carried in Jones Act vessels manned by U.S. crews, which results in higher transportation costs for domestic refiners.

However, if the Congress of the United States, through these and other similar laws, raises the cost of refining a barrel of crude oil into marketable products in domestic facilities, it should accept the corresponding responsibility of ensuring that the U.S. domestic refining industry remains competitively viable with those foreign refiners, as well as the foreign refining facilities of the international oil companies, which do not have to bear the same social costs.

If no import fee or an inadequate tariff on imported products is in place, our nation will, in the years ahead, import not only foreign crude oil, but foreign refined product as well. This is a situation which the United States cannot allow to develop.

Petroleum refining is a process industry which provides the vital energy input to the rest of American industry. It is what an economist might classify as a "basic industry", along

with such other industries as steelmaking and automobile production. Petroleum refining is not the type of industry which U.S. policymakers have the luxury of allowing other countries to assume responsibility for simply because it results in reduced costs to the American consumer. If a large percentage of our petroleum products were refined abroad, other nations would begin to dictate many of the day-to-day economic decisions now made in this country.

Petroleum refining is, like other basic industries, vital to U.S. economic, employment, and national security interests. As such, this industry must be sited in the United States where it can be protected from the conflicting and competing interests of other nations. It is also important that the bulk of U.S. refining capacity remain under the jurisdiction of U.S. laws, so that output can be directed in accordance with the national interest in time of war or a similar national emergency.

Nevertheless, at a time when most other basic American industries, such as steel, automobiles and petrochemicals, are afforded substantial degrees of protection under the customs laws of the United States, the domestic refining industry remains for all practical purposes unprotected. As the history of U.S. import controls on petroleum illustrate, no license fee has been collected on imports of either crude oil or petroleum product since April 1, 1979. In our view, this

is a classic example of how short-term political concerns over a few tenths of a percentage point in the Consumer Price Index can lead in the long-term to higher consumer prices resulting from foreign control over the supply and price of petroleum products.

Second, in the absence of a tariff, we believe several incentives exist, which as an unintended consequence of the decontrol of domestic crude oil prices, will encourage the diversion of foreign-produced crude oil, from U.S. facilities into foreign refineries.

Under the recent entitlements program, which was designed to equalize the benefits of price-controlled domestic oil among domestic refiners, an entitlements benefit was created when a barrel of uncontrolled crude was run in a U.S. refinery. At its peak in May of 1980, when the weighted average disparity between controlled and uncontrolled crude exceeded \$27.00, the benefit associated with the program was \$6.22. This subsidy offered a major integrated oil company with foreign oil production, and both domestic and foreign refining capacity, a compensatory incentive for refining the high cost, uncontrolled, foreign barrel in a U.S. refinery. This entitlement benefit helped to neutralize the lower social and economic costs associated with refining that same barrel in a foreign refinery.

But the decontrol of crude oil has eliminated this incentive. With immediate decontrol, the incentive for domestic refining has disappeared well in advance of the scheduled September 30, 1981 date for the expiration of crude oil controls. Thus, in the absence of an offsetting tariff or fee on imported product, the lower economic and social cost advantages accruing to foreign refiners will result in many of the foreign barrels of crude previously destined for the U.S. refiners being refined abroad instead.

There is no doubt that this change can occur very rapidly, for a great deal of excess capacity in foreign refineries currently exists. The depressed product market is another incentive for foreign refiners to maximize their U.S. sales. In Western Europe, the London Petroleum Economist reports that there is now over 500,000 bpd of sophisticated cracking capacity under construction or firmly planned (of which about 300,000 bpd is catalytic and the remainder thermal or visibreaking projects) in addition to the various completions in recent years. The Economist's September 1980 world refinery survey establishes that in 1979 U.S. refineries ran at 82 percent of capacity, compared to 86 percent and 85 percent in the previous two years. The projected cutback in gasoline use during 1980 has caused U.S. utilization rates to fall to a low of 70 percent. But in Western Europe, capacity utilized in 1979 equalled only 69 percent, up slightly from 66 percent and 65 percent in the previous two years. In Italy

the utilization rate earlier this year was only 55 percent. Utilization rates in the Caribbean during the last two years have only been in the 60-65 percent range.

When one combines the new sophisticated capacity in these areas, along with the lower utilization rates and the announced plans of certain OPEC nations to begin construction of new export refineries, some in joint ventures with large integrated U.S. oil companies, the likelihood of increasing product imports for this nation becomes a virtual certainty.

The establishment of a proper level for such an import fee is an exacting task. Last year, in testimony before the Senate Energy Committee in hearings on S. 1684, APRA supported a fee on imported product of \$.03 per gallon or \$1.26 per barrel. Given the demise of the entitlements program, the disappearance of the subsidy for domestically refined foreign crude, and the increasing costs of domestic crude to U.S. refiners, we feel that a substantially higher fee than \$.03 per gallon is justified. We stand ready to work with the Administration and staffs of this Committee as well as the House Ways and Means Committee to arrive at a fee which will provide an adequate level of protection for the domestic refining industry.

V. Capital Creation In The Independent Refining Industry

Currently the capacity of the U.S. refining industry is approximately 17.8 million barrels per day. Energy conservation and projections of slow economic growth during the 1980's contribute to estimates of sluggish demand for petroleum products during the next decade. And yet a tremendous amount of capital investment must be made by domestic refiners to upgrade and modernize their plant and equipment if even this level of demand is to be met.

Many U.S. refineries are not equipped to process streams of low gravity, high sulfur crude oil into environmentally acceptable products. Due to the growing scarcity of light sweet crudes, these refiners will be forced to upgrade their facilities in order to compete effectively for available crude oil supply. Petroleum refining is a highly capital intensive industry. The current industry capital need has been significantly exacerbated by a governmental program - the Council on Wage and Price Stability (COWPS) price guidelines. The unique treatment accorded petroleum refiners under the recently terminated COWPS guidelines had a profoundly negative impact on the refining industry, particularly the non-integrated refiners.

The COWPS price controls, introduced on October 2, 1978 and lasting through late January 1981, had the effect of discouraging capital improvements to refineries. The price

standard under the initial COWPS price regulations required firms to limit their cumulative price increases to one-half of a percentage point below the firm's average annual rate of price increase during the first year of the COWPS program of no more than 9.5%. Early in the program COWPS recognized that the price standard could not be met by petroleum refiners because the cost of their crude oil feedstocks was rising so rapidly that no refiner could meet the price standard and operate profitably. As a result, COWPS promulgated a separate gross margin standard for petroleum refiners shortly after the program began. */

The absence of a practical alternative forced nearly all refiners to use the gross margin standard for petroleum refiners. Under this modified standard, petroleum refiners compliance efforts were measured under a gross margin test that permitted only a fixed percentage markup over the cost of the petroleum inputs used in the refining process. Because this test did not take into account any costs other than petroleum inputs, non-petroleum cost increases could not be passed through in the form of higher prices to customers. Because capital investment in upgrading of refinery equipment is a non-petroleum cost, the cost of such

*/ 44 Fed. Reg. 9,585 (1979). Although refiners could choose to comply with an overall profit test, that test was so restrictive that almost no refiners were able to use it.

improvements could not be recovered under the COWPS limitations. Consequently, refiners faced a substantial incentive to minimize capital expenditures for refinery improvement. In the latter part of the COWPS program most refiners began to suffer an additional burden arising from the decline in the demand for petroleum products. A drop in sales volume of petroleum products resulted. Because the COWPS profit margin test was based on a dollar per barrel margin, declining volumes, coupled with constant or rising non-petroleum costs, forced a drastic profitability decline upon refiners complying with the COWPS guidelines.

The adverse effect of the COWPS regulations on both capital investment and profitability of refiners was recognized both by the Department of Energy (DOE) and by COWPS itself.

A May 30, 1980 DOE study entitled "Analysis of Impact of COWPS Program on Production and Investment Incentives for U.S. Refiners" documented the disincentives for capital investment the COWPS regulations were causing, as well as similar disincentives caused by DOE's own regulations:

Neither the DOE gasoline price control program nor the COWPS limitations allow refiners to pass through the full cost of new investments.

* * *

The COWPS gross margin limitation is more restrictive than the DOE program . . . because it provides no explicit recognition of any investment costs.

Id. at 7, 10.

In response to concerns raised by DOE, COWPS prepared a report addressing the conflict between its regulations and national energy policy, also issued May 30, 1980. COWPS recognized in its report, albeit reluctantly, that the DOE concerns had merit. In fact, a few months later, COWPS proposed guidelines for the third program year (to begin on October 2, 1980), designed to alleviate the disincentives for investment that the previous regulations imposed on refiners. These standards, short-lived as they were, provided for adjustment to the guidelines for productivity gains that resulted from, among other things, capital investment. COWPS also authorized additional adjustments to the petroleum refiners gross margin standard to reduce the disincentives for investment in energy conservation its prior regulations had imposed.

Disproportionate Burden Placed Upon Independent Refiners

Of great significance, moreover, is the fact that the substantial burdens imposed upon the refining industry by the COWPS regulations fell disproportionately upon the independent refining segment of the industry. Almost without exception, the independent refiners complied with the restrictive COWPS gross margin standard. Integrated oil companies, by contrast, could avoid the restrictive impact

of the gross margin standard for refiners by carefully structuring intracorporate transactions. Because there were no COWPS price limitations on production or purchase of foreign crude oil, for example, integrated companies were able to expand profit margins in their crude oil divisions to offset the restricted profits available in their refining operations. Independent refiners had no such luxury. As a result of this disparity, the major integrated oil companies were able to use earnings generated by their non-refining operations to fund the substantial capital investment needed for refinery upgrading. Independent refiners were restricted by COWPS regulations from building a sufficient profit cushion to be used for the same purpose.

The discriminatory effect of the COWPS regulations has contributed to the disproportionate lack of investment in the independent refining industry. This decline, caused in substantial part by governmentally imposed regulations, should be corrected by tax policy designed to compensate for past investment disincentives placed upon the smaller independent refining industry. Accelerated depreciation for refining assets is desperately needed. However, this investment must occur now, not later. The American Petroleum Refiners Association believes that a five year life for refining equipment fully justifies an accelerated effective date of January 1, 1981. We also believe that an additional 10 per

cent investment tax credit is needed to encourage investment in sour crude conversion equipment.

Huge amounts of capital are required to modernize or upgrade even the smallest refinery. This is why the American Petroleum Refiners Association has compiled and submitted to the Congress a very detailed description of tax incentives designed to encourage this needed modernization.

These tax incentives include:

- (1) A shorter, five year depreciable life for refinery processing equipment;
- (2) An additional 10 percent investment tax credit for expenditures made on certain new refining equipment (e.g., sour crude processing equipment);
- (3) Increased investment credits for certain additional items of refinery equipment whose principal purpose is the conservation of energy consumed in the refining process. (An expansion of existing provisions contained in the Energy Tax Act of 1978);
- (4) Immediate write-off of certain obsolete refining equipment; and

(5) Expensing of pollution control equipment.

We believe that these tax incentives should form an integral part of any comprehensive national refining legislation. Appended to our written testimony is a full description of these tax incentives.

It is important to recognize that tax incentives alone cannot assure that the needed investment in refinery retrofitting will occur. Tax credits are of benefit only if refiners can obtain loans at a rate of interest sufficient to allow a profitable return on investment.

Obtaining the capital to modernize is impossible without access to crude oil at a competitive price. Our testimony has already addressed this important prerequisite in some detail.

Petroleum refining consumes from 4 to 5 percent of a barrel of crude oil in the refining process. Together with the petrochemical industry, refining accounts for 35 percent of all energy consumed in the U.S. industrial sector. The potential for energy savings in downstream petroleum processing is very large.

APRA supports early passage of S. 750, The Industrial Energy Security Tax Incentive Act of 1981. This legislation will help ensure that U.S. refineries are modernized to process

crude oil into refined products with the least possible amount of energy loss.

The American Petroleum Refiners Association would also suggest that the Congress explore the desirability of providing a federal loan guarantee program for those refiners with crude access who must upgrade and modernize to remain competitive. We would recommend that Title II of Senator Johnston's Domestic Refinery Policy Act, S. 1684, be used as a basis for such a loan guarantee program. It is important, however, that any loan guarantee program be designed to assist only needed upgrading in refineries where the necessary capital cannot be acquired through conventional means. Federal loan guarantees should target refiners for assistance who have planned upgrading to make better use out of the residual fractions of the barrel and enhance their energy efficiency and should not encourage the construction of unnecessary excess distillation capacity in the U.S.

VI. An Independent Refiners Crude Purchasing Cooperative

As stated earlier, the critical problem facing domestic independent refiners is access to competitively priced crude oil. Smaller independent refiners acting individually are not usually capable of buying crude oil in significant enough quantities to obtain a quantity discount. In this sense, independent refiners face a problem similar to that experienced by the smaller farmers of this country who found themselves unable to borrow needed capital in the 1920's. It has been proposed that a partial solution to the crude access question may lie in the formation of a crude oil cooperative -- an industry-run purchasing organization that would buy appropriate grades of crude oil in volume for resale to small and independent refiners. Such an organization might, if properly organized, enable small and independent refiners to enjoy the advantages of size and market power when competing with major oil companies for crude oil supplies. In any case, the cooperative function should extend only to the acquisition of crude oil. Transportation, refining, and marketing operations should be operated free from any cooperative influence.

Informal crude purchasing cooperatives organized around a small group of refining companies are currently attempting to secure crude contracts from foreign governments. An effort should be made to determine what degree of success has been achieved or is expected by these informal purchasing groups.

The detailed organization of any such cooperative should be left to those smaller independent refiners who wish to participate. However, a small appropriation might be necessary in order to organize the cooperative and provide initial working capital. This amount should be repaid after a brief period of time.

After a start-up phase, operational funds might be provided by amounts retained from the purchase (from the Federal government, from other governments, from private parties) and delivery (to patrons) of crude oil supplies. Capital for acquisition of crude oil might be obtained by first determining the amounts of capital required and then requiring each member to provide its proportionate share based on actual or anticipated participation (taking of crude oil).

Decisions regarding quantities and qualities to be acquired and allocation of limited supplies might be made by officers or directors of the cooperative. Broad or specific criteria might be formulated by the members. It might be provided in the charter and/or by-laws that certain minimum percentages of crude available to the cooperative would be reserved for certain categories of refiners, such as larger independent refiners, small refiners, asphalt refiners, etc. Moreover, the cooperative could be divided into departments reflecting these categories of refiners. If desirable, there might be regional cooperatives owning shares in the national cooperative.

Legislation may be required to: (1) clarify the cooperative's status under the anti-trust laws, (2) empower it to negotiate with foreign governments as well as any other entity possessing crude oil supplies, (3) stamp the cooperative "Government approved" without making it a part of the Department of Energy (it might be made subject to oversight by an independent agency within the executive branch similar to the Farm Credit Administration), and (4) provide it with a tax exemption along the lines of the existing exemption for agricultural cooperatives.

VII. Standby Allocation Program

Though not within the legislative jurisdiction of this Committee, APRA believes that a standby allocation program, to be implemented only upon the occurrence of a specific and detailed set of circumstances, is an essential element of national refining policy. This program must be adopted in order to equitably allocate crude oil if a supply shortage, relative to domestic demand, is caused by events either at home or abroad. APRA believes that in today's market a crude oil supply shortage equal to seven percent of national supply requirements would serve as an appropriate triggering mechanism for implementing the standby allocation program. This trigger is the same as U.S. obligations to share crude oil under the International Energy Agreement [IEA]. The program should also be capable of being activated if distortions occur in the prices of crude oil available on the spot market, similar to the phenomenon which occurred in the summer of 1979.

APRA believes that it is incumbent upon Congress to fashion criteria which are as specific as possible in expressing Congressional intent regarding a standby allocation program for crude oil supplies. Under the DOE's previous Buy/Sell Program, as well as its mechanism for obtaining exception relief from the Office of Hearings and Appeals, there was a great deal of controversy among affected parties at the administrative level regarding the specific Congressional

intent behind the criteria utilized to assess a firm's eligibility to participate in these programs. APRA also recognizes that imperfections in the program will, to a certain degree, be inevitable. However, such imperfections are certainly preferable to a situation in which Congress fails to adopt any standby allocation program at all. APRA also believes that such a program should be capable of redressing supply interruptions experienced by specific refiners inordinately affected by unanticipated events.

APRA would like to emphasize that its members are both willing and capable of competing with larger integrated oil companies for available supplies of crude oil, provided such competition is open. However, when the crude oil market's normal supply/demand mechanisms are distorted such that equitable access to supplies at competitive prices is impossible, it is the obligation of the federal government to intervene and provide for an adequate allocation program.

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American Petroleum Refiners Association
Membership by State

ALABAMA

MARION CORPORATION
Mobile, AL
Refinery: Theodore, AL

MOBILE BAY REFINING COMPANY
Chickasaw, AL
Refinery: Chickasaw

ARIZONA

LA JET, INC.
Phoenix, AZ

CALIFORNIA

GOLDEN EAGLE REFINING
COMPANY, INC.
Los Angeles, CA
Refinery: Carson, CA

GULF STATES OIL & REFINING
COMPANY
Beverly Hills, CA

LA JET, INC.
Los Angeles, CA

LUNDAY-THAGARD OIL COMPANY
South Gate, CA
Refinery: South Gate, CA

MARLEX OIL & REFINING, INC.
Long Beach, CA
Refinery: Long Beach, CA

POWERINE OIL COMPANY
Santa Fe Springs, CA
Refinery: Santa Fe Springs, CA

COLORADO

ASAMERA OIL (U.S.) INC.
Denver, CO
Refinery: Commerce City, CO

GARY REFINING COMPANY
Englewood, CO
Refinery: Fruita, CO

WYOMING REFINING COMPANY
Denver, CO

GEORGIA

YOUNG REFINING CORPORATION
Douglasville, GA
Refinery: Douglasville, GA

IDAHO

UNITED INDEPENDENT OIL COMPANY
Boise, ID

INDIANA

GLADIEUX REFINERY, INC.
Fort Wayne, IN
Refinery: Fort Wayne, IN

INDIANA FARM BUREAU COOP
ASSOCIATION, INC.
Mount Vernon, IN
Refinery: Mount Vernon, IN

INDUSTRIAL FUEL AND ASPHALT
OF INDIANA, INC.
Hammond, IN
Refinery: Hammond, IN

LAKETON ASPHALT REFINING, INC.
Evansville, IN
Refinery: Laketon, IN

IOWA

PESTER REFINING COMPANY
Des Moines, IA

-2-

KANSAS

E-Z SERVE, INC.
Refinery: Shallow Water, KS

HUDSON OIL COMPANY, INC.
Kansas City, KS

PESTER REFINING COMPANY
Refinery: El Dorado, KS

PIONEER REFINING, LTD.
Wichita, KS

LOUISIANA

BRUIN REFINING, INC.
Refinery: St. James, LA

CANAL REFINING COMPANY
Church Point, LA
Refinery: Church Point, LA

CLAIBORNE GASOLINE COMPANY
Refinery: Lisbon, LA

CONSOLIDATED PETROLEUM
INDUSTRIES, INC.
Refinery: Lake Charles, LA

ERGON REFINING, INC.
Monroe, LA

EVANGELINE REFINING
COMPANY, INC.
Refinery: Jennings, LA

HILL PETROLEUM COMPANY
Refinery: Krotz Springs, LA

INTERNATIONAL PROCESSORS
New Orleans, LA
Refinery: St. Rose, LA

LA JET, INC.
Refinery: St. James, LA

MT. AIRY REFINING COMPANY
Refinery: Garyville, LA

PLACID REFINING COMPANY
Refinery: Port Allen, LA

SOUTH LOUISIANA PRODUCTION
CO., INC.
Lafayette, LA
Refinery: Mermentau, LA

T & S REFINING CO., INC.
Refinery: Jennings, LA

MICHIGAN

INDUSTRIAL FUEL AND ASPHAT
OF INDIANA, INC.
Grand Rapids, MI

LAKESIDE REFINING COMPANY
Southfield, MI
Refinery: Kalamazoo, MI

TEXAS AMERICAN PETROCHEMICALS
INC.
Refinery: West Branch, MI

MISSISSIPPI

ERGON REFINING, INC.
Jackson, MS
Refinery: Vicksburg, MS

SOUTHLAND OIL COMPANY
Jackson, MS
Refineries:
Yazoo City
Sandersville
Lumberton

NEW MEXICO

NAVAJO REFINING CO.
Artesia, NM
Refinery: Artesia, NM

TONKAWA REFINING COMPANY
Roswell, NM

NEW YORK

GULF STATES OIL & REFINING
COMPANY
New York, NY

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OHIO

MT. AIRY REFINING COMPANY
Cincinnati, OH

OKLAHOMA

ALLIED MATERIALS CORPORATION
Oklahoma City, OK
Refinery: Stroud, OK

BASIN REFINING, INC.
Refinery: Okmulgee, OK

CANAL REFINING COMPANY
Tulsa, OK

GULF STATES OIL & REFINING
COMPANY
Tulsa, OK

HUDSON OIL CO., INC.
Refinery: Cushing, OK

OKLAHOMA REFINING COMPANY -
Oklahoma City, OK
Refinery: Cyril, OK

TONKAWA REFINING COMPANY
Oklahoma City, OK
Refinery: Arnett, OK

SOUTH DAKOTA

WYOMING REFINING COMPANY
Rapid City, SD

TEXAS

BASIN REFINING, INC.
Dallas, TX

BRUIN REFINING, INC.
Houston, TX

CARBONIT REFINERY, INC.
Houston, TX
Refinery: Hearne, TX

CLAIBORNE GASOLINE COMPANY
Dallas, TX

COPANO REFINING, INC.
Midland, TX
San Antonio, TX
Refinery: Ingleside, TX

CONSOLIDATED PETROLEUM
INDUSTRIES, INC.
Abilene, TX
Houston, TX
Midland, TX

E-2 SERVE, INC.
Abilene, TX
Houston, TX
Refinery: Fort Worth, TX

EVANGELINE REFINING
COMPANY
Houston, TX

FRIENDSWOOD REFINING
CORPORATION
Houston, TX
Refinery: Friendswood, TX

GUAM OIL & REFINING CO.
Dallas, TX

GULF STATES OIL & REFINING CO.
Houston, TX
Refinery: Corpus Christi, TX

HILL PETROLEUM COMPANY
Houston, TX
Refineries:
Corpus Christi, TX
San Antonio, TX

INDEPENDENT REFINING CORP.
Houston, TX
Refinery: Winnie, TX

LA COSTE REFINING CORP.
San Antonio, TX
Refinery: La Coste, TX

LA JET, INC.
Abilene, TX
Houston, TX

MARION CORPORATION
Houston, TX

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MT. AIRY REFINING COMPANY
Houston, TX

NAVAJO REFINING COMPANY
Dallas, TX
Houston, TX

PETRACO-VALLEY OIL &
REFINING COMPANY
Houston, TX
Refinery: Brownsville, TX

PIONEER REFINING, LTD.
San Antonio, TX
Refinery: Nixon, TX

PLACID REFINING COMPANY
Dallas, TX
Refinery: Mont Belvieu, TX

QUITMAN REFINING COMPANY
Houston, TX
Refinery: Quitman, TX

SABER REFINING COMPANY
Houston, TX
Refinery: Corpus Christi, TX

SIGMOR CORPORATION
San Antonio, TX
Refineries:
Three Rivers, TX
Corpus Christi, TX

SOUTH HAMPTON REFINING CO.
Silsbee, TX
Refinery: Silsbee, TX

SOUTHWEST PETROREFINING
Houston, TX
Refinery: Donna, TX

T & S REFINING CO., INC.
Houston, TX

TEXAS AMERICAN PETROCHEMICALS,
INC.
Midland, TX

TEXAS ARMADA REFINING CO.
Houston, TX
Dallas, TX
Refinery: Fort Worth, TX

TIPPERARY REFINING CORPORATION
Houston, TX
Midland, TX
Refinery: Ingleside, TX

VEDETTE ENERGY CORPORATION
Houston, TX
Refinery: Brownsville, TX

WYOMING REFINING COMPANY
Houston, TX

WASHINGTON

UNITED INDEPENDENT OIL CO.
Refinery: Tacoma, WA

WYOMING

GLENROCK REFINERY, INC.
Glenrock, WY
Refinery: Glenrock, WY

WYOMING REFINING COMPANY
Refinery: Newcastle, WY

DISTRICT OF COLUMBIA

INTERNATIONAL PROCESSORS
Washington, D.C.

PETRACO-VALLEY OIL & REFINING
COMPANY
Washington, D.C.

ASSOCIATE MEMBERS

ALEXANDER & ALEXANDER, INC.

E. I. DUPONT DE NEMOURS &
COMPANY

ENGELHARD MINERALS & CHEMICALS
CORPORATION

ETHYL CORPORATION

FEDCO OIL COMPANY

FIRST CITY NATIONAL BANK OF
HOUSTON

HOWE-BAKER ENGINEERS, INC.

KNOX OIL OF TEXAS, INC.

MELLON ENERGY PRODUCTS COMPANY

MINRO OIL, INC.

NALCO CHEMICAL COMPANY

THE ORTLOFF CORPORATION

OXIRANE CORPORATION

PPG INDUSTRIES, INC.

THE QUARLES AGENCY, INC.

ROLLINS BURDICK HUNTER
AGENCY OF TEXAS, INC.

SOUTHWESTERN GULF PETROLEUM
COMPANY

WEST TEXAS MARKETING

Energy Data Reports

Department of Energy
Energy Information
Administration
Washington, D.C. 20401



For information call Susan J. Harris
Telephone: (202) 252-5992

Petroleum Refineries, Annual

PETROLEUM REFINERIES IN THE UNITED STATES AND U.S. TERRITORIES

JANUARY 1, 1980

On January 1, 1980, there were 319 refineries in the United States with a total crude oil distillation capacity of 18.0 million barrels per calendar day and 19.1 million barrels per stream day, according to the Energy Information Administration, United States Department of Energy. During 1979, the number of refineries in the United States, excluding the territories, increased by eight while the capacity increased by 443,736 barrels per calendar day. The net increase of eight in the number of refineries was the result of the start-up of eleven and the dismantling of three during 1979.

Crude oil distillation capacities projected for January 1 of 1981 and 1982, show increases of 589,497 barrels and 554,747 barrels per stream day, respectively.

The projected average refinery input of crude oil and other feedstocks to refineries in the United States during 1980 is 17.2 million barrels per stream day. Increases projected for the next two years will bring the total daily average input to 18.8 million barrels in 1982. These increases in input are reflected in the increases in projected product yields. The current year's projected output of 16.2 million barrels per stream day is expected to increase to an average of 17.8 million barrels per stream day during 1982.

Shell storage capacity for crude oil and selected petroleum products at refineries on January 1, 1980, totaled 662,509 thousand barrels. Compared with January 1, 1979, crude oil storage capacity increased by 8,406 thousand barrels. Refinery working storage capacity, collected for the first time this year, is 587,351 thousand barrels.

Prepared September 5, 1980 in the Office of Oil and Gas Statistics

TABLE 1.- CRUDE DISTILLATION CAPACITY IN THE UNITED STATES, BY
REFINER IN DESCENDING ORDER: JANUARY 1, 1980

(BARRELS PER CALENDAR DAY)

Companies controlling more than
100,000 b/d crude oil capacity:

Capacity b/d

Exxon Corp.

Exxon Co. U.S.A.

Baytown, Texas	640,000
Baton Rouge, Louisiana	500,000
Linden, New Jersey	290,000
Benicia, California	102,000
Billings, Montana	<u>45,000</u>

1,577,000

Standard Oil Co. of California

Chevron U.S.A. Inc.

El Segundo, California	405,000
Richmond, California	365,000
Pascagoula, Mississippi	280,000
Perth Amboy, New Jersey	168,000
El Paso, Texas	76,000
Honolulu, Hawaii	46,000
Salt Lake, Utah	45,000
Bakersfield, California	26,000
Kenai, Alaska	22,000
Willbridge, Oregon	15,000
Baltimore, Maryland	13,500*
Richmond Beach, Washington	<u>5,500</u>

1,467,000

Standard Oil Co. of Indiana

Amoco Oil Co.

Texas City, Texas	415,000
Whiting, Indiana	360,000
Wood River, Illinois	108,000
Sugar Creek, Missouri	104,000
Mandan, North Dakota	56,000
Yorktown, Virginia	53,000
Casper, Wyoming	48,000
Salt Lake City, Utah	39,000
Savannah, Georgia	18,000
Baltimore, Maryland	<u>15,000</u>

1,236,000

*Although these refineries are normally shutdown on January 1, they are operated at or near capacity during the asphalt paving season.

Capacity b/dShell Oil Co.Shell Oil Co.

Deer Park, Texas	285,000
Wood River, Illinois	283,000
Morco, Louisiana	230,000
Martinez, California	104,000
Wilmington, California	93,000
Anacortes, Washington	91,000
Odessa, Texas	32,000
Callup, New Mexico	<u>18,000</u>

1,136,000

Texaco, Inc.Texaco, Inc.

Port Arthur, Texas	365,000
Convent, Louisiana	140,000
Westville, New Jersey	90,000
Lawrenceville, Illinois	84,000
Anacortes, Washington	78,000
Wilmington, California	75,000
Lockport, Illinois	72,000
West Tulsa, Oklahoma	50,000
Port Neches, Texas	47,000
Casper, Wyoming	21,000
Amarillo, Texas	20,000
El Paso, Texas	<u>17,000</u>

1,059,000

Gulf Oil Corp.Gulf Oil Co. U.S.

Port Arthur, Texas	335,800
Philadelphia, Pennsylvania	206,300
Belle Chasse, Louisiana	195,900
Santa Fe Springs, California	51,500
Toledo, Ohio	50,300
Cleves, Ohio	43,700
Venice, Louisiana	<u>28,700</u>

912,200

Mobil Oil Corp.Mobil Oil Corp.

Beaumont, Texas	325,000
Joliet, Illinois	180,000
Torrance, California	123,500
Paulsboro, New Jersey	98,000
Ferndale, Washington	71,500
Augusta, Kansas	50,000
Buffalo, New York	<u>43,000</u>

891,000

		<u>Capacity b/d</u>
<u>Atlantic Richfield Co.</u>		
<u>Atlantic Richfield Co.</u>		
Houston, Texas	345,000	
Philadelphia, Pennsylvania	185,000	
Carson, California	180,000	
Paradise, Washington	110,000	
North Slope, Alaska	<u>14,200</u>	
		834,200
<u>Marathon Oil Co.</u>		
<u>Marathon Oil Co.</u>		
Garyville, Louisiana	255,000	
Robinson, Illinois	195,000	
Texas City, Texas	69,500	
Detroit, Michigan	<u>68,500</u>	
		588,000
<u>Union Oil Co. of California</u>		
<u>Union Oil Co. of California</u>		
Lemont, Illinois	151,000	
Nederland, Texas	120,000	
Wilmington, California	108,000	
Rodeo, California	70,000	
Arroyo Grande, California	<u>41,000</u>	
		490,000
<u>Sun Co. Inc.</u>		
<u>Sun Co. Inc.</u>		
Marcus Hook, Pennsylvania	165,000	
Toledo, Ohio	125,000	
Tulsa, Oklahoma	88,500	
Corpus Christi, Texas	57,455	
Duncan, Oklahoma	<u>48,500</u>	
		484,455
<u>Ashland Oil, Inc.</u>		
<u>Ashland Oil, Inc.</u>		
Catlettsburg, Kentucky	213,400	
St. Paul Park, Minnesota	67,143	
Canton, Ohio	66,000	
Buffalo, New York	64,000	
Louisville, Kentucky	25,200	
Findlay, Pennsylvania	20,400 *	
Freedom, Pennsylvania	<u>6,800</u>	
		462,943

* Although these refineries are normally shutdown on January 1, they are operated at or near capacity during the asphalt paving season.

		<u>Capacity b/d</u>
<u>Standard Oil Co. of Ohio</u>		
<u>Standard Oil Co. of Ohio</u>		
Lima, Ohio	168,000	
Toledo, Ohio	120,000	
<u>BP Oil Corp.</u>		
Marcus Hook, Pennsylvania	<u>164,000</u>	452,000
<u>Phillips Petroleum Co.</u>		
<u>Phillips Petroleum Co.</u>		
Sweeny, Texas	218,000	
Borger, Texas	97,000	
Kansas City, Kansas	80,000	
Woods Cross, Utah	24,000	
Great Falls, Montana	<u>6,000</u>	425,000
<u>Conco¹</u>		
<u>Conoco</u>		
Ponca City, Oklahoma	134,000	
West Lake, Louisiana	87,000	
Billings, Montana	32,500	
Paramount, California	46,500	
Wrenshall, Minnesota	23,500	
Egan, Louisiana	12,000	
Denver, Colorado	10,100	
Santa Maria, California	<u>9,500</u>	375,100
<u>Coastal Corp.</u>		
<u>Coastal States Petroleum Co.</u>		
Corpus Christi, Texas	185,000	
<u>Pacific Refining Inc.</u>		
Hercules, California	85,000	
<u>Derby Refining Co.</u>		
North Wichita, Kansas	<u>27,982</u>	297,982
<u>Cities Service Co.</u>		
<u>Cities Service Co.</u>		
Lake Charles, Louisiana		291,000
<u>Getty Oil Co.</u>		
<u>Getty Refining & Marketing Co.</u>		
Delaware City, Delaware	140,000	
El Dorado, Kansas	80,577	
Bakersfield, California ²	<u>22,500</u>	243,077

¹ Formerly Continental Oil Co.

² Formerly Mohawk Petroleum Corp.



AMERICAN PETROLEUM REFINERS ASSOCIATION

607 RING BUILDING • WASHINGTON, D.C. 20036 • (202) 331-7081

MEMORANDUM

DATE: November 6, 1980

SUBJECT: SMALL REFINER INVESTMENTS IN INNOVATIVE
PETROLEUM PROCESSING.

Listed below are innovative technological advancements in petroleum refining along with the name of the refining company which first installed the processing unit.

<u>Name of Process</u>	<u>Company</u>	<u>Year Started Up</u>
First Thermal Cracker	A small refinery in Independence, Kansas, apparently owned by UOP	1913
First Poly Unit	Small refiner (unidentified) in Michigan	1936
First FCC Unit	Root Refining, Eldorado, Kansas	1943
First HF Alkylation Unit	Root Refining, Eldorado, Kansas	1943
First Platformer	Old Dutch Refining Muskegon, Michigan	1949
First Udex Unit	Eastern States Refining Houston, Texas	1952
First Hydrocracker	Powerine Oil Company Santa Fe Springs, California	1962
First Molex Unit	Union Texas Petroleum Winnie, Texas	1964

"FOSTERING THE INTERESTS OF SMALL REFINERS"

S - U - M - M - A - R - Y

PROPOSALS FOR SMALL AND INDEPENDENT REFINERS

Small and independent refiners in this country face fierce competitive pressures from the major, integrated oil companies, on the one side, and erratic marketplace and regulatory forces on the other.

They and the country together face the need to produce a wider range of more sophisticated petroleum products at a lower cost to the consumer, to adjust to a more sour crude oil supply, and to continue to serve the many diverse--sometimes isolated--domestic markets.

In order to create a stable economic climate, in which refiners that are willing to adapt to the needs of the country can survive, the American Petroleum Refiners Association ("APRA") and its member companies are proposing that new tax and other legislative and administrative measures be adopted.

The proposals can be viewed as a package or separately.

A number of the proposed provisions would be temporary. They would apply only during a transition period lasting a few years (remembering, however, that delays in obtaining permits can postpone refinery construction for 5 years or more).

Given these measures, the small and independent refiners will be able to produce the petroleum products that this society needs and do so in competition with some of the world's largest corporations.

APRA and its members propose, for small and independent refiners:

- INCENTIVES TO "FREE-UP" CRUDE OIL SUPPLIES for small and independent refiners;
- AN ADDITIONAL 10 PERCENT INVESTMENT TAX CREDIT for certain investments in new refining equipment that expands and modernizes existing refinery facilities so as, for example, to permit the processing of more sour crude and to conserve energy;
- BROADENED ASSET DEPRECIATION RANGE (ADR) for this same type of investment to permit a lower range life of 7 years;

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- allowance of an IMMEDIATE WRITE-OFF, OR EXPENSING, OF POLLUTION CONTROL EQUIPMENT;
- RAPID WRITE-OFF OF CERTAIN OBSOLETE EQUIPMENT;
- NONRECOGNITION TREATMENT (tax to be deferred rather than paid currently) on sale of assets and reinvestment, plus RELAXATION OF EXISTING RESTRICTIONS ON CARRYOVERS OF NET OPERATING LOSSES; and
- CREATION OF SPECIAL FOREIGN TRADE ZONES for certain refineries, where their operations would be wholly or partially exempt from certain Federal, State and local taxes, duties and fees and from which the reexport of refined foreign crude oil would be simplified.

APRA and its members, together with other organizations and groups, will work with the Legislative and Executive Branches towards enactment of these proposals.

Also, the Administration is presently formulating its capital formation proposals. These proposals should take into account the situation facing domestic small and independent refiners.

REVENUE EFFECTS

The revenue effects of the APRA proposals have been estimated to the extent possible at this time. This work was performed by the accounting firm of Ernst & Whinney, based upon information provided by APRA, its independent consultant, William K. Hunter and its tax counsel, Charles M. Bruce of Cole Corette & Bradfield.

Revenue estimates for three of the proposals (additional 10% investment tax credit, broadened asset depreciation range, and immediate write-offs for pollution control equipment) have been made. One of the proposals (incentives to "free-up" crude oil supplies) is not susceptible of accurate revenue estimates at this time, due to the difficulty of estimating the response to such a proposal and the size of the deduction that would be necessary to create an effective incentive. The revenue effect of another proposal (relaxation of existing restrictions on carryovers of net operating losses) could not be accurately determined because the NOLs of small refiners cannot be accurately estimated and, furthermore, no reasonable estimate can be made of the extent to which such NOLs ultimately would be utilized. In any event, it is likely that this proposal would have a negligible revenue effect. One proposal (rapid write-off of certain obsolete equipment) is thought to be largely a clarification of existing practice.

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Two remaining proposals (changes in the non-recognition rules and creation of special foreign trade zones) are estimated to have only slight revenue effects. For the three proposals for which revenue effects are available, the maximum aggregate revenue loss for fiscal year 1980, assuming an effective date for these proposals of January 1, 1980, would be \$42.4 million; for fiscal year 1981, \$164.5 million; and for fiscal year 1982, \$236.9 million.

The revenue effects of the proposals can be summarized as follows:

-- Aggregate Revenue Effects. Taking into consideration the three proposals for which revenue estimates are available, the maximum aggregate revenue effects for each year in a 10-year period beginning with 1980 are as follows:

	<u>Calendar Year</u> (in millions)	<u>Fiscal Year</u> (in millions)
1980	(\$ 56.6)	(\$ 42.4)
1981	(\$ 195.7)	(\$ 164.5)
1982	(\$ 240.2)	(\$ 236.9)
1983	(\$ 226.9)	(\$ 231.1)
1984	(\$ 230.8)	(\$ 228.7)
1985	(\$ 204.3)	(\$ 211.5)
1986	(\$ 122.9)	(\$ 141.5)
1987	(\$ 46.5)	(\$ 61.0)
1988	\$ 19.0	\$ 6.3
1989	\$ 68.1	\$ 59.1

-- Revenue Effects for Four Hypothetical Refiners. Revenue estimates were made for four hypothetical refiners. These estimates show the magnitude of the tax benefits being proposed in comparison with the expenditures that will have to be made by small refiners.

A small, sweet crude refiner that finds itself faced with the necessity of processing sour crude--or going out of business, will need to spend as much as \$140,000,000 in order to upgrade its facilities. This expenditure will allow it to operate at a capacity of 30,000 bpd. In the likely event that it decides at the same time to expand its capacity, the required expenditure may be twice that amount.

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For purposes of illustration, four hypotheticals were developed: Refiner A has a Category I refinery and expends \$28,100,000 to expand its facility and move into Category II. (This development is unlikely to occur since Refiner A would simply be increasing its capacity and therefore compounding its marketing problems; it would not be growing in sophistication of processing or improving the marketability of its product slate.) Refiner B has a Category I refinery and expends \$77,500,000 to move into Category III. Refiner C has a Category I refinery and expends \$127,900,000 to move into Category IV. Refiner D has a Category I refinery and expends \$139,100,000 to move into Category V.

For purposes of these estimates, the small refining industry is divided into the following five categories:

<u>Category</u>	<u>Operation Type</u>	<u>Crude Oil Capacity</u>	<u>Crude Oil Type</u>
I	Topping	8,500 BPD	Lt. Crude with 0.5% S
II	Topping	30,000 BPD	Lt. Crude with 0.5% S
III	Hydroskimming	30,000 BPD	Lt. Crude with 0.7% S
IV	Catalytic Cracking	30,000 BPD	Lt. Crude with 2.0% S
V	Hydrocracking	30,000 BPD	Lt. Crude with 2.0% S

The total and individual year revenue effects for each hypothetical refiner are as follows (in thousands of dollars):

<u>Refiner A</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
	(23.5)	(237.2)	(517.6)	(1,194.0)	(1,891.2)
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
	(1,645.6)	(1,061.3)	(659.8)	(310.7)	38.4
<u>Refiner B</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
	(65.0)	(654.3)	(1,448.5)	(3,409.1)	(5,398.0)
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
	(4,675.4)	(3,009.4)	(1,869.7)	(879.2)	113.9

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<u>REFINER D</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>
	(116.8)	(1,174.3)	(2,639.8)	(6,345.3)	(10,057.5)
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
	(8,687.8)	(5,591.5)	(3,477.4)	(1,639.4)	203.5

A FEW WORDS ABOUT ASPHALT REFINERS

Special attention should be given to another class of small refiners, small asphalt refiners.

Small asphalt refiners typically have designed their facilities and made substantial capital expenditures so as to be able to first process low-gravity sour crude oils and then store (in many cases at high temperatures) the finished petroleum products. These refiners have normally been in existence for many years. They were not spawned by recent government regulations and product shortages. These refiners have the ability to refine sour crude into finished petroleum products ready for sale to the ultimate consumer without requiring further processing by another refinery, large or small. Many of these refiners produce sizeable quantities of specialty products and are substantial marketers in their geographic area. Many of these small refiners are today, and have been, suppliers of sizeable quantities of various petroleum products to the United States Armed Forces. They are also substantial suppliers of roofing and paving grades of asphalt for the home and commercial building and highway construction industries.

One of the primary concerns of this segment of the small refining industry is equal access to suitable types of crude oil at competitive prices. As more of the major oil companies, with their vast financial resources, begin processing these sour crude oils, it is possible, perhaps even probable, that the major oil companies will discontinue making this quality of crude oil available to this category of small refiners. In most cases the major oil companies will convert "the bottom of their barrel" to coke. Not only will the historic small refiner of sour crude be adversely impacted, but many of his customers, including the military and highway construction industries, will find that their source of petroleum products is disappearing. If replacement suppliers can be located, they will normally be at more distant locations, requiring higher transportation costs.

At a minimum the major oil companies should be encouraged--by the enactment of the aforementioned incentives to "free-up" crude oil supplies--to continue to make this type of crude oil available to this category of small refiners at competitive prices.

APPENDIX E

A HISTORY OF GOVERNMENT CONCERN FOR THE VIABILITY OF
THE INDEPENDENT REFINING INDUSTRY

Critics of smaller and independent refiners often ignore the reasons behind the long history of government concern for the independent refining industry.

Federal programs attempting to address the particular problem of equitable access to crude oil have been an integral element of this nation's energy policy for many years. The evolution of these programs began in the 1950's when the United States initially recognized its growing dependence on foreign oil imports. The first formal effort by this country to control its level of oil imports occurred on July 29, 1957, when President Eisenhower accepted the report of his Special Committee to Investigate Crude Oil Imports. This report recommended that national crude oil imports should not exceed 1,031,000 bpd, an amount which represented a level of imports equal to approximately 12 percent of domestic production at that time.

A voluntary compliance program was then adopted to achieve this goal, but it failed to attract the necessary level of cooperation within the industry. As a result, on March 10, 1959, President Eisenhower issued Executive Order No. 3279

which abolished the voluntary program and established in its place a mandatory oil import program (MOIP).

The MOIP was based on a system of granting import quotas to all refiners and permitting exchanges as the means by which imported oil was allocated. The "historic" importers were cut back to 80 percent of their last allocation under the voluntary program and the remaining imports were then distributed to all refiners by the application of a sliding scale formula. The sliding scale allocations were cumulative so that every refiner, regardless of size, would receive the same allocation as a percentage of its first 10,000 bpd, of its second 10,000 bpd, and so forth. Moreover, this system resulted in a benefit to smaller refiners, since that refiner's quota allocation constituted a greater proportion of its refinery runs than a large refiner.

The end result of the MOIP's sliding scale approach was to force large, integrated multi-national oil companies to share the advantages of the cheaper imports with independent refiners. Exchanges were usually accomplished by a contractual agreement between an interior refiner which held an import quota and a coastal refiner which had access to foreign oil. The inland refiner agreed to buy a specific amount and type of foreign oil for delivery to the coastal refiner. In return, the tidewater refiner agreed to deliver a specific amount of domestic oil to the inland

refiner. The "exchange" of oil was largely a matter of paperwork, since both the inland and coastal refineries continued to arrange for supplies from their customary sources.

The quota sharing aspect of the program was supported at the time by the Justice Department on the grounds that it would counteract concentration in the petroleum industry. Although stated with reference to residual fuel oil, Assistant Attorney General Lee Goevinger expressed what was believed to be the Department's attitude toward historic allocations.

Use of the historic pattern as the principal basis of allocation, other than for temporary purposes . . . [is] . . . antithetic to the normal process of growth and change through competitive efforts. By virtue of the competitive advantage in costs of imported over domestic residual, what changes in industry structure do occur are in the direction of growing concentration and increasing domination by the principal historic importers.

An additional reason underscoring the need for quotas was that the program helped guarantee crude access to inland independent and small refineries and thereby aided in the dispersement of refining facilities for national security purposes. The federal government recognized the vulnerability of the country during military attack if our domestic refining capacity was concentrated in a few large coastal locations. This vital national security factor continues to be an important reason for insuring the viability of the nation's small refiners.

The MOIP and the sliding scale allocation system continued in effect with few changes until 1973. It is interesting to note that in 1969 the Justice Department reiterated its support of regulatory efforts to aid the smaller segments of the petroleum industry in the interests of enhanced competition. Richard W. McLaren of the Antitrust Division announced that his office had designed a plan to prevent the special allocative powers of the integrated firms from affecting the ability of some segments of the industry to compete. According to McLaren's plan, a different distribution of product quotas, as well as the power that came with import quotas, would serve to prevent the major integrated firms from restricting competition.

Although flexible enough to last more than a decade, the MOIP was simply not equipped to deal with the cataclysmic disruption in the world and national petroleum markets that took place in the early 1970's, culminating in the Arab boycott of October 1973 and the subsequent quadrupling of world oil prices. On one hand, the energy policy embodied in the MOIP clashed with the Nixon administration's effort to control inflation through wage and price controls. Either prices had to rise to discourage consumption or import controls had to be adjusted to increase supplies. Furthermore, under the MOIP allocation system, the major advantage given small independent, inland refiners, namely their ability to exchange their import licenses for cheap imported oil for domestic

crude, was virtually eliminated. This placed small independent refiners in direct competition with the majors for domestic supplies, and as a result pressure grew in favor of extending federal allocation controls to domestic crude oil. Public alarm over rising prices and concern with the possible existence of major oil company oligarchy benefiting from the oil crisis created demands for a change in our national energy policy.

The first efforts to replace the mandatory quota program were embodied in a new license-fee system that extended existing import fees and granted certain exemptions to historical importers under the MOIP. Although the fees and exemptions were designed to become gradually more restrictive, thereby providing greater protection for domestic production and refining, the license-fee system in the short-term represented a significant easing of controls on imports in an effort to resolve oil shortage problems resulting from the embargo. As was the case with earlier programs, the license-fee system also provided special treatment for small and independent refiners. Under the new system the Oil Import Appeals Board had authority to grant a 50,000 bpd fee-free allocation to be distributed to hardship cases, with a specific emphasis on small and independent refiners.

As stated above, the license-fee system, although initially increasing oil imports, was also concerned with the long-term problem of how equitably to distribute existing and

future domestic crude oil supplies. On November 7, 1973, in an effort to further resolve this problem, the President requested the Office of Petroleum Allocation to prepare a plan for the distribution of all crude oil and refined products, and one day later he asked the Congress for authority to implement the plan. Three weeks later, Congress responded by passing the Emergency Petroleum Allocation Act of 1973 (EPAA) (P.L. 93-159). Contained within the EPAA was authority to freeze existing crude oil supplier/purchaser relationships and reallocate crude oil supplies among refiners. Specifically, the allocation system required refiners with crude supplies priced above the U.S. industry average to sell to those whose supplies were priced sufficiently below the average. It is evident from the express objectives of the mandatory allocation provisions of the EPAA that the preservation of competitive small and independent refiners and the need to assure them adequate supplies were two primary considerations of the Congress under the Act.

(b)(1) The regulation under subsection (a), to the maximum extent practicable, shall provide --

(D) preservation of an economically sound and competitive petroleum industry; including the priority needs to restore and foster competition in the producing, refining, distribution, marketing and petrochemical sectors of such industry, and to preserve the competitive viability of independent refiners, small refiners, nonbranded independent marketers, and branded independent marketers;

...

(F) equitable distribution of crude oil, residual fuel oil, and refined petroleum products at equitable prices among all regions and areas of the

United States and sectors of the petroleum industry, including independent refiners, small refiners, nonbranded independent marketers, branded independent markets, and among all users;

15 U.S.C. §§ 753(b)(1)(D) and (F).

As the shortage conditions that had existed during the Arab embargo began to abate, the demand for scarce petroleum products likewise fell and price again became the dominant force in the marketplace. Refiners who were dependent upon high-priced foreign crude oil found that they were unable to compete with other firms that had large supplies of cheaper domestic crude. The first response to this inequity came from the newly created cabinet-level Energy Resources Council, headed by Interior Secretary Rogers C.B. Morton. The Council advised the President to develop a crude oil cost equalization program to distribute crude oil acquisition costs equitably among all refiners. This "entitlements" program, as it came to be called, was embodied in a set of rules issued by FEA on December 4, 1974. Under this new regulatory framework, each refiner would receive entitlements for old, price-controlled domestic crude oil equal to the national average ratio of old crude oil to total crude runs to stills. Despite the emergency conditions prevalent at the time, the federal government once again demonstrated a commitment to smaller refiners. Refiners with less than 175,000 bpd runs to stills were to be given bonus entitlements on a sliding scale that was quite similar to the scale used under the old

import quota program. The major difference in the two programs was that while the "price" of import quota tickets had been determined by market forces, the entitlements price was to be set by the FEA.

Support for the small and independent refining industry continued to be a matter of legislative concern within the nation's energy policy as reflected by provisions contained in the Energy Policy and Conservation Act (EPCA) (P.L. 94-163), which amended the EPAA. Specifically, Section 403 of the EPCA provided an explicit small refiner preference by exempting all refiners with a capacity of less than 100,000 bpd from purchasing entitlements on their first 50,000 bpd. Thus, again Congress specifically provided a regulatory remedy to the crude access problem experienced by small refiners.

As detailed above, efforts by the federal government to assure the competitiveness of small and independent refiners in one form or another have been an integral part of this nation's energy policy for the past two decades. Clearly this circumstance is the product of deliberate Congressional action to protect important national interests. These interests, such as the need for dispersing our refining capacity in the interest of national security, are as valid today as they were in 1959.

The elimination of the small and independent refining industry, and the subsequent impact it would have on the affected refiners, would cause permanent and significant changes in the refining industry. To eliminate the nation's small and independent refiners would signal the abandonment of a quarter century of Congressional support for an integral part of the modern day petroleum industry, and it would be contrary to a sound national energy policy. Furthermore, such an attitude would signal to foreign nations that the United States is willing to rely increasingly upon imports of petroleum products.

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STATEMENT OF GARY PETERSEN, SPOKESMAN FOR INDEPENDENT REFINERS' ASSOCIATION OF CALIFORNIA, AND PRESIDENT OF THE U.S. OIL & REFINING CO., TACOMA, WASH.

Mr. PETERSEN. Thank you, Mr. Chairman and members of the subcommittee.

It is a pleasure to appear before you today to present the views of the Independent Refiners' Association of California. I am Gary Petersen, president of U.S. Oil & Refining Co., and accompanying me today is Joseph Helyer, vice president and general counsel of the association.

Our association is a 45-year old trade association, comprised of mostly independent, small refiners operating on the west coast of the United States, principally as refiners and marketers with little or no crude oil production of their own.

With respect to U.S. Oil & Refining Co., we operate a 21,400-barrel-per-day refinery in Tacoma, Wash., and have executive offices in Los Angeles.

We have been in operation since 1957 and produce a full line of petroleum products. Our petroleum products are marketed directly or by exchanges throughout the west coast and areas east of the Cascade Mountains.

The issues which we on the west coast feel are most significant to our future are, first and foremost, equitable access to crude oil, including the continued sale of Elk Hills production to independent refiners; second, relaxation of unreasonable restrictive export controls to allow the export of heavy fuel oil from the west coast, along with tax or other incentives to promote the movement of needed products from the west coast to the east coast; third, protection of the domestic refining industry against injury from imported petroleum products from insecure foreign sources; and fourth, tax incentives to encourage retrofitting of domestic refineries.

A tariff or quota system controlling the imports of foreign petroleum products is, however, of great importance to us. We believe it is in the national interest to encourage a strong domestic production and refining industry by, among other methods, restricting importation of products from foreign sources that are subject to interruption for a multitude of reasons.

The destructive influx of foreign petroleum products has begun, and we are just now seeing the tip of the iceberg. We are already experiencing substantial increases in the importation of Mexican asphalt in the Western United States.

Another clear example is gasoline being shipped to the west coast of the United States from the Peoples Republic of China. Several cargoes of such gasoline have already been received in west coast ports at costs well below domestic rack prices.

With regard to tax incentives for upgrading retrofitting domestic refineries, we fully support such incentives to encourage capital improvements for independent refiners. We especially need such assistance on the west coast to help independent refiners install conversion facilities for processing the predominant heavy, high-sulfur west coast crudes into marketable products.

At this point, we would like to address the windfall profits tax issue raised this morning by Congressman Thomas. Because of this tax and the resulting economics, approximately 100,000 barrels

per day of lease crude oil is being burned to produce steam for enhanced recovery operations.

Prior to this tax, substantial amounts of residual fuel oil were used for this purpose.

H.R. 1974, introduced in the House of Representatives, by Congressman Thomas, would remedy this oversight in the windfall profit tax law, and should be enacted at the earliest possible date.

I would like now to discuss the issue that is most vital to the west coast independent refining industry: Access to suitable supplies of crude oil at equitable prices.

An equitable crude oil access program must be developed to provide economic crude oil supply to crude deficient refiners when an adequate economic crude supply is not available as a result of international or domestic crude supply dislocations or price disparities.

In recent years, IRAC members have spent approximately \$260 million to expand and upgrade their refineries and currently have plans to spend an additional \$900 million to further allow the utilization of heavy, domestic crude oil for the manufacture of environmentally acceptable products most in demand by the consuming public.

However, at this time, approximately \$880 million of these proposed expenditures are on hold because of the uncertainty of future crude supplies and the impact of decontrol.

U.S. Oil & Refining Co., alone, has invested \$17 million since 1978, mainly to increase higher sulfur crude oil processing capability and unleaded gasoline production.

An additional \$7 million has been spent for engineering and equipment purchases, a part of a \$90 million project for downstream facilities to allow economic processing of Alaskan North Slope crude oil.

However, because of the lack of assured crude supply, this \$90 million project for North Slope crude oil has been put in abeyance while we continue to attempt to line up long-term crude supplies.

The current administration has decontrolled the petroleum market in efforts to return to a free market system, a system which we support.

However, IRAC members, most of whom were in business prior to the inception of the FEA/FEO/DOE controls, do not believe that a full free market exists, partially as a result of distortions caused by many years of controls and partially as a result of remaining Government impediments to free operation.

The most glaring examples of Government impediments are the short supply control regulations administered by the Department of Commerce pursuant to the Export Administration Act.

Mr. Chairman, we commend you for the leadership role you and other members of the subcommittee are taking to insure that our country's energy security is not held hostage to the petroleum policies of foreign nations.

In conclusion, we would state, once again, that while tax and tariff measures will be an important factor in the development of a strong and flexible domestic refining industry, unless a reasonable crude oil access program is developed to assure a continued source

of supply at equitable prices, we fear the efforts of your committee may well be undermined.

Without raw materials, tax incentives will do very little for any American business.

Thank you for the opportunity to present these comments.

Senator WALLOP. Thank you, Mr. Petersen.

[The prepared statement of Mr. Petersen follows:]

STATEMENT
OF
GARY L. PETERSEN
PRESIDENT
U.S. OIL & REFINING CO.

ON BEHALF OF THE
INDEPENDENT REFINERS' ASSOCIATION OF CALIFORNIA, INC.

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

REGARDING
TAX INCENTIVES FOR DOMESTIC REFINING

WASHINGTON, D.C.

MARCH 27, 1981

Mr. Chairman and members of the Subcommittee, it is a pleasure to appear before you today to present the views of the Independent Refiners' Association of California (IRAC). I am Gary L. Petersen, President of U.S. Oil & Refining Co., and accompanying me today is Joseph A. Helyer, Vice President and General Counsel of the Association.

The IRAC, a 45-year old trade association, is comprised of most of the independent, small refiners operating on the West Coast of the United States. Refineries operated by our member companies range in size from 4,000 barrels per day up to about 45,000 barrels per day. The product output of member company refineries varies with each company -- ranging from some that are predominantly fuel oil, asphalt, and distillate refiners to others that provide a full range of petroleum products. These companies operate principally as refiners and marketers with little or no crude oil production of their own.

A unique, and not so desirable, characteristic of the western refining industry is the predominance of heavy crude oil produced in the State of California. Over 65% of California production is 20° API gravity or less, while the corresponding percentage for the rest of the country is only 5%. This predominance of heavy, high sulfur crude oil clearly illustrates the importance of access to sources of light, sweet crude oils to enable production of environmentally acceptable petroleum products and an immediate need for refinery retrofit. Our emphasis is directed more to the upgrading of our facilities than to substantial capacity increases.

The IRAC members, most of whom were in business prior to the inception of the FEO/FEA/DOE controls, support a free market but do not believe that de-control has yet resulted in such a market.

With respect to U.S. Oil & Refining Co., we operate a 21,400 barrel per day refinery in Tacoma, Washington and have executive offices in Los Angeles.

We have been in operation since 1957 and produce a full line of petroleum products including two grades of leaded gasoline, two grades of unleaded gasoline, commercial and military jet fuel, diesel fuel oil, low-sulfur fuel oil, bunker fuel cutter stocks and several grades of asphalt. We have continued to make substantial investments in our facilities over the years and would like to make even larger investments in the future which I will discuss later in the statement. Our petroleum products are marketed directly or by exchanges throughout the West Coast and areas east of the Cascade Mountains.

We appreciate the opportunity to appear before this Subcommittee today to present comments and suggestions on tax and other incentives for domestic refiners, particularly as they relate to West Coast independent, small refiners. The issues which we on the West Coast feel are most significant to our future are:

1. Equitable access to crude oil, including the continued sale of Elk Hills production to independent refiners.
2. Relaxation of restrictive and unreasonable export controls to allow the export of heavy fuel oil from the West Coast, along with tax or other incentives to promote the movement of needed products from the West Coast to the East Coast.
3. Protection of the domestic refining industry against injury from imported petroleum products from insecure foreign sources.
4. Tax incentives to encourage retrofitting of domestic refineries.

Although we consider equitable crude access to be the most pressing problem, we will first comment on the tax/tariff concepts referred to in the Subcommittee's March 11, 1981 press release.

Concerning the modification of foreign tax credit rules, we certainly would not oppose any legislation along these lines that would motivate major oil companies to sell crude oil to independent refiners. However, because of West Coast circumstances, we feel that this concept may not prove beneficial to the western small refiners and, therefore, this is not a prime objective of the IRAC members.

A tariff or quota system controlling the imports of foreign petroleum products is, however, an item of great importance to us. We believe it is in the national interest to encourage a strong production and refining industry within the United States by, among other methods, restricting importation of petroleum products from insecure foreign sources.

The influx of destructive foreign petroleum products has only begun, and we are now just seeing the tip of the iceberg. We have already seen substantial

increases in the importation of Mexican asphalt into the western United States. Another clear example is gasoline being shipped to the West Coast of the United States from the Peoples Republic of China. Several cargoes of such gasoline have already been received in West Coast ports at costs well below domestic rack prices. Even more distressing is information contained in a report from Platt's Oilgram Price Report of Monday, March 23, 1981 which indicated:

"European Stocks Still Declining -- Rotterdam 3/20 - Mogas, naphtha, and heavy fuel stocks decreased, with other products quiet and unchanged.

Mogas trade was active; cargoes continue to arrive from Morocco, China, and Russia with five or six outflowing cargoes primarily to the U.S. already loaded and another four due to load by the end of March, also destination U.S...."

It is difficult to see how a strong domestic refining industry will be maintained if our nation is allowed to become dependent upon insecure foreign sources of supply, particularly when these products have no true economic cost but result from foreign government-owned production, government-owned refining facilities, and government-controlled marketing.

We commend the Subcommittee Chairman and other Senators who joined in a letter to the Secretary of Commerce on February 20, 1981, requesting an immediate investigation into the impact upon our national security resulting from foreign petroleum product imports.

With regard to tax incentives for upgrading or retrofitting domestic refineries, we fully support such incentives to encourage capital improvements for independent refiners. We especially need such

assistance on the West Coast to help independent refiners install conversion facilities for processing the predominant heavy, high-sulfur West Coast crudes into marketable products. However, it must be pointed out that independent refiners must have suitable crude supply at equitable prices to justify committing large sums of money to such projects in order to receive the benefits of these tax incentives.

Crude oil purchasing cooperatives are a good idea and may be very beneficial to independent refiners east of the Rockies. We do, however, have reservations about the ability of crude oil purchasing cooperatives to serve the interests of West Coast independent refiners. For example, if foreign crude is moved directly to the West Coast, a likely source is either Indonesia or Malaysia -- both of which are charging prices far in excess of that which can be recovered in the product markets on the West Coast. The other alternative is to purchase crudes

that can be transported to the Gulf Coast or East Coast in exchanges with major oil companies for West Coast crude oil. However, to date, these exchanges have tended to significantly increase the prices of West Coast crude oils above the posted FOB prices. The concept is a fine example of "self help" and free market thinking, and we will continue to explore the system to determine if it can be beneficially applied to West Coast refiners.

At this point, we would like to address a tax issue which has created a severe hardship on many independent refiners in California, the Windfall Profit Tax Act enacted last year. Because of this tax and the resulting economics, approximately 100,000 barrels per day of lease crude oil are being burned to produce steam for enhanced recovery operations. Prior to this tax, substantial amounts of residual fuel oil were used for this purpose. This in turn has added to the oversupply in the West Coast heavy

fuel oil market. By burning crude oil instead of heavy fuel oil, light products are being consumed inefficiently rather than being converted to usable products for the consuming public.

H.R. 1974, recently introduced in the House of Representatives by Congressman William M. Thomas of California, would remedy this oversight in the Windfall Profit Tax law. This bill would exempt crude produced from steam generation enhanced recovery projects in an amount equal to the amount of residual fuel oil used to power the steam generators.

With the use of the fuel oil rather than the burning of crude, slightly higher efficiencies would be achieved and therefore, more crude oil would be produced. The "exemption" therefore, would also slightly increase the revenues from the Windfall Profit Tax as well as allowing the recovery of the light end products from the crude now burned on the lease. Our Association strongly supports the

legislation and would hope that this Subcommittee would also consider this issue. While the Windfall Profit Tax impact is extremely minimal, the impact upon the residual fuel market in California is significant.

I would like now to discuss the issue previously mentioned as the most vital to the West Coast independent refining industry.

Access to suitable supplies of crude oil at equitable prices is the most critical problem of any independent refiner. An equitable crude oil access program must be developed to provide economic crude oil supply to crude deficient refiners when an adequate economic crude supply is not available as a result of international or domestic crude supply dislocations or price disparities.

We understand that such a program may not come under the jurisdiction of this Subcommittee. However,

we ask you to recognize that, without this type of program, the tax incentives which this Subcommittee may recommend would be rendered considerably less meaningful. Financial institutions would not be willing to lend money for large refining investments without such protection, and furthermore, company management would be unlikely to invest funds without a realistic access program.

The IRAC member companies have been willing to spend large sums of money in the past to upgrade their refining facilities when there was a certainty of crude oil access in shortage periods, such as provided for by the Buy/Sell Program and the Supplier/Purchaser Freeze Rule. More importantly, additional large expenditures were planned for the future to construct additional facilities to process heavy crude, provided there were some type of crude access program in existence.

In recent years IRAC members have spent approximately \$260 million to expand and upgrade their refineries and currently have plans to spend

an additional \$900 million in the near future to further allow the utilization of heavy, domestic crude oil for the manufacture of environmentally acceptable products most in demand by the consuming public. However, at this time approximately \$880 million of these expenditures are "on hold" because of the uncertainty of future crude supplies and the impact of decontrol.

U.S. Oil & Refining Co. alone has invested \$17 million since 1978, mainly to increase higher sulfur crude oil processing capability and unleaded gasoline production during the past five years, and has already expended an additional \$7 million for engineering and equipment purchases in an estimated \$90 million project for downstream facilities to allow economic processing of Alaskan North Slope crude oil. However, because of the lack of assured crude supply, this \$90 million project for North Slope crude oil has been put in abeyance while we have been making attempts to line up long-term crude supplies.

The current Administration has decontrolled the petroleum industry in efforts to return to a "free market" system. However, IRAC members do not believe that a full free market exists, partially as a result of distortions caused by many years of controls and partially as a result of remaining government impediments to free operations.

The most glaring examples of government impediments are the "short supply control" regulations administered by the United States Department of Commerce pursuant to the Export Administration Act.

These controls were developed to meet "short supply" conditions of the type that occurred during the world-wide embargo conditions in the 1970's. However, as crude oil and petroleum products have become relatively surplus in the world, we are still locked into "short supply" controls that prevent the "free" export of surplus fuel oil into

an available world market. These controls are unduly restrictive and cumbersome for today's supply conditions and are not consistent with the decontrol mode of the current Administration.

The IRAC supports the relaxation of petroleum product export restrictions to allow for the free export of surplus products for sale into the world markets.

Similarly, the movement of surplus West Coast residual fuel oil to the fuel oil-deficient East Coast is economically hindered as a result of the Jones Act requirement for use of American flag vessels in such transportation. We urge the Subcommittee to review the situation to determine if tax or other considerations could be developed which would provide for the movement of surplus West Coast residual fuel oil to the East Coast, where the product is needed, and now mainly imported. Such a concept would continue to support the use of the American merchant fleet while achieving a greater utilization of our nation's energy resources.

CONCLUSIONS

Mr. Chairman, we commend you for the leadership role you and the other Members of the Subcommittee are taking to insure our country's energy security is not held hostage to the petroleum policies of foreign nations. We believe that healthy domestic refineries are an essential ingredient to the well-being of our national energy security.

After only two months of decontrol, an overall assessment of the future is not possible. The western small, independent refiners, for the most part, existed prior to controls and believe we will continue to compete effectively in a free market. However, to do this, we believe we will require governmental action removing existing barriers to free market operations as well as reasonable tax incentives which could be applied across the board to the refining industry to bring about the modern, efficient refining industry that the West Coast and the United States deserve.

In conclusion, we would state once again that, while tax and tariff measures will be an important factor in the development of a strong and flexible domestic refining industry, unless a reasonable crude oil access program is developed to assure a continued source of supply, we fear the efforts of your Committee in areas of its jurisdiction may well be undermined. Without raw materials, tax incentives will do very little for any American business. Thank you for the opportunity to present these comments.

STATEMENT OF WILLIAM H. BODE, GENERAL COUNSEL, EMERGENCY SMALL INDEPENDENT REFINERS' TASK FORCE, WASHINGTON, D.C.

Mr. BODE. Mr. Chairman and members of the committee, small efficient refiners are today unable to procure sufficient crude oil to sustain their operations.

Domestically, only about 2 million barrels per day of independent crude oil is available on the open market. There are over 170 independent refiners with 6 million barrels per day capacity vying for this production.

However, the integrated oil companies are also seeking this crude oil and, as a DOE study recently noted, can bid up to \$10 more per barrel than can the independents.

As a result, small refiners are effectively denied access to even the limited sources of crude oil available domestically.

Small refiners have also been unable to produce crude oil abroad. Small refiners, acting individually and in consortium, have been unable to secure supply contracts with OPEC countries. Indeed, the only countries which have been willing to deal with small refiners are the most price-militant members of OPEC which demand exorbitant premiums.

As a result of this lack of access to crude oil, ESIRTF predicts that over 75 small and independent refiners will be forced from business by the end of this year.

Mr. Chairman, small refiners are efficient. Their refineries utilize the latest engineering advances and are rigorously maintained. In fact, they are more efficient than many large, but antiquated, refineries of the major oil companies.

Small refineries are geographically dispersed, and have traditionally represented an important source of supply for the Department of Defense. They are also a major supplier of petroleum products to farmers in many regions of the country.

Small independent refiners offer vigorous competition to the major oil companies, to the benefit of the consumer. For every 1 cent per gallon increase in the price of petroleum products which is deferred because of competition by small refiners, the American consumer saves \$2.5 billion annually.

The majors would like to eliminate this competition, and they are able to do so by subsidizing their refinery operations with crude oil profits. Their success in eliminating the small refining sector will not only injure the consumer, but it will also cause severe dislocations in the farming industry and threaten the national security.

ESIRTF believes that the swift enactment of legislation establishing an oil import fee, with a small refiner exemption, is crucial to maintaining small refiners. While ESIRTF is interested in the concept of tax incentives for independent foreign crude purchasing cooperative, the association suggests that creation of an oil import agency could more effectively achieve this objective of assuring independent refiners access to foreign crude oil.

Mr. Chairman, we will submit, for the record, a complete statement.

Thank you.

Senator WALLOP. Thank you very much, Mr. Bode.

[The prepared statement of Mr. Bode follows:]

SUMMARY STATEMENT BY WILLIAM H. BODE
OF THE EMERGENCY SMALL INDEPENDENT
REFINERS TASK FORCE

I. Small Efficient Refiners Cannot
Survive in the Decontrol Era

As a result of the termination of certain regulatory programs by President Reagan's decontrol order, small efficient refiners are unable to procure sufficient crude oil to sustain their operations. Domestically, about 2 million barrels per day of independent crude oil is available on the open market. There are 170 independent refiners with 6 million barrels per day capacity vying for this production. However, the integrated oil companies are also seeking this crude and, as a DOE study recently noted, can bid up to \$10 more per barrel than can independents. As a result, small refiners are effectively cutoff from much of the domestic crude oil supply.

Small refiners find foreign crude unavailable as well. Small refiners, acting individually and in a consortium, have been unable to secure supply contracts with moderate OPEC countries, as those countries deal only with international oil companies or on a country-to-country basis. The only foreign crude they have found available is in militant OPEC countries at exorbitant prices.

As a result of this lack of access to crude, ESIRTF predicts that over 75 small refiners are in imminent danger of going out of business.

II. The Country Needs Small Efficient Refiners

Small refiners are efficient. Their refineries utilize the latest engineering advances and are rigorously maintained. In fact, they are more efficient than many large antiquated refineries of the major oil companies.

Small refineries are geographically dispersed, and have traditionally represented an important source of supply for the Department of Defense. They are also a major supplier of petroleum products to farmers in many regions of the country.

Small independent refiners offer vigorous competition to the major oil companies, to the benefit of the consumer. For every 1 cent per gallon increase in the price of petroleum products which is deferred because of competition by small refiners, the American consumer saves \$2.5 billion annually.

The majors would like to eliminate this competition, and are in a position to do so by bidding up the price of domestic crude oil to uncompetitive levels. Their success in eliminating the small refining sector will not only injure the consumer, but it will also cause severe dislocations in the farming industry and threaten the national security.

III. Suggested Programs to Ensure the Viability Of Small Independent Refiners

ESIRTF believes that the swift enactment of legislation establishing an oil import fee, with a small refiner exemption, is crucial to maintaining small refiner access to crude oil. While ESIRTF is interested in the concept of tax incentives for an independent foreign crude purchasing cooperative, the association believes that creation of a crude oil import agency would be a much more effective way to achieve the objective of giving independent refiners leverage in obtaining foreign crude.

ESIRTF

EMERGENCY SMALL INDEPENDENT REFINERS TASK FORCE

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WILLIAM H. BODE
SECRETARY AND
GENERAL COUNSEL

Statement of

Emergency Small Independent Refiner
Task Force

by

William H. Bode
General Counsel

Before the Subcommittee on Energy and
Agricultural Taxation
of the
Senate Finance Committee

Hearings on Problems Facing
the United States Refining Industry

March 27, 1981

STATEMENT OF THE
EMERGENCY SMALL INDEPENDENT
REFINERS TASK FORCE

By William H. Bode
General Counsel

Mr. Chairman and members of the subcommittee, my name is William H. Bode. I am General Counsel to the Emergency Small Independent Refiners Task Force ("ESIRTF"), an organization formed over a year and a half ago by 17 small refiners concerned about the competitive viability of the small independent sector of our domestic refining industry.

ESIRTF commends the subcommittee, and especially you, Chairman Wallop, for holding these timely hearings on the problems facing the domestic refining industry. We urge you to act on what you hear today to ensure that there will be competitive refining in the decades to come. We fear that, if you wait for even a year you will find that there is no longer a small, independent sector to help keep competition alive in the industry. At that point, it will be too late to undo the damage.

Small independent refiners are indeed facing a real and potentially fatal emergency. I will point out the dimensions of that emergency for you today. I will also outline for you the crucial importance of small refiners to a healthy refining industry. And I will suggest some easily-administered solutions which you can enact into law without resurrecting a regulatory structure such as existed prior to January 28.

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I. Small Efficient Refiners Cannot Survive in the Decontrol Era

As you know, President Reagan's decontrol order terminated several programs designated to assure small refiners access to crude oil by neutralizing the market dominance of large integrated oil companies. The Crude Oil Allocation and Mandatory Buy/Sell Programs gave access to crude oil to small refiners which otherwise would have been unable to procure supplies. The Entitlements Program removed the crude oil cost disadvantage otherwise suffered by small refiners. Without these programs, small efficient refiners will be unable to procure sufficient domestic or foreign crude oil to maintain their operations.

Domestically, there are about 8.5 million barrels of crude oil produced daily. Vying for this 8.5 million barrels are domestic refiners with about 18.3 million barrels per day of refining capacity. Clearly, domestic production would fall far short of meeting domestic refineries' needs, even if every refiner had access to a fair share of this production.

However, access to a large portion of domestic production is foreclosed to a significant segment of the refining industry because it is owned by the major integrated refiners. A study prepared by the Senate Antitrust Committee revealed that in 1973, the eight largest oil companies alone controlled approximately 68% of domestic crude oil production. They control this production directly, through ownership of producing fields, or indirectly, through ownership of the gathering pipelines.

The control by the major oil companies of domestic crude oil production is increasing. The newspapers have reported the acquisition by Shell Oil of the huge resources of Bellridge Oil Company, and by Mobil Oil Corporation of General Crude Oil. Dozens of other independent crude producers have also been acquired by major refiners.

As a result, there are only about 2 million barrels per day of domestic production available on the "open market." This is the only domestic oil which is available to the 170 refiners who are not among the 16 major integrated refiners. The combined capacity of these refiners constitutes over 30% of the domestic refining capacity, or about 6 million barrels per day. Even if the majors did not compete for available open market crude and even if each of the independent refiners were able to obtain a share of this crude, there would only be sufficient domestic crude to supply 1/3 of the needs of the independent sector.

However, it is unrealistic to assume that the majors are not attempting to capture these "open market" crude supplies. As their controlled production declines, their incentive to replace these volumes with crude oil otherwise available to independent refiners increases. Data in the recent "Crude Oil Access Study" by the Office of Oil Policy of the Department of Energy points to such a trend. That study indicates that from 1976 to 1979, the four largest integrated refiners turned to the open market to fill an additional 18% of their domestic crude requirements. ESIRTF greatly fears that this

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increased activity by major integrated companies in the open market will result in independent refiners being outbid for available domestic crude supplies.

The "Crude Access Study" confirms our fears. In the study, DOE recognizes that the integrated companies, because of their captive crude oil production, "can afford to pay higher prices than the independents for open market supplies." The Department estimates that this potential for the integrated companies to subsidize their open market crude oil purchases is indeed substantial. The study indicates that the 16 major integrated companies can afford to bid over \$10.00 per barrel more than independents for crude oil while maintailing their profitability.

DOE has doubts about whether the majors would want to subsidize crude acquisitions in this manner. But ESIRTF submits that they are already engaged in the bidding up of open market crude prices. Indeed, recent data indicates that posted prices for decontrolled domestic crude exceeds product revenues by several dollars per barrel.

Faced with this outlook on the domestic market, small and independent refiners are forced to turn abroad for sources of crude feedstocks. Unfortunately, the outlook is grim for small refiners seeking foreign crude supplies under contract. Approximately one-half of ESIRTF's members have traveled abroad in the last year and a half in an attempt to obtain contracts with foreign producing

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countries. None have been successful. Several members of ESIRTF have formed a "buying consortium" and have retained professional representatives to continue this task. Yet this group has been unable to obtain crude oil.

The fact is that crude oil contracts with OPEC nations have been extremely elusive. As the DOE study on crude access notes, producing nations increasingly are tying crude sales to commitments by the purchaser to make investments in their countries. Only the largest companies can undertake these huge expenses.

The few foreign sources of crude which small refiners have found have been with the most price militant members of OPEC. Nigeria and Libya are quite willing to offer contracts at prices four to five dollars per barrel higher than OPEC benchmark postings. But such contracts effectively price the small independent refiner out of the market, since small refiners can not "cost average" higher price crude with low priced crude, as the majors can.

This bleak picture of crude availability for the small refining sector points unavoidably to one thing -- the demise of a significant number of small refiners. DOE's Office of Oil Policy, in its "Refinery Policy Study," predicted that decontrol would cause approximately 40 small refiners to shut down. ESIRTF believes that DOE's estimate is off by nearly 100%. It is much more likely that over 75 small independent refiners will go out of business within the coming months.

In fact, small refiners have already begun to close down.

A number of ESIRTF members have either ceased operations or are operating at greatly reduced capacity. If these and other small refiners are not able to gain access to competitively-priced crude very soon, they will be forced to go out of business. When that happens, the nation will have irretrievably lost an important source of refined products.

II. The Country Needs Small Efficient Refiners

Some members of the subcommittee may wonder whether the closing down of small independent refiners will make any difference to the nation. After all, you have probably been hearing that small refiners are merely inefficient "tea kettles" which have existed solely off of government subsidies.

ESIRTF urges you to examine closely the facts behind what you have been hearing. We believe you will discover that the assertion that all small refiners are inefficient is a myth, perhaps fabricated by Big Oil in order to get rid of competition by small refiners.

Let us examine the meaning of efficiency in the refining industry. DOE has defined "efficiency" in terms of heat exchange losses in the refining process, or as the ability to process sour crude oils into unleaded gasoline.

With respect to the first definition, small independent refiners are probably more efficient than the older refineries of the major companies. Members of ESIRTF operate distillation units which have been designed and constructed by utilizing the latest

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engineering advances which are rigorously maintained. The heat loss in their operation is certainly comparable to the heat loss experienced in the distillation units of the average refinery operated by the majors. With respect to the production of aviation fuel oils, the small refiner consumes no greater part of a barrel of crude oil than the average major refinery.

As to the second definition of "efficiency," ESIRTF submits that it is simply incorrect. If "efficiency" is to be equated with production of gasoline, we must presume a relatively greater demand for gasoline than for other petroleum products. Certainly, no one would claim that it is efficient to expend three and one-half to four dollars per barrel more in refining costs to manufacture gasoline if additional gasoline were not needed. Yet, this is the situation today. Mr. Chairman and members of this subcommittee, the fact is that this country needs not one barrel more of additional gasoline refinery capacity. Department of Energy projections indicate that demand for gasoline will actually decrease in the future, as the mileage of the automobile fleet improves and consumption declines due to higher prices.

ESIRTF would also point out that small refiners in fact devote a substantial portion of their product slates to gasoline. In 1978, small refiners devoted 15-29% of their production to gasoline. Small refiners with 10 to 50 thousand barrels per day of capacity devoted a greater percentage of their output to motor gasoline than any other product.

More importantly, the subcommittee should appreciate that a substantial portion of the naphthas and lighter ends produced by small independent refiners are sold as feedstock to large refiners. These larger refiners input these petroleum products to vaccum towers and hydrocracking units to produce unleaded motor gasoline. By this activity, approxiamtely 40% of small refiners' output ends up as gasoline.

In considering efficiency in terms of product yield, the subcommittee should consider the potential for increased demand for products other than gasoline which are produced by small refiners. The Administration and members of Congress are suggesting the deregulation of natural gas and the repeal of coal conversion requirements for utilities. Such actions will induce utilities and industrial to use increasingly competitive residual fuel oil and middle distillates. Increased demand for diesel-powered automobiles will increase demand for diesel fuel. Thus, it would appear that small refiners which are producing scarce middle distillates and residual fuel oils are more "efficient" than the majors which produce gasoline.

In this regard, it should be noted that the United States has imported negligible quantities of gasoline in the last two to three years. Imports of middle distillates and residual fuel oil, however, have exceeded one million barrels per day for the last three years.

The implications of our dependence on foreign sources of residual fuel oil are potentially serious. This fuel is used

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to fire industrial and utility boilers. Over half of the East Coast residual fuel market, which includes many of the most heavily industrialized and highly populated areas in the country, has been supplied by foreign refineries for the past 20 years. Thus, a curtailment of foreign supplies of residual oil could threaten the economic base of an important region of the country.

A Congressional Research Service study points out the danger to national security posed by reliance on foreign-refined products, a danger which may be even greater than that posed by dependence on foreign sources of crude oil. In light of this threat, it is in the national interest to adopt programs to ensure that small refiners will be able to continue to provide domestic sources of residual fuel oil.

Finally, the most "efficient" refining industry is not one in which every refining entity is capable of refining sour crude oils. Approximately 50% of crude oil imports and 50% of domestic crude oil production consists of "sweet" crude oils. The National Petroleum Council predicts that by 1990, the lowest level this proportion of sweet crude will reach is between 41% and 45%. Since the capacity of small refineries which process only sweet crude is considerably less than 41% of the total U.S. refining capacity, it is clear that there will be an ample quantity of sweet crude to be efficiently refined by small refiners until well beyond 1990, if small refiners have access to this crude.

The U.S. not only has sufficient sweet crude supplies available to accommodate sweet crude refining capacity but it

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also has sour crude capacity to process present and projected future supplies of sour crude. DOE recently concluded that current high sulphur refining capacity combined with planned additions and lower product demand make it "highly unlikely that the nation will face a shortfall of sour crude capacity."

We agree that economics of scale are important in the processing of sour crude oils. However, in light of the sweet and sour crude supply picture, this simply means that the largest refineries should process sour crude oils. That is what they can do most efficiently. The smaller refiners should process sweet crude oils, which is what they can do most efficiently. In this way, the total efficiency of the domestic refining industry is maximized.

Thus, it is clear that the allocation of crude oil to small independent refiners is not a "misallocation" of resources, as is maintained by major oil companies.

The animus of the majors toward the small refiners is easily explained. They fear the competition. Small independent refiners are efficient, they are resourceful, and they are creative. They assure that monopoly profits will not be available to major oil companies. They further the competitive model upon which our free market system is based.

Unfortunately, the majors are in a position to do more to combat competition than foster myths about small refiners. The majors have the ability to bid up the price of open market

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crude to levels not justified by product prices and thus foreclose crude supplies to small refiners. Without crude, small refiners will cease to compete and thereby keep the majors honest.

The Federal Trade Commission has found evidence that the "big eight" companies have already initiated such a concerted effort to eliminate competition by independent refiners. If the majors succeed, it is the consumer who will ultimately pay the price in higher product costs and lessened supply.

But the implications of the elimination of small refiners go beyond potential impacts on consumers. Small independent refiners provide a large proportion of the diesel fuels and heating oils used by farmers, upon whom our nation's agriculture depends. The loss of small independent refiners, upon which the farm industry depends, is therefore of the utmost concern to all Americans. In addition, small refiners are major suppliers of vital petroleum products to the Department of Defense. Since small refiners are geographically dispersed, they also enhance our national security while serving local industries.

If Congress permits small independent refiners to be forced from business, the American economy will suffer greatly. If this is allowed to happen, the trust which binds the governed to those who govern will be broken. Small independent refiners must be provided government assistance.

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III. Suggested Programs to Ensure the Viability
Of Small Independent Refiners

ESIRTF strongly believes that one of the most important legislative steps that this Congress could take to ensure that small independent refiners have access to crude oil would be to enact an oil import tariff or fee. ESIRTF recommends that a fee of approximately five dollars per barrel on crude oil imports be imposed on all importers except qualifying small independent refiners. The former Oil Import Control Program provided this form of protection for small refiners for over 14 years.

A number of distinguished petroleum experts and economists have recommended the immediate implementation of such a tariff. Import fees would not only protect the country from increased dependence upon imported crude oil, but would also assure the maintenance of competition during shortages.

ESIRTF was interested in your suggestion, Chairman Wallop, that the subcommittee consider the possibility of legislation to grant tax-exempt status to an independent refiner's purchasing cooperative. The idea behind such legislation would be to encourage independents to join together so that they can bargain on an equal footing with the majors.

We will certainly give this idea further consideration. However, we fear that, even if independents succeeded in forming such a cooperative, they would find that their bargaining power in

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foreign oil markets does not equal that of the majors. It is the entrenched position which the majors enjoy in the moderate OPEC nations such as Saudi Arabia that gives them their advantage in obtaining lower cost supplies of foreign crude. We are not sure that even a very large independent cooperative could overcome that advantage.

ESIRTF believes that a more viable concept would be to create a government agency to oversee the importation and distribution of foreign crude oil. Such an agency could administer a special preference for small refiners. We realize that the creation of such an agency is not within the jurisdiction of the subcommittee. However, ESIRTF urges that, as Members of the Senate, you consider such an approach as an alternative to the concept of independent refiner cooperatives.

The establishment of such an import agency is supported by countless, compelling factors. In a world as complex as ours, it is surprising that this nation's very lifeline is left to a handful of companies motivated primarily by their own private financial interests. We believe that the stark realities of international politics demand the establishment of an oil import agency. We believe that the sooner such an agency is established, the better.

* * * * *

In closing, ESIRTF would like to leave the subcommittee with a concrete example of the importance of competition in the refining industry: For every 1 cent per gallon increase in the price of petroleum products which is deferred because of vigorous competition,

the public saves \$2.5 billion annually.

We appreciate this opportunity to testify and would welcome the chance to further assist the subcommittee in its consideration of legislation relating to the refining industry.

Respectfully submitted,

STATEMENT OF ROBERT VINSON, CHAIRMAN OF THE TAX COMMITTEE, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, AND PRESIDENT OF THE STERLING PETROLEUM CO., WICHITA FALLS, TEX.

Mr. VINSON. Mr. Chairman, I am Robert E. Vinson, an independent oil and gas producer from Wichita Falls, Tex. I am appearing today in my capacity as chairman of the tax committee of the Independent Petroleum Association of America, which represents the independent oil and gas producer.

Since independent producers are suppliers of crude oil to all domestic refiners, we are concerned with the problems of small refiners as well as the major refiners.

Although, as producers, we do not have expertise to suggest detailed solutions, we do want to insure that no solution to the refiners' problems creates or compounds problems for the independent producer.

We think it is vital that the United States decrease its dependence on foreign sources of crude oil and refined petroleum products. To reach the goal of increasing domestic energy supply, we have advocated that energy prices be set in the marketplace in order to increase domestic production, reduce consumption, and encourage the development of alternative sources of energy supply.

We believe that many of the policy changes that IPAA advocated to increase domestic energy supplies have relevance for this hearing, since the crux of the problem faced by all domestic refiners is the insufficient supply of domestically produced crude oil.

For example, the so-called windfall profits tax acts as a reverse tariff which subsidizes and thereby encourages the import of foreign crude oil and discourages domestic production.

This is why IPAA believes the energy security of the Nation requires repeal of the tax. Any attempt to link the crude oil tax to solving the small refiner problems would be counterproductive. It would tend to perpetuate the tax by establishing a constituency that would benefit from its continued existence.

Adding the additional requirements necessary for the administration of such a program would significantly increase an already onerous regulatory burden.

If it is determined that Federal action is needed to address any perceived competitive disadvantage that domestic refiners face vis-a-vis foreign refiners, IPAA suggests tax incentives rather than any type of allocation or entitlement program which disrupts and distorts the energy market.

Finally, IPAA believes that any contingency plans for dealing with interruptions in supplies of foreign crude oil should, to the

fullest extent possible, rely on existing industry mechanisms and market forces. Any allocation proposal should be only at the refinery level and not at the producer's level.

In closing, I think it appropriate to quote from the comments of a small domestic refiner in a letter to IPAA last year. This letter was specifically in response to the Department of Energy draft refinery policy study published last year.

This small refiner stated:

If a company sincerely wants to prosper in the refining or any other industry, it will change and grow without specific subsidies that often have very limited benefit to fellow businessmen and consumers. Any special programs will benefit equally deserving firms to different degrees, a lesson taught by the entitlements program and the supplier-purchaser rules.

Mr. Chairman, thank you for this opportunity to express our views.

Senator WALLOP. Thank you, Mr. Vinson, for your statement. I appreciate it.

[The prepared statement of Mr. Vinson follows:]

STATEMENT OF ROBERT E. VINSON, CHAIRMAN, TAX COMMITTEE, INDEPENDENT
PETROLEUM ASSOCIATION OF AMERICA

Mr. Chairman, I am Robert E. Vinson, an independent oil and gas producer from Wichita Falls, Texas. I am appearing today in my capacity as chairman of the tax committee of the Independent Petroleum Association of America.

We are joined in these comments by the thirty unaffiliated state and regional oil and gas associations listed on the cover page. The combined membership of these associations includes virtually all of the same 12,000 independent oil and gas producers in the United States.

The IPAA is a national association of some 6,500 independent domestic explorer-producers of crude oil and natural gas. Virtually all of the oil and gas exploration and production activity of the IPAA membership takes place within the "lower 48" states of the United States.

IPAA recognizes that domestic refiners, particularly the smaller ones may have transitional problems stemming from decontrol which are different from those of integrated oil companies. Since independent producers are suppliers of crude oil to all domestic refiners, we are concerned with the problems of small refiners as well as the proposed solutions to those problems. Although as producers, we do not have the expertise to suggest detailed solutions, we do not want to insure that no solution to the refiner's problems creates or compounds problems for the independent producer. This is the purpose of our testimony today.

We think it is vital that the United States decrease its dependence on foreign sources of crude oil and refined petroleum products. To reach the goal of increasing domestic energy supply, we have advocated that energy prices be set in the market place in order to increase domestic production, reduce consumption, and encourage the development of alternative sources of energy. In addition, we have advocated legislative and administrative changes in the tax, environment and public lands areas which we believe will enable domestic producers to maximize domestic energy supply and thereby reduce our foreign dependence.

Concerning today's proposals I would like to make a few brief points:

We believe that many of the policy changes that IPAA advocated to increase domestic energy supplies have relevance for this hearing since the crux of the problem faced by all domestic refiners is the insufficient supply of domestically produced crude oil. For example, the so called windfall profit tax which is an excise tax on domestic crude oil, acts as a reverse tariff which subsidizes and thereby encourages imports of foreign crude oil, and discourages domestic production. This is why IPAA believes the energy security of the Nation requires repeal of the tax. Any attempt to link the crude oil tax to solving the small refiner problem would be counterproductive. It would tend to perpetuate the tax by establishing a constituency that would benefit from its continued existence. Adding the additional requirement necessary for the administration of such a program would significantly increase an already onerous regulatory burden.

To the extent that there are inefficient and obsolete refiners such linkage would eliminate any incentive for upgrading and modernizing them as they would not

have to compete for crude supplies. It would tend to make smaller producers captives of the refineries which they supply. This is because the economic consequences of selling their production to someone else would be severe due to the additional tax burden.

Small refiners frequently have potential competitive advantages over the larger integrated companies in obtaining supplies of crude oil. Because of their smaller size, they have greater flexibility and are able to respond more quickly to changing circumstances. This enables them to deal more directly with the specific problems of individual producers. They can provide what amounts to customized service for each producer. It is important for the small producers to have their crude oil physically collected from the lease at appropriate times. Also, they need to receive payment for their crude oil as quickly as possible. With larger companies this is usually very difficult if not impossible to arrange. Independents have been placed somewhat at the mercy of the refiners throughout the existence of the crude oil allocation program because of the lack of competition among crude oil purchasers. For larger producers, this is a problem of relatively insignificant proportions, but for smaller producers operating marginal properties, it can be quite significant.

If it is determined that Federal action is needed to address any perceived competitive disadvantage that domestic refiners face vis-a-vis foreign refiners IPAA suggests tax incentives rather than any type of allocation or entitlements program which disrupts and distorts the energy market.

There are several advantages to tax incentives over many other proposed solutions. It would make possible modernization and improving the efficiency of existing refineries and encourage construction of additional total refining capacity as well as refining capacity for hard to refine types of oil such as heavy and sour crudes. These incentives, however, would not in anyway be disruptive to crude oil production.

The proposal for the creation of crude oil purchasing cooperatives is another possibility far more preferable than artificial, mandated allocation or subsidy programs. Cooperatives have proved quite successful in many other instances and are very much in keeping with the spirit of initiative and private enterprise which are so important to a strong domestic petroleum industry.

Finally, IPAA believes that any contingency plans for dealing with interruptions in supplies of foreign crude oil should to the fullest extent possible rely on existing industry mechanisms and market forces. Any allocation proposal should be only at the refinery level, not at the producer level. This significantly reduces the number of entities which must be considered in designing administrative provisions and would significantly increase efficiency.

In closing, I think it appropriate to quote from the comments of a small domestic refiner in a letter to IPAA last year. This letter was specifically in response to the Department of Energy Draft Refinery Policy Study published last year. This small refiner stated, "If a company sincerely wants to prosper in the refining or any other industry, it will change and grow without specific subsidies that often have very limited benefit to fellow businessmen and consumers. Any special programs will benefit equally deserving firms to different degrees—a lesson taught by the entitlements program and the supplier-purchaser rules."

Mr. Chairman, thank you for this opportunity to express our views.

STATEMENT OF RICHARD WILCKE, PRESIDENT, COUNCIL FOR A COMPETITIVE ECONOMY, WASHINGTON, D.C.

Mr. WILCKE. Mr. Chairman, the Council for a Competitive Economy is a national membership organization of businesses and individuals from all 50 States, including businesses of all sizes and from every industry, and our common bond is a principled belief in the justice and the efficiency of a free and competitive economy.

While we certainly oppose, with other business organizations, the burdens of taxes and regulations, we also stand with consumer groups, or alone on other occasions, in opposition to subsidies, protection, or special privileges.

We have listened with extreme interest to the discussions of competition within the refining industry over the past several years, and we're firmly convinced that American consumers, were they adequately represented by those who claim to speak for them as lobbyists or as elected officials, would always be on the side of true unbiased economic competition.

That such competition does not now exist in the domestic refining industry is explained easily by a previous purposeful Government intervention at the behest of certain interests.

We believe it is not now, nor was it ever, in the interest of consumers of petroleum products to attempt to divest, subsidize, control, or manage the structure or the procedures of the various segments of the petroleum industry.

We suggest that economic distortions caused by prior interventions do not justify new distortions, and unless this fact is acknowledged, there can be no hope of ever depoliticizing our economy. We urge that current proposals be considered on their face without regard to prior action by Government.

No one can blame consumers or taxpayers for mistaken or ill-advised Government policies of the past. Arguing that Government created a problem, and should, therefore, solve it with new positive steps may please some business interests, but it cannot be said that new manipulation is in the best interests of energy consumers.

Looking then briefly at current proposals, tariffs, quotas, or fees on foreign refined petroleum products are definitely not pro-consumer. While every industry threatened by foreign competition, from steel to textiles, to the energy industry, uses a national security argument to justify protection, there is no economic justification for restricting the rights of American people to buy foreign goods.

From an economic standpoint, it makes no difference whether energy imports are in the form of crude oil or refined products. If we can create an efficient and unhampered refining industry in the United States, then the mix of imported versus domestic crude, as well as the mix of imported crude versus imported refined products, would be and could be determined by market forces.

We are not unaware of the problems of small refiners as a result of decontrol. However, no one can deny the fact that the growth in number of small refineries over the past 5 years is a direct result of a biased entitlement program.

That some of these small refineries are suddenly in a far different situation is a possibility we feel each investor group should have considered.

The question is, whether it is possible to help them without hurting consumers or taxpayers. It's hard to believe that members of this committee, or the entire Congress, are so convinced of the virtue of small refineries that they would be willing to raise the price of all refined petroleum products to their constituents.

Plus, I think while large refineries are not necessarily lobbying for stiff tariffs on refined products, they would also certainly stand to gain. In fact, they might stand to gain more because of their greater capacity and efficiencies due to scale and technology.

Policies which tend to increase concentration in American industry or policies which tend to penalize size, are opposed by our organization. There is no reason why the Federal Government should be encouraging large numbers of small refineries.

Again, we feel the number and size of domestic refineries should be based on economic factors and worldwide competition, and we would think that the country is best served when entrepreneurs are turning attention in ways to compete in real terms; not turning

your attention in ways to take advantage of a complex maze of taxes and controls.

Finally, in brief, are the general notion of tax-related solutions. Our view is that the tax code should be simplified and that tax should not be a tool of economic policy, but only a means of funding Government.

Modifying tax rules through new gimmicks won't lead to a more responsive, more consumer-oriented, or more competitive economy.

Now, I should also say that we do not consider tax credit subsidies. We think there is a significant difference between keeping more of one's own money and getting funds transferred. So, we don't oppose tax credits.

However, we are not in favor of using selected or discriminating tax credits to help or hurt certain industries.

Finally, our recommendation for tax reform is a repeal of the corporate income tax, and we have a paper on that that I, with your permission, ask be put into the record.

Senator WALLOP. By all means, it will be.

Thank you very much, Mr. Wilcke.

Mr. WILCKE. Thank you.

[The prepared statement of Mr. Wilcke and material mentioned above follow:]



TESTIMONY OF RICHARD W. WILCKE
PRESIDENT, COUNCIL FOR A COMPETITIVE ECONOMY

Before

Subcommittee on Energy and Agricultural Taxation
Committee on Finance
U.S. SENATE
March 27, 1981

Mr. Chairman and members of this Committee, thank you for the opportunity to present our perspective on this issue, namely problems facing segments of the domestic refining industry. My name is Richard W. Wilcke, president of the Council for a Competitive Economy, a national membership organization of businesses and individuals from all 50 states. Our membership includes businesses of all sizes and from practically every industry. Our common bond is a principled belief in the justice and efficiency of a free and competitive market economy. While we certainly oppose, with other business groups, the burdens of taxes and regulations on U.S. business firms, we also stand with consumer groups, or alone on many occasions, in opposition to subsidies, protection or special privileges meant as "pro-business" interventions.

We have listened with extreme interest to the ongoing discussions of competition within the refining industry. We

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have, quite frankly, been amazed at the skill with which such a good word has been used to justify intervention of the most complicated and counterproductive nature. We are firmly convinced that American consumers, were they adequately represented by those who claim to speak for them as lobbyists or as elected officials, would always be on the side of true and unbiased economic competition. That such competition does not now exist in the domestic refining industry is explained by previous, purposeful government intervention at the behest of certain business interests. It is not now, nor was it ever, in the interest of the consumers of petroleum products to attempt to divest, subsidize, control or manage the structure or the procedures of the various segments of the petroleum industry. It is unfortunate that consumers have been used by certain political and business interests as the very rationale for interventions.

While the notion of principle is treated harshly in the halls and hearing rooms of Congress, especially by lobbyists for various business groups, we would nonetheless wish to suggest that there are principles which might make this issue clear. One is that problems and economic distortions caused by prior interventions do not justify new distortions or new taxpayer subsidies as solutions. Unless this fact is acknowledged, there can be no hope of ever depoliticizing our economy. Therefore, we urge that current proposals be considered on their face without regard to prior action by

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government. Certainly, no one can blame consumers or taxpayers for mistaken or ill-advised government policies of the past. Arguing that government created a problem and should, therefore, solve it with new positive steps may please the owners and managers of small refineries, for example, but it cannot be said that new manipulation with economic forces is in the best interest of energy consumers who are best served by free and open competition.

Looking, then, at current proposals aimed at aiding domestic refiners, several observations can be made from the standpoint of consumers. One is that tariffs, quotas or fees on foreign refined petroleum products are not pro-consumer. While every industry threatened by foreign competition, from steel to textiles, uses a national-security argument to justify protection, there is certainly no economic justification for restricting the rights of American people to buy foreign goods. It makes no difference, from an economic standpoint, whether energy imports are in the form of crude oil or refined products. Give an efficient and unhampered refining industry in the U.S., the mix of imported vs domestic crude, as well as the mix of imported crude vs imported refined products, would be determined by the market. No one who truly understands economics can argue that tariffs are in the best interest of consumers, not if the arguments are honest and in good faith.

Now, this is not to suggest that we are unaware of the problems of small refiners as a result of decontrol. However, no one can deny that the growth in number of small refineries over the past five years is a direct result of a biased

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entitlement program. That these small refineries are suddenly in a far different situation is a possibility each investor group should have considered. The question is whether it is possible to help them without hurting consumers or taxpayers. It's hard to believe that members of this committee, or the entire Congress, are so convinced of the virtue of small refineries that they would be willing to raise the price of all refined petroleum products to their constituents. Plus, it should be noted that, while large refineries are not lobbying for stiff tariffs on refined products, they also would certainly stand to gain. In fact, it could be that they stand to gain even more because of their greater capacity and efficiencies due to scale and technology.

This brings up the fact that the Council is opposed to policies which tend to increase concentration in American industry, and also the policies which attempt to penalize size. The discussions of the past half-dozen years about the need for small, "mom-and-pop" refineries has sounded like populist rhetoric surrounding the virtues of small farms. There is no reason why the Federal government should be encouraging large numbers of small refineries. To the extent possible, the number and the size of domestic refineries should be based on economic factors and worldwide competition. Entrepreneurs should be turning attention to ways to compete in real terms, not, as many have done, in ways to take advantage of a complex maze of taxes and controls. Consumers aren't helped by schemes which cause more than 60 new refineries to

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be built just to take advantage of tilted laws. Neither were they helped by laws which developed an artificial refining industry in the Caribbean.

Rejecting most strongly the idea of tariffs or fees as a means of aiding domestic refineries, let me comment briefly on the general notion of tax-related solutions. The position of our organization is clearly different from that of most others, and also touches on this idea of tilting the structure.

In our view, there are a number of factors which tend to exacerbate the tendency of concentration and make it more difficult for smaller firms to compete with large ones. One, of course, is the fact that regulation invariably falls more heavily on smaller firms. This argument was a cornerstone of Lee Iacocca's when he was arguing for loan guarantees for the Chrysler Corporation. We reject the idea of aid to Chrysler, but certainly do agree that smaller firms are relatively more hampered by regulation. So all regulations tend to tilt the structure of industry toward more concentration of larger and fewer firms. Also, however, is the fact that the corporate income tax also has this effect. Small companies need their profits for growth and investment much more than do the large, heavily capitalized firms. There's no secret why larger companies are more enthused about proposals to accelerate depreciation, such as 10-5-3. Smaller companies would be better served simply by a reduction in the corporate tax rate.

The view of the Council is that the tax code should be simplified, and that taxes should be a means to fund the

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government, rather than a tool of economic policy. Modifying tax rules through new gimmicks doesn't lead to a more responsive, more consumer-oriented, or more competitive economy. We do not consider tax credits subsidies. There is a significant difference between keeping more of one's money and getting funds transferred from taxpayers. Therefore, we do not oppose them. However, we also are not in favor of using selected or discriminatory tax credits to help or hurt certain industries or certain-sized firms. We believe that depoliticization of the economy is in the best interest of all parties; large and small business, taxpayers, and consumers.

Our recommendation for tax reform is the repeal of the corporate income tax. This proposal is supported by economists from widely differing viewpoints, including both Milton Friedman and Lester Thurow. Income from the sale of stock or from stock dividends would be taxable to stockholders, including corporate executives, in a clear and above-board way. The taxable income of corporations, already in the very place needed, with no question about whether it might be invested or consumed, and already in the hands of the so-called "winners" in the economy, would give a tremendous boost to U.S. companies, including refineries. There is not sufficient time to go into details of this proposal, but it would accomplish many worthwhile reforms. Only a mistaken belief that corporations as entities pay taxes that people might otherwise pay, has kept it out of the public dialogue for so long.

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We urge this committee to take the tax and regulatory roadblocks away from the domestic refining industry. We urge that, in the interests of consumers and taxpayers, the industry not be shielded from competition nor further politicized by tax gimmicks. In addition, we urge that the government be neutral with regard to size and not grant special privileges to small refineries. There is a great deal that could be done to make up for past interventions, but new subsidies or protective devices are not justified. We urge a domestic energy industry based on free and open competition, and supply and demand. We urge it on behalf of our membership and on behalf of American consumers. Thank you.

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ISSUE ANALYSIS

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Repeal the Corporation Income Tax The Key to Tax Equity and Economic Growth

by Joe Cobb
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Emerging issues in public policy always begin with someone daring to speak the truth and advocate some politically unrealistic proposal--which starts to move political realities, inch by inch, closer to that solution. With the election of Ronald Reagan, and the ideas he brings to his office, we have seen what was "politically unrealistic" one day can become public policy the next. Indeed, the label "politically unrealistic" is often merely an excuse timid politicians use to evade thinking or speaking the truth about economic problems.

There is a perverse tendency in economics to look for the "second best" solution to problems, because the best solution is believed to be politically impossible. Yet, the economists who offer such second-best solutions never explain how they believe they obtained their expertise in politics. In reality, there are only "best" or correct solutions and a long list of worse proposals that defy any preference ranking. In his excellent book, Politically Impossible . . .?, Professor W. H. Hutt has demonstrated how damaging a reigning orthodoxy can be when it loses the ability to distinguish intellectually between truth and error--due to the economists' desire to be politically fashionable. His case in point is the Keynesian movement.¹

The productivity of U.S. labor has fallen rapidly in recent years, both in terms of international competition and our own historical record. Economists agree that the key to this problem is the rate of capital formation; that something must be done to increase the rate of savings by the general public. Real capital can only come from real savings, not from credit expansion through monetary policy. Real savings,

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moreover, can only be increased by changing the relative prices of savings vs. consumption expenditures. When we look at the present tax structure in the United States, it is clear that there is a heavy tax penalty of savings. If this penalty can be removed, the relative prices of consumption vs. savings will be restored to levels that the free market can best determine.

It seems that President Reagan understands the importance of tax neutrality. In his address to the joint session of Congress February 18, 1981, on his Program for Economic Recovery, he said:

For too long now, we've removed from our people the decision on how to dispose of what they created. We have strayed from first principles. We must alter our course.

The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change. We've tried that and surely we must be able to see it doesn't work.²

The Undersecretary of Treasury for Tax Policy, Norman B. Ture, has further explained the implications of this new economic philosophy as follows:

Corporate earnings would not face a separate tax. Instead, they would be taxed to the shareholders. The corporation would deduct all investment in plant and equipment in the year it incurred the cost for these facilities; accordingly, there would be no depreciation allowances with their complicated rules and accounting problems. Retained earnings would be counted as saving too. Dividends or other capital returns not reinvested or saved by individuals would be taxable to them...

The elimination of the corporation income tax, of the taxation of capital gains, and of depreciation would greatly simplify the tax structure as well as reducing the bias against saving....³

The tax-reduction proposals that the President has sent to Congress, however, do not include the repeal of the corporation income tax. The accelerated depreciation proposals for business are a cautious, halfway measure, due it seems to the administration's fears about ideas that may not be "politically possible." Indeed, when the idea of repeal is mentioned to individual Congressmen or their staff assistants in charge of economics and tax policy, the reply is: "That's politically unrealistic." So long as this remains the catechism in tax policy debates, the President's objective of tax neutrality will not be achieved.

A major part of the problem is the anthropomorphic fallacy in the minds of so many of our fellow citizens. When the news

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broadcasters report that a large corporation's profits in the previous quarter were \$100 million, how many viewers absorb this information in personal terms, comparing it to their own meager biweekly after-tax wages? This fallacious frame-of-reference is reinforced by the legal doctrine that corporations are "entities."

WHAT IS A CORPORATION?

In U.S. law, the "entity" doctrine was first stated by Chief Justice John Marshall in 1819: "[The] corporation is an artificial being, invisible, intangible, and existing only in contemplation of law."⁴ The origins of this doctrine can be found in British history, when corporations were created by the king to exercise various trade monopolies. In modern capitalism, however, individuals can form corporations as easily as they can form partnerships, and there are no special privileges that confer any economic advantage that is not also available to anyone else.

The legal doctrine that a corporation is a separate entity, apart from the human beings who own, operate, or work for it, is a convenience for those who might want to sue it for damages in court--because they don't have to list all of its shareholders by name on the legal papers. Robert Hessen has argued:

Every organization, regardless of its legal form or features, consists only of individuals. A group or association is only a concept, a mental construct, used to classify different types of relationships between individuals. Whether the relationship is a marriage, a partnership, a team, a crowd, a choir, a corps de ballet, or a corporation, one fact remains constant: the concept denotes the relationship between individuals and has no referent apart from it. In a marriage, for example, there are two individuals whose relationship is designated by the concepts of husband and wife. There is no need to posit or invent an artificial entity to represent "the marriage" or to account for the fact that, in the eyes of the law, the husband and wife are regarded as a unit for some purposes (community property, for example).⁵

This idea that we get from accountants, therefore, that a corporation has an annual income, which may be a proper basis for the income tax, is just an extension of the legal doctrine that the corporation is an "entity." Yet, in economic terms, why should the working capital of a corporation be treated any differently from the cash flows of a partnership? Would it make any sense, or reflect a social concern for equity, to tax the combined earnings of a husband and wife as joint-income to "the marriage" and then tax again the individual spendings of the husband or the wife as personal income? This is precisely what

the U.S. tax code does to corporations.

President Reagan seems to understand this issue, which is a giant step toward making the repeal of the corporation income tax "politically realistic." He declared in his February 5, 1981, televised address to the nation that "business doesn't pay taxes... Only people pay taxes--all the taxes. Government first uses business in a kind of sneaky way to help collect the taxes." Indeed, the only justification for collecting the tax revenue from stockholders at their corporate treasurer's office is because corporations have to keep accurate books for financial and cost accounting--the tax auditor has an easier job. Those employees who remit the revenue have no personal stake whatsoever in cheating because it is not their own money. Politicians believe that this is a hidden tax, one that no one will object to because they won't ever see the money disappear.

Yet the politicians are wrong: the corporation income tax is a very obvious and serious tax for investors. They may not sign the tax forms, but they understand the reduced equity yields.

RELATIVE PRICES IN THE CAPITAL MARKETS

This easy-to-collect, sneaky tax is the most damaging tax in the U.S. tax code. It has been estimated that the cost to the economy of having capital in less than its most productive locale because of the tax differentials is approximately \$300 billion⁶ (1980 dollars). The tax revenues are supposed to be \$65 billion dollars in fiscal year 1981. This implies that if the tax were immediately repealed, the federal government would not lose a cent. It receives about 22 percent of the GNP these days.

The corporation income tax distorts the allocation of capital by imposing a particular burden on certain investments, making them less attractive relative to others that are not taxed. For example, if a corporation can earn \$20 per year on \$100 of capital, but only \$10.80 is left after taxes to the investor, he might well choose to put the \$100 in a money-market fund and earn as little as \$10.81 from some less-important use of the capital.

Because the U.S. tax code is a byzantine maze of different tax rates on different kinds of investments, we observe a plethora of tax-schemes and a vast array of job opportunities for tax lawyers and financial whiz-kids. Their earnings are even included in the gross national product but we must observe they do not, in truth, make our nation wealthier in any way. Although it is all legal and honest work, the impact is the same as those who cheat on welfare payments; the tax code just creates opportunities to redistribute wealth without producing anything except the ingenuity to figure out how to get their clients a larger share of the pie.

All of modern, scientific economics is grounded on the concept of subjective marginal utility and opportunity costs.⁷ Individuals

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allocate their scarce resources, their time, and their labor on the basis of what they expect to get in return for whatever they have to give up. For the free market to be effective, moreover, it is not important for everyone to be rational in his behavior, since market prices are determined at the margin--by a relatively small number of consumers or investors.

The prices that are revealed in the market by the process of experimentation and discovery are the information signals that businessmen use to calculate the optimal amounts of capital and labor, the kinds of capital investment they will make--and the duration. This information system is necessarily and essentially decentralized; it has been proven that government planning cannot simulate nor outguess it.⁹ The price signals that people rely upon, however, can be distorted by tax policy because the after-tax amounts are what affect everyone's choices.

Members of Congress have questioned the Reagan administration's claim that most of the taxpayers' benefits from the Kemp-Roth plan would flow into savings and investment. While we agree with President Reagan that there are strong reasons to believe the major impact would be to increase savings and the available capital for business, the same Congressmen who doubt the President are the ones most likely to oppose repeal of the corporation income tax.

The \$65 billion that the U.S. Treasury will collect from corporations in fiscal year 1981 is already in the very place that these Congressmen would like to see the money go. It exists as the working capital of the corporations. The liquid capital of a business is like gasoline in a car. It has to be maintained at a certain level to accomplish various goals. The corporation income tax is like a steady leak in the gas tank, taking fuel away from the engine of our economy so that we can't achieve the business-growth rates we want. In a period of inflation, the method of calculating the net income of a business is distorted as well, since the cost-of-goods-sold that is deducted from gross revenues to compute the profit is understated: the historical cost-of-goods-sold is less than the business has to spend to replace the inventory to stay in business. The tax eats up phantom profits.

The financial policies of corporations are also distorted by the income tax, since it is relatively cheaper to borrow funds than to raise capital in the equity markets. U.S. corporations are far deeper in debt than they would otherwise be if there were not a tax-incentive to borrow capital. A heavily leveraged corporation is a more fragile business, more likely to face bankruptcy in hard times. It is possible that the Chrysler Corporation would not be in the trouble it is in, with the political pressures to bail out its bankers and bondholders, if the corporation income tax had not been skewing its financial policy since 1909. Would there be pressure from the auto and steel industries for protection from international competition were it not so dangerous to run a temporary loss?

The size of the federal deficit is of great concern to the people on Wall Street because they fear that whatever capital is available in the market will be scooped up by the Treasury bills and government bonds, driving up interest rates. High domestic interest rates are credited with strengthening the U.S. dollar, since Arab sheiks and European money-market managers can get a higher rate of return by sending liquid capital to the New York markets.

Yet, one immediate effect of repealing the corporation income tax would be approximately to double the value of shares in U.S. corporations. The price of a stock is determined by its yield, or its expected future yield. Since the yield is sliced dramatically by the corporation income tax, the removal of this tax will make equity investments much more attractive. Foreign investors would be strongly motivated to invest in the United States equity markets. The attraction of foreign capital could eradicate the perceived capital shortage in one sudden sweep--even if the federal deficit increased.

Members of Congress who are under populist pressure from constituents to vote for lower interest rates should observe that an influx of foreign capital to the United States in response to higher equity yields would relieve all of the pressure on the supply of lendable funds. Since the purchase of stocks on Wall Street would require also the purchase of U.S. dollars with which to make the transactions, the dollar would become very much stronger internationally and this would have a powerful impact on domestic prices. OPEC oil could even become cheaper, in relative-price terms!

WORKERS ARE HURT MOST BY TAXING CORPORATION INCOME

The principal objection by members of Congress to the Reagan tax-cut proposals is based on an appeal to "social justice" or "vertical equity"--the idea that taxes should fall more heavily on the income of the rich than of the poor. The Reagan proposals, however, by cutting tax rates equally across-the-board allow those who earn more--and would thus be liable to pay more without the cuts--to keep more of the fruits of their labor. The "social justice" objection confuses some basic concepts in taxation: rates vs. amounts due.

The corporation income tax, however, is a far heavier tax on the savings of the poor than on the savings of the wealthy. If an individual's marginal tax rate is more than 46 percent, it is in his self-interest for the corporation in which he owns stock to cut dividend payments and reinvest the funds--perhaps by becoming a conglomerate and buying another company that may have some "loss carry-over" credits that could be used to reduce the corporation income tax even further. One's personal tax rates might be as high as 70 percent on dividends, but if the corporation's reinvestment program is adequately managed, it is

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preferable for the company to grow and diversify so that only a long-term capital gain would be due when the stock is sold--at a maximum rate of 28 percent.

On the other hand, most working people rely upon a company or union pension fund as their main vehicle for savings toward retirement. Pension funds are heavy investors in corporate stock. Instead of accumulating wealth for the worker's retirement at a rate that would be determined by the productivity of the corporation, the income tax reduces this growth by removing 46 percent of the pension fund's accumulation before dividends are paid. The growth in market value of its investments is correspondingly reduced, so even if the pension fund seeks long-term growth rather than dividends, the penalty works against the poor. Since the pension fund would not otherwise pay a tax on its earnings, the corporation income tax is perhaps the worst tax in terms of "social justice." Peter Drucker, in his book The Unseen Revolution, writes:

The corporation income tax has thus become a highly regressive tax, and one that is paid increasingly by the employees, especially those least able to afford a high rate of taxation--older retired workers. It is in effect a tax to 'soak the poor.' Yet any proposal to reduce the corporation income tax, or to allow the individual taxpayer to offset it in his tax return, is immediately shouted down as a 'giveaway to the rich' by the labor unions, [i.e., by] the representatives of the people who are most penalized. Actually, nothing would so effectively promote greater equality of income as to eliminate the corporation income tax, or at least that part of it which is levied on the holdings of the corporate pension funds. This would give the lowest income group in the adult population, the retired older people, substantially more purchasing power without inflationary impact. 10

To the extent that some employees of a corporation participate in an employee stock-ownership plan, or buy shares (because they want to invest in the productive organization with which they may be most familiar), the regressive impact of the tax on their ability to accumulate wealth is worsened. Yet in rational terms, Congress might well prefer to see workers support their own companies, as do the Japanese workers, rather than buy silver coins or take some of the other tax-shelter opportunities open to small savers.

The question of who pays the corporation income tax in the long-run, after all the relative-price impacts of the tax on stockholders' investment choices have passed throughout the system, is an open question to many economists. The earliest

empirical studies of the shifting of the corporate tax burden were performed by Professor Arnold Harberger.¹¹ He argues, as we have, that stockholders pay in the short-run, but in the long-run there is a reduction in economic efficiency. The productivity of labor is therefore reduced. The reason that economists debate the true incidence of the tax burden is that it is almost impossible to measure: Who pays a higher cost for economic inefficiency and lost worker productivity--the workers by missing out on wage increases or consumers by paying higher prices? All economists agree, however, that some of the tax is paid by consumers and some of it by employees of the corporations.

We can appreciate the intuitive idea that if workers are hurt by the corporation income tax in the long run, then it is regressive. The way it hurts workers requires a brief digression to see why wages rise.

All economists, except those employed by labor unions, understand that real wages are paid at a rate determined by the marginal productivity of labor. As workers are supplied modern capital-intensive tools and production processes, they become more productive. Ludwig von Mises, in an excellent essay, "Capital Supply and American Prosperity,"¹² asks why workers in America are so much better paid than workers in India, and shows how capital investment in America has made the difference. Wages are bid up by employers who have more capital year-after-year and need to recruit more workers to put it to use. Competition in the labor market assures workers that their wages will rise as capital formation advances, and workers become relatively scarce and more productive. This process is often obscured, not only by labor union propaganda and false reporting about the Industrial Revolution by historians,¹³ but also because unemployment occurs in particular segments of society, or in depressed geographical regions, leading workers to believe they are competing against each other for jobs rather than that employers are competing for good workers.

The corporation income tax, by reducing the rate of capital formation in the business sector, reduces the need for employers to bid against each other to keep their best workers. The long-term upward pressure on real wage rates slows down. To make matters worse, employers in recent years have offered increased compensation in the form of pension benefits instead of direct wages. For the individual worker, this is a shelter from the personal income tax for his savings, but as we have seen, the pension funds' long-run value for his retirement is caught by the perverse impact of the corporation income tax.

THE TAX HURTS SMALL MORE THAN LARGE FIRMS

At first glance, repeal of the corporation income tax might look like a benefit to big business because the absolute dollar amounts might be larger. Yet there is considerable evidence that

small businessmen are hurt much more by the tax. Milton Friedman has pointed out that the ability of corporations to reinvest funds internally, and create a tax advantage for wealthier stockholders, encourages inefficient reinvestment and promotes the concentration of industry. Even though stockholders could take their dividends and invest in a diversified portfolio themselves, it is to their advantage to have the corporate management do this for them under present tax laws.¹⁴ Roger Sherman has argued that industrial concentration and the trend toward conglomerate firms are further stimulated because such firms can shift their internally-generated funds from division to division, where the greatest productive opportunities may lie, thus enhancing the value of their stock; and by such diversification, they can also attract borrowed funds at a lower interest rate by reducing the risk of bankruptcy.

Every small businessman, moreover, has experienced that unpleasant moment at the bank when the banker agrees to finance less than the full amount of his loan request because his after-tax earnings are too small. The ability of a business to borrow funds is directly related to its cash flow--and this is especially the case for the small businessman with fewer assets and perhaps a shorter track-record for the banker to evaluate.

A smaller business may well be a faster-growing one, with a much higher rate of return on its investments than a larger, established firm. Small business accounts for over 55 percent of all non-agricultural employment and 45 percent of GNP in the United States. It also produces over 50 percent of all new inventions, innovations, and patents. In the last ten years, 69 percent of all new jobs were created by firms with less than 100 employees, many located in the centers of large cities.¹⁶ Yet, if access-to-capital is viewed as a "social justice" issue, the corporation income tax takes it away from the very entrepreneurs who might make the best use of it. Certainly the larger corporations, with established market shares and recognized brand names, are less likely to be hurt by a tax that takes money equally from the small and large business, as this tax does above \$100,000 in income.

POLITICAL DISHONESTY

No discussion of the inequity of the corporation income tax would be complete without a brief discussion of why it is a popular tax among politicians and labor leaders. It is in the interest of some politicians for the rest of us to believe that it is "politically unrealistic" to discuss its repeal.

Sadly, they believe the employees and the poor are too stupid or naive to realize that they are its real victims. It is easy for a politician to rail against the rich corporations, especially when inflation--and the public's misunderstanding of the causes of inflation--make business such a handy scapegoat. "Tax the giant corporations!" they shout. Yet, no friend of the

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working class or the poor who is intellectually honest can support such a policy.

Much to his credit, Lester C. Thurow of MIT has strongly advocated the repeal of the corporation income tax--as a policy for helping the poor. Professor Thurow is widely known as an economist identified with government policies to benefit the socially disadvantaged. The Council has reprinted the relevant sections of his book, The Zero-Sum Society, in its Perspectives on Public Policy series. In his view,

When you review the arguments, there isn't any case for the retention of the corporate income tax. It is both unfair and inefficient. It ought to be eliminated.¹⁷

With such diverse agreement on the issue, it hardly seems possible that repeal of the corporation income tax could be "politically unrealistic." The Council for a Competitive Economy believes that its repeal ought to be among Congress's top priorities as it debates President Reagan's tax-cut proposals. Certainly if the Congressional Democrats want to amend the Kemp-Roth plan in the direction of tax cuts on business, they should not be timid.

Why waste effort to puncture the corporation income tax like a slice of swiss cheese when it would be so much better to abolish it?

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Senator WALLOP. Thank you all, gentlemen.

Senator Durenberger, do you have a question?

Senator DURENBERGER. Yes, Mr. Chairman.

Mr. Van Arsdall certainly represents a number of the concerns of the refiners we have in our State. I was struck by Mr. Wilcke's first principle in his testimony, which is one that is hard to argue with.

The first principle is that problems and economic distortions caused by prior interventions do not justify new distortions or new taxpayer subsidies as solutions.

My question to you relates to your testimony on standby allocations. I read the NCFRC paper on standby allocation, and I'm wondering if you could summarize for us, briefly, the kind of allocation program that you have in mind. I'm concerned being whether or not it's simply the old buy-sell program that we had before decontrol.

Mr. VAN ARSDALL. Well, to start with, I would like to reiterate that we are owned by the consumers of our product. Thus, we do represent consumers of one special kind, and that's the American farmer.

Senator DURENBERGER. I should have made that point for you.

Mr. VAN ARSDALL. We're not asking for a subsidy or a free ride. We have efficient refiners and an efficient system that can serve farmers' needs in a truly competitive market.

Again, I emphasize that a decontrolled market does not necessarily equate to a free market. To state the extreme, a monopoly could exist. Significant barriers exist today which preclude a timely free market.

In terms of the program that we are advocating, there are a number of ways to get there. We are anxious to see the debate proceed forward in the appropriate committees. We are looking at a program in which the basic objective is to make sure that timely access to crude oil at competitive prices is available to efficient domestic refiners. To the extent that a competitive marketplace functions normally, there is no need for any program to be in operation.

We are looking at some sort of standby mechanism which would have some clear triggers in and out, and provide that timely access. In terms of just what those triggers are, I think that we have some specific views that we would like to share with the Members of Congress as the debate goes forward. You will be hearing from a number of parties, and I am sure that at that time you will want to make up your own mind, after evaluating the different views.

Obviously, we don't want to be without crude oil, as our farmers would be without product. And we don't want to see them paying disproportionately more for their fuel.

Senator DURENBERGER. Thank you for the response. I think we'll all look forward to those more specific recommendations.

I have a question that is partly on the point that was raised by Gary Petersen. You know where I come from, geographically. You know our concerns for access to Alaskan crude, and you are aware, I am sure, of the proposals for trying to move crude from west to east in this country. I'm trying to read the parts of your statement that refer to refinery expansion along the west coast and figure out what the position of the independent refining industry along the west coast relative to Midwest access to crude or refined products.

Mr. PETERSEN. Well, we're sitting in a location where we're watching ships go by, setting down and going through the canals to the gulf, because the major producers on the North Slope will not sell the crude. Last year they would not sell at all. This year they will only sell it on short term contracts because of what they consider apparently as a short term glut.

I think the northern tier pipeline would be valuable to your refiners if they were looking at foreign crude. I don't know how they are going to buy crude from the producers if people on the west coast can't buy it.

Senator DURENBERGER. Well, I see your point, yes. Yours is a problem of access?

Mr. PETERSEN. Ours is a problem of access.

Senator DURENBERGER. Not a problem of price or anything else, but of access?

Mr. PETERSEN. Well, as far as the North Slope goes, it's not a problem of price. If we could have, you know, the guarantees that would be there when we expanded—when I say expanded, I'm talking about retrofitting the refinery to more efficiently convert the North Slope—but we have no guarantee.

Like I say, we can get a 3-month contract and we're not going to invest \$90 million on a 3-month contract. Our banks aren't going to let us do that.

This is a problem of crude access. If that pipeline is built, it's going to have a problem of crude access if they intend to put the North Slope in it, because your refineries out there, with the exception of one, I believe, are all independents. I don't know any reason why any of the majors producing on the North Slope would prefer to sell to somebody in Minnesota than they would to somebody in Tacoma, Wash.

Senator DURENBERGER. Well, one reason that somebody who is producing in Alaska would prefer Washington to Minnesota is the cost of delivering it to the refinery, and that is, of course, where

refiners on the west coast have an advantage over refiners in the Midwest.

Mr. PETERSEN. That's correct, and you can see the net backs to Valdez when you look at the crude delivered to the gulf. Simultaneously, you would have the same problem on a pipeline.

Senator DURENBERGER. Thank you very much.

Senator WALLOP. I would like to ask Mr. Van Arsdall or any of the advocates of access and competitive prices, who or what mechanism would you put in place to provide that access and the competitive price, and who would determine what access was adequate and what price was competitive, without a major Government intrusion?

Mr. VAN ARSDALL. I think that when you examine past history, one can readily agree with a number of people who have said that the minimum Government intervention opportunity lies at the crude oil end of the petroleum system. When there are disruptions, they tend to be regional and they tend to fall upon sectors differentially. They are not shared equally across the refining system.

We have all experienced the attempts to deal with such shortages at the product end, particularly out in rural areas, in the northern tier States, for example. We found that trying to allocate a gallon of diesel fuel to a farmer in the midst of spring planting when there is no product out there is a bit difficult to implement. These product shortages develop because the refineries that serve rural areas do not have access to crude oil.

So, we hope that by approaching it from the crude oil end, you can minimize Government intervention and never get to the crisis situation that faces us when shortages develop at the product end.

Senator WALLOP. Well, as an aside, that's obviously a question more for the Energy Committee than the Finance Committee. It concerns me because somebody, somewhere along the line is going to have to say, "That's a competitive price and that is sufficient or insufficient access." Some entity is going to have to make a judgment, then we'll get back to the whole business of distortion and I don't know how to solve that. I was hoping there was some Solomon amongst you who could advise the Senate.

Mr. BODE. Mr. Chairman, I believe there is a mechanism which could let the marketplace make those determinations. The Independent Petroleum Association of America, I understand, is supporting legislation which would exempt from the windfall profits tax the first 1,000 barrels per day of independent crude production.

If that exemption could be conditioned upon sales by independent crude producers to independent and small refiners, there would be an established mechanism that would not require Government bureaucracy or Government decisions regarding supply and demand. Rather, the independent crude production, which now is unavailable to independent small refiners, would be available.

If such legislation were adopted and limited—because we don't support the continuation of the windfall profits tax; rather, we think the tax should be lifted when the statutory objective of \$227 billion is obtained—we would build, I think, a very viable and competitive independent sector. We would assure that the independent crude producers receive the revenues that they so desperately need to enhance their production activities, and on the other

hand, we could assure that small and independent refiners would obtain a viable source of domestic crude oil to sustain their operations.

Senator WALLOP. As I read and listened to Mr. Vinson's statement, it would be my understanding that you do not endorse that concept.

Mr. VINSON. We, unequivocally and vehemently oppose that proposition.

Senator WALLOP. I gathered that when it was going on. [Laughter.]

I just want to make an aside here because it is a matter of some fascination. I hope that some in the press and some in the audience would be able to see from this discussion that there is no conspiracy in the energy industry in America. You cannot get them to agree what time to leave the room. [Laughter.]

The interests, as displayed here, are so varied, that there is no level at which it meshes enough to control this economy, and I think refiners and producers alike and this panel would agree on that if they didn't agree on any of the other roads to travel that might be imposed.

Mr. STEENBERG. Our tax credit proposal, I think, has some real benefits in the terms of the question that you asked, because it requires none of the answers that you are seeking.

Our tax credit proposal is voluntary in terms of using it by those who are selling and those who are buying and, therefore, requires no mandate, no regulation, no system, no bureaucracy, and the price at which the crude oil moves from seller to buyer is a negotiated price motivated by an incentive to bring home a tax credit.

But, what is the competitive price is determined by the parties who are dealing, and so no one has to determine, by computer model or regulation or formula or system, what is a competitive price.

If I go out into the marketplace and attempt to use this mechanism to buy crude, and I negotiate a price, and I can't compete on that price, I'm not going to buy it or I'm very silly.

So, I think our proposal for a tax credit system avoids all the complications that the previous regulatory programs had.

Senator WALLOP. Mr. Wilcke, let me just ask you this: It's my understanding that your organization contains a few small refinery members. Would it be your opinion that they would endorse your comments today?

Mr. WILCKE. Well, our organization is sort of a collection of Mavericks, Mr. Chairman, from all industries. On almost every issue, in almost every industry, there are a few people who don't agree with the consensus. So, I would say yes, our organization is supported by a few who would endorse it, but I don't think—they speak for themselves and they speak for our organization; they don't speak for their industry.

Senator WALLOP. Senator Durenberger, do you have any further questions?

Senator DURENBERGER. No further questions.

Senator WALLOP. Gentlemen, thank you. There may be a question or two that we would like to submit to you, but I appreciate your taking the time to come here and I also very much appreciate

your abiding by the clock. I realize how far it is, but I also realize that others have come as far.

Thank you.

**STATEMENT OF JOHN VENNERS, MANAGING DIRECTOR,
INTERDEPENDENT CRUDE & REFINING, WASHINGTON, D.C.**

Mr. VENNERS. Thank you, Mr. Chairman.

My name is John Venners. I'm managing director of Interdependent Crude & Refining, a joint venture of five established U.S. refiners to acquire foreign crude oil directly from the oil-producing countries.

With a refining capacity of nearly 200,000 barrels per day, the ability to process a full slate of products and individually strong corporate financial positions, our group can effectively compete in the world oil market under proper circumstances.

IC&R will continue to take the lead in recognizing our growing interdependence by implementing new concepts and programs in the oil-producing countries.

It is important that we take a look at the drastic structural changes that have taken place in the world oil market during the last few years. When OPEC was founded 20 years ago, the eight largest international oil companies controlled nearly 98 percent of all OPEC oil produced.

In addition to serving their own needs, the majors were in a position to market large surplus volumes to their third-party customers, many of whom were independent refiners throughout the United States.

Today, more than 50 percent of OPEC's production is controlled and marketed directly through the OPEC national oil companies. Most of this transformation has taken place in the last few years, and OPEC's control of oil is increasing steadily.

As a result, independents have been forced into the volatile spot market and government allocation programs which have recently been terminated.

We believe the best way to achieve price and supply ability in the world market today is to align the responsible independent refiners directly with the oil-producing countries.

As relatively new entrants to the world oil market, independents face numerous difficulties and obstacles which must be confronted head on in order to be successful in meeting our future needs.

A free market for world crude oil in the pure economic sense does not exist. As a highly politicized commodity, crude oil is no way divorced from political considerations.

As independents, we welcome the challenge to compete in the world oil market, but we must have the opportunity to gain direct access to the politicized commodity on a competitive basis.

The energy policy of this Government should provide the diplomatic initiatives which encourage producing countries to make available all crude being marketed by national oil companies to all responsible refiners on a nondiscriminatory basis.

First, our Government officials must convince the producing countries that a strong, viable independent sector is vital to our economy and national security.

Second, Congress and the administration must make it clear that we will not subsidize inefficiencies or allocate supplies under non-emergency conditions as we have in the past.

Third, it must be understood that our Government has no intentions of forming a Federal oil purchasing agency to enter into government-to-government contracts with the producing countries. In lieu of a purchasing agency, our Government policymakers should explore ways in which our refiners could be placed on a similar favored or preferential basis as foreign national oil companies are today.

To deny needed volumes to U.S. refiners on the grounds that we do not have a national oil company should be considered an unfriendly act against this country.

In addition to the diplomatic initiatives, I would like to suggest that Congress consider the following suggestions:

One, explore the possibility of guaranteeing crude oil payments to the producing countries through the Export-Import Bank. Under such a concept, individual refiners could post acceptable letters of credit from their commercial banks to the Export-Import Bank guaranteeing credit; therefore, removing any risk or exposure to the bank. This would help individuals and independent buying groups in their negotiations, since they would post only one letter of credit, backed by the Government, instead of several individual letters of credit from different banks.

This would be another signal to the producing country that our Government not only sanctions the individual joint efforts of our refiners, but is also willing to back them up.

In addition, we would like to suggest that any of the volumes that we would have guaranteed through the Export-Import Bank could possibly flow directly to the Strategic Petroleum Reserve during low demand and surplus supply periods.

Mr. VENNERS. The independent refining sector must act in a responsible manner to be worthy of our Government's support and to be considered viable customers by the oil-producing countries.

Past subsidies and allocation programs have provided an artificial shield over the oil industry. To say that the only way we can survive in the future is through continued Government subsidies suggest that we have lost our original competitive spirit. Some may suggest it is impossible for independents to compete effectively in the historically major-dominated world oil market. We disagree. We must and will succeed.

To blame OPEC, or the majors, for the current distortions in the marketplace only diverts attentions and efforts required to adapt to the changing circumstances.

Our Government can play a vital role in providing the proper atmosphere which will enable us to be on an equal footing with the majors and other purchasing nations in order to meet the future petroleum needs of our country.

Thank you.

Senator WALLOP. Thank you, Mr. Venners.

[Statement follows:]



Interdependent
Crude &
Refining

TESTIMONY OF
JOHN P. VENNERS
MANAGING DIRECTOR
INTERDEPENDENT CRUDE AND REFINING
Before the
Subcommittee of Energy and Agricultural Taxation
Senate Committee and Finance
March 27, 1981

SUMMARY OF STATEMENTIntroduction

Interdependent Crude and Refining is a joint venture of five established U.S. independent oil refiners to acquire foreign crude directly from the oil producing countries. We have pooled our resources and strengths to implement new marketing concepts enabling us to compete effectively in the restructured world oil market.

Restructured World Oil Market

It is important to look at the world oil market, as it is today, and then examine ways that government and industry can adapt to the changing circumstances. Until recently, the major oil companies controlled most of the OPEC production and were in a position to sell surplus volumes to the independents. As the OPEC National Oil Companies assumed control, as well as the marketing aspects, of their oil the majors terminated most of their third party sales. We believe the best way to achieve price and supply stability in the volatile world market is to assist the independents with their crude access problems by aligning the responsible refiners directly with the oil producing countries on a similar competitive basis as other purchasers.

A free market for world crude oil in the pure economic sense does not exist. Therefore, we must examine ways that government can play a constructive role in assisting new entrants in the world market to gain fair access to this highly politicized commodity.

Recommended Diplomatic Initiatives

1. Convince the producing countries that a strong viable independent sector is vital to our economy and national security.
2. Make it clear that subsidies and allocation programs during non-emergency times are a thing of the past.
3. Assure the world that the U.S. has no intentions of establishing a federal oil purchasing agency just to enter into country-to-country deals. Denying available volumes to qualified U.S. refiners on the grounds that we do not have a national purchasing agency should be considered a discriminating and unfriendly act against this country.

Bank Guarantees, SPR Fill Option and Anti-trust

1. Explore feasibility of guaranteeing crude oil payments through the Export-Import Bank. The guarantees would be backed up by each refiner's commercial bank to remove any risk to the Ex-Im Bank. Federal guarantees would not cost our government anything and would assist independents in their negotiations with the producing countries.
2. Any refiners, utilizing the Ex-Im Bank guarantee could give the government first option on all or part of their contracted volumes, at their official cost, for the Strategic Petroleum Reserve during surplus and low demand periods. This would assist the government in acquiring volumes at official prices without tampering with the delicate spot market. It would also afford the independents the flexibility required to maintain contracted volumes during these times of surplus.
3. Provide for any exemption in the anti-trust laws deemed necessary for groups of refiners to compete effectively in the world market.

Conclusion

We, as responsible refiners, must and will compete in the restructured world oil market given the proper atmosphere and circumstances. Government has a vital role to play to put us on an equal footing with other purchasers in the highly politicized world oil market. Instead of subsidies, we seek cooperation and understanding in recognizing our mutual goals during this transitional period.

STATEMENT

Mr. Chairman, distinguished Members of the Subcommittee, let me begin by expressing my appreciation for giving us an opportunity to share views on the rapidly changing world oil market and possible ways to make adjustments so that our refining industry can continue to meet our country's petroleum needs. My name is John Venners and I am Managing Director of Interdependent Crude and Refining (IC&R), a joint venture of five established U.S. independent refiners. Our goal is to acquire foreign crude oil directly from the oil producing countries. IC&R was originally founded in February, 1980, by Rock Island Refining Corporation of Indiana and Farmers Union Central Exchange, Inc. of Minnesota. IC&R has since expanded to include Marion Corporation of Alabama, Pester Refining Company of Iowa, and Southern Union Refining Company of New Mexico. With a combined refining capacity of nearly 200,000 b/d, the ability to process a full slate of products, and individually strong corporate financial positions, our group can compete effectively in the world oil market under proper circumstances.

We feel strongly that the recognition of our growing mutual interdependence with the oil producing countries is essential to building a foundation for long-term working relationships. IC&R will continue to take the lead in this area by implementing new concepts and programs to further that recognition.

Before we can examine ways to assist the responsible independent refiners in their world-wide efforts, it is important that we take a look at the drastic structural changes which have taken place in the world oil market during the past few years. When OPEC was founded twenty years ago, the eight largest international oil companies controlled nearly 98% of all OPEC oil produced. In addition to serving their own needs, the majors were in a position

to market large surplus volumes to their third party customers, many of whom were independent refiners throughout the United States. However, today more than 50% of OPEC's production is controlled and marketed directly through the OPEC National Oil Companies (NOCs). Most of this transformation has taken place in the last few years, and OPEC's control of its oil is increasing steadily. Thus, most of the crude oil which was once available to the independents through the majors is no longer available. As a result, in order for the independents to acquire their needed crude oil, they have been forced into the volatile spot market and to government allocation programs which have recently been terminated. We believe the best way to achieve price and supply stability in the world oil market today is to align the responsible independent refiners directly with the oil producing countries. If the volumes, once marketed by the majors, flowed directly to the responsible independents on an equitable and competitive basis, we would eliminate the need for many of the traders and brokers who are currently speculating on the crude oil rather than refining it. Rather than a continued state of confusion and misunderstanding, the restructured oil market can actually provide new opportunities for the developing oil producing countries and the independent refiners by working together on a direct basis.

As relatively new entrants in the world oil market, independents face numerous difficulties and obstacles which must be confronted head-on in order to be successful in meeting our future needs. A free market for world crude oil in the pure economic sense does not exist. As a highly politicized commodity, crude oil is in no way divorced from political consideration. As independents, we welcome the challenge to compete in the world market, but we must have

the opportunity to gain direct access to this politicized commodity on a competitive basis.

Our government can play a vital and constructive role in enabling U.S. refiners to compete effectively in the world markets. The energy policy of our government should provide for diplomatic initiatives which encourage producing countries to make available all crude being marketed by national oil companies to all responsible end-user refiners on a non-discriminatory basis. First, our government officials must convince the producing countries that a strong, viable independent sector is vital to our economy and national security. Secondly, Congress and the administration must make it clear that we will not subsidize inefficiencies or allocate crude supplies under non-emergency conditions as we have in the past. Further, it must be understood that our government has no intentions of forming a federal oil purchasing agency to enter into government-to-government contracts with the producing countries. In lieu of a purchasing agency, our government policy makers should explore ways in which our refiners could be placed on a similar "favored" or "preferential" basis as foreign National Oil purchasing entities' Companies are today. We have found that some producing countries refused to negotiate possible crude contracts with us because their government policies limited new crude sales to government-to-government arrangements. A federal oil purchasing agency may work for some countries who have only a few government controlled refineries. However, it would be impractical, unworkable, and counter productive to establish such an agency in the U.S. where we have almost 300 individual refineries with 18 million barrels per day of capacity. As such, to deny needed volumes to U.S. refiners on the grounds that we do not have a national

oil company should be considered a discriminatory and unfriendly act against our country.

In addition to the diplomatic initiatives discussed above, we suggest that Congress consider the following suggestions for assisting the responsible independent refiners in their efforts to meet the needs of their customers:

1. Explore the possibility of guaranteeing crude oil payments to the producing countries through the Export-Import Bank. Under such a concept, individual refiners would post acceptable letters of credit from their commercial bank to the Ex-Im Bank guaranteeing payments. This would remove any risk or exposure to the Ex-Im Bank but give U.S. government guarantees to the foreign crude selling countries. A fee could be charged to the individual refiners to cover any administrative costs associated with providing these guarantees. An arrangement like this would help individuals and independent buying groups in their negotiations since they would post only one letter of credit, backed by the U.S. government, instead of several individual letters of credit from different banks.

Federal guarantees through the Ex-Im Bank should make it easier to deal with foreign national oil companies who may doubt that they would receive payment for their crude oil. This approach would be another signal to the producing countries that our government not only sanctions individual and joint efforts of our refiners but is also willing to back them up when necessary.

2. A refiner, or group of refiners, receiving Ex-Im Bank guarantees would give the government first option to assume all or part of their contracted volumes at their official cost for the Strategic Petroleum Reserve (SPR) during times of low demand and surplus crude supplies before offering such volumes into the spot market. There are several reasons why arrangements of this sort could be beneficial. First of all, I believe we can all agree that SPR should be filled primarily during periods of surplus supply, and that industry can do a better job of acquiring volumes at the lowest price for storage than the government. This suggested approach would assist the government in filling SPR without tampering with the tempermental spot market by soliciting bids on spot volumes. Secondly, such an accommodation would help the independents maintain their contracted volumes during times of surplus or low demand. We have heard several times from OPEC Countries that, in the past, independents were good customers during times of short supply but have been known to reduce liftings or walk away from contracts when a temporary glut developed. Quite frankly, many independents have hesitated signing long-term contracts in the erratic world oil market. Unlike the majors, independents lack the storage capacity and the flexibility of owning several refineries here and abroad which is necessary to accommodate contract crude supply during low demand periods. In addition, independents have difficulty in absorbing the high cost of carrying substantial surplus inventory. Being able to divert some of these volumes into SPR, at our official purchasing

price, would make it much easier for more independents to enter into term contracts. Last, an accommodation of this sort would tend to downplay previous criticism and threats to reduce production by various OPEC officials. The Saudis and other moderate producing countries face strong criticism at home when our government encourages them to maintain higher than needed production levels while the U.S. simultaneously announces stepped up fill rates for SPR to protect us from those same countries. Other industrialized countries have developed substantial reserves in the event of another disruption. However, in most instances this has been accomplished with the assistance of industry in a quite, non-confrontational manner. Our government should explain that the reserve will be in place for all disruptions and not just to protect us from political acts aimed against the U.S. Internal revolutions within producing countries, wars among producing countries, or occupation of those producing countries by unfriendly nations, or even unforeseen domestic disruptions, could quickly and drastically reduce supplies normally available to us. Any one of these potential events would have a tremendous impact on our economy and society unless we are prepared to deal with them.

3. The main goal of the responsible independent refiners is to be a competitive force in the marketplace. The anti-trust laws, to the extent that they act to protect will not interfere with the independents efforts to enter the world market. However, when two or more companies attempt to act in concert, anti-trust issues naturally

arise. We have carefully designed the IC&R joint venture to eliminate any present anti-trust objection. The logical extension of the IC&R concept may, however, require limited, specific exemptions from anti-trust laws if independent refiners attempt to purchase crude in the world market on a cooperative basis.

The independent refining sector of the U.S. must act in a responsible manner to be worthy of our government's support and to be considered viable customers by the oil producing countries. Past subsidies and allocation programs have provided an artificial shield over the oil industry. Likewise, these programs have overshadowed the significant role of independents in the marketplace. We seem to forget that most of the independent refiners got into the business prior to government programs because they were able to provide the consumer with needed products in the most efficient and cost effective manner. To say that the only way we can survive in the future is with continued government subsidies, suggests that we have lost our original competitive spirit. Some may suggest it is impossible for independents to compete effectively in the historically major-dominated world oil market. We disagree. We must and will succeed. The price of failure is much greater than the simple profitability of a few independent refiners.

To blame OPEC, or the majors, for the current distortions in the marketplace only diverts attentions and efforts required to adapt to the changing circumstances. Our government can play a vital role in providing the proper atmosphere which will enable us to be on an equal footing with the majors and other purchasing nations in order to meet the future petroleum needs of our country. We are not suggesting that government once again assume a caretaker role.

Rather we seek cooperation and understanding in recognizing our mutual goals during this transitional period.

Mr. Chairman, I wish to commend you for taking the initiative in exploring the various avenues of cooperation available between industry and government. As independent refiners, bound together by a common desire to serve our country's needs, we welcome this opportunity and challenge.

Thank you.

STATEMENT OF EDWIN JASON DRYER, EXECUTIVE SECRETARY, INDEPENDENT REFINERS' ASSOCIATION OF AMERICA, WASHINGTON, D.C.

Mr. DRYER. Mr. Chairman, I have about five highlight points and I will try to stay within my allotted time.

The first is that the issue of equitable access to crude oil is so fundamentally a background factor to the future of the independent refiners that we think appropriate priority has to be given to that. It has to be identified as a problem which, if it is not solved, then all of the other measures that may be under consideration will be as of naught.

We have, as of yesterday, finally brought to fruition the best judgment of our group, developed over a period of about a year, as to the best solution for that problem. We delivered it to Secretary Edwards yesterday. We will be delivering it to your committee as a matter of information in the immediate future.

That program, incidentally, does not involve a large bureaucracy. The most important element is that—

Senator WALLOP. Does it involve a small one? Because, they turn into big ones. [Laughter.]

Mr. DRYER. Well, the largest number of people involved would be in data monitoring and, incidentally, that is an aspect of just keeping track of what is going on in the world oil market, about which all elements of the industry are in agreement, as indicated by a symposium under the API auspices a month ago, and Secretary Edwards agreed with us yesterday on that subject.

The second element is just the mechanics of how you redistribute oil in the event of a shortage, and that will take six people. That is not a very large bureaucracy dealing with the significance of the problems involved.

We have a specific triggering mechanism tied to pricing; price being the leading edge of every shortage.

Now, turning to the other main point that we wish to make today, and that has to do with the independent refiner purchasing cooperatives. We formerly endorsed that concept at a board of directors meeting. We fleshed it out in specifics. We believe it will be a very useful adjunct by way of self-help for the independent refiners.

The principal problem we have faced in seeking oil abroad is the fact that we cannot negotiate the long-term contracts in most areas of the world, because they prefer government-to-government deals.

That was specifically told to the president of our association by Yamani. It has been repeated in other areas.

So, we have to have something which gives a Federal imprimatur upon some entities; not necessarily one. Certainly not one, but several, who then will be able to negotiate for oil with the Federal Government's foreign relations policy backing them up. If the foreign governments want to negotiate for wheat or arms or what have you, the foreign relations policy can be negotiated, having in mind the fact that there are federally sponsored entities who should then have, under those negotiations, perhaps a most favored purchaser treatment.

On that subject, I might add that with respect to the tax exemption feature, the Treasury Department representative was correct, that under existing tax law we do not need a tax exemption for those cooperatives, but they necessarily are because they would be conducted as nonprofit operations for the participants.

But, I would say that the fact that they are alternatives to tax-exempt entities might be appropriately considered by your committee.

Finally, on the tax and tariff proposals, we have supported over time the necessity of a tariff to protect the domestic refining industry against the competitive advantage of foreign refineries. Any tax measures should, however, end up being applied across the board to all the small independent refineries without some kind of artificial distinction based upon size or otherwise.

Senator WALLOP. Thank you very much.

[Statement follows.]

STATEMENT OF
INDEPENDENT REFINERS ASSOCIATION OF AMERICA

BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON
ENERGY AND AGRICULTURAL TAXATION
HEARING ON TAX AND TARIFF PROPOSALS
TO AID THE DOMESTIC REFINING INDUSTRY

March 27, 1981
Washington, D.C.

SUMMARY OF STATEMENT

1. Long-Term Fundamental Problems.

Tax, tariff and similar measures to aid the domestic refining industry will be as of naught, if we do not address fully the fundamental problem -- varying and inevitably-repeating curtailments in world oil supply. IRAA has specific proposals for assuring equitable access to crude oil in shortage situations -- a data monitoring and standby crude oil allocation program.

2. IRAA's Independent Refiner Purchasing Cooperative Proposal.

A Federally-chartered independent refiner purchasing cooperative, following the pattern of COMSAT and Amtrak, will be a very useful supplement to any standby crude oil access program. It will meet foreign demands for "government-to-government" deals without involving a Federal crude oil purchasing authority. It can be a valuable element of U.S. foreign policy negotiation and implementation. We will work with the Congress in developing the specific details of enabling legislation.

3. Tax And Tariff Measures.

IRAA has consistently pointed to the need for a tariff on imported products when decontrol should remove the offset, through lower U.S. crude oil costs, to the substantial cost advantages enjoyed by off-shore refineries.

On other tax measures, any benefits intended to aid domestic refiners should be extended to all small and independent refiners.

STATEMENT OF
INDEPENDENT REFINERS ASSOCIATION OF AMERICA

BEFORE THE
SENATE FINANCE SUBCOMMITTEE
ON
ENERGY AND AGRICULTURAL TAXATION

HEARING ON TAX AND TARIFF PROPOSALS
TO AID THE DOMESTIC REFINING INDUSTRY

March 27, 1981
Washington, D.C.

Mr. Chairman and Members of the Committee:

My name is Edwin Jason Dryer and I appear as General Counsel and Executive Secretary of the Independent Refiners Association of America. Our membership consists of small or independent refiners (or both) as those terms are defined by the Emergency Petroleum Allocation Act. Independent refiners in all size categories and in virtually all locations of the United States where oil is found are represented in our membership.

(It should be noted, parenthetically, that the definitions established by the Emergency Petroleum Allocation Act were selected by the Congress in terms of the overall structure of the oil industry and the impact of that structure on the competitive viability of separate segments of that industry. It is, therefore, the most appropriate definition or demarcation in any consideration of the basic problems facing this nation's domestic refining industry. In particular, it may be noted that the EPAA definitions are quite different from those used by the Small Business Administration for the separate, specific and narrowly-defined objectives of SBA programs which, incidentally, exclude

from the SBA category of "small business" many very small refining companies including a number of firms in the 10,000 - 20,000 b/d size category.)

1. IRAA Position on Tariffs and Tax Measures.

The agenda for today's hearing contains four items, three of which deal with tax and tariff proposals to aid the domestic refining industry, and the fourth concerns crude oil purchasing cooperatives. We believe that the first three items will be addressed adequately by other witnesses, and we would, therefore, confine our remarks on those proposals to the following:

a. Tariffs. We have actively supported, for some time, the need for a tariff on imported petroleum products when the removal of price controls on domestic crude oil would terminate the offset which such controls provided, in the form of lower U.S. crude oil costs, to the other substantial cost advantages of foreign refineries. We continue to do so, and we would point out that the Congress should not be lulled into a false sense of security by the current state of world crude oil supplies and the absence of an immediate flood of foreign products into the domestic market. Congress should note the announced plans of Caribbean and European refineries to expand and upgrade their facilities targetted to the U.S. market. Accordingly, the long-term tariff policy of this country must be determined and clearly announced for consideration in these off-shore plans.

b. Other tax measures. With respect to other tax measures designed to aid the domestic refining industry, we believe that any benefits should be made available to all small or independent refiners as defined by the EPAA and not confined to a portion of this group.

2. Other Measures.

Instead of further comment on the foregoing items, our testimony will be concerned primarily with a) identifying the most pressing long-term problem we face and then b) specific comments on the fourth item on today's agenda: crude oil purchasing cooperatives. As to the co-op idea, we agreed, at a meeting of the IRAA Board of Directors on February 18, 1981, to support this concept as one which would be very helpful in aiding the domestic refining industry and, in particular, the small and independent refiners. The purchasing cooperative proposal should not, however, be viewed as a substitute for an adequate crude access program (or the tax and tariff measures under consideration by this Subcommittee today), but instead, as a very useful supplement thereto.

3. Long-Term Fundamental Problems.

Without detracting in any way from the consideration of various measures supportive of the domestic refining industry, we believe it important to note that there are fundamental abnormalities and weaknesses in the world oil supply situation which pose a serious threat not only to the independent refiners, but to the domestic oil industry generally and, indeed, to the basic economic fabric of this nation. We must have an adequate response to the varying and inevitably repeating shortages in world oil supply. This is in the national interest, and it is of paramount importance to the many independent refiners and marketers who are the first to feel the impact of shortages as they develop. All other measures to aid the domestic refining industry will be as of naught, if this fundamental problem is not adequately addressed.

For this reason we are pressing, as a first priority on our legislative agenda, for some continuing data monitoring and standby

crude oil allocation program. This will presumably come before other committees of the Congress, but we will supply our recommendations to your Committee as a matter of information.

4. Background Factors Leading to Co-op Proposal.

The purchasing cooperative proposal has its genesis in, and it is designed specifically as a response to, major problems which the independent refiners have encountered in negotiating for crude oil abroad. There are three key problems.

a. Producer country preference for government-to-government deals. Many independent refiners have negotiated contracts for foreign oil, but these are all short-term in nature or on a spot basis. Independent refiners desiring longer-term contracts find the door shut to them in many major producing countries because of the expressed preference of such countries to negotiate on a government-to-government basis.

b. International financial standing. A second obstacle is the lack of international financial standing which small refiners, or even coalitions of small refiners, may have. This is only partially a question of the small refiners' relatively weaker financial posture compared with the international majors. Even small refiners with superior financial credentials, and credit guarantees from U.S. banks, find some financial hardships in dealing abroad, particularly with respect to contracts which are to be of some duration. Apparently, something more is needed -- in effect a government guarantee or seal of approval with respect to the ultimate performance of the U.S. banking system itself over time.

c. Antitrust complications. A third obstacle, faced by those independent refiners who would band together in negotiating for

foreign oil, is posed by antitrust restrictions on the conduct of U.S. firms. The chilling effect of these restrictions cannot be ignored.

5. IRAA's Independent Refiner Purchasing Cooperative Proposal.

We are aware of some proposals, responding to the problems I have just described, for the creation of a Federal crude oil purchasing entity. In our view it is not necessary to go that far, by way of a substantial Federal role, to solve these problems. We believe, instead, that Federally chartered independent refiner purchasing cooperatives may a) provide the necessary Federal "imprimatur" and backup (in terms of U. S. foreign relations policy coordinated with these co-ops) to meet the government-to-government condition imposed by producing countries and b) minimize the Federal role in the actual negotiation and procurement of foreign oil. These cooperatives would have the following features.

a. Federal charter. A Federal charter is the first essential step. We suggest, based upon prior experience with COMSAT and Amtrak, that these cooperatives be incorporated in the District of Columbia under District of Columbia corporate law as modified by the enabling legislation. At the outset, there are two important aspects to such a charter. First, it provides the all-important Federal imprimatur to meet the expressed needs of the foreign national oil companies. Second, the form of the charter and the enabling legislation will set an appropriate framework of corporate governance, including some measure of Federal supervision, which will justify the other Federal supporting actions described below.

b. Foreign relations policy support. The Federal imprimatur just described is not a mere matter of appearances. We expect that United States foreign relations policy will be carried out

by the agencies normally responsible therefor, notably the Department of State and the Department of Agriculture. Access to crude oil, however, by these purchasing cooperatives, should be one of the elements of foreign relations policy and international negotiations thereon by these agencies. As a minimum, for example, the State Department and the Agriculture Department can request "most favored purchaser" status for chartered co-ops as part of treaties, food and equipment, mutual assistance pacts and other government-to-government arrangements.

c. Export-Import Bank loan guarantees. A second area of support for these cooperatives would be in the form of Export-Import Bank (Ex-Im Bank) crude oil payment guarantees to foreign countries or their national oil companies. As we understand it, existing legislation authorizes such guarantees but they have been used to only a limited extent with respect to imports, as distinct from exports. Congressional clarification on this point may be helpful. More importantly, we believe that the enabling legislation should recognize the special nature of the guarantees which may be needed by these cooperatives and which will not require any significant funding out of the Federal treasury or provision in the Federal budget. We believe that these cooperatives will be able to provide acceptable guarantees or letters of credit from the co-op members through their commercial banks so that all risk to the Ex-Im Bank will be removed (except in the event of the collapse of the U. S. banking system). The Federal Government, in its supervisory role over the national banking system, can calculate an appropriate premium to cover the risk of loss in any individual U. S. bank and this could be assessed against the cooperatives so that no Federal funds need be required. Whatever reserves are adequate for Federal bank depositor

guarantees should be adequate to protect the Ex-Im Bank here. Under these circumstances we believe that Ex-Im Bank guarantees could be authorized without pressure upon the Government's fiscal plans and yet they would perform a most needed function in international crude oil negotiations. Consistent therewith the legislation should provide that the Ex-Im Bank guarantees themselves, backed as described, should be treated as non-Federal-budget items.

d. Federal supervision. Some minimal Federal supervision is appropriate, to insure compliance with the eligibility standards for initial chartering and conformance of the actual operations of the cooperatives to their charter, as a price for the Federal assistance described above. We suggest that the Department of Commerce have this responsibility and it can be the vehicle for coordination with the Departments of State, Agriculture and others which may be involved.

e. Antitrust immunity. The structure of these cooperatives and their method of operation, as provided in the enabling legislation, should be such as to eliminate antitrust concerns. Accordingly, cooperatives so organized and so operating should have specific anti-trust immunity provided by the legislation. In these circumstances there should be no need for further review by the Department of Justice as to whether such immunity is warranted.

f. No impact upon Treasury. These cooperatives will be non-profit by their nature. No special tax exemption is required and there will be no loss of tax revenues to the Treasury.

g. Other details. We have not developed in this statement the other details, regarding the organization and operation of these cooperatives, which would be included in the enabling legislation. Our

objective here has been to show simply the need for such legislation and the objectives which such legislation should seek to attain. We shall be most happy to work with the members of this Committee and the staff and other interested members of the Congress in the furtherance of this proposal for refining industry self-help, with minimal but necessary Federal support, in dealing with the highly complex world crude oil situation.

Senator WALLOP. Senator Durenberger?

Senator DURENBERGER. I would just like to clarify one point right near the end of your statement.

Would you repeat what is necessary or unnecessary for us to do if we were to move in the direction of providing tax-exempt status for crude purchasing coops?

Mr. DRYER. It will not be necessary to provide tax-exempt status as that term is used in the Internal Revenue Code. What we really need is a Federal stamp of approval, a Federal imprimatur on entities which would then be included in foreign relations negotiations by the State Department, or by the Department of Agriculture, in which these entities would be recognized as the sponsored entities for the Federal Government and meet the requirements of foreign producing countries that they want to deal government to government.

If they want to deal for wheat, for oil, that is something which we have to recognize. At the moment, we are completely precluded from getting any long-term contracts with a country like Saudi Arabia who says, "We want to deal government to government."

Now, once you've done that, we have the structure created. It can be incorporated like Amtrak or Comsat, under the laws of the District of Columbia, as modified by the enabling legislation. You have the precedence there for entities that are not government instrumentality, but are government-sponsored entities, privately operated and would have, most importantly, the sponsorship of the Federal Government in the negotiations of our foreign relations policy.

Senator DURENBERGER. John, let me ask you a related question.

Is your joint venture, or are the members of your joint venture now benefiting from some form of tax-exempt status, or is there something in the proposal before us that would make a specific change in tax status for your joint venture?

Mr. VENNERS. Well, the way we're structured, I don't see where a tax exemption would really help us. I would like to defer that to our counsel, Mr. Phillips. He could submit a written comment on that.

[The comment referred to follows:]

WASHINGTON, D.C., April 14, 1981.

Mr. EDWARD DANIELSON,
Senate Committee on Finance,
Washington, D.C.

DEAR MR. DANIELSON: In the course of the testimony given by John P. Venners, Managing Director, Interdependent Crude and Refining, before the Subcommittee on Energy and Agricultural Taxation, Senate Committee on Finance, on March 27,

1981, Mr. Venners, in response to a question by Senator Durenberger, offered to submit by counsel a written comment for the record in response thereto. Accordingly, I submit the following comment which we request be made part of the record of the above proceeding.

At the conclusion of Mr. Venner's testimony, Senator Durenberger, at page 87 of the transcript (attached hereto), inquired as follows:

Is your joint venture, or members of your joint venture now benefiting from some form of tax-exempt status, or is there something in the proposal before us that would make a specific change in tax status for your joint venture?

Interdependent Crude and Refining (IC&R) is a joint venture of five domestic, independent oil refiners. The Agreement creating IC&R calls for joint efforts to develop and identify opportunities to purchase long-term supplies of acceptable foreign crude oil. The joint venture, by design, is specifically limited to developing and identifying opportunities to purchase foreign crude oil. Any and all contracts entered into for the supply of foreign crude oil through the efforts of the joint venture will be contracted for and executed by each refiner so purchasing in its individual corporate capacity. The Agreement creating IC&R therefore envision neither IC&R as a purchasing entity for its members, nor joint purchases by the joint venturers. Further, all joint venturers specifically agreed that each was free to purchase foreign crude oil through its own efforts.

As a result of the agreed upon structure of IC&R, the tax consequence of any purchase of crude oil is the direct obligation of the refiner who so purchases. Since the joint venture as such will not purchase for its members, as would be the case under a co-operative arrangement, neither the joint venture nor the joint venturers will benefit from a tax-exempt status nor propose by this testimony a specific change in tax status for the joint venture or its' joint venturers.

Thank you for the opportunity to respond to the Senator's inquiry.

Best regards,

MICHAEL P. PHILLIPS,
Counsel,
Interdependent Crude & Refining.

Mr. VENNERS. The way we are structured is that any crude volumes that we would acquire through the joint venture would flow directly to the refineries, and it would be actually purchased by the individual refineries in a joint effort.

So, we don't envision any direct profits within the joint venture; any profits that we would have would be distributed back to the joint venture partners.

Senator DURENBERGER. Let me ask you another question that relates to allocation.

As I understand, as I look through your summary, you seem to be completely opposed to allocation programs, and I would like to ask you why you are, and what you think the biggest harm is in allocation?

Mr. VENNERS. Well, under a dire emergency, I'm not necessarily opposed to it. I think one of the problems we faced with the producing countries was when we would go in there and try and negotiate a contract with them, they would come back and say, "Well, don't give us that song and dance. We know you can go back to your Government and they will allocate some crude for you."

We want to be on an equal footing, and we feel that if the independents are successful in acquiring their own direct contracts, then maybe whatever eventually is a trigger for some type of an allocation program, wouldn't be triggered as quickly because we would have the direct sources.

Senator DURENBERGER. Thank you very much.

Senator WALLOP. I want to pay a compliment to both of you, because you offer some attempts to be creative involving a situation that is very complex, and each path has a thicket in it someplace.

Unfortunately, most of the proposals that you would have Congress consider don't really fall within the reach of this committee, and my experience as a witness to the process with the former majority party was that those chairmen fight hard for their turf, and might look with some disfavor on us engaging in some kind of a departure from jurisdictional standards.

But, I guess we will at least be able to pass on some of your recommendations, because, as you know, there are bills in the Energy Committee, as well, which would have to do this.

Mr. Venners, in your attempts to acquire crude oil supplies from foreign producers, have you found that contracts are written which require you to purchase more complex crudes, heavier or sourer, in addition to the light crudes which you need? Is there a mix effectively mandated by the very dealings you are engaged in?

Mr. VENNERS. Yes. That, naturally, varies from country to country, but we have found that in countries such as Libya, Mexico, and others that have large volumes of heavier sour crudes, it's one way for them to dispose of those volumes and they usually demand that you must take a mix of the two.

If that can be acquired at a competitive price, or there are some reasonable differentials, or if OPEC ever unifies their price structure, it shouldn't be that big of a problem, because you should be able to exchange it off as long as it's acquired on a competitive price.

Senator WALLOP. Mr. Dryer, in your cooperative concept and the imprimatur that you seek of official or semiofficial status, if that were to take place, what percentage of the small independent refiners in the country would such a policy affect? Would it be of benefit to someone who was refining in the Midwest, for example, as opposed to one of the coasts, or either of the coasts?

Mr. DRYER. Yes, it would be to the benefit of the refiners in the Midwest and, indeed, most of the independent refiners in this country are located in the midcontinent.

But, fortunately, most of them can be reached with foreign oil through existing pipeline systems. I guess the longest pipeline, for any independent refiner, starts at the gulf and goes on north and then ultimately over to Warren, Pa.

But, most of our independents can be reached by foreign oil, and most of them of any size, 5,000 barrels a day and up, would be interested in sharing.

Several of our members are members of Mr. Venners' venture, and they are also participants in the other two ongoing consortiums of which we are aware. So, they are interested and able.

Senator WALLOP. Thank you both very much.

The next witnesses will be the final panel, consisting of Mr. John Roper, vice president of Koch Refining Co., Wichita; Don Davis, who I'm happy to welcome as president of the Glenrock Refinery, Inc. in Casper, Wyo.; Dennis Juren, group vice president, Tesoro Petroleum Corp., San Antonio; Mr. Theodore Eck, chief economist of the Standard Oil Co. of Indiana, Chicago, Ill.; Mr. Frank Cahoon, chairman of Copano Refining Co., Corpus Christi, Tex.

Mr. Roper, would you begin?

Mr. ROPER. I'd be happy to.

Senator DURENBERGER. Before he does, I wonder if I could ask you two things, Mr. Chairman?

One, that the opening statement that I have might be made part of the record.

Senator WALLOP. Absolutely, it will be made part of the record.

OPENING STATEMENT OF SENATOR DURENBERGER

Mr. Chairman, I want to thank you for taking up this subject as the first item to be considered by the Energy Subcommittee this year. There are few energy issues that are more important to Minnesota than the future of the independent sector of our refinery industry.

Minnesota has three refineries within its borders. Two and by far the largest two are independent refineries. They are owned by Koch Refining Company and Ashland Oil. Two thirds of the petroleum products consumed in Minnesota are produced by these two refineries. In addition much of the petroleum available in rural parts of our state is marketed by the Farm Cooperatives. Two cooperatives, Cennex and Midland have their headquarters in Minnesota.

I know that there are some who will read the hearing announcement for today and conclude that the Finance Committee of the United States Senate is still operating in the old way. They will think that this hearing is intended to find ways to use the tax laws to prop up inefficient refineries that cannot survive in the new decontrol environment that the President has created.

I haven't come to that conclusion yet and hope that I don't have to. The issue is not efficiency. The two independent refineries in Minnesota are extremely efficient processing heavy, dirty crude oil into the range of products that is necessary for our economy. The issue is fair access to the world crude oil market. The question I hope to explore is, "to what extent does size determine the availability and price for the crude oil that independent refiners are able to get in a decontrolled market?" Is it the case that vertical integration or foreign concessions give some companies such an advantage in crude oil costs that other companies do not have a fair opportunity to compete in the marketplace? And if so, what should be done about it?

I hope to approach this hearing with an open mind and know that the opinions expressed today will be diverse. Again, Mr. Chairman, I thank you for these hearings and offer my assistance to you in exploring these questions.

Senator DURENBERGER. Second, that you let me say something nice about Mr. Roper before he starts speaking.

Senator WALLOP. Indeed, because I'm going to say something nice about Mr. Davis before he starts speaking.

Senator DURENBERGER. Well, I've already learned something about Mr. Davis that I didn't know. [Laughter.]

I want to compliment you first on pronouncing the name of the association correctly. There are so many ways of doing that.

But, John is the executive vice president of Koch Refining Co., as you pointed out, which is one of the refineries located in Minnesota. It is the largest by far, and contributes to a large portion of Minnesota's supply of petroleum products.

This particular refinery is a very efficient user of heavy crude oil and, until recent months, most of its crude runs came by pipeline from Western Canada. As you well know, Mr. Chairman, back in 1974, the Canadians signaled their intention to reduce their imports. Ever since then, Mr. Roper, who is really a Kansan, has qualified for Minnesota citizenship and has been spending much time in our State trying to guarantee the people of Minnesota an adequate source of supply.

I must say to Mr. Dryer, now that he's gone, there may be pipelines reaching all over this country to the independent and other kind of refiners. But there are pipelines and there are pipelines, and I guess one of the issues that Mr. Roper has been dealing

with for 6 or 7 years is the size of crude that can be brought into our State for refining.

We now have the start of a new transportation system from the south, and if I haven't said this officially, thank you, John, for the personal efforts that you put forth to guarantee access to refined products of crude oil for the people of our State.

Mr. ROPER. Thank you, Senator.

STATEMENT OF JOHN DEE ROPER, VICE PRESIDENT, KOCH REFINING CO., WICHITA, KANS.

Mr. ROPER. Koch is an independent refiner as that term is defined in law. It has 127,300 barrels a day rated capacity.

The subcommittee here is considering several proposals which would grant subsidies or biases to small and independent refiners, and particularly they include a proposal to provide them equitably priced crude access, as you've heard.

Well, Koch is maybe in a unique position. There could be other independent refiners in our position with the same view but they are not before this panel. We would stand to benefit by a buy-sell program, possibly. We would stand to benefit short term, possibly with the proposal for foreign tax credit. We even potentially, if we got the exemption and our competitor, who is larger than us, didn't get the exemption on imported fees, we could stand to gain through that.

But, we have had too much experience with Government regulation to want to support that sort of a program, and for that reason we strongly oppose any tax incentives or benefits which would, in effect, provide a small and independent refiner with a competitive advantage.

Now, we're not against tax incentives. We're not against tax credits, but we would ask that it be across the board.

Koch believes that the free market is the best mechanism to regulate the market. As I say, this past 7 years prove that a Government subsidy program which has caused small refiners to spring up all over the place that are very inefficient, and really probably will not continue to exist, and perhaps I think our country, our Nation, would be better off without them.

I have attached to my statement a much longer statement, and I have also attached to it an analysis made in the February Energy Report published by the Department of Energy. It shows that with all the new refineries that you have described in this information bulletin, the ability of our country to produce motor gasoline has not really increased substantially.

The products that we heard mentioned such as jet fuel are not difficult products to produce. In fact, with a light, sweet crude, they can be produced with a very inefficient refinery.

There isn't really any national defense question. We are not protecting our defense by protecting the products that are specially produced by small refiners. If the small refiner is, in effect, producing a product that is needed and can do so efficiently, it will stay in business on a competitive basis, and if it's not, it shouldn't be in business.

That's kind of the long and short of it, gentlemen. Senator Dur-enberger, I appreciated your introduction. I'd be happy to answer questions.

Senator WALLOP. Thank you, Mr. Roper.

[Statement follows:]



SUMMARY OF STATEMENT
of
JOHN DEE ROPER
on behalf of
KOCH REFINING COMPANY

I am John Dee Roper. I am Executive Vice President of Koch Refining Company, a subsidiary of Koch Industries, Inc. in Wichita, Kansas. Koch is a small, independent refiner with a plant near St. Paul, Minnesota with a capacity of 127,300 barrels per day.

This Subcommittee is considering several proposals which would grant subsidies to small and independent refiners, particularly with crude oil access. Koch strongly opposes any such tax incentives or benefits which would, in effect, provide a small and independent refiner with a competitive advantage. Koch believes that the free market is the best mechanism to regulate the market.

The past seven years of Governmental regulation of the petroleum industry have resulted in the construction of small, inefficient refineries which cannot operate without government subsidy. Despite the U.S. need to develop efficient and sophisticated facilities to produce gasoline and other sophisticated products,

the government heavily subsidized topping plants which predominately produce residual fuel oils.

Koch believes that Congress should accept its new mandate and permit the market to function without artificial incentives. Specifically, Koch recommends that this Subcommittee reject any proposal to:

- impose import tariffs on refined petroleum products; and
- grant bias or subsidy to one part of the industry at the expense of other parts of the industry.

These proposals only promote inefficiency, raise costs and are unnecessary.

March 27, 1981



STATEMENT

OF

JOHN DEE ROPER

on behalf of

KOCH REFINING COMPANY

ON

**"TAX INCENTIVES FOR DOMESTIC
REFINING"**

before the

**SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION
COMMITTEE ON FINANCE
UNITED STATES SENATE**

Washington, D.C.

March 27, 1981

I. Introduction

I am John Dee Roper, Executive Vice President of Koch Refining Company, a subsidiary of Koch Industries, Inc. in Wichita, Kansas. Koch is a small, independent refiner with a plant near St. Paul, Minnesota with a capacity of 127,300 barrels per day.

I am here today to present testimony on tax incentives for domestic refiners and have reviewed specifically four proposals pending before the subcommittee. They are:

1. Modification of Foreign Tax Credits
2. Tariffs on Imported Petroleum Products
3. Tax Incentives for Upgrading or Retrofitting Domestic Refineries
4. Tax Exemptions for Crude Oil Purchasing Cooperatives.

Koch strongly opposes the proposals on foreign tax credits and import tariffs, but does not oppose any generally applied tax reduction. In addition, if the proposal on tax-exemptions for crude purchasing cooperatives would disadvantage independent crude oil resellers, then Koch would oppose any such proposal.

II. Free Market vs. Regulation

The adoption of the proposals on foreign tax credits

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and import tariffs would substitute a government-sponsored program in whole or in part for free market mechanisms. Koch believes that the free market is the only valid manner in which to allocate resources in the economy.

It is critically important that this nation move toward a free market system for the petroleum industry, and that principle certainly applies to the small and independent refining segments as well. A significant step was taken toward the free market when President Reagan removed price and allocation controls from crude and product on January 28, 1981. We cannot allow this effort to be reversed or slowed by any new government subsidy or incentive measure.

A free market permits active competition in the market. Competition in turn exerts downward pressure on prices and provides consumers with petroleum and petroleum products at the lowest possible cost delivered in the most efficient and economical manner.

In contrast, a regulated market increases costs and promotes inefficiencies. The Government's record is not an enviable one.

During the past seven years each new Department of Energy regulation created a new problem, requiring yet another regulation to try to rectify the problem. The result was a wholly inflexible system.

In 1979, during a relatively brief crude supply shortage triggered by the Iranian Revolution the allocation program created gasoline lines in urban areas, while rural areas had too much product. The gasoline lines in California were the worst of all, yet there was a crude glut in the state the whole time. Unfortunately, it was the wrong kind of crude, heavy crude. That situation could have been avoided if the government had allowed the heavier Alaskan crudes to be exported in exchange for sweeter, lighter crudes more suited to domestic refining configurations. In a free market, efficient management and distribution of crude and product would have been a relatively easy task. Under government regulations, it was an impossible task.

Moreover, because it was exceedingly difficult to predict how a particular regulation might affect the market, the Government could only guess. Frequently, implementation of a regulation had an affect exactly opposite that which was intended.

Contrary to the desired purpose of encouraging efficient competitive refineries, the small refiner bias under the Department of Energy entitlements program caused a boom in grass roots construction of small, unsophisticated refineries which typically were designed to run sweet, light crudes. In fact, according to a DOE publication, Trends In Refinery Capacity and Utilization, there were fifty-five

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grass-roots refineries built since January 1, 1975, only one of which had a capacity over 40,000 barrels per day. (The exception was the ECOL plant at Garyville, Louisiana with a capacity of 200,000 barrels per day.) Of these 54 plants of 40,000 B/D or smaller, only 4 had capacities in excess of 30,000 B/D, 14 had capacities 10,000 B/D and 30,000 B/D, and the preponderance, 36, were 10,000 B/D or smaller. The total number of refining companies in the five years between 1975 and 1979 grew 30%. However, the 54 new plants represented an increase of only 4% of the U.S. refining capacity with virtually no growth in the capacity to produce motor gasoline. See the attached February, 1981 Monthly Energy Review which describes the change in refining production during controls.*/

At precisely the time when there should have been incentives for more sophisticated refinery expansion and reconfiguration, the regulations created incentives sufficient to ignore market signals and create largely unneeded plants. In addition, the problem was compounded by the crude allocation regulations which allocated crude away from the more sophisticated plants to generally smaller,

*/ See Attachment A.

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less sophisticated plants that simply could not get the maximum use out of each barrel. This was no minor problem. The January 12, 1981 edition of Fortune reported:

By extracting a maximum percentage of gasoline and other high-value products, a truly-efficient U.S. Refining industry could reduce oil imports by perhaps a million barrels a day--equal to the goal of...[the] \$80-billion synfuels program.

The regulations caused precisely the wrong result.

It is no coincidence that the greatest number of refineries constructed through the period of regulation were also the type of refineries which received the greatest subsidy under the Department of Energy Entitlements Program. 10 C.F.R. §211.67. Unfortunately these smaller, less sophisticated plants built in response to governmental subsidy, were generally only able to produce a limited slate of finished products which consisted primarily of heavier fuel oils and residual fuel oils from sweeter, lighter crude oil. This production was occurring when the U.S. market called for the construction of larger, more efficient and sophisticated plants to produce more sophisticated products from the increasingly heavier and sour crudes available.

There are a number of small refiners that would never have started operations in the absence of the regulations. The small refineries in existence before controls

competed and thrived in the free market precisely because they had a vital purpose in the market. These companies serve markets that larger companies simply cannot afford to serve. They will survive again in a free market.

It is fair to say that more than a few companies are anxious, perhaps even afraid, of what lies ahead. The petroleum industry has operated under controls for so long it scarcely remembers what it was like to operate without them. Companies that are most concerned are those that occupy the least secure place in the market.

Some refining companies that either do not have their own domestic sources of supply or do not have long-term contracts with foreign governments argue that they are being "frozen" out of the crude oil market. Recently, Senator J. Bennett Johnston (D-La.) introduced a bill which would force companies with crude oil inventories to supply feedstocks to refiners who might be cut off in a tight market. This "guaranteed crude oil access" program would require a refiner with adequate crude supplies to sell feedstock to crude-deficient refiners at its average acquisition cost rather than at its incremental cost. The inequity of this proposal should be obvious; the company which may be ordered to share its crude oil inventory at the average cost would then be forced to go out onto the spot market and replace that oil at the higher marginal (incremental) cost that

would exist during a shortage. While Koch might at some future time expect to benefit from such a program it strongly opposes any such subsidy. The free market, not government regulation, should allocate crude oil among all U.S. refiners.

The companies that built refineries based on the Department of Energy "small refiner entitlements bias" (subsidy) knew full well that the bias was due to expire this year. That is a risk they took.

The test for survival is not who has the biggest association, or the best-funded lobbying effort, or even the most refineries in key congressional districts. The appropriate test for survival is the market. Congress should not try to begin building a regulatory framework for the petroleum industry now when it has just been freed from those burdens.

Congress does not have a mandate to preserve-- or create--a place for each business entity. In fact, the best way in which to restore vitality to this industry is restore a free market and let the best prepared companies serve their customers. Those companies who cannot serve their customers in a competitive market, those companies who have not anticipated and planned for the day that they can no longer rely on government subsidy, do not deserve still more protection from the government.

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Most importantly, the potential failure of some companies will not be a signal that decontrol is not working. Rather, it will be a positive sign that the free market is working and providing consumers the opportunity to be served by efficient, market-oriented companies. That should be applauded, not avoided.

III. Conclusion

In sum, Koch advocates that this Subcommittee reject any proposals:

- (1) to modify the foreign tax credit regulations to provide an advantage to small and independent refiners for crude oil purchases;
- (2) to impose tariffs on imported petroleum products;
- (3) to subsidize small and independent refiners so that they may obtain crude oil supply contracts; and
- (4) to exempt independent refiners from tax obligations on crude oil purchases made through cooperatives unless the same exemption is granted to independent crude oil resellers.

All of these proposals inhibit the operation of the free market. They encourage and subsidize smaller, less efficient refiners and only add to the cost of refined petroleum products. The Congress should not repeat the regulatory mistakes of the past seven years by adopting this new package of incentives.

Thank you very much.

DOE/EIA-0035(81/02)

February 1981

ATTACHMENT A

Monthly Energy Review



**Preliminary 1980 Estimates
See Executive Summary**

U.S. Department of Energy
Energy Information Administration

Petroleum
Motor Gasoline

		Product Supplied						
		Total	Unleaded	Unleaded Percent of Total	Refinery Production ¹	Imports	Exports	Stocks ²
		Thousand barrels per day						
		Thousand barrels						
1973	AVERAGE	6,874	NA	NA	6,527	134	4	209,395
1974	AVERAGE	6,537	NA	NA	6,358	204	2	218,348
1975	AVERAGE	6,675	NA	NA	6,518	184	2	234,925
1976	AVERAGE	6,978	NA	NA	6,838	131	3	231,387
1977	AVERAGE	7,177	1,976	27.5	7,031	217	2	257,578
1978	AVERAGE	7,412	2,521	34.0	7,167	190	1	237,956
1979	January	6,830	2,609	38.2	7,246	179	1	256,894
	February	7,254	2,715	37.4	6,924	160	1	252,478
	March	7,229	2,733	37.8	6,654	188	(s)	240,007
	April	7,055	2,786	39.5	6,770	156	1	236,600
	May	7,213	2,751	38.1	6,792	145	(s)	228,515
	June	7,191	2,787	38.8	7,001	261	(s)	231,014
	July	6,902	2,789	40.4	7,002	222	(s)	241,489
	August	7,330	2,970	40.5	6,882	148	1	232,734
	September	6,851	2,815	40.9	6,626	135	(s)	229,542
	October	7,020	2,802	39.9	6,483	150	(s)	218,065
	November	6,791	2,928	43.1	6,673	182	1	220,472
	December	6,730	2,890	42.9	6,988	263	(s)	237,082
	AVERAGE	7,034	2,798	39.8	6,837	181	(s)	
1980	January	6,335	2,718	42.9	6,977	141	1	262,134
	February	6,594	2,969	45.0	6,851	153	(s)	274,422
	March	6,411	3,032	47.3	6,512	154	(s)	262,688
	April	6,799	3,021	44.5	6,268	152	1	271,729
	May	6,726	2,980	44.3	6,294	132	1	262,938
	June	6,651	3,099	46.5	6,552	148	1	264,583
	July	6,735	3,131	46.5	6,446	149	3	260,711
	August	R6,846	3,135	R47.2	R6,437	141	1	R259,013
	September	6,515	3,054	46.9	6,368	106	7	257,948
	October	6,621	3,110	47.0	6,123	150	1	247,171
	November	R6,344	3,123	49.2	R6,458	126	(s)	R258,538
	December	6,732	NA	NA	6,781	89	NA	260,060
	AVERAGE	6,593	NA	NA	6,505	138	NA	

Geographic coverage: the 50 United States and District of Columbia.

¹See Definitions.

Estimated data in italics. These are likely to be revised next month.

²Total as of December 31.

³Preliminary data. R = Revised data. NA = Not available.

(s) = Less than 500 barrels per day.

Note: Bureau of Mines' stock coverage was expanded at the end of 1974 to include an additional 100 bulk terminal operators; the new coverage begins here with 1975.

Sources: *See Sources on the last page of this section.

Petroleum

Jet Fuel

		Product Supplied	Refinery Production	Imports	Exports	Stocks
		Thousand barrels per day				Thousand barrels
1973	AVERAGE	1,059	859	212	4	28,544
1974	AVERAGE	993	836	163	3	29,435
1975	AVERAGE	1,001	871	133	2	30,380
1976	AVERAGE	987	918	78	2	32,065
1977	AVERAGE	1,039	973	75	2	34,548
1978	AVERAGE	1,057	970	86	1	33,665
1978	January	1,096	950	97	1	32,114
	February	1,149	998	94	1	30,475
	March	1,101	1,098	61	1	32,267
	April	980	1,043	49	1	35,581
	May	989	980	79	1	37,698
	June	1,095	958	57	1	35,301
	July	1,094	965	90	1	34,063
	August	1,085	1,040	49	1	34,136
	September	1,099	958	84	1	32,420
	October	1,055	1,046	90	(s)	34,920
	November	1,070	1,029	83	1	36,161
	December	1,103	1,072	108	1	38,520
		AVERAGE	1,076	1,012	78	1
1980	January	1,101	1,004	95	1	38,412
	February	1,072	1,026	43	2	38,258
	March	1,118	1,031	99	2	38,661
	April	1,105	1,023	107	3	39,339
	May	1,015	1,001	79	2	41,310
	June	1,057	1,004	88	1	42,283
	July	1,110	974	93	2	40,902
	August	R1,043	R959	R67	1	R40,331
	September	1,041	1,043	60	1	42,191
	October†	1,013	970	75	1	43,130
	November†	R1,010	R987	R49	1	R43,916
	December†	1,005	1,016	34	NA	43,310
		AVERAGE	1,057	1,003	74	NA

Geographic coverage: the 50 United States and District of Columbia.
Estimated data in italics. These are likely to be revised next month.

†Total as of December 31.

‡Preliminary data. R=Revised data. NA=Not available.

(s) = Less than 500 barrels per day.

Note: Bureau of Mines' stock coverage was expanded at the end of 1974 to include an additional 100 bulk terminal operators; the new coverage begins here with 1975.

Sources: *See Sources on the last page of this section.

Petroleum
Distillate Fuel Oil

		Product Supplied	Refinery Production ¹	Imports	Exports	Stocks ²
		Thousand barrels per day				Thousand barrels
1973	AVERAGE	3,092	2,820	392	9	198,431
1974	AVERAGE	2,848	2,668	289	2	200,029
1975	AVERAGE	2,851	2,653	188	1	206,787
1976	AVERAGE	3,133	2,924	146	1	188,848
1977	AVERAGE	3,352	3,277	280	1	280,280
1978	AVERAGE	3,432	3,187	173	3	218,439
1979	January	4,581	3,043	226	1	175,823
	February	4,812	2,688	196	7	127,275
	March	3,664	3,019	176	1	112,275
	April	3,016	2,945	150	2	115,124
	May	2,998	3,066	185	(a)	123,042
	June	2,708	3,153	180	15	141,387
	July	2,563	3,305	225	7	171,203
	August	2,781	3,321	218	(a)	185,365
	September	2,647	3,354	126	2	220,377
	October	3,119	3,251	211	1	231,058
	November	3,289	3,239	235	(a)	236,641
	December	3,708	3,221	229	(a)	226,712
	AVERAGE	3,314	3,182	197	3	
1980	January	3,732	3,023	179	7	212,126
	February	3,706	2,778	221	8	191,464
	March	3,171	2,564	179	19	177,659
	April	2,630	2,462	147	2	177,006
	May	2,402	2,471	126	1	183,072
	June	2,331	2,645	108	(a)	195,780
	July	2,225	2,688	117	3	213,758
	August	R2,136	R2,462	R77	(a)	R226,305
	September	2,638	2,724	98	(a)	232,436
	October	2,983	2,648	125	(a)	225,864
	November	R2,894	R2,676	R125	(a)	R223,143
	December	3,625	3,098	142	NA	202,054
	AVERAGE	2,871	2,687	197	NA	

Geographic coverage: the 50 United States and District of Columbia.

¹See Definitions.

Estimated data in *italics*. These are likely to be revised next month.

²Total as of December 31.

³Preliminary data. R = Revised data. NA = Not available.

(a) = Less than 500 barrels per day.

Note: Bureau of Mines' stock coverage was expanded at the end of 1974 to include an additional 100 bulk terminal operators; the new coverage begins here with 1975.

Sources: *See Sources on the last page of this section.

Petroleum

Residual Fuel Oil

		Product Supplied	Refinery Production	Imports	Exports	Stocks
		Thousand barrels per day				Thousand barrels
1973	AVERAGE	2,822	971	1,853	23	53,480
1974	AVERAGE	2,839	1,070	1,897	14	69,894
1975	AVERAGE	2,462	1,235	1,223	15	74,126
1976	AVERAGE	2,901	1,377	1,413	12	72,344
1977	AVERAGE	3,071	1,754	1,359	6	99,993
1978	AVERAGE	3,023	1,967	1,355	13	90,184
1979	January	3,560	1,912	1,371	6	81,853
	February	3,595	1,792	1,300	10	67,699
	March	3,239	1,719	1,642	14	71,852
	April	2,507	1,639	1,134	2	79,959
	May	2,503	1,586	1,051	8	84,261
	June	2,583	1,548	880	8	79,816
	July	2,451	1,575	1,065	5	85,907
	August	2,550	1,584	1,023	14	87,622
	September	2,809	1,627	979	2	87,789
	October	2,540	1,629	1,042	18	91,611
	November	2,815	1,736	1,046	5	90,799
	December	3,013	1,894	1,278	14	95,598
	AVERAGE	2,826	1,687	1,151	9	
1980	January	2,865	1,766	1,132	5	97,153
	February	3,099	1,770	1,119	17	90,959
	March	2,650	1,581	971	2	88,269
	April	2,434	1,591	769	40	85,219
	May	2,234	1,507	812	20	87,639
	June	2,324	1,575	749	14	87,657
	July	2,287	1,480	787	60	85,605
	August	R2,287	R1,444	R875	2	R86,949
	September	2,304	1,515	904	21	89,855
	October	2,320	1,544	860	70	90,754
	November	R2,425	R1,564	R1,017	88	R93,282
	December	3,050	1,936	1,070	NA	89,071
	AVERAGE	2,822	1,606	922	NA	

Geographic coverage: the 50 United States and District of Columbia.

¹Beginning in April 1980, residual fuel oil exports increased due to shipments of high sulfur fuel to a Caribbean refinery to be desulfurized and returned to the United States.

Estimated data in *italics*. These are likely to be revised next month.

²Total as of December 31.

³Preliminary data. R = Revised data. NA = Not available.

Note: Bureau of Mines' stock coverage was expanded at the end of 1974 to include an additional 100 bulk terminal operators; the new coverage begins here with 1975.

Sources: *See Sources on the last page of this section.

Senator WALLOP. Don, I appreciate your taking the time to come to Washington. I would say for those gathered in this room that you have provided quite a service for our State, spending a good deal of capital—risk capital which is something unusual in this day and age; upgrading Glenrock Refinery to be more efficient and to compete with any refinery in the country, small or large, so I welcome you.

**STATEMENT OF DON C. DAVIS, PRESIDENT, GLENROCK
REFINERY, INC., CASPER, WYO.**

Mr. DAVIS. Thank you, Mr. Chairman.

Glenrock Refinery is a small independent refinery with certified throughput of about 6,000 barrels per day. Our refinery is located in Glenrock, and our principal offices are in Casper, Wyo.

We refine gasoline, diesel and jet fuel, and we serve local markets in Wyoming, northern Colorado, western Nebraska, and western South Dakota.

Glenrock can compete with most refineries on the basis of efficiency. However, Glenrock cannot compete if it cannot buy crude at prices that allow a positive return on product yields.

Unlike the major integrated refiners, Glenrock cannot subsidize its refinery operation from production gains. Glenrock has no production and anticipates no production.

Likewise, Glenrock suffers when majors use their production gains to bid up the price of crude available on the open market to levels which make it uneconomic for any small refiner to buy. We have crude on long- and short-term contracts tied to major oil company postings. This crude is usually scheduled for delivery, refined, and the product is sold before we have received word of the actual posted price.

Therefore, our economics are very unpredictable, and this affects our ability to arrange bank financing and to attract capital for growth and for expansion.

In short, a free market for crude does not presently exist. Glenrock requests equitable access to crude, competitive prices established in a truly free market, or tax treatment that achieves this end. We have done the engineering and obtained permits to expand to 20,000 barrels per day with the most efficient equipment available.

However, it's difficult to assess an expansion of this magnitude in the face of distortions in the current price structure of crude. It is not easy to make investment decisions and long-range plans when each month it is so unpredictable.

Even if we were given tax-exempt incentives, they will do no good if there is no flow of income to offset this.

Major oil companies already have tax advantages that we cannot utilize. We refer to this as the "major refinery bias."

Glenrock supports an exemption from the windfall profits tax for royalty owners and independent producers for the first 1,000 barrels of daily production, when such production is sold to small and independent refiners.

Glenrock supports tax incentives which will permit domestic refineries to quickly upgrade their configurations to handle heavier sour crudes which will become increasingly available in the 1980's.

Glenrock supports an amendment to the foreign tax credit rules providing that sales of foreign or domestic crude to an unrelated domestic small refiner would be treated as foreign source income for the seller.

In addition, Glenrock urges consideration of a tax deduction for any sales of crude to a qualified small refiner so long as the purchaser is not buying such crude for resale in the open market.

Glenrock supports the imposition of increased tariffs and/or import fees on imported petroleum products to protect the strength of the domestic refining industry and to enhance national security.

In closing, I'd like to leave you with the impression that what we are asking for is an opportunity to compete on an equal basis with the majors, and that consideration should be given to reward those refiners who are efficient and competitive, regardless of size.

Thank you.

Senator WALLOP. Thank you, Don.

[Statement follows:]

UNITED STATES SENATE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION

Testimony of

DON C. DAVIS
President
GLENROCK REFINERY, INC.
Casper, Wyoming

March 27, 1981

Of Counsel:

Charles M. Seeger
Michael K. Hammaker
POPHAM, HAIK, SCHNOBRICH,
KAUFMAN & DOTY, LTD.
Washington, D.C.

I. INTRODUCTION

Chairman Wallop and members of the Subcommittee, I'm Don Davis, President of Glenrock Refinery, Inc., and with me is Charles Seeger, our Washington counsel. Our principal office is in Casper, Wyoming, while the refinery itself is located in nearby Glenrock. GRI has a present DOE certified throughput of 6,000 barrels per day capacity.

We are here this morning to describe the oil industry from the perspective of a small, efficient, independent refiner trying to find crude at a price that will allow us to refine it and market it at better than dead even. We try this having no crude production of our own. We vigorously support the free market as the best arbiter of economic success or failure. But we suggest that the market for crude is not that ideal, competitive, free market. Thus, GRI believes some adjustments are necessary in the tax structure to accomplish what the marketplace fails to achieve: a vigorous, truly competitive domestic refining industry.

First, a glimpse at Glenrock Refinery's history. We began in an effort to meet the obvious diesel product demand in central Wyoming resulting from rapid discoveries of both coal in eastern Wyoming and oil under the Overthrust Belt. GRI has spent over \$3 million in upgrading and retrofitting its refinery to make it an efficient competitor in our region. Financing this expansion has been incredibly difficult as I must persuade bankers that GRI can succeed despite all the factors beyond our

control, most particularly the possibility of crude simply being unavailable at a price which allows us to market the product yield at a profit. We have now completed Phase I of our expansion plan and are providing the local Casper market with gasoline, diesel fuel, and aviation jet fuel.

While GRI is a small, independent refinery, it is not a "tea kettle" or "bias baby" refinery. GRI's existing modernization and expansion program demonstrates that it has anticipated and prepared for decontrol by using profits to upgrade and expand the refinery. Our present analysis of GRI's financial situation reveals that GRI can remain competitive with any refinery after January 28, 1981 if it has some form of equitable access to crude oil priced at competitive market levels.

Moreover, small, independent refineries play a special role in the Northern Rocky Mountain Region. Because of the isolated nature of our region, small independents often provide the most efficient and only source of energy which many users have. If these small but efficient businesses are now forced out of the market as a result of an inability to obtain needed volumes of crude at competitive prices, consumers in Wyoming and other Northern Rocky Mountain states will be the ones who suffer.

II. CRUDE SUPPLY

This Subcommittee must understand that gaining crude oil does not simply mean finding barrels available for purchase. Gaining crude supply is ultimately a question of price, not just

availability. The most important distinction between a small, independent refiner and a major, integrated refiner is this: the major can subsidize refining operations from production gains; the small cannot.

This ability to subsidize refining from production was emphasized by one major's 1980 fourth quarter net income statement. Amoco (Standard Oil Co. of Indiana) reported that its exploration and production income rose 88% to \$272.2 million while its net loss from refining and marketing more than doubled to \$115.6 million. Such statistics emphasize that a business judgment is being made by major refiners to control crude at the lease level which will have the effect of ultimately forcing others out of the market.

This critical distinction between the majors and small independents was bolstered by a recent DOE study that noted survival of refineries under decontrol may depend more on access to crude than efficiency in the refining and marketing of crude products. ^{1/} This is due to several factors. First, the major integrated companies have long produced such a substantial amount of their own crude that they are no longer dependent on the open market for significant percentages of the crude they use. In contrast, independent refiners by definition still remain highly dependent upon the open market to purchase the crude that they

^{1/} "Crude Oil Access Study Draft," Office of Competition, Office of Oil Policy, Assistant Secretary for Policy and Evaluation, Department of Energy, October 6, 1980, p. I-3.

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need for refinery operations. In 1979, for example, the 16 largest integrated refiners purchased approximately 68% of the total refinery input from cheaper "non-market" sources (i.e., sources which the majors controlled themselves either as owned production or sales from a foreign production company to affiliates). In contrast, the 25 largest independent refiners in 1979 were required to purchase the vast majority of their crude input on the open market at significantly higher prices. ^{2/}

The significant disparity between the amount of production owned or controlled by a major refiner versus an independent one results in numerous competitive disadvantages for the independents, and particularly for small independents such as GRI. Assuming a world market price of \$37 per barrel, the after-tax advantage to the majors of controlling their own production and obtaining it at cost is approximately \$6-7 per barrel under the average market price of crude for independents. ^{3/} While independents such as GRI are able to compete with larger companies in terms of refinery efficiency, this efficiency parity cannot overcome the substantial cost advantage and potential for market manipulation which the majors have in controlling their own non-market sources of production.

Small independents such as GRI are placed at a further competitive disadvantage because, unlike the majors, we are

^{2/} Id., p. 3. By definition, an independent refiner owns or controls less than 30% of the crude oil run in his refinery.

^{3/} Id., p. 5.

unable to obtain access to foreign crude at prices below the prevailing market level. For example, in June 1979, the average crude cost of the 25 largest independents was 6% higher (\$1.05 per barrel) than the average cost of imported crude for the four Aramco partners (Exxon, Texaco, Chevron and Mobil). ^{4/} Because small independents such as GRI are unable to negotiate with foreign producers who demand the purchase of substantial quantities of crude, or significant capital outlays for exploration, production, and the transfer of technology to the country of sale, they are again at a disadvantage in gaining access to crude at competitive prices.

These inherent advantages of the majors in obtaining crude will inevitably be reflected in competitive bidding for crude available on the open domestic market. The crude price advantage enjoyed by the Aramco companies, and by all of the majors, could be used to subsidize competitive purchases on the open market. During June 1979, for example, Aramco imported 1.6 million barrels per day into the United States at a price approximately \$2 less than the average per barrel price for all domestic refiners. Because of the volumes involved, the Aramco companies could have purchased on the U.S. open market an additional 320,000 barrels per day at \$10 per barrel above the industry average, or 640,000 barrels per day at \$5 above the average, without raising the average Aramco cost above the industry average.

4/ Id.

More importantly, the cost advantage enjoyed by the majors in the control of their domestic production provides an even greater potential for subsidization of open market purchases which they make in competition with small independents such as GRI. According to DOE, domestic production by the largest 16 majors at cost provided a \$6.45 per barrel advantage over the average market level price paid for domestic crude in 1979. Thus, the integrated companies could have bid over \$10 per barrel higher than the competitive price for each of the 3,470,000 barrels per day they purchased on the open market in 1979 without raising their average crude price above the competitive price. Again, the cost advantage offered by the majors' control of domestic production in 1979 would have allowed them to bid an extra \$5 above the competitive price both for their share of the open market plus the share of the market which in 1979 went to the independents. ^{5/} The advantages of controlling substantially cheaper non-market sources of crude permit the majors to easily take over significant shares of the crude oil presently bought by independents. Importantly, subsequent to decontrol, the majors will of course not be required to provide any of this crude to any crude deficient refiner.

Small refiners such as GRI are particularly hurt when the larger majors, cushioned by the savings provided by their own production, bid up the price of crude on the open market above

^{5/} Id., III--11-14.

that price which would exist were no cost advantage available to the majors at the outset. In the third quarter of 1979, for example, domestic refineries purchased 305,000 barrels per day at prices between \$5-10 above official selling prices, and 291,000 barrels per day at prices between \$10-15 above such official prices. ^{6/} Such premiums are not the result of the free market. Rather, they represent an ongoing subsidization by the majors of crude prices which is very seriously forcing small refiners such as GRI out of business.

For all of the above reasons, certain steps must be taken by this Congress to insure that equitable access to crude is available to all refiners who possess the efficiency to compete once equitable access, in both price and availability, is gained.

III. RECOMMENDATIONS FOR LEGISLATIVE ACTION

GRI proposes the following recommendations as a means of insuring some equality between independents and the majors in access to crude. First, GRI supports an exemption from the windfall profits tax of 1980 for royalty owners and independent producers for the first 1,000 barrels of daily production when such production is sold to small and independent refiners such as GRI. Such legislation would have several positive effects. One, such a proposal would encourage the production of additional

^{6/} Id., III-12.

supplies of domestic energy and provide necessary additions to U.S. oil and gas reserves. Second, by eliminating a tax upon such producers, the proposal would permit independent producers and royalty owners to provide substantial volumes of crude oil to small and independent refiners at a price which would help to offset the numerous advantages in access to crude which the majors already enjoy for the reasons we've stressed. Three, such legislation would reward small investors who have invested capital in an industry of great importance to the security of our country, while not penalizing any of the major integrated oil companies. GRI thus supports such a windfall profits tax exemption when crude is sold to a small and independent refiner.

Second, GRI supports the passage of some tax incentive which will permit domestic refineries to quickly upgrade their configurations to handle the heavier, sour crudes which will become increasingly available in the 1980's. GRI supports proposals to shorten the depreciable life for refining assets under the Asset Depreciation Range system, and supports additional energy tax credits for both refinery upgrading and for certain equipment capable of saving significant quantities of oil and gas if implemented by the refining industry. In this regard, GRI commends Senator Wallop for his introduction of S. 750. These measures are necessary if the projected \$20 billion required to upgrade existing domestic capacity in the forthcoming decade is to be raised.

Third, GRI supports an amendment to the foreign tax credit rules providing that sales of foreign or domestic crude to an unrelated domestic small refiner would be treated as foreign source income for the seller. Such a proposal is not detrimental to the major oil companies, and does encourage sales to domestic small independent refiners such as GRI. In addition, GRI urges consideration by this Subcommittee of a tax deduction for any sales of crude--with or without unused foreign tax credits--to a qualified small refiner so long as the purchaser is not buying such crude for resale in the open market. Because price access to crude is the central issue, this approach is a positive one.

In short, the majors presently enjoy cumulative tax advantages because they have their own production. Until smalls enjoy similar tax advantages, smalls are doomed. We ask this Subcommittee not to penalize the majors, but rather to give the small refiners tax treatment that allows the independent sector to have equal footing with the majors.

Finally, GRI strongly supports the imposition of increased tariffs and/or import fees on imported petroleum products. At present, no import fees are imposed on crude products brought into the United States, and only minimal tariffs exist. The highest tariff imposed on crude oil or petroleum products is \$.525 per barrel for imported motor fuels. Such protection is inadequate if the refining industry is to avoid the disastrous impact to our economy presently caused by the OPEC cartel.

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The imposition of an import fee on petroleum products would provide advantages to the entire domestic refining industry and avoid U.S. dependence on foreign production of such products, and thus strongly enhance national security. ^{7/}

IV. CONCLUSION

Small and independent refiners such as GRI play a crucial role in the U.S. refining industry. In the Northern Rocky Mountain Region, for example, we are able to serve markets which the majors are simply less interested in serving. Moreover, small refiners across the country have traditionally played a special role in producing fuels needed by military installations as well as products demanded by the nation's agricultural communities. For all of these reasons, Glenrock trusts that this Subcommittee will work to insure that the domestic refining industry remains vigorous, healthy, and competitive, and that small independents have some basis for obtaining an equitable price access to crude in the decontrolled environment of the 1980's. Frankly, Mr. Chairman, you need to act with speed. Thank you for this opportunity to testify this morning.

^{7/} "Costs and Benefits of a Protective Tariff on Refined Petroleum Products After Crude O Decontrol--Draft" Office of Policy and Evaluation, U.S. Department of Energy, January 31, 1980, p. 1.

**STATEMENT OF DENNIS F. JUREN, GROUP VICE PRESIDENT,
TESORO PETROLEUM CORP., SAN ANTONIO, TEX.**

Mr. JUREN. Mr. Chairman, my name is Dennis Juren. I am group vice president of refining and marketing for Tesoro Petroleum Corp. We are regional refiners and marketers who have refineries in Texas and Alaska.

To give you a little perspective of our size, we have about 75,000 barrels a day capacity which represents approximately four-tenths of the domestic refining industry capacity.

Tesoro supports modification of the foreign tax credit rules as a possible way to create an incentive for the international majors to share some of their crude supplies with independent refiners in the United States.

This, in our view, is only a partial solution; a treatment of a symptom, if you would, as opposed to the disease. What you have heard over and over here this morning is really the gut issue. Equitable access to crude oil at fair prices, at competitive prices.

There is truly no real free market for crude oil today. The NPC study, which purports to represent a means of allocating crude in a major shortfall is really a disaster, as far as the independent sector of the industry is concerned.

By the time the trigger's envisioned by that study would be activated, half the independent sector would be out of business.

A crude shortfall of 10,000 barrels a day from my company would represent a loss of 15 percent of my total capacity. A 10,000 barrel a day loss of crude oil for an Exxon size company would represent less than 1 percent of their capacity.

We support a tariff as a possible way to equalize some of the disadvantages that U.S. refiners have vis-a-vis foreign refiners. Much of that disadvantage is regulation or Government induced. Things such as the Jones Act, environmental constraints required by U.S. refiners, foreign tax, exemptions granted foreign refiners.

A 1978 DOE study indicated that this difference would range from 45 cents upwards to \$2.14 a barrel, depending on the location and the complexity of the refinery.

It may be politically infeasible, however, to impose a tariff that would be high enough to truly deter imports. As a result, Tesoro would recommend that perhaps a product quota system would be a better alternative than a tariff which would be so low as to be ineffective in its purpose.

Without detracting from the importance of the other subjects being considered here today, I think that perhaps the matter of upgrading and retrofitting refineries is perhaps the most critical issue facing the independent sector of the industry today.

The increased requirement for unleaded gasoline, notwithstanding that total gasoline is declining; the shift on a worldwide basis of a sweet to a sour ratio change that is deteriorating, will require significant capital expenditure by many refiners for hardware capable of chewing up the bottom of the barrel.

The magnitude of these investments, coupled with the high cost of money, will make the economics of these investments almost impossible for the very small refiner, and very difficult, at best, for even the financially sound midsized refiner.

As an illustration, we estimate that it would cost in the magnitude of \$250 million to \$300 million to retrofit and modify a 50,000 barrels per day, somewhat integrated, sweet crude refinery so that it could process sour crude.

The debt service alone for that magnitude of investment could add about \$2 a barrel or 5 cents a gallon to the cost of operating that facility.

With respect to crude oil purchasing cooperatives, this is not a new idea. They have been tried before. They have not met with a great deal of success.

Cooperatives, to meet with success, would have to be structured close to a government-to-government type of arrangement, and we would be strongly opposed to any structure that might be a precursor to the Government becoming the purchasing agency for the industry.

Thank you for the opportunity to share my views with you.
Senator DURENBERGER. Thank you, Mr. Juren.

[Statement follows:]

TESTIMONY

BY

DENNIS F. JUREN, GROUP VICE-PRESIDENT

TESORO PETROLEUM CORPORATION

MARCH 27, 1981

Mr. Chairman, subcommittee members, I am Dennis F. Juren, Group Vice-President, Refining and Marketing, Tesoro Petroleum Corporation. Thank you for giving me the opportunity to testify before this subcommittee today.

Tesoro is a publicly owned (NYSE), small and independent refiner as defined in the Emergency Petroleum Allocation Act of 1973. In addition to its refineries located in Carrizo Springs, Texas and Kenai, Alaska, Tesoro is also involved in marine, pipeline, and truck transportation, refined product marketing at the wholesale and retail levels, exploration and production, contract drilling, oil field equipment rental and services, and coal mining. For your further information, I have attached a copy of Tesoro's Annual Report for 1980. Tesoro is also a member of the Committee for Equitable Access to Crude Oil (CEACO), an ad hoc committee of 14 similarly situated, long-time established, independent refiners (membership list attached as Appendix I) which was formed to address the problem of obtaining crude oil at economic prices during periods of limited supply. Although I am speaking today only on behalf of Tesoro, I believe that my comments will also reflect the views of many established independent refiners who make up what might be called the "middle class" of the refining industry.

For the subcommittee to understand the thrust of my comments, it is essential that you recognize the negative attitude that has developed during the period of federal controls toward the oil industry in general and the independent refining sector in particular. Over the last several months, there has been much bad publicity about the small independent refiners who were heavily subsidized by the so-called entitlements program and its small refiner bias feature. Recent press accounts have focused on efforts by these refiners "to stay on the public dole." I would be less than candid if I did not acknowledge that there are elements of truth in those accusations. Unfortunately, however, the media and other critics of the oil industry are not too selective in who gets hit by their broadsides. Often as not, the innocent get categorized with the guilty and get tarred by the same brush. In discussions of the crude oil access issue with members of Congress and their staff and with members of the Administration, we have detected among some of them a cynical, almost sarcastic, attitude towards our efforts to rectify what we perceive to be a real problem. For the above reasons, we were pleased to note, Mr. Chairman, that in announcing this hearing you recognized that all problems confronting the refining industry did not automatically disappear as the result of decontrol.

Focusing on the specific proposals that are the subject of this hearing:

MODIFICATION OF FOREIGN TAX CREDIT RULES

This proposal aims directly at the crude oil access problem for independent refiners which led to the creation of CEACO. In our discussions with government officials, we have come face to face with the idyllic presumption that now that decontrol of crude oil has taken place, there is no need for governmental intervention of any kind. The government can just step back and let the free market set the prices and allocate the crude. Efficient refiners will prosper and the inefficient will fail, and that is as it should be.

Tesoro wholeheartedly endorses the concept of competing in a free market. We not only competed, but grew and prospered during a period when no controls existed. But times have changed. There is, in fact, no free market for crude oil today. A major portion of domestic crude oil production is either owned by or controlled by the major integrated oil companies. In addition, certain of these same major companies are given preferred positions by the more moderate OPEC countries for the purchase of contract crude oil while others have no option but to purchase crude on the spot market or negotiate contracts with the more radical producer countries. What this means is that even during temporary periods of adequate supply, some refiners enjoy a decided economic advantage over other refiners. In times of even moderate short supply, this economic advantage will increase as many buyers chase the same limited barrels, thereby driving up spot market prices. Ultimately, contract prices will follow the spot prices to the detriment of the consumer and the U.S. economy but, in the meanwhile, crude rich integrated major refiners will enjoy a veritable "profit explosion." Further, if there is no allocation mechanism in place, these majors will experience little or no short-fall. It will be the independent refiners who will be forced to run at reduced rates and pay prices for crude at levels which makes competing impossible.

What is frustrating is that the advantages enjoyed by these integrated majors has nothing to do with efficiency of operation, or lack of effort on the part of the independent oil companies to secure crude supplies at equitable prices. To a large extent, it is the direct result of the internal policies of the various OPEC members. In effect, certain OPEC members have more control of the fate of many independent U.S. refiners than does management or even the United States government.

It must be remembered, however, that independent refiners are important factors in many regions of the country. For example, one CEACO member supplies 70 percent of the gasoline and 50 percent of all other petroleum products in Puerto Rico. Another supplies 50 percent of refined products used in Buffalo, New York. Two more supply over 70 percent of the petroleum requirements of Hawaii. Tesoro alone produces about 70 percent of all gasoline, 25 percent of all commercial aviation fuel, and 20 percent of all highway diesel fuel consumed in Alaska. We are also a major supplier of fuel to military installations in Alaska. Independent refiners are also the major suppliers to many of the more sparsely populated areas of the midwest, southwest, and mountain states where the major oil companies do not choose to market, and from which some of them have only recently chosen to withdraw even further. Obviously, the needs of these consumers must be taken into account in formulating the U.S. energy policy as it relates to refining.

Tesoro supports modification of the foreign tax credit rules because it would remove an existing disincentive for sale of crude oil by international oil companies to independent domestic refiners. We believe that the proposed modification would result in increased availability of crude oil to independent refiners but that it will be only a partial solution to the crude access problem. In this regard, we will also continue to work for the development of a comprehensive standby emergency crude oil allocation program.

TARIFF ON IMPORTED PETROLEUM PRODUCTS

Tesoro supports a tariff, fee, or product quota to encourage refining within the United States. And, as suggested in the notice of this hearing, a tariff or fee must be substantial to be effective. An update of a recent study done for the Department of Energy in 1978 indicates that existing offshore foreign refineries have an economic advantage, depending upon location, of between \$0.45 to \$2.14 (1978 dollars) per barrel when compared to domestic refineries. This same study estimates that if downstream conversion facilities were installed at an existing Caribbean refinery, the advantage could increase to \$2.54 per barrel, and that the advantage for a new offshore refinery over a new domestic refinery would range from \$2.00 to \$3.00 per barrel.

Unlike the automotive industry, much of the offshore advantage has nothing to do with efficiency per se. Rather, it is created by government law and regulation. For example, transportation (Jones Act and port limitations) and the cost of compliance with environmental protection restrictions result in advantages of \$1.42 and \$0.94 per barrel for Caribbean and European refiners, respectively, over a Gulf Coast refiner marketing on the East Coast. In addition, many offshore refineries enjoy a very favorable tax treatment.

In view of the size of the tariff that would have to be imposed to provide meaningful protection against large volume imports, it may be difficult to enact the necessary legislation. We, nevertheless, believe that it is important to send the offshore refiners, particularly any Caribbean refiners who may be considering the installation of high conversion facilities, a clear-cut message that the United States does not intend to impair its national security by increasing its dependence on foreign refiners for its refined products needs. Therefore, as an alternative to a tariff or fee which is too small to prevent product imports, we suggest consideration of a product import quota which recognizes historical importers and import patterns. This product quota could, of course, be lifted during periods when crude supply shortages prevent domestic refiners from meeting demand.

TAX INCENTIVES FOR UPGRADING OR RETROFITTING DOMESTIC REFINERIES

Without meaning to minimize the importance of the other proposals, I believe that providing tax incentives for upgrading or retrofitting domestic refineries is the most important issue before the subcommittee today. Changes that are occurring both on the crude supply and products sides are impacting, and will continue to impact, on the refining industry:

- Overall demand for petroleum products is declining.
- Although motor gasoline demand is down, demand for unleaded gasoline is growing. With lower crude runs, an increasing percentage of crude oil must be converted to unleaded gasoline.
- Utility and industrial use of heavy fuel oil is being replaced by coal, nuclear energy, and natural gas. As this decline continues, the residuum must be processed to yield more light products.
- The ratio of sweet to sour crude is deteriorating world wide. As sweet crude availability declines, a corresponding amount of refining capacity must be retrofitted to process sour crude. Generally, sour crude is also heavier than sweet crudes, creating a disproportionately higher requirement for "bottom of the barrel" processing equipment to simply maintain the same light product yield at a constant throughput level.

The investments for upgrading and retrofitting refineries are very expensive in relationship to the base refinery investment. The magnitude of the investments, coupled with the high cost of money, will make it virtually impossible for small refiners to upgrade their facilities, and even financially sound, mid-sized refiners will have difficulty with the economics in the absence of investment incentives such as the ones proposed by this subcommittee.

CRUDE OIL PURCHASING COOPERATIVES

Although we are not opposed to the idea of purchasing cooperatives, we do not believe they will be of any real value to small and independent refiners. This is not a new concept and past efforts at cooperative purchases by refiners have had little or no success. We believe that for a purchasing cooperative to be successful, it would have to be structured so that the producing country could consider any contracts entered into as government-to-government deals. We would be opposed to formation of purchasing cooperatives that might be precursors of a governmental purchasing agency for all imported crude oil.

APPENDIX I
MEMBERSHIP LIST

COMMITTEE FOR EQUITABLE ACCESS TO CRUDE OIL

<u>Name of Company</u>	<u>B /D</u>
American Petrofina	143,300
Ashland Oil	475,000
Clark Oil	131,200
CORCO	161,000
Earth Resources	70,000
ECI	126,000
Good Hope	82,100
National Cooperative Refinery Assn.	54,150
Powerine	44,120
Pacific Resources	67,900
Rock Island	41,400
Tesoro	74,600
Total Petroleum	87,230
United Refining	<u>52,000</u>
	1,610,000 B/D

Total U.S. capacity (incl. Puerto Rico) 17,401,231

SUMMARY OF TESTIMONY

BY

DENNIS F. JUREN, GROUP VICE-PRESIDENT

TESORO PETROLEUM CORPORATION

MARCH 27, 1981

MODIFICATION OF FOREIGN TAX CREDIT RULES

Government cannot completely disassociate itself from the matter of crude oil access, because

- There is, in fact, no free market for crude oil today
- Major oil companies control much of the domestic production and have preferred positions in international crude markets
- Crude oil control gives majors economic advantage over independents in "normal" markets and exponential economic and supply advantages in short supply situations
- Much of the economic advantage of majors is not due to lack of effort or efficiency of independents but is conferred by certain OPEC members
- Independent refiners are important suppliers in many regions of the country. The consumers served by the independents must be considered in making U.S. energy policy
- Tesoro supports modification of the foreign tax credit rules but believes a comprehensive standby emergency crude oil allocation program is also needed.

TARIFF ON IMPORTED PETROLEUM PRODUCTS

- Tesoro supports tariff or fee
- Foreign refineries enjoy significant economic advantages over domestic refiners
- Much of this advantage is the result of the Jones Act, environmental regulations, and foreign tax exemptions
- It may be politically infeasible to impose a tariff large enough to be effective
- Tesoro would prefer a product quota as opposed to a tariff which might be too small to deter product imports .

TAX INCENTIVES FOR UPGRADING OR RETROFITTING DOMESTIC REFINERIES

- A combination of factors--increased lead free gasoline, declining market for heavy fuel oil, and a shift to heavier high sulfur crude oil will require large capital expenditures for many refiners
- The magnitude of the investment, coupled with the high cost of money, will make the economics of these investments very difficult for even financially sound independent refiners without the incentives proposed by this subcommittee.

CRUDE OIL PURCHASING COOPERATIVES

- Past cooperative purchasing attempts by refiners have had little success
- Cooperatives structured to provide government-to-government deals would be needed for success
- Tesoro is opposed to structure which might be precursor to governmental purchasing agency for all imported crude oil.

**STATEMENT OF THEODORE R. ECK, CHIEF ECONOMIST,
STANDARD OIL CO. OF INDIANA, CHICAGO, ILL.**

Mr. Eck. The question arose earlier today whether this is the right committee to discuss these issues. I think it's absolutely the right committee, because the only legislative changes that we believe need to be made affecting the industry are tax changes.

The issue of why Standard Oil Co. is here, we're by far and away the largest company represented, and because we indeed are a large domestic petroleum refiner who does not operate overseas export refineries. We are the largest supplier of oil products to the farm belt, and we share much the same problems of the smaller refineries that you have heard from today.

Now, what are those problems? Our most serious, current problem is we're operating at only 70 percent capacity. Indeed, the U.S. refining industry is operating at less than 70 percent of capacity.

We cannot operate, as an industry, profitably, with 30 percent of our plant idle. Margins have declined and something has to be done.

What we have done is we have closed down one large refinery that produces in excess of 100,000 barrels a day, which is larger than the refineries of most any one operating here on this panel. If everyone else were to shut down an equal percentage of their capacity, that would total about 1.5 million barrels a day or 10 percent of total U.S. refinery capacity.

Even a shutdown of that size would leave the U.S. refining industry operating at only about 80 percent of capacity, and we estimate that for this industry to operate profitably, we have to get operating rates up to the 85 and 90 percent range. This suggests the magnitude of the current problem.

But, it's not just a current problem, because looking into the whole decade of the 1980's, we estimate that our requirements for refining capacity are going to go down 20 percent.

Looking specifically at products, we're going to be making roughly 30-percent less gasoline, a third less residual fuel and heating oil, the major products of the smaller refineries. At the same time,

we have got to increase by a third our production of the high quality distillates for jet fuel and for motor diesel requirements.

This is going to necessitate a different kind of refining industry in terms of equipment. The hydroskimming refining equipment that makes primarily residual fuel oil will face shrinking markets, and I'm frankly not surprised at the comments we have heard around the table of the unprofitability of hydroskimming, because residual fuel sells for less than crude oil.

That condition we expect to be maintained throughout the visible future. It's not a question of the price of the crude oil. It's the fact that residual sells for less than crude oil and will continue to do so.

The only way out of this is making investments necessary to convert the residual fuel to higher value products, and this is precisely what the petroleum industry is going to have to do.

The issue has also been raised as to whether or not we need to institute import fees or import quotas. It's our judgment that the industry, if it can get efficient, if we can shut down this redundant capacity and get up to an efficient operating range, that we do not need protective duties, that we can compete with overseas refining.

Turning also to another question that has been raised frequently around the table, that of access to crude oil in the world. I, frankly, am very surprised at the comments that have been made, because there is ample supply of crude oil in the world. Crude oil prices are declining, and quite frankly, the refiner that doesn't have a long-term crude purchase contract is in great shape, because the spot price of crude oil is substantially below the price that those of us who have long-term contracts are paying.

We expect this condition to persist. We expect crude availability to be good throughout the balance of the decade. Indeed, we're in a buyer's market for crude oil and we believe this market will sustain.

Finally, as to tax policy, we support the President's program as it applies to the refiners. We would be very major beneficiaries in the refining industry of 10-5-3 provided it is accompanied by the investment tax credits and the ability to receive these benefits during the construction of the equipment.

So, in summary, we have a big problem with excess capacity that we need to work off. Crude oil access is not a problem, and if we enact the President's program in the area of tax relief, especially depreciation acceleration, we don't need any special taxes or special tax programs applied to the refining industry.

Thank you.

Senator WALLOP. Thank you, Mr. Eck.

[Statement follows.]

STATEMENT TO SENATE FINANCE COMMITTEE
ON ENERGY TAXATION
BY THEODORE R. ECK
STANDARD OIL COMPANY (INDIANA)

*** SUMMARY STATEMENT ***

THE BIGGEST PROBLEM FACING THE REFINING INDUSTRY IS EXCESS CAPACITY, WHICH HAS RESULTED FROM DECLINING OIL DEMAND AND INCREASING CAPACITY. PUBLIC POLICY SHOULD ALLOW THE INDUSTRY TO REDUCE THE COSTLY BURDEN OF REDUNDANT REFINING CAPACITY. LEFT ALONE, THE FREE MARKET WILL CORRECT THIS IMBALANCE BY PRUNING OUT THE LEAST EFFICIENT.

EXCESS REFINING CAPACITY ALSO EXISTS OVERSEAS. U.S. REFINERS WILL BE UNDER PARTICULARLY INTENSE PRESSURE TO IMPROVE THEIR EFFICIENCY DUE TO THE HIGHER COSTS THEY FACE RELATIVE TO FOREIGN SUPPLIERS FROM JONES ACT TANKER REQUIREMENTS AND MORE STRINGENT ENVIRONMENTAL REGULATIONS. THE INDUSTRY SHOULD BE ABLE TO COMPETE WITHOUT PROTECTIVE QUOTAS OR TARIFFS, PROVIDED IT IS NOT SADDLED WITH ADDED COSTS FROM FORCED SUBSIDIES TO HIGH COST, INEFFICIENT REFINERS.

CRUDE OIL ACCESS SHOULD NOT BE A PROBLEM IN THE DEVELOPING BUYER'S MARKET FOR CRUDE OIL. ONLY IN THE EVENT OF A GENERAL WAR IN THE MIDDLE EAST OR SIMILAR CATASTROPHE IS THERE A LIKELIHOOD OF A CRUDE OIL SHORTAGE.

SUMMARY

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THE DOMESTIC REFINING INDUSTRY'S EXCESS CAPACITY PROBLEM DOES NOT MEAN THERE IS NOT A NEED FOR ADDED INVESTMENT. SUBSTANTIAL REFINING INVESTMENTS WILL BE NEEDED TO PROCESS THE CHANGING MIX OF CRUDES AVAILABLE TO THE INDUSTRY INTO THE KINDS AND QUALITIES OF PRODUCTS NEEDED IN THE FUTURE. THE PRESIDENT'S ACCELERATED COST RECOVERY TAX PROGRAM SHOULD PROVIDE THE INCENTIVES NEEDED TO MAKE THESE INVESTMENTS WITHOUT NEED FOR TAX INCENTIVES SPECIFIC TO THE REFINING INDUSTRY.

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STATEMENT TO SENATE FINANCE COMMITTEE
ON ENERGY TAXATION
BY THEODORE R. ECK
STANDARD OIL COMPANY (INDIANA)

I APPRECIATE THE OPPORTUNITY TO SHARE OUR THOUGHTS WITH YOU ON THE DOMESTIC REFINING INDUSTRY AND OUR VIEWS ON THE ACTIONS BY THE COMMITTEE THAT MAY BE APPROPRIATE IN THIS AREA. I WILL START WITH A BRIEF REVIEW OF THE CURRENT REFINING SITUATION.

OIL INVENTORIES ARE HIGH WITH GASOLINE INVENTORIES IN PARTICULAR CURRENTLY AT A RECORD LEVEL OF 286 MILLION BARRELS. OIL DEMAND, ON THE OTHER HAND, HAS CONTINUED TO DECLINE. FOR EXAMPLE, DEMAND IN 1980 WAS DOWN 8 PER CENT FROM THE LEVEL IN 1979, AND IS EXPECTED TO DROP ANOTHER 5 PER CENT THIS YEAR. DURING THIS PERIOD, REFINING CAPACITY HAS CONTINUED TO INCREASE. AS A RESULT, THE INDUSTRY TODAY IS OPERATING AT AROUND 70 PER CENT OF CAPACITY. HIGH INVENTORIES, DECLINING SALES, AND LOW OPERATING RATES HAVE LED TO DEPRESSED MARGINS IN THE REFINING/MARKETING SEGMENT OF THE INDUSTRY. THIS IS THE NATURAL WORKING OF THE FREE MARKET. LEFT ALONE, IT WILL LEAD TO A CORRECTION OF THE IMBALANCE BY PRUNING OUT THE LEAST EFFICIENT.

SPEAKING FOR MY COMPANY, THESE ECONOMIC FORCES HAVE CAUSED US TO LOOK LONG AND HARD AT OUR OWN REFINING SYSTEM. THIS RESULTED IN A RECENT ANNOUNCEMENT TO SHUT DOWN ONE OF OUR

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OWN REFINERIES, REDUCING OUR TOTAL REFINING CAPACITY BY ABOUT 9 PER CENT. A SIMILAR REDUCTION BY THE REST OF THE INDUSTRY WOULD RESULT IN A SHUTDOWN OF 1.5 MMB/D OF CAPACITY. EVEN THEN, THE INDUSTRY WOULD OPERATE AT LESS THAN 80 PER CENT OF CAPACITY. PRESS REPORTS INDICATE OTHER OIL COMPANIES HAVE TAKEN ACTION SIMILAR TO OURS. WE EXPECT THIS TO CONTINUE, LEADING TO THE SHUTDOWN OF A LARGE AMOUNT OF CAPACITY THAT IS NO LONGER COMPETITIVE.

LET ME FOCUS BRIEFLY ON THE LONGER TERM TO DETERMINE WHERE THE INDUSTRY IS HEADED. OIL DEMAND IS EXPECTED TO CONTINUE DECLINING THROUGH THE 1980'S WITH DEMAND IN 1990 DOWN ABOUT 20 PER CENT FROM THE 1978 LEVEL. CONSTRUCTION CURRENTLY UNDERWAY WILL LEAD TO A FURTHER INCREASE IN U.S. REFINING CAPACITY. ABSENT SHUTDOWN OF REFINING CAPACITY, EXCESS CAPACITY WILL AMOUNT TO AROUND 30 PER CENT BY 1990. THIS IS BY NO MEANS A UNIQUELY U.S. PHENOMENA. FREE WORLD OIL DEMAND HAS BEEN DECLINING WHILE REFINING CAPACITY HAS BEEN INCREASING. CURRENT AND FORECAST EXCESS REFINING CAPACITY FOR THE FREE WORLD IS COMPARABLE TO THAT FOR THE U.S.

THE EXCESS CAPACITY CREATES A COST BURDEN WHICH ULTIMATELY THE CONSUMER PAYS. HENCE, IT IS IMPORTANT THAT THE WORKINGS OF THE FREE MARKET IN ELIMINATING THE EXCESS NOT BE INTERFERED WITH. U.S. REFINERS WILL BE UNDER PARTICULARLY INTENSE

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PRESSURE TO IMPROVE THEIR EFFICIENCY DUE TO THE HIGHER COSTS THEY FACE RELATIVE TO FOREIGN SUPPLIERS FROM JONES ACT TANKER REQUIREMENTS AND MORE STRINGENT ENVIRONMENTAL REGULATIONS.

SO FAR I HAVE TALKED ONLY ABOUT TOTAL OIL DEMAND, AND NOT ABOUT THE SIGNIFICANT SHIFTS THAT WILL OCCUR IN THE DEMAND FOR PARTICULAR PRODUCTS. IN THE DECADE OF THE 1980'S, GASOLINE DEMAND IS EXPECTED TO DECLINE BY 30 PER CENT AND THE DEMAND FOR RESIDUAL FUEL AND DISTILLATES FOR HEATING BY ONE THIRD. ON THE OTHER HAND, THE DEMAND FOR HIGH QUALITY DISTILLATES FOR MOTOR DIESEL AND JET FUEL IS EXPECTED TO INCREASE 35 PER CENT. AT THE SAME TIME, DEMAND WILL CONTINUE TO SHIFT FROM LEADED TO UNLEADED GASOLINE. IN ADDITION TO THE PRODUCT SHIFTS, THE CRUDE AVAILABLE TO REFINERS IS EXPECTED TO BECOME HEAVIER AND CONTAIN MORE SULFUR.

THESE SHIFTS WILL NECESSITATE CHANGES IN REFINERY EQUIPMENT. UNNEEDED WILL BE THE LARGE NUMBER OF HYDROSKIMMING REFINERIES WHICH PRODUCE LARGE AMOUNTS OF FUEL OIL. INSTEAD, INVESTMENT IS NEEDED IN HYDROCRACKING AND HEAVY FUEL UPGRADING EQUIPMENT TO MAKE HIGH QUALITY DISTILLATES AND REDUCE THE AMOUNT OF UNNEEDED RESIDUAL FUEL. THIS EQUIPMENT IS EXPENSIVE AND NECESSITATES CONSTRUCTION OF LARGE SIZE UNITS TO GAIN THE ECONOMIES OF SCALE. THERE IS NO ECONOMIC BASIS FOR UPGRADING SMALL REFINERIES WHICH WOULD RESULT IN CONSTRUCTING SMALL UNECONOMIC UNITS.

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AS I MENTIONED, WE HAVE ANNOUNCED THE SHUTDOWN OF A REFINERY AND SO HAVE OTHER MAJORS. BOTH LARGE AND SMALL REFINERS WILL BE CLOSED IN AREAS OF SURPLUS CAPACITY SUCH AS THE GULF COAST, WHERE ONLY THE LOWEST COST REFINERS WILL BE COMPETITIVE. THE SHUTDOWNS WILL NOT RESULT IN ANY REGIONAL SHORTAGE OF REFINED PRODUCTS. THE INDUSTRY HAS AN EXTENSIVE DISTRIBUTION SYSTEM AND THOSE REFINERS SERVING REGIONAL MARKETS WILL SURVIVE.

LET ME TURN NOW TO SOME OF THE SPECIFIC ISSUES REFERRED TO IN THE HEARING NOTICE. FOR NATIONAL SECURITY REASONS, THE U.S. NEEDS A STRONG DOMESTIC REFINING INDUSTRY THAT IS COMPETITIVE ON A WORLDWIDE BASIS. TARIFFS ON IMPORTED PRODUCTS SHOULD NOT BE NECESSARY TO SHELTER THE INDUSTRY. HOWEVER, AS I MENTIONED, THE COMPETITIVE PRESSURE WILL BE INTENSE. THE INDUSTRY CLEARLY WILL NOT BE ABLE TO COMPETE WITH IMPORTED PRODUCTS IF IT MUST BEAR THE ADDED COST FROM SUBSIDIES TO HIGH COST, INEFFICIENT REFINERS AS A RESULT OF GOVERNMENT PROGRAMS. DISGUISED SUBSIDIES, SUCH AS THE PROPOSED MODIFICATION OF FOREIGN TAX CREDIT RULES, SERVE ONLY TO SHELTER THE INEFFICIENT FROM THE RIGORS OF COMPETITION.

THERE IS CERTAINLY NOTHING WRONG WITH SMALL REFINERS JOINING TOGETHER TO BECOME MORE EFFICIENT AND CAPABLE IN MAKING CRUDE PURCHASES. THERE SEEMS NO NEED, THOUGH, FOR SETTING UP A SEPARATE INSTITUTION WITH A TAX FREE STATUS TO ACCOMPLISH THIS PURPOSE. THE OBJECTIVE OF THE GROUP SHOULD BE TO OPERATE ON

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A NON-PROFIT BASIS, PASSING THE CRUDE ON TO ITS MEMBERS AT COST. CONFERRING A TAX FREE STATUS SEEMS NOT ONLY UNNECESSARY, BUT COULD INVITE UNINTENDED ABUSES.

THERE IS AMPLE CRUDE IN THE WORLD TODAY, AND THERE ARE EXPECTED TO BE AMPLE SUPPLIES FOR THE REST OF THIS DECADE, EXCEPT DURING EMERGENCIES. WORLD CRUDE PRICES ARE CONVERGING AND QUALITY PREMIUMS ARE SHRINKING. OIL ON THE SPOT MARKET IS GENERALLY LESS THAN THAT UNDER CONTRACT. OVER THE LONGER TERM, THE MAJORITY OF OIL SALES WILL BE DIRECTLY FROM OIL PRODUCING COUNTRIES RATHER THAN BY MAJOR OIL COMPANIES. IN SHORT, A BUYER'S MARKET IN CRUDE OIL IS DEVELOPING FOR THE 80'S.

LIGHT SWEET CRUDES WILL CONTINUE TO SELL AT A PREMIUM OVER HEAVY, HIGH SULFUR OILS. IF THERE WERE NO PREMIUMS, REFINERS WOULD NOT INSTALL THE EXPENSIVE EQUIPMENT REQUIRED TO PROCESS THESE CRUDES. GOVERNMENT ACTIONS TO ERASE THESE PREMIUMS BY SUBSIDIES OR ALLOCATIONS WILL ELIMINATE THE INCENTIVE TO UPGRADE REFINERIES.

TURNING NOW TO REFINERY TAX POLICY. THE PRESIDENT'S PROPOSED ACCELERATED COST RECOVERY PLAN SHOULD PROVIDE ADEQUATE INCENTIVES SO THERE WILL BE THE NECESSARY UPGRADING AND RETROFITTING OF THE DOMESTIC REFINING INDUSTRY. THERE IS NO NEED FOR SPECIAL TREATMENT UNAVAILABLE TO OTHER INDUSTRIES.

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MOST REFINERY INVESTMENT IS EQUIPMENT AND WOULD QUALIFY FOR A FIVE-YEAR WRITE-OFF. THE SHORTER RECOVERY PERIOD PLUS RECEIPT OF THE FULL 10 PER CENT INVESTMENT TAX CREDIT SHOULD ALLOW SUFFICIENTLY RAPID CAPITAL RECOVERY TO COPE WITH TODAY'S RAPID INFLATION. MOST REFINERY PROJECTS HAVE CONSTRUCTION PERIODS SUBSTANTIALLY IN EXCESS OF TWO YEARS. ALLOWING CAPITAL RECOVERY AND THE INVESTMENT TAX CREDIT TO BE TAKEN AS THE MONEY IS SPENT IS A SIGNIFICANT HELP TO THESE LONG LEAD-TIME PROJECTS. NO ADDITIONAL DIRECT REFINING TAX INCENTIVES ARE NEEDED. HOWEVER, IF A 10:5:3 TYPE BUSINESS TAX REDUCTION IS NOT ENACTED, SPECIAL INCENTIVES FOR CAPITAL INTENSIVE INDUSTRIES, SUCH AS REFINING, WILL BE NEEDED.

IN CONCLUSION, THE BIGGEST PROBLEM FACING THE REFINING INDUSTRY IS EXCESS CAPACITY. PUBLIC POLICY SHOULD ALLOW THE INDUSTRY TO REDUCE THE COSTLY BURDEN OF REDUNDANT REFINING CAPACITY. THE INDUSTRY WILL BE UNDER INTENSE PRESSURE FROM OFFSHORE REFINERIES, BUT SHOULD BE ABLE TO COMPETE PROVIDED IT IS NOT SADDLED WITH ADDED COSTS FROM FORCED SUBSIDIES TO HIGH COST, INEFFICIENT REFINERIES. CRUDE OIL ACCESS WILL NOT BE A PROBLEM IN THE DEVELOPING BUYER'S MARKET FOR CRUDE OIL. ONLY IN THE EVENT OF A GENERAL WAR IN THE MIDDLE EAST OR SIMILAR CATASTROPHE IS THERE A LIKELIHOOD OF A CRUDE OIL SHORTAGE. SUBSTANTIAL REFINING INVESTMENTS WILL BE NEEDED TO PROCESS THE CHANGING MIX OF CRUDES AVAILABLE TO THE INDUSTRY

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INTO THE KINDS AND QUALITIES OF PRODUCTS NEEDED IN THE FUTURE. THE PRESIDENT'S ACCELERATED COST RECOVERY TAX PROGRAM SHOULD PROVIDE THE INCENTIVES NEEDED TO MAKE THESE INVESTMENTS WITHOUT NEED FOR TAX INCENTIVES SPECIFIC TO THE REFINING INDUSTRY.

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Senator WALLOP. Our last witness is Frank Cahoon.

I am informed by the floor that we are about to have a 10-minute vote starting. If that takes place and you see me quietly vanish, don't panic. I will permit you to continue, for the record, with your remarks. I probably will adjourn the meeting as soon as you are finished so that we can go on. We will submit our questions to you by mail, for the record.

I apologize for that, but the schedule on the Senate floor governs what I can do here.

STATEMENT OF FRANK K. CAHOON, CHAIRMAN, COPANO REFINING CO., CORPUS CHRISTI, TEX.

Mr. CAHOON. Thank you, Mr. Chairman. I certainly understand. Copano is an independent refiner located in Corpus Christi, Tex. Copano favors an incentive-based national refining policy that works with, rather than against, market forces. That is better for both the refining industry and the American taxpayer.

Domestic refinery operations have been substantially curtailed since decontrol restored the uncompetitive, nonmarket crude oil cost advantage of the four multinational oil companies in Aramco.

Texas has been particularly hit hard by the nonmarket oil that is now being refined in our State after decontrol.

This is a map, Mr. Chairman, of the State of Texas showing 38 independent refineries in the State. These refineries range in size from 186,000 barrels a day to 2,400 barrels a day. I think you can see, maybe from the map, that they are well dispersed around the State.

These refineries, Mr. Chairman, export products to other States in the range of two-thirds of their capacity, with Texas taking about one-third of their capacities end products.

The noncompetitive, nonmarket oil costs that I have described principally has to do with the Saudi oil, which is officially priced at \$32 per barrel versus a domestic decontrol price that the independent refiner must pay in Texas of \$38 per barrel.

Our proposed solution is to correct this nonmarket bias by restoring the mandatory oil import quota program with allocations of import tickets to all U.S. refineries and the strategic petroleum reserve.

The largest oil importers would receive relatively fewer tickets, while the domestic-oriented refiners would receive more. The exact

allocation formula between the two groups of refiners would be determined according to cost equalization criteria.

The exchange value of the tickets would be determined by market forces, and the resultant exchanges would produce a rough cost parity among all U.S. refiners.

Copano would suggest that the tickets be labeled by country of origin. By including the strategic petroleum reserve in the program, the tax requirements for the reserve would be less and America's security interests would not be compromised due to budget belt-tightening.

We urge you, Mr. Chairman, to recommend to the Senate Finance Committee that legislation be adopted that would direct the President to immediately reactivate the mandatory oil import quota program.

This program, Mr. Chairman, as you know, was first put in place by President Eisenhower in 1959. It required a very small staff to administer this program. This program was basically put in place because at the time you had cheaper foreign oil than domestic oil.

The program then was taken out in 1973 when, under controls, the situation reversed itself. Now we find ourselves again in the condition that existed in 1959.

In the Saudi case, of a wide discrepancy in crude oil price. So, it's our feeling that the mandatory crude oil import quota program should be put back in place, and it will restore the balance of crude oil costs.

Thank you, Mr. Chairman.

Senator WALLOP. Thank you, Mr. Cahoon.

I have to respond to that. It gives me the willies to even contemplate that proposal, because I think that it is part and parcel of a series of events going back, as you point out, to the late fifties. Energy decisions made then have caused the complexity and confounded this country's energy economy beyond the simple little act that was ostensibly a "consumer protection program," and it frankly scares me to death to try to go back into it that way.

But, obviously, the committee will look at all the recommendations from the testimony here today.

[Statement follows:]

SUMMARY OF TESTIMONY

Presented by

Mr. Frank K. Cahoon
Copano Refining Company
March 27, 1981

1. An incentive-based national refining policy that works with rather than against market forces is better for both the domestic refining industry and the American taxpayer.
2. Domestic refinery operations have been substantially curtailed since decontrol restored the uncompetitive, non-market crude oil cost advantage of the four multinational oil companies in Aramco. The Department of Energy has indicated that this may be the greatest threat to price competition in the U.S. refining market.
3. Our proposed solution is to correct this non-market bias by restoring the mandatory oil import program, with allocations of import tickets to all U.S. refiners and the Strategic Petroleum Reserve. The largest oil importers would receive relatively fewer tickets, while the domestic-oriented refiners would receive more. The exact allocation formula between the two groups of refiners would be determined according to cost equalization criteria. The exchange value of the tickets would be determined by market forces, and the resultant exchanges would produce a rough cost parity among all U.S. refiners.
4. By including the Strategic Petroleum Reserve in the program, the tax dollar requirements of the reserve would be less and America's security interests would not be compromised due to budget belt-tightening.
5. We urge Chairman Wallop to recommend to the Senate Finance Committee that legislation be adopted that would direct the President to immediately reactivate the mandatory oil import program.

AN IMPORT QUOTA PROGRAM TO
EQUALIZE ACCESS TO NON-MARKET OIL FOR
DOMESTIC REFINERS AND THE STRATEGIC PETROLEUM RESERVE

Presented by

Mr. Frank K. Cahoon
Chairman of the Board
Copano Refining Company
Ingleside, Texas

Before the

SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON AGRICULTURAL AND ENERGY TAXATION
HEARING
ON
INCENTIVES FOR A STRONG DOMESTIC REFINING INDUSTRY

March 27, 1981

AN IMPORT QUOTA PROGRAM TO
EQUALIZE ACCESS TO NON-MARKET OIL FOR
DOMESTIC REFINERS AND THE STRATEGIC PETROLEUM RESERVE

Mr. Chairman, thank you for the opportunity to appear before your subcommittee today. My name is Frank Cahoon, and I am Chairman of Copano Refining Company, a small and independent refiner located in Ingleside, Texas. I have been in the refining business for seventeen years. Our present plans call for expanding our refinery to 45,000 barrels per day of sour crude capacity. The timetable for this expansion hinges on our having competitive access to sufficient crude oil volumes.

Before outlining our proposal for an oil quota program, permit me to commend you and your colleagues for your initiative in calling this hearing. Without presuming to speak for my competitors and friends in the domestic refinery industry, I do believe that most refiners agree with you that the regulatory approach to a national refining policy is not in the best interest of either the industry or the consuming public. An incentive-based policy, on the other hand -- one that works with rather than against market forces -- should be preferred by both refiners and individual citizens whose tax dollars must finance vast regulatory bureaucracies.

Other witnesses scheduled to testify in this hearing will undoubtedly provide substantial documentation on the post-decontrol plight of the domestic refining industry. So that our proposal for a crude oil import ticket program can be presented in as clear and concise fashion as possible, and in recognition of your famil-

ilarity with the industry's problems, I will focus my comments on the non-competitive crude cost dilemma facing today's domestic refiners.

I would, however, like to highlight one set of statistics that summarizes the worsening situation. As domestic refiners feared and government analysts predicted, refinery operations have had to be substantially curtailed in the wake of decontrol. Department of Energy data indicate that domestic refineries operated at 71.9 percent capacity during the four weeks ending March 13, 1981, compared with 76.4 percent in the four weeks ending January 30, 1981, the week of decontrol. Two weeks ago, an informal survey of twenty-seven independent refiners in my own state of Texas indicated an even more critical situation. Refinery utilization had fallen below 50 percent. Eight refineries with average capacity of over 20,000 B/D were shut down, and ten more with a capacity of nearly 24,000 B/D planned to shut down unless they could get their crude costs down to at least equal the prices they could obtain for their refined products.

There is little doubt that these curtailments are a direct result of a void in our national refining policy -- a void that permits four multinational oil companies, the Aramco partners, virtually exclusive access to foreign oil that is priced well below market levels. The advantage accruing to these four companies by virtue of their being able to purchase much of our Nation's imports at \$32 per barrel -- when most other U.S. refiners can only acquire it on a spot basis for \$36 to \$38 per barrel -- is so large that the Department of Energy refers to those volumes as "non-market oil" to

distinguish it from other imports whose prices are determined by supply and demand.

I have attached excerpts from a DOE "crude oil access study" prepared in October. This study, which is undoubtedly less suspect in the eyes of an objective observer than anything the oil industry could prepare, is quite candid in its assessments, as the following excerpt indicates:

Increased market concentration could be hastened if prices do not stabilize in the world crude market and the major integrated firms enjoy greater if not exclusive access to the relatively cheaper crude oils sold by the producing countries. Indeed, continuation of the principal disparity of the last 18 months -- that of Saudi Arabian crude being sold largely to only four U.S. firms at prices well below market levels -- could adversely affect the competitiveness not only of the independents but also several integrated refiners that do not have similar access to large volumes of cheap foreign crude oil to supplement their captive domestic supplies. Thus, the greater threat to vigorous price competition in the U.S. refining market may not be the greater access to captive domestic crude oil supplies enjoyed by all of the major integrated refiners, but rather the possibility of wide disparities in foreign oil prices that would benefit only a few of the major integrated firms. (Draft Crude Oil Access Study; Office of the Assistant Secretary of Energy for Policy and Evaluation; October 6, 1980.)

The DOE study found that, in 1979, the twelve non-Aramco integrated firms and the twenty-five largest independent refiners were incurring imported crude costs ranging from 6 to 18 percent higher -- \$1 to \$3 per barrel -- than the Aramco refiners' costs. If DOE conducted a similar study today, I am confident that the cost disadvantage would prove to be even larger.

Mr. Chairman, your March 12 comments printed in the Congressional Record are exactly right. This Aramco advantage is "...an outgrowth of U.S. policy since the 1930's, a practice that utilized major oil companies as an instrument of U.S. foreign policy in certain areas of the world."

My comments today are not intended to suggest that our foreign policy has been misguided. Indeed, we are strongly supportive of initiatives aimed at protecting vital U.S. interests, and if a by-product of that policy is a foreign government decision to moderate oil price rises, then all consuming nations would appear to benefit.

However, our hope is that one of the accomplishments of this hearing will be to explode any myths that the Aramco advantage is due to free market forces.

If that is achieved, then our hope is that the hearing will produce some concrete policy proposals that take this non-market aberration into account and seek to correct it without creating a new set of market dislocations and inefficiencies.

Briefly stated, we believe that this can be accomplished by a program of import controls that would be similar in principle to the old mandatory oil import program (MOIP) established by President Eisenhower in 1959. We believe that such a program can work with the market place in such a way that uncompetitive non-market advantages would be neutralized, truly competitive pricing would not be disturbed, and the administrative burden for both the industry and the government would be minimal.

Under our proposal, the Strategic Petroleum Reserve (SPR) would participate in the quota program just as if it were a domestic refiner. This would ensure that our security reserve would not be less than full strength due to budget limitations and lack of access to lower cost, non-market crude oil supplies.

As you will recall, the MOIP became unnecessary after the OPEC price increases in 1973 made domestic oil less expensive than foreign

oil. With full decontrol of domestic prices now, however, and with non-market forces holding substantial volumes of foreign oil below average price levels, today's market situation is similar, in at least one respect, to the pre-1973 conditions: the weighted average cost of crude imports has dropped below U.S. domestic crude prices.

On the surface, this would not appear to be a problem; indeed, it appears that, on the average, refiners' crude costs and consumers' product costs are lower as a result.

The problem, of course, is that "averages" do not reveal inequitable distributions of lower- and higher-priced oils. As you know, it is the crude cost advantage of a few multinational companies with a virtual lock on production from one foreign government oil company that has prompted domestic refiners to seek a public policy solution to the very real threat of being undercut and forced out of business.

What I want to emphasize, however, is that the Strategic Petroleum Reserve -- and, therefore, the security interests of the American people -- also suffer due to this skewed distribution of crude costs.

Most everyone would agree that accelerating U.S. purchases of crude oil for the SPR is an important national security measure. Few agree, however, on the mechanism for financing such purchases. You will recall that the SPR became a participant in the entitlements program last year, and the federal budgetary impact of U.S. crude acquisitions was substantially softened as a result. As near as I can determine, the average post-entitlement cost of all SPR crude -- domestic and foreign -purchased between September 1980 and February

1981 was no more than \$20 per barrel, and probably less. Since decontrol, however, the per barrel cost has risen to nearly \$40 per barrel. The total federal dollar drain has increased even more dramatically because the purchased volumes have accelerated.

As you are well aware, news accounts in recent days have highlighted the policy controversy over the financing of the strategic reserve. Congressman Gramm (D-Texas) and other conservative Democrats have continued to push for the private "oil bond" concept, while Senator Kassebaum (R-Kansas) has introduced legislation that would, in effect, require major oil companies to fill the SPR, with the federal government paying ten percent annual dividends on the deposits for eleven years. Last week, the Senate Budget Committee unanimously adopted spending guidelines that hinge on a Kassebaum-type proposal, and thus encouraged reducing the SPR funding below the President's requested level. Of course, the Senate Energy Committee then immediately reconfirmed its commitment to the President's original funding proposal.

In the midst of this controversy, the Department of Energy continues to resist innovative proposals for financing the SPR despite the sharp run-up in costs and the increasing likelihood that the targeted fill rates cannot be achieved with the money that will be available.

A crude oil quota program that included the SPR as a participant along with all U.S. refiners would be capable of producing a rough parity of crude costs among all purchasers. The parity would be approached as the average crude costs of the SPR and most U.S. refiners are lowered substantially, while the multinational import-

ers' average crude costs would rise, but only slightly due to their ability to "roll in" the costs of the quota program over very large volumes. Most other integrated refiners would experience relatively little change in their crude costs under the program.

Briefly, the program we envision would work this way: A fixed target ratio between imported and domestic crude oil would be adopted, such as 35 percent. The resultant percentage would translate into a volumetric quota for specific time periods such as a month or calendar quarter. Each participant, including the SPR, would be issued a number of import "tickets" conferring the right to import crude oil during that specified time period. Those tickets, by being issued to all participants -- including those without real access to non-market foreign oil -- would take on an exchange value due to their being sought after by refiners having access to more foreign oil than could be imported legally on the basis of their own limited tickets. The market price differentials among crude oils of like quality and location would determine the exchange value of the tickets in the hands of the non-importers.

The exchange of tickets would lower the effective crude costs of most U.S. refiners and the SPR. The domestic refining industry and the SPR would be maintained on a sound footing, and the national security interests of the American people would be duly enhanced. The inflationary effect of, at most, a one or two cents-per-gallon increase in product prices would probably be more than offset by the deflationary effect of reducing deficit spending through reduction in SPR tax dollar requirements. Furthermore, SPR oil subsequently needed in any emergency would be less costly to refiners

and, therefore, to consumers.

As outlined above, the program would closely resemble the old MOIP. However, the wide disparities existing among various exporting nations' prices might necessitate a modification to the familiar "import ticket" concept. Some domestic refiners who favor such a program believe that it would be necessary to have the tickets labelled according to country of origin. For example, if 40 percent of the oil were imported from Saudi Arabia, then 40 percent of the tickets would confer rights to import Saudi oil. Then the exchange transactions would sort out the relative values of tickets according to the relative values of different imported crude oils.

Obviously, of critical importance to the success of such a program would be the original allocation of tickets among all participants in the program. Just as under the old MOIP, some refiners will have to receive relatively more tickets than others if a rough cost parity is to be achieved. We are not recommending, however, that any "bias" be given to any particular class of refiners. We believe that a sound national refining policy should promote competition among all refiners rather than permit non-market forces to create non-competitive advantages.

Therefore, we believe that the quota allocations can be handled simply and equitably by dividing all U.S. refiners into just two categories: the largest importers in one group, and the domestic-oriented refiners in the other. The percentage of tickets allocated to the domestic refiners might have to be in the range of 85 percent to achieve cost equalization. The guiding principle in arriving at such an allocation, however, should be cost equalization

rather than special benefits to one class of refiners over another.

One alternative to a quota program as outlined here would be a crude oil tariff that would have to be selectively applied to importers having preferential access to low cost non-market oil. I should point out, however, some important advantages of a quota program over such a tariff program. First, no initial administrative decision would have to be made regarding the "correct" tariff level. Under a quota program, market forces would determine the initial value of the import tickets. Second, a quota program would be self-adjusting as relative crude values changed, and, thus, no government "finding" would be necessary to adjust tariff levels as conditions change. This would minimize the on-going politics of the program. Although initial determinations would have to be made regarding the criteria for import ticket allocations, this would probably prove less controversial than the design of tariff program criteria for rebates to domestic refiners and the SPR.

Thus, while either policy could achieve the desired national security and budgetary objectives, the quota approach has definite advantages with respect to ease of implementation and the minimizing of program politics and pressures for amendments as market conditions change.

Of course, under either approach, a corollary quota program would be necessary to keep the flow of refined product imports from rising above historical levels. Otherwise, importers could circumvent raw material limits by importing finished products.

In summary, Mr. Chairman, we propose that your subcommittee recommend to the full Senate Finance Committee that legislation be

adopted to direct the President to restore the mandatory oil import program immediately. We recommend further that the quota program include the Strategic Petroleum Reserve as a participant. In this way, the refining industry and our nation's strategic storage program would remain healthy and our nation's security would be enhanced.

Oil for U.S. petroleum reserve costing more than OPEC price for crude

BY PETER J. BERNSTEIN
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WASHINGTON — A large share of the oil pumped into the nation's strategic petroleum reserve is being supplied by a little-known trading firm that is selling oil to the government at prices above those charged by the Organization of Petroleum Exporting Countries.

The Energy Department, using a competitive bidding process that is kept strictly confidential, has signed a spate of contracts in the past month with the trading firm, Derby & Co., for crude oil.

Department officials confirmed Monday that roughly a third of the 11.2 million barrels of crude obtained by the government since Feb. 13 were purchased from Derby, a subsidiary of Engelhard Minerals & Chemicals Corp., the giant commodities conglomerate with headquarters in New York.

Officials said the oil has been obtained on the world spot market, where cargoes not under long-term contract are bought and sold. The government paid slightly more than \$442 million for the 11.2 million barrels of crude, or nearly \$39.50 per barrel — \$1 higher than the average weighted price charged by the 13-member OPEC cartel.

The government's oil purchasing policy will undergo congressional scrutiny today when the House energy subcommittee on fossil fuels convenes hearings on the strategic reserve program. The subcommittee, led by Rep. Phillip R. Sharp, D-Ind., is considering legislation that would enable the government to pay for oil purchases by selling energy bonds to private investors.

Under a timetable approved by Congress, the reserve is to total 750 million barrels by 1989, growing to 1 billion barrels at a later date. Currently, the United States has about 123 million barrels stored in Gulf Coast salt domes in Texas and Louisiana.

The government during the past month has been stockpiling oil more rapidly, in-

creasing the reserve by as much as 200,000 barrels a day, up from the 100,000-barrel daily rate of last fall.

The step-up represents something of a risk for the Reagan administration. Many oil-producing countries have been loudly critical of U.S. stockpiling, and could seize on the new purchases as a pretext for a price increase, production cut or other action.

The government has been obtaining bids from nearly 200 companies every week under what bureaucrats term a "continuous open solicitation" for oil purchases.

Of eight contracts awarded to oil companies in the past month, three have been with Derby.

Federal officials declined to say why other companies' bids were rejected. Nor would they say where Derby and other firms are getting the oil they'll deliver. "We have refrained from giving any details on particular contracts, the source of supply or price," said Navy Capt. Frank Tauriello of the Pentagon's Defense Fuel Supply Center, purchasing agent for the strategic reserve.

"Secrecy is better for us so that we can obtain a significant number of bids," Tauriello said.

He said Derby has gotten "a large number" of the oil supply contracts awarded since the government began buying oil for the reserve in 1975.

Energy Department official Larry Pettis said the current series of spot purchases represent "an attempt to buy small quantities of oil currently on the market at relatively favorable prices." If the purchases continue to be successful, Pettis said, the government might seek to negotiate larger, long-term purchases to assure a continuous flow of oil into the salt domes.

Derby officials could not be reached for comment on the firm's oil-buying practices.

"They're not especially anxious to give out information," said Arthur Mackweil, a spokesman for the parent, Engelhard Corp.

Derby oil traders conduct business from Engelhard offices situated high above Manhattan's Avenue of the Americas and facing the corporate headquarters of Exxon Corp.

Office of Competition
Office of Oil Policy
Assistant Secretary for
Policy and Evaluation

October 6, 1980

Company Groupings

Group A

Exxon
Mobil
Socal
Texaco

Group B1

Gulf
Shell
Standard Oil of Indiana (Amoco)
Standard Oil of Ohio (BP/Sohio)

Group B2

Atlantic Richfield (Arco)
Cities Service
Conoco
Getty
Marathon
Phillips
Sun
Union Oil of California

Group C

All other companies reporting on the ERA-51 for a given month. These include:

Amerada Hess	Guam Oil
American Petrofina	Kerr-McGee
Ashland	Koch Industries
Champlin Petroleum	Murphy
Charter	National Cooperative Refinery Association
Clark Oil	Pacific Resources
Coastal States	Tenneco
Commonwealth Oil	Tesoro
CRA-Farmland	Texas City Refining (Agway)
Crown Central	TOSCO
Energy Cooperative	Total Petroleum
Farmers Union	United Refining
Good Hope Industries	Vickers Petroleum

Captive Foreign Crude Access.

Table 3 shows the volumes and percentage of the crude imported by each group that was obtained on a captive basis in 1976 and the first half of 1979.^{1/} The Aramco Companies have suffered a slight decline in captive supply since 1976, but still obtain close to 90% of their imports on a captive basis. The Group B companies obtain slightly more than a third of their imports on a captive basis, and this has not changed significantly since 1976. The Group C companies obtained only 6% from captive sources in 1976, and 14% in 1979, indicating an improving position in the captive category but one that is still not significant in terms of overall supply.

Table 3. Volume and Percentage of Crude Imported That Is Captive (Thousands of b/d)

	<u>1976</u>	<u>1979^{2/}</u>
Volume of Captive Imports		
Group A	1659	1394
Group B	790	890
Group C	83	240
Percent of Group's Imports That is Captive		
Group A	94%	88%
Group B	33%	35%
Group C	6%	14%

^{1/} Only the data for the first six months of 1979 were available for this study. It should be recognized that this was a period of considerable turmoil and shortage on the world crude market.

^{2/} January-June only.

Captive Domestic Crude Access.

Table 4 shows the volumes and percentage of crude acquired domestically by Groups A and B that is acquired from owned production. The volumes shown in Table 4 may understate actual captive domestic access in that control over pipelines may give these companies effectively captive access to crude production which they do not actually own.

Table 4 shows that the Aramco companies experienced a substantial decline in the share of their domestic supply accounted for by owned production, while the other integrated companies increased their percentage somewhat. Both groups were well-integrated domestically, deriving approximately three-fourths of domestic supply from owned production.

Table 4. Volumes and Percentage of Domestic Crude That Is Acquired From Owned Production
(Thousand of b/d)

	<u>1976</u>	<u>1979^{1/}</u>
Volume of Owned Domestic Production		
Group A	2116	1920
Group B	3252	3579
Percent of Total Domestic Supply Derived From Owned Production		
Group A	91%	73%
Group B	77%	82%

1/ January-June Only.

Combined Captive Access.

Table 5 shows the combined totals of captive imports and domestic owned production for Groups A, B, and C, assuming that Group C owns no domestic production (this assumption understates Group C's captive access total, since in fact there is some domestic ownership among Group C companies.) Table 5 also shows this combined total of captive supplies as a percent of total crude oil runs for each group. This percentage may be thought of as a "self-sufficiency ratio" since it is a measure of the portion of its requirements which each group can cover without going into the competitive market.

Table 5 documents the wide disparity between integrated and independent refiners' access to captive crude supplies. The integrated companies rely on the market for 20-35% of their requirements, while the independents rely almost entirely on the market. There appears to be a moderate trend towards a decrease in this very substantial disparity in captive access.

It should be pointed out that the independents considered here are the 25 largest. Presumably the smaller independents not considered in Table 5 have even smaller self-sufficiency ratios than the 25 independents shown.

Table 6 compares the 16 largest integrated refiners' open market purchases with the total crude input of all other refiners (the "Independents"). The table shows that the two volumes are roughly comparable. Thus if the independents had no captive access, and no help from government programs (such as the Buy-Sell Program, the supplier-purchaser rules, allocations of Naval Petroleum Reserve and U.S. Government royalty oil, and exceptions relief from DOE's Office of Hearings and Appeals), they would depend on the open market for roughly the same quantity of oil as the integrated companies. Of course, as pointed out above, the amount required from the open market makes up a much larger percentage of the independents' total crude input than it does for the integrated companies.

In absolute terms, however, it appears that the independent and integrated companies are about equally dependent on the open market. Whether the independents are on an equal footing with the integrated companies in competing for open market supplies must be examined.

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Table 5. Total Captive Supplies And Self-Sufficiency Ratios^{1/}

	<u>1976</u>			<u>1979^{2/}</u>		
	Refiner Group			Refiner Group		
	<u>A</u>	<u>B</u>	<u>C</u>	<u>A</u>	<u>B</u>	<u>C</u>
Captive Imports	1559	790	83	1394	890	240
Owned Production (mb/d)	2116	3252	0 ^{3/}	1920	3579	0 ^{3/}
Captive Total (mb/d)	3675	4042	83	3314	4469	240
Total Crude Input (mb/d)	4089	6593	2000 ^{4/}	4220	6933	2300
Self-Sufficiency Ratio	90%	61%	4%	79%	64%	10%

1/ The self-sufficiency ratio is the ratio of captive supply to total crude input.

2/ January-July only.

3/ Assumed to be zero. Actually there is some degree of domestic production ownership by "independents".

4/ PE estimate.

Table 6. Crude Input by Independent and Open Market Purchases by Integrated Refiners (mb/d)

	<u>1976</u>	<u>1979</u>
Total Crude Input By All Independents	2734	3359
Open Market Crude Purchases by 16 Integrated Refiners	2965	3470

Ratio of Certain Refiner Groups' Average
Imported Crude Cost to Average Imported
Crude Costs of the Four Aramco Partners

<u>Refiner Group</u>	<u>January 1976</u>	<u>January 1979</u>	<u>June 1979</u>
4 Largest Integrated Refiners (Not Including Aramco Companies)	1.03	1.03	1.12
Next 8 Largest Integrated Refiners	.99	1.04	1.18
25 Independents	1.00	1.02	1.06

Whether Saudi Arabia will continue to sell its oil to a limited number of U.S. firms at prices significantly below the price of competitive crudes on the world market is unknown. If OPEC achieves the price unification that some of its members are seeking, the cost advantage that the Aramco Companies currently enjoy will virtually disappear.^{1/} (Service payments for production could sustain some advantage.) The point remains, however, that the administered prices of the major oil-producing countries can vary widely from time to time, and any substantial price disparities that exist are likely to inure to the benefit of the major integrated companies because in general they have greater access than the independents to the crude oil produced by the more moderate OPEC members.

Finally, the independents may experience a competitive disadvantage in the foreign market either because they are unable to purchase in quantities demanded by producing nations, or because they lack the capital resources necessary to make the investments in exploration, refining, or petrochemicals production

^{1/} The Saudi Arabian price increase of \$2/bbl announced at the OPEC summit in Vienna on September 18 was a substantial step in this direction. In addition, it has been reported (Petroleum Intelligence Weekly, June 9, 1980) that rising direct sales of crude oil by the Saudi Arabian State Agency Petrovin are also reducing the Aramco companies access to Saudi crude. The Aramco companies lifting are expected to decline to 6 million b/d, down from an average of 7 million b/d under a production ceiling of 8.5 million b/d.

Market and Non-Market Flows of
International Crude Supply
(Millions of B/D)

	<u>1973</u>	<u>1976</u>	<u>1979</u>
Market			
Commercial Sales by Producing Nations	.9 (3%)	3.3 (11%)	7.8 (26%)
Third Party Sales by Oil Companies	<u>6.8 (22%)</u>	<u>4.7 (16%)</u>	<u>3.4 (11%)</u>
Total Market	7.7 (25%)	8.0 (28%)	11.2 (37%)
Non-Market			
State-to-State Sales by Producing Nations	1.5 (5%)	3.8 (13%)	5.0 (17%)
Parent Company Transfers to Affiliates	<u>21.1 (70%)</u>	<u>17.1 (59%)</u>	<u>14.1 (46%)</u>
Total Non-Market	22.6 (75%)	20.9% (72%)	19.1 (63%)

Percentage of Each Group's Crude Input
Supplied From "Non-Market" Sources

	<u>1976</u>	<u>1979</u>
16 Integrated Refiners		
Foreign	22%	20%
Domestic	50%	48%
TOTAL	72%	68%
25 Largest Independent Refiners		
Foreign	4%	10%
Domestic	N/A	N/A
TOTAL	N/A	N/A

Senator WALLOP. Don, I was curious again, in light of what Mr. Eck said about crude oil supplies on the world market, and what role the things that are taking place in Wyoming that are exciting the entire energy world will play. Significant new discoveries are a matter of daily announcement in our papers and in the trade journals around, and many people think that the abundance of the Overthrust Belt will significantly add to the U.S. oil reserves.

It will not be a question of, once again, finding ourselves in just a little bit less of a decline, but next year as last year, having more reserves on hand despite our domestic consumption.

So, what does that do for your supply situation?

Mr. DAVIS. Well, you are right. The production in Wyoming, on a daily basis, is rising. We do have more production this month than we had 1 month ago or 2 months ago, I believe.

The problem is that in Wyoming right now the crude oil resellers are attempting to control the crude at the lease. In order to do that, that means that they want to have the highest posting possible.

Senator WALLOP. Are those the pipeliners you are talking about?

Mr. DAVIS. Crude oil resellers and major companies. If a major company goes out and drills a well and has 65 to 70 percent of it as a working interest, the balance of that well may belong to other operators.

So, even though the operator has a right to call for that crude in kind, the major may put up a high posting to see to it that all of the participants in that well sell the crude to the major.

The best way to do that is with a high posting, and this is a little bit of the situation and it may be more regional than anything, but it's a little bit of a problem in Wyoming. The independent crude oil resellers and the major companies are keeping postings, we think, artificially high.

It's substantially over the spot price. You can buy crude at the lease and pay \$38 for it. You can gather the crude, take it to your tanks, and if you called up one of the resellers and said, "I would like to sell it to you now as a refiner," your price is probably going to be \$3 to \$4 less per barrel.

We think that that indicates that maybe posting is a little too high.

Senator WALLOP. Well, the vote bell has gone on, and we have two votes back to back which will take a half an hour, and I wouldn't ask you people to remain here.

Mr. Eck, I have one question of you and that deals with the refining capacity of foreign refiners.

We have been told that foreign refiners, as well, have an excess capacity, with the implication from all of this being that they can easily increase their production and assume a much larger share of our market over here.

Isn't it true that the foreign refiners would have to significantly modify their operations to produce the product that is consumed in this country? Are they not really designed to meet our market conditions?

Mr. Eck. That is absolutely true, sir. They do not have an export capability in nolead gasoline of the octanes that we require in this market. They, themselves, have a shortage of the high-quality dis-

tillates, motor diesels. They have a surplus of the very products that we have a surplus of and that's the residual fuels.

We feel an efficient refiner, particularly one located in the mid-continent, well distant from the ports, does not have to fear the foreign product imports.

Senator WALLOP. Gentlemen, you know, each of you have presented us with an interesting concept and a dimension to a problem that, if you listened to the testimony, may or may not exist. If you've got it, it exists; if you don't have it, it doesn't. That's usually the way it is in business.

What the Government role will be at this moment, at least, escapes me. I was hoping, as I said earlier, that some Solomon would come down and propose something that would have no Government program and everybody would walk away smiling. But, unfortunately, that does not seem to be the nature of business.

We will look at it, and any further remarks that you or your colleagues in the industry might wish to submit to the committee would be welcome. We will keep this record open for 2 weeks to such comments as may be generated, either from friends or colleagues of yours or those who may be aware of it.

I thank you very much for taking your time and your expense to come here.

Mr. ROPER. Thank you.

Mr. JUREN. Thank you.

Mr. CAHOON. Thank you.

Mr. ECK. Thank you.

Mr. DAVIS. Thank You.

[Whereupon, at 11:58 a.m., the hearing was adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

JAMES A. Mc CLURE, CHAIRMAN
 DAVID S. I ATTYLLA, OHIO
 LOVELL P. WEDGER, JR., OHIO
 PETE G. SCHMIDT, N. CAROL.
 MALCOLM WALLACE, WYO.
 JOHN W. WARREN, VA.
 GEORGE J. HANFORTH, FLA.
 FRANK J. MARSHWELL, ALABAMA
 DON HODGLES, OKLA.
 JOHN P. TAPP, N.H.
 JOHN HENNE, PA.

MICHAEL B. NATHAN, STAFF DIRECTOR
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 EDWARD M. METZGERMAN, MISS.
 DONALD E. MATTHEWS, MARYLAND
 JOHN BALEWELL, MONT.
 PAUL E. THOMPSON, MASS.
 BILL BRADLEY, N.J.

United States Senate

COMMITTEE ON
 ENERGY AND NATURAL RESOURCES
 WASHINGTON, D.C. 20510

February 20, 1981

Honorable Malcolm Baldrige
 Secretary
 U. S. DEPARTMENT OF COMMERCE
 Fourteenth Street between
 Constitution Avenue and
 E Street, N.W.
 Washington, D. C. 20230

Dear Mr. Secretary:

President Reagan's Executive Order No. 12287 of January 30, 1981, which decontrolled crude oil and petroleum products, also abolished the entitlements program. This program, as you know, lowered the average cost of crude oil to domestic refiners to several dollars below the world price of crude oil, making them more competitive vis a vis foreign refiners who might otherwise acquire increased shares of the market in the United States for refined petroleum products. Many small refiners received additional benefits through the small refiner bias. Finally, although the buy-sell program still affords independent refiners limited assurances of access to crude oil supply, that program apparently will expire, too, on March 31, under the terms of the Executive Order.

The expiration of these programs is expected to place many U. S. refiners at a competitive disadvantage with respect to foreign refineries. In fact, the report on Refinery Flexibility issued by the National Petroleum Council in December, 1980, concluded:

"Because of U. S. domestic crude oil price controls, U. S. refineries now compete favorably with typical foreign export refineries in U.S. east Coast markets. With the end of domestic crude oil price controls in October 1981, these foreign export refineries will have a competitive advantage over U. S. refineries in these markets."

We think that any significant increase in petroleum product imports to the United States, particularly of light products, should be given careful scrutiny. Our dependence on foreign crude oil is excessive as it is. Our vulnerability would be compounded if we became more dependent on foreign refineries as well. Moreover, our balance of payments deficit would increase to the extent of the value added by refining.

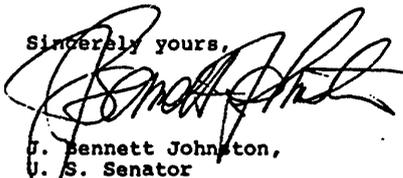
Honorable Malcolm Baldrige
Page Two
February 20, 1981

As you know, 19 USC 1862(b) authorizes the President, after an investigation and report by the Secretary of Commerce, to take action to adjust the imports of any article that is imported into the United States in such quantities or under such circumstances as to threaten to impair the national security.

We are formally requesting pursuant to 19 USC 1862(b) that you commence an investigation as to whether petroleum product imports in the post-decontrol era pose such a threat. We would urge you to hold public hearings as a part of your investigation. While the statute requires the Secretary to conclude his investigation and report his recommendations to the President within one year of the request for such an investigation, we would expect that if petroleum product imports rise significantly you will expedite your report to the President to permit timely remedial action.

Any questions regarding this request should be directed to James T. Bruce, counsel to the minority of the Committee on Energy and Natural Resources, at 224-9894.

Sincerely yours,

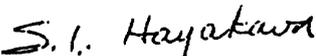


J. Bennett Johnston,
U. S. Senator

JBj:jbg



Wendell Ford,
U. S. Senator

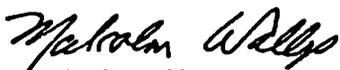


S. I. Hayakawa, U. S. S.

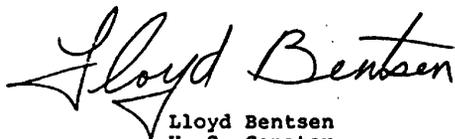


Walter D. Huddleston, U.S. S.

Honorable Malcolm Baldrige
Page Three
February 20, 1981



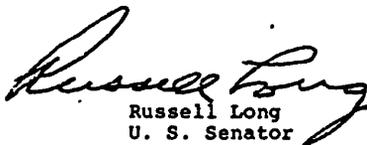
Malcolm Wallop,
U. S. Senator



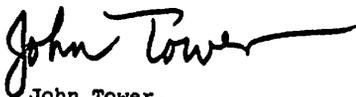
Lloyd Bentsen
U. S. Senator



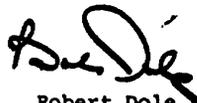
Alan W. Simpson,
United States Senator



Russell Long
U. S. Senator



John Tower,
U.S. Senator



Robert Dole
U. S. Senator



Charles McC. Mathias, Jr.



J. James Exon
U. S. Senator



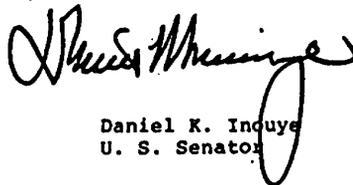
Pete V. Domenici,
U. S. Senator



Spark Matsunaga
U. S. Senator



Alan Cranston,
U. S. Senator



Daniel K. Inoué
U. S. Senator



810277Y
 THE SECRETARY OF COMMERCE
 Washington, D.C. 20230

APR 6 1981

Honorable Robert Dole
 United States Senate
 Washington, D.C. 20510

Dear Senator Dole:

Thank you for your letter requesting that I conduct an investigation pursuant to section 232 of the Trade Expansion Act of 1962, as amended (19 U.S.C. 1862), on the effect on the national security of petroleum product imports subsequent to the termination of oil price controls and other actions under Executive Order No. 12287 of January 30, 1981. I regret the delay in responding to you.

I have given this matter a great deal of thought and have carefully reviewed the concerns expressed in your letter relative to present laws and procedures. On the basis of this examination, I wish to advise you of the following:

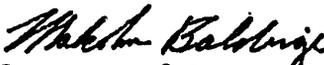
On March 14, 1979, the Secretary of the Treasury (who then had the authority now vested in the Secretary of Commerce) completed a section 232 investigation concerning imports of crude oil, crude oil derivatives and products, and related products derived from natural gas and coal tar. The Secretary found that such imports threatened to impair the national security. This confirmed the findings of an earlier section 232 investigation completed on January 14, 1975, by Treasury Secretary Simon. With these findings, the President is authorized to "take such action, and for such time, as he deems necessary."

Conclusions on the specific impact of petroleum product imports on national security can only be conjectured at this time. However, in an effort to project the likely effects of decontrol under what is now Executive order 12287, the Department of Energy (DOE) completed in January 1980 an analysis entitled "Costs and Benefits of a Protective Tariff on Refined Products after Crude Oil Decontrol." The analysis examined the probable economic and national security implications of protective tariffs. According to the report, while imposition of a protective tariff will reduce U.S. imports of refined oil products, the resulting increase in domestic refinery output to meet the domestic demand for product would significantly increase U.S. imports of crude oil. The analysis concludes that a large tariff on refined products would merely shift the mix of the total crude oil and refined product imports from products toward increased quantities of crude. Thus, a tariff probably would not reduce any threat to national security resulting from crude or refined oil imports.

Though the analysis was conducted prior to the rise in world oil prices caused by the reduction in oil supplies during the Iranian Revolution, DOE has undertaken additional analyses to assess the effects of higher prices and lower demand on imports of refined products following crude oil decontrol.

Accordingly, because the President may rely on the findings of the two previous investigations to "take such action, and for such time, as he deems necessary," and given the study and the continuing assessments being conducted by DOE, we do not believe further proceedings under section 232 are necessary at this time.

Sincerely,


Secretary of Commerce



Canal Refining Company

POST OFFICE BOX 8
CHURCH POINT, LOUISIANA 70525

March 3, 1981

Honorable Russell B. Long
United States Senate
Russell Senate Office Building
Suite 217
Washington, D. C. 20510

Dear Senator Long:

Thank you and your able Legislative Assistant, Karen Stall, for the time and attention given us at our Wednesday meeting. We recognize the strong support you have given to small business in the past, and especially to the small refiners. Our prime concern now is being able to acquire crude oil at a price that we can live with.

As members of The American Petroleum Refiners Association (APRA), we strongly support, and ask your assistance with the following:

Incentives for Crude Oil Access: A foreign tax credit proposal that will provide an incentive for major international oil companies to provide crude oil supplies to domestic small and independent refiners.

Import Tariff: APRA supports a tariff on imported petroleum products. We agree completely with your Senate Committee on Energy and Natural Resources in your letter of 2/20/81 to Secretary of Commerce Malcolm Baldrige when you pointed out that our dependence on foreign crude oil is excessive and that our vulnerability would be compounded if we became more dependent on foreign refineries as well.

We will appreciate your continued efforts in our behalf.

Best personal regards,

CANAL REFINING COMPANY

Coty R. Dupre
Coty R. Dupre, President

CRD:ewl

cc Mr. Ray Bragg
Executive Sec'y. APRA

Mr. Joe Wright

CANAL

IT'S E-CO-NOM-I-CAL

HILL PETROLEUM
Company

921 Main, Suite 1900/Houston, Texas 77002

(713) 652-2167/Telex 77-5104

March 4, 1981

The Honorable Russell Long
The United States Senate
Washington, D.C.

My dear Senator Long:

As representatives of not only Hill Petroleum Company and the American Petroleum Refiners Association (APRA) but all small and independent refiners in this country, we would like to thank you for allowing us the opportunity to discuss the vital issues and difficult positions currently being experienced by our segment of the petroleum industry in a decontrolled environment.

As we discussed, the next few months will be an extremely critical time for all of us due to our inability to compete with the major oil companies, specifically the ARAMCO partners, both from the standpoint of crude oil cost and accessibility. Presently, ARAMCO imports crude oil from the Saudi Arabian government at prices \$6 - \$8 per barrel below the domestic posted price for crude oil in the United States. The only avenue available for a small and independent refiner to take is to purchase barrels on the spot market at prices approaching the \$40 level.

Due to high levels of inventory, both in gasoline and middle distillates, wholesale product prices are causing a "break-even or less" situation in relation to feedstock cost. While we are and always have been in favor of a "decontrolled" atmosphere, and believe free enterprise serves the best interests of the American consumer, the sole road to profitability to our segment of the industry lies in accessibility to crude oil at competitive prices.

the Honorable Russell Long
 March 4, 1981
 2.

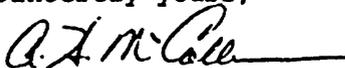
Therefore, we ask your support in adopting APRA's four point program for the survival of the small and independent refiner:

1. A foreign tax credit to major oil companies as an incentive to provide access to crude oil at competitive prices to the small and independent refiner;
2. A standby crude oil allocation program in the event of a national emergency;
3. An adequate import tariff on refined products to reduce the dependence on foreign refinery capacity;
4. Tax incentive for the refining industry to allow upgrading and retrofitting of domestic refiners to run heavier and higher sulfur level crude oil.

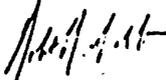
It is our hope to gain support from members of the House and the Senate to have the Senate Energy Committee, chaired by Senator McClure of Idaho, conduct hearings on domestic refining policy and crude oil access. We request your assistance in reviewing our proposals and encouraging the Energy Committee members to establish such a vitally needed forum.

Thanking you for your kind consideration, we are

Sincerely yours,



A. H. McCollum



R. R. Webb

RRW/lis

COMMENTS
OF
CROWN CENTRAL PETROLEUM CORPORATION
FOR THE RECORD
OF THE
PUBLIC HEARING
HELD BY
THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE
SENATE FINANCE COMMITTEE
ON
MARCH 27, 1981

POSITION PAPER
DOMESTIC REFINERY POLICY

OVERVIEW

Domestic refiners were affected significantly by the legislative response to the Arab oil embargo of 1973. The Emergency Petroleum Allocation Act of 1973, as amended, imposed controls that endured long after the crisis that induced them, thereby affecting domestic refiners both favorably and adversely.

In general, the legislative program froze the historical supply relationship among producers, refiners, wholesalers, and retailers. At the same time, profit margins were constrained by a program that was not designed to account for long-term levels of inflation. Normal market forces were substantially displaced in both allocation and pricing. Specifically, the highly restrictive pricing controls on domestic crude oil created a cost advantage for domestic refiners that tended to limit the ability of Caribbean and other foreign refiners to compete in the U.S. market. The impact of the lower U.S. crude oil costs resulting from price controls on domestic crude oil was, in fact, so great that subsidies on residual fuel and occasionally on #2 fuel oil were adopted to maintain the competitive viability of these foreign refiners.

In the spring of 1980, the Office of Policy and Evaluation of the Department of Energy ("DOE") released a draft study regarding the direction of refinery policy following crude oil decontrol

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on October 1, 1981. The study asserted that: (1) the implementation of a protective tariff is not required for economic and security reasons; and (2) since total demand for petroleum products is expected to be relatively constant through 1980, refinery investments will be needed to increase the heavy, high sulfur crude oil capacity of existing facilities.

Since the President decontrolled crude oil and petroleum products on January 27, 1981, it is paramount that consideration be given now to these issues, i.e., the need for a tariff and refinery investment incentives.

I.

PROTECTIVE TARIFFISSUE

Should the Federal government impose a protective tariff on product imports to reduce this Nation's dependence on foreign oil and to strengthen its production capability and efficiency?

POLICY STATEMENT

The competitive viability of domestic refiners must be maintained by discouraging levels of petroleum product imports detrimental to the existence of, as well as the development and expansion of, domestic refining capacity. A product tariff

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must at least offset the costs imposed by Federal and State governments on domestic refiners and, additionally, should encourage the modernization and expansion of existing capacity. These costs include Jones Act transportation, high taxes, the regulatory lag in issuing permits, and environmental costs such as constraints on the sulfur level of refinery fuels. A less costly option to a single-level tariff is a two-tier tariff established at a level designed to discourage only a certain portion of product imports.

National Security

The United States must ensure its stability and maintain its security as a world power. Rather than magnifying risk, it must seek to eliminate as many political and economic uncertainties as possible. For example, the reduction of this Nation's product imports through the imposition of a tariff would serve as a signal of discouragement to those countries contemplating the linkage of crude oil sales to product sales at some future date. If this Nation were to rely upon foreign refiners, efforts to reduce crude oil dependence would be damaged and new problems would be created. Crude oil producers in the Middle East and North Africa anticipate constructing refineries in the near future with the hope of exporting products to the United States. European refiners appear anxious to utilize their

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surplus capacity by exporting products to the U.S. Of greatest concern is the excessive refining capacity of the Caribbean. The Caribbean is currently the major supplier of U.S. product imports. This region has become the main source for meeting the demand for residual fuel in the United States and also supplies gasoline and heating oil when the U.S. market is more attractive than the European one. Such reliance is misplaced since Caribbean yields do not fit this Nation's demand, particularly for gasoline.

Reliance on foreign refiners imposes a serious limitation on strategic diversity, particularly when those refiners lack the flexibility to vary product yields in response to a shortage. In managing a shortage, the United States would possess no control over foreign refiners with regard to yield, price, and allocation. Instead, these refiners would respond to world market pressures charging the highest prices for products in shortest supply. The generation of this revenue would further increase the purchasing power of foreign refiners and simultaneously worsen the shortfall of domestic refiners.

Crude oil price decontrol necessitates a reexamination of the competitive situation in the refining industry. If foreign refiners are not restricted by a protective tariff, the domestic refining industry will suffer from declining utilization rates, reduced profit margins, and inadequate investment in conversion and expansion. This Nation will

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face the dangers of unemployment, supply interruption threats, greater probabilities of gasoline rationing, a less favorable balance of trade, arbitrary foreign pricing policies, decreased defense capabilities, and less freedom for foreign policy initiatives.

Economic Considerations

Several factors contribute to this Nation's dependence on foreign oil, including availability of supply, worldwide demand, refinery efficiency, and incentives to increase domestic production capabilities. The East Coast's relationship with the Caribbean mirrors these many elements.

Caribbean refineries possess an economic advantage over all U.S. Gulf Coast refineries in supplying the East Coast. The components of this advantage, as cited in the Data Resources, Inc., Study for the Domestic Refining Group ("DRI"), are (1) lower crude oil transportation costs (due to the use of foreign flag VLCC's to carry crude oil without transshipment); (2) lower income tax rates; (3) lower product transportation costs because of the availability of foreign flag vessels; and (4) less stringent environmental regulations resulting in lower operating and capital costs. An additional factor (not mentioned in the DRI study) is the cost of U.S. regulatory lag incurred to permit new facilities.

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All of the above costs are the creation of the government, not the result of market forces. They must be offset unless the Federal government is willing to see a displacement of capacity offshore by virtue of other nations benefiting from the military protection that the U.S. provides and from the absence of their commitment to restrict air and water pollution. To offset the domestic disadvantage created by these Federal regulatory programs, a protective tariff is a means of assuring the continued viability of the refining industry as well as the increased retrofitting of existing refineries and the construction of new refineries capable of processing heavy, high sulfur crude oil.

CONCLUSION

Any consideration of a protective tariff relates to the competitive viability of domestic refiners and the question of domestic refinery development. Competitive viability is a direct result of tariff imposition; domestic refinery development is an indirect result. The ability of an independent refiner to construct a grass roots refinery is greatly dependent on the Federal government, not in search of subsidies but rather to offset the inhibiting effects of the many Federal requirements that have created the chronic cost disadvantages of domestic refiners.

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Simply stated, a tariff is needed to guarantee that the domestic refining industry can be competitive with foreign refiners, particularly those in the Caribbean. It need not exceed that amount necessary to compensate domestic refiners for the added costs mandated by Federal programs that are not borne by foreign competitors. If such a tariff were imposed, the expansion of domestic refining capacity would be encouraged, and this Nation's reliance on foreign products would be lessened.

II.

REFINERY INVESTMENT INCENTIVESISSUE

Would the institution of investment incentives be a viable solution for decreasing this Nation's dependence on foreign products?

POLICY STATEMENT

The development of domestic refining capacity is essential to the strategic and economic security of the United States. As residual fuel imports decrease, the ability to convert the available high sulfur crude to unleaded gasoline, heating oil, diesel fuel, jet fuel, petrochemical feed-

- 8 -

stocks, and low sulfur distillate fuel will become critical. Dependence on foreign refiners for petroleum products, particularly those from the Caribbean, underscores the need to retrofit domestic refineries and to construct grass roots facilities.

There are several options this Nation can choose in order to reduce our dependence on foreign petroleum supplies. Decontrol permits the marketplace to allocate resources and allow refiners to earn competitive returns on their investment. However, just as a protective tariff is needed to ensure the competitive viability of domestic refiners because of the foreign cost advantage, so too are investment incentives needed to assure U.S. national and economic security. The choices are many, including accelerated depreciation and investment tax credits. These options could be applicable to all industries.

National and Economic Security

Essential to this Nation's security is the upgrading of its existing refining capacity and the development of new facilities to convert available feedstock into desired products with particular regard to assuring the ability to refine heavy, high sulfur crude oil into the needed mix of lighter petroleum

products. Domestic refining flexibilities must be improved for the following reasons:

1. World reserves of heavy oil far exceed light oil reserves.
2. Much of the domestic crude oil to be produced from the Alaskan North Slope, California, and the Naval Petroleum reserves is heavy oil.
3. Additional available supplies obtainable from Canada, Venezuela, or Mexico will be heavy crude oils.
4. Technology can upgrade heavy, high sulfur crude oils into light clean products, thereby reducing our enormous import bill for high cost, high quality foreign crude oils.

Basic statistics enforce the decision to retrofit and newly-construct facilities for refining heavy, high sulfur crude oil. Current estimates of remaining world oil reserves indicate a mix of 35% low sulfur and 65% high sulfur crude oils. Therefore, the best prospects for increasing domestic crude oil production in the future lie in the heavier reserves. This Nation must develop the ability to process whatever type of crude is available and the flexibility to produce different products according to demand.

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Currently, many refineries in the United States that produce large amounts of residual fuel are not capable of further downstream processing to maximize the production of other products. Facilities are needed to desulfurize more resid so that portion of crude oil can be used without damage to the environment. This ability becomes increasingly important due to the availability of less expensive heavy crude.

Reliance upon foreign refineries for products subjects this Nation to the vagaries of international politics. In a crisis, the lack of adequate, modern domestic refining capacity would prevent the processing of the type of crude oil most likely to be available. Also, the excess distillation capacity overseas points out the fallacy of depending on foreign countries for our product needs. For example, European countries, in order to meet their own changing demand, are building cracking facilities to increase their yields of gasoline and petrochemical feeds at the expense of residual fuel oil.

In addition to the strategic benefits of domestic refinery development, there are significant economic benefits. These include an improved balance of trade and increased employment.

The tremendous funding required for retrofitting existing facilities and constructing new ones can be staggering. It is also difficult to justify economically unless product

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margins are adequate. Some assurance is needed from the Federal government that such a capital expenditure will be fiscally sound.

Refinery Investment Incentives Options

Two choices are available: an investment program to benefit solely the oil industry or a program to encourage investments in all industries. The United States is experiencing a general slowdown in capital investment. This results in a lack of productivity from which all industries suffer. Therefore, an investment incentives program should not be limited in its application to just the oil industry. An incentives program for all industries is the preferable course of action.

Tax legislation applicable to all industries appears to be the best and most equitable solution. There are numerous possibilities available within the scope of tax legislation. Tax credits and accelerated depreciation deserve the most attention because of the amount of investment recovery that can be achieved, as well as the administrative flexibility that is available.

The Administration's proposed "accelerated cost recovery system" is purported to be a comprehensive approach and the least inflationary measure possible. It would establish three broad types of capital investments for depreciation purposes

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and assign write-offs of either ten, five, or three years. This proposal should provide sufficient incentive for the necessary upgrading and development of the refining industry while not excluding other industries.

A tax credit also represents an attractive investment incentive. However, the more difficult question of legislative passage diminishes its appeal.

CONCLUSION

An investment incentives program is needed, not just for the oil industry, but for all industries. If such a program were implemented, its accomplishments would be two-fold: (1) alleviating the concerns of national and economic security specifically applicable to the oil industry; and (2) increasing overall productivity for every industry to encourage resolution of inflation, unemployment, and several other economic problems.

April 10, 1981

STATEMENT ON BEHALF OF
EXXON COMPANY, U.S.A.
A DIVISION OF EXXON CORPORATION
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION OF THE
SENATE COMMITTEE ON FINANCE
MARCH 27, 1981, HEARING ON VARIOUS TAX AND TARIFF
PROPOSALS TO AID THE DOMESTIC REFINING INDUSTRY

Exxon Company, U.S.A.'s position has been and continues to be that the market should be allowed the maximum opportunity to function as the basic mechanism for achieving balanced supply and demand, greater energy conservation, and increased petroleum industry efficiency, productivity, and competitiveness. This position applies to domestic and international trade.

Exxon's views on specific proposals addressed by this hearing follow:

1. Modification of Foreign Tax Credit Rules

This proposal would amend the foreign tax credit rules to provide an economic incentive for multinational oil companies to sell crude oil to small and independent refiners. The net effect of this proposal would be to reduce United States tax obligations on United States source income by allowing a multinational oil company, to the extent that it has available excess foreign tax credits, a credit against its United States tax obligation for each barrel of crude sold to a small or independent refiner. Utilizing the foreign tax credit to reduce United States tax obligation on United States source income is a violation of the principles of the foreign tax credit which should not be allowed.

The alleged intent of this proposal is to improve small and independent refiners' access to crude supplies. The DOE crude access study released in December 1980 shows that, even after making the inaccurate assumption that all crude produced by major integrated refiners is retained in their own refining systems, at least twice as much crude is available to small and independent refiners as they need to meet their processing requirements. This crude is acquired by domestic refiners in "arms length" crude market transactions from independent domestic producers or from foreign markets for import. The DOE study shows that ample crude supplies are available to refiners willing to compete for its acquisition. In a non-emergency supply environment, a market oriented crude system, free of regulation, will do a far better job of ensuring that crude supplies are available to all refiners in quantities sufficient to meet consumer demands in every part of the country. For these reasons, programs to provide preferential crude access to select segments of the domestic refinery industry are unnecessary and counterproductive and represent a disguised form of subsidy.

Supporters of crude access programs generally point to difficulties encountered by some refiners in recent years in obtaining crude supplies. Often, however, they fail to recognize that these difficulties occurred under, and were generally caused by, government regulations which interfered with the normal operation of the crude supply system, or which prevented crude price relationships from changing in a manner that would encourage crude supplies to move to a refiner in a deficit crude position.

A combined report issued by the U.S. Energy and Treasury Departments in January 1981 also pointed out in its analysis of tax recommendations developed by the American Petroleum Refiners Association (APRA) that this proposal, or a similar one, is in conflict with national security objectives. In order to qualify as an independent refiner by the government's traditional definition and thus be eligible for participation in the proposed program, a refiner may not produce crude volumes in excess of 30% of its refining capacity. Therefore, the provisions of the APRA proposal will encourage divestiture of present producing properties by small refiners who produce more crude than 30 percent of their refining capacity and tend to discourage independent refiners from investing in the exploration for and development of additional crude reserves.

2. Tariff on Imported Petroleum Products

Due to crude oil price controls in the United States, from 1973 until early 1981 domestic refiners incurred an average cost of crude oil which was less than international crude market prices. On January 28, 1981, President Reagan by executive order eliminated domestic crude price controls, thereby abolishing domestic refiners' crude oil cost advantage relative to foreign refiners who also trade in the international crude market.

Some U.S. refiners argue that, without U.S. crude price controls, a petroleum products tariff will be necessary to protect the domestic refining industry from foreign competition because higher domestic labor costs and environmental, safety, and marine shipping regulations have increased the costs of U.S. refiners above those of foreign refiners. However, U.S. refineries generally are better equipped by design and location to serve anticipated product demands and should be able to compete successfully in the domestic market without special protection. According to DOE's "Costs and Benefits of a Protective Tariff on Refined Petroleum Products after Crude Oil Decontrol" draft study (January 1980), import fees would not substantially raise U.S. refinery capacity utilization.

An excessive product import fee could promote the construction of new U.S. refining capacity while forcing a shutdown of offshore capacity which has been efficiently supplying U.S. import requirements. This could have a disruptive effect on the economies of friendly nations which have been an integral

and traditional part of the United States petroleum supply system. Residual fuel oil comprises about 60 percent of U.S. petroleum product imports, mostly Caribbean refineries built primarily to supply East Coast heavy fuel oil markets. Caribbean refineries are typically low conversion plants with high yields of fuel oil. Massive investments would be required to enable these refineries to produce high yields of light products to serve an export market in the U.S. Such investments would result in increases in fixed operating costs which would largely offset any benefits due to improved product mix.

Imposition of a product import fee would directly increase the cost of imported products and could induce price increases in domestically refined products as well. In the absence of a demonstrated need, consumers should not be asked to pay the cost of product import fees. According to the DOE, a \$1/B fee would cost U.S. consumers about \$3.3 billion/year.

There is no demonstrated need for product import fees or duties above the current levels to protect efficient domestic refiners from foreign competition. However, a strong domestic refining industry is in the national interest. If necessary, the President could at any time exercise existing authority under the Trade Expansion Act to impose product import fees to prevent the domestic refining industry from being significantly harmed by large increases in product imports above historical levels. This fact should discourage any substantial new refining investments by foreign export refiners to supply U.S. markets.

3. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

Refiners in the U.S. are facing the need for significant investments to meet changes in crude quality and product demand mix. On the input side, crude quality is declining as available crudes become increasingly heavier and higher in sulfur content. On the output side, demand for gasoline, home heating oil, and residual fuel oil is expected to decline while demand for diesel fuel, jet fuel, and petrochemical feedstocks increases. These trends will require refining investments in desulfurization equipment for sulfur removal and in coking and cat cracking to upgrade the heavier crude fractions to lighter products. Further investment in reforming capacity will also likely be required to meet the octane requirements of the increasing proportion of unleaded gasoline in the nation's total gasoline requirements.

U.S. refiners have been under federal price and allocation controls or wage and price guidelines since the early 1970s. By denying refiners an opportunity to generate an adequate return, these controls have generally discouraged refining investments in facilities needed to run lower quality crudes or to increase the refinery yield of light products.

U.S. crude runs peaked at 14.7 MMB/D in 1978 and declined to 14.5 MMB/D in 1979 and 13.6 MMB/D in 1980. In spite of this downward trend in crude runs, additional crude distillation capacity continued to be constructed during these years--primarily in subsidized small refineries. As a result, utilization of U.S. refining distillation capacity has declined from an average of 86% in 1978 to an average of about 75% in 1980--meaning that a significant portion of the nation's crude distillation capacity currently stands idle and unproductive, though contributing to fixed costs of U.S. refiners. The preferable approach is to allow the market to bring about a rationalization of distillation capacity to a level consistent with national needs. Then, the burden of the cost of the unproductive distillation capacity will be lifted from the shoulders of consumers.

The federal subsidies offered to small refiners were based on crude runs or crude distillation capacity without regard for the type or quality of product output. The per barrel subsidy level was biased toward the smaller capacity refineries of simple design. Most can only process high cost (light, low sulfur) crudes. Furthermore, most produce a relatively high yield of residual fuel oil (for which demand is declining) and a low yield of lighter products (for which demand is increasing). Often no finished gasoline is produced in these small refineries. The practicality and economic attractiveness of adding conversion capacity to small refineries, spawned to take advantage of the subsidies, is highly questionable. Economies of scale are substantial in the refining industry. More efficient existing capacity--catalytic cracking units, sour crude processing, vacuum distillation, etc.--already exists today in larger refineries. Where additional capacity is needed, such as for resid conversion to clean products, larger units will require less capital per barrel of capacity and will cost less to operate.

Encouragement of U.S. refinery investments to process poorer quality crudes into more highly refined products can best be accomplished by removal of disincentives to capital formation and by permitting the petroleum companies to respond to the market. Discontinuation of the COWPS wage and price guidelines and the elimination of the DOE price and allocation controls effective with President Reagan's executive order of January 28, 1981, are both positive steps toward this objective. Anticipating expiration of controls, many refiners have already proceeded with plans and investments to modify their refineries.

Any further encouragement or incentives for the necessary refining investments should be handled as part of a much broader program for modernization and improved productivity for all major industries. No special encouragement or subsidies

should be offered to a selected segment of the refining industry. Refiners face many problems which are indistinguishable from those in steel, auto, and other basic industries. Furthermore, general tax incentives, such as investment tax credits and shorter depreciation schedules applicable to all investment in manufacturing equipment avoid distortions in market forces which create inefficiency, higher consumer costs, and misallocation of limited resources.

4. Crude Oil Purchasing Cooperatives

The apparent intent of this proposal is to encourage small and independent refiners to pool their resources in seeking supplies of imported crude oil by permitting them to set up privately owned tax-exempt crude oil purchasing cooperatives. At least two cooperatives already exist without the benefit of special tax legislation.

Moreover, oil is quite frequently traded internationally in relatively small volumes. Producing countries have within the past year concluded a number of contracts at volumes between 10,000 and 30,000 B/D. In addition, the services of traders and brokers are available to aid refiners in making imported crude oil supply arrangements. There is no need for government involvement in this aspect of petroleum trade.

Summary

- Treating sales of domestic crude oil to small and independent refiners as foreign source income violates fundamental principles of the foreign tax credit and should not be considered. The foreign tax credit should not be used to reduce United States tax obligation on United States source income.¶?
- There is no demonstrated need for import fees or duties above the current levels on refined petroleum products to preserve the national security or to protect efficient domestic refiners from foreign competition. If necessary, the President could at any time exercise existing authority under the Trade Expansion Act to impose product import fees to protect the domestic refining industry from being significantly harmed by large increases in product imports above historical levels.¶?
- Any further encouragement or incentives for refining investments should be handled as part of a broad program for modernization and improved productivity for all major industries.¶?
- In a non-emergency environment, ample supplies of crude oil in the world market are available to small and independent refiners to meet their processing requirements. Small and independent refiners have already joined together without the benefit of special tax legislation to acquire crude oil directly from oil-producing countries.

4/9/81

WTAS/ADR-??/CD

GETTY OIL COMPANY COMMENTS ON PROPOSED TAX AND TARIFF
INCENTIVES FOR THE DOMESTIC REFINING INDUSTRY
BEFORE THE SENATE FINANCE ENERGY SUBCOMMITTEE

Getty Oil Company is opposed to all policies of economic protection for any class of domestic petroleum refiners. Government programs of preferential economic treatment inherently entail the misallocation of resources and consequently reduce the efficiency of the economy. Therefore Getty opposes a tariff on refined products, government mandated crude allocation systems and subsidization of refinery investments.

Tariffs

A tax on imports, or a tariff, is detrimental to the interests of consumers and society as a whole. A tax on imports would raise the price of all refined petroleum products and would reduce the total amount of products supplied to the market. Protected by a tariff, domestic refiners would expand production, but by less than the total reduction of imports because higher prices would reduce overall consumption.

By reducing the volume of trade, the tariff would impose a loss on the economy because, even with increased output by domestic refiners, the volume of total refined product sales would be reduced. The lost refined product transactions would have had real economic value to those who would have engaged in them. By reducing these opportunities for exchange, a tariff would reduce the overall efficiency of the economy.

In addition to this loss, a tariff creates other distortions. By artificially inducing domestic refiners to increase production to partially offset reduced imports, the government induces

a misallocation of resources such as land, labor, plant and equipment. In responding to the tariff-induced higher prices, domestic refiners use resources that cost more than the resources which would have to be exported in order to pay for an additional barrel of imports from a more efficient foreign refiner. In other words, a tariff imposes a higher resource cost on each additional barrel of refined product. A market free of government tariffs would have directed those resources to some sector of the domestic economy other than refining where they would have been more productive, i.e. more highly valued. This misallocation of resources impairs the overall productive capacity of the economy and thus, contrary to the claims of tariff proponents, tends to exacerbate rather than alleviate the imbalance of foreign trade payments.

At this point, it should be noted that there are significant economies of scale in petroleum refining. Larger refineries permit lower per unit operating costs than small refineries, and this efficiency difference becomes larger as the number of refinery products increases.

Viewing the domestic refining industry as a whole, efficiency requirements would dictate increased production from the refineries with the greatest efficiency, generally the largest refineries. Only after capacity has been reached at all larger refineries should smaller, less productive refineries be utilized to produce increased product volumes. By expanding production at small refineries, a tariff-subsidy would impose a higher resource cost for any given volume of refinery product. This is not to say that in certain cases for special products in isolated or special markets, small specialized refineries are uncompetitive per se.

There are at least four aspects of the alleged need for special economic protection that should be addressed. Admittedly there are laws and regulations (e.g. Jones Act, Clean Air Act, OSHA, et al.) that raise domestic refiners' costs. Therefore, to the extent such legislative creations are inefficient, they should be repealed. The overall economic well

being of society will not be improved by adding additional layers of laws and regulations in the attempt to remove already legislated inefficiencies; even though certain classes of refiners may be thereby enriched.

Secondly, foreign refineries do not pollute the domestic environment. If other countries are willing to allow their refiners to pollute and pass the savings on to American consumers in the form of lower product prices, our economy gets both a cleaner environment and cheaper energy.

Thirdly, to the extent that foreign product prices are cheaper than domestic prices, the American economy can expend fewer real resources to acquire energy by buying foreign products. The economy can only be strengthened by a policy of procuring resources at the lowest possible cost. A policy of procuring high priced resources, whether they be foreign or domestic can only weaken the overall economy.

Fourth, the probability of a supply cutoff of foreign products is obviously a real cost to the consumer of those products. Buyers in the free market take this risk into account and adjust their bid for such products accordingly. In some cases inventories are stored, in others, substitutions are made. The net result is that the price for such products reflects their true cost (cutoff risk included) to the consumer. If the true cost of foreign refined products is lower than domestic products, the choice is clear: buy foreign.

Several OPEC countries are building refineries. It has been claimed that once these were to be completed, OPEC countries could undercut the world market at will, at the same time maintaining high prices for their crude oil and hence OPEC's power would be increased even more than it is now. Several lines of reasoning suggest that such an argument is false.

The price for refined products is set in the world market. Would-be refiners must meet or beat this world price or their products will remain unsold. Bearing this in mind, there are three possible scenarios that may ensue upon OPEC development of significant refining capacity, none of which would be detrimental to U.S. interests:

1) Although very unlikely, if OPEC were to have a comparative advantage in refining relative to existing refiners it would either a) lower the world price of refined products, which would be beneficial or b) charge the world price for its products and collect economic rents, i.e. higher than normal rates of return on investments, in which case nothing would be changed from the consumers' point of view.

2) If OPEC had the same average costs as existing refiners, it would simply charge the existing world price and earn a normal rate of return. Nothing would be different for consumers.

3) What is most likely is that OPEC's comparative advantage in refining is less than that of existing refiners. Again, in order to sell its products it must meet the world price. Sales of their low cost crude would be replaced by sales of product. OPEC's total sale of petroleum—crude plus products—would be essentially unchanged, its costs higher, its profits lower and its total "leverage" over consuming nations no greater than previously.

Subsidies

Irrespective of the particular programs adopted, preferential treatment for small or independent refiners adds nothing to national security. At present and for the foreseeable future, domestic refining capacity exceeds domestic crude production. Therefore, the binding constraint in satisfying national demands during an energy supply interruption is crude oil, not refining capacity.

Subsidization of additional refining capacity, under the pretext of national security, would simply increase the amount of refining capacity that would sit idle during a supply interruption. Clearly, national security is in no way adversely affected by reliance upon the free market since strategic military supplies can be readily furnished without recourse to a tariff or other forms of government intervention. If a small refiner, for example, provides an economic source of jet fuel, defense procurement agencies will contract with that refiner for supplies.

It should be noted that the primary sources of economic competition for the small and independent refiners are the Caribbean refineries. It is these refineries that are alleged to pose a grave threat to national security. Such contentions are not well founded. Most of the Caribbean refineries are owned by U.S. companies. Furthermore, because of their proximity to the U.S. such refineries could be defended as easily as domestic refineries in the event of an emergency. Additionally, Caribbean refineries are positively beneficial to the domestic economy because they provide refined products without adding to air or water pollution in domestic population centers. In short, they produce products at lower real cost.

Claims that a policy of subsidization of small and independent refiners would enhance

competition in the refining industry confuse the distinction between preservation of competition and preservation of competitors. There has always been a niche for small refiners, serving small or isolated oil markets or producing specialized products. But everything else being equal, small refiners incur a higher resource cost in producing a given amount of output. Unrestricted competition would cause marginal firms, the less efficient, higher cost ones, to leave the industry and go out of business. A policy of special treatment for high cost producers raises costs and makes consumers worse off.

Many of the arguments concerning competition in the refining sector promote the false notion of competition as a contest of the "majors" versus the small refiner. In reality each refiner is competing against all other refiners and all other refiners are competing against him -- and each other as well. Size, per se, is immaterial; economic efficiency is the only relevant criterion.

In a manner similar to the imposition of a tariff, a policy of government subsidized refiner investment would be ill-advised. The untenable assumption behind such a policy is that the private capital market is incapable of recognizing which sectors of the economy require what amount of capital and/or is unable to direct capital to those sectors where it is most productive. A further presumption is that a process of political haggling and compromise can determine a more efficient allocation of capital than can the private market. Both economic logic and American's economic history refute the need for government-directed investment.

The U.S. refining industry, in response to nothing more than free market forces, has, in its history, adapted to changes of far greater magnitude than those now anticipated for the

near future. It has adjusted to the shifting of supply sources from the exhausted Appalachian fields, to Ohio-Indiana, to Mid-Continent, to East Texas, to the Gulf. It also adjusted to the sometimes drastic changes in crude quality as supply sources changed. It endured crude price fluctuations and massive product demand changes. The declining demand for its first principal product, kerosene, and the rising demand for gasoline and quality lubricants required investment changes that dwarf those contemplated for the 1980's. Yet the young industry made those changes and laid the foundation for American refining's current preeminence without assistance from the government.

Crude Allocation

Finally, government mandated crude oil allocation programs impair the efficient functioning of the oil industry and can be shown to be detrimental to national readiness for an oil supply reduction.

Any request for government directed crude allocation is essentially a request for a policy in which the government "nationalizes" the available petroleum supply in the event of a supply reduction. We have the past experience of 1973, 1974 and 1979 to illustrate the inability of government to allocate crude either equitably or efficiently.

As U.S. energy history has demonstrated, government crude allocation programs or the threat of their imposition clearly reduce the incentive for private firms to maintain adequate levels of precautionary oil inventories. Obviously, if the government indicates that it will confiscate some portion of the inventories of private firms in the event of a cutoff, a firm will significantly reduce the amount of precautionary crude stored. Likewise,

a government allocation program diminishes the incentive for refiners to actively seek out the lowest cost source of alternative crude supplies since the government stands ready to "ball out" lethargic refiners.

Since the government's policies in this area actively discourage the private stockpiling of appropriate levels of precautionary reserves, the nation thereby holds fewer barrels of oil in reserve than it prudently should. The economy and the nation is, then, left more vulnerable rather than less vulnerable to a supply cutoff. On the other hand, if the crude oil market were free of government constraints, it would, through the system of unregulated prices, direct crude oil to its highest and best use, a portion of which would obviously include precautionary reserves, toward efficient refiners and away from inefficient refiners.

Conclusion

Although economically inefficient, many small and independent domestic refiners have succeeded in shifting the field of competition from economics to the arena of politics. Since 1959 with the Mandatory Oil Import Program, the independents have proven more politically efficient than the integrated refiners. The fact that small refiners rather than large ones have the upper hand is not as significant or detrimental as the shifting of competition from the economic to the political domain. Political competition produces benefits that come only at the expense of others, a zero sum game at best. Economic competition produces benefits that are mutual in nature and reveals opportunities to make everyone better off.

It is Getty's hope that government recognizes the superior efficiency of the free market in the allocation of society's resources and allows a greater opportunity for market solutions rather than political solutions, to America's energy problems.

Statement of A. Johnson & Co., Inc.
submitted to the
Subcommittee on Energy & Agricultural Taxation
Committee on Finance
United States Senate

April 10, 1981

Preliminary Statement and Summary of Position

A. Johnson & Co., Inc. ("Johnson") appreciates the opportunity to present its views to the Subcommittee on various tax proposals regarding the domestic refining industry. Johnson a Delaware Corporation, headquartered in New York, has oil interests in refining and marketing in the New England States and the Southeast. In addition, in the last few years Johnson has invested substantial sums in domestic oil production. Its wholly owned subsidiary, C. H. Sprague & Son Company, Inc., a Portsmouth, New Hampshire based residual fuel oil and home heating oil distributor, has been supplying heating energy needs to New England for over 100 years.

Johnson has been running two small refineries on the East Coast, in Newington, New Hampshire and in Wilmington, North Carolina. These refineries were built to serve local markets and currently provide residual fuel oil and heating oil to industry and residential consumers in each area.

Johnson is currently studying what is required for these refineries to remain viable in the near term. We are considering upgrading our facilities to refine products such as jet fuel and asphalt which can serve local markets efficiently and on a competitive basis. Additional capital investment will be required and it is in the area of tax incentives and assured crude access that the federal government can be most helpful.

Specifically, Johnson is recommending the following proposals to permit small, independent refiners to remain viable.

- a. Permit full depreciation of existing investments if the realized saving is invested in refinery upgrading or crude production facilities.
- b. Permit accelerated depreciation of new equipment in combination with an incremental investment tax credit.
- c. Impose import fees on refined petroleum products that would provide an adequate level of incentive to support the domestic refining industry.
- d. Provide federal financial guarantees in support of independent refinery crude purchasing cooperatives.

Background and Discussion

Johnson, through its wholly owned subsidiary, ATC Petroleum, Inc., has been engaged in the refining of heating oil and residual fuel oil in Newington, New Hampshire since November 1974 and in Wilmington, North Carolina since September 1977.

The refinery facility at Newington was originally designed in 1972 as an asphalt plant at a projected cost of \$6 million. By mid 1973, the first stage of the plant had been completed on the site of an existing fuel oil terminal and a second stage was well under way. However, during the construction phase in 1973, import fees were placed on petroleum products under proclamation No. 4210, but no such protective fees were assessed against the importation of asphalt. Simultaneously the quota restrictions on asphalt importation were eliminated. Thereafter, price controls applicable to the sale of asphalt, coupled with its unrestricted importation, effectively eliminated any possible competitive position Johnson's domestic asphalt plant might have had over the direct importation of asphalt from the Caribbean. Consequently, although this facility was designed and intended to produce asphalt, after construction had commenced and substantial resources had been committed, the effect of the Regulatory Programs by the government necessitated a complete, costly change in plans by Johnson.

In order to obtain some benefit from the six million dollars invested in the facility, it was decided to revamp the plant in order to use "pipeline interface" material as a feedstock. This material was "slopped" by Colonial Pipeline and collected at Linden, N.J. from where it could be delivered by barge to New Hampshire. Refineries near Linden would not handle the material because the lead in the gasoline portion of the mix could contaminate their refinery catalyst and cause a severe economic penalty.

Johnson successfully bid for the "pipeline interface" and in October 1973 commenced operations at Newington using this "interface" as a feedstock. In late 1973 pursuant to the Emergency Allocation Act of 1973, the Government instituted price controls on the sale and distribution of domestically produced crude oil and petroleum products. By January 1974, OPEC had increased the price of crude oil appreciably and the effects of the Arab embargo caused spot product prices to rise dramatically in the market place. To protect its supply of feedstock, in February 1974 Johnson requested that the FEA determine that Johnson's interface supply agreement should fall under the freeze on supplier/purchaser agreements which were given other independent refiners at the time.

Although the interface material was a mixture of gasoline and kerosene, both controlled products, the FEA responded that interface material was not covered by the Mandatory Allocation Program. Therefore, the FEA was unable to take any other action in terms of the distribution of the material other than to let the free market determine the allocation. Subsequently, increased competitive bidding resulted and Johnson lost its bid on this material to a processor who had a plant with access to cheaper pipeline transportation.

At the same time, the FEA had established an allocation program popularly known as the buy/sell program. Its purpose was to provide access to crude oil supplies for small and independent refiners. It was also supposed to correct any supply imbalances between the major integrated refiners and the small independent refiners. The President emphasized his support for this

allocation program in his special energy message to Congress on January 23, 1974. He stated that...

"as part of this allocation effort, refiners are being encouraged to produce less gasoline and more of the products that are needed in homes and industry, such as heating oil, diesel oil, residual fuel oil and petro chemical feedstocks."

The President's position was taken right after the government had frozen crude oil supplier/purchaser relationships as of December 1, 1973.

Encouraged by these government actions, Johnson revamped its refinery in order to process crude oil. In addition, Johnson, believing that increased petroleum refining capacity represented the "wave of the future" in the domestic U.S. oil industry, proposed to expand and upgrade the capacity at its Newington plant to 50,000 bbls per day in order to manufacture gasoline, heating oil, diesel fuel, and residual fuel.

Unfortunately, the prospect of a large refinery in New Hampshire was not a new one. In mid 1973 through early 1974, the Onasis group proposed the construction of an oil refinery with a capacity of 600,000 bbls per day including tank farms, pipelines and an offshore unloading facility in the Isle of Shoals. The controversy over this proposal resulted in the passage of two laws at a special session of the New Hampshire Legislature called in the Spring of 1974. The first of these statutes required extensive permitting while the second statute required approval by a majority of the voters in the town where the refinery would be located. Pursuant to this legislation, a vote at a special town meeting narrowly defeated the Johnson refinery expansion proposal shortly after the Onasis proposal had already been soundly defeated.

Having been frustrated in its attempts to expand in New Hampshire, Johnson actively considered some alternate investment in refining capacity on the East Coast. In doing so it was relying upon existing import policies, pursuant to Section 232 of the Trade Expansion Act of 1962, as amended. On April 18, 1973 the President had shifted to a fee system of charging importers for the right to import petroleum products and stated that he deemed it necessary to do so consistent with the national security objectives of the Trade Expansion Act of 1962 in order to discourage the importation into the United States of petroleum products. The President further provided provisions for the gradual transition from the then existing quota method of imports to a long term program for adjustment of imports of petroleum products through the institution of a system of fees applicable to imports. The stated purpose of this new import policy, which placed a higher fee on finished products than on crude oil, was to "create conditions in the long range for domestic refining needed for projected national security requirements and more specifically, to increase the capacity of domestic refiners to meet such requirements and to encourage investments in these plants".

Residual fuel oil marketers on the East Coast had historically marketed fuel oil obtained from offshore sources primarily Venezuela and Caribbean refineries. Heeding the government's policy that product imports would be more expensive than products manufactured domestically, Johnson believed that the only way to remain viable in the residual fuel oil market was to supplement and eventually supplant its imports of residual fuel oil as much as possible.

On September 1, 1977 with the approval and endorsement of the then FEA's office of Exception & Appeals, Johnson acquired the leasehold rights of the Wilmington Refinery of the Pace Oil Co. This 12,000 bbls per day refinery located in Wilmington, N.C. was acquired at a cost of \$4.8 million. By owning two small refineries, Johnson gave up benefits that would have accrued to each refinery if owned by separate owners. The "small refiner bias" and the reverse entitlement provision (which penalized a refiner for producing more than 5000 b/d of residual fuel oil destined for East Coast consumption) encouraged larger refiners to "spin off" small refineries of under 10,000 b/d capacity to "concubines" so as to get the maximum benefit under the entitlement program set forth in Part 211.67 of the Federal Energy Regulations. However, Johnson felt that in the long term, domestic refinery capacity would be a desirable property.

In spite of the historical facts which showed the government endorsing the building and expansion of domestic refineries, the Federal Energy Administration unbelievably published a proposal on September 2, 1977, the very next day after Johnson acquired the Wilmington refinery, making amendments to guidelines which would authorize persons to import all the residual fuel oil needed in District I on a fee-free basis. This proposal was published out of the blue, with no national security finding that such a program was necessary under the objectives of Section 232 of the Trade Expansion Act. The proposal had been made without regard to those persons such as Johnson who invested in domestic refining to take up the expected slack in reduced fee-free imports.

The advent of decontrol has brought another degree of uncertainty to the small and independent refiners, particularly to those without their own crude oil production. The current emphasis on free market forces appears to many to be the desirable new "wave of the future". Unfortunately, free market forces do not truly exist since the largest share of crude oil not controlled by major refiners is in the hands of OPEC countries who are not disposed to deal with small independent refiners. Even small refiners having new efficient refineries will have difficulty competing with refined product imports from offshore refineries capable of receiving large tanker quantities of crude and operating in an environment of lower cost labor and taxes. These lower operating costs of offshore refineries will continue to exist even though access to crude oil can be achieved.

It would be naive to think that the clock will be turned back to the days of small refiner subsidies. Most independent business men really do not want that anyway. Those that do want to continue in the refining business recognize that they will have to compete in the world market place in an era of increased crude and product prices and reduced consumption. However, during the transition period there are some things that government can do to alleviate the injustices caused by past widely changing government oil policies.

First, since if refiners were to close down they would be able to write off undepreciated equipment to scrap value, they should be given the opportunity to fully depreciate now existing investments as long as the saving is put into new refinery upgrading or crude production facilities.

Second, all new refinery investment should be permitted to be fully depreciated rapidly. A shorter period than five years would be beneficial to stimulate investment particularly for small businesses dependent on refinery income. An additional incentive in the form of an additional 10% investment tax credit proposed by the Reagan Administration would be most helpful as well.

Third, the government should impose product import fees at levels that would provide an adequate incentive to the domestic refining industry. This would also permit the government to limit the amount of crude and products imported and provide an incentive for industry to maintain the refining function in this country. It is of vital necessity in times of national emergency to be able to refine the products needed when and where they are needed. This will also keep American skilled workers in jobs rather than exporting these jobs to foreign soil. At Johnson's admittedly small scale refinery operations in North Carolina and New Hampshire over 100 people are employed at both refinery locations with an annual payroll of more than two and a quarter (\$2.25M) million dollars.

Fourth, the government should support small independent companies' efforts to form crude oil purchasing cooperatives. Although it will be difficult for several refiners to match up crude needs with available supplies, the first big hurdle will be the joint financing requirement imposed by foreign governments which could be eased if the U.S. government could provide back up guarantees of payment.

All the tax incentives being discussed will only be meaningful if the industry remains profitable, so these changes must be made quickly while refineries are still viable. Once refineries are closed there will be very small likelihood of start-ups of older plants. Grass root refineries to replace closed facilities where environmental regulations permit will prove too costly to be built in this country. We will be playing right into the hands of crude producing countries when we become dependent on foreign sources for our product supplies as well as for our crude supplies. If we have a viable domestic refining industry, we will have the incentive to keep looking for domestic oil in places that have yet to be fully explored. If we must import crude oil, we at least will have the option of shopping around between the crude exporting countries of the world.

It seems now to be the time to take a long look at our overall oil policy not only for today but for the next 10 years at least. This policy must be compatible with our desire for energy self sufficiency. Discouraging the continuation of a viable independent refining industry will truly reduce competition and reduce our ability to convert raw material to finished products in the future, whether the source of these raw materials be crude oil, coal, shale or biomass.

STATEMENT
OF
MARATHON OIL COMPANY

ON

SMALL REFINER TAX PROPOSALS

BEFORE THE
SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION
OF THE
COMMITTEE ON FINANCE
UNITED STATE SENATE

April 7, 1981

Marathon Oil Company appreciates this opportunity to submit its views on domestic refinery policy and the tax and tariff policies being considered by the Subcommittee on Energy and Agricultural Taxation of the Senate Finance Committee.

The fundamental issue of domestic refinery policy is what the proper role of the government should be in ensuring a strong domestic refining industry. It is Marathon's firm conviction that the free market system is the best determinant of an efficient and economically healthy domestic refining industry and that governmental interference is neither necessary nor justified to achieve that goal. Our experiences during the last decade of government regulation of the petroleum industry should clearly illustrate that governmental intervention into the market system, regardless of how well intentioned, produces unintended results, many of which are undesirable and totally inconsistent with the original purposes of the actions taken.

The original purpose of the federal price and allocation controls on the petroleum industry was to preserve competition within the industry and thereby ultimately benefit the consuming public in the form of lower product prices and adequate, stable sources of supply. It is now clear, however, that the net effect of those regulations was to --

- ° induce construction and perpetuation of a large number of unnecessary small and inefficient refineries that survived almost entirely on the subsidies provided by the regulations;

- increase, rather than decrease, imports of foreign crude oil through the explicit subsidy of the Entitlements program which actually discouraged the exploration for and production of domestic sources of crude oil;
- reduce the volume of high-demand light products available to the nation by directing the sale of crude oil through the Buy/Sell and other programs to small inefficient refiners; and
- inhibit efficient refiners' incentives and ability to compete for crude in the world market by penalizing them for proper business decisions and through the uncertainty inherent in a regulated environment.

The petroleum market is operating efficiently since decontrol on January 28, 1981. Crude oil is plentiful, prices are soft, and all refiners have access to needed supplies. The claims of some refiners that they do not have "equitable access" to crude oil are in reality an admission that their operations are not economically viable without the continuation of past subsidization. It is true that a number of refineries have shut down since decontrol, both large and small; however, this is the product of a dynamic, evolving market which would have occurred previously except for the distortions of government controls which artificially maintained many otherwise unviable refineries in operation. Moreover, this trend is likely to continue in the immediate future. The present refinery utilization rate of 70 percent is a clear indication that we have excess distillation capacity and that only those refineries able to efficiently meet market needs will survive. This is a natural process in any competitive free market place and is beneficial to the ultimate consumer.

There appears to be a general consensus within all segments of the industry and government that the industry needs to upgrade its downstream

processing capabilities to be able to efficiently utilize the lower quality crudes that are becoming increasingly prevalent and produce the higher value, light products that the consuming public demands. Marathon agrees with this. Marathon also believes that the price differentials between high and low quality crudes and the greater value of high-demand products offer sufficient incentives to cause the necessary upgrading in refinery capabilities. It is not necessary for the government to provide incentives which result in a transfer of economic resources from the general public or any specific sector if those incentives are already available in the market place.

Marathon believes that government involvement in the domestic refining industry is warranted only in times of severe supply shortfalls and would endorse any emergency program, such as the recent National Petroleum Council study, which is basically market oriented and treats all refiners equally.

If it is determined that the government should provide some incentive to stimulate refinery investment, Marathon would suggest that traditional tax-based incentives, such as accelerated depreciation and investment tax credits, are preferable to other alternatives. Most importantly though, any government action must be applied equally to all segments of the industry. We must not repeat the mistakes of the past and allow well meaning programs to distort the market place to the ultimate detriment of the industry and the public as a whole.

In view of the foregoing, Marathon does not support the tax or tariff proposals now being considered by the Subcommittee. Our specific criticisms of these proposals are as follows:

1. Modification of Foreign Tax Credit Rules

Under this proposal, sales of domestic crude oil by integrated international companies to small and independent refiners would be sourced outside the United States so that the selling companies could utilize excess foreign tax credits. We believe this plan to be impractical as well as potentially affording an unfair and unwarranted competitive market advantage to those U. S. producers which have available excess creditable foreign taxes. The Treasury would provide a 46-cent subsidy per dollar of profit margin to those producers uniquely situated to take advantage of this newly targeted U. S. market. This subsidy would be given without certainty that any substantial portion of it would ultimately accrue to the small and independent refiners of the ultimate consumer. This proposal would further complicate a portion of the tax law, dealing with foreign tax credits, that is already unduly complicated.

2. Tariff on Imported Petroleum Products

Marathon supports development of a free competitive market for crude oil and petroleum products throughout the world except in times of crisis. Although a tariff on foreign refined products is one way of reducing dependence on such imports, we believe government should instead adopt non-protectionist measures to strengthen the domestic industry. A products tariff, as any artificial market constraint, would tend to prolong and promote inefficiency and the consequent higher cost of product to domestic consumers.

3. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

Proposals in this category include a) accelerated depreciation, b) additional investment credit, and c) the immediate expensing of facilities certified as effecting pollution control.

Marathon believes that tax incentives are only one of several government policy decisions necessary to create a climate supportive of the industry so that all refiners can proceed with confidence to make the substantial investments required to upgrade our processing capability. Any tax incentives should apply equally to all refiners without regard to size or access to crude. Such incentives should never be offered to further subsidize those plants which are inefficient and will remain so without configuration or process equipment alterations. The recently proposed five-year depreciation life for refinery plant under the President's Accelerated Capital Recovery System is certainly a giant step toward creating the desired environment to support new capital investment. That proposal also incorporates the full ten percent investment tax credit for such expenditures even though the depreciable life is shortened.

4. Tax-Exempt Crude Oil Purchasing Cooperatives

Tax-exempt status for crude oil purchasing cooperatives is not necessary to encourage their formation because we do not envision them operating for the purpose of making a profit. Furthermore, such cooperatives are already being formed without tax incentives. For example, the March 23, 1981 issue of Platt's Oilgram News reports - a crude oil purchasing cooperative formed by Rock Island Refining, Farmers Union Central Exchange, and several other small refiners. They plan to offer oil producing countries their expertise in agriculture and fertilizers in return for crude oil purchase contracts.

We would also like to comment on the suggestion made by one of the witnesses appearing before the Subcommittee that crude oil be exempted from the windfall profit tax if sold to a small or independent refiner. This exemption amounts to nothing more than a continuation of the Small Refiner Bias program in another form and would likewise subsidize inefficient refineries and remove the necessity and incentives for upgrading refinery capabilities. Further, since the windfall profit tax is scheduled to expire once it has reached the fixed revenue target of \$227.3 billion, any legislation which would reduce the windfall profit tax revenues should also include provisions for an equal corresponding reduction in the target revenue ceiling. Unless this reduction is made, we will again be in the position of subsidizing a societal purpose with private capital.

In conclusion, Marathon's position is aptly summarized by the Department of Treasury/Department of Energy evaluation of tax-based incentives for domestic refining investments:

"neither termination of price controls nor future changes in the characteristics of raw material inputs justify a public subsidy to investment in domestic petroleum refining. Subsidies to refining investment would serve no social purpose. They would have the effect of producing abnormal profits for refiners whose plants and locations already assure them economic survival, and they would deter the exit from the industry of inefficient and badly located plants, depriving the private sector of capital which may be used more efficiently in other activities, within both the energy and non-energy sectors."

Thank you for your consideration of our views.



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REFINERY POLICY STATEMENT

Attached is a statement adopted by the NPRA Executive Committee recommending steps that should be taken by the Federal Government to preserve a healthy, competitive refining industry since price and allocation controls have been removed from crude oil and refined petroleum products.

The principal recommendations are:

- (1) We fully support the President's recent action to decontrol crude and refined products.
- (2) The United States should send a clear message to the world that a strong domestic refining industry is important to our national security and that we will take the steps necessary to prevent that industry from being threatened by increased product imports.
- (3) A standby program of crude oil allocation for use in a supply disruption should be put into effect as soon as possible.
- (4) The government should not establish any operating subsidy to replace the small refiner bias.
- (5) Any allocation program should recognize the importance of non-energy petroleum products.
- (6) There should be programs which will provide the tax incentives for capital formation and investment applicable to U.S. industries in general. These will encourage investments in refining facilities to meet a changing product slate and crude oil availability.
- (7) The government should recognize that many regulations not only increase the cost to the consumer but have a strong anti-competitive effect.
- (8) The government should continue to add to the strategic petroleum reserve.

- 2 -

- (1) We fully support the President's recent action to decontrol crude and refined products.

The removal of allocation and price controls from crude oil and petroleum products is in the public interest. This will promote the search for new oil supplies, the development of alternative fuels, and encourage conservation. Together these developments will reduce our dependence upon foreign imports.

- (2) The United States should send a clear message to the world that a strong domestic refining industry is important to our national security and that we will take the steps necessary to prevent that industry from being threatened by increased product imports.

It must be recognized that decontrol will require adjustments by domestic refiners, because they will be subject to increased competition with products imported from foreign refiners. We think it should be recognized that many of the disadvantages of domestic refineries are created by U.S. Government policy. An important factor is the additional cost imposed on U.S. refineries by environmental restrictions. For example, the elimination of lead from gasoline and the prohibition on the use of MMT have added millions of dollars to the cost of refinery operations and investments in the United States. Foreign refiners will be able to maintain a balanced operation, because they will not be forced to convert all of their gasoline to unleaded. The costs imposed on stationary sources, such as waste disposal, water pollution, and air emission controls will be much higher for U.S. refiners. A study prepared for the Federal Energy Administration,^{1/} outlines some of the additional advantages held by foreign refiners. These include investment-incentive legislation which provides for partial or, in some cases, total exemption from income taxes and local ad valorem taxes; lower transportation costs in the use of foreign-flag tankers, the use of super tankers and the availability of deep water ports.

It is generally recognized that our dependence upon foreign suppliers for crude oil threatens our national security. One of the chief objectives of our energy policy has been to reduce this dependence. An increased reliance upon imports of foreign products would make us even more dependent. Several statements by government officials indicate that they do not recognize how much more our national security would be affected if we become more dependent upon foreign product imports. A recent D.O.E. study, for example, says "Any reduction in product imports would be replaced by an essentially equivalent amount of crude imports to feed the increased domestic refining activity. On its face, therefore, it appears that the nation's import vulnerability would remain the same." This conclusion overlooks the fact that we can utilize crude oil from many sources if we have within our own borders the refining capacity to satisfy our requirements for finished products. Having our own manufacturing capacity makes it possible for us to substitute crude oil from different sources of supply as the situations change in some countries such as political unrest in Iran, a deliberate embargo such as that imposed by the Arab countries in 1973, a declining supply in some countries, or hopefully, the possibility of new supplies being discovered in countries where exploration is presently underway.

^{1/} Report by the Pace Company, Consultants and Engineers, Inc., July, 1976.

Historically, when refineries located near markets in the United States suffered reduction in crude oil supply, they have adjusted operations to process crude from other sources. For example, one of the largest centers of refining capacity in the United States is the area along the Delaware River involving both the Philadelphia area in Pennsylvania and portions of New Jersey on the other side of the river. These refineries originally were built to refine crude oil moved by tanker from the Gulf Coast. As the supply of U.S. oil declined, these refineries were gradually converted to run very largely on Venezuelan oil; and as the supply from Venezuela declined, these refineries have begun to run increasing quantities of oil from Iran, Kuwait, Saudi Arabia, Nigeria, Libya and other sources. The same thing is true of the refineries in the Chicago area, which originally ran on crude oil from Oklahoma and gradually shifted to Texas crude. For a time they used quantities of Canadian oil and, as the Canadian Government is cutting us off, these refineries are using oil imported from other foreign countries by tanker into the Gulf Coast and transported by pipeline into the Chicago area. The refineries in the Los Angeles area were built to serve the huge market in Southern California. They originally were supplied with crude oil produced in California. As this production declined, these refineries have been able to use oil from Venezuela, Indonesia, and now from Alaska. The important thing to remember is that as long as we had refining capacity located near the markets in the United States, we were able to adjust to changes in crude oil supply.

We think that future government policy should not encourage the building of refining capacity outside the U.S. to serve the U.S. market or increase product imports. The President should retain the authority to restrict imports that threaten the national security.

- (3) A standby program of crude oil allocation for use in a supply disruption should be put into effect as soon as possible.

We believe that the government should have a standby crude-sharing program to be put into effect in the event of a supply disruption. This program should not confer an unfair advantage to any refiner. There should be a provision for suspending the program when the disruption is ended.

- (4) The government should not establish any operating subsidy to replace the small refiner bias.

Small, independent refiners contribute to making the refining industry the highly competitive industry that it is. They also perform an important function in the supply of products to many areas, particularly agricultural areas, and in the supply of specialty products. The NPRA has supported various government projects to help these refiners. For example, we proposed the first program for this purpose -- the plan under which a percentage of the Defense Department purchases of petroleum products are set aside for small refiners. This helped to keep many small refiners in business with no additional cost to the government. The government is now in the process of phasing out controls including the entitlements program and the small refiner bias. We do not favor the establishment of another operating subsidy to replace the small refiner bias.

(5) Any allocation program should recognize the importance of non-energy petroleum products.

More than 90% of petroleum by volume is consumed for energy purposes. However, we should not overlook the fact that there are important uses for petroleum in non-energy fields. For example, lubricating oils which consume only a small fraction of the total petroleum supply are essential both in industry and transportation. Asphalt, which is widely used as a binder for aggregate, is actually more energy efficient than its chief competitor, Portland cement. The development of lightweight petrochemical substitutes for metal in automobiles is making an important contribution to our energy saving by reducing the consumption of gasoline.

Petrochemical feedstocks comprise only about 4.5% of total U.S. oil and natural gas consumption, but they make a contribution to our economy which is far greater than this percentage would indicate. Almost 80% of total rubber products and over 50% of our nation's fibers are man-made from petroleum feedstocks. In terms of total sales, the petrochemical industry is significantly larger than such basic industries as steel, aluminum, and pulp and paper manufacturing. It employs more than 310,000 persons directly as well as creating jobs for many others in related industries. The petrochemical industry invested 4.6 billion dollars in new plants and equipment in 1978, over 10% of new capital invested by all United States manufacturers during the year.

We believe it is in the national interest to ensure that any government imposed program during a supply emergency fully recognize the special feedstock requirements for all branches of the refining industry.

(6) There should be programs which will provide tax incentives for capital formation and investment applicable to U.S. industries in general. These will encourage investments in refining facilities to meet a changing product slate and crude oil availability.

The growing demand for higher quality petroleum products such as unleaded gasoline and the changing quality of supplies of crude oil will require increased investment in downstream processing facilities. Recent estimates suggest that present plans for expansion of these facilities will not be adequate to meet anticipated demand. The National Petroleum Council's Refinery Flexibility Report indicated that between 1979 and 1990 at least five billion dollars (in constant 1978 dollars) must be invested in new downstream processing facilities in the U.S., and the investment needed may be as great as \$12 billion. Due to inflation, these costs are subject to considerable escalation. Therefore, we foresee the need for programs which will provide the proper tax incentives for capital formation and investment. It is our belief that improvements to the present depreciation allowances and increased tax credits for capital formation, which are applicable to U.S. industry in general, will encourage investments in refining facilities to meet anticipated demand.

- (7) The government should recognize that many regulations not only increase the cost to the consumer but have a strong anti-competitive effect.

Most of the discussion of environmental regulations has dealt with the additional costs imposed. However, there is another issue -- that is the effect of the government's policy upon competition. The Refinery Policy Study recently released by the D.O.E. speaks of "the Department's policy to support and preserve an efficient, competitive, and viable domestic refining industry." We strongly support this policy. One of the tests to determine whether an industry is truly competitive, and one for which antitrust lawyers look first, is what is known as "ease of entry." That is, is it possible for new competitors to enter into the industry or does a monopoly have the power to prevent new competitors from entering the business? The Federal Trade Commission has pending a complaint Docket 8934 in which it charges, "There has been no significant new entry into the refining of petroleum products..." and at another point, "Since at least 1950, (oil companies), through common courses of action and agreements, have erected and maintained barriers to entry into refining."

The fact is that prior to the imposition of government control in the early 70's, a number of new competitors entered the refining business and many independent refiners substantially increased their capacity. The result was that the share of the refining business held by the 20 largest companies in 1951, declined from 80.68% in 1951 to 73.98% in 1974. With the coming of government controls, new competitors were effectively barred from entering the industry. For example, 14 attempts by independent companies to build refineries on the East Coast alone were rejected for environmental reasons during the past twenty years. In the whole United States only one large refinery has been built since 1973.

It is equally difficult to get permission to add equipment such as desulfurization units and reformers necessary to manufacture unleaded gasoline. In such cases the EPA requires that in order to obtain a permit in most areas, a company is required to reduce the pollution from some other source.

- (8) The government should continue to add to the strategic petroleum reserve.

Current statutes require the buildup of a strategic petroleum reserve to cushion the effect of any important shut-off of supply of crude oil. We recommend that this program be continued. For a number of years the Federal Government has recognized that in an emergency we might be short of certain essential materials which are imported. The government now maintains stockpiles of these materials which include antimony, aluminum, cadmium, cobalt, tin, lead, zinc, and even feathers and sperm oil. In all these cases we have recognized that these products are being stored in the national interest. All of these products are purchased by the Federal Government and are stored in locations owned or leased by the government. We believe that this principle, which already has been recognized by the Congress, should be the guiding principle for the storage of oil for emergencies and that the oil to be held in storage for national security should be owned by the government and stored under the government's control. We recommend that the government continue the present policy of storing crude oil rather than finished products. The storage of crude oil in salt caverns is a much less expensive way of storing oil and it also keeps the oil in a form that can be converted into products that will be needed in the event of an emergency.

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BEFORE THE SUBCOMMITTEE ON ENERGY AND
AGRICULTURAL TAXATION, COMMITTEE ON
FINANCE, UNITED STATES SENATE
HEARING OF MARCH 27, 1981 ON
TAX INCENTIVES FOR DOMESTIC REFINING

STATEMENT OF THE
PETROCHEMICAL ENERGY GROUP

The Petrochemical Energy Group (PEG) is an ad hoc group of 19 independent U.S. petrochemical producers. The PEG member companies are all independent in that they are not owned or controlled by any of the integrated oil companies. PEG members range from very large companies, such as Union Carbide Corporation and Monsanto Company, to much smaller companies, but among the key characteristics all share is the fact that none produces or refines a significant percentage of its own raw materials. For the most part, PEG companies purchase raw materials, which are hydrocarbons-- oil, naphtha and gas oils, natural gas liquids, and natural gas, from the companies that produce, refine and transport energy products, or import them directly from abroad. Many of these energy producers also compete with the PEG Companies as producers and sellers of petrochemical products. Together the members of PEG account for the majority of the U.S. production of petrochemical intermediates. The petrochemical industry plays a very major role in the U.S. economy and makes a major contribution to the positive side of the U.S. balance of trade accounts. The industry exists in a highly competitive world market in which the flow of trade may be significantly affected by changes in government policy. We

therefore appreciate Senator Wallop's statement that in focusing on other energy issues, ". . . we must not ignore the downstream processes required to refine raw materials into usable commodities and to deliver those products to the American people."

I.

Raw Material Use of Hydrocarbons

Our industry is uniquely concerned with oil imports and related policies such as taxation of foreign petroleum products because, unlike other manufacturing industries, the petrochemical industry uses oil and gas not only as fuel but as raw materials. Molecules of oil, petroleum products, natural gas liquids, and natural gas are structurally reformed in our plants into petrochemical intermediate materials, which are then formed into a wide variety of essential industrial and consumer end products indispensable to our national economy. This manufacturing process, of course, also requires fuel as does the production of, for example, aluminum, petroleum products, or steel. Our raw materials should be recognized as different from liquid hydrocarbons used as fuel. This is because there is no significant conservation potential in our use of oil and gas as raw materials (feedstocks) and no significant potential to switch from one feedstock type to another within our existing plants. The only way our industry can reduce

consumption of a particular feedstock today is to reduce production.

Federal policies have for many years recognized this important distinction between fuels and feedstocks. Both the curtailment priority system for natural gas 1/ and the allocation priority system for petroleum products 2/ granted high priority status to the use of liquid hydrocarbons for feedstock and provided a lower priority to those types of uses such as boiler and transportation fuel where fuel substitutions or conservation is possible without directly reducing industrial production.

II.

Nature and Seriousness of Problem Not Yet Clear

As major consumers of petroleum products, the petrochemical industry has a strong interest in a healthy United States refining industry. The domestic refining industry is facing significant changes--changes that may require extensive investment and certainly will require careful planning.

Therefore, it is appropriate that the Congress should take a very careful look at the current condition of the U.S. refining industry and its prospects for the future in an increasingly competitive environment at a time when the United States is still forming an energy security policy.

1/ See 18 C.F.R. § 2.78 (1980).

2/ See 10 C.F.R. Part 211 (1980).

Only limited consideration of these difficult, interrelated issues was possible during the last Congress, but full scale consideration of these problems is certainly appropriate now that the country is decontrolling crude oil and is taking a close look at environmental legislation which is now on the books.

In our view, it is too soon to tell whether or not Federal assistance to the refinery industry would be advisable. While current evidence does not strongly suggest the necessity for such assistance, future events under decontrol or the results of further investigation might warrant a change in this tentative conclusion.

If the refining industry is found to be sick, however, we think the cure ought to fit the disease. First, Congress needs to take a careful look at exactly what has caused any problems which affect the domestic refining industry. If for example, the problem has been environmental regulation, the solution may be regulatory change, rather than tariff protection. Second, the Congress needs to make certain that any refinery assistance plan does not create problems worse than the ones it seeks to cure. For example, establishment in 1974 of the crude oil price control and allocation program in response to the Arab boycott was a cure which imposed a heavy burden of economic distortion and inefficiency for over six years.

Today, we offer for consideration by the Subcommittee our comments on two proposed methods of assistance

that others have suggested for the refinery industry: tariffs or fees on imported petroleum products, and tax incentives for refinery upgrading or retrofitting.

III.

Import Tariffs As A Means Of Refiner Aid

The first of the possible methods of assistance some have proposed, a tariff or fee on imported petroleum products, would have the following effects:

- o First, tariffs on imported petroleum products are likely to be an inefficient approach to refiner subsidies;
- o Second, tariffs on imported petroleum products will seriously harm the United States petrochemical industry, and the United States economy, especially our international position and balance of trade.

Tariffs, or fees (essentially, taxes) on petroleum products may be either inefficient or unfair or both. Recent Department of Treasury and Department of Energy Studies suggest that they are inefficient because they produce more United States refining capacity than free market forces would yield. Such capacity presumably could be or has been developed more cheaply elsewhere. 3/

3/ A 1981 Treasury Department study of various proposals for tax change assistance to the refinery industry states:

Price controls have had two related effects on the size of the U.S. refining industry. By delaying the adjustment of petroleum product prices to world price levels, controls have helped to sustain higher rates of U.S. consumption than otherwise would have occurred. Additionally, since lower prices of domestic

In addition, an import fee will directly or indirectly force the price of petroleum products to all Americans above the prices paid by industries and consumers

[Footnote continued]

refinery products were achieved by controlling domestic crude oil and refined product prices, the price control system had the incidental effect of discouraging imports of refinery products and encouraging the import of crude instead. Consequently, the lapse of price controls will both shrink the size of the U.S. market for petroleum products and shrink the share of U.S. consumption refined domestically. This implied near term shrinkage in domestic refinery industry capacity will be accomplished, as it usually is in competitive industries, by a failure to replace obsolete, high cost units that have been sustained by the price control system....Subsidies to refining investment.... [w]ould have the effect of producing abnormal profits for refiners whose plants and locations already assure them of economic survival, and they would deter the exit from the industry of inefficient and badly located plants....

(Evaluation of Certain Proposals to Aid Domestic Refiners, Department of the Treasury, Office of Tax Analysis and Department of Energy, Office of Oil, Policy and Evaluation, January 16, 1981, p. 9).

And a 1980 draft Department of Energy study of the impact of petroleum product tariffs stated:

The increase in domestic refiners' marginal costs due to crude oil decontrol will result in their reduced profits, production, or both. The computer analysis indicates that as domestic crude prices are gradually brought to parity with foreign crude during the period 1979 to 1981, the total output of domestically refined products by 1982 will be reduced by 750 MBD. This implies that the U.S. refining industry as a whole will reduce its utilization rate from its 1978 level of 87 percent to 83 percent...The model indicates that foreign refineries will be able to increase

abroad. Thus, an import fee will increase inflationary pressures and add an artificial handicap to any U.S. manufacturer who must compete with foreign industry for both foreign and domestic markets.

A factor any new program should deal with is the implications for the U.S. position in world trade of any price barriers that risk raising petrochemical feedstock costs above world prices. In 1970, the Cabinet Task Force on Oil Import Control concluded that product exceptions should be introduced for petrochemical feedstocks imported or exchanged in order to preserve the competitive viability of the industry in world markets. In 1972 the allocation-for-export program was introduced into federal regulations to implement this conclusion and to allow U.S. petrochemical companies access to feedstocks at world prices.

The U.S. petrochemical industry competes in a fiercely competitive world market, and our industry has done extremely well in this market. For each of the past fifteen

[Footnote continued]

their U.S. sales of particular products-- primarily distillate and residual fuel--by roughly 750 MB/D.... The results of the computer simulation indicate that both the \$1 and \$2 tariffs would enable the existing U.S. refining industry to increase capacity utilization, as indicated in the two right-hand columns of Table 1. Specifically, the \$1 fee would increase utilization to 84 percent, and the \$2 fee would raise it to 86.

(Department of Energy, "Costs and Benefits of a Protective Tariff on Refined Petroleum Products After Crude Oil Decontrol" draft, January 31, 1980, pp. 5-7.)

years we have contributed over a billion dollars each year to the favorable side of the nation's trade balance. In 1978 the petrochemical industry contributed \$5 billion to our positive trade balance. Even more significantly, U.S. exports of petrochemical and petrochemical dependent products were over \$54 billion in 1978--nearly 39 percent of all U.S. exports.

But U.S. chemical companies are far from dominant in the world market. Of the largest ten chemical companies only three are headquartered in the U.S. The other seven are based primarily in Western Europe where the chemical industry has undergone rapid expansion in the last twenty years.

If our industry is unable to secure adequate supplies of domestic and imported feedstocks at internationally competitive prices, not only will our ability to contribute to a favorable balance of trade be limited but foreign petrochemical products will increasingly flow into the United States to replace the capacity that we forfeit. An increase in the importation of petrochemical products would be disastrous to the U.S. trade balance since the cost of a barrel of petrochemical products is far more than that of crude oil or petroleum products. It is in the neighborhood of \$100-200.

A study recently conducted for the Petrochemical Energy Group by Arthur D. Little, Inc. which will be published later this month documents the adverse impact of earlier oil import limitations on U.S. petrochemical investment and sub-

sequently on U.S. export performance during the years when U.S. oil import tariffs and quotas pushed U.S. feedstock costs above world oil prices.

The Arthur D. Little study demonstrated that the higher costs of energy and feedstocks in the U.S. during the period 1965-1972 when the Mandatory Oil Import Control Program was in force had a significant long-term impact on U.S. and worldwide petrochemical investment. During that period U.S. petrochemical investment per dollar of annual sales was substantially below that in Western Europe and Japan. The annual growth of U.S. petrochemical investment was only 2.1 percent ^{4/} per year from 1965 through 1972 under the MOIP, compared to annual growth of 24.8 percent during the period 1972-1978, after limitations on oil imports were removed and U.S. energy and feedstock costs were fully competitive worldwide.

The restriction of U.S. chemical producers' access to world price crude oil and naphtha feedstocks during the 1965-1972 period also resulted in increased overseas investment by U.S. chemical companies, from 24 percent of total U.S. investment in 1966 to 31 percent in 1972. Only after chemical producers were allowed "free access" to heavy liquid feedstocks in 1972, did the share of total spending that had gone abroad decline.

The Arthur D. Little study further demonstrates that the different investment patterns of the U.S. petro-

^{4/} In current dollars.

chemical industry during 1967-1972 had a profound effect on world trade thereafter. For example, in 1970 net exports of chemicals 5/ for the U.S. and Europe were about equal at \$2.6 billion per year. By 1979 European net exports equalled \$18 billion per year while the U.S. balance of trade in chemicals was just under \$10 billion. The overwhelming dominance of Europe in today's world export market for chemicals and its favorable balance of trade position are clearly the result of its ambitious investment program during the years 1960-1972.

Looking ahead, the Arthur D. Little study projects that if United States energy policies increase energy and feedstock costs in the range of 20-40% above levels in other areas of the world, by 1995:

- U.S. petrochemical consumption would be reduced as much as 15%; this is equivalent to 28 billion dollars per year--
- Petrochemical investment in the United States would likely fall 20%; this is equal to a loss of nearly 4 billion dollars of investment annually;
- The U.S. balance of trade in petrochemicals would be 21% lower than otherwise expected, a loss of almost four billion dollars annually. 6/

The petrochemical industry has been a major positive contributor to the precarious United States balance of trade for a number of years. In 1979 the positive trade balance was \$8.4 billion, in 1980 it was \$9.4 billion. It

5/ SITC - 5 only.

6/ All estimates are in 1980 dollars.

is reasonable to expect this sort of contribution to continue if competitive conditions are not altered significantly. Even without an import tax, our industry's energy and feed-stock costs have been increased by the recent decontrol of oil prices. We strongly approve of oil decontrol and believe we can compete effectively in a decontrolled environment. Adding a tariff to the decontrolled oil price, however, would impose a serious disadvantage on our industry.

But the loss to the U.S. economy from a decline in domestic petrochemical production would be far greater than just the adverse impact on the U.S. balance of trade, for the petrochemical industry is a strong pillar of the entire U.S. economy. An independent consultant studying our industry in 1978 found that 35-45 percent of U.S. business activity, as measured by employment, capital investment, taxes, and sales, was dependent on the U.S. petrochemical industry. 7/

These statistics are striking. They become more understandable when you consider the wide distribution throughout the economy of petrochemical products. Seventy-six percent of all rubber products, including the tires on virtually all U.S. passenger cars, are made primarily of synthetic rubber. 8/ Man-made fibers currently provide

7/ The Petrochemical Industry and the U.S. Economy, A Report to the Petrochemical Group by Arthur D. Little, Inc. (December 1978).

8/ "Industry Rubber Report," Rubber Manufacturers Association, December 1980.

75 percent of all fibers used in domestic textile mills for apparel, home furnishings, and industrial products. 9/ Petrochemicals go into 99 percent of our carpeting, 90 percent of our blankets, and 65 percent of our clothing. 10/ There are no substitutes for high performance plastics used in wiring insulation, in radios and electronic systems. Plastic films and packaging protect the freshness of food supplies and save millions of dollars in spoilage. Agricultural chemicals and fertilizers increase production. Construction materials, from paints to insulation to structural materials and glues, contribute to new, energy efficient buildings, while pharmaceuticals and other medical products are essential to the nation's health needs. The majority of medicines are derived from petrochemicals. 11/

Finally, a fee distorts production costs in the petrochemical industry to the disadvantage of independent petrochemical companies vis-a-vis our major oil company competitors. The independent petrochemical industry, those of us who must buy our petroleum feedstocks either domestically or abroad, will pay the import fee directly or through higher domestic product prices. Our competitors, the petro-

9/ "Man-Made Fibers' One Percent," Man-Made Fibers Producers Association, Inc., Fall 1979.

10/ Ibid.

11/ "Petrochemicals: Their Role in Human Needs, Use of Resources and the Economy," The Petrochemical Energy Group, June 1, 1978, p. 26.

chemical arms of the integrated oil companies, can largely escape the product fee by importing crude oil, which is not taxed, for their integrated refining and petrochemical operations.

IV.

Tax Incentives For Capital Investment

Our concern is that a tariff on product imports may be inefficient and would be harmful to the United States petrochemical industry.

However, we recognize the possibility that the Congress may conclude that assistance is needed for refinery modernization. If so, we urge assistance be provided as part of a program of tax incentives for capital formation and investment applicable to U.S. industries in general. These will encourage investments in refining facilities to meet a changing product slate and crude oil availability. This type of incentive program would benefit the economy generally, and the refinery industry in particular, without causing offsetting harm to others affected by it.

STATEMENT OF
SABER ENERGY INC.
BEFORE
THE SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
OF THE SENATE FINANCE COMMITTEE
ON
TAX INCENTIVES FOR DOMESTIC REFINING

March 27, 1981

Washington, D.C.

SABER ENERGY INC.
on
Refining Tax Incentives
March 27, 1981

Saber Energy Inc. has a stake in the future of the domestic refining industry and welcomes the opportunity to present its views on refining tax incentives. Saber operates a 45,000 barrel-per-day refinery in Corpus Christi, Texas.^{*/} In addition, it is engaged petroleum marketing, exploration and production, and terminaling operations in Corpus Christi, Houston and New Orleans.^{**/}

Saber believes it will be at the forefront of the refining industry in the near future. We have plans on the drawing board to greatly enhance the flexibility of our refinery operations. Specifically, Saber has completed preliminary plans for a substantial upgrading project for its Corpus Christi refinery. When completed, the refinery will vastly expand Saber's capability to process low quality, atmospherically reduced crude oil or residual fuel oil, allowing the removal of substantially

^{*/} The refinery presently has a capacity of 21,000 bpd of crude oil for input into distillation units and an additional 24,000 bpd of capacity for vacuum unit input.

^{**/} Recently, Valero Energy Corporation of San Antonio, Texas acquired a 50 percent interest in Saber. Valero also has an option to purchase the remaining 50 percent of Saber after five years. Valero operates some 8,000 miles of natural gas pipelines and seven gas processing plants in the State of Texas. It is principally engaged in the gathering, transporting, processing and marketing of natural gas and natural gas liquids.

all minerals and sulfur. The anticipated yield from processing this low quality feedstock will be close to 65 percent gasoline and 26 percent other light transportation fuels. The project's design, developed primarily by M.W. Kellogg, but using several major oil company patents, has an estimated cost of approximately \$350 million.

However, these plans may not be nearly as promising unless the economic climate of the refining industry changes. Under the federal government's policies today, which have had a substantial negative affect on industry investment and modernization, the industry is faced with a less than optimal situation to respond to changing demand and supply situations. The dampening affect of these very policies may threaten the continued existence of the industry in the mid to long term future.

Saber believes that its plans will help it respond to the changing market place for petroleum products. For example, by using various new technologies to maximize yields of light transportation fuels from heavy crude and residual oil, the increasing demand for unleaded gasoline due to the phaseout of older automobiles can be met. In order to do this and also to avoid weakening the industry whose strength is important to our national economy and security, Saber urges Congress to enact several of the tax incentives indicated below.

Specifically, Saber proposes the enactment of tax legislation to:

- (1) revise, extend, and make more effective the existing investment tax credits designed to encourage energy conservation and conversion of equipment from the use of oil or gas to the use of alternate fuels (the Wallop-Heftel Industrial Energy Security Tax Incentive Act of 1981 - S. 750, H.R. 2640);
- (2) provide a 10 percent investment credit in addition to the regular 10 percent investment credit for investments in refinery upgrading;
- (3) increase the availability of tax-exempt financing for pollution control equipment installed as part of refinery upgrading projects;
- (4) provide an additional 10 percent investment credit for pollution control equipment;
- (5) provide a five year depreciable life for refinery processing equipment effective January 1, 1981; and
- (6) exempt product imports which are to be further refined by domestic refiners, if a tariff on imported products is enacted.

Need for Refining Incentives

Saber is not interested in government hand-outs or subsidies. We are committing hundreds of millions of dollars to stay in the refining business, given the proper economic circumstances. But the present "circumstances" in the refining industry call into question the wisdom of making such an investment.

First, consumer demand for petroleum products has radically and quickly changed in the last few years. Industry no longer wants high sulfur residual fuel oil to run its factories and drivers won't buy low-octane gasoline. Federal environmental and fuel efficiency laws are largely the cause of this development. In its effort to clean the emissions of factories and increase the efficiency of automobiles, Congress has increased the demand for cleaner and "lighter" (e.g., high octane) fuels.

This doesn't mean that consumer demand has settled into any predictable pattern which would provide a basis for an investment decision. As the July 1980 Congressional Research Service report on "U.S. Refineries: A Background Study" stated:

No refiner can be certain of the future demand for his products. The product mix is changing more rapidly than ever before, and higher prices for all products, efforts to back out residual fuel oil in industries and utilities, fuel efficiency standards for automobiles, and conversions from distillate fuel oil use to natural gas have made it much more difficult to anticipate product demand very far into the future. As a result many refiners are reluctant to commit large amounts of capital to build or reconfigure plants which might prove to be uneconomic. */

Second, the crude oil supply picture has also changed. The high gravity, low sulfur crude which most U.S. refineries were designed to process is no longer available in sufficient

*/ Congressional Research Service of the Library of Congress, "U.S. Refineries: A Background Study," July, 1980, p. 2.

quantities. In 1973 only 36 percent of the crude processed by U.S. refineries was the difficult to process sour crude oil; ^{*/} that percentage should reach 52 percent next year. ^{**/}

Of course, the processing difficulties presented by sour, heavy crudes are compounded when you try to squeeze environmentally acceptable, light products out of this lower quality crude. In fact, the only way to avoid these difficulties is to purchase more sophisticated and more expensive refining equipment.

If Federal policies had always encouraged the full development of domestic sources of crude oil, U.S. refineries might now have additional supplies of light, sweet crude oil to utilize and more time to "heavy-up" and "sour-up" their facilities. Instead, for nearly half their runs, domestic refiners must take what they can get from foreign sources of supply. In addition, as OPEC countries increase their own refining capacity, the less valuable crude oil remaining after their refinery runs will be available for export. Simply put, this means the heavy, high sulfur crude oil and reduced crude oil are becoming more prevalent.

Third, domestic refineries must face competition from foreign refiners who need not operate under U.S. environmental, labor and shipping laws that add significantly to the cost of

*/ National Petroleum Refiners Association, "Capability of U.S. Refineries to Process Sweet/Sour Crude Oil," March 15, 1978.

**/ Oil and Gas Journal, June 4, 1979, p. 53.

domestic petroleum products. In addition, these foreign refiners often share the advantage of lower income tax rates (i.e., in the Bahamas).

Foreign producers of crude oil have added to the pressures placed on domestic refiners by beginning efforts to dominate the world refining markets. For example, OPEC producers have linked supply of crude oil to agreements by U.S. refiners to enter into joint venture refining projects in the producing countries. In essence, OPEC countries are no longer content to control the price and supply of a large segment of the crude oil market in the United States, they wish to control the product market as well.^{*/}

Fourth, the investment climate in the refining industry has been adversely affected by federal price control policies, which have only recently ended. For years the DOE allocation and price controls on motor gasoline and other products created regulatory uncertainty which inhibited investment in refinery expansions and improvements needed to make lighter fuels and to process the heavy, high sulfur feedstocks. For example, the price controls on products denied refiners a return on new investment which was greater than the total amount they realized as of May 15, 1973.

^{*/} See Petroleum Intelligence Weekly, "Saudi Petromin Chief Plays Down Moves Into Export Refining," March 2, 1981; Capitol Energy Letter, October 1, 1979 (OPEC Secretary General Ortiz states that OPEC is "determined to steadily penetrate" into the downstream sector of the industry); New York Times, "OPEC: Profits in Package Deals," January 11, 1980.

In the words of Deputy Secretary of Energy John O'Leary, when he appeared before the Energy Committee on December 11, 1978, to discuss refining policy:

When we create an environment for [the refining] industry in which it does not realize a benefit from increased efficiency, we discourage improvements in production techniques

Therefore, we believe that the refining industry in the United States is facing a crisis. For many refineries it is already too late. According to our conservative calculations, at least 23 refineries, representing approximately 300,000 barrels per day of capacity, have recently shut-down. A recent Department of Energy report stated that planned refinery increases through 1983 have been cut 2.2 million barrels per day due to economic difficulties.^{*/} In other words, existing refineries are being closed and new refining projects are being scrapped.

Who will take up the slack? No one can be sure that it will be taken up without severely disrupting domestic markets. However, to the extent it is, we expect that the United States will become more dependent on OPEC and Caribbean countries for product supplies. Such a development represents a threat to our national security. This fact has been well documented in the Conant and Associates study "The National Security Implications of Increased Reliance Upon the Importation of Refined Products"

^{*/} Department of Energy, "Trends in Refinery Capacity and Utilization," March 12, 1981.

(July 31, 1979). This study pointed out that Middle Eastern governments should be expected to raise prices for refined products to a level higher than that which would prevail if the crude oil were refined in the United States. The study further explained that Caribbean refineries are located in an area which is becoming radicalized by Cuban subversion, unfulfilled expectations and racial disputes.

Finally, the Conant study emphasized that it does matter whether we import a barrel of crude or a barrel of product. It is far more preferable to be dependent on crude rather than product. By becoming dependent upon product imports, we weaken the flexibility and capability our domestic refining industry gives us to adjust to a crude supply disruption. The ability of the United States to "juggle" world crude oil supplies, as it did in 1973, so as to eliminate the effectiveness of politically-motivated embargoes is an extremely important national security issue. Moreover, increased dependence on product imports would mean that the United States would be susceptible to a supply disruption by the refining country, as well as by the producing country, thereby increasing our vulnerability to a cutoff. Finally, by keeping the refining capacity in the United States, the GNP of our domestic economy is enhanced to the extent of the value of goods and services added in the process. It is more economically advantageous to add to GNP at home than abroad.

A Domestic Refining Tax Incentive Program

To lessen the problems outlined above and to insure that our national security is not further threatened by a weakening in the domestic refining industry, Sabers recommends the adoption of a number of tax incentives. This program would be open to all refiners, regardless of size, as well as many other capital extensive industries and would feature no subsidy of any type. It would provide meaningful incentives to modernize an industry of crucial importance to the nation.

First, we advocate the enactment of S. 750, the Wallop-Heftel Industrial Energy Security Tax Incentive Act of 1981. This legislation provides a tax credit incentive to accelerate private investments in industrial energy efficiency. The refining industry consumes approximately 12 percent of the total energy used each year in the United States by manufacturers. Consequently, the potential energy savings in our industry are substantial.

As Senator Wallop has correctly pointed out, this legislation is needed to increase capital formation for energy conservation at a time when capital is scarce and energy conservation projects must compete with a long list of investment options. Moreover, this legislation will accelerate investments in energy efficiency and avoid any further delay in such investments which causes energy waste and continued heavy dependence on imports.

Second, Sabar supports the enactment of an additional 10 percent investment tax credit for refinery upgrading expenditures. As explained above, the need for this investment is well recognized. However, given the economic climate in the refining industry and the country in general, investments of the magnitude required will not occur unless incentives are created.

Third, we recommend the expansion of tax-exempt financing opportunities for pollution control equipment of a type utilized by refineries as part of upgrading projects. At present, only a small portion of the pollution control expenditures by refiners are eligible for tax-exempt financing through, for instance, industrial development bonds. This is because much of the pollution control equipment at a refinery is designed to prevent pollution "off the site", or in other words, by the ultimate user of the refined product. Legislation such as S. 169, as introduced by Senator Heinz, could cure this problem.

Fourth, either in addition to or as an alternative to complement number three, we recommend the enactment of an additional 10 percent investment tax credit for pollution control equipment.

Fifth, we support efforts to move refinery expenditures from a 16 year depreciation category into a five year category, through the enactment of comprehensive accelerated depreciation legislation. However, we strongly oppose any effort to

phase in these changes, since such a move will cause a postponement in needed investment. Delay in needed refining investment would be extremely unwise from a national energy policy viewpoint.

Sixth, we agree that there exists a need for a tariff on imports of petroleum products. A tariff would send a strong signal to foreign energy producers that the United States does not intend to compound its energy problems by becoming dependent on product imports.

However, any such tariff should exempt product imports that are to be further refined by domestic refiners. Saber believes that high-sulfur residual fuel oil, and similar products could become an important feedstock for domestic refiners in the future, when retrofit projects have been completed. The enactment of a fee on all products could inhibit the commencement of needed projects designed to refine high sulfur residual fuel oil into environmentally acceptable products.

Conclusion

Saber believes that the enactment of the tax incentives discussed above is imperative for the continued viability and future modernization of the refining industry. As such, we strongly urge the Congress to seriously consider and act upon these various proposals.

STATEMENT OF DR. FRED SCHULMAN
INSTITUTE FOR RESPONSIBLE ENERGY POLICY
SILVER SPRING, MD. APRIL 1981

I Summary

The domestic refining industry is facing a severe crisis due to unreasonably high costs of crude oil and feedstocks. The foreign oil tax credit discriminates against the domestic oil industry, discourages domestic oil production and provides unfair price advantages to foreign oil. In 1981, at a price of \$32 per barrel for Arabian marker crude, the foreign oil tax credit climbs to about \$74 billion. The amount is so large that relief for the domestic petroleum industry can most effectively be obtained by complete elimination of the OPEC tax credit rather than extending a small credit to the domestic industry. Denial of the credit to OPEC will provide the U.S. Treasury with vitally needed additional revenue of about \$25 to 40 billions and help break the present unilateral power of OPEC to raise its prices and world inflation ever upward. Benefits are enormous in the areas of inflation, unemployment and political and economic stability. Survival of a healthy U.S. industry and agriculture is at stake.

II INTRODUCTION

Misperceptions in American energy policy (1) have brought the domestic refining industry to the verge of the most dangerous threat to its survival in its history. The danger will grow during the months and years ahead unless wise policy changes in energy tax policy are implemented. It is not often realized that present energy

tax policy, despite our rhetoric to the contrary, still favors foreign oil production and imports. As OPEC's huge refineries and petrochemical plants come on stream, the situation will worsen when OPEC forces its oil-starved customers to buy its refinery products in order to obtain needed crude oil.

III DISCRIMINATION AGAINST DOMESTIC REFINERS

If any one cause of the present dangerous ^{situation} can be identified, it is the foreign oil tax credit which incredibly subsidizes wealthy OPEC countries and discriminates against the domestic oil industry by multibillions of dollars each year. When OPEC unilaterally raises its oil prices, the amount of this OPEC tax subsidy automatically increases. At the 1981 minimum OPEC price of \$32 per barrel, the OPEC tax credit may amount to the huge sum of \$70 to 75 billions. Prior to decontrol of U.S. oil prices, domestic refiners were able to compete because they enjoyed a feedstock cost advantage of about \$2.50 to \$4 per barrel. With this advantage, the U.S. petrochemical industry was able to contribute \$11 to 13 billion to our net exports during each of the last two years.

A foretaste of the fate awaiting the domestic industry is the sad experience of Britain's giant Imperial Chemical Industries, Ltd. It blamed its collapse in profitability (2) on troubles caused by oil-based raw material costs. Particularly hard hit were petrochemicals and their derivatives. Hopefully, we can avoid a similar fate.

Price and tax discrimination against domestic refiners will increase rapidly as oil-producing countries build their own downstream refineries. Oil costs in Mexico for Mexican industry are considerably below the OPEC level. Recently the director of the Mexican national oil company, PEMEX, Diaz Serrano announced (3) a \$3.4 billion expansion of petrochemical capacity which will be able to meet

3.

all of Mexico's needs and provide a large export capacity. Similarly, Indonesia plans to invest \$7 billion to enlarge its petrochemical and refinery operations. In a move that will compete with U.S. exports, Indonesia plans to export 60% of the output to South Korea, Japan and the United States. The foreign oil tax credit not only provides Indonesia with much of the funds for this program, but it discourages U.S. companies from exploring in non-OPEC countries. As a result, OPEC is given the power to keep oil prices unnecessarily high.

IV FOREIGN OIL TAX CREDITS

Foreign oil tax credits have long been recognized as detrimental to both the domestic oil industry and the national economy. Former Assistant Treasury Tax Legislative Counsel Stanford G. Ross told the Senate Subcommittee on Multinational Corporations in 1973 that the tax laws are not neutral. He said they are tipped in favor of foreign, not domestic, oil (4) and that these preferences have adverse effects on our balance of payments and on domestic employment and investment. Since 1973, OPEC has raised prices of crude oil more than 1000%, far exceeding inflation. These OPEC actions have thrown the entire non-communist world into economic and political distress creating the social climate ripe for revolution and overthrow of democratic or friendly regimes in various parts of the world.

The costs of energy affects virtually all aspects of civilized society. Today's inflation, -President Reagans number 1 ~~priority~~-obviously is not due to the traditional economic cause of too much demand chasing too few goods. Our idle industrial capacity stands a mute witness to our ability to produce more goods if needed. As I have indicated to the House Ways and Means Committee and to this

Committee (5), the prices of all goods and services tend to rise to their EQUIVALENT VALUE TO OIL. Implicit in this statement is the conclusion that the inflationary damage of an unrestrained OPEC is quite serious. Policymakers and some economists are beginning to understand the new and dangerous situation (6,7,8). A large portion, as much as 80%, of the 1980 inflation rate was blamed on price increases triggered by higher energy costs in a speech by the Deputy Secretary of State for Economic Affairs. Looking to the future, the outlook is not bright if U.S. policy is not more effective in restraining OPEC's unilateral ability to raise prices.

A remarkable OPEC document has come to light recently (9) which clearly sets forth future OPEC pricing strategy. This is a report of the OPEC Ministerial Committee on Long Term Strategy chaired by Saudi oil minister Sheik Zaki Yamani. According to this report, three elements will determine the level of future price increases: 1) Western inflation rates, 2) currency depreciation, and 3) increases in Western GNP. In other words, OPEC prices will not only rise to compensate for the very inflation it largely causes, but will also rise an additional amount to cover the inevitable decline in values of paper currency. Finally, a "work" surcharge will be imposed on top of these heavily burdensome oil prices equal to a portion of the GNP gain obtained from our work and investment! Only a very confident cartel sure of no effective countermeasures could have the gall to impose such impossible economic burdens upon supposedly strong and intelligent Western countries!

OPEC is well served by the foreign oil tax credit. It provides them with a large extra income subsidized by hard-pressed U.S. taxpayers. It creates a symbiotic relationship between the interests of international oil companies and the cartel, effectively making the companies agents of the host countries. It discourages development

of the plentiful oil resources in non-OPEC countries. Finally, the foreign oil tax credit feeds inflation to the point at which development of alternative, renewable, and synthetic fuels become very costly and uneconomic. In Saudi Arabia alone, oil production in 1981 generates a U.S. income tax credit of about \$74 billion based on Saudi production of about 10.3 million barrels per day (mbpd) at a posted price of \$32 per barrel. Derivation of the gross tax credit of \$74 billion is shown in Table 1. The Saudi so-called "income tax" of \$20 per barrel equal to 85% of the gross profits applied to petroleum exports is really an integral part of the posted price of \$32 per barrel. Otherwise the price would be only \$7.50 per barrel with the balance of \$24.50 constituting gross profit. It should be very clear that nobody talks of Saudi or OPEC oil costing only \$7.50 per barrel. The so-called "income tax" is a sham credit for which should be denied.

At the 1981 Saudi oil production rate of 3.7 billion barrels, the \$20 per barrel tax credit generates a gross foreign tax credit of \$74 billion. Since Aramco's apparent share of profits from Saudi oil production is only \$6.7 billion, its share of the \$74 billion gross tax credit is also limited by law to the extent of its profits there or to \$6.7 billion. But much of the balance of \$67.3 in credits is utilized in a variety of ways including deferred credits and to offset U.S. taxes on profits from intercompany transfers and transportation and from oil purchases. Obviously, availability of such a large reservoir of tax credits constitutes a tremendous incentive to create additional profits in Saudi Arabia so that these profits can also be offset by the billions in remaining credits. What results is a distortion in U.S. - OPEC operations favoring OPEC and harmful to the United States petroleum industry.

Table 1.

DERIVATION OF FOREIGN OIL INCOME TAX CREDITS

	<u>\$/bbl</u>	<u>\$ in billions</u> for 1981 Saudi prod'n 3.7 billion bbls
Saudi Posted Price	32.00	
less costs		
production	0.50	
royalty to gov't @ 20%	6.40	
variable fee	0.60	
total cost to company	<u>7.50</u>	
Gross taxable profit	24.50	90
Saudi income tax @85%	20	74
(applied only to ex- ported oil)		
Net Profit	4.50	
Saudi share @ 60%	2.70	10.0
Aramco share @ 40%	1.80	6.7
Total Saudi income, royalty, variable fee, export income tax & net profit.	29.70	110
Aramco income	1.80	6.7
<u>Aramco foreign tax credit</u> (equals Saudi income tax paid to gov't)	<u>20</u>	<u>74</u>

The crucial role of foreign tax credits to the petroleum industry is readily apparent from a review of tax data available for 1976. In that year, Saudi oil sold for \$11.69 per barrel (10) compared to \$32/bbl in 1981. In 1976, 86% of the foreign tax credits allowable to the entire petroleum industry was claimed by only 5 large firms.⁽¹¹⁾ The remaining companies derived very little benefit from the credit and in fact were thereby discriminated against competitively. One of the favored companies, Aramco, had 1976 income before taxes of \$25.8 billion. Normally, Aramco would pay about \$12.4 billion to the U.S. Treasury on this income. However, Aramco claimed a foreign tax credit of \$25.1 billion against 1976 income leaving a balance of only 0.7 billion taxable by the IRS. The nearly 300% increases in OPEC oil prices since 1976 have vastly increased the value of the credits. By 1981, the 25.1 billion in tax credits had grown to a potential 74 billion as indicated in Table 1.

V EFFECTS ON U.S. OIL PRODUCTION

Exploration activity for oil in the United States has dropped sharply ever since the foreign oil tax credit became allowable. In 1955 the IRS issued its first ruling allowing payments by Aramco to the Saudi government to be credited dollar for dollar against U.S. income taxes. The following year, exploratory drilling in the U.S. reached its peak and started its unfortunate decline. In 1956, more than 16,000 exploratory wells were drilled in the United States with 19.2% of them successfully finding new oil and gas. But by 1979, although success rates had climbed 55% over 1956, only 10,500 new exploratory wells were drilled.

The United States has suffered a loss of at least 50 billion barrels of new oil reserves because of reduced exploratory drilling in the U.S. (12). At the same time, under the influence of the for-

foreign tax credit, imports from unstable eastern hemisphere oil producers have been increased from 55% of total imports in the year of the oil embargo to 82% in 1979. Imports from the secure Western hemisphere, which generate little foreign tax credits, dropped from 45% to 18% of imports during the same period. Clearly, the immense value of the foreign oil tax credits is chiefly to blame. It seems incredible and very unwise for the U.S. to shift to more OPEC imports in the face of threats from Saudi Arabia to reduce oil production. A wiser policy would encourage an oil boom in the United States instead.

Some geologists, using new sophisticated technology, now estimate that only about 2% of the nation's potential oil and gas reserves have been explored (13). Charles Masters of the U.S. Geological Service reports a consensus of at least 60 to 100 billion bbls of undiscovered oil (14). More recently, geologist Frank Pitts estimated that 210 billion bbls of oil can be added to U.S. reserves when the largely unexplored regions of the United States are drilled (15).

Accompanying the new better climate for future oil discoveries in the U.S., is the equally encouraging development of advanced refinery technology. With this new technology (16), more than 75% of crude oil, including the less desirable heavier and sour crudes, can be turned into gasoline and other transportation fuels. We now have the attractive feasibility of not needing a single drop of OPEC oil if the United States can take two actions. First, use the new refinery technology to refine domestic crude into 75% transportation fuels. Second, use plentiful domestic coal and nuclear energy for process heat, space heating and cooling, and for electricity. If this can be achieved, the United States would be able to reassert its independence from OPEC as befitting a superpower.

Furthermore, such a policy produces long range benefits in the area of alternative fuels. Freed from economic drain of OPEC, the United States can proceed with development of renewable and synthetic fuels without fear of bankruptcy or high inflation for whatever years are required for efficient research and development. We could calmly view the threats of the Saudi oil weapon which have been brandished freely lately against the United States, International Monetary Fund and World Bank. Many policy and opinion makers have been unduly influenced and frightened by such threats. Such threats are less menacing as their consequences fade into impotency.

VI CONCLUSIONS

OPEC's price inflation, if left unchecked to the end of the century just 19 years ahead, will be disastrous and should be countered. Unchecked, in the year 2,000, OPEC oil could cost about \$180 per barrel and the costs of basic necessities will shoot skyward. A loaf of bread will cost at least \$2.50. A modest house will be priced in the range from \$450,000 to \$600,000. Such a tragedy can best be avoided by developing an effective strategy to contain OPEC.

OPEC's pricing monopoly can be broken by removing the foreign oil tax credit for OPEC oil, thereby opening up new sources of oil both in the United States and throughout the world. Denying the foreign oil tax credit to OPEC will bring in at least \$25 to 40 billion of new revenue to the Treasury. This non-inflationary revenue can be used for any worthwhile purposes now restricted by budget limitations. Most of all, it will provide important incentives to assure plentiful supplies of domestic energy at reasonable prices. Removal of the OPEC foreign oil tax credit is essential to the restoration of economic and social health to the United States.

-April 10, 1981-

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CAMILLA S. AUGER
EXECUTIVE VICE PRESIDENT
CHIEF OPERATING OFFICER
GOVERNMENT RELATIONS AND
PUBLIC AFFAIRS DIVISION

April 16, 1981

The Honorable Malcolm Wallop
Chairman
Subcommittee on Energy and Agriculture Taxation
Senate Committee on Finance
2227 Dirksen Senate Office Building
Washington, DC 20510

RE: Comments of the Tosco Corporation on the Issues of Tariffs, Crude Access, and Tax Incentives for the Domestic Refining Industry

Dear Mr. Chairman:

Tosco Corporation wishes to take this opportunity to comment on the need for a tariff on product imports, and the issues of crude access and tax incentives for domestic refiners which you raised in your floor statement of March 12, 1981 (51 Cong. Rec. S2120, 1981). We request that these comments be made part of the record for the hearing held by the Energy and Agricultural Taxation Subcommittee on March 27, 1981.

At the outset, Mr. Chairman, Tosco commends you for your interest in the major issues currently facing the domestic refining industry as a consequence of decontrol and changing world-market conditions. Your timely interest and concern with these issues is greatly appreciated.

Tosco is the second largest independent gasoline refiner in the country.¹ At present, Tosco owns and operates four refineries in California, Oklahoma and Arkansas with a total refining capacity of approximately 260,000 barrels per day.

¹ Tosco is also recognized as the preeminent pioneer in the development of the nation's oil shale reserves. Tosco is a co-participant in the Colony Shale Oil Project in Colorado, which is anticipated to be the first full-scale commercial oil shale project in the U.S., and is developing a second commercial oil shale project on its state leases in Utah.

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April 16, 1981

As a result of Tosco's long-range planning and capital investments program, these refineries are among the most flexible and complex in the country. Tosco long ago recognized that the premium, sweet crude oils upon which many refiners have historically relied would become increasingly scarce compared to the heavier, sour crude oils and specifically acquired refining capacity to process heavy sour crudes in an efficient and cost effective manner.

Moreover, as an independent refiner lacking proprietary crude oil supplies, Tosco foresaw that meaningful access to crude oil supplies for an independent refiner might well be restricted to the lower grade, distressed crudes, such as the heavy California oils. Therefore, despite the regulatory impediments and uncertainties associated with the pricing and availability of world crude supplies, Tosco undertook the substantial investments necessary to provide its refineries with the flexibility to process these more abundant, less desirable crude oils into premium products.

In your floor statement of March 12, you addressed three general areas of concern and interest. Set forth below are Tosco's views on each of those issues.

I. Refined Petroleum Product Imports.

In your floor statement you discussed the issue of import tariffs and fees. In Tosco's view, this is the issue of paramount concern to domestic refiners.

Tosco applauds the Administration's decision to remove price and allocation controls from domestic oil and to dismantle the various regulatory strictures which have placed substantial burdens on industry operations for the last decade. Notwithstanding the substantial benefits of decontrol, however, the domestic refining industry will continue to experience the special costs associated with such factors as the Jones Act, comparatively high U.S. labor rates and environmental standards. These factors, while an important part of our way of life, represent costs not experienced by foreign operations which compete in U.S. markets and which current market and regulatory conditions do not compensate for. In the absence of tariffs, fees or other offsetting measures, these costs place domestic refining operations at an unreasonable, and inequitable disadvantage with respect to our foreign counterparts.

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For all their shortcomings, the price control system and the entitlements program, by distributing the benefits of lower priced domestic oil to all U.S. refiners, served to offset the economic disadvantages imposed by these higher environmental, labor and U.S. flag vessel transport costs. In addition, the imposition of fees and duties on imported products also helped domestic refiners to offset the competitive advantages of off-shore operations.

In 1978, President Carter removed the fees on imported products. This action, coupled with the Reagan Administration's decision to remove price controls from domestic oil in January of this year, has left U.S. refiners in the position of operating their facilities at a substantial competitive disadvantage vis a vis their foreign counterparts.

The effect of this cost disadvantage will be to significantly increase petroleum product imports, and over the long term seriously weaken, or possibly destroy the viability of the country's domestic refining industry. Increased imports of refined products will ultimately result in decreased utilization of existing domestic refining capacity and the stifling of private investment in domestic refining facilities.

In addition to the obvious economic losses in terms of jobs and domestic investment, a major disadvantage of losing our capability to maintain a viable domestic refining industry is the threat to national security. In times of shortage, our ability to alter product slates and specific product yields is largely dependent on the processing flexibility of domestic refining operations. The maintenance of such a capability, coupled with prudent inventory management, affords the domestic refining and distribution system an inherent advantage in mitigating the dislocations of specific product interruptions or shortfalls in a timely manner without driving up prices.

Additionally, since refined products generally are priced higher than crude oil, depressed crude import levels offset by increased product import volumes would negatively affect our balance of trade position.

In light of the above, Tosco believes that the U.S. market is now highly vulnerable to foreign refiners. Accordingly, Tosco recommends that the Congress take the initiative and send the clearest signal possible to offshore refiners that increased imports of petroleum products is contrary to our national interest.

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We believe that such action would have the immediate effect of heading off major new investments in foreign refining capacity which otherwise might be available for similar investment at home. The clearest signal in our estimate, would be for the Congress to impose a fee or tariff on such imports.

II. Access to Crude Oil by Domestic Refiners

In your statement you noted that the issue of crude oil access is the principal concern of small and independent refiners. Tosco is an independent refiner, and while some refiners may have problems or fears with regard to access to crude oil, Tosco sees no need or justification for a government program which favors any individual refiner, particular class of refiners, or particular region of the country.

Tosco opposes the adoption of a crude oil allocation program, except on an emergency basis, because of our belief that market mechanisms should be given an opportunity to work before any new government programs are developed to address what might be perceived rather than actual problems. The domestic refining industry operated from late 1973 until January 1981 under strict price and allocation controls. By contrast, we have been operating in a "decontrolled" world for less than three months. Tosco believes that the market should be allowed the opportunity to operate for a significant period of time so that the effects of price and allocation controls can be overcome.

It is Tosco's view that, while there have been instances over the past decade when refiners have been unable to secure adequate supplies of crude oil, in most cases these instances were the direct result of price and allocation controls. Those controls impeded the market's ability to match the supply and demand for crude oil. Since no refiner is presently crude short, Tosco believes that adoption of a crude oil allocation program is premature, unwise, and could result in more problems for the industry than it solves.

Except in the event of a crude oil supply interruption of emergency proportions, the market should be allowed to operate to distribute crude supplies without the need for government action. However, in the event of a severe crude oil supply emergency, the President should have the authority to intervene in the marketplace.

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The President currently has the power to implement an emergency allocation program². However, this statutory authority will expire on September 30, 1981. In order to provide the President with authority beyond this date, new legislation must be enacted. In developing such legislation, Tosco recommends that the Congress critically review the effects of the Emergency Petroleum Allocation Act of 1973 ("EPAA")³.

The EPAA authorized the imposition of regulations on the petroleum industry in a manner designed to preserve the status quo. The regulatory programs implemented under the EPAA sought to apportion available supplies on a percentage basis through existing distribution systems; to control and to limit price increases at all points within the system; to protect the independent sector; and, to supply priority needs. Notwithstanding the desirable objectives of the EPAA, it is Tosco's view that, upon critical examination, the effort to equitably apportion shortages across the entire spectrum of industry and the public had several significant shortcomings.

First, by allocating petroleum supplies on a historic basis, the programs implemented via the EPAA allowed little or no responsiveness to changes in consumer demand. Moreover, this reliance upon historical patterns did not permit the most efficient operators in the marketplace to bring supply and demand into balance.

Second, the imposition of price controls had the effect of sending a false signal to consumers. Since price controls maintained domestic crude oil prices at unrealistically low levels substantially below world market levels, conservation on the part of consumers was not encouraged. Lastly, the reliance on historical patterns, while having the effect of protecting the independent sector of the industry, also insulated that sector from the rapidly changing realities of the marketplace. Consequently, because normal market forces were not allowed to operate, and because, to a significant extent, the domestic refining industry was insulated from changing market conditions

² Emergency Petroleum Allocation Act of 1973, as amended, 15 U.S.C. 751 et seq. The Department of Energy Regulations implementing this authority are the Standby Mandatory Crude Oil and Refinery Yield control Programs, 10 C.F.R. 211-1 (Appendix A).

³ Supra.

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and the effects of competition, some domestic refiners failed to engage in the necessary planning for a return to the free market condition and, in general, the less efficient, less viable sectors of the industry were inadvertently supported and encouraged.

Given the unanticipated consequences of the regulatory programs implemented under the EPAA mandate, Tosco recommends that several policy parameters be incorporated into any legislation mandating the development of a standby allocation program. First, the legislation should accord the President the flexibility to deal with a range of issues affecting production, conservation and fuel switching with the objective of causing supply and demand to be balanced. Second, to the maximum extent possible, the legislation should allow market forces rather than direct government intervention to bring supply and demand into balance. Third, the "triggering" of any governmental action should occur only when a clear emergency situation exists. And lastly, any government program put into effect should be maintained only so long as the emergency situation persists. If these conditions or parameters are established, then Tosco believes there will be an effective, responsive standby allocation program are maximized.

In your floor statement, you spoke of two possible mechanisms to assist independent and small refiners in gaining increased access to crude oil, both foreign and domestic. A third approach was suggested during the hearing on March 27, 1981, and we offer the following comments on the three proposals.

A. Amending the Internal Revenue Code Treatment of Foreign Tax Credits.

As Tosco understands the proposal to amend the Internal Revenue Code ("IRC") with respect to Foreign Tax credits, the proposal would permit the multinational oil companies to treat income derived from the sale of domestically produced crude oil to unrelated small and independent refiners as foreign oil extraction income or foreign oil-related income. The purpose of this special tax treatment is to provide the major multinational companies with an incentive to sell crude oil to the small and independent refiners. Tosco is opposed to this proposal.

We believe that the establishment of a special program to direct crude oil supplies to any segment of the industry at any time other than during dire emergencies is both unnecessary and unwise. Programs designed to lower crude acquisition costs and divert petroleum supplies in accord with special interest considerations would only serve to distort the market and distribution systems and encourage lack of planning and inefficiency in the industry. Such programs would serve to promote and sustain the least cost effective and well managed operations at the expense of the U.S. taxpayer.

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B. Privately Owned Crude Oil Purchasing Cooperatives.

Tosco recognizes that many individual independent or small refiners have experienced substantial difficulties in effectively competing in the world market for contract supplies of crude oil. Generally these firms have difficulty in being effective competitors because of either their size, and consequently their small crude oil requirements, or the cost requirements inherent in participating in the contract market. The inability to deal in the contract market has often forced these firms into the spot market to compete for oil at unstable and volatile prices. All of these factors argue for those firms to begin operating in a coordinated and cohesive fashion.

However, since the benefits of crude oil buying consortia are clear, the provision of special tax benefits does not appear to be necessary or warranted. There are presently at least three such consortia, to Tosco's knowledge, already operating. While we are unaware of the varying degrees of success of these consortia, we do believe that they may be an effective tool for addressing the access of such independent refiners. However, we are not aware of any evidence that these consortia, in order to be effective, require any special tax status or governmental status.

It is Tosco's understanding of the IRC that these consortia can operate in a fashion that exposes them to a minimum tax liability. Subchapter T of the IRC permits a dollar-for-dollar recovery of costs associated with such a cooperative endeavor.⁴ Since current law permits consortia to operate in essentially a tax-exempt status, Tosco sees no requirement for according these consortia a preferential tax status.

It also has been proposed that any such consortia be accorded special treatment in order to enable them to secure financial assistance from such entities as the Import-Export bank. Again, such an approach appears to us to be both unnecessary and undesirable. As is the case with allocation controls, noted earlier, such a conferred status would have the unintended effect of discouraging advance planning, efficient and effective management and responsiveness to changing market conditions. In short, such special government treatment, where unnecessary to correct a true imbalance or inequity in the system which is truly beyond the control of refiners, serves only to undermine the beneficial effects of competition in creating a strong and viable domestic industry.

⁴I.R.C. §1381-1383

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C. Independent Producer Exemption from the Crude Oil
Windfall Profits Tax.

On March 27, 1981, testimony from the Emergency Small Refiners Task Force advocated exempting from the Crude Oil Windfall Profits tax, Independent Producers who sell their crude oil production to small refiners. Tosco is opposed to such a tax program for the reasons stated earlier.

III. Tax Incentives for Refinery Upgrading

As previously noted, Tosco's refineries are complex, high conversion facilities, capable of efficiently processing heavy, high sulfur crude feedstocks into premium products. To achieve this processing capability, Tosco was required to make substantial, high risk capital investments in refinery upgrading equipment. Tosco made those investments as a matter of prudent management practice and in spite of the substantial uncertainties associated with world oil markets.

Tosco anticipates that, as a result of the removal of price and allocation controls from crude oil and refined petroleum products and the return to free market conditions, efficient refining operations will be able to finance appropriate upgrading and expansion projects without the benefit of specialized tax treatment. In this regard, Tosco concurs with the Administration's position (as stated by John Chapoten, Assistant Secretary of the Treasury for Tax Policy) that the refining industry has not demonstrated a need for federal assistance in making desired capital investments beyond that being provided for industry and business in general under regular investment tax provisions.

- We very much appreciate having the opportunity to submit these comments and look forward to working with you and staff on these matters in the future.

Very truly yours,

Camilla S. Auger
Camilla S. Auger

STATEMENT OF ALBIN W. SMITH
SENIOR VICE PRESIDENT
THE COASTAL CORPORATION
ON
THE FUTURE OF THE DOMESTIC REFINING INDUSTRY
BEFORE THE
SUBCOMMITTEE ON ENERGY AND AGRICULTURAL TAXATION
SENATE FINANCE COMMITTEE
March 27, 1981

To the Senator and the Subcommittee:

On behalf of The Coastal Corporation, its subsidiaries and affiliates, I wish to express our appreciation to this Subcommittee for the opportunity to present for your consideration some of the problems which currently plague Coastal and the domestic refining industry, and to share our views on some possible tax-based solutions. We commend this Subcommittee's recognition of the importance of independent refiners to the nation's economic and strategic interests.

The Coastal Corporation, a Delaware corporation with its principal place of business in Houston, Texas, is a diversified energy company, the parent of numerous companies which discover, produce, transport and market energy products worldwide. Through its subsidiaries, the company is an independent refiner, having a combined crude oil throughput of 298,000 barrels per day (bpd). Coastal operates three refineries in the United States: Coastal States Petroleum Company, a 185,000 bpd refinery located in

Corpus Christi, Texas; Pacific Refining Company, an 85,000 bpd refinery (recently expanded from 53,000 bpd) located in Hercules, California; and Derby Refining Company, a 28,000 pbd refinery located in Wichita, Kansas. Coastal owns and produces approximately 10,000 bpd of the crude petroleum refined in its own refineries.

Derby Refining Company, acquired by Coastal in 1973, is a traditional example of the regional refiner-marketer. Its refinery was constructed in the 1920s near existing crude oil fields, from which it gathered its crude oil supply. During the period of Federal price controls on crude oil, including the entitlements program, Derby refined substantial quantities of foreign and stripper crude oil because the additional lower cost domestic crude oil was not available to it. The after-entitlement price of the crude oil refined by Derby was substantially higher than the after-entitlement cost of price-controlled crude oil of that type. Derby was forced to compete on an unequal basis with the small refiners, who received the small refiner bias entitlements advantage, although Derby operated in the same market and was generally much more efficient than the small refiners who were recipients under that program.

Derby's refinery is designed to yield a high percentage of gasoline. A complex and high conversion refinery is

necessary in order to accomplish a high yield of gasoline and other transportation fuels. The refinery units at Derby consist of crude oil and vacuum distillation, catalytic cracking, naphtha desulfurizer, reforming, alkylation and delayed coking, all built prior to 1963. The reformer at Derby was revamped in 1980 to increase gasoline production. The company markets its transportation fuels in 13 midwestern states (especially Iowa, Kansas, Missouri and Nebraska) through over 600 company-owned and jobber retail outlets. Derby was the first refiner to offer gasohol through its company-owned outlets; many of its jobber outlets also market gasohol.

When this Subcommittee considers how best to distinguish efficient refiners, small or otherwise, from "teakettles" or topping units, it may wish to use an approach suggested in a Bonner & Moore study done for Derby Refining. A formula called the Nelson complexity factor can be used to determine the complexity rating of a refinery, which indicates the percentage of gasoline and light-end transportation fuels which that refinery can produce from a given throughput of crude oil processed daily. Lead phasedown has caused Derby's efficiency rating to drop somewhat in absolute terms, but Derby retains its relative position among the most efficient refineries in production of transportation fuels.

Our largest refinery, at Corpus Christi, does not rank as high as Derby in the percentage production of transportation fuels, but is also a complex refinery which produces essential petrochemicals and feedstocks. Unlike Derby,

which markets its products for the most part to independent marketers who supply local, city and state districts, independent jobbers and retailers, and agricultural users in local markets. The Corpus refinery is also a substantial Defense Fuel Supply Center supplier. Because, unlike Derby, the Corpus refinery does not have its own service stations and is dependent on local independent wholesale markets, the refinery needs the flexibility to produce the products demanded by those markets. We have therefore prepared studies and begun plans for an extensive retrofit of the Corpus refinery. We have already obtained permits from the Texas Air Control Board and the Environmental Protection Agency for specific modifications which will increase its production of transportation fuels.

The Pacific refinery in California was acquired by Coastal in 1976. We have very ambitious plans for a retrofit program at the Pacific refinery, which primarily produces fuel oil at the present time. Our plans for Pacific have been informally presented to the California Air Quality Board to obtain their input on an informal basis before submitting our applications for permits formally. Currently, we plan to install a vacuum unit, for which our permit has been obtained; a hydrocracker; a hydrogen unit; boilers; a reformer; alkylation; a sulfur recovery unit with tail gas scrubber (which is required by California regulation with the other equipment to be installed); and a hydro-desulfurization unit.

The major problem with our retrofit program is finding the front-end funds to meet our timetable for the retrofit. While a tax credit program for retrofit has been discussed and debated at some length, we would like to point out that a tax credit does not really take into account the fact that the refinery is not producing during the period in which it is undergoing retrofit; there is no cash benefit to a tax credit at the time of major cash expenditures while there is no income. A tax credit program may be beneficial in the long run only when coupled with carryback and carry-forward provisions. What is urgently needed in the case of Pacific, Corpus and similar refineries is a source of front-end funding for the retrofit. We will return to this subject shortly.

The Coastal Corporation acquired RBP (Raffinerie Belge de Petroles), a 100,000 pbd refinery in Antwerp, Belgium, in 1980. Parenthetically, we would like to bring to your attention a result which was probably not intended in S. 409, a bill proposed by Senator Bennett Johnston (D-LA), to allocate crude oil among refiners in the event of an emergency. This legislation, by current definition, would exclude Coastal as a recipient of crude oil under an emergency crude allocation program. The definition of "domestic refiner" in that bill is

"...a petroleum refiner whose total petroleum refinery capacity (including the refinery capacity of any person who controls, or is

controlled by, or is under common control with such refiner) is located within the United States..."

If S. 409 were to pass in its present form, Coastal, which is almost entirely dependent on foreign crude to operate most of its refineries, would be designated as a crude oil seller. In the event of a severe supply interruption or a national emergency, Coastal's refining capacity would be as essential to the security objectives of this country as is the refining capacity of any of the entities protected in the current version of S. 409.

We do stress the need for the passage of a stand-by crude oil allocation program this year. However, the program should be so constructed that the trigger mechanism would not be tripped unless certain defined types of shortfalls occur -- on a world, national or regional basis -- and that our responsibilities to International Energy Agency member nations are upheld. Over the long term, those refiners who are efficient and aggressive in world crude markets will ultimately survive. "Quick fix" solutions will only postpone current problems. However, in this transition period to energy self-sufficiency, Congress should examine measures that can be helpful to the industry on an interim or temporary basis.

Two measures currently pending which would aid in crude access for independent refiners in this country are the

foreign tax credit amendment for majors who sell crude to independents and a windfall profits tax exemption for sales to independent and small refiners. Senator Wallop, in his March 12 announcement of these hearings on the future of the U.S. domestic refining industry, drew a very clear distinction between various segments of the refining industry, and pointed out the crude access problems of the larger independent refiners such as Coastal. Congress showed a similar awareness of the importance of the independent segment of the industry in its passage of the Emergency Petroleum Allocation Act of 1973, which contained a legislative mandate "...to preserve the competitive viability of independent refiners, small refiners..." and to provide for "...equitable distribution of crude oil...among...independent refiners, small refiners..." However, in spite of this recognition by Congress of this numerically small segment of the industry, the Department of Energy consistently limited regulatory protections and benefits during its control period to a group which the DOE termed "small and independent refiners" (to be read in the conjunctive). We urge that any crude access legislation include specific direction that the large independent refiners be included as potential recipients of allocated crude oil.

The suggested amendment to the foreign tax credit rules in the Internal Revenue Code, providing that income from sales of domestic or foreign crude to unrelated domestic small or independent refiners be treated as foreign source

income, appears to be one of the most logical and most necessary courses of action. Removal of a tax disincentive to sell crude to an unrelated refinery is essential. The proposal to allow use of the foreign tax credit for sales of domestic crude oil to unrelated small or independent refiners would allow major oil companies to use excess foreign tax credits, thus encouraging this type of sale.

To encourage more dollars presently abroad to be spent at home, we suggest that Congress approve legislation which would permit the relocation of qualified Domestic International Sales Corporations' (DISC companies) foreign assets back into the United States. The DISC program, at §991, et seq., of the Internal Revenue Code, could have a one-time reversal mechanism allowing qualified companies to relocate assets currently abroad to a home base for use in a low-interest loan program for domestic refinery retrofit. A tax credit based in inverse proportion on the discounted interest rate charged to the refiner-borrower could motivate DISC companies to relocate dollars to the American economy, stimulating refinery investment, creating new jobs and contributing to national security.

The 10-5-3 year program of depreciation on business assets recommended in President Reagan's tax cut bill would be extremely helpful in encouraging refinery retrofit. The additional 10 percent energy tax credit for installation of energy conservation equipment or processes introduced as S. 750 by Senator Wallop and others is a necessary augmentation, particularly in the case of refineries in environmentally

restrictive states. Additional equipment expenditures required to meet California environmental regulatory standards, for example, would make retrofit substantially more expensive in that state, where retrofit to produce lighter-end products from heavier crudes is so desperately needed. Additional tax incentives for refinery modification should be considered, as, for example, possible immediate tax write-offs for obsolete refining equipment.

The Coastal Corporation would be more than happy to provide explanations of our refinery retrofit plans, of materials explaining the complexity ratings of refineries, or further information on the role of the large independent refiners in the industry. We wish the Subcommittee well in its efforts to provide some solutions for the refining industry as this country achieves energy independence.

SUMMARY COMMENTS ON STATEMENTS AT
ENERGY AND AGRICULTURAL TAXATION SUBCOMMITTEE
HEARING ON MARCH 27, 1981

Itemized below are statements in the written responses that we feel should not go in the record uncorrected. A sufficient amount of the statement is included so the context in which it was made is not changed.

#1. "First, major refiners own the majority of domestic crude oil production. In 1979, the 16 largest integrated refiners got about 75 per cent of their domestic crude oil supply from their own production."

Reply: 1979 statistics for the 16 majors:

	<u>Million B/D</u>
Net U.S. Crude Oil Production	4.9
U.S. Crude Oil Runs	10.7

Thus the 16 majors received 4.9 + 10.7 or 46 per cent of their domestic crude oil supply from their own production.

#2. "Dozens of other independent crude producers have also been acquired by major refiners. As a result, there are only about 2 million barrels per day of domestic production available on the open market. This is the only domestic oil which is available to the 170 refiners who are not among the 16 major integrated refiners."

Reply: 1979 statistics:

	<u>Million B/D</u>
Total U.S. Crude Oil Production	8.5
Crude Oil Production by 16 Majors	4.9
Difference	3.6

The majors purchase domestic crude oil in addition to their net production as do other refiners. These purchases are made at market prices that are competitively determined.

Total crude runs in 1979 were 14.5 million barrels per day. The 8.5 million barrels per day of total U.S. production amounts to 59 per cent of total industry crude runs. As noted above, the 16 majors net crude production was 46 per cent of their crude runs.

#3. "Indeed, it is interesting to note that among the ten largest companies that refine crude oil in the United States, 70 per cent of the actual refineries that these firms control would qualify as small refiners if they were independent entities. These refineries process 33 per cent of the total crude oil run by these major integrated companies. Moreover, a full one-third of the refineries in question would qualify for membership in APRA because their capacities are 50,000 barrels per day (bpd) or less. See Appendix B. In view of this data, it is ironic that it is always the independent small refiner, and never the captive small refinery owned by these major firms, which must reply to allegations that their facilities are inefficient and lack adequate economies of scale."

Reply: Using the data in Appendix B referred to in this statement gives the following:

	<u>Million B/D</u>
Total capacity of 10 largest refiners	10.2
Refineries 50 MB/D or smaller	.8

Thus, the 50 MB/D and smaller refineries of the 10 largest companies amounts to 8 per cent (0.8 + 10.2) and not 33 per cent of their total refining capacity. In certain instances small refineries are a preferred method for supplying some geographic areas or for producing certain products. This is not large, and the 8 per cent reflects this fact.

#4. "Smaller refiners also currently provide the Defense Department with close to 40 per cent of our Nation's military jet fuel requirements. To shift this important responsibility to foreign refiners would jeopardize our Nation's security."

Reply: Small refiners are given preferential treatment in the bidding on military fuel requirements and so would be expected to have a disproportionately large share of this market. There is no unique equipment required to produce military jet fuel. On the contrary, this fuel can readily be produced across the entire industry, and implying that the military would have to look overseas to supply their needs if small refiners were shutdown is simply not correct.

#5. "Small refiners have also historically provided highly specialized refined petroleum products which larger integrated refiners are reluctant to produce because of the limited market for such products. For instance, it is the small refining segment of the industry which produces a disproportionate amount of products such as asphalt, military jet fuel, lube oil, printing inks, and speciality chemicals which serve vital functions in the industries in which they are utilized."

Reply: Producing disproportionate amounts of these products is not unexpected since in most cases their production avoids the installation of more costly equipment to further upgrade the product or because of preferential treatment, e.g., military jet fuel. There is no reluctance by large refiners to produce these products and they, in fact, are the major suppliers.

#6. "The Administration and members of Congress are suggesting the deregulation of natural gas and the repeal of coal conversion requirements for utilities. Such actions will induce utilities and industries to use increasingly competitive residual fuel oil and middle distillates. Increased demand for diesel-powered automobiles will increase demand for diesel fuel. Thus, it would appear that small refiners which are producing scarce middle distillates and residual fuel oils are more "efficient" than the majors which produce gasoline."

Reply: Increased demand for diesel-powered automobiles will certainly increase the demand for high quality distillates, but not for lower quality heating fuel distillates. A certain amount of high quality distillates occur naturally in a large number of crudes. Additional volumes above this amount require the installation of expensive hydroprocessing facilities which are not economic to install in small refineries. The naturally occurring high quality distillate is available to any refiner who processes the crude oil.

Lower quality heating fuel distillates and residual fuel are not scarce fuels. In fact, residual fuel is the least valued and hence lowest priced product on the market. Decontrolling natural gas will increase the incentive and hence production of natural gas, decreasing the demand for heating fuels. In the past few years, with the partial lifting of gas price controls, gas shortages have disappeared and homes are once again converting to gas heat. Economics will drive coal conversions and so repealing coal conversion requirements for utilities is not a factor. The industry need is to convert these displaced heating fuels into higher value products.

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Arco
Cities Service
Conoco
Exxon
Getty
Gulf
Marathon
Mobil

Phillips
Shell
Socal
Sohio
Standard Oil (Indiana)
Sun
Texaco
Union

