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CRUDE OIL WINDFALL PROFIT TAX ACT OF 1979

REPORT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

together with

ADDITIONAL AND SUPPLEMENTAL VIEWS

ON

H.R. 3919

NOVEMBER 1 (legislative day, OCTOBER 15), 1979
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CRUDE OIL WINDFALL PROFIT TAX ACT OF 1979

NOVEMBER 1 (legislative day, OCTOBER 15), 1979.—Ordered to be printed

Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompony H.R. 3919]

The Committee on Finance, to which was referred the bill (H.R. 3919) to impose a windfall profit tax on domestic crude oil, having considered the same, reports favorably thereon with an amendment and an amendment to the title and recommends that the bill as amended do pass.

I. SUMMARY

The Finance Committee substitute for H.R. 3919, the "Crude Oil Windfall Profit Tax Act of 1979," imposes a windfall profit tax on domestic oil producers and royalty owners to supplement the decontrol of oil prices announced by the Administration. It also provides for the use of the revenue from the tax to encourage energy conservation, to promote production from alternate energy sources and to ease the burden of higher energy prices on lower-income households.

Over the period 1979–1990, the windfall profit tax will raise $138.2 billion. The various tax cuts provided in the bill will reduce revenues by $32.4 billion. $64.3 billion is set aside in a trust fund to finance aid to lower-income households. An additional $15 billion is set aside in a trust fund to encourage energy efficient transportation. This will leave a surplus of $26.6 billion, which will be available for tax reductions, additional spending or reduction of the national debt.

In fiscal year 1980, the committee substitute will raise $0.9 billion in revenue and involve outlays of $1.2 billion. The revenue gain is expected to be $2.1 billion in calendar year 1980, $9.0 billion in 1981, and $14.1 billion in 1982.

There are six principal parts of the committee substitute:

(1) A windfall profit tax on domestic oil producers and royalty owners.

(2) Tax incentives to encourage energy conservation in homes.
(3) Tax incentives to encourage energy conservation by businesses and production of alternative energy sources.
(4) Programs to assist lower-income households to deal with higher energy prices.
(5) Establishment of a Transportation Trust Fund, a Low-Income Energy Assistance Trust Fund, and a Taxpayer Trust Fund.
(6) Repeal of carryover basis.

Windfall profit tax

The windfall profit tax is an excise, or severance, tax on domestic oil producers and royalty owners. On each barrel of taxable crude oil, the tax equals the tax rate multiplied by the "windfall profit." The windfall profit equals the selling price of the oil minus the sum of a base price, which will vary depending on the tax tier into which the oil falls, and an adjustment for severance taxes on the windfall profit. The committee believes that this tax will reduce profits of oil producers and royalty owners, rather than be passed on to consumers as higher prices.

In designing the tax, the committee attempted to reduce or eliminate the tax burden on those types of oil the production of which is likely to be relatively sensitive to changes in tax rates or prices. It tried to maintain a higher tax burden on types of oil whose production is likely to be less sensitive to price changes. This greater concern for production incentives is a significant difference between the committee substitute and the House bill.

To encourage greater oil production, the committee decided to exempt from the tax newly discovered oil, incremental production resulting from use of tertiary recovery techniques, heavy (low-gravity) oil, and the first 1,000 barrels per day of stripper oil produced by independent producers. Also, the committee substitute reduces the harsh treatment of Alaskan oil under the House bill by providing it with the same base price received by other upper tier oil. The substitute reduces the tax burden on high water-cut oil. The committee substitute, however, increases the tax rate on old oil (tier one) to 75 percent because the production of this oil is less sensitive to price and because it receives the greatest benefit from decontrol.

Other exemptions from the tax in the committee substitute are designed to avoid imposing a tax burden on income devoted to public purposes. For this reason, oil production owned by State or local governments, Indian tribes or nonprofit educational or medical institutions specifically is exempted from the tax.

Finally, the committee substitute phases out the windfall profit tax after the cumulative net revenue raised by it exceeds $127.1 billion, 90 percent of the estimated revenue which would otherwise be raised by the tax through 1990.

The windfall profit tax in the committee substitute will raise $4.6 billion in calendar year 1980, $11.8 billion in 1981, $15.2 billion in 1982 and $138.2 billion in the 11-year period 1980 to 1990. In fiscal year 1980 it is expected to raise $2.3 billion.

Residential energy conservation

The committee substitute uses part of the revenue provided by the windfall profit tax to finance tax incentives to encourage energy conservation in residences.

The present 15-percent home insulation credit, which was enacted in 1978, is extended to heat pumps, airtight wood stoves, efficient replacement oil or gas furnaces, and (at a 25-percent rate) replacement coal furnaces or boilers. The solar energy credit is increased to 50 percent of the first $10,000 of expenditures and extended to the year 2000. Also, changes are made to the structure of these credits, including making them available to landlords.

The committee substitute also includes a tax credit for utilities which participate in programs to finance investments in residential energy conservation.

The residential energy tax incentives are expected to reduce revenues by $0.4 billion in calendar year 1980, $0.5 billion in 1981, $0.6 billion in 1982 and $8.3 billion between 1980 and 1990. In fiscal year 1980, the revenue loss is expected to be $131 million.

Business energy incentives

The committee substitute provides significant tax incentives to encourage businesses to conserve energy and produce alternative sources of energy.

Solar and wind energy.—The present refundable 10-percent energy investment credit, which is available in addition to the regular investment credit, is increased to 20 percent, extended through 1990 and expanded to include equipment to provide process heat.

Geothermal energy.—The present 10-percent energy investment credit is increased to 20 percent and extended through 1990.

Ocean thermal energy.—The substitute adds a 20-percent energy investment credit for equipment to use ocean thermal energy.

Hydroelectric power.—The substitute provides a 10-percent energy investment credit and more rapid depreciation for property to generate electricity from small scale hydroelectric plants at existing dams and new sites where no dam is involved. Tax exemption is provided for industrial development bonds used to finance dams and hydroelectric equipment.

Conservation.—The present 10-percent energy investment credit is extended to nonoil cogeneration equipment, industrial heat pumps, equipment used to burn petroleum coke and pitch, and modifications to alumina electrolytic cells. Also, a liberal transition rule is provided for energy credits which would otherwise expire after 1982. Many of the new and existing energy credits are extended to public utilities. The Treasury's regulatory authority to add new items to the business energy conservation credit is repealed.

Biomass.—The energy credit is increased to 20 percent for equipment and other property used to burn biomass (other than wood) or to process it into a solid fuel. Also, tax exemption is provided for industrial development bonds used to finance facilities to use solid waste as fuel.

Alternative fuel production credit.—A nonrefundable tax credit is provided for production of certain alternative energy sources. Eligible

fuels include oil shale; tar sands; liquid, gaseous, or synthetic solid fuel produced from coal liquefaction or gasification facilities; unconventional natural gas; gas produced from biomass; steam produced from solid agricultural products; and processed wood. The credit will be $3.00 per barrel of oil-equivalent (based on the energy content of the fuel relative to a barrel of crude oil) and will phase out as imported oil prices rise from $23.50 to $29.50. The credit would be indexed fully for inflation occurring after 1979.

Gasohol.—To encourage production of gasohol, the committee substitute replaces the present gasoline excise tax exemption for gasohol with a 40-cent refundable tax credit for domestic alcohol fuel made from substances other than oil, gas or coal and a 10-cent credit for alcohol fuel made from coal.

The business energy tax incentives will reduce revenue by $0.2 billion in calendar year 1980, $0.3 billion in 1981, $0.4 billion in 1982 and $15.0 billion in the 11-year period 1980–1990. The revenue loss is $78 million in fiscal year 1980.

Lower-income energy assistance

Direct cash payments will be made by the Social Security Administration to SSI recipients and by State welfare agencies to AFDC recipients and to food stamp households which do not receive AFDC or SSI benefits. The funds available ($1.2 billion in fiscal year 1980 and $3 billion in fiscal years 1981 and 1982) will be allocated among the States under a formula which reflects household energy expenditures, heating degree days, and number of low-income persons. Benefit amounts will be determined on a uniform basis within each State, taking into account the amount of the State's allocation and the number of recipent households. Benefit amounts for multiperson households will be 150 percent of the amounts for single individuals, with a $10 monthly minimum in either case. States will be permitted the option of receiving the funds as a block grant and utilizing them to provide energy-related assistance according to a State-devised plan.

Taxpayers will be allowed a nonrefundable tax credit equal to a percentage of the amount spent for heating their homes. The percentage will be different for each heating source and will be based on the extent to which the increase in the cost of these fuels has exceeded increases in the cost of living. The credit will be subject to a minimum of $30 per household ($20 in 1979) and a maximum of $200 per household, and it will phase out between incomes of $20,000 and $22,000 ($18,000 and $20,000 in 1979).

Trust funds

The committee substitute establishes three trust funds. An amount equal to one-half of the net receipts from the windfall profit tax will be placed in a Low-Income Energy Assistance Trust Fund. One-fourth of the net receipts, up to $15 billion, will go into a Transportation Trust Fund. An amount of general revenues resulting from the decontrol of oil prices is to be set aside in a Taxpayer Trust Fund to assure that adequate resources are available to the Congress for action it may wish to take next year to provide relief to taxpayers who face the combined impact of higher prices as a result of oil decontrol and a

substantial increase in social security taxes. The amount of funds to be deposited in the Taxpayer Trust Fund will be sufficient to offset the increase in social security taxes scheduled for 1981 under existing law.

Carryover basis

The committee substitute repeals the provision for carryover basis, which was enacted in 1976 but whose effective date has been deferred until the end of 1979. Thus, heirs will continue to be allowed to use the fair market value of appreciated, inherited property at time of death as the basis for calculating their capital gain or loss when they dispose of the asset, rather than having to carry over and use the decedent's basis.

II. REASONS FOR THE BILL

The Crude Oil Windfall Profit Tax Act of 1979 is needed because of the Administration's decision to phase out price controls on crude oil, the recent increases in world oil prices, and the nation's continuing overdependence on imported energy. The Finance Committee substitute is intended to tax a fair share of the additional revenues received by oil producers and royalty owners as a result of oil price decontrol in a way that will not adversely affect incentives to produce domestic oil. Part of the revenue raised by the tax is to be used for tax incentives to encourage energy conservation and production of alternate energy sources. Part is to be used for assistance to lower-income households to help them cope with higher energy prices. Part is to be used to fund a Transportation Trust Fund. Thus, the bill will provide both greater equity in the distribution of the gains from higher oil prices and mechanisms to deal with our overdependence on imported energy.

Oil price decontrol

In April 1979, the Administration announced its intention to use its discretionary authority over oil prices to phase out price controls between June 1, 1979, and September 30, 1981, when the existing price control authority expires. Since then, the Department of Energy has issued final regulations on the decontrol program. The decontrol program involves the immediate decontrol of newly discovered oil (oil produced from a property which had no production in 1978), the gradual merger of the lower tier of price controls (oil discovered before 1973) with the upper tier (oil discovered between 1972 and 1979), and the gradual phaseout of controls on oil in the upper tier.

Oil price decontrol will cause a significant increase in revenues received by oil producers and royalty owners. In May 1979, just prior to the start of phased decontrol, lower tier oil (one-third of domestic production) was controlled at an average price of $5.91 per barrel and non-Alaskan upper tier oil (also one-third of domestic production) at an average price of $13.02 per barrel. In October 1979, the average price of uncontrolled oil, to which lower and upper tier oil will rise as controls are phased out, was approaching $30 per barrel; and most experts predict that the price of uncontrolled oil will continue to rise sharply in the coming months.

The committee believes that the large price increases on previously discovered oil resulting from phased decontrol are an appropriate object of taxation. However, it believes that any such tax should be structured carefully to eliminate, as much as possible, adverse effects on domestic production. For this reason the committee substitute contains several exemptions from the tax for types of oil whose production it believes to be especially responsive to more lenient tax treatment, such as newly discovered oil, tertiary oil, stripper oil and heavy oil.

The committee does not believe that the logic of a windfall profit tax extends to oil which has not yet been discovered and from which there can be no "windfall." Thus, the committee substitute exempts newly discovered oil. Also, stripper oil has been exempt from controls since 1976 and, therefore, will receive no benefit from the President's decontrol program. This, and the concern that taxation may lead to premature abandonment of stripper wells, justifies an exemption for up to 1,000 barrels per day from stripper wells owned by independent producers. Alaskan North Slope oil has, until recently, sold well below its ceiling price, and the committee substitute taxes it only on price increases above that ceiling price.

Thus, the windfall profit tax in the committee substitute is carefully structured to provide production incentives and to exempt categories of oil from which there are no windfalls from decontrol. Even so, it still will raise a large amount of revenue—$138.2 billion in the 11-year period 1980 to 1990.

A carefully structured windfall profit tax, such as the one in the committee substitute, will make a significant contribution to the nation's energy problem. It will greatly mitigate any inequities resulting from oil price decontrol and, thereby, allow decontrol to go forward. It will provide funds to help reduce our dependence on foreign oil.

The committee believes that most of the revenue raised by the tax should be used to deal with the energy problem. The committee substitute uses most of the revenue raised by the tax to help lower-income households pay their higher energy costs, to finance tax incentives for both residential and business energy conservation and for the production of alternative energy sources, and to finance a trust fund to encourage energy efficient transportation. Thus, the committee substitute will be the foundation of a comprehensive national energy program.

Burden of higher energy prices

The recent increases in energy prices will impose severe burdens on lower-income households. The price of heating oil, for example, has risen from 50 cents a gallon in 1978 to 90 cents. Heating a home with 1,200 gallons of oil, therefore, would cost $1,080, an enormous burden for a low-income person. Natural gas prices, while lower than heating oil prices, have also risen sharply in recent years. The increased cost of propane has hurt the living standards of many rural Americans.

The committee believes that a fair sharing of the costs of higher energy prices requires that part of the tax on oil producers and royalty owners be used to finance assistance to lower-income families. The committee substitute includes programs designed to provide such assistance.

Energy tax incentives

The ultimate solution to the energy problem does not lie in taxing energy producers or simply in helping people cope with higher prices; it lies in reducing our consumption of energy and in increasing domestic energy production. A very important part of the committee substitute is a program of tax incentives designed to achieve these goals.

Many methods of energy conservation and of production of alternate energy sources require new and advanced technologies. Investments are often too risky to be undertaken without some federal subsidy, and the initial investors in these projects create benefits for the whole economy by generating information on how to develop the needed new technologies. In many cases, a tax incentive is the most efficient way of enacting the necessary subsidy because it dispenses with the need for a cumbersome bureaucracy to administer a spending or regulatory program.

For this reason, the committee substitute uses a large part of the revenue from the windfall profit tax to finance tax incentives for a wide range of alternate sources of energy—solar, wind, geothermal, wood, biomass, hydroelectric, ocean thermal, oil shale, tar sands, coal liquefaction and gasification and unconventional natural gas. There are also tax incentives to encourage energy conservation both by businesses and by homeowners.

Transportation

Use of more energy efficient methods of transportation is another way of conserving energy. Often, this requires government spending for new transit systems or modernization of existing systems. To ensure that money is available in future budgets to finance these investments, the committee substitute sets aside a substantial part of the windfall profit tax revenue in a Transportation Trust Fund, from which money can be spent in future authorization and appropriations bills.

III. BUDGET EFFECTS

Table 1 summarizes the revenue effect of the committee substitute for calendar years 1979 to 1990. In 1980, the windfall profit tax will raise $4.6 billion, and the various tax reductions in the bill will reduce revenues by $2.5 billion. The overall revenue gain, then, will be $2.1 billion. Over the entire 12-year period 1979 to 1990, the tax will raise $138.2 billion, and the tax reductions will lose $32.4 billion, for a net revenue gain of $105.8 billion.

Table 2 summarizes the revenue effects of the bill for fiscal years 1980 to 1985. In fiscal year 1980, the windfall profit tax raises $2.3 billion, and the tax reductions lose $1.4 billion. Thus, the net tax increase in fiscal year 1980 is $0.9 billion.

Tables 3 and 4 present the gross and net revenues raised by the windfall profit tax for calendar years 1980–90 and fiscal years 1980–85, respectively. The gross windfall profit tax is the actual receipts from the tax itself. However, the imposition of the tax affects corporate and individual income tax receipts because it is deductible, because it reduces deductible State income taxes, and because it affects oil drilling. The net windfall profit tax is the gross windfall profit tax minus the reduction in corporate and individual income taxes expected to result from imposition of the windfall profit tax.

These revenue estimates assume that the price of uncontrolled oil equals $30 per barrel in the fourth quarter of 1979 and grows at the rate of inflation plus two percent per year. The $30 starting point is approximately the mid-point of expert estimates of the oil price in the fourth quarter which were given to the committee.

Table 5 reconciles the revenue effects of the windfall profit tax in the committee substitute with the tax in the House bill by showing the revenue effects of each of the significant changes to the House bill made by the committee.

Tables 6 and 7 show the revenue effects of each of the individual residential energy tax incentives for calendar years 1979–90 and fiscal years 1980–85, respectively.

Tables 8 and 9 show the revenue effects of the various business tax incentives for calendar years 1980–90 and fiscal years 1980–85, respectively.

Table 10 shows the revenue effects of the residential heating tax credit and the outlays expected from the low-income energy assistance program for calendar and fiscal years 1979–82, the years for which these programs are included in the committee substitute.

Table 1.—Summary of Estimated Revenue Effects of the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Calendar Years 1979–90

[In millions of dollars]

Item	Calendar year liabilities						
	1979	1980	1981	1982	1983	1984	1985
Net gain from windfall profit tax		4,567	11,816	15,150	15,014	14,609	14,234
Residential energy credits	−69	−408	−500	−610	−606	−728	−899
Business energy incentives [1]	−4	−174	−257	−364	−1,174	−1,323	−1,401
Heating fuel credit	−947	−1,901	−1,997				
Repeal carryover basis		(2)	−36	−95	−163	−238	−330
Total	**−1,020**	**2,084**	**9,026**	**14,081**	**13,071**	**12,320**	**11,604**

Item	Calendar year liabilities					Total 1979–90
	1986	1987	1988	1989	1990	
Net gain from windfall profit tax	13,794	13,492	12,972	12,761	9,835	138,244
Residential energy credits	−600	−719	−867	−1,034	−1,243	−8,283
Business energy incentives [1]	−1,460	−1,667	−1,973	−2,349	−2,828	−14,976 [3]
Heating fuel credit						−4,845
Repeal carryover basis	−440	−560	−680	−810	−950	−4,302
Total	**11,294**	**10,546**	**9,452**	**8,568**	**4,814**	**105,838** [3]

[1] Includes outlay portion of refundable tax credits which are treated as a tax cut for purposes of this table, although not in the committee substitute itself.

[2] Less than $1 million.

[3] This total includes $2 million in calendar year liability reductions from 1978.

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Table 2.—Summary of Estimated Revenue Effects of the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Fiscal Years 1980–85

[In millions of dollars]

Item	Fiscal year receipts					
	1980	1981	1982	1983	1984	1985
Net gain from windfall profit tax	2, 317	10, 222	16, 199	15, 106	14, 673	14, 399
Residential energy credits	−131	−420	−516	−608	−625	−756
Business energy incentives [1]	−78	−206	−290	−694	−1, 183	−1, 281
Heating fuel credit	−1, 232	−1, 916	−1, 697			
Repeal carryover basis	([2])	([2])	−36	−95	−163	−238
Total	**876**	**7, 680**	**13, 660**	**13, 709**	**12, 702**	**12, 124**

[1] In addition to the energy credits shown here, the outlays associated with the refundable credits are estimated to be $8 million in 1981, $11 million in 1982, $19 million in 1983, $44 million in 1984, and $69 million in 1985.
[2] Less than $1 million.

Table 3.—Estimated Revenue Effects of the Crude Oil Windfall Profit Tax as Reported by the Committee, Calendar Years 1980–90

[In millions of dollars]

Item	Calendar year liabilities					
	1980	1981	1982	1983	1984	1985
Gross windfall profit tax	7,885	20,704	26,714	26,492	25,797	25,161
Change in income taxes	−3,318	−8,888	−11,564	−11,478	−11,188	−10,927
Net windfall profit tax	**4,567**	**11,816**	**15,150**	**15,014**	**14,609**	**14,234**

Item	Calendar year liabilities					Total 1979–90
	1986	1987	1988	1989	1990	
Gross windfall profit tax	24,396	23,868	22,939	22,563	17,424	243,942
Change in income taxes	−10,602	−10,376	−9,966	−9,802	−7,589	−105,698
Net windfall profit tax	**13,794**	**13,492**	**12,972**	**12,761**	**9,835**	**138,244**

Note: Details may not add to totals because of rounding.

Table 4.—Estimated Revenue Effects of the Crude Oil Windfall Profit Tax as Reported by the Committee, Fiscal Years 1980–85

[In millions of dollars]

Item	Fiscal year receipts					
	1980	1981	1982	1983	1984	1985
Gross windfall profit tax	3,785	16,005	26,272	26,632	26,023	25,472
Change in income taxes	−1,468	−5,783	−10,072	−11,526	−11,350	−11,073
Net windfall profit tax	**2,317**	**10,222**	**16,199**	**15,106**	**14,673**	**14,399**

Note: Details may not add to totals because of rounding.

Table 5.—Comparison of Estimated Revenue Effects of the Crude Oil Windfall Profit Tax as Passed by the House and as Amended by the Committee, Calendar Years 1979–90

[In millions of dollars]

Item	Calendar year liabilities						
	1979	1980	1981	1982	1983	1984	1985
Net gain from windfall profit tax:							
Under the House bill	**59** [1]	**7, 986**	**16, 202**	**20, 673**	**22, 163**	**23, 868**	**26, 093**
(1) Exemption for new oil	−59	−723	−1, 328	−2, 108	−3, 087	−4, 260	−5, 702
(2) Exemption for heavy oil	----------	−430	−530	−624	−722	−868	−1, 034
(3) Exemption for tertiary production	----------	−262	−451	−730	−1, 145	−1, 779	−2, 758
(4) Tier 2 treatment for certain Alaskan oil	----------	−671	−620	−594	−567	−537	−507
(5) 75-percent rate on tier 1 oil	----------	+87	+480	+661	+356	+48	----------
(6) Tier 2 treatment for high water-cut oil	----------	−38	−153	−200	−109	−15	----------
(7) Exemption for 1st 1,000 barrels per day of stripper oil production	----------	−1, 202	−1, 244	−1, 286	−1, 326	−1, 374	−1, 435
(8) No denial of percentage depletion	----------	−160	−480	−568	−481	−414	−367
(9) Exemption for oil income of Indian tribes	----------	−15	−43	−53	−48	−43	−39
(10) Exemption for oil income of charitable schools and hospitals	----------	−5	−17	−21	−20	−17	−17
(11) Phaseout of the tax	----------	----------	----------	----------	----------	----------	----------
As reported by the Committee	----------	**4, 567**	**11, 816**	**15, 150**	**15, 014**	**14, 609**	**14, 234**

Table 5.—Comparison of Estimated Revenue Effects of the Crude Oil Windfall Profit Tax as Passed by the House and as Amended by the Committee, Calendar Years 1979–90—Continued

[In millions of dollars]

Item	Calendar year liabilities					Total 1979–90
	1986	1987	1988	1989	1990	
Net gain from windfall profit tax:						
Under the House bill	**27,941**	**29,740**	**31,654**	**33,994**	**36,449**	**276,821**
(1) Exemption for new oil	−7,169	−8,796	−10,708	−12,615	−14,466	−71,018
(2) Exemption for heavy oil	−1,193	−1,376	−1,589	−1,837	−2,124	−12,329
(3) Exemption for tertiary production	−3,467	−3,708	−3,965	−4,231	−4,507	−27,004
(4) Tier 2 treatment for certain Alaskan oil	−447	−466	−475	−516	−549	−5,948
(5) 75-percent rate on tier 1 oil	----	----	----	----	----	+1,632
(6) Tier 2 treatment for high water-cut oil	----	----	----	----	----	−515
(7) Exemption for 1st 1,000 barrels per day stripper oil production	−1,499	−1,573	−1,657	−1,752	−1,861	−16,210
(8) No denial of percentage depletion	−321	−282	−245	−211	−180	−3,708
(9) Exemption for oil income of Indian tribes	−37	−33	−30	−28	−25	−395
(10) Exemption for oil income of charitable schools and hospitals	−14	−14	−13	−11	−10	−158
(11) Phaseout of the tax	----	----	----	−32	−2,892	−2,924
As reported by the Committee	**13,794**	**13,492**	**12,972**	**12,761**	**9,835**	**138,244**

[1] The House bill would raise a small amount of income tax revenue in 1979 because the estimates assume that the tax on newly discovered oil reduces intangible drilling deductions in that year.

Note: Details may not add to totals because of rounding.

Table 6.—Estimated Revenue Effects of Residential Tax Credits Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Calendar Years 1979–90

[In millions of dollars]

Item [1]	Calendar year liabilities						
	1979	1980	1981	1982	1983	1984	1985
Conservation credits:							
Credit for heat pumps	—7	—32	—37	—51	—66	—88	—123
Credit to landlords (10 percent)	—14	—51	—54	—57	—61	—67	—78
Eliminate principal residence requirement	—1	—5	—6	—6	—6	—7	—8
Credit for airtight wood stoves	—13	—57	—53	—57			
Credit for coal furnaces (25 percent)	—7	—32	—42	—52			
Credit for replacement oil and gas furnaces and boilers	—9	—136	—186	—229	—274	—325	—402
Solar, wind and geothermal credits:							
Raise credit rate to 50 percent and extend to the year 2000	—14	—72	—92	—119	—150	—181	—217
Credit to landlords (40 percent)	—4	—21	—28	—36	—45	—55	—66
Eliminate principal residence requirement	([2])	—2	—2	—3	—4	—5	—5
Total	**—69**	**—408**	**—500**	**—610**	**—606**	**—728**	**—899**

Table 6.—Estimated Revenue Effects of Residential Tax Credits Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Calendar Years 1979–90—Continued

[In millions of dollars]

Item[1]	Calendar year liabilities					Total 1979–90
	1986	1987	1988	1989	1990	
Conservation credits:						
Credit for heat pumps						−404
Credit to landlords (10 percent)						−382
Eliminate principal residence requirement						−39
Credit for airtight wood stoves						−180
Credit for coal furnaces (25 percent)						−133
Credit for replacement oil and gas furnaces and boilers						−1, 561
Solar, wind and geothermal credits:						
Raise credit rate to 50 percent and extend to the year 2000	−514	−616	−740	−887	−1, 065	−4, 667
Credit to landlords (40 percent)	−79	−95	−117	−136	−164	−846
Eliminate principal residence requirement	−7	−8	−10	−11	−14	−71
Total	**−600**	**−719**	**−867**	**−1, 034**	**−1, 243**	**−8, 283**

[1] The table contains only items of the committee substitute which involve significant revenue changes.
[2] Less than $1 million.

Table 7.—Estimated Revenue Effects of Residential Tax Credits Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Fiscal Years 1980–85

[In millions of dollars]

Item[1]	Fiscal year receipts					
	1980	1981	1982	1983	1984	1985
Conservation credits:						
Credit for heat pumps	—11	—33	—39	—53	—69	—94
Credit to landlords (10 percent)	—22	—51	—54	—58	—62	—69
Eliminate principal residence requirement	—2	—5	—6	—6	—6	—7
Credit for airtight wood stoves	—22	—56	—54	—48	----------	----------
Credit for coal furnaces (25 percent)	—12	—33	—44	—44	----------	----------
Credit for replacement oil and gas furnaces and boilers	—30	—143	—192	—236	—282	—337

Solar, wind and geothermal credits:						
Raise credit rate to 50 percent and extend to the year 2000	−24	−75	−96	−123	−155	−187
Credit to landlords (40 percent)	−7	−22	−29	−37	−47	−57
Eliminate principal residence requirement	−1	−2	−2	−3	−4	−5
Total	**−131**	**−420**	**−516**	**−608**	**−625**	**−756**

[1] The table contains only items of the committee substitute which involve significant revenue changes.

Table 8.—Estimated Revenue Effects of Business Tax Incentives Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Calendar Years 1980–85

[In millions of dollars]

Item	Calendar year liabilities					
	1980	1981	1982	1983	1984	1985
1. Business energy investment credits: [1]						
Solar and wind property [2]	−30	−57	−94	−221	−344	−449
Geothermal equipment	−24	−28	−31	−34	−37	−40
Ocean thermal equipment				([3])	−3	−3
Small-scale hydroelectric facilities [4]	−5	−10	−15	−19	−23	−29
Cogeneration equipment	−37	−62	−92	−97	−77	−42
Modifications to alumina electrolytic cells	−1	−1	−1	−1	−1	−1
Industrial heat pumps	−5	−7	−9	−10	−8	−5
Petroleum coke and pitch [4]	−43	−50	−56	−60	−58	−53
Biomass equipment	−6	−10	−15	−207	−249	−285
Affirmative commitments			([5])	−448	−358	−202
Total, investment credits	**−151**	**−225**	**−313**	**−1, 097**	**−1, 158**	**−1, 109**

2. Alternative energy production credits	−4	([6])	([6])	([6])	([6])	([6])
3. Production incentives for alcohol used in motor fuels [2]	([3])	([3])	−4	−7	−69	−168
4. Exemption from distilled spirits rules for alcohol fuel	([7])	([7])	([7])	([7])	([7])	([7])
5. Deduction for tertiary injectants	−13	−10	−8	−7	−6	−5
6. Industrial development bonds:						
Hydroelectric facilities	−5	−19	−34	−54	−76	−100
Solid waste disposal facilities	−1	−3	−5	−9	−14	−19
Total, industrial development bonds	−6	−22	−39	−63	−90	−119
Total, noncredit provisions	−19	−32	−51	−77	−165	−292
Total, Business Tax Incentives	−174	−257	−364	−1, 174	−1, 323	−1, 401

See footnotes at end of table.

Table 8.—Estimated Revenue Effects of Business Tax Incentives Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Calendar Years 1986–90—Continued

[In millions of dollars]

Item	Calendar year liabilities					
	1986	1987	1988	1989	1990	Total 1980–90
1. Business energy investment credits: [1]						
Solar and wind property [2]	−495	−548	−605	−669	−739	−4, 251
Geothermal equipment	−43	−46	−49	−53	−57	−442
Ocean thermal equipment	−25	−30	−63	−73	−114	−311
Small-scale hydroelectric facilities [4]	−55	−114	−207	−343	−508	−1, 328
Cogeneration equipment	−13	−6	−1	([3])		−427
Modifications to alumina electrolytic cells	([3])					−12 [8]
Industrial heat pumps	−1	−1	([2])			−46
Petroleum coke and pitch [4]	−52	−58	−63	−68	−74	−635
Biomass equipment	−327	−361	−398	−433	−470	−2, 761
Affirmative commitments	−90	−42	−12	([5])	([3])	−1, 152
Total, investment credits	**−1, 101**	**−1, 206**	**−1, 398**	**−1, 639**	**−1, 962**	**−11, 365** [8]
2. Alternative energy production credits	([6])	([6])	([6])	([6])	([6])	−4

3. Production incentives for alcohol used in motor fuels [2]	−204	−262	−324	−384	−445	−1,867
4. Exemption from distilled spirits rules for alcohol fuel	([7])	([7])	([7])	([7])	([7])	([7])
5. Deduction for tertiary injectants	−5	−6	−6	−6	−7	−79
6. Industrial development bonds:						
Hydroelectric facilities	−126	−163	−208	−274	−361	−1,420
Solid waste disposal facilities	−24	−30	−37	−46	−53	−241
Total, industrial development bonds	−150	−193	−245	−320	−414	−1,661
Total, noncredit provisions	−359	−461	−575	−710	−866	−3,607
Total, Business Tax Incentives	−1,460	−1,667	−1,973	−2,349	−2,828	−14,976 [8]

[1] Neither the regular investment credit changes nor the changes for eligible public utility property are listed as separate items but rather are included in the estimates for the type of property involved.

[2] Includes outlay portion of refundable tax credits, which is treated as a tax cut for the purposes of this table, although not in the bill itself.

[3] Less than $1 million.

[4] This item includes the revenue loss from the business energy credit, changes in depreciation, and changes in the regular investment tax credit.

[5] Less than $5 million.

[6] Based on oil price assumptions used for calculating the windfall profits tax, the average refiners' acquisition price for imported oil will exceed the credit phaseout amount. Without the phaseout the revenue loss for these production credits would be $18 million in 1980, $45 million in 1981, $78 million in 1982, $125 million in 1983, $223 million in 1984, $354 million in 1985, $1,239 million in 1990 and $4,941 million for the period 1980 through 1990.

[7] The revenue loss for this item is included in the estimate of production incentives for alcohol used in motor fuels.

[8] This total includes $6 million in calendar year liability reductions from 1978 and 1979.

Table 9.—Estimated Revenue Effects of Business Tax Incentives Contained in the Crude Oil Windfall Profit Tax Act of 1979 as Reported by the Committee, Fiscal Years 1980–85

[In millions of dollars]

Item	Fiscal year receipts					
	1980	1981	1982	1983	1984	1985
1. Business energy investment credits: [1]						
Solar and wind property [2]	−11	−34	−59	−121	−221	−313
Geothermal equipment	−11	−26	−29	−32	−35	−38
Ocean thermal equipment				([3])	−1	−3
Small-scale hydroelectric facilities [4]	−2	−7	−12	−16	−20	−26
Cogeneration equipment	−17	−48	−75	−94	−88	−61
Modifications to alumina electrolytic cells	−6	−2	−1	−1	−1	−1
Industrial heat pumps	−2	−6	−8	−9	−9	−7
Petroleum coke and pitch [4]	−19	−46	−53	−58	−59	−56
Biomass equipment	−3	−8	−12	−101	−226	−265
Affirmative commitments		([5])	([5])	−202	−407	−288
Total, investment credits	**−71**	**−177**	**−249**	**−634**	**−1,067**	**−1,058**
2. Alternative energy production credits	([3])	**−4**	([6])	([6])	([6])	([6])

3. Production incentives for alcohol used in motor fuels [2]	([2])	([3])	−2	−5	−35	−114
4. Exemption from distilled spirits rules for alcohol fuel	([7])	([7])	([7])	([7])	([7])	([7])
5. Deduction for tertiary injectants	−5	−12	−9	−8	−6	−6
6. Industrial development bonds:						
Hydroelectric facilities	−2	−11	−26	−43	−64	−87
Solid waste disposal facilities	([3])	−2	−4	−7	−11	−16
Total, industrial development bonds	−2	−13	−30	−50	−75	−103
Total, noncredit provisions	−7	−25	−41	−63	−116	−223
Total, business tax incentives	−78	−206	−290	−697	−1, 183	−1, 281

[1] Neither the regular investment credit changes nor the change for eligible public utility property are listed as separate items but rather are included in the estimates for the type of property involved.

[2] In addition to the credits shown here, the outlays associated with all refundable credits are estimated to be $8 million in 1981, $11 million in 1982, $19 million in 1983, $44 million in 1984, and $69 million in 1985.

[3] Less than $1 million.

[4] This item includes the revenue loss from the business energy credit, changes in depreciation, and changes in the regular investment tax credit.

[5] Less than $5 million.

[6] Based on oil price assumptions used for calculating the windfall profits tax, the average refiners' acquisition price for imported oil will exceed the credit phaseout amount. Without the phaseout the revenue loss for these production credits would be $8 million in 1980, $30 million in 1981, $60 million in 1982, $99 million in 1983, $169 million in 1984, and $282 million in 1985.

[7] The revenue loss for this item is included in the estimate of production incentives for alcohol used in motor fuels.

Table 10.—Estimated Budget Effects of Energy Assistance Program for Lower Income Users of Residential Energy

[In millions of dollars]

	Fiscal year		
	1980	1981	1982
Budget outlays for low-income energy assistance	−1, 200	−3, 000	−3, 000
Heating fuel tax credit for lower-income users of residential energy	−1, 232	−1, 916	−1, 697
Total	**−2, 432**	**−4, 916**	**−4, 697**

NOTE: Minus signs indicate revenue reductions and increases in budget outlays.

IV. GENERAL EXPLANATION

A. Windfall Profit Tax

(sec. 101 of the bill and new secs. 4986–95, 6050C, 6076, 6429, and 7241 of the Code)

Present Law

There is no Federal excise tax on oil producers and royalty owners under existing law.

Reasons for Change

Decontrol of oil prices, whether as a result of President Carter's phase out of controls or immediate decontrol in 1981 when the legislative authority for those controls expires, will increase the profits of oil producers and royalty owners significantly. World oil prices have been increasing dramatically over the past months, and President Carter's proposed oil import tariff or quota could raise domestic prices even higher than the world price.

The committee recognizes that while price increases for some oil will encourage additional oil production and exploration, price increases beyond a certain level for other types of oil may not elicit a significant production response. The committee believes, therefore, that there should be a tax on the windfall price increases attributable either to the decontrol of oil prices or to excessive rises in oil prices, and that revenues from this tax should be used to encourage energy production and conservation and to ameliorate the financial impact of those price increases on lower-income households.

To accomplish these goals, the committee substitute is designed to place heavier tax burdens on those categories of oil the production of which is less likely to be affected by a higher tax burden, and with respect to which the price increases are the greatest. Thus, the committee substitute imposes a 75-percent rate of tax on lower tier (old) oil, and a 60-percent rate of tax on upper tier oil. To prevent the shutting-in of some lower tier properties where the production is unusually expensive, the committee substitute would tax marginal properties and high water-cut properties in the more lenient tier two of the tax.

Generally, for categories of oil where the production response is likely to be the greatest, the windfall increases smaller, or production costs greater, the committee has given special tax treatment. Thus, it has exempted newly discovered oil, incremental tertiary oil, and heavy oil production. In addition, because independent producers generally have undertaken a disproportionately large share of domestic exploratory drilling, the committee has decided to exempt up to 1,000 barrels per day of stripper oil produced by independent producers.

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This limited exemption, which applies only with respect to the generally more expensive stripper oil, should encourage independent producers to increase their drilling activities and thereby supplement our domestic oil supply.

In recognition of the fact that it is inappropriate to tax additional revenues which are generated by increases in oil prices that, in turn, are devoted to public uses, the committee substitute exempts oil owned by State and local governments, Indian tribes, and charitable medical facilities and educational institutions.

In designing its tax to accomplish both an increase in energy production and conservation, as well as to decrease the financial impact of oil price increases on the economy, the committee has decided that the tax should phase out after estimated cumulative net revenues exceed $127.1 billion. This is 90-percent of the amount of estimated net revenue which would otherwise be raised by the tax by the end of 1990.

Explanation of Provision

1. Overview

The committee substitute to H.R. 3919, the "Crude Oil Windfall Profit Tax Act of 1979," imposes a windfall profit tax on increases in domestic crude oil prices resulting from the deregulation of crude oil prices or from excessive increases in world oil prices.

The tax will raise $4.6 billion in calendar year 1980, $11.8 billion in 1981, $14.2 billion in 1985, $9.8 billion in 1990 and $138.2 billion over the 11-year period 1980–90. In fiscal year 1980, the net revenue raised will be $2.3 billion.

The windfall profit tax is an excise, or severance, tax applying to crude oil produced in the United States according to its classification in one of three tiers. For oil in tier one, the tax is 75 percent of the difference between the actual selling price of the oil and the May 1979 lower tier, or old oil, ceiling price (which averaged just under $6 a barrel), adjusted for inflation. The tier two tax is 60 percent of the difference between the actual selling price and the May 1979 upper tier, or new oil, ceiling price (which averaged just over $13 a barrel), adjusted for inflation. Between 1986 and 1990, the tier two base price will be increased from $13 to $16 .The tier three tax is 60 percent of the difference between the actual selling price of the oil and $15.30 a barrel, adjusted for inflation and for differences in quality and location.

The windfall profit subject to tax is reduced by State severance taxes on the windfall profit.

To prevent the tax from burdening high-cost properties, the committee substitute also limits the windfall profit subject to tax to 90 percent of the net income from a property.

The tier one tax applies to oil that had been controlled as lower tier oil prior to the President's phased decontrol program but that receives a higher price as a result of decontrol. The quantity of oil subject to the tier one tax on a property is the amount of production from the property below an amount represented by a statutory decline curve. This decline curve initially equals the average daily production of lower tier oil from the property in the period October 1978–March 1979, and this base is reduced by 1½ percent a month beginning January 1979. This decline rate causes the tier one tax to phase out after June 1984. After June 1984, this oil will be taxed in tier two; that is, on price increases above the inflation-adjusted upper tier ceiling price.

The tier two tax applies to oil produced on a property in excess of the amount indicated by the tier one decline curve. Thus, the tier two tax base will include most oil that had been controlled as upper tier oil prior to the decontrol program as well as oil released to tier two through the 1½-percent monthly decline curve. Because of the decline curve, *increases* in production on old properties resulting from

additional drilling, secondary recovery or other methods will generally be taxed under the more lenient tier two tax.

The tier two tax also applies to oil produced from the Sadlerochit reservoir on the Alaskan North Slope, to oil produced from marginal properties, which were given special treatment under the decontrol program, to oil production from properties with a 9:1 water-oil ratio (high water-cut oil), and to any amount of lower tier oil deregulated by DOE to finance tertiary recovery projects.

The tier three tax generally applies to stripper oil owned by integrated oil companies.

To maximize production incentives, the committee substitute exempts certain categories of oil, including newly discovered oil, heavy oil, and incremental oil produced from properties using qualified tertiary recovery methods. The committee substitute also provides an exemption for a limited amount of stripper oil produced by independent producers and royalty owners. In addition, income from interests in oil production owned by State or local governments, or by their instrumentalities, is exempt. A similar exemption is provided for certain oil owned by Indians, and for interests held by charitable medical facilities and educational institutions.

The windfall profit tax is a deductible business expense under the income tax.

The tax would begin to phase out after $127.1 billion of net revenue has been received by the Treasury. The phase out would be accomplished by exempting an additional 3 percent of production for each month after the month when the Secretary of the Treasury determines that the $127.1 billion level will be reached. Thus, the tax will phase out 34 months after the $127.1 billion level of revenue is reached.

2. Tier One

a. *Treatment under price controls*

Old pricing regulations.—Under DOE price control regulations as they stood prior to the President's decontrol program, lower tier oil generally was most oil produced on a property that first began production prior to 1973. Lower tier oil was, and continues to be, subject to a ceiling price equal to the sum of (1) the highest posted field price for that oil on May 15, 1973, (2) $1.35 per barrel, and (3) certain post-1975 increases intended to provide adjustments for inflation and to provide production incentives.

The volume of lower tier oil on a property was determined by computing a property's "base production control level" (BPCL). Oil production above this level was classified as upper tier oil, and production at or below this level was classified as lower tier oil. Prior to recent regulatory changes, a property's BPCL was the lesser of (1) the average daily amount of all oil produced from the property in 1972, or (2) the average daily amount of lower tier oil produced from the property in 1975.

In the case of certain properties, the BPCL could be adjusted downward to project the 1972–1975 rate of production decline on the property. Specifically, under the Department of Energy regulations in effect before June 1, 1979, downward adjustments to the BPCL worked

as follows: if production from the property during the five-month period between February and July 1976 was less than the BPCL during that period, the property qualified for a downward BPCL adjustment beginning July 1, 1976. If upper tier oil was produced between February and July 1976, the property could not qualify for a downward adjustment to its BPCL until the first six-month period following the six-month period in which the property's total production fell below the BPCL. If the property qualified for a BPCL adjustment, the producer could reduce the BPCL every six months at a rate equal to the property's actual 1972–1975 decline rate. Otherwise, its BPCL remained constant. Oil actually produced in excess of the adjusted BPCL was classified as upper tier oil, and was entitled to receive the upper tier price.[1]

Decontrol Regulations.—Pursuant to a rule published by the Economic Regulatory Administration of the DOE on April 12, 1979, a producer may elect to have the BPCL for any property be the average daily production of lower tier oil from the property for the six-month period ending March 31, 1979. For properties for which the producer elects to use this BPCL, the BPCL is reduced by 1.5 percent per month for 1979. The first such adjustment was effective as of June 1, 1979, and was calculated as if the adjustment had become effective January 1, 1979. Therefore, if an election was made for a property, its BPCL was reduced by 9 percent, effective June 1, 1979 (six months × 1.5 percent).

Effective June 1, 1979, the rule eliminated all existing cumulative deficiencies. However, cumulative deficiencies may be built up in the future and will reduce the amount of oil eligible for the upper tier price.

On January 1, 1980, the BPCL decline rate will be increased from 1.5 percent to 3 percent per month. The 3-percent decline factor applicable to 1980 and 1981 will be available to all properties, including those electing not to use the updated BPCL in 1979.

The effect of the DOE pricing decline curve is to phase down the lower tier of price controls so that relatively little lower tier oil (19 percent of the original updated BPCL) will remain just before price control authority expires after September 30, 1981.

Marginal properties.—Under the DOE rule published on April 12, 1979, oil produced from "marginal properties" was established as a new classification of oil generally eligible to receive upper tier prices. Pursuant to this rule, specific properties qualify as "marginal," depending upon the average production level at different average well depths. A property would qualify as marginal if, for calendar year 1978, the average completion depth of all the property's producing wells and the average daily per well production from the property met the following limits:

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[1] Once a property had produced an amount of oil above its adjusted BPCL, if it subsequently produced an amount of oil below the level of its adjusted BPCL, the difference between the actual production and the adjusted BPCL resulted in a "cumulative deficiency." Before a property's production in excess of its adjusted BPCL could be classified as upper tier oil, any amount of oil by which the property fell below its BPCL for all prior months, *i.e.*, its cumulative deficiency, had to be eliminated or "paid back."

Average depth (in feet)	*Average daily production (in barrels)*
2,000, but less than 4,000	20 or less.
4,000, but less than 6,000	25 or less.
6,000 but less than 8,000	30 or less.
8,000 or more	35 or less.

For pricing purposes, on June 1, 1979, the BPCL for a marginal property was reduced to 20 percent of the average daily production of lower tier oil from that property for the last six months of 1978, and the BPCL for marginal properties will be reduced to zero on January 1, 1980. Hence, after June 1, 1979, all production on a marginal property in excess of 20 percent of 1978 old oil production from the property can be sold at upper tier prices. On January 1, 1980, all oil from marginal properties will be eligible for the upper tier price.

To qualify as a marginal property, each well on the property must have been maintained at the maximum feasible rate of production consistent with recognized conservation practices throughout calendar year 1978. In addition, production from each well on the property must not have been curtailed significantly by reason of mechanical failure or other disruption in production.

Front-end financing for tertiary projects.—Under a DOE rule adopted on August 21, 1979, producers who invest in enhanced oil recovery projects are allowed to receive the market price for specified volumes of lower tier oil to finance that investment. Revenue from the sale of this released production ("the tertiary incentive revenue") may not exceed 75 percent of certain specified expenses (excluding the cost of any hydrocarbons) actually incurred for enhanced oil recovery. No more than $20,000,000 of expenses can be recouped with respect to a particular project. However, no limitation is placed on the number of projects for which a producer can recoup expenses through the release of oil to the market price. The rule permits producers to charge market prices for oil produced from properties other than the one in which the enhanced recovery project was located.

b. *Oil in tier one of tax*

Oil taxed in tier one is oil which would have been lower tier oil for pricing purposes had the old pricing regulations been continued. However, some of the oil which would have been lower tier oil under the pre-June pricing regulations is taxed in a higher tier.

All production from certain kinds of properties specifically is exempt from tier one of the tax. These are (1) newly discovered oil properties; (2) stripper oil properties; (3) heavy oil properties; (4) marginal oil properties; and (5) high water-cut oil properties. Although exempt from the tier one tax, certain of these categories are subject to the tier two or tier three tax; others are exempt, *in toto*, from the windfall profit tax.

In addition, on properties not specifically exempt from the tier one tax, a certain amount of production on those properties will be exempt from the tier one tax. Oil deregulated by DOE as front-end financing for tertiary recovery projects is taxed in tier two, not tier one; and special rules apply to properties on which qualified tertiary recovery projects are undertaken. The exemption from tier one for oil deregulated to provide financing for tertiary recovery projects applies only through September 30, 1981, when price controls expire.

Apart from these exceptions, the amount of oil on a property taxed in tier one will be all production up to an amount represented by a linear decline curve. The tier one decline curve will be the same as the decline curve used for phasing out the lower tier of price controls under the DOE regulations issued April 12, 1979, except that the monthly decline rate will be 1½ percent throughout the life of the tier one tax (i.e., until the 1½ percent curve reaches zero after June 1984), instead of accelerating to 3 percent after 1979, which is done to phase out price controls on tier one oil. For tax purposes, producers will compute their decline curves using the 1½ percent monthly decline rate, even if they elect not to use that rate in 1979 for pricing purposes. (Under the new pricing regulations, only a producer who elects the updated BPCL may use the 1½ percent decline rate in 1979.) However, producers would be allowed a property-by-property election to use, for tax purposes, whatever BPCL is elected for pricing purposes. Therefore, a producer who elects to use a BPCL based on 1972 or 1975 production for pricing purposes may compute the tax decline curve with that BPCL.

If total production on the property is less than the amount represented by the 1½-percent monthly decline curve plus any cumulative deficiency built up for tax purposes, all production on the property will be taxed in tier one. If production exceeds the sum of the decline curve and the cumulative deficiency, then an amount of production equal to the amount represented by the 1½-percent decline curve and the cumulative deficiency would be taxed in tier one, and remaining production would be taxed in tier two.

The cumulative deficiency used for tax purposes is the same as that used for pricing purposes except that it involves shortfalls in production below the 1½-percent tax decline curve, not the 3-percent pricing decline curve. However, cumulative deficiencies are disregarded for tax purposes unless the shortfall in production has resulted from an attempt to avoid the tier one tax.

In the case of oil still controlled in the lower tier, the committee expects the Department of Energy to adjust lower tier ceiling prices so that they always will be equal to or less than the tier one adjusted base price, in which case there would be no tier one tax on oil still controlled in the lower tier. (Decontrol of lower tier oil is being accomplished through the use of a special decline curve rather than through increases in the lower tier ceiling price.) However, should the DOE fail to do this, and should the lower tier ceiling price exceed the tier one adjusted base price on a particular property, some oil controlled in the lower tier for pricing purposes could be subject to the windfall profit tax on the (presumably small) gap between the lower tier ceiling price and the tier one adjusted base price.

The House bill definition of tier one oil generally is similar to the committee substitute. However, the House bill would require all producers to use the updated BPCL for the tax decline curve even if they had not elected to use that BPCL for pricing purposes. In addition, the House bill would not eliminate cumulative deficiencies which do not result from attempted tax avoidance. The House bill also would not exempt high water-cut properties from the tier one tax.

c. *Base price and adjustments*

Oil subject to the tier one tax will have an initial base price, determined separately for each property, equal to the May 1979 ceiling price of lower tier oil from the property. May 1979 ceiling prices averaged about $5.91 per barrel. This base price would be adjusted quarterly for increases in the GNP deflator, but the inflation adjustment would be lagged by two quarters. Thus, the first inflation adjustment to the tier one base price would occur for the third quarter of 1979 (July-September) and would be based on the inflation which occurred between the last quarter of 1978 and the first quarter of 1979.[2] (For more detail on the inflation adjustment, see section 8(e) below.)

The determination of the adjusted base price for tier one is the same in the House bill.

d. *Tax rate and computation*

The windfall profit on a barrel of taxable crude oil included in the tier one tax equals the difference between the actual selling price of the oil and the applicable inflation-adjusted base price. However, in computing the windfall profit on oil included in the tier one tax base, the windfall profit subject to tax may be reduced by the amount of any increase in the applicable State severance tax that results from the increased price of oil over the adjusted base price; however, severance tax rate increases after March 1979 may not be taken into account unless the increase applies to the entire price of the barrel of oil. (For more detail on the severance tax adjustment, see section 8(f), below.)

The windfall profit tax on oil in tier one is 75 percent of the difference between the selling price and the sum of the adjusted base price and the severance tax adjustment.

The House bill would impose a 60-percent tax on tier one oil and would not permit an adjustment for any post-March 31, 1979, increases in State severance taxes.

3. Tier Two

a. *Treatment under price controls*

Under DOE regulations, upper tier oil is the amount of oil produced from a property in excess of its adjusted BPCL, less the amount of any cumulative deficiency. This includes all production from properties which first began production after 1972, including oil from the Sadlerochit reservoir in Prudhoe Bay on Alaska's North Slope (within the meaning of section 2(36) of the Natural Gas Policy Act of 1978). However, it does not include oil produced from a stripper property, newly discovered oil, certain heavy oil, or incremental production from a qualified tertiary enhanced recovery project.

The DOE rule published on April 12, 1979, established oil produced from "marginal properties" as a new classification of oil generally

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[2] More precisely, if B_0=the May 1979 lower tier ceiling price on a property and P_i=the GNP deflator in the ith quarter, the adjusted base price in the ith quarter (B_i) is $B_i = B_0 \left(\frac{P_{i-2}}{P_{1978\text{-}4}}\right)$

eligible to receive upper tier prices (see description of marginal properties in section 2(a) above).

Generally, the ceiling price for upper tier oil from a property is the highest posted field price for uncontrolled oil on September 30, 1975, less $1.32 per barrel, plus certain post-1975 increases intended to offset inflation. (The Energy Policy and Conservation Act of 1975 (EPCA) required a rollback of the upper tier ceiling price.) The estimated average May 1979 ceiling price per barrel of upper tier crude oil was $13.02.

The Administration has proposed eliminating upper tier oil between January 1980 and October 1981 by increasing the amount of upper tier oil which can be sold at the market price. For the period beginning January 1980, 4.6 percent of upper tier oil on each property would be deregulated. In each succeeding month, ending October 1, 1981, an additional 4.6 percent would be deregulated.

b. *Oil in the tier two of tax*

The oil included in tier two of the tax would be (1) oil production on a property in excess of the amount represented by the 1½ percent monthly decline curve; (2) oil from properties where production started between 1972 and 1979, including production from the Sadlerochit reservoir in Alaska; (3) production from marginal properties; (4) production from high water-cut properties; and (5) oil deregulated by DOE as front-end financing for tertiary recovery projects. Incremental tertiary oil, certain heavy oil, newly discovered oil and stripper oil would not be subject to the tier two tax.

The tier two treatment for oil deregulated by DOE as front-end financing for tertiary recovery projects applies only to the specific barrels of oil deregulated, not to any subsequent production from the property. Thus, this rule will not apply after the termination of price controls in October 1981.

The committee substitute provides that production from a property transferred after 1978 may not qualify as marginal if it could not have qualified prior to the transfer.

High water-cut oil.—Under the committee substitute, tier two of the tax includes production from "high water-cut" properties that otherwise would have some oil classified as tier one oil.

For tax purposes, high water-cut oil is production from a property on which the average water-oil ratio for all wells was at least 9 to 1 for any consecutive 12-month period beginning after 1977. In addition, to qualify as a high water-cut property, each well on the property must have been maintained at the maximum feasible rate of production consistent with recognized conservation practices throughout the 12-month measuring period. Furthermore, production from each well on the property must not have been curtailed significantly by reason of mechanical failure or other disruption in production. (See section 8(i) below.)

To qualify as a high water-cut property, the producer must maintain adequate records to substantiate the average per well water-oil ratio for the 12-month measuring period.

Once this 9 to 1 ratio has been met for a 12-month period, the property would be classified as a high water-cut property for all periods thereafter.

The committee substitute also provides that production from a property transferred after 1978 may not qualify as high water-cut oil if it could not have qualified prior to the transfer.

The House bill is the same as the committee substitute except that the House bill does not include Sadlerochit oil in tier two and does not contain any special treatment for high water-cut oil. Also, the House bill merged tier two with tier three after 1990, while the committee substitute retains two separate tiers until the phase out of the entire tax occurs. (See section 16 below.)

c. *Base price and adjustments*

The base price for oil included in tier two, including oil produced from the Sadlerochit reservoir in Alaska, is the May 1979 ceiling price of upper tier oil for each property. May 1979 ceiling prices averaged about $13.02 per barrel. This base price, with respect to which any windfall profit is measured, is adjusted quarterly for increases in the GNP deflator in exactly the same manner as the tier one base price. (For more detail on the inflation adjustment, see section 8(e) below and footnote 2 above.)

The base price for Sadlerochit oil, after taking into account the quarterly increase in the GNP deflator, would be increased to reflect any decrease in the amount of the Trans-Alaskan Pipeline System (TAPS) tariff for the previous quarter below $6.26 per barrel (the 1979 level). The $6.26 amount would not be adjusted for inflation.

The committee substitute also provides an upward adjustment to the tier two base price between November 1986 and December 1990. The adjustment will be 6 cents per barrel for each month after October 1986. Thus, after 1990, the average tier two base price will equal $16.00.

The House bill differs from the committee substitute in several respects. The upward adjustment to the tier two base price would be determined by the Secretary of the Treasury under the House bill rather than be a flat 6 cents per month. The flat 6-cent monthly adjustment is a simplification. The adjusted tier two base price will be the same after 1990 under both the House bill and the committee substitute. The House bill would provide a $7.50 base price for Sadlerochit oil, instead of the usual upper tier base price. This base price for Sadlerochit oil would be adjusted for the inflation and for changes in the real value of the TAPS tariff (*i.e.*, the difference between the actual tariff and $6.26 adjusted for inflation).

d. *Tax rate and computation*

The windfall profit tax on oil subject to the tier two tax is 60 percent of the amount by which the price of a barrel of oil exceeds the sum of its adjusted base price and the severance tax adjustment. In computing the tax base, producers may reduce the windfall profit by the amount of any State severance tax attributable to the increase in price of the barrel of oil over the adjused base price; however, severance tax rate increases after March 1979 cannot be taken into account unless the increase applies to the entire price of the barrel of oil. (For more detail on the severance tax adjustment, see section 8(f) below.)

In the case of Sadlerochit oil, the tier two tax would be calculated on the basis of average monthly removal prices for each producer. The average wellhead price for each producer is used in lieu of the

actual sale price of each particular barrel of oil to make sure that wellhead price differentials attributable only to the final destination of a particular barrel of Alaskan oil do not affect windfall profit tax liabilities. (Unlike other oil, North Slope oil will have a range of wellhead prices in a particular month depending on the final destination of the oil because each integrated producer determines the wellhead price for each barrel by subtracting transportation costs from the price of the oil at the refinery gate.)

The computation of the tax under the House bill would be the same as in the committee substitute, except that the tax on Sadlerochit oil in the House bill would be at the rate of 50 percent on increases above a $7.50 base price, adjusted for inflation and changes in the real value of the TAPS tariffs. In addition, the House bill would not provide a severance tax adjustment for Sadlerochit oil.

4. Tier Three—Stripper Oil

Tier three oil consists of two categories of oil that are not now subject to price controls. These categories are (1) oil produced from stripper well properties, *i.e.*, those properties where the average daily production per well has been 10 barrels or less per day during any consecutive 12-month period after 1972, and (2) oil produced on the Naval Petroleum Reserve.[3]

a. *Treatment under price controls*

The Trans-Alaska Pipeline Authorization Act provided a statutory exemption from price controls for the first sale of crude oil produced from stripper well leases. For this provision, a stripper well lease was defined to mean a property whose average daily production during the preceding calendar month did not exceed the qualifying limits set by the statute. This test for stripper well lease qualification was modified by the Emergency Petroleum Allocation Act of 1973 from one based on production levels during the preceding calendar month to one based on production levels during the preceding calendar year. EPCA reimposed controls on stripper oil, but the Energy Conservation and Production Act once again exempted stripper oil from controls. However, it provided that to qualify for this exemption a property's average daily per well production of crude oil (excluding a condensate recovered in non-associated production) could not exceed 10 barrels per day during any consecutive 12-month period beginning after December 31, 1972. This definition of stripper oil is still in effect.

The reason for the stripper property exemption was to prevent the early shutting-in or abandonment of properties which might be uneconomic under existing price controls in light of their level of production and operating costs.

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[3] Production from the Naval Petroleum Reserve is owned by the United States, as is oil production from various other Federal enclaves. Production from the Naval Petroleum Reserve is not subject to price controls and, therefore, is subject to the tier three tax. These tax revenues would not change the Federal unified budget deficit because the government would, in effect, be paying a tax to itself and are not included in the revenue estimates in this report.

To qualify under the stripper exemption a property must be operated at the maximum feasible rate of production which is consistent with recognized conservation practices. However, once a property has qualified as being within the exemption, it retains that status regardless of any future increase in the level of its production.

b. *Oil in tier three of tax*

Tier three includes oil produced on the Naval Petroleum Reserve and stripper oil. Stripper oil is oil produced on properties on which the average daily production per well has been 10 barrels or less for any consecutive 12-month period after 1972. All oil that qualifies for stripper treatment under the standards of the price control regulations in effect on June 1, 1979, is included in tier three with two exceptions. The first exception relates to cases in which a nonstripper property is divided into several properties and one or more of the new properties qualifies as a stripper property for pricing purposes. If the entire property would not have qualified for stripper treatment prior to the transfer, then none of the subdivisions are eligible for the tier three tax, and they must instead follow the general tier one and tier two rules. (See section 8(b) below for a discussion of the transfer rule.) The second exception is an exemption from tax for certain stripper oil produced from properties in which independent producers have an economic interest. (See section 4(e) below for a discussion of this exemption.)

c. *Base price and adjustments*

The base price for oil included in tier three generally is the estimated price, to be prescribed by Treasury regulations, at which uncontrolled crude oil of the same grade, quality, and location would have sold in September 1979 if the average landed price for imported crude oil were $15.30 a barrel. This base price is adjusted for inflation in exactly the same manner as the tier one and two base prices.

The windfall profit is the difference between the selling price and the sum of the adjusted base price and the severance tax adjustment. (For more detail on the severance tax adjustment, see section 8(f) below). Use of this variable $15.30 formula is intended to take quality and location differentials into account in measuring the windfall profit. The Secretary of the Treasury will publish a schedule of tier three base prices for various classifications of oil based on quality, grade and location differentials. This schedule could, for example, be based on the price of uncontrolled oil in various oil fields in a particular month in 1979, adjusted to achieve an average price comparable to $15.30.

The House bill used a $16.00 base price for tier three but began the inflation adjustment two quarters later. The $15.30 base price with two additional quarters of inflation adjustment is exactly equivalent to the House bill's $16.00 base price, but it will simplify the tax by allowing the same inflation adjustment for all three tiers.

d. *Tax rate and computation*

The windfall profit on a barrel of crude oil included in the tier three tax base is subject to a 60-percent tax. The amount of the windfall profit may be reduced by the amount of any State severance tax attributable to an increase in the price of the barrel of oil sold over the adjusted base price; however, increases in tax rates after March 31,

1979, are not taken into account, unless such increases apply to the entire price of the barrel of oil.

e. *Exempt stripper oil*

Overview.—The committee substitute contains two provisions relating to an exemption for a limited number of barrels of stripper oil owned by taxpayers who are not integrated oil companies. The first of these provisions pertains to situations in which independent producers (within the meaning of section 613A) hold more than 50 percent of the working interests in a stripper property; the second provision is concerned with stripper properties with respect to which more than 50 percent of the working interests are held by persons other than independent producers. In either instance, the maximum aggregate exemption available to any party under the combined provisions is 1,000 barrels per day.

The provision of the committee's substitute that relates to stripper properties controlled by independent producers focuses on the status of the *property*, and is referred to as the "qualified property" exemption; the provision that relates to stripper properties not controlled by independent producers focuses on the status of a person vis-à-vis the property, and is referred to as the exemption for production from a "nonqualified property."

If exactly 50 percent of the working interests in a stripper property are held by independent producers, the committee substitute provides that 50 percent of the property's production is considered to be from a qualified property.

Qualifying properties.—A qualified property is one on which independent producers own more than 50 percent of the working (*i.e.*, operating) interests both on October 24, 1979, and in the taxable period in question. (While independent producers would have to own more than 50 percent of the working interests to have the property qualify for the exemption, the property could be operated by a party who was not an independent producer.) Transfers of interests in a property would not affect entitlement to the exemption except to the extent they cause a property to fail the 50-percent test in any given period. For example, if a property was owned 51 percent by independent producers on October 24, 1979, and later was sold to an integrated company, independent producers could acquire the property later and qualify for the exemption as long as the property was a stripper and they owned more than 50 percent of the working interest during the taxable period for which the exemption is sought.

For purposes of the qualified stripper property exemption, the rules of section 613A (relating to eligibility for percentage depletion) apply to determine who qualifies as an independent producer. Thus, if a producer or related persons refine more than 50,000 barrels of crude oil on any day in the taxable year or sell more than $5,000,000 annually of oil or natural gas or products therefrom through retail outlets or under trademarks or tradenames, the producer would not be considered an independent producer. In the case of a working interest owned by a partnership, for purposes of determining whether the property qualifies, the interest would be treated as being owned proportionately by each of the partners. Thus, if the entire working interest in a property is owned by a partnership, whether the property

qualifies for exemption will depend on whether more than 50 percent of the interests in the partnerships are owned by independent producers.

A working interest is an interest in crude oil that must pay the costs of production or would have to pay such costs if the well were in production. Such interests generally would be those in respect of which the costs of production must be taken into account in computing the net income limit on percentage depletion. The term does not include royalty interests or similar interests such as production payments or net profits interests.

If the property qualifies for less than the entire taxable period, then the exemption for that period must be prorated. This could occur, for example, if the working interests in a partnership shift from more than 50 percent independent ownership to more than 50 percent ownership by integrated companies.

The Secretary is authorized to provide regulations to ensure that the benefit from the exemption is not reduced as a result of unitization in cases when a qualified stripper property is unitized with non-qualified properties. (See section 8(c), below.)

In addition to the 50-percent independent ownership requirement that must be satisfied to qualify for the exemption, a property also must be operated at the maximum feasible rate of production consistent with recognized conservation laws during the 12-month period in which its average daily per well production was 10 barrels or less. (See section 8(i), below.)

If the property meets the requirements to be classified as a qualified stripper property, the committee substitute would exempt the interests of each independent producer and royalty owner in up to 1,000 barrels per day per taxpayer. (The 1,000 barrel amount is the sum of the allowable exemption from both qualified properties and other stripper properties.)

If a property qualifies for the exemption, the operator would certify that fact to the Secretary and to the first purchaser of production from the qualified stripper property, and the purchaser would not be required to withhold any tax from the purchase price. However, some owners of production from an exempt property may be required to file quarterly returns and pay tax on some or all of their share of production. Specifically, an integrated oil company (*i.e.*, one defined as not eligible for percentage depletion under section 613A) would be required to pay the tier three tax with respect to its entire interest in production from qualified stripper properties. Because the first purchaser will not withhold any tax on this production, the integrated company would be required to file quarterly returns, make estimated tax payments, and pay the tax under the generally applicable rules (see section 11 below).

Independent producers and royalty owners are exempt from tax with respect to the first 1,000 barrels a day of aggregate production from qualified properties. To the extent that an independent producer or royalty owner receives more than an aggregate of 1,000 barrels a day from qualified properties, the tier three tax would be payable on the excess. For example, an independent producer with an economic interest in 1,200 barrels per day of stripper production would have to file a quarterly return and pay a tax equal to one-sixth of the tax

on the entire 1,200 barrels per day. The filing of returns, making of deposits and payment of tax on the excess would be subject to the generally applicable rules, except that deposits with respect to the excess barrels would be due by 45 days after the end of the quarter. In the case of a partnership with an integrated company as a partner, the integrated company would continue to be subject to the normal estimated payment rules, and would not be exempt.

For purposes of determining whether a taxpayer has received more than 1,000 barrels a day of qualified stripper production, the rules provided in section 613A(c) relating to percentage depletion and businesses under common control and members of the same family would apply. Thus, components of a controlled group and business entities under common control, if otherwise eligible, would be treated as one taxpayer entitled to one exemption for 1,000 barrels a day of exempt oil to allocate among themselves.

If exactly 50 percent of the working interests in a stripper property are held by independent producers, the committee substitute provides that 50 percent of the property's production is considered to be from a qualified property. When this special 50-percent rule applies, the allocation of production subject to the exemption must be made in proportion to all economic interests in the property, including those held by integrated companies. For purposes of this special rule, independent producers must have held 50 percent or more of the working interests on October 24, 1979, and 50 percent of those interests in the taxable period for which the exemption is sought.

Non-qualifying properties.—The committee substitute also provides a more limited exemption for independent producers on nonqualifying stripper properties, *i.e.*, ones on which integrated companies own more than 50-percent of the working interests. This exemption applies *only* to independent producers who are actively engaged in the trade or business of producing oil and gas. It does not apply to passive investors, *e.g.*, limited partners in drilling funds, regardless of whether they hold operating interests or are considered to be in a trade or business for other purposes of the Internal Revenue Code. In addition, it does not apply to royalty owners or to others who hold nonoperating interests.

One possible test for whether an independent producer is actively engaged in the trade or business of producing oil and gas would be the relationship of the taxpayer's gross income from all sources to gross income from producing oil and gas. For example, an independent producer with 25 percent or more of his or her gross income from oil and gas production generally would be in the active trade or business of producing oil and gas for purposes of this exemption. It would not be necessary, of course, for all of the taxpayer's gross income to be from the property in question, or even that the taxpayer have net income from that property. A taxpayer not determined to be actively engaged in the trade or business of producing oil and gas according to the percent-of-gross-income test could, of course, qualify under some other test included in the regulations.

Independent producers on nonqualifying stripper properties may be eligible for an exemption from tax with respect to 1,000 barrels of oil per day. However, in determining eligibility for this exemption, each independent producer must take into account any exemption

provided with respect to a qualifying stripper property, *i.e.*, only an aggregate of 1,000 barrels per day is eligible for exemption under the combined provisions.

For purposes of this exemption, the independent producer's interest in the nonqualifying property must not have been held by an integrated oil company on October 24, 1979. Therefore, if the independent producer derived the interest in question from another independent producer or nonintegrated company that held that interest on October 24, 1979, the exemption would be available, assuming that all other requirements are satisfied, even if an integrated company held that interest at sometime during the interim.

When an integrated company holds 50-percent or more of the working interest in a stripper property, the generally applicable rules pertaining to tax withholding, deposits, and returns apply. In such an instance, any independent producer who qualifies for an exemption with respect to production from such property must file for a tax refund after the close of the taxable year. In the case of a partnership, a refund attributable to this exemption, i.e., to an independent producer's interest in a stripper property controlled by an integrated oil company, would be determined in proportion to interests of those partners who are independent producers and who are actively engaged in the trade or business of producing oil and gas. Thus, if 30 percent of the interests in a partnership were owned by persons actively engaged in the trade or business of producing oil and gas (other than major oil companies), the partnership would be exempt on 30 percent of its oil production from nonqualifying stripper properties. The partnership would file for the refund in such a case.

The House bill would not exempt any stripper oil from the tier three tax.

5. Newly Discovered Oil

a. *Treatment under price controls*

Under regulations published on May 2, 1979, "newly discovered oil" is defined as crude oil that is sold after May 31, 1979, and that is produced from (1) an outer continental shelf area for which the lease was entered into on or after January 1, 1979, and from which there was no production in calendar year 1978, or (2) an onshore property from which no crude oil was produced in calendar year 1978. Oil produced from a property, as defined by DOE regulations, which previously had been developed but from which there was no production in calendar year 1978 is treated as newly discovered oil under this definition. The determination of whether crude oil production from a particular property may be sold as newly discovered crude oil on or after June 1, 1979, is to be made by the producer, subject to DOE's possible review.

Newly discovered oil sold after June 1, 1979, is allowed the market price.

b. *Definition and tax exemption*

For windfall profit tax purposes, the term "newly discovered oil" has the same meaning given to that term by DOE's May 2, 1979, regulations. Under the committee substitute, newly discovered oil is exempt from the tax.

For purposes of the exemption, newly discovered oil includes production from a property (including the Lisburne and Kuparuk formations in the Prudhoe Bay oil field) which did not produce oil in commercial quantities during calendar year 1978. Thus, it would include production from a property on which oil was produced in 1978 if that production was incident to the drilling of exploratory or test wells and not part of continuous or commercial production from the property during 1978.

The committee substitute also provides that production from a property transferred after 1978 may not qualify as newly discovered oil if production from the property prior to the transfer could not have qualified as newly discovered oil.

Under the provisions of the House bill, newly discovered oil generally has the same meaning as that contained in the committee substitute. However, the House bill excludes from the definition of newly discovered oil production from properties that produced oil in commercial quantities after 1969 and before 1979, and oil produced from certain reservoirs that were penetrated after 1969 and before 1979 ("behind-the-pipe" oil).

Under the House bill, sales of newly discovered oil would be taxed on price increases above a base price of $17. The tax rate would be 50 percent on the first $9 of windfall profit, and 60 percent on price increases above $9. A severance tax adjustment would be allowed only with respect to the windfall profit taxed at the 60-percent rate. Both the $17 base price and the first $9 of windfall profit would be adjusted for inflation plus 2 percent. The tax on newly discovered oil would terminate after 1990.

6. Qualified Tertiary Enhanced Recovery Projects

a. *Treatment under price controls*

Under DOE regulations, first sales of incremental crude oil resulting from the implementation or expansion of a "qualified tertiary enhanced recovery project" are exempted from the otherwise applicable ceiling price limitations. A qualified tertiary enhanced recovery project is one that involves one or more of several specified chemical, fluid, or gaseous recovery techniques and that would be uneconomic at the otherwise applicable ceiling price. The following nine specific techniques qualify as tertiary recovery: (1) miscible fluid displacement, (2) steam drive injection, (3) microemulsion or micellar emulsion flooding, (4) in situ combustion, (5) polymer augmented flooding, (6) cyclic steam injection, (7) alkaline or caustic flooding, (8) carbon dioxide augmented water flooding, and (9) immiscible carbon dioxide displacement.

Producers may self-certify their projects if they employ certain of the processes listed above;[4] otherwise, the project must be approved in advance by DOE.

In the case of a new tertiary project, incremental tertiary oil is the amount produced in excess of the amount that could have been pro-

[4] The processes eligible for self-certification are (1) miscible fluid displacement, (2) unconventional steam drive injection, (3) microemulsion flooding, and (4) in situ combustion.

duced from the property through maximum feasible production from the ordinary recovery method used prior to certification. In the case of an expansion of an existing project, the incremental tertiary oil is the amount produced as a result of the expansion over the amount that could have been produced through maximum feasible production from the use of the pre-expansion recovery methods. In the case of a tertiary project that antedated the DOE regulations, incremental tertiary oil is that amount produced by continuing either the project, or a high-cost phase of the project, in excess of the amount that could have been produced through maximum feasible production from methods other than the tertiary method, or any phase thereof, which would be discontinued in the absence of a price incentive.

b. *Explanation of exemption from tax*

Under the committee substitute, incremental tertiary oil production would be exempt from the windfall profit tax. For this purpose, incremental tertiary oil is the amount of production from a project area, on which the producer uses a qualified tertiary recovery method, in excess of the base level amount for the project. The base level is the average daily amount of oil removed from the project area during the six-month period ending March 31, 1979, reduced by the sum of: (1) the greater of (i) one percent of that average amount for each month beginning after 1978 and before the beginning date of the project, or (ii) the actual average monthly decline rate for the project area for each post-1978 month before the beginning date of the project, multiplied by the number of months after 1978 and before the beginning date, and (2) 2½ percent for each month thereafter.

If, in connection with its deregulation of incremental tertiary production, DOE determines that the incremental production resulting from the tertiary project exceeds the amount in excess of the statutory decline curve used for tax purposes, then the larger amount determined by DOE qualifies as incremental tertiary oil under the tax. If a certification (other than a self-certification) is obtained from DOE prior to the effective date of the tax, the 2½ percent decline rate may be used for all months subsequent to the commencement or expansion of the project (or, if the project began before 1979, all months subsequent to December 1978) if that decline curve is more favorable than the one determined by DOE.

If a qualified tertiary recovery project affects only a portion of the property, that portion is to be treated as a separate property, with an appropriate proration of its base level. (The portion not affected by the project also would be treated as a separate property, with a corollary allocation of its base level.) Similarly, if a pre-existing tertiary recovery project is expanded significantly, the expansion is to be treated as a separate project. If a project affects more than one property, the base level for the project is to be computed with respect to all of the affected properties under the rules generally applying to unitized properties (see below in section 8(c)). In determining the base level with respect to which the incremental production from a tertiary recovery project is measured, therefore, it may be necessary to allocate the base level of a single property or to combine the base levels of more than one property. In all instances, it will be necessary to maintain the

appropriate records to substantiate the computation of the base level with respect to which the incremental tertiary oil is measured, both for that purpose and for purposes of re-establishing a previously existing BPCL in the event that a qualified tertiary project is discontinued under circumstances that no longer entitle the production to be treated as incremental tertiary oil (see Continuing Qualification, below).

The special 2½-percent decline rate with respect to which the incremental tertiary oil eligible for exemption is measured commences as of the project's beginning date and continues only during the period for which a qualified tertiary recovery method continues to be used. The 1-percent monthly decline for months beginning after 1978 applies to months before the project's beginning date; the 2½-percent monthly decline applies for each month thereafter.

Generally, if the project is discontinued, oil production from the property no longer is eligible for exemption under this provision. However, special rules may apply to allow the exemption in certain instances (see Continuing Qualification, below).

The project's beginning date, *i.e.*, the time after which production may qualify for the exemption, must be established by the producer's records. Generally, the beginning date is the later of (1) the date of submission to the Secretary of the producer's regulatory or self-certification, or (2) the date on which the tertiary injectant initially is introduced into the reservoir. Thus, some production may be exempted prior to the time at which the producer could establish that the tertiary method has affected the reservoir. Nevertheless, the project will not be considered to have commenced if the tertiary injectant is utilized merely on a pilot or experimental basis. Similarly, mere preparation or planning for the tertiary process, such as drilling an injection well, would not be sufficient to establish the project's beginning date.

Prior to the phase out of the tier one decline curve in July 1984, producers using qualified tertiary methods will have to calculate two decline curves: the generally applicable 1½-percent tier one decline curve based on the production of lower tier oil in the six-month period ending March 31, 1979, and the special tertiary decline curve based on production of all oil in the project area for that period. Producers first will calculate how total production would have been divided between the tiers in the absence of any special rule for tertiary projects, using the 1½-percent decline curve. They then will use the special tertiary decline curve to measure how much oil will be exempted. The exempted oil comes pro rata from each category of production which had been produced from the property prior to the commencement of the project. To determine exactly which barrels from each category are exempted, the producer first releases oil from each category in order of its removal price, starting with the barrel with the highest selling price.

c. *Qualifying projects*

Overview.—For tax purposes, a qualified tertiary recovery project either is a project with respect to which specified requirements are certified by the producer as having been satisfied, or a project with respect to which a regulatory certification is in effect. Regulatory certifications that entitle a project's production to be exempted include

those furnished by the Economic Regulatory Administration (ERA) of DOE, the U.S. Geological Survey, and any supplied by a regulatory body designated for that purpose by the governor of the State in which the project is located. In the case of DOE certifications, only those furnished by ERA are considered to be regulatory certifications. Thus, a DOE certification of a project under the pricing rules pertaining to incremental tertiary recovery projects is not to be treated as a regulatory certification for tax purposes if the project's pricing status was based on a self-certification by the producer.

Generally, a tertiary project that has not been preceded by secondary recovery methods would not meet the tax's requirements unless the certification set forth an explanation of why such action was in accord with sound engineering principles.

Self-certification.—If a regulatory certification is not in effect, a project may qualify if it meets the following specifications: (1) it involves the application of one or more tertiary recovery methods, (2) the methods are applied in accordance with sound engineering principles, (3) the application of the tertiary methods reasonably can be expected to result in a significant increase in the amount of oil that ultimately will be recovered from the property, or the project area, above the amount that reasonably could be expected to be recovered in the absence of the project, (4) the project's beginning date is after May 1979, and (5) the operator submits to the Secretary such information, forms, and certification (including any certification as to continuing qualification) as may be required by regulations.

Regulatory certification.—As an alternative to self-certification, producers may have tertiary projects certified by a competent governmental regulatory body. In the case of projects located on land under Federal jurisdiction, projects could be certified by either the U.S. Geological Survey or pursuant to an approved DOE application. Other projects could be certified by an appropriate State agency designated by the governor of the State in which the project is located. If a State agency is to certify projects, the Secretary must be notified by the governor. If no State regulatory body is designated by the governor to certify projects within 180 days of of the effective date of the tax, producers with projects located in such jurisdictions could have the projects certified by the U.S. Geological Survey. By an "appropriate State agency," the committee means one that is authorized by State or local law to administer generally applicable regulatory or tax provisions pertaining to mineral or oil production if the State has such an agency.

A regulatory certification would be effective for purposes of qualifying the production from the project area for the exemption if it establishes the following: (1) the project involves a tertiary recovery process, (2) the project is implemented and operated in accordance with sound engineering principles, (3) the project area is delineated such that the property is that area from which the ultimate recovery of crude oil reasonably can be expected to be enhanced as a result of the implementation and operation of the tertiary project, and (4) the operator submits to the Secretary such information, forms, and regulatory certifications as may be required for tax purposes, including a certification that the regulatory approval has not been revoked and that the project continues to meet the tax's requirements.

The use of regulatory certifications is intended, in part, to eliminate the need for duplicative proceedings, to give producers some additional certainty as to the qualifications of a project, and to reduce the *de novo* review obligations of the Internal Revenue Service. Because many jurisdictions require producers to obtain regulatory approval, and/or compulsory unitization, prior to the undertaking of a tertiary project, the use of regulatory certifications should advance these objectives.

Other rules.—Production from a tertiary recovery project will not be given an exemption if the producer uses the project merely as a method of accelerating (as opposed to increasing) the total amount of oil expected to be recovered from the property or project area. The requirement that the tertiary project be expected to increase production from the property could be satisfied by showing that the project would reduce the decline in production significantly below what it otherwise would be; that is, an actual increase in production over earlier levels is not necessary. In addition, qualification under these provisions is to focus initially on the project area involved rather than upon the property's production prior to the implementation of the project. As a result, it is unnecessary to demonstrate that production from the property (or project area) would be uneconomic in the absence of the tertiary project. Instead, it must be established that the overall amount of production expected to be obtained from the property (or project area) with the use of the tertiary process is significantly greater than the corresponding amount of oil production expected under pre-project conditions. Such a showing could be accomplished, for example, by comparing the total projected tertiary production with the overall amount indicated by the property's (or project area's) decline rate.[5]

In the case of a self-certified project, to qualify for the exemption the producer must submit to the Secretary a certification from a petroleum engineer that the project meets, and continues to meet, all the necessary requirements, and continues to involve use of an approved method in a sound manner, as well as any other information which the Secretary may require by regulations. Such a certification submitted by the operator must include the specifications of the project, including the tertiary method to be applied, an identification of the area to be affected, supporting geological and engineering data, and other information sufficient to establish that all requirements for a qualified tertiary enhanced recovery project are satisfied.

Sound engineering principles.—To qualify for the incremental tertiary oil exemption provided under the committee substitute, the

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[5] If the life of the tertiary project, *i.e.*, the period during which production might be expected to be affected by the process, is shorter than the expected producing life of the property (project area), then only the correspondingly reduced production projection may be used. (Once the life of the tertiary process ceases, and production no longer is affected, the qualifications necessary for preferential tertiary treatment may or may not be satisfied. For example, they could continue to be satisfied if another tertiary process replaced the originally approved process and if the substituted tertiary project otherwise satisfied the tax's criteria, including the certification requirement. Similarly, a project could be considered to remain in effect after the termination of a tertiary process previously certified by a regulatory body if the discontinued process, in turn, was certified as being ineffective or counterproductive.)

project must involve a tertiary process that is selected, applied, and continued in accordance with recognized and sound petroleum and reservoir engineering principles. Generally, these principles require a thorough examination of the particular formation in question, its geological characteristics, permeability, reservoir pressure, and current and projected productivity ratios. Most frequently, these principles also may require viscosity, pressure build-up, and sweep efficiency analyses. In addition, they clearly necessitate a comparative examination of various stimulative methods, based on formation type, and statistical data relating to actual and projected well performances, process costs, and anticipated investment return under reasonable assumptions of future oil prices.

An example of a project implemented and operated in accordance with sound engineering principles would be a project that is planned, implemented, and operated under the direct supervision of a qualified petroleum or reservoir engineer experienced in enhanced oil recovery engineering and that applies the tertiary technique in a manner that generally is recognized in the professional literature of engineering as likely to increase the amount of oil that can be recovered economically from the property.

Because sound engineering principles generally require implementation of secondary recovery processes, *e.g.*, waterfloods or gas injection, prior to the undertaking of more enhanced recovery methods, a project ordinarily would not qualify under the tax if it had not been preceded by secondary techniques. However, such a project could qualify for tax purposes if the absence of secondary methods were explained adequately, and was due to peculiar characteristics of the reservoir or oil.

Certification revocation.—A certification issued by a regulatory body after a review of the producer's application would remain effective for tax purposes, unless (1) a material fact was misrepresented by the producer or its agent in obtaining the certification, or (2) the project was not implemented and operated in a manner reasonably consistent with the plan upon which the certification was based. If either of these facts is established, a revocation of the project's tax certification, and hence its exemption, may be retroactive. However, if the project was implemented and operated initially in a manner reasonably consistent with the plan upon which the certification was based, and subsequently was modified in a nonqualifying manner, a revocation would be effective only as to the date of the nonqualifying modification. In the case of a self-certified project, including one under DOE jurisdiction which was not reviewed by the Economic Regulatory Administration, the project could be found to be nonqualifying from its inception if, upon a review, the producer failed to establish that the project initially met and continued to meet the tax's requirements.

Continuing qualification.—Generally, the exemption is available only so long as a qualifying tertiary recovery method continues to be used in the project. Depending upon the particular tertiary process involved, this may not require that a specific tertiary substance be injected continuously. This rule was adopted, in part, because some tertiary processes, *e.g.*, cyclic steam injection, do not require continuous

injection from the surface in order to be implemented and operated in accordance with sound engineering principles. It does necessitate, nevertheless, that the particular process involved be implemented and operated in a manner that is consistent with sound engineering principles intended to increase the ultimate production expected from the property (or project area).

To minimize the possibility of discouraging producers from implementing a risky tertiary project that turns out *ex post* not to enhance the ultimate production obtained from the property, the exemption would continue to apply after the termination of a tertiary project which previously was certified by a regulatory body if the discontinued process, in turn, was certified by that body to be ineffective or counterproductive. To retain qualification for a project previously certified by a regulatory body after the termination of the use of an approved tertiary process, the following requirements must be satisfied:

(1) the project must have been implemented and operated in accordance with sound engineering principles;

(2) the project must have been implemented and operated in accordance with the regulatory approved plan, or an approved modification of such a plan;

(3) the regulatory approval must not have been revoked;

(4) the discontinued process must be certified by a petroleum engineer as being ineffective or counterproductive; and

(5) the certifying agency must certify the process as being ineffective or counterproductive.

Such a supplementary certification would be effective for purposes of continuing the tax exemption only if it were issued after a full review of the data obtained from the project and subsequent to the passage of sufficient time to allow the process to affect the reservoir. The supplementary determination must be made pursuant to the application of sound engineering principles as they pertain to the particular project. A self-certified tertiary project could qualify under this exception to the general rule if the supplementary certification was issued by the regulatory body after both a review of the initial process and the requisite information required for supplementary certification. However, this continuing qualification would only continue for the period during which the tertiary project was originally expected to affect production from the reservoir. In no event would the 2½ percent decline rate continue to apply after the tertiary project was discontinued.

IRS examination.—All self-certified projects (including any project self-certified for pricing purposes) would be subject to the generally applicable rules pertaining to reviews by the IRS upon an audit examination. In other words, the producer would have to establish that the facts underlying the claimed exemption for tertiary production, in fact, had satisfied the requirements for exemption.

A special audit examination review rule would apply to projects certified by a regulatory body because these projects would have been reviewed by that regulatory body prior to the time the exemption was claimed. Project certifications issued by a regulatory body would

be subject to a "substantial evidence" rule.[6] Under this rule, the tax qualification of a project certified by a regulatory body would be sustained on audit unless the Internal Revenue Service established that the certification was not supported by substantial evidence or presented substantial evidence that the project did not qualify for certification. In making such a review, the IRS could "go behind" the certification issued by the regulatory body. If the IRS established that the certification was not supported by substantial evidence, or presented substantial evidence that the project did not qualify for certification, the producer then could introduce additional evidence to sustain the exemption. At that point, the generally applicable rules pertaining to reviews upon audit examination would apply.

The application of the substantial evidence rule to certifications issued by a regulatory body would apply to issues concerning both the project's initial qualification and its continuing qualification.

This substantial evidence rule would be adopted, in part, because a regulatory certification should aid the Internal Revenue Service in enforcing the tax by having producers generate documentary evidence in support of the tertiary project prior to any audit examination and by having that evidence reviewed independently, in advance of any exemption, by an expert regulatory authority. Furthermore, since the administrative record upon which a regulatory certification was based would be included in the category of material facts necessary for a tertiary exemption, it would be available, with the producer's records, for review and examination by the Service upon an audit.

If a certification application is denied by a regulatory body, the Service would be free to use that information in a later review of a self-certified project, or upon an examination of a regulatory certification subsequently issued for such a project. This is consistent with the standard of review applicable to natural gas.[7]

The substantial evidence rule would allow the Service to disregard a regulatory certification that was issued prefunctorily and largely was unsupported by the documents presented to the regulatory body.

Advance determination.—In the case of tertiary projects certified by a regulatory body, producers could apply for an advance IRS determination, to be issued within 180 days of application, as to the windfall profit tax status of the project.

Tertiary methods.—For windfall profit tax purposes, a tertiary recovery method is any method that would make a property eligible for price deregulation under the June energy regulations.

In addition, the Secretary is authorized to approve other tertiary enhanced recovery methods, including a variation of the specifically recognized processes or one similar to such processes, singularly or in combination. However, tertiary processes do not include water flooding or immiscible natural gas injection.

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[6] This standard of review is similar to that contained in the Administrative Procedure Act (5 U.S.C. sec. 705(2)(E)), and found in section 503(b) of the Natural Gas Policy Act of 1978 (Pub. L. 95–621). It also is similar to the standard used by the Tax Court in *Ditter Bros., Inc.* v. *Comm'r*, 72 T.C. —— (No. 77) (1979) (declaratory judgment as to certain transfers from the U.S.).

[7] The Natural Gas Policy Act of 1978 treats the absence of substantial evidence in an administrative record as substantial evidence against qualification for inclusion in a particular category. *See, e.g.*, H. Rept. No. 95–1752, 95th Cong., 2d Sess. 117 (1978) (Conference agreement on section 503 of Pub. L. 95–621).

Nonincremental production.—Any amount of nonincremental production from a qualified tertiary project remains taxable in the appropriate tier to the extent it would be subject to the tax in the absence of the project.

House bill.—Under the House bill, incremental tertiary oil would be classified as tier three oil with a base price of $17. The first $9 in excess of the base price would be taxed at a 50-percent rate, and any additional amount would be taxed at a 60-percent rate. Both the base price and the first $9 over that amount would be adjusted for inflation plus 2 percent. The tax on incremental tertiary oil would terminate after 1990.

The definition of incremental tertiary oil under the House bill would use a 1-percent decline rate before the project's beginning date, which would be defined as the date at which the tertiary process can be expected to affect production from the project area.

Under the House bill, a tertiary project could be certified by DOE (prior to September 30, 1981), or self-certified by the producer, but there would be no provision for advance certifications by State agencies, the USGS or the IRS.

Under the House bill, a project would have to meet the requirement that the project would be uneconomic without preferential tax treatment, in addition to the requirements in the committee substitute.

7. Heavy Oil

The weight of crude oil generally is measured by its gravity. The gravity of crude oil is an indicator of the thickness or viscosity of a particular crude oil. The lower the gravity of crude oil, the more tarlike and difficult to produce it becomes. The weight of oil normally is measured in degrees on the American Petroleum Institute scale (API). On this scale, oil with the least specific gravity has the highest API gravity. Generally, the higher the API gravity, the greater the value of the oil. Crude oils vary in gravity up to a high of above 40 degrees API. However, most domestic crude oils range from 27 degrees to 35 degrees API.

The United States has an estimated reserve of over 10 billion barrels of heavy oil. Most of this oil is located in California, with additional reserves in Texas, Louisiana, Oklahoma, Mississippi, and Wyoming.

a. *Treatment under price controls*

Pursuant to Executive Order No. 12153, 44 Fed. Reg. 48948 (Aug. 21, 1979), first sales of certain heavy crude oil were exempted from price controls. For purposes of this exemption, the term "heavy crude oil" means all crude oil produced from a property, but only if, during the last month prior to July 1979 in which crude oil was produced and sold from the property, such crude oil has a weighted average of 16.0 degrees API or less, corrected to 60 degrees Fahrenheit. Most oil with a gravity of 16 degrees API or less is stripper or tertiary production.

b. *Explanation of exemption from tax*

Under the committee substitute, heavy oil that was deregulated by Executive Order No. 12153 would be exempt from the windfall profit tax.

To prevent avoidance of the tax by a transfer of a portion of a property, the committee substitute provides that heavy oil produced from a portion of a property transferred after 1978 is not to constitute exempt heavy oil if the oil would not have qualified for the exemption in the absence of the property transfer (see section 8(b) below).

The House bill contains no provision directed specifically to the production of heavy crude oil.

8. Special Rules and Definitions Applicable to All Tiers

a. *Definition of "property"*

For windfall profit tax purposes, the word "property" has two different meanings. Generally it has the same meaning as that term is given by the price control regulations. See 10 C.F.R. sec. 212.72(a); FEA Rul. 1977–1, 42 Fed. Reg. 3628 (1977). "Property," therefore, generally means either (1) a right to produce domestic crude oil that arises from a lease or fee interest, or (2) at the election of the producer, separate and distinct producing reservoirs that are subject to the same right to produce and that are recognized as separate and distinct reservoirs by the appropriate government regulatory authority.

However, in some cases the word "property" has the meaning given to it in section 614 of the Code, which generally does not allow a producer to elect to treat separate reservoirs as separate properties. In the committee substitute, this tax definition of the term property is used for purposes of the 90-percent-of-net income limit on the taxable windfall profit.

b. *Property transfers*

To prevent avoidance of the windfall profit tax through a transfer of a portion of a property, the committee substitute provides that oil produced from a portion of a property transferred after 1978 is not to constitute marginal, heavy, stripper, high water-cut or newly discovered oil if the oil would not have qualified as marginal, heavy, stripper, high water-cut or newly discovered oil if the transferred portion of the property had not been transferred. This provision is intended to prevent abuses resulting from transfers of portions of properties designed to create new properties qualifying for special treatment. In addition, in the case of post-1978 transfers of any portion of a property, the committee substitute requires an allocation of the BPCL among the portions of the divided property.

The House bill contains a similar provision but fails, apparently unintentionally, to apply the rule to marginal properties.

c. *Property unitization*

To facilitate the economic production of oil from a single pool or reservoir that is subject to more than one separately owned producing lease, producers frequently enter into an agreement for the joint, or "unitized," operation of their interests. Such an agreement may make it economically feasible to undertake various pressure maintenance and secondary or tertiary recovery programs.

In the absence of some ameliorative price control action, producers of price-preferred oil could be hesitant to join with other producers in a unitization plan that might result in a loss of some of their price-

preferred oil, even though total production might be increased through enhanced recovery techniques. For this reason DOE has adopted special pricing rules with respect to production pursuant to a unitization agreement. Generally, producers who enter into unitization agreements are guaranteed the continued classification of their production as price-preferred oil in an amount equal to the pre-agreement level of that production. If total post-unitization production exceeds the combined pre-unitization production, the excess is categorized in proportion to each type of oil that had been produced immediately prior to the unitization. Thus, for example, production from stripper leases retains its exempt status when unitized with other leases with respect to the average daily production for the 12-month period immediately preceding unitization. Alternatively, if it is more favorable to the producer, the unitized property can be guaranteed the same percentage of stripper production that existed prior to unitization.

Generally, similar "hold harmless" treatment is provided for newly discovered oil and for production from marginal properties which are subject to a unitization agreement. Therefore, as is the case with production from stripper properties subject to a unitization agreement, producers of newly discovered oil, or oil from a marginal property, would be guaranteed the continued classification of prior price-preferred production after entry into a unitization agreement. either the absolute amount of such production or the same percentage, whichever is greater. The balance of any increased production from the unitized property would be eligible for the upper tier price.

The committee substitute authorizes the Secretary of the Treasury to issue regulations necessary to accomplish the purposes of the windfall profit tax. It is anticipated that these regulations will include rules with respect to the unitization of oil properties. The regulations may adopt or modify, where appropriate, unitization rules established for price control purposes. Additional unitization rules may be necessary for the effective implementation of the tax, such as in those instances where the windfall profit tax and regulatory treatment of a particular type of oil differ, as with incremental tertiary production and production from high water-cut properties. Unitization rules will also be needed to make sure that the exemption for stripper production by independent producers does not discourage unitization.

The House bill also would provide "hold harmless" treatment for unitizations.

d. *Determination of selling or removal price*

The term "removal price" generally means the amount for which the barrel of oil is sold. The committee substitute provides special rules for determining the removal price when oil is removed from the premises prior to sale and when refining is begun prior to the oil's removal. If crude oil is removed from the premises before it is sold, the removal price is the constructive sale price used in determining gross income from the property under section 613 (relating to percentage depletion). If the crude oil's conversion or manufacture into refined products begins before the oil is removed from the premises, the oil is treated as removed on the day when manufacture or conversion begins, and the removal price is the constructive sale, or representative field,

price at the time of removal of the oil from the property for depletion purposes. For purposes of the windfall profit tax, the terms "premises," "refined product," and "constructive sales," or "representative field," price have the same meaning as when used in determining gross income from the property for depletion purposes. Thus, oil returned to the property from which it came, either by reinjection or through the powering of production processes or equipment, is not considered sold or removed from the premises. For example, no tax would be imposed on the on-site use of oil to generate power for an artificial lift device, or water flood project, or a tertiary injection process. However, powerhouse oil removed from the property prior to its use, or oil used to power refining or manufacturing processes, would be taxed.

Under the committee substitute, the rules for determining the constructive removal price also apply in the case of sales of crude oil between related persons. For this purpose, the term "related person" has the same meaning as it does for purposes of the small issue exemption from the limitation on the issuance of tax exempt industrial revenue bonds (sec. 103(b)(6)(C)). Under this definition, persons are related if losses would be disallowed on exchanges between them under section 267 or section 707(b), or if they are members of the same controlled group of corporations (under sec. 1563(a)). In the latter case, the rules for determining membership in a controlled group apply with the exception that "more than 50 percent" is substituted for "at least 80 percent" in the common ownership of voting control or value tests. (See section 11(c), below for a discussion of administrative enforcement rules applicable to all taxpayers.)

Under the existing administrative practices relating to the determination of a constructive sale price, the Internal Revenue Service may determine such a price for oil when transactions occur between persons under common control. In the past, taxpayers may have sought to increase the size of their depletion deduction by means of artificial transactions. In such an instance, the determination of a constructive sale price has reduced the amount of gross income from the property for depletion purposes. If the oil is sold for an artificially low price, the windfall profit tax would be imposed on the higher constructive sale price.

The committee substitute also allows the Secretary to adjust prices in transactions between unrelated parties when such an adjustment is needed to make the removal price reflect the fair market value of the oil. For example, if the producer gives the purchaser a discount for paying for the oil in advance, the removal price could be adjusted up to the fair market value without the discount. (See section 11(c) below).

e. *Inflation adjustment*

The committee substitute provides that the inflation adjustments required by the tax are to be computed by using the GNP deflator. The GNP deflator, that is, the implicit price deflator for the gross national product, measures inflation in domestically produced goods and services.

Under the committee substitute, the inflation adjustment to the base prices for any calendar quarter is the percentage by which the GNP

deflator for the second preceding calendar quarter exceeds the GNP deflator for the last calendar quarter of 1978. The first such adjustment occurs, therefore, for the third quarter of 1979. This two-quarter lag in measuring the inflation adjustment is necessary because of the lapse of time before the data become available. The DOE inflation adjustments to the lower and upper tier ceiling prices have a similar lag in the adjustment.

In all cases, the first revision of the price deflator, which becomes available in the third week of the second month following the close of the quarter, is to be used in determining the inflation adjustments.

The method of computing inflation adjustments in the House bill is the same as that in the committee substitute except that the House bill starts the tier three inflation adjustment two quarters later. In the committee substitute, the earlier tier three inflation adjustment is offset by a correspondingly lower base price; therefore, the adjusted tier three base prices are the same under both versions of the tax.

f. Treatment of State severance taxes

Various States impose severance or production taxes on the extraction of oil. These taxes are imposed either on each unit of production as a fixed fee per barrel or as a percentage of the value of each barrel.

Severance taxes generally are imposed on the owners of the various interests in a property (i.e., the operator, other investors, royalty owners, etc.). However, the taxes normally are paid by the first purchaser of the oil, who withholds the tax from the amount paid to the producer and royalty owners. For Federal income tax purposes, the amount of severance taxes is included in the producer's or royalty owner's gross income from the property, and an offsetting deduction for the severance tax is permitted.

Generally, under the committee's substitute there is a deduction in computing the taxable windfall profit for the State severance taxes imposed on the windfall profit element of the price of a barrel of oil—the difference between the selling price and the adjusted base price. The severance tax adjustment is necessary to avoid placing an undue burden on the producer of oil when the combined effect of the windfall profit tax, the severance tax, and State and Federal income taxes is taken into account. To discourage States from raising severance taxes at the expense of the Federal Treasury, any post-March 31, 1979, increase in the rate of severance tax can be taken into account only if the increase applies to the entire price of a barrel of oil.

Severance taxes imposed by an Indian tribe recognized as eligible for services provided to Indians by the Secretary of the Interior are to be treated in the same manner as State imposed severance taxes. By providing for such treatment of tribal severance taxes, the committee does not intend to prejudge the outcome of the cases on appeal before the Tenth Circuit Court of Appeals respecting the right of Indian tribes to impose taxes on persons or organizations other than Indians who are engaged in business activities on Indian reservations. The outcome of the cases on appeal will determine the legality of imposing such taxes. The cases are *Jicarilla Apache Tribe et al. v. J. Gregory, Merrion and Robert L. Bayless* (78–1154, 10th Cir.) and *Jicarilla Apache Tribe v. Amoco Production Co. and Marathon Oil Co.* (78–1251, 10th Cir.)

The House bill permitted an adjustment for severance taxes only if the windfall profit tax rate on the oil subject to the severance tax exceeded 50 percent. For purposes of the severance tax adjustment under the House bill, post-March 31, 1979, increases in the rate of severance tax were ignored, and no provision was made for severance taxes imposed by Indian tribes.

g. *Other definitions*

Crude oil.—The term "crude oil" includes a natural gas liquid treated as crude oil under the June 1979 energy pricing regulations. The term applies only to natural crude petroleum and does not include synthetic petroleum, such as oil from shale or tar sands.

Barrel.—The term "barrel" means 42 United States gallons.

Domestic.—When used in reference to crude oil, the term "domestic" means crude oil produced from an oil well located in the United States, or in a possession of the United States.

United States.—The term "United States" when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to territorial waters of the United States over which the United States has exclusive rights under international law to explore for and exploit natural resources. This is the same meaning given the term, "United States" by paragraph (1) of section 638 of the Internal Revenue Code (relating to Continental Shelf areas).

Possession of the United States.—The term "possession of the United States" when used in a geographical sense includes the seabed and subsoil of the submarine areas adjacent to the territorial waters of the possession over which the United States has exclusive rights under natural law to explore for and exploit natural resources. This is the same meaning given the term "possession of the United States" by paragraph (2) of section 638 of the Internal Revenue Code (relating to Continental Shelf areas).

Energy Regulations.—The term "energy regulations" means crude oil price control regulations prescribed under section 4(a) of the Emergency Petroleum Allocation Act of 1973, as amended. Energy regulations, for windfall profit tax purposes, are treated as continuing in effect without regard to decontrol of oil prices or any other termination of the regulations. The March 1979 energy regulations are the terms of the energy regulations as the terms existed on March 1, 1979. The June 1979 energy regulations are the terms of the energy regulations as the terms existed on June 1, 1979, and are to be treated as including final action taken on particular cases under them before June 1, 1979, as well as action taken before, on, or after June 1, 1979, with respect to incremental production from qualified tertiary enhanced recovery projects. Exceptions relief actions by DOE would not be considered final actions because they are subject to periodic review.

Operator.—The term "operator" means the party or parties responsible for management of production from the property. This may be one of the owners of the property or a third party who manages the property under a contractual agreement with its owners. Thus, the operator may or may not be the "producer" under the provisions of the tax, and may or may not be the "operator" for purposes of section 614(b)(3) (relating to certain unitization or pooling arrangements).

In other words, for windfall profit tax purposes, the "operator" may be, but is not necessarily, a party with an economic interest in the property.

Indian tribe.—The term "Indian tribe" means an Indian tribe recognized as eligible for services provided by the Secretary of the Interior to Indians.

h. *Regulatory authority*

The committee substitute authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary to effectuate the purpose of the tax. The windfall profit tax is based on several concepts used in previous price control regulations. To apply these concepts within the context of an excise tax structure, the Secretary may have to prescribe regulations which interpret how the price control regulations are to be applied for the windfall profit tax. This regulatory authority is essentially the same as the authority which the Secretary generally has with respect to tax legislation. The committee does not anticipate that major changes in price control regulations will be needed to apply them for tax purposes, but it intends that references to price control regulations in the committee substitute are not to be interpreted as denying the Secretary the usual regulatory authoriy.

Generally, the committee substitute adopts various price control regulations in effect on specified dates, *i.e.*, 'energy regulations,' to implement the tax. In addition, the committee substitute provides that the energy regulations adopted for tax purposes are to be treated as being effective without regard to decontrol of oil prices or any other termination of their application or any changes in those regulations by DOE. Therefore, the specific energy regulations incorporated by reference into the tax would be effective for the duration of the tax. Reference to the energy regulations also would be important when the Secretary or producers must make determinations by analogy to the energy regulations, *e.g.*, computing the base level for a tertiary project. To facilitate taxpayer's access to such energy regulations, the Secretary may include some or all of them as an appendix to regulations promulgated under the tax.

Since the energy regulations adopted by the tax do not purport to embody a comprehensive compilation of rules pertaining to all relevant crude oil matters, it is anticipated that the Secretary will give due consideration to the various administrative rulings and judicial decisions which have interpreted or which construe those regulations. To the extent such rulings and decisions are consistent with the provisions of the committee substitute, it is anticipated they will be followed by the Secretary; to the extent they are not consistent entirely with the committee's substitute, it is anticipated that the Secretary will attempt to reconcile them with the tax with the least change feasible.

Generally, the committee's substitute only includes in the energy regulations adopted for tax purposes final actions taken thereunder prior to June 1, 1979. Therefore, the tax does not recognize temporary actions, *e.g.*, special treatment granted under DOE Exceptions Relief, that antedate June 1, 1979. However, the energy regulations would include, for tax purposes, certifications made after May 31, 1979, with respect to production from qualified tertiary enhanced recovery proj-

ects. In addition, it is anticipated that the Secretary will take into consideration, in promulgating regulations and administering the tax, any actions taken under the energy regulations after May 31, 1979.

In all instances, it is anticipated that the Department of Energy will cooperate fully with the Secretary in the administration of the tax (see also section 12(c), below).

i. *Maximum feasible rate*

To qualify as a high water-cut or stripper property, the committee substitute requires that the property must be operated at the maximum feasible rate of production that is consistent with recognized conservation principles, and that production not be curtailed significantly by reason of mechanical failure or other disruption in production. For these purposes, the maximum *feasible* rate of production essentially is equivalent to the maximum *efficient* rate of production, as determined in accordance with recognized conservation practices. Thus, the maximum feasible rate takes into consideration the fact that the practicalities of producing crude oil may limit the operation of some wells to a rate of production that is less than the maximum *possible* rate. The maximum feasible rate, therefore, is the highest rate of production that can be sustained for an appreciable length of time without damage to the reservoir, and which if exceeded would lead to avoidable waste through loss of ultimate oil recovery. For instance, some State regulatory bodies establish allowable production rates ("allowables") for various types of properties, that may not be exceeded by the operator. While it might be possible to produce crude oil from the property at a rate above the allowable rate, the ultimate *total* recovery of oil from the property generally is considered to be maximized when production is held to the lower, more efficient, rate. For example, although a specific property might be capable of producing 900 barrels of oil a month over the short-term, to produce continuously at that rate could result, in a particular instance, in a lesser total recovery of oil from the reservoir than the sustained production of, say, 600 barrels per month. Production of the lower number of barrels, while not at the maximum *possible* rate, would be at the maximum feasible rate, in accordance with recognized conservation practice.

9. Taxable Income Limit

The windfall profit on a barrel of oil may not exceed 90 percent of the net income attributable to the barrel. In applying this limitation, the net income attributable to a barrel is determined for the taxable year by dividing the taxable income from the property which is attributable to taxable crude oil by the number of barrels of that oil produced from the property during the taxable year. In computing net income for this purpose, taxable income from the property is determined under section 613(a) (relating to percentage depletion) but without any deductions for depletion, intangible drilling and development costs under section 263(c) (except the costs of drilling a dry hole), and the windfall profit tax. For this provision, "property" has the meaning given to it in section 614, not in the price control regulations, and costs on properties producing both oil and gas are allocated under the rule generally applicable for percentage depletion

purposes. (See section 613A(c)(7)(C).) In the case of partnerships, the computation of the net income limitation would be made by the partnership rather than the separate partners.

The committee substitute further provides that, in determining the 90-percent limit, the producer's taxable income from the property is to be reduced by the deduction for cost depletion which would have been allowable if all intangible drilling costs incurred by the taxpayer with respect to the property (other than those incurred in drilling a nonproductive well) had been capitalized and taken into account in computing cost depletion, and if the producer had used cost depletion for the property for all periods during which he owned his economic interest in the property (even if he had actually used percentage depletion on his income tax return). However, if a producer actually capitalizes intangible drilling costs for income tax purposes, he may reduce his taxable income from the property by the amount deductible under section 611 of the Internal Revenue Code in connection with those costs (either as cost depletion or depreciation) instead of assuming that all those costs were deducted as cost depletion.

The committee's substitute provides a special rule for determining the taxable income limit in the case of certain transfers of proven oil or gas properties after 1978. If a transfer of a proven property would result in an increase in the amount by which a transferee producer's taxable income could be decreased by virtue of a larger imputed depletion deduction, the committee substitute provides that the transferee producer may compute the imputed cost depletion deduction on only those costs incurred during periods after the transfer of the property. For purposes of this rule, a proven property is given the same meaning as that applicable to the Internal Revenue Code's limitation on the allowance for percentage depletion in the case of oil. This rule applies to any post-1978 transfer, including the creation of a production payment which results in the transfer of an economic interest, and leases and subleases of an interest (including an interest in a partnership or a trust) in any proven oil or gas property.

In the absence of this rule, it is arguable that the owner of a producing property with a low cost basis could transfer the property to another who could hold the property at an increased basis. The increased basis would increase the cost depletion deduction and, therefore, lower the taxable income limitation. The net effect could be the avoidance of a significant portion of the windfall profit tax liability. For example, if an operator owned a producing property with a cost basis of $2 per barrel, lifting and local tax costs of $2 a barrel, an adjusted base price of $8 a barrel and a selling price of $18 a barrel, that operator would pay a windfall profit tax on $10 for each barrel produced. If the owner were to sell the oil in place at a cost of $10 per barrel of estimated reserves, the transferee would have a cost basis of $10 a barrel and other costs of $2 a barrel; his taxable income limitation would be $5.40 (90 percent of $18 minus $12). Thus, the windfall profit subject to tax would be reduced from $10 to $5.40 by the transfer.

If any portion of the taxable crude oil removed from the property is applied in discharge of a production payment, the gross income from such portion must be included in the gross income from the property in computing the taxable income of the producer. Thus, this amount of

gross income will be taken into account in computing the taxable income limits of two persons—the creator of the production payment and the owner of it.

10. Taxable Person

a. *General rule*

The committee substitute generally imposes the windfall profit tax on the first sale of taxable crude oil and requires payment of the tax by producer of the oil by virtue of its ownership of the economic interest. Generally, the tax is to be withheld by the first purchaser of the oil and deposited with the Treasury by him. The committee substitute defines the producer as the owner of the economic interest in the oil and thus places the burden of the windfall tax on the persons who will receive the increased income resulting from decontrol and OPEC price increases.In the case of a partnership that owns an economic interest in taxable crude oil, the partnership is the producer of the oil by virtue of its ownership of the economic interest, even though section 613A requires the calculation of percentage depletion separately by the partners. Thus, each investor and royalty owner who owns an economic interest in the oil (including governmental units and organizations described in section 501(c)(3)) is liable for tax on its share of the gross revenues. Whether a particular taxpayer is the owner of an economic interest in the oil is determined under the same rules that apply for Federal income tax purposes.

b. State and local governments

The committee substitute provides that if an economic interest in crude oil is held by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing including an educational institution, and all of the net income received pursuant to such interest is dedicated to public education or any other public purpose, then the windfall profit tax would not be imposed with respect to crude oil properly allocable to such interest. For this purpose, the term "net income" means gross income from the property reduced by production costs and severance taxes of general application. A severance tax of general application is one imposed at a uniform rate on all owners of rights in oil production, both public and private. The exemption would not apply to the extent another party had an economic interest in the production.

A similar exemption is provided in the House bill but is limited to economic interests that must be used, directly or indirectly, to finance public education.

c. *Exemption for medical and educational charities*

Oil produced from properties owned by charitable medical facilities and educational institutions is exempt from the windfall profit tax if the properties were owned by the medical facility or educational institution on October 24, 1979, or if the medical facility or educational institution receives the property as a bequest after October 24, 1979. For purposes of the exemption, a medical facility is defined as an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or, if in conjunction with a hospital, medical research (see Code section 170(b)

(1)(A)(iii)). For purposes of the exemption, an educational institution is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on (see Code section 170(b)(1)(A)(ii)). An organization that normally receives a substantial part of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, and that is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a public college or university is also considered to be an educational institution (see Code section 170(b)(1)(A)(iv)).

The exemption also applies to oil produced from interests held by a church on October 24, 1979, if the net proceeds from production of such oil were permanently dedicated, by appropriate official action of the church prior to October 25, 1979, to the support of a medical facility or educational institution.

The House bill contains no similar provision.

d. *Indian oil production*

The committee substitute would exempt from tax certain oil production owned or received by Indian tribes, tribal organizations, and individual Indians over whom the United States exercises trust responsibilities. Specifically, the exemption would apply to three types of oil production that generally also are exempt from Federal income taxation. First, production received by Indian tribes and individuals from Tribal Trust Lands would not be taxed. Tribal Trust Lands are lands and mineral interests title to which is held by the United States in trust for Indian tribes or their members. Secondly, oil produced from lands or mineral interests held, subject to Federally imposed restrictions on alienation, by a recognized Indian tribe or by members of a recognized tribe, would be exempt from the tax. A recognized Indian tribe is one that is eligible for services provided by the Secretary of the Interior to Indians. Thirdly, oil, the proceeds from which are paid into tribal or native trust funds in the United States Treasury, would be exempt from tax.

The committee substitute would not exempt oil received by non-Indian lessees of tribal interests, by tribes or tribal organizations over which trust responsibilities have been terminated by the United States, or by individual Indians or tribes from unrestricted lands. Thus, the exemption would not apply to Alaskan Native Claims Settlement Act Corporations.

The House bill did not specifically exempt oil produced by Federally recognized Indian tribes. However, various court decisions and Internal Revenue Service rulings hold income from Tribal Trust Lands to be exempt from income tax in the absence of a clear Congressional intention to impose a tax. Thus, it is unclear whether the courts and Internal Revenue Service would interpret the House bill as taxing tribal trust oil production.

e. *Integrated companies*

The committee's substitute generally imposes the windfall tax on the first sale of taxable crude oil and calculates the tax based on the first sale price. If the taxable crude oil is sold to a related person

before it is removed from the premises, the committee's substitute provides for imposition of the tax on the basis of the constructive sale price for determining gross income from the property at the time the taxable oil is removed from the premises, sold to a related person within the meaning of Code section 103(b)(6)(C) (relating to the small issue limitation on industrial revenue bonds), or first subjected to manufacturing or conversion processes that produce refined products. (See section 8(d), above, for rules pertaining to the determination of the removal price and the treatment of oil used for production purposes.)

f. *Production Payments*

In the case of oil produced subject to a production payment, the windfall profit tax will be imposed, as is true for all taxable oil, on the owner of the economic interest as determined under Federal income tax provisions. No special provisions are made for production payments because the committee understands that production payment contracts usually provide for an automatic adjustment to reflect the imposition of additional severance taxes such as the windfall profit tax.

Under the House bill, an exception to the general rule that the owner of the economic interest bears the tax would be made in the case of production payments that involve payment of oil to someone until the cumulative payment amounts to a fixed number of dollars (as opposed to a fixed number of barrels). In such cases, the House bill would shift the tax burden to the holder of the residual interest. The committee believes this provision is unnecessary.

11. Administrative Provisions

a. *Deposit and return requirements*

Overview.—The comittee substitute requires that only a few hundred persons file tax returns and make tax deposits. Although the tax generally is imposed on each producer, *i.e.*, on each party with an economic interest in taxable production, the committee substitute provides that the first purchaser generally is liable for collecting the tax, by withholding it from the purchase price, for depositing the tax, and for filing quarterly tax returns. (These obligations are similar to those imposed on an employer, with respect to the employee's payment of various taxes, by Code section 3403, and which are enforceable pursuant to Code section 6672.) The quarterly returns must be filed by the last day of the second month following the end of the quarter.

To facilitate the first purchaser's compliance with these obligations, the committee substitute requires that the property's operator, *i.e.*, the party who actually manages production from the property, to certify to the purchaser all the information necessary for the purchaser to compute and deposit the tax and file the return. This information includes the tax tier into which the production falls, its adjusted base price, the property's BPCL, the amount of any exempt incremental tertiary production, whether the *property* is exempt entirely from withholding and any other data that the Secretary prescribes by reg-

ulations. The operator, however, would not be required to certify to the purchaser information pertaining to whether any *person* with an interest in the property was exempt from tax. Under the committee substitute, the operator must certify this information to the purchaser by the last day of the month of purchase.

Although the first purchaser generally would be liable for withholding and depositing the tax, the first purchaser ordinarily would not be responsible for any tax deficiency attributable to the operator's misrepresentation of the oil purchased. However, the first purchaser would remain liable for any failure to pay over the tax withheld, or for any misrepresentation of the oil purchased to which the purchaser was a party. In addition, the first purchaser could be liable, depending upon the circumstances, for negligence in satisfying its obligations.

To provide operators and purchasers with the maximum degree of flexibility in their contractual arrangements that is consistent with effective and efficient tax administration, the committee substitute authorizes the Secretary to promulgate regulations that allow the operator and purchaser to elect to have the operator deposit the tax and file the quarterly returns.

The committee substitute requires that integrated oil companies and their affiliates (who are not independent refiners) must make semimonthly estimated tax deposits. The amount of these payments would be determined in a manner similar to that which is applicable for estimated income tax payment purposes. Integrated companies would include, generally, only those integrated companies which are ineligible for percentage depletion under section 613(A)(d)(2) or (d)(4).

"Independent refiners," within the meaning of section 3(3) of the Emergency Petroleum Allocation Act, would not be subject to estimated tax obligations, even if they also are integrated companies. For this purpose, an independent refiner is one who (a) obtained, directly or indirectly, in the preceding taxable period, more than 70 percent of its refinery input of domestic crude oil (or 70 percent of its refinery input of domestic and imported crude oil) from producers who do not control, are not controlled by, and are not under common control with, such refiner, and (b) marketed or distributed in such preceeding period, and continues to market or distribute, a substantial volume of its refined gasoline through branded independent marketers or nonbranded independent marketers.

The committee substitute provides special tax deposit rules for purchasers who are not integrated oil companies, for independent refiners, and other taxpayers. These rules are intended to take into account the various information and cash flow problems frequently encountered by nonintegrated companies. Generally, nonintegrated companies must make deposits of tax within 45 days after the end of the month of purchase. "Independent refiners," however, as defined above, could make tax deposits as much as 60 days after the end of the month of purchase if oil is purchased pursuant to a delayed payment contract under which the refiner has more than 45 days from the end of the month of purchase to pay for the oil.

The committee substitute further authorizes the Secretary to determine what, if any, other returns or information statements are to be required.

Exemptions.—The committee substitute provides special deposit and return rules for producers of exempt and partially exempt oil. If production from a property is wholly exempt from the tax, the operator is to certify that fact to the purchaser. In such a case, no tax withholding is necessary. For incremental tertiary oil, in which the production from the property is only partly exempt, the operator must inform the purchaser of the amount of exempt oil, as well as the tax tiers into which the non-exempt oil falls, and the purchaser will withhold the appropriate amount of tax. In the case of taxable stripper oil on qualifying stripper properties, such as economic interests of integrated companies, the purchaser does not have to withhold tax, and the producer, i.e., the integrated company, must deposit the tax and file the returns as to the taxable production and make semi-monthly estimated tax deposits.

Persons with "excess" stripper oil, i.e., over the 1,000 barrel daily limit, from a qualified stripper property would have to deposit the tax on that excess within 45 days after the close of the quarter.

Under the House bill, matters relating to tax and information returns, tax deposits, and information exchanges generally would be determined under the Secretary's regulatory authority. However, the House bill required certain specific exchanges of information which are eliminated in the committee substitute.

b. *Tax overpayments*

The committee substitute adopts several provisions relating to overpayments of the windfall profit tax. First, the substitute clarifies that excess windfall profit tax payments may be credited on the producer's annual income tax return. Furthermore, the Secretary is authorized to provide regulations pertaining to the offset of estimated income tax payments with excess windfall profit taxes. In each instance, an overpayment of the tax is to be subject to the 45-day interest rule of Code section 6611(e), and not to the 30-day rule of Code section 6611(b). This last modification is intended to simplify the tax by eliminating the need to compute interest in two different ways as to the same tax.

Under existing Code section 6402 an overpayment may be reflected as a credit on the tax return. To the extent such a credit exceeds the liability on the return, it is refunded to the taxpayer (producer). Since the credit merely would be a refund of an overpayment of the windfall profit tax, the refund would not be subject to the provisions of P.L. 95–355, which requires a separate appropriation for effecting a payment of newly enacted refundable tax credits. Section 6402 also permits the crediting of the overpayment against other outstanding tax liabilities of the taxpayer. Although a refund of the excess windfall profit tax could be used for this purpose, the IRS would still have to account for the entire amount of credit to ensure that it was taken into account for estimates of the revenue produced from the windfall profit tax.

Tentative refunds.—The committee substitute also provides for expedited refunds of windfall profit tax overpayments in excess of $1,000 attributable to the net income limitation or to a tax exemption. Thus, expedited refunds would be available to State and local governments, Indians, medical facilities and educational institutions, and independent producers with stripper production from properties con-

trolled by integrated companies. Applications for such tentative refunds are to be made on an annual basis, and are outside the statutory refund review jurisdiction of the Joint Committee on Taxation. Tentative refunds attributable to the net income limitation must be reconciled, to the extent necessary, by the producer. An application for a tentative refund must include all the information specified by Treasury regulations, including a verification of the amount of tax paid.

Within 90 days after the application is filed (or, if later, within 90 days after the last day of the month in which the tax return for the year with respect to which the overpayment occurs must be filed, including extensions), the Secretary of the Treasury must review the application, determine the amount of the overpayment and apply, credit, or refund the overpayment to the taxpayer (unless the application contains errors in computation or material omissions).

This application for tentative refund will be administered in a manner similar to the manner prescribed under present law for tentative refunds due to carryback of net operating losses, investment tax credits, etc. Thus, special rules may be needed to be prescribed by the Secretary of the Treasury to take into account special problems involving consolidated returns, and refunds due to partnerships.

The House bill generally is similar to the committee substitute, except that it contains no specific provision for tentative refunds.

c. *Administrative enforcement*

To ensure that transactions are not arranged primarily to avoid the windfall profit tax, the committee substitute provides the Secretary with the general authority to take appropriate actions, including the promulgation of regulations, to see that transactions between unrelated, as well as those between related, parties use a removal price which reflects the fair market value of the oil and are not structured to avoid tax liability artificially.

Generally, it is anticipated that this authority will be exercised only after a thorough review of the transaction involved. For example, the facts in a given case might support a determination that the sales prices under an advance payment contract did not reflect the fair market value of the barrels sold, perhaps because a large discount was permitted for the advance payment. In such a case, the Service could adjust the removal price so that it reflects the market value of the oil and compute the tax accordingly. Similarly, if oil is sold along with other goods or services, the Service could adjust the removal price to ensure that the sale proceeds were allocated properly between the oil and the other goods and services.

The adjustment authority provided under the committee substitute is in addition to any existing Code sanctions, and to any new or existing Code civil or criminal penalties which otherwise might be applicable.

d. *Statute of limitations*

To facilitate the operation and administration of the tax, and to accommodate its special provisions to generally applicable income tax rules, the committee substitute modifies the statute of limitations in two respects. First, the committee substitute provides that the statute of limitations begins to run, under the generally applicable Code rules,

as to the producer when the tax is deposited and the return is filed. Because the producer generally is deemed both to have paid the tax and filed the return, even though these obligations actually are satisfied by the first purchaser, the statute of limitations otherwise would not run on these depository and filing requirements.

The second modification of the statute of limitations would hold open the statute for one year following a property or oil reclassification under price controls, or a mandated price change. Without such a modification of the statute, the producer might be barred from seeking a tax refund or the Service might be prevented from making an assessment for a tax deficiency. Because regulatory examinations of oil properties frequently have taken an extended period of time to complete, the committee believes the statute of limitations should be modified to allow tax adjustments following such a reclassification or price change. However, when the statute is held open, it is to be open only as to the adjusted item and other items directly affected by it.

The House bill does not modify the statute of limitations.

12. Windfall Profit Tax Enforcement

In considering the windfall profit tax, the committee has been aware of the enforcement difficulties encountered by DOE in administering price controls. The committee's substitute avoids many of the difficulties experienced by DOE by imposing the windfall profit tax on only one event rather than at several points in the production and distribution process, by imposing strict deposit, return and information requirements and stiff penalties for noncompliance, and by relying upon the general rule of tax law that places the burden of proof on the taxpayer in civil proceedings.

a. *Imposition of tax at first sale*

DOE price controls must be applied at several stages of production and distribution, each of which presents an opportunity for noncompliance. In contrast, only one event determines the windfall profit tax liability—the first sale. Because the tax is imposed on the producer and collected at the first sale by the purchaser, there is only one opportunity for a party to falsify "well data," such as meter readings or oil classifications. The items of information required to calculate the tax liability have to be reported or certified under the provisions of the committee substitute. Each of these items is an operative element in the determination of any party's tax liability, so that the misrepresentation of any item gives rise to the imposition of the appropriate tax sanction. Each item of information also must be categorized as a "material fact" necessary for the filing of a valid return or the furnishing of accurate information statements. As a result, supporting records must be maintained, and misrepresentation of any of these items will render a party subject to any applicable civil or criminal sanction.

Noncompliance with the obligations imposed by the windfall profit tax subjects the responsible party both to the generally applicable civil and criminal penalties and those set forth in the committee substitute. Specifically, the committee substitute makes it a misdemeanor punishable by up to a fine of $10,000 and up to 1 year of imprisonment to fail willfully to comply with these obligations. Further, additions to tax

for failure to comply are required. In addition, the obligations imposed upon the various parties by the windfall profit tax also are subject to generally applicable tax penalties for civil or criminal fraud, as well as those for negligence.

In this regard, the committee substitute further clarifies that the following civil and criminal penalties, presently contained in the Internal Revenue Code, also apply for windfall profit tax purposes: section 6651 (relating to a 5 percent addition per month (25 percent limit) for failure to file); section 6652(b) (relating to a $1.00 per information return not filed ($1,000 limit); section 6653(b) (relating to a 50 percent addition to tax for fraudulent underpayment); section 6656 (relating to a 5 percent penalty for underdeposits); section 6672 (relating to a 100 percent penalty for willful failure to collect or pay over); section 7201 (relating to a $10,000 fine and/or 5 years for willful attempt to evade tax); section 7202 (relating to a $10,000 fine and/or 5 years for willful failure to collect or pay over); section 7203 (relating to a $10,000 fine and/or 1 year for willful failure to file returns, supply information, or pay tax); and section 7206 (relating to a $5,000 fine and/or 3 years for false or fraudulent statements).

The committee substitute also clarifies that although the first purchaser generally is responsible for paying the tax, the producer (or operator), and not the first purchaser, would be liable for any tax deficiency attributable to its misrepresentation of the oil sold. (The first purchaser, of course, would be liable for any failure to pay over the tax withheld, or for any misrepresentation of the oil purchased to which it was a party.) Moreover, the Secretary, pursuant to a specific grant of regulatory authority, may take appropriate actions, including the promulgation of regulations, to ensure that transactions between unrelated, as well as those between related, parties use a removal price which clearly reflects the fair market value of the oil so as not to avoid tax liability artificially. (See Administrative enforcement, section 11(c), above).

b. ***Burden of proof***

The inclusion of DOE regulation concepts in the windfall profit tax does not affect the general rule that the burden of establishing the entitlement to preferential tax treatment is upon the taxpayer asserting that right. In other words each taxpayer must be able to establish that the tax reported is fairly mandated by the applicable windfall profit tax provision. Thus, each taxpayer must be prepared to establish the various items upon which windfall profit tax liability is predicated, including the classification and base price of oil sold and the category to which the producing property belongs.

In connection with the assessment of civil penalties, the usual tax rules apply. The standard employed by some courts, e.g., *Saunders* v. *DOE*, —— F. Supp. ——, 3 CCH *DOE* ¶ 26,157 (D.Kan. 1979), for the imposition of civil penalties under the EPAA pricing rules is not to apply for tax purposes. It is not intended, therefore, that a tax violation or infraction be "flagrant" before such penalties can be imposed. Similarly, in an appropriate case, tax sanctions might be applied even though "business" considerations prompted the action in question.

Notwithstanding these general rules, the committee substitute modifies the burden of proof rules in the case of incremental tertiary projects certified by a regulatory body (see section 6(c), above). Due to the initial review of such projects by expert regulatory bodies, the committee substitute accords projects certified by a regulatory body a presumption of tax qualification for audit examination purposes.

c. *Responsibilities of DOE*

Responsibility for administration and enforcement of the windfall profit tax will fall primarily upon the Treasury and the Internal Revenue Service. However, under OMB guidelines on the Privacy Act, DOE is not prevented from assisting the Treasury and the Internal Revenue Service by granting access to records held by DOE. The committee also anticipates that DOE will assist the Secretary in formulation of regulations under the tax. In addition, DOE certifications of qualified tertiary enhanced recovery propects and release of front-end money for such projects are recognized specifically for windfall profit tax purposes.

The provisions in the House bill relating to enforcement basically are similar to those in the committee substitute.

13. Interaction With Income Tax

a. *Deductibility*

Under the committee's substitute, a deduction from gross income in determining Federal income taxes for windfall profit taxes paid is permitted. Such a deduction is consistent with the usual treatment of excise taxes and prevents the imposition of combined income and excise taxes in excess of the taxpayer's gross windfall profit.

b. *Depletion*

Generally, percentage depletion is not available in the case of oil and gas production. However, independent producers and royalty owners, those not involved in the "downstream" activities of the oil business, are entitled to percentage depletion to the extent that their average daily production does not exceed a specified exemption. For 1979, the exemption is 1,200 barrels per day or the equivalent amount of natural gas. The exemption will be established permanently at 1,000 barrels per day in 1980. Oil production eligible for percentage depletion represents approximately 23 percent of domestic production, which is split about evenly between royalty owners and independent producers. The rate of percentage depletion is 22 percent of gross income, but this is scheduled to phase down to 15 percent between 1980 and 1984 except for oil produced from secondary and tertiary recovery, which remains at 22 percent depletion until 1984 when it too drops to 15 percent.

The committee substitute would not change the percentage depletion rules. Thus, qualified independent producers and royalty owners could claim percentage depletion with respect to oil production subject to the windfall profit tax.

The House bill would provide that, in determining the percentage depletion allowance under sections 613 and 613A of the Code, gross

income is to be reduced by the difference between the selling price and the adjusted base price of taxable oil (i.e., the windfall profit without regard to the severance tax adjustment).

14. Tax Court Jurisdiction

Under the committee substitute, the U.S. Tax Court would be granted exclusive trial court jurisdiction over all civil controversies relating to the windfall profit tax, including suits for tax refunds. The committee substitute also specifically provides the Tax Court with jurisdiction over equitable claims, issues, and remedies related to the windfall profit tax, to the extent that these would be available to litigants in tax cases in the U.S. district courts. Thus, for purposes of the windfall profit tax, the committee substitute would change such holdings as that of the court in *Continental Equities, Inc.* v. *Commissioner*, 551 F. 2d 74 (5th Cir. 1977). In addition, the committee substitute clarifies that appeals involving the tax essentially are tax cases, even though the tax incorporates by reference many of the regulations promulgated under the Emergency Petroleum Allocation Act of 1973, and tax liability is predicated in part on the phased in oil price decontrol program. As tax controversies, these appeals would be within the jurisdictional competence of the U.S. courts of appeal generally, and would not be subject to the exclusive jurisdiction of the Temporary Emergency Court of Appeals. Any windfall profit tax appeals would be subject to the normal appellate procedures available after Tax Court litigation.

Controversies that involve only issues relating to price controls, *e.g.*, DOE reclassifications of production, would remain subject to the ordinarily applicable litigation rules.

The grant of exclusive Tax Court jurisdiction is intended to provide taxpayers with a prepayment forum in which to litigate issues involving the tax. By granting a single trial court exclusive jurisdiction over the windfall profit tax, taxpayers should have an expert tribunal in which to resolve issues in an efficient, expeditious, and uniform manner, regardless of the location of the taxpayer or the oil. Because the Tax Court conducts sessions at various locations around the country, no taxpayer should be unduly inconvenienced by distance from the Court. In addition, under the provisions of the committee substitute, taxpayers would have the option of using the simplified rules of the Tax Court's small case procedure.

In granting the Tax Court exclusive jurisdiction, the committee anticipates that sufficiently flexible procedures will be adopted so as to avoid having parties joined, or continued, unnecessarily in a suit. For example, in a controversy involving the proper classification of oil, or the computation of the windfall profit, it is anticipated that the Court will make an early and expeditious determination of which potential litigants need not be parties to the proceeding. Thus, the Court might determine that the first purchaser reasonably relied upon the operator's certification pursuant to withholding and depositing an amount of tax less than that claimed to be due by the Internal Revenue Service. Similarly, the Court might find that an operator, without an economic interest in the property's production, reasonably

certified to the purchaser information that the producer previously had furnished to the operator and that the Service contends did not reflect accurately the data required for the purchaser to compute and deposit the tax. In instances such as these, the Court might find, incident to a preliminary procedure, that the first purchaser (in both situations) and the operator (in the latter example) need not be parties to the litigation.

To minimize the involvement of passive royalty owners with the tax, it is anticipated that the Court will develop a procedure whereby the holder of the working interest in a property would be designated automatically as the representative of all passive royalty owners, other than any such party who elects to join in the proceeding. (Any litigation involving a royalty owner which basically is unrelated to the computation of the windfall profit tax, of course, would not be within the ambit of such a special procedure.)

The committee substitute also provides a modified evidentiary rule applicable to the qualification of certain incremental tertiary projects certified by a regulatory body (see section 6(c), above). Pursuant to this rule, such projects are deemed to meet the requirements for exemption unless the Internal Revenue Service establishes that the certification was not supported by the weight of evidence presented to the regulatory body, or unless the Service presents substantial evidence that the project does not satisfy the tax's prerequisites for exemption. In applying this standard, the Court and the Service may "go behind" the documentary evidence contained in the administrative record. However, the Court is not to review the project on a de novo basis unless the Service meets either of the above standards.

To facilitate the Court's administration of its existing and new jurisdictional responsibilities, the committee substitute adds three judges to the Tax Court.

The House bill contains no provision relating to jurisdiction over the tax.

15. Effective Date

The windfall profit tax applies to oil removed on or after January 1, 1980. Although decontrol was begun on June 1, 1979, the committee has chosen the later date to permit producers, operators, purchasers, and the Treasury to adjust their business and administrative practices to the requirements of the tax. This effective date will not affect the producer's windfall tax liability in later years because the base prices on which the windfall profit is calculated are established at pre-decontrol levels. While the tax is intended to be consistent with President Carter's oil price decontrol program, the tax will apply regardless of whether that program is in fact carried out or whether controls are reimposed at some time in the future.

16. Phaseout

The tax imposed by the committee substitute would phase out after the net revenues received by the Treasury, or for which taxpayers are liable, total $127.1 billion. (The net revenue is the gross amount of windfall profit tax reduced by the reduction in individual and cor-

porate income tax receipts caused by imposition of the tax.) The phase-out would be accomplished by exempting 3 percent of production in the first month following the month the Secretary estimates the $127.1 billion level has been reached and by exempting an additional 3 percent of production from the tax in each succeeding month. The oil exempted during the phase out period would come prorata from each category of taxable oil produced from the property, with the determination of which barrels are exempt beginning with those barrels with the highest removal prices in each category. Thus, the tax would be entirely phased out 34 months after the $127.1 billion level is reached. In determining the net revenue raised by the tax, any revenue from the Federal government's economic interest is not to be taken into account.

Under the House bill, the tier three tax would have been a permanent tax. The tax on newly discovered oil and incremental tertiary oil would terminate after 1990.

17. Study of Decontrol and Tax

The committee substitute requires the President to submit a report to the Congress no later than January 1, 1983, on the effect of decontrol and the windfall profit tax on (1) domestic oil production; (2) oil imports; (3) oil company profits; (4) inflation; (5) employment; (6) economic growth; (7) Federal revenues; and (8) national security. The report is to be accompanied by such further energy-related legislative recommendations as the President may care to make.

The House bill contains an identical provision.

B. RESIDENTIAL ENERGY CREDITS

(secs. 201-3 of the bill and sec. 44c of the Code)

Present Law

Insulation and other energy conserving components

A 15-percent credit on the first $2,000 of qualifying expenditures, a maximum credit of $300, is available for installations of eligible insulation and energy conserving items made after April 19, 1977, and before January 1, 1986. Installations must be made in or on a taxpayer's principal residence. The residence must have been in existence or substantially completed on April 19, 1977, and used primarily for personal residential purposes. The $2,000 maximum on allowable expenditures is the total creditable by the taxpayer through December 31, 1985, and the limit will be reduced each year by expenditures for which the energy conservation credit was taken in prior years for the same residence. An individual is eligible for the maximum credit for each principal residence he may occupy while the credit is available.

The credit is allowed for expenditures to install (1) insulation, (2) a replacement burner for an oil- or a gas-fired furnace, (3) a device to modify flue openings, (4) an electrical or mechanical furnace ignition system, (5) an exterior storm or thermal door or window, (6) an automatic energy-saving thermostat, (7) caulking or weatherstripping for an exterior door or window, and (8) an energy usage display meter. Each energy conservation item must be capable of reducing heat loss or gain, increasing the efficiency of the heating system, or reducing fuel consumption.

Renewable energy source property

A 30-percent credit on the first $2,000 and 20 percent on the next $8,000 of expenditures for renewable energy source property, a maximum credit of $2,200, is allowed for installation of (1) solar, (2) wind, or (3) geothermal energy equipment made after April 19, 1977, and before January 1, 1986. Installations must be made in or on a taxpayer's principal residence, if the residence is used by the taxpayer primarily for personal residential purposes. The $10,000 maximum on allowable expenditures is the total creditable by the taxpayer through December 31, 1985, and the limit will be reduced each year by expenditures for which the energy conservation credit was taken in prior years for the same residence. An individual is eligible for the maximum credit for each principal residence he may occupy while the credit is available.

Generally a solar energy equipment system transforms sunlight into heat, hot water, or electricity through the use of collectors to absorb sunlight, rockbeds to store heat, and heat exchangers to transfer the heat into a usable form. Wind energy equipment involves a windmill

which uses wind to generate electricity and mechanical forms of energy. Solar and wind energy property need only be installed in connection with a dwelling, rather than in or on it. Solar and wind energy property does not include conventional heating or cooling systems which serve to supplement the solar or wind energy equipment in heating or cooling the residence.

General provisions applicable to residential energy credits

Any increase in basis of the residence attributable to energy conservation expenditures must be reduced by the amount of the credit which the taxpayer has claimed with respect to the expenditures. For example, basis otherwise would be increased by $10,000 for that amount of qualified renewable energy source expenditures, but the increase would be reduced to $7,800 for tax purposes, to the extent that the $2,200 credit was allowed for the expenditures.

An individual is eligible for the maximum credit for each principal residence he may occupy while the credit is available. Principal residences include condominiums and cooperative housing, whose owners or tenant shareholders are eligible for their proportionate shares of costs. The credit is available to homeowners and renters. Joint occupants of a principal residence also may claim the tax credit for their qualified expenditures. The statute, however, does not directly refer to cases in which owners or renters of several principal residences jointly own eligible energy conservation property.

The Secretary of the Treasury is authorized to issue regulations which specify performance and quality standards for each item, and in addition, he was granted statutory authority to add to the list energy conservation items which increase the energy efficiency of a dwelling.

For years when credits exceed tax liability, the credits may be carried over to subsequent years through 1987, i.e., 2 years after expiration of the credit.

Reasons for Change

The committee reviewed the provisions for residential energy credits in present law to assess their effectiveness in increasing efficiency in energy usage and in encouraging less reliance on oil and gas as fuel. There are two aspects to consider: first, whether the various provisions governing eligibility of equipment are broad enough to provide taxpayers with a reasonable range of alternative efficient devices, and second, whether changes are needed in the rules governing taxpayer eligibility for the credits.

With respect to the first consideration, the committee concluded that present law does not provide taxpayers with a broad enough range of alternative equipment for reducing fuel costs. Except for new structures, most residences have inefficient heating systems which reflect aging and the absence of the most recent technical improvements. Furthermore, since the start of the rapid rise in oil prices, manufacturers of furnaces have been able to increase the energy efficiency of their furnaces, and the Department of Energy has instituted a project which now will permit labeling oil and gas furnaces according to their fuel efficiency. The committee believes, therefore, that the public should be encouraged to replace inefficient and aging furnaces with new, highly efficient furnaces.

Renewable energy source property (solar, wind and geothermal) represent new energy systems for heating, cooling, providing electricity and heating water for use in dwellings. Not only are they new and often unfamiliar to potential purchasers, but the installation often is quite costly. Furthermore, it is reasonable to expect homeowners to install new heating or cooling systems only when an old unit needs to be replaced. As a result, the current market for new systems consists of replacement needs in existing homes and installations in new residences.

Making a larger credit available for new installations of renewable energy source property will have desirable effects on both the demand and supply sides of these industries. A substantial increase in the credit will induce more people to incur the costs of installing one of these new systems. The successful experience of these persons can be expected to provide the most persuasive evidence available to other individuals that it pays to install a new, renewable energy source system with respect to a dwelling.

It is also important to encourage manufacturers of renewable energy source systems and the essential component parts and the distributors and retailers who install and service the systems. The encouragement must come from sustaining and expanding the size of the market so that it is large enough to make it possible for investors to expect to earn a competitive rate of return and for employees to anticipate a long period of stable employment at a reasonable level of real earnings. A higher tax credit for renewable energy sources will encourage the demand for the equipment and services which accompany them and that in turn will encourage additional investment in the industry.

The existing credit, which is an average of 22 percent on $10,000 of expenditures, is a substantial offset to the cost of putting in new solar, wind or geothermal systems. Although the response so far to the credit has been reasonable in view of the barriers which must be overcome, the committee believes that a much stronger response must be stimulated. Consequently, the committee decided to increase the tax credit for renewable energy source property.

The review of the types of renewable energy source systems indicates that the major systems are covered under present law. Some uncertainty does exist, however, whether equipment used with a solar or wind system to generate electric energy for use in a residence may be included as property which qualifies for the credit. Photovoltaic cells may be used as part of a solar system to generate electricity for use in the residence. Similarly, wind energy also may be used to generate electricity. In both cases, the electricity may be used directly as it is generated, or it may be stored in a storage battery and drawn upon for later use.

There often are installation costs which are necessary to enable the structure in which the residence is located to bear the additional weight of the renewable energy source systems. For example, solar collectors installed as part of a roof, or as the roof, require structurally stronger roof supports. Proposed regulations would treat solar system components, such as solar collectors, as property which is an addition to a structure rather than a structural component. On the other hand, if the solar collector is part of the roof but is eligible for the credit as solar

energy property, the credit then becomes available for a normal necessary structural component. Since the committee did not intend initially that either of these two interpretations should prevail, it decided that renewable energy source property that is also a structural component would be eligible for the tax credit to the extent of the excess cost. The committee expects installation contractors to assist taxpayers by providing them with the requisite information to establish the excess cost.

Secondly, the committee's review of the provisions relating to the credit brought it to the conclusion that the rules governing the eligibility of taxpayers for the credit require several changes. The restriction of the credit to a principal residence was eliminated because it implies that it may not be desirable to have all residences refitted to increase their energy efficiency. Similarly, the credit was extended to landlords to avoid situations in which a dwelling unit would not have energy conservation property installed because the renter did not own property and the landlord was not allowed the credit. The committee decided to remove uncertainties by providing that joint owners of energy conservation property may be eligible for the credit. Finally, the committee concluded that, in light of its own reexamination of the credits, the provisions relating to the Secretary's authority to add new items to the list of qualifying property should be repealed.

Explanation of Provisions

1. *Energy conservation expenditures*

a. *Additional energy-conserving components.*—Four additional items are added to the list of energy conserving components eligible for the residential energy credit. Each item must be installed in a residence that was in existence or substantially completed before April 20, 1977. The $2,000 expenditure limit continues to apply to the total expenditures for all energy-conserving components by the taxpayer for each dwelling limit. The additional items are:

(1) A heat pump (including a water source heat pump), which replaces an electric resistance space or water heating system or is used as a back-up system for a solar hot water heater. These items will be eligible for a 15-percent credit on expenditures within the $2,000 limit for these items after September 30, 1979, and before January 1, 1986.

(2) An airtight woodburning stove, which is a nonleaking, wood burning device with a closed combustion chamber which permits the ambient air in the room to circulate over at least 50 percent of the heat radiating surface of the fire box, and more efficiently generates heat in the consumption of the wood fuel. These stoves will be eligible for a 15-percent credit on expenditures, within the $2,000 limit for energy-conserving components, made after September 30, 1979, and before January 1, 1983.

(3) A replacement oil or gas furnace or boiler will be eligible for the credit for expenditures on these items made after September 30, 1979, and before January 1, 1986. These items will not be eligible for the credit unless they meet minimum fuel efficiency standards which are:

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(a) in the case of an oil furnace, a minimum average fuel utilization efficiency rating of 80 percent, and

(b) in the case of a gas furnace, a minimum average fuel utilization efficiency rating of 75 percent.

The efficiency of oil or gas furnaces or boilers will be determined by testing procedures specified by the Secretary of Energy in regulations, and a plate or shield indicating the efficiency rating will be attached to each furnace or boiler sold. For furnaces purchased before plates or shields are attached, written certification by the manufacturer will be acceptable.

(4) A replacement coal furnace or boiler and associated equipment will be eligible for a 25-percent credit on expenditures made after September 30, 1979, and before January 1, 1983. The 25 percent credit is applicable to expenditures for a coal furnace or boiler up to the $2,000 limit that applies to all energy conservation components and insulation. Amounts spent in addition to the costs for a coal furnace and boiler within the overall $2,000 limit by the taxpayer for the same dwelling unit will be eligible for the 15 percent credit, as are insulation and all other energy-conserving components.

b. *House bill.*—The House bill would not make any changes to the conservation credits provided for in present law.

2. *Renewable energy source expenditures*

a. *Amount of credit.*—The committee increased the credit that applies to qualified renewable source expenditures to 50 percent of $10,000, a maximum credit of $5,000. This is an increase from the rates of credit in present law which are 30 percent of the first $2,000 and 20 percent of the next $8,000, a maximum credit of $2,200 on $10,000 of qualified expenditures. As in present law, the limit of $10,000 applies to the expenditures made by the taxpayer on the dwelling unit.

b. *Termination of credit.*—The termination date for renewable energy source expenditures was extended from December 31, 1985, to December 31, 1999. Unused credits may be carried over to subsequent taxable years through December 31, 2001.

c. *Electric energy.*—The definitions of renewable energy sources in present law indicate clearly that such systems also may be used to produce electrical energy for use in the residence. The committee expanded the definition of equipment eligible for the credit to include solar, wind, or geothermal equipment may be used to generate electricity for use in a dwelling unit. Electricity may be generated as part of a solar power system through the action of the sun upon a photovoltaic cell or by the wind turning, for example, the blades of a fan. In both of these cases as well as others, electric energy may be used directly or may be stored in batteries and other storage cells and used subsequently as needed.

d. *Costs of drilling a geothermal well.*—This amendment clarifies the relationship of geothermal well drilling costs that are eligible for the renewable energy source credit to the provisions in sec. 263(c) that relate to the deduction for intangible drilling costs. The committee substitute provides that a taxpayer may not take both the credit and the intangible drilling cost deduction. As a result, the amendment pro-

vides that expenditures for drilling an onsite well for any geothermal deposit qualify as renewable energy source expenditures, but only if the taxpayer has not elected to deduct any portion of these expenditures as intangible drilling costs.

The committee also clarified that renewable energy source expenditures also include expenses for labor costs attributed to preparation of the drilling site, and assembly and installation of the renewable energy source property. In other words, the costs eligible for the credit are not restricted to hardware expenses.

e. *House bill.*—The House bill would not make any changes to the renewable energy resource credit provided for in present law.

3. *General provisions relating to residential energy credits*

a. *Repeal of principal residence requirement.*—The committee extended eligibility on a per residence basis for the residential energy credits to expenditures made with respect to any residence occupied during the year by the taxpayer. As a result, a taxpayer may insulate or install other energy conserving equipment in a vacation or second home and qualify for the energy conservation credit. In addition, the taxpayer also may install solar energy equipment to provide space heating and cooling, as well as hot water, in a vacation or second home, and those expenditures will be eligible for the separate renewable energy source credit.

A residence generally will be defined as a dwelling unit including any appurtenant structures. A dwelling unit may be a single family house, an apartment in a multiunit structure or a cabin in the woods, on a mountaintop or at a shore. An appurtenant structure may include a structure housing a solar, wind or geothermal energy source, or a more conventional furnace which provides heat and/or hot water to one or more dwelling units. Such structures also may include a greenhouse or a garage which were considered part of the residence and were heated before April 20, 1977. An appurtenant structure does not include, for example, a swimming pool, or a gazebo.

b. *Allowance of credit to landlords.*—Landlords, as well as tenants, are eligible for the residential credits for energy conservation equipment and renewable energy source property. For the landlord, the limit on qualifying expenditures for both credits will apply to each dwelling unit he owns. The rate of credit, however, allowed for each dwelling will be reduced for each dwelling unit for which the lessor is allowed a depreciation allowance or amortization under section 167.

With respect to expenditures eligible for the energy conservation credit, the credit rate for landlords will be reduced fom 15 percent to 10 percent; for the renewable energy source credit, the rate of credit will be reduced from 50 percent to 40 percent. The credit rates were reduced for landlords in recognition that they are able to claim a depreciation allowance for the property, which a renter or the owner-occupant of a dwelling unit may not claim, and the depreciation allowances over the life of the qualifying property reduce the costs of the landlords.

Many multifamily residential structures are operated as a trade or business. The organizational forms range from sole proprietorships

through corporations. Each will become eligible for the residential credits.

Present law permits a renter to claim the credit for qualifying property which is added to the dwelling unit. The landlord and renter both may not claim the credit for the installation of the same qualifying property.

c. *Joint ownership of energy property.*—Under present law, two or more individuals who jointly occupy a dwelling unit as a residence may claim the residential energy credits for their proportionate shares of the expenditures for qualified energy conservation property and renewable energy source property, subject to a single $2,000 or $10,000 limit, whichever is appropriate to the kind of property. The committee decided that this rule should be expanded to cover the case of two or more individuals who occupy different dwelling units and share the installation costs and use of qualified property. The amount of qualifying expenditures shall be apportioned among the individuals according to their proportionate contributions to the cost. Each individual may claim a credit for his share of expenditures up to $2,000 for energy conservation property and $10,000 for renewable energy source property. Among the kinds of property that may be shared by individuals through a joint ownership are a geothermal well and associated heat transfer equipment.

d. *Repeal of discretionary authority.*—As a result of its review of the residential energy credits, the committee has deleted the authority given to the Secretary in the Energy Tax Act of 19798 to use his discretion to add to the statutory list of insulation, energy conserving components, and renewable energy source systems. Under this authority, the Secretary could add items which increase the energy efficiency of the dwelling, which are used initially by the taxpayer, which can reasonably be expected to remain in operation or perform services for at least 3 years (5 years in the case of renewable energy source property) and which meet performance and quality standards in effect at the time. As a result of the committee decision, no items may be added to the list of qualified equipment without legislation.

e. *House bill.*—The House bill did not contain any provisions that affect the residential energy tax credits.

Effective Date

The amendments made by this section shall apply to expenditures made after September 30, 1979. The two year carryforward rule in present law also will apply to expenditures in 1979 which a taxpayer may not be able to claim on the 1979 tax return because the authority for the credit was enacted after the income tax forms for 1979 were printed.

Revenue Effect

The residential energy credits will reduce calendar year tax liabilities by $408 million in 1980, $500 million in 1981, $899 million in 1985, $1,243 million in 1990 and $89,283 million in the period 1980–90. The reduction in budget receipts in fiscal year 1980 will be $131 million.

C. Business Tax Incentives

1. Business Energy Investment Credits

(secs. 231–235 of the bill and secs. 46, 48 and 167 of the Code)

Present Law

Present law provides both a 10-percent regular investment credit and a 10-percent energy investment credit for investments in certain property. The amount of each credit is generally 10 percent of a taxpayer's cost in acquiring or constructing eligible property, and the credits are used to offset the taxpayer's income tax liability.

To be eligible for either credit, property must be depreciable with a useful life of three years or more. For purposes of the regular investment credit, qualifying property includes tangible personal property (such as machinery and equipment), and also other tangible property (such as electric utility dams, powerhouses and other special purpose structures) used as an integral part of manufacturing, production, extraction or furnishing certain services, including electrical, gas and steam utility services. However, buildings and their structural components are not generally eligible for the regular investment credit, nor are certain boilers which use oil or natural gas (or a product of oil or natural gas) as a fuel. Vans which are owned by employers and used for vanpooling purposes qualify for the full 10-percent regular credit if they have useful lives of three years or more.

In order to qualify for the energy investment credit, property must be new (not used) property which was first placed in service after September 30, 1978. Qualifying energy property generally includes equipment which utilizes certain energy resources other than oil or natural gas or a product of oil or natural gas. Specifically, energy property includes boilers, burners, and related fuel handling and pollution control equipment to burn substances (such as coal, wood, agricultural and municipal waste, and biomass) other than oil or natural gas (or their products) or to convert these alternate substances into a synthetic fuel. Equipment which uses coal as a feedstock for the manufacture of chemicals or other products (other than coke or coke gas) and equipment that modifies existing equipment to use an alternate substance as at least 25 percent of a fuel or feedstock also is eligible for the energy credit. In addition, energy property includes equipment to produce, distribute or use geothermal energy, equipment which uses solar or wind energy to generate electricity or to heat or cool a structure, equipment to produce natural gas from geopressured brine or oil from shale, and equipment to recycle solid waste.

The energy investment credit is also provided for a category of specially defined energy conservation equipment used to improve the energy efficiency of facilities and processes in existence on October 1,

1978. In addition to specific items of equipment, such as heat wheels and recuperators, the Secretary of the Treasury is authorized to specify other similar items of conservation property under regulations.

The energy credit is available for structural components of a building which otherwise qualify as energy property. However, the energy credit does not extend to energy property used to provide electrical, gas, steam and other public utility services.

The regular investment credit may be used to offset the first $25,000 of tax liability plus a percentage of tax liability in excess of $25,000. This percentage is 60 percent for 1979 and will increase by increments of 10 percentage points a year to 90 percent for 1982 and later years. The energy credit applies against all tax liability not offset by the regular credit, and energy credits for solar or wind energy property are fully refundable to the extent these credits exceed tax liability. (However, an appropriations act is needed for the Internal Revenue Service to pay out refunds in excess of tax liability.) Other excess regular and energy credits from a taxable year may be carried to apply against tax liability for the three preceding and seven succeeding taxable years.

The energy credits generally apply to costs incurred for the period from October 1, 1978 through December 31, 1982. There is no termination date for the regular investment credit.

Reasons for Change

The committee has considered the energy investment tax credit in present law to determine whether changes are desirable in view of the past year's experience with the provisions, the effectiveness of the provisions in realizing the energy policy objectives of the Energy Tax Act of 1978, and the current statements of broader energy perspectives.

The past year's experience with present law indicates that the range of incentives is not broad enough to carry out the objectives of the Energy Tax Act of 1978 because important means to conserve use of oil-and-gas-derived energy were not accorded the additional credit. Several forms of energy property which uses alternative energy resources were not included in the 1978 legislation, and current perspectives indicate they should be added to the committee substitute. In addition, certain essentially procedural rules need clarification or amendment so that they will facilitate carrying through national energy policy.

Many industrial investments, especially those which involve construction of new facilities or development of production facilities for new technologies, require longer periods to design and construct. New technologies, particularly, involve more than usual amounts of uncertainty about the probable success of the entire project as well as whether any components of a new process will require redesign. These considerations convinced the committee to extend the termination date for certain affirmatively committed projects, and to increase the credit and extend the effective period for selected energy equipment.

Explanation of Provision

The committee substitute includes a coordinated package of energy investment credit incentives to encourage the development of additional energy resources other than oil and natural gas, to promote increased utilization of alternate resources for which incentives were provided under the Energy Tax Act of 1978, and to increase energy conservation. Specifically, these incentives take the form of new categories of energy property, increased rates of energy credits, broadened availability of the credits, and extension of the effective period for energy credits in areas of new technology and where energy projects require long periods of planning and construction which would necessitate their completion after 1982. The committee's decisions are described below, generally by category of energy property.

Solar or wind property

The present 10-percent refundable energy credit for equipment which uses solar or wind energy to generate electricity or to provide heating, cooling or hot water in a structure, is increased to a 20-percent credit, and the effective period of the credit for this property is extended from 1982 through 1990. In addition, equipment which uses solar energy to provide industrial, agricultural, or commercial process heat is added as eligible solar energy property. Solar process heat equipment includes, for example, collectors and heat exchangers which use solar energy to generate steam at high temperatures for uses in such facilities as beverage bottling plants, laundries and canneries.

Geothermal equipment

The present 10-percent nonrefundable energy credit for equipment to produce, distribute or use geothermal energy (including the generation of electricity) is expanded to a 20-percent credit under the committee substitute. In addition, the termination date for this credit is extended from 1982 through 1990.

Ocean thermal equipment

A new category of energy property, ocean thermal equipment, is provided a nonrefundable energy credit of 20 percent through 1990. Ocean thermal equipment is defined as equipment used to convert ocean thermal energy into electrical energy or another form of useful energy. Qualifying property in this category includes generators and other equipment, up to, but not including, the electrical transmission stage, used in the conversion of ocean thermal energy into usable electric power. In addition, qualifying equipment includes barges and structures specifically designed and used to support, house and service qualifying equipment.

Small-scale hydroelectric facilities

The committee substitute provides a 10-percent nonrefundable credit through 1990 for property used in the production of electrical energy by hydroelectric power where the generating equipment has an installed capacity of 25 megawatts or less and is installed either at the site of an existing dam or at a site which does not involve the use of

a dam or other water impoundment structure. For purposes of this provision, an existing dam or impoundment structure is intended to mean one on which construction was completed before October 18, 1979, and which does not require any new construction or enlargement of the impoundment structure (other than repairs or reconstruction) in connection with the installation of small hydroelectric power equipment. Sites which do not involve the use of a dam or other impoundment structure include conduit sites, such as flood control, sewage treatment and irrigation water flows (and other similar constructed water flows), and also river flows where small hydroelectric equipment is installed in a natural watercourse.

Qualifying items of hydroelectric property for purposes of this credit are generating equipment (including turbines, generators, switch gear and transformers) up to, but not including, the electrical transmission stage, powerhouses and similar structures to house and support generating equipment, penstocks for the passage of water from the impoundment to the turbine, and fish passageways (such as fish ladders) and related equipment (such as fish counters) used to facilitate the movement of fish upstream or downstream from the impoundment structure or generating site. In addition, qualifying property includes costs to rehabilitate or reconstruct existing dams where these costs are incurred in connection with the installation of qualifying generating equipment.

In addition to these investment credit incentives, the committee substitute provides liberalized depreciation treatment for qualifying small scale hydroelectric property in order to make depreciation allowances for this property more comparable with depreciation allowed other electrical generating property under present law. Under the committee substitute, this property may be depreciated with a 20-year useful life (or a range from 16 to 24 years using the 20-percent variance) under the Asset Depreciation Range (ADR) system, rather than the 50-year useful life (40 to 60 years with 20 percent variance) generally provided for hydroelectric property under present law. Similarly, the annual repair allowance under the ADR system is increased to 4.0 percent from the 1.5 percent allowance generally allowed this property under existing law. Finally, the bill specifies that accelerated methods of depreciation will be allowed for small-scale hydroelectric property without regard to the provisions of existing law which deny accelerated depreciation to utilities when the tax benefit from the accelerated deductions is flowed through too rapidly as lower consumer prices.

Cogeneration equipment

Another category of property made eligible for an energy investment credit under the committee substitute is cogeneration property, for which a 10-percent nonrefundable credit is provided through 1982. To qualify as energy property, cogeneration equipment must be installed in connection with an existing non-oil-burning boiler or burner at an existing facility and must result in an expansion in the facility's cogenerating capacity (including the start of cogenerating activity). The determination of when a facility is in existence is made as of January 1, 1980 and, in the case of cogeneration equipment installed

in connection with a facility which uses natural gas as a fuel, the facility must have used natural gas on January 1, 1980. Under the committee substitute, cogeneration equipment means property which produces steam, heat, or some other form of useful energy (other than electricity), for industrial, agricultural, commercial, or space heating purposes, and which also produces electricity.

In this context, cogeneration equipment includes the addition of equipment to produce or distribute steam, heat, or other usable energy in a secondary function from an existing electric generating facility and also the electrical generating equipment which is added to an existing industrial or commercial facility which presently produces steam or another form of energy other than electricity.

It is intended that cogeneration equipment include steam and heat distribution systems that are added to an existing electrical generating facility. In addition, it covers a supplemental boiler and an electrical generating turbine which are added to an existing industrial or commercial boiler or other heat-producing sources, where these additions are necessary in order to enable the facility to cogenerate. Where it is necessary to replace an existing boiler in order to enable an existing industrial or commercial facility to cogenerate, this replacement boiler will be covered only to the extent of additional capacity which is related to a cogenerating function.

Where a taxpayer has operational cogenerating capacity in place on January 1, 1980, the credit will be available only to the extent that additional or replacement cogeneration equipment increases the cogenerating capacity of the facility. For this purpose, the eligible investment is determined from either the incremental capacity (in terms of megawatts) to produce electricity or the incremental capacity to produce steam (in terms of pounds per hour) or other forms of heat.

Specially defined energy property

Several changes are made under the committee substitute to provisions of present law which provide a 10-percent nonrefundable energy credit through 1982 for heat wheels, recuperators and other items of specially defined energy property used to increase the efficiency of energy consumption in existing processes at existing agricultural, industrial and commercial facilities. A new category of property, modifications to alumina electrolytic cells, is added where these modifications are for the principal purpose of reducing the amount of energy consumed or heat wasted and the costs of these modifications are incurred after September 30, 1978, in connection with alumina processing operations which were carried on in a facility in existence on October 1, 1978. For this purpose, qualifying modifications are intended to mean either a substitution or a substantial change in technology and not periodic cleaning, repairs, or replacement of these cells or their components.

A second new category of specially defined energy property is industrial heat pumps (including water source heat pumps) placed in service after December 31, 1979, and added to industrial facilities in existence on that date. Industrial heat pumps are devices, utilized in industrial or manufacturing processes, that use the compression and expansion of a gas in a system to extract heat from a gas or liquid and

transfer it to another gas or liquid at a higher temperature. This provision does not include heat pumps used for the primary purpose of providing space heating or cooling in a building.

The third change made by the committee to these specially defined energy property provisions involves elimination of the authority delegated to the Secretary of the Treasury under the Energy Tax Act of 1978 (and not yet exercised) to specify similar items of qualifying property under regulations.

Petroleum coke and pitch

The committee substitute also treats petroleum coke and petroleum pitch as alternate substances for purposes of the present 10-percent energy credit. In addition, these materials will not be considered as petroleum products for purposes of the provisions in present law which deny the regular 10-percent investment credit and accelerated methods of depreciation to certain boilers fueled by oil, natural gas or their products.

Petroleum coke and petroleum pitch are solid by-products of petroleum refining. They are the residues which result from coking and deasphalting processes which are applied to heavy oil in order to maximize the recovery of gasoline and other distillate products from the oil. Both of these petroleum by-products contain concentrated amounts of sulphur and other impurities, which make them usable as a fuel only where used with expensive pollution control equipment or as a gasification feedstock. The committee substitute will encourage the increased utilization of these materials in the United States.

Biomass property

The use of waste products and other biomass is presently underutilized as an energy resource in the United States but is widely used in other countries, particularly in Europe. Boilers and other equipment used to burn biomass, convert biomass into a synthetic fuel or burn these fuels are presently provided the 10-percent energy credit through 1982. The committee substitute expands this incentive for various biomass-related activities in coordination with production credits and the incentives which are provided for the production of alcohol for gasohol purposes.

Under the committee substitute, the credit is expanded to 20 percent and extended through 1990 for alternative energy property (as defined under present law) which is used to burn nonwood biomass and to equipment to process nonwood biomass into a solid fuel.

In addition, the present 10-percent credit is extended through 1990 for alternative energy property used to produce a solid fuel from biomass, or to burn wood biomass or a solid fuel derived from wood biomass. The present 10-percent credit will continue to be available through 1982 for energy property used to process biomass into a liquid or gaseous fuel. The committee substitute does not increase the present investment credit for these kinds of equipment because these products are provided either a production credit or the gasohol tax incentives under other provisions of the committee substitute.

For purposes of these rules, biomass is defined as living matter, including animal waste, wood biomass, municipal and industrial waste, sewage, sludge, and oceanic and terrestrial crops. Wood biomass is

that derived from timber and trees, including wood, wood products, timber waste and wood-based industrial waste (such as sawmill and papermill waste), but excluding wood-based end products (such as paper) in municipal and other waste.

Regular investment credit for energy property

In order to reduce ambiguities concerning the definition of qualifying energy property and the eligibility of property for the energy credit, Congress provided, in the Energy Tax Act of 1978, that certain generally applicable rules pertaining to investment credits would not be applicable for purposes of the energy credits. Although it is generally perceived that energy property also qualifies for the regular 10-percent investment credit, there are a number of situations where energy property will not in fact qualify for this credit. In order to resolve this ambiguity, the committee substitute specifically makes energy property eligible for the regular investment credit for the period beginning January 1, 1980, and ending when an energy credit terminates for a specific category of energy property. For example, coal-fired boilers installed in a lodging or commercial facility will qualify for the regular credit through 1982, and expenditures for rehabilitation of existing dams for small hydroelectric industrial power generating purposes will qualify for the regular credit through 1990.

Vanpooling

A modification is also made to the present law rules which allow a full 10 percent regular investment credit (rather than, in effect, either one-third or two-thirds of the full credit) for employer-owned vans which have a useful life of at least three years and are used for vanpooling purposes. The availability of this provision is expanded under committee substitute, so that vans owned by either employees or third parties will also qualify for the full regular credit where the vans are used for vanpooling purposes and have a useful life of three years or more.

Public utility property

Under the committee substitute, exceptions are made to the present law rules under which public utility property is ineligible for the energy investment credit. Under these exceptions, public utility property which is solar, wind, geothermal, ocean thermal, small-scale hydroelectric or cogeneration energy property will qualify for an energy credit. In addition, the energy credit is extended to public utility property which is biomass property, that is, alternative energy property used in connection with the burning of biomass as a fuel, converting biomass into a solid, liquid or gaseous synthetic fuel, or burning a solid fuel derived from biomass. Other categories of property, such as specially defined energy property, which are public utility property will continue to be ineligible for the energy credit.

Affirmative commitments

The committee has noted that a number of categories of energy property investments under both the 1978 legislation and the committee substitute involve complicated licensing procedures and lengthy design and construction periods and corresponding long-term com-

mitments of funds. Because under present law there is a period of only slightly more than three years before some of these credits expire on December 31, 1982, the bill sets forth a rule under which energy credits which otherwise expire in 1982 may be claimed for qualifying investments which occur after that date and before January 1, 1991, where certain tests are satisfied to manifest an affirmative commitment to acquire or construct qualifying energy property which involves long-term projects, such as large boiler and electrical generating systems and gasification and synthetic fuel plants. Under these rules, an energy credit will be allowed for basis attributable to construction or acquisition of qualified property after December 31, 1982, and before January 1, 1991, where (1) the taxpayer has, before January 1, 1983, both completed engineering studies sufficient to identify the site, processes, and equipment required in connection with a qualifying facility, and has applied for all environmental and construction permits necessary for the construction of the facility; and (2) has entered into binding contracts, before January 1, 1986, to acquire or construct at least 50 percent of all equipment (determined on the basis of cost as of December 31, 1985) that is specially designed for that facility. An increase in the cost of specially designed equipment due solely to a modification in design (which does not increase capacity) after 1985 will be disregarded for purposes of the 50-percent test.

It is the intent of the committee that relatively short-term projects to acquire and install energy equipment (such as specially defined energy property) are excluded from this rule, and, as a reflection of this intent, projects which qualify for this extended effective date rule are those which it is expected will have a normal construction period of two years or more under the rules which pertain to the treatment of qualified progress expenditures for purposes of investment credits (Code sec. 46(d)).

House bill

There are no provisions in the House bill related to business energy credits.

Effective Date

These provisions generally are effective for property placed in service after December 31, 1979, to the extent of expenditures incurred after that date and before the relevant expiration date for the specific provisions, either January 1, 1983, or January 1, 1991. The amendment concerning vanpooling vehicles will be effective for qualifying vans which are acquired on or after January 1, 1980. In addition, the provision which relates to the qualification of modifications to alumina electrolytic cells will be retroactive to apply to expenditures incurred after September 30, 1978, for qualifying modifications placed in service after that date.

Revenue Effect

The business energy investment credits will reduce calendar year liabilities by $151 million in calendar year 1980, $225 million in 1981, $313 million in 1982, $1,109 million in 1985, $1,962 million in 1990, and $11,365 million in the period 1978–90. The revenue loss in fiscal year 1980 will be $71 million.

2. Alternative Energy Production Credit (sec. 251 of the bill and new sec. 44D of the Code)

Present Law

Present law contains no tax credit specifically for the production of energy.

Reasons for Change

The committee believes that a tax credit for the production of energy from alternative sources will encourage the development of these resources by decreasing the cost of their production relative to the price of imported oil.

These alternative energy sources typically involve new technologies, and some subsidy is needed to encourage these industries to develop to the stage where they can be competitive with conventional fuels. The information gained from the initial efforts at producing these energy sources will be of benefit to the entire economy.

Thus, the production credit in the committee substitute is designed to apply only for a limited period of time, after which the committee expects that no special incentive will be needed.

The United States possesses vast reserves of many of the alternative sources eligible for the credit, including oil shale, geopressured gas and coal. If the credit leads to the development of these alternative sources, it would make a major contribution to reducing our dependence on imported energy.

Explanation of Provision

Overview

The committee substitute would provide a tax credit for the domestic production of energy from certain alternative sources. The credit would be nontaxable and nonrefundable. It would be equal to $3 for the production of an amount of energy equivalent to that contained in a barrel of crude oil, and all energy equivalent measurements would be made on the basis of Btu content. Therefore, a $3 credit would be allowed for the production of 5.8 million Btus of energy.

Eligible sources

The credit would be available for the following forms of energy production:

(1) Oil from shale;
(2) Oil from tar sands;
(3) Natural gas from geopressured brine, coal seams, or Devonian shale;
(4) Liquid, gaseous, or solid synthetic fuel (other than alcohol) from coal liquefaction or gasification facilities;
(5) Gas from biomass (including wood);
(6) Steam from solid agricultural by-products; and
(7) Qualifying processed solid wood fuels.

Definitions

Shale oil is the liquid oil obtained from shale rock after the retorting (heating) process but before hydrogenation, refining, or any other process subsequent to retorting.

For purposes of the credit, the definition of natural gas from geopressured brine, coal seams and Devonian shale would be the same as that determined by the Federal Energy Regulatory Commission under the Natural Gas Policy Act of 1978. Solid synthetic fuel produced from coal liquefaction or gasification would include solvent refined coal.

Qualifying processed solid wood includes raw wood products derived from timber and trees, including timber waste and wood-based industrial waste. It does not include wood-based products contained in municipal and other waste (such as paper).

Solid fuels produced from wood would qualify for the credit only if the energy content, per unit of volume, of the processed wood exceeds that of the unprocessed wood by at least 40 percent. Generally, the unprocessed wood is raw wood, e.g., forestry wastes. However, for purposes of the credit, "unprocessed" wood also may refer to some wood by-products prior to energy-enhancement processing, but after some unrelated manufacturing or industrial processing. Wood processed for recreational or ornamental uses, e.g., barbecue fuel or garden ground coverings, would not qualify for the credit.

Although under some circumstances a 40 percent dehydration of the unprocessed wood could indicate a 40 percent increase in energy content, based on a unit of volume, the producer would have to be prepared to establish that the production meets this standard.

Biomass would include organic waste, municipal and industrial waste, sewage, sludge, and oceanic and terrestrial crops.

Eligible uses

Generally, the credit would be available for energy produced for sale to other persons. However, in the case of steam produced from solid agricultural by-products, the credit would be allowed for energy production used in the taxpayer's trade or business.

Generally, the credit would be available for post-1979 production from domestic facilities placed in service between October 1, 1979, and December 31, 1989, if the sale occurs after December 31, 1979, and before January 1, 2001. However, special rules would apply in the case of steam produced from solid agricultural by-products and for the production of qualifying processed wood. In the former instance, the credit would be available for post-1979, and pre-1985, production from facilities placed in service after September 30, 1978; in the latter instance, the credit would be available for post-1979, and pre-1985, production from facilities placed in service after April 20, 1977, if the sale occurs after 1979 and before 1985.

Credit allocation

Taxpayers would be entitled to the credit in proportion to their ownership interest in the facility or the production. In the case of production from shale, geopressured brine, coal seams, Devonian shale, and tar sands, the credit would be based on the taxpayer's economic interest in the property (within the meaning of Code section 613(a)). The production attributable to the taxpayer for any taxable year would be equal to an amount which bears the same ratio to total production

from the property for that year as the amount of the taxpayer's gross income from the property, on account of that production, bears to the aggregate gross income from the property of all persons having an economic interest in the property. In the case of energy production from biomass, solid agricultural by-products, coal liquefaction and gasification, and qualifying processed wood, the credit would be based on the taxpayer's interest in the facility.

Amount of credit

The credit would be $3 for the production of 5.8 million Btus, and would be adjusted for post-1979 inflation, as measured by changes in the GNP deflator from its average level in 1979.

The amount of the credit available for production from any particular facility would be reduced in proportion to tax-exempt financing and Federal grants used to construct or acquire the facility or its equipment. For example, the credit would be $1.50 per 5.8 million Btus, rather than $3, if 50 percent of the facility was constructed or acquired with Federal grants or tax-exempt financing. For purposes of this credit reduction rule, loan guarantees are not considered to be Federal grants.

It is anticipated that the credit will be taken into consideration by any Federal instrumentality in conjunction with decisions relating to loan guarantees, price supports, purchase agreements, etc.

Phaseout

Notwithstanding the termination date for the credit, it would phase out as the average refiner acquisition cost of imported crude oil, including any applicable import duties or fees and transportation charges, rises from $23.50 to $29.50 per barrel. The average refiner acquisition cost of imported crude oil is to be determined by the Secretary and disseminated to producers of alternative fuels. The $23.50 to $29.50 phase out range is to be adjusted for post-1979 inflation, as measured by changes in the GNP deflator from its average level in 1979.

If, once the adjusted phaseout price of $29.50 is reached, the average price of imported oil falls below the phaseout level, the credit would be reactivated.

The House bill contains no comparable provision.

Effective Date

Subject to the previously described limitations, the credits would apply for production after December 31, 1979.

Revenue effect

Under the price assumptions used in this report, the production credit would have a negligible revenue effect. However, if oil prices are sufficiently low that the phaseout is not triggered, the revenue loss would be $18 million in calendar year 1980, $45 million in 1981, $354 million in 1985, $1,239 million in 1990, and $4,941 million over the period 1980–1990.

3. Incentives for the Production of Alcohol Used in Motor Fuels (sec. 236 of the Bill and new secs. 86 and 6430 and secs. 39, 4041, 4081, and 6427 of the Code)

Present Law

Under present law, a manufacturers excise tax of 4 cents a gallon is imposed on gasoline sold by the producer or importer (sec. 4081). Also, a retailers excise tax of 4 cents a gallon is imposed on diesel and other special motor fuels sold for use (or used) in a highway vehicle (sec. 4041).[1]

A number of exemptions from these taxes are provided for certain tax-exempt uses of fuel (such as use in farming) as well as for certain tax-exempt users (such as State and local governments). In many situations, if tax-paid fuel is used for a tax-exempt use or by a tax-exempt user, a refund or credit may be obtained.[2]

Revenues from these taxes, as well as certain other excise taxes[3] imposed on highway-related items, are deposited in the Highway Trust Fund. Also, the Highway Trust Fund generally is reduced by credits or refunds of these taxes.

Prior to the Energy Tax Act of 1978, motor fuel which was a blend of gasoline and alcohol ordinarily would have been subject to a 4-cent-per-gallon tax if used in a highway vehicle. This is the same rate of tax as would apply to ordinary gasoline used in highway vehicles. Under the Energy Tax Act of 1978, gasohol (i.e., fuel which is a blend of gasoline, or other motor fuel, and alcohol) that is at least 10 percent alcohol (other than alcohol derived from petroleum, natural gas, or coal) is exempted from the Federal excise taxes on motor fuels on or after January 1, 1979, and before October 1, 1984. The Act provides that gasoline may be sold free of tax if it is to be used in the production of gasohol. The Act also provides that if the gasohol for which an exemption from the tax is obtained is later separated into gasoline and alcohol, the person doing such separation is to be treated as the producer of the gasoline and thus would ordinarily be liable for the 4-cent-a-gallon tax. No provision is made for refund of the tax on gasoline if tax-paid gasoline is mixed with alcohol to produce gasohol.

Approximately 14 States also provide an exemption for gasohol from all or a portion of comparable State gasoline taxes. These exemptions range from $.095 in Arkansas to $.01 in Connecticut and Maryland.

Entitlements.—Under the entitlements program of crude oil price controls, producers of alcohol that is used in the manufacture of gasohol receive 4.5 cents a gallon ($1.89 a barrel) for each gallon that is blended into a 90 percent gasoline, 10 percent alcohol fuel mixture.

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[1] The other special motor fuels are benzol, benzene, naptha, liquified petroleum gas, casinghead and natural gasoline, or any other liquid (other than kerosene, gas oil, fuel oil, gasoline, or diesel fuel).

[2] See secs. 39, 6416, 6420, 6421, and 6427.

[3] These taxes are the manufacturers excise taxes on lubricating oil, trucks, truck parts, tires, tubes, and tread rubber and the tax on use of heavy highway motor vehicles (secs. 4061, 4071, 4091, and 4481).

Investment credits.—Equipment used to produce alcohol for use as a fuel is eligible for the 10-percent energy investment credit, as well as the regular 10-percent investment credit.

Reasons for Change

In 1978 Congress concluded that it was important to encourage the development of energy sources other than petroleum products for use in motor fuels. Consequently, Congress provided that gasohol which is at least 10 percent alcohol (other than alcohol derived from petroleum, natural gas, or coal) would be exempted from the 4-cent-a-gallon Federal excise taxes on motor fuels.

On reexamination of this issue, the committee concluded that the amount of the tax incentive provided by this excise tax exemption—which confers a tax benefit approximately equal to 40 cents per gallon of alcohol—is generally appropriate. However, the basic policy to provide a tax benefit for alcohol used in motor fuels can be somewhat better effectuated by a revised approach. Also, the excise tax exemption provided in 1978 has certain technical defects which should be corrected.

Some of the problems with the exemption approach include the following. First, the maximum benefit per unit of alcohol is obtainable for mixtures in which the alcohol constitutes 10 percent. There is no incentive to make the alcohol a greater percentage of the fuel. Second, there is no incentive for tax-exempt users, or persons purchasing for tax-exempt uses, to use gasohol as opposed to regular gasoline or diesel fuel (since no excise tax would be imposed in either event). Third, there is no tax incentive to blend less than 10 percent alcohol in motor fuels although mixtures with less than 10 percent alcohol do involve some savings of petroleum fuels. Fourth, the excise tax exemption for gasohol is not limited to conferring a benefit only on gasohol which includes domestically produced alcohol or alcohol produced from domestic ingredients, and apparently such a limitation could not be provided under our trade agreements. Fifth, the exemption approach does not provide any tax incentive to produce alcohol from coal to be mixed with motor fuels.

The committee has concluded that these deficiencies in the current provision can be alleviated by adopting (in lieu of the current excise tax exemption) provisions which provide for a 40-cent-a-gallon refundable income tax credit on alcohol (other than alcohol derived from petroleum, natural gas, or coal) used in motor fuels and a 10-cent-a-gallon credit on alcohol made from coal and used in motor fuels. This credit is limited to domestic production of alcohol from domestic resources. Since the credit is measured by the amount of alcohol used in these fuels, it provides additional incentives to use more than 10 percent alcohol in gasohol, provides some incentive for the use of less than 10 percent alcohol, and also provides incentives for the use of gasohol by tax-exempt users and for tax-exempt uses. Also, consistent with our obligations under trade agreements, such a production credit can be limited to domestically produced alcohol. In addition, an appropriate tax incentive can be granted for the use of coal-derived alcohol in motor fuels.

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A problem concerning the application of current law relating to the excise tax exemption has come to the committee's attention. In what appears to have been a technical oversight, the Energy Tax Act of 1978 made no provision for refund of the tax on gasoline if tax-paid gasoline is mixed with alcohol to produce gasohol. To overcome this problem, the committee believes that it is appropriate to provide that if a person mixes alcohol (other than alcohol derived from petroleum, natural gas, or coal) and tax-paid gasoline to produce gasohol for resale or for use in his trade or business, that person should obtain a direct refund of the Federal excise taxes paid on the gasoline. This provision applies only with respect to calendar year 1979, the period for which the Federal excise tax exemption on gasohol is in effect.

Explanation of Provisions

Overview

The committee substitute provides a refundable income tax credit to the producer of 40 cents a gallon on domestically produced alcohol (other than alcohol produced from petroleum, natural gas, or coal) used or sold for use in motor fuels and 10 cents a gallon on alcohol made from coal and used or sold for use in motor fuels. An advance refund is available once during each of the first 3 quarters of the taxpayer's taxable year if the amount payable is at least $1,000.

The credit referred to above is in lieu of the current Federal excise tax exemption for gasohol which is repealed as of January 1, 1980. However, the committee substitute provides that with respect to gasohol which is exempt from Federal excise taxes on motor fuels under current law, the person who mixes alcohol and tax-paid gasoline may obtain a direct refund of the Federal excise taxes paid on the gasoline.

Refundable income tax credit

Eligibility for credit.—This refundable income tax credit may be obtained by the producer of domestically produced alcohol (from domestic ingredients).[4] Alcohol will qualify for the credit if (1) it is used by the producer in a mixture with gasoline or other motor fuels which are blended for sale or for use in a producer's trade or business, (2) it is sold by the producer for use by the purchaser, or resale by the purchaser to a second purchaser for use, in the production of such a mixture but only if such mixture is to be held for sale or for use in a trade or business, or (3) it is actually used in the production of such a mixture for sale or use in a trade or business by a subsequent purchaser and the producer is notified of such a use.[5] The alcohol may be eligible

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[4] The producer to whom the credit applies is the final producer of the alcohol. Thus, if a person distills alcohol to approximately 170 proof and then transfers the alcohol to a second person who further distills the alcohol to 190 proof, the second person would be entitled to the credit when the alcohol is used or sold for use in a mixture with gasoline or another motor fuel.

[5] If a person has certified to, or notified, the producer of alcohol that such alcohol is to be used in the production of gasohol, and any person sells or uses the alcohol for another purpose, a tax equal to 40 cents a gallon (10 cents a gallon in the case of alcohol produced from coal) is imposed on the person who has diverted the alcohol for such a use. Thus, if the credit or refund is allowable with respect to alcohol and the alcohol is diverted from use in gasohol, the credit or refund is "recaptured" from the person responsible for the diversion.

for the credit if it is mixed with gasoline or any other motor fuel (including any motor fuel which has the same physical characteristics of any motor fuel which, if it were used for an appropriate purpose, would be subject to tax under section 4041 or 4081).

No credit is available if the alcohol is to be exported or used in gasohol which is exported.

It is anticipated that the Internal Revenue Service will develop a procedure whereby persons who produce alcohol or blend alcohol with motor fuels may register as producers or blenders and also that the Internal Revenue Service will develop a simple form on which such blenders can certify to the producer that they are purchasing the alcohol for blending with motor fuels. It is also anticipated that the amount and the availability of the credit will be reflected upon the invoice andd other documentation when alcohol is transferred from a producer to a blender.

Although there is no statutory requirement that the producer of alcohol pass the credit on to the blender, it is anticipated that the credit will be passed through (by reductions in the price of the alcohol) since without the credit the alcohol will be priced too high to make gasohol competitive with ordinary gasoline.

Amount of credit.—The amount of the credit is 40 cents per gallon of alcohol [6] produced from any type of ingredient other than petroleum, natural gas, or coal. The credit is 10 cents per gallon for alcohol produced from coal. No credit is available for alcohol produced, directly or indirectly, from petroleum or natural gas.[7]

Advance refund.—An advance refund may be obtained once a quarter for each of the first 3 quarters of the taxable year if the amount of the credit available for such quarter is at least $1,000. The credit is payable only at the time the alcohol is sold or used by the producer (or, if a credit or refund has not previously been claimed, at the time the producer is notified that a purchaser has used the alcohol in producing gasohol). The quarterly refund procedure provided by the committee substitute is similar to other quarterly refund producers with respect to certain excise tax refunds (see sec. 6427).[8]

Any amounts of credit which are not claimed on a quarterly claim for refund are to be claimed by the taxpayer as a credit against the taxpayer's income tax. This credit is refundable; that is, it may exceed the taxpayer's tax liability and any such excess will be refunded to the taxpayer.

Inclusion in income.—An amount equal to the amount of credit claimed by the taxpayer for the taxable year is included in the tax-

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[6] In the case of ethanol which contains less than five percent by volume of a denaturant other than gasoline, the volume of the ethanol is to be treated as including the volume of the denaturant.

[7] The restriction on the availability of the credit to materials other than materials made from petroleum or natural gas will not apply in the case of alcohol produced from waste products which might contain such ingredients.

[8] An additional refund procedure is provided for persons who are generally exempt from income tax. Such a person may obtain a refund of the amount payable with respect to its annual accounting period if the person files a claim not later than the time prescribed by law for filing a claim for credit or refund of overpayment of income tax for such annual accounting period. Tax-exempt organizations are also eligible for quarterly refunds under the same circumstances as other persons.

payer's income for such year. This includes the amount of credits claimed pursuant to the advance refund procedure with respect to any calendar quarter ending during the taxable year as well as the amount of credit claimed on the tax return for the taxable year.

The reason for this income inclusion is that the benefit is intended to be generally the same as the benefit of a 4-cent-per-gallon excise tax exemption for a gallon of gasohol which is comprised of 10 percent alcohol and 90 percent otherwise taxable motor fuels.[9]

Effect on Highway Trust Fund.—The present exemption of gasohol from the Federal excise taxes on motor fuels reduces the amounts which are transferred to the Highway Trust Fund (because it reduces taxes which are earmarked for this Fund). This credit will not reduce the amounts in the Highway Trust Fund.

Effect of credit approach on fuels taxes.—Under the committee substitute, the excise taxes applicable to fuel which is a blend of gasoline or other motor fuels and alcohol would be determined under the same general approach as under the law prior to the Energy Tax Act of 1978. Thus, under the committee substitute, the excise tax ordinarily would be 4 cents per gallon on the entire amount of the mixed fuel (or gasohol). In cases where the alcohol is blended with gasoline, the resulting fuel will be treated as gasoline and the mixer will be treated as the producer of the gasoline (see sec. 4082). Consequently, the manufacturers excise tax under section 4081 will apply. In the case of alcohol mixed with diesel fuel or special motor fuels, the retailers excise taxes or use taxes on such fuels will apply to the entire amount of the fuel.[10]

Since the mixing of gasoline and alcohol is treated as the production of gasoline, the person who mixes gasoline and alcohol will be able to purchase gasoline tax-free (see sec. 4083). Also, if such a person acquires tax-paid gasoline which is used in a mixture of alcohol and gasoline, such person may obtain a refund of the taxes imposed on the gasoline under the provisions of existing law.

Credit or refund of excise taxes on tax paid gasoline used in gasohol

Under present law, as amended by the Energy Tax Act of 1978, gasohol is exempted from the Federal excise taxes on motor fuels on or after January 1, 1979. However, no provision is made for the refund

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[9] Because the excise tax is a deductible expense for the person on whom it is imposed (the producer in the case of gasoline or the retailer in the case of diesel fuel or special motor fuels), it is necessary to have an amount equivalent to the income tax credit (or refund) includable in income to produce the same net tax effect. Thus, for a taxpayer in the 40 percent marginal tax bracket, a 40 cent excise tax exemption is worth 24 cents after income tax since the loss of the deduction will increase income tax liability by 16 cents. Similarly a 40 cent refundable income tax credit plus the inclusion in income of 40 cents will result in a benefit of 24 cents after income tax.

[10] Section 221(c) of the Energy Tax Act of 1978 directs the Secretary of Energy, in consultation with the Secretary of the Treasury and the Secretary of Transportation, to submit to the Congress annual reports on the use of alcohol in fuel for 1980 through 1984. These reports are to include information on the use of alcohol in motor fuels, the amount of gasoline saved by the use of alcohol in fuels, and the revenue costs of the exemptions for gasohol from the Federal excise taxes motor fuels. The committee substitute makes changes in this provision to conform the statutory language to the revisions in the rules relating to tax incentives for alcohol used in motor fuels and deletes the requirement that a report be made in 1980 because of the change in the law made by this provision.

or credit of the tax on gasoline if tax-paid gasoline is mixed with alcohol to produce gasohol. (In general, no similar problem occurs in the case of diesel fuel or special motor fuels purchased to be mixed with alcohol since the tax is imposed at the retail level and not the manufacturer level.) This exemption is repealed for sales or uses after December 31, 1979.

The committee substitute provides that, with respect to gasohol which is tax exempt because it is sold or used during 1979, a person who mixes alcohol and tax-paid gasoline to produce gasohol for resale or for use in his trade or business may obtain a direct refund of the Federal excise taxes paid on the gasoline. These refunds may be obtained directly from the Treasury Department if a claim for refund is filed before July 1, 1980.

This refund applies to tax-paid gasoline used in tax-exempt gasohol which is sold or used after December 31, 1978 and before January 1, 1980. The initial date is the same effective date that applies with respect to the exemption for excise taxes on gasohol, and the termination date is the date of the repeal of the exemption from Federal excise taxes under the committee substitute.

To prevent the allowance of more than one credit or refund of the same taxes, the committee substitute also provides that a refund of excise taxes on gasoline is allowable under these new provisions only if no credit or refund of these taxes was made under any other provision of the Code.

The House bill does not contain any provisions similar to these provisions of the committee substitute.

Effective date

The income tax credit provided by these provisions generally applies to alcohol which is sold or used by the producer after December 31, 1979, and before January 1, 2000.

The excise tax exemption for gasohol is repealed for gasohol which is sold or used after December 31, 1979.

A special transitional rule is provided to take care of situations (1) in which a taxpayer has gasohol on hand on January 1, 1980, for sale or use in his trade or business or (2) in which a taxpayer has acquired alcohol before January 1, 1980, to mix with gasoline or other motor fuels on or after such date. In these situations, if the taxpayer sells or uses the gasohol before April 1, 1980, the taxpayer will be treated as if he had produced and sold or used the alcohol (including the alcohol previously mixed in the gasohol) on January 1, 1980, and thus the taxpayer would be eligible for the credit or refund generally available only to a producer of alcohol. In applying the transitional rule, the credit or refund is not available for alcohol produced from coal but is available for imported alcohol (because of the rules relating to the alcohol which could be used in producing tax-exempt gasohol under the Energy Tax Act).

Revenue effect

The decrease in calendar year tax liabilities will be negligible in 1980 and 1981, $168 million in 1985, $445 million in 1990, and $1,867 million in the period 1980–90. The reduction in budget receipts in fiscal year 1980 will be negligible.

4. Exemption From Distilled Spirits Rules for Alcohol Fuel Facilities

(sec. 236(d) of the bill and secs. 5181, 5601, 5214, 5004 and 5005 of the Code)

Present Law

Present law sets forth a detailed regulatory scheme for distillery plants and persons involved in the production of alcohol. This regulatory scheme applies to the production of alcohol for industrial uses, as well as production for human consumption. The regulatory scheme requires the registration of a distillery and an investigation of the background of the individuals operating the distillery prior to its commencement of business. This scheme also requires approval of the details of plant construction, provides for supervision of production by employees of the Bureau of Alcohol, Tobacco and Firearms, and of bonds requires that a series be obtained by an operator of a distilled spirits plant in order to engage in the production of distilled spirits.

Reasons for Change

The committee intends that producers of alcohol to be used in gasohol should be encouraged to begin commercial production of such alcohol as soon as possible subject to the minimum amount of regulation needed to insure against violation of the alcohol taxes. The bill consequently provides a statutory framework for a reasonable relaxation of the existing regulatory rules in order to facilitate the production of alcohol for fuel purposes.

Explanation of Provision

The committee substitute provides for a special type of distilled spirits plant, that of the fuel producer. Under the substitute these plants may be established for the production of alcohol for fuel purposes only, and distiller may remove the alcohol free of tax from these plants only after rendering it unfit for beverage purposes. In addition, the Secretary would be provided with broad authority to waive or reduce existing regulatory requirements for these new types of plants, such as by allowing simplified application and recordkeeping procedures, and providing reduced control and bonding requirements for small distilled spirits plants which produce alcohol for fuel purposes.

Effective Date

These provisions will become effective on the first day of the first calendar month which begins more than sixty days after the date of enactment.

Revenue Effect

No significant revenue loss is expected from these changes.

5. Deduction for Tertiary Injectants (sec. 238 of the bill and new sec. 193 of the Code)

Present Law

Expenditures to acquire, create, or enhance an asset with a useful life which extends beyond the end of the taxable year generally must be capitalized and recovered over the asset's useful life. If such expenditures relate to an asset with an indeterminate useful life, they generally must be capitalized and recovered only upon a disposition or abandonment of the asset. Ordinary and necessary business expenses, on the other hand, are deductible currently.

Taxpayers may elect to deduct as current expenses intangible drilling and development costs (IDCs) which are incident to and necessary for the drilling or preparation of wells for production. This election extends to IDCs incurred in drilling nonproductive injection wells necessary for the primary development of a property.

The IRS' position with respect to certain hydrocarbon injectants has been that expenditures to increase the ultimate recovery from a hydrocarbon reservoir generally must be capitalized since they increase or enhance the reservoir's value beyond the year of injection by augmenting the recoverable amount of hydrocarbons. These expenditures ordinarily are recoverable through depreciation. Any undepreciated portion of such expenditures for unrecoverable injectants may be deducted as a loss in the year it is established that the injectant did not benefit production or in which the project is abandoned.

However, if the injectant is a gas or hydrocarbon liquid produced from the property, i.e., a recycling operation, there is no cost to capitalize for the gas or liquid. The costs of production and reinjection are deducted currently.

Generally, therefore, costs related to tertiary injectants are treated in one of the following ways, depending upon the expense involved:

1. Costs of injectants with a transitory effect on production, e.g., alkaline solutions or CO_2, generally are deductible currently.

2. Costs related to injecting a substance with a transitory effect on production are deductible currently.

3. Costs of producing and reinjecting gas or hydrocarbon liquids utilized in a recycling process, i.e., where the gas is produced from the property, are deductible currently.

4. Intangible drilling costs incurred in drilling nonproductive injection wells necessary for the primary development of a property may be deducted currently.

5. Expenditures for some injectants which affect production for more than one year generally must be capitalized and recovered through depreciation over the period for which they affect production.

6. The cost of injectants described in 5, above, but which also include an unrecoverable component of that injectant, ordinarily are recouped through depreciation over the period for which the injectant affects production. Any undepreciated portion of such expenditures for unrecovered injectants may be deducted as a loss in the year it is established that the injectant did not benefit production or in which the project is abandoned.

Reasons for Change

To encourage the use of expensive tertiary enhanced oil recovery processes, the committee decided to provide that expenditures for tertiary injectants normally would be deductible in the taxable year in which they are injected into the reservoir.

Explanation of Provision

The committee substitute provides, by way of a specific statutory clarification, that expenditures for tertiary injectants generally are deductible in the taxable year in which the tertiary substance is injected into the reservoir. Such tertiary injectants generally would include those used in a qualified tertiary enhanced recovery project, as defined under the windfall profit tax, and which the taxpayer establishes are tertiary injectants.

However, the provisions of the committee substitute would not apply to expenditures incurred for water flooding, or for tertiary hydrocarbon injectants, i.e., natural gas or crude oil. Nevertheless, expenses for these tertiary hydrocarbon injectants would be deductible under the committee's substitute, in the taxable year in which they are injected, to the extent that the producer establishes that the hydrocarbon injectant is not ultimately recoverable from the reservoir. The cost of a tertiary hydrocarbon injectant which the producer cannot establish is not ultimately recoverable would continue to be capitalized and recouped through depreciation. Any undepreciated amount of such capitalized expenditures would remain deductible as a loss in the year in which the producer establishes that the injectant did not benefit production or in which the tertiary project is abandoned.

For purposes of the general prohibition on the current deduction of expenditures for tertiary hydrocarbon injectants provided in the committee substitute, tertiary hydrocarbon injectants would include all forms of natural gas and crude oil (including syncrudes), regardless of whether they were injected separately, as a component of a tertiary process, or as a tertiary drive medium. Tertiary hydrocarbon injectants also would include injectants which are comprised, by blend, mixture, or chemical bonding, of more than an insignificant amount of natural gas or crude oil. (Expenses allocable to the non-hydrocarbon part of such an injectant would be deductible, however, to the extent that the producer establishes the cost attributable to that part of the injectant.) Tertiary hydrocarbon injectants would not include injectants which merely are hydrocarbon derivatives, or petroleum-based, and which otherwise do not contain more than an insignificant amount of natural gas or crude oil.

The committee substitute also provides that expenses deducted for tertiary injectants are subject to the generally applicable recapture rules.

The committee substitute would not apply to any cost which is subject to the section 263 intangible drilling cost election, or to any expenditure which otherwise is deductible under the Internal Revenue Code.

The clarification of the income tax treatment of the cost of tertiary injectants is not to create an inference as to the proper categorization of those costs prior to the effective date of this provision.

The House bill contains no comparable provision.

Effective Date

The provision would be effective for expenditures deducted for injectants after December 31, 1979.

Revenue Effect

The decrease in calendar year liabilities will be $13 million in 1980, $10 million in 1981, $5 million in 1985, $7 million in 1990, and $79 million in the period 1980–90. The loss would be $5 million in fiscal year 1980.

6. Industrial Development Bonds for Hydroelectric Facilities (sec. 237 of the bill and sec. 103 of the Code)

Present Law

Interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial development bonds with certain exceptions. A State or local government bond is an industrial development bond if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business not carried on by a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured, in whole or in major part, by an interest in, or derived from payments with respect to, property used in a trade or business.

Certain industrial development bonds qualify for tax exemption, where the proceeds of the bonds are used to provide exempt activity facilities. Such facilities include facilities for the local furnishing of electric energy (Sec. 103(b)(4)(E)) of the Code) and facilities for the furnishing of water (Sec. 103(b)(4)(G)).

A facility for the furnishing of water will qualify as an exempt activity facility if it meets three requirements. It must be for the furnishing of water, it must be operated by a governmental unit or regulated public utility, and it must make water available to members of the general public.

The requirement that a facility make water available to members of the general public requires that a facility make available a substantial portion (i.e., 25 percent) of its water to the residential users in its service area. The requirement that a facility be a facility for the furnishing of water means that the facility must be used for the collection, treatment or distribution of water to a service area. Equipment which is used for the production of electric energy, such as generators or turbines, does not qualify as a facility for the furnishing of water, even where such equipment is located within a dam or reservoir which qualifies as a facility for the furnishing of water. However, a tax exempt obligation may be used to finance this type of equipment if (1) the obligation is not treated as an industrial development bond or (2) the obligation is an industrial development bond used to provide facilities for the local furnishing of electric energy.

Under Treasury regulations, the use of more than 25 percent of the proceeds of an issue of obligations in the trade or business of a

nonexempt person will constitute the use of a major portion of the proceeds in such manner and will cause an issue to be treated as an industrial development bond. (Treas. Reg. 1.103–7(b)(3)). In the case of electric energy facilities, the use by one or more nonexempt person of more than 25 percent of the output of the facility will in general, cause an issue to be treated as an industrial development bond where the payments with respect to such use exceeds 25 percent of the total debt service on the issue. (Treas. Reg. 1.103–7(b)(5)).

Under section 103(b)(4)(E) and Treasury regulations, property will qualify as a facility for the local furnishing of electric energy if it is part of a system which provides electric energy to the general populace in a service area comprising no more than two contiguous counties, or a city and one contiguous county.

In addition, in order to qualify for tax-exempt financing, a facility for the local furnishing of electric energy must satisfy a public use requirement. In general, this provision requires that a facility serve or be available on a regular basis for general public use. (Treas. Reg. 1.103–8(a)(2)). A facility for the local furnishing of electric energy will, in general, satisfy this requirement only if such facility or the output from it is available for use by members of the general public. (Treas. Reg. 1.103–8(f)(1)(i)).

Treasury regulations provide that the public use requirement with respect to a facility for the local furnishing of electric energy will be satisfied if (1) the owner or operator of the facility is obligated, by a legislative enactment, local ordinance, regulation, or the equivalent thereof, to furnish electric energy to all persons who desire such services and who are within the service area of the owner or operator of such facility, and (2) it is reasonably expected that such facility will serve or be available to a large segment of the general public in such service area. (Treas. Reg. 1.103–8(f)(1)(ii)).

Reasons for Change

Under present law, interest on a State or local government obligation used to provide electric energy facilities is in general exempt from Federal income tax where (1) the obligation is not treated as an industrial development bond or (2) the obligation is an industrial development bond used to provide facilities for the local furnishing of electric energy. In addition, interest on State or local government obligations used to provide water facilities is in general exempt from Federal income tax where the facilities constitute facilities for the furnishing of water to members of the general public.

The interaction of these two provisions often results in a situation in which a dam may be constructed with tax-exempt obligations, but generators and turbines used to produce electric energy are not eligible for tax-exempt financing. In addition, at existing dam sites newly installed electric generating equipment may not be eligible for tax-exempt financing. The committee believes that in order to reduce the United States' dependence on oil import by encouraging the production of hydroelectric power, the local furnishing and public use requirements under section 103 should be waived for facilities for the generation of hydroelectric power.

Explanation of Provision

The committee substitute provides that interest on industrial development bonds used to provide facilities the primary function of which is the generation of hydroelectric power is exempt from Federal income taxation.

The provision, in general, applies to all new and certain existing hydoelectric power facilities located on a natural watercourse or a constructed water flow. The provision does not, however, apply to "pumped storage" facilities, "ocean thermal" facilities or "ocean tidal" facilities.

Generally, in order to qualify under this provision a bond must provide facilities, and the primary function of the facilities must be the generation of hydroelectric power. The requirement that the proceeds of a bond be used to provide a qualifying facility will, in general, be satisfied where the proceeds are used for the construction, reconstruction or installation of qualifying property. On the other hand, where the proceeds are used to refinance an existing facility or a portion of an existing facility this requirement will not be satisfied.

The requirement that the primary function of the facilities be the generation of hydroelectric power in general means that a facility will constitute a qualifying facility only if its primary function or use is to direct the flow of water for the production of electric energy or to produce electric energy from the flow or fall of water.

Qualifying property will, in general, include generating equipment (i.e. turbines, generators, switch gear and transformers) up to the electrical distribution stage, powerhouses and similar structures to house generating equipment, penstocks for the passage of water from the impoundment to the turbine, and fish passageways (such as fish ladders) and related equipment (such as fish counters) used to facilitate the movement of fish upstream or downstream from the impoundment structure or generating site.

In general, only existing dam sites with an installed generating capacity of 25 megawatts or less will qualify under this provision. In addition, all new dam sites will, in general, qualify under this provision where construction was commenced after October 24, 1979. Finally, dam sites under construction on October 24, 1979, will qualify under this provision where the installed generating capacity will be 25 megawatts or less.

In the case of a qualifying existing dam, the provision provides that the proceeds of an obligation may be used for the acquisition and installation of qualifying property and for the rehabilitation or reconstruction of the dam where such rehabilitation or reconstruction was performed in connection with the installation of qualifying property.

The substitute also provides that in the case of a qualifying dam under construction and a qualifying new dam, the proceeds of an obligation may be used to install qualifying property and construct the dam structure where the primary function of the dam is to collect and channel water for the production of electric energy. For purposes of this provision, the primary function of the dam is to be determined on the date construction is commenced, and is to be determined by the intended use of the water. If more than one-half of the

impounded water which will be released will be used for the generation of hydroelectric power, the primary function of the dam will be considered to be the generation of hydroelectric power.

The effect of the primary function requirements is illustrated by the following example:

M, a political subdivision of a State, proposes to construct a dam and a hydroelectric plant. Before construction on the facility commences, M entered into a contract agreeing that X gallons of water will be released per second for the hydroelectric plants. M has also entered into a contract agreeing to release X gallons of water per record for the use of D, a nonexempt person. M intends to fulfill its agreement with D by channeling the water it has agreed to release to the hydroelectric plant to D. In this case, the primary function of the dam will be considered to be for the generation of hydroelectric power since all the water which will be released will be used for the generation of hydroelectric power.

In the case of a dam which does not meet the primary function test, tax-exempt financing under this provision will still be available for the installation of qualifying property. However, in the case of any hydroelectric facility qualifying property does not include any property that is used for the distribution of water.

In addition in the case of a qualifying existing dam with respect to which qualifying property is installed, and in the case of a qualifying new dam or qualifying dam under construction which meets the primary function requirement. the public use requirements of section 103 will be deemed to be satisfied. Consequently, the water impounded by the dam may be used by any person or persons and the electric energy may be used by any person or persons. However, because property used for the distribution of the impounded water is not qualifying property, tax exempt financing of such property will not be available unless such property qualified as facilities for the furnishing of water to members of the general public.

There is no comparable provision in the House bill.

Effective Date

The amendments made by provision would apply with respect to obligations issued after October 24, 1979.

Revenue Effect

The decrease in calendar year liabilities is expected to be $5 million in calendar year 1980, $19 million in 1981, $100 million in 1985, $361 million in 1990 and $1,420 million in the period 1980–1990. The revenue loss is $2 million in fiscal year 1980.

7. Industrial Development Bonds for Solid Waste Disposal Facilities (Sec. 237 of the bill and sec. 103 of the Code)

Present Law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, tax exemption is denied to State and local government issues of industrial

development bonds, with certain exceptions. A State or local government bond is an industrial development bond, if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business not carried on by a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured, in whole or in major part, by an interest in, or derived from payments with respect to, property used in a trade or business.

Certain industrial development bonds do qualify for tax exemption, where the proceeds of the bonds are used to provide exempt activity facilities. Such facilities include solid waste disposal facilities and facilities for the local furnishing of electric energy. (Sec. 103(b)(4)(E) of the Code). However, in the case of all State and local obligations the Internal Revenue Service has taken the position that if the financed facilities are to be acquired or used by an agency or instrumentality of the United States Government, the United States Government is the true obligor of the obligation and the obligation is not tax exempt. (Rev. Rul. 73–516, 1973–2 C.B. 23).

Solid waste disposal facilities are defined in Treasury regulations as property used for the collection, storage, treatment, utilization, processing or final disposal of solid waste. A facility which disposes of solid waste by reconstituting, converting or otherwise recycling it into material which is not waste will qualify as a solid waste disposal facility if at least 65 percent of the material introduced into the recycling process is solid waste. However, in the case of property which has both a solid waste disposal function and a function other than the disposal of solid waste, only the portion of the cost allocable to the solid waste disposal function will be treated as an expenditure for a solid waste disposal facility.

The regulations further provide that a facility which otherwise qualifies as a solid waste disposal facility will not be treated as having a function other than solid waste disposal merely because material or heat which has utility or value is recovered or results from the disposal process. Where materials or heat are recovered, the waste disposal function includes the processing of such materials or heat which occurs in order to put them into the form in which the materials or heat are in fact sold or used, but the waste disposal function does not include further processing which converts the materials or heat into other products. In addition, facilities used to burn solid waste and to produce steam from the resulting heat are treated as solid waste disposal facilities. However, pipes used to transport the steam and generation equipment which uses the steam to produce electric energy do not qualify as solid waste disposal facilities. (Temp. Treas. Regs. 17.1).

Although electric generation equipment generally would not qualify as solid waste disposal facilities, a tax exempt obligations may be used to finance such equipment if (1) the obligation is not treated as an industrial development bond or (2) the obligation is an industrial development bond used to provide facilities for the local furnishing for electric energy.

Under Treasury regulations, the use of more than 25 percent of the proceeds of an issue of obligations in the trade or business of a nonexempt person will constitute the use of a major portion of the proceeds in such manner and will cause an issue to be treated as an industrial development bond where the issue is secured in major part

by payments with respect to such property. (Treas. Reg. 1.103–7(b)(3)). In the case of electric energy facilities, the use by one or more nonexempt persons of more than 25 percent of the output of the facility will, in general, cause an issue to be treated as an industrial development bond where the payments with respect to such use exceeds 25 percent of the total debt service on the issue. (Treas. Reg. 1.103–7(b)(5)).

Under section 103(b)(4)(E) and under Treasury regulations, property will qualify as a facility for the local furnishing of electric energy if it is part of a system which provides electric energy to the general populace in a service area comprising no more than two contiguous counties, or one city and one contiguous county.

Reasons for Change

Under present law, tax-exempt financing is available for solid waste disposal facilities. In general, such facilities include property necessary for the processing of solid waste into a form which is commercially marketable, but such facilities do not include property for the further processing of the commercially marketable product of the solid waste. An example of a qualifying solid waste disposal facility is provided in the temporary Treasury regulation under section 103. In the example, waste is processed in a manner which removes glass and metals. The remaining waste is burned, and the resulting heat is used to produce steam, a commercially marketable product. The regulation provides that the boiler used to produce the steam qualifies as a solid waste disposal facility. The regulation also provides that pipes used to transport the steam and generating equipment used to transform the steam into electric energy are not solid waste disposal facilities.

Since the regulation was promulgated, methods of processing the waste remaining after separation of glass and metal have advanced to the stage that the residual waste may be transformed into a commercially salable energy form known as refuse-derived fuel. In certain instances, this material is burned to produce steam which is sold or is used to generate electric energy. As a result of the fact that the refuse-derived fuel is commercially marketable, it is unclear whether equipment which utilizes refuse-derived fuel and is used to produce steam would qualify as solid waste disposal facilities. The committee believes that such equipment should be treated as solid waste disposal facilities.

In addition, under present law, a tax exempt obligation may only be used to finance electric generating equipment powered by steam produced by the burning of solid waste or refuse-derived fuel where in general (1) the obligation is not treated as an industrial development bond or (2) the obligation is an industrial development bond used to provide facilities for the local furnishing of electric energy.

The committee believes that production of electric energy from solid waste is a desirable objective. The committee also believes that in order to encourage the production of electric energy from solid waste, electric generating equipment powered by steam produced from the burning of solid waste or refuse-derived fuel should be eligible for tax-exempt

financing where the facility is owned by, and operated by or on behalf of, a governmental unit, and all the electric energy generated is used by a Federal, State, or local governmental unit. In addition, in such cases as described above the committee believes that where the interest or principal on the obligation is derived from, or secured by, payments from an agency or instrumentality of the Federal Government for the purchase of steam and electric energy produced from solid waste, tax exemption should not be denied.

Explanation of Provision

The committee substitute makes two changes in present law. First, it provides that the solid waste disposal process includes all functions up to and including the production of steam. Second, it provides that interest on State and local government obligations used to provide facilities to produce electric energy from solid waste is exempt from Federal income taxation where all the electric energy is sold to any governmental unit, notwithstanding the fact that the purchaser of the steam and electric energy generated by the facility is the Federal Government.

The first change provides that the term solid waste disposal facility includes any facility which has the function of producing steam from solid waste or any product derived from solid waste. This provision, in general, provides that the solid waste disposal function includes all functions involved in the processing of solid waste up to and including the production of steam.

Under this provision of the committee substitute, any property which has the function of recovering material from solid waste qualifies as a solid waste disposal facility. Thus, where solid waste is processed in a manner which separates metals, glass, and similar materials and the remaining waste is processed into a form of energy (in some cases, referred to as refuse-derived fuel), the property used in separating the metal and glass and in the processing of the remaining waste qualifies as solid waste disposal facilities.

In addition furnaces and boilers used to burn solid waste and transform the resulting heat into steam are treated as solid waste disposal facilities. However, where less than 65 percent, by weight or volume, of the material burned is solid waste, the boilers will not qualify as solid waste disposal facilities.

In addition, in the case where solid waste is separated and processed, and the processed solid waste product is burned and the resulting heat is used to produce steam, the furnace and boiler used to burn the product and produce steam are, in general, treated as solid waste disposal facilities. However, where the processed product is commercially salable, neither the furnace nor the boiler will qualify as a solid waste disposal facility unless at least 65 percent, by weight or volume, of the material burned is a processed solid waste product.

The second change in present law provides that an obligation used to finance qualified facilities which produce electric energy from solid waste will be treated as an industrial development bond used to provide solid waste disposal facilities where four requirements are met. First, all of the electric energy not used in the operation of the

facility is purchased by an agency or instrumentality of any governmental unit. Second, the facility is owned by, and operated by or on behalf of a governmental unit. Third, the issuer of the obligations with respect to the electric energy facility is the same governmental unit which issued obligations with respect to the related solid waste disposal facilities. Fourth, substantially all the fuel used to operate the facility is solid waste or is derived from solid waste from the related solid waste disposal facility.

Under the first requirement, all electric energy produced from the facility and not used in the operation of the facility must be sold to an agency or instrumentality of the United States Government or to a State or local governmental unit. The electric energy purchased by a governmental unit must be purchased for its own use and not for resale.

Under the second requirement, the electric energy facility must be owned by and operated by or on behalf of a governmental unit. In order to qualify under this provision, the facility must in fact be operated by a governmental unit, i.e., the governmental unit must bear the cost of and be in control of maintenance and repairs of the facility, or on behalf of a governmental unit.

Under the third requirement, the governmental unit must be the issuer of the obligations used to provide both the electric energy facility and the related solid waste disposal facility. However, such facilities need not be adjacent or located on the same sites. In addition, such facilities may be located in different governmental jurisdictions.

Under the fourth requirement, substantially all the fuel used to operate the facilities must be solid waste or must be derived from solid waste from the related solid waste disposal facility. In order to satisfy this requirement it must be reasonably anticipated at the time the obligation is issued that 90 percent or more of the fuel used to produced electric energy will be solid waste or derived from solid waste.

The committee substitute also provides that an obligation used to provide qualified facilities which produce steam and electric energy from solid waste will not be denied tax-exempt status solely because the steam or electric energy are used by or for the benefit of an agency or instrumentality of the United States Government, or payment of the principal or interest on the obligation is derived from payments for such use by such an agency or instrumentality.

An example of the facilities covered under this provision is as follows: A is a constituted authority empowered to issue obligations on behalf of State Z. A issues $X of bonds and uses substantially all the proceeds to construct a facility which will be owned by A and operated by A. The facility will process solid waste collected from municipal and industrial sources throughout the region within the jurisdiction of A and produce steam and electric energy from the incineration of the solid waste. A portion of the proceeds of the bonds will also be used to acquire equipment relating to the collection, storage, and transfer of waste material.

The waste will be processed by A in a manner which will remove any noncombustible material, including metals or glass. The combustable material will be shredded to a size compatible with the requirements for combining it with a small amount of coal for incinaration. The mixture of the combustible solid waste materials and coal

will be comprised of 90 percent combustible solid waste material and 10 percent coal.

After further processing, the metals will be sold to commercial users, and the remaining noncombustible material will be placed in a landfill. The mixture of combustible solid waste materials and coal will be incinerated. The heat derived from the incineration will be used to produce steam. A portion of the steam will be used by A to provide for the steam needs for operation of the solid waste facility, and a portion will be utilized in condensing turbines to produce electricity. A portion of the electricity will be utilized to provide for the electrical needs for operation of the solid waste and electrical facility. All the remaining steam and electricity will be delivered and sold for use at a facility owned and operated by the U.S. Government.

Under the committee substitute, the facility constructed by A would be a qualified facility, since the facility is comprised of a solid waste disposal facility, and a facility for the generation of electrical energy substantially all of the fuel for which is derived from solid waste from the related solid waste facility. In addition, because substantially all the proceeds of the bonds are used to provide a qualified facility, and because the facility is owned and operated by A and all the electrical energy produced by the facility is sold to an agency or instrumentality of the United States Government, the bonds will be treated as industrial development bonds which are part of an issue substantially all of the proceeds of which are used to provide a facility described in Code section 103(b)(4)(E), notwithstanding the fact that an agency or instrumentality of the United States Government purchases and uses all the electric energy and steam generated by the facility.

There is no comparable provision in the House bill.

Effective Date

The amendments made by this provision would apply with respect to obligations issued after October 18, 1979.

Revenue Effect

The decrease in calendar year liabilities would be $1 million in calendar year 1980, $3 million in 1981, $19 million in 1985, $53 million in 1990, and $241 million in the period 1980–90. In fiscal year 1980 the revenue loss would be negligible.

8. Residential Energy Efficiency Program (sec. 271 of the bill and new sec. 44E of the Code)

Present Law

There is no provision in present tax law relating to this subject.

Reason for Change

Many residences are not properly equipped to reduce heat loss in winter or heat gain in summer. As a result, substantially greater quantities of energy must be consumed in order to maintain given

temperature levels than would be the case were the residences properly equipped.

Although most existing homes have been insulated and many homes have some form of storm or thermal doors or windows, the efficiency of the installations is still not very high relative to what is possible. Furthermore, most homeowners are not in a position to make an objective assessment of the energy loss sustained by their homes. Comparison of their annual energy consumption bills is beset by too many changes and variables. Furthermore, the energy bills provide no guide to the potential reduction in energy consumption with better insulation or energy conserving components, unless there is a simultaneous effort to maintain the identical temperature levels as in past years.

Homeowners and landlords usually need assistance from technical specialists to measure heat loss from the building, for example, by using infra-red light techniques. While the availability of such technical assistance is not well known, public agencies and public utilities know about them and can help to make the services more generally available.

In a Federal program presently under study, local agencies would contract for the services of energy experts who would visit residences and offer to perform evaluations of energy saving potentials for owners or residents. With consent of the resident for the inspection, the expert would identify sources of energy loss and recommend the changes necessary, whether replacement of obsolete or inefficient equipment, refitting with new kinds of equipment, or insulating attics, floors, walls, windows and doors.

Residential owners, whether homeowners or landlords, would not be charged for the installation, but the costs would be charged to a fund specifically established for this purpose. Local utility companies would be assessed for payment into the fund of the value of the energy saved through installation of the energy conservation equipment. The value of the energy saved would be measured by the marginal cost of the fuel saved or the need for capacity which is displaced.

If such a program would be instituted, the committee believes that the utilities should be allowed a tax credit to offset the reduction in revenues.

Explanation of Provision

A public utility will be allowed an income tax credit equal to the net revenue loss for the taxable year which is attributable to a qualified residential energy efficiency program.

Net revenue loss attributable to a qualified residential energy efficiency program is equal to the reduction in anticipated revenues for the taxable year from furnishing energy to residential buildings when the reduction can be attributed to the installation of insulation and other energy conserving components in buildings participating in the program. The revenue loss shall be reduced by the savings of the cost of fuel for the taxable year that would have been required to furnish energy to the buildings that are participating in the program, if the insulation and other energy conserving components had not been installed. The only revenue loss eligible for the credit is the revenue loss anticipated for the taxable year because of installations of insulation and energy conserving equipment under the qualified residential energy efficiency program. Estimates of the anticipated net revenue loss will be

based on the difference between the energy supplied to a building in the taxable year before installation of energy conserving components and in the taxable year after such installations. The relevant interior space will be estimated and then the cost of energy associated with that space with and without energy conserving installations. Forecasts of the heat of the summer and the cold of the winter, relative to the preceding year, must be taken into account. Reductions in fuel cost during the taxable year because of the smaller amount of fuel consumed must be offset against the net revenue loss.

A residential energy efficiency program is a program which receives financial assistance from the United States to underwrite the costs of installing insulation and other energy conserving components, as defined in Federal law, in residential buildings in the taxpayer's service area. The installations must be made without expense to the owners or tenants of the buildings.

A qualified residential energy efficiency program means one which meets requirements for such programs as may be imposed by Federal law enacted after October 31, 1979. The reference is to Federal law that would provide financial assistance to public utilities which participate in the prescribed energy efficiency programs. Qualification also requires certification to the Secretary of the Treasury from the head of the United States department or agency charged with the responsibility to administer the law for the taxable year for which the credit is claimed.

The credit that will be allowed for the taxable year is equal to the net revenue loss which can be attributed to a qualified residential energy efficiency program. The amount of the credit is limited to the amount of net additional revenue that would have been necessary in order to maintain the taxpayer's rate of return for the taxable year, in the absence of the credit. As a result, the taxpayer may claim a credit for the anticipated net revenue loss associated with participation in a qualified program, but if the net additional revenue needed to maintain the anticipated rate of return is less than net revenue loss from participating in the program, the amount of credit will be reduced to only the amount necessary to maintain the rate of return.

A public utility, for the purposes of this section, means a corporation engaged in the sale of electrical energy or gas, if the rates for such sale have been established or approved by a State or political subdivision thereof or public utility or public service commission or similar body of the District of Columbia or of any State or political subdivision thereof.

In cases where the credit allowed under the provision is in excess of the taxpayer's tax liability, the amount of excess shall be treated as an overpayment of tax. The taxpayer may make adjustments in the quarterly payments of estimated tax that derive from a credit attributable to this section.

Effective Date

This section shall apply with respect to taxable years beginning after December 31, 1979.

Revenue Effect

The revenue effect is expected to be negligible.

D. Lower-Income Energy Assistance

1. Low-Income Energy Assistance: Direct Payments or Block Grants Program (sec. 321 of the bill and new sections 412, 1619, and 1132 of the Social Security Act)

Present Law

There are a number of governmental programs designed to provide assistance to low-income families and individuals. Some of these programs are designed to meet specific needs. This is the case, for example, with the medicaid program, which provides assistance to the poor in obtaining health care, and the food stamp program, which is directed at meeting nutritional needs of low-income households. Other programs are designed to provide general income aid to assist low-income persons in meeting their overall living costs. The major federally assisted program of general income support for families is aid to families with dependent children. This program provides income assistance to needy families in which the children have been deprived of support because at least one parent is deceased, disabled, absent from the home, or (at State option) unemployed. For low-income families with children which are primarily dependent upon earnings, general income aid is provided by the earned income tax credit—a refundable credit equal to 10 percent of earnings up to $5,000 (a maximum annual credit of $500) and phased out over an income range of $6,000 to $10,000. For individuals who are needy because of age, blindness, or disability, general income support is provided through the program of supplemental security income (SSI). This program provides a basic monthly Federal payment (reduced to take into account other income available to the individual) which (at State option) may be supplemented by an additional State-funded payment.

As a rule, the programs designed to provide general income assistance establish uniform payment amounts among individuals or families of similar category, composition, and income with the recipients being responsible to determine how that assistance will be used for the various budget items such as food, clothing, fuel, shelter, and so forth. In some instances, States vary AFDC payments according to differences in shelter costs or, less often, according to other specific budgetary needs of individual families. Similarly, individual differences in budgetary needs are sometimes reflected in the determination of State payments made in supplementation of SSI benefits. In general, however, the trend in recent years has been away from the use of individual budget items in favor of greater use of the flat grant approach.

Reasons for Change

Energy costs have risen substantially over the past few years and particularly so in the past year. Gasoline prices have now risen by over 30 percent, while residential energy prices climbed more than 17 percent above last year's levels. Among residential energy sources, fuel oil prices have increased most dramatically, by over 30 percent through May and over 40 percent through July. However, other residential energy prices have also moved upward substantially—exceeding 20 percent for gas and 5 percent for electricity.

Increases have also taken place to some extent in benefits under programs for low-income families. The Revenue Act of 1978 modified the earned income tax credit, and the increased entitlement will largely be received by eligible families in early 1980. The supplemental security income program for the aged, blind, and disabled is indexed to cost of living changes, and benefit levels under that program accordingly increased by 9.9 percent in July of this year, with a further increase of the same approximate magnitude expected next July. The food stamp program is similarly indexed to account for rising food prices. Increased benefit levels under the AFDC program depend upon State action, but the open-ended matching nature of that program assures that Federal funding will be available to pay for approximately 50 to 83 percent of any increases provided by the States under that program.

The committee is concerned that the ordinary mechanisms for adjusting income assistance programs to rising costs of living may be inadequate to meet the extraordinary increases which have taken place in energy costs, particularly because energy costs for many low-income households may represent a large and vitally important element of their budgets. For this reason, the committee believes it is essential, in addition to the tax credit (described below) for increased residential heating costs of low-income taxpayers, to provide a special adjustment to the existing programs of supplemental security income and aid to families with dependent children which can provide energy related income assistance to recipients of those programs as well as to other low-income people who do not directly benefit from those programs but are recipients of food stamps. The committee recognizes that the particular hardships worked by increased energy costs do not fall evenly on all low-income households and that many States have developed (or have the capacity to develop) programs of assistance which may be better able to target the available funds to the most severely affected cases. For this reason, the committee proposal includes an option for States to utilize the available funds to operate a block-grant program of their own devising as an alternative to the more general approach otherwise applicable under the committee provision.

Explanation of the Provision

General

As described in part F of this report, the committee substitute establishes a Low-Income Energy Assistance Trust Fund which would receive one-half of the net receipts of the windfall profit tax

established by the bill. The amounts in this trust fund would be available to meet the revenue costs of the residential heating energy tax credit and the costs of the program of cash assistance for low-income households. Through fiscal year 1982, the amount of funding for the cash payments program would be approximately $3 billion per year ($1.2 billion for fiscal 1980 when the program would be in effect with respect to only a portion of the full year). Before the end of fiscal 1982, the committee intends to review the program and the manner in which it operates and to propose further legislation concerning the form this type of assistance should take in subsequent years.

Allocation of funds

The purpose of the cash payments program is to help low-income households cope with the extraordinary increases which have been occurring in the cost of energy. It is the objective of the committee substitute to provide assistance in as equitable a manner as possible. The committee recognizes that accomplishing that objective will make it necessary to take into account a variety of factors and that there is not now available all of the data that might be desirable for that end. However, the committee believes that it has developed an allocation formula which reasonably accounts for the elements which ought to be considered.

It is clear that all low-income households have suffered from the impact of rising energy costs. For this reason, the committee substitute provides that one-half of the available funding for the cash payments program is to be allocated among the States in proportion to the total costs of energy usage of low-income households (including residential and nonresidential usage) in each State compared with the total of such costs for low-income households nationally. Because data for computing this factor are not now available, the committee substitute provides, for the fiscal 1980 allocation, a substitute factor of total residential energy expenditures as estimated for 1979. Starting with fiscal 1981, the factor of total low-income household energy costs will be available on the basis of a study to be conducted by the Department of Health, Education, and Welfare, and that factor will be used for 1981 and 1982. The allocations would be adjusted as necessary to assure a $10 monthly minimum payment for all recipient households.

Although all low-income households have suffered from increased energy costs, a particular hardship has fallen on those households in the very coldest parts of the country who must pay for heavy fuel usage during a substantial part of the year. To recognize this particular need, the committee bill provides that the other half of the funds for the cash payments program will be allocated among the States on the basis of the average annual number of heating degree days for each State multiplied by the number of households in the States with incomes below 125 percent of the official poverty line. (Currently, 125 percent of the poverty line is about $7,300 for a four-person family. The number of heating degree days is the total of the number of degrees below 65° Farenheit on all the days on which the average temperature in the State was below that temperature. For example, if the average temperatures for a three day period are 60°, 68°, and 64°, there would be 5 heating degree days for the first day,

none for the second, and one for the third or a total of 6 for the period. The degree day factor in the bill is based on the average annual total for each State measured since July 1931 when statistics first began to be compiled.)

Direct payments program

Prior to the beginning of each fiscal year (or in the case of fiscal 1980, as soon as possible after enactment), the Secretary of Health, Education, and Welfare would determine the allocation described above and, from it, would establish benefit amounts for each State on the basis of the funding allocated for each State divided by his best estimate of the number of recipient households in the State (after setting aside 10 percent of the total for administrative costs). Recipient households would consist of households in which an individual receives SSI, AFDC, or food stamps. In making this determination, the Secretary would do so on the basis of a payment amount for multiperson households which would be 150 percent of the payment amount for households consisting of one individual with a $10 minimum monthly amount.

The benefit amounts determined under the above procedure for SSI and AFDC households would be paid to those households by the Social Security Administration (in the case of SSI recipients) and by the State or local welfare agency (in the case of AFDC recipients). Payments would not vary in different areas of a State and would be made monthly throughout the year in the form of an additional amount included in the regular monthly benefit checks. The income levels for establishing eligibility under these programs would not be affected in any way by these additional payments.

The benefit payments to food stamp recipients would be made by the State or local welfare agency at least twice each year and would not vary across different areas of a State. Prior to disbursing funds to the States for making payments to food stamp recipients, the Secretary of Health, Education, and Welfare would re-estimate on the basis of the best data then available the expected costs of the payments to AFDC and SSI recipients. If it then appeared that total amount of expected payments would exceed the overall allocation for the year, the Secretary would proportionately reduce the amount available for payments to food stamp recipients (and the resultant benefit amounts) so as to avoid exceeding the year's total allocation insofar as possible.

The committee recognizes that establishing a program of this nature represents a significant administrative undertaking both for the Social Security Administration and for the State and local welfare agencies who will be involved. The committee substitute therefore provides for setting aside 10 percent of the available funding to cover State and Federal administrative costs. In addition, to ease the initial administrative difficulties, the bill would permit payments to be made to recipients on the basis of the information on file at the time as to such factors as State of residence without a requirement for retroactive adjustments if this information proved to be incorrect. The committee expects, however, that the agencies involved will as quickly as feasible to develop the capability for more sophisticated administration of the

program. A particular problem is the lack of information concerning which food stamp households also contain SSI and AFDC recipients. States would be expected, insofar as practicable, to avoid making duplicate payments to food stamp households which are also receiving payments on the basis of AFDC or SSI eligibility, and any such duplicate payments made after October 1, 1980, would be subject to recovery. While States might in many instances be unable to prevent such duplication before that date, they would be encouraged to move as rapidly as possible in that direction by a provision permitting them to retain half of any savings based on preventing duplicative payments prior to October 1, 1980.

The committee substitute also provides that erroneous payments under this program would be specifically excluded from the calculation of overall error rates in the AFDC, SSI and food stamp programs; the Secretary of Health, Education, and Welfare would have the discretion to account for these programs either through the existing program accounting structure or separately as he determines to be the more feasible.

1980 payment

As described above, the committee substitute provides for a monthly payment program for AFDC and SSI recipients. For fiscal year 1980, this program would be effective starting with May 1980 under the ordinary provisions of the bill. However, in order to allow additional time to prepare for the operation of a monthly payments program and to make the funds available as soon as possible for individuals who are severely affected this winter, the bill permits the entire fiscal 1980 allocation amount to be paid in a single payment as soon as possible after enactment. The Administration has advised the committee that such a payment can be made within about 90 days after enactment.

Block grant option

In order to assure that assistance to low-income households can quickly and efficiently be made available, the committee bill establishes the above described modifications to the existing federally operated program of supplemental security income and the existing federally assisted program of aid to families with dependent children. Benefits are also provided for an additional already defined category of recipients—food stamp recipients—with payments to be made through the AFDC agencies. The committee recognizes, however, that at least in the near term this method of distributing funds will frequently not match the particular hardships caused by higher energy costs which may vary widely even within a given State from one recipient to another. The committee is also aware that many States have been developing the capacity to provide energy-related assistance to low-income households on a basis more carefully targeted to individual need than is possible under a general payments program of the type described above.

To allow and encourage those States which have the capacity and willingness to operate separate programs of this type to do so, the committee bill gives States the option of receiving the available funding in the form of a block grant. States could elect to receive the funds

otherwise allocated for their State for any one or more of the three categorical eligibility groups (SSI recipients, AFDC recipients, Food stamp recipients not receiving AFDC or SSI). If a State wishes to exercise this option, only the following requirements would apply: (1) if the State wished to utilize the block grant approach for fiscal 1980, notice would have to be given by the Governor to the Department of Health, Education, and Welfare within 15 days after enactment of the bill; (2) election to begin or cease using the block grant approach for fiscal years after 1980 would have to apply to the full fiscal year and notice of a State's election would have to be given at least 90 days prior to the start of the fiscal year; (3) the State would have to agree that block grant funds would have to be used only to provide assistance to lower-income households (according to a definition to be established by the State) to meet needs related to increased energy costs; (4) assistance would have to be provided on an equitable basis to lower income Indian households within the State; and (5) any unused funds would have to be returned to the Federal Treasury.

States electing to utilize the funds on a block-grant basis would be specifically permitted to use these funds to operate a program under which suppliers of residential heating fuel would receive a State tax credit to offset reductions that they allow in the fuel charges of lower income households. Another specifically permitted option would be a program of vendor payments to suppliers for heating fuel provided to lower income households. Under these options, any certifications of eligibility for such households would have to be administered by appropriate State agencies. (States would have access for this purpose to SSI eligibility information under existing data exchange provisions.)

Treatment of benefits under other programs

The committee substitute provides that any assistance provided under this section to lower-income households would not be counted for purposes of determining eligibility or benefit amount under any Federal or State program which is based on need.

Allocation table

The table below shows the State by State allocation of the $3 billion annual funding amount on the basis of data now available. For fiscal year 1981 the allocation will differ to some degree since the factor of total low-income energy costs will then be available and will be substituted for the factor of total residential energy expenditures. (In the table below, one-half of the allocation is based on the total residential energy expenditures in each State as a percentage of the national total. One-half of the allocation is based on each State's usual annual heating degree days multiplied by its low-income (below 125 percent of poverty) population as a percentage of those two factors for all States.) The allocations in this table are adjusted to reflect the amounts which would be payable under a payments program to AFDC, SSI, and Food Stamp recipients in which multi-person households receive 150 percent of the amount paid to single person households. A monthly $10 minimum for either single or multi-person household is also assumed. The first column does not represent benefit

amounts under the payments program but shows how much each State would receive under this allocation in relation to its total low-income population. Because the low-income population exceeds the number of AFDC, SSI, and food stamp recipients, the amounts in the first column are in some cases lower than the $120 minimum which applies to those categories.

Distribution of $3 Billion in Low-Income Energy Assistance Under Finance Committee Formula

State	Annual amount per low-income household	Distribution of funds	
		Millions of dollars	Percentage
Total	$291	$3,000.00	100.00
Alabama	[1] 110	46.30	1.54
Alaska	465	6.29	.21
Arizona	133	24.39	.81
Arkansas	[1] 117	29.76	.99
California	125	196.96	6.57
Colorado	231	36.89	1.23
Connecticut	364	49.64	1.65
Delaware	240	8.37	.28
District of Columbia	147	10.32	.34
Florida	[1] 83	65.29	2.18
Georgia	[1] 102	55.57	1.85
Hawaii	[1] 113	4.52	.15
Idaho	264	13.61	.45
Illinois	267	186.14	6.20
Indiana	267	81.23	2.71
Iowa	283	43.48	1.45
Kansas	221	28.38	.95
Kentucky	148	53.99	1.80
Louisiana	[1] 89	39.01	1.30
Maine	302	24.82	.83
Maryland	251	50.27	1.68
Massachusetts	319	101.29	3.38
Michigan	269	146.99	4.90
Minnesota	330	74.90	2.50
Mississippi	[1] 92	31.52	1.05
Missouri	188	77.49	2.58
Montana	260	13.72	.46
Nebraska	236	23.68	.79
Nevada	207	8.07	.27
New Hampshire	368	15.84	.53

See footnote at end of table.

Distribution of $3 Billion in Low-Income Energy Assistance Under Finance Committee Formula—Continued

State	Annual amount per low-income household	Distribution of funds	
		Millions of dollars	Percentage
New Jersey	295	108.40	3.61
New Mexico	149	16.81	.56
New York	256	323.90	10.80
North Carolina	138	74.38	2.48
North Dakota	309	11.49	.38
Ohio	255	166.63	5.55
Oklahoma	140	37.16	1.24
Oregon	193	31.51	1.05
Pennsylvania	241	190.75	6.36
Rhode Island	274	17.29	.58
South Carolina	134	33.66	1.12
South Dakota	265	12.06	.40
Tennessee	139	62.01	2.07
Texas	[1] 110	119.28	3.98
Utah	235	15.63	.52
Vermont	277	10.98	.37
Virginia	205	62.35	2.08
Washington	200	44.85	1.49
West Virginia	175	32.18	1.07
Wisconsin	351	74.62	2.49
Wyoming	247	5.38	.18

[1] The amount shown in this column for each State represents the total dollar allocation to the State divided by the total number of low-income households. The number of low-income households exceeds the total number of AFDC, SSI, and food stamp households. If the program of payments to AFDC, SSI, and food stamp households is operated in this State, each such household would receive a minimum annual payment of $120.

2. Tax Credit for Users of Residential Energy (sec. 301 of the bill and new sec. 44F of the Code)

Present Law

There is no tax provision in present law dealing with residential heating costs.

Reasons for Change

The committee believes that a portion of the revenues from the windfall profit tax should be directed to lower income taxpayers to provide relief from the burden of higher residential energy costs. Although the price increases facing users of heating oil have been especially dramatic, all residential energy sources have become more

expensive recently. Thus, the committee substitute allows to each household with income less than $22,000 ($20,000 in 1979) a tax credit equal to a percentage of their heating expenditures. A separate percentage is used for each heating source and is based on the extent to which the increase in the cost of the heating source has exceeded increases in the cost of living. However, a minimum level for the credit would be set at $30 ($20 in 1979).

Explanation of Provision

The committee substitute would provide taxpayers with incomes less than $22,000 ($20,000 in 1979) with a nonrefundable credit for a portion of the amount by which the increase in the price of energy used for heating a principal residence exceeds the increase in the general cost of living. Generally, the taxpayer will determine the amount of his credit by multiplying his cost during the year for heating energy by a relative energy price percentage ("REPP") determined by the Treasury Department. The REPP would be different for each energy source. The credit could not exceed $200, nor be less than $30 ($20 in 1979), for any household.

General method for computing the credit

The Secretary of Treasury will compute the REPP for a given year and a given energy source by taking 25 percent of a fraction which reflects the portion of the current cost of the energy which is the excess in the rise in the cost of that energy over the rise in the cost of living since 1978. The numerator of the fraction is (a) the national average price for the home heating energy for the calendar year, minus (b) the national average base price for the home heating energy multiplied by the inflation adjustment factor. The denominator of the fraction is equal to the national average price for the energy for the calendar year.

For purposes of this computation, the "national average price" with respect to any type of home heating energy for any calendar year means an amount determined by the Treasury Department, after consultation with the Energy Department, to be the average price paid for that energy for residential heating use in the United States during September of the calendar year. It is anticipated that a separate percentage will be prescribed for each type of home heating energy in common use during the calendar year. It is also anticipated that a separate percentage will be prescribed for natural gas imported into the United States from gas wells in Canada. The Treasury may prescribe a single residual percentage for all home heating fuels not in common use. The term "national average base price" with respect to any home heating energy source means the amount determined by the Treasury, after consultation with the Energy Department, to be the national average price paid for residential heating use in the United States for that energy source during September, 1978.

The "inflation adjustment factor" means, with respect to a calendar year, a fraction the numerator of which is the Consumer Price Index (all items—United States city average, all urban consumers) as of September of the calendar year and the denominator of which is that price index as of September, 1978.

The calculation of the REPP by the Secretary of the Treasury can be illustrated by the following example. Suppose the September 1978 residential heating oil price was 50 cents per gallon, and the increase in the Consumer Price Index is 20 percent between September 1978 and September 1980. Thus, if the heating oil price rose only at the rate of inflation, the 1980 price would be 60 cents. Suppose, however, that the actual heating oil price in September 1980 is $1.00, which is 40 cents more than the 60-cent figure. The REPP would be computed so that the credit amount would be equal to 25 percent of the 40-cent excess, or 10 cents, times the number of gallons purchased. In this example, for a taxpayer who used 1,000 gallons of oil, the REPP would be set so that the credit would be 10 cents times 1,000, or $100. In this example, then, the REPP for heating oil would be 10 percent. Taxpayers would compute the amount of credit by multiplying the REPP applicable to the type of energy they use by the amount spent on heating. The credit will be based on the amount spent for heating energy even if the taxpayer knows the actual quantity of the energy consumed. The REPP for each fuel is to be rounded to the nearest one-tenth of 1 percent.

Although the determination by the Secretary of the appropriate percentage, as illustrated above, is somewhat complex, the taxpayer would simply multiply this percentage by the total amount he has spent for heating energy. The seller of the energy would furnish a certificate after the year's end showing how much the taxpayer had paid for heating energy in that year.

Minimum credit, maximum credit and income phase-out

The minimum credit amount is $20 for 1979 and $30 for 1980 and 1981. (Married taxpayers filing separately would receive a minimum credit of one-half these amounts.) This minimum is determined without regard to the amount actually spent on heating.

The amount of the credit, calculated using either the REPP or the minimum amount, is subject to a number of limitations. First, the maximum amount of the credit may not exceed $200. For this purpose, married taxpayers filing a joint return are treated as a single individual; married taxpayers filing separately are each subject to a maximum limitation of $100. Second, for 1979, the maximum amount is reduced by 10 percent of the amount by which the taxpayer's adjusted gross income exceeds $18,000 ($9,000 in the case of a married individual filing separately). Thus, for 1979, no credit would be allowed to the taxpayer if his adjusted gross income is at least $20,000 ($10,000 in the case of a married taxpayer filing separately). For 1980 and 1981, the phase-out of the credit will begin at $20,000 (rather than $18,000) in general and at $10,000 (rather than $9,000) for married taxpayers filing separately. Third, the credit is nonrefundable, and no carrybacks or carryovers of excess credits are allowed.

Individuals allowed the credit

The credit is available only to one individual in each household. That individual is the person in the household who furnished a portion (whether or not more than half) of the cost of maintaining the household greater than the portion furnished by any other member of the household. This rule is to apply even if another member of the house-

hold actually paid the heating bills. The individual in the household who is eligible for the credit is deemed to have paid all the costs of heating the household which were paid by the other members of the household. For purposes of this provision, a boarder in a house would be treated as having his own household and would be subject to the rules for renters, described below. However, if two or more individuals are co-owners of, or are co-lessees of, a dwelling unit, they would generally be treated as members of one household.

Principal residence

The costs of energy which would be eligible for the credit are the amounts paid for the energy by the taxpayer to heat that individual's principal residence in the United States for the taxable year. The determination of whether or not a dwelling unit is the taxpayer's principal residence shall be made under principles similar to those of section 1034, except that (a) no ownership requirement is to be imposed and (b) the principal residence must actually be used by the taxpayer as his residence during the taxable year. Thus, where part of a property is used for residential purposes and part is used for business or other purposes, only the heating costs allocable to residential purposes are eligible for the credit. Also, no credit would be allowed to the taxpayer for any period during which the taxpayer rents his residence to another individual.

Determination of amount of heating costs

In the case of a dwelling unit the heating costs of which are not separable from the cost of using energy for other purposes, such as cooling, cooking, or lighting, the Treasury Department is to determine the portion of the cost which is property allocable to heating, taking into account regional differences in climate and heating costs. For example, if in a given region the Secretary estimates that for homes heated with electricity 75 percent of electricity expenses are for heating, then taxpayers would multiply the REPP by 75 percent of electricity expenditures. In designing the tax form, the Secretary may combine the REPP with this percentage. In this example if the REPP for electricity is 10 percent then the form may specify that taxpayers who heat their homes with electricity calculate the credit amount by taking 7.5 percent of the total amount spent for electricity.

In the case of a tenant who does not pay a separate charge for heating costs, the REPP is determined by the heating source used by the landlord, and a portion of the rent paid is to be treated as paid for heating. The portion will be the percentage of rental amounts paid for principal residences during a calendar year which the Treasury determines, after consultation with the Department of Housing and Urban Development, and after taking into account regional differences in climate and heating costs, to be the average percentage of rental amounts paid in a region of the United States attributable to the payment of the costs of the home heating source used in the taxpayer's residence. This percentage will be different for each source. In designing the tax form the Secretary may combine the REPP with this percentage. For example, if the REPP for heating oil were 10 percent, and 15 percent of rent is the amount of rent deemed to be used for heating in rental units heated with oil in a given region, then the form may

specify that renters in this region calculate the credit amount by taking 1.5 percent of rent paid. Only the amount paid for the occupancy of space is to be considered rent for this purpose. For example, an allocation would be necessary if a flat amount paid by a boarder includes payment for meals.

Treasury is also to provide by regulation for the application of the credit to condominium management associations and members of those associations, and tenant-stockholders in cooperative housing corporations in such a fashion as to allow the credit to the individuals paying, directly or indirectly, for heating their principal residences.

Fiscal year taxpayers

In the case of a taxpayer whose taxable year is not the calendar year, the rules provided above for any calendar year will apply to all taxable years which begin with or within that calendar year. No annualization of the maximum and minimum amounts of the credit will be required for a taxable year of less than 12 months.

Effective Date

The credit would be available for taxable years beginning after December 31, 1978 and prior to January 1, 1982.

Revenue Effect

It is estimated that this provision will reduce calendar year tax liability by $947 million in 1979, $1,901 million in 1980 and $1,997 million in 1981; fiscal year 1980 receipts will be reduced by $1,232 million.

E. Repeal of Carryover Basis Provisions (sec. 401 of the bill and sec. 1023 of the Code)

Present Law

Under the Tax Reform Act of 1976, the basis of property passing or acquired from a decedent dying after December 31, 1976, was to be "carried over" from the decedent, with certain adjustments, to the estate or beneficiaries for purposes of determining gain or loss on sales and exchanges by the estate or beneficiaries. Under prior law, the basis of inherited property was generally stepped up or down to its value on the date of the decedent's death. The Revenue Act of 1978 postponed the effective date of the carryover basis provisions for 3 years. As postponed, the provisions apply to property passing or acquired from decedents dying after December 31, 1979.

Reasons for Change

A number of administrative problems concerning the carryover basis provisions have been brought to the attention of the committee. Administrators of estates have testified that compliance with the carryover basis provisions has caused a significant increase in the time required to administer an estate and has resulted in raising the overall cost of administration. The committee believes that the carryover basis provisions are unduly complicated. The committee therefore believes that the carryover basis provisions should be repealed. However, the committee believes that an election to apply the carryover basis provisions should be permitted for the period these provisions would have been in effect but for the subsequent postponement under the Revenue Act of 1978. This election would cover situations where executors and beneficiaries have made sales, bequest funding, and asset retention decisions in reliance upon the carryover basis provisions.

Explanation of Provision

The committee substitute repeals the carryover basis provisions. For property passing or acquired from a decedent (within the meaning of Code sec. 1014(b)), the basis of property will be its fair market value at the date of the decedent's death or at the applicable valuation date if the alternate valuation provision is elected for estate tax purposes.

With respect to property passing or acquired from decedents dying after 1976 and before November 7, 1978 (the date after the date of enactment of the Revenue Act of 1978), the carryover basis provisions may be elected by the executor of an estate. If elected, the basis of all carryover basis property considered to pass from the decedent, including jointly owned property passing by survivorship, would be deter-

mined under these provisions. The election is to be irrevocably made no later than 120 days after the date of enactment of the bill and in such manner as prescribed by the Secretary of the Treasury.

The House bill did not contain a similar provision.

Effective Date

The amendments are to take effect as if included in the Tax Reform Act of 1976. Thus, the repeal applies to property passing or acquired from a decedent dying after December 31, 1976.

Revenue Effect

Repeal of carryover basis will reduce revenues by a negligible amount in calendar year 1980, by $36 million in 1981, $95 million in 1982, $330 million in 1985 and $950 million in 1990. The revenue impact in fiscal year 1980 is negligible.

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F. Establishment of Trust Funds (sec. 103 of the bill)

Present Law

There is no trust fund in present law from which expenditures can be made for public transit or to ameliorate the effect increased energy costs on the poor. Some costs associated with public urban rail and motor transportation, as well as some highway construction costs, may be funded presently from receipts appropriated to the Highway Trust Fund. In present law regarding highway funds, it is provided in 23 U.S.C. 142(k) that the Secretary of Transportation may not use his discretionary authority to transfer funds from the Highway Trust Fund for urban mass transportation purposes, if an urban mass transportation trust fund is enacted or another form of assured funding is provided for both highway and public transportation.

Under present law, the overall social security tax rate for employers and employees (each) is 6.13 percent of annual earnings not exceeding $22,900 in 1979 or $25,900 in 1980. Effective in 1981, the tax rate will crease to $29,700. These changes are anticipated to increase budget receipts by a total of $16.6 billion in calendar year 1981 as compared to the receipts which would be generated if the tax rate and base did not increase over 1980 levels. The total social security tax liability for calendar year 1981 related to the increases is $18.7 billion.

Reasons for Change

The committee believes that the receipts from the windfall profit tax should be returned to the economy in part to offset the financial burden on lower-income families from rising fuel oil prices.

Substantial increases in gasoline prices and the uncertain supply of gasoline are inducing increasing numbers of people to use public transportation. This change in behavior is an important part of the national energy efficiency program. It is anticipated that this trend will continue, and passenger-miles carried by public transportation will increase through the next decade. Many of the projects that may be constructed in the next ten years require a period of several years from planning through completion of construction. The committee believes that such projects should not be deferred because of doubt about the availability of funds, and therefore it is establishing a Transportation Trust Fund.

The significant social security tax increases which are scheduled for 1981 were enacted as a part of the 1977 Social Security Amendments to assure that adequate resources would be available to enable that program to meet its benefit obligations. That need continues to be a

matter of high priority. At the same time, the committee is keenly aware of the importance of exploring ways to reduce the heavy burden of payroll taxation, particularly in the light of the existing situation in which taxpayers also face the economic impact resulting from the decontrol of oil prices. The committee addressed this problem in 1978 through a general reduction in income taxes which tended to offset the impact of social security tax increases at that time. The committee anticipates that it will want to take some action in 1980 to address the problems which the economy generally and taxpayers individually would otherwise face when the 1981 social security taxes become effective. However, the importance of that program to the economic security of millions of Americans requires that the problem be addressed only after careful study and consideration of the financing needs of the social security program. The committee fully intends promptly to commit itself to such careful study with a view to making recommendations in this area to the Senate early next year. The committee is concerned, however, over the possibility that its ability to take the action which might be most appropriate and desirable could be foreclosed if adequate budgetary resources are not now set aside. For this reason, the committee substitute provides for the establishment of the Taxpayer Trust Fund using increases in income tax revenues which will result from decontrol of oil prices.

Explanation of Provision

Three-quarters of the net receipts from the windfall profit tax will be deposited in two Trust Funds. One-half of the net receipts from the tax will be deposited in the Low-Income Energy Assistance Trust Fund, and one-quarter of the receipts from the tax will be deposited in the Transportation Trust Fund. The Low Income Energy Assistance Trust Fund, however, will reimburse the general fund for the estimated revenue loss from the home heating tax credit provided in the committee substitute. The Secretary of the Treasury will estimate the revenue loss from the home heating tax credit six months after the end of each fiscal year for which that credit is in effect, and at that time the corresponding amount will be withdrawn from the trust fund. The total amount deposited into the Transportation Trust Fund for all fiscal years may not exceed $15 billion.

The committee substitute sets aside in a newly established Taxpayer Trust Fund an amount equivalent to general revenues received as a result of oil price decontrol in an amount sufficient to offset the scheduled 1981 increases in social security taxes (about $18.7 billion). The committee is not at this time recommending such a modification in the financing of social security, but the committee intends to study this issue carefully next year. The establishment of the Taxpayer Trust Fund would assure that adequate revenues have been set aside for the action the committee may recommend next year.

The net receipts from the windfall profit tax are equal to the gross amount of windfall profit tax collected minus the reduction in income tax receipts resulting from imposition of the windfall tax. It does not include tax collected on economic interests held by the Federal government.

Expenditures from the Transportation Trust Fund may be made as approved by law. Amounts in the Low Income Energy Assistance Trust Fund shall be available for expenditures to carry out the low income assistance program established by Title III of the bill.

Transfers to the trust funds of net receipts appropriated for their use shall be made monthly from the general fund. The Secretary shall make the transfers on the basis of monthly estimates of net receipts from the windfall profit tax. Adjustments will be made in the monthly transfers to correct for errors made in estimates for earlier months.

The Secretary of the Treasury will be responsible for holding the trust funds. He will submit an annual report to Congress at the end of each fiscal year on the financial conditions and operations of each trust fund during the fiscal year covered by the report and the expected conditions during the next 5 fiscal years.

The funds which are not required to meet current withdrawals will be invested by the Secretary of the Treasury only in interest-bearing obligations of the United States. Such obligations may be acquired on original issue at the issue price or by purchase of outstanding obligations at the market price. The interest on any obligations held in the trust fund, and the proceeds from the sale or redemption of such obligations, shall be credited to and form a part of the trust fund.

In the House bill, an Energy Trust Fund would be established into which the gross receipts from the windfall profit tax would be deposited. Expenditures may be made from the trust fund, as provided by appropriation acts, for purposes specified by law.

Effective Date

The trust funds will be established on the date of enactment of this bill.

V. BUDGETARY IMPACT OF THE BILL

In compliance with section 252(a) of the Legislative Reorganization Act of 1970 and sections 308 and 403 of the Congressional Budget Act, the following statements are made relative to the costs and budgetary impact of H.R. 3919, as reported.

Budget effect of the tax provisions

The committee estimates that the budget effect of the tax provisions of the committee substitute will be a revenue gain of $876 million in fiscal year 1980, $7,680 million in 1981, $13,660 million in 1982, $13,709 million in 1983, $12,702 million in 1984, and $12,124 million in 1985. Part III of this report gives a more detailed breakdown of the revenue effects.

The Treasury Department agrees with this statement.

Budget effect of income assistance program

The committee estimates that the low-income assistance program in the bill will provide budget authority and require budget outlays of $1.2 billion in fiscal year 1980, $3.0 billion in 1981, and $3.0 billion in 1982.

The amounts for fiscal year 1980 were not assumed in the first concurrent budget resolution for fiscal year 1980. The Committee, as indicated in its revised allocation report filed on October 30, 1979, assumes that allowances for this purpose will be included in the second budget resolution, action on which has not been completed by the Congress. The budget authority for this program will be derived from a trust fund, the receipts of which will consist of amounts (transferred from the general funds of the Treasury) equivalent to amounts of taxes received in the Treasury under specified provisions of the Internal Revenue Code of 1954.

Refundable tax credits

The committee substitute provides three new refundable tax credits and increases an existing refundable credit (for investments in solar or wind energy property). Tax refunds in excess of tax liability are outlays which would require an appropriation. Without such an appropriation, the Internal Revenue Service could not pay out the refundable part of the credits. The new refundable tax credits are the 40-cent tax credit for production of alcohol from sources other than oil, gas, or coal for use as fuel; the 10-cent credit for production of alcohol from coal for use as fuel; and the tax credit for utilities participating in residential energy conservation programs.

The two alcohol credits and the utility credit are expected to result in negligible refunds. The outlays from the solar and wind credits are expected to be $8 million in fiscal year 1981, $11 million in 1982, $19 million in 1983, $44 million in 1984 and $69 million in 1985.

The fiscal year 1980 refundable amounts under these provisions are reflected in the allocation report filed by the Committee on October 30, 1979.

Taxpayer Trust Fund

The committee substitute includes the establishment of a new Taxpayer Trust Fund into which will be paid receipts from specified provisions of the Internal Revenue Code to the extent that such receipts result from the increased costs of energy because of the decontrol of oil prices. The exact nature of the use of amounts in this trust fund will be determined in subsequent legislation, but the general purpose is to assure that adequate revenues are available to provide relief to taxpayers who face the impact of those higher energy costs at the same time as they face a significant increase in social security taxes. The budget authority created by the establishment of this trust fund is estimated to be $2.7 billion in fiscal year 1980, $10.4 billion in fiscal year 1981, and $5.6 billion in fiscal year 1982. The amount paid into the trust fund would not exceed the amount of increased social security taxes under the rate and tax base increases scheduled to become effective in 1981. As indicated in the revised fiscal year allocation report filed by the committee on October 30, 1979, the budget authority for this trust fund was not reflected in the assumptions underlying the first budget resolution. However, the committee expects to consider its budgetary impact in developing its allocation report at such time as action on the second budget resolution for fiscal 1980 is completed by the Congress.

Consultation with Congressional Budget Office

The committee has consulted with the Congressional Budget Office in preparing its estimates on the budgetary impact of the bill. As of the time the report is being filed, the formal report of CBO had not been completed, as indicated in the letter below. [Insert attached letter.]

U.S. CONGRESS
CONGRESSIONAL BUDGET OFFICE,
Washington, D.C., October 31, 1979.

HON. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: The Congressional Budget Office is currently examining the Senate Finance Committee substitute for H.R. 3919, the Crude Oil Windfall Profit Tax Act of 1979. We expect to complete our analysis by November 9. We will send you our report on the budget effects of the bill as soon as our analysis is completed, and in any event prior to consideration of the bill on the Senate floor.

Sincerely,

ALICE M. RIVLIN, *Director.*

VI. REGULATORY IMPACT OF THE BILL AND VOTE OF THE COMMITTEE

A. Regulatory Impact

In compliance with paragraph 5 of rule XXIX of the Standing Rules of the Senate, the following statements are made concerning the regulatory impact of the bill.

The bill is primarily a revenue measure rather than one involving any direct extension of regulatory authority. The regulatory impact of the measure therefore is essentially limited to the necessary elements of regulation inherent in the application of new tax provisions. The categories most affected by any such regulatory impact would be the producers and royalty owners of domestic crude oil. The bill also contains a number of tax reductions related to energy usage. The categories affected by any regulatory impact required to implement these provisions are indicated by the nature of the provisions themselves as described in the body of the report. No unusual regulatory impact is anticipated. One provision of the bill should reduce the regulatory impact of existing law by removing certain Treasury regulations now applicable to the producers of alcohol for use as fuel. The bill also includes a repeal of the carryover basis legislation which should reduce the amount of paperwork involved in complying with that provision of existing law. Another feature of the bill is the provision of aid to lower income individuals through a tax credit related to increased heating energy costs and through a program of direct payments to SSI, AFDC, and food stamp recipient households (or, alternatively, block grants to States to provide low-income energy assistance). While these provisions will affect a substantial portion of the population, the implementing regulations should have little direct impact. In the case of the tax credit provision, most individuals would simply be required to claim the credit, to file an additional form with their 1979 tax returns. It is anticipated that the required information would be incorporated into the basic tax return forms in subsequent years. In the case of the direct payments program, no additional application is required inasmuch as payments would simply be added to the benefit checks of those already on the benefit rolls of the programs (or paid as an additional check in the case of food stamp receipients). If a State elects the block-grant option, very little Federal regulatory activity would be called for under the bill. The nature of any State regulatory impact under such programs cannot be determined since States would be free to design such programs in whatever form they found appropriate.

In general, the economic impact of all the above-described provisions would flow from the nature of the statutory provision itself and any economic impact caused by the implementing regulations would

be expected to be incidental and minimal. No significant impact on privacy is anticipated. The information which taxpayers would be required to provide in connection with the various revenue provisions does not differ in character from the types of information required under existing-law tax provisions. The direct payments program would require no new disclosure of information since it affects existing recipient groups except that information would have to be developed concerning which households concurrently receive benefits under the three recipient categories in order to avoid duplication of benefits. If States elect to operate these programs as block grants, individuals applying for State benefits could in some cases be required to provide income and assets data in order to demonstrate that they fall within the category of low-income individuals as is required by the bill. This is considered to be a minimal impact on personal privacy which is related to meeting the essential purposes of the bill.

As indicated above, the provisions of the bill will in some cases involve the filing of additional applications and forms. Generally, however, such paperwork requirements are anticipated to be of a routine nature not differing in any significant degree from the paperwork reasonably associated with proper administration of tax and benefit provisions of law. (The one exception is the provision relating to carryover basis which is expected, under existing law, to require additional paperwork; under the bill this paperwork impact would be eliminated.)

B. Vote of the Committee

In compliance with section 133 of the Legislative Reorganization Act of 1946, the following statement is made relative to the vote by the committee on the motion to report the bill, H.R. 3919, as amended by the committee, was ordered reported by a vote of 15 to 1.

VII. CHANGES IN EXISTING LAW

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of subsection 4 of rule XXIX of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, as reported).

VIII. ADDITIONAL VIEWS OF SENATORS RIBICOFF, NELSON, MOYNIHAN, BAUCUS, BRADLEY, PACKWOOD, ROTH, DANFORTH, CHAFEE, HEINZ, AND DURENBERGER

Our Nation faces a dire crisis of overdependence on insecure foreign oil, a dependence which makes us vulnerable to supply disruptions and further weakens the dollar. The philosophy which has guided our taxing and spending decisions in this legislation has been to direct a major portion of the revenues generated by decontrol to accelerate conservation and domestic production of energy. Our concern has been to provide energy security for America. We seek to get our energy problem under American control, not to punish any one segment of our economy.

Clearly, we need to increase domestic production of oil. The urgent need for new oil requires the elimination of obstacles in the way of increased production. Some of us departed from past-held views by agreeing to exempt from the tax newly discovered oil and oil extracted by tertiary methods. We believe that on those categories of oil there should be no tax which impedes a significant production response.

Where a higher price will not result in significantly greater production, we believe a stiff tax should be levied. Substantial revenues must be raised to stimulate development of alternative sources of energy, relieve the growing energy cost burden on lower income persons, fund energy efficient transportation and moderate economic imbalances caused by decontrol and OPEC price increases.

The bill is a reasonable one, but only partly embodies this philosophy. Several special exemptions are allowed which are unjustified because they do not enhance production and because they significantly reduce badly needed revenue. In addition, the tax on some categories of oil and the phaseout of the tax should be reconsidered.

TIER I TAX

The committee remained true to its general philosophy of taxing those categories of oil which are not expected to experience a significant increase in production from a higher price by approving a 75 percent tax rate on lower tier oil. This is oil that is now selling for an average of $6 and will sell for the world price, which is already $23, after decontrol. Here, we believe, there is a huge "windfall" to producers; presumably, this oil was profitable at $6 and will be over 400 percent more profitable after decontrol. Because a negligible production response is expected from increasing the price of lower tier oil, we unanimously supported a 75 percent tax rate.

Those who disagreed with us and supported a lower tax rate contend that revenues from this oil are essential to ensure the cash flow necessary for new exploration and production. We believe this is not so.

Oil companies do not need to keep all the windfall profits from prior investments as an incentive to expand exploration and production, as long as they are assured of higher prices. According to their third quarter reports, cash flow is not a problem for most oil companies. Even under the committee bill, decontrol will add $374 billion to oil producers' net revenues over the next 10 years.

TIER II TAX

The committee's decision to tax upper tier oil at 60 percent and allow a severance tax deduction is disappointing. Similar to lower tier oil, this oil is now profitably flowing at $13 and will rise to the world price after decontrol. Decontrol will add at least $10 to the price of this oil, without a significant production response. Given the generous exemptions from the tax provided as production incentives, we believe a higher tax on upper tier oil is appropriate.

INDEPENDENT PRODUCERS & STRIPPER WELLS

We concur with the committee's rejection of the proposed 3,000 barrel per day independent producer exemption. This exemption is unwarranted. The committee wisely agreed that an exemption of this magnitude was not consistent with the supply response estimated by the Treasury Department, Department of Energy and most observers. In addition, independent producers are entitled to percentage depletion on 1,000 barrels of oil production per day under current law. This favorable treatment under current law and the absence of significant supply response required rejection of the 3,000 B/D exemption.

We also agree with the committee's rejection of an exemption for all stripper well production. While some argue that there would be a modest supply response, this estimate was not large enough to justify the reduction in revenues from such an exemption. Price sensitive, high cost stripper wells will be protected by the net income limitation provided in both the House and committee bills.[1]

PHASEOUT

Under the committee's version, the tax will begin to phaseout once net revenues reach 90 percent of the total now estimated, or approximately $138 billion. We differ on the question of whether the tax should be phased out, or whether all or parts of it should remain to recapture future "windfalls" caused by increases by OPEC. We are in agreement that the phaseout adopted by the committee is not the best option, although some of us supported it as the best available alternative at the time.* Setting a specific dollar figure leaves the tax at the mercy of the committee's economic assumptions. No one can say what future oil prices will be or how fast they will rise. We can make guesses, and they may be good ones. But the history of oil prices in recent months and years has defied all predictions. A tax limited by a guess is not the proper way to legislate.

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[1] Senators Ribicoff, Nelson, Moynihan, Bradley, Danforth and Chafee believe the 1,000 B/D exemption for stripper wells produced by independents is unwarranted.

* Senators Packwood, Roth, Danforth, Chafee, and Heinz.

LOW-INCOME ASSISTANCE

Heating bills of all Americans are soaring, but in considering the uses and distribution of tax revenues, a primary objective of the committee was to assure that those segments of the population most adversely affected by the decision to decontrol oil be assisted in bearing the resultant financial burden. This means principally those low and lower middle income households that heat their homes with oil and other energy sources whose price is directly responsive to oil. Within this group people have difficulty paying the price to heat their homes during the winter.

The committee's income assistance program is to provide aid in the form of a small tax credit for all households with incomes below $20,000, a slightly larger credit for those that heat with oil, propane and imported Canadian natural gas, and cash grants to recipients of AFDC, SSI and food stamps. Flexibility is given to those States which desire to revise the target populations.

We fully recognize that the committee's program is the result of compromises made by all members and is in one sense comprehensive. However, it departs from our original intentions. We did not set out to institute a general tax cut, particularly one which is large in its application but small—some would say nominal—in its effect. Rather, we sought a program of targeted, and substantial assistance to the principal victims of unprecedented price increases that are directly attributed to the soaring price of oil.

The committee's decision was reached in a spirit of comity and in the recognition that other persons also face high energy costs. We may, however, have ended up—with respect to the $20 minimum "general" tax credit—spending a significant amount of money in a way that will provide a tiny amount of assistance to a very large number of people. Included are many whose energy costs, while possibly high, cannot be attributed to the decontrol of domestic petroleum prices—the reason that we have a windfall profits tax at all. The relief offered is token. It helps little, if at all, while using up funds that could be far better employed to aid those with greater and more pressing needs.

SOLAR AND CONSERVATION CREDITS

S. 1760, introduced by Senator Packwood on behalf of himself, each signer of these views, and also Senators Dole, Wallop, and Boren, provided tax incentives for a range of conservation and alternative energy sources, including the purchase by individuals and businesses of conservation property, renewable energy property (solar, wind, geothermal, hydroelectric, biomass and ocean thermal energy conversion), cogeneration property and for the production of alcohol fuels. We are encouraged that the windfall profits bill which was reported by the Committee contains most of these provisions (although modified to provide lower credit percentages and shorter duration in most cases), tax credits for high efficiency wood stoves and residential furnaces as well as important additional production subsidies for oil shale and certain unconventional gases. The windfall profits tax is an excellent source of revenues for financing these credits.

TRANSPORTATION

The committee wisely decided to set aside $15 billion in a trust fund for energy efficient transportation initiatives.

TAXPAYER TRUST FUND

We are also pleased the committee earmarked a portion of the increased Federal revenues which will result from oil price decontrol for a Taxpayer Trust Fund. The revenues in this trust fund will be available if the Congress decides to offset the substantial payroll tax increases scheduled for 1981. The committee action will enable Congress to use a portion of the increased revenues from oil decontrol to provide additional tax relief to the American people.

Abraham Ribicoff.
Gaylord Nelson.
Daniel Patrick Moynihan.
Max Baucus.
Bill Bradley.
Bob Packwood.
William Roth.
John Danforth.
John Chafee.
John Heinz.
David Durenberger.

IX. ADDITIONAL VIEWS OF SENATORS RIBICOFF, NELSON, MOYNIHAN, AND BRADLEY

The impetus for this legislative endeavor was the President's decision to decontrol crude oil, an action which will ultimately result in tremendous financial gain for some, and hardship for others. Therefore, the committee set out to devise a plan to be implemented through our system of taxation which would rectify some of the injustices which would otherwise result.

However, as with any labor which involves compromise, there are segments of this work which departed from our original intent. These diversions are not irrevocable, we have the opportunity to strengthen those segments in question, and offer a sound legislative response to the now inequitable energy marketplace.

The issues that we discuss in this statement are illustrative, but by no means exhaustive of the areas where we believe the bill must be improved.

INDEPENDENT-STRIPPER EXEMPTION

The committee bill exempts from taxation stripper wells producing up to 1,000 barrels a day which are at least 50 percent owned by independent producers. Stripper wells are those which produce 10 barrels per day or less in any 12-month period. Once wells qualify, there is no limit on the amount of oil they can then produce while still getting the advantages already in the law for stripper treatment. In most cases, these are lower tier wells, that is, wells with production costs incurred when oil was selling at $4–$5 per barrel, not $23 as now.

The effect of this "modified independent-stripper" exemption is to reduce revenues from the tax by over $16 billion. The exemption will not lead to increased production. In fact this added tax benefit may actually operate as another incentive to reduce production in some wells so as to qualify for stripper status.

The committee's consideration and rejection of other, more generous proposals for stripper wells and independent producers highlights the unjustifiable decision the committee ultimately made. There may have been a sentiment among some members that "something" should be done for the independents, something with comparatively less revenue impact than oil exemption. This decision may be based on the belief that independents are small, high-risk operations. But many of the independents which qualify under the committee's provisions are very large companies. Indeed, the 1,000 barrel per day limitation translates into oil revenues of as high as $11,000,000 a year per company. This is unjustified and no basis for a major revenue exemption.

TIER II TAX RATE AND PHASE OUT

A good example of the committee's rejection of preferential treatment that is not justified by a production response was its decision to

impose a 75 percent tax rate on tier one oil—oil in production prior to 1973. By contrast, its decision to apply a lower rate on tier two is inconsistent. Tier two, or upper tier oil, is also oil now in production. These wells were drilled more recently and their production costs are somewhat higher, but decontrol offers revenues vastly greater than that contemplated when the wells were first drilled. As with other old oil, tier two oil will be produced in no more significant quantities if the tax rate remains at 60 percent. A 75 percent rate for this oil is fully warranted.

The committee bill has adopted a phase-out based upon an arbitrary level of receipts. Under this formulation, the tax would begin to phase-out when receipts reach $127.5 billion. When that will occur is anyone's guess, since it relies on OPEC decision to raise its prices to higher levels. If oil prices continue to rise at the extraordinary levels of the past few months, the tax will end in a few years. If moderation governs OPEC decisions, the tax will stay in effect longer. Thus the committee bill presents the peculiar results of ending the tax earlier if prices rise faster. And the greater the future windfalls from these increases, the better off the oil companies will be.

This tax should be permanent. We should have in place a permanent mechanism to recapture for future public needs, part of any new windfalls that come from decontrol. There is no more reason to permit oil companies to retain the full benefit of future unwarranted increases in the value of their domestic revenues than there is in giving them the full amount of the present windfall.

Future increases in the price of oil will encourage the development of alternative energy sources, increased conservation, and renewed efforts to develop more energy-efficient transportation. As oil prices continue to go up, they will present new crises and new policies to meet them. While we cannot anticipate what these crises may be, it is certain that they will make new demands on the federal treasury.

While the revenue impact of making the Tier II tax permanent will at first be modest ($2.9 billion in the next decade), in the years thereafter the revenue will be directly related to the pace of OPEC prices.

We intend to urge the full Senate to complete the good beginning made by the committee, and to enact a windfall profits tax which will be fair and beneficial to the Nation.

X. ADDITIONAL VIEWS OF SENATOR BENTSEN

The design and structure of any windfall profits tax will profoundly affect the patterns of development of the petroleum industry during the decade of the 1980's. I am concerned that the tax bill reported by the committee will result in a significant and undesirable shift in the relative competitive positions presently held by the two major segments of the industry: the 30-plus major integrated companies and the roughly 12,000 active independent oil and gas producers.

Although their ranks have declined by approximately 40 percent since the 1950's, independent producers still have no equals in the business of oil and gas exploration. In recent years, independents have drilled approximately 90 percent of all domestic wildcat wells and have discovered 75 percent of all new fields. A study by the Independent Petroleum Association of America has shown that for the period 1973–77 independent producers reinvested 105 percent of their gross revenues in their production budgets (earnings plus borrowed capital).

Unlike independent producers who have but one principal source of income for drilling—oil and gas production—major companies enjoy a variety of investment capital sources: refining, transportation, marketing and overseas operations. While the windfall profits tax will affect one of the several revenue sources for major companies, it will zero in on the very lifeblood of drilling capital for independent operators.

To be sure, even with the windfall tax, oil decontrol will result in higher cash flows for independents. But the tax will significantly impair the relative ability of independent producers to generate investment capital vis-a-vis the major oil companies. Independent operators will be able to compete less effectively for new domestic oil leases, and will gradually lose their foothold on the approximate 15 percent of crude production which they presently control.

In addition, the windfall tax will create a tidal wave of complex new crude oil regulations that will swamp thousands of smaller operators. For example, under the committee bill oil from a single well can be priced and taxed simultaneously in three separate categories; i.e., that portion of a well's production which is below the lower tier pricing and tier-one taxing decline curves would be priced as lower tier oil and not taxed, that portion above the pricing decline curve and below the taxing decline would be priced as upper-tier and taxed at a 75 percent rate in tier-one, and that portion which exceeds both the pricing and taxing decline curves would be priced as upper tier oil and taxed at a 60 percent rate in tier-two. Without the battalions of accountants and lawyers employed by major oil companies, many independent producers will succumb under the tremendous regulatory weight of this legislation. For those independents who survive, the windfall tax will divert substantial drilling

revenues into administrative overhead expenses, further reducing their competitive ability.

I believe the public interest is best served through government policies that promote diversity in the market place and that encourage vigorous competition among producers. In the domestic petroleum industry these goals can best be achieved through policies that foster a thriving segment of independent operators. That is why during committee consideration of this legislation I sponsored an amendment which would exempt from the tax all but the very large independent producers. The failure of the committee to accept my amendment will lead to the imminent decline of the independent segment of the industry at the ultimate expense of the energy consumer. For these reasons, when the full Senate considers the windfall tax bill I intend to offer an amendment which will create an exemption from the tax for the first 1,000 barrels of oil produced by independent operators.

The committee bill also addresses the problems of lower income Americans who must stretch their limited financial resources to cope with rising energy prices. We are all painfully aware of the agonizing choice that has been forced on many of the Nation's poor: the choice of buying food or buying energy for their essential needs.

I believe that it is appropriate that a portion of the revenues from the windfall tax be dedicated to helping the poor survive this period of skyrocketing energy prices. However, in the distribution of Federal funds for this purpose, we must provide even handed treatment of all energy expenditures that are drawn from the pockets of the poor.

The committee has proposed distributing energy assistance funds according to two factors: total residential energy expenditures and "heating degree days." The use of the degree day factor, which is a surrogate measure for average residential heating expenditures, fails to take into account the total range of energy needs of the poor. According to a report prepared for the Community Services Administration by the Washington Center for Metropolitan Studies, residential heating accounts for only one-half of the poor's residential energy consumption. Other essentials, such as water heating, refrigeration of food, preparation of meals, and lighting account for the other half of the poor's residential energy needs.

Furthermore, in addition to their residential energy expenditures, the poor also face significant increases in the costs of energy for transportation to their places of employment and commerce. Higher energy prices will reduce the mobility of the poor, limiting their employment options and their access to less expensive retail outlets.

For this reason, I believe energy assistance funds should be distributed on the basis of total energy expenditures by low income Americans. Although the data is not available to distribute funds on this basis in fiscal year 1980, it could be easily assembled for future years. For the administration of the program in the current year, funds could be distributed according to average residential energy expenditures which can be computed from existing data.

The use of "heating degree days" not only fails to account for other essential energy expenditures, it also fails to accurately represent actual heating expenditures by region. Because the base price

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of residential energy may vary significantly from State to State and city to city, individuals in similar climates may experience dramatic differences in their actual energy bills. For example, Washington State and North Dakota have very cold climates but are well below the national average in residential energy expenditures due to their low average costs of energy. Although I agree that any distribution formula should recognize the greater energy needs of Northern States, the allocation of funds on the basis of actual energy expenditures will give colder States additional funds in exact proportion to their additional energy needs.

I also disagree with the method used in this legislation for awarding energy assistance tax credits for low income wage earners. Rather than awarding credits as a percentage of increases in residential energy outlays, I believe the credits should be awarded as a percentage of a taxpayer's total residential energy expenditures. If two individuals have the same income, it makes sense that the taxpayer with 50 percent higher energy bills should receive a 50 percent larger credit than the other. Under the formula used in the committee bill, it is possible for the individual with the lower energy bill to receive a greater tax credit if his or her energy expenditures had increased by a greater amount. Distributing tax credits only on the basis of recent increases will unfairly disadvantage individuals who have already experienced major increases in energy costs and are presently paying much higher energy bills than the national average.

XI. ADDITIONAL VIEWS OF SENATOR GRAVEL

History of Domestic Oil Price Controls

The price of oil since its discovery at Titusville, Pa., in 1859, has been low in relation to other commodities. Initially, farmers considered the black goo a liability and sold oil rich lands as worthless. As industrial economies began to realize the attractiveness of oil as a fuel source the commodity became marketable and eventually the search for oil expanded beyond the United States. Throughout the first half of this century world oil reserves expanded faster than consumption. Major discoveries in Texas, the American Southwest and the Near East added huge reserves to the world stock of oil.

The major multinational oil companies are predominantly American owned and operated. These companies opened up the large foreign oilfields which now form the bulk of OPEC production. During the decades of the fifties and sixties the majors, controlling production from the huge fields of the Middle East, kept the price of oil low. In fact, the price of foreign crude was so low that import quotas were placed on foreign oil to prevent it from driving higher cost domestic oil out of the market.

At the beginning of the 1970's the countries which had provided us so abundantly with cheap oil began to realize that they were selling their birthrights for less than they might receive. Reacting in a perfectly logical fashion they joined together to seek higher prices for their crude oil. Because of the gluttony of the industrialized West, OPEC became a success and has continued to set the world price for oil since its formation in 1973.

The United States responded to the OPEC challenge in a most unsatisfactory way. Instead of acknowledging our dependence on imported oil and adjusting to price increases through encouraging domestic production of hydrocarbons, we levied price controls on domestic oil in an effort to delay the consequences of the OPEC price increases. Price controls on oil were initiated by President Nixon on August 15, 1971, as part of a general program of price controls. Prices were frozen at May 15, 1971, levels and not allowed to rise with the world price for oil.

By early 1973 price controls lapsed to voluntary guidelines. Due to heating oil shortages the Cost of Living Council imposed mandatory controls on the oil industry alone. We decontrolled the price of all other commodities, but continued controls on domestic oil with President Nixon freezing all oil prices. This was phase IV of the price control program which became the forerunner of the DOE programs of today.

In 1973 the Arab-Israeli war led to prices rising faster and higher than expected. In the United States, domestic crude prices were allowed to rise in response to supply shortfalls. The Cost of Living Council targeted regulations more specifically on the functions of the industry. Production, refining, marketing, and ceiling prices were set and mandatory allocations began. New oil was decontrolled. Producers increasing their production above 1972 levels were allowed one barrel of old oil at world price for every new barrel produced.

In November 1973, Congress passed the Emergency Petroleum Allocation Act which enacted into law most of the Cost of Living Council regulations. In addition, that act created the Federal Energy

Administration to regulate prices and allocate production. It also created a cost equalization program for purchasers of crude oil bringing with it the "entitlements" program. President Ford imposed two $1 per barrel tariffs on imported crude oil under the Trade Expansion Act of 1960. These tariffs did not require congressional approval.

In 1975 the Energy Policy and Conservation Act was passed; largely continuing EPAA price regulations. This bill allowed FEA to establish "old" and "new" domestic oil prices such that the weighted average of domestic oil prices would not exceed $7.66 per barrel. The bill also placed stripper oil under controls, disallowed the release of oil to uncontrolled status, and authorized the President to initiate major regulatory program changes with congressional oversight.

In August 1976, the Energy and Conservation Act was passed by the Congress. This act decontrolled stripper well output allowing this oil to rise to world price. Authority was granted to raise the EPCA composite price by 10 percent per year although this action has never been taken by either FEA or DOE to the full extent allowed by law.

The dominant theme in this history of domestic oil price controls in the United States is one of increasing complexity. Starting with a general price control program on all goods we have developed in less than a decade a price control program for one domestic commodity which requires thousands of people and billions of dollars to administer. These price controls have helped keep the price of oil to U.S. industry and consumers below that paid by other countries. But the controls have not been without cost. We have continued our energy gluttony, our oil imports have risen, domestic production has been discouraged by artificially low prices, and we have lost face in the world by hiding from our energy problems.

Efforts to establish a domestic energy policy in the field of oil have centered around increasing the consumer price of oil to the market price established by OPEC while denying producers the revenues from higher retail prices. The crude oil equalization tax proposed by President Carter in 1977 and rejected by the Congress would have taxed the price of domestic oil to the world price. It, like the windfall profits tax, was deregulation without decontrol. Congress wisely rejected this tax, understanding that it promised higher prices with no hope for increased domestic production.

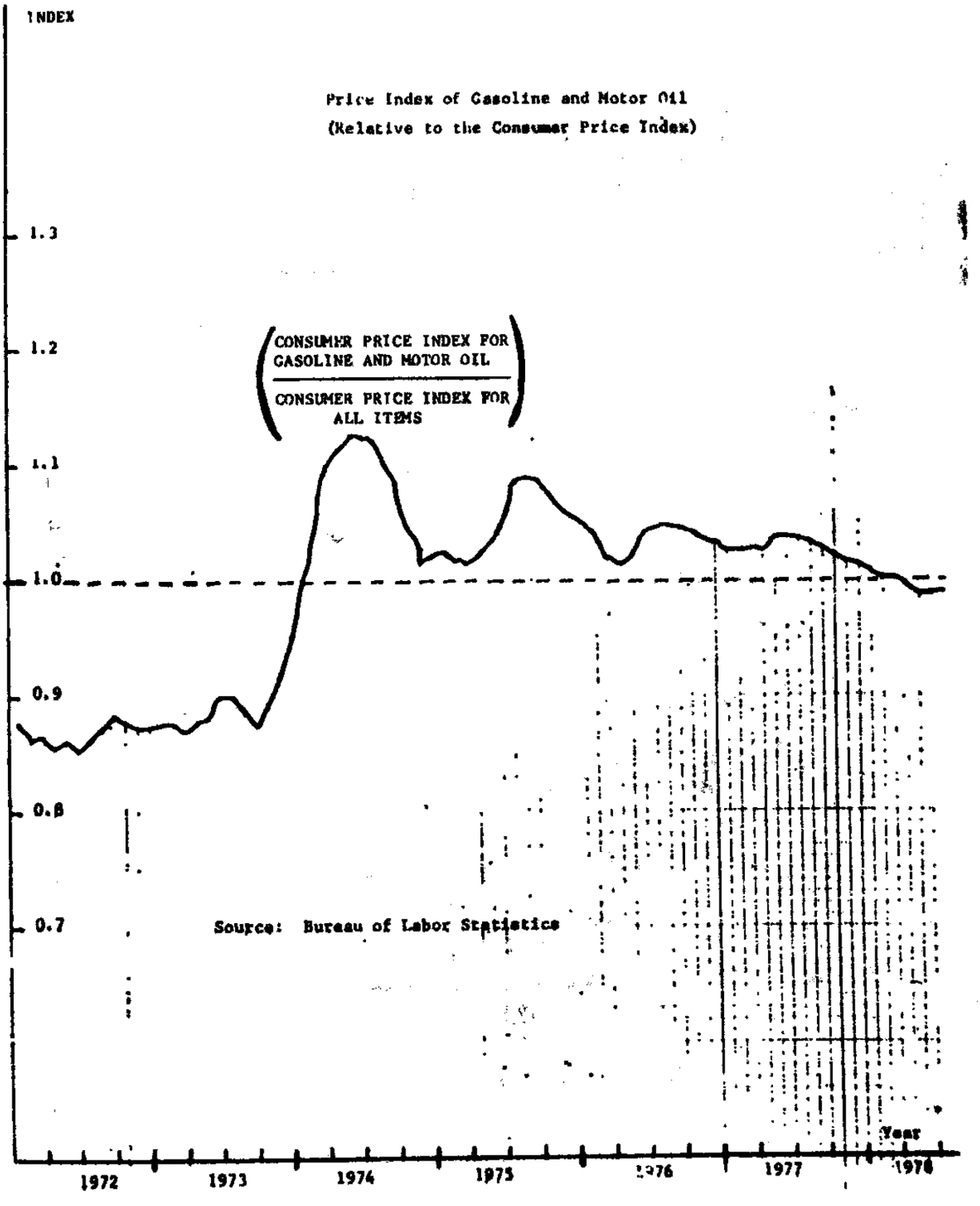
President Carter took a courageous step earlier this year when he announced a plan for the phased decontrol of domestic oil prices. As pointed out in his announcement, decontrol of domestic oil prices will contribute significantly to increased domestic production of oil. However, in a proposal which takes back with the left hand that which has been given with the right, the President asked the Congress to impose a "windfall profits tax" on the revenues flowing to domestic petroleum producers as a result of decontrol. The proposed tax has nothing to do with profits of domestic oil producers but simply places an excise tax on each barrel of oil produced domestically from certain categories. It is a punitive tax which does nothing to reduce our reliance on foreign oil, but reduces the incentive to produce American oil. Most discouragingly the crude oil severance tax is unnecessary since a rational national energy policy for the United States can be financed out of increased corporate income tax revenues resulting from decontrol.

There Are No Windfall Profits

The question of oil company profits has been thoroughly demogogued. Political and media denunciations of oil industry profits ring with moral outrage and colorful adjectives. What most of these denunciations lack is any reference to the facts. Prices of oil and related products are not exceptionally high, nor are oil companies abnormally profitable.

OIL PRICES ARE NOT OUT OF LINE

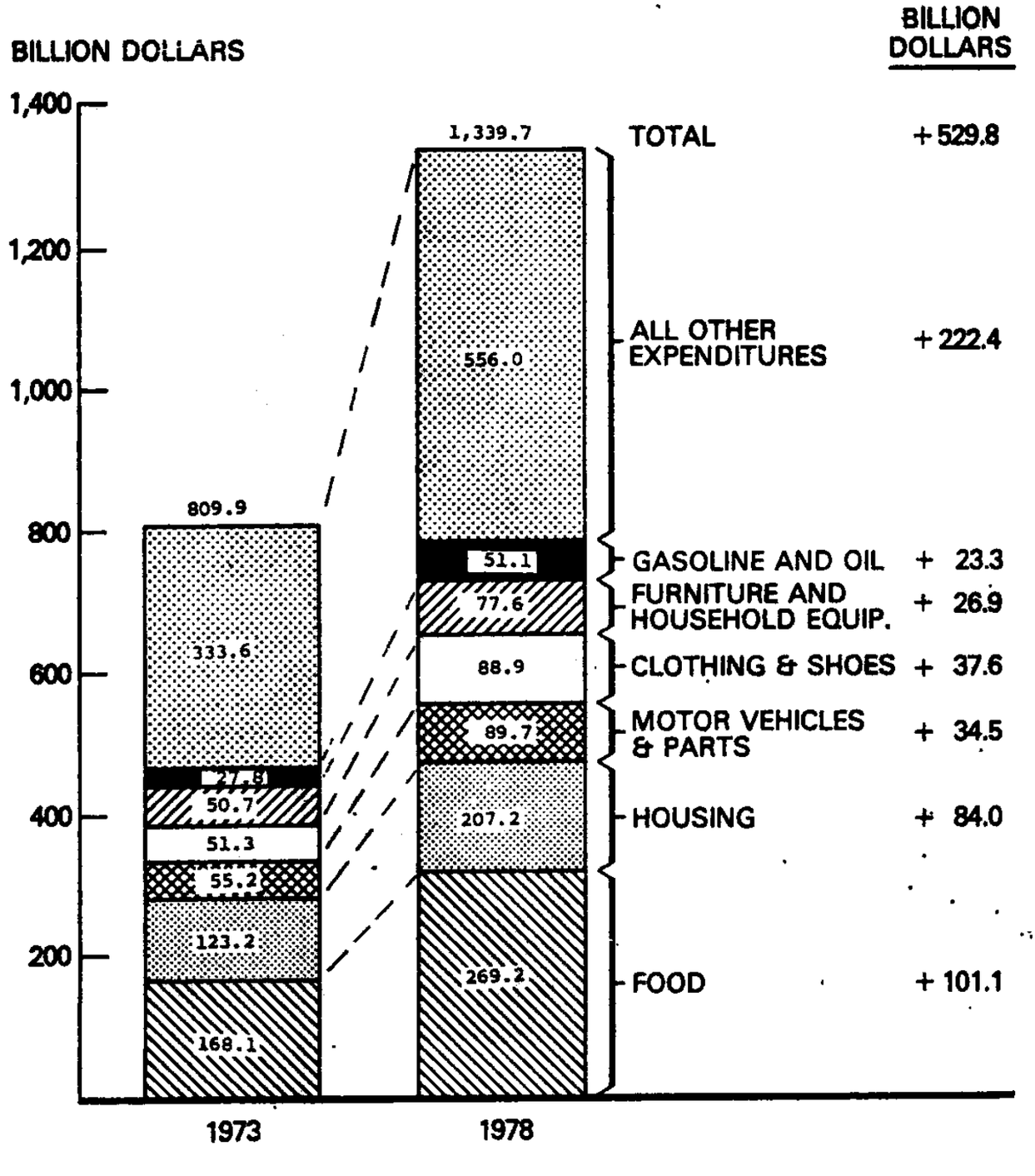
There have been allegations that much of the inflation in our economy is due to the rapid OPEC price increase in crude oil. It is interesting to compare the price of crude oil and related products with the Consumer Price Index to determine just how much the price of oil has risen in real terms. The relationship between the CPI and the price of gasoline and motor oil for the years 1972–78 is shown by the following chart:



Prior to the first quarter of 1974 the price of these commodities lagged behind the increases in the general level of prices. Following the oil embargo in 1974 gasoline and motor oil prices rose above the general level of prices. But, by 1978 prices fell back to a point where, in real terms, they were no higher than the general level of prices measured by the CPI.

In addition to dramatic price increases in the nominal cost of energy other goods have inflated rapidly. President Carter's economic report to Congress relates the cost of energy and all other items in a chart set forth below:

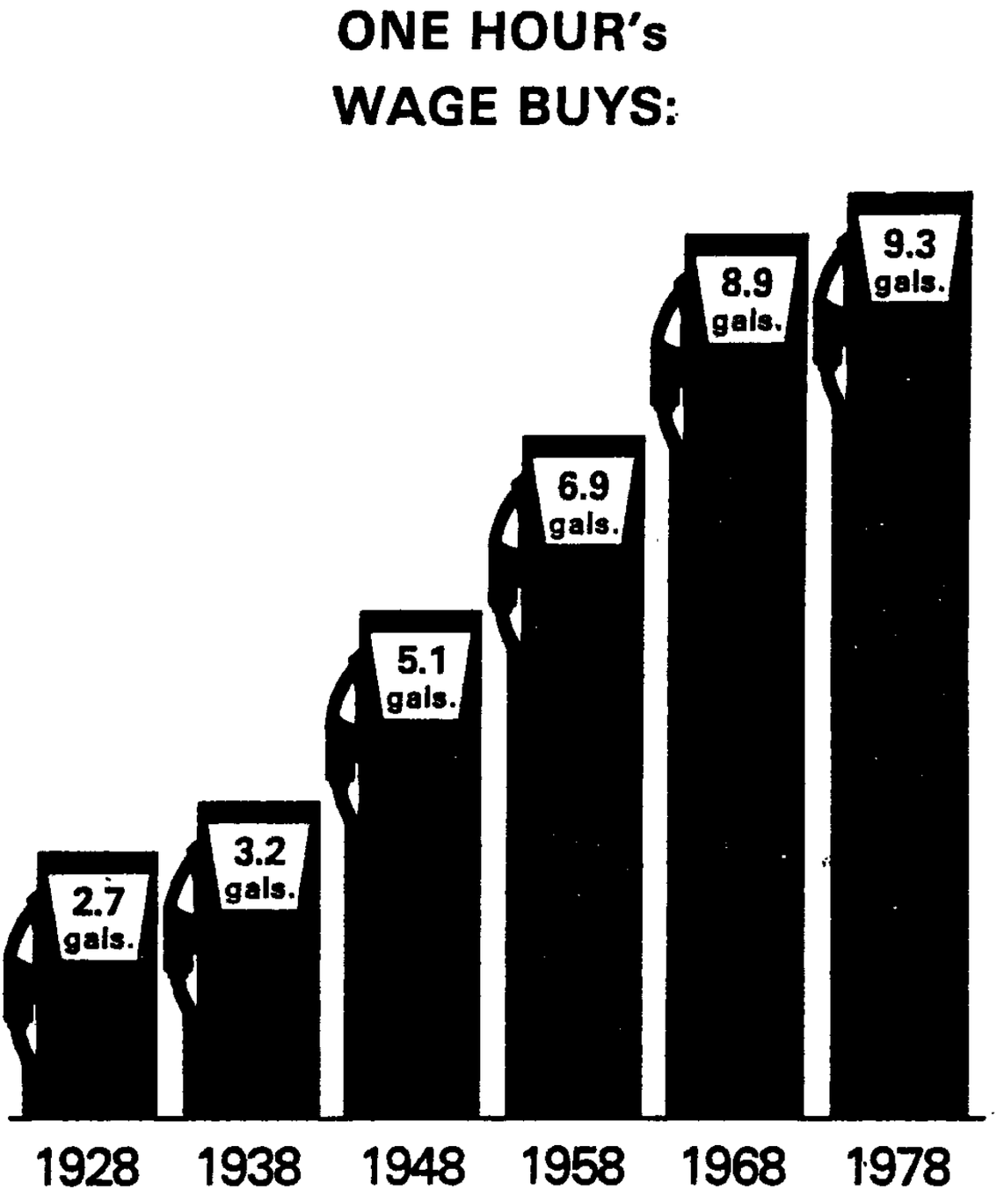
PERSONAL CONSUMPTION EXPENDITURES
1978 vs 1973



SOURCE: 1979 ECONOMIC REPORT OF THE PRESIDENT

IPAA CHART
APRIL - 1979

In terms of dollars the increased outlay for gasoline and oil was far down the list, less than the increased expenditures for furniture. A further illustration of the status of domestic energy costs can be shown by comparing the cost of a gallon of gasoline with the average hourly earnings of American workers. The following chart shows dramatically that the cost of fuels in the United States fell significantly between 1928 and 1978 in relation to wages.



Note: Calculated by IPAA based on average hourly earnings published by U.S. Bureau of Labor Statistics and Retail Price of Regular Grade Gasoline (inc. tax) as published by Platt's Oilgram.

IPAA Chart
April 1979

This discussion is not intended to suggest that all is well with U.S. energy policy, but merely to put the discussion of "windfall profits" into perspective. Since World War II the cost of petroleum based energy products in the United States has fallen in terms of real dollars until only very recently. It has been only since the beginning of 1979 that the cost of oil based hydrocarbon fuels in the United States has risen in real dollars. This is an exemplary record for the industry which our leaders have chosen to vilify.

PRICE INCREASES ARE DUE TO OPEC

The argument is made that domestic oil should not receive the current world price of oil because that price is an artificial one established by the OPEC cartel. However, from the standpoint of the United States the cost of a barrel of domestic oil which is not produced is the OPEC price because we must import that barrel from abroad. We must give up the goods and services from our domestic economy necessary to pay the OPEC price.

Because we must pay the OPEC price for imported oil the real cost of an additional barrel of oil, regardless of its source, is the OPEC price. If we are unwilling to pay this price for domestic production we use more of our resources to purchase foreign oil than domestic oil. But, clearly, it is preferable from the viewpoint of our economy to encourage domestic production to its fullest. Even at the OPEC price a barrel of domestic oil is preferable to a barrel of imported oil because the domestic production brings employment, income and tax revenues which foreign production exports.

Because of price controls, continued in de facto form by the crude oil severance tax, the United States is not producing those quantities of oil which could be produced with fewer resources than we use to purchase oil abroad; that is the oil which could be produced above the domestic controlled or tax base price and below the full world price. For every additional barrel of domestic oil we produce costing less than the world price, we obtain a net resource savings, which can then be used for the production of additional goods and services for consumption within the United States. If the price of oil received by domestic oil producers is permitted to rise to the world price, we could get more oil for the resources used at home and reap increased real income at the same time.

This is not to say that OPEC is not important with respect to a determination of domestic crude oil profits. If domestic prices are decontrolled increases in world prices will increase domestic oil prices and the profits of petroleum companies. This increase in profits is desirable in that it will encourage capital to flow to the domestic oil industry expanding domestic production until the cost of producing an additional domestic barrel of oil equals the cost of purchasing an additional barrel abroad. As the committee substitute is currently drafted an incentive remains to purchase oil abroad rather than to produce it at home.

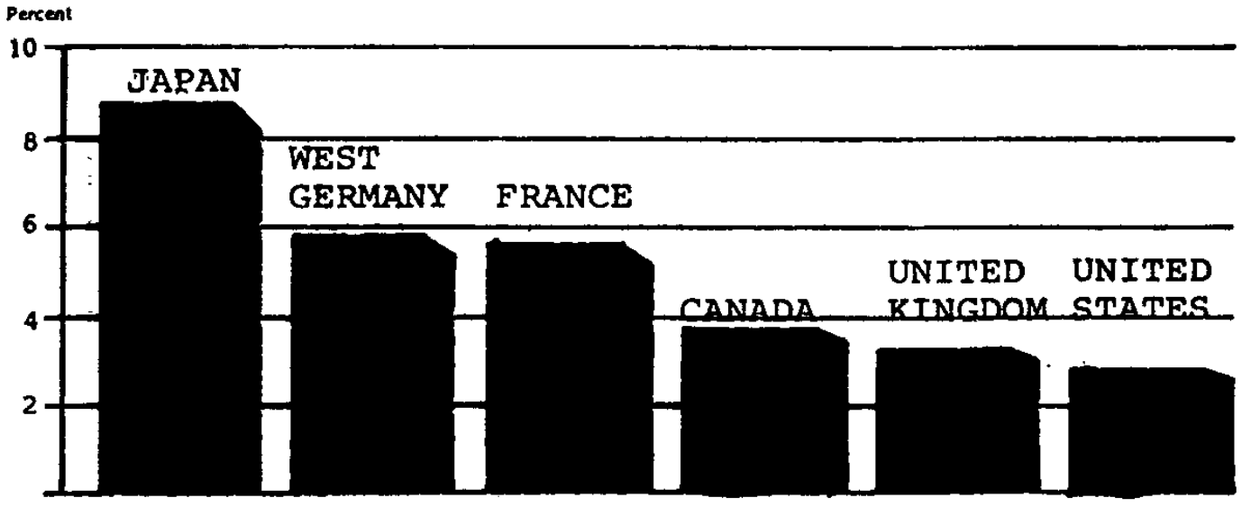
INFLATION NOT CAUSED BY OIL PRICES ALONE

Many people in the United States blame the chronic increases they are witnessing in the cost of living on skyrocketing oil prices. By association, they place much of the onus for inflation on oil companies taking advantage of OPEC pricing practices. But rising oil prices are not the whole explanation for the inflation we are now experiencing in the United States. The predominant responsibility lies with the deplorably low productivity experienced in the United States since the early 1960's.

Japan, which is almost totally dependent on oil imports from OPEC, has far surpassed U.S. productivity in manufacturing and other non-

farm business since 1960. Likewise, many European nations and Canada have experienced higher productivity than the United States. The economic slowdown associated with rising oil prices has not occurred nearly as fast in those countries as in the United States. The table below shows the low productivity in U.S. manufacturing from 1960–76, contrasted with that of several European countries and Japan.

Productivity in Manufacturing, 1960-76
(Average Annual Percent Change)



Note: Data for 1976 are preliminary estimates.
Source. U.S. Department of Labor, Bureau of Labor Statistics

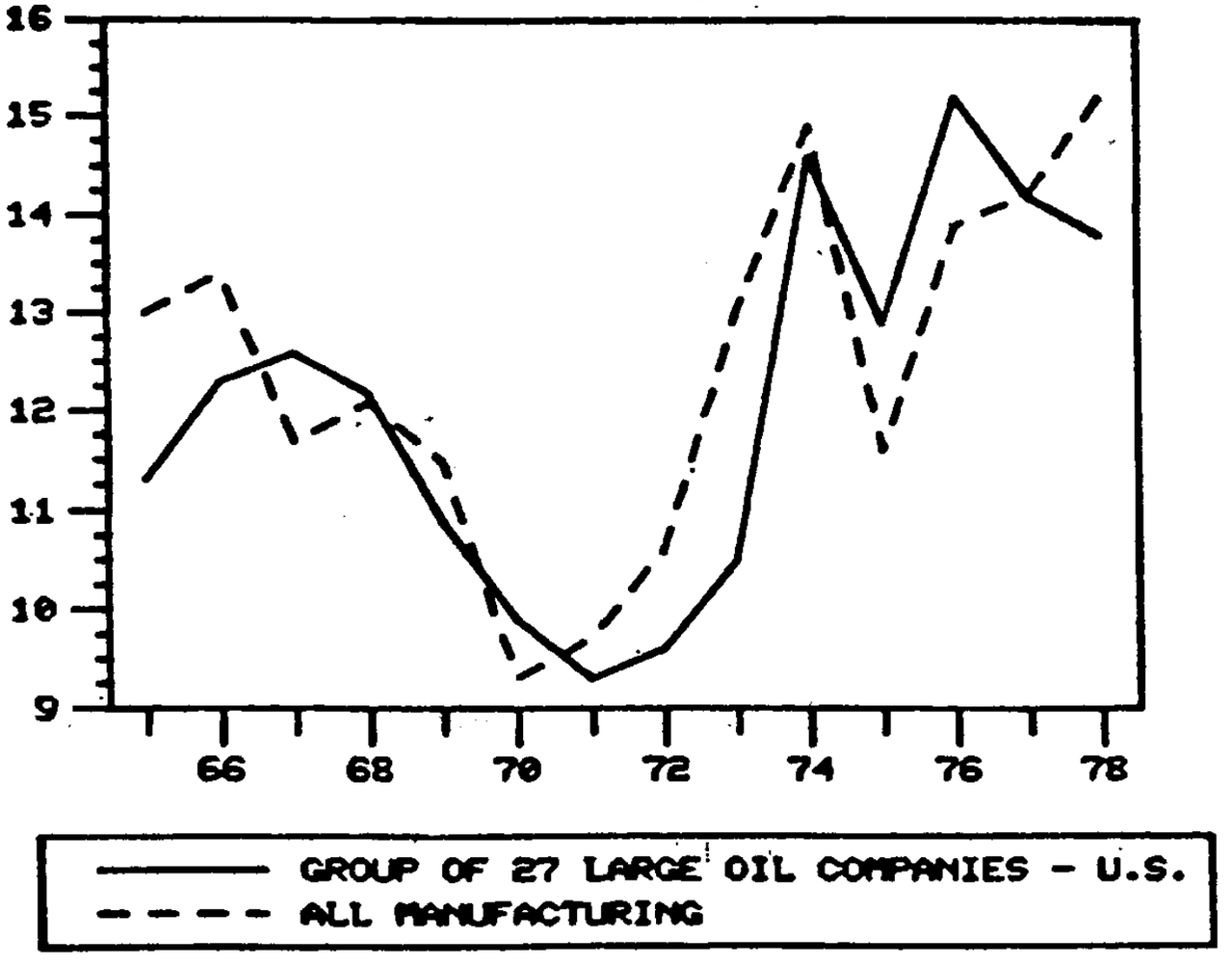
The committee substitute concentrates on punishing the oil companies for profiting from oil price increases over which they have no control. This does nothing to resolve the problem of inflation in our economy. Instead, the Committee should be addressing the problem of inflation by stimulating productivity through the growth of capital stock and supplies of primary resources at home. Efforts to reduce the tax and regulatory barriers to growth will be far more constructive than creating additional programs for removing corporate profits from the economy.

PETROLEUM COMPANY PROFITS

Many of America's major oil companies operate worldwide and their costs and investments as well as their profits are measured in billions of dollars. But, their return on investment and their profits are not unfair. In fact, oil companies make about the same return on their investments as most other segments of American industry. Over the past 10 years the return on capital invested by U.S. petroleum companies has been about 10 percent. Ten percent return on invested capital is similar to publishing, slightly less than the automotive average, and considerably less than the office equipment industry (13 percent) or the drug industry (16 percent). Until 1974 the return on equity in the oil industry was below that of average manufacturing. As a result of the OPEC price increases of 1973–74 the returns in the oil industry increased slightly above that of average manufacturing, but by 1977 were back to their earlier levels. The following chart traces the return on equity of a number of major oil companies from 1965 through 1978.

RETURN ON EQUITY FOR 27 LARGE OIL COMPANIES FOR U.S. OPERATIONS AND FOR ALL U.S. MANUFACTURING

(1965 - 1978)



Source: The Chase Manhattan Bank, N.A.

Our financial magazines, such as Forbes, Fortune, and Business Week, report regularly on corporate profitability and a glance at their charts will show that oil company profits average only in the middle range. Time and Newsweek have also pointed this out in recent editions.

Even with the current surge in oil and gas prices, profits have not become excessive. Television reports have emphasized the percentage increase of profits in the third quarter of 1979 over profits in the same quarter a year ago. But this can't tell the whole story unless we're aware that last year's profits were relatively low. Exxon's profits in the recent quarter were reported up 118 percent, but at that rate Exxon's return on investment for the year would be only 18 percent. Gulf's profits were reported up 97 percent for the third quarter, but

at that rate, annualized return on investment for Gulf would be only 10.8 percent. Boeing, by contrast, had earnings for the second quarter up 139 percent with an annualized return of 19.3 percent. On a 5-year average, Exxon's profits at the current rate would yield only 12.9 percent return on invested capital; Gulf's would yield only 10.8 percent. Lockheed makes an interesting comparison with a 5-year return based on recent earnings of 24.8 percent. On the same basis the Washington Post is earning a 16.5 percent return on capital.

The highest profit year for the oil industry in recent decades was 1974, the result of price increases by OPEC, not the industry. In 1974, according to the Salomon Bros. investment firm, return on investment for large oil companies averaged 17.5 percent. This compares interestingly with performance by the most profitable of the Fortune 500, America's 500 largest corporations. More than 30 percent of these companies earned better than 20 percent last year as defined by return on equity and/or return on total capital.

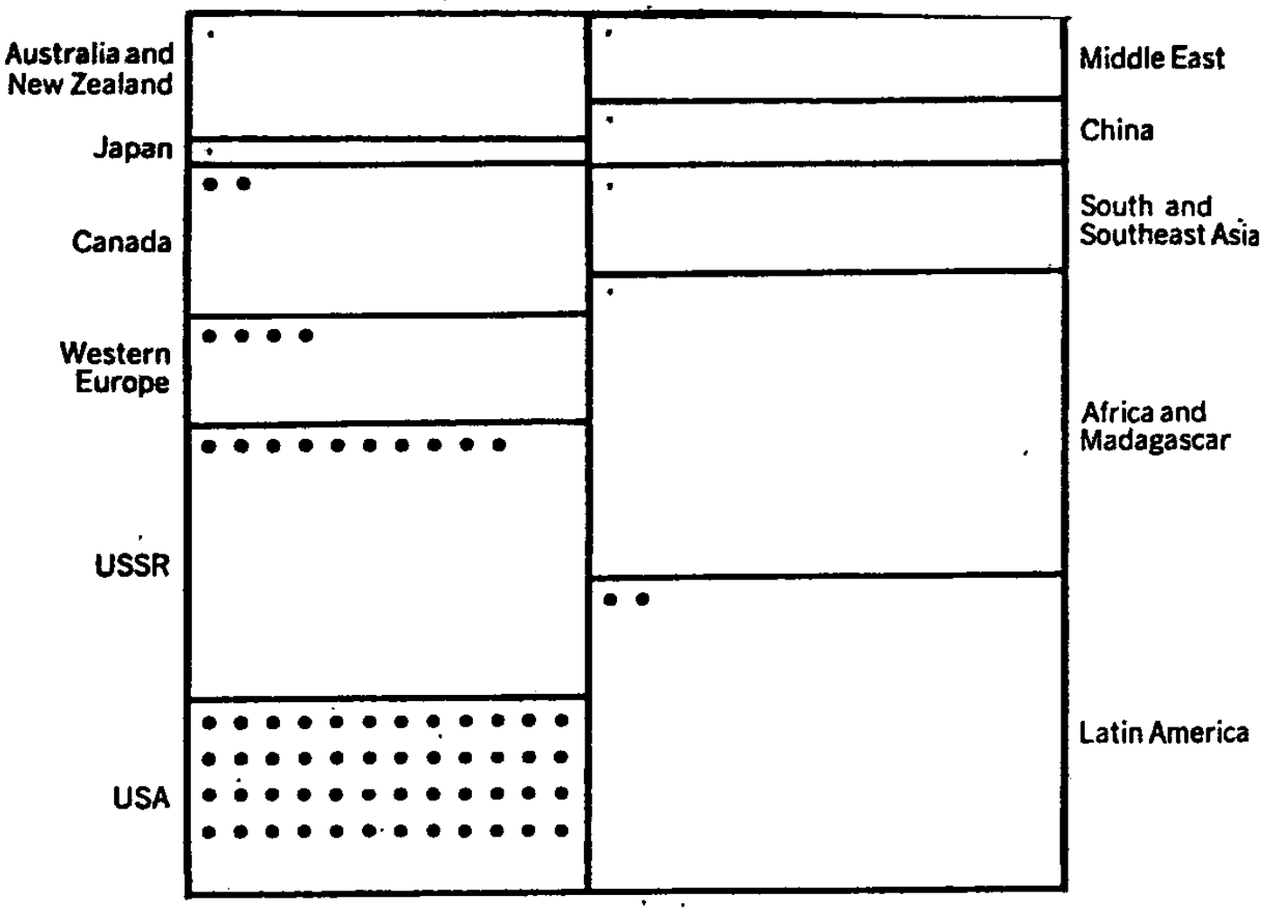
Oil Exploration and Development

Oil reserves in the United States have been shrinking in the past decade. Our reserves in 1978 were sufficient for only 4 years of production while in 1970 reserves had been sufficient for over 7 years of production. Much of this decline in reserves has been due to a smaller rate of reserve addition per foot of well drilled in the past decade. In the period 1973 to 1976 the barrels of oil discovered per foot of well drilled dropped from 52 to 18. This large drop has come since the regulation of domestic oil prices was instituted in 1973. The decrease in domestic reserves occurred in the face of a 53-percent increase in the footage of wells drilled during this same period.

Oil in the United States is becoming more difficult to find as the best prospects are drilled and more land is closed to drilling through environmental legislation and regulation. What this means is that a massive investment program in the exploration for new oil will be required to maintain and increase both domestic reserves and production. Chase Manhattan Bank estimates that just to replace domestic reserves produced currently will require capital expenditures of $350 to $400 billion in the period 1979–85.

PRICING POLICIES ARE NOT THE ONLY PROBLEM

The price controls on domestic oil are not the only impediment to increased domestic exploration for oil. The United States is the most thoroughly explored country in the world. As of the end of 1975 exploration wells in the United States had been drilled to a density of .20 per square mile, nearly 10 times the density of our closest competitor, the Soviet Union. The density of exploration in the United States as compared with the rest of the world is graphically demonstrated in the following chart in which each black circle represents 50,000 wells and the space for each country or region represents its petroleum prospective areas (sedimentary basins) both onshore and offshore to the depth of 200 meters.



Window on oil. Areas within black bars represent, to scale, the extent of the petroleum prospective area (onshore and offshore to 200 meter water depth). Each full black circle represents 50,000 wells (exploratory and development) drilled in each portion of the chart. Number of wells smaller than 50,000 are approximated by segments of the full black circles.

Source: Bernardo Grossling, *U S. Geological Survey*, Reston, Virginia, "The Future Supply of Nature-Made Petroleum and Gas, Technical Reports", Pergamon Press, New York, 1977.

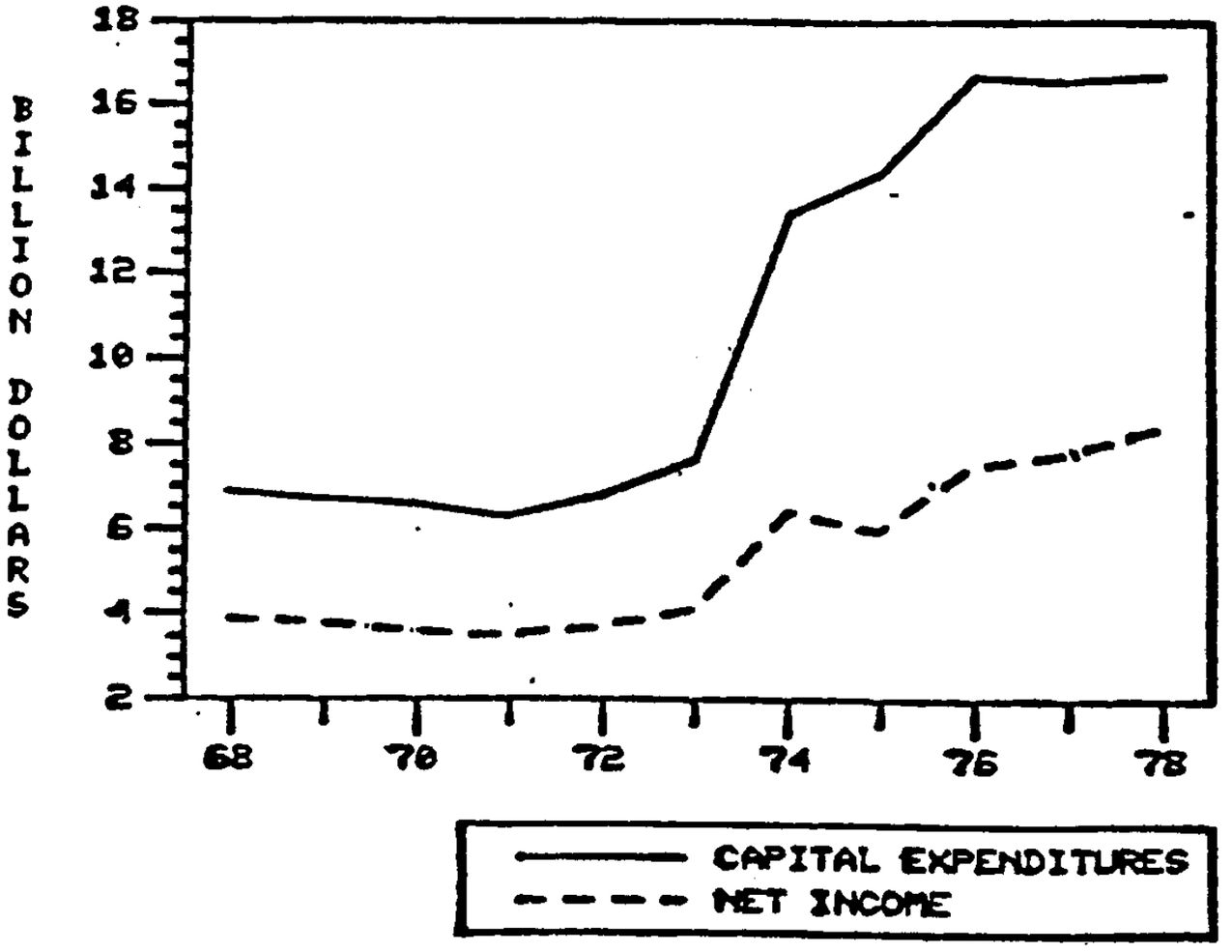
In spite of the considerable density of exploratory wells drilled within the United States 98 percent of our potential oil and gas bearing lands remain totally unexplored. Many of the most favorable areas for the exploration of oil and gas in America may never be drilled. Our environmental laws place heavy burdens on companies seeking to drill for oil and gas. We have set aside thousands of acres of potentially oil rich sedimentary basins in national parks, refuges and wilderness areas. In Alaska alone the President has adversely impacted 40 million acres of potentially oil rich but unexplored lands. Compare this to Prudhoe Bay, which sits on only 190,000 acres of land and provides one-third of all U.S. oil and one-fourth of U.S. gas reserves.

PROFITS HAVE BEEN REINVESTED IN OIL

We have already pointed out that oil company profits are not "extreme", "outrageous", "obscene" or any of the other invectives which have been used to describe them. In fact, oil companies earn returns on their investments which are comparable to manufacturing companies operating in the United States. But then, one must ask, what do oil companies do with these profits? The answer is that they reinvest them in the search for and production of oil. The following chart compares oil company profits and oil company investments for a group of 27 of the largest domestic oil companies.

U.S. PETROLEUM PROFITS AND U.S. PETROLEUM

INVESTMENTS FOR CMB STUDY GROUP, 1968-1978



Source: The Chase Manhattan Bank, N.A.

In all the years shown in the chart capital expenditures exceed net income. This means that oil companies in this group were investing more each year than they were earning. They were borrowing to invest. Between 1973 and 1976, when U.S. petroleum profits expanded rapidly, investment expenditures increased even more rapidly than profits in both absolute and percentage terms. Since 1976 as the growth rate in petroleum profits fell and earnings leveled off investment declined.

This increased investment has been concentrated in the oil and gas production and transportation fields. The following chart gives the breakdown of oil company investment by type for the years 1968–77:

COMPARISON OF PETROLEUM COMPANY INVESTMENT BY TYPE

	1968–72		1973–77	
	Amount (billions)	Percent of total	Amount (billions)	Percent of total
Production	$17.2	51.4	36.6	53.2
Transportation	1.7	5.2	11.1	16.2
Refining and petrochemicals	6.9	20.6	13.7	19.9
Marketing	5.8	17.5	3.0	4.4
Other	1.8	5.3	4.3	6.3
total	33.4	100.0	68.7	100.0

Source: Chase Manhattan Bank for the Chase group of companies.

It can be seen that oil company investment in the 1973–77 period was much more oriented toward production and transportation than in the earlier period. Since 1973 the bulk of the transportation investments were directly related to the movement of crude oil from the producing areas. The expenditures for production and transportation grew from 57 percent of total capital expenditures in the earlier period to 69 percent in the later period.

Allegations have been made that oil companies are using their profits to invest heavily in nonoil industries diversifying their operations and getting out of the oil business. Analysis of the situation by Chase Manhattan Bank indicates that the magnitude of capital expenditures outside the industry is extremely small in comparison to total expenditures made within the oil industry. The share of capital expenditures going to "other" in the chart has remained constant over the period at approximately 6 percent. Stock acquisitions are not reported as capital expenditures but a review of SEC filings over the last 5 years indicates that the major noncapital acquisitions have been the Mobil acquisition of Marcor, ARCO's acquisition of Anaconda, and SoCal's acquisition of 20 percent of AMAX. Chase analysis suggests that such acquisitions represent a small fraction of the amount of funds that these firms reinvested in the oil business and that, on an industry basis, the outside investment has been very small. By and large the oil industry is the least likely of American industries to invest outside its own industry.

THE UNITED STATES: AMERICA'S LARGEST OIL COMPANY

The largest owner of potential oil reserves in the United States is the Federal Government. Through its ownership of millions of acres of Federal lands, our Government, and indirectly the American people, control a large share of the as yet unexplored or undeveloped petroleum potential in the United States. Yet, the Federal Government has acted to close off large portions of these lands to exploration through national parks, wildlife refuges and wilderness areas.

The Alaska experience is illustrative of the problem. At a time of grave energy shortages, the President of the United States, the same President who now calls for massive synfuels development, established by administrative action 17 new national monuments in Alaska. By this act alone, he withdrew from oil exploration and development 56 million acres of land. Additional withdrawals made at the same approximate time and the blocking of access to remaining lands significantly reduces the likelihood of exploration of an additional 100 million acres. In all, on December 19, 1978, he jeopardized oil development in an area nearly the size of Texas.

Over 10 million of the acres in monuments fall within sedimentary basins having potential for oil and gas discovery. That is 15,000 square miles of sedimentary basins. Little exploration has been carried out in these areas, and virtually no wells have been drilled. In fact, outside of known fields, less than 30 exploration wells have been drilled throughout Alaska.

Throughout Alaska there have been less than 1,000 oil and gas wells drilled to date, or about one well for every 375,000 acres in Alaska. In the lower 48 States there have been more than 2 million

oil and gas wells drilled, or about one well for every 1,000 acres. With this level of exploration it is absurd to "write off" any area as having no potential for oil and gas.

In addition to the potential areas within the monuments, these designated areas, because of their vast size, effectively block access to adjacent areas having oil and gas potential. As an example, the combined Noatak/Gates of the Arctic Monuments form an interlocking barrier stretching nearly 400 miles across the central and western Brooks Range. This prohibits any surface access route through this area to reach nearly 30 million acres of State, Native corporation, and Federal lands within the petroleum reserve to the north, all of which have high potential for oil and gas.

What is happening in Alaska is just the most outrageous of administrative and congressional actions which are taking a resource rich nation and making it a net importer of strategic materials, oil among them. The administration takes the position that even if the petroleum industry were to receive the full revenues from the sale of its domestic oil heavy reinvestment of those revenues in the search for oil and gas would not produce major increases in supply. As can be seen from the examples pointed out here the administration position is a self-fulfilling prophecy. Through environmental closures and delays in Federal leasing the administration is assuring that their predictions of "no more oil" will come true.

FEDERAL DEVELOPMENT IS TOO SLOW

Even when the Federal Government decides to develop the oil and gas potential on Federal lands the process is so slow as to be absurd. The United States has been engaged in a program to determine the quality of reserves in the national petroleum reserve in Alaska. The Naval Petroleum Reserve Act of 1976 authorized the President to study the best way to produce and transport the NPR–A reserves. As part of this study the Department of Interior has untertaken through private contractors a drilling program on NPR–A.

To date 14 wells have been drilled and 11,000 miles of seismic data collected. The administration has recommended a 19-well program with a cost of over $600 million. The Congress is suggesting an even more extensive program stretching well into the 1980's. In a time of gravest national emergency, we are taking a costly, go slow approach to the development of the Government-owned oil resources. Immediate lease sales on the Naval Petroleum Reserve-Alaska would bring private bidders to develop the resources in the shortest possible time.

The administration's position on NPR–A is to terminate the Government exploration program and seek the necessary legislative authority to open portions to private exploration. It is the view of the administration that:

> Petroleum would be discovered sooner using different exploration strategies rather than a single government exploration strategy;
>
> The high cost of Government exploration places an unnecessary burden on the Federal Treasury; and,
>
> Additional drilling information would not significantly improve the accuracy of the overall resources estimate.

Yet, in spite of these conclusions drawn by the Department of Interior, the Congress has refused to terminate the Federal exploration program and put leases on the NPR–A out to private bid. Many of the same elected officials who voted not to develop the NPR–A in the most expeditious and inexpensive manner are among those first to rail against the petroleum companies for failing to solve our energy supply problems. Thus, we see that even when the Federal Government chooses to develop a portion of its oil resources it acts slowly failing, to take what steps it can to contribute solutions to our energy shortage.

The Committee Substitute

INCENTIVES FOR OIL PRODUCTION

The best incentive for the production of domestic oil has already been taken. President Carter, in his decision to decontrol the price of domestic oil, has done more for the production and conservation of oil in this country than any provision of this bill. By permitting prices to rise to world levels, the President will encourage conservation by individuals and businesses. Price is the appropriate means of encouraging conservation in a free economy because it allows each individual to determine where he wishes to conserve. The alternative is a bureaucratic regulatory system inevitably causing shortages and misallocation of resources. However, what the President has done through decontrol of oil prices he would undo through the adoption of the crude oil severance tax. The crude oil severance tax effectively continues the control of domestic oil prices for the production subject to the tax. To the producer of oil the world price is irrelevant except as that price is reflected in the price which he receives for his oil. If a portion of the selling price is taxed away in the form of a severance tax on his production, is is the same as if the price controls on his oil were never lifted, or as if the controlled price were merely increased to something below the world price.

The committee chose to impose a crude oil severance tax in order to shift decontrol revenues away from the petroleum companies to the Government for programs involving transfer payments and alternative energy development. However, the committee recognized that the tax constituted a significant disincentive to the production of domestic oil. Domestic oil and gas provides the only short and mid-term solution to the energy problems of the United States. Alternative energy sources cannot hope to provide sufficient energy during the 1980's to alleviate the crises which we are experiencing today. Thus, the committee decided that it was necessary to give back to producers a portion of that incentive which was initially granted by the President and then taken away again by the proposed tax.

The incentives which the committee adopted in the form of exemptions from the tax are good as far as they go. These incentives will prevent the crude oil severance tax from having an effect as drastic as might otherwise be. However, they do not go far enough. They tend to favor one type of oil over another. Stripper oil remains favorably priced and, although no examples have been given of reduced production to obtain stripper status, the economic incentive still remains on a marginal well to reduce production rather than

increase it. With respect to high cost oil the committee has failed to take into account the high production costs associated with some tier one oil which may result in deferred maintenance on many wells further decreasing their production.

The committee made some progress in the treatment of Alaskan North Slope crude oil when it voted to increase the base price at which the tax would begin to apply. The committee rejected the better solution of exempting Arctic oil from the tax altogether and as a result of that decision as much as 3 billion barrels of reserves may remain in the ground because at the lower price they will be uneconomic.

When one considers what needs to be done in the exploration and development of oil and gas in the Arctic and other frontier regions, the tax treatment of Alaska North Slope crude oil is inappropriate. Taxing the only major project contributing to domestic energy supplies in the last 10 years is counterproductive. There remains a great deal of work to be done on Prudhoe Bay to have that oil field realize its full potential in both oil and natural gas production. Estimates of future capital expenditures required to maintain the productivity of Prudhoe Bay exceed $12 to $15 billion.

It is generally agreed that there is a greater degree of risk in exploration and development in frontier areas, such as the Alaska North Slope than there is in the traditional lower 48 oil exploration. Major factors contributing to these increased risks are severe weather conditions, remoteness, sensitive environmental and geological characteristics, and a lack of normal social and industrial infrastructure.

Future exploration for significant oil and gas finds in this country will need to be in frontier areas. Frontier oil development in such locations as the Alaskan North Slope, the Baltimore Canyon, Gulf of Alaska, and deep drilling on the Overthrust Belt and the Beaufort Sea require a recognition of the higher risk of exploration of these frontiers and commensurate returns to those willing to take the risks. It does not make any sense to tax away the returns to producers who are knowledgeable in frontier exploration and expect those same companies or other companies to turn around and take the significant risks for further frontier exploration.

Frontier oil is characteristically distant from the marketplace and requires expensive transportation costs to bring the oil to market. Savings in these transportation costs should not be subject to the ravages of both inflation and the windfall profits tax. Adjustments recognizing the changes in transportation costs, such as the TAPS tariff adjustment, should receive the same protection from the ravages of inflation as the wellhead price of oil and, therefore should be adjusted for changes in inflation.

As pointed out in earlier discussions, incentives for the production of oil are only a part of the necessary structure for successful exploration and development of domestic oil. Incentives without capital sources will never produce oil. By taxing existing oil at the levels proposed in the committee substitute the capital required for additional exploration and development of new domestic reserves is impaired. Since exploration for new oil is a very risky proposition, lenders are unwilling to finance such projects. By taxing away revenues of existing oil production, we assure that the petroleum industry's sole source of finance for exploration is impaired.

CONSERVATION AND ALTERNATIVE ENERGY TAX INCENTIVES

In general, my position on the committee substitute does not arise as a result of committee action on tax incentives for conservation and alternative energy production. While disagreeing with the committee's approach on a number of these issues, I voted against referral of the committee substitute because the committee sought to fund these credits and incentives with the proceeds of an unnecessary tax on the domestic production of oil. Even with its faults, the committee substitute would have been an acceptable bill if the committee had relied on increased revenues from the corporate income tax on petroleum companies to finance its programs and rejected the call for a crude oil severance tax.

One of the greatest concerns which must be dealt with in fashioning energy policy for America is to avoid reliance on uneconomic energy sources for our future supplies. Nuclear generation of electricity was America's first synthetic fuel. Because of our national pride and guilt over the destructive use of the atom, Government force fed the development of peacetime nuclear power. When it became clear that private investors would not assume the large risks inherent in the construction of nuclear generating facilities, the Government removed the liability. We now have significant nuclear generation and, after 25 years, are just beginning to discover what nuclear power really costs. The Three Mile Island accident is only the tip of the iceberg. Plants all over the country are shut down for long periods while consumers pay their high cost but without increases in energy supply. Storage of atomic wastes is a bureaucratic horror story waiting to explode into our national consciousness.

The lesson which should be learned from the open ended cost of nuclear power is that the market, not the Government, should be making the decisions with respect to our energy future. Bureaucratic force feeding of one or several alternatives will assure the United States of power in the future priced far above our competitors who rely on free market forces to shape their energy futures. If we shackle our factories and homes with exotic energy sources generated by large subsidies or price supports, America will be left at a serious competitive disadvantage in international trade, and we will have simply exchanged one problem for another.

One of the bright spots in the committee substitute is the provision extending the privilege of tax exempt financing to all hydroelectric facilities. This provision promises to encourage and facilitate construction of environmentally sound hydroelectric facilities. Hydroelectric generation has been with us for over 100 years and has proved to be a clean and efficient source of renewable electric energy. In addition, hydroelectric generation provides the lowest cost power per kilowatt of any alternative source. The Washington Post, in an article of Sunday, October 29, 1979, noted that the utility rates in the Pacific Northwest are the cheapest in the Nation. In August, the cost of 500 kilowatt-hours of electricity was $9.45 in Seattle and $46.72 in New York City. This differential is due to the heavy use of hydroelectric power in the Northwest. The reason hydroelectric power proves so inexpensive in spite of large capital costs is that

there are no fuel costs involved in generating hydroelectric power. Operating costs for hydroelectric facilities are extremely low, allowing rapid retirement of construction costs and low fees for power thereafter. The United States should move quickly to develop to its fullest extent our capacity for generating hydroelectric power.

The use of tax exempt financing for hydroelectric construction is attacked by the administration on the grounds that expansion of the use of tax exempt financing into this field will increase interest rates, driving out other tax exempt borrowers such as schools and hospitals. The administration position has no basis in fact. Historically, when the investments eligible for tax exempt financing have been expanded, the markets have expanded to absorb the new issues without affecting interest rates. In recent years two major new markets for tax exempt bonds have developed without affecting interest rates. These two major new markets were pollution control facilities and housing mortgage bonds.

The tax exempt bond market has consistently expanded in volume year by year without affecting interest rates on tax exempt bonds. The interest rate on tax exempt bonds is not tied to the volume of bonds issued but to the cost of money generally. The Treasury and the Federal Reserve System do more to affect the interest rate on tax exempts than any conduct in the market. The market for tax exempt bonds is not a closed market with a limited volume all its own, but a market like other markets, which interacts with markets for other financial assets. The Treasury appears to view this market as closed, with a finite possible size in spite of historical evidence to the contrary.

LOW-INCOME ENERGY ASSISTANCE

Low-income people are particularly hard hit by rising energy prices. Although the price of energy generally has tracked with the cost of living, the heating problems of the poor are exacerbated by the sheer size of heating bills. The poor of America felt the harsh rise in the price of home heating oil last year through prices which began the steep upward trend during the winter. This winter promises to be even worse for the poor and any effort we in the Congress can take to alleviate the problem is important.

The low-income energy assistance provisions of the committee substitute are a step in the right direction. The committee substitute will help soften a portion of the higher fuel costs experienced by low-income individuals. The direct benefit payment to individuals and households will be a welcome addition to this winter's budgets. The fuel budget will also benefit from the tax credits which low-income taxpayers will receive. Together these provisions give a wide range of energy assistance and allow the States to administer programs which are already underway or under consideration by the various States. The committee was properly concerned that funds be available for distribution this winter so that America's poor need not suffer through another winter without some help. For that reason it was very encouraging to see the Senate act expeditiously to appropriate funds for this purpose.

While the committee substitute provides an acceptable form of low-income energy assistance it is unfortunate that the committee chose to rely on the crude oil severance tax to finance the low-income energy assistance program. Testimony before the full committee and the Subcommittee on Energy and Foundations indicated that sufficient revenues would be generated by the corporate income tax to adequately fund this low income energy assistance program, as well as the other programs and credits adopted by the committee in its committee substitute.

Financing the Programs

The committee substitute relies on the crude oil severance tax to finance the programs for energy conservation and alternative energy production as well as the programs for low-income assistance. The committee has completely ignored the $340 billion in additional corporate income tax revenues which will accrue to the Federal Government as a result of deregulation. All of the programs which the committee substitute provides and many other programs as well could be financed in their entirety without the adoption of any new taxes. Why then, one must ask, do we find the committee substitute proposing a massive new tax on an essential industry. The conclusion can only be drawn that the committee and the Congress seeks to penalize the petroleum industry in the United States for the actions of OPEC because of our colossal national misperception with respect to corporate profits and their function in our free enterprise system. Such a course of action is irrational, for the petroleum industry in the United States has served us well. It has provided us with the cheapest energy in the world for over half this century and provided this energy in abundance. These companies are not disembodied spirits, but representatives of their millions of shareholders in the United States and the world upon whom this massive new tax will fall. By taxing the petroleum companies and the consumers of energy in this unnecessary manner we tax millions of our own people in an effort to draw capital from the only industry which can solve our short and medium term energy problems.

Time and time again during consideration of the committee substitute the question was asked regarding the use of the revenues accruing to the Federal Government above and beyond those raised by the crude oil severance tax. No satisfactory answer was given. The committee substitute raises $138.2 billion in revenues over the 10-year period to 1990; $141 billion in new taxes at a time when the Federal Government anticipates additional revenues of $340 billion with no new taxes. Until a satisfactory answer is given to the question of what is to be done with the additional income tax revenues the committee left laying on the table when it passed this crude oil severance tax the Congress should be loathe to enact any new tax.

Thus, I voted against adoption of the committee substitute for the following reasons:

1. It discourages production of domestic oil.
2. It levies an additional $141 billion in unnecessary taxes on American companies, shareholders and consumers.

3. It provides incentives for the production of uneconomic energy alternatives.

4. It will do nothing to reduce our reliance on foreign oil.

5. It will destroy our already impaired productivity.

6. It will create additional governmental interference within the U.S. economy.

I support provisions in the committee substitute encouraging the development of mass transit, hydroelectric power and conservation. I also support provisions for low-income energy assistance to help the poor in our Nation bridge the long jump into an energy expensive future. In spite of these attractive features of the committee substitute, I find I must oppose this legislation as extremely detrimental to the Nation because it will launch us into a decade of economic difficulties. Therefore, I encourage its defeat by the Senate.

XII. ADDITIONAL VIEWS OF SENATOR MATSUNAGA

The administration initially proposed the windfall profits tax as a substitute for oil price controls. On the one hand, decontrol would allow domestic oil prices to rise and encourage conservation efforts. On the other hand, a tax would largely recapture decontrol profits to finance alternative energy programs, conservation measures, and heating assistance to the poor. In reviewing the administration's proposals, the committee within the political process has balanced the producers' ownership interests and production demands with national needs.

The world price for foreign oil has been artificially increased by an international cartel comprised of members of the Organization of Petroleum Exporting Countries (OPEC). Although OPEC has rapidly increased the price for foreign crude oil, domestic U.S. oil production has remained under price controls which expire on October 1, 1981.

The Department of Energy has not been able to police price controls for domestic oil production effectively. Increasing criticism has been directed at oil companies' circumvention of domestic oil price controls. Moreover, U.S. oil refineries use both domestic and foreign oil; the refiners average the low controlled price of domestic oil with the higher price for imported foreign oil, before they sell oil products to the ultimate consumer. This averaging increases the cost of controlled domestic oil and at the same time decreases the cost for high priced foreign oil. This averaging in effect subsidizes the importation of foreign oil.

To eliminate this complex system of controls, with its inequities and inefficiencies, and also to eliminate the current subsidy provided to imported oil, the President announced the gradual phaseout of domestic oil price controls beginning on June 1, 1979, and ending on October 1, 1981, the expiration date for price control authority.

However, the new margin of profits to be received by domestic oil producers reflects the artificially imposed world price set by the OPEC cartel. During the 11-year period 1979–90, it is estimated that decontrol and rising OPEC prices would provide oil producers with additional gross revenues of $1.1 trillion. These profits result from the cartel established price domestic consumers will pay for oil. The higher prices will impose an awful burden on consumers and put our economic resiliency to great test. The dire consequences which may follow are enough to question the advisability of decontrol.

In this light, it is only proper that the Federal Government place a levy on domestic producers' windfall profits and use part of the proceeds to ease the inevitable hardships imposed on the poor. It is imperative, too, that a major part of the windfall tax be used to develop alternative, domestic energy resources to end our unhealthy dependence on foreign oil.

It is a very sad fact that today, as during the Arab oil embargo of 1973, the American public does not believe that the oil shortage is real. According to opinion surveys, most Americans believe that the oil companies and the Government conspired to hold back supplies. The effective gasoline rationing systems temporarily instituted by a number of States have only increased public suspicion that there was no real shortage of gasoline; instead, producers and refiners curbed supplies until they commanded an inflated price.

This public distrust makes it difficult for the Congress to convince the American people that there is a need to conserve petroleum products and to turn to alternative sources of energy. Even the substantial increases in the price of gasoline made little dent in consumer demand. Americans continue to consume 30 percent of the world's energy supply, with never a thought that the supply would ever run short. But oil supplies have in fact run short, and it is the task of Congress, as much as it is that of the President, to convince the American public of this fact and to face it resolutely. To win the energy war, major action must be taken to promote conservation and energy self-sufficiency.

The committee bill incorporates the principle of the National Energy Act of 1977 that the least expensive and most immediate means of cutting imports is domestic conservation. The inadequate supply of oil is our major energy problem today, but the lack of cheap, efficient alternatives contributes much to the problem. Encouraging the development and use of these alternatives as well as encouraging conservation will without a doubt lessen our dependence on oil and reduce our need to import foreign oil. One of the most effective ways to do this is to provide taxpayers with major tax incentives to conserve oil and use alternative inexhaustible sources of energy, such as solar, wind, ocean-thermal, and geothermal energy, and also easily produced fuel such as ethanol and methane.

The committee bill incorporates many tax incentives proposed in S. 1571 and S. 1760, two bills I cosponsored with Senator Packwood and various other Senators. The tax credits in the committee bill will effectively stimulate the development and use of solar, wind, biomass, and geothermal energy. Such tax incentives also have the added important benefit of fighting another major problem, the recession, by stimulating the economy. No other program can as effectively address two of the major problems facing the country at this time. The windfall profits tax will finance these alternative energy and conservation tax credits, in addition to providing assistance to the poor and a mass transportation program.

In levying the new tax, the committee has exempted newly discovered oil, incremental tertiary oil, and heavy oil. These oil resources are costly to develop and exploit; development of these areas should be made profitable to the fullest possible extent, since domestic production will lessen our dependence on foreign oil. For this reason, I supported these exemptions, and for the same reason I supported taxing Alaskan oil in tier two.

I supported a 60-percent rate of tax on other oil categories and opposed efforts to lower this rate. I believe that a 60-percent rate strikes an acceptable balance between the needs of producers and those of the

Nation. A higher rate would be punitive and even self-defeating by discouraging production.

When the committee considered tier one oil, proponents of the windfall tax were in disarray and fearful that the tax would be severely reduced. The 75-percent rate on tier one was adopted in a test of strength between opponents and proponents of the tax. (Although I voted for it, I believe 75 percent is much too high.) Subsequently, proponents of the tax succeeded in defending a significant tax level.

As adopted by the committee, the tax rates leave substantially higher revenues for producers because of decontrol. For example, in 1980, while producers would have received $6.09 a barrel in net revenues for tier one oil under controls, the committee bill would allow $8.64 in net revenues to the producers conservatively assuming a $22.50 price for a barrel of oil. (A table showing the effect of the tax and decontrol on producers' revenues follows.)

The additional profits should spur maximum production from existing wells and also provide the capital needed for increased exploration and development of domestic petroleum reserves.

While producers enjoy the windfall profits that will accrue because of cartel pricing, it is only fair that they should share this windfall profit with the Nation for the purposes of assisting the needy and financing our development of alternative energy resources.

SPARK M. MATSUNAGA.

NET REVENUE TO PRODUCER[1]

[In dollars per barrel]

	Tier 1			Tier 2			Stripper			Newly discovered and tertiary[2]			Alaska		
	Controls	House bill	SFC bill[3]	Controls	House bill	SFC bill[3]	Controls	House bill	SFC bill[3]	Controls	House bill	SFC bill[3]	Controls	House bill	SFC bill[3]
1980	6.09	10.17	8.64	13.60	14.68	14.68	22.56	18.59	18.59	13.60	19.80	22.56	12.56	10.01	10.01
1981	6.60	13.17	10.71	14.75	18.05	18.05	24.66	20.24	20.24	14.75	21.66	24.66	13.61	11.40	11.40
1982	7.13	15.02	12.07	15.93	20.30	20.30	26.85	21.95	21.95	15.93	23.71	26.85	14.71	12.84	12.84
1983	7.68	16.25	13.04	17.14	21.93	21.93	29.12	23.70	23.70	17.14	25.86	29.12	15.82	14.33	14.33
1984	8.23	17.53	14.04	18.37	23.61	23.61	31.47	25.51	25.51	18.37	28.10	31.47	16.97	15.85	15.85
1985[4]	8.79	18.83	15.07	19.62	25.33	25.33	33.89	27.36	27.36	19.62	30.43	33.89	18.12	17.58	17.58
1986[4]	9.36	20.15	16.11	20.88	27.08	27.08	36.35	29.23	29.23	20.88	32.83	36.35	19.28	18.62	18.62
1987[4]	9.87	21.51	17.16	22.14	29.23	29.23	38.91	31.14	31.14	22.14	35.32	38.91	20.44	19.67	19.67
1988[4]	10.51	22.98	18.31	23.47	31.74	31.74	41.67	33.18	33.18	23.47	38.00	41.67	21.66	20.76	20.76
1989[4]	11.14	24.53	19.51	24.88	34.42	34.42	44.60	35.34	35.34	24.88	40.87	44.60	22.97	21.90	21.90
1990[4]	11.82	26.19	20.80	26.37	37.32	37.32	47.75	37.65	37.65	26.37	43.97	47.75	24.35	23.12	23.12

[1] Gross sales price less State severance tax and windfall profit tax.

[2] While incremental tertiary production was decontrolled in August 1978, the regulations at that time were so restrictive that only a few projects were approved.

[3] Assumes the following modifications to the House passed bill: (a) a lower tier rate of 75 percent, exemption for newly discovered oil, (c) exemption for incremental tertiary production.

[4] All production from tier 1 has been transferred to tier 2.

XIII. ADDITIONAL VIEWS OF SENATOR BAUCUS

I agree with the sentiments expressed in the combined additional views of Senators Ribicoff, Nelson, Moynihan, Baucus, Bradley, Packwood, Roth, Danforth, Chafee, Heinz, and Durenberger, with the exception that I support the House position taxing tier II oil at 60 percent.

MAX BAUCUS.

XIV. ADDITIONAL VIEWS OF SENATOR DOLE

It has been almost 3 years since the energy crisis was declared by the administration to be the moral equivalent of war. Since that time, the country has failed to come to grips with our energy problem. Instead, national energy policy has vacillated between leaderless drift and misguided emotionalism.

There is no question that the United States is facing a serious energy short-fall. Domestic crude production has been sluggish in recent years, much of it due to government policies of price control and excessive regulation. Foreign political instability and excess domestic demand have and continue to threaten the very economic and social fiber of the country. It remains clear that the United States has no comprehensive energy program and what program it does have is based on government regulation, government control, and government manipulation.

The President on several occasions has correctly outlined the dimensions of the energy crisis which faces the United States. Unfortunately, the proposed solutions are built on faulty premises. These faulty assumptions result in an energy strategy that ignores completely the shortrun problem, and fails to address the long-range tradeoffs that any rational program must face.

The most glaring shortcoming of the President's program is the failure to provide any short-term remedy for the shortages and gas lines that prompted the retreat to Camp David. Having outlined the crisis—a politically dangerous dependence on foreign (mainly OPEC) oil—the solution consists of sacrifice, retrenchment, and a reduction in our standard of living.

Congress in recent years has done virtually nothing to address the issues. We have lost sight of the problem. Rhetoric and policies designed to punish the industry and the American consumer make good re-election speeches but do little to address the issue. The promise of quick-fix solutions, energy corporations, energy mobilization boards, trust funds, synfuels, and other such gimmicks further deceives the American public.

DECONTROL

There is no question that the imposition of price controls on domestically produced oil are the root of our energy situation. It was fortunate, albeit belated, that the administration finally decided to decontrol the price of domestic oil. Artificial prices, more than any other factor, have increased our reliance on imported petroleum. The subsidization of foreign oil has discouraged domestic production and helped create our enormous petroleum appetite.

When the Senate Finance Committee began its hearings on H.R. 3919, the crude oil tax, I pointed out to the Secretary of the Treasury, Mr. Blumenthal, that the tax is not a "windfall profits tax." The pro-

posal which is reported out by the Committee is not a tax on profits. No where is the term, nor even the concept, or profits mentioned. Rather, the tax is an extremely complicated excise tax imposed at the wellhead on crude oil. The oil tax will not increase supplies of energy.

It is misleading to talk about "total price decontrol" of domestically produced petroleum. The windfall profits tax will perpetuate domestic controls through the tax system. Nevertheless, given the set of circumstances which the Finance Committee was faced, and given the amendments which the committee adopted, I have chosen to support the Finance Committee substitute.

During the committee consideration there was spirited disagreement about the amount of revenue that the tax will raise. The administration's manipulation of figures has caused great confusion. In fact, no one can be certain how fast the price of oil will rise and most of the economic assumptions on which the figures are based are mere speculation. Indeed, the Finance Committee changed its economic assumptions daily, including the day the bill was finally reported out.

In the area of production response, many members of the committee strongly disagreed with the administration. It is inconceivable that based on any set of price circumstances there is no more oil and gas to be discovered or produced in this country. At some point, price produces a supply response.

If one thing is certain, the Crude Oil Tax of 1979 will generate enormous revenues for the Federal Government. This is clearly the largest tax bill which has ever been considered by Congress. Its impact will change the course of economic and social events of the country for decades to come. In the next 10 years, at least $138 billion will accrue to the Federal Government from the net windfall profits tax. This is in addition to the almost $400 billion that will be added to the Treasury because of the Federal income tax and increased royalty payments. Thus, the Federal Government will be the greatest beneficiary of any "windfall profits" that might be generated.

I have stated on many occasions that I support a properly structured tax on increased revenue generated by decontrol. Earlier this summer, I introduced the energy development surtax, which would have imposed a stiff tax on energy producers unless the money was put back into increased expenditures for domestic petroleum development and exploration. I remain committed to this concept. It is the only intellectually honest way to proceed. Giving the choice to the energy companies of either paying a stiff tax or exploring for new energy meets the expectations of the American public. It is, after all, the consumers who will have to pay the increased bill for higher energy costs. To the dismay of many, and to the discredit of the energy industry, there was not much support for a "plowback provision." The concept was criticized as being too complicated. But, it is no more complicated than many of the other issues that the Finance Committee deals with on a daily basis. The tax, as reported by the Committee, is likely to keep an army of expensive attorneys and accountants busy for years. It appears that the bare fact of the matter is that many of the energy companies would prefer to keep the increased revenues from decontrol to buy nonenergy related assets than to put their money back into energy production. I was surprised when the

same companies which supported the plowback concept in the 94th and 95th Congresses stared blankly across the witness table when the concept of plowback was mentioned.

HOUSE BILL

The bill approved by the House of Representatives is harsh. It is more or less a rubber stamp of the administration's ill-conceived program. The actions taken by the Finance Committee to reshape the bill makes it barely acceptable.

NEWLY DISCOVERED OIL

The committee approved my motion to exempt newly discovered oil. In my opinion, this is the single most significant portion of the bill. It was inconceivable that there would be a so-called "windfall profit" on oil yet to be discovered. Any oil which is left in the ground must be replaced by imported oil.

It was also important that the committee adopted a change in definition for newly discovered oil. Unlike the complicated House proposal, the committee agreed to conform the definition of newly discovered for tax purposes to the pricing regulations; that is, crude oil sold after May 31, 1979, and which is produced (1) from an outer-continental shelf area for which the lease was entered into on or after January 1, 1979 and from which there was no production in calendar year 1978 or (2) an onshore property from which no crude oil was produced in calendar year 1978. It seemed incongruous that a barrel of oil could be newly discovered for price purposes, but receive a different treatment of tax purposes.

INCREMENTAL TERTIARY EXEMPTION

The committee also agreed to exempt from the tax incremental tertiary oil. Oil produced from tertiary or enhanced oil recovery projects should play a vital role in our total domestic energy picture. With the proper economic incentives, it is possible to double our current domestic reserves within a short period of time. The Department of Energy believes that as much as 45 billion barrels of oil may be recovered by using enhanced oil recovery techniques. The production-oriented action taken by the committee will help foster these infant recovery techniques and help produce oil that has been locked in the ground for years because primary recovery methods are proving inadequate.

STRIPPER EXEMPTION

The committee also adopted an amendment which I sponsored to exempt the first 1,000 barrels of stripper oil produced by independent producers. Approximately 73 percent of the oil wells in the United States are stripper wells, which are defined by law as wells producing an average of 10 or less barrels of oil a day. The average daily stripper production per well is 2.9 barrels of oil from 368,930 wells in 28 States. The aggregate stripper well production amounts to 1 million barrels a day, 14 percent of domestic crude oil supply.

Many stripper wells are operated by the small independent producers, not major oil companies. These small producers tend to operate on tiny profit margins and, hence, these wells are quick to react to adverse economics. The so-called "windfall profits tax" would result in the plugging and abandoning of thousands of wells with producible oil forever locked within them. These wells serve as the principal resource for future potential enhanced recovery. This domestic crude oil source for the U.S. consumer will dry-up rapidly if incentives are taxed away. Also, imposing any taxation will delay and reduce well workovers and general maintenance of stripper wells.

According to testimony before the Finance Committee, a tax on stripper oil would result in a loss of much of the 7.8 billion barrels of proven stripper well reserves recoverable by primary and secondary methods.

Stripper operators increased recoverable reserves by 2.3 billion barrels from January 1, 1974 to January 1, 1978, as a direct result of the more favorable and correct economic treatment. Approximately, 73,000 wells were saved from premature abandonment for economic reasons and an additional 181 billion barrels of crude was produced in direct response to improved pricing treatment. Price changes for stripper oil resulted in only 9,916 wells being plugged in 1976—a 16 year low. During 1977, plugged and abandoned wells declined even further to 9,000 wells.

One of the central purposes of the committee substitute is to tax oil decontrol income. It should be noted that oil from stripper wells did not receive any benefit from decontrol because the production has been free of price controls since 1976.

It makes no economic sense to reverse an established policy that has clearly proven effective. Such signal switching from our Government is one of the root causes of the frustration of domestic energy resource development. A tax on stripper wells for independent producers, which last year produced an average of less than 3 barrels daily per well, will cause the loss of an important energy resource that we desperately need.

TIER 1

I did not support the increase of the Tier 1 tax from a 60 percent rate of the House bill to a 75 percent rate. Such action by the committee is punitive and will result in lower domestic energy production and increased reliance on imported oil. I understand the motivation of the committee's decision, but hope that this provision could be modified. Although my State of Kansas is a producing State, it has little old oil. Nevertheless, old oil is the backbone of our domestic production. Lower tier oil constitutes approximately one-third of our daily supply. Production of primary and secondary recovery oil in old oil fields has in many cases reached a point where the expenses of producing the oil are extremely high when compared with the revenues received from the market price. A heavy tax on old oil will cause premature abandonment of important oil production. The result of the heavy tax burden on oil fields to a decline curve of less than 2 percent combined with a 75 percent tax rate may lead to premature abandonment of this essential incremental production. I must point out to the American consumer and to American industry it makes no difference whether the oil is "old" or "new" or in some other government imposed

category or production. It is all oil which is essential to heat homes and propel the machinery of commerce.

TIER 2

Fortunately, the committee rejected a 75 percent tax rate on the so-called Tier 2 oil. A 75 percent tax rate on Tier 2 oil would have further eroded the market incentives provided by decontrol. Reduced funds available for reinvestment by a higher windfall profits tax on Tier 2 would have diluted incentives to stimulate production from existing reservoirs. One energy company estimated that an increase in the windfall profit tax rate from 60 percent to 75 percent for Tier 1 and 2 would reduce production by 1985 by 200,000 barrels per day and recoverable reserves by 700 million barrels.

The committee adopted a number of changes I suggested which make the bill more palatable. The committee agreed to eliminate cumulative deficiencies for purposes of determining the volume of oil taxable in Tier 1. The committee accepted a clarifying amendment which makes expenditures of tertiary injectants deductible in the year injected. Because of the complexity of the payment of the tax, the committee adopted new rules and specifically provided relief for independent refiners. In addition, the committee agreed to exempt certain charitable organizations from the tax.

ENERGY CREDITS

The committee has also agreed to a host of credits of dubious validity. During the Energy Tax Act of 1977 I opposed most of these same credits. Essentially, most expenditures are made on an economic basis. Fuel switching and conservation will occur when the economics of the situation dictate the most prudent course to take. It does not make any sense to subsidize activities which are already economical. If the government chooses to subsidize certain investments it should choose those which provide the greatest energy saving for the least amount of expenditure.

LOW- AND MIDDLE-INCOME ENERGY ASSISTANCE

Undoubtedly, crude oil decontrol will increase somewhat the energy costs of all Americans, but the burden of higher prices will fall most heavily on lower income individuals. The average energy costs of low income households are now approaching 25-percent of annual income and total energy costs may claim half of a poor person's income. Thus, the provisions in this bill aimed at alleviating the higher energy costs of lower income individuals are absolutely essential. By directly addressing the needs of the poor, we have more flexibility to pursue the necessary programs, such as decontrol, that are aimed at increasing America's total energy supply.

One-half of the net windfall profits tax proceeds will be dedicated to providing energy aid to low and middle income citizens. The bill sets up a program for 1980 through 1982 to provide additional energy assistance payments to participants in the AFDC, SSI and Food Stamp programs. The State by State allocation of money under this program is correctly weighted on the basis of climate and actual average energy

expenditures in the State. While the committee's low income energy assistance program may not be a perfect plan, it will provide a good short range solution while we develop a better one. To a large extent, the committee was thwarted in the development of a better plan by the administrative limitations of the Department of Health, Education, and Welfare and the States.

A vital part of the low income aid plan is the State's option to take any or all of its allocation in the form of block grant. Under this option, the electing States will be free to device its own program to provide energy assistance to the poor. I anticipate a number of States will demonstrate they are far more capable of effectively delivering such assistance than is the Federal Government.

Another key part of the bill is the tax credit for users of residential energy. This credit is not just limited to the poor, but is available to middle income taxpayers up to $18,000 in 1980 and $22,000 thereafter. This tax credit will provide a minimum of $20 to every household ($30 in 1981 and thereafter). Families that heat with fuels that are becoming increasingly more expensive, such as heating oil and propane, may receive more than the minimum tax credit, up to a maximum of $200. This tax credit should provide at least some energy assistance to millions of beleagured taxpayers.

CARRYOVER

Finally, the committee has adopted a significant nonenergy related amendment. The committee decided by an overwhelming vote of 19–0 to recommend the repeal of the onerous and misguided carryover basis rules enacted by the Tax Reform Act of 1976.

The Tax Reform Act of 1976 changed the law with respect to the income tax basis of a decedent's property to provide in general, for a carryover of the decedent's basis with certain adjustments. The change was very controversial and applicable to estates of decedents dying after December 31, 1976. The Revenue Act of 1978 contained an amendment which I sponsored with Senator Byrd of Virginia to delay the effective date of the carryover basis provisions for three years until December 31, 1979.

I believe that carryover basis is a complicated disaster. There is no question that the 1976 law is riddled with complexities that defy even the most sophisticated tax technician. Even if the inordinate complexities can be eliminated, which I doubt, there still remains many difficulties with carryover basis. First of all, it is often difficult to prove basis. The recordkeeping requirements and the question regarding fiduciary responsibility should not be overlooked. Carryover basis also increases the relative tax burden. The impact of carryover basis must be examined from the standpoint of both death taxes and income taxes generated by the sale of assets to pay for estate taxes. The cumulative effect of Federal estate tax, State death taxes, the Federal and State income taxes imposed upon an estate will often consume nearly all of the assets. The harsh tax results that flows from selling assets to raise money to pay death taxes should not be allowed to continue. I am afraid many small businesses and farmers will suffer.

Carryover basis was a mistake. Congress must erase this grievous error.

BOB DOLE.

XV. SUPPLEMENTAL VIEWS OF SENATOR ROTH

As a cosigner of the additional views included in this report, I have expressed my views on the windfall profits tax. In short, my votes in the committee have been based on the principle of providing incentives for the production of more energy while preventing oil companies from reaping excess profits at the expense of the American people. However, I am including these supplemental views to provide additional information on the committee's decision to provide for the establishment of a Taxpayer Trust Fund.

TAXPAYER TRUST FUND

By a unanimous vote of 17–0, the committee approved my amendment to earmark a portion of the increased tax revenues from oil decontrol for a Taxpayer Trust Fund. The revenues in this trust fund will thus be available for the Congress to offset the substantial payroll tax increases scheduled for 1981.

Under present law, the already high payroll tax increases are scheduled to increase substantially in 1981. The tax rate is scheduled to increase from 6.13 percent to 6.65 percent and the wage base will increase to $29,700. The maximum payroll tax will increase from $1,588 in 1980 to $1,975 in 1981, a tax increase of $387.

Unless action is taken, the higher oil prices from decontrol and the increased payroll taxes will deliver a one-two punch to all Americans. The higher taxes and energy prices will increase inflation and impose a tremendous drag on the economy, aggravating the recession and increasing unemployment.

According to a Congressional Budget Office analysis, a rollback of the 1981 payroll tax increases will have a positive impact on the economy, resulting in less inflation and more jobs. According to CBO, this amendment will reduce the inflation rate by 0.3 percent, lower the unemployment rate by 0.2 percent, and prevent the loss of 250,000 jobs.

Under the amendment adopted by the committee, the Taxpayer Trust Fund is to be funded out of the increased Federal tax revenues resulting from decontrol. Oil price decontrol will produce two windfall profits—one for oil producers and one for the Federal Government. Because of the higher prices and profits resulting from decontrol, an enormous amount of revenues will be flowing into the Federal Government, over and above whatever windfall profits tax bill is enacted by Congress. According to both the Treasury Department and the Joint Committee on Taxation, nearly $400 billion in additional tax revenues will be collected by the Federal Government over the next ten years solely as a result of decontrol. I believe—and the committee agreed—that a portion of this Government windfall should be placed in the Taxpayer Trust Fund to be returned to the greatest energy resource of them all—the American people.

WILLIAM V. ROTH, JR.

XVI. ADDITIONAL VIEWS OF SENATOR DANFORTH

I oppose the home heating tax credit. The credit is designed to soften the blow of increased energy costs. As such, it is directly contrary to our Nation's energy policy.

A primary objective of decontrol is to require American consumers to face realistic prices of energy. It is our clear public policy to encourage Americans to turn down thermostats, insulate homes and convert their energy use away from expensive fuels. The home heating tax credit contradicts this basic policy. The more the taxpayer heats, the larger the tax subsidy. If a person conserves or converts to lower cost fuel, the credit is reduced.

H.R. 3919 establishes a $3 billion program of direct, cash assistance for the truly poor—those eligible for state and federal welfare—to help them meet their increased fuel bills. For this population, assistance is critical. I strongly support this expenditure. It may be the difference between life and death. But a nonrefundable tax credit, claimed when the tax return is filed, by taxpayers with incomes up to $22,000, by definition is not designed to prevent people from freezing. It is simply a tax subsidy for consumption.

H.R. 3919 provides over $8 billion in residential conservation tax credits, aimed mainly at the middle class. In addition, H.R. 3919 also establishes a trust fund containing over $16 billion which may be used to reduce social security taxes, which also is targeted to working Americans.

I support these forms of tax relief. But I oppose tax relief which works against our nation's fundamental—and crucially needed—energy conservation policy.

I believe a general tax reduction is the most effective method of helping lower and middle-income taxpayers meet their increased energy costs and have argued for such a reduction. Given that the credit may be claimed by anyone—renters as well as owners, people who heat with oil, natural gas, electricity, or wood—it could be argued that the committee has actually enacted a mini-tax cut, averaging about $30 per household. However, it has structured a tax cut in the most complicated manner possible—one which Treasury is uncertain that it can administer.

The credit applies to taxable years 1979, 1980 and 1981. In 1979, the credit phases out at income levels of $20,000; in 1980 and 1981, at $22,000. In 1979, the minimum credit is $20; in 1980 and 1981, the minimum credit is $30. In each year, the Treasury Department is required to develop a complicated percentage reflecting the increase in cost of every kind of energy used for heating in various parts of the country, a task for which it is ill-equipped.

Even if a taxpayer can figure out the complicated rules, he or she will have trouble learning about it because the 1979 tax returns have already been printed. If a tax cut is needed—and I think it is—a straightforward change in rate or exemption makes much more sense and does not undercut our conservation efforts.

JOHN C. DANFORTH.

XVII. ADDITIONAL VIEWS OF SENATORS DANFORTH, CHAFEE, HEINZ, AND DURENBERGER

The Crude Oil Windfall Profits Tax, H.R. 3919, as reported by the Senate Finance Committee contains an exemption for oil production of state and local governments if the proceeds are used for public purposes. We believe that this exemption is unwarranted.

The Carter administration's original recommendation was to subject state royalty interests, as well as similar royalties held by private individuals, to the windfall tax. The House Ways and Means Committee provided an exemption from the tax for royalty interests held by states and their educational instrumentalities where the royalty income was earmarked for public education. This exemption was expanded by the Senate Finance Committee to include royalties received by these entities which were earmarked for any "public purpose."

It is estimated by the Treasury Department that as a result of decontrol state revenues will increase by approximately $128 billion between 1980 and 1990, of which $95 billion will be from income and severance taxes and $33 billion will be from state royalties. If these royalties were subject to the tax, states would be allowed to retain $117.5 billion instead of $128 billion resulting from decontrol. In other words, the revenue loss to the Treasury that is associated with this exemption is estimated to be $10.5 billion between 1980 and 1990.

A primary issue in the committee's deliberation on the windfall profits tax and, in particular, this exemption, was whether it is possible to create and finance a *national* energy policy. The Congress and the President must devise an energy policy and finance that policy in a way that is fair for all parts of the country and that transcends sectional interests. The entire nation faces an energy crisis. If the OPEC nations decide to impose another oil embargo, it will not be imposed on certain states. It will be imposed on the United States.

Yet, the funds resulting from this exemption will not be used to reduce our nation's energy problem. They will not produce one additional barrel of oil. They will not finance one additional synthetic fuel plant. And they will not result in any additional energy conservation. This measure simply carries out an exemption which transfers wealth from the country as a whole to a few states which are lucky enough to hold royalty interests on oil produced from state lands. Those states will benefit greatly anyway. The question is how much they should benefit—$128 billion or $117.5 billion. If indeed, decontrol creates a "windfall" for oil producers, it creates that windfall for all oil producers. The Congress has decided that some of this windfall will be placed in a fund for the common good. To be consistent, all oil should be treated the same. It is simply a matter of equity.

The primary argumnt put forward by those who favor exempting state royalty interests from the windfall tax is that federal taxation of these interests would lead to litigation over the constitutionality of

such a provision. We don't believe that the threat of litigation constitutes a sufficient basis for failure to enact a provision which is designed to enhance the equity of a major piece of legislation. Besides, we believe there is compelling evidence that such a provision if considered by the courts would be held constitutional.

The leading case on the question of the constitutionality of federal excise taxes imposed on states is *New York* v. *United States*, 326 U.S. (1946). In that case the Supreme Court upheld the constitutionality of a federal excise tax imposed on sales by the State of New York of mineral water extracted from New York state lands. Justice Frankfurter announced the judgment of the court and delivered an opinion in which he said (326 U.S. 313–314):

> New York urges that in the use it is making of Saratoga Springs it is engaged in the disposition of its natural resources. And so it is. But in doing so it is engaged in an enterprise in which the state sells mineral waters in competition with private waters . . . To say that states cannot be taxed for enterprises generally pursued, like the sale of mineral water, because it is somewhat connected with a state's conservation policy, is to invoke an irrelevance to the federal taxing power.

It is argued that the proposed windfall tax is different because the state will bear the tax—not the consumer. However, the Supreme Court in *Allen* v. *Regents*, 304 U.S. 439 (1938), in upholding a federal admissions tax expressly assumed that the state could not pass on all of the tax but nevertheless sustained its validity.

The General Counsel of the Treasury Department has looked at this question and in an October 9, 1979, memorandum concluded:

> The principles which the Supreme Court found to sustain the tax on the sale of mineral water also sustain the tax on the removal of oil.

In addition, the Congressional Research Service, of the Library of Congress, concluded in an August 9, 1979 memorandum:

> Therefore, it would appear that there would be no constitutional problem with taxing leases of state lands on their windfall profits from extracting oil; or does there appear to be a constitutional problem with taxing a state which extracts and sells oil as if it were a private company.

In summary, we believe the proposed imposition of the windfall tax on state royalties is constitutional and the real question is one of equity and whether we are going to have a truly national approach to solving our energy problem.

JOHN C. DANFORTH.
JOHN H. CHAFEE.
JOHN HEINZ.
DAVID DURENBERGER.

XVIII. SUPPLEMENTAL VIEWS OF SENATORS BOREN AND WALLOP

The Finance Committee's windfall profits tax bill is a significant improvement over the House-passed bill in addressing the Nation's energy problem. The committee bill provides greater incentives for conventional oil production while offering new incentives for development of synthetic fuels and the conservation of energy. Nevertheless, it should be recognized that the imposition of a windfall profits tax will significantly reduce the amount of domestically produced energy which would have resulted from decontrol. The tax will diminish incentives for domestic oil production and retard the ability of the industry to finance exploration. One source estimates that the Finance Committee's windfall profits tax will reduce domestic oil production by 1 million barrels per day in the late 1980's. This is compared to a production loss of 2 million barrels per day that would result if the House-passed windfall profits tax were enacted into law.

Most of the changes made by the Senate Finance Committee are in the best interest of American consumers. They will result in the production of more energy at a far lower per unit cost than OPEC oil or synthetic fuels produced with government inducements.

One of the most positive steps taken by the Finance Committee was the exemption of newly discovered oil from the tax. It will help to reduce our dependence upon foreign sources of energy. It is expected that this exemption will increase oil production by as much as 1½ million barrels per day by 1990. This exemption would cover oil which was first produced on a property after January 1, 1979. The whole rationale for having a "windfall profits tax" has been that it would be a tax on inventory profits. Obviously there can be no windfall profits on something which has yet to be discovered.

More positive action was taken with the exemption of incremental tertiary oil from this excise tax. An exemption of this kind is necessary to provide maximum incentives for producers to make the large investments required for tertiary projects. The Department of Energy has testified that with proper inducement over 2 million barrels of oil production per day could be recovered by 1990.

To practice these enhanced recovery methods and to recover the large amounts of oil which remain in the ground after primary production, there must be special incentives to keep these wells in production. If they are prematurely abandoned, the resource may be lost forever. It was with this thought in mind that the Finance Committee provided for the exemption of stripper oil owned by independent producers. There is well documented proof that special treatment for stripper wells produces constructive conservation results. Since the price for stripper oil was decontrolled in 1975, the abandonment rate on stripper wells has decreased by 500 percent. It is estimated that

exempting stripper wells from the tax will increase production of oil in this country by ½ million barrels per day by 1990, and maintain millions more in reserve which otherwise might not be saved for enhanced and tertiary recovery methods.

The committee also recognized the importance of keeping marginal properties on line by expanding the definition of marginal wells to include properties which produce a high ratio of water to oil. These properties are operated at a very high cost and are often prematurely plugged, resulting in a loss of production. By giving high water producing wells marginal well treatment, it is estimated that 11,000 barrels per day of production could be saved at a cost of about one-third the price of OPEC oil. For example, there is a field in Garvin County, Okla., where nine wells produce 350 barrels of oil per day and 9,133 barrels of water per day. The operator of the field has estimated that with marginal oil tax treatment an additional 700,000 barrels of oil could be produced during the life of the field.

Percentage depletion was also reinstated on the oil taxed by the windfall profits tax. Independent producers are the only producers entitled to the use of this deduction. They are already facing a 32 percent increase in their tax burden over the next four years resulting from the scheduled reduction in the depletion rate from 22 percent to 15 percent. To deny percentage depletion on that portion of oil taxed by windfall profits is to even further increase the income tax independent producers and royalty owners must pay on top of the windfall profits tax which would also be imposed on this portion of their income. It is estimated that this action by the committee will encourage the drilling of over 630 new wells a year.

The tax was also made subject to a phaseout once 90 percent of the revenue from the tax is raised. The phase-out of the tax would begin at a rate of 3 percent per month over a 10 year period. The committee decided that it made no sense to structure a tax which takes into the government coffers more money than is actually needed to provide revenue for conservation and alternative energy programs.

While the committee improved the bill and provided a much more balanced approach, there are still other changes which were not made by the committee which would have benefited all Americans.

It was a mistake for the committee to reject the exemption for the first 3,000 barrels per day of production owned by the independent producer. The windfall tax will have a greater impact upon independent producers than on the large oil corporations. Because the independent producer derives his income from a single activity, the discovery and production of oil and gas, any capital loss resulting from increased taxes will mean that fewer wells can be drilled. During the five year period from 1969 through 1973 independent producers accounted for 89.2 percent of the wildcat wells drilled, 75 percent of the new fields found, and 54 percent of the total oil and gas discovered. These producers plow-back 105 percent of their wellhead revenues from both crude oil and natural gas production into more explanation, drilling, and production activities.

An exemption for these producers would also have helped to reduce the heavy administrative burdens under which independents

must operate. Although the first purchaser collects the tax, the operator must certify the applicable pricing and tax classifications for each barrel of crude oil. Before oil is completely decontrolled in 1981 the producer must constantly reclassify his oil for pricing according to the decontrol schedule. He must also keep a separate accounting for tax purposes.

For example, it requires countless attorneys and accountants to figure out what the legal price and tax would be when the oil can be priced at a lower tier rate and taxed on an upper tier base. There are countless other complex situations.

The exemption of independent producers from the tax would have eliminated most of the regulatory maze. These smaller producers are not equipped, as are large international corporations, to deal with complex regulations. These regulations become a significant deterrent to exploration and production, sometimes surpassing pricing restrictions and tax rates in importance.

Another major flaw in the bill as reported is the failure to exempt all stripper oil from the windfall tax. The United States needs to maintain and increase stripper production. The soundest conservation policy of all is the preservation of a resource which we now have. Every time a well is prematurely plugged we have lost oil now being produced on which the environmental costs have already been paid. In addition, for secondary and tertiary recovery to be possible, the life of the stripper must be prolonged. Wells which are plugged are gone.

In addition, there is a substantial production response to increased stripper price. CBO estimates that a stripper exemption would increase production by 235,000 barrels per day by 1985 and a study by Dr. William Talley estimates an additional 497,000 barrels by 1990, if all stripper production were exempt.

Although the language in the bill exempts about 50% of the stripper wells (those owned by independent producers) the remaining stripper wells are facing what is in effect a roll-back in price from the world price of $23 a barrel to the Tier III base price of $16. In addition, the provision against avoiding a net loss on a property (the net income limitation) won't provide enough help to stripper wells. Individual stripper wells which are losing money will be shut down even if the total property is not losing money. In addition, stripper wells periodically must be shut down for workovers. On the average, workovers cost $3,000 for a 3,000 foot well. Costs may run much higher. A new surface pump costs $17,500, for example. Even if a well is doing better than breaking even, it still might not justify a major workover because the pay out period would be too long and uncertain. Without proper pricing and tax incentives, it may be plugged prematurely in this situation.

The economics and operational problems associated with stripper wells are real for all producers, independents and major companies alike. The cost of materials and labor for workovers and maintenance are the same for all producers. Pumps still fail and wells need to be reworked, no matter who owns the well. Half of all stripper wells are not exempt from this tax and may be shut in for failing to pay their own way.

The greatest shortcoming of the committee bill was the outright refusal to address the near term supply problems facing America. The only measures adopted by the committee which can help reduce our dependence on foreign energy supplies in the early 1980's are the energy conservation tax incentives. The committee should be commended for recognizing the contribution that energy conservation can make to reducing our dependence on imported oil over the next few years. Unfortunately, the committee abandoned support for measures that would increase energy production in the near term, thereby losing an increasingly rare opportunity to affect the national energy supply picture in a coordinated manner.

The bill reflects a tragic misunderstanding of how various categories of oil respond to price and incentives over time. A commonly held belief is that the exemption for newly discovered oil is a panacea, creating abundant new energy sources immediately. The exemption for newly discovered oil is perhaps the most significant production oriented provision in the committee bill, but the benefits of this action will not accrue to the nation until the mid 1980's. Bringing production on line from newly discovered properties is a process of several years, even under the most favorable conditions.

In the immediate future, domestic oil production can only be increased by allowing producing properties to realize the benefits of decontrol. Lower and upper tier of properties could provide the most immediate response to improve prices. Imposing a 60 percent tax on upper tier oil, a harsher levy than the one originally proposed by the President, will reduce the incentive to develop these properties to their full potential. Penalizing lower tier oil with the 75 percent tax and a 1.5 percent decline curve, will not only end the hope of increased production from these properties, but will also cause the premature abandonment of old oil wells. How painfully short sighted.

Lower tier oil represents the properties discovered prior to 1973, and has the highest production decline rates among the major categories of oil. The production objectives for this category are similar to those for stripper wells. Investments must be made to arrest or slow the production decline in each well. The adoption of a 75 percent tax and 1.5 percent decline curve on Tier I oil will give producers little incentive to reduce the declining oil production. Since the lower tier properties were placed under price controls, economic returns from these wells have not been adequate to support the full cost of well workovers, infield drilling, or the replacement of old equipment. These investments are needed if the declining production of these wells is to be arrested.

The 2 percent decline rate originally adopted by the administration offers promising production incentives for more than half of the lower tier properties. The committee adopted the 1.5 percent decline rate contained in the House bill. By selecting a 1.5 percent decline rate a significant number of properties, those with faster than average decline rates, will not be able to realize the benefits of phased decontrol. The 1.5 percent decline rate leaves many producers with little alternative but to let their production decline naturally with no additional incentives to increase production. This production could have been available to help meet our acute short term shortages.

Our current energy crisis in this country is not primarily economic. It is certainly not a shortage of energy resources. We have enough coal, for example, to last for more than 100 years. Our problem is political.

It is obvious that we produce too little energy within the United States and that we consume too much, yet we continue to follow a policy of taxing production while subsidizing consumption. It makes no sense economically even though it plays well politically.

It is always popular to tell people what they want to hear. Many wish to believe that we can have more energy by paying less for it. Unfortunately, the only way that we can free ourselves from dependence upon OPEC is to invest more money to produce energy here at home. Oil wells cannot be drilled, or coal mined, or solar panels built for free. Soneone must pay the bill.

The truth is that the public will pay the bill. New energy production must be financed either by the profits of private companies or by the government through money collected in taxes.

History clearly shows that the free enterprise system produces goods and services much more cheaply than the government. Private companies can move a barrel of oil through pipelines from the Gulf of Mexico to New York City for a fraction of the cost to the U.S. Postal system for delivering a letter from Houston or New Orleans to New York.

In the long run, the only way to bring down the high cost of energy, is to invest now to produce more here within the United States.

Regional rhetoric also will not do the job. All Americans should favor more oil production whether that oil lies beneath Texas or Oklahoma or Massachusetts or Connecticut. We should all be for mining more coal whether it comes from Rhode Island or West Virginia or Wyoming. We should all be for developing mass transit where it is feasible, even those of us from areas where population density makes it unlikely that we will receive mass transit funds. We must pull together to help ease the burdens for the elderly who can't protect themselves against the rapidly rising costs of heating oil, even if heating oil isn't used in our States.

In short Americans must stand together and have the will to face the truth and meet it head on. The "windfall" tax is a retreat from that goal. The government will already reap hundreds of billions of dollars, over 60 percent of every dollar generated in profits as a result of decontrol without "windfall" tax. It will already have enough to adequately pay for aid to the poor, proper conservation programs, and the development of alternate energy sources.

If our job is to produce more energy and to reduce the wasteful consumption of energy, the windfall tax has no economic justification. Politically, it may have its short term benefits, but economically the best that can be said of the bill as reported by the committee is that it isn't as destructive of the national interest as it was before the committee amended it.

DAVID L. BOREN.
MALCOLM WALLOP.

XIX. ADDITIONAL VIEWS OF SENATOR WALLOP

Upon passage of the House windfall profits tax bill, the legislation was projected to raise $105 billion in net windfall profits tax revenues using a price assumption of $22 per barrel for imported oil. The President declared his support for the House-passed bill, because it provided adequate funds for the aide to the poor, the Energy Security Corporation and incentives for conservation and transportation programs.

The Finance Committee bill would raise $138 billion in net windfall tax revenues over the next decade, but the committee faces accusations that its bill provides inadequate revenues. This accusation fails to recognize the dynamics of the windfall tax, and the constantly changing position of the administration in regard to how much revenue is in fact needed to address the problems which President Carter identified in his proposals.

The windfall tax is tied to the world price of oil, so that as oil prices increase, there is an increase in revenue from the tax. Over the last six months, every oil price increase or change in the future price of oil creates a windfall to the government in projected tax revenues. As oil price assumptions and revenue projections rose, the Administration made corresponding increases in its estimates of how many billions in tax revenues must be spent without so much as a backward glance at their original purpose. This procedure and the policy rationale behind its conflict with the prevalent economic belief that higher energy prices will induce more private investments in conservation and cost competitive synthetic energy development, thereby reducing the need for government subsidies and windfall profits tax.

The committee bill commits the nation to a windfall profits tax with a limited revenue goal and a specific policy purpose. The bill is designed to raise funds to be used to encourage energy conservation, synfuels production, and help Americans make the transition from an era of low cost energy. The phaseout provision provides a guarantee that the tax will raise adequate revenues while avoiding the consequences of establishing a permanent tax.

There is no reason to establish a tax that raises more revenue than is actually needed to address these identified problems of the nation. If we need revenue to fund other programs, unrelated to our energy problems, Congress can consider raising taxes or establishing a new tax. The windfall tax should not be established to fund an expanding federal government or shelter future administrations from the national cry for greater fiscal responsibility.

The tax must nonetheless be criticized for its complexity and its costly administrative burdens for both government and industry. The maddening structural complexity of different categories of oil, base prices, decline curves and tax rates demonstrates that phased

decontrol of oil prices will not solve the administrative burdens facing oil producers. If anything, the complexity and cost of the administrative burden will only increase as the windfall tax imposes a new form of price controls on the oil industry. Where oil was previously controlled by the Department of Energy through the regulation of price, future controls will be maintained through a tax mechanism. All private industry should be concerned by this precedent. Given the national aversion to price controls, future administrations may be tempted to selectively control the returns of industry through a similar excise tax.

The Senate and the public should be aware that the "windfall profits" tax bears no relation to profits in the oil industry. As an excise tax, it applies only to domestically produced oil and it will have no effect on the profits earned by international oil companies in their overseas operations. Under the Finance Committee bill, the House bill, and the President's original proposal, not one penny's worth of tax will ever be paid on foreign OPEC oil, or by those who broker it. Can anyone cite the logic behind a policy which penalizes domestic production and subsidizes foreign imports? That is precisely what we will do and through existing legislation as well. Despite the rhetorical speeches calling for energy independence, this tax will perpetuate a circumstance that makes it a better business deal to explore for, produce, and import foreign oil than to solve America's energy problems. If the public feels deceived, it is because it has been.

MALCOLM WALLOP.

XX. ADDITIONAL VIEWS OF SENATOR DURENBERGER

During the markup of H.R. 3919, the Finance Committee decided several major issues by narrow margins on roll call votes that were generally interpreted as divisions between senators who represented oil producing states and those who represented consuming states. No one can deny that crude oil price decontrol and the windfall profits tax result in significant interstate and interregional transfers of wealth. However, as one senator who voted both for amendments to increase the tax rate and amendments to exempt several categories of oil from the tax, I would say to my colleagues that the legislation here reported reflects a division more fundamental than a producer/consumer dispute over the distribution of oil and tax revenues.

Throughout the debate representatives of the oil industry have maintained that world prices and the revenues from decontrol are necessary elements of a strategy to produce our way out of the energy crisis. Proponents of the tax including the administration advocate high prices to encourage conservation and conversion to alternative energy resources, but do not believe that additional domestic oil production will be a significant factor in achieving energy independence. It is a difficult question to judge and neither side deserves plaudits for the case they have presented. Advocates of the tax concentrate on the "undeserved" character of the profits that result from the OPEC price, while ignoring the supply response from additional investment. Opponents seem to believe that an unlimited amount of money can be invested in exploration and drilling with each new dollar having the same productive result as the last.

Without ever explicitly stating its judgment, the committee has authored a bill which reflects a decided opinion on the future of domestic oil production in our energy supply. By voting to exempt new oil and incremental production through tertiary recovery, we have concluded that additional domestic production will come only at a very high price. By maintaining high tax rates on lower and upper tier oil, the committee majority has acknowledged that the supply response to decontrol will be minimal and does not require the financial support of extraordinary cash flow from existing wells. By diverting oil revenues to conservation and alternative energy tax credits, we have recognized that conservation and renewable energy resources will be cheaper than domestic oil at the world price. The judgment that new domestic oil production will not play a significant part in achieving energy independence is more fundamental to the structure of the committee bill than any producer/consumer dispute over income distribution.

Although I concur in the judgment of the majority on this question, I am not unmindful of the caution raised by thoughtful individuals in the oil industry who rightfully point out that this legislation has

the potential for self-fulfilling prophecy. We did not design this legislation to punish the industry nor to raise revenues for government programs, but rather to capture the OPEC tax without discouraging production. The committee has a responsibility to monitor drilling and recovery rates and to make certain that this legislation does not lead to undercapitalization that wastes precious resources.

Today, the world crude oil price is basically a tax collected by the OPEC cartel from consuming nations. As President Carter's decontrol program is phased-in, this tax will be collected by American oil producers from American oil consumers. Even though the world price does not reflect the cost of production at existing domestic fields, we will have to pay much higher prices for new oil in the future as our easily produced reserves are depleted. Over the next decade decontrol and the windfall profits tax can provide the foundation for a gradual adjustment to the new, high cost of energy.

All parties essentially agree that the adjustment should include programs to assist those who cannot afford the OPEC tax and to encourage energy conservation and conversion to new and renewable energy resources. President Carter, the House Ways and Means Committee and the Senate Finance Committee have all proposed one or more trust funds to be created with the revenues from the windfall profits tax for these purposes. I opposed the trust fund concept in committee.

I believe that the committee deliberations on this legislation are sufficient evidence to demonstrate the flaws in a trust fund for energy security. At one point the committee had adopted $99 billion of energy tax credits—all of which would have reduced oil imports—but believed that it had only $65 billion in revenues from the tax. The credits were cut to $25 billion. Later the price assumptions on which the revenue estimates are based were changed and the committee found that its tax would raise $138.2 billion. It quickly added new tax credits—none of which would reduce oil imports or go to oil users—and a trust fund to rollback social security taxes. Frankly, it is very difficult to project the revenues that will result from the tax or the spending that is necessary to achieve energy security. In any event, there is no cause and effect relationship between the two. The tax should fairly reflect the economics of the industry and the revenues from the tax should not limit our efforts to achieve energy security at an early date.

TAX CREDITS

The committee bill includes a number of new tax credits and other incentives with tax effects to encourage the production of alternative fuels and the conservation of our remaining oil reserves. It is my hope that the Senate will not be put in the position of choosing between these tax credits and bills reported by other committees that authorize direct appropriations, loans and loan guarantees for the same purposes. However, should the debate develop along these lines, I will be counted among the dedicated advocates of the tax credit approach.

This issue is more than an intramural contest between committees for jurisdiction over energy legislation. H.R. 3919 as reported by the Finance Committee puts the American public rather than the federal

government in charge of our energy policy. Coupled with decontrol of oil and natural gas prices this broad program of tax credits will allow the marketplace decisions of energy producers and energy consumers to choose the most efficient mix of conservation and fuel resources in response to our rapidly changing energy condition. Although the marketplace would eventually achieve the most efficient allocation of resources without the credits, the incentives are needed now to assure that the adjustment will be gradual and come at an early date.

Tax credits are not without problems, however. The public is neither well-informed as to the availability of the credits, nor well-equipped to use them for maximum advantage. The Energy Tax Act of 1978 is presented as a three page IRS form that must be specifically requested before it comes to the attention of the taxpayer. Credits provide no incentive for those who do not pay taxes and qualifying investments may not be within the reach of those with low and moderate incomes. Furthermore, to the extent that these incentives are successful, consumers will be faced with a wide variety of new products, but little guidance as to the efficacy of particular items. If our energy future is to be determined by the choices of individual producers and consumers, and I am fairly convinced that it should be, the committee and the Congress have a responsibility to address and resolve the special problems of the incentive approach.

TRANSPORTATION CONSERVATION

The incentives for conservation and conversion to alternative energy resources contained in the committee bill focus on the residential, commercial and industrial sectors. We did little that would influence the future demand for transportation energy. Although I supported our decision to dedicate a portion of the tax revenues for transportation, I do not believe that these monies would be wisely used if put in a new trust fund for urban mass transit. Transportation conservation offers many other possibilities including long-distance passenger rail service, carpooling, vanpooling and new vehicle technologies. I hope the committee's action in this regard will be interpreted as a broad mandate for energy conservation and not as a narrow commitment to a particular mode of transport.

INCOME ASSISTANCE

The most difficult decisions taken by the committee were related to the issue of income assistance and even now, with the bill reported, a solid consensus remains elusive. There is no division on the need for the program. Daily reports of advancing energy inflation put that question beyond doubt. However, this committee with long experience in assistance programs found that it could not acquire the information necessary to bring this problem into sharp focus and, thus, make it accessible to solution. The two-part package of cash payments and tax credits assures that both social equity and individual need are reflected in national energy policy, but the specific mechanisms for allocating those benefits among citizens will require further deliberation.

The cash payments program for low income households is intended to guarantee that every household has sufficient resources to meet its basic needs. Without such a program, the "heat or eat" decision will become a daily part of life for millions of Americans. But identifying which Americans and the extent of the need in individual cases was beyond the competence of the committee because we are not informed as to the energy consumption characteristics of low income households and cannot reach a large portion of the population in need—particularly the elderly—with existing Federal assistance programs. We can correct the information problem with additional study and legislation in the next session. We have provided a state block grant option with broad definitions of eligibility to achieve maximum participation.

To some extent the income assistance portion of this legislation works at cross-purposes with the tax incentives for conservation and fuel conversion. This is particularly true of the credits for low and middle income families designed to offset the high cost of energy. Because these credits are based on volumetric consumption, they provide a subsidy for higher levels of energy use as Senator Danforth has ably and consistently stated. However, without these credits, American families of low and moderate income are left defenseless against an energy inflation that is affecting all fuels and too rapid to allow gradual adjustment. I support the tax credits as a short-term measure to provide equity for those not able to afford rapid adjustment and not eligible for programs of cash assistance.

These views are as much an agenda for additional action as they are a personal explanation and appeal on specific issues. H.R. 3919 deserves the support of every Senator but that support should serve as the foundation and not the capstone of our national energy policy. It is a good start, but nevertheless only a start, on a decade that will fix the pattern of our energy future.

DAVE DURENBERGER.

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