U.S. Tax Law and the Price of Oil

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The new administration in Washington has found it can afford to begin devoting attention to the malaise which has been besetting the nation's economy in recent years. More particularly, it is addressing last year's spectacular and unwarranted rise in the world export price of oil.

Yet in his policy speech of September 23 President Ford temporized and fudged on the subject of energy: "Our needs then and now for energy are increasing much faster than our ability to produce it." That is hardly an accurate reflection of the present state of the world. And it is a bit of blustering to mention the possibility (which, of course, he dismissed) of going to war "over natural advantages such as water or food." The speech did nonetheless underline an unmistakable concern over the high world export price of oil.

Secretary of State Kissinger joined in with a speech before the United Nations the same day. Mr. Kissinger, in fact, came closer to spelling out the real cause for the warnings when he stated that the high cost of oil, unlike that of food, "is not the result of economic factors, of an actual shortage of capacity or of the free play of supply and demand, [but] is caused by deliberate decisions to restrict production and maintain an artificial price level."

The Arab states, Venezuela, and Iran naturally took offense at the threats veiled in the September 23 speeches. President Carlos Andres Perez of Venezuela responded in the form of a full-page advertisement in the *New York Times* (September 25). He spoke of "the economic totalitarianism that has been coming to the fore in business and world trade" and expressed concern at "the lack of understanding" between developed and underdeveloped nations "in regard to the need to arrive at satisfactory formulas for equal treatment and mutual respect in economic matters."

President Ford's speech, for all its unclarity, should not be dismissed as mere saber-rattling or jingoism. He is right: "The prices for oil are now too high." The high price has not yet—and may never—wreak the havoc in the West which many prophets are anticipating; but it must come down, and come down drastically. In the recent past oil prices were a fraction of what they are now, and neither exporting states nor oil companies voiced public dissatisfaction. Even those low prices consisted mostly of a "monopoly rent," a markup several times greater than the actual capital and operating costs of finding the oil and getting it to tankers.

The prices of the recent past were, in turn, 30 to 40 per cent higher than those prevailing for the decade previous. Ranging roughly from $2.10 to $2.40, they encompassed all Near Eastern, then Venezuelan and Nigerian, oil—which is the bulk of the oil entering international trade. These prices resulted from agreements the oil firms reached with Libya in September, 1970, followed by a more comprehensive pact concluded at Teheran in February, 1971. The pact included six Persian Gulf states (Abu Dhabi, Iran, Iraq, Kuwait, Qatar, and Saudi Arabia) and the seven major oil companies, together with two European state or quasi-governmental firms and four small American companies.

The Teheran agreement of 1971 was a handsome settlement at the least and probably a giveaway. The Persian Gulf states acknowledged this by accepting the stipulation that the terms would last "for a period from 15th February 1971 through 31st December 1975." In other words, all signatories agreed that the price should remain stable for five years.

In his September letter in the *Times* President Perez failed to mention the Gulf settlement of February, 1971, which lasted not five but two-and-a-half years. He also failed to note that the Gulf states

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were elated over a $2.40 tax reference price in 1971 and now cannot endure the loss of face which might befall them if the price dropped below $11.65.

The 1973-74 hikes disrupted an equilibrium which the February, 1971, agreement had fortified. Again, the hikes are simply not justifiable, even though the countries benefiting from them are mostly underdeveloped and those lodging the complaints are the world's richest and most advanced. (Yet others, most notably India, have suffered far more than America, while remaining silent.) President Perez said oil has to keep pace with other price rises. Three days after the publication of his letter a *New York Times* editorial put the issue in perspective: "The world export price of oil has climbed by 636 per cent since 1963—compared to about 290 per cent for nonferrous metals, 230 per cent for food, and 174 per cent for manufactures."

But merely saying that the prices are too high is hardly enough to get a price decline without creating an atmosphere for chaos or war. Here again Messrs. Ford and Kissinger have temporized, for the key to a peaceful resolution of the oil price controversy is not in the hands of the producing states but in the hands of the oil companies. Especially the seven majors—Exxon, British Petroleum, Shell, Texaco, Gulf, Mobil, and Standard of California—will have to be pressured by the American government, which will probably not be pleasant. Washington's failure to take a stand on the price problem until it had become impossible to ignore, and then its attempt to bear down on the exporting states rather than on the companies, illustrates how unlikely a peaceful resolution may be.

The major companies bear the main responsibility for the steep price increases. Until at least mid-October, 1973, the price policies of the oil exporting nations were passive and negative. They were chiefly concerned that the tax, if not the price, not drop. This was reason for concern enough in an era of potential crude oil glut. Even between September, 1970, and May, 1971, when the states did mount a campaign to raise the price, they succeeded only because the companies readily agreed to worldwide negotiations and then failed to unite among themselves. The heart of the matter is that the companies did not do all they might have done to keep the price down because they had nothing to lose by the price rising. In fact, the major seven largely abandoned common cause with their small competitors, allowing the states to crowd the latter into a corner.

It must be added that the major seven, at a crucial period in September, 1970, did not receive the backing they considered necessary from the U.S. State Department. They might have mounted a strong defense of existing prices in Libya, for example. But this hardly negates the point that, if an "international producers' cartel" exists at all, it exists with the compliance of the major seven. They established the pattern that has dominated international oil trade over the past two generations. Meanwhile, these firms are insisting that the "deliberate decisions to restrict production and maintain an artificial price level" are exclusively the doing of the exporting states and that they themselves have "lost all control of the international market."

The pattern—and the abuses it created—can be broken. At present it is intact and is being consolidated. The major seven, while professing helplessness in bringing down prices, continue to concentrate their crude oil exploration and production investments in the very states which supposedly constitute the "producers' cartel" (the principal members of OPEC, or the Organization of Petroleum Exporting Countries). A serious campaign to bring prices down, or at least to create the conditions leading to a price drop, would suggest the opposite course: The companies could stop investing in the biggest OPEC states and turn to the newer crude oil provinces of the world, especially the North Sea, offshore Indonesia, other areas of the South China Sea, northern Alaska and Canada, the western Amazon Basin, and West Africa. OPEC's writ does not extend to some of these areas at all.

Though the major seven have been putting money into these new areas, their investments in new production in the classic areas of OPEC continue unabated. It is the relative newcomers to international oil, such as Atlantic Richfield, Continental, Union, Standard of Indiana, and Phillips, which are making the heaviest investments in the new areas. The majors account for less than half the wells being drilled in the North Sea but the overwhelming share of investment in the Persian Gulf.

Mobil has been pursuing a most aggressive drilling campaign in Libya and Iran. Abu Dhabi Marine Areas Ltd. (primarily a British Petroleum venture) has six jackup rigs at work expanding the Umm Shaif and Zakum fields, and the Iranian Consortium (owned 89 per cent by the major seven) has two dozen rigs at work in the Ahvaz field alone. At least eight of these are developing the deep Bangestan formation, where wells cost at least a million dollars apiece. Were BP to stop investing in the Persian Gulf at all it could be developing its Forties field in the North Sea far faster than it is. It might even have got the field onstream by now.

Aramco's expenditures also continue to skyrocket. This venture's capital investments in properties, plant, and equipment totaled $163 million in 1971, $413 million in 1972, and about $620 million in 1973. In 1973 Aramco increased its productive capacity by at least 2.5 million barrels a day and, according to *The Oil and Gas Journal* (April 15, 1974), has reached agreement to spend $2.5 billion and increase production another 2 million barrels a day by the

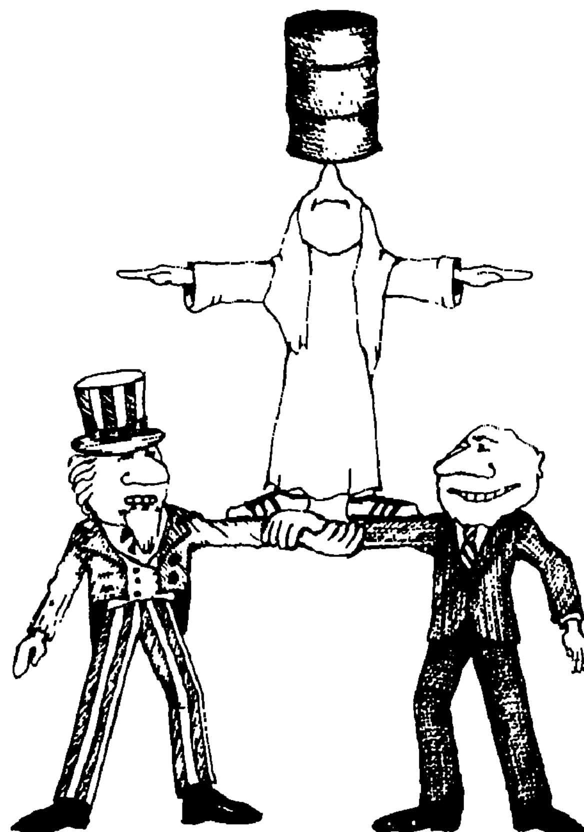
end of 1975. It is building a brand-new oil export terminal, from scratch, at the Persian Gulf port of Juayma, costing at least $100 million.

Investment in these countries is not drying up as it did in Libya in 1970 when the revolutionary government of Muammar el-Qaddafi put pressure on the companies to increase their tax payments. This is yet *another sign that the majors are not unhappy* over their present relationships with the Gulf states. The majors claim they have to invest in these states in order to prevent the world from falling prey to a crude-oil famine, but, given the abundance of promising new oil provinces, that argument will not wash. The effect of their investments is, in fact, to keep the world dependent on crude oil sources which *they*, rather than others, dominate. It also preserves the present high prices for the commodity.

Ironically, it is also cheaper for the majors to continue concentrating investments in these established oil states. There are two reasons for this. Huge as the expenditures are, they are in fact lower than those in new areas because they represent far lower risk. The choice is between expanding old, established fields (always relatively cheap) or discovering and developing new ones. Even virgin prospects in the established states are already accessible, due to their proximity to existing roads, pipelines, and other facilities. Then too there is the familiarity with the proper strategy for developing old fields. Exploration costs represent only a small portion of an established venture's expenses—no more than 15 per cent, even in the case of a firm which explores actively, such as the Iranian Consortium.

Second and more significantly, the majors still enjoy privileged access to the crude resources of the old, established areas. Thus they have a virtual monopoly over the disposition of the oil they provide. In fact, the companies' relationships with these states have not changed essentially in the last three years. The recent excitement over host government "participation" and "nationalization" has somewhat obscured this fundamental fact of international oil life. In times past the oil companies used to state flatly: "We determine price and regulate production." As it stands now, they have acquiesced in much higher prices, at absolutely no loss to themselves, and still have almost a monopoly on access to the means of production in the established exporting countries. One executive, Chairman H.J. Haynes of Standard of California, euphemistically explained it in a recent interview with *The Oil and Gas Journal:* "We continue to have a great deal to contribute to these countries—which makes it mutually beneficial for both parties to continue these relationships."

Mutual benefit is the key to it all, of course. The major seven protect the established exporting countries from the brutalities of the open market. The companies are paid, in turn,



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to do so by the U.S. Internal Revenue Service. The biggest payment they receive consists of a 100 per cent tax credit which makes SoCal and the other four American majors all but indifferent to the amount of tax they pay their hosts in Saudi Arabia, Iran, Libya, or other states. They can deduct it in toto, dollar for dollar, from the U.S. tax bills and at the same time pass it on to their consumers. This enables them virtually to eliminate their domestic obligations while incurring no out-of-pocket costs. In 1972, for instance, SoCal had a U.S. tax bill of $200.9 million on its consolidated earnings (largely domestic); foreign tax credits eliminated all but $3 million of this. (Ultimately, the company paid the IRS a minimum tax of $14 million.) A second tax benefit, the 85 per cent dividend exclusion, accounted for most of the rest.

SoCal and its American partners in Aramco will only be able to avail themselves of tax credits in Saudi Arabia as long as they own the minimum which the IRS stipulates for eligibility, namely, 40 per cent of the enterprise. The government of Saudi Arabia currently holds 60 per cent of Aramco; if it takes over any more of Aramco, the American majors will no longer qualify for an 85 per cent tax exemption for their dividends. If Saudi Arabia takes over the venture completely, the American majors will become mere purchasers of Saudi oil. Then they would no longer be paying tax to the Saudis at all, and of course would not qualify for the foreign tax

credit either. In that case the price they pay for the oil would be only an expense, and they would thus be able to gain only a maximum 48 per cent credit against their American tax bill for the oil they lift from Saudi Arabia.

As one Arab spokesman, Dr. Muhammad Mehdi, recently said: "When Aramco is finally and fully owned by Saudi Arabia, the price of oil will substantially go down as this greedy middleman disappears." When that happens, the price will in fact drop, because Saudi Arabia will cease to be particularly attractive to the American majors participating in Aramco.

The Saudis seem aware that their position at the moment—flush though it may be on the surface—is quite precarious, and current events bear this out. Not only are the American firms insistent on holding on to their remaining 40 per cent share of Aramco, but the Saudis, as of this writing, seem reluctant to take a larger share. This also explains why the Saudis have expressed a willingness to bring down their prices. (Though they will not do it on their own, since that would mean breaking ranks with OPEC and subject them to intense opposition and criticism in the Arab world. It was to free themselves from this that the Saudis sought to assume leadership in oil policy-making among the exporting states in the first place.)

The same rules apply, although in different form, to Iran. Iran has "nationalized" the old Consortium properties, but it still permits the Consortium (of which American interests own 40 per cent) to lift off almost all the oil the properties produce.

Once the Saudis, Iranians, and others took over the disposition of their crude oil completely, the international companies would have little special reason to buy from any one of them specifically—*unless* one country was willing to undercut the others and sell oil at a lower price. In that case the oil states would become sellers in a competitive market.

In sum, the main obstacle to eliminating the present high prices for oil is not the cupidity of the big oil exporting states in OPEC but U.S. tax law, which encourages the states in their cupidity. Yet the U.S. Government refuses to abolish the special privileges it grants to the major oil firms. The only way to work to bring the price down, without firing a shot or word in anger, is to ensure that it is no longer worth the American majors' while to stay in foreign countries as operators of oil properties —unless they diversify their investments drastically, at the very least. This means eliminating their foreign tax and dividend credits or at least restructuring them to favor investment in virgin areas or non-OPEC countries.

Failing this, the next move would have to be the more radical one of breaking up the integrated firms into producing, transportation, refining, and marketing companies. In any event, the pressure for reform must come from the American public. The government's stillborn "Project Independence" will hardly help to bring the price down, since it is avowedly a strategy for making domestic energy so expensive that the exploitation of expensive domestic resources will come to seem attractive. Calling for cutbacks in consumption will not work either; and it is, in any case, a measure which unfairly punishes the innocent. Nor, in the final analysis, will threats of economic reprisals against OPEC states do much good. They are decidedly "out of vogue," besides being futile.