



Testimony of Mason Gaffney Before the Joint Hearings of the House Resources and House Finance Committees on the Beaufort Lease Sales

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TESTIMONY OF MASON GAFFNEY

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BEFORE THE JOINT HEARINGS OF THE HOUSE RESOURCES AND HOUSE FINANCE COMMITTEES

ON THE BEAUFORT LEASE SALES, JUNEAU, ALASKA, MARCH 31, 1979

INTRODUCTION

The 1978 Alaska leasing act, Act. No. 854, gives the Commissioner of Natural Resources a flexibility in selecting leasing terms which he did not have before. He may at his discretion use net profit rather than cash bonus as the bid variable. He may also increase the fixed royalty share well above the traditional 12½% and he may fix the net profit share above 30%. Finally he may combine these options in several ways. He might, for example, set a fixed royalty of 25% plus a fixed net profit share of 35%, and then put the lease up for cash bonus bid subject to those pre-announced terms. He could also include a work commitment if he saw fit. He also has the flexibility of imposing a high fixed royalty initially, and then reducing it over time to compensate for increasing costs in the later stages of production decline. The Commissioner shall define all terms and adopt all regulations necessary for a reasonable understanding and evaluation of a particular bidding method. Thus, while you have burdened your Commissioner with a heavy responsibility, you have given him great authority and wide latitude in fulfilling it.

I have heard several people speak of the advantages or disadvantages of royalty bidding when what they evidently meant was a high royalty. Your legislation lets there be a high fixed royalty announced in advance, coupled with bonus bidding. So let's be clear up front that there may be a high royalty without

there being royalty bidding. The same is true, of course, of net profits.

Note, too, that the Commissioner's power to reduce royalties over time constitutes a kind of sliding scale or step royalty, the purpose and function of which is to take a higher share of gross during the flush production years when revenues are extremely high relative to costs. Such arrangements are common throughout the world. It is only the more elaborate kinds of sliding scale royalties that are uncommon.

In this testimony, I shall review the reasons why the Legislature might wish the Commissioner to use leasing methods other than the traditional low royalty with bonus bidding; and then look at the implementation problems associated with administering high royalties and high net profit shares.

I. BONUS BIDDING

A. THE ATTRACTIVE SIDE

The advantages of bonus bidding are often cited and may be quickly reviewed. There is a large commitment by the lessee, who will not walk away. After he pays the bonus there is no marginal disincentive imposed on the lessee. There being little further participation by the State, administrative costs and aggravations are minimized. The State receives its money up front. It does not have to wait for its money and neither does it assume any risk of not getting the money. It even gets money for dry acreage. Corporate outlays for bonus bids receive favorable income tax treatment, thus encouraging higher bids. If there is a propensity towards preemptive bidding by firms of oligopolistic bent, the State may benefit by this system which induces them to tie up resources at their own expense rather than at the State's expense.

I pass over this case swiftly, not because it is weak but to save time. Others have made this case persuasively.

B. PROBLEMS WITH BONUS BIDDING

1. THE FRONT END BARRIER

a. HIGH CONCENTRATION

The ability to put up front money is highly concentrated, much more so than the ability to find and produce oil. One of the first principles of the economics of market structure is that economies of scale are found most strongly in the ability to raise and accumulate money. The results of this are seen in the concentration of acreage leased in Alaska in past years under this system. The top eight corporations have 64% of the acreage in Alaska that was leased under the competitive bonus bidding system. Each of them has more than 200,000 acres. The other 72 corporations have 36% of the acreage. These data are in my 1977 report on Oil and Gas Leasing Policy: Alternatives for Alaska in 1977, in Appendix C, Table C-4. The top eight companies are Atlantic-Richfield, Phillips Petroleum, Union, Standard Oil of California, Exxon, Sohio, Mobil and Cities Service.

b. REDUCED COMPETITION

i. PREEMPTION AND PRECLUSION

The more and better acreage the giant firms get, the lesser base there is for others. It is to the advantage of any seller to have a large number of competitive bidders for his wares, in this case your leaseholds. The effect of the front end filter is to strengthen the big ones and weaken the little ones.

ii. JOINT BIDDING

The medium and small firms are forced into joint bidding by the bonus system. This, of course, damps the competitive edge of bidding by reducing the numbers.

Professor Walter J. Mead has likened joint bidding to collusion and a combination in restraint of trade (Anti-Trust Bulletin, Fall 1967, page 839). Professor Richard Norgaard in his study of the results of leasing in Alaska (Appendix E of my 1977 report) like Professor Mead found that the number of independent bidders is a most important variable determining the size of bids.

If oil firms sold their products in joint ventures they would be violating the Sherman Act. Yet, joint bidding has the same effect of reducing competition. In my opinion, the State would benefit from prohibiting joint bidding. The problem is that when we use the front end bonus system, that gives it a rationale. The smaller firms have to join forces in order to bid at all. But, when we adopt other systems which let payments be deferred, then we could prohibit joint bidding.

iii. EFFICIENCY AND THE HIGH BIDDER

With the high front end bonus the dominant factor in bidding becomes the financial power of accumulated wealth. Those firms which most resemble large banks, and which have good banking connections, get the nod over other firms which most resemble oil producers. This necessarily means that efficiency moves down the scale as a factor determining the high bidder. The most efficient firm is the one that can pay Alaska the most money over time. This is not the firm normally which can pay the most money up front. "Front money power" and production efficiency are two different things. This principle is the beginning of wisdom in resource economics, so let me underline it and say it again. Front money power and production efficiency are two different things. That's one of the important facts of life. Without it we'll never understand why the world of Milton Friedman is not Utopia. If you want your resources managed by the most efficient producer you've got to help finance him.

iv. POSSIBILITIES OF INCREASING COMPETITION

The oil and gas industry has long been an oligopoly, with a large fringe of independents and potential interlopers buzzing around it. The argument has raged for decades over whether it is sufficiently competitive, the reason being that it is poised on the margin between competition and restriction. This means that if you give it a strong nudge in the direction of competition, the benefits to you can be substantial. If you create a system that favors a few giants you'll get oligopoly, but if you let in the competitors you'll get the benefits of competition.

c. ABSENTEE OWNERSHIP - BIG CAPITAL IS OUTSIDE CAPITAL

The policy that gives the nod to big capital gives the nod to outside capital and penalizes local entrepreneurship and local ownership. While in the short run the inflow of outside capital may improve Alaska's economic base, in the long run it hurts it because of the outflow of profits which constitutes a large and permanent leakage of Alaska's economic base. Meantime, the inflow of capital followed by an outflow of payments leads to swings of boom and bust.

d. REDUCED EMPLOYMENT

Larger firms do almost everything in more capital-intensive, less labor-intensive ways than smaller firms. Data on this point are found in Appendix K of my 1977 report. Unhappily, this Appendix is blemished in its first two pages with many serious typos (the only ones I believe which were not caught) and if any legislator wishes to make hay out of this point be sure to contact me for corrected figures first.

2. INCREASED RISK

The State could ease the problems listed above by letting successful bidders pay their bonus on the installment plan at a fixed interest rate over about 10

years, and I would recommend that that be done. But there is also an increase of risk that cannot be remedied this way. We have been working with a gambling system, a lottery system where most will lose so that a few can win big.

Because bidding takes place in the dark there is an extra premium placed on preleasing exploration. This calls for even more front money and, as we know, there is a great duplication of effort by competing firms so that much of this front money is waste. Then there is the bonus itself, committed to be paid before exploratory drilling has occurred, a shot in the dark. Firms without strong financing are close to the edge of "gamblers ruin" with each throw of the dice. This cuts way down the willingness of small firms to bid. The financial success ratio drops overall because even the firm which makes a small find loses financially if its bid was premised on a large find.

The medium and smaller firms would bid much more if they could pay over time and if payments were contingent on successful exploratory drilling. Industry spokesmen are constantly telling us this in fact, all we need to do is listen. It's the high risk that forces them to require high target rates of return. This is another way of saying that they discount future returns at high rates of interest, which necessarily results in low bonus bids. The smaller firms no doubt have to do this because of the risk involved. The larger firms which can spread the risk around the world and bury it in statistical probabilities can set high target rates of return as a device of implicit collusion to lower bids. The best response for the rational lessor seeking to increase bids is to reduce the risk and thereby reduce the required target rate of return.

Some of us are also bothered by the moral implications of having the State knowingly sell dry acreage, as sometimes happens. This is using inside information to practice fraud, and it sets or legitimizes a moral tone which would seem

to justify any skulduggery that private enterprise chooses to engage in. Fair dealing is a two-way street.

3. THE STATE AS A BUMPKIN

Bonus sales are for paupers and primitives, the kind of people who are easily dazzled by the flash of money in their faces, people who take no thought for tomorrow, people who would sell Manhattan for \$24 worth of beads and trinkets.

The State of Alaska has a surplus and a permanent fund. The best of all investments for the permanent fund is to participate in future revenues from oil and gas. The big corporations tell us that their target rate of return is 20% or more: that is, they come right out and tell us that they calculate their bids by discounting the future at 20%. That means if you would like to invest at 20% or more, participate! This would look good even if you started as an outsider, but you are starting as an insider. When you sell for cash then you must go through all the expense of converting the cash back into real assets again, and in the process you'll lose a good deal of it, I do not doubt. If you look at how Iran and Saudi Arabia and even Alberta invest their surplus revenues from oil and gas, you will not be impressed with the efficiency of the process. If anything was ever written on the wall it is the strong and growing demand for oil in the ground. So, if you want a sure fire return at a high rate: participate!

4. THE CAPITAL CRUNCH

Paying out a high front end bonus reduces the capital available to explore and develop lands. The bonus requirement hits the small and medium firms at exactly the time they most need to husband their limited capital for exploration and development. You could hardly contrive a system better calculated to discourage them, and that is not what you want.

5. INEQUITY

Bonus bidding is almost necessarily inequitable unless one believes in gambling as a basis for the distribution of wealth and income. This is not to deny that there is a large element of skill in calculating bonus bids, just as there is skill in playing poker, but there are too many unknowns to be covered by any skill short of omniscience. There are not simply the geological risks which themselves consist of several dimensions such as the volume of reserves, the depth from the surface, the cost of drilling per foot, the cost of transportation, the icepack hazards, the permeability and porosity of the rock, the durability of gas pressure and so on. There is also the risk of general inflation, the risk of oil inflation, the question of sour versus sweet crude, the behavior of federal price regulations, the behavior of State geologists, the future of the gas pipeline, the fortunes of environmentalism, the disposition of the question of who owns title to the land in disputed areas, the future of federal payments in lieu of taxes, the future of state and federal taxation of oil and gas, and so on. No one without a private wire to the Almighty can handle all these questions and bid correctly.

The upshot is that a bonus is inequitable in the same sense that a regressive tax is inequitable. It falls the same on the lucky winners as on the unlucky losers, and it does this even though the difference between winners and losers is a matter of luck rather than ability.

6. THE KACHEMAK EFFECT

The winner of a bonus bid has a fair claim to object to future environmental regulations, even though new information should prove these to be necessary as happened at Kachemak Bay.

7. DIFFERENTIAL TIME HORIZONS

If a small weakly financed firm does win a bonus bid it may be under excessive pressure to produce fast, to recover its capital quickly. This could lead to an excessive and unnecessary loss of ultimate recovery. On the other hand, the super financed giants may be under too little pressure. This is suggested by the fact that Professor Norgaard's Appendix to my 1977 study found that only a tiny fraction of the leased land in the upper Cook Inlet was actually producing.

Because of these problems with bonus bidding, the State Legislature sought alternatives when it framed the 1978 leasing act. This act gives us two ways to keep bonuses down: a high fixed royalty; and a high net profit royalty. In addition, these may be combined; and finally, net profit may be made the bid variable.

Looking at 200 years of history of disposal of public lands in the United States, we see this problem to have been solved primarily by saddling lands with property taxes and perhaps other taxes after they were sold. This includes property taxes on mineral rights too, especially in California which has a history of assessing these carefully for property tax purposes. But Alaska is faced with a different situation since most State lands to be leased are not in jurisdictions with heavy populations or any populations, and will not normally be subject to any substantial property taxes. It is, therefore, necessary for the State to accomplish this pattern through putting something in the lease itself.

Again if we look at other large jurisdictions with large public lands to lease, we see that most of these are nations, not states. Many of these nations impose national corporate income taxes at high rates, something like 50%, and these tax rates in conjunction with the leasing terms constitute the means for

extracting a high net profit share for the sovereign. Alaska as a State necessarily has a much lower corporate income tax rate, so what Norway or The Netherlands can accomplish through income taxation, Alaska must accomplish through its leasing terms. The most comparable cases around the world are quite nearby in British Columbia and Alberta. In Alberta particularly a most sophisticated leasing system has been developed (British Columbia tried but botched the job). And so the Alaska legislature has understandably pushed ahead to create mechanisms where leasing may be used as the primary device for participating in future revenues from oil and gas. Let us next take a look at the mechanisms legislated and the problems of implementing them.

II. HIGH ROYALTY RATES

The 1978 leasing act permits the Commissioner to set a fixed royalty as high as he thinks fit in the circumstances (royalty bidding is also permitted for drainage sales, but not otherwise so we concentrate on the high fixed royalty). High royalties are in wide use in oil and gas today ever since Venezuela and the other OPEC Countries broke through the tradition of 12½%. In farming, crop shares greater than 50% to the landlord have been commonplace for centuries on the best lands, and there is a large ongoing literature on the frictions this may create and how they are resolved.

Sharecropping, profit sharing, and high royalties succeed in deferring payments by the lessee and sharing risks, thus overcoming two problems with high bonuses. No one would claim, however, that the system is perfect. Let's take a look at some of its problems and their solutions.

A. INADEQUATE COMMITMENT

1. WILD BIDS

The most common proposal for high royalties is that of making royalty the bid variable. The common objection to this -- and I think a valid one -- is that this opens the door to wild and irresponsible bidding, unless a substantial ante be charged. Otherwise, promises are cheap and a royalty bid is nothing but an unbonded promise. This argument, however, carries little weight against Alaska's Act 854 because it does not allow for royalty bidding except on drainage sales. So long as the royalty is fixed, however high the level, wild bids are no problem. At this time I would recommend that we set a high fixed royalty but yet keep bonus as the bid variable because of its familiarity. Thus, we can please those who advocate bonus bidding while at the same time we satisfy those who argue for high royalties. (Royalty bidding would work if we combined it with a fixed bonus up front, high enough to screen out wild bids.)

2. PREEMPTION

If the royalty be high and the bonus low, then the winning bidder ties up acreage on the cheap. The best way to prevent this, more effective than a high bonus bid, is a delay rental. But Act 854 doesn't mention delay rentals. There are other possibilities, however, as follows:

a. We may limit the acreage that anyone can hold. The State already has acreage limitations, but they are absurdly high. No landlord dealing with share tenants would ever let a share tenant take as much acreage as he wants. The landlord keeps leases reasonably small to be sure that the lessee concentrates his resources on the acreage at hand. Professor Stephen Cheung at the University of Washington has made a career out of documenting this point.

b. We may write a work-commitment into the lease, as 854 allows.

Work commitments have been criticized for inducing excessive application of resources to the lease. However, high royalties have been criticized for the opposite effect, and the idea of combining work commitment with high royalty is to compensate for the excesses of both systems and work towards a golden mean.

c. We can and should impose substantial delay rentals on lessees.

If Act 854 doesn't allow this, it could easily be changed to do so. Delay rentals are a most positive incentive to action. They have been used traditionally between private lessees and lessors only at a low level, probably because federal income tax law makes them less advantageous than other payments to private lessors. As a public lessor, however, Alaska is not affected by this, and should therefore not bow to a custom which was developed for private lessors in other circumstances.

d. We should enforce the 5-year diligence rule with an iron hand.

If we really are serious about the problem of preempted undeveloped acreage in Alaska, we have to ask ourselves why we have allowed so much of it to accumulate already under the bonus bidding system and why we have not used the tools already at our disposal to solve the problem.

B. STIFLING MARGINAL EFFORT

High royalty rates will have the effect of destroying incentives at the margin so that marginal effort is made subeconomic by the threat of the royalty. This is because receipts are shared while costs fall entirely on the decision maker. This is indeed a serious problem when royalty rates are high. The time was when we could shrug and say that the negative incentive effect was more than offset by the excessively positive incentive effect of the depletion allowance, which is a large negative royalty. But now that this allowance is being phased out we need to give new attention to this question. Let us also be aware that Interstate Commerce Commission rate-making principles applied to the Trans-Alaska Pipeline result in

imposing rates considerably above the economic level. Such rates have the same effect as imposing a royalty, and they include a return to the State. There is also the severance tax imposed by the State. The sum of these taxes and charges based on production is substantial, and when we raise royalties to a high level we need to consider substantial counter-measures.

1. STEP DOWN ROYALTIES

The 1978 leasing act lets us drop the royalty rate over time. Using this legislative authority the Commissioner can impose royalties at a very high rate during the early flush years of production when costs are very low relative to receipts. After the first two years of production, he can lower the rate when necessary to allow for increasing costs, and I see nothing in the Act to stop him from lowering the royalty rate progressively in several steps. Thus, in effect, you have legislated a sliding scale royalty of sorts.

The peculiar production economics of oil and gas reservoirs make royalties more feasible than they are with hard rock minerals. At a bonanza well head, even an 80% royalty would not shut off production, while in the later years of dropping pressure and increasing costs you can drop the rate, following fairly objective and measurable criteria. Thus to mix a metaphor you can skim the cream without killing the goose that lays those eggs. The menace of premature shutdown, which people talk about so much, is easy to avoid.

This argument about stifling marginal effort is really derived from the facts of hard rock mining where everything is closer to the margin and royalties can be very destructive. But flows from oil and gas reservoirs can be reasonably neatly divided into the flush years and the hardscrabble years. It will take expert professional staff work to administer this kind of royalty and I trust the Commissioner is seeing that this is being done. But it is do-able.

2. The Commissioner can let the lessee deduct part of his costs from the royalty base, by combining the fixed royalty with a fixed share of net profit as provided for in option 2 in Act 854. Using his power to define terms, he can combine royalty and net profit bases in any of several ways. He could, for example, reserve for the State the top 20% and then say 25% of net profit after that. Or again, he could levy 20% on all receipts but allow lessees to deduct half their costs. Yet again, he might let lessees deduct all their costs but without allowing any interest on capital invested. I have my own opinions on which of these options is best, but they are hardly relevant. At this point the question is what does the Commissioner think is best, and what is he proposing to do?

3. The Commissioner can require that certain costs be incurred, just as the Forest Service requires successful bidders to observe what it regards as good conservation practices. The Commissioner can impose regulations requiring water injection and gas injection, just as he already does.

4. The Commissioner can lower the royalty rate contingent on the lessee's making certain investments. An obvious point at which to lower the rate is after secondary recovery investments begin. The Commissioner could make the royalty rate contingent on depth that wells have to be drilled, or on other indices of lifting costs. Again this kind of royalty adjustment would call for expert professional staff work and I trust that this is being done. It would be disastrous to arrive at the 11th hour and suddenly discover that there was no viable option except old-fashioned bonus bidding, because of lack of staff preparation.

5. Decades of experience have taught private lessors to put a delay rental into the lease terms. While Act 854 does not seem explicitly to allow for this, I see no obstacle to having lessees pay their bonus on the installment plan, which would have about the same effect. If the lawyers say "no" it should be no great trick to amend 854 if the spirit is willing.

C. INCOMPLETE COLLECTION OF RENT

A fixed royalty at a uniform rate would succeed in stifling marginal production while at the same time failing to collect much of the rent from bonanza producers. If the royalty rate be irrevocably fixed before we know what lies underground there is little remedy for this. However, the Commissioner could under law set a uniform high royalty rate with the understanding that he would lower the rate for all deposits other than those resembling Prudhoe Bay, using his power to lower rates in recognition of high costs. The perils of that course are too obvious to labor so let's look at another solution. The Commissioner could take advantage of the law's delegation to him of authority to go part way towards a net profit base. That is, he could allow total or partial deduction of costs from the royalty base. The purpose of this is to prevent the royalty's stifling marginal production; and therefore allowing a much higher basic rate to be set. This higher rate would capture more of the full rent of the better deposits. Of this, more later.

D. PRODUCTION DELAY

In my 1977 report I stressed that the major unrecognized problem with the high royalty is its tendency to defer production: because the costs of increasing production rates are borne by the lessee, while the benefits are shared with the lessor. But the Commissioner has considerable control over this by his power to regulate well spacing, and I would suggest that so long as the Commissioner's staff is aware of the benefits of adopting policies to maximize discounted cash flow (as opposed to maximizing ultimate recovery), they should be able to control this problem reasonably well. In any event, it should be noted that people other than economists and businessmen do not regard production deferral as a major problem, so that if high royalties do defer production many people would be pleased. And

the great thing is that the royalty achieves the goal of deferring production by raising money instead of by regulation. The way demand for oil and gas keeps soaring, and the way demand is artificially hyped up by underpricing and roll-in pricing and so on, I have lost most of the enthusiasm I once had for accelerating the production of oil and gas.

E. UNREALIZED APPRECIATION

The lessee subject only to a royalty pays you nothing in the early years after discovery even though his wealth has increased by a large factor. Alaska stands ahead of most other jurisdictions in having recognized this loophole years ago and enacting its special reserves tax. Something along the same lines would be useful to supplement a system of high royalties, but that gets beyond our scope today.

III. HIGH PROFIT SHARE

Here, as with royalties, I speak of a "high" profit share rather than "profit share bidding," because these are two separate issues. I would not now advocate profit share bidding any more than I would royalty bidding, for the same reasons. But, I do see a strong case for a high fixed profit share.

Step 1 here is obviously to define "profit." The 1978 act leaves this to the Commissioner. You may think that profit has one standard meaning but, in fact, profit means many things to many different people and this legislative delegation has left the Commissioner with the widest latitude and the widest responsibility. I trust that he is defining profit, or rather that he has already done so because until one defines profit nothing else can be implemented or have any meaning. If there is a time bind at the end it will be tempting simply to borrow tax definitions of profit, and this would be a catastrophe comparable to letting Senator Long of Louisiana write your lease contracts. Here are some basic questions that must be answered.

A. OFF-SITE EXPENSES

Shall we let lessees deduct only expenses incurred on the leasehold site itself; or in Alaska; or anywhere in the world? There is a lot to be said for limiting deductions to expenses on site. This would be consistent with the nature of a lease, which deals with a piece of real estate, as opposed to an income tax, which the lawyers call in personam and which relates to individuals and corporations. It would make the lease terms rather resemble the "net proceeds" tax as it exists in the State of Nevada, and has been successfully administered for many years. It avoids any need to survey and audit the worldwide operations of multinational corporations, but limits deductions to expenses incurred close at home right on your land where they can be seen and evaluated easily. In addition to Nevada, this net proceeds tax approach is used in Idaho, South Dakota and Utah. Its prominent and persuasive spokesman is Robert Paschall, until recently Senior Petroleum and Mining Appraisal Engineer with the California State Board of Equalization. I strongly recommend his several writings on the subject, the latest of which is in the Assessors Journal for December, 1977.

An incidental benefit of limiting deductions to those expenses incurred on site is the encouragement to "local hire." This advantage should not be lost on legislators who frequently are under more pressure to generate local employment than to maximize State revenues. This net proceeds approach to defining profits is not impossibly hard to administer. Robert Paschall tells us that we need only an accountant to audit expenses and an engineer with field experience to pass on the reasonableness of expenditures and capital outlays. But you definitely need more than borrowed income tax data, or rather less than income tax data, but definitely different data. The net proceeds definition is what the lawyers call in rem, that is based on the parcel of real estate instead of the personal

circumstances of the lessee. The lessee cannot avoid it for example, as he could an income tax, by borrowing heavily and deducting the interest. So we have to ask, is the Commissioner ready to consider this alternative, or is he only ready to borrow data generated by and for the Internal Revenue Service?

B. DEPRECIATION PATHS: THE SCHEDULING OF WRITE-OFF OVER TIME

1. WITH OR WITHOUT INTEREST

Do we let the lessee deduct simple depreciation on his capital invested, or do we let him also deduct interest at some rate on the unrecovered balance? There is a good case for letting him deduct interest, and raising the basic rate to compensate for the loss. There is also a good case for keeping the allowable interest rate down around 6% or so in order to avoid goldplating. But, this is just my opinion. The important question now is what is the Commissioner's plan -- how will he handle this, and why?

2. PER YEAR OR PER BARREL

It probably would make sense to let capital outlays be deducted from profits on a basis of so much per barrel of production, thus creating a positive incentive to produce, and offsetting the royalty rate in part. There is a case for saving the credit per barrel until late in the game when production is becoming marginal and an offset is needed. There is another case for letting the lessee deduct it up front, in order to favor those producers with the most acute need to recover their capital quickly. I myself lean towards the idea of deferred recovery with a fixed interest rate allowed on unrecovered capital, but the important question now is what is the Commissioner's position?

C. PADDING AND CHISELING

Walter Mead, in his comments on House Bill 854, dated May 15, 1978, has provided an impressive list of chisels that an administrator must guard against with a net profit lease. We must be sure to exclude off-site expenses, for one.

We must exclude expenses properly assigned to research and development. We must exclude any incremental expenses caused by allocating bad equipment to our site. We must exclude training expenses. We must exclude public relations expenses. You get the general drift. We need an accountant with oil field experience to audit expenditures closely, and we need an engineer with field experience to evaluate unusual spending, just as Robert Paschall said. It seems clear that we also need compliance rules with penalties for chiseling and cheating.

Another chisel that calls for special attention is the understatement of price. This becomes extra important with a profit sharing lease because profit is much more sensitive to price than gross revenue is. This could call for drastic measures including even a State Marketing Agency such as British Columbia uses for marketing its natural gas.

A great deal is said about the danger of goldplating. The answer here I think has already been suggested. That is, that we only allow the deduction of capital outlays with an interest rate on invested capital of 6%, which is well below the market, and not therefore high enough to occasion any goldplating.

Extending the same thought there is a general precaution to take against all padding and chiseling, and this is simply to allow the deduction of less than full costs. This creates a system which is a hybrid, combining the principle of a royalty based on gross with a net proceeds charge from which costs are deductible. Thus, by combining and balancing the working principles of the two different systems and mixing in some common sense, professional expertise and dedication to the public interest, we can get a good workable system.

I hear industry spokesmen criticizing net profits leases for causing excessive outlays on capital and expenses, and in the next breath criticizing royalty systems for destroying the incentive to lay out capital and expenses.

This suggests there must be a middle ground where the depressing effect of the royalty is more or less offset by the overstimulating effect of net profit sharing. We must not let industry critics scare us, at any rate, with both bogeymen at once, because they are exact opposites and mutually offsetting.

CONCLUSION

Administering a good leasing system will cost some money. That's okay, you have to spend money to make money. We are looking at tens of billions of dollars in State-owned assets. Administering and leasing public lands is as delicate as an appendectomy, and much less routine. The men working the other side of the street are pros, out for the best deal they can get, and they have a track record scoring some real lulus, dealing with disorganized, confused, unsophisticated citizens -- people a lot like us. We should not hesitate to pay well for people to guard our interests.

I am frankly concerned that the Department of Natural Resources has not been back here beating on your doors for more staff and more compliance powers.

There is always this temptation to say it is all too complicated and go back to the simple old front money system. Yet, a lease for oil and gas is no more complex than the standard deal between a cinema distributor and a theatre owner. Businessmen are used to working with complex contracts, risk sharing arrangements, and joint ventures. It is we, the general public, who are too soon tempted to stop scratching our heads, grab the money and run. That is the worst mistake we can make.