Oil and Gas Leasing: a Study in Pseudo-Socialism

Mason Gaffney, 1983; rev. 2/93

Paper delivered at Annual Conference, Western Tax Association

Queensway Bay Hilton, Long Beach, CA, June, 1983

INTRODUCTION

I pose three questions.

I) What is Socialism?

II) What is pseudo-Socialism?

III) How should we administer public lands bearing oil and gas?

I. WHAT IS SOCIALISM?

"Socialism," in common usage, is a Protean word, slippery and shifting. Many use it without defining it, whether from innocence, negligence, or cunning. These many include not just the vulgar, but most economists: semantic care is weak in the traditions of the profession. "Rigorous" model-builders today are among the offenders: the premium is on gilding the superstructure, neglecting the foundation. Indeed, foundations are not even needed for models that float in outer space, vouching for and communing mainly with each other.

Those who do define Socialism, explicitly or implicitly, use the word for different things. A major difference, treated here, is between Managerial Socialism (who decides) and Distributive Socialism (who gets). These may overlap, but are independent of each other and often conflict. For example, Riverside, CA, owns its own electric utility (on whose Board I sit, losing battles). This is Managerial Socialism, municipal style. Its traditional rate structure includes large elements of cross-subsidy, mainly taking from the lower middles for the rich, tempered by crumbs thrown to the very poor. The same is true of our water system, and of most municipally owned and managed utilities around the nation. Water and sewer service are common examples of Managerial Socialism (from which the mnemonic "sewer socialism"). They have little in common with Distributive Socialism.

At higher levels of government, also, Managerial Socialism may play reverse Robin Hood. In British Columbia the "Socred" (right-wing) party in the 1960s socialized the ferry service, the provincial railroad, and the electric utility (now B.C. Hydro), using them in schemes to enrich land speculators. To boost along B.C. Hydro they raided the teachers' pension fund, borrowing from it at rates near zero. The New Democratic Party (NDP) (left-wing), taking power in 1972, ended the raid on teachers, but not the cross-subsidy. In California, the State Department of Water Resources (DWR) designed, built, and operates the California Water Plan (CWP) for the primary gain of a handful of giant landowners. They, too, raided education, taking certain State oil revenues (known as the COPHE fund) previously earmarked for The University of California. Such examples could, of course, be extended at length.

Another form of Managerial Socialism is direct administration of public lands. Our National Forests are an example. The track record is not good. The Forest Service manages a national asset worth over $100 billions, from which it generates no positive cash flow. Latent surpluses die a-borning. At one time this was from an excess of ideological commitment to slow cutting cycles and "community stability," as exemplified by Congressman James Weaver's dedication to Roseburg, OR. More recently it is from internalizing profits and plowing them into roading submarginal forests for premature cutting. Either way it soaks in revenues from other sources, yielding nothing back. Even if one likes the model, it could not be universalized.

More commonly, public landlords lease lands to private firms, limiting their managerial input to dirigisme expressed in regulations and guidelines. The Bureau of Land Management (BLM) thus administers its vast empire as mainly a passive landlord. Its main task is just collecting rents. To the extent The Bureau does a good job, or Congress lets it do a good job, this evinces more of Distributive than Managerial Socialism. To the extent it does a bad job it is "Pseudo-Socialism," to be discussed presently.

Distributive Socialism, in contrast to Managerial, means tapping surpluses in the private sector and using them for the public good. The revenues may provide public services that are available to all, like schooling and social security; or be used to abate regressive taxes; or be used to finance social dividends paid in cash, as in Alaska. Revenues may also be used to finance public works, even though these benefit only a few specific landowners. This becomes Distributive Socialism when the enhanced land rents are tapped to recoup more than the allocated expenditure. (If only expenditures are recouped, it is more like a contract between the state and the landowners.)

Interjurisdictional transfers are not properly "Socialism," but a reshuffling of rents among landowners. These transfers are called "horizontal balancing" in the lingo of fiscal federalism. They are a long step removed from the social dividend paid to individuals as such. They are properly decried for "taxing poor people in rich places to help rich people in poor places." These "poor places" include developmental regions and local districts, poor today but prospectively rich, where landholdings are large and speculative. Horizontal balancing devices thus fall in a class of artful dodges, seductions, and diversions leading from Distributive Socialism to Pseudo-Socialism.

Distributive Socialism also means administering public lands pro-actively, affirmatively, to maximize revenue, in the manner of private landlords. Not to do so is to let private lessees keep and privatize the surpluses generated by resources in the public domain. The NDP in B.C. earned its Socialist stripes by raising rents on Crown lands owned by the Province ("The Crown Provincial," in Canadian terms). The Minister of Lands did this directly by renegotiating timber and other leases, on a site-specific basis.

The NDP Administration tried to socialize the surpluses in gas production by joining Managerial and Distributive Socialism in the B.C. Gas export monopoly, a Crown Corporation. It was to levy a tax in the form of a monopoly profit on gas transmission and export. Here they stumbled by failing to recognize the differential, site-specific nature of rent. They made it too easy, thinking it was just a matter of buying low and selling high, across the board. They set a uniform field price. It was, naturally, too low not to stifle high-cost producers, and yet too high to tap most of the rent taken by low-cost producers. They failed to rifle in on the source of the surplus.

Thus, to define Distributive Socialism we need to define "surpluses." These are primarily rents from lands and resources given by nature. In an open tax jurisdiction, labor and capital are mobile and their supply is elastic; only land is fixed. Land rent is the basic taxable surplus. Where there is no land rent, an attempt to levy any tax can only abort production and land use, rather than collect the tax. Where is there no land rent? First, there is no rent generated on "marginal" land that is just barely worth using at all. Second, and more generally, there is no rent generated by marginal increments of labor and capital applied on any land, from the best to the worst. Otherwise, all production on land generates some rent, which is a taxable surplus.

The statement above expresses "The Physiocratic Doctrine" of tax incidence, harking back to Francois Quesnay, and even earlier writers like John Locke and Jacob Vanderlint. The Doctrine has staying power: it is used, for example, by Bogart, Bradford, and Williams writing in the *National Tax Journal*, December, 1992, on tax incidence in New Jersey.

Capital, unlike land, migrates among taxing jurisdictions. The return to reproducible, depreciable capital is not, therefore, generally a surplus. Capital differs from land. Capital has to be attracted, and, if domestically generated, dissuaded from emigrating. It is true that in the short run existing capital, if affixed to land, cannot be exported. Its returns thereby become a temporary taxable surplus - hence the name "quasi-rent." Capital can still be dissaved, however, through neglect of maintenance, and will not be replaced. The demonstration effect of disappointing old investors' earlier expectations will have a high cost in repelling future investing by them and others. Old buildings, unmaintained, will shed blight on their surroundings. Non-replacement, in a dynamic world, guarantees early obsolescence. Capital finds many subtle ways of emigrating, or being disinvested and consumed. Its yields are not really a taxable surplus when we factor in the consequences of trying to tax them: withering away of the community.[1]

The Physiocratic rule, which may seem novel and subtle in tax discourse, stands out nakedly whenever landowners, public or private, negotiate leases. If a lessee is required to pay a share of his gross sales (a royalty), he compensates by offering that much less on the "bid variable," (often a "bonus" paid up front). Lessors and lessees understand this well: it is central to all their negotiations. Whatever the twists and turns, the rule of compensation applies: take more here, get less there. The lessee is to supply labor and capital at full cost; acquiring use of land will yield him a surplus above costs. That surplus is all he can and will pay for. The maximum of economic surplus is the rent of land in its highest and best legal use.

Distributive Socialism, then, means tapping land and resource rents for the public. On the public domain, acknowledged to be public property, the institutional basis of Distributive Socialism is fully in place. We need only apply a good leasing system, keeping rent payments up to current values. On fee simple lands, Distributive Socialism means and requires modifying tax systems to rifle in on rents.

Rifling in is essential. Recall, the Physiocratic rule of compensation says all taxes are shifted to rents anyway; some take that to mean any tax will do. However, "broad-based" taxes like VAT

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[1]These strictures apply a fortiori when the substance of capital, along with the yield, is taxed away.

or a general sales tax sterilize lands that would be just marginal before tax. They also abort all marginal and near-marginal activity on all lands, for marginal inputs (where marginal cost equals price) generate no rent. That in turn forces rates to be kept low, to avoid destroying half the economy. Such taxes socialize all the rent from lands that are now made marginal after-tax, but leave most rent untapped on the most rentable lands and resources. Taxes that rifle in on rent, on the other hand, inherently exempt marginal activity. They may be set at very high rates, tapping more of the taxable surplus, or rent.

Analogously, recall the case of the B.C. Gas Corporation cited earlier. This is a public agency set up to extract rents from gas resources by monopolizing export, buying low and selling high. Its fatal initial error was to set a uniform field price. This price must remain fairly high to avoid stifling the high-cost (marginal) producers. As a result the price is high above that needed for the low-cost producers, leaving them enjoying the rent of the resource.

Let's look at a simple numerical example, to make the point. Say the uniform field price is set at $1/mcf, while costs of production range from 20 cents to $2 per mcf. All producers with costs over $1 are wiped out; all those with costs under $1 are left taking a surplus per unit of $1 less their respective costs. The example is useful to understand how taxes work, too. The B.C. monopoly cut is just like a tax levied on each unit of production.

Whether on public domain or fee simple lands, Distributive Socialism has three compelling attractions. One is, it requires no Managerial Socialism; it may work through the free market. It does not preclude elements of Managerial Socialism, where these are otherwise desirable; it simply does not require them.

The second attraction is that it lets taxes be progressive without impairing incentives. Taxes that rifle in on rents are progressive and distributively socialistic because the ownership and control of rent-bearing lands is highly concentrated in a few hands.

The third attraction is that taxes on rent may be heavy without impairing incentives, precisely because rent is a surplus. The land-tax component of the existing property tax is a good model. With this tax, there is no “taxable event” required. Taxes are simply due periodically, based on an external assessment of the land's market value, which in turn derives from rent of its highest and best prospective use.

Most political leaders live and orate in a world of dismal choices and trade-offs. To them, there is no cutting the deficits, either state or federal. We must cut taxes or lose jobs. We must make taxes regressive or destroy useful incentives. On the other hand, once we define, identify, and rifle in on rent as taxable surplus, those hard choices vanish. We can have higher taxes and more jobs, both at once. We can tax progressively while simultaneously enhancing incentives to produce and save.

Likewise, on lands still in the public domain, we can rifle in on rent by framing and administering a good leasing policy. Leasing does have some transaction costs, but the private market does it anyway. There is a reasonable, if less than perfect, track record. Ground leases are common in downtown real estate, nationwide, even under imposing structures like the Empire State Building, and Rockefeller Center. The Irvine Company, holding 20% of Orange County, California, has long declined to sell land, but only lets it for intermediate terms. Much of Hawaii is developed on the same terms. Most oil and gas is developed by lessees on private land, yielding large rents to the lessors.

Why cannot the U.S. Government as lessor do what private lessors do, extracting the surplus for the owner? Here we meet the obstacle of Pseudo-Socialism, to which we turn.

II. WHAT IS PSEUDO-SOCIALISM?

Pseudo-Socialism is what happens when resources in the public domain are leased below a market rental, giving away part of the public interest. That has the effect of installing the lessee as though he were the owner. The BLM, leasing grazing privileges on Federal lands in the west, has fallen into this pattern conspicuously and notoriously, subject to pressure from western Senators who have the power of many votes in the U.S. Senate relative to their state populations. The dollar values are small, but the object lesson is visible, depressing, and cautionary.

Some other bad examples are school section lands in the middle states. These originated as Federal land grants intended to support local schools. Some of them are corruptly let to insiders in "sweetheart deals" for token rents. Another bad example is the County of Los Angeles, which owns lands in the Marina del Rey district. One parcel lay idle for 25 years in the control of a politically well-connected developer who finally went bankrupt and walked away from it, leaving unpaid even the token rent charged. A third bad example is ironic: Fairhope, AL, founded and chartered specifically as a "single-tax colony," to exemplify the principles of Henry George. The Fairhope Corporation owns the land and collects the ground rent for public purposes. However, when a new generation arose "that knew not Joseph" it proved politically impossible to keep colony ground rents up to market.

Another aspect of Pseudo-Socialism, practised by Interior Secretary James Watt, is to offer for immediate sale, for spot cash, much more than the current market can absorb. For example, in April, 1982, Interior leased out coal reserves in the Powder River Basin of Wyoming and Montana. The sale comprised 1.6 billion tons, at 3.5 cents/ton. Leases were for 50 years, with few development requirements. The industry already had a 200 year supply under lease, with the result that few bid, and they bid low. The winning bidders were a tiny number of huge corporations, those with slack money to buy reserves for the far future.

Meantime, on the Outer Continental Shelf (OCS), a billion acres (ten times the area of California) was to be leased before 1984. Before that, major oil firms had about 1/5 of that area under lease, looking many years or several decades ahead of need. This helps explain why a recent Alaska sale, an old Naval Petroleum Reserve (NPR 4), fetched only 14% of the anticipated amount.

Who buys to hold these vast reserves for distant future use? They are of investment grade only for those with waiting power. Unripe lands and resources are probably the most closely held assets there are. Poor people and small businessmen need busy capital right now. Only a few of the wealthiest people have the deep pockets and slack money to buy far ahead, to maintain high reserve/output ratios. These markets in far future values are their special preserve.

What is being bought? Are these not "leases," contracts to pay rent? No, these leases are not that. Here is the heart of Pseudo-Socialism. The U.S. Government leases mineral-prone lands under the “Bonus Bid System,” whereby most of the payment is required up front in spot cash. This makes a “lease” more like a sale, a sale in which buyers are screened by their banking connections rather than by their ability to find and produce hydrocarbons.

The bonus system originated on private uplands. It was a way for big oil firms to dazzle various rustics, pressed for cash, by tempting them with front money for their mineral rights. The companies had the cash, the connections, and intimidating expertise; they wrote the rules their way. The rules included a cap of 12.5% on the long-term “royalty,” the only means by which lessors participated over the long pull, and retained a share in gushers and bonanzas that proved in excess of original estimates - estimates much better known to the bidders than the lessors. When the companies moved onto public lands they brought the same system with them. It was by then an industry standard.

The only “bid variable” in this system is the bonus. With the royalty capped, there are large potential surpluses to attract bonus bids. The Physiocratic rule of compensation applies: a low royalty translates into a high leasehold value. The advantage of this to “the industry” - meaning the largest firms that are its most visible spokesmen and exemplars - is that it screens out many bidders, those pressed for front money. It reserves the field for a much smaller number of players, increasing their bargaining power.

All that may sound familiar to students of 19th Century American history, and the privatization of the vast Federal domain. It is a long story of conflict between cash sales and more democratic means of placing lands. Those with cash and bank connections naturally favored cash sales. President Jefferson saw the merit in credit sales, so from 1801-20, sales were on credit. The system was badly administered, but so were all other systems of land disposal tried in that era. Collections became a problem, yet landownership was democratized. It enabled Andrew Jackson to proclaim on Thanksgiving Day, 1835, “We thank Thee for the absence of unemployment which in the King-ridden countries of the world is causing widespread suffering among the toiling masses and has led to riots ... (and that) there will be none to freeze, starve, or be beset by the fear of want this winter or the winters yet to come.”

Following the period of credit sales, the return to cash sales re-introduced front-money bias. Small owners still had ways of fighting back at the state and local levels. States and counties and their subdivisions relied mainly on the property tax. They used this with good effect, often quite deliberately, to induce absentee speculators to release large holdings for sale and settlement. The impact of land taxes is analogous to that of credit sales. The specter of future taxes is capitalized into lower current land prices. They in turn let one buy cheaper up front, in return for a higher level of deferred payments. The net effect is like extending permanent credit on equal terms to all potential buyers, something private credit markets never do or could be expected to do.

Thus, the property tax, especially on land, is twice effective as an instrument of Distributive Socialism. First, it rifles in on the rent surplus and socializes it. Second, it democratizes the ownership and operating control of land. Thus it achieves something akin to the “worker control” that is an ideal avowed by many modern Socialists, melding egalitarian distribution with egalitarian management and control. To be sure, it does so in a small-business framework, an ideal that is traditionally Populist, not Marxist. However, in this new post-Communist age, when Socialists are seeking new ways to express their yearnings for the good society, they might want to reconsider the value of this approach to worker control. Perhaps Marx, like other reformers of his generation, was oversold on the economies and inevitable triumph of large scale capital and organization, and the substitution of capital for labor. Perhaps small is beautiful, after all.

Today's industry is faced less with the property tax than the income tax. Most state property taxes are applied only at low levels to mineral-bearing lands. Worse, the most active leasing today is on the OCS, outside the tax reach of any state or county, and so exempt from property taxation.

The Federal income tax does reach out to the OCS. Its effect, however is to redouble the industry's support for the bonus system by treating bonuses most favorably. The bonus, being a cost of land acquisition, might normally not be easily deductible or depreciable. Oil and gas are exhaustible, however, so the bonus might reasonably be written off slowly on a unit-of-production basis, or by means of the depletion allowance where that is still used. In the distinctive conditions of frontier oil exploration, however, much of the bonuses paid are deducted before production even begins.

It works like this. In the normal course of exploration, some five leaseholds are taken and explored for every one where post-leasing drilling will show commercially producible hydrocarbons. The other four may be “abandoned,” which means the lessee formally terminates the lease. At this time, which the lessee may choose at his tax convenience, all bonuses previously paid are taken as current expenses, fully deductible in the year of abandonment. In addition, all pre-leasing exploration costs that the lessee assigns to the abandoned leaseholds are expensed also. Thus, before production begins, the exploring firm may have expensed 80% of its land acquisition costs.

Expensing on so large a scale is useful, of course, mainly to large, diversified firms with other income against which to take the expenses. Partnerships of high-tax-bracket individuals are also involved. This works in tandem with high front-money requirements to screen out smaller, leaner firms, leaving easier pickings for the larger firms and deeper pockets.

The lease not abandoned, whose value has been acquired and built-up by costs that are mostly expensed, may now be sold as a “capital asset,” with all the preferential tax treatments appurtenant thereto. The buyer, in turn, now begins a new set of games for deducting his acquisition cost. We do not spell these out, but the overall result is extremely easy tax treatment compared with most other businesses.

Many economists allege that the bonus system is the best way to collect rent from the public lands. The lands are public; the industry pays for them; bidding is modestly competitive; and the industry is subject to taxation. All those conditions seem favorable to making it a case of applied Distributive Socialism. However, for the reasons given, the net result deserves better to be called “Pseudo-Socialism.”

III. ADMINISTERING PUBLIC LANDS FOR JUSTICE AND EFFICIENCY

Here are four corners of an effective policy for socializing rent from public lands: participate in revenues; control time of lease sales for the seller's best advantage; participate in exploration;

and participate in marketing. Some detail follows. The writer has elaborated the points elsewhere.[2]

A. Participating in revenues

1. Defer payments. Access to private equity and credit is extremely uneven, putting most potential bidders at a fatal disadvantage relative to the wealthy few. Deferring payments according to any uniform formula has the same effect as extending long-term credit to all parties on equal terms.

2. Vary payments according to what is on the site, as that is disclosed by exploration and production. This shares risk with the lessee, and has somewhat the same effect as providing insurance. It does somewhat dilute incentives at the margin, but this can be largely offset by sharing in costs. Arguably, such risk-sharing actually raises marginal incentives, on balance. Such, at least, is a standard theorem in the literature of income taxation.

Such variation of payments, as with a royalty, also shares other kinds of risks, like price.

3. Give credits for lessee inputs, writing these off against later royalties.

4. Leave a bid variable to soak up any advantage of the leasehold site that the lessor has overlooked in setting the parameter charges, but sharp or sanguine bidders detect. Thus exploit the Physiocratic rule of compensation.

5. Limit the area leased to any one person or firm, especially where there is a high royalty rate (lessor participation), and consequent low cost to lessors of holding land unused. This is the practise of private landlords, as analyzed and documented in the works of Stephen Cheung.

B. Timing lease sales

Sales need to be deferred until the lands are economically “ripe,” from the seller's viewpoint. Ripeness, roughly speaking, is a condition when the growth rate of value over time falls to equal or less than the interest rate. “Value,” in this context, is the anticipated high bid. The tendency today is to time sales by industry “nominations,” meaning at the convenience of certain powerful members of the industry. These may well be firms that have a lead in exploring a certain frontier area, and a competitive edge to exploit before other firms know as much as they. Even if several firms are involved, every member of the group would like to get in on the steep part of the growth curve, meaning growth of value.

C. Participating in exploration

Public landlords today generally know less about their own property than do private firms. The firms have leave to range all over unleased lands, taking seismic soundings, studying satellite images, developing sophisticated, top-secret computerized models of the geology, even doing a bit of exploratory, pre-leasing drilling. When potential lessees know more than the public's agents, the latter's bargaining power is deeply eroded.

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[2] *Oil and Gas Leasing Policy: Alternatives for Alaska in 1977*. A Report to The State of Alaska, Jay S. Hammond, Governor; Alaska Department of Natural Resources, Guy Martin, Commissioner; and Alaska State Legislature, Interim Committee on Oil and Gas Taxation and Leasing Policy. Juneau, 1977. Pp. i-ix, 1-132, plus Technical Appendices A-K, by myself, Michael Crommelin, Richard Norgaard, and Robert Rooney.

The public may protect itself in several ways. One is to do some drilling of its own -- it may hire the same contractors used by industry. Another is by checkerboarding followed by “drainage sales”: sales of parcels abutting proved producing leaseholds. A third is by registering all well logs.

D. Participating in marketing

Royalties received by lessors are a percentage of wellhead price, but who sets the price? Transfer pricing scams are all too common in an industry whose dominant firms are vertically integrated. The public landlord may well want to take its share of production in kind, using its own marketing agency, to avoid being exploited. The mere threat of such a yardstick would have a profound effect on wellhead pricing.

CONCLUSION

Is there any chance that Distributive Socialism will make headway on the OCS, and other Federal lands? There is always a chance. The lands, after all, are public, as a matter of history. However conservative the administration, none would take pride in giving away its assets. A business oriented administration need not call it any kind of “Socialism.” It prides itself on businesslike management of public assets. It is our little secret that businesslike management in this case is the essence of Distributive Socialism.

What about James Watt? He was the most unpopular figure in Reagan's Cabinet, just as Douglas McKay was in Eisenhower's, and Albert Fall was in Harding's. The public does not find giveaways and sweetheart deals attractive. On the other hand the public does not always recognize giveaways when there is some subtlety involved. The appearance of open bidding, and substantial bonus payments for leaseholds, may be enough to appease the public, the moreso when the appearance of true competition is reinforced by the endorsement of many respected economists.

What must be inculcated in everyone's thinking is the essential difference between competition with front money, and competition where payments are deferred. The first is limited competition, with places reserved for an affluent few. The second is evenhanded, democratic competition on a more level playing field, where preferential access to credit confers no differential advantage. This is the condition under which Distributive Socialism can coexist with, and reinforce, a free market economy. It is achieved on fee simple lands by subjecting them to heavy land taxes, whereby newcomers can buy in at low prices in return for paying more over time. It is achieved on public lands by writing leases with high lessor participation over time, and low bonuses required up front.