Oil Industry Tax Issues in the FY2010 Budget Proposal

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Summary

President Obama, in an Earth Day speech, addressed the linkage between the problems he associated with U.S. reliance on imported oil and the importance of a future based more on alternative energy sources. These problems could be partially addressed by reducing what the Administration sees as favorable treatment of the oil and natural gas industries that were designed to increase production of petroleum products.

The FY2010 budget proposal outlined a set of proposals, framed in terms of deficit reduction, or the elimination of tax expenditures, that would potentially increase the taxes of the oil and natural gas industries, especially the independent producers. These proposals included an excise tax on Gulf of Mexico oil and natural gas production to limit previously granted royalty relief, repeal of the enhanced oil recovery and marginal well tax credits, repeal of the expensing of intangible drilling costs and the deduction for tertiary injectants, repeal of passive loss exceptions for working interests in oil and natural gas properties, and the manufacturing tax deduction for oil and natural gas companies, and the increasing amortization periods for certain expenses and the repeal of the percentage depletion allowance for independent oil and natural gas producers.

It was estimated that these changes would provide $12.7 billion categorized by the Administration as deficit reduction over the period 2010 to 2014. The changes, if enacted, also would reduce the tax advantage enjoyed by independent oil and natural gas producers over the major integrated oil companies. On what will likely be a small scale, the proposals also will make oil and natural gas more expensive for U.S. consumers, with the effect of reducing consumption of those fuels.

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Background

In an Earth Day speech, President Obama linked the importance of winning the technological race to develop clean energy sources with the economic problems associated with U.S. dependence on oil. The President said that the federal deficit, the trade deficit, as well as global warming, were all related to U.S. dependence on oil, especially imported oil. He also described a fickle attitude held by American consumers, who typically are outraged by high gasoline prices or shortages, while displaying apathy toward the issue of oil prices during periods of low prices.[1]

In a market economy, the government can alter the behavior of consumers and producers through tax and subsidy policies. If the government wants to discourage the consumption of a commodity, it can raise the cost of the good to consumers by levying taxes at various stages of the production process, or by levying a tax at the point of sale. Typically, the higher cost faced by the consumer will lead to reduced consumption. If the government chooses to encourage the development of a technology or a good, it can lower private costs through various types of subsidy, which may then benefit consumers in the form of lower prices.

Given the President's position, as reflected in his Earth Day speech, his FY2010 budget proposal includes both subsidies for alternative energy sources and increased taxes on the oil industry. This report analyzes the likely economic effects that might occur if the President's proposed tax increases on the oil industry are enacted by Congress.

During most of the 20th century the oil industry received favorable tax treatment in comparison with other U.S. industries through tax provisions such as the percentage depletion allowance and the expensing of intangible drilling expenses. Favorable tax treatment helped to keep petroleum product costs low, and encouraged consumption. Low gasoline prices were a factor in both residential and business location decisions, holiday travel, and other aspects of American life. These decisions represent economic investments which might no longer be viable if the relative price of gasoline and oil increase. For example, when the price of gasoline rose to more than $4 per gallon, based on oil prices that rose to over $145 per barrel, during the second half of 2008, consumers shifted their spending away from sport utility vehicles and light trucks toward more fuel efficient vehicles, reducing the sales and profitability of the U.S. automobile industry, and accelerating the collapse of the industry. Shifting the energy consumption pattern from oil to alternative fuels is unlikely to occur without adjustment costs to consumers and U.S. industry.

The Fiscal 2010 Budget Proposal

Under the pressure of an economic recession that began at the end of 2007 and continues in 2009, a financial crisis which has required support of the banking system and financial markets, and the costs of new policy initiatives in healthcare, carbon emissions, and other areas, the level of projected federal deficit is a matter of concern.

The desire to shift the nation away from oil, and to try to control the federal deficit, has led to a number of proposals to increase taxes on the oil industry. Many of these proposals represent the

[1] *Oil Daily*, "Obama Says U.S. Must Win Clean Energy Race," Vol. 59, No. 77, April 23, 2009.

elimination of tax expenditures.[2] **Table 1** identifies the proposed tax changes for the oil industry, and the White House's estimates of the revenues, or in its terms, deficit reduction, generated to 2014, if enacted by Congress. Many of these measures have the effect of equalizing the treatment of the independent oil producers to that of the major oil companies. This equalization is accomplished through eliminating preferential tax treatment of the independent companies compared to that of the major oil companies. In some cases, for example, the expensing of intangible drilling expenses, the major oil companies have been excluded from the benefits of the tax provision while the benefit was still in effect for the independent oil producers.

Table 1. FY2010 Budget: Oil Industry Tax Proposals

(revenues in millions of dollars)

	2010	2011	Total, 2010-2014
Excise Tax on Gulf of Mexico Oil and Gas	-	582	2,273
Repeal Enhanced Oil Recovery Credit	-	-	-
Repeal Expensing of Intangible Drilling Costs	-	347	1,863
Repeal Deduction for Tertiary Injectants	-	5	31
Repeal Marginal Well Tax Credit	-	-	-
Repeal Passive Loss Exception for Working Interests in Oil Properties	-	2	19
Repeal Manufacturing Tax Deduction for Oil and Natural Gas Companies	-	757	4,924
Repeal Percentage Depletion for Oil and Natural Gas	-	316	2,953
Increase Geological and Geophysical Amortization Period for Independent Producers to Seven Years	-	41	668
Total	-	2,250	12,731

Source: Table S-6, *A New Era of Responsibility,* available at http://www.whitehouse.gov/omb.

Notes: (-) means program will have no effect.

As shown in **Table 1**, none of the proposed revenue changes are estimated to have a significant effect in 2010. Almost 80% of the total proposed tax changes would come from only three of the proposals. These three proposals are likely to increase total taxes on the oil industry: an excise tax on Gulf of Mexico oil and natural gas production, the rescinding of the manufacturing tax deduction for the oil industry, and the repeal of percentage depletion.

[2] Tax expenditures are the losses to the U.S. Treasury as a result of granting deductions, exemptions, or tax credits to specific categories of taxpayers. For additional analysis of energy tax expenditures, see United States Senate, Committee on the Budget, *Tax Expenditures, Compendium of Background Material on Individual Provisions,* December 2008, pp. 97-228. Available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_senate_committee_prints&docid=f:45728.pdf.

Excise Tax on Gulf of Mexico Oil and Gas

Oil and gas producers operating in federal waters in the Gulf of Mexico pay up to a 16.67% royalty on revenue from existing production. New production, defined as production after March 2008, is subject to an 18.75% royalty rate. However, a program to encourage deep water drilling allowed a zero royalty rate until a set level of production was attained. This production, which is currently not paying any royalty, is what would be subject to the new royalty provisions of the 2010 budget. The new rate is not, then, a new excise tax on Gulf production, but could be considered as the reversal of an earlier tax expenditure.[3]

Under normal economic circumstances, an excise tax on the production of a good is likely to reduce its production level and increase its price. However, the production of oil and natural gas might not be goods subject to normal economic circumstances. The price of oil is determined on a world market and over the past five years has generally been sufficiently high to cover even the costs of relatively high cost producers. During the period from 2004 through 2009, prices have at times reached record levels, resulting in record setting profits for the oil industry. Under these circumstances, it is unlikely that the excise tax, especially one that "leveled the playing field" between various Gulf producers, would result in higher consumer prices for petroleum products or curtail output because the independent oil producers are not likely to have the market power to pass the excise tax on to consumers.

While it is likely true that the existing exclusion from royalty payments may have acted as an incentive for encouraging exploration and development, it does not necessarily follow that the incentive should be left in place to keep the wells producing. As long as producing wells are covering costs, it is likely that they will be kept in production with little or no reduction in output.

It might also be argued that the imposition of the excise tax reduces the incentive to invest and expand domestic production in the affected exploration areas. However, this is unlikely to happen unless the companies have alternative investment opportunities available in other areas that offer lower government taxes and lower costs. A recent study by the Government Accountability Office found that the total government take in the U.S. was low compared to what oil companies must pay to other nations in production royalties and taxes.[4] The implication is that even if effective repeal of the royalty exclusion through the imposition of an excise tax might be a disincentive to continued exploration and development, the oil companies might have a difficult time finding better alternatives, yielding little change in investment activity.

Repeal Enhanced Oil Recovery Credit[5]

The enhanced oil recovery tax credit allows for a credit of 15% of allowable costs associated with the use of oil recovery technologies, including the injection of carbon dioxide to supplement natural well pressure, that enhance production of older wells. The credit is only available during periods of low oil prices, determined by yearly guidance with respect to what constitutes a low

[3] An excise tax is a tax levied on a specific product.

[4] United States Government Accountability Office, *Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners*, GAO-07676R, May 1, 2007, p. 4. "Government take" refers to the total of taxes, royalties, fees, and other instruments used around the world by nations to claim a portion of oil revenues generated by their domestic production from oil companies.

[5] Tax credits are direct dollar-for-dollar offsets to the companies' tax liability.

price. The credit has not been in effect over the past several years. Elimination of this credit would likely not have any effect on current oil supplies, unless the price of oil fell. Prices generally fall in a market characterized by excess supply. During periods of excess supply, it is unlikely that keeping older, high cost, low production rate wells producing is the optimal strategy, based on the likely inability of the price of oil to cover the costs associated with operating these wells.

Repeal Expensing of Intangible Drilling Costs

The expensing of intangible drilling costs has been part of the federal tax code since 1913. Intangible drilling costs generally include cost items that have no salvage value, but are necessary for the drilling of exploratory wells or the development of wells for production. The purpose of allowing current year expensing of these costs is to attract capital into what has historically been a highly risky investment. In recent years, however, the risk associated with finding oil has been reduced, but not eliminated, by technology, including three-dimensional seismic analysis and advanced horizontal drilling techniques. These advances make expensive "dry holes" less likely, and expand the physical range of exploration and production available from drilling rigs, reducing the cost of exploration of prospective oil fields.

Currently, the full expensing of intangible drilling expense provision is only available to independent oil producers. According to White House estimates, elimination of this tax provision is expected to contribute more than $1.8 billion in deficit reduction over the period 2010 to 2014, and approximately $3 billion by 2019. The Independent Petroleum Association of America (IPAA) estimates that revoking the expensing of intangible drilling costs provision might reduce investment in U.S. oil development by about $3 billion in the future.[6] The IPAA estimate of reduced oil development appears to be based on an assumed dollar for dollar decline in investment activity for every extra dollar of tax paid, with no empirical evidence to support this assumption.

The actual decline in oil resource development as a result of eliminating this tax preference is likely to depend on the price of oil. If the price of oil settles in the $40 per barrel range that prevailed in December of 2008, the burden of additional tax expense could reduce drilling activity. The combination of low price and additional taxes might not justify the development of relatively high cost resources, especially in deep waters, as in the Gulf of Mexico. However, if the price of oil exceeds $100 per barrel, as prevailed during the summer of 2008, the additional tax expense is likely to have a smaller effect in reducing oil development activity.

Repeal Deduction for Tertiary Injectants

Tertiary injection expenses, including the injectant cost, can be deducted in the current tax year. Supporters of the current favorable treatment of these expenses point to the importance of tertiary recovery in maintaining the output of older wells, as well as the environmental advantages of injecting carbon dioxide, a primary tertiary injectant, into wells. Repeal of the deduction or less favorable tax treatment of the expenses would be likely to reduce output if the profit margin on

[6] Independent Petroleum Association of America, *New Natural Gas and Oil Taxes Would Crush America's Clean Energy and Energy Security*, available at http://www.ipaa.org/news/docs/ObamasNewtaxes2009.pdf.

oil were low. In a high oil price environment, the repeal is likely to have a smaller effect on production levels.

Repeal Marginal Well Tax Credit

The marginal well tax credit was implemented as the result of a recommendation by the National Petroleum Council in 1994 to keep low production oil and natural gas wells in production during periods of low prices for these fuels. This tax credit is designed to maximize U.S. production levels even when volatile energy markets result in low prices. It is believed that up to 20% of U.S. oil production, and 12% of natural gas production, is sourced from this category of well. The credit was enacted in 2004, but has not been necessary because market prices have been high enough since that time to justify production without the credit. The credit is not likely to be an important factor if prices remain high, or if the United States is successful in transitioning to alternative energy sources. The high cost wells that fall into the marginal well category are likely to be some of the first to be eliminated on economic efficiency grounds if enhanced use of alternative energy sources leads to a reduction in petroleum demand.

Repeal Passive Loss Exception for Working Interests in Oil Properties

Repeal of the passive loss exception for working interests in oil and natural gas properties is a relatively small item in terms of revenue contribution—$19 million from 2010 to 2014. The provision exempts working interests in gas and oil exploration and development from being categorized as "passive income (or loss)" with respect to the Tax Reform Act of 1986. This categorization permits the deduction of losses in oil and gas projects against other active income earned, which would not be permitted if the income (or loss) were considered to be passive. The current provision is believed to act as an incentive to induce investors to finance oil and gas projects, because losses incurred in oil exploration can be used as an offset against profits earned in other investment activities.[7]

Repeal Manufacturing Tax Deduction

The most significant item in the proposed budget in terms of oil and natural gas industry tax liabilities is the repeal of the manufacturing tax deduction. As shown in **Table 1**, the White House estimates that repeal of this deduction would contribute approximately $4.9 billion in tax revenue for the period 2010 to 2014. The total estimate might increase to $13 billion by 2019, according to the Administration. This provision was enacted in 2004 as part of the American Jobs Creation Act to encourage the expansion of American employment in manufacturing. The oil industry was categorized as a manufacturing industry, and hence, eligible for the deduction, which was to be phased in over several years, beginning at 3% in 2005 and rising to a maximum of 9% in 2010. The base of the tax is net income from domestic manufacturing activities, capped by a company payroll limitation.

[7] See CRS Report RL30406, *Energy Tax Policy: An Economic Analysis*, by (name redacted), for a discussion of how tax subsidy provisions for the oil and natural gas industries cause non-neutrality in the tax system.

This tax deduction was intended to increase domestic employment in manufacturing at a time when there was concern that manufacturing jobs were migrating overseas. By allowing a percent deduction of net income, up to the payroll limitation, the effective cost of labor to the manufacturer was reduced. The reduction in net labor cost was intended to expand employment, increase output, and reduce prices, making domestic manufactured goods more competitive in the world market.

Although the oil and natural gas industries are classified as manufacturing industries for national data reporting purposes, they differ from traditional factory manufacturing in a number of ways. Most importantly, the level of oil production is only indirectly related to the level of employment. This implies that if wage costs go down, due to the tax deduction, there is less chance that the industry will increase employment. Even if employment did increase, it would be expected to be of a minor magnitude due to the capital intensive nature of the industry. The Bureau of Labor Statistics reports that oil and natural gas extraction employed approximately 165,000 workers in 2009, of which fewer than 100,000 were classified as production workers.

The period since 2004, while difficult for American manufacturing as a whole, has been one of record profit levels in the oil industry. The high price for oil prevailing since 2004 that has led to record profit levels, is the critical factor in oil investment. Oil exploration tends to increase when prices are expected to remain high, and decrease in times of falling prices. The variability in actual and expected oil prices is likely to be a more important factor in determining capital investment budgets in the oil industry than the elimination of a tax that is capped by a relatively low wage bill.

Repeal Percentage Depletion Allowance

Percentage depletion is the practice of deducting from an oil company's gross income a percentage value, in the current law 15%, which represents, for accounting and tax purposes, the total value of the oil deposit that was extracted in the tax year. Percentage depletion has a long history in the tax treatment of the oil industry, dating back to 1926. The purpose of the percentage depletion allowance is to provide an analog to depreciation for the oil industry, in effect, equating oil deposits to capital equipment in more traditional manufacturing industries. In its current form, the allowance is limited to American production, by independent producers, on the first 1,000 barrels per day of production, and is limited to 65% of the producer's net income.

Percentage depletion was eliminated for the major oil companies in 1975. Although major oil companies' profits were likely affected by the tax change, their production of oil showed little variation. Production of oil within the United States remains attractive for companies because ownership of the oil is allowed in this country. In most areas of the world, ownership is vested in the national oil company, as a proxy for the state. The result is a lower share of revenues for companies producing outside the United States. The Administration projects that repeal of the percentage depletion allowance would yield approximately $2.9 billion in deficit reduction over the period 2010 to 2014, and more than $8 billion by 2019.

Increase Geological and Geophysical Amortization Period

Geological and geophysical expenses are necessarily incurred during the process of oil and natural gas resource development. The most favorable tax treatment of these costs is to allow them to be deducted in the year they are incurred. Requiring these costs to be amortized, or

spread out, over several years is less favorable. The longer the amortization period, the less favorable the tax treatment, because a smaller amount is deducted in each year, and it requires several years to recover the entire cost. As a result, it is possible that the cost of capital may be increased, and the level of investment reduced.

Currently, the major integrated oil companies amortize geological and geophysical costs over a period of seven years. In the Obama budget proposal, independent producers that benefit from a shorter amortization period would have their amortization period extended to seven years, equalizing treatment with the integrated oil companies. The extended amortization period for independent producers is projected by the Administration to contribute almost $1.2 billion in deficit reduction over the period 2010 to 2019. The IPAA estimates that independent producers would likely reduce exploration and development activities on a one-to-one dollar basis as a result of lengthening the amortization period. However, it seems unlikely that oil producers would reduce exploration investment to this extent if the spread of market price over full cost of exploration and development remains strong, as it generally has been in the period of high oil prices since 2004. Additionally, if prices decline to a level near the cost of exploration and development, investment is likely to be curtailed even with more favorable tax treatment of geological and geophysical expenses. If the industry were experiencing a time of stagnant oil prices that were near the cost of production, relatively small changes in tax expense might affect investment and production activities. However, in a time of high and volatile oil prices, small changes in tax expense are overshadowed by price variations.

Conclusion

On the one hand, the deficit reduction proposed items in **Table 1** can be considered to be effective tax increases on the oil and natural gas industries that could have the effect of decreasing exploration, development, and production while increasing prices and increasing our foreign oil dependence. These same proposals, from an alternate point of view, can also be considered to be the elimination of tax preferences that have favored the oil and natural gas industries over other energy sources, and made oil and gas products artificially inexpensive, with consumer costs held below true cost of consumption, when the costs associated with climate change and energy dependence, among other effects, are included.

Whichever view is adopted, the real effects of these proposals on oil production, consumption, and imports are likely to be small relative to both the federal deficit and the revenues of the oil industry.

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