Oil Industry Tax Issues in the FY2011 Budget Proposal

name redacted
Specialist in Energy Economics

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Summary

President Obama, in a speech on April 22, 2009 (Earth Day), addressed the linkage between the problems he associated with U.S. reliance on oil, especially imported oil, and the importance of a future based more on alternative energy sources. To move in the direction of accomplishing these goals, the Administration, in the FY2011 budget proposal, proposes that certain tax expenditures designed to increase domestic production of oil and natural gas be revised, thus reducing what the Administration sees as favorable treatment of the oil and natural gas industries.

The FY2011 budget proposal outlined a set of proposals, framed in terms of deficit reduction, or termination of tax preferences, that would potentially increase the taxes of the oil and natural gas industries, especially the independent producers. These proposals included repeal of the enhanced oil recovery and marginal well tax credits, repeal of the expensing of intangible drilling costs, repeal of the deduction for tertiary injectants, repeal of passive loss exceptions for working interests in oil and natural gas properties, elimination of the manufacturing tax deduction for oil and natural gas companies, increase of the amortization periods for certain expenses, and repeal of the percentage depletion allowance for independent oil and natural gas producers. In addition, a variety of inspection fee increases and a per-acre fee on unused leases were proposed to generate revenue for the Department of the Interior (DOI).

The Administration estimates that the tax changes would provide $18.2 billion in deficit reduction, or new revenues, over the period 2011 to 2015. 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 would likely be a small scale, the proposals also would make oil and natural gas more expensive for U.S. consumers, likely achieving the intended effect of reducing consumption of those fuels.

This report will be updated as events warrant.

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Background

In a speech on April 22, 2009 (Earth Day), 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 an oil-based society. The President said that the federal deficit and 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, governments can, and do, 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 direct 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, or consumption, of a good, it can lower the price consumers face through subsidies, typically applied to the producers of the good, who then may pass the benefit of reduced costs on to consumers in the form of lower prices.

Given the President's position on shifting U.S. energy consumption patterns toward renewable energy sources, his FY2011 budget proposal includes both subsidies for alternative energy sources and increased taxes on the oil and natural gas industries. 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 enjoyed favorable tax treatment in comparison with other U.S. industries through tax provisions such as the percentage depletion allowance and the write-off of intangible drilling expenses. These benefits helped to keep petroleum product costs low and encouraged consumption. Low gasoline prices were, and are, a factor in both residential and business location decisions, holiday travel, and other aspects of American life. Many of these decisions represent economic investments that might no longer be viable if the relative price of gasoline and oil increases. For example, when the price of gasoline rose to over $4 per gallon, based on oil prices that rose to over $145 per barrel in 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, accelerating the collapse of the industry. Shifting the U.S. energy consumption pattern from oil to alternative fuels is unlikely to occur without adjustment costs to consumers and U.S. industry.

In addition, available technology makes it unlikely that rapid large-scale transformations of usage patterns can be achieved. Although hybrid fueled automobiles are becoming popular, gasoline-powered vehicles promise to dominate the U.S. auto stock for some time. Over two-thirds of U.S. oil consumption is in the transportation sector, and it is unclear how renewable fuels can be utilized to substantially alter that pattern.

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

The FY2011 Budget Proposal

Under the pressure of an economic recession, which began at the end of 2007 and continues to affect the United States in 2010, a financial crisis that has required federal support for the banking system and financial markets, and the costs of new policy initiatives in health care, carbon emissions, and other areas, the level of projected federal revenues and deficits is a matter of concern in terms of achieving a structural change in preferences for petroleum products and alternative energy.

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. **Table 1** identifies the proposed tax changes for the oil industry, and the White House's estimates of the impact of each on projected deficit effects to 2015, if enacted. Many of these measures also 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.

Although the White House prefers to call these proposals deficit reductions, or the elimination of tax preferences, they, for the most part, eliminate tax expenditures and would actually, or potentially, under certain market conditions, increase tax revenues.

Table 1. FY2011 Oil Industry Tax Changes

(deficit reductions in millions of dollars)

	2011	Total, 2011-2015
Repeal Enhanced Oil Recovery Credit	-	-
Repeal Expensing of Intangible Drilling Costs	1,202	5,635
Repeal Deduction for Tertiary Injectants	5	38
Repeal Marginal Well Tax Credit	-	-
Repeal Passive Loss Exception for Working Interests in Oil Properties	20	98
Repeal Manufacturing Tax Deduction for Oil and Natural Gas Companies	851	7,272
Repeal Percentage Depletion for Oil and Natural Gas	522	4,328
Increase Geological and Geophysical Amortization Period for Independent Producers to Seven Years	44	858
Total	2,644	18,229

Source: FY2011 federal budget request, Dept. of Energy, *Terminations, Reductions, Savings*, p. 39.

Note: (-) means program will have no deficit effect.

Compared to the FY2010 federal budget request, the 2011 document differs in that it eliminates the excise tax provisions on Gulf of Mexico oil and gas production. This tax provision was intended to equalize the royalty rate on certain deepwater drilling projects that were allowed to pay a zero royalty rate until specified production targets had been reached.[2]

As shown in **Table 1,** the proposed revenue changes would have immediate effects in 2011 of raising over $2.6 billion. Over half of the total proposed deficit reduction from 2011 to 2015 would come from only two of the proposals. These two proposals could increase taxes on the oil industry, and influence its behavior. The repeal of the expensing of intangible drilling expenses, and the rescinding of the manufacturing tax deduction for the oil industry, would increase the industry's tax payments by $25 billion through 2020.

Repeal Enhanced Oil Recovery Credit[3]

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 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 is low, a market period usually associated with excess supply in the market. 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 inability of the price of oil to cover the costs associated with operating these wells.

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 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

[2] For a more complete analysis of this provision, see CRS Report R40715, *Oil Industry Tax Issues in the FY2010 Budget Proposal*, by (name redacted), p. 3.

[3] Tax credits are direct offsets to the company's tax liability.

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 a reduction in petroleum demand is achieved.

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 deficit reduction contribution—$98 million from 2011 to 2015. 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, and is believed to act as an incentive to induce investors to finance oil and gas projects.

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 $7.3 billion in federal deficit reduction for the period 2011 to 2015. The total tax revenue might increase to $17.3 billion by 2020, according to the budget proposal.

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 payroll limitation.

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 domestically 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 prices for oil prevailing since 2004 that have led to the record profit levels are seen as 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.

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.

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 $0.8 billion in deficit reduction over the period 2011 to 2015. The Independent Petroleum Association of America estimates that independent producers would likely reduce exploration and development activities on a one-to-one dollar basis as a result of altering this tax provision. 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 high, 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.

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 $4.3 billion in deficit reduction over the period 2011 to 2015, and over $10 billion through 2020.

Department of the Interior Budget

The Department of Interior (DOI) budget proposal contains several changes in fees and other revenue-generating items that would affect the oil and natural gas industries.

The 2011 budget proposal includes provisions to transfer part of the cost of both onshore and offshore drilling inspection fees to involved companies. However, the costs to industry are relatively minor. The onshore fee expected to generate $10 million in revenues, or 25% of the cost of inspections. The offshore inspection fee is to be doubled from the current level; it is expected to generate $10 million in revenues. In addition, the budget proposal includes a $4-per-acre fee on nonproducing leases. This fee is expected to yield $2.5 million in receipts.

The budget proposal also seeks congressional repeal of Section 365 of the Energy Policy Act of 2005 (P.L. 109-58). Section 365 prohibits the Bureau of Land Management from charging producers for processing onshore drilling permit applications.[4]

Although these fees and charges would increase the cost of exploring, developing, and operating oil and natural gas facilities under DOI's management and hence are likely to reduce those activities, as suggested by opponents of the proposals, the effects are likely to be minor, as these fees represent only a fraction of a percent of revenues, profits, or other taxes and fees paid to the government. Supporters of these fees might make the argument that they represent "user charges" consistent with environmentally sound management of resources on federal lands.

Conclusion

On the one hand, the tax changes proposed in **Table 1** would increase tax collections from the oil and natural gas industries and may have the effect of decreasing exploration, development, and production, while increasing prices and increasing the nation's 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 the 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 and natural gas industries.

[4] *Oil & Gas Journal*, Week of February 8, 2010. pp. 26-27.

Author Contact Information

(name redacted)
Specialist in Energy Economics
-redacted-@crs.loc.gov, 7-....