U.S. Congress Joint Economic Committee

End Tax Breaks For Big Oil:

Reduce the Federal Deficit Without Increasing Prices At The Pump

A Report by the Joint Economic Committee Chairman's Staff
Senator Bob Casey, Chairman

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Congress is currently searching for efficient ways of reducing the deficit. Democratic members of the 112th Congress, along with the Obama administration as evidenced in the fiscal year 2012 budget, propose repealing certain tax benefits for the major integrated oil companies.[1] Eliminating these tax preferences, which subsidize fossil fuel production, will both reduce the federal deficit and expedite the transition to a cleaner-energy economy.[2]

Critics of repealing these subsidies argue that the targeted tax breaks spur production and lower energy prices.[3] In reality, most of the so-called incentives have no impact on near-term production decisions, and thus repealing them would have no effect on consumer energy prices in the immediate future.[4] Even in the longer term, the current proposed changes to these tax provisions would have little impact on global production and a negligible effect on consumer energy prices. More importantly, these subsidies failed to prevent spikes in the price of gasoline, such as the spike that occurred in 2007-08. At the same time, these tax breaks may have discouraged investment in other industries, including alternative energy sources or energy efficiency, by distorting the effective tax rate on investments in oil and natural gas.

The proposed changes targeted to the major integrated oil and natural gas companies include: (1) eliminating the ability to claim the domestic manufacturing deduction (Section 199) against income derived from the production of oil and gas; (2) repealing expensing of intangible drilling costs; (3) repealing expensing of costs of tertiary injectants used as part of a tertiary recovery method; and (4) modifying the foreign tax credit rules for dual-capacity earners.[5] The Joint Committee on Taxation (JCT) estimates that making these four changes would reduce the deficit by $1.2 billion in FY 2012 and $21 billion by FY 2021.[6]

A description of these proposed changes follows, along with a discussion of the short- and long-run impacts on oil production, crude oil prices and consumer energy prices.

Description of Proposed Changes to Current Tax Provisions

(1) Section 199 credit

The American Jobs Creation Act of 2004 (P.L. 108-357) modified Section 199 of the Internal Revenue Code to allow manufacturers to deduct a specified percentage of qualified domestic production activity income as a business expense each year. The specified percentage started at 3 percent of qualified income in 2005 and ratcheted up to 9 percent in 2010, reducing the marginal corporate tax rate from its statutory 35 percent to 31.85 percent when fully implemented. However, for oil and gas producers, the Emergency Economic Stabilization Act of 2008 (P.L. 110-343) held the deduction at its 2008-09 level of 6 percent in future tax years, for an effective marginal tax rate of 32.9 percent. The proposal eliminates this deduction for major oil and gas producers, bringing the marginal corporate tax rate back to the statutory rate of 35 percent. Eliminating this deduction for major integrated oil companies will reduce the deficit by $604 million in FY 2012 and $12.8 billion by FY 2021, according to JCT.

(2) Intangible drilling costs

Current tax law allows oil and gas companies to expense certain costs of drilling and development, known as intangible drilling costs (IDCs), at the time they are incurred rather than capitalizing and recovering the investments over time. IDCs include costs related to the construction of derricks, tanks, pipelines and other physical structures that have no salvage value.[7] The major integrated oil and gas companies are currently permitted to expense up to 70 percent of these costs, allowing a quicker return on investment through reduced taxable income.[8] The proposal will require the major integrated oil and gas companies to capitalize these costs, rather than expense them. Eliminating this deduction for major integrated oil companies will reduce the deficit by $190 million in FY 2012 and $1.8 billion by FY 2021, according to JCT.

(3) Tertiary injectants

Current tax law allows oil and gas companies to expense the costs of tertiary injectants in the tax year that these costs are incurred rather than capitalizing these costs over the lifetime of the well. Eliminating this tax preference for major integrated oil companies will reduce the deficit by $7 million in FY 2012 and $57 million by FY 2021, according to JCT.

(4) Foreign tax credit rules for dual-capacity earners

Major oil and gas companies are currently able to reduce their U.S. income tax liabilities by the amount of foreign income taxes they pay. In some instances, these companies are able to deduct payments made to foreign governments that are more in the nature of royalties than income taxes. Modifying the foreign tax credit rules for major integrated oil companies will limit their ability to reduce their U.S. tax liability with foreign royalty payments. As proposed, this change will reduce the deficit by $429 million in FY 2012 and $6.5 billion by FY 2021, according to JCT.

Effects of Repealing Tax Breaks for Major Integrated Oil Companies

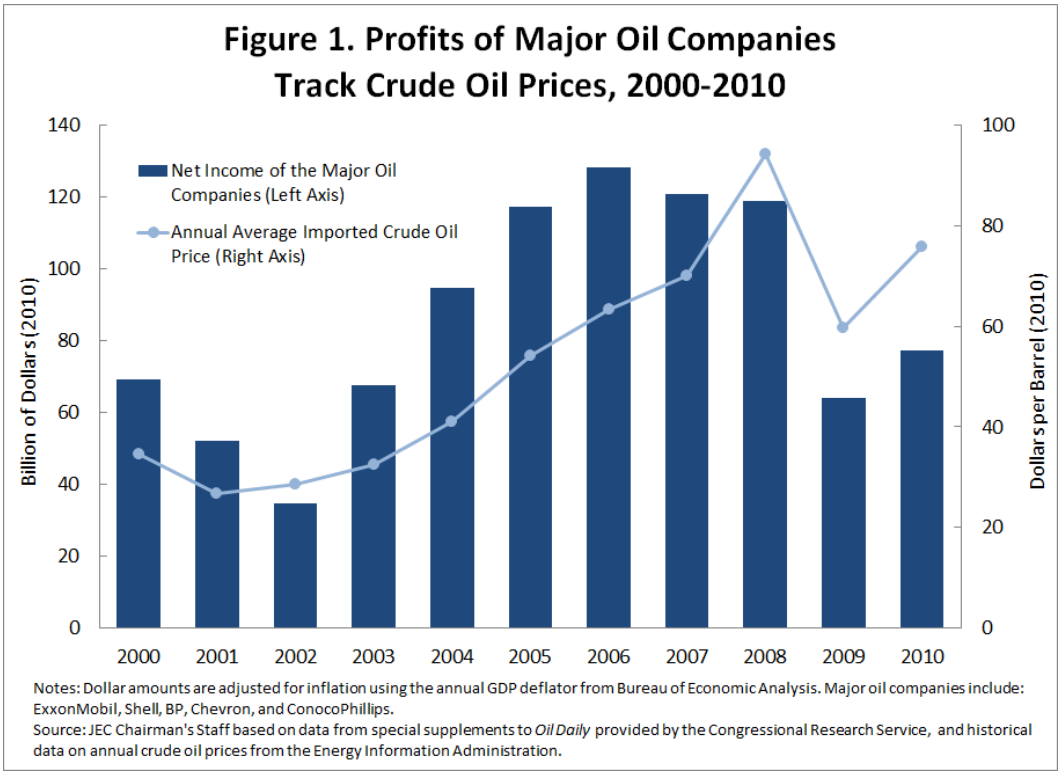
Impact on Short-Run Production

Modifying or repealing the tax breaks for the major integrated oil and gas companies will increase the amount of taxes they pay by increasing either the average income subject to tax or the rate at which corporate income is taxed. Contrary to critics' claims, doing so will not affect the output or price of crude oil or natural gas. In the short run, producers will continue to produce up to the point where the marginal cost of extracting (or refining and transporting) the next unit of crude oil (or natural gas) is equal to the price of crude oil (or natural gas). An increase in the marginal tax rate or the average income subject to tax will raise average costs of engaging in the activity, but it will not affect the short-run marginal cost. Eliminating these subsidies for the major oil and gas producers is unlikely to affect production decisions in the near term and, thus, is not likely to have any impact on consumer prices for gasoline and natural gas in the immediate future.

Impact on Long-Run Production and Crude Oil Prices

In the long run, the removal of these tax preferences will have a minimal impact on profits of oil and gas companies compared to the impact of crude oil prices. The current high prices of crude oil are resulting in high profits for the oil and gas industry. As **Figure 1** shows, profits of the major integrated oil and gas companies are highly correlated with crude oil prices. Although crude oil prices fell during the global recession in 2008-09, prices began to rise quickly during the economic recovery. The five major integrated oil companies boosted net income in 2010 by an average of 21 percent, as rising oil prices inflated their profits.[9] Profits are continuing to skyrocket in 2011 as crude oil prices remain elevated, with the five major

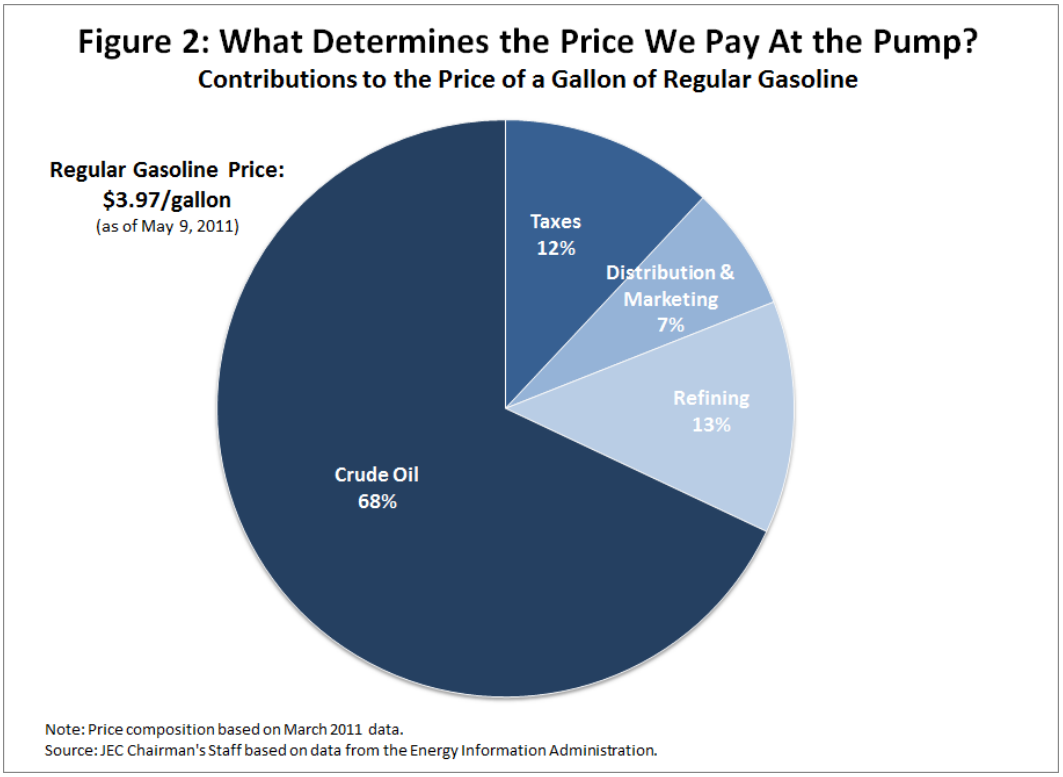
integrated oil companies reporting profits of $32.3 billion in the first quarter, a 42 percent increase from the first quarter of 2010. Projections of elevated crude oil prices in the future will continue to attract investors to this industry even in the absence of these subsidies.[10] Thus, the removal of these preferences is unlikely to affect long-run production decisions. In testimony before Congress in 2005, one oil executive stated that removing many of the tax breaks currently being debated would have no effect on his company's production activity.[11]



Impact on Gasoline Prices

More importantly to consumers, these subsidies, which lowered the effective tax rates for oil and gas producers, have not translated into lower prices at the pump. As **Figure 2** shows, the bulk of the price of gasoline is determined by the price of crude oil, which is set in the global market. Prices for crude oil fluctuate based on global supply and demand conditions. For example, experts attribute the run-up in crude oil prices in 2007-08 to rising global demand, especially in emerging markets such as China.[12] Because the United States is the world's largest petroleum consumer, reductions in the country's crude oil demand may lower crude oil prices.

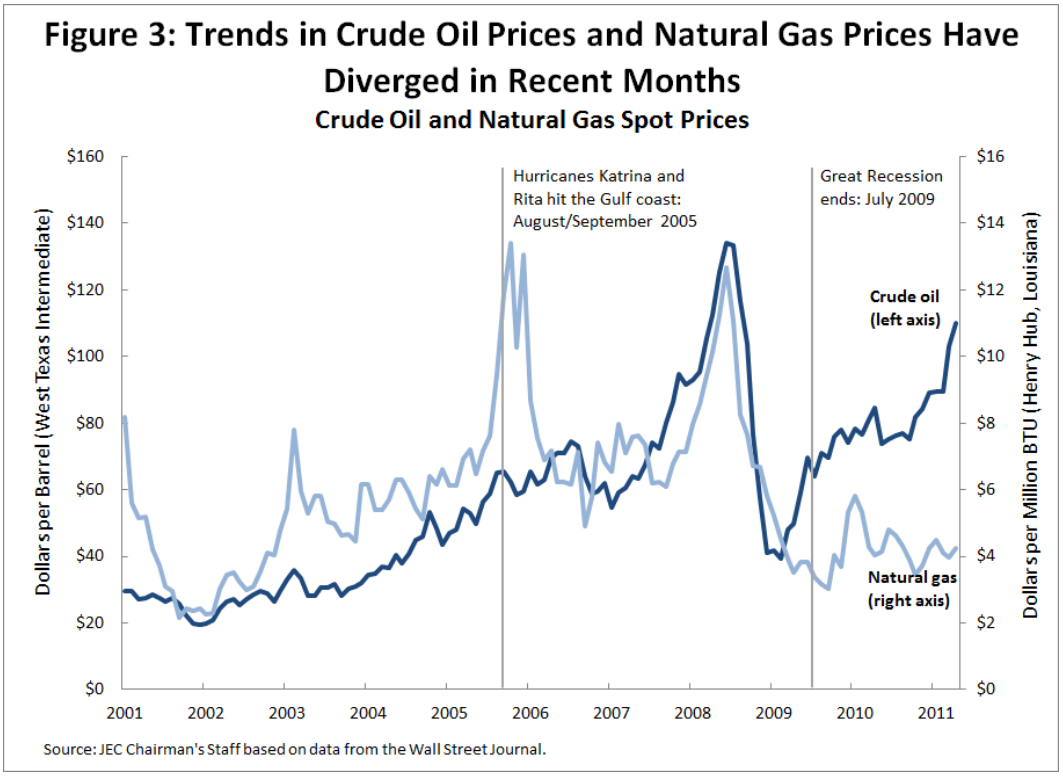
The United States consumed almost one-quarter of the total amount of oil consumed globally in 2009.[13] On the other hand, with only 2 percent of the world's proven oil reserves,[14] increases in U.S. oil production are unlikely to have a large impact on global supply and therefore are unlikely to lead to lower crude oil prices or lower gasoline prices.



Impact on Natural Gas Prices

Eliminating or modifying these tax provisions for major integrated oil and gas companies is unlikely to have any impact on natural gas production or prices. Natural gas proved reserves, which are estimated quantities of economically recoverable supplies, increased by 11 percent in 2009 due to major improvements in shale gas exploration and production technologies.[15] Natural gas prices are expected to remain low due to the continued exploration and development of shale gas resources, with shale gas estimated to increase from 16 percent of total U.S. gas production in 2009 to nearly half by 2035.[16] The development of shale basins as a source of natural gas is a recent phenomenon. In fact, the U.S. Energy Information Administration (EIA) did not start reporting shale gas production until 2008. The recent

development of shale gas as a viable resource, both within the United States as well as in 31 other countries, is a major component in the recent divergence in natural gas and crude oil prices.[17] (See **Figure 3**.) The expected increase in shale gas production will keep natural gas prices low for the foreseeable future.



Oil and Gas Subsidies May Impede Investment in Alternative Energy Sources

Because of these subsidies, oil and gas companies face extremely low effective tax rates on capital income. According to the Congressional Budget Office (CBO), the effective tax rate on oil and natural gas structures is 9.2 percent, compared to an overall effective tax rate for all assets in the corporate sector of 26.3 percent.[18] According to CBO, the variation in effective tax rates generally arises from these tax preferences, including tax-depreciation rules.[19] Distorting the relative returns on different investments simply because of differences in tax-depreciation rules can result in underinvestment in some industries. According to CBO, equipment used for the transmission and distribution of electricity faces an effective tax rate of 24.9 percent. The higher tax rate on electricity structures relative to oil and gas structures may deter

investments in smart-grid technology or electric transmission lines that are needed to transport electricity produced from renewable resources to the regions of the country that have higher demands for electricity.

Conclusion

Tax breaks designed to spur domestic oil and gas production have resulted in very low effective tax rates for oil and gas producers. But these subsidies to major integrated oil companies have not led to lower gasoline prices for consumers. Repealing or modifying the tax incentives discussed in this report will not affect oil companies' production decisions in the near term and would have little or no impact on consumer energy prices in the immediate future. The impact in the long term also will be negligible. Importantly, eliminating these tax breaks for the major oil companies will reduce the deficit by $21 billion over the next 10 years and accelerate the United States' move to a cleaner energy economy.

With the price of crude oil near $100 a barrel, major integrated oil companies are again making near-record profits. The current tax provisions have helped big oil companies boost their bottom lines, but have done little to prevent spikes in gasoline prices for consumers – either in 2007-08 or this spring. As has been acknowledged by oil executives, projections of high crude oil prices in the future will be sufficient to attract additional investment in the industry. Repealing these tax subsidies will provide a valuable source of deficit reduction, will have little or no impact on oil supply or prices, and will remove a distortion in the tax code that may have limited investment in clean energy alternatives.

Endnotes

[1] Section 167(h) (5) (B) of the Internal Revenue Code defines major integrated oil companies to be to be producers of crude oil with average daily worldwide production of crude oil of at least 500,000 barrels and gross receipts in excess of $1,000,000,000 for the taxable year. As of 2010, these companies are Royal Dutch Shell, ExxonMobil, BP, Chevron and ConocoPhillips. See also Carl Hulse, "Democrats See Strategy to End Big Oil Tax Breaks," New York Times, May 8, 2011 available online at http://www.nytimes.com/2011/05/09/us/politics/09congress.html?ref=us.
[2] Office of Management and Budget, Fiscal Year 2012, Budget of the U.S. Government, Analytical Perspectives, p. 204. Additionally, the Administration has proposed removing a number of tax provisions that benefit domestic coal companies.
[3] Jonathan Karl, "No Apologies: Rep. Barton Defends Tax Breaks For Big Oil," *ABC News, The Note,* March 9, 2011, available on-line at http://blogs.abcnews.com/thenote/2011/03/no-apologies-rep-barton-defends-tax-breaks-for-big-oil.html.
[4] See, *e.g.*, Joint Economic Committee, "The Proposed Modification of Internal Revenue Code Section 199 Will Not Increase Consumer Energy Prices," December 2007, available on-line at http://jec.senate.gov/public/?a=Files.Serve&File_id=f26dccde-9ea6-4539-a44c-f638240fa055.
[5] Close Big Oil Tax Loopholes Act, S. 940, 112th Congress, 1st Sess. (2011).
[6] Joint Committee on Taxation, Estimated Revenue Effects of the "Close Big Oil Tax Loopholes Act," JCT No. 11-2053, May 4, 2011.
[7] See General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Department of the Treasury, February 2012.
[8] Robert Pirog, Congressional Research Service, Oil and Natural Gas Tax Issues in the FY2012 Budget Proposal, CRS Report R41669, March 3, 2011.
[9] Special Supplement to Oil Daily, March 10, 2011.
[10] Energy Information Administration, *Annual Energy Outlook 2011*, April 2011, p.23 available online at http://www.eia.gov/forecasts/aeo/pdf/0383(2011).pdf.
[11] See transcript of the Joint Hearing before the Committee on Commerce, Science, and Transportation and the Committee on Energy and Natural Resources, 109th Congress, November 9, 2005. In that hearing, the chairman and CEO of Exxon-Mobil testified that if Congress took back the billions of dollars in brand new tax breaks, it would not affect Exxon-Mobil.
[12] James D. Hamilton, "Causes and Consequences of the Oil Shock of 2007-08," Brookings Papers on Economic Activity, Spring 2009.
[13] See Energy Information Administration, Petroleum Statistics 2009, available at http://www.eia.doe.gov/energyexplained/index.cfm?page=oil_home#tab2.
[14] BP Statistical Review of World Energy 2010, data as of the end of 2009, available online at http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/2010_downloads/oil_section_2010.pdf.
[15] Energy Information Administration, Natural Gas Explained: How Much Natural Gas Is Left, available online at http://www.eia.gov/energyexplained/index.cfm?page=natural_gas_reserves.
[16] Energy Information Administration, Annual Energy Outlook 2011.
[17] Energy Information Administration, World Shale Gas Resources: An Initial Assessment of 14 Regions Outside the United States, April 2011, available online at http://www.eia.gov/analysis/studies/worldshalegas/pdf/fullreport.pdf.
[18] Congressional Budget Office, "Taxing Capital Income: Effective Rates and Approaches to Reform," October 2005.
[19] *Ibid.*