SUBSIDY GUSHER

TAXPAYERS STUCK WITH MASSIVE SUBSIDIES WHILE OIL AND GAS PROFITS SOAR

Photo: Bureau of Land Management, Buffalo Field Office

TAXPAYERS FOR COMMONSENSE
MAKING GOVERNMENT WORK

There are a couple of basic truths about oil and gas companies today--they are highly profitable, heavily subsidized, and well-connected in Washington. While this scenario makes for a very lucrative business model, it has and continues to needlessly cost taxpayers billions. Now that the deficit and debt limit are pressing our budget to its limit, these outdated and unnecessary giveaways must end.

Oil prices are predicted to remain high, all but locking in the high profitability of the industry. Just this spring the average price per barrel has been on the rise. In February the average price per barrel was $89, in March $103, and in April it reached $110. For the next two years the average price per barrel is projected to remain over $100. Natural gas prices are also predicted to increase in 2012.[i] These high prices spell a good financial situation for oil and gas companies and provide marked incentive for production.

With these prices in mind, it seems reasonable that these companies don't need to be heavily subsidized, but the oil and gas industry's Congressional ties run deep. Because of these ties they have been able to maintain their special deals for nearly a century.

Not surprisingly, oil and gas companies have spent hundreds of millions of dollars over the past decade in an effort to lock in the preferential treatment they receive from Washington. Since the start of the 2002 election cycle, the oil and gas industry has donated $138.7 million to the campaigns of elected officials in Washington, according to the Center for Responsive Politics. Compared to other industries in the energy and natural resources sector, oil and gas is the biggest player by far in terms of campaign contributions and lobbying. By comparison, the mining industry, which also enjoys government subsidies in different forms, spent $32.3 million in campaign contributions during the same period. During just the 111th Congress (2009-2010), oil and gas companies spent an additional $321.3 million on lobbying expenses – approximately $440,000 a day – and employed at least 798 lobbyists, more than one lobbyist per member of Congress. In the first quarter of 2011, the industry spent $39.6 million on lobbying, more than almost every other industry.

Table 1

Selected Oil and Gas Subsidies	Projections for 2011-2015 ($)
Volumetric Ethanol Excise Tax Credit	31,050,000,000
Intangible Drilling Costs	8,963,000,000
Oil and Gas Royalty Relief	6,909,000,000
Percentage Depletion Allowance	4,327,000,000
Expensing for refining equipment	2,300,000,000
Geological and Geophysical Costs Tax Credit	698,000,000
Natural Gas Distribution Lines	500,000,000
Ultra-deepwater and Unconventional Natural Gas and other Petroleum Resources R&D	230,000,000
Passive Loss Exemption	105,000,000
Unconventional Fossil Technology Program	100,000,000
Liberalize the definition of independent producer	83,000,000
Exemption from bond arbitrage rules	39,000,000
Expensing of Tertiary Injectants	34,000,000
Natural gas gathering lines as a 7 year property	5,000,000
Total	**55,343,000,000**

For a long time the oil and gas industry has had the system working to their advantage. But it is the job of Congress to protect the taxpayer, not the special deals of the oil and gas industry.

Subsidies, Subsidies, Subsidies

During World War I, U.S. taxpayers provided the oil and gas industry with its first federal tax break. Over the decades, more lucrative tax breaks have been added. The latest major installment came with the passage of the 2005 Energy Policy Act, which included another $2.6 billion in subsidies for oil & gas companies. But it hasn't stopped there. As recently as December of 2011, oil and gas companies received more subsidies. Each year the oil and gas industry takes advantage of tax breaks and other subsidies worth billions of dollars. **In all, oil and gas companies are expected to receive more than $78 billion in industry specific and general business subsidies over the next five years.**

The first of the federal subsidies provided to the industry came with the establishment of the intangible drilling costs tax credit in 1918; other tax breaks including the geological and geophysical tax break were enacted as recently as the Energy Policy Act of 2005 (EPACT05). Other recent subsidies came in the Emergency Economic Stabilization Act of 2008 and the volumetric ethanol excise tax was just extended in a tax package passed last December.

Table 2

General Business Subsidies: Oil and Gas Portion	Projections for 2011-2015 ($)
Last-in, First-out Accounting	11,250,000,000
Manufacturing Tax Deduction	6,212,000,000
Foreign Tax Credit	5,350,000,000
Total	**22,812,000,000**

The subsidies included in the table above cover a range of tax breaks and other government support for the oil and gas industry and their estimated benefits to the oil and gas industry over the next five years. This analysis includes tax breaks and subsidies that are industry specific as well as those that disproportionately benefit the oil and gas industry. The general business tax breaks for oil and gas are listed above in Table 2 and include the section 199 manufacturing deduction enacted in 2004 and last in, first out accounting method (see general business reform). These subsidies should be repealed across the board and in this analysis we include the amount of these breaks that benefit the oil and gas industry. We also include the Foreign Tax Credit which should be reformed to only enable credit for true income taxes paid to foreign government and not taxes that were in exchange for an economic benefit.

The subsidy calculations come from the Joint Committee on Taxation, a non-partisan congressional committee that tracks and assists in the legislative tax process, the Office of Management and Budget, and industry sources. For more detailed information on the subsidies included please see Appendix One.

Profits, Profits, Profits

Over the last 130 years the oil and gas industry has established itself as a mature financial powerhouse both domestically and internationally. It has made a significant portion of its wealth by extracting billions in profits from oil and gas removed from taxpayer-owned federal lands and waters.

In the last ten years oil companies have been particularly lucrative for the industry, with the top five companies garnering more than $850 billion in profits (see table below).

The oil and gas industry has also shown itself to be more than resilient in the face of what would have easily put other industries out of business. While the economy took a downward spiral for just about everyone in 2008, profits continued to come in for oil and gas companies.

The largest oil spill ever, in the Gulf of Mexico, also appears to have little impact on the profitability of oil giant BP. In the face of what for most companies would spell economic ruin, BP quickly emerged from the red with two straight quarters of profits amounting to more than $6 billion. BP was able to write-off billions of the costs related to its oil spill clean-up in 2010, significantly decreasing their tax burden. The company lowered its taxes by $13 billion because of costs related to the oil spill. This effectively means that taxpayers subsidized BP and its clean up of the oil spill that it caused.

Other oil companies have consistently done well over the last decade. In 2010, net profits for the largest oil and gas companies (Shell, Exxon, Total SA, BP, Chevron) were $76.8 billion – a $12.4 billion increase from 2009 profits and a 49.7% increase from just a decade earlier.

Table 3

Big Oil Total Profits 2001 – 2010 ($ Billions)	
BP	144
Chevron	128.2
Exxon	284.8
Shell	186
Total S.A.	111.9
Total Profits	**$854.9 billion**

With the price per barrel of oil having eclipsed the $100 mark again this year and predicted to stay there, Big Oil will rake in billions of dollars more in profits these next few years. In 2008 with high oil prices: Exxon posted the largest annual corporate profit in U.S. history, Chevron became the second most profitable company in the U.S, and the five companies listed above hauled in nearly $150 billion.

Clearly these companies do not need taxpayer subsidies.

Subsidies Must End

After more than a century to establish itself, the oil and gas energy sector should clearly be able to stand on its own two feet without taxpayer handouts. Congress must act to end the siphoning of taxpayer dollars to powerful energy companies. Taxpayers cannot continue to perpetuate an endless cycle of subsidies.

If we continue on with business as usual taxpayers will be on the hook for an additional $80 billion in subsidies over the next five years. It's time to stop rubber stamping age old policies and enact meaningful reforms.

The 112th Congress came into office promising to reduce our deficits and debt and to reroute our current fiscal course to a sustainable one. To do this, Congress needs to target inefficient, ineffective, and wasteful programs that deplete the nation's treasury and cause a fiscal nightmare for taxpayers.

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Appendix One: Oil and Gas Subsidies Summary

The numbers in Table 1 project future costs for selected oil and gas subsidies for fiscal years 2011-2015. These values and projections are based on reports from government agencies including the Joint Committee on Taxation (JCT), the Office of Management and Budget, and industry data from the American Petroleum Industry Association. In general, government data on federal spending for subsidies and tax incentives to the oil and gas industry is highly decentralized. Government tracking and reporting of these subsidies is spread across multiple agencies that do not observe a standard methodology for calculating costs.

Volumetric Ethanol Excise Tax Credit
In 2004, the American Jobs Creation Act implemented the VEETC to replace these two historical subsidies as a combined excise tax exemption and tax credit. The tax credit is worth 45 cents per gallon of ethanol blended with gasoline.ii Under the recently enacted Renewable Fuels Standard, the U.S. is required to blend up to 15 billion gallons conventional corn ethanol with gasoline by 2015.iii Assuming ethanol production reaches the mandated cap every year, it will cost $31.05 billion from 2011-2015.

Intangible Drilling Costs (Expensing of exploration and development costs):
Created in 1918, intangible drilling costs (IDCs) include all expenditures made for wages, fuel, repairs, hauling, supplies, etc that are incidental to the drilling of wells and the preparation of wells for the production of oil and gas. While most costs that bring future benefits must be capitalized according to the Internal Revenue Code (IRC), IDCs are an exception that can be expensed in the period the costs are incurred. Special rules are provided for intangible drilling and development costs so that these costs can either be expensed (current deduction) or capitalized (current law). When the decision is made to "expense" the IDCs, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. If the IDCs are capitalized, they are generally recovered through either depreciation or depletion.[iv] The President has proposed eliminating this tax break and the JCT estimates this would save $8.963 billion from 2011-2015.[v]

Royalty Relief
Oil and gas companies that drill on public lands or off-shore pay for the oil and gas they remove in the form of royalties. Because of out-dated energy policy, oil and gas companies often pay little or no royalties to the owners of the resources. Additional royalty relief was enacted with the Deepwater Royalty Relief Act of 1995. Most of the leases granted under this act contained price thresholds such that when the price of oil was above the threshold, royalty relief would not apply. However, the contract language for 1998-1999 failed to contain price thresholds, leading to a huge windfall for those leases.[vi] Annual reports of the Minerals Management Service (MMS) from 1998-2009 report $2.14459 billion in "royalty free" oil and gas production[vii] [viii] and estimate the royalty free production for 2011-2015 will total $4.365 billion for oil, $159.867 million for gas (deep gas) and $2.384 billion in gas (deep water).[ixx]

Percentage Depletion Allowance (excess of percentage of cost depletion)
Enacted in 1926, the Percentage Depletion Allowance permits 27.5% of revenue to be deducted for the cost of the depletion of the mineral deposit. The percentage depletion allowance is a tax break currently given to independent oil producers, but formerly given to all oil and gas producers and can exceed capital costs.[xi] The President has proposed eliminating this subsidy and the JCT estimates this would save $4.327 billion from 2011-2015.[xii]

Expensing for Refining Equipment
Established in 2005 by the Energy Policy Act of 2005 (EPAct 2005), the Temporary 50-Percent Expensing of Equipment Used in the Refining of Liquid Fuels Deferral allows companies to deduct 50% of the cost of applicable equipment used to refine liquid fuels.[xiii] In the New Energy Reform Act of 2008, this credit is extended to refineries processing fuel derived from oil shale. The JCT estimates this subsidy will cost $2.3 billion from 2011-2015.[xiv]

Geological and Geophysical Costs Tax Credit
Included in EPAct 2005 and modified in the Tax Increase Prevention and Reconciliation Act of 2005, this tax credit provides a deduction for all costs incurred while searching for oil and gas deposits.[xv] The President has proposed eliminating this subsidy for savings and the JCT estimates this would save $698 million from 2011-2015.[xvi]

Natural Gas Distribution Lines
As established by the Energy Policy Act of 2005, the "Natural Gas Distribution Pipelines Treated as 15-Year Property" tax deferral accelerates the rate at which companies can deduct the cost of natural gas distribution pipelines, reducing the depreciation time from 20 years to 15 years.[xvii] The JCT projects a cost of $500 million for the years 2011-2015.[xviii]

Ultra-Deepwater and Unconventional Natural Gas and other Petroleum Resources R&D
Title IX, Subtitle J of the Energy Policy Act of 2005 creates a program in the Department of Energy for "research, development, demonstration, and commercial application of technologies for ultra-deepwater and unconventional natural gas and other petroleum resource exploration and production." The program is funded through 2017.[xix] According to the National Energy Technology Laboratory (NETL), 32.5% of the funding is spent on unconventional oil and gas exploration, 35% is spent on ultra-deepwater architecture, 25% is spent on complimentary research and 7.5% is spent addressing technology challenges of small producers.[xx] EPAct 2005 set the program's budget at $50 million a year, and the program's budget from 2006-2009 was about $202.52 million when adjusted for inflation.[xxi] The President has proposed phasing this program out for a savings of $190 million in 2011-2015.[xxii]

Passive Loss Exemption
Passive loss activity refers to any activity that does not constitute a taxpayer being "materially involved" in a business activity. This is defined as not having a working interest in an oil or gas property – in other words, not being regularly involved in the operations of the activity. The amount of the credits cannot exceed the regular tax liability of the taxpayer.[xxiii] This tax break was established with the Tax Reform Act of 1986 (Public Law 99-519).[xxiv] The President has proposed eliminating this tax preference and the JCT estimates this would save $105 million from 2011-2015.[xxv]

Unconventional Fossil Technology Program
The discretionary program was established with 2010 appropriations to replace the Petroleum-Oil Technology Program and subsidizes the research and development of fossil fuel production technologies.[xxvi] The President has proposed eliminating this subsidy for an estimated savings of $100 million from 2011-2015.[xxvii]

Liberalize the Definition of Independent Producer
The Energy Policy Act of 2005 redefined an independent producer as producing no more than 75,000 barrels a day on average for a year, as opposed to the earlier ceiling of 50,000 barrels calculated based on actual daily production.[xxviii] JCT projects it will total $83 million from 2011-2015.[xxix]

Exemption from Bond Arbitrage Rules

Tax-exempt, bond-financed prepayments violate the tax code's arbitrage restrictions. EPAct 2005 created an exemption to that general rule. Arbitrage is the practice of profiting by investing the profits from tax-exempt bonds in higher yielding instruments. Generally, under arbitrage rules, these proceeds must be rebated back to the U.S. Treasury. Under the EPAct 2005 provision, a prepayment financed with tax-exempt bond proceeds for the purpose of obtaining a supply of natural gas for service area customers of a governmental utility would not be subject to the general arbitrage rule.[xxx] JCT projects a cost of $39 million from 2011-2015.[xxxi]

Expensing of Tertiary Injectants

Established as part of the Crude Oil Windfall Profit Tax Act of 1980, this tax incentive allows for the expensing of tertiary oil recovery methods. In order to remove the most viscous oil from reservoirs, fluids and other chemicals must be injected into the reservoir to push out the oil. Nine of these so-called tertiary recovery methods can be expensed under this tax break.[xxxii] The President's budget proposes eliminating this subsidy and the JCT estimates this would save $34 million from 2011-2015.[xxxiii]

Natural Gas Gathering Lines as a 7 Year Property

With the enactment of the Energy Policy Act of 2005, the recovery period for all natural gas gathering lines became 7 years, as opposed to some which were 15 years, for the Modified Accelerated Cost Recovery System depreciation deduction.[xxxiv] The JCT calculates this subsidy and projects it will total $5.6 million from 2011-2015.[xxxv]

Appendix Two: General Business Reforms Summary

Last In, First Out Accounting (LIFO)

Last In, First Out (LIFO) accounting allows oil companies to count the most recently acquired, barrel of oil in their inventories as being sold first. Considering the last barrel is the most expensive barrel due to high prices and inflation, oil companies are able record older, cheaper, recovered oil as being in inventory. This reduces the value of the inventory and thus, reduces the company's tax burden. An attempt was made in the Senate's Tax Relief Act of 2005 to reform this practice, but the language did not appear in the final version of the act.[xxxvi] The President has proposed eliminating LIFO for a total savings of $59.085 billion for 2011-2020, but it is unclear how much of this amount applies to the oil and gas industry.[xxxvii] The American Petroleum Institute estimates that LIFO saves the oil and gas industry $22.5 billion from 2011-2020.[xxxviii]

Manufacturing Tax Deduction for Oil and Gas Companies (IRC Sec 199)

The domestic production deduction benefits oil and gas companies to the extent that their products are "manufactured, produced, or extracted in whole or in significant part in the United States." The deduction was 3% of income for 2006, rising to 6% between 2007 and 2009, and 9% thereafter; it is subject to a limit of 50% of the wages paid that are allocable to domestic production during the taxable year.[xxxix] This was enacted under the American Jobs Creation Act of 2004 and is now part of IRC Section 199. The JCT estimates that the oil and gas portion of this tax deduction cost more than $1.949 billion between 2007-20010.[xl] The President has proposed repealing this subsidy specifically for the production of oil and gas and the JCT estimates this would save $6.212 billion from 2011-2015.[xli]

Deductions for Foreign Tax Credit

The foreign tax credit (FTC) serves to prevent double taxation of income earned abroad by U.S. residents and corporations. This credit unfairly benefits U.S. oil companies because many of the countries in which they conduct business impose levies that are not really income taxes, but are simply traditional royalty payments. As a result, in some cases the foreign tax credit actually leads to a reduction of taxes on domestic source income.[xlii] The FTC was an even larger giveaway to the oil and gas industry before the Tax Reform Act of 1976 limited the tax credit for oil and gas. The President proposed to reform the foreign tax credit by requiring companies to pool and report all foreign income, not just those pertinent to U.S. taxation. Also, other reforms prohibit the splitting of foreign income and foreign taxes for more accurate accounting and modify tax rules for dual capacity taxpayers. According to the President's budget, these reforms would save $29.772 billion from 2011-2015 across all industries.[xliii] JCT's analysis for some aspects of foreign tax credit reform for oil and gas companies alone indicates that taxpayers will save $1.885 billion from 2011-2015.[xliv] The American Petroleum Institute estimates that modifications of the dual capacity rule will save $5.35 billion from 2011-2015.[xlv]

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