First Step in Shifting to Cleaner Energy: End Unjustified Tax Loopholes for Oil and Gas

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In the past month, lawmakers beholden to the oil industry blocked consideration of a bill (S. 3044) that would shift tax subsidies away from oil and gas companies to alternative energy investments. This legislation also included a windfall profits tax on oil companies.

If Congress wants to raise revenue to encourage the development of alternative energy, it makes sense to start, as this bill would, by closing the tax loopholes that favor oil and gas companies. These loopholes in effect provide a subsidy to oil and gas companies that other firms do not receive.

Many of these subsidies have existed for years and have surely helped boost the profits of oil company shareholders. As this paper explains, the American public has received little, if anything, in return. Congress can recoup some of the benefits showered on the oil and gas industry over the years by implementing a windfall profits tax.

Recently Filibustered Bill Would Have Closed Tax Loopholes for Oil and Gas Companies

S. 3044 would bar large oil and gas companies from using the deduction for domestic manufacturing (often called the Section 199 deduction), raising about $10 billion over ten years. Some might wonder why oil and gas companies could use a deduction for "manufacturing" in the first place. A few years ago, Congress actually redefined manufacturing for the purposes of this deduction so that it included oil and gas production, obviously at the behest of the energy industry.

The bill would also restrict the abuse of credits for foreign taxes by oil and gas companies, raising $4 billion over ten years.

The bill would also impose a 25 percent tax on windfall profits, which are defined as profits more than ten percent greater than the average over the 2002-2006 period. Any profits invested in renewable energy development would not be subject to this tax.

Revenue raised by these provisions would be dedicated to an Energy Independence and Security Trust Fund to be used for the development of renewable energy sources. Other provisions in S. 3044 address price gouging, speculation in the oil future market and related issues.

Tax Subsidies to Oil Companies Provide Little Benefit to the Public

The evidence indicates that the public actually receives very little benefit in return for subsidizing oil and gas through the tax code.

People associated with the oil and gas industry often argue that the tax breaks they enjoy encourage them to locate and extract more oil and gas, which allows them to increase supply and thus keep energy prices down below the level they would otherwise reach.

But among the largest five oil companies, less than 8 percent of profit goes to exploration for new oil fields.[1] High profits do not seem to encourage exploration.

In fact, in the top five oil companies, managers have actually directed most of their excess cash to dividends and stock repurchases, both of which drive up the companies' share prices and the executives' stock option values.[2] The percentage of net profits directed towards dividends and stock repurchases for the top five oil companies was 58 percent in 2005, 73 percent in 2006, and 72 percent in 2007. These figures are high in comparison to other industries. To the extent that tax loopholes targeting the oil and gas industry boost their profits, there is no evidence that the additional profits lead the companies to explore for more oil so that they can increase the supply.

Nor does the current tax treatment of oil and gas companies encourage them to develop alternative energy. These companies always claim to be interested in alternative energy, but they actually invest very little in it. The American Petroleum Institute (API), the organization funded by the oil industry to disseminate its version of the facts, admits that in the six years stretching from 2000 through 2005 the oil industry only put a total of $1.2 billion towards investment in alternatives to fossil fuels.[3] To put that in perspective, the total net profit for the five largest oil companies in the 2000-2005 period was $383 billion, meaning the $1.2 billion spent on developing renewable energy is miniscule. If this figure had increased since then, the industry would surely be publicizing that fact.

It's obvious why these companies devote so little to alternative energy. Any substitute for oil would result in a reduced value for the industry's reserves, refineries, pipelines and the like. These companies cannot be relied upon to make these investments, at least not without public policies that change their incentives.

Oil and Gas Companies' Profits Will Not Suffer Unfairly Due to Tax Changes

Some anti-tax lawmakers argue that eliminating tax breaks for oil and gas companies or subjecting them to new taxes will make energy production less profitable, causing the a reduction in supply and a consequent increase in price. But oil and gas companies are enjoying so much success that it seems preposterous to think they will suffer if their tax treatment is altered.

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[1] According to the Security and Exchange Commission (SEC) Form 10-K filings of the top five oil companies, in 2005 to 2007 "exploration" expenses were about 4 percent of profits per year. The oil companies use a form of accounting called "successful efforts accounting," whereby a dry hole is expensed and a successful well is capitalized. Perhaps two thirds of exploratory wells are dry, so one can safely assume that the total amount of profits devoted to exploration (both unsuccessful wells that are expensed and successful wells that are capitalized) add up to no more than 8%.

[2] Ibid.

[3] American Petroleum Institute, "Oil and Gas Industry Investments in Alternative Energy, Frontier Hydrocarbons, and Advanced End-Use Technologies." May 2006. http://www.factsonfuel.org/images/API_Emerging_Energy_Report.pdf

Had you invested $10,000 in the top five oil companies 20 years ago, your portfolio would now be worth $100,000. That same $10,000 invested in an S&P 500 index fund is now worth $60,000.[4] Oil shareholders enjoy a big advantage.

Some energy executives argue that their profits are really not very big because only 9 cents of every dollar in oil sales is profit, which is below the average for American business. However, if profit margin were a reliable yardstick, all supermarkets would close, because they earn less than 1 cent per sales dollar.[5] The real measure of the industry's health is its return on investment, which, if you ask any oil company stockholder, is quite high.

Other Ways Congress Can Improve the Tax Code's Treatment of Energy Companies

There are several other tax loopholes that benefit oil and gas companies and that Congress should close.

For example, Congress could repeal the deduction for "intangible" costs of exploring and developing oil and gas sources. The "intangible" costs of exploration and development generally include wages, costs of using machinery for drilling and the costs of materials that get used up during the process of building wells. Most businesses must write off such expenses over the useful life of the property, but oil companies, thanks to their lobbying clout, get to write these expenses off immediately. **This loophole costs $3.5 billion over five years (the five-year period starting in 2007).**[6]

Congress could also repeal "percentage depletion" for oil and gas properties. Most businesses must write off the actual costs of the property over its useful life (until it wears out). If oil companies had to do the same, they would write off the cost of oil fields until the oil was depleted. Instead, some oil companies get to simply deduct a flat percentage of gross revenues. The percentage depletion deductions can actually exceed costs and can zero out all federal taxes for oil and gas companies. The Energy Policy Act of 2005 actually expanded this provision to allow more companies to enjoy it. **This loophole has a five-year cost of $5.9 billion.**

Another example of a loophole ripe for repeal is a provision allowing companies to deduct 50 percent of the costs of certain equipment used in refining liquid fuels. This provision was created in the 2005 act and serves as another example of the sort of "incentives" Congress claimed were necessary for the oil industry at a time when the price of oil was topping $55 a barrel. **This loophole costs $2.1 billion over five years.**

What Oil and Gas Companies Have Extracted – from the American Public

American taxpayers have been subsidizing the fossil fuel industry through the tax code for several years. It is not clear that the taxpayers have received anything in return. The United

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[4] Analysis of top five oil companies stock price and dividend returns performed by Hooke Associates over the 1988 to 2008 time period, using COMPUSTAT and Yahoo Finance databases.
[5] Value Line Report. April 2008, Summary of supermarket chain financial results.
[6] Cost estimates were projected by the Congressional Joint Committee on Taxation for the 2007-2011 period.

States has grown no closer to being independent of foreign oil and the price of gasoline has reached record-breaking heights. Congress is therefore justified in closing the tax loopholes that subsidize the industry and in considering a windfall tax that would recoup some of the benefits bestowed on oil companies that now have abnormally high profits.

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