What Oil and Gas Companies Extract — from the American Public

It's Time to End Unjustified Tax Loopholes for Oil and Gas Companies

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In the wake of the disastrous oil spill in the Gulf of Mexico, the public and the media have turned their attention to some of the subsidies provided through the tax code to BP, the corporation that leased the ill-fated Deepwater Horizon drilling platform.[1] The truth is that oil and gas companies have for years received a bonanza of unjustified tax breaks that serve only to boost profits for their shareholders.[2]

This has become particularly problematic in recent years as Americans hope to shift resources towards cleaner energy and energy independence. If Congress wants to raise revenue to encourage the development of alternative energy, it makes sense to start 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. As this paper explains, these subsidies do not spur the exploration of new reserves nor stimulate alternative energy investment.

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 10 percent of profit goes to exploration for new oil fields.[3] High profits do not encourage exploration.

In fact, in the top five oil companies, managers direct 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.[4] 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

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[1] David Kocieniewski, "As Oil Industry Fights a Tax, It Reaps Subsidies," New York Times, July 3, 2010. http://www.nytimes.com/2010/07/04/business/04bptax.html?_r=1&src=busln

[2] Tax breaks for oil and gas companies are just one of the many types of subsidies the federal government provides through the tax code. For more general information on tax expenditures, see Citizens for Tax Justice, "Limiting Tax Expenditures Must Be Part of Congress's Efforts to Balance the Budget," April 22, 2010. http://www.ctj.org/pdf/taxexpenditures.pdf

[3] According to the Security and Exchange Commission (SEC) Form 10-K filings of the top five oil companies, in 2005 to 2009 "exploration" expenses were about 5 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 10%.

[4] Ibid.

percent in 2007, 71 percent in 2008 and 89 percent in 2009. 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. Reviews of oil company press releases, SEC filings and published articles suggest that alternative energy investments approximate less than of 5 percent of profits for the top five firms. For example, Shell Oil announced in 2009 that it was reducing alternative investment because conventional operations provided higher returns.[5]

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 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.

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.[6] 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.[7]

The real measure of the industry's health is its return on investment, which, if you ask any oil company stockholder, is quite high. Over the last two years, the top five oil companies had an average annual return on equity of 21 percent. (Even this number understates their true profits because oil reserves are not " written up" for accounting purposes when the price of oil increases.) In contrast, the U.S. Treasury bond yielded approximately 3 percent, and the two top supermarket chains had average returns around 16 percent.

[5] Robin Pagnamente, "Anger Over Shell Reduces Renewable Investment," Sunday Times (London), March 18, 2009. http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article5927869.ece
[6] Analysis of top five oil companies' stock price and dividend returns performed by Hooke Associates over the 1990 to 2010 time period, using COMPUSTAT and Yahoo Finance databases.
[7] Value Line Report. May 2010, Summary of supermarket chain financial results.

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

President Obama's most recent budget plan proposes to close or reduce a number of the most expensive tax loopholes for the oil and gas industry. Here are some of the most significant of these proposals.

Bar large oil and gas companies from using the deduction for domestic manufacturing (often called the Section 199 deduction). 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 President's proposal to close this loophole would raise $14.8 billion over ten years.** [8]

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. **The President's proposal to close this loophole would raise $10.9 billion over ten years.**

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. **The President's proposal to close this loophole would raise $9.6 billion over ten years.**

Reduce the break for amortization of geological and geophysical expenditures. As already explained, most businesses write off the actual cost of property over its useful life (until it wears out). If a business can amortize (write off the costs) more quickly, that means it receives tax deductions earlier, making them much more valuable. The amortization over a two-year period of the costs of searching for oil was introduced in the Energy Policy Act of 2005 and is available even when oil and gas is discovered. The tax cut bill Congress passed in 2006 changed the rule to allow a five-year amortization. The President proposes to change the rule to allow seven-year amortization. **The President's proposal to reduce this loophole would raise $1 billion over ten years.**

Modify Rules for "Dual Capacity" Taxpayers. Dual capacity taxpayers generally are corporations that make two types of payments to foreign governments. One type of payment is some form of corporate income tax, while another type is a royalty or fee or other type of payment made in return for a particular economic benefit. The U.S. tax code allows American corporations to take a credit against any corporate income taxes they pay to foreign

[8] Cost estimates were projected by the Congressional Joint Committee on Taxation for the 2011-2020 period.

governments to avoid double-taxation of foreign income. The problem is that the current rules sometimes allow these corporations to, in effect, take foreign tax credits for non-tax payments they make to foreign governments. This of course has nothing to do with avoiding double-taxation, which is the sole purpose of the foreign tax credit. The President proposes to change the rules to end this practice, which is often used by oil and gas companies, as well as others (particularly mining companies). **The President's proposal to reform these rules would raise $8.5 billion over ten years.**

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

American taxpayers have subsidized the fossil fuel industry through the tax code for decades. The taxpayers have received nothing in return. The United States has grown no closer to being independent of foreign oil imports, even as domestic drilling practices threaten our environment here in the U.S. Congress should, as a start, stop subsidizing the oil and gas industry with these unjustified tax breaks.

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