$1 Trillion in Profits And Still at the Trough:

Oil and Gas In the 21st Century

Committee on Natural Resources
Democratic Staff Report

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U.S. gasoline prices have increased 44 cents per gallon in the last year to an average price of $3.10 per gallon, with some parts of the country paying much more (Figure 1). The Energy Information Administration projects regular-grade gasoline to rise further to an average price of $3.17 per gallon this year and $3.29 per gallon in 2012.[1] At these prices, Americans will pay an additional $67 billion for gasoline this year, or $262 per driver.[2] Economy-wide gasoline expenditures will top $541 billion for the year. These figures could rise dramatically if instability in Egypt leads to a disruption in trade flows through the Suez Canal or if any other events in this volatile region threaten the supply and flow of oil.

Figure 1. Gasoline Prices Around the United States

Gasoline (Dollars per Gallon)			
01/31/11		Change from	
	Price	Week Ago	Year Ago
U.S.	3.101	↓ -0.009	↑ 0.440
East Coast	3.108	↓ -0.016	↑ 0.423
New England	3.188	↓ -0.002	↑ 0.453
Central Atlantic	3.165	↓ -0.007	↑ 0.450
Lower Atlantic	3.041	↓ -0.027	↑ 0.392
Midwest	3.086	↓ -0.001	↑ 0.523
Gulf Coast	2.937	↓ -0.027	↑ 0.396
Rocky Mountain	2.931	↑ 0.013	↑ 0.316
West Coast	3.299	↑ 0.006	↑ 0.388
California	3.364	↑ 0.007	↑ 0.389

Source: Energy Information Administration, http://www.eia.doe.gov/oog/info/gdu/gasdiesel.asp

Meanwhile, high oil prices gave a huge boost to the Big 5 oil companies, ExxonMobil, Chevron, ConocoPhillips, BP, and Shell. A Natural Resources Democratic staff review of recent earnings announcements by the five largest oil companies operating in the United States shows that this industry has generated outsized profits that undermine the necessity for continued tax subsidies and royalty-free drilling access.

This week, these companies reported $29 billion in profits for the fourth quarter of 2010, $77 billion in profits for the full year, and $952 billion in total profits over the last decade (Figure 2).

Figure 2. Big 5 Oil Profits

	2010 Profits (billions)						2001-2010 Profits (billions)
	Q4	% change		Full Year	% change		
Exxon Mobil	$9.3	↑ 53%		$30.5	↑ 58%		$326
Chevron	$5.3	↑ 72%		$19.1	↑ 81%		$147
ConocoPhillips	$2.0	↑ 59%		$11.4	↑ 157%		$100
BP	$5.6	↑ 30%		-$3.7	---		$158
Shell	$6.8	↑ 246%		$20.1	↑ 61%		$221
Total	$29.0			$77.4			$952

Compiled by Natural Resources Democratic Staff using data from earnings reports and data from the Center For American Progress, available at: http://www.americanprogress.org/issues/2011/01/oil_lust.html

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[1] EIA, Short-Term Energy Outlook. Available at: http://www.eia.gov/emeu/steo/pub/contents.html

[2] Calculation based on vehicle fuel consumption data from the U.S. Department of Transportation, Annual Vehicle Distance Traveled in Miles and Related Data. Available at: http://www.fhwa.dot.gov/policyinformation/statistics/2008/pdf/vm1.pdf

Old Habits Die Hard

> *"Historically, Federal energy tax policy was focused on promoting the development of oil and gas, at the expense of the commercialization of alternative and nonconventional energy technologies."*[3]
>
> *--Congressional Research Service*

While American businesses and consumers are tightening their belts, hugely profitable multi-national oil and gas companies are set to enjoy $53 billion in royalty-free drilling over the next 25 years and $36.5 billion in taxpayer subsidies over the next decade.[4] In his State of the Union speech, President Obama called for an end to these tax subsidies:

> *"I'm asking Congress to eliminate the billions in taxpayer dollars we currently give to oil companies. I don't know if you've noticed, but they're doing just fine on their own. So instead of subsidizing yesterday's energy, let's invest in tomorrow's."*[5]

The President's remarks have focused renewed attention on the impact that outdated legacies of the tax code and failed royalty-relief policies have on our current energy system.

Most oil and gas subsidies have been on the books in the United States for many decades (Figure 3). They represent an era when oil and gas exploration was in its infancy, and when resources were plentiful but remained largely unexplored. However, while the industry has now become the most profitable in the world, its legacy of U.S. tax subsidies remains alive and well. Some of the subsidies have been on the books for nearly 100 years.

Figure 3. Date of Initial Enactment of Targeted Oil and Gas Tax Provisions

Tax Incentive	Year Added to the Tax Code
Excess of Percentage over Cost Depletion	1926[a]
Expensing of IDCs	1916[b]
Credit for Enhanced Oil Recovery Costs	1990[c]
Expensing of Tertiary Injectants	1980[d]
Reduced G&G Amortization Period	2005[e]
Election to Expense 50% of Refinery Costs	2005[e]
Credit for Production from Marginal Wells	2004[f]
Oil and Gas Exemption from Passive Loss Limitation	1986[g]

Source: U.S. Congress, Senate Committee on the Budget, ***Tax Expenditures: Compendium of Background Material on Individual Provisions***, committee print, prepared by Congressional Research Service, 111th Cong., 2nd sess., December 2010.

Notes:

[a] An allowance for depletion was added to the tax code in 1913. Percentage depletion replaced discovery-value depletion in 1926 (The Revenue Act of 1926).

[b] 1916 Treasury Regulation, Number 45, Article 223.

[c] The Omnibus Budget and Reconciliation Act of 1990.

[d] The Crude Oil Windfall Profit Tax Act of 1980.

[e] The Energy Policy Act of 2005.

[f] The American Job Creation Act of 2004.

[g] The Tax Reform Act of 1986.

Source: Congressional Research Service memo to Natural Resources Democratic Staff, February 3, 2011

Congress has allowed oil and gas companies to deduct "intangible drilling costs" since 1916 – only 3 years after the 16th amendment to the Constitution established the power of the federal government to levy

[3] Congressional Research Service, Salvatore Lazzari, *A History of Federal Energy Tax Policy: Conventional as compared to Renewable and Nonconventional Energy Resources*, 1988.

[4] Office of Management and Budget, Budget of the U.S. Government, Fiscal Year 2011, p. 161-162. Available at: http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/budget.pdf

[5] ABC News, Transcript of President Obama's State of the Union Speech
http://abcnews.go.com/Politics/State_of_the_Union/state-of-the-union-2011-full-transcript/story?id=12759395&page=2

income taxes.[6] Intangible costs of exploration generally include wages, costs of using machinery for drilling, and the costs of materials like drilling muds, chemicals, and fuel that get used up during the process of building wells. While most businesses must write off these expenses over the useful life of the property, oil companies can write these expenses off immediately.[7] Since 1968, this program has cost the U.S. Treasury $78 billion.[8] Ending this tax subsidy would raise nearly $8 billion over the next decade.

Tax breaks that allow oil and gas companies to use the "percentage depletion allowance" were first put in place in 1926. Rather than writing off the actual costs of the property over its useful life, like most businesses must do, some oil companies get to simply deduct a flat percentage of gross revenues. Under this method of accounting, total deductions regularly exceed the actual capital invested to acquire and develop the reserve.[9] When this program was started, stimulating massive exploration around the geologically unknown United States was so important that oil and gas companies were allowed—through this preferable tax treatment—to recover amounts in excess of their investment. Since 1968, this program has cost the U.S. Treasury $111 billion.[10] Ending this tax subsidy would raise more than $10 billion over the next decade.

The list goes on. As Figure 4 demonstrates, the remnants of our 20th century energy policy remain with us today. Since 1968, six different oil and gas tax subsidies have cost us more than $190 billion in revenue losses. Figure 4 does not include the Section 199 manufacturing deduction, which allows eligible oil extraction operations to deduct up to 6% of taxable income. In 2004, the definition of "manufacturing" was amended so that oil and gas production could qualify. It is not yet clear how much this provision has cost so far, but it is estimated that closing this loophole would raise more than $17 billion over the next ten years.

Figure 4. Cumulative Revenue Losses (1968-2010)
billions of dollars

Tax Incentive	Revenue Loss in Constant Year 2010 Dollars
Excess of Percentage over Cost Depletion	$111.0
Expensing of IDCs	77.7
Credit for Enhanced Oil Recovery Costs	2.4
Expensing of Tertiary Injectants	0.4
Reduced G&G Amortization Period	0.3
Election to Expense 50% of Refinery Costs	1.6

Source: CRS calculations using GAO and JCT data.

Notes: Values are adjusted to 2010 dollars using the Office of Management and Budget (OMB)'s GDP price index.

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[6] Congressional Research Service, Molly F. Sherlock, *Energy Tax Policy: Historical Perspectives on and Current Status of Energy Tax Expenditures,* May 7, 2010 (R41227). Available at: http://www.crs.gov/pages/Reports.aspx?PRODCODE=R41227&Source=search

[7] Senate Budget Committee, Tax Expenditures: Compendium of Background Materials on Individual Provisions, December 2008. Available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_senate_committee_prints&docid=f:45728.pdf

[8] In constant 2010 dollars. Congressional Research Service memo to Natural Resources Democratic Staff, February 3, 2011.

[9] Senate Budget Committee, Tax Expenditures: Compendium of Background Materials on Individual Provisions, December 2008. Available at: http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_senate_committee_prints&docid=f:45728.pdf

[10] In constant 2010 dollars. Congressional Research Service memo to Natural Resources Democratic Staff, February 3, 2011.

Subsidies to Oil Companies Do Not Benefit the Public

The oil and gas industry argues that the tax breaks they enjoy encourage them to develop more oil and gas deposits, which lead to increased oil and gas supplies and lower energy prices.[11] The Natural Resources Committee Democratic Staff's analysis suggests otherwise for two primary reasons:

1. Depending on the reservoir and the physical characteristics of the hydrocarbon, the cost of producing oil can range from as little as $2 per barrel in the Middle East to more than $15 per barrel in some fields in the United States, according to the Energy Information Administration. Bringing once-expensive deepwater Gulf of Mexico oil into production can now be done for less than $10 per barrel.[12] The profit incentive to explore and produce new supplies for this lucrative market dwarfs any marginal benefit that existing federal tax breaks for oil exploration or production could provide. As President George W. Bush said in 2005, "With oil at more than $50 a barrel, by the way, energy companies do not need taxpayers'-funded incentives to explore for oil and gas."

2. In recent years, higher oil company profits have increasingly been redirected into dividends and stock purchases, not exploration. Among the Big 5 oil companies, less than 10 percent of profits are reinvested into exploration of new oil deposits.[13] Net profits directed towards dividends and stock repurchases for the Big 5 oil companies were 58 percent in 2005, 73 percent in 2006, and 72 percent in 2007, 71 percent in 2008, and 89 percent in 2009. Dumping profits into stock buybacks drives up share prices for remaining shareholders by concentrating ownership, and, in the process, acts to increase the values of stock options for executives. It also reduces the amount of capital available for new exploration, improvements in drilling safety, and for other purposes (see below).

The current tax treatment does not incentivize oil and gas companies to diversify into clean energy alternatives. While some oil companies tout their commitment to research into alternative energy resources, a review of actual corporate investments in research and development (R&D) reveal a business model which appears wildly *averse* to innovation. While companies in high-tech sectors like pharmaceuticals and semiconductors regularly invest 15-18 percent of their revenues in R&D, U.S. energy companies invest less than one quarter of one percent of revenues in R&D.[14] Viable new substitutes for oil are a clear threat to the industry, as they would act to reduce the value of the oil companies' reserves, refineries, pipelines, and other infrastructure.

Repealing the oil industry's tax subsidies will not impact gas prices for American consumers. Oil, the main input and primary cost driver of gasoline, is traded in a global market and oil companies get paid the going market price for the oil they produce. On the oil market, there is no difference between an unsubsidized barrel of oil that costs $10 to produce and a subsidized barrel that costs $9.50 to produce. Each barrel will sell for the

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[11] J. Larry Nichols on behalf of the American Petroleum Institute, testimony before the Senate Finance Subcommittee on Energy, Natural Resources, and Infrastructure, September 10, 2009. Available at: http://www.api.org/Newsroom/upload/090910_Finance_Committee_Testimony.pdf

[12] EIA, *Supply*. Available at: http://www.eia.doe.gov/pub/oil_gas/petroleum/analysis_publications/oil_market_basics/supply_text.htm#Oil%20Production

[13] Citizens for Tax Justice, *What Oil and Gas Companies Extract—from the American Public,* July 9, 2010. Available at: http://ctj.org/pdf/energy20100709.pdf

[14] Susan Hockfield, testimony before the House Select Committee on Energy Independence and Global Warming, September 10, 2008.

same price, currently more than $90 on the oil market. Oil companies that receive tax subsidies pass on that benefit to their shareholders, not to consumers.

Oil Markets: Hostage to Fear

The political instability in Egypt has, so far, not had any actual impact on the world's oil trade. The two million barrels per day of petroleum product that flow through the Suez Canal have not been disrupted in any way. The head of the International Energy Agency has said that even a closure of the Suez Canal would only delay, rather than cut, oil supply because shipments could be rerouted around Africa.[15]

While oil supplies and flows are unchanged and unlikely to significantly change, oil prices have noticeably reacted. The price of Brent crude oil has surged above $100 per barrel for the first time since 2008.We are seeing, yet again, that events on the other side of the globe involving a country that produces less than one twelfth the amount of oil as the United States can have significant impacts on American consumers.

American consumers are *price takers* when it comes to buying oil. When oil markets react negatively to unfavorable political events or when OPEC decides to cut production, American consumers must simply pay more at the pump. The world has little spare production capacity that can be tapped during supply crunches, and what does exist lies almost entirely in Saudi Arabia and other OPEC countries. Expanded domestic drilling will not significantly change that dynamic, as the United States lacks sufficient oil reserves and production capacity to offset OPEC production decisions.[16]

Like American consumers, multi-national oil companies are also price takers. However, since the oil companies are selling into the same global market as OPEC, the political instability and supply fears that drive up prices only act to increase the price that oil companies get for their product. This is one more example of how the status quo works well for the oil and gas industry but not for American consumers. Until there are alternatives to oil, American consumers will continue to be held hostage to volatile oil markets and far away events.

Beyond Tax Subsidies: Royalty Relief and the $53 Billion Windfall

In addition to the tax code, there also exist other federal policies designed to incentivize drilling. Chief among these is so-called royalty relief. Oil companies pay a fraction of the value of oil produced on federal land to the federal government. Offshore, this royalty rate is typically 12.5 percent.

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[15] Muriel Boselli, Reuters, *No oil supply crisis over Egypt – IEA,* February 1, 2011. Available at: http://www.reuters.com/article/2011/02/01/idINIndia-54561920110201?pageNumber=2

[16] The EIA estimates that, even if the entire lower 48 OCS were opened to drilling, this would increase cumulative U.S. oil production by only 1.6 percent by 2030 and would have an "insignificant" impact on prices (http://www.eia.doe.gov/oiaf/aeo/otheranalysis/ongr.html). As to the Arctic National Wildlife Refuge, EIA estimates that if the Refuge were opened for drilling, production would likely peak in 2027 at just 0.78 million barrels per day—reducing world oil prices by 78 cents per barrel in EIA's average price and resource case. EIA notes that "the Organization of Petroleum Exporting Countries (OPEC) could neutralize any potential price impact of ANWR oil production by reducing its oil exports by an equal amount." (http://www.eia.doe.gov/oiaf/servicerpt/anwr/index.html)

In 1995, at a time when oil prices where under $20 per barrel, the Republican Congress passed the Deep Water Royalty Relief Act (DWRRA) which allowed for royalty free deepwater production in the Gulf of Mexico when prices were low, for leases issued between 1996 and 2000. The intent of this law was to encourage deepwater production by waiving royalties until prices rose above certain thresholds. However, the oil and gas company Kerr-McGee (now Anadarko) filed suit to challenge the Interior Department's authority under the poorly drafted 1995 law to end royalty free drilling when prices were high. The courts ultimately sided with Kerr-McGee's interpretation of the law and the Supreme Court declined to hear the case.

As a result of the Court's ruling, ExxonMobil, BP, Chevron, Shell, Conoco Phillips and many other companies are now drilling for free on public land offshore and will continue to do so for the life of these leases no matter how high oil prices climb. The Government Accountability Office (GAO) has estimated that the federal government and American taxpayers stand to lose up to $53 billion in foregone royalties over the next 25 years.[17] Ranking Member Markey has authored legislation that would recover these royalties rightfully owed to the American people. The House has repeatedly passed Rep. Markey's legislation, including as part of H.R. 3534 that passed the House on July 30, 2010, but the Senate has never taken action.

Stop the Giveaways to the Oil Industry, Reorient Towards Innovation

The oil companies and their representatives frequently suggest that their high publicly reported profit numbers are misunderstood because only 7 cents of every dollar in sales is profit, which is similar to other American industries.[18] However, intensely competitive industries like retail and food service are lucky to earn 1 or 2 cents of profit per sales dollar. The real measure of the oil industry's financial health is how much profit they generate with the money shareholders have invested. Over the last two years, the Big 5's average annual return on equity was 21 percent. The U.S. Treasury bond, in contrast, yielded about 3 percent during this same period. The oil and gas industry's very high profitability has provided a financial a bonanza for shareholders over the last decade. A $10,000 investment in the Big 5 in 1990 is worth $100,000 today. In contrast, the same investment in an S&P 500 index fund is now worth $60,000.[19]

The oil and gas industry is a mature and highly profitable sector that is no longer in need of generous tax breaks or royalty-free drilling access. The $36.5 billion in subsidies that the industry is set to receive over the next decade will not help consumers with rising energy prices. These subsidies will not strengthen America's energy independence or help to develop alternatives to oil. Allowing $53 billion in royalties to go uncollected is a fiscal misstep that must be responsibly corrected.

Reorienting America towards a 21st century energy system that prioritizes innovation, domestic job growth, and clean alternatives must start with repealing 20th century tax and royalty policies that favor the oil industry.

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[17] United States Government Accountability Office, June 5, 2008. (GAO-08-792R Royalty Relief). Available at: http://www.gao.gov/new.items/d08792r.pdf

[18] Email from Jack Gerard, American Petroleum Institute, *The Economics of Oil Company Earnings*, **February 1, 2011.**

[19] 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.