Taxing Our Way to Energy Insecurity Again

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The administration's FY 2010 budget proposal was the opening salvo in an effort to fund the government's record spending via some $33 billion in new taxes and fees exclusively on the oil and gas industry. This brings the total sum of new taxes on this industry to more than $80 billion when the industry's share of other general business tax increases is included.[1]

While our nation continues to diversify its energy sources, the U.S. Energy Information Administration nevertheless predicts that even in its most optimistic scenarios, oil and natural gas will play a major role in meeting our energy needs for many decades.[2] But increased reliance on foreign imports to meet those needs is a growing concern, and with unemployment the highest in 25 years, the worst economic growth in a generation, and volatile energy prices, it is important to take stock of lessons learned two decades ago and apply them to our current challenges. The Windfall Profits Tax (WPT) implemented in 1980 operated as an excise tax on domestically produced oil and provides a solid historical reference to judge the impacts of recently- proposed new taxes and fees.

Government proposals would levy more than $80 billion in new taxes and fees on the oil and gas industries to fund record spending. History demonstrates that such policies would actually increase imports, make energy more expensive, and lead to significant job losses.

In 2006, the Congressional Research Service estimated that implementation of the WPT resulted in as much as an 8% decline in domestic production and as much as a 13% increase in imports.[3] In 1986 imported oil as a share of total U.S. consumption jumped from 32% to 38% from the previous year. This 19% increase is one of the largest annual increases on record and one of the primary reasons the WPT was ultimately repealed in 1988.

Now, two decades after the demise of the WPT, the new administration has included proposals of a similar nature in its FY 2010 budget proposed to Congress last month. To finance record high spending for administration priorities, the budget aims to impose new taxes that again will raise the costs of producing domestic oil and natural gas and place U.S. businesses at a disadvantage with foreign government-owned oil and gas companies. This budget proposal would creates new taxes and fees, while repealing several long-standing tax rules for companies that incur significant economic risk in exploring for oil and natural gas without any guarantee of profitable recovery.

The elimination of these tax rules is not about "closing loopholes" as some have suggested. These provisions were specifically crafted by Congress to create and preserve American jobs and to increase the country's energy security by supporting greater domestic production. Similar tax rules, not proposed for elimination, apply to other industries. Thus, these new tax changes disproportionately target one industry simply to finance increased federal spending.

In addition to the administration's budget proposal, late last month the House Natural Resources Committee Chairman Nick Rahall (D-WV) introduced draft legislation which would increase fees and the regulatory bureaucracy associated with U.S. oil and gas production. Chairman Rahall's bill would reduce the initial lease period by half, effectively doubling the cost of new leases; increase the minimum royalty rate collected on production of oil or gas; as well as impose new fees on non-producing leases.[4]

Taken together, the administration's budget and Chairman Rahall's draft legislation foreshadow a less secure energy future. History has demonstrated that arbitrary tax increases that raise the costs of doing business in this country are counterproductive, failing to achieve stated long-term goals of creating permanent jobs, supplying affordable domestic energy, and increasing overall energy security. Moreover, close scrutiny demonstrates that such policies are likely to create harmful unintended consequences like increased oil imports, significant job losses, and more expensive energy bills.

Threatens Energy Security and Increases Imports

All of the proposed new taxes, fees, and additional regulatory hurdles have one thing in common; they will increase the cost of producing domestic oil and natural gas. While the U.S. currently produces over 5.3 million barrels of oil per day, it is estimated that America has abundant technically recoverable oil and gas resources totaling approximately 134 billion barrels of oil, and 2,246 trillion cubic feet natural gas on and off its shores.[5,6,7,8] The clearest way to meet the administration's stated goals of job creation, energy security, and reduced reliance on foreign imports is to take advantage of these abundant domestic natural resources. But by keeping these resources off limits, and making the costs of developing those that are available more expensive, the policies put at risk affordable and reliable sources of American energy.

The price of oil is set by the world oil market. If any one country raises the price to extract its oil, companies that produce this energy often look to other countries where they can produce these products at a lower price. However, investor-owned oil companies own about 6% of the world's oil reserves and government-owned oil companies own close to 80%.[9] By levying additional taxes at home and encouraging energy operations to move overseas, the U.S. is actually strengthening the competitiveness of those state-owned companies in nations that do not operate under the same fiscal constraints.

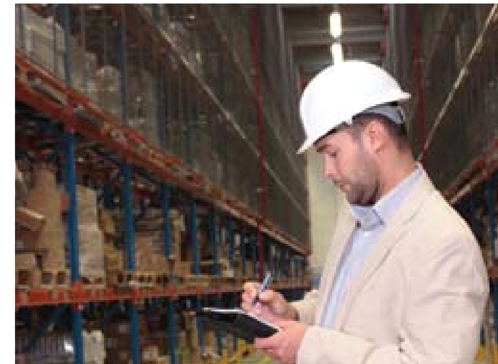
To remain competitive, domestic producers will be forced to bear the additional costs of production caused by new taxes and fees, thereby creating an inherent disincentive for them to increase production of domestic oil and gas resources, and in some cases even creating a disincentive for them to maintain existing production levels. Absent a significant drop in demand, the only way to meet the resulting supply gap this will create is to import more oil. Today we import about 60% of the oil consumed in the United States, and history has proven increased taxes will only serve to increase that percentage.[10]

If the U.S. becomes more dependent on foreign imports, it also becomes more susceptible to the volatile price swings and potential supply disruption. As many of America's policy leaders continue to urge "energy independence," raising taxes and fees on oil and gas will result in the exact opposite effect. Bluntly, the objective of increasing America's energy security is undercut by these proposed new taxes.

Harms U.S. Economic Competitiveness

The U.S. oil and gas industry is already competing against foreign government-owned corporations whose operations are largely subsidized by their parent government. Recognizing that business taxes play an important role in economic decision-making and influence incentives to acquire and use capital, many of our trading partners have lowered corporate tax rates relative to the United States, which maintains the second highest effective corporate tax rate of all developed countries. Further, most other countries do not tax income earned outside of their borders (relying on a "territorial" taxation system). Thus, our "worldwide" tax system imposes a burden on American businesses and workers by raising the costs to invest both inside and outside the United States, placing U.S. firms at a competitive disadvantage.

National oil companies (NOCs) are owned or controlled by the governments of oil-rich countries, the largest of which are based in the Middle East, Russia, China, and Venezuela, and increasingly dominate world oil and gas supply. In fact, of the top 25 oil and gas producing companies, 17 are national companies.[11] NOCs currently account for 51% of world oil and gas production as compared to 12% for the supermajors, and nearly 80% of global oil reserves.[12] U.S. companies continue to compete against NOCs, subsidized by their parent governments, for access to the ever-decreasing pool of global oil supplies not already under exclusive control of a foreign state. Clearly, this imbalance strengthens the market power of the nationalized oil companies and gives them a competitive advantage and more influence in the global marketplace as the world's demand for energy grows. Accordingly, a number of national oil companies have been expanding internationally.



The majority of NOCs are required to supply oil or gas to their country's domestic market at subsidized prices.[13] This policy applies to all of the national oil companies in OPEC countries and many large consuming countries including China, India, Indonesia, Brazil, and Mexico. Because energy is a critical underpinning for economic growth, the reduced cost to produce energy in these countries when compared to the higher costs of

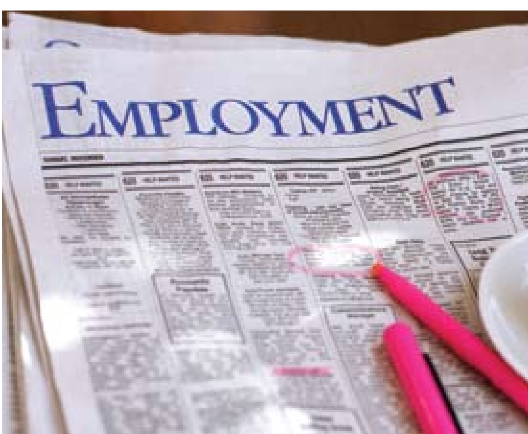
U.S. energy production through new taxes would clearly make the cost of doing business in America higher.

For natural gas, the impact of new taxes and fees is different as the market is not truly global and therefore prices are determined regionally. As such, some of the increased production costs that result from increased taxes and fees will get passed to consumers through higher natural gas prices. As the price of natural gas rises, the production cost of the many petroleum-based products that rely on natural gas as a feedstock will also increase. The past decade has witnessed various industries that rely heavily on natural gas decimated as prices escalated dramatically, largely due to a lack of available supply to produce.[14] Significant portions of many of these industries relocated overseas to avail themselves to cheaper natural gas supplies, or went out of business altogether. Enacting policies that cause increased prices for natural gas now would be nearsighted as we should be encouraging those industries to return to the U.S. market and/or expand domestic operations to create jobs and generate economic growth.

Increasing taxes and costs on domestic energy production makes the United States less attractive for investment as compared to projects outside of the country. The net result is reduced investments into our own economy, and increased reliance on foreign energy sources. Compounding that by taxing American companies on their foreign operations at higher rates than their competitors further weakens America's competitiveness and increases our reliance for the imported energy.

Jeopardizes Jobs and Increases Costs to Consumers

Over 1.8 million Americans are employed by the oil and gas industry, with another 4 million workers indirectly tied to the industry.[15] Over 90% of U.S. wells are developed by independent producers, which are small businesses employing 12 people on average.[16] And the overwhelming majority of investment into very capital-intensive deep and ultra-deepwater development is made by U.S. based major oil and gas companies that currently operate 80% of the top producing areas in the Gulf of Mexico.Increasing the production costs of oil and gas via new taxes and fees place American jobs in jeopardy as small and large firms alike look to reduce operating expenses or shift to lower cost overseas production opportunities. Already we are seeing cutbacks in spending programs, particularly in the U.S. Further increasing production costs will likely result in the shedding of American jobs, at the same time the government is spending hundreds of billions of taxpayer dollars to create and retain jobs.



The International Energy Agency has projected global oil and gas investment to decline 21% this year, largely owing to decreased demand as well as lower oil and gas prices.[17] Additional taxes will only exacerbate this situation and invariably lead to even less investment in new U.S. production. Over time, as economic growth returns, demand will increase as well and if needed investment in new energy supplies are not made, the cost for oil and natural gas will rise.

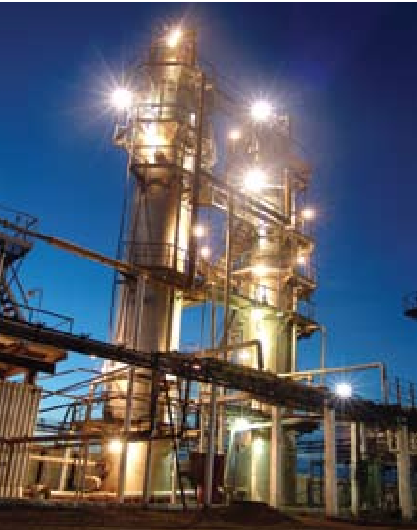
Additionally, the impact of any new taxes and fees on domestic natural gas will lead to higher costs paid by consumers for natural gas and its products. The elasticity of demand for natural gas dictates how much of the increased costs can be passed to the consumer before consumers begin to buy less. Two of the largest uses of natural gas in the United States are for electricity generation and residential consumption.[18] Since some of the taxes will get passed on to the purchaser, it is likely that utility rates will rise at a time when American families can least afford it. In addition, because a significant amount of natural gas produced domestically is also used as a feedstock for the production of goods like plastics, chemicals, and fertilizers, increased taxes will also lead to increased costs of these goods that permeate the American economy.

Targets a Single U.S. Industry

By nearly every comparison, the oil and gas industry is more capital intensive and pays more taxes than most other industries. Yet, when measured as earnings per dollar of sales, the oil and gas industry's profit margins are within the average range when compared to other major industries.

In 2008 the oil and gas industry earned 5.7 cents for every dollar of sales as compared to 6 cents for manufacturing industries (excluding the financially troubled auto industry) and 4.5 cents compared to all manufacturing.[19] In fact, several other industries experienced significantly higher rates of return.

In addition, the oil and gas industry has recently accounted for more than half of the massive investments in technology needed to meet growing demand for energy and improve environmental stewardship.[20] From 2000 to 2007, the U.S. oil and gas industry invested about $121.3 billion on emerging energy technologies in the North American market. This expenditure represents almost two-thirds of the estimated total of $188 billion spent on these technologies by the private sector and the federal



government during this time period. In comparison, other private companies account for 31% of this total and the federal government accounts for merely 4% on these technologies. Since 1990, the industry has invested $175 billion to improve the environmental performance of its products, facilities and operations, or about $582 for every man, woman, and child in the U.S.[21]

The oil and gas industry also currently faces significant taxes on its profits. In fact, the financial bailout package enacted in September of last year was offset by nearly $9 billion in new taxes on the industry.[22] This was on top of increases enacted at the end of 2007. But even before taking these increases into account, EIA estimated the industry's 2007 income tax expenses (as a share of net income before income taxes) averaged 40.4%, as compared to 26.7% for all manufacturing companies. Moreover, EIA data shows that for the three-year period from 2005-2007, the major oil and gas producing companies paid or incurred over $252 billion of income tax expense.[23] We need a balanced approach to developing America's energy resources that is both fair to producers and provides reliable and affordable energy to American families; the new taxes run contrary to those fundamental principles.

Furthermore, from a purely practical standpoint, it is worth noting that past increases in oil taxes have not produced the new revenue to the federal government that had been predicted. The Windfall Profits Tax of the 1980s was projected to increase gross federal revenues by $393 billion over the 11 years the tax was supposed to be in place.[24] However, the tax generated only a 20% net increase of what was projected when enacted. In addition, as the proposed new taxes and fees are levied on marginal increases in production (i.e., per barrel), fewer barrels will actually be produced because the necessary capital needed for production will instead be collected by the government. The oil and gas industry paid in excess of $22.5 billion to the federal government in royalty, rent, and bonus payments in FY 2008.[25] If tax increases lower domestic production, as happened with the WPT in 1980, the government can expect to collect much less in the coming years.

Conclusion

We call on Congress and the Obama administration to reject the historically disproven policies of targeting a single industry or source of energy with punitive taxes. Instead our national leaders must implement policies that encourage the efficient expansion of all energy sectors and sources, create new American jobs and opportunities, and create an environment that enables U.S. business to be more competitive in the global market. We offer the following recommendations that would generate revenue for the government as well as increase America's energy security.

- Expeditiously make public areas that are not legally prohibited available for lease for exploration and development. Developing domestic resources, owned by every American, could create as many as 160,000 new jobs, increase federal, state and local revenues by as much as $1.7 trillion, and offset nearly 20% of imported oil[26]

- Allow more rapid depreciation of capital equipment through the federal tax code to encourage new investments that would accelerate reductions in energy and carbon intensity, such as by:
  - Reducing the recovery period for investment in electricity transmission lines and smart grid devices from 20 years to 10 years
  - Reducing by half the cost-recovery period for the installation of best available energy efficiency devices by commercial facilities and small businesses
  - Providing for immediate expensing for investments that meet the standard for breakthrough low carbon technologies

- Implement policies that encourage the greater use of natural gas. Recent discoveries have significantly increased the supplies available, and U.S. policies should encourage greater and broader use of this clean energy resource in areas like transportation and power generation

- Increase and make permanent the research & development tax credit to provide businesses with the necessary certainty to make long-term commitments to developing new and improved technologies. This credit is technology neutral and allows the private sector to invest its resources in an efficient and deliberative way

We are reminded on a daily basis of the precarious economic condition in which we exist. Unemployment is higher than any point in the past 25 years. Economic growth is the worst seen in a generation. To reverse these trends, the government enacted an economic stimulus package, costing the federal taxpayer a staggering $800 billion. As families and businesses alike slowly start spending, building, hiring, and taking the actions that will truly stimulate economic recovery, now is the time for the federal government to craft policies that will accelerate American jobs, not kill them; enable American businesses to be more competitive, not handicap them in a global market; and increase our energy security, not threaten it.

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