TAXPAYERS for COMMON SENSE

Oil & Gas Issue Brief

October 2021

Getting the Facts on Oil & Gas Preferences

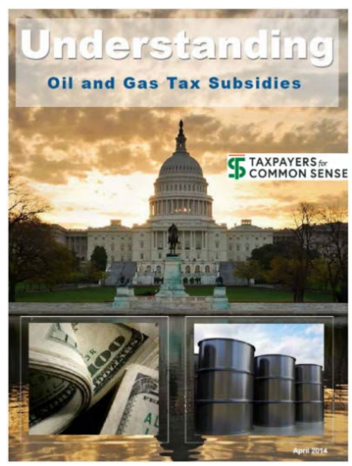
Big oil has benefited from every reconciliation bill in modern day history. This time let's get it right. Century-old oil and gas policies that threaten our climate goals must go.

The time has come to clean up the code and stop oil and gas companies from skirting their climate liabilities. With $80/barrel oil, and climate liabilities piling up, taxpayers can't afford another round of industry giveaways.

Over the years we've dug into the details of all federal oil and gas subsidies. Below is a summary of what we've found and where reform is needed.

Needless Century-Old Tax Breaks Remain on the Books

Preferences for oil and gas producers baked into the tax code date back to 1916 and allow the industry to recover their capital costs unlike any other, tabulate inventory in ways that defy reality, and skirt taxes on foreign income. Together the provisions cost taxpayers more than $61 billion over the last decade. Below is a brief description of some of these tax breaks:



Percentage Depletion Allowance (PDA) (26 U.S.C. §613)

Created in 1926, the Percentage Depletion Allowance (PDA) enables independent oil and gas producers to deduct 15% of their revenue (up to 25% for marginal wells) from their gross income before taxes are calculated. It was meant to allow companies to recover their investment costs in a well, but because they can take the deduction as long as the well generates income, total deductions typically exceed the original investment. In effect, PDA provides oil and gas companies an ongoing production subsidy.

JCT estimated cost from FY2011 – FY2020: **$8.52 billion.**

Expensing of Exploration and Development Costs (26 U.S.C. §263)

Businesses constructing a property, plant, or equipment must capitalize their costs (deduct them) over the life of the asset. But oil and gas companies can fully deduct these costs from taxable income as they are incurred. Specifically, oil and gas producers can fully expense (deduct) **intangible drilling costs (IDCs)** like wages, fuel and drilling site preparations.[1] The subsidy has existed since 1916.

JCT estimated cost from FY2011 – FY2020: **$10.1 billion.**

[1] Rules differ slightly for integrated producers vs. nonintegrated oil and gas producers (producers without substantial refining or retail activities)

Master Limited Partnerships Exemption (26 U.S.C. §7704)

In 1986, Congress closed a loophole in the tax code by requiring businesses organized as partnerships but selling equity interests, like stock, on a public exchange to be treated as corporations for tax purposes. Except, these publicly traded partnerships, or "master limited partnerships" (MLPs), can avoid corporate income tax if at least 90% of their income comes from qualifying sources, like oil and gas production and transportation. As of 2017, 82% of the MLPs that can duck corporate taxes are energy and natural resources companies, with a total market capitalization of over $390 billion, according to the Master Limited Partnership Association.

JCT estimated cost from FY2011 – FY2020: **$5.8 billion.**

Amortization of Geological and Geophysical Expenditures (26 U.S.C. §167)

Companies use geological and geophysical (G&G) assessments to locate new oil and gas deposits, often as the first step in developing a new well. Instead of deducting the G&G costs like capital costs over the life of the well as normal tax rules dictate, oil and gas producers can amortize over 2-7 years, depending on the company.

JCT estimated cost from FY2011 – FY2020: **$1.14 billion**

Passive Loss Limitations Exemption (26 U.S.C. §469)

Passive business activity refers to any activity in which a taxpayer has an economic interest but does not "materially participate" in normal business activities. Normally, taxpayers can deduct losses from passive activities (passive losses) up to but not over their total amount of passive income. Working interests in oil or gas wells, however, are exempt from the passive loss limitation. This allows oil and gas companies to deduct their passive losses in excess of their active income from normal business activities.

JCT estimated cost from FY2011 – FY2020: **$167 million**

Other tax breaks enable oil and gas companies to reduce their taxes further:

Some allow companies to recover their capital costs through tax deductions quicker than other businesses can. These include:

- Expensing of Tertiary Injectants (26 U.S.C. §193)
- 15-year MACRS for Natural Gas Distribution Lines (26 U.S.C. §168)
- 15-year recovery period for retail motor fuels outlets (26 U.S.C. §168)
- Election to expense 50% of qualified property to refine liquid fuels (26 U.S.C. §179C)

Others simply reward certain activity, like production from marginal (low producing) wells or the use of injectants and other methods to stimulate more production from existing wells.

- Credit for Production from Marginal Wells (26 U.S.C. §45I)
- Credit for Enhanced Oil Recovery (EOR) (26 U.S.C. §43)

Lastly, some take the form of obscure accounting rules that govern how much foreign tax can be deducted or how to tabulate the cost of inventory.

- Deductions for Foreign Tax – Dual Capacity (26 U.S.C. §901)
- Last-In First-Out Accounting (26 U.S.C. §472)

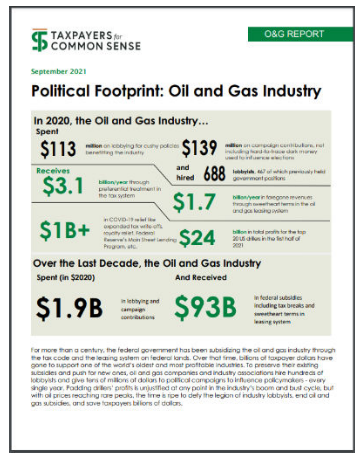
Endless Deferral and Immediate Cost Recovery Cost Taxpayers

The U.S. tax system allows oil and gas companies to use immediate cost recovery to defer taxes that ultimately never come due. The U.S. tax system is so generous, that **even deferred taxes are often minimal or negative** – they expect to get credits in the future that totally eliminate tax liability.

- **Cumulative U.S. taxes incurred by the top 20 U.S. E&P companies in 2019 (current and deferred), was -$1.3 billion**

The Oil Industry Is Exerting Influence to Keep Their Subsidies

The oil and gas industry has one of the largest lobbying forces in U.S. politics, employing hundreds of lobbyists with connections on Capitol Hill and in federal agencies, and donating hundreds of millions of dollars to congressional candidates. And that's just what is disclosed. More influence is exerted through extensive dark money networks. Below is a recap of the oil and gas industry's political footprint: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O&G REPORT
September 2021
Political Footprint: Oil and Gas Industry
In 2020, the Oil and Gas Industry…
Spent
$113
$139
Receives
$3.1
and hired
688
$1.7
$1B+
$24
Over the Last Decade, the Oil and Gas Industry
Spent (in $2020)
$1.9B
And Received
$93B

- In 2020, the O&G industry spent **$113 million on lobbying** and hired **688 lobbyists**, **467** of which are revolving door personnel
- In 2020, the O&G industry spent **$139 million on campaign contributions**, a 22.7% increase over last presidential election cycle despite being hit by the pandemic
- Over the last decade, the O&G industry spent **$1.9B** on lobbying and campaign contributions
- Campaign contributions have grown by **25%**, on average, every presidential election cycle since Citizens United vs. FEC

And benefitting from billions in subsidies…

- TCS estimates **the O&G industry receives $3.1 billion through preferential tax treatment and $1.7 billion through sweetheart terms in oil and gas leasing system EACH YEAR**
- Over the last decade, the O&G industry received at least **$93 billion in federal subsidies**


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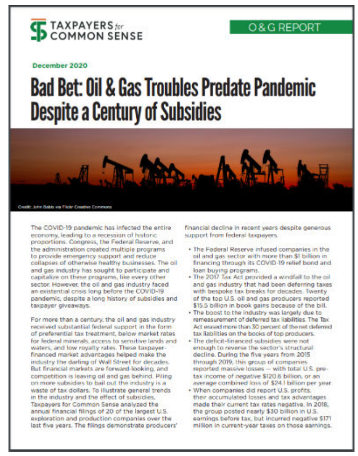
O&G REPORT
August 2021
18 Months after the Pandemic Started, Where Do Top U.S. Oil and Gas Companies Stand?

While Raking in Profits despite the pandemic…

- Top 20 U.S. O&G companies reported combined profits of **$23.5 billion** during the first 2 quarters of 2021, **$1 billion** more than their profits over the same period in 2019, before the pandemic started.
- The energy sector earning in Q2 2021 increased by **$25.5B** compared to Q2 2020. **Exxon Mobil and Chevron**, the top 2 oil giants account for the lion share of this recovery— **$17.32B** of the $25.5B year-over-year improvement

- Although some of the top 20 companies recorded losses due to derivative losses, almost all of the companies doubled their revenue compared the same period in 2020, mostly thanks to soaring oil and gas prices
- With the economy opening up, higher demand and rising prices is helping O&G companies recover from the pandemic; production has also followed suit

Big Oil also cashed in on the pandemic after winning big in the 2017 Tax Act and paid little consequence for reckless financial moves that would have been disastrous for other industries.



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O&G REPORT

December 2020

Bad Bet: Oil & Gas Troubles Predate Pandemic Despite a Century of Subsidies

Credit: John Babb via Flickr Creative Commons

The COVID-19 pandemic has infected the entire economy, leading to a recession of historic proportions. Congress, the Federal Reserve, and the administration created multiple programs to provide emergency support and reduce collapses of otherwise healthy businesses. The oil and gas industry has sought to participate and capitalize on these programs, like every other sector. However, the oil and gas industry faced an existential crisis long before the COVID-19 pandemic, despite a long history of subsidies and taxpayer giveaways.

For more than a century, the oil and gas industry received substantial federal support in the form of preferential tax treatment, below market rates for federal minerals, access to sensitive lands and waters, and low royalty rates. These taxpayer-financed market advantages helped make the industry the darling of Wall Street for decades. But financial markets are forward-looking, and competition is leaving oil and gas behind. Piling on more subsidies to bail out the industry is a waste of tax dollars. To illustrate general trends in the industry and the effect of subsidies, Taxpayers for Common Sense analyzed the annual financial filings of 20 of the largest U.S. exploration and production companies over the last five years. The filings demonstrate producers' financial decline in recent years despite generous support from federal taxpayers.

- The Federal Reserve infused companies in the oil and gas sector with more than $1 billion in financing through its COVID-19 relief bond and loan buying programs.
- The 2017 Tax Act provided a windfall to the oil and gas industry that had been deferring taxes with bespoke tax breaks for decades. Twenty of the top U.S. oil and gas producers reported $15.5 billion in book gains because of the bill.
- The boost to the industry was largely due to remeasurement of deferred tax liabilities. The Tax Act erased more than 30 percent of the net deferred tax liabilities on the books of top producers.
- The deficit-financed subsidies were not enough to reverse the sector's structural decline. During the five years from 2015 through 2019, this group of companies reported massive losses — with total U.S. pre-tax income of negative $120.6 billion, or an average combined loss of $24.1 billion per year
- When companies did report U.S. profits, their accumulated losses and tax advantages made their current tax rates negative. In 2018, the group posted nearly $30 billion in U.S. earnings before tax, but incurred negative $171 million in current-year taxes on those earnings.

- The 2017 Tax Act provided a windfall to the oil and gas industry that had been deferring taxes for decades, thanks to provisions described above. Twenty of the top U.S. oil and gas producers reported **$15.5 billion** in immediate book gains because of the bill.
- The boost to the industry was largely due to remeasurement of deferred tax liabilities. The Tax Act erased **more than 30 percent of the net deferred tax liabilities** on the books of top producers by taxing it at the new lower corporate rate.
- The deficit-financed subsidies were not enough to reverse the sector's structural decline. During the five years from 2015 through 2019, this group of companies reported massive losses — with total U.S. pretax income of negative $120.6 billion, or an average combined loss of $24.1 billion per year.
- When companies did report U.S. profits, **their accumulated losses and tax advantages made their current tax rates negative**. In 2018, the group posted nearly $30 billion in U.S. earnings before tax, but incurred negative $171 million in current-year taxes on those earnings.
- In 2018, ExxonMobil reported $4.4 billion in pre-tax domestic earnings over the last three years, more than any other producer, yet reported **total federal taxes of negative $8 billion**. Largely due to the Tax Act, the company ran up relatively low tax bills in the present and gained the ability overall to reduce its taxes later by $8 billion.

Time to Enact Real Reforms

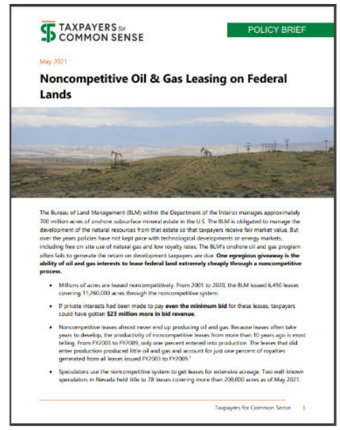
To end subsidies for oil and gas companies, Congress must tackle both the slew of preferences in the tax code and the below-market terms that let companies produce oil and gas on federal lands and waters for cheap.

Leasing reform

- **Royalty Rates** The federal onshore oil and gas royalty rate is set at 12.5 percent, well below the offshore rate of 18.75% and the rates charged on state lands. If we had been collecting the offshore rate on every barrel of oil and cubic foot of gas produced from federal lands over the last decade, taxpayers could have received up to **$12.35 billion more**.
- **Rental Rates** The current rental rates are set at $1.50/acre for the first half of the lease term and $2.00/acre for the second half of the lease term. The rates were set in 1987 and have not

been adjusted for inflation since then. Had the rates kept up with inflation, taxpayers would have received roughly **$330 million more** in rental revenues from FY2011 to FY2020.

- **Minimum Bids in Lease Sales** Like rent, the minimum amount companies can bid at auctions for federal oil and gas leases hasn't been updated since 1987. It remains at $2/acre, and bidders take full advantage. Of the 544,000 acres sold at auction in 2020, roughly 200,000 got the minimum bid. From FY2011 to FY2020, taxpayers would have received $5 million more had minimum bids been adjusted for inflation.



TAXPAYERS for COMMON SENSE

POLICY BRIEF

May 2021

Noncompetitive Oil & Gas Leasing on Federal Lands

The Bureau of Land Management (BLM) within the Department of the Interior manages approximately 700 million acres of onshore subsurface mineral estate in the U.S. The BLM is obligated to manage the development of the natural resources from that estate so that taxpayers receive fair market value. But over the years policies have not kept pace with technological developments or energy markets, including free on site use of natural gas and low royalty rates. The BLM's onshore oil and gas program often fails to generate the return on development taxpayers are due. **One egregious giveaway is the ability of oil and gas interests to lease federal land extremely cheaply through a noncompetitive process.**

- Millions of acres are leased noncompetitively. From 2001 to 2020, the BLM issued 6,450 leases covering 11,260,000 acres through the noncompetitive system.
- If private interests had been made to pay **even the minimum bid** for these leases, taxpayers could have gotten **$23 million more in bid revenue.**
- Noncompetitive leases almost never end up producing oil and gas. Because leases often take years to develop, the productivity of noncompetitive leases from more than 10 years ago is most telling. From FY2003 to FY2009, only one percent entered into production. The leases that did enter production produced little oil and gas and account for just one percent of royalties generated from all leases issued FY2003 to FY2009.[1]
- Speculators use the noncompetitive system to get leases for extensive acreage. Two well-known speculators in Nevada held title to 78 leases covering more than 200,000 acres as of May 2021.

Taxpayers for Common Sense 1

- **Noncompetitive Leasing** In 1987, Congress created the competitive leasing system to get more revenue from leasing valuable federal land. But the process has a significant loophole: the day after a competitive auction, a company (or land speculator) can avoid paying a bid by submitting a noncompetitive offer for anything that didn't sell the day before. Oil and gas companies have disproportionately used the noncompetitive system to avoid paying the $2/acre minimum bid on parcels with more acreage. Over the last 10 years, 2.3 million acres – an area roughly twice the size of Rhode Island – have been leased with no bid.
- **Reclamation Bonding** If not reclaimed timely and properly, orphaned oil and gas wells can pose environmental and public health risks. The GAO found 84 percent of bonds covering 99.5 percent of all wells are not enough to cover even the low-end estimate of reclamation costs. The bonding minimums have not been adjusted for inflation since the 1950s and 1960s. Adjusted for inflation, today's $10,000 minimum bond for an individual lease was the equivalent of $87,436 in coverage when it was set in 1960. The rate of $25,000 for statewide bonds originally provided the equivalent of $240,531 in coverage in 1954, and the $150,000 nationwide bond minimum provided $1,443,184 in coverage. Low bond minimums incentivize operators not to reclaim wells when it is more costly to clean up well sites than simply forfeit the minimum bonded amount.

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FACT SHEET

May 2021

Federal Oil and Gas Bonding

When oil and gas companies do not reclaim wells, taxpayers end up picking up the slack.

What is Oil and Gas Bonding?

The Bureau of Land Management (BLM) under the Department of the Interior (DOI) oversees the leasing of federal lands to oil and gas operators. When operators drill wells on federal lands, they change the landscape. This "surface disturbance" includes: road construction to the well site, topsoil excavation and leveling, drilling the well, installing machinery to control operations (the wellhead), and storage of other equipment and materials used or generated during drilling and production.

When a well ceases production and becomes inactive, it can pose environmental and public health risks if not reclaimed properly. The Bureau of Land Management defines well reclamation as a process to restore lands to a condition "equal to or closely approximating" their original natural state[1], which involves plugging the well, removing structures and reshaping and revegetating the land around the wells. To ensure complete and timely reclamation of lands, the Mineral Leasing Act of 1920, as amended, requires the Bureau of Land Management to obtain an adequate bond or other financial assurance from operators before drilling begins. The Bureau of Land Management uses the bonds to recuperate at least some of

[1] https://www.blm.gov/programs/energy-and-minerals/oil-and-gas/reclamation

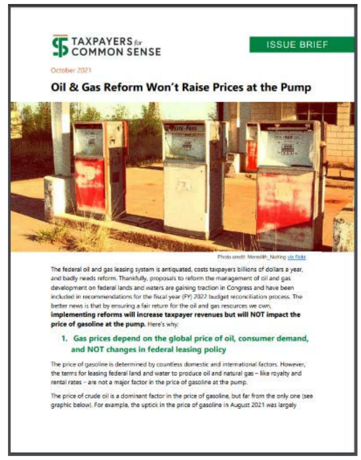
Taxpayers for Common Sense 1

Tax reform

- For the FY2022 reconciliation process, the House is proposing to cut one preference regarding "dual capacity" taxpayers – mostly O&G companies that claim too much in foreign tax credits by counting royalty payments and similar payments as tax. JCT estimates it would save $5.7 billion over 10 years.
- Repealing the other provisions listed above would provide roughly $30 billion in additional revenue over 10 years.

Reforms Won't Raise Prices at the Pump

Despite what some may claim, enacting the leasing reforms above will NOT affect gasoline prices, which depend on the global price of oil, consumer demand, and NOT changes in federal leasing policy.


TAXPAYERS for COMMON SENSE

ISSUE BRIEF

October 2021

Oil & Gas Reform Won't Raise Prices at the Pump

Photo credit: Meredith_Nutting via Flickr

The federal oil and gas leasing system is antiquated, costs taxpayers billions of dollars a year, and badly needs reform. Thankfully, proposals to reform the management of oil and gas development on federal lands and waters are gaining traction in Congress and have been included in recommendations for the fiscal year (FY) 2022 budget reconciliation process. The better news is that by ensuring a fair return for the oil and gas resources we own, **implementing reforms will increase taxpayer revenues but will NOT impact the price of gasoline at the pump.** Here's why:

1. **Gas prices depend on the global price of oil, consumer demand, and NOT changes in federal leasing policy**

The price of gasoline is determined by countless domestic and international factors. However, the terms for leasing federal land and water to produce oil and natural gas – like royalty and rental rates – are not a major factor in the price of gasoline at the pump.

The price of crude oil is a dominant factor in the price of gasoline, but far from the only one (see graphic below). For example, the uptick in the price of gasoline in August 2021 was largely

Higher royalty rates will increase taxpayer revenue with little or no effect on oil and gas production.

- Officials in Texas and Colorado report no reduced demand for leases after implementing higher royalty rates for leases on state lands.
- CBO estimates that the effects on production from an onshore royalty of 18.75% would be "negligible."

Reforms will have no impact on gas pump prices

- Increasing the onshore royalty rate would have **no impact on current leases or current production**. Higher rates would only kick in for new leases, which usually take years to develop.
- Roughly half of onshore oil & gas royalty receipts in 2013 came from leases issued more than 50 years prior. Just 6% of oil & gas royalty payments came from leases issued in the last 10 years.

If…

- Congress increases the royalty rate for leases on federal lands from 12.5% to 18.75%,
- 6% of onshore oil production is subject to the new rate in 10 years,
- The entire supply chain is able to pass on the increased royalty cost via a 7.69% price increase,
- That price increase affects just 7.6% of all U.S. crude oil used to make gasoline, and
- The price of crude oil affects 52% of the price at the pump,

Then…

- A gallon of gas costing $3.00 would suddenly cost $3.00055.