EMBARGOED UNTIL DELIVERY
Remarks as Prepared for Delivery

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Senate Committee on Finance
Subcommittee on Energy, Natural Resources, and Infrastructure

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Good afternoon Chairman Bingaman, Ranking Member Bunning, and members of the Subcommittee. Thank you for inviting me to testify before your Subcommittee today. I appreciate the opportunity to discuss the Obama Administration's FY 2010 Budget proposals that focus on the oil and gas industry.

In my testimony I will discuss several aspects of the proposals in the Obama Administration's FY 2010 Budget that are related to the oil and gas industry. First, I will briefly discuss the Administration's environmental and energy policy in order to provide context for the oil and gas related proposals. Second, I will describe the Administration's proposals related to the oil and gas industry. Third, I will evaluate why, from an economist's perspective, these proposals are good tax policy. Fourth, I will analyze the potential effects of removing these subsidies on consumer prices, productivity and domestic jobs. Finally, I will address possible concerns that removing these tax subsidies will affect our energy security.

Overview of the Administration's Environmental and Energy Policy

The Obama Administration believes that our nation must build a new, clean energy economy, reduce our dependence on oil and limit the emissions of greenhouse gases (GHG). The Intergovernmental Panel on Climate Change's (IPCC) best estimate is that global average air temperature will increase by more than 7 degrees Fahrenheit in this century if we proceed with fossil fuel-intensive energy technology development.[1] The costs of such an increase would likely be very significant, as higher temperatures would devastate many ecosystems and negatively impact agricultural output and productivity in many parts of the world. The Administration believes that it is no longer sufficient to address our nation's energy needs by finding more fossil fuels, and instead we must take dramatic steps towards becoming a clean energy economy. These include encouraging the use of, and investment in, clean energy infrastructure and energy efficient technologies.

The Congress took an important step in that direction by providing $16.8 billion in funding for energy efficiency improvement and renewable energy in the American Recovery and Reinvestment Act of 2009.[2] In addition, the Congress recently passed, and the President signed,

[1] Intergovernmental Panel on Climate Change, "Climate Change 2007: Synthesis Report," 2008
[2] Examples of this include: $5 billion for low-income home weatherization projects; $6.3 billion for state and local renewable energy and energy efficiency efforts; $2 billion in competitive grants to develop the next generation of

legislation that will increase fuel economy for all new cars and trucks sold in the United States. As a result, we will save 1.8 billion barrels of oil over the lifetime of the program – the projected equivalent of taking 58 million cars off the road for an entire year. The Administration's Budget further promotes these objectives by investing in a variety of renewable sources of electrical generation, by investing to accelerate deployment of energy conservation measures, and by providing Federal assistance for state-level programs related to clean energy and energy conservation.

In addition to direct investments in clean energy, the Administration's Budget proposed a cap-and-trade program that would provide incentives for firms to reduce GHG emissions and to invest in new, cleaner lines of business. The proposed cap-and-trade program holds the promise of creating new industries and jobs; decreasing our dependence on oil; and limiting the release of pollutants that threaten the health of families and communities and the planet itself.

The Administration's Proposals Related to the Oil and Gas Industry

With this as background, let me turn to the Obama Administration's proposals to eliminate several subsidies that likely benefit oil and gas companies. More details on each proposal can be found in the appendix.

Repeal existing oil and gas preferences

Current law provides a number of credits and deductions that are targeted towards certain oil and gas activities. The Administration proposes to repeal the following tax preferences that are currently available for certain non-integrated oil and gas firms: (1) the use of percentage depletion with respect to oil and gas wells; (2) the exception to passive loss limitations provided to working interests in oil and natural gas properties; and (3) two-year amortization of non-integrated producer's geological and geophysical expenditures, instead allowing amortization over the same seven-year period as for integrated oil and gas producers.[3] Eliminating these three tax preferences is projected to raise revenues by approximately $10.3 billion from 2010 to 2019.

The Administration proposes to repeal the following tax preferences that are currently available for both integrated and non-integrated oil and gas firms: (1) the expensing of intangible drilling costs; (2) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; (3) the ability to claim the domestic manufacturing deduction against income derived from the production of oil and gas. Eliminating these three tax preferences is projected to raise revenues by approximately $20.3 billion from 2010 to 2019.

Finally, the Administration proposes to repeal the following tax preferences that are not currently taken by any oil and gas firms because the price of oil exceeds the phase out price: (1) the

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batteries. ARRA also included additional renewable energy incentives. These include extending the production tax credit (PTC) to 2012 for wind and 2013 for other renewable sources of energy; creating a new grant program for clean energy projects; and providing $2.3 billion in credits for investment in advanced energy manufacturing facilities.

[3] A non-integrated company is one that receives nearly all of its revenues from production at the wellhead. The definition contained in the IRS code is that a firm is non-integrated if its refining capacity is less than 50,000 barrels per day on any given day or their retail sales are less than $5 million for the year.

enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; and (2) the credit for oil and gas produced from marginal wells. Eliminating these two tax preferences is projected to have no impact on revenue from 2010 to 2019 because oil prices are projected to remain above the phase out price for the coming ten years.

Levy tax on certain offshore oil and gas production

According to a review of several existing studies by the Government Accountability Office in 2007, the return received by the federal government from oil production in the Outer Continental Shelf is lower than the return from oil production received by many foreign governments.[4] In the interest of advancing important policy objectives, such as providing a more level playing field among producers, raising the return to the taxpayer, and encouraging sustainable domestic oil and gas production, the Administration is working with Congress to develop a proposal to impose an excise tax on certain oil and gas extracted offshore in the future.

Repeal last-in, first-out (LIFO) method of accounting for inventories.

Under the LIFO method of accounting for inventories, it is assumed that the cost of the items of inventory that are sold is equal to the cost of the items of inventory that were most recently purchased or produced. The Administration proposes to repeal the use of the LIFO accounting method for Federal tax purposes, effective for taxable years beginning in 2012. Assuming inventory costs rise over time, taxpayers required to change from the LIFO method under the proposal generally would experience a reduction in their deductions for cost of goods sold and a corresponding increase in their annual taxable income as older inventory with a lower purchase price is taken into account in computing taxable income. In the context of oil and gas this would apply to stocks of already extracted oil and gas stored by refiners and other users of crude product, but not to unextracted stores of oil and natural gas. Upon enactment, taxpayers required to change from the LIFO method also would be required to report their existing inventory at its first-in, first-out (FIFO) value in the year of change, causing a one-time increase in taxable income that would be recognized ratably over eight years.

An Economist's View of Tax Policy for the Oil and Gas Industry

Next, I will outline a few economic principles of good tax policy and evaluate the current tax subsidies for oil and gas production in light of those principles.

Tax Policy Should be Neutral Across Industries

In a competitive market, a tax system free of subsidies will promote investment decisions that reflect an investment's economic returns rather than its tax benefits. Differences in tax treatment across industries give rise to differences in after-tax returns for investments that would otherwise have the same pre-tax returns. These differences in after-tax returns drive important changes in investment and output. For example, tax subsidies that are not designed to correct an existing distortion or market failure lead to an over allocation of resources to the tax-favored industries

[4] Government Accountability Office, "Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners," May 1, 2007

and an under allocation of resources to other industries. These distortions in resource allocation result in inefficiency and generally reduced economic growth. Maintaining neutrality in economic policy, absent a strong reason otherwise, is a long standing principle that was emphasized by George Washington, who said in his farewell address, "even our Commercial policy should hold an equal and impartial hand: neither seeking nor granting exclusive favours or preferences…".

The tax subsidies that are currently provided to the oil and gas industry lead to inefficiency by encouraging an over investment of domestic resources in this industry. In 2005 the Congressional Budget Office (CBO) estimated that the effective marginal tax rate on investment in petroleum and natural gas structures was 9.2 percent.[5] This is well below the average effective marginal tax rate for all asset types (26.3 percent). The size of the distortion – equal to the difference between the effective marginal tax rate for investment in the oil and gas industry and the average effective marginal tax rate – is quite large for the oil and gas industry and removing this distortion would improve overall economic efficiency.

In addition to subsidizing an inefficient amount of investment in the oil and gas industry, the tax subsidies result in distortions within the industry by favoring investment in nonintegrated firms. A 2009 study estimated that percentage depletion and the favorable tax treatment for intangible drilling costs, which are available only for individuals and non-integrated firms, reduced the effective marginal tax rate for investment in oil drilling to -13.5 percent for non-integrated firms, compared to 15.2 percent for integrated firms that cannot claim percentage depletion and cannot expense all of their intangible drilling costs.[6] Because of the large subsidy provided by percentage depletion and full expensing of intangible drilling costs, the size of the distortion for non-integrated firms is especially large.

Addressing Externalities through Tax Provisions

Tax provisions that encourage investment in a specific industry may be justified in cases where they address a positive externality associated with either production or consumption of certain goods. Private market decisions can be inefficient when market prices do not reflect the full social costs. Oil and natural gas prices, for example, do not reflect the environmental harm caused by the release of greenhouse gases in the atmosphere associated with oil and gas production and consumption. In addition, the price of oil does not reflect the risks associated with U.S. oil dependency or the costs of traffic congestion. Tax provisions can address this problem by incorporating the social costs into the price of the resources.

However, the current set of tax subsidies for oil and gas production work against the goal of reducing the negative externalities associated with oil and gas production. The Administration proposes to address the negative externalities associated with GHG production through the use of

[5] The effective marginal tax rate is equal to the difference between the before- and after- tax return divided by the before-tax return on the last dollar of investment.

[6] Gilbert Metcalf, "Taxing Energy in the United States: Which Fuels Does the Tax Code Favor?" Center for Energy Policy and the Environment, 2009. If an investment has a negative effective marginal tax rate, then the benefit from that investment exceeds the tax-free economic return from that investment (i.e. the tax code provides for a net subsidy).

a cap-and-trade system, which provides certainty on the reduction of GHG production in the future. To the extent that removing the current tax subsidies for oil and gas production increases energy prices, the Administration's proposals would move prices closer to appropriately reflecting the negative externalities associated with oil and gas production. However, as I discuss in more detail below, the effect on prices of these tax proposals is unlikely to be sufficient to address the social costs of oil and gas production.

Oil Prices and Percentage Depletion

Under the current tax system, percentage depletion causes tax subsidies to increase as oil and gas prices increase, which lowers the overall effective tax rate when commodity prices are high. This is because the size of the deduction under percentage depletion is equal to a fixed percentage of revenue, and as oil prices rise and revenue increases (assuming the demand elasticity for oil is less than 1) the amount of the deduction also rises, which reduces the effective tax rate on the original investment. There is no rationale for a tax system that reduces the effective marginal tax rate when the price of the good sold increases. Removing percentage depletion will make the tax treatment of this industry more neutral with respect to changes in price.

Economic Impacts of Removing Favored Treatment

In analyzing the impact of repealing oil and gas tax preferences, we consider the impact on firms' costs and how that might impact prices. We also consider how repealing oil and gas tax preferences may impact output and employment in the oil and gas industries and output and employment in the broader economy.

Tax preferences reduce a firm's cost of doing business, and by lowering costs they can lead to an increase in the firm's production and employment. Whether or not the price of the good produced by a firm is affected by an increase in production depends on the size of the increase in production relative to the market as a whole and on how much a price increase would reduce consumption. To the extent a tax subsidy does not cover an entire industry, production may simply shift from unsubsidized firms within the industry to subsidized ones, without affecting price.

Oil

Impact on Prices: The domestic price of oil is determined by global supply and demand because oil is an internationally traded commodity. Although the U.S. does constitute a large share of world demand, the U.S. contribution to world oil supply is relatively small: U.S. petroleum production accounts for about 10 percent of the world annual total, and U.S. proved crude oil reserves represent less than 2 percent of the world total.[7] The relatively small U.S. share of global production means that any change in U.S. domestic oil production will have a limited impact on the world supply of oil. Based on parameters in the literature, we estimate that world supply would fall by less than one-tenth of one percent due to the elimination of these tax

[7] Energy Information Agency, "International Energy Statistics 2005-2009: Production of Crude Oil including Lease Condensate and Crude Oil Proved Reserves"

subsidies proposed in the Obama Administration's budget.[8, 9] Because we expect little or no effect on the world supply of oil, removing these subsidies would have an insignificant effect on world oil prices.

If the world oil price does not change, U.S. consumers would feel no impact at the pump from removing these tax preferences. *Even if* the full additional cost to domestic oil companies was passed on to consumers through higher gasoline prices, which is highly unlikely because prices are set on the world market, the cost would be equivalent to less than one cent per gallon. To put this in context, consider that since 2000 retail gasoline prices have fluctuated between $1.14 and about $4.10, and over this period crude oil has accounted for only about 50 percent of the price of gasoline.[10] Thus, even in the unlikely case that costs of removing the subsidies were passed on directly to consumers, the increase in prices would certainly be trivial compared to normal fluctuations.

Impact on Domestic Output: Because the price of oil will almost surely not change as a result of eliminating these tax preferences, consumers will not change their demand for petroleum products. On the supply side, a change in domestic producer costs could cause production to shift from domestic non-integrated producers to integrated domestic or foreign suppliers. According to estimates made by the Office of Economic Policy at the Department of Treasury, removing the subsidies for the oil industry would be equivalent to increasing total oil finding and lifting costs by less than 2 percent.[11] Of course, the increase in costs would not translate into a one-for-one decrease in production. Based on estimates of short and long run supply elasticities, we estimate that the decrease in domestic production due to these proposals will be less than one half of one percent, even in the long run.[12]

We have also considered the impact of higher oil prices on macroeconomic outcomes. The economics literature suggests that large increases in energy prices can lead to meaningful reductions in GDP.[13] However, even upper bound estimates suggest that any change in prices due to removing the tax subsidies would be trivial, and as a result the impact on GDP of the Administration's proposals will likely be too small to measure. On the other hand, over the long term, reducing tax preferences will result in a more efficient allocation of capital, which will tend to increase national output.

Impact on Employment: Because domestic crude oil output is not expected to change appreciably, employment in the oil extraction sector would likewise not be expected to change

[8] Oil supply elasticities used here are from Salvatore Lazzari, "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy," Congressional Research Service, March 9, 2006; and Caldwell and Gordon, "Federal Oil Subsidies: How Can They Best Be Targeted?" May 2004 (prepared for the National Commission on Energy Policy).

[9] The cost associated with eliminating LIFO is excluded from this analysis because eliminating LIFO will have little impact on production at the margin, and to the extent it does have a marginal impact, the impact will be very small.

[10] Energy Information Agency. "A Primer on Gasoline Prices," 2009

[11] Estimates based on U.S. Energy Information Agency, "Performance Profiles of Major Energy Producers 2007," December 2008, which contains data on a large portion of the oil and gas industry.

[12] Congressional Research Service, "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy," March 2006

[13] Crane et. al, "Imported Oil and U.S. National Security," RAND, 2009.

by a significant amount. A rough assumption would be that employment in oil production could fall in the same small proportion as the decline in output (less than one half of one percent).

In terms of the overall economy, it is also important to note that the oil and gas industry is about ten times more capital intensive than the U.S. economy as a whole. Consequently, subsidizing oil industry production is not an effective policy for raising labor demand. As noted above, over the long term, reducing tax preferences will result in a more efficient allocation of capital and labor, which will tend to increase national output..

Natural Gas

Impact on Prices: Unlike oil, a large majority of the natural gas consumed in the U.S. is domestically produced, and global trade in natural gas has a small impact on domestic prices. As a result, changes in domestic natural gas production costs have the potential to influence U.S. prices. To yield an upper bound estimate of the effect on prices, we could assume the full cost of the eliminated tax preferences are passed through to consumers in the price of natural gas. According to estimates made by the Office of Economic Policy at the Department of Treasury, the costs of the subsidies for the natural gas industry are equal to about one percent of average total revenues for natural gas over the last two years. Thus, in the upper bound case, removing the tax subsidies might result in about a one percent increase in natural gas prices. Taking into account the demand response if costs increase, any price increase would likely be less than one percent in equilibrium. For context, consider that since 2000, prices for residential natural gas have fluctuated an average of plus or minus 6 percent per month. Thus, the potential effect on prices from removing the tax subsidies for gas production would be small relative to normal price fluctuations, even in the upper bound case.

Impact on Domestic Output: This small increase in price may cause consumers to respond by decreasing their consumption of natural gas. However, the effect is likely to be small: the demand elasticities in the literature suggest that a one percent increase in natural gas prices might result in a reduction in natural gas consumption and production of less than half a percentage point over the long term.[14]

Impact on Employment: Over the long term, employment in the natural gas production and supply industry could change by an amount similar to the change in production. As in the case of oil, eliminating the distortionary influence of the tax preferences for natural gas will result over time in new jobs being created in other sectors. And like oil production, the natural gas industry is highly capital intensive relative to the U.S. economy as a whole, suggesting these tax subsidies are not effective means for domestic job creation.

The Impact of Tax Preferences on Energy Security

Some proponents of tax subsidies for the oil and gas industry suggest that encouraging exploration of domestic resources will improve our energy security. Concerns about our energy security are focused on the possibility that a sudden and lasting disruption in oil supplies would

[14] Calculation using long-term residential demand elasticity of -0.41 from Steven Wade, "Price Responsiveness in the AEO2003 NEMS Residential and Commercial Building Sector Models."

lead to a substantial increase in the price of oil. Such an increase in prices could have ripple effects throughout our economy by leading to a decline in output in energy intensive industries, by raising unemployment if real wages do not adjust to higher oil prices, and by making energy intensive capital stock obsolete. These proponents argue that encouraging domestic production may limit our vulnerability to such an oil price shock.

However, as I discussed above, the domestic price of oil will be determined by the world price of oil, and the size of our domestic production has little or no influence on the world price of oil. As such, current tax subsidies that encourage domestic production are very unlikely to affect the domestic price of oil and do not significantly promote our energy security. Policies that reduce our dependence on oil, such as a cap-and-trade system or investing in clean technologies, are a more effective way to reduce our vulnerability to an oil price shock and promote energy security.

Conclusion

To the extent that current tax subsidies for the oil and gas industry encourage the overproduction of oil and natural gas, they divert resources from other, potentially more efficient investments and they are inconsistent with the Obama Administration's goals to reduce GHG emissions and build a new, clean energy economy. Furthermore, as discussed above, removing these subsidies will have a very small effect on the price of oil and gas, the production of oil and gas, and domestic jobs. In fact, removing these subsidies could actually make our economy more efficient by reducing distortions in the tax code. The possibility to promote our broader energy goals at a very low cost – in terms of prices, productivity, and jobs – makes removing these subsidies sound economic and public policy.

Mr. Chairman, this concludes my prepared testimony. I will be pleased to answer any questions you or other members of the Subcommittee may have.

APPENDIX:
GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS RELATED TO THE OIL AND GAS INDUSTRY

LEVY TAX ON CERTAIN OFFSHORE OIL AND GAS PRODUCTION

Current Law

No Federal tax is imposed on the production of oil and gas on the Outer Continental Shelf (OCS).

Reasons for Change

According to the Government Accountability Office, the return to the taxpayer from OCS production is among the lowest in the world, despite other factors that make the United States a comparatively good place to invest in oil and gas development. An excise tax on OCS production would advance important policy objectives, such as providing a more level playing field among producers, raising the return to the taxpayer, and encouraging sustainable domestic oil and gas production.

Proposal

The Administration is developing a proposal to impose an excise tax on certain oil and gas produced offshore in the future. The Administration will work with Congress to develop the details of this proposal.

Revenue Estimate

This proposal is projected to raise $5.3 billion in revenue from 2010 – 2019.

REPEAL CREDIT FOR ENHANCED OIL RECOVERY (EOR) PROJECTS

Current Law

The general business credit includes a 15-percent credit for eligible costs attributable to EOR projects. If the credit is claimed with respect to eligible costs, the taxpayer's deduction (or basis increase) with respect to those costs is reduced by the amount of the credit. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaska natural gas for pipeline transportation and any of the following costs with respect to a qualified EOR project: (1) the cost of depreciable or amortizable tangible property that is an integral part of the project; (2) intangible drilling and development costs (IDCs) that the taxpayer can elect to deduct; and (3) deductible tertiary injectant costs. A qualified EOR project must be located in the United States and must involve the application of one or more of nine listed tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. The allowable credit is phased out over a $6 range for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds an inflation adjusted threshold. The credit was completely phased out for taxable years beginning in 2008, because the reference price ($66.52) exceeded the inflation adjusted threshold ($41.06) by more than $6.

Reasons for Change

The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the credit encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The investment tax credit for enhanced oil recovery projects would be repealed for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $0 billion in revenue from 2010 – 2019.

REPEAL CREDIT FOR PRODUCTION FROM MARGINAL WELLS

Current Law

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit rate is $3.00 per barrel of oil and $0.50 per 1,000 cubic feet of natural gas for taxable years beginning in 2005 and is adjusted for inflation in taxable years beginning after 2005. The credit is available for production from wells that produce oil and gas qualifying as marginal production for purposes of the percentage depletion rules or that have average daily production of not more than 25 barrel-of-oil equivalents and produce at least 95 percent water. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rate for crude oil is phased out for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are $3.00 and $15.00 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit rate for natural gas is similarly phased out for a taxable year if the annual average wellhead price for domestic natural gas exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are $0.33 and $1.67 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit has been completely phased out for all taxable years since its enactment. Unlike other components of the general business credit, the marginal well credit can be carried back up to five years.

Reasons for Change

The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the credit encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The production tax credit for oil and gas from marginal wells would be repealed for production in taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $0 billion in revenue from 2010 – 2019.

REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS

Current Law

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply to intangible drilling and development costs (IDCs). IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property) done by contractors under any form of contract (including a turnkey contract). IDCs include amounts paid for labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property.

Under the special rules applicable to IDCs, an operator (i.e., a person who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) who pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs. The uniform capitalization rules do not apply to otherwise deductible IDCs.

If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year the cost is paid or incurred. Generally, IDCs that a taxpayer elects to capitalize may be recovered through depletion or depreciation, as appropriate; or in the case of a nonproductive well (“dry hole”), the operator may elect to deduct the costs. In the case of an integrated oil company (i.e., a company that engages, either directly or through a related enterprise, in substantial retailing or refining activities) that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.
A taxpayer that has elected to deduct IDCs may, nevertheless, elect to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate IDC adjustments or preferences under the AMT.

The election to deduct IDCs applies only to those IDCs associated with domestic properties. For this purpose, the United States includes certain wells drilled offshore.

Reasons for Change

The expensing of IDCs, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent expensing encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of IDCs would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

Expensing of intangible drilling costs and 60-month amortization of capitalized intangible drilling costs would not be allowed. Intangible drilling costs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules.

The proposal would be effective for costs paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $6.9 billion in revenue from 2010 – 2019.

REPEAL DEDUCTION FOR TERTIARY INJECTANTS

Current Law

Taxpayers are allowed to deduct the cost of qualified tertiary injectant expenses for the taxable year. Qualified tertiary injectant expenses are amounts paid or incurred for any tertiary injectant (other than recoverable hydrocarbon injectants) that is used as a part of a tertiary recovery method. The deduction is treated as an amortization deduction in determining the amount subject to recapture upon disposition of the property.

Reasons for Change

The deduction for tertiary injectants, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent expensing encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of tertiary injectants would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The deduction for qualified tertiary injectant expenses would not be allowed for amounts paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $62 million in revenue from 2010 – 2019.

REPEAL PASSIVE LOSS EXCEPTION FOR WORKING INTERESTS IN OIL AND GAS PROPERTIES

Current Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.

Reasons for Change

The special tax treatment of working interests in oil and gas properties, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent this special treatment encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the working interest exception for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Eliminating the working interest exception would subject oil and gas properties to the same limitations as other activities and reduce economic distortions.

Proposal

The exception from the passive loss rules for working interests in oil and gas properties would be repealed for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $49 million in revenue from 2010 – 2019.

REPEAL PERCENTAGE DEPLETION

Current Law

The capital costs of oil and gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to oil and gas properties. The amount of the deduction is a statutory percentage of the gross income from the property. For oil and gas properties, the percentage ranges from 15 to 25 percent and the deduction may not exceed 100 percent of the taxable income from the property. In addition, the percentage depletion deduction for oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before the deduction and with certain other adjustments).

Other limitations and special rules apply to the percentage depletion deduction for oil and gas properties. In general, only independent producers and royalty owners (as contrasted to integrated oil companies) qualify for the percentage depletion deduction. In addition, oil and gas producers may claim percentage depletion only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (applied on a combined basis in the case of taxpayers that produce both). This quantity limitation is allocated, at the taxpayer's election, between oil and gas production and then further allocated within each class among the taxpayer's properties. Special rules apply to oil and gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). Only marginal well production can qualify for percentage depletion at a rate of more than 15 percent. The rate is increased in a taxable year that begins a calendar year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil is less than $20 by one percentage point for each whole dollar of difference between the two amounts. In addition, marginal wells are exempt from the 100-percent-of-net-income limitation described above in taxable years beginning during the period 1998- 2007 and in taxable years beginning in 2009. Unless the taxpayer elects otherwise, marginal well production is given priority over other production in applying the 1,000-barrel limitation on percentage depletion.

A qualifying taxpayer determines the depletion deduction for each oil and gas property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Reasons for Change

Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would

occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting oil and gas producers to cost depletion would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

Percentage depletion would not be allowed with respect to oil and gas wells. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in oil and gas wells.
The proposal would be effective for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $9 billion in revenue from 2010 – 2019.

REPEAL DOMESTIC MANUFACTURING DEDUCTION FOR OIL AND GAS PRODUCTION

Current Law

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning in 2009, the manufacturing deduction is equal to 6 percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50-percent of the W-2 wages of the taxpayer for the taxable year. For taxable years beginning after 2009, the deduction is computed at a 9 percent rate, except that the deduction for income oil and gas production activities is computed at a 6 percent rate.

Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the U.S.; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the U.S.) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts.

The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of oil, natural gas or primary products produced in the United States.

Reasons for Change

The manufacturing deduction effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The proposal would exclude from the definition of domestic production gross receipts all gross receipts derived from the sale, exchange or other disposition of oil, natural gas or a primary product thereof for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $13.2 billion in revenue from 2010 – 2019.

INCREASE THE AMORTIZATION PERIOD FOR GEOLOGICAL AND GEOPHYSICAL COSTS TO SEVEN YEARS

Current Law

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States is two years for independent producers and seven years for integrated oil and gas producers.

Reasons for Change

The accelerated amortization of geological and geophysical expenditures incurred by independent producers, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent accelerated amortization encourages overproduction of oil and gas, it is actually detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Increasing the amortization period for geological and geophysical expenditures incurred by independent oil and gas producers from two years to seven years would provide a more accurate reflection of their income and more consistent tax treatment for all oil and gas producers.

Proposal

The proposal would increase the amortization period from two years to seven years for geological and geophysical expenditures incurred by independent producers in connection with all oil and gas exploration in the United States. Seven-year amortization would apply even if the property is abandoned and any remaining basis of the abandoned property would be recovered over the remainder of the seven-year period. The proposal would be effective for amounts paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $1.2 billion in revenue from 2010 – 2019.

REPEAL THE LAST-IN, FIRST-OUT (LIFO) METHOD OF ACCOUNTING FOR INVENTORIES

Current Law

The Internal Revenue Code (Code) permits a taxpayer with inventories to determine the value of its inventory and its cost of goods sold using a number of different methods. The most prevalent method is the first-in, first-out (FIFO) method, which matches current sales with the costs of the earliest acquired (or manufactured) inventory items. As an alternative, a taxpayer may elect to use the last-in, first-out (LIFO) method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. The LIFO method can provide a tax benefit for a taxpayer facing rising inventory costs, since the cost of goods sold under this method is based on more recent, higher inventory values, resulting in lower taxable income. If inventory levels fall during the year, however, a LIFO taxpayer must include lower-cost LIFO inventory values (reflecting one or more prior-year inventory accumulations) in the cost of goods sold, and its taxable income will be correspondingly higher. To be eligible to elect LIFO for tax purposes, a taxpayer must use LIFO for financial accounting purposes.

Reasons for Change

The repeal of LIFO would eliminate a tax deferral opportunity that is available to taxpayers that possess inventories whose costs increase over time. In addition, LIFO repeal would simplify the Code by removing a complex and burdensome accounting method that has been the source of controversy between taxpayers and the IRS.

International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Security and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO removes this possible impediment to the implementation of these standards in the United States.

Proposal

The proposal would not allow the use of the LIFO inventory accounting method for Federal income tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. However, this one-time increase in gross income would be taken into account ratably over the first taxable year and the following seven taxable years.