Statement by

Alice M. Rivlin
Director

Congressional Budget Office

Before the

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

May 5, 1983

Mr. Chairman:

At the request of this Committee, the Congressional Budget Office has examined several of the tax code provisions that affect integrated and nonintegrated oil companies differently. We have provided a detailed analysis of these provisions in an Appendix to my statement. In my testimony this morning I would like to discuss some of the broad energy and tax questions that are raised by the policy of taxing integrated "major" oil companies and nonintegrated "independents" differently. My testimony will cover:

- The tax code provisions that distinguish between independent and integrated producers;
- The relationship between these provisions and energy and tax policy goals; and
- The revenue effects of changing these provisions.

STRUCTURE OF THE INDUSTRY

A broad spectrum of firms are engaged in the oil and gas industry, ranging in size from Exxon (with $63 billion in assets) to the small stripper operator in Texas. For purposes of the tax code, firms are often taxed differently depending on whether or not they qualify for independent producer status. The code defines an independent company as a producer that does not have annual retail sales of more than $5 million nor refine more than 50,000 barrels on any single day during the year. Producers that do not qualify for this status are typically referred to as the major or integrated companies.

In general, the major oil companies are the largest firms in the industry and are extensively engaged in refining and marketing, as well as in other lines of business. In addition, most of the majors have large foreign oil and gas operations. Table 1 provides information on 240 publicly held oil and gas companies, ranked by their level of production. Very few of the 50 largest companies qualify for independent status under the tax code, although many of them are classified as independents under looser and more general industry standards.

The independents are a very diverse group of firms and range in size from small proprietorships to corporations with over $1 billion in assets. Most publicly held corporations other than the 50 largest producers qualify as independents under the tax code, as do many private corporations, sole proprietorships, and partnerships. Although a number of the larger independents produce more than 1,000 barrels per day, most produce much smaller amounts. As a rule, these companies are almost exclusively engaged in the exploration and production phases of the industry in the United States. Individual taxpayers who receive royalty payments from oil and gas companies may also qualify as independent producers for tax purposes, although their role is generally limited to ownership of the mineral rights to oil and gas reserves.

DISTINCTIONS IN THE CURRENT TAX LAW

The first statutory distinction between major and independent oil companies was made in 1975 when the Congress repealed the percentage depletion allowance for the majors--until then both majors and independents had been treated the same for

TABLE 1. DISTRIBUTION OF PUBLICLY HELD CORPORATIONS, BY SIZE OF PRODUCTION

Daily Production (bbls/day[a])	Number of Companies	Median Daily Production (bbls/day[a])	Median Net Assets (millions of dollars)	Median Total Revenue (millions of dollars)
0 - 100	28	43	8.7	1.2
100 - 500	41	247	17.2	3.6
500 - 1,000	18	706	31.0	20.1
1,000 - 2,000	18	1,485	88.1	26.5
2,000 - 5,000	27	3,384	130.5	78.0
5,000 - 10,000	26	6,323	246.0	98.4
10,000 - 20,000	24	15,409	858.0	809.1
20,000 - 30,000	11	23,123	708.5	712.0
30,000 - 50,000	9	40,249	1,541.3	973.1
50,000 - 75,000	11	61,310	2,850.7	2,738.2
75,000 - 100,000	4	89,951	2,178.0	1,956.9
100,000 - 500,000	11	264,800	6,048.5	9,443.6
500,000 - 1,000,000	6	685,816	13,701.1	16,747.5
1,000,000 and above	6	3,384,249	25,584.5	52,953.0

SOURCE: 1983 U.S.A. Oil Industry Directory (PennWell Publishing Company, 1983).

a. Production of natural gas is converted into barrels of oil at the conversion rate of 6,000 cubic feet per barrel. Production is on a net worldwide basis.

tax purposes. Since 1975, the Congress has raised oil industry taxes in a number of ways, and has tended to focus the burden more heavily on the major oil companies. Some of the important tax provisions that currently affect oil producers differently are:

- An independent producer (including royalty recipients) may claim percentage depletion on up to 1,000 barrels of oil per day or an equivalent amount of natural gas. Although many of the large independents produce more than 1,000 barrels per day, they are only allowed percentage depletion on their first 1,000 barrels per day. Thus, this provision is relatively more important to the smaller independents that are allowed percentage depletion on their full production.

- The Windfall Profit Tax Act of 1980 established lower tax rates on the first 1,000 barrels per day on most types of oil produced by the independents. Oil from new fields, however, is taxed the same for all firms.

- The Economic Recovery Tax Act of 1981 (ERTA) exempted independent stripper production (that is, oil from wells that produce less than 10 barrels per day) from the windfall profit tax.

- The Omnibus Reconciliation Act of 1980 provided for a $1,000 tax credit against windfall profit tax liabilities for royalty recipients. ERTA

changed the credit to a two-barrels-per-day exemption in 1982, rising to three barrels per day in 1985. Royalty recipients, however, are not allowed reduced windfall profit tax rates or the stripper exemption.

- The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required the majors to amortize 15 percent of their intangible drilling costs over three years, rather than writing them all off right away as prior law permitted. (Intangible drilling costs are capital expenditures with no salvage value, such as amounts paid for fuel, labor materials, and supplies used in the preparation or drilling of oil or gas wells.) Independents were allowed to continue writing off all of these costs in the first year.

These provisions and others that provide different treatment for majors and independents are described in more detail in the study appended to my statement.

Impact of Different Tax Treatment on Sample Oil Properties

CBO has estimated the effect of several of these provisions on three oil properties, depending on whether the producer is an independent or an integrated company. Table 2 sets out the present value of future tax payments for each property and three different producers. Well No. 1 is a well in a new field, Well No. 2 is a well in an existing field that becomes a stripper after five years, and Well No. 3 is a well in an existing field. The present value of the tax payments reflects the total taxes--corporate, personal, and windfall--that an investor can expect to pay over the life of an investment, discounted for the fact that future payments have a lower

TABLE 2. ESTIMATED PRESENT VALUE OF TAXES FOR THREE OIL WELLS (In thousands of dollars, except as otherwise noted)

Type of Producer	Well No. 1	Well No. 2	Well No. 3
Integrated Corporation			
Corporate income tax	2,125.3	127.8	335.5
Add-on minimum tax	0	0	0
Windfall profit tax	200.9	140.7	602.5
Personal income tax	1,695.0	122.2	323.9
Total taxes	4,021.3	390.7	1,261.8
Tax per barrel (dollars)	8.25	7.71	10.40
Tax rate[a]	56 Percent	61 Percent	67 Percent
Independent Corporation			
Corporate income tax	1,760.4	98.1	261.9
Add-on minimum tax	64.1	11.3	30.2
Windfall profit tax	200.9	79.9	430.3
Personal income tax	1,782.3	145.2	386.4
Total taxes	3,808.7	334.4	1,108.8
Tax per barrel (dollars)	7.81	6.61	9.14
Tax rate[a]	53 Percent	54 Percent	61 Percent
Sole Proprietorship or Partnership			
Corporate income tax	0	0	0
Add-on minimum tax	0	0	0
Windfall profit tax	200.9	79.9	430.3
Personal income tax	1,802.6	106.9	285.1
Total taxes	2,003.5	186.8	715.4
Tax per barrel (dollars)	4.10	3.69	5.90
Tax rate[a]	31 Percent	33 Percent	44 Percent
Property Characteristics			
Peak production (bbls/day)	200	15	50
Initial reserves (barrels)	487,539	50,622	121,262
Oil tier classification	3	1-2	1
Drilling investment (producing well)	750	250	400
Drilling investment (dry well(s))	2,100	0	300
Depreciable equipment	160	40	60
Inflation rate	5 Percent	5 Percent	5 Percent
Discount rate (or hurdle rate)	12.5 Percent	12.5 Percent	12.5 Percent

NOTE: For further details on the methods used to calculate these tax payments, see Appendix, Part III.

a. The tax rate is the percentage difference between the pretax and post-tax rate of return on the total investment, based on a corporate tax rate of 46 percent and a personal tax rate of 50 percent.

current value than more immediate ones. As the table shows, the independent corporation pays significantly lower taxes than the integrated company. On a per-barrel basis, the integrated firm would pay $0.44 more per barrel in tax on oil from Well No. 1, $1.10 more on oil from the stripper well, and $1.26 more on oil from Well No. 3. These differences are equivalent to price subsidies for oil produced by an independent. The lowest price subsidy is for new oil because the windfall profit tax rate is the same for both types of firms.

The biggest difference in tax treatment, however, is between corporations and sole proprietorships or partnerships. Investors in corporations pay a substantial corporate income tax for the privileges of that form of legal organization. In the hypothetical cases shown in Table 2, the tax on a barrel of new oil produced by a corporate firm is more than $3.00 higher than that on a barrel produced by a non-corporate firm. Because almost all partnerships or sole proprietorships in the oil and gas industry are independents, the special provisions for independents enlarge the tax differential between integrated corporations and noncorporate firms.

EVALUATION OF SPECIAL TAX TREATMENT FOR INDEPENDENTS

Although the special tax treatment of independents is a departure from the normal tax policy standards of fairness and efficiency, it has been justified by its proponents for other reasons: encouraging competition in the oil industry, for example, or stimulating domestic oil production.

Tax Policy Issues

Fairness. Currently, corporations produce most oil and gas. Both integrated and independent corporations are subject to the corporate income tax, and their dividends (or capital gains) are subject to the personal income tax. On grounds of fairness or equity, there does not appear to be a sound argument for taxing one corporation differently from another equally profitable corporation in the same industry. Similarly, there is no apparent justification for taxing one set of investors differently from another simply because one set invests in a company that does not own refining or retailing operations.

Efficiency. Artificial distinctions among different producers are generally not consistent with economic efficiency. When considering an investment in a domestic onshore oil property, the integrated and the independent are not competing on an equal footing. As indicated by the per-barrel tax differentials, for example, the independent can afford to devote more resources to a property because of lower windfall tax rates or percentage depletion. Thus, even though an integrated firm might be more able to produce at lower real cost, the independent can pay more for the property, or charge lower prices, simply because of the tax benefits. Neutral tax treatment would help ensure that the most efficient producers remain in business, while the less efficient ones are weeded out. To the extent that differential tax treatment diverts capital to less efficient producers, it is not consistent with the most effective use of our nation's resources.

Rationales for Differential Taxation

Although differential taxation may not be consistent with tax policy concerns, there may be other justifications for it. One set of arguments made on behalf of special tax treatment for independents both in 1975 and more recently turns on the special difficulties of independents in obtaining financing, and on the advantages of encouraging competition in the oil industry.

- Access to Capital. It is argued that the independents have a harder time raising capital than the major companies. Because they are not diversified, the earnings of the independents are subject to greater variation. In general, the independents have higher debt-equity ratios than the majors; this exacerbates the variation in their rates of return on equity. Thus, it is said that banks tend to consider the independents to be more risky and may restrict credit or charge them higher interest rates. In addition, private individuals must be willing to accept a higher degree of risk when considering investing in an independent. According to this view, preferential tax treatment not only allows the independents to increase their cash flow, but it makes them more attractive to private investors. By somewhat reducing the risk associated with an independent producer, special tax treatment allows the independents to generate more capital than they would otherwise.

- Low Profits. Another argument for differential taxation is that the independents are smaller than the integrated firms and do not earn the

same level of profits. The independents cannot rely on other operations (that is, refining or retailing) to maintain their cash flow when the extraction business is depressed. This is held to be particularly important because the high level of fixed interest payments makes the independent very susceptible to bankruptcy during cyclical downturns.

- Competition. Proponents of preferential tax treatment for the independents also hold that it allows them to compete more effectively against the integrated companies, thereby limiting the control the major companies can exert over the oil market. Thus, the tax code can work as a supplement to the antitrust laws by restricting the market power of the larger companies.

These arguments for providing favorable tax treatment to a subset of firms in the oil industry are based largely on firm size: small firms make lower profits, have less access to national capital markets, and have smaller market shares. These arguments, however, could be made for any sector of U.S. industry. For the independents in the petroleum industry, the allowance of special tax preferences extends privileges not accorded small businesses in other industries. On the other hand, the oil industry is riskier than other sectors and tax incentives help reduce the high risks that an independent must face.

Special tax treatment for the independents has also been justified as a way of promoting domestic oil and gas production. Because most of their exploration and

drilling activity is in domestic onshore fields, preferential tax treatment for independents represents an investment in more secure and reliable energy production. Furthermore, it is argued that the independents will operate wells and fields that a major oil company would no longer consider economic, thus gaining production from fields that have already been developed. The independent exemption for stripper oil under the windfall profit tax, for example, allows independents to maintain domestic stripper wells that might otherwise be abandoned if their production were subject to the tax. Similarly, the allowance for percentage depletion reduces the cost to the independents of investing in domestic exploration and production activities. In general, any provision that reduces the tax burden on an oil and gas investment will marginally increase domestic exploration and production.

Although the special independent tax provisions are consistent with the purpose of increasing U.S. production, they could be designed in a more uniform fashion; both integrated and independent producers could be provided the same incentives. For example, if the stripper exemption prevents the premature abandonment of wells, both independents and integrated producers could be exempted. More uniform incentives would increase domestic production by the majors, as well as by the independents.

An even more direct way of increasing domestic production, however, would be the imposition of an oil import fee. This would increase the profitability of domestic operations of both the majors and the independents alike. In addition, it

would encourage energy conservation and the production of other domestic fuels, such as coal or natural gas.

REVENUE ESTIMATES FROM CHANGING TAX PROVISIONS

Significant revenues could be raised over the 1984-1988 period by making tax provisions consistent for all oil and gas firms. Table 3 sets forth CBO's revenue projections from various changes in the tax law that would move toward uniformity of treatment for different producers.

Two options are presented for intangible drilling costs (IDCs). The first option--capitalization of all intangible drilling costs associated with producing wells--would apply to both independents and integrated companies. This would require firms to amortize their drilling costs over the productive life of the well, rather than expensing them all (or 85 percent in the case of majors) in the first year. These costs would be added to the depletable basis of the property and recovered through cost depletion. Currently, this is the generally accepted practice that firms use for financial (as opposed to tax) reporting. This option would raise $15.3 billion over the 1984-1988 period. A second intangible drilling cost option would affect only independent companies--it would require them to amortize 15 percent of their intangible drilling costs over three years, as is currently required of integrated companies. This alternative would raise $0.4 billion over the 1984-1988 period.

The option to repeal percentage depletion also would affect only the independent firms and would raise $8.7 billion over the 1984-1988 period. Under this

TABLE 3. ESTIMATED REVENUE EFFECTS OF CHANGING TAX PROVISIONS FOR OIL AND GAS PRODUCERS (In fiscal years and billions of dollars)

Option	1984	1985	1986	1987	1988	Cumulative Five-year Increase
Capitalize all IDCs	2.1	3.6	3.3	3.2	3.1	15.3
Amortize 15 percent of IDCs over 3 years	0.1	0.1	0.1	*	*	0.4
Eliminate Stripper Exemption for Windfall Profits Tax (Retain Reduced Tax Rate)	0.2	0.2	0.2	0.2	0.2	1.1
Eliminate All Reduced Windfall Profit Tax Rates for Independents (No Stripper Exemption)	0.5	0.6	0.5	0.5	0.5	2.6
Repeal Percentage Depletion	0.9	1.7	1.9	2.0	2.2	8.7
Repeal Exemption for Royalty Holders	0.4	0.5	0.4	0.4	0.4	2.0
Expense All IDCs	-0.2	-0.2	-0.1	-0.1	-0.1	-0.6
Extend Stripper Exemption to All Producers	-0.7	-0.9	-0.9	-0.9	-0.9	-4.3
Impose Oil Import Fee ($2 per Barrel)	3.1	4.4	4.3	4.3	4.3	20.4

SOURCES: Joint Committee on Taxation and Congressional Budget Office.

* Less than $50 million.

alternative, firms would be required to use the cost depletion methods that the integrated companies are currently required to use. In general, the independent companies already use cost depletion for financial reporting purposes so that they can report higher earnings to their shareholders.

One option for making the windfall profit tax more uniform is the repeal of both the stripper exemption and the reduced rates for independents. Under this option, all oil would be taxed at the same set of rates for independent and integrated producers. (Royalty interests currently exempt--such as those owned by state and local governments, Indian tribes, or charitable institutions--would remain untaxed.) These changes would increase revenues by $2.6 billion over the five-year period.

A second alternative for improving the uniformity of the windfall profit tax is to extend the current stripper oil exemption to the major oil companies. This would reduce revenues by $4.3 billion over the 1984-1988 period. As a result, the windfall profit tax would not impose an incentive on any firm to abandon stripper wells that might still be economically productive.

Finally, CBO has estimated that a $2-per-barrel oil import fee would raise $20.4 billion over the 1984-1988 period. A fee on imported oil would heighten conservation incentives by pushing up the price of all foreign and domestically produced oil. In addition, because the fee would allow domestic energy prices to rise, it would provide a subsidy for all substitutes for imported oil, including domestic oil. Thus, an import fee could be combined with elimination or reduction of some of the

existing, more direct, subsidies to oil producers, such as percentage depletion or the deduction for intangible drilling costs.

To illustrate the effects of changes such as these on individual properties, the Congressional Budget Office has estimated the effects of repealing percentage depletion and capitalizing intangible drilling costs for producing wells on a discounted present value basis. The results for the hypothetical new oil well discussed earlier are shown in Table 4. Both changes in the tax law would have different effects on different types of oil producers. Because the majors are not currently entitled to percentage depletion, they would have the smallest change in their tax payments. The combination of both changes would raise the present value of taxes by 3 percent for the integrated company and 9 percent for the independent corporation. Both types of firms would pay the same total taxes after the changes because the well is assumed to produce new oil that is taxed at the same windfall profit tax rate for all firms.

CONCLUSION

In general, greater uniformity in the taxation of oil and gas producers would further the policy goals of economic efficiency and tax fairness, and could encourage domestic energy production. Smaller independents might, however, have more difficulty obtaining financing and competing with larger producers. Movement toward uniformity could also raise substantial revenue and help reduce the size of projected long-term budget deficits.

TABLE 4. PRESENT VALUES OF TAXES FROM REPEALING PERCENTAGE DEPLETION AND CAPITLIZING INTANGIBLE DRILLING COSTS (In thousands of dollars, except as otherwise noted)

Type of Producer	With Cost Depletion	With Capitalized Intangible Drilling Costs[a]	With Cost Depletion and Capitalized Intangible Drilling Costs[a]
Integrated Corporation			
Corporate income tax	2,125.3	2,310.0	2,310.0
Add-on minimum tax	0	0	0
Windfall profit tax	200.9	200.9	200.9
Personal income tax	1,695.0	1,641.5	1,641.5
Total taxes	4,021.3	4,152.3	4,152.4
Percent change in taxes[b]	0	+3 percent	+3 percent
Tax per barrel (dollars)	8.25	8.52	8.52
New tax rate	56 percent	57 percent	57 percent
Independent Corporation			
Corporate income tax	2,117.5	2,085.1	2,310.0
Add-on minimum tax	0	32.8	0
Windfall profit tax	200.9	200.9	200.9
Personal income tax	1,697.3	1,697.2	1,641.5
Total taxes	4,015.7	4,016.0	4,152.4
Percent change in taxes[b]	+5 percent	+5 percent	+9 percent
Tax per barrel (dollars)	8.23	8.24	8.52
New tax rate	56 percent	56 percent	57 percent
Sole Proprietorship or Partnership			
Corporate income tax	0	0	0
Add-on minimum tax	0	0	0
Windfall profit tax	200.9	200.9	200.9
Personal income tax	1,840.3	2,052.2	2,072.7
Total taxes	2,041.2	2,253.0	2,272.6
Percent change in taxes[b]	+2 percent	+12 percent	+13 percent
Tax per barrel (dollars)	4.19	4.62	4.66
New tax rate	32 percent	35 percent	35 percent

a. Only drilling costs for producing wells are capitalized; dry hole costs are expensed.

b. Change in tax payments from payments under current tax law. See Table 2, Well No. 1.