New Taxes for Oil and Gas Companies: Where Does this Lead Us?

Posted by Gail the Actuary on February 27, 2009 - 10:28am
Topic: Policy/Politics
Tags: taxation [list all tags]

The oil and gas industry is already pulling back sharply. If one looks at drilling rig counts, the number of drilling rigs operating in the United States has dropped by close to 40% from peak levels in 2008. Now changes to the tax law which would make it more expensive for oil and gas companies to operate are being proposed by the Obama administration.

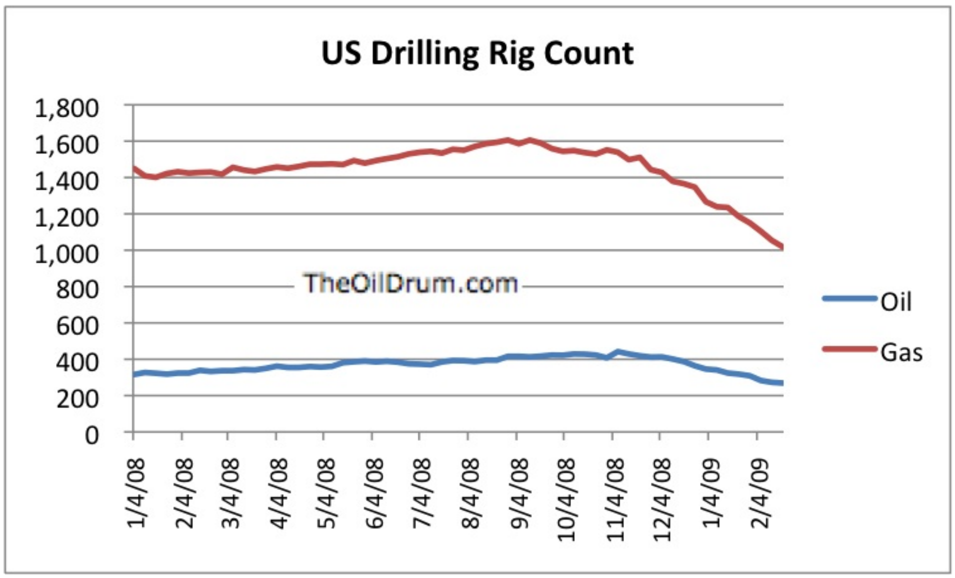

Figure 1. US operating rig counts, split between oil and gas, based on Baker Hughes Data

What is the likely outcome? I fear it is an even steeper drop in US produced oil and gas supplies than would otherwise be the case. This drop will come primarily because of the likely impact on small oil and gas companies that dominate the US production market, especially for natural gas.

I have read that Speaker Nancy Pelosi and Senate Majority Leader Harry Reid are asking that the Capitol Power Plant change from coal to natural gas for producing electricity. With the proposed tax policy, I am afraid that they will find themselves asking to switch back to coal within a few years, because sufficient natural gas will not be available. If the natural gas industry is to maintain or raise production levels, it will need assistance, not higher taxes.

Last September, I wrote a post saying that there was a possibility that US natural gas production could be ramped up, if quite a number of obstacles could be overcome. I included this graphic of possible future production.

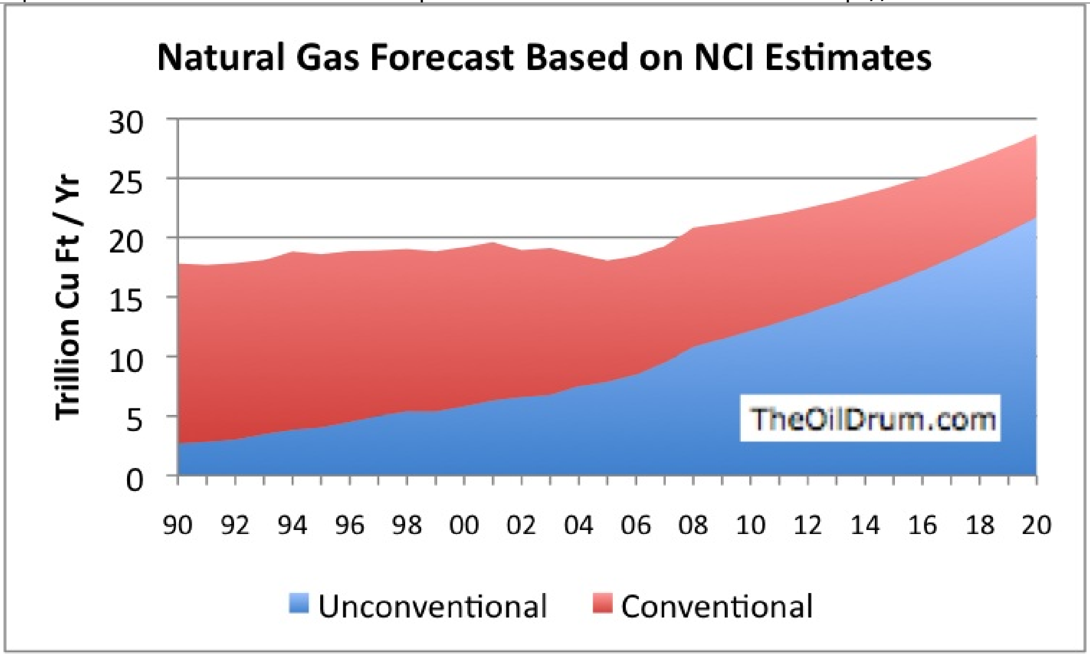

Figure 2. Approximate future US natural gas production, based on Navigant Consulting estimates of shale gas and tight gas production.

The credit crisis has reduced demand, and this has reduced prices of both oil and natural gas. At current prices, it is no longer profitable to drill most unconventional natural gas wells. If taxes are higher, this will only make the situation worse, driving more marginal producers out of business.

The effect on supply won't be felt immediately, because drilling rigs are used for drilling new wells and for servicing existing wells. Wells that have been drilled continue producing for several years, but the amount of oil or gas produced each year decline, as the pressure in the well declines, and as the percentage of water produced increases. Companies need to continue drilling new wells to keep production up. Figure 1 shows that companies are already cutting back dramatically on drilling new wells. Adding new taxes will only make matters worse. Even without new taxes, a decline in natural gas production is likely within two years.

President Obama has recently released his budget proposal for 2010. I understand it has tax benefits for green energy, while also increasing taxes and adding fees on the oil and gas industry.

As I understand it, the proposed tax increases on the oil and gas industry are not huge. They are expected to produce revenues of "at least $31.5 billion" over 10 years, according to the Wall Street Journal. This would average $3.15 billion a year (or more).

According to recent testimony of Gary Luquette, President of Chevron North America Exploration and Production Company, the industry spent $152 billion on tax and royalty revenues paid to federal, state, and local governments. This averages about $25 billion a year. If the tax amounts to only $3.15 billion a year, this would amount to a 12% increase. Of course, it is not clear it will come to only $3.15 billion a year--it may be considerably more.

One of the more widely discussed changes is new tax treatment for leases in the Gulf of Mexico. According to Reuter's:

> Obama's plan, which must still be approved by Congress, would levy an excise tax on

> Gulf of Mexico oil and natural gas, raising $5.3 billion in revenue from 2011 to 2019.
>
> This new 13 percent tax on all oil and gas production in the Gulf would only affect those companies that are currently not paying any royalties due to a loophole, said an Interior Department official. The official said producers who already pay royalties will receive a tax credit.
>
> The proposal would also place a $4 per acre annual fee on energy leases in the Gulf that are designated as non-producing, another Interior official said. The budget proposal expects the fee to generate $1.2 billion from 2010 to 2019.

If this is as far as the legislation went, I don't think there would be a major problem. I think the oil majors would be able to live with these provisions, but it might make them less likely to take leases in the Gulf of Mexico, and thus slightly reduce our future oil and gas supply.

The budget also calls for ending federal funding for an ultra-deepwater oil and gas research and development program. If we want our oil and gas companies to be able to maintain or expand their output, this doesn't seem like the direction to go, unless we have decided to give up on ultra-deepwater.

The legislation has provisions that will hit small producers particularly hard, if we believe the press release of the Independent Petroleum Association of America, an organization that represents small oil and gas companies. Some of the more obscure provisions it is concerned about include the following, with its descriptions:

> Repeal Expensing of Intangible Drilling Costs – expensing of the some of the normal costs of business (i.e., fuel, repairs, hauling supplies).
>
> Repeal of Percentage Depletion – as an oil or natural gas well is developed over time, it depletes the natural resource. This tax incentive allows for the “depreciation” of these wells many of which are small, barely economic wells. Without this provision, many could be shut down. ["Regular" depletion would still be allowed, though.]
>
> Repeal Marginal Well Tax Credit – a credit that serves as a safety net for those wells that only produce small amounts of oil and gas. Most of these wells are barely economic to keep operating, but collectively they supply almost 20 percent of the nation’s oil and 12 percent of its gas.
>
> Repeal Enhanced Oil Recovery Credit – a credit that allows industry to get more energy from wells that are “tired” and depleted, instead of drilling new wells.
>
> Increases Geological and Geophysical Amortization Costs – allowed for some expensing of the high costs of doing seismic and other high-tech studies/surveys. Such surveys are important to locate reserves and reduce the number of dry holes and unnecessary wells (a.k.a. the industry’s footprint).
>
> Repeal of Manufacturing Tax Deduction – a provision given to every other American manufacturer.

Smaller companies are the ones doing much of the enhanced oil recovery, and are the ones operating the many stripper wells in this country. They also are the ones drilling the majority of the unconventional natural gas supplies, which is the increasing part of the natural gas in Figure 2. According to the IPAA, the companies it its association drill 90 percent of the nation's oil and natural gas wells and produce 68 percent of American oil and 82 percent of American natural gas.

The smaller companies tend to be more dependent on debt than the "majors", so they have been hit particularly hard by the credit crisis. As one can see from the drilling rig numbers, these companies are already cutting back greatly. New taxes will only increase the degree of cutback, and will mean that more people and businesses will leave the industry. If this happens, it will be even more difficult to expand when demand picks up again.

If the Obama Administration expects natural gas to replace some of the coal currently in use, it needs to be careful in crafting its tax legislation not to penalize the many small companies that today produce natural gas and oil.

In fact, if the Obama Administration wants natural gas growth, it should really be thinking about ways it can aid the industry. One thing the industry needs help with is long term stable prices, at a levels high enough to encourage investment. Another thing it needs help with is building infrastructure, like long distance gas pipelines and underground storage tanks to go with new production, so that new gas production has a place to go, when it is completed. Also, some planning needs to be done to match up new production with new uses, so that one does not end up with a supply/demand mismatch. Without action along these lines, US natural gas supply is likely to shrink, and, in the long run, make us more dependent on coal (or leave us with gaps in fuel supply).