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Oil Industry Financial Performance and the Windfall Profits Tax

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Summary

Over the past 13 years, surging crude oil and petroleum product prices have increased oil and gas industry revenues and generated record profits, particularly for the top five major integrated companies, ExxonMobil, Royal Dutch Shell, BP, Chevron, and ConocoPhillips. These companies, which reported a predominant share of those profits, generated more than $104 billion in profit on nearly $1.8 trillion of revenues in 2008, before declining as a result of the recession and other factors. From 2003 to 2008, revenues increased by 86%; net income (profits) increased by 66%. Oil output by the five major companies over this time period declined by more than 7%, from 9.85 million to 9.12 million barrels per day. In 2010 the companies' oil production was 9.4 million barrels per day. Being largely price-driven, with no accompanying increase in output resulting from increased investment in exploration and production, some believe that a portion of the increased oil industry income over this period represents a windfall and unearned gain. A windfall income is not earned as a result of additional production effort on the part of the firms, but due primarily to record crude oil prices, which are set in the world oil marketplace.

Since the 109th Congress, numerous bills have been introduced seeking to impose a windfall profits tax (WPT) on oil. An excise-tax based WPT would tax only domestic production and, like the one in effect from 1980-1988, would increase marginal oil production costs. Theoretically, such a policy could reduce domestic oil supply, which could raise petroleum imports, making the United States more dependent on foreign oil, undermining goals of energy independence and energy security. By contrast, an income-tax based WPT would likely be more economically neutral (less economic distortion) in the short-run. Sizeable tax revenues could potentially be raised without reducing domestic oil supplies. Neither the excise-tax based nor income-tax based WPT are expected to have significant price effects. Neither tax would increase the price of crude oil, which means that refined petroleum product prices, such as pump prices for gasoline, would likely not increase.

In lieu of these two types of WPT, an administratively simple way of increasing the tax burden on the oil industry, and therefore recouping some of any excess or windfall profits, particularly from major integrated producers, would be to raise the effective corporate tax rate. One option would be repealing or reducing the domestic manufacturing activities deduction under IRC § 199. The 112th Congress voted on this measure as part of the Close Big Oil Tax Loopholes Act (S. 940). Going forward, in the context of deficit reduction, the 112th Congress may continue evaluating various methods for increasing taxes on the oil and gas industry to address concerns surrounding possible windfall profits.

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Introduction

Over the past 13 years, the price of crude oil has generally been increasing and volatile. High crude oil prices, which have led to high gasoline prices, have contributed to a weakening of the U.S. economy. Further, high gasoline prices put increased pressure on household budgets, during a time when households continue to struggle with persistently high levels of unemployment and a flagging housing market. While much of the American economy has suffered as a result of high oil prices, those prices generated record profit levels for the oil industry. Five companies—ExxonMobil, Royal Dutch Shell, BP, Chevron, and ConocoPhillips—earned a predominant share of those profits.

Record oil and gas industry profits have raised the concern of many public policy experts and federal policymakers, including many in Congress, who have questioned whether these profits were justified, or whether they constituted a "windfall" to the industry: an excessive, unearned, and unfair gain. Important factors in considering this issue might include the ultimate source, or reason, for the price increases, and what the industry's role was in generating them, i.e., whether it was through the direct result of the industry's efforts, in terms of employing its resources, decision-making, or risk-taking, or whether it was the result of fortuitous factors and events. Also important to the public policy question might be the actual size of the profits and what the industry did with them. If an industry invests profits into increased production capacity, the increased supply may ultimately cause prices to fall and the profits to dissipate. As the analysis in this report shows, the experience between 2003 and the first quarter of 2011 suggests that investments in oil exploration and development have not managed to keep company oil output from declining from the peak attained in 2006.

Numerous bills have been introduced in the Congress over this period to tax the oil and gas industry's record profits. Broadly, there are two ways that tax policy can be used to increase taxes on oil and gas profits. First, Congress could scale back or eliminate various tax incentives and preferences currently available to the industry. Second, Congress could directly increase taxes on the industry, through some form of an excess profits tax or windfall profits tax.

During the 1st session of the 112th Congress, the Senate considered a measure that would have eliminated various tax preferences for major integrated oil companies. A motion to proceed to consideration of the Close Big Oil Tax Loopholes Act (S. 940) was rejected in May 2011. S. 940 sought to eliminate industry-specific incentives, such as the ability to partially expense intangible drilling costs (IDCs). Further, the legislation would have prevented major integrated oil companies from taking advantage of tax incentives available to firms operating in other industries, such as the domestic production activity deduction (the § 199 deduction).

High crude oil prices and the associated profits may lead policymakers to look at the tax burden on the oil and gas industry broadly, shifting the focus beyond the major integrated oil companies. Since the inception of the federal income tax system in the early 20th Century, the oil and gas industry has accrued sizable benefits (in excess of $190 billion,[1] according to one estimate). While some of the traditional tax incentives, notably percentage depletion for integrated producers, have been significantly pared back over the years, some have argued that no tax incentives should be available to the industry at a time of high profits.

[1] For an estimate of cumulative historical revenue losses associated with tax preferences for oil and gas, see CRS Report R41227, *Energy Tax Policy: Historical Perspectives on and Current Status of Energy Tax Expenditures*, by Molly F. Sherlock.

As was noted above, a second option for increasing taxes on oil and gas industry profits is to take a more direct approach. Congress could choose to impose a windfall or "excess" profits tax-a supplemental or additional tax on the oil industry-one based on windfall or excess profits in addition to other income or other taxes that the industry might pay. While some might envision this as a totally new type of tax on windfall gains, an alternative would be to model it after the windfall profits tax on oil that existed from 1980 to 1988. A windfall profit tax would be in addition to the current tax on corporate and business income that applies to the oil and gas industry, whose profits are taxed at rates as high as 35%.[2]

This report contains information useful in evaluating the windfall profits tax policy option. The first section analyzes the major oil companies profit performance, particularly from 2003 to 2010, both in terms of earnings and how those earnings have been used. The second section is a brief legislative history of windfall profit tax proposals and legislation in the 109th through 112th Congresses. The third section analyzes the concept of a windfall profits tax, including experiences with the tax of the 1980s, its viability, and potential role in the tax system and economy.

Oil Industry Financial Performance

During the 2000s, oil prices have been volatile, and generally rising. Rising oil prices have been associated with increased revenues and net incomes amongst major integrated oil producers. While prices, revenues, and incomes have risen, production levels have remained relatively constant. The following sections review trends in oil prices as well as the revenues, income, and production levels of major integrated oil companies. This information, combined with information on the use of profits, is helpful when evaluating whether the industry has benefitted from windfall profits in the face of high oil prices.

Crude Oil Prices

Since the late 1990s, crude oil prices have been volatile, but also trending upward (see **Figure 1**). During the fall/winter of 1998/1999, the spot market price of West Texas Intermediate (WTI) crude oil was between $11 and $12 per barrel.[3] By July 2003, it had risen to $30.75 per barrel. Five years later, in July 2008, the spot market price of WTI was $133.37, an increase of 334% in five years, and more than 1,000% over the 1998 price. In June 2008, the spot market price reached the all-time high of $147 per barrel.[4] With the onset of the effects of the financial crisis and the recession, as well as a reaction to higher consumer gasoline prices, the price of WTI fell to $39 per barrel in February 2009. By the end of 2009 the price of WTI was almost $75 per barrel. During 2010, the price of WTI ranged between $73 and $90 per barrel. Unrest in the Middle East and North Africa brought the price of WTI back over $100 per barrel in April 2011.

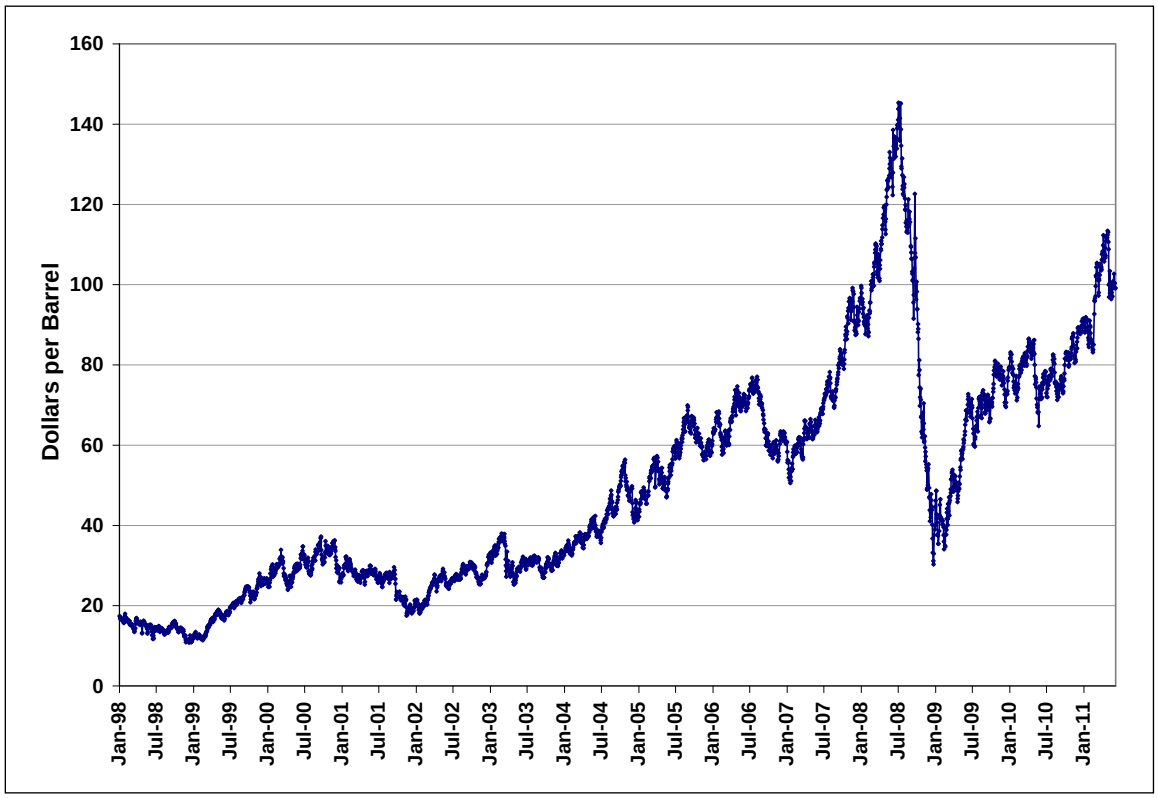
[2] As discussed below, the effective marginal corporate income tax rate is currently less than 35% for most domestic manufacturing activities due to the 6% domestic manufacturing activities deduction, which typically applies to large corporations such as oil and gas producers and refiners, and which is equivalent to a marginal corporate income tax rate of 32.9% (35% x 0.94) rather than 35%. In addition, present federal tax law imposes a minimum tax on corporations (and individuals) to the extent that their minimum tax exceeds their regular tax liability.

[3] The low of $10.82/barrel was reached on December 10, 1998.

[4] The $147 is in nominal or current dollars; crude oil prices also reached a record high in real terms, or inflation adjusted terms.

Figure 1. Spot Price of WTI Crude

(January 2, 1998–June 7, 2011)



Source: Energy Information Administration.

Notes: Spot prices are in current dollars.

This 13-year period of generally increasing oil prices, punctuated by a major decline in 2008/2009, began after a poor year for profitability in the oil industry, 1998, and included another poor year, 2002, along with record profit years. The oil price increases that began in late 2003 seemed to be largely unanticipated by the industry. They have since been attributed primarily to (1) a growing world economy, particularly the emerging economies of China and India; (2) declining excess production capacity, particularly within OPEC (Organization of the Petroleum Exporting Countries) producers; and (3) a number of financial factors, including futures market speculation, exchange rate, and inflation hedges. As the price of oil rose, company revenues, net incomes, and income taxes paid also rose, with ExxonMobil eventually becoming the most profitable corporation in the history of American industry.

The oil industry is composed of thousands of companies, ranging from the major integrated oil companies with operations around the globe, to independent producers (which range in size from small to very large), to relatively small oil service and equipment companies. The increase in oil prices over the past 13 years—particularly over the past five years—has enhanced the profitability of virtually all sectors of the industry, directly or indirectly.[5] This report highlights the financial performance of the industry's largest players, the major integrated oil companies.

[5] There are, of course, exceptions. For example, Stone Energy Corporation lost money (it reported negative net income) during 2006. See Standard and Poor's. *Industry Surveys: Oil and Gas, Production and Marketing.* March 20, 2008. p. 48.

The Major Integrated Oil Companies

While the oil and gas industry's high profitability has been widespread, it has also been concentrated among the industry's largest firms. Financial data show that the performance of the industry is dominated by the five largest firms: ExxonMobil, Royal Dutch Shell, BP, Chevron, and ConocoPhillips.[6] Generally, the net income of these five firms constituted 90% of the total net income of the nine firms considered to be integrated oil companies, at various times over the period, operating in the United States.

Table 1. Revenue of the Top Five Major Integrated Oil Companies, 2003-2010

(billions of dollars)

Company	2003	2004	2005	2006	2007	2008	2009	2010
ExxonMobil	246.7	298.0	371.0	377.6	404.5	477.6	310.6	383.2
Shell	269.1	265.2	306.7	318.8	355.8	458.4	285.1	378.1
BP	236.0	294.8	253.6	270.6	291.4	365.7	246.1	308.9
Chevron	120.0	155.3	198.2	210.1	220.9	273.0	171.6	204.9
ConocoPhillips	105.0	136.9	183.4	188.5	194.5	246.2	152.8	198.6
Total	**976.8**	**1,150.2**	**1,312.9**	**1,365.6**	**1,467.1**	**1,820.6**	**1,116.3**	**1,473.9**

Source: Profit Profile Supplements, Oil Daily.

With the exception of 2009, revenues of the five major firms have increased annually since 2003 (see **Table 1**). Total revenue is measured as price times the quantity of goods and services sold. In the case of the five major oil companies over this period, the increase in revenues was largely price-driven, with quantities of oil produced largely stagnant. For example, in 2003, ExxonMobil produced 2.59 million barrels per day (b/d) of crude oil, and in 2010, ExxonMobil produced 2.42 million b/d, a decrease of about 3%. In general, the five major oil firms did not produce more crude oil and petroleum products in response to the incentive of higher prices. As illustrated in **Table 2,** production of crude oil during the period was relatively stable. Only Chevron and BP produced more crude over this period, and, for the five firms as a whole, output declined by 4.5% from 2003-2010.

Table 2. Crude Oil Production by the Major Oil Companies

(million barrels per day)

Company	2003	2004	2005	2006	2007	2008	2009	2010
ExxonMobil	2.51	2.57	2.52	2.68	2.61	2.40	2.39	2.42
Shell	2.39	2.25	2.09	2.03	1.82	1.69	1.68	1.71
BP	2.12	2.53	2.56	2.47	2.41	2.40	2.53	2.37
Chevron	1.81	1.71	1.67	1.73	1.76	1.65	1.87	1.92
ConocoPhillips	1.02	0.90	0.91	1.13	1.03	0.98	1.04	0.98
Total	**9.85**	**9.96**	**9.75**	**10.04**	**9.63**	**9.12**	**9.51**	**9.40**

[6] ExxonMobil, Chevron, and ConocoPhillips are U.S. based firms. BP is a British firm, and Royal Dutch Shell is a Dutch and British firm, both with U.S. subsidiaries.

Source: Profit Profile Supplements, Oil Daily.

Revenue data for the first half of 2011 reflects the sharp increases in the price of oil observed during the first four months of the year, with the price of WTI reaching $112 per barrel in April. For the first quarter of 2011, the five firms earned total revenues of $422 billion and net incomes of $32.3 billion. These values could result in yearly values approaching the results of 2008, assuming the price of oil remains near its peak.

In recent years, trends in net income have also tended to follow trends in revenues and crude oil prices (see **Table 3**). While revenues increased by 86% from 2003 to 2008, net income increased by a greater percentage, on average 108%, except for ConocoPhillips, which can be considered as a special case in 2008.[7] These percentages suggest that price increases for crude oil, which can be both a revenue and a cost for these firms, increased at a higher rate than other costs and taxes, yielding net income growth for the five major firms. Analogously to the observed increase in revenues, the increase in net income experienced by the five firms was largely price-driven.

Table 3. Net Income of the Major Oil Companies, 2003-2010

(billions of dollars)

Company	2003	2004	2005	2006	2007	2008	2009	2010
ExxonMobil	21.5	25.3	36.1	39.5	40.6	45.2	19.3	30.5
Shell	12.7	18.5	22.9	25.4	27.6	26.3	12.5	20.1
BP	16.4	16.2	19.3	22.2	17.3	25.6	16.6	-3.7
Chevron	7.2	13.3	14.1	17.1	18.7	23.9	10.5	19.0
ConocoPhillips	4.7	8.1	13.5	15.5	11.9	-17.0	4.8	11.4
Total	**62.5**	**81.4**	**105.9**	**119.7**	**116.1**	**104.0**	**63.7**	**77.3**

Source: Profit Profile Supplements, Oil Daily.

Note: Data reflect consolidated worldwide earnings of these firms. Data segmenting net income on the basis of geographical earnings are not available.

The measures of financial performance shown in **Table 1** and **Table 3** focus on absolute levels: absolute levels of revenue, and absolute net income. An additional measure of financial performance is the profit rate, which may also be measured in variety of ways. One measure of the profit rate is the profit margin, essentially net income divided by revenue. As a result of the increasing price of oil driving up both total revenues and net incomes, the return on revenue, or the profit rate performance, has been mixed for the major integrated oil companies, as shown in **Table 4.** This indicator of industry performance does not appear excessive when compared to the profit rate in the manufacturing sector as a whole, which in 2007 had a profit rate of 8.9%. However, an additional measure of the relative profit rate is the rate of return on equity (ROE). Using this measure of profit rate, the oil and gas industry's ROE was, on average, greater than the ROE for the manufacturing sector generally. According to the Energy Information Administration (EIA), the oil and gas industry earned a 27% ROE in 2006, down slightly from 2005, but more than 9 percentage points higher than the average ROE for all manufacturing companies.[8]

[7] ConocoPhillips had a number of financial write-offs in 2008, including exploration and production goodwill and reducing the value of its Lukoil stake. See ConocoPhillips *Annual Report 2008,* p. 5.

[8] The EIA reports these data in its annual reports for the Financial Reporting System (FRS), which are based on detailed financial and operating data and information submitted each year to the EIA on Form EIA-28, the Financial Reporting System (FRS). The FRS Companies derive the bulk of their revenues and income from petroleum operations,

For the entire 2000-2008 period, the oil and gas industry's ROE averaged 7 percentage points higher than manufacturing's ROE, while for the 1985-1999 period, the oil and gas industry's ROE was only 2 percentage points higher. However, in 2009 the oil and gas companies' ROE fell to 4%, below the manufacturing industry average.[9] By these measures, the industry's recent high profits, measured both in absolute terms, and relative to ROE, suggest that high oil price volatility is a key factor in explaining profits in the oil industry.

Table 4. Average Profit Margins In the Oil Industry, 2003-2010

(percent)

	2003	2004	2005	2006	2007	2008	2009	2010
Major Integrated Companies	6.4	7.0	8.0	8.7	7.9	5.7	5.7	5.2

Source: Profit Profile Supplements, Oil Daily. CRS calculations.

There are multiple ways to interpret the price, income, and production data presented above. The data on net income and oil production could be viewed as a characterization of a set of firms that were unable to respond to the market signal of higher price by increasing output as predicted by economic theory. As a result, their revenues and net incomes increased proportionately, possibly supporting the conclusion that those profits constituted a "windfall," at least in the sense that they were not earned through output expansion or improvement, risk-taking, or investments leading to cost reductions in production. However, the data could also be taken to suggest that the major oil companies did not earn more net income relative to the value of their product than many other industries, and the value of their product was determined on a world market, beyond their control. From this point of view, oil was attaining only its fair market value.

The net income data presented in **Table 2** and **Table 3** was earned across three sectors of the industry. Namely, these three sectors are upstream operations (the exploration and production of oil and natural gas), downstream operations (the refining, transportation, distribution, and marketing of petroleum products, including motor gasoline, diesel, jet fuel, and other petroleum products), and chemicals and all other "non-oil" activities. Over time, the relative importance of these sectors may shift in terms of their potential to generate net income. For example, while downstream activities were strong in 2005 and 2006, they weakened from 2007 to 2009. In terms of general corporate income taxation, this cyclical pattern of change is likely to have little effect, since it is over-all corporate net revenues that form the tax base. In terms of possible windfall profit taxation, however, this cyclical pattern might be important, as it is net-income from crude oil ownership and production that is likely to have a windfall gain, or "unearned" income component.

which include natural gas production. A majority of these companies are multinational, with 40% percent of the majors' net investment located abroad. EIA supplements the FRS data with additional information from company annual reports and press releases, disclosures to the U.S. Securities and Exchange Commission, news reports and articles, and various complementary energy industry data sets. See Energy Information Administration. *Performance Profiles of Major Energy Producers (Issues December 2007, March 2006, February 2004, and January 2002).*

[9] The financial performance of the oil industry as well as many other U.S. industries has been affected by the financial crisis and the recession that followed. The potential for differential effects of the recession across industries suggests that cross-industry comparisons should be viewed with caution.

Use of Profits[10]

Firms that earn returns in excess of the market rate of return tend to reinvest these returns. Reinvestment can mean expanding business through increasing output or investing in technological improvements to meet the challenge of new firms entering the industry (i.e., remain competitive). Firms that seek to maximize shareholder value use profits to invest in business projects that offer a higher potential rate of return than the average return currently earned by the firm.

Increased Investment

Capital expenditures for the five major oil companies were $48.6 billion in 2003, $48.7 billion in 2004, $57.2 billion in 2005, and more than $80 billion in 2006 and 2007, for a total increase of 77% over the five-year period. This increase is proportionately less than the increase in net income over the period. From 2008 to 2010, capital expenditures were over $115 billion in 2008, fell to $99.8 billion in 2009 and recovered to $101 billion in 2010. Part of capital investment funding is directed to environmental compliance for both facilities and products, and does not increase capacity to bring petroleum products to the market.[11] The five companies have not committed to the construction of a new refinery in the United States since the 1970s, though existing refineries have been expanded and upgraded.[12] When the demand for gasoline exceeds the ability of the U.S. refineries to produce, the gap has been filled with imported product.

Increased Oil Output

Although the oil industry, including the five major firms, has invested in exploration, development, and production, those investments, to date, have not led to increased output. **Table 2** shows that the companies have failed to expand, or even maintain, their oil production rates.

Cash Reserves, Dividend Payouts, Stock Buybacks[13]

Between 2003 and 2010, cash reserves held by the major integrated oil companies increased from $19.4 billion to $63 billion. Cash reserves increased from $19.4 billion in 2003 to $52.7 billion in 2007, an increase of nearly 170%. While cash holdings declined in 2007, compared to 2006, this was the result of reduced balances at only one company, Chevron.[14] The other four major oil companies continued to build their cash balances. Cash holdings for the five major companies rose to almost $65 billion in 2008 before falling to $38 billion in 2009. Higher revenues and net incomes in 2010 resulted in cash reserves rising to over $63 billion in 2010.

Accumulating cash balances gives firms flexibility and positions them to take advantage of investment and other opportunities quickly. It is also likely that the rapid increase in the price of

[10] This section of the report is based on CRS Report RL34044, *The Use of Profit by the Five Major Oil Companies*, by Robert Pirog.

[11] The Energy Information Administration, *The Impact of Environmental Compliance Costs on U.S. Refining Profitability 1995-2001*, May 2003.

[12] For additional background on the oil refining industry, see CRS Report R41478, *The U.S. Oil Refining Industry: Background in Changing Markets and Fuel Policies*, by Anthony Andrews, Robert Pirog, and Molly F. Sherlock.

[13] See CRS Report RL34044, *The Use of Profit by the Five Major Oil Companies*, by Robert Pirog, for more detail on these topics.

[14] Balance sheet data for the five major oil companies can be obtained at http://www.hoovers.com.

oil and profits from 2003 to 2010 exceeded corporate plans and strategies on how to use it, resulting in accumulating cash holdings.

Cash dividend payouts by the five major oil companies were over $36 billion in 2008 and $38 billion in 2009, increasing even though 2009 saw declining revenues and profits for the firms. Although dividends fell to about $31 billion in 2010, this reduction was largely due to a 73% fall in dividend payments by BP associated with the expense of the Macondo oil spill.[15] The firms also paid out funds to investors in the form of stock buybacks. Although this activity diminished in light of the financial crisis of 2008, it was an important source of investor returns over the 2000s.

The theory of corporate finance, under the rule of maximizing shareholder value, suggests that extraordinary cash returns to shareholders are appropriate only when the management feels that individual shareholders are likely to have access to higher return investment alternatives than management can identify for the firm. The oil companies' large cash balances, dividend payments, and stock buybacks could be considered to be key factors in judging whether excess, or windfall, profits were earned.

Windfall Profits Tax Proposals

As crude oil prices rose in the mid-2000s, Congress began to explore the option of imposing a windfall profits tax on the oil and gas companies. The rising price of crude oil and petroleum products led many in Congress to become concerned over the level of oil industry profits. Various legislative proposals that would have raised taxes on the oil and gas industry were considered during the 109th, 110th, and 111th Congresses. Early in the 112th Congress, the spot market price of West Texas Intermediate (WTI) crude oil surpassed the $100/barrel mark. Should high crude oil prices be associated with increased industry profits, Congress may once again choose to consider windfall profits tax proposals.

A windfall profits tax can be viewed as a way to allow the government to share in financial gains, particularly when the financial gains are not the direct result of industry activities. Some proposals have suggested that the additional tax revenues be used to fund subsidies for low-income persons to offset the burden of high petroleum prices. Additional revenues could also be used for energy conservation programs, alternative and renewable fuels, or deficit reduction.[16] Additional revenues generated through a windfall profits tax need not be dedicated to a specific purpose.

The concept of a windfall profits tax is not new; a tax on windfall, or excess, business profits has been one the instruments of fiscal policy, used by both state and federal governments, whenever business profits either rise too fast or rise to levels that are considered too high—above "normal" or fair rates of return. At the federal level, however, such taxes have been used sparingly—being viewed as extraordinary measures, their use limited to wartime or other periods characterized by economic emergencies and instabilities such as hyper-inflations. Such was the case with the surtax on business profits imposed as a temporary measure to control large profits earned during

[15] For additional information on the BP oil spill, see CRS Report R41262, *Deepwater Horizon Oil Spill: Selected Issues for Congress*, coordinated by Curry L. Hagerty and Jonathan L. Ramseur, and CRS Report R41531, *Deepwater Horizon Oil Spill: The Fate of the Oil*, by Jonathan L. Ramseur.

[16] For more information on budget deficits and various federal revenue options, see CRS Report R41641, *Reducing the Budget Deficit: Tax Policy Options*, by Molly F. Sherlock.

World Wars I and II, and the Korean War.[17] A windfall profits tax on health insurers was also discussed, though ultimately not adopted, during the healthcare reform debate in 2009.[18]

A type of windfall profits tax on domestic crude oil production was in effect from April 1980 to August 1988. This tax, which was actually an excise tax, not a profits or income tax, was part of a compromise between the Carter Administration and the Congress over the decontrol of crude oil prices.[19, 20] Some have proposed reinstating this tax, although it should be underscored that the current situation giving rise to possible windfall profits—the current reasons for the high price of petroleum products and record profits—is different from the conditions and rationale which existed at the time that tax was imposed.[21]

Reinstating the oil windfall profits tax was also discussed during the 1990s, when crude oil prices doubled in just two months due to the crisis in the Middle East (Iraq invaded Kuwait on August 2, 1990).[22]

Windfall Profits Tax Legislation in the 109th–111th Congresses

After the enactment of the Energy Policy Act of 2005 (EPACT05; P.L. 109-58), congressional interest in a windfall or excess profits tax on the oil and gas industry intensified. More than a dozen windfall profits tax bills were introduced in the 109th Congress. Many of these bills proposed to use the revenues from the WPT to offset the burden of higher gasoline prices for consumers.[23] There were two types of windfall profits tax bills in the 109th Congress: those that would have imposed an excise tax on windfall profits based on the price of crude oil, and those that would have imposed an income tax on windfall profits based on either the existing tax law's definition of corporate taxable income or excessive rates of return.

WPT legislation introduced during the 110th Congress tended to be of the income tax type, rather than the excise tax type. In addition to imposing WPT, legislation in the 110th Congress sought to repeal the IRC § 199 deduction for domestic manufacturing activities. Repeal of the § 199 deduction would effectively increase the marginal tax rate of affected entities. Repealing § 199

[17] John Hakken, Excess Profits Tax. *The Encyclopedia of Tax Policy*. Joseph J. Cordes, and Jane Gravelle, eds. The Urban Institute Press, 1999. pp. 108-111.

[18] Sam Goldfarb, "Prospects Dim for Proposed Profit Tax on Health Insurers," *Tax Notes*, October 19, 2009, p. 279.

[19] Excise taxes are paid on the purchase of a specific good. The WPT of the 1980s was a per-barrel tax on oil, rather than a direct tax on profits.

[20] For detailed analysis, see CRS Report RL33305, *The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy*, by Salvatore Lazzari.

[21] As noted above, the 1980 WPT was imposed as part of a compromise to decontrol crude oil prices—a *quid pro quo*. From a control regime level of about $6/barrel before the tax, crude prices were allowed to rise gradually to market levels (as influenced strongly by OPEC), which at that time were about $24/barrel. By contrast, today there are no price controls on crude oil and prices are determined in a generally competitive global crude oil market, one in which the United States is a price taker, and one in which OPEC plays a relatively smaller (but still important) role. Also, more recently crude oil prices have increased for significantly different reasons than was the case in the 1970s. Unlike the 1980s when crude oil prices declined sharply to pre-decontrol levels just after the WPT was imposed (and for most of the life of the tax), crude oil prices since the trough of 1998/1999 have increased fairly steadily and consistently and have surpassed the levels of 1982 in real terms.

[22] From the beginning of July 1990 to August 1990, domestic oil prices (the spot price of West Texas Intermediate) nearly doubled, increasing from just over $16 per barrel to nearly $32 per barrel.

[23] Some of the bills would have allocated the receipts to offset the cost of supplemental spending bills targeted to aid victims of Hurricanes Katrina and Rita. Others would allocate them to the highway trust fund to compensate for any losses from the proposed commensurate reduction in motor fuels excise taxes to offset the WPT. Several bills would have appropriated the proceeds for the Low-Income Home Energy Assistance Program (LIHEAP), which gives grants to low-income households to offset high energy bills and for residential weatherization.

would increase the tax rate on all profits, not just those considered to be windfall profits. As discussed in more detail below, the corporate income tax system could be used as an administratively simple way to increase the tax burden on the oil and gas industry, approximating a WPT, while likely limiting the risk of adverse economic and energy market effects.

There were fewer legislative efforts to impose a windfall profits tax on oil and gas companies during the 111th Congress. Oil prices declined late in 2008, with WTI spot prices falling to $41 per barrel by the end of the year. During 2009, WTI spot prices averaged $62 per barrel. WTI spot prices averaged $79 per barrel during 2010, climbing to $89 per barrel toward the end of the year. Crude oil prices below the levels reached in late 2007 and throughout 2008 may have muted legislative efforts to impose a crude oil WPT.

Excise Tax Type of WPT

As noted above, the WPT that was in effect from 1980 through 1988 was an excise tax rather than an income tax. In other words, it was not a type of tax that most economists would consider a true tax on "windfall gains or income." The tax was imposed on the difference between the market price of oil, which was technically referred to as the removal price, and a statutory 1979 base price that was adjusted quarterly for inflation and state severance taxes. Almost every barrel of domestically produced crude oil—i.e., every barrel of domestic production that was not specifically tax-exempt—was subject to this excise tax.

The excise tax type of WPT was the type proposed in most of the WPT bills in the 109th Congress. These bills would have generally imposed an excise tax equal to 50% of the windfall profits not reinvested in (1) oil and/or gas exploration and drilling, (2) increased refinery capacity, (3) renewable electricity property, or (4) facilities for producing alcohol fuels or biodiesel. These bills would have defined a windfall profit as the difference between the market price of oil (at the wellhead) and an inflation-adjusted base price of $40/barrel.[24]

During the 110th Congress, legislation was introduced that would have imposed a 50% excise tax on major integrated oil companies, based on the difference between the market price of oil and $50/barrel (the $50 would be adjusted annually for inflation).[25]

Income Tax Type of WPT

Some of the WPT proposals in the 109th Congress were of the income tax type, using the existing corporate income tax system to assess the tax, or defining the tax base in terms of taxable income under the existing corporate income tax. Typical of the income tax type of WPT were those that would have imposed a 50% tax on the excess of the adjusted taxable income for a taxable year over the average taxable income during the 2000-2004 period. The 50% tax would have applied to crude producers and integrated oil companies with sales in 2005 or 2006 above $100 million. The tax would have been temporary and would have applied to petroleum products as well as crude oil.[26]

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[24] Specific legislative proposals of this type included S. 1631, H.R. 3752, H.R. 4203, H.R. 4248, H.R. 4449, H.R. 4263, S. 1981, and S. 2103 were of this type. S. 1631 was offered as an amendment to S. 2020, the Senate's version of tax reconciliation which went to conference, but was ruled out of order.

[25] See S. 1238.

[26] Income tax types WPT proposals in the 109th Congress included S. 1809 and H.R. 4276 in the House. Senators Schumer and Reed sponsored S. 1809 as an amendment to S. 2020 (S.Amdt. 2635 and S.Amdt. 2626). In both cases, the amendments were ruled out of order.

An alternative income tax based WPT would tax profits above a legislatively determined rate of return. One proposal made during the 109th Congress would have taxed profit from the sale of crude oil, natural gas, or products of crude oil and natural gas above a 15% rate of return at 100%.[27]

Income tax type WPT legislation was also introduced in the 110th Congress. Similar to previous legislation, this legislation sought to tax the windfall profits of major integrated oil producers or oil producers with gross revenues in excess of $100 million per year, averaged over a base period.[28] Generally, excess profits were defined as taxable income above 110% of taxable income during the base period. Income tax type WPT proposals made during the 110th Congress would generally have taxed 50% of what was deemed to be excess profits. Various proposals differed in the rate that would be levied on the taxable portion of excess profits, with some proposing a tax rate of 50%,[29] while others proposed a lower rate of 25%.[30]

Other Types of WPT Proposals

Other types of WPT proposals are not easily categorized as being excise tax type or income tax type. Some WPT proposals in the 109th Congress would have imposed a WPT with graduated rates, ranging from 50% to 100%, depending on the extent to which profits exceeded a "reasonable level."[31]

Similar to legislation introduced in the 109th Congress, legislation introduced in the 110th Congress proposed taxing excess profits above a "reasonable" amount. A Reasonable Profits Board would be created to determine reasonable profits levels. Taxable profits would be taxed at some rate ranging from 50% to 100%.[32]

One House bill introduced during the 111th Congress (H.R. 1482) would have taxed profits in excess of reasonable profits, where reasonable profits were determined by a Reasonable Profits Board. The tax would have ranged from 50% to 100%, increasing as profits exceeded reasonable profits by a larger margin. Revenues from this tax would be used to fund the Low-Income Home Energy Assistance Program (LIHEAP).[33]

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[27] See H.R. 3712 in the 109th Congress. Under this proposal, tax revenues would have been earmarked for a program of gas stamps to help indigent persons offset the burden of recent high gasoline prices, which would be similar to the current federal food stamp program.

[28] Various legislative proposals using 2000 through 2004 as a base period, while others used 2001 through 2005 or 2002 through 2006.

[29] See S. 701 and S. 2971.

[30] See S. 2991 and S. 3044. These proposals also stipulated that any increased investment in renewable energy over the same base period would be credited toward the tax, reducing tax liability under the WPT. S. 3044 would also roll back $17 billion in existing oil and gas industry tax breaks over 10 years for the largest oil companies; revenues would be earmarked to expanding renewable energy development. In addition to the tax provisions, S. 3044 would prohibit, and provide penalties for, price gouging by the oil and gas industry, tighten regulation of speculators in offshore oil, and suspend filling of the Strategic Petroleum Reserve.

[31] Proposals of this nature included H.R. 2070, H.R. 3664, and H.R. 3544. Whether the WPT would have been excise tax based or income tax based, or whether they would have used some other tax base, is unknown since the bills did not provide a definition of either profits or a reasonable profit. These bills also differed in how the proceeds would be used. H.R. 3544 would have imposed price controls on gasoline, banned drilling in the Arctic National Wildlife Refuge, mandated minimum levels of inventory of crude oil and petroleum products, banned the export of Alaskan oil, and facilitated the draw-down of the Strategic Petroleum Reserve. H.R. 2070 would have funded income tax credits for the purchases of fuel-efficient passenger vehicles, and allowed grants for mass transit.

[32] See H.R. 5800 and H.R. 6000.

[33] For background on LIHEAP, see CRS Report RL31865, *The Low Income Home Energy Assistance Program*

Analysis of Economic and Policy Issues

High crude oil and petroleum product prices are one factor that may contribute to oil industry profits. Not all profits, even with high oil prices, are windfall profits or unearned income. Oil industry income and profits also reflect a return on investment from capital stock or a return on the firm's decision-making and risk-taking.

Governments share in the profits of companies through tax collections. **Table 5** presents income taxes reported on the financial statements of major integrated oil companies between 2005 and 2010. These include income taxes paid to the U.S. federal government, as well as income tax payments to state and local governments and foreign governments. Tax payments by these five companies increased 32% between 2005 and 2007, before decreasing in recent years. Total tax payments by the major integrated oil companies in 2009 and 2010 were substantially lower than tax payments during the previous four years. Any windfall profits tax that might be adopted would add to these tax revenues.[34]

Table 5. Tax Payments by Major Oil Companies, 2005-2010

(billions of dollars)

	2005	2006	2007	2008	2009	2010
ExxonMobil	23.30	27.90	29.86	36.53	15.00	21.56
Shell	17.99	18.31	18.65	4.90	5.39	6.08
BP	9.29	12.31	21.17	12.82	6.32	6.60
Chevron	11.10	14.84	13.48	19.00	7.96	12.90
ConocoPhillips	9.91	12.78	11.38	13.40	5.00	8.30
Total	**71.59**	**86.14**	**94.54**	**86.65**	**39.67**	**55.44**

Source: Company Income Statements, available at http://www.hoovers.com.

While tax payments of the major integrated oil companies did increase during the 2005 through 2007 period, the presence of or change in tax payments does not directly indicate whether oil and gas companies have experienced windfall gains or unearned income. A well-designed WPT would tax only the true windfall component of oil industry incomes. Moreover, such a tax would be simple to administer and easy to comply with, and would avoid or minimize any adverse economic and energy market effects. As the discussion below suggests, while in theory the concept of a windfall profit seems simple and intuitive, in practice it can be difficult to accurately measure. The actual implementation of a WPT involves a compromise over differing fiscal policy objectives: (1) administerability—collecting the excess revenues (or windfall gains) in the least costly manner in terms of tax administration and compliance, and (2) economic efficiency—devising and structuring the tax in a way that minimizes economic distortions, including adverse output and price effects, and adverse impacts on petroleum imports, energy independence, and energy security.

(LIHEAP): Program and Funding, by Libby Perl, and CRS Report RL33275, *The LIHEAP Formula: Legislative History and Current Law*, by Libby Perl.

[34] According to the U.S. Department of the Interior, the domestic oil industry in the United States also pays billions in royalties, which are not taxes but factor payments, the return to landowners on their mineral assets. For FY2010, total federal royalties on oil and gas (including natural gas liquids) were $6.7 billion. See the Minerals Management Service website at http://www.onrr.gov.

The remaining sections of this report discuss some of the more important economic issues surrounding proposed legislation, and draw relevant policy implications. The final section discusses alternative policy options.

Defining and Measuring Windfall Gains

One challenge in designing a WPT is how to define a true windfall gain, i.e., the tax base. In theory, windfall gains and excess profits are distinct concepts. A windfall gain applies to income or wealth that is unexpected. This type of gain is often due to factors outside of the control of the benefitting institution. Excess profits, on the other hand, are based on defining an acceptable profit, and attributing everything above that level as excessive. Defining the level of profits that constitute excess profits can be subjective. This difference might be illustrated with a hypothetical example. A firm might be so efficient that its above-average profitability (or returns) might be considered excessive, but not a windfall. However, if its production waste, which formerly was costly to dispose of, became valuable, that gain might be considered a windfall.

One goal of a WPT could be to tax profits that are price driven, or those that are not the result of additional output or investment. From this perspective, it may not necessarily be appropriate to compare rates of return in the oil and gas sector to rates of return in other industries, for the purpose of defining excess returns. Higher rates of return in the oil and gas sector do not necessarily indicate the presence of windfall profits. If, however, the profits are price-driven and a windfall, and there is little or no output or investment effect, an excise tax type or an income tax type WPT could be used to collect the tax revenues related to the windfall.

Excise tax type and income tax type WPTs may elicit different responses from oil producers, and may have different administrative and compliance costs. The following sections examine the possible output and price effects of the different types of WPT, and explore which type of WPT is more likely to minimize economic distortions.

Economic Effects of the Excise Tax Type of WPT

An excise tax on domestically produced crude oil is one option for approximating a WPT. As discussed in more detail below, an excise tax on domestically produced crude oil may only approximate a windfall profit tax, and may have certain adverse energy market and economic effects. In other words, depending on how a WPT was structured, an excise tax type of WPT—for instance, by reinstating the WPT of the 1980s—might make the United States more dependent upon foreign oil, which in turn might have implications for energy security.

Output Effects

A WPT in the form of an excise tax could affect domestic oil production. In economic terms, oil producers would likely view the tax as an increase in the marginal, or incremental, cost of domestic oil production—the marginal cost of producing every barrel of taxable crude oil would be higher by the amount of the excise tax. An increase in the marginal cost of production might reduce domestic oil production. However, this effect is likely to be mitigated in the U.S. oil market by other factors.

For the tax to effectively reduce domestic oil production, the difference between price and marginal cost would have to be relatively small. If the difference between price and marginal cost were small, the imposition of a tax could reduce or eliminate profits. In the current oil market, oil prices are typically far above the marginal cost of production, implying that even after paying a tax, profitability could remain high, continuing to provide an economic incentive for production.

Additionally, marginal production adjustments are unlikely to be made to existing oil wells. Once an oil well goes into production, the maximum sustainable flow rate is likely to simultaneously be the maximum economic flow rate. In other words, once a well goes into production, operating the well at maximum capacity tends to maximize economic returns. From this perspective, oil field management tends to be based on physical factors related to output.

Oil Imports and Energy Independence

If the domestic supply of oil was reduced in response to an excise tax on domestically produced oil, the demand for imported oil and petroleum products would likely increase, unless some other policy would concomitantly reduce the demand for petroleum to offset a tax-induced reduced supply. This is because oil imports to the United States are a residual, adjusting to reflect the difference between aggregate demand for oil and aggregate domestic oil supply.

Price Effects

One concern is that a WPT on crude oil would be passed forward to consumers in the form of higher prices.[35] Given that oil prices are determined in the worldwide oil market, however, it seems more likely that a WPT would reduce the price received by oil producers, rather than increase the price for petroleum consumers.

As discussed above, an excise tax only on domestically produced oil would increase marginal production costs. In theory, a profit maximizing firm would respond to this type of tax by reducing output and attempting to raise prices to offset the higher marginal production costs. However, in the case of domestic crude oil, the higher marginal cost cannot be shifted forward as a higher oil price, because oil is priced in the international (world) oil market.[36] Oil producers would not be able to shift the tax forward as a higher oil selling price because the first purchaser (generally, the refiner) could merely substitute imported crude, which would be tax-exempt. Instead, this type of WPT would reduce the net selling price paid to producers. As a result, the first purchaser would subtract the tax from the price paid to the producer (supplier)—the producer's net selling price of each barrel of oil would be reduced by the amount of the WPT.

The Corporate Income Tax Type of WPT

Output Effects

In the short-run, an income tax based WPT—such as those that use the existing corporate tax system to define excess or windfall taxable income—may be less likely than an excise tax type WPT to distort output decisions of oil producers. The reason for this is that firms maximize profit at the point at which market prices are equal to marginal production costs, and neither are affected in the short-run by an increase in the corporate tax burden. In other words, the profit maximizing level of output is unaffected by the tax. Thus, to the extent that a surtax on the corporate income of crude oil producers on their upstream operations could approximate a WPT, this would not raise crude oil prices and domestic production *in the short-run*.

In the long-run, however, all taxes tend to distort resource allocation. A corporate profit tax (either of the pure type or the surtax on the existing rates) would raise average long-term

[35] If the tax is not passed forward to consumers in the form of higher prices, then the tax would result in lower returns for oil producers.

[36] There may be some small price effects if the export supply curve is not perfectly elastic.

production costs, reduce the rate of return and reduce the flow of capital into the industry relative to other industries, and move resources away from the corporate form of business organization. All these effects could adversely affect domestic production, possibly resulting in increased petroleum imports.

Oil Imports and Energy Independence

Because the income tax type of WPT does not create incentives to reduce domestic production in the short-run, there is no increase in the demand for imports under such a tax in the short-run, although it could if the tax were still in effect in the long-run.

Price Effects

Economic theory suggests that increasing marginal tax rates would have little effect on petroleum product prices, at least in the short-run. Profit maximizing firms choose production levels by producing up to the point where the marginal cost of production equals market prices. Since marginal changes in income taxes do not affect marginal production costs or market prices, profit maximizing levels of production, theoretically, would be unaffected by an income tax type of WPT. Over time, as the long-run average cost of production rises, firms may reduce output, thereby driving up prices.

Alternative Policy Options

A number of policy options are available should Congress decide to increase taxes on the oil and gas industry. President Obama's FY2012 budget proposes to eliminate a number of tax incentives available for oil and gas as well as coal producers.[37] Eliminating existing tax subsidies is one option for increasing taxes paid by the oil and gas sector. Rather than review all options related to oil and gas tax incentives, the remaining sections of this report address alternatives that are variations on the two WPT options discussed above.

Rescinding the § 199 Deduction

Marginal tax rates for oil and gas companies could be increased by repealing the IRC § 199 deduction for domestic manufacturing activities. This option does not actually attempt to measure or tax windfall profits, but uses the existing corporate income tax system to effectively increase the marginal corporate tax rate on domestic oil and gas producers. A repeal of the § 199 deduction could apply to all oil and gas producers, as proposed in the President's FY2012 budget,[38] or apply only to major integrated oil companies, as proposed in the Close Big Oil Tax Loopholes Act (S. 940).

Enacted in 2004 as an export tax incentive, IRC § 199 allows a deduction for a specified percentage of the qualified production activity's income (or profit).[39] The deduction was originally established as a substitute for the repeal of the export tax benefits under the extra-

[37] For additional background, see CRS Report R41669, *Oil and Natural Gas Industry Tax Issues in the FY2012 Budget Proposal*, by Robert Pirog.

[38] President Obama has proposed repealing the domestic production deduction for oil and gas companies in his FY2010, FY2011, and FY2012 budget proposals.

[39] This deduction was enacted under the American Jobs Creation Act of 2004 (P.L. 108-357, also known as the "JOBS" bill).

territorial income tax exclusion, which was ruled to be in violation of trade laws.[40] The deduction is subject to a limit of 50% of the wages paid that are allocated to the domestic production during the taxable year. The deduction was phased-in over time, starting at 3% in 2005, increasing to 6% in 2007, and increasing again to the full rate of 9% in 2010. Oil extraction is permanently limited to a 6% deduction.[41]

For the domestic oil and gas industry, which qualifies for this deduction (i.e., it is not excluded from claiming it), the deduction applies to oil and gas or any primary product thereof, provided that such product was "manufactured, produced, or extracted in whole or in significant part in the United States." Note that extraction is considered to be manufacturing for purposes of this deduction, which means that domestic firms in the business of extracting oil and gas from underground reservoirs or deposits qualify for the deduction. Oil-related production activities such as refining, processing, and transportation are also limited to a 6% deduction.

Repealing or cutting back this deduction would be effectively equivalent to an increase in the marginal income tax rate. As was discussed above, a change in the corporate tax burden in the short-run is relatively neutral. Repealing the § 199 deduction would increase the top effective federal marginal tax rate for affected oil and gas producers from 32.9% to 35% (the statutory rate).[42] All other large corporations would continue to face a top effective marginal tax rate of 32.9%, with the exception of non-manufacturing enterprises (services, for example), which do not qualify for the § 199 deduction. As was noted above, repealing the § 199 deduction does not attempt to measure and tax the oil industry's windfall profits. Instead, the repeal can be viewed as a way of using the existing corporate income tax system to increase the tax burden on the oil industry, and recoup some of any potential windfall or excess profits in the form of corporate income taxes.

As before, eliminating the deduction—that is to say, raising the corporate tax rate—would increase total (or average) business costs and therefore reduce profitability among the major oil and gas producers. As long as marginal production costs are unaffected, there would be no price effects *in the short-run*. Similarly, the demand for imports is likely to remain the same in the short-run. Thus, this type of corporate income tax increase would arguably be an administratively simple way to capture at least some of the oil industry's windfalls in the short-run. However, at a current deduction of 6%, and a marginal corporate tax rate of 35%, removing the deduction might only capture a small portion of the industry's potential windfalls.

The market price of crude oil and natural gas, or even of refined petroleum products, such as gasoline, would not be expected to increase very much, if at all, by such a change in the short-run. In general, also, the income tax increases are not expected to have real output effects in the short-run, although they could cause resources to flow to other industries in the long-run as long as these other industries are allowed the manufacturing deduction, which is equivalent to a lower marginal tax rate.

Researchers have attempted to quantify the effects of repealing various energy tax incentives on oil and gas markets. In 2009 testimony before the Senate Committee on Finance, Subcommittee on Energy, Natural Resources, and Infrastructure, Alan B. Krueger presented analysis from the Treasury Department on the economic impact of removing various tax incentives for oil and gas

[40] CRS Report RL32652, *The 2004 Corporate Tax and FSC/ETI Bill: The American Jobs Creation Act of 2004*, by David L. Brumbaugh.

[41] Provisions permanently limiting oil and gas to a 6% deduction were enacted as part of the Emergency Economic Stabilization Act of 2008 (P.L. 110-343).

[42] The production activities deduction of 6% reduces the top marginal tax rate from 35% to 32.9% (35% x 0.94).

producers.[43] The tax incentives under consideration were those presented in the President's FY2010 Budget Proposal, which included a repeal of the § 199 deduction, among other provisions.[44] Similar proposals appear in the FY2011 and FY2012 budget proposals. Overall, Kruger's testimony suggested that the effect of removing existing tax incentives for oil and gas would have small market impacts. Treasury officials estimate that eliminating the § 199 deduction and other tax incentives for oil and gas would have little or no effect on the world supply of oil and world oil prices. Removing tax incentives for the oil and gas industry would be unlikely to result in significantly higher prices for consumers of refined petroleum products. Treasury officials also estimate the long-run effects on domestic production to be small. According to Kruger, removing the § 199 deduction along with other oil and gas tax incentives might result in a long-run reduction in domestic production of roughly 0.5%.

An Income Type WPT Tax and § 199 Repeal

A WPT proposal could be combined with a repeal or reduction in the § 199 manufacturing activities deduction. This effectively uses two instruments to raise the corporate tax rate on domestic oil and gas producers. As noted above, repealing the § 199 deduction does not target windfall profits. Legislation could be designed that would attempt to tax windfall profits, or profits attributable to high petroleum prices, while also increasing marginal tax rates on oil and gas producers by eliminating the § 199 deduction.

A Tax on Imported and Domestically Produced Crude Oil

Another option would be to impose an excise tax on both imported and domestically produced oil.[45] This tax would tend to have upward price effects—the price of crude oil in the United States would tend to be higher than under the WPT on domestic oil alone. This is because the tax would be imposed on imports, which are the residual source of oil supplies and therefore the benchmark for crude oil prices. The effect on domestic production and the level of imports—dependence on foreign imports—would depend on the size of the tax and the responsiveness of domestic supply and import demand to price changes.

An Excise WPT and Gas Tax Suspension

A gas tax suspension could be enacted alongside an excise tax type WPT. The goal of this option might be to use the excise tax holiday—the suspension of the 18.4¢/gallon tax on gasoline—to offset any price increases associated with the excise tax type WPT. A suspension in the federal gas tax could have revenue consequences for the highway trust fund (HTF), if lost revenue are not offset from the general fund or some other source.

The statutory or legal incidence of the federal gas tax falls on the refiners. Depending on how responsive consumers of gasoline are to changes in price, some of the reduction in tax liability may be shifted forward to consumers, resulting in lower gas prices for consumers. In the short-

[43] U.S. Congress, Senate Committee on Finance, Subcommittee on Energy, Natural Resources, and Infrastructure, *Oil and Gas Tax Provisions: A Consideration of the President's FY 2010 Budget Proposal*, 111th Cong., September 10, 2009. Full text of the testimony is available at http://finance.senate.gov/imo/media/doc/091009aktest.pdf.

[44] For a summary of the oil and gas provisions in the President's FY2010 budget, see CRS Report R40715, *Oil Industry Tax Issues in the FY2010 Budget Proposal*, by Robert Pirog.

[45] The Reagan Administrated proposed a tax on oil in the early 1980s. Others have proposed an excise tax on crude oil to act as a floor on the price of oil. For details of the later proposal, see Richard A. Westin, "A Case for a Crude Oil Price Stabilization Tax," *Tax Notes*, January 25, 2010, pp. 481-494.

run, consumers are not very responsive to changes in prices (e.g., the short-run price elasticity of demand for gasoline is low).[46] Given that consumer demand is not responsive to changes in gas prices in the short-run, refiners would be unlikely to reduce prices with a gas tax holiday. In the long-run, as consumers are better able to change their behavior to adapt to higher gas prices, refiners may use the savings associated with a gas tax holiday to reduce gas prices for consumers. Thus, over a longer period of time, it is possible that a gas tax suspension could be used as a tool to offset potential price increases resulting from a WPT on crude oil.

Possible Revenue Effects

A WPT on crude oil could generate sizeable revenues depending on the tax rate and the tax base. As discussed above, the tax base for a WPT would depend on which type of WPT was implemented: an excise tax type or income tax type. Revenues might also depend on crude oil prices at the time the tax were imposed. Providing estimated revenues associated with a WPT is beyond the scope of this report.

The excise tax type WPT probably has the greatest revenue potential when crude oil prices are high, partially because the tax base is not adjusted for operating costs. With an excise tax type WPT, the tax base is the difference between the market price and a legislatively determined base price. The tax rate applied to this base would also be determined by Congress. For example, an excise tax type WPT could be structured to impose a 50% tax on the difference between the market price of oil and $50/barrel. If oil prices remain high, this tax could generate substantial revenues.

The income tax type of WPT generally has a smaller revenue potential, as the tax base is likely to be smaller. In an income-tax-type WPT, taxable income is used as the tax base. Taxable income is generally smaller than book income (which is the net income measure reported in **Table 3**). Also, the income tax based proposal typically uses the average of taxable income over a lagged five-year period. Thus, in a period of generally rising prices, the base tends to vary proportionately with prices.

Eliminating existing tax preferences for oil and gas has the potential to generate substantial federal revenues. Repealing the IRC § 199 deduction would generate an estimated $18.3 billion in additional revenues over the 10-year, 2012 through 2021 budget window.[47] As was noted above, the President's FY2012 budget proposes to eliminate a number of tax incentives for fossil fuels. Eliminating oil and gas tax preferences would generate an estimated $43.6 billion over the 10-year, 2012-through-2021 budget window.[48]

Concluding Remarks

High crude oil prices of the late 2000s have raised concerns that oil companies may be earning windfall profits, or profits that were excessive, unearned, or unfairly gained. As oil prices increased in the period leading to their 2008 peak, revenues and net income of the major integrated oil companies were also relatively high. When oil prices rose again in 2010, so did revenues and net incomes. During this period of high oil prices and price volatility, oil production

[46] For additional background, see CRS Report R40808, *The Role of Federal Gasoline Excise Taxes in Public Policy*, by Robert Pirog.

[47] For more details on the Administration's proposals and revenue estimates, see Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, February 2011, available at http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf.

[48] Ibid.

by the major integrated oil companies remained relatively constant. The fact that revenues and income have risen without a corresponding increase in production has led to the observation that some of the gains enjoyed by the industry may be windfall profits.

Profit rates for major integrated oil companies, however, are in-line with profit rates in the broader manufacturing sector. Further, returns in the oil and gas sector are highly volatile. Over some periods, returns may exceed those earned in manufacturing broadly. Over other periods, profits earned by oil and gas producers may fall short of profits earned in other sectors. From this perspective, short periods of high profitability may represent volatility in the industry, rather than potentially sustained windfall profits.

Should a WPT—or other type of additional tax—be imposed on the oil and gas industry it is important to note that the potential economic consequences of different types of taxes differ. An excise tax type of WPT could lead to a reduction in domestic oil production, but would not likely lead to an increase in the price of petroleum for consumers. An income tax type WPT would be less likely to distort domestic production in the short-run. However, as resources are reallocated over time, and income tax type WPT could affect domestic production. In the short-run, an income tax type WPT would be unlikely to have much effect on prices. Over time, however, it is possible that an income tax type WPT could lead to price increases.

Another option for increasing taxes on the oil and gas industry, one that has been considered in the 112th Congress, is scaling back existing tax benefits. Rescinding the § 199 domestic production deduction for oil and gas companies is another option for increasing taxes on the industry. This option, however, does not target windfall profits, but would instead effectively increase the marginal corporate tax rate for domestic oil and gas producers. Repeal of the § 199 deduction would be unlikely to reduce output or increase prices in the short-run. Further, any long-run market impacts on production and prices would likely be small.

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