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Proposed Gulf of Mexico OCS Severance Tax: Bad Policy to "Fix" Past Government Decision, and Bureaucratic Overload

Any new Gulf of Mexico federal severance tax proposal should be rejected

Overlaying existing Gulf of Mexico federal oil and gas royalty and tax structures with an entirely new regime (which is likely to face legal challenge) – a federal severance tax on the value of Outer Continental Shelf (OCS) production – would be costly and inefficient, much less inappropriate policy at a time when this country is facing a delicate energy supply/demand balance.

Background

Natural gas producers – especially the large U.S. independent exploration and production companies – are going all-out to find and develop new North American natural gas supplies from our very large resource base, with positive results beginning to be seen. Drilling has been at record high levels. Reserves are growing. Price volatility has diminished and price levels declined as weather cooperated and exploration and production activity has continued at a strong pace.

In addition, drilling in the OCS of the Gulf of Mexico for oil and gas continues at a feverish rate despite the extremely high-risk – and increasingly high-cost – nature of operating in that region. Significant deep water oil discoveries and production increases are good news.

A Senate proposal to put a 13% federal severance tax on Gulf of Mexico production, with royalty payments credited against the new tax, is designed to raise money from deep water production on federal leases issued in 1998 and 1999 which are royalty free (to certain volume limits). Those leases issued by the Department of the Interior granted royalty "relief" without regard to the prices of oil and gas.

Many companies relied on the resulting improved project economics to invest hundreds of millions of dollars in the federal leases and in resulting exploration and production.

Now, after companies have made these substantial investments, some in Congress believe that the Department of the Interior's granting of royalty "relief" without regard to the prices of oil and natural gas was wrong. They apparently believe that companies should not have relied on their U.S. lease contracts and should now pay royalties on production in a manner inconsistent with those contracts.

Problem: Bad Policy, Bureaucratic Overload

The federal severance tax proposal fails the test of good public policy in a number of ways:

- It punishes successful efforts of companies that relied on a U.S. government contract to make investment decisions.

- It will change the economics of specific projects, resulting in earlier abandonment of production.

- It will take even more revenue from the offshore without sharing it with the affected coastal states and does so through an unprecedented federal severance tax, a form of taxation historically left to the states to levy.

- It will require tax payments on production from projects that may not even be profitable.

- It will add a new taxation layer on top of existing federal royalty and income tax programs, creating confusion and the likelihood of future rate increase proposals as federal spending proposals multiply.

- It will be one of the most inefficient taxes ever imposed if it is implemented as promised – collecting billions and billions of dollars only to rebate all but a small fraction based on the work of an entirely new structure of Internal Revenue Service auditing procedures and increased staffing.

- It will rely on government determinations of federal oil and gas royalty “value” for crediting against the severance tax since most Gulf of Mexico oil royalties, and approximately half the natural gas royalties, are not paid in dollars. Instead, those royalties are paid “in kind”, meaning that the government, in a highly successful program, takes its share of oil and gas to sell in the competitive marketplace.

- It will require government value determinations for oil royalty-in-kind payments to the government that go directly into the Strategic Petroleum Reserve and for which there is never a market price set by a sale.

- It will lead to increased value determination disputes with the IRS and its auditors, and probably litigation.

- With different valuation standards for royalties by the IRS and MMS, there will be confusion and disputes between and among IRS, MMS and the producers.

- It will cause contract and other issues among assignees and assignors of the leases and between multiple interest owners in projects, some of which may make royalty payments (that are supposed to be creditable against the severance tax) on behalf of other interest owners.

- It will require significant new government and private sector administrative burdens and costs across the board because of the new program itself, and also because of the overlapping royalty, severance tax and income tax integration and compliance and enforcement issues that will be generated.

Solution

Any new Gulf of Mexico severance tax proposal should be rejected.