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From Page:
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6/15/2011
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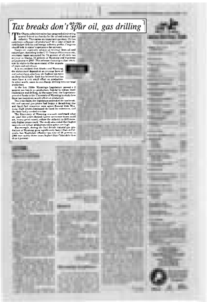

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Tax breaks don't spur oil, gas drilling

The Obama administration has proposed eliminating several federal tax breaks for the oil and natural gas industry. This raises an important question: Do tax incentives influence oil production? At a time of both record budget deficits and energy industry profits, Congress should look to states' experiences for answers.

States are especially reliant on revenue from oil and natural gas. According to the U.S. Census of Governments, severance taxes accounted for 74 percent of all state tax revenue in Alaska, 34 percent in Wyoming and 9 percent in Louisiana in 2010. This reliance encourages close attention by states to the assessment of the impacts of rates and incentives.

It is no accident that Alaska and Wyoming, the states most dependent on revenue from oil and natural gas, also have the highest tax rates on these fossil fuels. Each has learned that tax rates have a very small effect on production. In other words, rates do not change drilling rates or total production.

In the late 1990s, Wyoming's Legislature passed a 2 percent tax break on production, hoping to induce more exploration and drilling. At the same time, the Legislature provided funds to the University of Wyoming to study how these tax incentives would affect oil production.

Two years later, the legislature rescinded the tax break. Oil and natural gas prices had begun a decadelong rise and fossil fuel resources were again flowing from Wyoming. High prices eliminated the need for incentives, and the state badly needed revenue.

The University of Wyoming research confirmed what the past two years showed: Lower severance taxes could not, to any great extent, induce the industry to drill more; only higher prices could. The study also noted that higher taxes do not reduce production when prices are high.

For example, during the last decade natural gas production in Wyoming grew significantly faster than in Colorado, but Wyoming's effective tax rate of 16 percent in 2008 was nearly three times higher than Colorado's (less than 6 percent).

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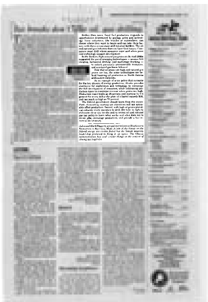

Rather than taxes, fossil fuel production responds to opportunities determined by geology, price and technology. Some industries, like textiles or automakers, can choose where they want to locate and can take their factory with them across state and national borders. The oil and natural gas industry does not have that luxury. Companies must drill where resources exist and when price and technology support development.

In the Rockies, high natural gas prices in the mid-2000s supported the use of emerging technologies — seismic 3-D imaging, horizontal drilling, and multistage fracking — to unlock previously unrecoverable resources, and a natural gas boom followed.

Now that oil prices are high and natural gas prices are low, the same technologies are behind booming oil production in North Dakota and eastern Colorado.

As an example of a tax policy that accounts for the key drivers of energy production, Alaska provides incentives for exploration and technology to encourage the full development of resources, while calibrating production taxes to maximize revenue when prices are high. Production taxes begin at 25 percent and increase by 0.4 percent for every dollar the price of a barrel exceeds $30, and can reach as high as 70 percent.

The federal government should learn from the states. First, eliminating existing tax incentives will not noticeably affect production. Second, with high oil prices providing industry every incentive to drill, the time is right to eliminate these tax breaks and to revisit oil and natural gas tax policy to learn what works and what does not to create jobs, encourage production, and provide a fair return to the treasury.

Julia and Mark Haggerty are policy analysts at Headwaters Economics in Bozeman, Mont. A vote in the Senate on the federal energy tax credits failed but the Senate majority leadership promised to bring it up again. The Obama administration has said similar things in the context of closing tax loopholes.

GUEST SHOT

Julia and Mark Haggerty