The Oil Depletion Allowance

http://educationforum.ipbhost.com/index.php?showtopic=3704

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I was researching the oil depletion allowance on-line and encountered this information.

It would appear the elimination of the oil depletion allowance may have had unintended consequences.

DISCUSSION:

2. No new refinery has been built in the US in 17 years.

It's worse than that. Between 1977 and 2002, the number of refineries operating in the US fell from 282 to 153. There are 129 refineries sitting idle. They can be purchased for 20% of the cost of building new, so why would anyone want to build a new one?

To understand why that's so, you have to understand the Oil Depletion Allowance and how it influenced oil company accounting. Big oil companies have four major business units -- Exploration and Production, called Upstream, and Refining, Transportation and Marketing, called collectively Downstream. (I'm ignoring Chemicals here.) The Oil Depletion Allowance used to allow them to deduct 15% of upstream *gross profit* from corporate income tax, which is based on *net profit*. The four divisions 'sell' product to each other for intracompany prices that are easily manipulated to move profit from one division to another. The Oil Depletion Allowance gave them a strong incentive to move as much as possible upstream. To see this, look at any oil company's P&L. For instance, Exxon Mobil in the first quarter of 2004 reported (in millions):

US upstream *net* income $ 1,154 75%
US downsteam *net* income 392 25% (up from 174 same quarter 2003)
Total US income 1,546

Prices are artificially set so that refineries and transportation lose money, retail operations make a little, most profit is in production and exploration. On $1,154 *net* profit, the *gross* profit is at least double. Thus corporate income tax would be (1546 * .35) - (2500 * .15) = 166 or 11%. If refineries lose money, why build new ones? Better to shut them down (129 above) or sell them to Valero for 20% of new (they're fully depreciated).

In 1975, the Depletion Allowance was limited to small producers who do not operate a refinery (I used to be one). That was intended to stop the 'tax break for the rich.' In its place, Big Oil got the 'intangible drilling cost deduction', which produced an even bigger deduction by letting them deduct 70% of the cost of drilling a well in the first year, and the rest over five years.
They also got the 'enhanced oil recovery credit', which pays them for operating stripper wells (marginal, almost played out) and for pumping out-of-spec oil (high sulphur, high viscosity). Something for everyone -- new wells and old. Profits were still moved upstream; refineries still lose money.