

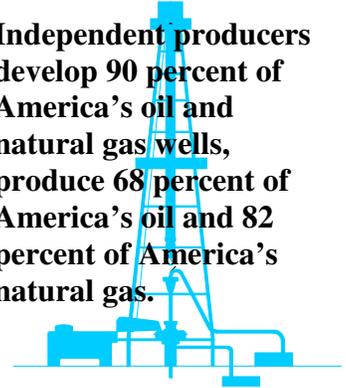
## Percentage Depletion

Depletion, like depreciation, allows for the recovery of capital investment over time. Percentage depletion is used for most mineral resources including oil and natural gas. It is a tax deduction calculated by applying the allowable percentage to the gross income from a property. For oil and natural gas the allowable percentage is 15 percent.<sup>1</sup>

A part of the tax code since 1926, percentage depletion has changed over time. Current tax law limits the use of percentage depletion of oil and gas in several ways. First, the percentage depletion allowance may only be taken by independent producers and royalty owners and not by integrated oil companies. Second, depletion may only be claimed up to specific daily American production levels of 1,000 barrels of oil or 6,000 mcf of natural gas. Third, the deduction is limited to 65% of net taxable income. Fourth, the net income limitation requires percentage depletion to be calculated on a property-by-property basis.<sup>2</sup> It prohibits percentage depletion to the extent it exceeds the net income from a particular property. These limitations apply both for regular and alternative minimum tax purposes. Percentage depletion in excess of the 65 percent limit may be carried over to future years until it is fully utilized.

Despite these limitations, percentage depletion remains an important factor in the economics of American oil and natural gas production. Most independent producers do not exceed the 1000 barrel per day limitation. Yet, these producers are a significant component of America's oil production. For example, they are the predominant operators of America's marginal wells. Over 85 percent of America's oil wells are marginal wells – producing less than 15 barrels per day. Yet, these wells produce about 20 percent of American oil production. About 75 percent of American natural gas wells are marginal wells, producing approximately 12 percent of American natural gas. Marginal wells are unique to the United States; other countries shut down these small operations. Once shut down, they will never be opened again – it is too costly. Even keeping them operating is expensive – they must be periodically reworked, their produced water (around 9 of every 10 barrels produced) must be disposed properly, the electricity costs to run their pumps must be paid. The revenues retained by percentage depletion are essential to meet these costs. For larger wells, percentage depletion provides more revenues to be used to find new oil and natural gas in the United States. Independent producers historically invest more than their cash flow back into projects.

**Independent producers develop 90 percent of America's oil and natural gas wells, produce 68 percent of America's oil and 82 percent of America's natural gas.**



## **Action Needed**

The Obama Administration budget proposal would repeal percentage depletion of oil and natural gas. Loss of percentage depletion would adversely affect American oil and natural gas production. Lost American production runs counter to America's energy security needs, America's move toward cleaner energy and even the development of alternative energy sources like wind and solar that require natural gas backup when they cannot generate energy. The Obama Administration proposal should be rejected.

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<sup>1</sup> For marginal wells the allowable percentage is increased (from the general rate of 15 percent) by one percent for each whole dollar that the average price of crude oil for the immediately preceding calendar year is less than \$20 per barrel. In no event may the rate of percentage depletion under this provision exceed 25 percent for any taxable year. The term "marginal production" for this purpose is domestic crude oil or domestic natural gas which is produced during any taxable year from a property which (1) is a stripper well property for the calendar year in which the taxable year begins, or (2) is a property substantially all of the production from which during such calendar year is heavy oil (i.e., oil that has a weighted average gravity of 20 degrees API or less corrected to 60 degrees Fahrenheit). A stripper well property is any oil or gas property which produces a daily average of 15 or less equivalent barrels of oil and gas per producing oil or gas well on such property in the calendar year during which the taxpayer's taxable year begins.

<sup>2</sup> The net income limitation for marginal wells is suspended during 2009.