

Status of Tax and Environmental Issues in Obama Administration/111th Congress April, 2009

Overview

Clearly, the dynamics of energy policy direction are dramatically different in the Obama Administration and the 111th Congress. Most obviously, the Obama Administration's budget proposals on oil and natural gas taxation, its intense interest in developing "green" energy and its commitment to global climate initiatives present substantial challenges because the Administration's rush to action ignores the potential consequences of its actions. Similarly, the Democratic dominance of the 111th Congress – particularly the strong liberal bias of the House and Senate leadership – suggest the Administration initiatives will be well received, if not driven, by the Congress.

The budget process has been an early test. While House-Senate conference negotiations must be completed, the budget resolution debate showed significant Congressional resistance to many of the sweeping Administration proposals and to leadership suggestions as well. Most notably, neither the House nor the Senate directly embraced the Administration assumptions on taxes. Moreover, the resolutions do not compel the development of major tax legislation under the debate limiting process of reconciliation. Nor do they compel action on global climate legislation.

Tax Issues

For oil and natural gas production taxation, these actions mean that the worst case scenario has been, at least, deferred. The worst case scenario would have occurred if the budget resolution had required a major tax bill under reconciliation instructions. Such a bill would have presented the likelihood of all the Obama oil and natural gas proposals being debated. Moreover, the reconciliation process would limit Senate debate, impede amendments and allow approval based on a simple majority vote.

Now, the most likely scenario for an energy tax debate will be in the context of an energy tax title probably as part of an energy bill. In this context, oil and natural gas tax provisions are at risk to "pay for" new tax incentives to alternative energy, conservation or efficiency enhancements. Significantly, this scenario means that those oil and natural gas tax provisions needed to offset the new incentives will be in play. It is a shift from the Administration broad attack on oil and natural gas tax policy to funding as the primary driving force. While all of the tax issues could be considered, Congress will more likely choose those where it has the least path of resistance. Specifically, the Section 199 manufacturers' tax deduction and the Gulf of Mexico royalty related excise tax become more vulnerable because they were debated extensively in the 110th Congress.

IPAA aggressively advocated against the Obama Administration tax proposals. At the IPAA March "Call-Up", members met with over 60 offices. These were important initial efforts. For independent producers the IDC, percentage depletion and passive loss exception of working interests proposals drew the broadest opposition. A number of oil state Democrats weighed opposing a tax package that would adversely affect American natural gas and oil production, specifically identifying effects on independent producers. These included: Rep. Chet Edwards (D-TX), Rep. Dan Boren (D-OK), Rep. Gene Green (D-TX) who organized a letter with over 15 Democrats signing it, and Sen. Mary Landrieu (D-LA). The next challenge will be broadening the level of opposition to including adverse tax policies in future tax legislative proposals. It is far better to suppress the addition of adverse provisions than to try to remove them after they have been included.

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IPAA's messages on taxes build on the broader messages of the role of natural gas and oil in the Obama/Democratic Congress agendas. These are:

Natural gas and oil provide 65 percent of America's energy. New wind energy and solar energy require new natural gas turbines to run when the wind doesn't blow and the sun doesn't shine. American natural gas is essential to meeting any clean energy agenda associated with global climate. American natural gas and oil are essential to any energy security plan.

America's independent natural gas and oil producers develop 90 percent of US wells, produce 82 percent of US natural gas and produce 68 percent of US oil. Independent producers reinvest over 100 percent of American oil and natural gas cash flow back into new American production. Lower natural gas and oil prices and the tight credit market are limiting investment capital; drilling activity is down over 25 percent since a year ago.

The Obama Administration's budget request would strip essential capital from new American natural gas and oil investment by radically raising taxes on American production. American natural gas and oil production would be reduced. It runs counter to the Administration's clean energy and energy security objectives.

Taken together, these tax changes would strip over \$30 billion from US natural gas and oil production investment. As President Obama has said:

The energy challenges our country faces are severe and have gone unaddressed for far too long. Our addiction to foreign oil doesn't just undermine our national security and wreak havoc on our environment – it cripples our economy and strains the budgets of working families all across America.

America needs an energy policy that recognizes the roles that all forms of energy supply can play. American natural gas and oil are essential elements – natural gas should be part of any clean energy initiative; natural gas and oil should be part of any energy security strategy. The Administration's budget request could cripple the American producers that are pivotal in developing US natural gas and oil.

The specific descriptions of the Obama tax proposal consequences are set forth below.

Intangible Drilling and Development Costs (IDC) – IDC tax treatment is designed to attract capital to the high risk business of natural gas and oil production. Expensing IDC has been part of the tax code since 1913. IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. Only independent producers can fully expense IDC on American production. Eliminating IDC expensing would remove over \$3 billion that would have been invested in new American production.

Percentage Depletion – All natural resources minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926. Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers, only available for the first 1000 barrels per day of production, limited to the net income of a property and limited to 65 percent of the producer's net income. Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. Eliminating percentage depletion would remove over \$8 billion that would have been invested in maintaining and developing American production.

Passive Loss Exception for Working Interests in Oil and Gas Properties – The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. The Act exempted working interests in natural gas and oil from being part of the passive income basket and, if a loss resulted, it was deemed to be an active loss that could be used to offset active income as long as the investor's liabilities were not limited. Most natural gas and oil producers in the United States are Small Business

Owners. Natural gas and oil development require large sums of capital and producers frequently join together to diversify risk. To qualify for the exception, the producer must have liability exposure and definitely be at risk for any losses. If income/loss, arising from natural gas and oil working interests, is treated as passive income/loss, the primary income tax incentive for taxpayers to risk an investment in oil and natural gas development would be significantly diminished.

Marginal Well Tax Credit – This countercyclical tax credit was recommended by the National Petroleum Council in 1994 to create a safety net for marginal wells during periods of low prices. These wells – that account for 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable to shutting down forever when prices fall to low levels. Enacted in 2004, the marginal well tax credit has not been needed, but it remains a key element of support for American production – and American energy security.

Enhanced Oil Recovery (EOR) Tax Credit – The EOR credit is designed to encourage oil production using costly technologies that are required after a well passes through its initial phase of production. For example, one of the technologies is the use of carbon dioxide as an injectant. Given the increased interest in carbon capture and sequestration, carbon dioxide EOR offers the potential to sequester the carbon dioxide while increasing American oil production. Currently, the oil price threshold for the EOR tax credit has been exceeded and the oil value is considered adequate to justify the EOR efforts. However, at lower prices EOR becomes uneconomic and these costly wells would be shutdown.

Section 199 Manufacturing Tax Deduction – Congress enacted this provision in 2004 to encourage the development of American jobs. All US manufacturers benefitted from the deduction until 2008 when the oil and natural gas industry was restricted to a six percent deduction while other manufacturers will grow to a nine percent deduction. While many producers' deductions are capped by the payroll limitation in the law, it is another tax provision that provides capital to America's independent producers to invest in new production.

Excise Tax on Gulf of Mexico Production – American independent producers hold 90 percent of the OCS leases in the Gulf of Mexico. Offshore federal lands produce 27 percent of America's oil and 15 percent of America's natural gas. Producers pay royalties as high as 18.75 percent on their production. A portion of this production is produced without royalty payments until it reaches a set volume that was designed to encourage – and effectively so – development of deep water areas. Creating a new tax designed to add a \$5 billion burden on US offshore development will drive producers from the US offshore reducing new American production of natural gas and oil.

Geological and Geophysical (G&G) Amortization – G&G costs are associated with developing new American natural gas and oil resources. For decades, they were expensed until a tax court case concluded that they should be amortized over the life of the well. In 2005 Congress set the amortization period at two years. Later, Congress extended the amortization period to five years for large major integrated oil companies and then extended the period to seven years. Early recovery of G&G costs allows for more investment in finding new resources. Extending the amortization period would remove over \$1 billion from efforts to find and develop new American production.

While our interactions with oil state Democratic members have produced solid responses toward independent producer issues, they have not shown a similar interest in supporting integrated oil companies, particularly the large majors. Similarly, while all of these tax provisions have some effect on independent producers, some of them will be more targeted than others – e.g., the Section 199 provision and the Gulf of Mexico tax proposal – because of the past history of votes on those issues.

Environmental Issues

Both traditional and global climate environmental issues are active in the Obama Administration and the 111th Congress.

IPAA, a substantial number of state and regional associations and API initiated a series for significant efforts responding to the threat of new legislation and regulation under traditional federal environmental laws – Safe Drinking Water Act, Clean Air Act, Clean Water Act, Resource Conservation and Recovery Act, Superfund, Toxic Release Inventory, etc. The first of these is the Bringing Real Information on Energy Forward (BRIEF) projects. Phase I of BRIEF will produce documents on the key federal laws and why they differentiate on natural gas and oil production, the effectiveness of the current federal-state regulatory process, and the energy/economic consequences of changing these laws. Phase II of BRIEF will create materials to present this information in federal and state venues – advocacy, town meetings, hearings, op eds, and a new web site, EnergyInDepth.com. EnergyInDepth.com will provide materials to the public on production environmental issues and management. Beyond BRIEF, IPAA initiated efforts to create a more interactive communication network between the state associations and the national ones. The next challenge will be to keep these efforts going and to adequately fund actions to aggressively respond to environmental groups pushing for new regulations and legislation.

This year, environmental groups have renewed efforts to extend federal Safe Drinking Water Act regulation to hydraulic fracturing, to expand Clean Air Act regulation over hydrogen sulfide, to reconsider the regulation of storm water during construction activities under the Clean Water Act and to expand the scope of the Toxic Release Inventory to natural gas and oil production. Similarly, these environmental initiatives have been aggressively pursued in the states through efforts to revise state regulations or pressure federal legislators through state activism. The new industry programs must be correspondingly aggressive.

With regard to global climate, most of the focus has been on legislative initiatives but there is a corresponding and potentially more significant regulatory element to the debate. Court decisions have given the Environmental Protection Agency authority to potentially expand the scope of the Clean Air Act into the regulation of Greenhouse Gases (GHG). The Obama Administration's early reaction to this potential expansion is far broader than the scope considered by the Bush Administration. The threat of Clean Air Act expansion provides a political lever on Congress regarding potential global climate legislation. That is, if Congress fails to enact a global climate bill, EPA could act under its Clean Air authority. A significant consequence of regulating under the Clean Air Act relates to the size of facility that is covered at the point of regulation. Under the Clean Air Act a regulated facility is generally one that emits 100 tons/year of the pollutant. This is an extremely low threshold for GHG such as carbon dioxide – probably capturing almost all oil and natural gas production facilities. As a contrast, most legislation sets the threshold at 25,000 tons/year or 10,000 tons/year.

Legislation, however, is no simple matter. Despite the regular claims that movement will be quick on global climate legislation, there are significant issues that must be resolved. Essentially, a global climate law will largely define American industrial policy, American energy policy and international economic positioning for the next 50 years. Questions of how to utilize the funds that will be collected, the international implications, the impacts on coal use and coal related jobs will be among those that must be addressed. During the budget resolution debate, the Senate passed language to prevent this complicated legislation from being considered in the reconciliation process – a sign that the many issues are still being evaluated. In the 110th Congress, IPAA participated in analyses of Senate legislation showing that it would increase demand for natural gas. However, changes to the point of regulation in the Senate bill – to gas processors – would have resulted in the compliance burden shifting from emissions sources to producers. The consequence would be to reduce American natural gas production investment and supply.

While other issues may arise, IPAA's primary focus has been on the point of regulation and the question of pre-empting other laws that might be used to regulate GHG. Specifically, IPAA wants to assure that the point of regulation falls on emitting sources, not on fuel production at the wellhead. (Refineries will likely be required to account for emissions associated with gasoline and diesel fuels.) On pre-emption, IPAA wants whatever federal global climate law that is passed to be the only venue to address GHG – preventing further litigation to try to impose additional requirements through the Clean Air Act, the Endangered Species Act and the growing array of state and regional programs.