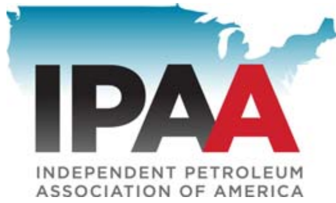

Comments

Submitted

To

Senate Committee on Finance

Regarding

Chairman Baucus'

Proposal to Reform Cost Recovery and Tax Accounting Rules

January 17, 2014

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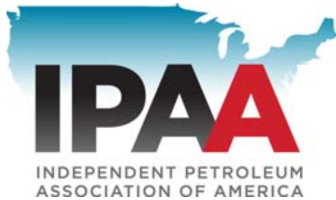

These comments are filed on behalf of the Independent Petroleum Association of America (IPAA), the Association of Energy Service Companies (AESC), the International Association of Drilling Contractors (IADC), the International Association of Geophysical Contractors (IAGC), the National Stripper Well Association (NSWA), the Petroleum Equipment Suppliers Association (PESA), and the following organizations:

Arkansas Independent Producers and Royalty Owners Association
California Independent Petroleum Association
Coalbed Methane Association of Alabama
Colorado Oil & Gas Association
East Texas Producers & Royalty Owners Association
Eastern Kansas Oil & Gas Association
Florida Independent Petroleum Association
Illinois Oil & Gas Association
Independent Oil & Gas Association of New York
Independent Oil & Gas Association of West Virginia
Independent Oil Producers Agency
Independent Oil Producers Association Tri-State
Independent Petroleum Association of New Mexico
Indiana Oil & Gas Association
Kansas Independent Oil & Gas Association
Kentucky Oil & Gas Association
Louisiana Oil & Gas Association
Michigan Oil & Gas Association
Mississippi Independent Producers & Royalty Association
Montana Petroleum Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas Association
New Mexico Oil & Gas Association
New York State Oil Producers Association
North Dakota Petroleum Council
Northern Alliance of Independent Producers
Northern Montana Oil and Gas Association
Ohio Oil & Gas Association
Oklahoma Independent Petroleum Association
Panhandle Producers & Royalty Owners Association
Pennsylvania Independent Oil & Gas Association
Permian Basin Petroleum Association
Petroleum Association of Wyoming
Southeastern Ohio Oil & Gas Association
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Independent Producers and Royalty Owners Association

Utah Petroleum Association
Virginia Oil and Gas Association
West Virginia Oil and Natural Gas Association
Western Energy Alliance

Collectively, these groups represent the thousands of independent oil and natural gas explorers and producers, as well as the service and supply industries that support their efforts, that will be the most significantly affected by the proposed actions in these regulatory actions. Independent producers drill about 95 percent of American oil and natural gas wells, produce about 54 percent of American oil, and more than 85 percent of American natural gas.

In addition to the specific comments made herein, we support those comments submitted separately by the participants in these comments.

These comments address the Senate Committee on Finance Chairman Max Baucus' Proposal to Reform Cost Recovery and Tax Accounting Rules. We appreciate the opportunity to comment on the significant impacts that would accrue to American oil and natural gas development – and American energy security - as a result of these proposals.

Outlook with Respect to American Oil and Natural Gas Development

The United States requires energy growth for economic prosperity and to carry on the necessities of everyday life. To the chagrin of fossil fuel opponents, oil and natural gas will remain a part of America's for the foreseeable future. The U.S. Energy Information Administration (EIA) projects in the *Annual Energy Outlook 2014*[1] that total primary energy consumption in the United States will grow by 12 percent between 2012 and 2040. To meet that nation's energy demand in 2040, EIA calculates that oil and natural gas will account for 62 percent of the total primary energy consumption. Once it is accepted that America will continue to require oil and natural gas to meet its energy needs, it is only a question of where those resources are produced – either in the United States or elsewhere.

The story with respect to American oil and natural gas is one of incredible perseverance and growth. In a little more than six years, the outlook with respect to American oil and natural gas production has drastically shifted – for the better.

Today, the United States is currently third in the world in crude oil and natural gas liquids production and America continues to expand its output. Most importantly, the United States is one of the only countries in the world where energy security is improving. For example, crude production in the United States, after sinking to levels not seen since the mid-1940s, rose

[1] U.S. Energy Information Administration, *Annual Energy Outlook 2014 (AEO2014)* available at http://www.eia.gov/forecasts/aeo/er/pdf/0383er(2014).pdf

1,400,000 barrels per day between 2007 and 2012. That size of increase has not been witnessed in the United States in more than forty years. Imports have declined more than 5 million barrels per day since 2005. America's reliance on foreign petroleum is drastically shifting. According to EIA, net oil imports dropped from 60.3 percent of products supplied in 2005 to 40 percent in 2012 and less than 34 percent in 2013.

The picture is equally bright with respect to natural gas production in the United States. The Potential Gas Committee (PGC) recently determined, in the PGC's 2012 year-end biennial report, that the United States possesses a technically recoverable natural gas resource potential of 2,384 trillion cubic feet (Tcf). The 2012 year-end report was the highest resource evaluation in the PGC's 48 year history—exceeding by 486 Tcf the previous record-high assessment from year-end 2010. The PGC's resource evaluation shows that the United States, at current consumption levels, has a 100 year supply of natural gas.

The Need for Capital and Developing Trends

The ability of independent producers to reinvest their cash flow is critical to funding American oil and natural gas production. Horizontal drilling is necessary to develop American oil and natural gas from shale resources. Shale oil and gas is located more than a mile below the earth's surface. Shale wells with horizontal components can cost in excess of $10 million per well. Moreover, producers have historically reinvested more than 100 percent of their cash flow back into their American operations (i.e. oil and natural gas companies have spent more money on leasing and drilling than they made selling crude and natural gas). Without capital to fund operations, development of America's oil and natural gas resources will drastically slow.

The landscape with respect to available capital is competitive and, in some ways, limited for American producers. This is particularly the case with independent oil and natural gas producers. For example, smaller independent producers are unable to attract financing from institutional investors or even community banks. The advent of Dodd-Frank has increasingly made lending to smaller producers insignificant. Those producers that seek access to capital in the public markets must compete with other industries that do not have the same capital intensive burdens. As such, it is challenging for independent producers to compete in the market place under current conditions. Capital flows to those industries with the highest rate of return; generally these are not capital intensive industries. If the current treatment of oil and natural gas tax provisions are significantly altered, it will accelerate this trend, thereby incentivizing capital to flow to the highest rate of return, not necessarily to those industries that are in the national interest (i.e. those industries that create the products and jobs needed to lead American out of its economic malaise and provide secure, middle class jobs).

In recent years, producers have been able to attract some capital from international investors. The trend of international investment in American energy development, however, is slowing. According to a recent IHS Herold study, in 2013, international companies spent less than half of

what they invested in 2012 for stakes in U.S. shale-rock formations. The amount of investment in 2013 was a tenth of investment that occurred in 2011.[2]

The Role of American Tax Policy

The United States can continue to expand American oil and natural gas production or the country can return to a future dominated by decreasing American production. Tax policy is critical in influencing which path America takes. Congress must recognize that changes to tax policy do not occur in a vacuum. It is a myth that American energy policy and American tax policy are separate and do not interrelate. If American oil and natural gas producers are unable to reinvest their cash flow, because of changes to the tax code that take this critical cash for increased taxes, fewer wells will be drilled in the United States. If Congress reforms the tax code, it must recognize that it can either enhance or impede American oil and natural gas development.

The current tax system is working and has resulted in an increasing amount of American oil and natural gas development which, in return, has decreased the United States reliance on imported sources of energy for the first time in decades. It makes little sense for Congress to enact policies that would encourage a return to increased oil and natural gas imports; this is especially the case when America will rely on oil and natural gas as an energy source for decades. However, the Chairman's discussion draft on proposals to reform cost recovery rules strikes at the crux of this issue by adversely altering the current treatment of important independent producer provisions such as the current treatment of Intangible Drilling Costs (IDC) and the Percentage Depletion deduction. Simply put, the Chairman's proposals to revise the current treatment of these key tax provisions for independent producers would result in fewer wells drilled in the United States and less American oil and natural gas production. The following is a discussion of the specific provisions altered by the Chairman's discussion draft.

Intangible Drilling Costs

Expensing Intangible Drilling Costs (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. Loss of IDC for independent producers will have significant effects on their capital development budgets. A Raymond James analysis in 2009 reported that the complete elimination of IDC would result in capital drilling budgets being reduced by 25 to 30 percent. This compares with information provided to IPAA by its members indicating that drilling budgets would be cut by 25 to 40 percent. Regardless of

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[2] Daniel Gilbert, "*For U.S. Drillers, the Days of Easy Money End, Oil and Gas Companies Slash Spending as Foreign Investment Dries Up*," The Wall Street Journal (January 2, 2014) available at http://online.wsj.com/news/articles/SB10001424052702304753504579282983108494214?KEYWORDS=oil+drillers+capital

the exactness of the assessments, clearly, the consequences would be significant. And, the consequences would soon be evident. Roughly half of America's current natural gas production is provided by wells developed during the past four years.

The Chairman's proposal does not eliminate the treatment of IDC entirely. However, the proposal in the Chairman's discussion draft does little to alleviate the impact to independent producers. Instead, the Chairman's proposal requires IDC to be recovered over a 60 month period (i.e. qualified extraction expenditures are required to be capitalized and amortized over five years, beginning with the midpoint of the taxable year in which such costs were paid or incurred). The Chairman's proposal is little better than outright repeal of IDC because of the drastic change in cost recovery occurring the first year. Under the proposal, independent producers would still realize a 90 percent reduction in recovered IDC in the first year of the Chairman's proposal. The loss of recovered IDC is compounded in each successive year of the recovery period. Independent producers will not simply increase capital budgets because of increased federal taxation. Instead, producers will be forced to use capital that would have otherwise been reinvested into American operations to pay the federal government. As such, the crippling effects of extending the cost recovery period will harm independent producers' cash flow and result in fewer wells drilled in each successive year.

Percentage Depletion

All natural resources minerals are currently eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926 after Congress determined that relying solely on cost depletion was leading to the loss of important American mineral resources. 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 and for royalty owners, only available for the first 1000 barrels per day (6000 mcfd of natural gas) of production, limited to the net income of a property and limited to 65 percent of the taxpayer's net income.

The restraints placed upon oil and natural gas percentage depletion make it a provision that affects small businesses and individuals – oil and natural gas percentage depletion is not a large producer issue. Larger oil and natural gas operators produce in excess of the 1000 barrels per day (6000 mcfd of natural gas) threshold. The percentage depletion deduction, therefore, is of little importance to larger producers. For smaller oil and natural gas producers, however, the percentage depletion deduction is critical. Percentage depletion is especially important for marginal well operators. These wells – that account for approximately 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable economically. Loss of percentage depletion puts these resources in jeopardy.

Additionally, many small producers file their tax returns as individuals – not as corporations. More than half of IPAA's membership is comprised of businesses that are not corporations. By eliminating the percentage depletion deduction to generate some yet to be determined lower

corporate tax rate would, in fact, be a tax increase on independent producers that are organized as something other than corporations. There is no reason why Congress should eliminate a tax provision – that is limited in such a way as to only apply to small businesses and individuals – for the benefit of corporations.

Therefore, as with IDC expensing, percentage depletion is critical for smaller independent producer's ability to finance drilling operations from cash flow and maintain existing marginal operations. To achieve North American energy independence, America's existing and marginal production must be maintained. Retention of oil and natural gas percentage depletion is critical to these efforts.

The draft proposal also raises a question of whether to restructure the currently restrictive percentage depletion provision as it applies to oil and natural gas production. The draft suggests the possibility of retaining a percentage depletion provision for smaller producers but capping the deduction at the same amount as the cost depletion provision. While the concept of limiting percentage depletion at the same value as cost depletion has been discussed for several years, it fails to recognize the underlying purpose of creating value depletion (e.g., percentage depletion) in the first place. Following the initiation of income taxation, only cost depletion was available as a deduction to reflect the reduction of mineral resources as they were produced. As such, Congress found that the limitations of cost depletion as a deduction resulted in the premature abandonment of important national mineral resources, such as oil and natural gas. It created value depletion to assure that the tax code was not adversely affecting US mineral development. The proposal to limit percentage depletion at the same value as cost depletion merely creates to paths to the same end point – the end point that Congress sought to avoid by creating value depletion.

Other Provisions

IPAA would oppose other restrictions placed on independent producers' ability to recover costs, generate capital and reinvest in American operations. For example, the Chairman's proposal repeals present-law amortization of geological and geophysical expenditures ("G&G costs") and tertiary injectants. G&G costs are associated with developing new American natural gas and oil resources while tertiary injectants are costs associated with extracting as much oil and natural gas from an existing field as possible. Moreover, IPAA would urge the Committee to not alter any tax provisions that would decrease the availability of capital available to independent producers.

Conclusion

As the Committee considers policies related to America's oil and natural gas resources, it must recognize that federal actions can dramatically affect the future of the nation's energy security and the nation's ability to meet the potential for its economic growth. We urge the Committee to support those actions that enhance that future and reject the ill-advised calls for adverse

restrictions to capital. Should you have any questions please contact Lee Fuller (lfuller@ipaa.org) or Matt Kellogg (mkellogg@ipaa.org) at IPAA.