December 9, 2013

The Honorable Dave Camp
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

The Honorable Sander Levin
Ranking Member
Committee on Ways and Means
U.S. House of Representatives
1106 Longworth House Office Building
Washington, D.C. 20515

The Honorable Max Baucus
Chairman
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Orrin Hatch
Ranking Member
Committee on Finance
U.S. Senate
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairmen Camp and Baucus, Ranking Members Levin and Hatch,

America's independent oil and natural gas producers are helping to revitalize the American economy by investing and creating jobs in the United States. The American shale revolution, spurred by horizontal drilling and hydraulic fracturing, has propelled the United States to become one of the biggest oil and natural gas production countries in the world; it results in creating profound economic, trade and geopolitical advantages for the country. This remarkable American energy revitalization could end if tax reform legislation limits independent producers' access to capital by changing oil and natural gas tax provisions. As such, the undersigned urge you to preserve the current tax treatment of capital formation and recovery provisions such as the expensing on intangible drilling costs (IDC), the percentage depletion deduction and the passive loss exception for working interests.

Collectively, the signatories of this letter represent the thousands of independent oil and natural gas explorers and producers, millions of American royalty owners and the service and supply industries that support American production, that will be the most significantly affected by changes to IDC, the percentage depletion deduction and the passive loss exception for working interests. Independent producers drill about 95 percent of American oil and natural gas wells, produce about 56 percent of American oil, and more than 85 percent of American natural gas.

According to a recent study by IHS[1], the unconventional oil and gas value chain supports more than 2.1 million jobs today, a figure forecast to rise to more than 3.3 million jobs in 2020 and 3.9

[1] IHS, "America's New Energy Future: The Unconventional Oil and Gas Revolution and the U.S. Economy," available at http://www.anga.us/media/content/F7D1441A-09A5-D06A-

million by 2025. The oil and gas value chain's contribution to U.S. GDP was more than $284 billion in 2012, and is on track to grow to $533 billion in 2025. IHS foresees the U.S. trade deficit reduced by more than $164 billion in 2020 thanks to unconventional production, equivalent to one-third of the current U.S. trade deficit. Moreover, these numbers omit the sizeable value from conventional production which constitutes almost two-thirds of our country's oil and natural gas production (approximately one third of our crude oil and over 40 percent of our natural gas according to the Energy Information Administration).

With respect to American oil production, in 2012, crude oil production rose by the largest volume ever in its history, nearly 850,000 barrels per day, or 14.9 percent. More American oil production has resulted in improvements in American energy security. The changing dynamics with respect to oil imports provide one of the most striking examples. As recently as 2005, 60 percent of American oil consumption was supplied by net imports; in 2012 that share dropped to just under 40 percent. That number is expected to continue to decline. The large shifts in physical trade volumes have had a financial impact in the billions of dollars. Imported oil prices roughly doubled between 2005 and 2012. The significant decline in total imports during this time saved the United States $180 billion in import costs.[2]

The story of American natural gas and natural gas liquids production is equally bright. The United States became the largest producer of natural gas in the world when it overtook the Russian Federation in 2009. American output of natural gas liquids reached an all-time high in 2012, up nearly 40 percent from 2005. During the same period, U.S. marketed production of natural gas set another all-time record, at 25.3 trillion cubic feet, an increase of 34 percent.[3]

These positive trends could all be put at risk if tax reform limits independent producers' access to capital and cost recovery mechanisms. To develop oil and natural gas from deep shale formations, producers require access to significant amounts of capital. An average onshore will in 2010 costs about $2,000,000, but the average North Dakota shale oil well cost $8.3 million. Removing independent producers' ability to expense IDC in the year that they are incurred would strip away roughly 25 percent of the capital available for independent producers at current tax rates. Even if top corporate marginal tax rates were lowered from 35 percent to 25 percent, corporate independent producers would still face approximately a 20 percent hit on capital budgets. Less access to investment capital means a decline in drilling activity and less energy output – challenging outcomes given that producers typically reinvest close to 150 percent of

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9EC93BBE46772E12/files/Americas_New_Energy_Future_Mfg_Renaissance_Main_Report_4Sept13.pdf (accessed October 22, 2013).

[2] Declaration of Independents, "Global Trade Impact of the American Oil Resurgence" available at http://oilindependents.org/global-trade-impact-of-the-american-oil-resurgence/ (accessed October 22, 2013).

[3] Independent Petroleum Association of America, "IPAA Ranks Top 10 U.S. Oil & Natural Gas Records" available at http://www.ipaa.org/2013/07/30/ipaa-ranks-top-10-u-s-oil-natural-gas-records/ (accessed October 22, 2013).

their American cash flow into American drilling in order to manage exploratory risk, prove up their properties and contend with decline rates.

Additionally, changes to IDC expensing could be perilous for smaller independent producers, most of which file as individuals. Unlike larger oil and natural gas companies, 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 impossible. As such, smaller producers must finance their drilling operations with cash flow generated from the wellhead. Changing the ability to immediately expense IDC will drastically curtail drilling budgets for all independent producers and will be especially impactful for smaller producers.

Elimination of oil and natural gas percentage depletion could be equally negative, particularly for America's existing marginal well base. Oil and natural gas percentage depletion is only available for independent producers' first 1,000 barrels/day of production and for royalty owners – farmers, ranchers, retirees whose families own mineral resources. *Oil and natural gas percentage depletion is really a provision that affects small businesses and individuals – it is not a large producer issue*.

These small producers operate America's marginal oil and natural gas wells, which are critical to America's energy output. Marginal oil wells account for 20 percent of U.S. production; marginal gas wells account for about 13 percent of U.S. natural gas production. To achieve North American energy independence, America's marginal production must be maintained. Loss of percentage depletion puts marginal well production in jeopardy.

Repealing percentage depletion would impact millions of royalty owners across the United States. Royalty owners exist in every state and Congressional District. Often, royalty payments are a major component of a royalty owner's income – particularly for retirees. Elimination of percentage depletion would have the unintended impact of harming these individuals.

The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. The Tax Reform Act provided an exception for working interests in natural gas and oil from being part of the passive income basket and, if a loss resulted (from expenditures for drilling wells), 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. Natural gas and oil development require large sums of capital and producers frequently join together to diversify risk. Additionally, natural gas and oil operators have sought individual investors to contribute capital and share the risk of drilling wells. Most American wells today are drilled by small and independent companies, many of which depend on individual investors. There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in this system.

Moreover, Congress applied the passive loss rules only to individuals and not to corporations. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations. There is no apparent reason why Congress would or should favor corporate ownership over individual ownership of working interests.

Furthermore, since Alternative Minimum Tax (AMT) restrictions apply to IDC of individual working interest investors, the application of the passive loss rules to those investors is unnecessary and excessive. In sum, to qualify for the exception, the taxpayer 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 natural gas and oil development would be significantly diminished. In today's banking climate, smaller producers find banks uninterested or incapable of providing capital; taking private investors away will further exacerbate the challenge of raising capital to sustain American marginal well production.

Eliminating or significantly altering independent producers' tax provisions will have no meaningful revenue impact on paying for tax reform legislation but will seriously harm independent producers' capital generation and capital cost recovery. No current formulation of tax reform proposals would lower effective rates for independent producers – whether they file as corporations or individuals – to offset the loss of these deductions.

The Ways and Means Committee, the Finance Committee and the larger Congress face a key question: should policymakers promote increased American oil and natural gas production and the corresponding economic benefits to America or should Congress enact policies that will return the United States to the days of increasing reliance on imported energy? The undersigned urge the Committee to support the retention of IDC, the percentage depletion deduction and the passive loss exception for working interests that will enhance American energy production.

Sincerely,

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Independent Petroleum Association of America

V. Bruce Thompson
American Exploration and Production Council

Jerry Simmons
National Association of Royalty Owners

Kenny Jordan
Association of Energy Service Companies

Kelly Robbins
Arkansas Independent Producers and Royalty Owners Association

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