



Testimony
Of
The
Independent Petroleum Association of America
Regarding
Senate Committee on Finance
April 27, 2021 Hearing
Climate Challenges: The Tax Code's Role in
Creating American Jobs, Achieving Energy
Independence, and Providing Consumers with
Affordable, Clean Energy

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The Independent Petroleum Association of America (IPAA) submits the following materials.

IPAA represents thousands of America's independent oil and natural gas producers. Our members are the primary producers of the nation's oil and natural gas and account for 83 percent of America's oil production and 90 percent of its natural gas output. These independent producers are a driving force in our economy and support roughly 4.5 million jobs in the United States. IPAA member companies are innovative leaders and broke the code to usher in the shale oil and natural gas revolution in the United States.

As the United States and the world struggle to rebound from the economic hardship caused by the COVID-19 pandemic, it is essential for America to continue to be a leader in energy development. All forms of energy will be needed in the coming years and natural gas and oil produced in the United States will be a key component of that energy mix. Oil and natural gas will not be the only energy source for the United States, but they will be essential to the American economy for years to come.

The choices the nation makes regarding its energy mix will have a huge impact on its economy and its international position. If America does not pursue a thoughtful energy policy, the nation will suffer economically. Unless demand for fossil energy changes dramatically, efforts to suppress U.S. oil and natural gas production will be counterproductive to the goals of addressing greenhouse gas emissions, increasing job growth and expanding America's impact around the globe. Energy is a geopolitical issue. For the last half-century, American foreign policy has been predicated on the nation's vulnerability to oil and natural gas supply disruptions. The shale revolution turned the United States into an energy superpower, has enhanced American national security and created significant geopolitical advantages for this nation around the globe.

Additionally, natural gas production and use has created the cleanest air quality the nation has seen in two decades. The United States has become the envy of nations for its dedication to reliable, affordable, responsible energy production.

Independent producers recognize the need to manage their emissions, including methane emissions. Over the past several years, as methane regulations have been developed, IPAA has been active in trying to assure that the regulations are designed appropriately for the diverse elements of the industry, including the small business operations that dominate ownership of low producing wells.

However, a troubling undercurrent of effort to suppress American oil and natural gas production appears directed at numerous factors that affect production. Among these is a false claim of "tax subsidies" for oil and natural gas production that are, in fact, normal business deductions.

The Role of American Oil and Natural Gas

Despite the hyperbole of new energy sources displacing oil and natural gas, in reality, oil and natural gas supplied about 70 percent of America's energy in 2020 and is projected to supply about 70 percent in 2050. Internationally, oil and natural gas are about 50 percent of total energy consumption. These realities cannot be ignored and wished away. Oil and natural gas are a key component of the American economy – an economy that must grow for a strong nation to continue.

- They provide the fuels for the vast majority of the 275 million vehicles registered in the United States – vehicles that will be on the road for decades to come. Included among these are the millions of trucks that transported and delivered the key commodities that kept America functioning for the past year of the COVID pandemic.
- They provide fuel for the trains and the airplanes that are essential for interstate and international commerce.
- They fuel the vessels that transport America’s exports and imports.
- Altogether, oil and natural gas provide 93 percent of transportation energy.
- They heat and cool America’s homes and businesses, providing 95 percent of the energy needed.
- They generate American electricity; natural gas generates 40 percent of American electrical power.
- They produce the synthetic fibers, pharmaceuticals, medical supplies, computer and cell phone components, agricultural fertilizers and chemicals that are essential for a modern country.
- They provide revenues to state governments and the federal government to fund important programs ranging from education to land and water conservation.

While oil and natural gas greenhouse gas emissions must be managed, their use provides key environmental benefits. America’s success in reducing its greenhouse gas emissions comes from its expanded use of natural gas. Internationally, expanded use of natural gas promises to help the world improve its greenhouse gas emissions. Meanwhile, cleaner American oil products like low sulfur diesel fuel provides lower income countries the opportunity to reduce their reliance on dirty fuels in their homes and huts that place severe risks on their health and to limit the devastation of their forests. The environment and public health challenges across the world are large and complex and failure to address fundamental health challenges limits nations’ ability to address their greenhouse gas emissions.

Unfortunately, rather than recognize the key roles oil and natural gas play in the American economy, anti-oil and natural gas interests concoct elaborate fiction that American oil and natural gas companies somehow duped the American public into using its products. Realistically, demand for these products has driven the advanced economies of the world. Following World War II, Americans began the long sought recovery from the Great Depression. Their demand for vehicles, electricity, emerging new products and homes resulted in increasing the need for more and more oil and natural gas and their products. In fact, American demand exceeded the capacity of American oil and natural gas production. America had to import more and more oil and eventually turned to importing natural gas.

American oil dependency after 1970 led to fifty years of international security issues where America’s foreign policy choices depended on its effect on oil supply. Two clear crises were oil embargoes in 1973 and 1979. By 2007, the United States was importing 65 percent of its oil supply. While much of it came from Canada and Mexico, significant amounts came from the Middle East where relationships were tenuous or hostile. The shale oil revolution changed international energy security dynamics significantly, positioning the United States more securely.

However, new efforts to suppress American oil and natural gas supply could reverse these important policy shifts. Demand drives the need for oil and natural gas supply. Crushing American supply will not reverse American demand. Instead, America will need to meet its energy demand by returning to imports. Global greenhouse gas emissions will not be reduced but American energy security will be threatened again like the fifty years following 1970.

Tax Issues

One path to reducing American oil and natural gas production involves restricting its capital investment. Because all oil and natural gas production declines – or depletes – over time, new production must replace the lost production. New wells must be drilled. Existing wells must be maintained even as their production diminishes. For independent producers, most of its capital comes through the well head. That is, the revenue it receives from selling its production becomes the capital it needs to drill and maintain wells. Clearly, tax policy then plays a significant role. Taxes remove capital.

Oil and natural gas tax policies will continue to draw attacks from those anti-oil and natural gas factions that want to cripple American production. Much of the rhetoric surrounding these attacks will hide behind the red herring of “tax subsidies for Big Oil” when the reality is that the tax provisions are not “subsidies” but normal business deductions. The impact of changing the provisions will fall on independent oil and natural gas producers, substantially on small businesses, and on royalty owners such as retirees, ranchers and farmers who own oil and natural gas mineral resources underlying their properties.

Two of the most targeted tax provisions are the treatment of intangible drilling and development costs (IDC) and percentage depletion.

Intangible Drilling Costs

Since 1913, a drilling and development costs deduction has been allowed as an ordinary and necessary business expense for those costs where there is no remaining equipment to value (salvage value) when an oil or natural gas well is completed. Because there is nothing tangible to value, these costs are generally called “intangible drilling costs” or IDCs. For the past 35 years, American tax policy has shortened the depreciation period for equipment to allow capital to be recovered and reinvested in new American projects. Like other rapid depreciation schedules in the tax code, the drilling cost deduction allows for investment capital to be immediately recovered and encourages its reinvestment. This is the same concept adopted as Bonus Depreciation in the 2017 Tax Reform Act. It is neither a “tax subsidy” nor a “loophole”. For American independent producers expensing has resulted in facilitating reinvestment in new American projects at rates up to 150 percent of American cash flow.

Within the past 15 years the combination of advanced horizontal drilling techniques and sophisticated hydraulic fracturing opened the development of both shale gas and shale oil formations. Clearly, while America has been producing these resources for 150 years, today’s production will reflect a vastly different onshore industry than in the past. Similarly, the industry will continue to advance its technology in the offshore where the challenges of deeper formations and deeper water depths have driven significant changes in the past twenty years. What is common to developing all of these resources is the need for capital. In 2017, independent producer capital expenditures were approximately \$110 million.

Independent producers have a history of investing in America. Prior to the economic challenges the industry has faced in the past several years, assessments have concluded independents reinvesting up to 150 percent of their American cash flow back into new American projects. And, independents drill 91 percent of wells in the United States. The faster that producers recover the capital invested in projects, the faster it can be reinvested. For independent producers since 1913 – at the inception of the tax code – drilling costs for the elements that are not a part of the final operating well could be deducted in the year they are incurred (expensed). These costs can be 60 to 90 percent of the development costs of a well – with shale wells on the high end. Clearly, putting this capital back into new production means more jobs, more production and more federal and state taxes.

For example, independent producers influenced almost \$1.2 trillion of sales activity in the United States during 2018. This, in turn, contributed about \$573 billion or 2.8% of U.S. GDP and supported 4.5 million jobs (3.0% of non-agricultural employment). IHS Markit estimates the independents initiated economic activity that generated over \$101 billion in federal state and local taxes in 2018.

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.¹

Depletion has been a part of the tax code since its inception. Initially, the only form of depletion was cost depletion; however, it limits depletion to the capital cost of a project. After World War I, Congress recognized that too many natural resources were being abandoned because of cost depletion limiting the economic viability of projects. Consequently, it began to allow forms of value depletion to be used as well. In 1926, it settled on percentage depletion.

Percentage depletion has changed over time. Current tax law limits the use of percentage depletion of oil and natural 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 net income limitation requires percentage depletion to be calculated on a property-by-property basis. It prohibits percentage depletion to the extent it exceeds the net income from a particular property. Fourth, the deduction is limited to 65% of net taxable income. 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 and

¹ 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.

natural gas 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, averaging about 2.5 barrels per day. Yet, these wells produce about 10 percent of American oil production. About 75 percent of American natural gas wells are marginal wells (averaging about 22 mcf/d), producing approximately 10 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.

In addition to independent producers, royalty owners can take percentage depletion on wells producing their mineral assets. Royalty owners can take percentage depletion on wells regardless of whether the producer is an independent or integrated company. One reason that percentage depletion draws attention is the revenue estimate associated with it; however, the revenue estimate never separates its evaluation between producers and royalty owners.

Conclusion

Oil and natural gas will remain a key component of energy supply in the world for the foreseeable future. Their emissions will need to be managed, but no modern economy will function without them. This is clearly true in the United States where oil and natural gas contributes approximately 70 of the energy consumed in the country now and in 2050. Growth in other energy sectors will occur but more energy will be needed to maintain a robust American economy.

If new policies reduce American demand for oil and natural gas, production and imports will diminish. However, artificial politic efforts to suppress American supply will not reduce demand; it will only lead to a return to an import dependent energy structure with attendant energy security risks.

False attacks on “tax subsidies” targeting American oil and natural gas producers and royalty owners will reduce supply while hurting independent producers, particularly small businesses, and royalty owners. They will not reduce greenhouse gas emissions. The ultimate beneficiaries of these actions would be foreign national oil companies producing with less emissions management than those in the United States. Congress should oppose these adverse policies.