Statement of API Chairman J. Larry Nichols on behalf of the American Petroleum Institute Subcommittee on Energy, Natural Resources, and Infrastructure of the Committee on Finance Hearing on "Oil and Gas Tax Provisions: A Consideration of the President's FY10 Budget Proposal"

September 10, 2009

I am J. Larry Nichols, Chairman and Chief Executive Officer of Devon Energy Corporation and Chairman of the American Petroleum Institute ("API").

Devon Energy is the largest U.S.-based "independent" oil and natural gas exploration-and-production company. API represents approximately 400 companies involved in all aspects of the U.S. oil and natural gas industry, including exploration and production, refining, marketing and transportation, as well as the service companies that support the industry.

The U.S. oil and gas industry supports, according to a new study by PricewaterhouseCoopers (PWC), more than 9 million American jobs and, in 2007, was responsible for 7.5% of the U.S. gross domestic product, as an employer and purchaser of American goods and services (see Appendix). Further, the U.S. oil and natural gas industry provides most of the nation's energy, spurring growth and job creation across America. At a time of economic recession, the oil and natural gas industry is actually responsible for creating more jobs and generating more revenue to the economy.

As Chairman of API, I appreciate the opportunity to provide the industry's views on the potential impact of the oil and natural gas tax proposals contained in the fiscal year 2010 budget proposals submitted by President Obama. In short, we believe these proposals are anti-jobs, anti-consumer, and anti-energy. They will depress investment in new domestic oil and natural gas projects, weaken the nation's energy security and slow the economic recovery. In addition, the proposals jeopardize the jobs of millions of industry workers across this country at a time when so many Americans are unemployed and economic recovery remains uncertain. In contrast, developing all of our energy options will actually create jobs, strengthen our energy security, and provide revenues for federal, state, and local governments. That is the direction we should choose.

The administration's proposals are based upon myths rather than facts, reaction rather than considered reflection. Combined, these proposals call for more than $80 billion over the next 10 years in new taxes on the oil and natural gas industry. These tax increases are in addition to the billions that would also be imposed on the industry by a carbon cap-and-trade system. The Treasury Green Book explanation of the proposals repeatedly justifies repealing oil and natural gas tax provisions by claiming each "distorts markets by encouraging more investment in the oil and natural gas industry" and "encourages overproduction of oil and natural gas," which, it says, is "detrimental to long-term energy security."

In other words, the administration's tax proposals are aimed at reducing domestic development of oil and natural gas. In fact, the Administration's tax proposals "can be considered to be

effective tax increases on the oil and natural gas industries that will have the effect of decreasing exploration, development, and production while increasing prices and increasing our foreign oil dependence," according to a recent report from the Congressional Research Service (Oil Industry Tax and Deficit Issues by Robert Pirog, Specialist in Energy Economics, July 21, 2009, R40715).

At a time when respected energy studies agree on the need to increase all sources of domestic energy, it makes absolutely no sense to discourage production of our leading sources, oil and natural gas. Moreover, this counter-productive approach is at odds with the administration's own carbon reduction policy because it would discourage natural gas production – our cleanest fossil fuel - even though increased reliance on natural gas would contribute more to carbon reduction than continued reliance on other forms of energy. Furthermore, when these proposals are combined with the House-passed Waxman-Markey climate legislation, they will lead to less U.S. refining capacity and more reliance on imported fuel products without any reduction in worldwide carbon emissions.

In addition, these proposals would impact the nine million jobs supported by the oil and natural gas industry - eliminating many and driving others out of the country. The administration ignores the potential loss of tens of thousands of new, well-paying jobs that would otherwise be created from increased domestic oil and natural gas development – not to mention the billions of dollars in revenues that would be generated for local, state and federal governments.

Restoring America's economic health remains at the top of the nation's agenda. Any new tax would inevitably lengthen the recession for a significant period of time. Even tax increases that are deferred until 2011 would impact the economy today, because of the long lead times associated with investments in oil and natural gas exploration and development. Historically, new taxes hurt businesses, threaten jobs, and lead to higher costs for consumers. Higher energy taxes that reduce oil and natural gas development and increase costs take money from every American household.

If we are to get America back on the road to economic recovery, it is vital that we meet the energy needs of U.S. consumers today and in the future. That means embracing policies that reflect the realities of America's energy challenges.

We need more from all sources of domestic energy to get America's economy on track and growing again and to increase our energy security. This is a point recognized by the Senate Energy and Natural Resources Committee when it put together the American Clean Energy Leadership Act of 2009 earlier this year. It is also well understood that transitions to new energy sources do not happen overnight; they take many years. Thus, we need a multi-pronged approach that along with current sources includes renewable energy and increased energy efficiency. Any approach to address our future energy needs must include oil and natural gas, which the U.S. Energy Information Administration projects will be our leading energy sources for decades to come. The U.S. oil and natural gas industry has the expertise and technology to produce the energy we need to fuel economic growth, create jobs, generate significant revenues

for local, state and federal governments, and bolster our national security. However, our companies cannot do so if held back by harmful tax policies.

The proposals offered by the administration will make it more difficult, and more expensive, to meet our country's energy needs, will undermine our goal of energy security, will reduce jobs, investment, and government revenues from our domestic energy sector, and frankly are punitive to an industry that represents a significant part of the U.S. economy. The major proposals are as follows:

- **Levy Excise Tax on Gulf of Mexico Oil and Natural Gas Production** – Additional taxes on offshore U.S. production may raise money for the government in the short run, but will severely dampen new exploration and development in the Gulf of Mexico That is because increasing the cost of developing U.S. offshore resources would limit interest in producing domestic reserves – which generate royalty, bonus and tax income to the government. Further, this particular proposal merely represents an attempt by Congress to impose an outcome on an issue that is currently being addressed in litigation, and which will be decided by the courts of this country.
- **Repeal Expensing of Intangible Drilling Costs (IDC)** – The treatment of intangible drilling costs is extremely important to the oil and natural gas industry. These items include costs like labor, engineering, logistics which do not in themselves relate to a tangible asset that has a salvage value. They represent the "research and development" costs of the oil and natural gas industry, since they all relate to a trial and error experiment to discover a commercial resource. As such, just as R&D costs are fully

expensed by other taxpayers, taxpayers in the oil and natural gas industry have had the option to take a normal business expense deduction for IDC since the inception of the Tax Code. This general approach is also similar to tax treatment other extractive industries receive (i.e., the treatment of coal and other minerals exploration and development costs). These "intangible drilling and development" costs are the foundation upon which exploration and production businesses operate. Repealing this deduction for the oil and natural gas industry would again single out one natural resource sector for punitive treatment by significantly raising the cost of oil and natural gas drilling and development in the U.S. Again, this proposal will lead to reductions in domestic development and supplies of oil and natural gas, as well as reductions in the revenues from such activities that would otherwise be paid to the government. Further, the proposal will cost U.S. jobs and undermine U.S. energy security.

- **Repeal Section 199 for Oil and Natural Gas Companies** – This deduction translates into a tax rate cut for all U.S. manufacturers and was enacted to help create and maintain well-paying U.S. jobs in the manufacturing and production industries. The call for full repeal of the deduction, but just for oil and natural gas, therefore again specifically singles out our industry for discriminatory treatment from all other U.S. manufacturers and producers. Repealing a tax provision put in place to encourage certain activities shortly after it was enacted sends a mixed signal to taxpayers on whether they can rely on government provisions to encourage investments. Further, this sends a distressing message to the 9 million workers supported by the oil and natural gas industry that their jobs are less valuable than others. A repeal of this deduction for just the oil and natural gas industry places a number of those jobs at risk, will reduce domestic oil and natural

gas development, will reduce refining investment, and will undermine efforts to strengthen U.S. energy security.

- **Increase G&G Amortization Period** – Efforts to find oil and natural gas reserves in the U.S. can be very expensive and recovering those costs for tax purposes is important to keeping domestic oil and natural gas production strong. Increasing the amortization period for these exploration costs would undermine that effort and further jeopardizes the goal of increasing domestic oil and natural gas development.
- **Repeal Percentage Depletion** – For almost a century, non-integrated producers and mineral rights owners have been able to avoid the complexity associated with recovering their investment costs as the underlying mineral is produced by using percentage depletion. Requiring cost depletion would add costs and administrative complexity to individual taxpayers and small companies. Further, if there is a policy concern about a deduction based upon percentage depletion, then it should be repealed for all industries (e.g. gold, copper, gravel, clay, etc) rather than discriminating against one particular industry,
- **Repeal Expensing of Tertiary Injectants** – The U.S. is a mature oil-producing region but still contains many viable fields whose lives are extended through the use of tertiary injectants. These efforts secure additional U.S. production and enable many production companies to remain in business. Changing how these costs are recovered could force producers to shut in older fields and significantly impact local economies. In addition, this deduction supports using carbon dioxide in enhanced oil recovery projects, one of the primary methods by which carbon dioxide is currently sequestered to prevent its release into the atmosphere.

- **Repeal Passive Loss Exception for Working Interests** – Many individual mineral interest owners incur significant expenses associated with developing an oil and natural gas reservoir. These are losses associated with actively participating in a business endeavor. Limiting the ability to take such losses against other income is unfair and would not recognize the true economic impact of their endeavors.
- **Repeal EOR Credit and Marginal Well Credit** – These tax credits were established to ensure continued production when prices are low. Accordingly, there is a built-in mechanism to phase out the credit when prices increase. Eliminating these credits would disregard the cyclical nature of oil prices and penalize marginal or tertiary production when prices are depressed and domestic production, as opposed to imports, is still needed.
- **Reinstate Superfund Taxes** – The proposal to reinstate Superfund taxes would impose additional taxes on crude oil and petroleum products unfairly. These products do not account for a substantial portion of the Superfund liability, yet would be responsible for most of the taxes. Accordingly, such taxes are unfair and would not ensure that remediation or cleanup will happen sooner.
- **Repeal LIFO** – The LIFO accounting method is a well-established way to determine book and taxable income for companies and it ensures conservative financial reporting reflecting the replacement costs of inventories, in times of anticipated inflation or rising prices over the course of their operations. Many U.S. manufacturers like refiners and fuel marketers employ the LIFO inventory method, and have since the 1930's. Repealing LIFO would require companies, especially those that have followed LIFO for many

years, to redirect substantial amounts of cash or sell assets in order to cover the tax payment – potentially destroying some businesses.

- **International Enforcement, Reform Deferral and Other Tax Reform Policies** – Proposals to restrict the deductibility of operating costs and to place new limits on the calculation of foreign tax credits on foreign earnings fail to recognize the multinational nature of the U.S. economy. They penalize industries that must seek foreign markets to grow – like the oil and natural gas industry. In particular, the Administration's proposal to modify the rules governing the creditability of foreign taxes paid by oil and natural gas companies would outright deny the ability for our companies to prove – to the IRS or a court - whether a payment they made was a foreign income tax (as it must do under current rules). This proposal, therefore, will directly lead to double taxation and would create unequal treatment of similarly situated taxpayers - undermining two fundamental tenets of our tax system. As a result our industry would be compromised in its ability to economically operate or expand abroad. This is a policy that weakens our energy security and is simply not in the best interests of the country.

Some have stated that implementing these proposals would not impact the industry given earnings over the last few years. While recent earnings have been high, that point alone fails to recognize the complex nature of the industry and is disconnected from some very important facts.

First, this industry is a very cyclical one. While the short-term peaks and valleys of the market can be very high and very low, it is important that investment continues with a long term view.

For example, between 1996 and 2007, the U.S. oil and natural gas industry invested more than $1.2 trillion in a variety of long-term energy initiatives compared to net income or earnings of $974 billion. In addition, the U.S. oil and natural gas industry invested an estimated $121.3 billion between 2000 and 2007 in emerging energy technologies, including renewable; frontier hydrocarbons, such as shale and oil sands; and end-use technologies, such as fuel cells. This investment represents 65 percent of the total $188 billion spent by all of industry and the federal government combined on emerging energy technologies during this time period, according to an October 2008 study by T2 and Associates and the Center for Energy Economics (CEE). The worldwide economic downturn, along with lower oil and natural gas prices and tight credit markets, has naturally caused many oil and natural gas producers to cut their 2009 capital budget plans. Yet investments in upstream projects are still going forward and investments either planned or currently under serious consideration would boost domestic refining capacity by 800,000 to one million barrels per day by 2010, the equivalent of four to five new, medium-sized refineries.

Second, the industry is already heavily taxed. According to the U.S. Energy Information Administration (EIA), the U.S. oil and natural gas industry pays a substantial amount in income tax. During the three-year period from 2005-2007, the major energy producing companies paid or incurred more than $242 billion of income tax expense. In addition, Congress has enacted tax laws over the past few years that are expected to cost the industry around $10 billion in additional taxes from what they would otherwise be expected to pay today. However, these amounts are dwarfed by the current administration’s efforts to raise taxes on the industry over the next 10 years.

Finally, it should be noted that while the oil and natural gas industry is one of America's largest industries, its earnings are typically in line with the average of other major U.S. manufacturing industries. The latest published data for 2008 shows that the oil and natural gas industry earned 5.7 cents for every dollar of sales. In comparison, all U.S. manufacturing industries earned 4.5 cents for every dollar of sales and 6.0 cents for U.S. manufacturing excluding the financially challenged auto industry.

Planning and investment cannot be turned on and off like a spigot, without entailing huge, potentially non-recoverable costs and delaying urgently needed projects. Because the industry must plan and operate under these long lead-times, it is hypersensitive to minimizing that risk over the course of its investments. It is crucial for an industry that must manage such huge risks that government provide an energy policy and tax framework that encourages investment, rather than discouraging it.

These tax proposals put the economic burden on hard-working Americans and their families. Higher energy taxes that reduce production and increase costs for oil and natural gas will impose costs on every American household. Historically, higher taxes have resulted in less domestic energy and restrained supplies often have led to higher energy costs for consumers. In today's economy, that could stifle a recovery and undermine U.S. energy security.

The administration should take to heart the desire of the majority of Americans who want a stronger economy using our own domestic oil and natural gas resources. Two-thirds of

Americans in exit polls taken during last November's election said they supported increased offshore drilling. At a time when other countries are providing incentives for and are encouraging the development of their oil and natural gas resources, the administration appears focused on not only restricting access to the responsible development of indigenous resources but also proposing tax law changes that will further discourage development of the resources that are accessible.

There is a better approach than saddling a troubled U.S. economy with new taxes that hurt consumers and workers. The oil and natural gas industry should be allowed to develop the domestic resources that belong to the American people. It would improve America's energy security, create jobs, and provide local, state and federal revenues. A recent ICF International study found that 160,000 jobs would be generated in 2030 if all off-limits offshore and additional new off-limits onshore areas were open for development.

We cannot get America on the road to economic recovery if we do not meet the energy needs of American consumers and the U.S. economy. And we cannot meet those energy needs if we impose additional taxes on the already heavily taxed oil and natural gas industry. We need to restore America's economic health and ensure our energy security today and in the years ahead. API and the people of America's oil and natural gas industry stand ready to work with you to address the urgent energy and economic challenges facing our nation.

Appendix

The Contributions to the U.S. National and State Economies

by the Oil and Natural Gas Industry

Prepared by PricewaterhouseCoopers for API

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Table 2. Total Contribution of the Oil and Natural Gas Industry to the U.S. Economy, 2007

Item	Amount	Percent of U.S. Total
Operational Impact		
Employment*	7,818,437	4.4%
Labor Income ($ millions)**	477,249	5.4%
Value Added ($ millions)	915,370	6.6%
Capital Investment Impact		
Employment*	1,418,944	0.8%
Labor Income ($ millions)**	81,012	0.9%
Value Added ($ millions)	121,690	0.9%
Total Impacts		
Employment*	9,237,381	5.2%
Labor Income ($ millions)**	558,260	6.3%
Value Added ($ millions)	1,037,060	7.5%

Source: PricewaterhouseCoopers calculations using IMPLAN modeling system (2007 database).

Numbers may not add to total due to rounding.

* Employment is defined as the number of payroll and self-employed jobs, including part-time jobs.

** Labor income is defined as wages and salaries and benefits as well as proprietors' income.

Table 3a. Total Operational Impact of the Oil and Natural Gas Industry by State in 2007 (*Sorted Alphabetically*)

State	Employment*		Labor Income**		Value Added	
	Amount	Percent of State Total	($ Million)	Percent of State Total	($ Million)	Percent of State Total
Alabama	94,732	3.7%	4,262	3.9%	7,836	4.7%
Alaska	43,454	9.8%	3,143	13.5%	6,064	16.6%
Arizona	96,685	2.9%	4,653	3.0%	8,278	3.4%
Arkansas	69,640	4.4%	2,884	4.9%	5,589	6.0%
California	752,614	3.7%	54,122	4.6%	100,958	5.5%
Colorado	190,408	6.0%	12,438	7.7%	24,099	9.3%
Connecticut	62,686	2.9%	4,345	3.1%	7,492	3.5%
Delaware	15,437	2.9%	916	3.2%	1,707	4.0%
District of Columbia	12,815	1.5%	1,157	1.4%	1,777	1.7%
Florida	267,277	2.6%	11,441	2.6%	19,946	2.8%
Georgia	145,806	2.7%	6,841	2.7%	12,032	3.0%
Hawaii	18,539	2.1%	855	2.1%	1,533	2.4%
Idaho	24,000	2.6%	928	2.7%	1,700	3.2%
Illinois	260,001	3.5%	16,953	4.2%	31,323	5.0%
Indiana	127,355	3.5%	5,907	3.8%	10,992	4.5%
Iowa	63,254	3.1%	2,295	3.0%	4,069	3.3%
Kansas	119,051	6.5%	6,738	8.8%	14,029	11.4%
Kentucky	87,490	3.6%	3,653	3.7%	6,712	4.4%
Louisiana	330,053	13.4%	18,449	16.6%	35,986	20.6%
Maine	29,897	3.6%	1,051	3.3%	1,948	4.0%
Maryland	78,224	2.3%	3,920	2.1%	6,688	2.4%
Massachusetts	112,086	2.7%	7,242	2.9%	12,197	3.3%
Michigan	179,495	3.3%	9,820	3.8%	17,711	4.4%
Minnesota	113,708	3.2%	5,351	3.2%	9,271	3.6%
Mississippi	83,820	5.5%	3,609	6.5%	7,244	8.4%
Missouri	122,820	3.4%	5,253	3.4%	9,115	3.9%
Montana	34,210	5.3%	1,584	7.0%	3,324	8.9%
Nebraska	49,784	4.0%	2,743	5.6%	5,112	6.7%
Nevada	43,140	2.7%	2,088	2.7%	3,839	3.1%
New Hampshire	26,256	3.1%	1,218	3.1%	2,181	3.6%
New Jersey	143,342	2.8%	9,461	3.1%	16,853	3.5%
New Mexico	88,814	8.1%	4,307	9.5%	8,292	12.2%
New York	281,267	2.6%	21,452	3.0%	36,347	3.3%
North Carolina	145,779	2.7%	6,007	2.6%	10,623	2.9%
North Dakota	27,914	5.7%	1,346	7.6%	2,773	9.6%
Ohio	229,438	3.4%	11,121	3.7%	20,201	4.5%
Oklahoma	348,627	16.3%	22,550	24.7%	47,839	31.3%
Oregon	60,122	2.6%	2,590	2.6%	4,494	3.0%
Pennsylvania	271,250	3.8%	14,494	4.1%	25,772	4.8%
Rhode Island	16,160	2.7%	822	2.8%	1,456	3.4%
South Carolina	68,303	2.8%	2,468	2.5%	4,292	2.8%
South Dakota	19,942	3.6%	763	3.9%	1,459	4.6%
Tennessee	114,194	3.1%	5,048	3.1%	8,750	3.5%
Texas	1,772,335	13.1%	140,941	19.5%	293,760	24.2%
Utah	76,188	4.7%	3,960	5.9%	7,822	7.6%
Vermont	14,159	3.3%	492	3.0%	900	3.6%
Virginia	143,479	3.0%	6,923	2.7%	11,968	3.1%
Washington	106,616	2.7%	5,792	2.9%	10,333	3.4%
West Virginia	60,891	6.7%	2,740	7.4%	5,412	9.4%
Wisconsin	103,821	2.9%	4,053	2.7%	6,837	3.0%
Wyoming	71,063	18.8%	4,060	24.3%	8,432	29.4%
U.S. Total	7,818,437	4.4%	477,249	5.4%	915,370	6.6%

Source: PricewaterhouseCoopers calculations using IMPLAN modeling system (2007 database).

Numbers may not add to total due to rounding.

* Employment is defined as the number of payroll and self-employed jobs, including part-time jobs.

** Labor income is defined as wages and salaries and benefits as well as proprietors' income.

New Taxes on Offshore Oil and Gas Production Will Increase Our Dependence on Foreign Oil Reserves.

Position: Congress should not impose a new tax on offshore oil and gas production for the following reasons:

- Congress and the Minerals Management Service created the deep water royalty relief program in order to encourage the drilling and production of oil and natural gas in Gulf of Mexico water depths of 200 meters or more (and now in water depths exceeding 5,000 feet). This relief program was needed because Gulf of Mexico production is very capital intensive – a single large deepwater platform costs more than $1 billion to develop.
- The relief program has worked. Deepwater Gulf energy production has significantly enhanced overall energy supplies in the U.S. Deepwater natural gas production is up 407 percent and deepwater oil production is up 386 percent since 1996. With respect to oil, total offshore production has gone from 980,000 barrels per day in 1995 to 1.5 million barrels per day in 2006.
- A new severance tax on Gulf of Mexico production would adversely affect this positive trend, leading to reduced domestic energy production, loss of well-paying U.S. jobs, and increased reliance on imported energy – all to the detriment of America's economic and energy security.
- MMS reported that deep water oil and gas development in the Gulf of Mexico may sustain between 80,000 and 100,000 jobs by 2010. Between 50,000 and 70,000 of these jobs will be retained well into the following decade. This increase in domestic production activity results in increased income tax revenues for federal and state governments.
- In addition to costing U.S. jobs and energy security, a new severance tax could result in higher energy costs for consumers, many of whom already are struggling to make ends meet during this economic downturn.

Background: Sen. Bingaman introduced the GOM severance tax idea as a means to "recover" revenues that would not be paid to the federal government due to the lack of royalty price thresholds in certain 1998-99 deepwater GOM leases. However, royalty relief is NOT limitless. Royalty relief can be limited by both volume and price. Once a lease produces a set amount of oil or gas (called the suspension volume), royalty relief comes to an end and the lessee must pay full royalties on all subsequent production. For leases that have applicable price thresholds, if the average prices for the year exceeds the thresholds, then lessees do not get any royalty relief for any of the production for that year. Pursuant to the Energy Policy Act 2005, future leases will continue to have suspension volumes and the Secretary of the Interior is already given specific authority to impose price thresholds. MMS has imposed price thresholds on all leases with deep water royalty relief since the passage of Energy Policy Act 2005. This new federal tax will merely push more U.S. investment and jobs offshore and increase U.S. reliance on imported oil and natural gas.

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Eliminating the Ability to Expense Intangible Drilling and Development Costs Will Hurt Our Energy Security

Position: Congress should not eliminate the ability to expense Intangible Drilling Costs (IDCs) for the following reasons:

- IDC represents a necessary and significant cost of conducting oil and gas exploration and production. Restrictions on the ability of energy companies to expense these costs will discourage new domestic oil and gas exploration—particularly with respect to very expensive but critical offshore production.
- Restrictions on expensing IDC will increase our reliance on imported oil at a time when investment in new domestic energy supplies is critical to meeting future U.S. energy demand, preserving U.S. energy security, and protecting U.S. jobs.
- The current tax treatment of IDCs is consistent with similar expenditures incurred by other industries. Like research and development costs, IDC represent expenses necessary to determine new and unproven opportunities in our industry. Further, mining companies are allowed to deduct development costs associated with new mines. Capitalizing IDCs would, therefore, be punishing oil and gas producers as compared with other similarly situated industries.
- According to the Energy Information Administration (EIA), U.S. based oil and gas companies spend about $70 to explore for and produce each barrel of oil or equivalent natural gas (BOE) in the US offshore, compared to less than $30 spent to explore for and produce each BOE abroad. Congress can help keep domestic projects cost competitive with foreign alternatives by retaining favorable tax treatment for expenditures made for domestic exploration.
- Eliminating or further restricting the ability to expense IDC would increase the cost of domestic exploration relative to foreign exploration projects, thereby eliminating many marginal domestic projects, and would render some of the costly, high-potential prospects in the U.S. economically unattainable.

Background: Intangible drilling and development costs, or IDC, are those costs spent to drill for oil and gas where no salvageable asset is created as a result. Despite great advances in geological and geophysical know-how and technology, drilling a well is still the only means of determining with absolute certainty the presence of hydrocarbons in reservoir rock or sand, and even today, nearly half of the offshore exploration wells drilled are classified as dry holes. IDC includes labor, fuel, materials, and, when the well is being drilled offshore, extensive engineering costs for equipment and alloy development to deal with the pressures, corrosion, and other difficulties associated with drilling offshore. Currently, independent producers can expense 100 percent of their IDC in the year those costs are incurred. Integrated oil companies may expense 70 percent of their IDC in the current year and must amortize the remaining 30 percent of those costs over 5 years.

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Repealing the Section 199 Manufacturing Deduction for Oil and Gas Companies Puts Jobs at Risk

Position: Congress should support the Section 199 deduction for oil and gas operations because:

- The section 199 deduction was enacted to help U.S. taxpayers maintain and create good paying manufacturing jobs in the U.S. The oil and natural gas industry directly employs about 1.8 million wage and salary workers in the U.S. and supports, through the purchase of goods and services from other industries, nearly 4 million indirect jobs across the country. Discriminatorily denying Section 199 tax treatment to the oil and gas industry puts those U.S. jobs at risk.
- Excluding the income derived from U.S. oil and natural gas production, refining and processing from Section 199's tax benefits would discourage new U.S. oil and natural gas investment.
- The United States is a mature producing region, which makes oil and natural gas exploration and production increasingly are more expensive relative to comparable projects abroad. The U.S. income taxes imposed on the income derived from those activities affects the economics of these projects, and as those taxes increase, more and more of the capital being invested in new energy resources is redirected overseas.
- The Section 199 deduction helps encourage more oil and natural gas production in this country as well as investments in new petroleum refining capacity. In so doing, high-paying U.S. jobs are preserved, and U.S. reliance on imported oil and related products is reduced.
- In addition to costing U.S. jobs, repealing the Sec. 199 deduction for oil and gas companies could result in higher energy costs for consumers, many of whom already are strapped financially during this economic downturn.

Background: While the American Jobs Creation Act of 2004 began as an effort to modify tax rules declared illegal by the World Trade Organization, Congress redirected that effort and developed a tax deduction to encourage investment in U.S. manufacturing jobs. The result was IRC Section 199, which makes deductible a portion of income derived from domestic manufacturing and production activities. For most U.S. manufacturers, the deduction will eventually be equivalent to a three-percentage point reduction (35% to 32%) in the corporate income tax rate for qualified domestic income. While the inclusion of oil and gas extraction and refining income for purposes of Section 199 had bipartisan support when the legislation was adopted, recent legislation has already limited the deduction for domestic oil and gas activities from fully phasing in.

March 2009

The Current Tax Treatment of Geological and Geophysical (G&G) Expenditures Supports the Production of Domestic Resources.

Position: Congress should not change the current tax treatment of G&G expenditures because:

- Extending the amortization period for the domestic G&G costs incurred by oil and natural gas production companies would further increase the cost of domestic exploration relative to foreign exploration, thereby jeopardizing U.S. jobs and increasing the nation's reliance on imported oil by pushing investment overseas.
- Increasing the cost of domestic exploration will result in higher energy costs to consumers. With America in a deep recession, now is not the time to increase energy costs for families who are struggling to make ends meet.
- According to the Energy Information Administration (EIA), U.S. based oil and gas companies spend about $70 to explore for and produce each barrel of oil or equivalent natural gas (BOE) in the US offshore, compared to less than $30 spent to explore for and produce each BOE abroad. Congress can help keep domestic projects cost competitive with foreign alternatives by retaining favorable tax treatment for these types of expenditures made for domestic exploration.
- Of the approximately 1.8 million jobs directly created by the oil and natural gas industry, over 170,000 are classified as support activities for oil and gas operations, the sub-sector that includes geological and geophysical exploration (except surveying) on a contract basis.

Background: Oil and natural gas exploration includes costs for geologists, surveys, and certain drilling activities. These costs are referred to in the oil and gas industry as G&G expenses. The function of G&G activities is to locate and identify the property with the potential to produce commercial quantities of oil and/or gas. Before Congress simplified the law in 2005, G&G costs associated with producing wells were required to be capitalized, suspended, and then amortized over a period of years in the form of cost depletion after production began. If, however, no property was acquired or retained, the G&G costs were deductible as a loss under IRC Section 165. In 2005, Congress made all G&G amortized over two years, which was later changed to first five years (in 2006), then seven years (in 2007), for the largest integrated oil and natural gas producers.

March 2009

Reinstating Superfund Taxes Will Not Guarantee a Cleaner Environment.

Position: Congress should not reinstate Superfund taxes for the following reasons:

- Reinstatement of expired Superfund taxes is unwarranted because “polluters” continue to pay for more than 70% of cleanups as responsible parties, according to EPA.

- A wide range of individuals, businesses and government agencies are responsible for the pollution at the remaining 30% of orphan sites, and Congress has appropriately provided general revenues to address this broad societal problem.

- Reinstating the expired Superfund taxes would be unfair because, prior to their expiration, the petroleum industry paid $7.5 billion (57%) of the taxes, yet, according to EPA, its share of the liability for cleaning up Superfund sites was less than ten percent. Moreover, reinstating the Superfund taxes could result in higher energy costs to hard-working Americans who already struggle to make ends meet.

- Resumption of the Superfund taxes will in no way affect the level of the program’s clean-up activity. Revenues from Superfund taxes do not go directly to EPA. Any expenditures from the Superfund trust fund are subject to the annual appropriations process, regardless of whether the taxes are reinstated.

Background: The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), otherwise known as Superfund, is the federal program created to pay for the cleanup of “orphan” waste disposal sites – those that are either abandoned or whose owners are bankrupt. Annual budget authority and appropriations for the Superfund program have remained stable. Future cleanups are not in jeopardy, and responsible parties will continue to pay for cleaning up the sites for which they are responsible, thereby ensuring the continued application of the “polluter pays” principle.

March 2009

Repealing the Use of LIFO (Last-In/First-Out) Accounting Will Jeopardize the Existence of Hundreds of American Businesses.

Position: Congress should reject efforts to repeal LIFO accounting because:

- LIFO (last in/first out) is a well-accepted accounting method that has been permitted under the Internal Revenue Code since the 1930s as a proper way to determine a taxpayer's income. It is considered a more accurate way to reflect the current financial health of a business that has rising inventory costs since it pairs current income with the current higher cost of inventory (such as with supplies of crude oil used at a refinery).
- Repeal of LIFO accounting would result in a significant up-front tax increase for businesses, placing significant cash constraints on them and limiting their ability to manage inflation. With respect to the petroleum industry, the proposed change would represent a one-time, multi-billion dollar tax penalty on petroleum refiners.
- This significant tax hit will ultimately be felt by US families at a time when they are struggling to make ends meet.
- Proposals to restrict or eliminate the use of LIFO lack any policy justification. No tax abuse problem has been demonstrated to support changing the LIFO rules, nor has any other valid policy reason been offered.

Background: LIFO accounting tracks and values a taxpayer's inventory for purposes of determining the cost of goods sold, which is deducted by the business from its gross income, and for determining the value of its inventory at year end. This inventory accounting method is based upon the assumption that the last goods brought into inventory are the first goods sold. Like taxpayers in other industries, many oil and gas companies properly elected to use LIFO many years ago to value and account for their inventory. Congressional proposals in the past to change LIFO were quickly dismissed after intense opposition from the broader business community.

March 2009

Modification of the Dual Capacity Taxpayer Rules – Taxing Profits Twice.

Position: Congress should not alter the current rules governing the treatment of dual capacity taxpayers for the following reasons:

- By limiting the creditability of taxes paid to certain foreign governments, taxpayers will be required to pay U.S. tax on income that has already been taxed – double taxation.
- The companies will have to consider a much higher tax burden when considering foreign projects. The additional cost would put U.S.-based companies at a disadvantage when competing with foreign entities. Every time a foreign competitor outbids a U.S. company for an overseas project, it will mean fewer employment opportunities for U.S. workers and supporting businesses and, ultimately, less revenue for shareholders and taxing authorities.
- Many nationally-owned foreign-based competitors are securing rights to petroleum reserves for their own demand needs. They would not be constrained by these rules and tax costs. That translates into less oil flowing to the United States, resulting in tighter supply and more price volatility.

Background: A fundamental fairness in the U.S. tax system provides that a U.S. taxpayer may take a tax credit for foreign taxes paid on income earned in foreign countries against the U.S. tax owed on that same income. Not allowing an offsetting credit for foreign income taxes paid, subjects the income to double taxation.

For example, Assume that Company A has operations in Country X and pays Country X a license for extraction rights. Country X also imposes an income tax on corporate profits of 35%. In Year 1, Company A earned $100 and paid $35 to Country X, then sent $65 back to the US. Normally, the U.S. subjects the $100 to tax at the U.S. rate of 35% and allows Company A to claim a foreign tax credit for the $35 already paid to Country X on that same income. This proposal, though, would require that Company A deduct the $35 paid to Country X, such that there would be an additional U.S. tax of 35% on $65 or $23. This would mean that Company A would end up paying $58 in taxes on the $100 of income instead of $35.

Currently, foreign tax credits, even for dual capacity taxpayers, can only be claimed if the taxpayer proves that payments are for taxes imposed upon income as defined in the Internal Revenue Code and existing regulations. These long-standing regulations prevent taxpayers from claiming as creditable taxes other payments that may be made to foreign governments for which a corresponding benefit is received (*e.g*. royalties paid for access to natural resources). Outright denial of foreign tax credits in cases where a taxpayer could otherwise prove that a payment was for taxes on local country income discriminates against U.S. based oil and gas producers and greatly lessens their ability to compete with foreign government-owned national oil companies.

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