Presentation to

U.S. Senate Committee on Finance

Business Income Tax Group

"Cost Recovery and Accounting Tax Reform Discussion"

On behalf of

Panhandle Producers & Royalty Owners Association

and

Texas Alliance of Energy Producers

April 15, 2015

The Texas Alliance of Energy Producers is a non-profit 501(c)(6) trade association that represents 3,300 members that are primarily independent oil and gas producers that drill and produce crude oil and natural gas in Texas. Attached is a one page description that details the composition of the Alliance's membership.

The Panhandle Producers & Royalty Owners Association was formed in 1929 as an advocate for oil and gas producers, mineral royalty owners and industry support companies. The Association is both proactive and responsive in providing representation before local, state and national governmental bodies and their leaders, representation before civic and service organizations, media and schools, providing resources and contacts for member education and training, along with networking and disbursement of industry information for over 40 counties in the Texas panhandle, western Oklahoma and southwestern Kansas.

Tax reform, tax simplification, tax fairness are terms that have been used numerous time by leaders in the U.S. House of Representatives, U.S. Senate, Secretaries of Treasury, and Presidents as an exercise that they would like lawmakers to undertake.

Even though the U.S. tax code is extensive, there are many reasons why certain provisions are still on the books.

When examining the tax code, one must recognize that the U.S. is very different from other countries. First, the U.S. is the only country that allows private individuals to own mineral rights. Private ownership means investment and development is undertaken by private individuals and not government. Individuals are incentivized to develop their minerals for monetary gain, which has allowed the U.S. to be a leader in fossil fuel extraction for more than a century. Domestic exploration and development of crude oil and natural gas in the U.S. has lowered the cost of energy to residential and commercial consumer when compared to other nations that have had to import virtually all of their energy needs.

Drilling and producing oil and gas in the U.S. is a high-cost, risky venture. Wells that cost $500,000 to drill 20 years ago now cost $5,000,000. The new technology that involved drilling as much as 6,000 feet vertically into the Earth and then another 6,000 feet horizontally and hitting an area the size of a basketball court is

very expensive and requires the latest in drilling equipment and experts to run the equipment.

Most of the wells drilled in the United States are drilled by independent producers, not major integrated oil companies. As a matter of fact, 96% of the wells drilled in Texas were drilled by independents in 2012. Most independents are privately held, meaning they are probably being taxed as individuals and not as a corporation. According to a certified public accountant (CPA) in Wichita Falls, Texas that belongs to a CPA firm that has mostly oil and gas producers as clients, the firm has only one oil and gas client that is a C Corporation and all of his other clients are taxed at the individual level. Other companies are publicly-held corporations under the tax code. Whether privately held or publicly held, the U.S. tax code recognized that they do not own refineries or market their petroleum products for sale to the public. Generally, independents drill and produce oil and gas and then sell it to someone else who makes it into a useful product.

Because of their corporate structure, most independents have to generate operating capital from within the company or take on outside investors, which can be other companies or individuals. Raising enough capital to drill and complete a well with today's costs is very difficult. The tax code allows independents to expense the drilling costs that have no salvage value in the year they are incurred. In other words, it makes no sense to require a company to capitalize drilling costs when these costs have no salvage value, meaning they cannot be used in the future to drill future wells.

Tax writers call these costs intangible drilling costs even though there is nothing intangible about them. They are real and they can account for as much as $4,000,000 on a well that costs $4,500,000 to dill and complete, or 89% of the total costs. A copy of a recent Authority For Expenditure (AFE) is a part of this presentation. "Intangible" costs are location preparation, drilling rig cost, completion costs, stimulation, directional services and trucking and fuel. All of these costs are very real, and all occur on the front end of the exploration process before a drop of oil is produced. These are all cash costs.

Allowing the independent to expense these costs in the year they are incurred allows him to write them off much quicker than if they were capitalized over five

years. This is not tax avoidance. It is writing it off the same amount sooner than being capitalized.

Another tax provision, percentage depletion, is similar to expensing of IDCs in that small companies are the primary sector of the economy that use percentage depletion. Since 1926, tax law has allowed a deduction for depletion. This deduction is based on the dollar value of current production and has many limitations. The depletion deduction is basically limited to small producers that are critical to keeping stripper well producers in business. The main limitation applies only to independents that have less that 1,000 barrels a day of production. The CPA I mentioned above has only one client that produces more than 1,000 barrels a day out of all his clients. Depletion is further limited to the net income from the oil and gas property. These are the properties that need it the most so the producer doesn't plug these wells. Another limitation is the deduction of depletion cannot exceed 65% of taxable income before the depletion deduction, which results in restricting the amount of money spent on drilling more wells.

One very important point to remember: The independents that make less than 1,000 barrels a day are considered "mom and pop" producers, and the nation cannot afford to lose the thousands of independents, especially those that are paying individual tax rates. These individuals are paying their own social security taxes and income tax. Without depletion and the deduction of intangible drilling costs, these individuals will face a very large burden.

Working interest owners are investors who share the costs and risks in drilling and production. Current tax law allows working interest owners, who are personally liable, to be classified as an active investor, rather than passive. Working interest owners incur continuing risks for operating and other losses and expenses from the operation throughout the life of the well. However, a large portion of those expenses occur early in the operation and without this exception percentage depletion and expensing of IDCs would be deferred until the well becomes profitable (or until the investors sell their interests). It is important to note that this is a temporary benefit in the sense that, over the life of the well, the tax revenue will be the same. It is the timing of this deduction that is crucial to attracting the necessary capital.

As part of our presentation, I also have included a report by the Texas Society of Certified Public Accountants published May 2013, the Authority For Expenditure that breaks out all of the costs of drilling a well, and a demographics of members of the Texas Alliance of Energy Producers.

Thank you for the opportunity to comment on this very important topic. If you have further questions, contact Alex Mills, President, Texas Alliance of Energy Producers, 900 8th Street, Wichita Falls, Texas 76301, 940-723-4131 or alexm@texasalliance.org. Also, Judy Stark, Executive Vice President, Panhandle Producers and Royalty Owners Association, 3131 Bell Street, Suite 209, Amarillo, TX 79106, 806-352-5637, or pproa@pproa.org.