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Comments submitted by:

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Comments submitted to:

**U.S. Senate Committee on Finance
Business Income Tax, Individual Income Tax, and
Community Development and Infrastructure Working Groups**

The Domestic Energy Producers Alliance (DEPA) is pleased to submit comments to the Finance Committee Working Groups on issues important to the U.S. domestic oil and natural gas exploration/production sector.

DEPA is an alliance of independent producers, royalty owners, oilfield service companies, and state and national oil and natural gas associations. America's 18,000 independent producers are responsible for drilling 95% of domestic oil and natural gas wells and account for 67% of oil and gas production. DEPA is proud to represent a majority of the individuals and companies primarily responsible for the current renaissance in American oil and natural gas production.

Preservation of current tax provisions affecting domestic independent energy producers – as discussed in this paper – is particularly important because of the recent significant drop in oil prices. Domestic independents have been the driving force in reducing U.S. reliance on imported oil from a high of 60% of consumption to current levels of around 25% of consumption during the past six years. This development clearly has served the economic and national interests of our country. To ensure that the U.S. continues on the path to energy independence, policies based on the outdated assumption of resource scarcity must be realigned to reflect the new reality of abundant energy supplies.

In today's global climate, abundant energy supplies and North American energy independence will have a huge influence geopolitically and economically. A long-standing tenet of DEPA is ensuring that the United States becomes – and stays – the world's number one producer of oil and natural gas. Changes in tax law that would reduce domestic production could threaten the reality of energy abundance that has been achieved thanks to the creativity and ingenuity of America's independent oil and gas producers.

It is important to note the distinction between independent producers and major, integrated companies. Integrated oil companies do business both in the U.S. and abroad, not only in exploration and production but also in refining, transporting and marketing oil, natural gas and refined petroleum products. In contrast, independents are domestic producers who primarily earn revenues from exploration and production. Generally, independent producers have only one opportunity for profit -- the well head.

While there are some large, publicly-traded companies among the nation's independent producers, the average company size is 11 employees. Whether they are large corporations or small owner/operator companies, independent producers have tax issues that differ distinctly from the Big Five major integrated oil companies. Independents are not "Big Oil."

Today, independents are working in an oil and gas price environment that is more demanding than at any time in the past several years. The inability of U.S. producers to either refine oil at home or export the raw products to refineries abroad that are equipped for American light sweet crude, combined with a global market flooded by oil from OPEC nations, has resulted in the lowest prices of oil in six years. This leaves no "breathing room" for U.S. producers, who often operate with very slim margins of profitability and often invest 110-113% of their revenue, with the help of beneficial tax provisions, into exploration and production of new wells. U.S. producers are currently being forced into decreased production—stacking rigs and shutting their doors for good.

In the current price environment, American oil and gas producers must retain the tax provisions that have made the American energy renaissance possible and that will help the energy sector rebuild when oil prices improve.

The vast majority of independent producers rely heavily on three provisions in the current tax code – those dealing with percentage depletion, intangible drilling costs, and tertiary injectants. The loss of these provisions would likely result in a 30% decrease in drilling activity and, within five years or less, a dramatic decline in U.S. oil and natural gas production. This would translate into:

- The loss of thousands of high-paying industry jobs in drilling, oilfield supplies, transportation, and oilfield manufacturing, as well as technical fields related to energy production, including engineering, geology, and the geosciences.
- A dramatic, negative impact on the nation's fragile economic recovery.
- A halt in the advances that the domestic industry has made toward lessening our dependence on foreign oil.
- Higher prices for consumers.

The Finance Committee has asked interested parties to provide additional data to the working groups, and DEPA would like to take this opportunity to cite the findings of a study released in January 2015 titled “The Economic Impact of Eliminating the Percentage Depletion Allowance.” This economic assessment was produced by IHS, a leading business research firm known for its expertise in the energy sector.

PERCENTAGE DEPLETION ALLOWANCE

Percentage depletion allows independent producers to recoup some of the costs involved in exploring for and producing oil and natural gas. It is akin to typical depreciation taken in other industry sectors except that because of the depleting nature of the oil and gas asset, the depletion is available throughout the economic life of the well. This distinction exists primarily because unlike, say, a real estate property that may have a stable or even increasing value over time, oil and natural gas wells decline in value over their economic lives to the point that they actually have a negative value at the end of their lives.

It is also important to point out that percentage depletion is limited to 15 percent of gross oil and gas income and to the first 1,000 barrels per day of production. Percentage depletion is further limited in that it cannot exceed 100% of net income computed on a property-by-property basis. In effect, this means that percentage depletion cannot be taken on a property that loses money. Also, the amount deducted for depletion cannot exceed 65% of a taxpayer’s net income before the deduction. Even with these limitations, the percentage depletion allowance is critical for producers to maintain the majority of America’s producing oil and gas wells.

The IHS study found that eliminating the percentage depletion tax provision for U.S. oil and gas producers would cut into economic growth, cost jobs and labor income, and cost the federal government a net \$2.5 billion in tax revenue over the next decade and another \$1.1 billion in royalty revenue from oil and gas produced on federal land.

If the percentage depletion allowance were to be eliminated, by the end of 2025, the number of new wells drilled would decline by 23.5%

Independent producers typically invest 110-113% of their revenue into exploration and production. Without percentage depletion, the money reinvested would quickly go negative, which means no exploration and production and no industry growth. Over a decade, more than 37,000 wells would not be drilled and 644 million barrels of oil and 2.8 trillion cubic feet of gas would not be produced.

Royalty owners also can claim the percentage depletion tax deduction, which is the only tax provision available to them with respect to production. Eliminating the percentage depletion allowance would affect royalty owners in two ways:

- It would lower the incentive for independent companies to invest new capital for wells seen as riskier ventures, which would result in fewer lease bonus and royalty payments to royalty owners.
- The number of producing wells would decrease, thus diminishing the amount of production revenue and lowering earnings for royalty owners.

Overall, the elimination of the percentage depletion allowance would cost the U.S. economy over the next decade:

- \$184.5 billion in gross value-added.
- An average 178,000 jobs per year.
- \$115 billion in labor income.

The immediate effect of eliminating the percentage depletion allowance would be a significant tax increase for thousands of America's smallest energy company owners, investors, and partners, as well as more than 8 million royalty and mineral owners.

INTANGIBLE DRILLING COSTS

Like the percentage depletion allowance, the deduction for intangible drilling costs (IDCs) is essential to the nation's 18,000 independent producers. These two provisions are critically important because of the capital-intensive nature of funding current exploration levels (where horizontal wells in many unconventional plays cost an average of \$8-10 million per well).

In today's exploration/production industry, most capital for drilling is generated by independent producers internally. However, even in instances when outside investors are involved, these two tax provisions are essential in attracting capital sufficient to maintain the pace and volume of drilling activity necessary to sustain current or increasing demand. Without these two tax provisions, neither large nor small domestic independents would generate the capital necessary for continuing to grow drilling and production activity.

To summarize briefly, IDCs permit a portion of the costs of drilling a well to be deducted fully in the year those costs are incurred, rather than being capitalized. This results in a deferral of the current tax liability, not a reduction. The election to expense intangible drilling and development costs applies to all expenditures made by the operator for "wages, fuel, repairs, hauling supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for production of oil or gas." Examples include costs incurred to (1) drill, shoot, or clean a well; (2) prepare the site for drilling, including ground clearing, drainage, road construction, and surveying and geological work; and (3) construct the physical facilities necessary to drill and prepare the well for production.

IDCs represent typical and ordinary business expenses within the oil and natural gas industry. This provision is not a tax subsidy or "loophole." In virtually all business and industry settings, taxpayers are allowed to deduct these types of operating expenses in the year in which they are incurred. Current tax treatment of IDCs does not reduce the actual tax liability over the life of the project, and it is available only for wells drilled in the U.S. Major oil companies that drill on foreign soil are not allowed to use the IDC deduction and their deduction on U.S. wells is limited.

If the IDC deduction were eliminated, the economic impact over the next decade would cost the U.S.:

- 265,000 jobs.
- 3.8 billion barrels of oil (equivalent) in production.

- 9,800 fewer wells drilled.
- A total loss in investment of \$407 billion.

Maintaining the oil and gas industry's energy and production activity is critical to the security of the domestic energy renaissance and to the U.S. jobs that a thriving energy industry will provide for future generations.

TERTIARY INJECTANTS

In addition to the need for continuation of the percentage depletion allowance and the deduction of intangible drilling costs, the current tax deduction for tertiary injectants also is a make-or-break provision for independent producers.

Domestic oil producers who wish to maximize production from older, depleted U.S. oilfields have to invest a substantial amount of capital over many years to bring fields back to productive capacity. Some of these enhanced oil recovery projects use carbon dioxide (CO₂), which comes primarily from naturally occurring sources and, to a lesser extent, from man-made sources. By injecting CO₂ into a well, producers are able to recover additional quantities of oil.

Refurbishing old oil fields to safely accept CO₂ injection requires a significant commitment of upfront capital resources to equip fields with up-to-date technology and address environmental issues typically found in older fields. Producers can spend several hundred million dollars preparing a site before CO₂ is injected. Once injection operations begin, it can be several months before optimum oil field pressure is realized and "first oil" is recovered.

Under Section 193 of the tax code, domestic oil producers are allowed to deduct the cost of the CO₂ in the year it is injected. As with IDCs, the deduction for tertiary injectants does not reduce the actual tax liability over time for the producer. Rather, it merely accelerates the deduction of these expenses, which, in turn, provides more capital to independent producers and opens the door for the potential recovery of an additional 40-80 billion barrels of domestic crude oil. This enhanced recovery process not only increases domestic oil production, it also provides an environmental benefit by storing underground billions of tons of CO₂ from power plants and industrial sources that would otherwise be emitted to the atmosphere.

CONCLUSION

The renaissance within the domestic oil and natural gas exploration and production industry is propelling a revitalization of U.S. manufacturing and helping lead the recovery from the deepest economic decline since the Great Depression. The key driver of this American energy boom is drilling activity. Fundamental factors in providing capital for current drilling and production activity are the long-standing tax provisions relating to percentage depletion and intangible drilling costs, as well as the deduction for tertiary injectants.

The Domestic Energy Producers Alliance (DEPA) urges Members of the Senate Finance Committee to maintain these provisions in their present form. Thank you for the opportunity to offer our perspective.

Respectfully submitted,



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Mike McDonald, DEPA President

DEPA Collaborating Organizations

- California Independent Petroleum Association
- National Stripper Well Association
- Illinois Oil & Gas Association
- Kansas Independent Oil & Gas Association
- Kentucky Oil & Gas Association
- Michigan Oil & Gas Association
- National Association of Royalty Owners
- Ohio Oil & Gas Association
- Oklahoma Independent Petroleum Association
- Permian Basin Petroleum Association
- Texas Alliance of Energy Producers
- Western Energy Alliance