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OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

HEARING

BEFORE THE

SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

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COMMUNICATIONS

OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

THURSDAY, SEPTEMBER 10, 2009

U.S. SENATE,
SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:15 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Jeff Bingaman (chairman of the subcommittee) presiding.

Present: Senators Hatch, Bunning, and Cornyn.

OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S. SENATOR FROM NEW MEXICO, CHAIRMAN, SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE, COMMITTEE ON FINANCE

Senator BINGAMAN. All right. Why don't we go ahead and get started. Thank you all for being here.

In the budget proposal that was sent to the Congress in February, the President called for significant changes beginning in 2011 to the taxation of domestic oil and gas activities. Taken together, the proposed changes would raise an estimated $31.5 billion over 10 years.

Some elements of the President's proposal are already familiar to the members of the Finance Committee, as we considered them at length in the last Congress: first, imposing an excise tax on production in the outer continental shelf, and second, disallowing section 199 domestic manufacturing deduction for the largest integrated producers.

There was broad bipartisan support from the Finance Committee for those proposals in the last Congress. The proposals were included in the comprehensive energy tax legislation that the committee reported, but which failed by one vote to achieve cloture on the Senate floor.

I continue to think those proposals have merit. But the President's proposals would go further, in that they would disallow the section 199 deduction for all oil and gas producers, not just the largest integrated firms. I have concerns about that expansion and believe we need to give it careful study. I also understand the administration is refining its OCS excise tax proposal, and we look forward to seeing the final version of that.

In addition, the President's budget proposal newly places on the table several tax preferences that have been imbedded in our tax code for decades and, in some cases, for nearly a century. In revenue terms, the most significant of those proposals are, first, to disallow expensing of intangible drilling costs, or IDCs, and instead require that those costs be capitalized; second, to prohibit percentage depletion for oil and natural gas firms and, instead, require the use of the cost depletion method; and, third, to increase the period over which independent producers amortize geological and geophysical, or G&G, costs and to increase that period from its current 2 years to 7 years.

IDCs and G&G costs are part of industry's everyday vernacular. Frankly, I think few in Congress have great familiarity with these concepts. I believe it is important, therefore, that this subcommittee carefully study the tax provisions at issue and hear not only from the administration, but from industry and from independent analysts. And I am very pleased that we have a panel of six distinguished witnesses to speak to us on those subjects today. I appreciate very much the benefit of their views.

Today's panel will walk through elements of the President's proposal. In addition, the non-partisan staff of the Joint Committee on Taxation has prepared a descriptive pamphlet for today's hearing. I want to thank the JCT staff for their characteristically good and thorough work, and I direct that we include that pamphlet in the hearing record for this hearing.

[The pamphlet appears in the appendix on p. 31.]

Senator BINGAMAN. As we evaluate each proposal, I believe Congress needs to look at it through three critical lenses. First, we need to ask whether the proposal would cause more than a negligible increase in consumer prices. I think we are all well aware of the burden on consumers last year with gasoline prices getting over $4 per gallon. We need to focus on the impact of any changes in policy on consumers.

Second, we need to ask whether the proposal would decrease domestic production. I know that is a serious issue as well.

Third, we need to ask whether the proposal would impact local economies or cause job losses. To be really specific about that issue, the oil and gas industry employs something in the range of 23,000 people in my home State, and the oil and natural gas production annually contributes about $1.2 billion to our economy. There are a lot of other States that also benefit from oil and gas production, and we need to be sensitive to the impact of policy on those issues.

I look forward to exploring these issues more with the panel. And before I introduce the panel members, let me call on Senator Bunning to make any statement he has.

OPENING STATEMENT OF HON. JIM BUNNING, A U.S. SENATOR FROM KENTUCKY

Senator BUNNING. Thank you, Mr. Chairman.

I am glad that we are holding this hearing today, because it raises some very important issues.

This is not just about raising taxes on the oil and gas industry. The President's proposal threatens our national security, energy security, economic security, and job security.

We are at a crossroads in our Nation's energy policy. I have long said that we have the resources and innovation to develop our domestic energy industry in a way that is more efficient and environmentally sound. We must, however, develop all of our energy resources and not get into the dangerous political game of excluding two of our most reliable sources of our national energy strategy.

We all want clean, renewable energy sources. But it will take decades before those sources come close to fueling our economy. In the meantime, we must have a rational national energy strategy, or American workers and consumers will pay the price.

With America in the midst of a recession, now is not the time to impose new taxes on our oil and natural gas industry. These new taxes will mean less domestic energy production, fewer American jobs, and less revenue at a time when we desperately need all three. It will also jeopardize our Nation's energy security by discouraging new investment in domestic oil and natural gas production and refining capabilities. These investments, and the jobs that go along with them, will be pushed abroad.

It will weaken American competitiveness in the global oil market and increase our reliance—and I emphasize this again—increase our reliance on foreign oil and natural gas from unfriendly countries. And ironically, these tax hikes may actually damage the environment by shifting production to countries with less stringent environmental standards.

For nearly a century, our tax code has recognized that oil and gas production is extremely capital-intensive, and it is in our national interest to ensure investments in domestic production go forward. This is not unique to oil and gas. The tax code is filled with incentives for domestic energy production from a variety of sources, and for good reason. Our economy grinds to a halt without abundant, affordable sources of energy.

The American public will be stunned to learn that increasing domestic production is no longer our national goal. Instead, the Obama administration wants to discourage domestic over-production, as it has said 8 times in Treasury's explanation of the President's tax proposal. I was not aware that over-production of American-made energy is a problem.

Some of today's witnesses will argue that the President's proposal will have a small impact on oil and gas production, prices, and jobs. But when the President's tax increase on oil and gas are combined with other tax increases in the President's budget, this amounts to an $80-billion tax hike on oil and natural gas.

It is foolish to believe that these tax hikes will not have an impact on investments, on domestic supply, on consumer prices, and on the 9 million jobs that depend on the oil and gas industry. The witnesses who believe the impact will be small have probably never had to raise capital for an enterprise or make long-term business plans. I would hope that we do not damage our national energy strategy and our economy in order to score political points.

Thank you, Mr. Chairman, and I look forward to hearing from our witnesses.

Senator BINGAMAN. Thank you, very much.

Senator Cornyn, did you wish to make a statement before we hear from the witnesses?

Senator CORNYN. Thank you, Mr. Chairman. I do not think that is necessary at this point. I do have some questions for the witnesses, so why don't we just proceed to them?

Senator BINGAMAN. Very good. Let me introduce everybody here, and then we will proceed in the order that I introduce them.

First would be Alan Krueger, who is Assistant Secretary for Economic Policy at the Department of the Treasury. Thank you for being here.

Next, Dr. Stephen Brown, who is a non-resident fellow at Resources for the Future, based in Arlington, TX. He recently retired from the Federal Reserve Bank of Dallas, where he retired as director of energy economics and micro-economic policy analysis.

Third, Calvin Johnson is the Andrews and Kurth centennial professor of law at the University of Texas School of Law.

Fourth, Larry Nichols, who is chairman of the American Petroleum Institute and the chief executive officer of Devon Energy in Oklahoma City.

Next, Kevin Book is managing director of ClearView Energy Partners, LLC.

And finally, Henry Kleemeier is the chairman of the Independent Petroleum Association of America and president and chief executive officer of Kaiser-Francis Oil Company in Tulsa.

So, thank you all very much for being here. Why don't each of you take about 5 to 6 minutes and summarize the main points you think we need to understand on these issues, and then we will have questions.

Go right ahead. Mr. Krueger?

STATEMENT OF HON. ALAN KRUEGER, ASSISTANT SECRETARY FOR ECONOMIC POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. KRUEGER. Thank you. Good afternoon, Chairman Bingaman, Ranking Member Bunning, and Senator Cornyn.

Thank you for inviting me to testify this afternoon. I appreciate the opportunity to discuss the economic effects of the administration's fiscal year 2010 budget proposals that focus on tax subsidies to the oil and gas industry.

The administration believes that our Nation must build a new clean energy economy, reduce our dependence on oil, and limit the emissions of greenhouse gases. Congress has already taken important steps in that direction by providing funding for energy efficiency improvements and renewable energy investments in the Recovery Act.

Consistent with the administration's goal to build a clean energy economy, the budget also includes several proposals to eliminate tax subsidies that benefit oil and gas companies, such as percentage depletion and expensing of intangible drilling costs, beginning in 2011.

In my testimony, I will describe why, from an economist's perspective, these proposals are good economic policy. I will also describe why I believe eliminating these tax subsidies would have small effects on prices, production, and employment.

An important principle of good tax policy is that a tax policy should be neutral across industries. By altering the pattern of

after-tax returns on investments, compared to the economic returns on investments, tax preferences distort resource allocation and reduce aggregate output.

Maintaining neutrality in economic policy, absent a strong reason otherwise, is a longstanding principle that was emphasized by George Washington, who said in his farewell address, "even our commercial policy should hold an equal and impartial hand: neither seeking nor granting exclusive favors or preferences. . . ."

The tax subsidies that are provided to the oil and gas industry lead to inefficiency by encouraging over-investment of resources in these industries. In 2005, the Congressional Budget Office estimated that the effective marginal tax rate on investments in petroleum and natural gas structures was 9.2 percent. This is well below the average effective marginal tax rate across all asset types, which is 26.3 percent. Removing this distortion would improve overall economic efficiency.

A second principle of good tax policy concerns externalities defined as benefits or costs that accrue to parties not involved in a transaction. One reason to subsidize or tax a particular industry more highly is to align market prices with the full social cost of producing or consuming a good.

Oil and natural gas prices may not reflect environmental harm caused by the release of greenhouse gases in the atmosphere associated with oil and gas production and consumption. Removing the current tax subsidies may move prices closer to appropriately reflecting the negative externalities associated with greenhouse gas emissions. Although, as I discuss shortly, our estimates are that the effect on prices of the proposed policies is likely to be very small.

Next, I would like to turn to an analysis conducted by the Department of Treasury on the potential impacts removing these tax subsidies will have on prices, production, and employment.

Tax preferences reduce a firm's cost of doing business and, by lowering these costs, they can lead to an increase in the firm's production and employment. Whether or not the market price of the good produced by a firm is affected by an increase in production depends on the size of the increase in production relative to the market as a whole and the availability of close substitutes.

I will first discuss impacts on oil. The domestic price of oil is determined by global supply and demand, because oil is an internationally traded commodity. The U.S. share of global oil production is only 10 percent and its share of proven crude oil reserves is less than 2 percent, which means that any change in U.S. domestic oil production will have a limited impact on the world supply of oil.

Because there will be little or no effect on the world supply of oil, removing the tax subsidies for oil production would have an insignificant impact on domestic prices and consumption. According to our estimates, removing subsidies for the oil industry would be equivalent to raising finding and lifting costs by less than 2 percent.

The small change in domestic producer costs could cause some production to shift from domestic to foreign suppliers and among integrated and non-integrated suppliers within the U.S. However,

we estimate that the decrease in domestic production due to these proposals will be in the neighborhood of one half of 1 percent or less. This is based on standard production supply elasticities in the literature.

A rough assumption would be that employment associated with oil production could fall in the same proportion as the decline in domestic production. The small increase in production costs would have no impact on employment in the refining of distribution sectors.

Finally, as I noted earlier, reducing tax preferences will result in a more efficient allocation of capital and labor which will tend to increase national output and employment in the long run.

I will next turn to the impacts on natural gas. Unlike oil, a large majority of the natural gas consumed in the U.S. is domestically produced. As a result, changes in domestic natural gas production costs have the potential to influence prices. However, the increase in production costs from eliminating the subsidies is small, and in the extreme situation, if all of the costs of cost increase are passed on to consumers, we estimate that the impact would be about 1 percent higher natural gas prices.

For context, consider that since 2000, prices for residential natural gas have fluctuated an average of plus or minus 6 percent per month. Thus, any price changes due to removing the tax subsidies will likely be small relative to normal price fluctuations and, as I mentioned, that is using an extreme assumption that all of the cost increase is passed on in the form of higher prices.

Small increases in price may cause consumers to respond by decreasing their consumption of natural gas. However, again, the effect is likely to be small. Using estimates of the demand elasticity from the literature, our analysis suggests that a 1-percent increase in natural gas prices might result in a reduction in natural gas consumption and production of perhaps half a percentage point in the long term.

Over the long term, of course, employment in the natural gas production and supply industry could change by a similar amount. As in the case of oil, eliminating the distortionary influence of the tax preferences for natural gas can improve efficiency and help to create jobs in other sectors over time.

I see that I am out of time, so why don't I stop there? You have my full statement in the record, and I will be happy to answer questions.

Senator BINGAMAN. All right. Thank you very much.

[The prepared statement of Mr. Krueger appears in the appendix.]

Senator BINGAMAN. Dr. Brown?

STATEMENT OF DR. STEPHEN P.A. BROWN, NON-RESIDENT FELLOW, RESOURCES FOR THE FUTURE, ARLINGTON, TX

Dr. BROWN. Thank you, Chairman Bingaman, Ranking Member Bunning, and my Senator Cornyn.

I am a non-resident fellow with Resources for the Future. Resources for the Future is a 57-year-old independent and nonpartisan research institution based here in Washington, D.C., and it focuses on energy, environmental, natural resource, and public

health issues. Non-resident in my title means that I primarily live and work somewhere else, in my case, Texas.

As my written testimony states, any views I present today are strictly my own and should not be attributed to Resources for the Future.

The President's proposed budget changes would amount to $31.5 billion in additional revenue. This contrasts with projections that the domestic oil and gas production over the same time period, for which this $31.5 billion would be raised, will be about $3.4 trillion, so the tax increase that is covered in this would be a little less than 1 percent of the overall revenue projected for the domestic industry over the 10-year time period.

What I am going to address today is how these preferences fit into an overall U.S. tax system, how eliminating the oil and gas company tax preferences likely will affect U.S. oil and natural gas markets, and what impacts these will have on U.S. energy security, employment, and regional economic activity.

Tax preferences, I think, are best viewed as instruments of policy. Their use should be limited to activities that need more encouragement than is provided by free market forces. Otherwise, tax preferences actually reduce overall economic well-being. Free markets should provide sufficient encouragement, as we are looking at projections of near-record high prices for oil and natural gas over the coming years.

Because these tax preferences amount to less than 1 percent of the projected revenue for the industry, my estimates show that ending these preferential taxes will have a very small effect on U.S. oil and gas markets. The average U.S. consumer would pay about $1.40 more per year for petroleum products and natural gas over the 10-year time frame used in the President's budget projections. At the same time, the U.S. Government revenue will be increased about $10.70 per consumer.

My estimates suggest that there would be a small impact on world oil prices of about 6 cents per barrel of oil and, when you translate that into price increases for gasoline, diesel, and home heating oil, we are looking at a little less than two tenths of a cent per gallon. Consumer prices for natural gas will be pushed upward by about 2.4 cents per million Btu. This is less than 1 percent. Producer prices will be pushed down by about 2.7 cents per million Btus, so there would be an overall increase in taxation on natural gas of about 5 cents. When you put this into context of the projected price increases that we will see for natural gas, it would put natural gas in the $3.50 to $8.00 range over the next 10 years. You can see that these are relatively small increases.

Of course, these are going to mean that these small changes will have some impact on domestic production and imports. And as a matter of context, the U.S. oil market is about a 20 million barrel-a-day market today and is projected to remain relatively constant over the next 10 years.

My estimate showed that out of that market, we are looking at about a 9,000 barrel-a-day reduction in consumption and about a 19,000 barrel-a-day increase in imports, for a total of a 26,000 barrel-per-day decrease in domestic production. Of course, those

could be significant if you happen to be the producer of the last 10 barrels in that 26,000 barrels.

The small changes in oil market conditions would slightly increase the exposure of the economy to oil supply disruptions, but again, this is very slight and I estimate on the order of $7.9 million per year over the 10 years. So when you are looking at raising billions of dollars in a trillion-dollar industry, again, that is a small figure.

One of the things that I was asked to do was assess the impact on regional economic activity, and I put these small changes into my model of regional economic activity and they were too small for the model to really give me any answers that I considered worth reporting.

In summary, the elimination of oil and gas tax company preferences should have little impact on the industry, consumers, oil security, or on U.S. economic activity. And, like the previous speaker, I look forward to answering your questions.

Senator BINGAMAN. Thank you, very much.

[The prepared statement of Dr. Brown appears in the appendix.]

Senator BINGAMAN. Professor Johnson, go right ahead.

STATEMENT OF CALVIN H. JOHNSON, ANDREWS AND KURTH CENTENNIAL PROFESSOR OF LAW, UNIVERSITY OF TEXAS SCHOOL OF LAW, AUSTIN, TX

Professor JOHNSON. I am Calvin Johnson. I thank the chairman and distinguished members for inviting me. I am truly honored.

My testimony is on honest and accurate tax accounting for oil and gas. I have been a professor of law at the University of Texas Law School since 1981, 28 years. I help run the "Shelf Project," which is a collaboration by tax professionals to develop and perfect proposals to raise revenue by defending the tax base.

Our Uncle Sam is going to need significant revenue. The Congressional Budget Office estimates that the Federal budget deficit for 2009 will total $1.6 trillion, or 11 percent of gross domestic product. Once the need for short-term stimulus has passed, that deficit must be closed. In the impending revenue crisis, base-protecting revenue provisions that were not possible under ordinary politics become political necessities.

In raising revenue, it is better to go after the low-tax and negative-tax transactions before raising tax rates. A tax system does the least harm to the private economy if it is broad, unavoidable, and neutral between investment choices. A broad, healthy tax base allows us to raise the necessary revenue at the lowest feasible tax rates. Investment decisions should be governed, not by arbitrary tax accounting, but by the real non-tax merits of the investment. We need to get the tax accounting right to describe the real economic income, just as we need to keep our laboratory data honest and accurate, no matter how important the experiment is.

Under the standards of a broad, unavoidable, and neutral tax base, we will need to have significant improvements in the tax accounting used for oil and gas. Tax accounting for oil and gas does not describe the economic income from the investment. Indeed, for a broad range under reasonable assumptions, oil and gas account-

ing delivers a negative tax or subsidy to very profitable investments.

For example, under reasonable assumptions, the combination of four tax preferences generates a subsidy that is a negative 42 percent of real income. The four preferences are expensing of intangible drilling costs, the pool of capital doctrine, the percentage depletion allowance, and domestic manufacturing deduction.

The subsidy from the combination means that oil and gas investments can, in reality, lose over half of their cost of capital before tax and still make money after tax. Investments are not more virtuous because they lose money in absence of tax. Honest and accurate tax accounting for oil and gas would make taxable income describe the economic income and stop the tax subsidies.

No one has yet made a plausible case that a subsidy is needed for oil and gas beyond the wisdom of the laws of supply and demand. The price of oil and gas is high enough to provide sufficient incentive, and, if more incentive is needed, the price will rise. Indeed, an increase in the price of oil and gas, if any, would help us conserve energy and adjust to alternative energy sources and the high energy prices in the future. The government should get out of the business of subsidizing oil and gas, especially via the tax system.

None of the tax advantages accorded to oil and gas has ever been subjected even to the care that we give to government spending. The competitive Federal budget is the primary mechanism by which the government applies rationality to use of resources.

Budgeted spending is subject to discipline because government spending is so widely hated. When items are off-budget, however, as when they are accomplished through the tax system, the subsidies avoid the budget competition for resources. When Congress allows tax advantages, they do not think of burdens as being real money and, therefore, they turn out to be quite irrational. Tax advantages are stealth subsidies, not understood to be real money by the people or by the Congress that adopted them.

The following eight tax privileges now available to oil and gas should be repealed.

One, repeal of the intangible drilling costs. These are real investments, and they should be treated as capital expenditures.

Two, repeal of the pool of capital doctrine. If you are going to describe the economic income from an activity, you have to have the adjusted basis equal to the real bank account, you have to capitalize the costs, and you cannot allow people to get any of these costs tax-free.

You need to have a repeal of the working interest exemption from the passive activity loss provisions. The Tax Reform Act of 1986 was so marvelously effective because it lowered rates, and in order to lower rates it had to go after tax shelters. The siege gun, the most effective anti-tax shelter provision in the 1986 act was the passive activity loss provisions. Working interests have an exemption. That means that outsiders who want to buy a lot of shelter but do not have any oil mud on their hands, have never seen, set foot, or have anything to do with the industry, can buy their way into the artificial tax loss coughed up by the bad accounting, by the

artificial accounting, and we need those passive activity losses to come in.

We need to limit the percentage depletion allowance to basis. Once somebody has recovered all their costs, that is it. There is no possible justification for percentage depletion, no engineering idea, no good accounting idea.

We need to repeal the special exclusions for domestic production and repeal the tax credits.

I thank you for your time.

Senator BINGAMAN. Thank you, very much.

[The prepared statement of Professor Johnson appears in the appendix.]

Senator BINGAMAN. Mr. Nichols? Go right ahead.

STATEMENT OF LARRY NICHOLS, CHAIRMAN, AMERICAN PETROLEUM INSTITUTE, OKLAHOMA CITY, OK

Mr. NICHOLS. Thank you, Mr. Chairman. I am Larry Nichols, chairman and CEO of Devon Energy Corporation, an independent oil and gas company, and I am also chairman of the American Petroleum Institute.

I appreciate the opportunity to present the industry's views on the potential impact of the oil and natural gas proposals that are contained in the administration's budget.

I particularly want to thank Chairman Bingaman for your efforts in the past for greater access to our domestic oil and gas reserves.

This budget calls for more than $80 billion over the next 10 years in new taxes on the oil and gas industry. These proposals are based on myth, rather than fact. They are based on academic studies that you have just heard, rather than real-world experiences or how real markets work.

Here is an example of what I mean. Lower demand in the current economy, the current recession, has reduced natural gas prices by 75 percent. Crude oil prices are down by 50 percent. Now, the administration proposes to further weaken an industry that is already suffering, along with the other vital sectors of this economy.

Incredibly, the administration states that its proposals are aimed at reducing domestic development of oil and gas. It does so as if this is a good thing, at a time when we need all sources of domestic energy to help our economy grow, to keep jobs in this economy.

The administration also states that the current tax treatment of our industry's normal business expenses somehow distorts investments, while not recognizing that other taxpayers in other industries get very similar treatment for their business expenses.

The proposals are aimed at crippling our industry, a fact that is borne out in the administration's own words. The Green Book, really the best argument produced by the Treasury, is the best argument against the proposals. It says on page 63, and elsewhere in the document, that the current tax system "encourages the over-production of oil and natural gas," which, it says, is "detrimental to the long-term energy security of this country."

That is absurd. The over-production of oil and natural gas—I had never heard anyone, until reading this document, think that we had a problem with producing too much oil and gas. Every President since President Nixon has talked about increasing—including

the current President—domestic energy and reducing our reliance on foreign oil. This proposal would have exactly the opposite effect.

At a time when everyone suggests we need all sources of domestic energy, it makes absolutely no sense to discourage production from our leading sources, oil and natural gas. This counterproductive approach is also at odds with the administration's own carbon reduction policy because it would discourage the production of natural gas—our cleanest fossil fuel.

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 gasoline, without any reduction in worldwide carbon emissions.

Yet, the President's tax proposals appear to be based on a myth that tax increases of this magnitude would have no adverse effect, that somehow companies would just absorb them without any impact. That assumption is naive and misleading. Increased taxes represent real increases in the cost of doing business, real cash out of the pockets of oil and gas companies. That will mean fewer jobs, less exploration, fewer wells and higher costs for the consumer.

API companies have a record of reinvesting their profits to get the oil and natural gas our economy needs. In fact, from 1996 to 2007 our companies invested more in new projects than we made in net income. This has been a driving force contributing to domestic supply growth for both crude oil and natural gas. The growth has largely come from the development of new shale programs, where each well can cost $3 to $9 million and deep-water Gulf of Mexico projects, where individual wells cost well over $100 million.

Basing tax policies on myths leads to the wrong choices for the long term. For example, the new excise tax on Gulf of Mexico production would raise money for the government in the short term, but cost money in the long term. The increased cost to find and develop U.S. offshore resources would reduce production of domestic offshore oil and gas, which generates royalties, bonuses, and tax income to the government.

The current ability to expense intangible drilling costs—and these are the real costs of drilling wells—recognizes that they are business expenses that serve as the foundation for our ongoing exploration and production operations. That is why this deduction has been a part of the tax code since its inception.

Repealing it would significantly raise the cost of drilling and development in the United States. For a company like mine, it would reduce our capital budget by nearly 20 percent. That is not de minimis. It would result in less drilling, less revenue to the government, higher energy cost, and fewer U.S. jobs.

Another example: section 199 was used to encourage U.S. manufacturers to maintain and create well-paying U.S. jobs. Our industry employs 9 million workers and their families. The proposed repeal of this deduction would specifically impose a higher tax rate on this industry, when our effective tax rates are already higher than the rest of manufacturing, and indicate that those hard workers are not as valued by Washington as the workforce in other industries.

I also want to mention two of the broad-based business tax proposals that would have a negative impact on our industry. The pro-

posal to modify rules governing the creditability of foreign taxes paid by dual-capacity taxpayers would lead to double taxation and compromise our ability to operate abroad.

The other proposal hits refineries by repealing the LIFO accounting method, a well-established method for determining book and taxable income which has been around for decades and decades.

The stark reality is that these proposals are anti-jobs, they are anti-consumer, and they are anti-energy. They will depress investment in domestic oil and natural gas projects, they will weaken our Nation's energy security, and make it more difficult to achieve economic recovery.

Instead of these proposals, we need policies that reflect the realities of America's energy challenges. We need a multiple approach that includes renewable energy, increased energy efficiency, and increasing our ability to produce oil and natural gas and other resources.

Thank you very much.

Senator BINGAMAN. Thank you, very much.

[The prepared statement of Mr. Nichols appears in the appendix.]

Senator BINGAMAN. Mr. Book?

STATEMENT OF KEVIN BOOK, MANAGING DIRECTOR, CLEARVIEW ENERGY PARTNERS, LLC, WASHINGTON, DC

Mr. BOOK. Thank you, Chairman Bingaman, Ranking Member Bunning, and Senator Cornyn, for the privilege of contributing to today's discussion.

My name is Kevin Book, and I lead the research practice at ClearView Energy Partners, LLC, an independent research and consulting firm that serves institutional and corporate energy investors.

I think I can summarize my lengthy testimony in three points. First, I am going to address our view that global oil demand is in an unusual and potentially deceptive lull that does not invalidate the long-term trends we saw going on in prices last summer.

Second, I will identify some general challenges that energy policy changes can create for certain classes of private companies, and, last, I will address several specific unintended consequences that could arise from the proposed oil and gas tax policy changes.

We are, indeed, in a historic demand lull, but the way we got here is nothing to celebrate. Moreover, it is unlikely to be sustainable. Thirteen months ago, the global oil system was running at about 99 percent of capacity. Prices reflected real and anticipated scarcity. Today, economic collapse and rare OPEC cooperation have left the world at less than 94-percent capacity. What changed? Demand, and it changed fast. U.S. automobiles got more efficient this year and will get more so as consumers recover, simply because drivers will replace old cars with new.

Policies will make a difference, too. Our model suggests that, if proposed vehicle greenhouse gas standards are met by fuel economy gains, U.S. motor gasoline demand could peak in 2012 or 2013 and slowly decline. American drivers literally drive global oil demand.

And this is a point I think I did not hear in any of the other testimonies: oil and oil products tend to price at the margin, so the marginal increase in demand when you are at 94 percent may have very little price increase. But when you are at 99 percent in the global system, and you have a significant change in demand to the upside, price can go up a lot, and fast.

American drivers are not going to be the only thing in the future, because it will not be just about us and our cars. The recession slowed purchasing in the West, stalling manufacturing in the East and lowering shipping demand. Oil use compressed at every link of the global value chain.

Yesterday's consumers, though, are not like an old clunker cast onto the scrap heap. They are still around to purchase tomorrow's goods, and they are likely to be growing in number.

On the supply side, we have abundant supply, which means we are less vulnerable to acute geo-political events. But as cash grows tighter, governments that control and influence industry investments may have fiscal motivations to dig deeper into natural resource profits. The resulting underinvestment could create a slow supply bleed, even as demand momentum grows, which is not to blame governments.

It is not easy to sync up energy policy with energy investment cycles. Governments mostly have relatively short cycles, and energy projects have long lead times and longer lifetimes. But unanticipated policy volatility can inject risk and impair investment.

Cautious companies plan to survive volatility in prices by earning sufficient returns in later years to pay back losses that they earn in earlier years. The time scale of this payback can be a decade or longer. As a result, corporate responses to policy changes can be long-lasting; petroleum is a global business, companies move.

Firms pursue projects that deliver the best returns for shareholders. Big resources can be worth big risks and tough terms. Conversely, contract rescission or policy changes could undermine the attractiveness even of low royalties, especially for smaller projects.

In addition, private firms with finite cash resources must compete with State-owned, State-funded companies. They may be among the most vulnerable to unanticipated government actions. For this reason, policy volatility within market democracies can be more damaging to private companies than to their State-owned competitors.

Before I comment on the proposed changes, one quick note. My firm analyzes energy economics and the policies that shape it. We do not take sides. We do not consider it our place to judge policy changes. More to the point, I am honored to sit alongside distinguished witnesses who have strong and credible arguments for both sides.

Accordingly, I want to focus only on potential unintended consequences. Most of the oil and gas tax incentives on the books today have been in force for decades. Some, as mentioned, date back to the last century, rather the 19th century. Some are newer, section 199, and the accelerated G&G amortization, but they all have basically two things in common. First, they encourage U.S.

petroleum supply security, and, second, they recognize that oil and gas investments are enormous. The oil business requires vast amounts of cash as a primary factor of production.

LIFO-to-FIFO, paired with rising prices, could motivate refiners to reduce inventories before it happens. This could flood the market with crude, artificially depressing prices in the short term and hurting the economics of higher-cost alternatives. Refiners might also hold leaner inventories thereafter, creating greater price volatility.

Deduction deferrals, dual capacity tax rule changes, and unraveling inversions could create cash-flow challenges or competitive disadvantages for international companies, but they also create incentives to re-domicile, rather than re-patriate businesses and taxable profits. A deep-water drilling surtax could deter higher-cost projects. If nothing else changed, pushing back production into the future would diminish the present value of royalties received to the Federal Government.

Far more vexingly, changes to lease life or royalty rates could diminish bid bonuses in future auctions, because leases that cost more per barrel to produce could be worth less to private companies.

I think a lot has been said about IDC deductions, and I do not want to belabor it, but anything you do to deprive re-investible capital in new production is likely to diminish new production.

And, perhaps, finally, the 199. One point worth making here also pertains to the refining sector, which has survived for years on razor-thin margins. You have some companies that are currently well-insulated against small tax increases by virtue of their debt structures and cash positions in cost structures, but some of the smallest companies undertaking some of the highest cost, most innovative and most environmentally-friendly projects, could be the most severely impacted.

Mr. Chairman, current policies embody the energy strategies and value judgments of past generations of lawmakers and regulators. I believe they can, and should, change with changing economic circumstances. I remain optimistic that this committee and this Congress will continue to craft energy policy that reflects practical and well-considered tradeoffs.

At this point in our Nation's economic history, it seems equally irrational to demonize the taxes that will fund government operations as it does to demonize the fossil energy that will power our economic recovery.

This concludes my prepared statement. I look forward to any questions at the appropriate time.

Senator BINGAMAN. Thank you, very much.

[The prepared statement of Mr. Book appears in the appendix.]

Senator BINGAMAN. Mr. Kleemeier? You are the clean-up witness here.

STATEMENT OF HENRY G. KLEEMEIER, CHAIRMAN, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, TULSA, OK

Mr. KLEEMEIER. Thank you. I like being last.

My name is Buddy Kleemeier. I am the president and CEO of Kaiser-Francis Oil Company in Tulsa, OK, and I am the current chairman of the Independent Petroleum Association of America. It is my pleasure to be here, Mr. Chairman. And thank you, Senator Bunning and Senator Cornyn, for allowing me to testify.

America's independent producers drill 90 percent of all the oil and gas wells that are drilled in the United States. We produce over 65 percent of the crude oil produced in the United States daily, and over 80 percent of the natural gas produced in the U.S. daily.

Notwithstanding some of today's testimony, the tax code has been written to encourage the development of American resources, and it has succeeded. America should not turn its back on public policy actions that are designed to attract capital to the high risk of developing natural gas and oil to keep those resources producing.

The outcome of the administration's proposals to producers, rather than the economists and tax accountants, is clear: investment will fall, production will fall, and, for America's marginal wells, production will cease altogether.

In the limited time available, I want to discuss a few of the items addressed in my written testimony: the intangible drilling costs, percentage depletion and the passive loss exception, the flawed logic behind the administration's proposal, and the likelihood that the Nation will spend more on imported oil than it will gain from the revenue increases projected by the administration.

Intangible drilling and development cost treatment is designed to attract capital to the high risk of the natural gas and oil business. The expensing IDC has been part of the tax code since 1913. Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers will have significant effects on their capital development budgets.

A Raymond James analysis reported that the loss of IDC would result in capital budgets being reduced by 25 to 30 percent. This compares with anecdotal information provided to IPAA by its membership indicating that drilling budgets will be cut by 25 to 40 percent.

Clearly, the consequences would be significant and soon evident. Roughly half of the natural gas we burn each day in this country comes from wells that have been drilled in the last 4 years. American producers are already facing significant reductions in their capital budget due to current low product prices. Layering loss of IDC on top of these limitations will only worsen the consequences for American production.

All natural resource minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926. Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers and royalty owners, only available for the first 1,000 barrels-a-day of production, limited to the

net income of a property, and limited to 65 percent of the producer's net income.

Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operations. Those wells that account for 20 percent of America's oil production and 12 percent of America's natural gas production are the most vulnerable economically.

Input to IPAA from its operators who take percentage depletion indicates that the combined effect of the Obama administration's proposal on IDC and percentage depletion would reduce drilling budgets in half. At this lower rate, new production will not offset the natural decline in production from existing wells.

For example, one of our producers reports that he drills 10 wells per year. Without IDC and percentage depletion, he will only drill 5 wells a year. A 5-well program will not replace declining production in existing wells, and over time his operation will just shut down.

Congress's choice is straightforward: reduce American oil production by 20 percent and its natural gas production by 12 percent or retain the current historic tax policies that have encouraged American production.

When the Tax Reform Act of 1986 divided investment income expense into two baskets—active and passive—it exempted working interests in natural gas and oil from being part of the passive income basket. If a loss occurred, it was deemed to be an active loss that could be used to offset active income so long as an 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 to share the risk of drilling wells.

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 should or would favor corporate ownership over individual ownership of working interests. Further, since AMT restrictions apply to IDC of individual working interest investors, the application of the passive loss rules to these investments is unnecessary and excessive.

Taken together, these administration-proposed tax changes are projected to strip about $36 billion from the U.S. natural gas and oil production investment over a 9-year period. The administration justifies its proposal based on two flawed rationales. First, it argues that each provision distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. And, second, to the extent that the provision encourages over-production of oil, it is detrimental to long-term energy security and is also inconsistent with the administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program.

The first issue is neither unique to natural gas and oil tax provisions, nor to the tax code generally. For natural gas and oil production, these provisions are intended to encourage the development of American resources—they were never intended to be neutral. More broadly, these provisions reflect business tax policy that is consistent with comparable treatment from other energy sources.

A 2007 Energy Information Administration report assessed the Federal Government's support for energy sources. The analysis demonstrates that natural gas and oil Federal treatment is comparable to other major energy sources on a total basis and is well below other sources on a unit basis. The Obama administration's first justification is simply an inaccurate characterization of the nature of Federal energy tax policies that have been crafted over decades by this Congress.

The administration's second rationale is simply irrational. Production of American oil and natural gas serves the Nation's goal of improving energy security. Production has been regulated since the mid-1930s by State regulatory commissions to assure that wells are limited to volumes that conserve long-term production and ultimate recovery for reservoirs. Current market conditions reflect the need for American production to be maximized, and nothing suggests that it should not be.

In summary, the administration's climate goals for reducing carbon emission and encouraging the use of renewable energy sources are enhanced by American natural gas and oil production. Natural gas is clean, American, abundant, and affordable, and must be a part of any climate initiative. Oil will continue to be a key component for America's energy supply for the foreseeable future, and any policies should rely on American oil first and foreign sources last.

The administration's revenue estimates raise significant and unanswered questions. Over the 9-year period of this proposal, the revenues from all of these provisions would average about $4 billion annually.

In August 2009, the Energy Policy Research Foundation released an analysis that addressed issues related to the Obama administration tax proposal. This analysis said the incremental benefit of reducing oil imports by one barrel is worth $14.70 to this economy. Thus, if American oil production is reduced by 745,000 barrels-per-day as a result of these tax provisions, the cost to the Nation of increased imports would be offset entirely by the increased revenues.

EIA estimates that marginal oil wells produced 844,000 barrels-per-day in 2006. This production would be lost because of the changes to IDC and percentage depletion. Clearly, the economic consequences of the administration's tax proposals forcing the closure of America's marginal oil and gas wells, even without addressing the impact of losing marginal natural gas wells for reduction in drilling affecting new production, would exceed the revenue expectations of the total tax changes.

Those are my comments. Thank you.

[The prepared statement of Mr. Kleemeier appears in the appendix.]

Senator BINGAMAN. Thank you all very much.

Let me start. We will just do 5-minute rounds of questions here. If I could start off.

One issue which seems to be in disagreement is this whole issue of the effective marginal tax rate that is being applied, or is imposed, on the oil and gas industry.

Mr. Krueger, I understand your testimony. You cited GAO reports saying that it is 9 percent as compared to 20 some-odd percent for most sectors of U.S. industry. Am I right about that?

Mr. KRUEGER. That was a CBO report, but the numbers are accurate.

Senator BINGAMAN. It was a CBO report, not a GAO report.

Mr. Nichols, I think your testimony was that the effective rate in the oil and gas industry is already higher than on other manufacturers. I guess I am just trying to figure out what the truth is here. What is the effective rate?

Mr. NICHOLS. You can listen to the second quarter conference call that we had in August with our investors. We do this every quarter. We update our estimate for what our effective tax rate will be. This is what we say. It is in our SEC filings. Our estimate for this year will be 32 percent. That is——

Senator BINGAMAN. Are you typical of the industry, or is Mr. Krueger right when he talks more generally about the industry?

Mr. NICHOLS. We are certainly typical of all the other large independents that I follow. In fact, if you look at the facts, the last 5 years our own effective tax rate has ranged between 28 percent and 33 percent.

Senator BINGAMAN. All right.

Mr. Krueger, did you have any comment on that issue?

Mr. KRUEGER. Well, I am not entirely sure how those figures were calculated. I think it is important to match the timing correctly, so it might be related to timing. It is not only the CBO who finds low effective marginal tax rates for the oil and gas industry. That has also been found by other independent analysts. For example, a study by Gilbert Metcalf at Tufts University finds—particularly for the non-integrated producers—lower marginal tax rates than for the integrated ones than compared to other industries.

Senator BINGAMAN. Let me ask. In the past, Congress, at least in certain circumstances, has made distinctions between the oil production and natural gas production. Again, I think in your testimony, Mr. Nichols, you were saying that natural gas prices are down 75 percent, oil prices are down 50 percent. I guess an obvious question is whether, in any change in tax law, if Congress were to enact a change in tax law, should we make a distinction between what we do with natural gas production versus what we do with oil production as far as the level of taxation? I do not believe the administration made that distinction in their recommendations.

Maybe, Mr. Krueger, you could comment on that and whether or not you think it would make sense for us to look independently or separately at those two sectors of the energy industry.

Mr. KRUEGER. Very quickly, we use the principle of neutrality, and the reason why a distinction was not made was to keep the rates neutral, to not distort production decisions, investment decisions, between the two industries.

Senator BINGAMAN. Let us just ask any of the other witnesses if you think that it would make sense for us to separately look at the appropriateness of any of these changes with regard to natural gas rather than just with regard to oil, or should we just keep them in one basket?

Mr. BOOK. Mr. Chairman, I could offer, as an outsider, maybe——

Senator BINGAMAN. Yes, please.

Mr. BOOK [continuing]. To the industry who does not have this at stake. You drill a hole in the ground to get petroleum out, and it can come out in gaseous or liquid form. I am not very familiar with any circumstances in American history where we have reinjected the associated crude into the ground from a natural gas well. They are both valuable, and companies have a hard time sometimes just getting one. So, I mean, it is tough to do in practice what the law might try to do tax-wise.

Senator BINGAMAN. All right.

Anyone else have a comment?

Mr. NICHOLS. Yes, reflecting on your earlier comments about the three goals that you wanted to address. If the goal is to protect jobs, or indeed enhance jobs in the United States, I do not think it matters to our workers whether they are producing oil or natural gas. The geologists are working for both commodities, and a job is a job. If the goal is to protect our national security and not reduce production, then we need oil production, we need natural gas production, and we need all we can get until we can achieve alternate forms of energy that can fuel our economy.

Senator BINGAMAN. Let me ask, just particularly, Mr. Nichols or Mr. Kleemeier, since both of you are industry representatives here on this panel, what is your reaction to Professor Johnson's proposal, which I understand on the depletion allowances, one of his suggestions is that we should limit the amount of depletion deduction to the amount of the investment, as I understand it, and not allow the circumstance which he indicates currently exists where you have more of a tax benefit realized than is in fact invested.

Mr. KLEEMEIER. Of course, percentage depletion has been eliminated for all of the integrated companies, and it is only available to independent producers and royalty owners. In fact, it is the only deduction that royalty owners receive. The small producer—the way a person gets to be a small producer usually is a result of properties being sold as they become less economic. It starts off with the most economic, the most high-risk, the most high-reward projects being developed by the integrated companies, the very large independents.

The bottom 80 percent of their property becomes 20 percent of their value, and to become efficient they sell off those properties to a mid-size producer. The mid-size producer then sells off his bottom 80 percent to a mom-and-pop small producer. The operating costs on those properties are very, very high, and the reason the mom-and-pop producer buys them is because they can operate more efficiently by producing the properties themselves.

Without IDC, and without percentage depletion, their very thin margins disappear, and that is why I comment on this. Twenty percent of American oil production and 12 percent of American natural

gas production is stripper wells, and the depletion allowances that now exist are focused on people who produce no more than 1,000 barrels a day. They have to be an independent producer, or they have to be royalty owners. So I think this Congress should be focused on the depletion allowance being used only by the people who need to have it to stay in business.

Senator BINGAMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman. Secretary Krueger, the first economic principle for tax policy that you listed in your testimony is that tax policies should be neutral across industries. Is that correct?

Mr. KRUEGER. Absolutely, it is a good reason otherwise. That is correct.

Senator BUNNING. Currently, oil and gas face strict limits on percentage depletion, while extractors of other mineral deposits do not have those limits. Is this policy neutral across industries?

Mr. KRUEGER. Thank you. That is an excellent question. I think the proposal that we made is a first step in trying to improve neutrality across all industries. As you know, the President has asked PERAB (the President's Economic Recovery Advisory Board), Paul Volcker's commission, to look at taxes with an eye toward making recommendations.

Senator BUNNING. Please answer the question. Do not give me all the—just answer the question.

Mr. KRUEGER. The answer that I was giving is that we are in the process, through the Volcker Commission chaired by Martin Feldstein, of looking at other subsidies across other industries and, hopefully, they will come back with some——

Senator BUNNING. In other words, it is not neutral right now.

Mr. KRUEGER. As I said, it is a first step to try to move toward neutrality.

Senator BUNNING. Is the administration proposing to eliminate percentage depreciation for all mineral deposits, or just for oil and gas industries?

Mr. KRUEGER. We are in the process, through the Volcker Commission, of reviewing——

Senator BUNNING. Presently, they are only doing it for just oil and gas. Is that correct?

Mr. KRUEGER. That is correct.

Senator BUNNING. All right.

Let us turn to the deduction for domestic manufacturing. The oil and gas industry is capped at a 6-percent deduction, while other U.S. producers will have a 9-percent deduction next year. Is this policy neutral across industries?

Mr. KRUEGER. That policy is not neutral across industry because——

Senator BUNNING. That is all. Thank you.

Mr. KRUEGER [continuing]. If you compare manufacturing, nonmanufacturing, and so on.

Senator BUNNING. Is the administration proposing to eliminate the manufacturing deduction for all U.S. industries, or just for oil and gas?

Mr. KRUEGER. The administration has asked the commission, chaired by former Federal Reserve Chairman Volcker, to look into these issues to make recommendations.

Senator BUNNING. In other words, it is not.

You described the President's proposal as removing favored treatment, when in fact two of the largest tax increases, percentage depletion and the manufacturing deduction, involve situations where the oil and gas industry is already at a disadvantage compared to similar industries and will be placed at a further disadvantage.

Mr. KRUEGER. I think, if you look at the various estimates of the effective marginal tax rate, that is not so clear. I am not necessarily disputing, I am saying that there are different estimates, and it is not clear that the rates are consistent with them being at a disadvantage.

Senator BUNNING. Mr. Book, some of our witnesses have suggested that the President's proposals will have minimal impact on our supply of energy. You elaborated in some of your testimony on why you think there will be some immediate impact on supply, particularly if LIFO is repealed. If LIFO repeal causes a big tax hit, could the need to raise cash to pay the tax create other problems like less hiring, less capital investment, and even bankruptcy?

Mr. BOOK. Yes. Thank you, Senator.

The question is a very good one, because I think it addresses how companies try to minimize their bleeding in down times. They ultimately have to try to keep producing to pay their debt obligations, so one of the first things they stop doing is investing for the future.

The next thing they try to do is minimize their variable costs, and last, but not least, they shut down if they cannot make it. So the implication is that you actually will probably bring about immediate cessation of reinvestment in future capital projects, then current projects, and then finally in staff and development.

Senator BUNNING. Mr. Nichols, is there a parallel between the oil and gas industry treatment of intangible drilling costs and other extraction industries, such as the mining industry's ability to expense research and development?

Mr. NICHOLS. Yes, not only the mining industry, but all industries' ability to expense research and development. Our exploration wells are all research and development, so there is a perfect analogy there between those.

Senator BUNNING. Secretary Krueger, is the administration's present position that because an industry is not always profitable, it should pay higher taxes?

Mr. KREUGER. Certainly not. The administration's position, as I mentioned, is that they seek a neutral impact of taxes across industries. One thing I would also add, the question you raised about flooding the market with LIFO and FIFO. I would just emphasize that the transition would take place over 8 years.

Senator BUNNING. I understand that. But in the first year you get whacked.

Mr. KREUGER. My projection would be that there be more gradual transition among companies.

Senator BUNNING. My last question is for you also. When did it become the United States' policy to produce less oil and gas domestically?

Mr. KREUGER. Let me clarify, also, what is said in the Green Book, because it was only partially——

Senator BUNNING. No, when did it become policy——

Mr. KREUGER [continuing]. To the extent that expensing encourages over-production of oil and gas.

Senator BUNNING. In particularly, the United States of America, you are talking about?

Mr. KREUGER. To improve energy security, the administration's position is that we should reduce our dependence on oil.

Senator BUNNING. We are 62-percent imported from not very friendly countries right now on oil.

Mr. KREUGER. That is correct.

Senator BUNNING. Petroleum.

Mr. KREUGER. It is a global market for oil, and the best way for us to reduce——

Senator BUNNING. Is to become less independent.

Mr. KREUGER. Or to use less energy.

Senator BUNNING. Is that what you are saying? To use less energy?

Mr. KREUGER. Given our production is a small part of the world supply——

Senator BUNNING. The Chinese would love you. [Laughter.]

I mean, that is—all right. Next?

Senator BINGAMAN. Senator Cornyn?

Senator CORNYN. Thank you, Mr. Chairman. Thanks to all the witnesses for participating in this very, very important hearing.

I want to go first to make the point that the chairman made about its impact in terms of jobs. The oil and gas industry in my State, like New Mexico, although we are a bigger State—we have 312,000 Texans, 3.1 percent of the workforce, who are employed in the oil and gas industry, with total industry wages of $30.6 billion a year, or 6.9 percent of all wages in Texas.

And, fortunately, for a variety of reasons, we have been more fortunate than the rest of the country when it comes to unemployment. The Texas unemployment rate is almost 2 percentage points below the national rate. But I worry about the impact of raising the tax burden on domestic oil and gas production in terms of jobs, which I thought was sort of our main focus in this recessionary economy. And, of course, while many people may have the impression that oil companies are big, multi-national corporations, the fact of the matter is that middle-class American households with mutual fund investments, pension accounts and other personal retirement accounts, and small personal portfolios, are the ones who own the stock in oil and gas companies.

I would like to return, Mr. Secretary, to something that Senator Bunning alluded to, and that was the Green Book's statement. He talked to you about the statement that these subsidies, these tax policies, encourage over-production, but it also says that it is detrimental to long-term energy security. Can you explain why it is not detrimental to our long-term energy security to decrease domestic production and rely more heavily on imported oil?

Mr. KREUGER. Yes. Let me make a couple of observations, first related to the comment you made about jobs.

Senator CORNYN. If you would answer my question first, and then I would be glad to hear your comment.

Mr. KREUGER. Sure.

Senator CORNYN. Thank you.

Mr. KREUGER. Sure.

The administration's goal is to have resources invested in the way which yields the highest social return. In ordinary circumstances, unless there are large externalities from a particular industry, that would imply that the tax code should be neutral.

The administration has proposed the cap-and-trade policy to reduce our energy consumption, which we think is our best way of reducing our reliance on oil and improving our energy security. So, I continue to look at the proposals as a whole, trying to move the country towards a clean energy economy.

Senator CORNYN. Well, these tax provisions would have a negative impact on production of domestic natural gas, would they not, by increasing the financial burden on producing it here in America?

Mr. KREUGER. That is correct. As I mentioned before, our calculations are that the subsidies could increase the cost of production by probably less than 2 percent overall, which could lead to a small reduction in the production of natural gas and oil.

Senator CORNYN. I think Mr. Kleemeier and Mr. Nichols, maybe Mr. Book, might disagree with you, but let us get to that in a minute.

So, what the administration is concerned about is achieving the largest social return?

Mr. KRUEGER. That is correct. What economists call the social return, which takes into account any of the external benefits, and social return does not mean——

Senator CORNYN. So we are not talking about the impact on average Texans, for example, when they go pump gas at their local gas station, or, let us just say, for example, to Senator Bunning's point, our reliance on imported energy comes from some potentially unfriendly nation's, like Iran, for example.

Has your calculation taken into account the possibility that at some future date there might be a conflict in the Middle East that would disrupt imports from countries like Iran, or perhaps Hugo Chávez in Venezuela decides to cut off exports to the United States? Have you calculated that in terms of calculating the largest social return?

Mr. KRUEGER. The answer is yes, we have. First of all, the social return obviously includes Texans and Kentuckians and so on, but right now we are not importing oil from Iran. Iran still influences the world price of oil so, to improve our energy security, the goal is to become less reliant on oil.

Now, if I can just get back to the jobs question.

Senator CORNYN. Let me ask you about Iran. Of course, we are not directly importing oil from Iran, but you indicate oil is a fungible commodity. And so, if you take Iran's oil off the market, will that not have a negative impact on prices for all consumers?

Mr. KREUGER. Absolutely, and that is why we want to reduce energy reliance on oil. That is absolutely right.

Senator CORNYN. I would like to ask just a couple more questions in the time remaining, quickly.

This has to do with the impact on refineries. And, Mr. Book, maybe I will ask you to take a shot at this. The President's proposed repeal of section 199 manufacturing deduction tax credits for income derived from American oil and gas operations, this policy, I believe, disadvantages the domestic refining industry, particularly independent refiners, to their worldwide competitors.

Could you explain your view of the impact this would have on refineries, particularly independent refineries? Do we know whether repealing the section 199 domestic manufacturing deduction will lead to an increase in imported fuel and less domestic investment in refining capacity?

Mr. BOOK. Yes, Senator. I think anything that increases the cost of producing oil products for domestic producers will lead to greater imports, and there are two reasons why. BP publishes data every quarter about what they think that the amount of money you make on a barrel of oil products is above the cost of that barrel of oil. That margin is below $5 for the last quarter on the books. At a carbon tax of $10 per metric ton, a carbon surcharge of $10 per metric ton would eat about half of that money, so half of your margin would go away right there. That would put just about everybody out of business, but the people it would hurt the most are the people with the highest debt obligations to make, and a lot of them are small refiners. Because what they did was strategically smart about 4 years ago. They went and built a lot of high-complexity refining capacity that can break down heavy sour oils they could buy cheap, and now they can sell gasoline that they made from cheaper stuff for the same price as everyone else.

The problem is that, if you turn it around and it is the same price that everyone else is paying for gasoline, so, if your costs now go up, you are still not able to sell it for more money, and where margins are right now and where demand is right now, those are the companies that will go out of business, and then that part of the industry will probably go overseas.

Senator CORNYN. Just so I have this right, if there is less refined product, less supply, same demand, prices are going to go up for our consumer?

Mr. BOOK. Globally, yes, and in all likelihood, the proportion of products that come from imports will also go up.

Senator CORNYN. Thank you, Mr. Chairman.

Senator BINGAMAN. Thank you. Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

Welcome to the committee. I appreciate you folks all testifying.

Mr. Krueger, you referred to the Intergovernmental Panel on Climate Change 2007 synthesis report to claim that the "best estimate is that temperature may increase by more than 7° Fahrenheit in this century." Actually, the report gives six different scenarios, as I view it, and a range of temperature changes for each scenario.

Now, most scientists associated with the IPCC consider the A1B scenario to be the most accurate, and the synthesis report lists the best estimate to be 2.8° Centigrade or just over 5° Fahrenheit. That is a very significant reduction from your 7° Fahrenheit. The table is on page 8 of the synthesis report if anyone wants to actually read it.

So, in other words, by simply taking a better look at the data, I was able to reduce the air's average temperature by 2° over the next century. Now that was easy. I think Americans deserve to know how much the temperature is expected to decline as a result of all the pain we are asking them to bear under a cap-and-trade scenario. The best estimates I have found, which use the assumptions and data from the United Nations scientists, is that Waxman-Markey would reduce the global temperature by somewhere between 0.2° and 0.07°C after 100 years.

Now let me restate that to make sure everybody hears that: the entire U.S. contribution to reducing the global temperature after 100 years, under Waxman-Markey would be between 0.2° and 0.07°. For the moment, let us assume that these benefit projections are accurate. As an economist, do you believe that such an immeasurable benefit is worth the tremendous burden cap-and-trade would place on American consumers?

Mr. KRUEGER. I am glad you threw in "as an economist" at the end, because I was going to start by saying I am not a scientist and I was relying on the IPCC, and I will certainly take another look before I call something the best estimate.

But let me get to your question.

Senator HATCH. All right.

Mr. KREUGER. And I think I made a similar response to a question Senator Bunning asked me at an earlier hearing. I believe it is critical for the rest of the world to follow similar policy or to follow policies of reducing their reliance on energy that produces greenhouse gases——

Senator HATCH. The rest of the world is not doing this.

Mr. KREUGER [continuing]. And, in particular, China and India. And I think it is very important that we work through diplomatic channels to bring that along, and I think us passing the cap-and-trade policy is an important step in bringing the rest of the world along, but it is actually critical, I think, that the rest of the world comes along, and that the U.S. take leadership on this issue.

Senator HATCH. You believe that is a risk worth taking, that we will actually be able to bring India and China along, and that we should do this even though it is going to make us uncompetitive with the rest of the world, environmentally?

Mr. KREUGER. Well, first of all I think we should try to minimize the cost on the U.S. economy, and there are ways of designing a cap-and-trade system which poses less risk for the U.S. economy.

Senator HATCH. We are talking about the one that we are going to have to vote on here in perhaps the next month or so.

Mr. KREUGER. I understand, and I appreciate the good work that the committee and the Congress are doing on this issue. But I think, if one considers the risk on the other side, you know, there are very severe, consequential risks of inaction.

Senator HATCH. Well, it does not appear to me they are that consequential over a 100-year period, compared to the tremendous economic difficulties that we are going to go through as a volunteer Nation, when these other nations are not coming along.

Now, admittedly, your argument is that, if we do it, maybe they will. I do not have nearly the confidence that they will do it that

you do, but even if they do, will the reductions be that significant that we can take the risk?

Mr. KREUGER. Well, I think that is a very important area for us to devote, for the administration and the Congress to devote, effort. I would say on the economic cost, Senator, that, as you know, the CBO estimates are about $170 per household. So, I think it is important to keep the economic costs in perspective as well.

Senator HATCH. But even so, if we should go forward and do this, should we pass this particular bill when you say that we have a lot of studying to do and a lot of work to do to make sure that there are not unfortunate results here.

Mr. KREUGER. I think, Senator, it is very important that the U.S. take leadership on this issue and that the administration remain committed to bringing the rest of the world along——

Senator HATCH. But you just got through admitting that it would be good if we could do some more studies on this to make sure that there is not that big of an impact.

Mr. KREUGER. I am not sure I said more studies; I think I said it is important to design the policy, for the policy to be designed in a way that minimizes economic cost.

Senator HATCH. Well, my question then is, is the policy well-enough designed so that we can actually pass this bill without any worries that it is going to make us uncompetitive with the rest of the world?

Mr. KREUGER. I would be happy to talk to you at length about the climate change proposal the administration has made, the cap-and-trade proposals, and ways of achieving the goal at minimum economic cost. I would be delighted to work with you and your staff and the committee on that.

Senator HATCH. In your testimony, you stated that, in the interest of advancing important policy objectives, including that of "encouraging sustainable domestic oil and gas production," the administration is working with Congress to develop a proposal to impose an excise tax on certain oil and gas extracted offshore in the future.

I want to make sure that this is not a typographical error. Did you actually mean that the administration believes that imposing an excise tax would encourage more domestic oil and gas production? And, if this is the case, why are you not making the argument that all of these tax increases will encourage sustainable domestic oil and gas production? And I wonder if any of our other experts believe that increasing taxes leads to more domestic production?

Mr. KREUGER. The point I was trying to make is that by not favoring oil and gas production, we would be pursuing an energy policy which is less dependent on oil and gas, and that would lead to a more sustainable production of renewable energies.

In the context—I am not exactly sure which part of the testimony you are reciting from, but the administration's approach is a comprehensive energy policy to lead us to a more sustainable path for energy consumption and production.

Senator HATCH. Can I ask one more question, Mr. Chairman?

Senator BINGAMAN. Go right ahead.

Senator HATCH. Well, it seems to me that anybody who looks at the energy situation will realize that all of these other alternatives, compared to oil and gas and coal, are alternatives that we should

be pursuing. I think almost everybody would agree then that, if over the next 10, 15, 20, 30 years, without oil and gas and coal, we are really hurting our future and the futures of our children and our grandchildren because we are not competitive and we cannot keep up the work that we are doing if we do not have the energy to do it. And even for trillions of dollars for developing the alternative forms of energy, but without oil and gas and coal over the next number of years—decades really—we are going to be at a tremendous disadvantage if we make the disincentives to finding and increasing and utilizing those forms of energy.

Mr. KREUGER. I do not think we are proposing a future without oil and gas and coal. I think we are pursing policies to try to have the appropriate investment in those industries and to have a neutral hand with respect to investment and capital across all sectors of the economy.

But, it is certainly the case in the energy industry. Take natural gas, where we have made breakthroughs, and I am sure that other gentlemen on the panel can comment on this with much more expertise than I can. Take logical breakthroughs, which have greatly increased our capacity in our reserves, and also which led to lower prices.

Senator BINGAMAN. Let me just ask one other question here to the witnesses, and that relates to this section 199. The proposal from the administration is to repeal the domestic manufacturing deduction as it relates to oil and gas production, as I understand it.

Let me ask you just to clarify, Mr. Kreuger. Would you also repeal it as it relates to refining of oil and gas products, or just as it relates to production?

Mr. KREUGER. I believe that is the administration proposal.

Senator BINGAMAN. Is to repeal it as it relates to both?

Mr. KREUGER. Yes.

Senator BINGAMAN. Both production and refining?

Mr. KREUGER. Yes.

Senator BINGAMAN. We did have a hearing, I think it was a joint hearing between the Commerce Committee and this committee—no it was the Commerce Committee and the Energy Committee, excuse me, back in 2005. This provision, this section 199, just became part of our law in 2004, as I understand it. And prior to that, there was no deduction of this type for the industry.

In 2005, we had a hearing of the two committees, and we had there the CEOs of the large integrated companies: Exxon, Mobil, BP, Shell, Chevron, Texaco, and ConocoPhillips. They all stated, I think, in answer to a question about whether they agreed with President Bush that tax incentives like this were not needed in order to encourage production, and they said that in their view they were not, at least that is my recollection of what they said. At that time, the price of oil was about $55 a barrel.

How do we square that? If my recollection is correct about that testimony, how do we square that testimony with what we are hearing today from industry witnesses about the importance of maintaining this manufacturing deduction?

Mr. NICHOLS. Well, Senator, I cannot comment on their testimony, because I was not there and do not know what it was. But

if you look at the overall intent that the Congress had in section 199, it was to effectively reduce the tax rate on U.S. companies that are in competitive positions with regard to foreign competition.

Senator BINGAMAN. But it was to promote export, right? I think that was the general idea.

Mr. NICHOLS. That was originally the intent, but it has been expanded dramatically for a lot of industries—the advertising industry, construction industry, even a sports franchise, things that have nothing to do with export.

Senator BINGAMAN. Yes, and I think there is a real question as to whether it should have been expanded that broadly, and whether we should either pare it back or reconsider it. What is your thought, particularly as it relates to oil and gas?

Mr. NICHOLS. Well, if you forget the history and just look at where we are from a competitive standpoint, oil and natural gas that are produced domestically in a more secure and a more environmentally sensitive way are in competition with foreign oil, whether we are importing or exporting. We import a lot of our oil. If it costs more to produce oil or refined gasoline in this country, then those jobs and that wealth will just get transferred outside this country. We will not be competitive, and the effective tax rate is, of course, a part of the cost that goes into that.

The same thing is true with natural gas. Increasingly natural gas is just not a domestic or North American market, it is a worldwide market. And the price is not as worldwide as with oil, but nevertheless, we are competitive. If it is more cost-effective for a utility to import foreign-produced natural gas, it will do so. And the tax rate that we have to bear is one of the burdens that our country has with higher effective tax rates than are in most of the rest of the world.

Senator BINGAMAN. Do you have any comment on that, Mr. Kreuger?

Mr. KREUGER. Just return to what I said earlier about seeking to make the tax code more neutral with respect to investment across different sectors and try to remove this distortion. I think the point that you raised is a very good one about the evolution of this credit. I mentioned earlier that the Volcker Commission subcommittee, chaired by Martin Feldstein, is looking into other sectors, and we are looking forward to their recommendations on simplifying and reducing other subsidies in the tax code.

Senator BINGAMAN. Well, I think, just as a matter of common sense, it is easier to explain and understand why a manufacturing deduction would apply to the refining of petroleum products than it is to why it would apply to the production, and I understand we have stuck a lot of other things in that benefit from this section 199 tax deduction as well that do not, under any normal understanding of the English language, qualify as manufacturing. But, I do think it makes sense to at least consider whether we ought to be having a manufacturing deduction that applies to so much that is so unrelated to manufacturing.

We have a vote that has started on the Senate floor. Unless Senator Bunning or Senator Hatch has another burning question, let me thank all of the witnesses very much. It has been useful testi-

mony. We appreciate your being here, and we will take your good advice to heart.

Thank you. We stand adjourned.

[Whereupon, at 3:47 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Statement of Chairman Jeff Bingaman

Senate Finance Subcommittee on Energy, Natural Resources, and Infrastructure

September 10, 2009

"Oil and Gas Tax Provisions: A Consideration of the President's FY 2010 Budget Proposal"

Good afternoon. In the Budget Proposal he sent Congress in February, President Obama called for significant changes beginning in 2011 to the taxation of domestic oil and gas activities. Taken together, the proposed changes would raise $31.5 billion over 10 years.

Some elements of the President's proposal are already familiar to the Senate Finance Committee, as we considered them at length in the last Congress: first, imposing an excise tax on production in the outer continental shelf, and second, disallowing the Section 199 domestic manufacturing deduction for the largest integrated producers. There was broad bipartisan support on the Finance Committee for those proposals in the last Congress. The proposals were included in comprehensive energy tax legislation that the Committee reported, but which failed by one vote to achieve cloture on the Senate floor. I continue to believe those proposals have merit. But the President's Budget Proposal would go further, in that it would disallow the Section 199 deduction for *all* oil and gas producers, not just the largest integrated firms. I have concerns about that expansion, and believe it will require careful study. I also understand that the Administration is refining the OCS excise tax proposal, and I look forward to working with them in doing so.

In addition, the President's Budget Proposal newly places on the table several tax preferences that have been embedded in our Tax Code for decades and, in some cases, nearly a century. In revenue terms, the most significant among those proposals are those to:

(1) disallow expensing of intangible drilling costs, or IDCs, and instead require that those costs be capitalized;
(2) prohibit percentage depletion for oil and natural gas firms, and instead require use of the cost depletion method; and
(3) increase the period over which independent producers amortize geological and geophysical, or G&G, costs, from two years to seven years.

"IDCs" and "G&G costs" are part of industry's everyday vernacular. But quite frankly, few in Congress have deep familiarity with these concepts. I believe it is important, therefore, for this Subcommittee to carefully study the tax provisions at issue, and to hear, not only from the Administration, but also from industry and independent analysts. I am very pleased, therefore, to have with us today a panel of six distinguished witnesses, and I appreciate the benefit of their views.

Before turning to their testimony, I would like to offer several observations.

Today's panel will walk through elements of the President's proposal. In addition, the non-partisan staff of the Joint Committee on Taxation has prepared a descriptive pamphlet for today's hearing. I thank the JCT staff for their characteristically thorough work, and I direct that the JCT pamphlet be made a part of this hearing's record.

As we evaluate each proposal, I believe Congress should look through three critical lenses.

First, we must ask whether the proposal would cause more than a negligible increase in consumer prices. Last year, gasoline prices increased to over $4 per gallon. After a significant falloff, prices have again ticked upwards. We must consider what impact, if any, modifying the tax treatment of oil and gas activities would have for the nation's consumers, keeping in mind that prices are set in a world marketplace.

Second, we must ask whether the proposal would decrease domestic production. As a nation, we are on course to make significant short- and long-term investments to lessen our dependence on fossil fuels. But we must remain realistic, and acknowledge that fossil fuels continue to play an important role in our nation's economy. The United States has become increasingly reliant on imported petroleum, and we now rely on overseas oil for nearly three-fifths of our petroleum. Congress must be cautious in enacting any policy, in the tax code or elsewhere, that could increase foreign oil's share.

Third, we must ask whether the proposal would impact local economies or cause job losses. For example, the oil and gas industry employs more than 23,000 people in New Mexico, and oil and natural gas production annually contributes $1.2 billion to New Mexico's economy. State taxes on oil and gas production contribute approximately 20% of my state's general fund, and royalties from production on New Mexico state trust lands have provided 95% of the revenues to our state's Land Permanent Fund, which supports education and health care across New Mexico. I would be very concerned by any tax law change that impacts economies in oil and gas producing regions, like New Mexico's San Juan and Permian basins.

I look forward to exploring these issues with our distinguished panel.

OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF THE PRESIDENT'S FISCAL YEAR 2010 BUDGET PROPOSAL

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES,
AND INFRASTRUCTURE
of the
SENATE COMMITTEE ON FINANCE
on September 10, 2009

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

September 9, 2009
JCX-34-09

CONTENTS

INTRODUCTION

The Subcommittee on Energy, Natural Resources, and Infrastructure of the Senate Committee on Finance has scheduled a public hearing on September 10, 2009. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description and analysis of the Administration's fiscal year 2010 revenue proposals affecting oil and gas production.

[1] This document may be cited as follows: Joint Committee on Taxation, *Oil and Gas Tax Provisions: A Consideration of the President's Fiscal Year 2010 Budget Proposal,* (JCX-34-09) September 9, 2009. This document can also be found on our website at www.jct.gov.

I. OIL AND GAS PRODUCTION PROPOSALS

A. Levy Tax on Certain Offshore Oil and Gas Production

Present Law

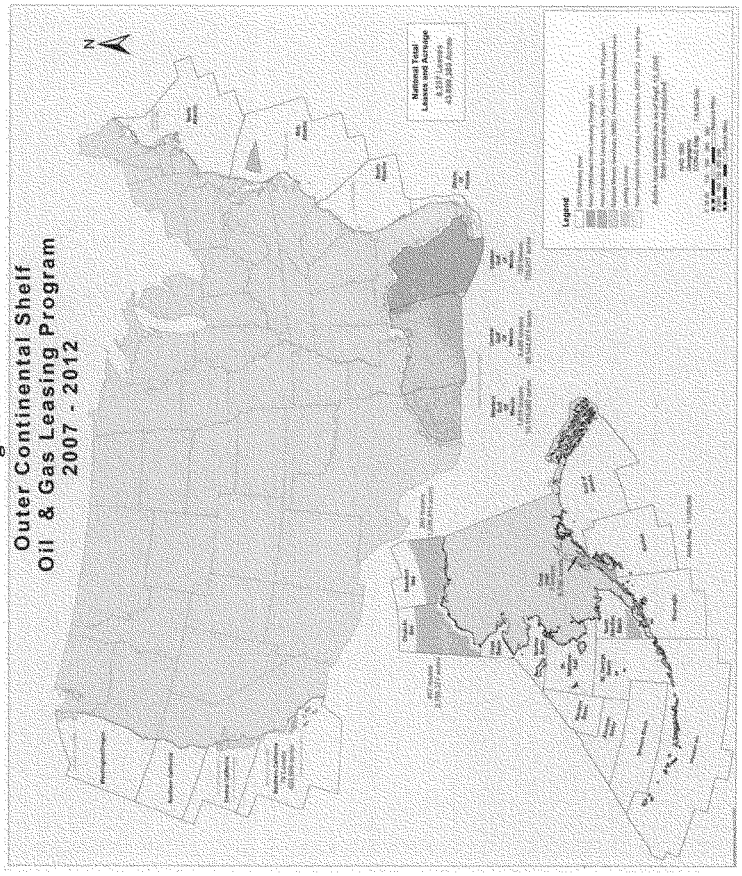
Under present law, there is no Federal severance tax on oil and gas produced on the Outer Continental Shelf ("OCS"). The Department of the Interior estimates reserves of OCS inventory at 8.5 billion barrels of oil and 29.3 trillion cubic feet of natural gas. Approximately another 86 billion barrels of oil and 420 trillion cubic feet of natural gas are classified as undiscovered resources.[2]

The United States leases Federal lands containing oil and gas deposits in offshore or submerged lands under the Outer Continental Shelf Lands Act of 1953, as amended.[3] Revenues are returned to the Federal government in the form of bonus bids (discussed below), rents, and royalties. The offshore leasing program is administered by the Minerals Management Service ("MMS") within the Department of the Interior. Figure 1 is a map of the OCS oil and gas leasing program.

[2] Department of Interior, *Report to the Secretary: Survey of Available Data of OCS Resources and Identification of Data Gaps* (2009) p. 5.

[3] 43 U.S.C. sec. 1331 et seq.

Figure 1



Source: Minerals Management Service, U.S. Department of the Interior.

Leases are awarded to the highest bidder in a competitive, sealed bidding process. Successful bidders make an up-front cash payment, called a "bonus bid," to secure a lease. In addition to the bonus bid, generally a royalty rate of 12.5 percent or 16.7 percent is imposed on the value of production, depending on location factors, or the royalty received in kind. The royalty rate could be higher than 16.7 percent depending on the lease sale. According to the Congressional Research Service, MMS officials have indicated that a royalty rate of 18.75 percent is likely for future lease sales.

The Outer Continental Shelf Deep Water Royalty Relief Act (the "DWRRA") authorized MMS to provide royalty relief on oil and gas produced in the deep waters of the Gulf of Mexico from certain leases issued from 1996 through 2000. Royalty relief waives or reduces the amount of royalties that companies would otherwise be obligated to pay on the initial volumes of production from leases ("suspension volumes").

In implementing the DWRRA for leases sold in 1996, 1997 and 2000, MMS specified that royalty relief would be applicable only if oil and gas prices were below certain prices thresholds. MMS did not include these price thresholds for leases issued in 1998 and 1999.

Kerr-McGee Corporation ("Kerr McGee," now owned by Anadarko Petroleum Corporation) filed suit challenging the government's authority to include price thresholds in DWRRA leases issued from 1996-2000. The district court for the Western District of Louisiana ruled in favor of Kerr-McGee. It held that the DWRRA suspended the payment of royalties on amounts severed up to certain specified production volume thresholds and the Department of the Interior could not collect royalties when the volume thresholds had not yet been met. Thus, because the statute specified that certain amounts are to be royalty free, the Department of Interior had no authority to collect royalties, regardless of whether the price threshold had been exceeded. On January 12, 2009, the Court of Appeals for the Fifth Circuit affirmed the district court's ruling.[4]

With respect to the 1998 and 1999 leases (with no price thresholds), the Government Accountability Office ("GAO") has estimated that the Federal government could lose royalties between $4.3 billion and $14.7 billion.[5] In light of the Kerr-McGee ruling, with respect to the 1996, 1997, and 2000 leases, the GAO asserts that the Federal government may have to refund over $1.13 billion in royalties already collected and forgo additional royalty revenues on future production from these leases. The GAO estimates additional forgone royalties between $21 billion and $53 billion.[6]

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[4] *Kerr-McGee Oil and Gas Corp. v. United States Department of Interior*, 554 F.3d 1082 (5th Cir. 2009).

[5] Government Accountability Office, GAO 08-792R, *Oil and Gas: Litigation over Royalty Relief Could Cost the Federal Government Billions of Dollars* (June 5, 2008) p. 3.

[6] *Ibid.* p. 4.

Description of Proposal

The Administration does not have a proposal at this time. The Administration is developing a proposal to impose an excise tax on certain oil and gas produced offshore in the future and indicates that the Administration will work with Congress to develop the details of this proposal.

Analysis

At this time, the Administration does not have a proposal to analyze.

B. Repeal Existing Oil and Gas Preferences

Present Law

In general

The Code provides a number of tax incentives that increase the after-tax return on investment in domestic oil and gas production projects. These incentives include the enhanced oil recovery credit, the marginal wells credit, the expensing of intangible drilling costs, the deduction for using tertiary injectants, the passive loss exemption for working interests in oil and gas properties, percentage depletion, the domestic manufacturing deduction for oil and gas production, and accelerated amortization for geological and geophysical expenses.

Some of these incentives are available to all domestic producers and all domestic production, while others target smaller producers or production that utilizes specific types of extractive technologies. Some of the incentives are not available (or are only partially available) to oil and gas producers whose production activities are integrated with refining and retail sales activities and one[7] is further restricted in the case of major integrated oil companies.[8]

Credit for enhanced oil recovery costs (sec. 43)

Taxpayers may claim a credit equal to 15 percent of qualified enhanced oil recovery ("EOR") costs.[9] Qualified EOR costs consist of the following designated expenses associated with an EOR project: (1) amounts paid for depreciable tangible property; (2) intangible drilling and development expenses; (3) tertiary injectant expenses; and (4) construction costs for certain Alaskan natural gas treatment facilities. An EOR project is generally a project that involves increasing the amount of recoverable domestic crude oil through the use of one or more tertiary recovery methods (as defined in section 193(b)(3)), such as injecting steam or carbon dioxide into a well to effect oil displacement.

The EOR credit is ratably reduced over a $6 phase-out range when the reference price for domestic crude oil exceeds $28 per barrel (adjusted for inflation after 1991; $42.01 per barrel for 2009). The reference price is determined based on the annual average price of domestic crude oil

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[7] See sec. 167(h) (relating to the amortization of geological and geophysical expenditures, discussed *infra*). Unless otherwise provided, all section references are to the Internal Revenue Code of 1986, as amended.

[8] Integrated oil companies subject to these limitations are oil and gas producers that sell more than $5 million of retail product per year or refine more than 75,000 barrels of oil per year. Major integrated oil companies are a subset of integrated oil companies that (1) have average daily worldwide production exceeding 500,000 barrels per year, (2) had gross receipts in excess of $1 billion in 2005, and (3) own at least a 15 percent interest in a refinery that produces more than 75,000 barrels of oil per year.

[9] Sec. 43.

for the calendar year preceding the calendar year in which the taxable year begins.[10] The EOR credit is currently phased out.

Taxpayers claiming the EOR credit must reduce by the amount of the credit any otherwise allowable deductions associated with EOR costs. In addition, to the extent a property's basis would otherwise be increased by any EOR costs, such basis is reduced by the amount of the EOR credit.

Marginal well tax credit (sec. 45I)

The Code provides a $3-per-barrel credit (adjusted for inflation) for the production of crude oil and a $0.50-per-1,000-cubic-feet credit (also adjusted for inflation) for the production of qualified natural gas. In both cases, the credit is available only for domestic production from a "qualified marginal well."

A qualified marginal well is defined as a domestic well: (1) production from which is treated as marginal production for purposes of the Code percentage depletion rules; or (2) that during the taxable year had average daily production of not more than 25 barrel equivalents and produces water at a rate of not less than 95 percent of total well effluent. The maximum amount of production for a taxable year on which a credit may be claimed is 1,095 barrels or barrel equivalents.

The credit is not available if the reference price of oil exceeds $18 ($2.00 for natural gas). The credit is reduced proportionately for reference prices between $15 and $18 ($1.67 and $2.00 for natural gas). Currently the credit is phased out completely.

In the case of production from a qualified marginal well which is eligible for the credit allowed under section 45K for the taxable year, no marginal well credit is allowable unless the taxpayer elects not to claim the credit under section 45K with respect to the well. The section 45K credit is currently expired with respect to qualified natural gas and oil production. The credit is treated as a general business credit. Unused credits can be carried back for up to five years rather than the generally applicable carryback period of one year.

Expensing of intangible drilling costs (sec. 263(c))

The Code provides special rules for the treatment of intangible drilling and development costs ("IDCs"). Under these special rules, an operator or working interest owner[11] that pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs.[12]

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[10] Secs. 43(b) and 45K(d)(2)(C).

[11] An operator or working interest owner is defined as a person that holds an operating or working interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting operating or working rights.

[12] Sec. 263(c).

IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work done by contractors under any form of contract, including a turnkey contract. Such work includes labor, fuel, repairs, hauling, and supplies which are used (1) in the drilling, shooting, and cleaning of wells; (2) in the clearing of ground, draining, road making, surveying, and geological works as necessary in preparation for the drilling of wells; and (3) in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items that have a salvage value (such as pipes and casings) or items that are part of the acquisition price of an interest in the property.[13] They also do not include (1) the cost to operators payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and (2) amounts properly allocable to the cost of depreciable property.

If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. Generally, if IDCs are not expensed, but are capitalized, they may be recovered through depletion or depreciation, as appropriate. In the case of a nonproductive well ("dry hole"), IDCs may be deducted at the election of the operator.[14] For an integrated oil company that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.[15]

Notwithstanding the fact that a taxpayer has made the election to deduct IDCs, the Code provides an additional election under which the taxpayer is allowed to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred.[16] This election applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. The election allows a taxpayer to reduce or eliminate the IDC adjustments or preferences under the alternative minimum tax ("AMT").

The election to deduct IDCs applies only to those IDCs associated with domestic properties.[17] For this purpose, the United States includes certain wells drilled offshore.[18]

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[13] Treas. Reg. sec. 1.612-4(a).

[14] Treas. Reg. sec. 1.612-4(b)(4).

[15] Sec. 291(b)(1)(A). The IRS has ruled that, if a company that has capitalized and begun to amortize IDCs over a 60-month period pursuant to section 291 ceases to be an integrated oil company, it may not immediately write off the unamortized portion of the capitalized IDCs, but instead must continue to amortize the IDCs so capitalized over the 60-month amortization period. Rev. Rul. 93-26, 1993-1 C.B. 50.

[16] Sec. 59(e)(1).

[17] In the case of IDCs paid or incurred with respect to an oil or gas well located outside of the United States, the costs, at the election of the taxpayer, are either (1) included in adjusted basis for purposes of computing

Pursuant to a special exception, the uniform capitalization rules do not apply to IDCs incurred with respect to oil or gas wells that are otherwise deductible under the Code.[19]

Deduction for qualified tertiary injectant expenses (sec. 193)

Taxpayers engaged in petroleum extraction activities may generally deduct qualified tertiary injectant expenses used while applying a tertiary recovery method, including carbon dioxide augmented waterflooding and immiscible carbon dioxide displacement.[20] The deduction is available even if such costs are otherwise subject to capitalization. The deduction is permitted for the later of—(1) the tax year in which the injectant is injected or (2) the tax year in which the expenses are paid or incurred.[21] No deduction is permitted for expenditures for which a taxpayer has elected to deduct such costs under section 263(c) (intangible drilling costs) or if a deduction is allowed for such amounts under any other income tax provision.[22]

A "qualified tertiary injectant expense" is defined as any cost paid or incurred for any tertiary injectant (other than a recoverable hydrocarbon injectant) which is used as part of a tertiary recovery method.[23] The cost of a recoverable hydrocarbon injectant (which includes natural gas, crude oil and any other injectant with more than an insignificant amount of natural gas or crude oil) is not a qualified tertiary injectant expense unless the amount of the recoverable hydrocarbon injectant in the qualified tertiary injectant is insignificant.[24]

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the amount of any deduction allowable for cost depletion or (2) capitalized and amortized ratably over a 10-year period beginning with the taxable year such costs were paid or incurred (sec. 263(i)).

[18] The term "United States" for this purpose includes the seabed and subsoil of those submarine areas that are adjacent to the territorial waters of the United States and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources (i.e., the Continental Shelf area) (sec. 638).

[19] Sec. 263A(c)(3).

[20] Sec. 193. Prior to the enactment of section 193, the income tax treatment of tertiary injectant costs was unclear. In enacting section 193, Congress sought to clarify the tax treatment and encourage the use of qualified tertiary injectants. See e.g., Joint Committee on Taxation, *General Explanation of the Crude Oil Windfall Profit Tax Act of 1980* (JCS-1-81), at 114-115.

[21] Treas. Reg. sec. 1.193-1.

[22] Sec. 193(c).

[23] Sec. 193(b). A tertiary recovery method is any of the nine methods described in section 212.78(c)(1) - (9) of the June 1979 energy regulations, as defined in former section 4996(b)(8)(C), or any other method approved by the IRS.

[24] Sec. 193(b)(2). Treas. Reg. sec. 1.193-1(c)(3) provides that an injectant contains more than an insignificant amount of recoverable hydrocarbons if the fair market value of the recoverable hydrocarbon component of the injectant, in the form in which it is recovered, equals or exceeds 25 percent of the cost of the injectant.

Exception from passive loss rules for working interests in oil and gas property (sec. 469)

The passive loss rules limit deductions and credits from passive trade or business activities.[25] A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[26] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person.

Losses from certain working interests in oil and gas property are not limited under the passive loss rule.[27] Thus, losses and credits from such interests can be used to offset other income of the taxpayer without limitation under the passive loss rule. Specifically, a passive activity does not include a working interest in any oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest. This rule applies without regard to whether the taxpayer materially participates in the activity. If the taxpayer has a loss from a working interest in any oil or gas property that is treated as not from a passive activity, then net income from the property for any succeeding taxable year is treated as income of the taxpayer that is not from a passive activity.

In general, a working interest is an interest with respect to an oil and gas property that is burdened with the cost of development and operation of the property. Rights to overriding royalties, production payments, and the like, do not constitute working interests, because they are not burdened with the responsibility to share expenses of drilling, completing, or operating oil and gas property. Similarly, contract rights to extract or share in oil and gas, or in profits from extraction, without liability to share in the costs of production, do not constitute working interests. Income from such interests generally is considered to be portfolio income.

When the taxpayer's form of ownership limits the liability of the taxpayer, the interest possessed by such taxpayer is not a working interest for purposes of the passive loss provision. Thus, for purposes of the passive loss rules, an interest owned by a limited partnership is not treated as a working interest with regard to any limited partner, and an interest owned by an S corporation is not treated as a working interest with regard to any shareholder. The same result follows with respect to any form of ownership that is substantially equivalent in its effect on liability to a limited partnership interest or interest in an S corporation, even if different in form.

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[25] Sec. 469. These rules were enacted in 1986 to curtail tax shelters. They apply to individuals, estates and trusts, and closely held corporations.

[26] Regulations provide more detailed standards for material participation. See Treas. Reg. secs. 1.469-5 and -5T.

[27] Sec. 469(c)(3). See also Treas. Reg. sec. 1.469-1T(e)(4).

When an interest is not treated as a working interest because the taxpayer's form of ownership limits his liability, the general rules regarding material participation apply to determine whether the interest is treated as a passive activity. Thus, for example, a limited partner's interest generally is treated as in a passive activity. In the case of a shareholder in an S corporation, the general facts and circumstances test for material participation applies and the working interest exception does not apply, because the form of ownership limits the taxpayer's liability.

A special rule applies in any case where, for a prior taxable year, net losses from a working interest in a property were treated by the taxpayer as not from a passive activity. In such a case, any net income realized by the taxpayer from the property (or from any substituted basis property, e.g., property acquired in a sec. 1031 like kind exchange for such property) in a subsequent year also is treated as active. Under this rule, for example, if a taxpayer claims losses for a year with regard to a working interest and then, after the property to which the interest relates begins to generate net income, transfers the interest to an S corporation in which he is a shareholder, or to a partnership in which he has an interest as a limited partner, his interest with regard to the property continues to be treated as not passive.

Percentage depletion for oil and natural gas (secs. 613 and 613A)

In general

Depletion, like depreciation, is a form of capital cost recovery. In both cases, the taxpayer is allowed a deduction in recognition of the fact that an asset is being expended to produce income.[28] Certain costs incurred prior to drilling an oil or gas property or extracting minerals are recovered through the depletion deduction. These include the cost of acquiring the lease or other interest in the property.

Depletion is available to any person having an economic interest in a producing property. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in minerals in place, and secures, by any form of legal relationship, income derived from the extraction of the mineral, to which it must look for a return of its capital. Thus, for example, both working interests and royalty interests in an oil- or gas-producing property constitute economic interests, thereby qualifying the interest holders for depletion deductions with respect to the property. A taxpayer who has no capital investment in the mineral deposit, however, does not acquire an economic interest merely by possessing an economic or pecuniary advantage derived from production through a contractual relation.

Two methods of depletion are currently allowable under the Code: (1) the cost depletion method, and (2) the percentage depletion method.[29] Under the cost depletion method, the

[28] In the context of mineral extraction, depreciable assets are generally used to recover depletable assets. For example, natural gas gathering lines, used to collect and deliver natural gas, have a class life of 14 years and a depreciation recovery period of seven years.

[29] Secs. 611- 613A.

taxpayer deducts that portion of the adjusted basis of the depletable property which is equal to the ratio of units sold from that property during the taxable year to the number of units remaining as of the end of taxable year plus the number of units sold during the taxable year. Thus, the amount recovered under cost depletion may never exceed the taxpayer's basis in the property.

A taxpayer is required to determine the depletion deduction for each property under both the percentage depletion method (if the taxpayer is entitled to use this method) and the cost depletion method. The taxpayer must use whichever method produces the larger deduction for any taxable year.[30]

In the case of domestic oil and gas wells, independent producers and royalty owners generally are allowed a deduction under the percentage depletion method of 15 percent of the gross income from the property. The deduction may not exceed the net income from the oil and gas property in any year (the "net-income limitation").[31] Additionally, the percentage depletion deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income for the year (determined before such deduction and adjusted for certain loss carrybacks and trust distributions).[32]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[33] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated;[34] each group is then treated as one producer in applying the 1,000-barrel limitation.

Because percentage depletion, unlike cost depletion, is computed without regard to the taxpayer's basis in the depletable property, cumulative depletion deductions for any property may be greater than the amount expended by the taxpayer to acquire and develop the property.[35]

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[30] Sec. 613(a).

[31] Sec. 613(a). For marginal production, discussed *infra*, this limitation is suspended for taxable years beginning in 2009.

[32] Sec. 613A(d)(1).

[33] Sec. 613A(c).

[34] Sec. 613A(c)(8).

[35] In the case of iron ore and coal (including lignite), a corporate preference reduces the amount of percentage depletion calculated by 20 percent of the amount of percentage depletion in excess of the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year). Sec. 291(a)(2).

Limitation on oil and gas percentage depletion to independent producers and royalty owners

As stated above, percentage depletion of oil and gas properties generally is not permitted to persons other than independent producers and royalty owners. For purposes of the percentage depletion allowance, an independent producer is any producer that is not a "retailer" or "refiner." A retailer is any person that directly, or through a related person, sells oil or natural gas (or a derivative thereof): (1) through any retail outlet operated by the taxpayer or related person, or (2) to any person that is obligated to market or distribute such oil or natural gas (or a derivative thereof) under the name of the taxpayer or the related person, or that has the authority to occupy any retail outlet owned by the taxpayer or a related person.[36]

Bulk sales of crude oil and natural gas to commercial or industrial users, and bulk sales of aviation fuel to the Department of Defense, are not treated as retail sales. Further, if the combined gross receipts of the taxpayer and all related persons from the retail sale of oil, natural gas, or any product derived therefrom do not exceed $5 million for the taxable year, the taxpayer will not be treated as a retailer.

A refiner is any person that directly or through a related person engages in the refining of crude oil in excess of an average daily refinery run of 75,000 barrels during the taxable year.[37]

Percentage depletion for eligible taxpayers is allowed for up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas.[38] For producers of both oil and natural gas, this limitation applies on a combined basis. All production owned by businesses under common control and members of the same family must be aggregated;[39] each group is then treated as one producer in applying the 1,000-barrel limitation.

Percentage depletion on marginal production

In the case of oil and gas production from so-called marginal properties held by independent producers or royalty owners,[40] the statutory percentage depletion rate 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 increased rate applies for the taxpayer's taxable year that immediately follows a calendar year for which the average crude oil price falls below the $20 floor. Because the price of oil

[36] Sec. 613A(d)(2).

[37] Sec. 613A(d)(4).

[38] Sec. 613A(c).

[39] Sec. 613A(c)(8).

[40] Sec. 613A(c)(6).

currently is above the $20 floor, there is no increase in the statutory depletion rate for marginal production.

The Code defines the term "marginal production" for this purpose as 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).[41] A stripper well property is any oil or gas property that produces a daily average of 15 or fewer 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.[42]

The determination of whether a property qualifies as a stripper well property is made separately for each calendar year. The fact that a property is or is not a stripper well property for one year does not affect the determination of the status of that property for a subsequent year. Further, a taxpayer makes the stripper well property determination for each separate property interest (as defined under section 614) held by the taxpayer during a calendar year. The determination is based on the total amount of production from all producing wells that are treated as part of the same property interest of the taxpayer. A property qualifies as a stripper well property for a calendar year only if the wells on such property were producing during that period at their maximum efficient rate of flow.

If a taxpayer's property consists of a partial interest in one or more oil- or gas-producing wells, the determination of whether the property is a stripper well property or a heavy oil property is made with respect to total production from such wells, including the portion of total production attributable to ownership interests other than the taxpayer's interest. If the property satisfies the requirements of a stripper well property, then the benefits of this provision apply with respect to the taxpayer's allocable share of the production from the property. The deduction is allowed for the taxable year that begins during the calendar year in which the property so qualifies.

The allowance for percentage depletion on production from marginal oil and gas properties is subject to the 1,000-barrel-per-day limitation discussed above. Unless a taxpayer elects otherwise, marginal production is given priority over other production for purposes of utilization of that limitation.

Deduction for income attributable to domestic production of oil and gas (sec. 199)

Section 199 of the Code provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to a portion of the lesser of a taxpayer's taxable

[41] Sec. 613A(c)(6)(D).

[42] Sec. 613A(c)(6)(E).

income or its qualified production activities income.[43] For taxable years beginning after 2009, the deduction is nine percent of such income. For taxable years beginning in 2005 and 2006, the deduction was three percent and, for taxable years beginning in 2007, 2008 and 2009, the deduction is six percent. With respect to a taxpayer that has oil related qualified production activities income for taxable years beginning after 2009, the deduction is limited to six percent of the least of its oil related production activities income, its qualified production activities income, or its taxable income.[44]

A taxpayer's deduction under section 199 for a taxable year may not exceed 50 percent of the wages properly allocable to domestic production gross receipts paid by the taxpayer during the calendar year that ends in such taxable year.[45]

Qualified production activities income

In general, "qualified production activities income" is equal to domestic production gross receipts (defined by section 199(c)(4)), reduced by the sum of: (1) the costs of goods sold that are allocable to such receipts; (2) other expenses, losses, or deductions which are properly allocable to such receipts.

Domestic production gross receipts

"Domestic production gross receipts" generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange or other disposition, or any lease, rental or license, of

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[43] In the case of an individual, the deduction is equal to a portion of the lesser of the taxpayer's adjusted gross income or its qualified production activities income. For this purposes, adjusted gross income is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the section 199 deduction.

[44] "Oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas or any primary product thereof (as defined in section 927(a)(2)(C) prior to its repeal). Treas. Reg. sec. 1.927(a)-1T(g)(2)(i) defines the term "primary product from oil" to mean crude oil and all products derived from the destructive distillation of crude oil, including volatile products, light oils such as motor fuel and kerosene, distillates such as naphtha, lubricating oils, greases and waxes, and residues such as fuel oil. Additionally, a product or commodity derived from shale oil which would be a primary product from oil if derived from crude oil is considered a primary product from oil. Treas. Reg. sec. 1.927(a)-1T(g)(2)(ii) defines the term "primary product from gas" as all gas and associated hydrocarbon components from gas wells or oil wells, whether recovered at the lease or upon further processing, including natural gas, condensates, liquefied petroleum gases such as ethane, propane, and butane, and liquid products such as natural gasoline. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iii) provides that these primary products and processes are not intended to represent either the only primary products from oil or gas or the only processes from which primary products may be derived under existing and future technologies. Treas. Reg. sec. 1.927(a)-1T(g)(2)(iv) provides as examples of non-primary oil and gas products petrochemicals, medicinal products, insecticides, and alcohols.

[45] For purposes of the provision, "wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A).

qualifying production property ("QPP") that was manufactured, produced, grown or extracted ("MPGE") by the taxpayer in whole or in significant part within the United States;[46] (2) any sale, exchange or other disposition, or any lease, rental or license, of qualified film produced by the taxpayer; (3) any sale, exchange or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction activities performed in the United States;[47] or (5) engineering or architectural services performed in the United States with respect to the construction of real property in the United States.

Drilling oil or gas wells

The Treasury regulations provide that qualifying construction activities performed in the United States include activities relating to drilling an oil or gas well.[48] Under the regulations, activities the cost of which are intangible drilling and development costs within the meaning of Treas. Reg. sec. 1.612-4 are considered to be activities constituting construction for purposes of determining domestic production gross receipts.[49]

Qualifying in-kind partnerships

In general, an owner of a pass-through entity is not treated as conducting the qualified production activities of the pass-thru entity, and vice versa. However, the Treasury regulations provide a special rule for "qualifying in-kind partnerships," which are defined as partnerships engaged solely in the extraction, refining, or processing of oil, natural gas, petrochemicals, or products derived from oil, natural gas, or petrochemicals in whole or in significant part within the United States, or the production or generation of electricity in the United States.[50] In the case of a qualifying in-kind partnership, each partner is treated as having MPGE the property MPGE or produced by the partnership that is distributed to that partner.[51] If a partner of a qualifying in-kind partnership derives gross receipts from the lease, rental, license, sale, exchange, or other disposition of the property that was MPGE by the qualifying in-kind partnership, then, provided such partner is a partner of the qualifying in-kind partnership at the time the partner disposes of

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[46] Domestic production gross receipts include gross receipts of a taxpayer derived from any sale, exchange or other disposition of agricultural products with respect to which the taxpayer performs storage, handling or other processing activities (other than transportation activities) within the United States, provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth or extraction of qualifying production property (whether or not by the taxpayer).

[47] For this purpose, construction activities include activities that are directly related to the erection or substantial renovation of residential and commercial buildings and infrastructure. Substantial renovation would include structural improvements, but not mere cosmetic changes, such as painting, that is not performed in connection with activities that otherwise constitute substantial renovation.

[48] Treas. Reg. sec. 1.199-3(m)(1)(i).

[49] Treas. Reg. sec. 1.199-3(m)(2)(iii).

[50] Treas. Reg. sec. 1.199-9(i)(2).

[51] Treas. Reg. sec. 1.199-9(i)(1).

the property, the partner is treated as conducting the MPGE activities previously conducted by the qualifying in-kind partnership with respect to that property.[52]

Alternative minimum tax

The deduction for domestic production activities is allowed for purposes of computing AMTI (including adjusted current earnings). The deduction in computing AMTI is determined by reference to the lesser of the qualified production activities income (as determined for the regular tax) or the AMTI (in the case of an individual, adjusted gross income as determined for the regular tax) without regard to this deduction.

Amortization period for geological and geophysical costs (sec. 167(h))

Geological and geophysical expenditures ("G&G costs") are costs incurred by a taxpayer for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties by taxpayers exploring for minerals.[53] G&G costs incurred by independent producers and smaller integrated oil companies in connection with oil and gas exploration in the United States may generally be amortized over two years.[54]

Major integrated oil companies are required to amortize all G&G costs over seven years for costs paid or incurred after December 19, 2007 (the date of enactment of the Energy Independence and Security Act of 2007).[55] A major integrated oil company, as defined in section 167(h)(5)(B), is an integrated oil company[56] which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year, had gross receipts in excess of one billion dollars for its last taxable year ending during the calendar year 2005, and generally has an ownership interest in a crude oil refiner of 15 percent or more.

In the case of abandoned property, remaining basis may not be recovered in the year of abandonment of a property, but instead must continue to be amortized over the remaining applicable amortization period.

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[52] *Ibid.*

[53] Geological and geophysical costs include expenditures for geologists, seismic surveys, gravity meter surveys, and magnetic surveys.

[54] This amortization rule applies to G&G costs incurred in taxable years beginning after August 8, 2005, the date of enactment of the Energy Policy Act of 2005, Pub. L. No. 109-58. Prior to the effective date, G&G costs associated with productive properties were generally deductible over the life of such properties, and G&G costs associated with abandoned properties were generally deductible in the year of abandonment.

[55] Pub. L. No. 110-140. Prior to the enactment of the Energy Independence and Security Act of 2007, major integrated oil companies were required to amortize G&G costs paid or incurred after May 17, 2006 over five years, as provided in Energy Tax Incentives Act of 2005.

[56] Generally, an integrated oil company is a producer of crude oil that engages in the refining or retail sale of petroleum products in excess of certain threshold amounts.

Description of Proposal

The proposal repeals (1) the enhanced oil recovery credit, (2) the marginal wells credit, (3) the expensing of IDCs, (4) the deduction for tertiary injectants,[57] (5) the exception for passive losses from working interests in oil and gas properties, (6) percentage depletion for oil and gas, and (7) the domestic manufacturing deduction for income derived from the domestic production of oil, gas, or primary products thereof. With respect to IDCs, in lieu of expensing, the proposal requires that such costs be capitalized and recovered through depletion or depreciation as applicable.

The proposal also increases the amortization period for G&G costs of independent producers from two to seven years. The seven-year amortization period would apply even if the property is abandoned such that any remaining unrecovered basis of the abandoned property would continue to be recovered over the remainder of the seven-year period.

Effective Date

The repeal of the enhanced oil recovery credit, the marginal wells credit, the exception for passive losses from working interests in oil and gas properties, percentage depletion for oil and gas, and the domestic manufacturing deduction for oil production is effective for taxable years beginning after December 31, 2010. The capitalization of IDCs, the repeal of the deduction for tertiary injectant costs, and the increased amortization period for G&G expenses are effective for amounts paid or incurred after December 31, 2010.

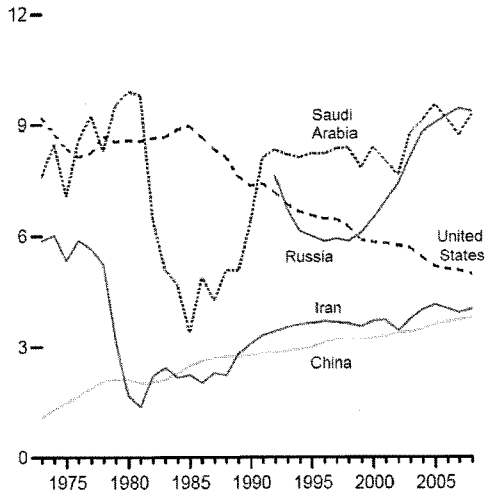
Analysis

Overview of domestic oil and gas production

Although domestic oil production has declined steadily since the mid-1980s, the United States remains one of the largest oil producers in the world.

[57] If section 193 were repealed, the treatment of tertiary injectant expenses would revert to prior law and might include capitalization and recovery through depreciation, capitalization and recovery as consumed (e.g., as a supply), or deduction as loss in the year of abandonment or the year production benefits ceased. Amounts expensed as depreciation, depletion, or supplies may be subject to capitalization under section 263A. See e.g., Treas. Reg. sec. 1.263A-1(e)(3).

Figure 2.–Crude Oil Production in Selected Countries (millions of barrels per day)



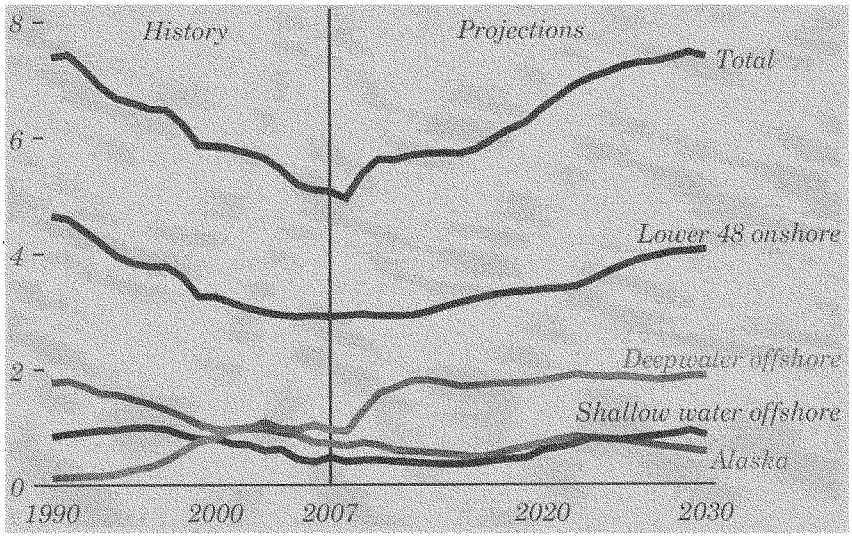
Source: Energy Information Administration, Monthly Energy Review, May 2009, Table 11.1a

Despite declining output in recent decades, domestic oil production is predicted to increase over the next twenty years, with most of the near-term increase resulting from deepwater offshore drilling.[58] Domestic onshore crude oil production is also projected to increase, primarily as the result of increased application of carbon dioxide-enhanced oil recovery techniques and the startup of liquids production from oil shale.[59]

[58] Energy Information Administration, *Annual Energy Outlook 2009*, March 2009, p. 79.

[59] *Ibid.*

Figure 3.–Projected Domestic Crude Oil Production by Source, 1990-2030
(millions of barrels per day)



Source: Energy Information Administration, Annual Energy Outlook 2009, March 2009, Figure 70, p. 79.

Because the remaining domestic oil reserves generally require more costly secondary or tertiary recovery techniques, domestic crude oil production is highly sensitive to world crude oil prices.[60]

Domestic production of natural gas is also expected to increase, with most of the increase attributable to onshore unconventional production (such as natural gas produced from tight sand and shale formations).[61] For 2008, the oil and gas extraction sector employed a seasonally adjusted average of 161,600 workers.[62]

History of specific provisions

The tax rules governing oil and gas production have undergone numerous changes over the past half century. The following table lists some of the major changes.

[60] *Ibid.*

[61] *Ibid.* p. 77.

[62] Bureau of Labor Statistics, *Monthly Labor Review*, vol. 132, no. 5, May 2009, Table 12, p. 87.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities

Year	Act	Code Section	Description of Modification
1969	Tax Reform Act of 1969 (Pub. L. No. 91-172)	613(b)	Percentage depletion rates for oil and gas wells decreased from 27.5 percent to 15 percent.
1975	Tax Reduction Act of 1975 (Pub. L. No. 94-12)	613A	Percentage depletion eliminated for integrated oil and gas companies; taxable income limitation to independent producers and royalty owners claiming percentage depletion added to the Code.
1980	Crude Oil Windfall Profit Tax Act of 1980 (Pub. L. No. 96-223)	193	Deduction for qualified tertiary injectant expenses added to the Code.
1982	Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. No. 97-248)	291(b)	Provision requiring amortization over 36 months of 15 percent of intangible drilling costs (IDCs) not currently deductible by integrated oil and gas companies added to the Code.
1984	Deficit Reduction Act of 1984 (Pub. L. No. 98-369)	291(b)	IDC capitalization percentage increased from 15 percent to 20 percent.
1986	Tax Reform Act of 1986 (Pub. L. No. 99-514)	291(b)	IDC capitalization percentage increased to 30 percent and extended the amortization period to 60 months.
		469(c)(3)	Provision excluding working interests in oil and gas property from the definition of a passive activity for purposes of the limitation on passive activity losses added to the Code.
1990	Omnibus Budget Reconciliation Act of 1990 (Pub. L. No. 101-508)	43	Enhanced oil recovery credit added to the Code.
		613	Maximum percentage depletion allowance for oil and gas properties increased from 50 percent to 100 percent of income from the property.
1997	Taxpayer Relief Act of 1997 (Pub. L. No. 105-34)	613A	Temporary suspension of taxable income limit for marginal production.[63]
2004	American Jobs Creation Act of 2004 (Pub. L No. 108-357)	45I	Marginal wells credit added to the Code.
		199	Deduction for domestic production activities (including domestic oil and gas production) added to the Code.

[63] This temporary suspension has been extended multiple times, most recently in the Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343) through December 31, 2009.

Chronology of Major Post-1954 Tax Law Changes Affecting Oil and Gas Production Activities

Year	Act	Code Section	Description of Modification
2005	Energy Policy Act of 2005 (Pub. L. No. 109-58)	167(h)	Two-year amortization of geological and geophysical (G&G) costs added to the Code. Prior to this, G&G costs incurred with respect to abandoned sites could be expensed, while G&G costs associated with producing wells had to be recovered over the life of the well.
2006	Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222)	167(h)	Two-year amortization period of G&G costs extended to five years for major integrated oil companies.
2007	Energy Independence and Security Act of 2007 (Pub. L. No. 110-140)	167(h)	Five-year amortization period of G&G costs extended to seven years for major integrated oil companies.
2008	Energy Improvement and Extension Act of 2008 (Pub. L. No. 110-343)	199	Section 199 deduction percentage for oil-related qualified production activities capped at six percent for taxable years beginning after 2009.
		907	Distinction between foreign oil and gas extraction income (FOGEI) and foreign oil-related income (FORI) eliminated; FOGEI rules applied to all foreign oil and gas income.

As the table makes apparent, Congressional action with respect to domestic oil and gas production incentives has varied over time. With some exceptions, during the 1970s and 1980s, the trend of Congressional action was to reduce or limit the tax benefits available to oil and gas producers. During the 1990s and the early part of this decade, the trend reversed direction and favored expanded incentives. More recently, Congress has begun reducing incentives once again. In the broadest sense, these trends tend to coincide with periods of high and low oil prices.

Effect of repealing oil and gas production incentives

A common rationale for favorable tax treatment of certain activities (tax credits or other forms of subsidy), or unfavorable treatment (taxes), is that there exist externalities in the consumption or production of certain goods. An externality exists when, in the consumption or production of a good, there is a difference between the cost or benefit to an individual and the cost or benefit to society as a whole. When the social costs of consumption or production exceed the private costs of consumption or production, a negative externality exists. When the social benefits from consumption or production exceed private benefits, a positive externality exists. When negative externalities exist, there will be over-consumption of the good causing the negative externality relative to what would be socially optimal. When positive externalities exist, there will be under-consumption or under-production of the good producing the positive externality. The reason for the over-consumption or under-consumption is that private actors will in general not take into account the effect of their consumption on others, but only weigh their personal cost and benefits in their decisions. Thus, they will consume goods up to the point where their marginal benefit of more consumption is equal to the marginal cost that they face.

But from a social perspective, consumption should occur up to the point where the marginal social cost is equal to the marginal social benefit. Only when there are no externalities will the private actions lead to the socially optimal level of consumption or production, because in this case private costs and benefits will be equal to social costs and benefits.

Pollution is an example of a negative externality, because the costs of pollution are borne by society as a whole rather than solely by the polluters themselves. In the case of pollution, one intervention that could produce a more socially desirable level of pollution would be to set a tax on the polluting activity that is equal to the social cost of the pollution. Thus, if burning a gallon of gasoline results in pollution that represents a cost to society as a whole of 20 cents, it would be economically efficient to tax gasoline at 20 cents a gallon. By so doing, the externality is said to be internalized, because now the private polluter faces a private cost equal to the social cost, and the socially optimal amount of consumption will take place. In the case of a positive externality, an appropriate economic policy would be to impose a negative tax (i.e. a credit) on the consumption or production that produces the positive externality. By the same logic as above, the externality becomes internalized, and the private benefits from consumption become equal to the social benefits, leading to the socially optimal level of consumption or production. The favorable tax treatment accorded the oil and gas industry represent other, less direct, means of subsidizing an activity through the tax code by reducing the tax burden on capital employed in the sector, thus encouraging more capital to be employed in that sector of the economy.

Many observers today would agree that there are negative externalities to the consumption of fossil fuels, including both pollution and increased dependence on foreign sources of oil. For this reason, many feel that fossil fuels should be taxed heavily rather than granted certain favorable treatment in the Code. Repealing incentives for oil and gas production would increase the after-tax costs associated with these activities, reduce the amount of capital employed in these activities in the long run, and potentially increase the prices of oil and gas. To the extent that oil and gas prices rise, there could be substitution from oil and gas and into other energy sources, including coal, nuclear, or renewable sources of energy. The impact on pollution of any such substitution is unclear and would depend on the type and quantity of pollution associated with the alternative energy resource. To the extent that addressing pollution concerns was a major objective, economic theory would suggest the need for a tax on the externality from the consumption of oil and gas that equaled the social harm from the consumption. Simply removing selected subsidies related to the production of oil and gas does not address the issue of establishing proper prices on the consumption of goods that cause pollution.

If the proposals cause substitution into alternative sources of energy, reliance on foreign sources of oil and gas could be reduced because nuclear and renewable energy sources are domestically produced, and the United States has an abundance of domestic coal resources. Alternatively, to the extent that the proposals primarily affect domestic production of oil and gas, it is possible that any substitution into these alternate energy sources reflects a substitution from domestic production of oil and gas into domestic production of these alternate sources, thus leaving the United States' reliance on foreign oil and gas unchanged. Furthermore, as the proposals are likely to have no effect on the world price of oil and gas, any increase in prices for domestically consumed oil and gas is likely to be attenuated, and the proposals could primarily result in substitution of foreign oil and gas sources for domestic sources whose production is more reliant on the subsidies provided in current law. Such an outcome would further imply that

the proposals would not lead to any shift into the alternate energy sources of coal, nuclear, or renewables. Lastly, other observers have argued that current prices and expected future demand for oil and gas provide sufficient market-based incentives for domestic exploration and production, and have argued that the present law subsidies are unnecessary to secure a viable domestic oil and gas production industry.

Additional motivations may also support specific proposed changes. For example, with respect to tertiary injectants opponents of repeal have also argued that the deduction for tertiary injectants encourages the use of carbon dioxide in enhanced oil recovery projects. Such projects represent a primary method of carbon sequestration, which reduces greenhouse gas emissions by capturing and storing carbon dioxide that would otherwise be released into the atmosphere.[64] Proponents of the proposal might argue that encouraging carbon dioxide sequestration is better handled through incentives directly targeting carbon sequestration.

Another example is the exception to the passive loss rules for working interests in oil and gas properties, which in addition to providing an incentive to produce oil and gas, creates the potential to shelter income that would otherwise be taxable. It could be argued that tax sheltering has become an increasing problem in the Federal tax system as some of the base-broadening and rate-lowering changes made by the Tax Reform Act of 1986 have been reversed or modified by subsequent legislation. From a tax policy perspective (rather than an energy policy perspective), some might argue that the perception of fairness in the tax system, as well as the need for improved horizontal equity among individual taxpayers, support repeal of the special tax benefits for oil and gas working interests.

Those in favor of retaining incentives for domestic production might argue that a healthy domestic oil and gas production base serves national security goals, by reducing our dependence on foreign sources of oil. However, it can be argued that such reliance is more effectively addressed through a direct tax on imported oil or an import fee, which could encourage less consumption and promote the use of lower emission, renewable energy alternatives. Others might argue that in the current economic environment, eliminating the incentives might adversely affect employment in domestic oil and gas production. Furthermore, the deduction for domestic production activities is a broadly available incentive for all domestic production industries, and thus does not bias investment in favor of the oil and gas sector. Repealing the deduction for the oil and gas sector alone would bias investment away from this sector.

Finally, it could be argued that some of the President's oil and gas proposals might reintroduce administrative complexity currently absent under present law, such as in the case of the repeal of the deduction for tertiary injectants.

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[64] See also, sec. 45Q, which provides a credit for certain qualified tertiary injectant projects that use carbon sequestration.

II. PROVISIONS OF GENERAL APPLICATION

A. Repeal Last-In, First-Out Inventory Accounting Method

Present Law

In general

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is a material income-producing factor to the taxpayer.[65]

Under the last-in, first-out ("LIFO") method, it is assumed that the last items entered into the inventory are the first items sold. Because the most recently acquired or produced units are deemed to be sold first, cost of goods sold is valued at the most recent costs; the effect of cost fluctuations is reflected in the ending inventory, which is valued at the historical costs rather than the most recent costs.[66] Compared to first-in, first-out ("FIFO"), LIFO produces net income which more closely reflects the difference between sale proceeds and current market cost of inventory. When costs are rising, the LIFO method results in a higher measure of cost of goods sold and, consequently, a lower measure of income when compared to the FIFO method. The inflationary gain experienced by the business in its inventory is generally not reflected in income, but rather, remains in ending inventory as a deferred gain until a future period in which sales exceed purchases.[67]

Dollar-value LIFO

Under a variation of the LIFO method, known as dollar-value LIFO, inventory is measured not in terms of number of units but rather in terms of a dollar-value relative to a base cost. Dollar-value LIFO allows the "pooling" of dissimilar items into a single inventory calculation. Thus, depending upon the taxpayer's method for defining an item, LIFO can be applied to a taxpayer's entire inventory in a single calculation even if the inventory is made up of different physical items. For example, a single dollar-value LIFO calculation can be performed for an inventory that includes both yards of fabric and sewing needles. This effectively permits

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[65] Sec. 471(a) and Treas. Reg. sec. 1.471-1.

[66] Thus, in periods during which a taxpayer produces or purchases more goods than the taxpayer sells (an inventory increment), a LIFO method taxpayer generally records the inventory cost of such excess (and separately tracks such amount as the "LIFO layer" for such period), adds it to the cost of inventory at the beginning of the period, and carries the total inventory cost forward to the beginning inventory of the following year.

[67] Accordingly, in periods during which the taxpayer sells more goods than the taxpayer produces or purchases (and inventory decrement), a LIFO method taxpayer generally determines the cost of goods sold of the amount of the decrement by treating such sales as occurring out of the most recent LIFO layer (or most recent LIFO layers, if the amount of the decrement exceeds the amount of inventory in the most recent LIFO layer) in reverse chronological order.

the deferral of inflationary gain to continue even as the inventory mix changes or certain goods previously included in inventory are discontinued by the business.

Simplified rules for certain small businesses

In 1986, Congress enacted a simplified dollar-value LIFO method for certain small businesses.[68] In doing so, the Congress acknowledged that the LIFO method is generally considered to be an advantageous method of accounting, and that the complexity and greater cost of compliance associated with LIFO, including dollar-value LIFO, discouraged smaller taxpayers from using LIFO.[69]

To qualify for the simplified method, a taxpayer must have average annual gross receipts of $5 million or less for the three preceding taxable years.[70] Under the simplified method, taxpayers are permitted to calculate inventory values by reference to changes in published price indexes rather than comparing actual costs to base period costs.

Special rules for qualified liquidations of LIFO inventories

In general, assuming rising prices, taxpayers using LIFO have an incentive to maintain or build inventory levels rather than allowing them to fall. So long as inventory levels are steady or growing the taxpayer never is deemed to have sold any of its older, lower-cost inventory, and inflationary gain is deferred indefinitely. However, in a period in which the inventory level falls, the taxpayer necessarily will (absent a special rule) be deemed to have sold some units purchased in a prior period, and the inflationary gain in those periods will be recognized in taxable income.[71]

In certain circumstances, reductions in inventory levels may be beyond the control of the taxpayer. Section 473 of the Code mitigates the adverse effects in certain specified cases by allowing a taxpayer to claim a refund of taxes paid on LIFO inventory profits resulting from the liquidation of LIFO inventories if the taxpayer purchases replacement inventory within a defined replacement period. The provision generally applies when a decrease in inventory is caused by reduced supply due to government regulation or supply interruptions due to the interruption of foreign trade.

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[68] Sec. 474(a).

[69] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986 (H.R. 3838, 99th Congress; Public Law 99-514)*, (JCS-10-87), May 4, 1987, p. 482.

[70] Sec. 474(c).

[71] By contrast, inflationary gain is generally recognized in earlier periods under the FIFO method, so taxpayers using FIFO do not have a similar incentive to maintain or build inventory levels.

Description of Proposal

The proposal repeals the LIFO inventory accounting method. Taxpayers that currently use LIFO would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. The resulting increase in income is taken into account ratably over eight taxable years beginning with the first taxable year the taxpayer is required to use FIFO.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2011.

Analysis

Proponents of the LIFO method argue that in periods of rising costs, the method provides the most accurate reflection of current-period income because it matches current costs against current sales revenues. They point out that the taxpayer will have to replace the inventory to continue in business and that by including the most recent additions to the inventory in cost of goods sold, the required cost of replacing the inventory is more closely projected.[72]

Alternatively, proponents of the FIFO method argue that LIFO permits deferral of inflationary gains in a taxpayer's inventory even when those gains arguably have been realized by the business. They note that outside of the inventory context, inflationary gains are generally taxed when the gain is realized (i.e., upon sale of the appreciated asset) and LIFO offers self-help against inflation that is not available in other contexts. FIFO proponents further assert that the use of earlier acquired items to value ending inventory understates net worth in times of rising prices resulting in an understatement of the income that measures the change in net worth for a given period.[73]

Proponents of FIFO also argue that a business whose inventory turns over with regularity during a taxable year should not value inventory as if it includes items purchased in prior years.

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[72] See e.g., LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18), wherein author Leslie J. Schneider explains that, "If a business is faced with the situation that, because of inflation, each time that it sells any item from its inventory, it must expend a larger amount of capital than the FIFO cost of the item to simply replace the item of inventory that has been sold, the business would continually be required to increase its capital investment in inventory to simply maintain the status quo. Presumably, this increased capital investment would ordinarily be financed from the proceeds of the sale of the inventory, but if that profit were taxed on a FIFO basis, the after-tax proceeds from the sale of the inventory would in many cases not be sufficient to finance the acquisition of the necessary replacement inventory."

[73] Commentators favoring FIFO have also noted that since ending inventory under LIFO can be controlled through the purchase of additional units at year-end, LIFO is susceptible to manipulation by taxpayers through timing year-end purchases or sales of inventory. See e.g., Testimony of George A. Plesko before the Committee on Finance United States Senate, June 13, 2006. However, proponents of LIFO point out that court decisions and IRS rulings effectively preclude taxpayers from acquiring unneeded inventory at year end to avoid liquidation of low-cost LIFO layers. See, LIFO Coalition letter to Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18).

However, LIFO advocates counter that, although there may be inventory turnover, it is highly unlikely that there is a time when there are no units in inventory. They view this perpetual inventory "layer" as a required condition of doing business and best valued at the time the layer was established, which is accomplished under LIFO. Thus, supporters of LIFO argue that during inflationary periods, using LIFO improves cash flow, thereby facilitating a business's use of retained capital to finance its physical inventory levels. In this respect, they note that LIFO functions much like accelerated depreciation for capital investment in productive machinery and equipment.[74]

Commentators contend that LIFO and, more specifically dollar-value LIFO (the most commonly used method of valuing inventory under LIFO), does not simply isolate changes in inventory cost resulting from inflation, but includes increases and decreases due to other factors outside of normal inflation such as changes in technology and changes in relative values as market supply and demand changes.[75] These commentators also note that a taxpayer's definition of an "item" for purposes of establishing its dollar-value LIFO pools can result in changes to inventory costs that are not attributable solely to inflation.[76] For example, a broad item definition generally results in fewer pools lessening the likelihood of that a previously established LIFO layer will be liquidated, which has the effect of deferring gain which results not from inflation, but from a change in the goods that comprise a particular dollar-value LIFO pool.

Supporters of LIFO have also pointed out the potential adverse economic effects of the recapture of the LIFO reserve, especially for those businesses that have used LIFO for decades. The tax imposed on the recapture of the reserve, even where the recapture is spread over a period of years (e.g., eight as is currently proposed), could be substantial, and could severely restrict the ability of such taxpayers to invest in capital, including maintaining their current physical inventory levels.[77] Moreover, studies of financial statement LIFO reserves indicate that oil and gas companies would be disproportionately affected by repeal of LIFO.[78]

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[74] LIFO Coalition letter to then-Senate Finance Chairman Grassley and Ranking Member Baucus dated June 26, 2006 (2006 TNT 125-18). See also, Alan D. Viard, "Why LIFO Repeal is Not the Way to Go," *Tax Notes*, Nov. 6, 2006, p. 574.

[75] See Edward D. Kleinbard, George A. Plesko, and Corey M. Goodman, "Is it Time to Liquidate LIFO?" *Tax Notes*, Oct. 16, 2006, p. 237.

[76] *Ibid.*

[77] This effect could be moderated by modifying the LIFO reserve recapture, for example, specifying partial reserve recapture based on business size or other mitigating factors, or extending the spread period for recapturing the LIFO reserve.

[78] See e.g., David Coffee, Reed Roig, Roger Lierly, and Phillip Little, "*The Materiality of LIFO accounting Distortions on Liquidity Measurements,*" Journal of Finance and Accountancy (Vol. 2 2009), noting that "the six largest [financial accounting LIFO] reserves and nine of the twenty largest reserves belong to oil and gas producers."

Recent discussion has surrounded the potential required use of international financial reporting standards ("IFRS") under which LIFO is not a permitted method of accounting.[79] The Securities and Exchange Commission has proposed the full adoption of IFRS by large U.S. companies by 2014.[80] The seemingly inevitable shift from Generally Accepted Accounting Principles ("GAAP") to IFRS raises the issue of whether companies will be able to continue using LIFO for tax purposes in light of the conformity requirement.[81]

[79] International Accounting Standards Board, International Accounting Standard (IAS) No. 2, *Inventories*, (rev. 2003).

[80] RIN 3235-AJ93, 73 Fed. Reg. 70816 (November 21, 2008).

[81] Some commentators have noted that the conformity requirement is a requirement "in form only" because changes to the regulations allowing alternative inventory valuations be disclosed in the financial statements provided the face of the income statement reflects LIFO. See Michael J. R. Hoffman and Karen S. McKenzie, "Must LIFO Go to Make Way for IFRS?" *The Tax Adviser* (March 2009).

B. Modify the Tax Rules for Dual Capacity Taxpayers

Present Law

Foreign tax credit - generally

The United States taxes its citizens and residents (including U.S. corporations) on their worldwide income. Because the countries in which income is earned also may assert their jurisdiction to tax the same income on the basis of source, foreign-source income earned by U.S. persons may be subject to double taxation. To mitigate this possibility, the United States generally provides a credit against U.S. tax liability for foreign income taxes paid or accrued.[82]

A foreign tax credit is available only for foreign income, war profits, and excess profits taxes, and for certain taxes imposed in lieu of such taxes. Other foreign levies generally are treated as deductible expenses. Treasury regulations under section 901 provide detailed rules for determining whether a foreign levy is a creditable income tax. In general, a foreign levy is considered a creditable tax if it is substantially equivalent to an income tax under U.S. tax principles. Under the present Treasury regulations, a foreign levy is considered a tax if it is a compulsory payment under the authority of a foreign country to levy taxes and is not compensation for a specific economic benefit provided by a foreign country.[83]

Dual capacity taxpayers

A taxpayer that is subject to a foreign levy and also receives a specific economic benefit from the foreign country is considered a "dual capacity taxpayer."[84] A "specific economic benefit" is broadly defined as an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.[85] An example of a specific economic benefit includes a concession to extract government-owned petroleum. Other examples of economic benefits that may be specific if not provided on substantially the same terms to the population in general, include property; a service; a fee or other payment; a right to use, acquire or extract resources, patents, or other property that a foreign country owns or controls (as defined within the regulations); or a reduction or discharge of a contractual obligation.

Treasury regulations addressing payments made by dual capacity taxpayers were developed in response to the concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in

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[82] Sec. 901.

[83] Treas. Reg. sec. 1.901-2(a)(2)(i).

[84] Treas. Reg. sec. 1.901-2(a)(ii).

[85] Treas. Reg. sec. 1.901-2(a)(2)(ii)(B).

substance, royalties or some other business expense.[86] To the extent that a taxpayer meets the definition of a dual capacity taxpayer, the taxpayer may not claim a foreign tax credit for the portion of the foreign levy that is paid for the specific economic benefit.[87] Treasury regulations require that a dual capacity taxpayer, similar to other taxpayers, must establish that the foreign levy meets the requirements of section 901 or section 903.[88] However, the regulations require that a dual capacity taxpayer use either a facts and circumstances method or a safe harbor method in establishing the foreign levy is an income tax.[89]

Under the facts and circumstances method, a separate levy is creditable to the extent that the taxpayer establishes, based on all the relevant facts and circumstances, the amount of the levy that is not paid as compensation for the specific economic benefit.[90] For purposes of applying the facts and circumstances method, the foreign country need not have a generally imposed income tax.

A dual capacity taxpayer alternatively may choose to apply the safe harbor method on a country-by-country basis to determine whether a levy is a creditable tax.[91] Under the safe harbor method, if the foreign country has a generally imposed income tax, the taxpayer may credit the portion of the levy that application of the generally imposed income tax would yield provided that the levy otherwise constitutes an income tax or an in lieu of tax. The balance of the levy is treated as compensation for the specific economic benefit.[92] If the foreign country does not generally impose an income tax, the portion of the payment that does not exceed the applicable U.S. federal tax rate, applied to net income, is treated as a creditable tax.[93] In general, a foreign tax is treated as generally imposed for this purpose even if it applies only to persons who are not residents or nationals of that country.[94]

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[86] Testimony of Treasury Secretary Schultz, Hearings on "Windfall" Excess Profits Tax before the House Committee on Ways and Means, 93rd Cong., 2d Sess. 151 (1974).

[87] Treas. Reg. sec. 1.901-2(a)(i).

[88] Treas. Reg. sec. 1.901-2A(b)(1).

[89] Treas. Reg. sec. 1.901-2A(c).

[90] Treas. Reg. sec. 1.901-2A(c)(2).

[91] A taxpayer may make an election to use the safe harbor method with respect to one or more foreign states. The election applies to the year of the election and to all subsequent taxable years unless revoked. The election is made by the common parent and applies to all members of the affiliated group. See Treas. Reg. sec. 1.902-2A(d).

[92] Treas. Reg. sec. 1.901-2A(d) and (e). Detailed rules are provided for determining the amount that imposition of the generally applicable tax to the dual capacity taxpayer would yield, based on the taxpayer's gross receipts, costs and expenses, and other factors.

[93] Treas. Reg. sec. 1.901-2A(e)(5).

[94] See Treas. Reg. sec. 1.903-1(b)(3), Ex. 4.

Limitation on the use of foreign tax credits

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[95] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the immediately preceding taxable year or carry forward the excess taxes forward 10 years.[96]

In addition, this limitation is calculated separately for various categories of income, generally referred to as "separate limitation categories." The total amount of foreign taxes attributable to income in a separate limitation category that may be claimed as credits may not exceed the proportion of the taxpayer's total U.S. tax liability which the taxpayer's foreign-source taxable income in that separate limitation category bears to the taxpayer's worldwide taxable income. The separate limitation rules are intended to reduce the extent to which excess foreign taxes paid in a high-tax foreign jurisdiction can be "cross-credited" against the residual U.S. tax on low-taxed foreign-source income.[97]

Special rule for foreign oil and gas income

A special limitation applies with respect to taxes on combined foreign oil and gas income applied prior to the foreign tax credit limitation discussed above.[98] This limitation was adopted prior to the issuance of the regulations providing the rules discussed above for dual capacity and were intended to address the concern that payments made by oil companies to many oil-

[95] Secs. 901 and 904.

[96] Sec. 904(c).

[97] Sec. 904(d). For taxable years beginning prior to January 1, 2007, section 904(d) generally provides eight separate limitation categories (or "baskets") and effectively many more in situations in which various special rules apply. The American Jobs Creation Act of 2004 reduced the number of baskets from nine to eight for taxable years beginning after December 31, 2002, and further reduced the number of baskets to two (i.e., "general" and "passive") for taxable years beginning after December 31, 2006. Pub. L. No. 108-357, sec. 404 (2004).

[98] Sec. 907. For taxable years beginning before January 1, 2009, the components of what is now defined as combined foreign oil and gas income included foreign oil and gas extraction income ("FOGEI") and foreign oil related income ("FORI"). Under the prior rules, FOGEI and FORI were subject to separate limitations under section 907. Pub. L. No 110-343, Sec. 402(a). Amounts claimed as taxes paid on FOGEI of a U.S. corporation qualified as creditable taxes (if they otherwise so qualified), if they did not exceed the product of FOGEI multiplied by the highest marginal U.S. tax rate on corporations. A separate limitation was deemed to apply to FORI which theoretically applied in certain cases where the foreign law imposing such amount of tax is structured, or in fact operated, so that the amount of tax imposed with respect to FORI generally was "materially greater," over a "reasonable period of time," than the amount generally imposed on income that was neither FORI nor FOGEI. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress*, (JCS-1-09), March 2009, at 358.

producing nations were royalties disguised as tax payments.[99] Additionally, the limitation sought to prevent the crediting of high foreign taxes on foreign oil and gas income against the residual U.S. tax on other types of lower-taxed foreign source income.[100]

Under this special limitation, amounts claimed as taxes paid on combined foreign oil and gas income are creditable in a given taxable year (if they otherwise qualify as creditable taxes) only to the extent they do not exceed the applicable U.S. tax on that income. The applicable U.S. tax is determined for a corporation as the product of the amount of such combined foreign oil and gas income for the taxable year and the highest marginal tax rate for corporations.[101] Any excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.[102] Amounts that are not limited under section 907 (relating to combined foreign oil and gas income discussed above) are included in the general basket or passive basket (as applicable) for purposes of applying the section 904 limitation.

Description of Proposal

In the case of a dual capacity taxpayer, the proposal treats a foreign levy that would otherwise qualify as an income tax or in lieu of tax as a creditable tax only if the foreign country generally imposes an income tax. An income tax is considered generally imposed for this purpose only if the income tax applies to trade or business income from sources in that country, and only if the income tax has substantial application to non-dual capacity taxpayers and to persons who are nationals or residents of that country. The proposal replaces the part of the present regulatory safe harbor that applies when a foreign country does not generally impose an income tax, but retains the present law rule where the foreign country does generally impose an income tax.

The proposal converts the special foreign tax credit limitation rules of section 907 into a separate category within section 904 for foreign oil and gas income. However, the proposal does not override existing U.S. treaty obligations that allow a credit for taxes paid or accrued on certain oil or gas income.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2010.

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[99] Joint Committee on Taxation, *Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, (JCS-38-82), December 31, 1982, sec. IV.A.7.a, footnote 63.

[100] H.R. Conf. Rept. No. 103-213, at 646 (1993).

[101] Sec. 907(a). For an individual, the limitation is the product of the amount of such combined foreign oil and gas income for the taxable year and a fraction, the numerator of which is the tax against which the credit under section 901(a) is taken and the denominator of which is the taxpayer's entire taxable income.

[102] Sec. 907(f).

Analysis

The proposal would address the distinction between creditable taxes and non-creditable payments that are made in exchange for a specific economic benefit and would modify the rules provided under the present Treasury regulations in two respects. First, the proposal would deny a foreign tax credit for amounts paid by a dual capacity taxpayer to any foreign country that does not have a generally applicable income tax. Thus, under the proposal, a taxpayer using the safe harbor would no longer be permitted to treat the portion of a foreign levy that does not exceed the applicable U.S. tax as a creditable tax if the foreign jurisdiction did not generally impose an income tax. Similarly, under the facts and circumstances method, no amount of a foreign levy paid to a foreign country without a generally imposed income tax would qualify as a creditable foreign tax.

Second, the proposal would modify the present regulatory criteria for determining whether a foreign income tax is "generally imposed" to require that the income tax apply to trade or business income from sources in that country, and that it have substantial application to non-dual capacity taxpayers as well as to persons who are nationals or residents of that country. [103] Thus, the proposal effectively would eliminate the provision in the present regulations that permits taxpayers to treat a foreign country generally imposing an income tax notwithstanding that such tax is inapplicable to persons who are nationals or residents of the foreign country.

The provisions in the regulations governing dual capacity taxpayers derive from a concern that payments which purported to be income taxes imposed on U.S. oil companies by mineral-owning foreign governments were at least partially, in substance, royalties or some other business expense. Nonetheless the present-law regulatory regime permits a foreign levy to be treated as a creditable tax, despite the lack of a generally imposed income tax on the foreign country's residents. The regulations thus presume that the foreign levy represents a special type of income tax, even where the tax is imposed solely on dual capacity taxpayers. The proposal would eliminate this presumption and only permit a dual capacity taxpayer to treat all or part of a foreign levy as an income tax if the country imposes a general income tax with substantial application to non-dual capacity taxpayers and to nationals or residents of the country.

Although primarily applicable to oil and gas producers (and other companies engaged in mineral extraction businesses), the "dual capacity" taxpayer provisions are broadly applicable to

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[103] This part of the proposal appears to be in response to the taxpayers using the facts and circumstances method following the Tax Court's decision in *Exxon Corp., et. al. v. Commissioner*, 113 T.C. 338 (1999). In that decision, the Tax Court concluded that the entire amount of the petroleum revenue tax paid by Exxon to the United Kingdom was not compensation for a specific economic benefit, but instead constitutes an excess profit or income tax creditable under section 901. The Court considered that Exxon entered into an arm's length licensing agreement with the U.K. government to gain access to the North Sea oil fields prior to the enactment of the petroleum revenue tax and Exxon's right to explore, develop and exploit petroleum was dependent on the licensing agreement and payment of license fees under that agreement and not in exchange for payment of the tax.

Anecdotal evidence suggests that subsequent to the court's decision in *Exxon*, a significant number of dual capacity taxpayers revoked their safe harbor elections and adopted the facts and circumstances method, which resulted in treating the entire foreign levy as a creditable tax under section 901.

any taxpayer that is treated under the regulations as receiving a specific economic benefit from a foreign government. Thus, for example, a corporation engaged in a banking business that loans funds to a foreign government may meet the definition of a dual capacity taxpayer and therefore be subject to the provisions in the Administration's proposal with the result that if the foreign country has no generally imposed income tax, the taxes paid by the bank would not be creditable.[104]

The proposal does not specify what constitutes a "substantial application" of an income tax. Presumably, Treasury would have the authority to issue guidance for determining when a country's income tax satisfies the "substantial application" requirement. Arguably, a country that imposes a comprehensive income tax similar to the United States would satisfy the definition. However, uncertainty arises when the tax applies to some portion of the residents or nationals of the country–for example, if a tax applies to a particular industry.

The proposal also does not provide a definition for "resident." It is likely that Treasury would have the authority to issue guidance defining "resident" for purposes of the provision. It is not clear whether any such guidance would provide that a controlled foreign corporation operating in the country and subject to tax in the country would be considered a resident, notwithstanding that its parent company has no direct operations in such country. Moreover it is not clear how such guidance would apply to joint ventures with resident and non-resident investors.

Under the proposal, dual capacity taxpayers and non-dual capacity taxpayers would be treated differently for foreign tax credit purposes solely on the basis of whether the taxing jurisdiction generally imposes an income tax. Thus, a non-dual capacity taxpayer would be entitled to claim foreign tax credits on foreign levies that otherwise meet the definition of an income tax notwithstanding that the foreign country does not generally impose an income tax. However, a dual capacity taxpayer that is assessed the same levy that is properly characterized as an income tax, would be denied a foreign tax credit for such amount if the country does not generally impose an income tax.

Proponents of the proposal argue that present law fails to achieve the appropriate allocation between a payment for specific economic benefit and a creditable tax in those cases where the foreign country imposes a levy on an item, but does not otherwise generally impose an income tax. Thus, they assert that the requirement that the foreign country generally impose an income tax ensures that the levy is not a payment for a specific economic benefit.

Opponents of the proposal also contend that the potential for double taxation created under the proposal does not constitute sound tax policy. Instead, they argue that if the dual capacity taxpayer can establish that it is paying fair compensation to the foreign country for the economic benefit received from that country, amounts paid pursuant to the foreign levy on net income or a levy on excess profits should constitute a creditable tax, notwithstanding that the

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[104] Treas. Reg. sec. 1.901-2A(c)(2)(ii), Example 1. In this example, the taxes paid by the bank were creditable because the bank met its burden of proof under the facts and circumstances method.

foreign country does not generally impose an income tax. Thus, they assert that the current rules adequately address the misallocation concern noted as a reason for the proposed change.

It is also asserted that the major U.S. based oil companies would be disadvantaged relative to foreign competitors in bidding for new projects as a result of the increased costs. This reduced competitiveness could, it is contended, impair energy security in the United States.

The proposal also creates a separate foreign tax credit limitation category for combined foreign oil and gas income, and eliminates the provisions for foreign oil and gas income under section 907. Replacing section 907 with a separate section 904 limitation category for combined foreign oil and gas income restricts cross-crediting of oil and gas-related taxes as well as simplifying the foreign tax credit limitation calculation.

TESTIMONY OF KEVIN BOOK
MANAGING DIRECTOR, RESEARCH
CLEARVIEW ENERGY PARTNERS, LLC

BEFORE THE

U.S. SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON ENERGY, NATURAL RESOURCES AND INFRASTRUCTURE

SEPTEMBER 10, 2009

Thank you, Chairman Bingaman, Ranking Member Bunning and Members of this Committee, for the privilege of contributing to today's discussion of proposed oil and gas industry tax policy changes. My name is Kevin Book and I lead the research practice at ClearView Energy Partners, LLC, an independent research and consulting firm here in Washington, D.C. that serves institutional and corporate energy investors.

The Wisdom of Looking Ahead in the Midst of Crisis

I want to begin, Mr. Chairman, by expressing my appreciation that this Committee is willing to examine the opportunities of the future even as it tackles the daunting challenges of the present. This, after all, is no ordinary moment in U.S. history. Job losses continue to mount even though the pace of decline appears to be slowing. Home prices remain depressed despite potentially auspicious inventory reductions. U.S. national debt grows relative to GDP despite hopes that record-low interest rates might inspire expansionary, new investment. Given these and many other jarring indicia of economic malaise, I am grateful that you and your colleagues remain committed not only to helping this industrial economy recover from a blistering recession, but also to powering its future with secure, economic and sustainable fuel sources and energy technologies.

Demand Moves Quickly

This foresight is critical, in my view, given the long lead-times and substantial capital outlays associated with energy investments. Energy supplies can take years – even decades – to come online, but recent events reveal how quickly demand patterns can shift.

A little over one year ago, the global oil system was running at nearly 99% of its capacity and price levels reflected real and anticipated scarcity. Today, as a result of economic collapse, and due – in part – to OPEC cooperation without modern precedent, we estimate production at less than 94% of global capacity. Accordingly, EIA data reveal record stockpiles of oil, oil products and natural gas, and U.S. electric power demand trends suggest that 2009 will bring the greatest year-on-year contraction in more than five decades.

Supply was tight last year, but the 2008 energy crisis was largely economic, not physical, in nature. Instead of lines at the pump, Americans endured holes in their pockets. Superficially, aggregate data suggest this "price crisis" is largely over: on a national average basis, our estimate of U.S. "consumer energy leverage" (the share of disposable income that goes to electricity, home heating and gasoline) fell from almost 12% in July 2008 to approximately 8.25% in July 2009, only slightly above the high end of the historical range.

In short: prices have fallen, but the way we got there is nothing to celebrate, nor is it likely to be sustainable.

Business-as-Usual was Brisk

As they industrialize, developing economies seek more energy from every source, but the rapid growth in Chinese demand for crude oil and oil products made headlines for years because, by some projections, it was on pace to soak up global excess capacity in less than a decade. Figure 1 presents recent trend data, distilled from the July 2009 IEA *Oil Market Report.* By IEA's projections, rapid Chinese demand growth could resume during 2010 at near-peak levels. More sobering: even the current recession did not stop demand growth entirely.

Figure 1 – IEA China Demand Forecasts (Top) and Percentage Growth (Bottom), July 2009 vs. July 2008

	Year/IEA Report Year, (A)ctual and (P)rojected						
Product, kbbl/d	2006/08	2007A/08	2008P/08	2008A/09	2009P/09	2010P/09	Δ08A vs P
LPG & Ethane	701	669	644	653	734	766	9
Naphtha	756	812	855	768	809	846	-87
Motor Gasoline	1,221	1,257	1,415	1,493	1,572	1,684	78
Jet & Kerosene	259	280	305	292	309	327	-13
Gas/Diesel Oil	2,415	2,576	2,843	2,837	2,624	2,759	-6
Residual Fuel Oil	791	744	688	603	606	631	-85
Other products	1,068	1,204	1,211	1,246	1,328	1,301	35
Total Products	7,213	7,542	7,962	7,892	7,982	8,315	-70

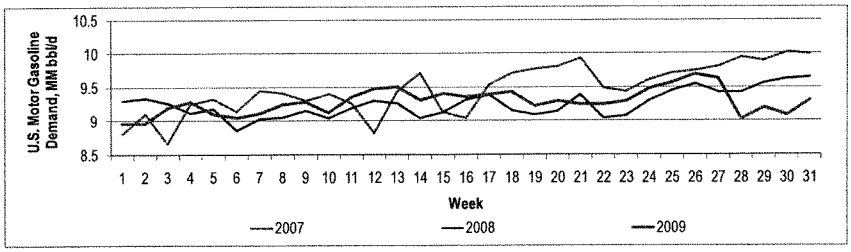
Product, kbbl/d	2007ΔA	2008ΔA	2009ΔP	2010ΔP
LPG & Ethane	-4.56%	-2.39%	12.40%	4.36%
Naphtha	7.41%	-5.42%	5.34%	4.57%
Motor Gasoline	2.95%	18.77%	5.29%	7.12%
Jet & Kerosene	8.11%	4.29%	5.82%	5.83%
Gas/Diesel Oil	6.67%	10.13%	-7.51%	5.14%
Residual Fuel Oil	-5.94%	-18.95%	0.50%	4.13%
Other products	12.73%	3.49%	6.58%	-2.03%
Total Products	4.56%	4.64%	1.14%	4.17%

Source: ClearView Energy Partners, LLC using IEA data

By the same token, the most dramatic change in global liquids (oil, oil products and alternatives) demand came not from China, but from the U.S. driver, as presented in Figure 2. The combination of demand contraction (motorists driving less) and destruction (drivers buying higher-efficiency automobiles) has led to 2009 weekly gasoline consumption levels 5-10% lower than comparable weeks during the 2007 peak year.

Notwithstanding Chinese demand growth, the U.S. driver still represents about 11% of global liquids demand, a critical "swing factor".

Figure 2 – U.S. Motor Gasoline Demand, 2009 vs. 2008 and 2007, MMbbl/d, thru July



Source: ClearView Energy Partners, LLC using data from MasterCard Advisors

The Risks of Ignoring the Long-Term Trend

Because of this "swing" factor, the U.S. is unlikely to feel the pinch of high prices for several more years, even as economic recovery builds. This would be welcome news, but no reason to ignore long-term trends.

If the Obama Administration's proposed vehicle GHG targets are met by automakers by improvements in fuel efficiency, we estimate that U.S. motor gasoline demand could peak in 2012 or 2013 and begin a slow decline thereafter. This could be a favorable outcome, but it may not necessarily usher in an enduring era of supply security or low prices for two reasons. First, by that time, the U.S. may have achieved most of its feasible, near-term efficiency gains even as developing world demand grows. Second, much of the contraction in global oil demand that came from economic weakness could reverse – and grow – if 2010 brings a brisk recovery.

High prices do tend to provoke efficiency gains. We estimate that CY2009 U.S. motor gasoline demand will average about 8.9-9.0 MMbbl/d, and demand destruction from organic (non-cash-for-clunkers) vehicle scrappage may already account for as much as 200,000 bbl/d of the 300,000 bbl/d decline from the 2007 demand peak. There may be more ahead, too, with as much as 500,000 bbl/d of additional U.S. demand destruction possible in the event that economic recovery releases more pent-up vehicle demand and creates a spike in passenger car scrappage similar to the one that arrived during the late 1970s. This could play a big role in keeping pump prices lower for longer.

On the other hand, it isn't just about cars. The buyers of export nations' goods accounted for a large fraction of global liquids consumption. As purchases slowed in the West, factories shut down in the East, reducing oil demand. Less manufacturing activity meant less shipping, paring back demand from every type of freight hauling, many of which rely on diesel fuel and other "middle distillates". In July, IEA projected that North American middle distillates demand will have contracted approximately 730,000 bbl/d between 2007 and 2009. Adding in cutbacks in China, this implies that nearly one million barrels per day used for making stuff and hauling stuff disappeared from the global oil system just in the U.S. and China alone! (See Figure 3).

The problem is: unlike an old clunker cast onto the scrap heap, yesterday's consumers are still around to purchase tomorrow's goods (even if credit is tighter), and they are likely to be growing in number.

Figure 3 – Net Demand Impact of China Growth and OECD North America Contraction vs. 2006 Demand, kbbl/d

Country/Region	2006A	2007A	2008A	2009P	2010P-High*	2010P-Low*
China	7,213	7,542	7,892	7,982	8,315	8,315
OECD North America	25,250	25,530	24,180	22,940	23,169	22,252
Net Δ vs. 2006	--	609	-391	-1,541	-979	-1,896

* CVEP scenarios: "High" is 1% growth in 2010; "Low" is 3% contraction in 2010

Source: ClearView Energy Partners, LLC using IEA data

Supply Challenges Haven't Disappeared, Either

The most explicit types of geopolitical risk are likely to contribute only modestly to energy prices – if at all – during the remainder of 2009 and 2010. Even so, other factors may set up a precarious future for global supply. First and foremost, stark financial circumstances can inject a "slow bleed" into global supply, particularly as smaller, higher-cost producers cut back their spending because they cannot profitably produce "marginal" barrels of oil or cubic feet of natural gas at today's prices.

In addition, a combination of internal politics and financial shortfalls could still lead to a downside supply surprise from the "usual suspects", especially:

- Mexico, where the Cantarell field is declining faster than expected and offshore investment is lagging;
- Iran, where budget challenges may lead to underinvestment in maintenance of producing fields;
- Nigeria, where MEND may continue the self-defeating pursuit of greater oil revenues share by scaring away investment;
- Russia, where taxes may starve maintenance cap-ex and bring faster-than-expected production declines; and
- North America, where tax policy can play a pivotal role in shaping long-term investment decisions.

Notably, with the exception of Nigeria, each "game changer" revolves around government policy choices.

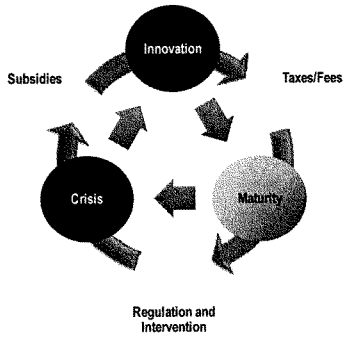
The Impact of Energy Policy Volatility on Private Companies

Energy tax policies are part of the broader system of fees and subsidies by which governments monetize, and manage the utilization of, their natural resources. As a vast oversimplification, during most of the 150-year history of the oil industry, the government energy policy toolkit has consisted of three basic elements:

1. **Performance-based subsidies** for desired outcomes and surcharges or penalties to discourage unwanted outcomes, either explicit (e.g. producer credits), or via tax/accounting mechanisms (e.g. depletion allowances, accelerated depreciation);
2. **Payments for resource rights**, including (a) bid bonuses [which are received at auction]; (b) rental payments [received as long as the leaseholder continues to lease the resource]; and (c) royalties [paid out in proportion to production, if it occurs]; and
3. **Regulation and intervention** to establish price or cost ceilings, cushions or collars (e.g. loan guarantees, countercyclical payments and windfall taxes).

In an ideal world, governments might strive to tailor these incentive mechanisms for fuels and energy technologies to their maturity by subsidizing innovation, taxing mature technologies and intervening at, or prior to, the onset of any supply or environmental crisis, as presented in Figure 4.

Figure 4 – Energy Policies and Energy Technologies are Both Cyclical in Nature – but the Cycles Don't Always Match Up



Source: ClearView Energy Partners, LLC

In practice, this theoretical ideal can be difficult or impossible to achieve: inadequate subsidies for innovative technologies may limit their diffusion; excessive taxation of mature technologies may deter necessary reinvestment; and overzealous regulation of access to, or the selling price of, natural resources could deter innovation and investment. Several factors may contribute to this disconnect.

The not-so-inconsequential problems of time and timing: many energy policy decisions tend to be made on an annual or biennial basis, but energy investment decisions can require years of planning and years further for execution and profitability. Cautious companies may plan to survive price volatility by earning sufficient returns in later years to offset losses in early years, even on a discounted cash-flow basis. Investment also generally continues throughout the life of an energy project. As a result, profits from greater-than-expected production may reflect a high level of ongoing investment and innovation rather than blind luck or a "windfall".

States competing with states. Although corporate decision-makers may prefer to work in their home nations, private companies invest in regions and nations where resources and policies deliver the highest, risk-adjusted return on invested capital for shareholders. The global energy industry is by no means a perfectly open or perfectly level playing field, but, at some level, nations compete for energy companies that will help them maximize the value of their resources. Large resources can encourage greater risk tolerance by firms that hope to capture the benefits of scale. By contrast, political and policy volatility can undermine the attractiveness of favorable royalty rates.

Firms competing with states. Last, many of the energy companies that are the most vulnerable to poorly-timed government actions may be the private entities that must compete with partially or wholly state-owned and/or state-funded entities. In this context, energy policy volatility within market democracies can be considerably more damaging to private companies than to their state-owned competitors.

Implications of the Proposed U.S. Oil & Gas Policy Changes

On August 25, 2009, the Office of Management and Budget published its *Mid-Session Review.* Figure 5, on the following two pages, summarizes projected impacts of the energy-related policies within President Obama's FY2010 Budget Request, using the revenue "scores" presented within the appendices to the *Review.*

Figure 4 – Energy-Related Revenue Impacts of the President's Budget Request from the *Mid-Year Budget Outlook*

Program Area	Revenue Year											
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	5Y	10Y
Could affect some oil, gas and refining companies												
Repeal LIFO method of accounting for inventories			-2,992	-6,748	-8,082	-8,431	-8,590	-8,545	-8,630	-9,036	-17,822	-61,054
Defer deduction of expenses, except R&E expenses, related to deferred income		-3,295	-5,594	-5,822	-6,012	-6,150	-6,206	-6,363	-6,598	-6,869	-20,723	-52,909
Likely to affect international oil companies												
Modify tax rules for dual capacity taxpayers		–275	–474	–503	–535	–563	–592	–623	–651	–681	–1,787	–4,897
Identified as oil/gas-specific												
Levy tax on certain offshore oil and gas production		-500	-500	-500	-600	-600	-600	-600	-700	-700	-2,100	-5,300
Repeal enhanced oil recovery credit												
Repeal credit for oil and gas produced from marginal wells												
Repeal expensing of intangible drilling costs		-1,399	-1,789	-1,115	-835	-749	-562	-279	-153	-113	-5,138	-6,994
Repeal deduction for tertiary injectants		-5	-9	-9	-8	-7	-6	-6	-6	-6	-31	-62
Repeal exception to passive loss limitations for working interests in oil and natural gas properties		-2	-5	-6	-6	-6	-6	-6	-6	-6	-19	-49
Repeal percentage depletion for oil and natural gas wells		-351	-835	-1,022	-1,053	-1,086	-1,124	-1,160	-1,189	-1,215	-3,261	-9,035
Repeal domestic manufacturing tax deduction for oil and natural gas companies		-757	-1,310	-1,392	-1,464	-1,531	-1,600	-1,670	-1,745	-1,823	-4,923	-13,292
Increase geological and geophysical amortization period for independent producers to seven years		-45	-169	-262	-251	-198	-143	-86	-46	-35	-727	-1,235
Identified as energy-specific												
Repeal ultra-deepwater oil and gas	-20	-40	-50	-50	-50	-30	-10				-210	-250

Program Area	Revenue Year											
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	5Y	10Y
research and development program												
Identified as increased return on mineral leasing												
Abandoned Mine Lands (AML) Payments to Certified States	-142	-164	-208	-210	-206	-90	-90	-94	-158	-161	-930	-1,523
Fee on nonproducing oil and gas leases	-122	-121	-115	-107	-109	-112	-114	-116	-119	-121	-574	-1,156
Repeal Energy Policy Act fee prohibition and mandatory permit funds	-42	-32	-33	-33	-33	-33	-9	-9	-9	-9	-173	-242
Identified as climate-specific												
Dedicated to climate policy (clean energy technologies)			-15,000	-15,000	-15,000	-15,000	-15,000	-15,000	-15,000	-15,000	-45,000	-120,000
Dedicated to making work pay tax credit			-62,158	-62,502	-62,826	-63,093	-63,461	-63,818	-64,130	-64,554	-187,486	-506,542

Source: ClearView Energy Partners, LLC, OMB

Above all, energy policy is about trade-offs. Many of the tax incentives for conventional energy production and refining on the books today have been in force for decades. Some, like intangible drilling cost deductions, are believed to date back to the latter half of the 19th Century and certainly to the 1926 Internal Revenue Code. Section 199 deductions and accelerated G&G amortization schedules are of a relatively recent vintage, but these benefits still have two characteristics in common with longer-lived mechanisms:

1. In general, most of these policies encourage U.S. petroleum supply security; and

2. Most of these policies appear to be predicated upon the recognition that oil and gas exploration, production and refining requires long-term capital commitments; in short, vast amounts of cash – much moreso than manpower and steel – are a primary factor of production.

The President's Budget Request proposes to rescind or modify several of these policies. As an analyst of energy economics and the policies that shape it, it is not my place to debate the merits of these changes. Moreover, I am honored to appear on a panel of many distinguished witnesses who are likely to make strong and credible arguments on both sides of each issue. Instead, I want to highlight some of the potential, unintended consequences that could result from the enactment of the proposed changes to frame them as a trade-off between short-term fiscal stabilization and long-term economic growth.

1. **A LIFO-to-FIFO change** would not uniquely impact energy companies, but a transition from a last-in, first-out to first-in, first-out system of inventory accounting, paired with the expectation of higher prices, could motivate commercial refiners to reduce their operating inventories ahead of its effective date, potentially flooding the market with crude, artificially depressing prices for the short-term and hurting the economics of higher-cost, alternative technologies. In addition, refiners might be motivated to hold leaner working inventories, potentially creating greater price volatility in the event of any future supply disruption.

The ramifications of this change could be particularly pronounced in light of long chronology of U.S. LIFO inventory practices, which date back to the 1939 Internal Revenue Code.

2. **Deduction deferrals, dual capacity tax rule changes and unraveling "inversions"** all have the potential, to create cash-flow challenges or competitive disadvantages for the international companies likely to make investments supporting U.S. energy security and greener fossil energy production. Another possible outcome could be the "re-domiciling", rather than the repatriation, of potentially-impacted international operating companies and, with them, jobs and taxable profits.

3. **A 13% Gulf of Mexico** surtax applied to production from Central Gulf of Mexico leases sold between 1998 and 1999 could lead to negative energy security consequences without substantially improving gross receipts to the U.S. Treasury. Drilling a well to produce ultra-deepwater resources in the lower and middle Miocene and lower Tertiary trends, more than one hundred miles from shore, can cost hundreds of millions of dollars. If, as many respected E&P analysts suggest, the real production cost of oil from these wells falls in the $50-70/bbl range, the expectation of this 13% surtax (as much as about $9/bbl) could deter higher-cost projects today. At minimum, production at a future date would diminish the present value of royalties received – possibly more than the 13% taxes. Far more vexing, changes to lease life or royalty rates could also diminish bid bonuses in future auctions, because leases that cost more per barrel to produce might be worth less, in present value terms, to private companies. This may be especially true for companies that value the "optionality" of having ten years to complete their planning decisions.

4. **Rescinding Intangible Drilling Cost (IDC) deductions and percentage depletion exemptions** could have the effect of diminishing the working capital available to fund new and continuing domestic investment in oil and gas production. Similarly, longer geologic and geophysical cost amortization periods and higher well permitting costs could present further deterrents to new production. Whether or not a well comes up dry or meets its breakeven production volumes, exploring and preparing for drilling imposes explicit costs on E&P companies. Average costs per well for U.S. oil and gas production remain in the $1.5 to $2 million range, despite retracement in land rig day rates. Production volumes could slow considerably without this deduction, and the cash squeeze for independent producers already facing margin compression due to low Henry Hub prices for natural gas could put some of them out of business. If past is any precedent, further industry consolidation could be the result of independent company bankruptcies.

5. **Repealing the "Section 199" deductions** created by the American Jobs Creation Act of 2004 would impose a *de facto* 2.1% tax increase on U.S. oil, gas and refining companies, assuming a 35% corporate tax rate. Some companies are well-insulated against small tax increases by virtue of their debt structures, cash positions and cost structures. Others, including some of the companies currently undertaking high-cost, innovative and environmentally-friendly production and refining projects, could be much more severely impacted by this change. Another particular area of concern may be the domestic refining sector, a business that has long lived and died by razor-thin margins. According to BP, 2008 global refining margins were approximately $6.52/bbl, the lowest full year in five years, and margins during the second quarter of 2009 were even worse, at about $4.98/bbl. In this environment, 2% is a big deal, particularly given the looming prospect of carbon surcharges that could erode about $2.40/bbl of that margin (this assumes 19.36 $lbCO_2e$/gal, $10/$MtCO_2e$ GHG prices and a 35% tax rate).

Conclusion

Mr. Chairman, current oil and gas tax policies embody the energy strategies and value judgments of past generations of lawmakers and regulators. These energy policies can and should change just as the economic circumstances and the energy technologies they govern are likely to change. I remain optimistic that this Committee and this Congress will continue to craft energy policy that reflects practical and well-considered trade-offs even as the nation charts a predictable course towards an "ideal" energy policy future. After all, at this point in our nation's economic history, it seems equally irrational to demonize the taxes that will fund government operations as it is does to demonize the fossil energy that will power our economic recovery.

This concludes my prepared statement. I will look forward to any questions at the appropriate time.

An Economic Assessment of Eliminating Oil and Gas Company Tax Preferences

Testimony Prepared for a Hearing on

Oil and Gas Tax Provisions:
A Consideration of the President's FY10 Budget Proposal

Subcommittee on Energy, Natural Resources and Infrastructure
Committee on Finance
United States Senate
Thursday, September 10, 2009

Stephen P.A. Brown
Nonresident Fellow, Resources for the Future

Mr. Chairman, thank you for the opportunity testify before the subcommittee about the president's proposal to raise about $30 billion in additional revenue by eliminating oil and gas company tax preferences. My name is Stephen Brown. I am a nonresident fellow at Resources for the Future (RFF), a 57-year-old research institution, headquartered here in Washington, DC, that focuses on energy, environmental, natural resource, and public health issues. Nonresident means that I primarily live and work elsewhere, in my case, Texas.

RFF is both independent and nonpartisan, and it shares the results of its economic and policy analyses with members of both parties, environmental and business advocates, academics, members of the press, and interested citizens. RFF neither lobbies nor takes positions on specific legislative or regulatory proposals, although individual researchers are encouraged to express their individual opinions, which may differ from those of other RFF scholars, officers, and directors. I emphasize that the views I present today are mine alone.

Summary Remarks

As part of his proposed budget, the president has recommended eliminating $31.5 billion worth of tax preferences for U.S. oil and gas production—as estimated over the time period 2011 to 2019. Over the same time period, U.S. oil and gas production is projected to value about $3.4 trillion.

Although the tax preferences represent less than one percent of the oil and gas industry's projected revenue, a call to end them raises questions about how such preferences fit into the overall U.S. tax system, how eliminating the preferences will affect U.S. oil and natural gas markets, and how the resulting changes in energy markets will affect U.S. energy security, employment, and regional economic activity. Those are the issues I address today.

Tax preferences are instruments of policy. Their use should be limited to activities that need more encouragement than is provided by free market forces. Otherwise, tax preferences reduce overall economic wellbeing. The near record-high prices that are projected for oil and natural gas over future years suggest that free markets will provide sufficient encouragement for the development of domestic oil and natural gas resources, and that additional government encouragement is not needed at this time.

Ending preferential tax treatment for U.S. oil and natural gas production will have very small effects on U.S. oil and natural gas markets—primarily because the increased tax revenue amounts to less than one percent of the total revenue the industry is projected to earn on its domestic production. Over the 2011 to 2019 timeframe used in the president's budget projections, eliminating the tax preferences would mean that the average U.S. consumer will pay about $1.40 more per year for petroleum products and natural gas. That figure compares with an annual gain in U.S. government revenue of about $10.70 per U.S. consumer that would be obtained by eliminating the tax preferences.

By my estimates, eliminating the tax preferences would boost the world oil price by an average of about 6 cents per barrel over this timeframe, which would mean increases in gasoline, diesel, and home heating oil prices of less than 0.2 cents per gallon. U.S. oil producers would receive an average of 84 cents less per barrel of oil. These changes are relatively small when compared to the U.S. Energy Information Administration's (EIA) projected trajectory for world oil prices of $65 to $115 per barrel over the reference period.

I also estimate that eliminating the tax preferences will boost the market price of natural gas by an average of about 2.4 cents per million Btu over the 2011 to 2019 timeframe. At the same time, the after-tax price received by domestic natural gas producers will fall, on average, about 2.7 cents per million Btu. Again, these changes are quite small when compared to the. EIA's projected trajectory for U.S. natural gas prices of $5.47 to $7.11 per million Btu between 2011 and 2019.

The small changes in oil and natural gas prices mean correspondingly small changes in market quantities. U.S. oil consumption would fall very slightly—about 0.04 percent. U.S. oil production would fall by 0.36 percent. U.S. oil imports would rise by an estimated 0.1 percent of U.S. oil consumption. U.S. natural gas consumption would fall by 0.2 percent, while domestic natural gas production will fall by more than 0.25 percent. Natural gas imports will rise by an estimated 0.03 percent of consumption.

The small reduction in U.S. oil consumption would slightly enhance energy security by reducing the overall exposure of U.S. economic activity to oil price shocks. The small gain in U.S. oil imports will likely have a small negative effect on energy security because it can be expected to increase the market share of unstable oil-producing countries. The net effect is to slightly increase the exposure of the economy to oil-supply disruptions. The very small gain in natural gas imports is of little concern because domestic sources are projected to supply more than 90 percent of U.S. natural gas consumption—even after tax preferences

are eliminated for domestic oil and natural gas production. Again, the security effects are small because the changes in oil and natural gas market conditions are small.

The U.S. economy tends toward full employment, so eliminating the oil and gas company tax preferences is unlikely to have a significant effect on overall U.S. employment. Given the relatively small effects on oil and natural gas markets, the primary economic effects will be to shift activity slightly away from those regions of the United States that either produce or heavily consume oil and natural gas toward the rest of the nation.

Introduction

The president's budget proposal calls for eliminating tax preferences for U.S. oil and natural gas production—an action that is estimated to boost U.S. government tax revenue by a total of $31.5 billion over a nine-year period from 2011 to 2019.[1] Over the same time period, calculations based on recent projections by the U.S. Energy Information Administration (EIA) indicate domestic oil and gas production will yield revenues of about $3.4 trillion (in constant 2007 dollars).[2] Although the tax preferences represent less than one percent of the oil and gas industry's projected revenue, a call to eliminate them raises questions about how such preferences fit into the overall U.S. tax system, how eliminating the preferences will affect U.S. oil and natural gas markets, and how changes in energy markets will affect U.S. energy security, employment, and regional economic activity.[3] These issues are examined in the sections that follow.

Some Economic Principles of Tax Preferences

The provision of services requires the government to generate revenue. It is generally recognized that the government claim on resources prevents their use in the private sector, so economists have often suggested that the productivity of resources used in the public sector ought to equal that in the private sector. What may not be well understood outside the economics profession is that the means of taxation reshapes economic activity in the private sector in such a way that the potential loss in the value of private sector output is greater than the simple transfer of resources to the public sector.[4]

To promote economic wellbeing, tax policy must be directed at minimizing the undesired interference with the private sector. Such a goal is generally furthered through broadly applied taxes that treat all economic activity equally.[5] The exceptions to such a rule occur when tax policy is used to redirect private economic activity toward socially desirable goals or away from socially undesirable outcomes, as examined by Schultze (1977). Therefore, tax preferences are instruments of economic policy, and their value should be assessed in light of current market conditions and policy objectives.

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[1] See Office of Management and Budget (2009) and U.S. Department of Treasury (2009).
[2] See Energy Information Administration (2009b).
[3] Changes in U.S. oil and natural gas prices also will affect U.S. coal markets. Given the small scale of the potential changes in policy, implications for coal markets are ignored.
[4] The provision of government services also can be inefficient. See Brown and Saving (2002).
[5] See Musgrave and Musgrave (1989).

As seen from the perspective of policy, tax preferences for domestic oil and gas production could be justified on the basis of promoting more U.S. oil and gas production than would be provided in a free market—perhaps to sustain the domestic industry and promote energy security when energy prices are unusually low. When energy prices are high, as they have been in recent years and are projected to be in coming years, such tax preferences are not needed to support a strong domestic energy industry, and do relatively little to enhance energy security.

Unless tax preferences are used as an instrument of policy, they can be harmful to economic activity. Tax preferences shift the overall mix of economic activity from that determined in a free market. Moreover, the foregone revenue necessitates higher taxes on other activities to close the budgetary gap, and those tax gains further shift the mix of economic activity away from that determined in a free market.

The Effects on U.S. Oil Markets

The estimated effects on U.S. oil markets of eliminating tax advantages for U.S. oil and natural gas production are quite small—primarily because the oil and gas company tax advantages that would be eliminated are miniscule in comparison to the projected world oil prices. Even at projected world oil prices in excess of $100 per barrel, the additional tax revenue is less than one dollar per barrel.

For the period used in the president's budget projections, eliminating the tax preferences would boost the world oil price by an average of about 6 cents per barrel, as is shown in Figure 1. Such an increase in oil prices translates into a gain of less than 0.2 cents per gallon of gasoline, diesel fuel, or home heating oil. The change in consumer prices is very small because oil prices are determined on an international market in which the United States accounts for less than 10 percent of production.

As a result of higher world oil prices, the average U.S. consumer would spend an estimated 60 cents more on petroleum products each year. Meanwhile, the government would collect an average of $7.06 in additional revenue from crude oil and natural gas plant liquids for each consumer annually.

With the international market dulling the impact on consumers, eliminating the oil and gas company tax preferences would reduce the after-tax price received by domestic oil producers by an average of 84 cents per barrel over the budget assessment period. As shown in Figure 1, this reduction is quite small in relationship to the EIA projected prices of $65 to $115 per barrel over the same time period.

The small changes in oil prices would yield correspondingly small changes in U.S. oil consumption, production and imports. The slight gain in consumer prices would reduce domestic oil consumption by an average of 7,000 barrels per day over the period 2011 to 2019, less than 0.04 percent of the projected U.S. oil consumption of 20 million barrels per day. Because domestic oil production is relatively sensitive to after-tax prices, it will fall by

an estimated 26,000 barrels per day—almost 0.4 percent of the projected 7.3 million barrels per day in U.S. oil production (including crude oil and natural gas plant liquids).[6] Filling the gap, U.S. oil imports will rise by an estimated 19,000 barrels per day—about 0.1 percent of projected U.S. oil consumption.

About the Oil Market Estimates: A small simulation model of the international oil market was used to estimate the effects on international oil markets of eliminating U.S. oil and gas company tax preferences. The model takes as its baseline the projected domestic and international oil market conditions reported in the *Updated Annual Energy Outlook 2009* produced by the EIA.[7] This April update incorporates revised expectations for overall economic activity and the provisions of the American Recovery and Reinvestment Act that were enacted in mid-February 2009. The EIA outlooks assume no new policy initiatives and are widely available, well documented, frequently compared with other major energy outlooks, and often evaluated for their ability to track the historical record. Specific estimates depend on the baseline assumptions, but the qualitative findings do not.

The Effects on U.S. Natural Gas Markets

Over the period used in the president's budget projections, eliminating oil and gas company tax preferences would boost the U.S. natural gas price by an average of about 2.4 cents per million Btu, as is shown in Figure 2. Over the same period, eliminating the tax preferences would reduce the after-tax price received by domestic natural gas producers by an average of about 2.6 cents per million Btu. As shown in Figure 2, these changes are quite small in comparison to the EIA projected trajectory of prices from $5.47 per million Btu at Henry Hub in 2011 to $7.11 per million Btu in 2019.[8]

As a result of higher prices, the average U.S. consumer would spend an estimated 82 cents more on natural gas each year. Meanwhile, the government would collect an annual average of $3.65 in additional revenue on dry natural gas for each consumer.

The changes in natural gas prices will yield correspondingly small changes in U.S. natural gas consumption, production, and imports. U.S. natural gas consumption would be reduced by an average of 42 billion cubic feet annually over the 2011 to 2019 timeframe—about 0.2 percent of the projected U.S. consumption of 21.3 trillion cubic feet per year. Domestic natural gas production will fall by an estimated 49 billion cubic feet annually—about 0.25 percent of projected U.S. natural gas production of 19.4 trillion cubic per year. Natural gas imports will rise by an estimated 7 billion cubic feet per year—about 0.03 percent of U.S. natural gas consumption.

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[6] The EIA finds that U.S. crude oil production is sensitive to price because the domestic resource base generally requires more costly secondary or tertiary recovery techniques. See Energy Information Administration (2009a).

[7] See Energy Information Administration (2009b).

[8] Henry Hub is the principal trading hub for natural gas in the United States, and the price at this location is used as a standard reference for U.S. natural gas pricing.

About the Natural Gas Market Estimates: A small simulation model of the U.S. natural gas market was used to estimate the effects on U.S. natural gas markets of eliminating the oil and gas company tax preferences. Similar to the approach taken for estimating the effects on oil markets, the model takes as its baseline the projected domestic natural gas conditions, including imports reported in the EIA's *Updated Annual Energy Outlook 2009*.[9] Specific estimates depend on the baseline assumptions, but the qualitative findings do not.

Consequences for Energy Security

Changes in oil consumption and oil imports raise issues about energy security. Practical experience and a long-established economics literature—assessed by Brown and Yücel (2002); Jones, Leiby, and Paik (2004); Kilian (2008); and Hamilton (2009)—has found that oil supply shocks can lead to sharply rising oil prices and weakened U.S. economic activity. In fact, sharply rising oil prices have preceded all but one of the eleven U.S. recessions since World War II.[10] Because the U.S. economy is vulnerable to oil supply shocks, reducing the potential size or economic consequences of such shocks is at the heart of energy security.[11]

Because oil is fungible, market forces transmit oil supply shocks to oil prices worldwide. The oil price shocks experienced in the United States depend neither on the extent of its oil imports nor on the specific countries from which it imports oil. U.S. oil consumption plays an important role in its energy security because oil consumption determines the extent to which its economic activity is exposed to internationally transmitted oil price shocks.[12]

U.S. oil imports play a role in energy security only to the extent that they affect the expected size of future supply shocks by changing how much potentially unstable producers contribute to world oil supply. Because historically unstable producers adjust their production to world market conditions, they are among the marginal sources of world oil—even though other producers have higher costs, which makes them among the most likely to respond to changes in U.S. oil imports. Consequently, small reductions in U.S. oil consumption will slightly enhance the nation's energy security, while gains in U.S. oil imports will reduce energy security slightly. The net effect on security is to increase the expected loss in economic activity and transfers abroad by an estimated $7.9 million per year.

The story is quite different for natural gas because high transportation costs limit international arbitrage of world natural gas prices.[13] So, the very small gain in natural gas imports is of relatively little concern because domestic sources are projected to supply

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[9] The EIA *Updated Annual Energy Outlook 2009* shows projected natural gas prices substantially below that suggested by the historical relationship with crude oil prices that is documented by Villar and Joutz (2006), Brown and Yücel (2008), and Hartley, Medlock, and Rosthal (2008). The historical relationship depends on substitutability between natural gas and petroleum products, which is seen as substantially diminished in the EIA outlook.

[10] See Hamilton (1983) and Balke, Brown, and Yücel (2008).

[11] See Leiby (2007).

[12] See Brown and Huntington (2009).

[13] See Brown and Yücel (2009).

more than 90 percent of U.S. natural gas consumption—even after tax preferences are ended for domestic oil and natural gas production.

Employment and Regional Economic Effects

The U.S. economy tends toward full employment, so eliminating the oil and gas company tax preferences is unlikely to have a significant effect on overall U.S. employment. Given the relatively small size of the changes in oil and natural gas markets, the primary economic effects will be to slightly shift activity away from those regions of the United States that either produce or heavily consume oil and natural gas toward the rest of the nation.

The shifts in economic activity should occur relatively smoothly. Although firms do look ahead, the slight reductions in energy industry employment and shifts in regional economic activity will come mostly from prospective growth rather than current employment. Even after losing their tax preferences, the industry can expect to benefit from rising oil and natural gas prices as the world economy recovers.

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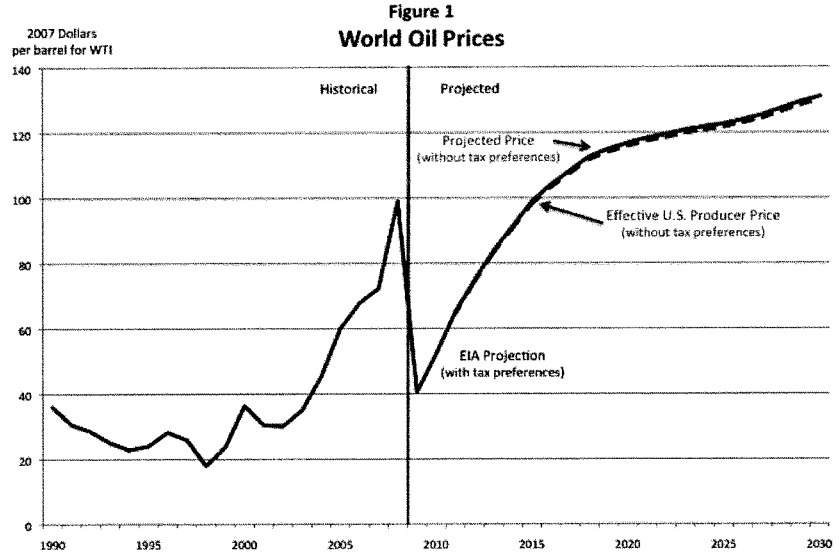
Figure 1
World Oil Prices

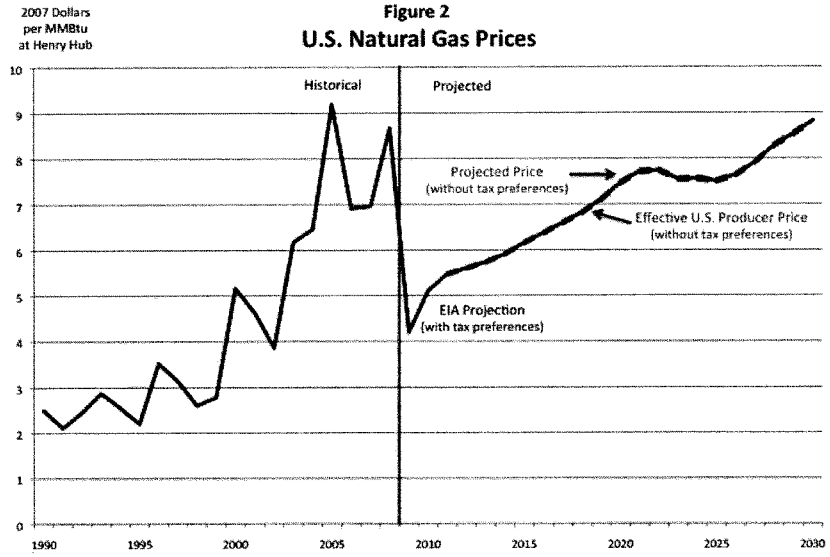


Notes:
EIA projections (represented in blue) show the price of oil rising from a low of $40.52 per barrel of West Texas Intermediate crude oil in 2009 to a high of $130.92 in 2030. Over the 2011 to 2019 period used in the president's budget projections, the EIA projection rises from $65.02 to $114.99 per barrel, averaging $94.87 per barrel.

With the tax preferences eliminated, the projected oil prices (represented in dashed red) rise from $65.06 per barrel in 2011 to $131.00 in 2030. Over the 2011-2019 timeframe, the projected oil prices rise from $65.06 to $115.06 per barrel, averaging $94.93 per barrel.

With the tax preferences eliminated, the effective price for U.S. oil production is $0.62 below the projected market price in 2011 and $1.24 below the projected market price in 2030. The effective price for U.S. oil production (represented in dashed green) rises from $64.44 in 2011 to $129.76 in 2030. Over the shorter timeframe used to analyze the budget, the effective price for U.S. oil production rises from $64.44 to $113.97 per barrel, averaging $94.03 per barrel.

Figure 2
U.S. Natural Gas Prices



Notes:
EIA projections (represented in blue) show the price of natural gas rising from a low of $4.20 per million Btu at Henry Hub in 2009 to a high of $8.83 in 2030. Over the 2011 to 2019 period used in the president's budget projections, the EIA projection rises from $5.48 to $7.12 per million Btu, averaging $6.20 per million Btu.

With the tax preferences eliminated, the projected Henry Hub natural gas prices (represented in dashed red) rise from $5.50 per million Btu in 2011 to $8.86 in 2030. Over the shorter 2011 to 2019 timeframe, the projected natural gas price rises from $5.50 to $7.14 per million Btu, averaging $6.23 per million Btu.

With the tax preferences eliminated, the effective price for U.S. natural gas production is 5.2 cents per million Btu below the market price in 2011 and 8.4 cents in 2030. The effective price for U.S. natural gas producers (represented in dashed green) rises from $5.45 in 2011 to $8.78 in 2030. Over the shorter timeframe used to analyze the budget, the effective price for natural gas producers would rise from $5.45 to $7.08 per million Btu, averaging $6.17 per million Btu.

Statement of Senator Jim Bunning
Finance Subcommittee on Energy, Natural Resources and Infrastructure
Hearing on "Oil and Gas Tax Provisions: A Consideration of the President's FY2010 Budget Proposal"
September 10, 2009

Thank you, Mr. Chairman. I am glad that we are holding this hearing today because it raises some very important issues.

This is not just about raising taxes on the oil and gas industry. The President's proposals threaten our national security, energy security, economic security, and job security.

We are at crossroads in our nation's energy policy. I have long said that we have the resources and innovation to develop our domestic energy industry in a way that is more efficient and environmentally sound.

We must, however, develop all of our energy resources and not get into a dangerous political game of excluding two of our most relied upon sources from our national energy strategy.

We all want clean, renewable sources of energy. But it will take decades before those sources come close to fueling our economy. In the meantime, we must have a rational national energy strategy or American workers and consumers will pay the price.

With America in the midst of a recession, now is not the time to impose new taxes on our oil and natural gas industry.

These new taxes will mean less domestic energy production, fewer American jobs and less revenue at a time when we desperately need all three.

It will also jeopardize our nation's energy security by discouraging new investment in domestic oil and natural gas production and refining capacity.

These investments -- and the jobs that go along with them -- will be pushed abroad.

It will weaken American competitiveness in the global oil market and increase our reliance on foreign oil and natural gas from unfriendly countries.

And ironically, these tax hikes may actually damage the environment by shifting production to countries with less stringent environmental standards.

For nearly a century, our tax code has recognized that oil and gas production is extremely capital-intensive, and it is in our national interest to ensure investments in domestic production go forward.

This is not unique to oil and gas. The tax code is filled with incentives for domestic energy production from a variety of sources, and for good reason – our economy grinds to a halt without abundant, affordable sources of energy.

The American public will be stunned to learn that increasing domestic production is no longer our national goal. Instead, the Obama Administration wants to discourage domestic "overproduction," as it said eight times in Treasury's explanation of the President's tax proposals. I wasn't aware that overproduction of American-made energy is a problem.

Some of today's witnesses will argue that the President's proposals will have a small impact on oil and gas production, prices at the pump, and jobs. But when the President's tax increases on oil and gas are combined with other tax increases in the President's budget, this amounts to an 80 billion dollar tax hike on oil and natural gas.

It is foolish to believe that these tax hikes will not have an impact on investments, on domestic supply, on consumer prices, and on the nine million jobs that depend on the oil and gas industry. The witnesses who believe the impact will be small have probably never had to raise capital for an enterprise or make long-term business plans.

I would hope that we don't damage our national energy strategy and economy in order to score political points.

Thank you, Mr. Chairman, and I look forward to hearing from our witnesses.

Testimony before the
Senate Finance Subcommittee on Energy, Natural Resources, and Infrastructure

September 10, 2009

"Honest and Accurate Tax Accounting for Oil & Gas"

Calvin Johnson
Andrews & Kurth Centennial Professor of Law
The University of Texas School of Law

I. Introductory Remarks.

My name is Calvin Johnson. I have been a professor of law at the University of Texas Law School since 1981.[1] I help run the "Shelf Project," which is a collaboration by tax professionals to develop and perfect proposals to raise revenue by defending the tax base.[2]

Uncle Sam is going to need significant revenue. The Congressional Budget Office estimates that the federal budget deficit for 2009 will total $1.6 trillion, or 11.2% of gross domestic product.[3] Once the need for short term stimulus has passed, that deficit must be closed. In the impending revenue crisis, base-protecting revenue provisions that were not possible under ordinary politics become political necessities.

In raising revenue, it is better to go after the low tax and negative tax transactions before raising tax rates. A tax system does the least harm to the private economy if is broad, unavoidable and neutral between investment choices. A broad, healthy tax base allows us to raise the necessary revenue at the lowest feasible tax rates. A broad, least-damage tax would impose uniform effective tax rates on all alternative investment choice. Investment decisions should be governed, not by tax accounting, but by real nontax merits of the investments. We need to get the tax accounting right to describe real economic income, just as we need to keep our laboratory data honest and accurate, no matter how important the experiment.

Under the standards of a broad, unavoidable, and neutral tax base, we will need significant improvement in the tax accounting used for oil and gas. Tax accounting for oil and gas does not describe the economic income from the investment. Indeed, for a broad range of reasonable assumptions, oil and gas accounting delivers a negative tax or subsidy to profitable investments. With tax accounting so bad, even highly profitable investments in the oil and gas area cannot provide a source of revenue for our Uncle Sam.

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[1] A curriculum vitae, frequently updated, which includes links to publication is found at http://www.utexas.edu/law/faculty/cvs/chj7107_cv.pdf.

[2] The shelf project is described at *The Shelf Project: Revenue Raising Projects that Defend the Tax Base,* 117 TAX NOTES 1077 (2007) [http://www.utexas.edu/law/faculty/calvinjohnson/shelf-project.pdf].

[3] Congressional Budget Office, The Budget and Economic Outlook:
An Update (Aug. 2009), http://www.cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate_Summary.pdf

For example, under reasonable assumptions, the combination of four tax preferences generates a subsidy that is a *negative* 42% of real income. The four preferences are the expensing of intangible drilling costs, the pool of capital doctrine, the percentage depletion allowance and the domestic manufacturing deduction. The subsidy from the combination means that an oil and gas investment can in reality lose over half of its cost of capital before tax and still make money after tax. Investments are not more virtuous because they lose money in absence of tax. Honest and accurate tax accounting for oil and gas would make taxable income describe the economic income from oil and gas and stop the tax subsidies.

No one has yet made a plausible case that a subsidy is needed for oil and gas beyond the wisdom of the laws of supply and demand. The price of oil and gas is high enough to provide sufficient incentive. If more incentive is needed, the price will adjust. Indeed, an increase in the price of oil and gas, if any, would help us conserve energy, and adjust to alternative energy sources and high energy prices in the future. The government should get out of the business of subsidizing oil and gas, especially via the tax system.

None of the tax advantages accorded to oil and gas have ever been subjected even to the care that we give to government spending. The competitive federal budget is the primary mechanism by which the government applies rationality to the alternative use of resources. Budgeted spending is subject to discipline because government spending is widely hated. When items are off budget, however, as when they are accomplished through the tax system, the subsidies avoid the budget competition for resources. When Congress allows tax advantages, they do not think of the burdens on the deficit as real money and the costs they incur, including the tax expenditures for oil and gas, therefore turn out to be irrational. Tax advantages are stealth subsidies, not understood to be real money by the people or the Congress that adopted them and they have never been justified by analysis or political legitimacy.

The following eight tax privileges now available to oil and gas should be repealed:

(1) Repeal Intangible Drilling Cost. Drilling for oil or gas is an investment, properly treated as a capital expenditure. But under current law, the investment is treated as a worthless expense, lost and deductible when made. Immediate expensing for an investment means that tax does not reduce the pre-tax internal rate of return from the investment. The economic or effective tax rate on a drilling investment has an expected value of zero.

(2) Repeal Pool of Capital doctrine. Under the pool of capital doctrine, a drilling enterprise may pay many of the costs of drilling by giving out an economic interest in the well, without either the enterprise or the provider of goods or services paying tax. An accounting system can describe real internal rate of return and impose tax at the statutory tax rates only if the adjusted basis of the investment is equal to discounted present value of the investment. Paying for royalties, goods and services with carried interests should be considered to be a taxable exchange of the underlying assets, both to the payor and to the recipient.

(3) Repeal of Working Interest Exemption from Passive Activity Loss Limitations. The Tax Reform Act of 1986 was able to reduce maximum tax rates from 50% to 28%, but only because the passive activity loss limitations so effectively attacked tax shelters as they were then

known. The Passive Activity Limitations remain the most effective of the anti-shelter tools. We need to end the exemption for working interests in oil and gas property from the limitations.

(4) Limiting Percentage Depletion to Basis. Percentage depletion allows the deduction of imaginary costs, because it continues even after real costs have been fully deducted. This accounting error was adopted because of an error in identifying "capital" to be recovered as the *value* of a gold mine when discovered, rather than its much lower cost.

(5) Repeal Exclusion as to Domestic Production. Six percent of income from oil and gas extracted in the U.S. or the continental shelf is excluded from tax. The exclusion is part of the reason why tax rate on oil and gas investments is negative and why money losing investments go forth for the tax benefits.

(6) Recover Geological and Geophysical Costs under Cost Depletion. Current law allows the geological and geophysical costs of identifying promising properties over two years, but a producing oil deposit found by the surveys can last for 30 years.

(7) Repeal LIFO inventory accounting. LIFO accounting allows taxpayer to keep in basis the oldest and lowest costs since the inventory accounts began. To reflect economic income, basis should come as close to fair market value as possible. FIFO should be mandated for oil and gas inventories.

(8) Repeal the tax credits. There is a 15% tax credit for Enhanced Oil Recovery Projects and a tax credit of $3 per barrel for marginal wells. Neither credit is now available because the price of oil has risen high enough to give adequate incentive, under the terms of the statutory provisions. The credits need to be repealed, while they have no effect. Indeed the lesson extends beyond the credits: the price of oil is high enough to give adequate incentive. No tax advantages better than normal taxation are needed or appropriate.

II. Fundamentals of Tax Economics for Oil and Gas.

Oil and gas transactions commonly benefit from a negative tax or subsidy, that is, the internal rate of return is higher for the investment after tax than before tax. This section presents a simple illustration that takes into account four tax preferences, i.e., expensing of intangible drilling cost, pool of capital doctrine, percentage depletion and domestic production exclusions, assuming that all are available. In the illustrative investment, tax *adds* 41% to the value of the investment and also allows investments to go forward that destroy over half their cost of capital. All of the tax advantages are subject to conditions and restrictions, which are discussed in the section which follows the simple illustration.

A. Soft Money Investing means Tax Exemption for Drilling.

The ability to deduct an investment immediately ordinarily means that tax does not reduce the taxpayer's pretax return from the investment. Getting into an investment with a deduction or exclusion is "soft money investing" and it means tax does not reduce the amount available for investment. "Soft money investing," is ordinarily of the same value as exemption

from tax for the profit or gain from the investment. The thesis is routine to tax economists, but is not commonly evident in statutory or judicial decision making.

Assume, to illustrate the point, a taxpayer, described in Table 1, below, has $100 income that will be invested in drilling for oil. The investment will triple in some unstated period of time. The assumed tax is a one-third, 33.3% tax rate. Exemption of the return is described in Column (A) of Table 1 and soft money investing is described in Column (B).

Column (A) describes the after tax result if the investment is capitalized, but the gain from the investment is exempt from tax. Capitalization of the investment is normal to an income tax because an investment is not a loss. Because of capitalization in column A, there is immediate tax on the $100 income, which reduces the amount available for investment to two-thirds. The amount invested then triples to $200. Our assumption in Column (A), however, is that there is no tax on the tripling so that the end result capitalization and exemption in Column (A) is $200.

An income tax would also ordinarily tax the gain in Column A. Under normal income tax, the gain in the tripling, $133.33, would be subject to a one third tax (or $44.44), which would reduce the after tax proceeds to $155.55. Tax of both the investing and the return is implied by our tax treating of debt financing, which gives both a deduction for interest and basis or exclusion for principal. Within in income tax, avoiding the tax on gain, which is shown in Column (A) is recognized as a benefit.

Table 1: Tripling is tax exempt		
	(A) Capitalized investment	(B) Soft Money Expensed or Excluded.
1. Income at $100	$100	$100
2. Tax on row 1 at 35%	($33)	0
3. Investable amount (1.-2.)	$67	$100
4. Investment (3.) triples	**$200**	$300
5. Basis	*$67*	0
6. Taxable amount	*$133*	$300
7. Tax at one-third of 6.	Tax Exempt	($100)
8. End result (4.-7.)	**$200**	**$200**

In Column (B), the $100 is an intangible drilling cost and the taxpayer is able to deduct the entire cost immediately. Because of the deduction, none of the $100 income is taxed. The full income of $100 may thus be invested. In Column (B) there is no exemption for the tripling. Still, the result in Column (B) is the same, $200, as in Column (A) with no tax on the profit. Therefore, the ability to expense the investment immediately is as valuable as a privilege of paying no tax on the gain.

Effective tax rate measures how much tax reduces the pretax internal rate of return from the investment.[4] The effective tax rate in Column (A) is zero because tax does not reduce the tripling before tax, and the effective tax rate in Column (B) is zero because tax has the same impact as in Column (A).

The results of Table 1 can be generalized by algebra, provided the tax rate at the start of the investment (row 2) is the same as at the end (row 7), the pretax return (tripling here) is the same on both columns, and the amount invested is sensitive to the upfront tax cost in row 2:

Terminal Value, Exempt Yield and Expensed		
Exempt income (col. A)	=	Expensed Investment (col. B)
$\$100 * (1-t) * (1+R)^n * (1-0)$	=	$\$100 * (1-0) * (1+R)^n * (1-t)$
Where \$100 is unit investment, t is tax rate, $(1+R)^n$ is compound growth at rate R over n, and (1-0) denotes no tax.		

The equivalence is an application of the commutative law of the multiplication, which says that it does not matter the order in which (1-t) and (1-0) appear. The equivalence of yield exemption and expensing is often called the Cary Brown thesis after its discoverer.[5]

The Column B model was set up to describe the portion of the investment qualifying as intangible drilling cost. Column (B), however, also describes the results of the pool of capital doctrine, or the results of a mixture of pool of capital doctrine and expensing of intangible drilling costs. The pool of capital doctrine, as discussed below, allows an enterprise to pay for goods and services put into a drilling venture by giving factor suppliers an economic interest in the well. If the supplier or royalty receiver is willing to take payment for value delivered in the form not of cash, but rather an interest in the outcome of the oil well, then there is no tax on the venture at row 2, before investment. Capitalized investments, under an income tax regime, requires a reduction by tax before the investment may be made (Row 2 of Column A, Table 1), but paying with untaxed interests allows enterprise to invest without tax (Row 2 of column (B)).

A corollary of the Cary Brown thesis is that you can deduce how much tax reduces the pretax interest or internal rate of return by looking to the ratio of adjusted basis to nontax fair market value.[6] Companies like Jet Blue and Macy's have a tax basis near or above their fair market value and thus they pay effective tax rates at or above statutory tax rates. Companies, including oil companies and software game development companies have a basis that is a small fraction of their value and so have modest effective tax rates. The impact of the differential real tax rates throughout the tax system is that tax warps the pretax value of an investment derived

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[4] Effective tax rate = $(IRR_{pretax} - IRR_{post\ tax})/ IRR_{pretax}$

[5] Cary Brown, *Business-Income Taxation and Investment Incentives*, *in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSON 300 (1948).

[6] Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (2008). Briefly a soft money investment ("S")(eg in Col. (B) of Table 1) can be 1/(1-T) the size of a capitalized investment ("H" for hard money), where T is the statutory tax rate. The effective tax rate is (pretax return – post tax return)/ pretax return or
$\{(H + S)*R - [H + S/(1 - T)] * R * (1-T)\}/ (H + S)*R = H/(H+S)* T$
H is basis and H+S is pretax value.

from real customer demand, and shifts investment to lower utility projects. The wide divergence in real tax rates, across the system, means that tax is damaging the allocation of capital unnecessarily.

B. Finding Economic income.[7]

A tax system that imposed the same economic effective tax rate on all investments would reduce the harm that the tax system now does to the private economy. Investments decisions should be driven by the real demand and by costs outside of the tax system and not by differential tax treatment or tax accounting misdescriptions. "Effective tax rate" is as the measure of impact of tax on pretax internal rate of return:

$$\text{Effective tax rate} = (IRR_{pretax} - IRR_{post\ tax})/\ IRR_{pretax},$$

where IRR stands for internal rate of return.[8] Internal rate of return is a universal yardstick for comparing diverse investments. It is the interest rate on a hypothetical bank account that is like the investment under examination. The impact of tax on that interest-like internal rate of return is measure of the real impact of tax, whatever the nature of the investment and whatever the manner or time of computation of the tax or the nominal, statutory tax rate. The formula for effective tax rate, above, asks how much tax has dropped the internal rate of return and then takes that drop as a percentage of the pretax internal rate of return. Imposing the same effective tax rate on investments across the economy prevents property from being worth more to high bracket taxpayers than low bracket taxpayers, and prevents tax from distorting the pre-tax choice of what is a good investment.

To impose a uniform effective tax rate, accounting must identify the interest-like internal rate of return from the investment and subject it to tax. If the tax accounting identifies the interest-like internal rate of return, it will simultaneously identify the amount that is like the bank account balance of that bank account that matches the investment under examination and will yield an adjusted basis for tax equal to that hypothetical bank account. Tax accounting identifying internal rate of return and bank account balance is forced, for instance, by our treatment of debt, which allows a deduction of interest and respect for the principal of the debt, which is the mirror image of treating the investment as a bank account. A neutral tax accounting that describes and taxes economic income would keep adjusted basis for an investment equal to the net present value of the investment, using internal rate of return as the discount rate to determined net present value.

Assume, for example, an oil and gas venture with cash flows set to give a 10% return over 5 years in absence of tax:

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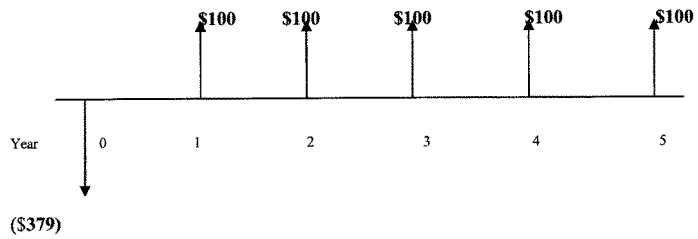
[7] The section is based on Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964).

[8] Effective tax is sometimes used to refer to total overall tax divided by overall income, in contrast to "marginal tax rate," which looks to the tax on the next dollar of change in income.



The investment gives a 10% interest-like internal rate of return per year before tax, because the $379 is the present value of the five $100 cash flows at 10% under the standard formula for present value of an annuity:

$$(1) \qquad \$379 = \$100 * \frac{1-(1+10\%)^{-n}}{10\%}$$

using i (discount rate) of 10% and n (number of years) of 5.[9]

The Cary Brown thesis that expensing is equivalent to no tax reduction of the pretax return can be restated simply from equation (1) because expensing would both reduce the after tax cost of the $379 investment by rate T, and tax would also reduce the $100 revenue by T:

$$(2) \qquad \$379 * \mathbf{(1-T)} = \$100 * \mathbf{(1-T)} * \frac{1-(1+10\%)^{-n}}{10\%}$$

Equation (2), the expensing case, becomes identical to the pretax situation, equation (1), when the tax of **(1-T)** is factored out of both sides of equation (2). The return rate "i" is the same 10% both pretax (equation (1)) and post tax, (2).

If we are to tax the 10% return in the investment, by contrast, and reduce the interest by the statutory tax rate, we would need to identify the interest earned every period. Table 2, analyzes the illustrated investment as if it were a bank account, giving the 10% interest rate. All investments are measured as if they were bank accounts because that is the universal yardstick by which very diverse investments are measured. Interest on the bank account that is like the investment under examination is the internal rate of return from the investment and it is what we mean by income in the economic sense.

To identify the interest or internal rate of return, it is necessary simultaneously to identify the bank account balance on which the interest is calculated, and keep that balance as part of undeducted adjusted basis. Table 2 assumes an investment of $379 in an oil and gas operation that returns pretax $100 or 10% interest a year for five years.

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[9] The standard annuity formula is a short cut, derived by series analysis, from the separate discounting of each $100 for different year, at the standard formula for present value, e.g., $100/ $(1+i)^n$.

Table 2. Economic Depreciation 5 Year, 10% Investment.						
	0	1	2	3	4	5
1. Revenue to give 10% IRR	($379)	$100	$100	$100	$100	$100
2. Adjusted basis, also bank account balance, also net present value of future revenue at IRR	$379	$317	$249	$174	$91	$0
3. Interest at 10% on bank account (prior year row 2.), also income.		$37.91	$31.70	$24.87	$17.36	$9.09
4. Withdrawal in excess of interest earned (a/k/a recovery of basis or depreciation) (row 1 minus rw 3.)		$62.09	$68.30	$75.13	$82.64	$90.91
5. New bank account balance rw 2. minus rw 4.		$317	$249	$174	$91	$0
6. Tax on rw 3 at 35%		$13.27	$11.09	$8.70	$6.07	$3.18
7. After tax cash flow (rw 1.-6.)		$86.73	$88.91	$91.30	$93.93	$96.82
7. Present value at found 6.5% {Rw 6./(1+6.5%)^n}. Row 7. sums to zero @ 6.5%	-$379.08	$81.44	$78.38	$75.58	$73.01	$70.67

In Table 2, each year the bank account earns interest, at the built-in 10% interest rate (identified in row 3). But the interest is not enough to cover the withdrawals from the bank account, that is, the cash flow revenue in row 1, so some part of each withdrawal is reduction of the bank account balance by amount of row 4. The row 4 withdrawals in excess of interest reduce the bank account balance to zero at the end of the term. The bank account balance (row 2) is always net present value of remaining revenue at the 10% IRR. Depreciation or recovery of basis is the drop in the bank account balance shown by row 4. If we tax the interest income identified in row 2, at 35%, the tax system will reduce the IRR from 10% to 10%*(1-35%) or 6.5%, which is the right after tax income implied by a 35% tax on 10% interest income. The present values of the after cash flows (row 7) sum to zero showing that the investment, under the tax of row 6, is like a bank account giving IRR or interest of 6.5%. Different investments will have different row 1 pretax cash flows, but if the depreciation and adjusted basis describe the income from the investment, the adjusted basis will equal net present value of the future cash flows from the investment at the IRR.

The adjusted basis that will identify economic income (IRR) can be calculated from net present value where future cash flows are assumed, as in the illustration, or when there is a broad market that sets a market price using estimates of fundamental value like the Table 2 analysis. More generally, however, the future cannot be known. Tax accounting thus must use conventions approximating fair market value basis to be administrable on a national basis with low audit rates. Still, the theoretical norm of what tax accounting would look like if we did tax

the economic income provides a purpose or goal for tax accounting. Accounting rules and conventions that leave the taxpayer with an adjusted basis closer to net present value of future cash flows are more accurate than accounting rules and conventions that leave the adjusted basis further away from net present value. The pool of capital doctrine and intangible drilling expense fail to reflect economic income because they drop the taxpayer's basis in the investment before the net present value of future cash flows.

C. Combining subsidies: Negative Tax.

Investments in oil and gas can sometimes qualify not only for the upfront, soft money investing benefits of expensing and pool of capital doctrine, but also for subsequent exclusions of revenue under percentage depletion and domestic production allowances. As discussed below, section 613 allows independent oil companies to exclude 15% of revenues from oil, and section 199, allows taxpayers to exclude 6% of earnings from domestic oil and gas production. Assume the same pretax investment discussed in Table 2, but assume soft money investing at the outset and the exclusions for percentage depletion and domestic production.

Table 3. Internal rate of Return after Four Tax Preferences (IDC, Pool of Capital, Percentage Depletion and Domestic Production).

year:	0	1	2	3	4	5	
1. Pretax cash flows, set up to give 10% IRR.	($379)	$100	$100	$100	$100	$100	
2. less 15% depletion allowance		$85	$85	$85	$85	$85	
3. less 6% of rw 2 for domestic manufacturing exclusion		$80	$80	$80	$80	$80	
4. Tax on row 3. at 35%		$28	$28	$28	$28	$28	
5. Expensing of row 1. saving tax at 35%	($133)						
6. After tax cash flow. {rw 1 less rw 4 or rw 5.}	($246)	$72	$72	$72	$72	$72	sum:
7. Present value at found 14.2 % IRR. {Row 6./(1+IRR)^n} Row 7. sums to zero at found 14.2% rate	($246)	$63	$55	$48	$42	$37	$0

The after tax cash flows, in row 6, have an internal rate return of 14.2% because 14.2% will sum the net present value of all the cash flows to zero. The 14.2% is the interest on a bank account that could give the cash flows equal to those in row 6. Tax has improved the investment from 10% pretax to 14.2% after tax. The improvement is a negative tax or subsidy of 42% of the original income.

Table 3 is undoubtedly a temporary advantage because competitors will move in like yellow jackets to sweet drinks when the return rate is so high. In equilibrium, returns drop on investments in a competitive economy, so that they have an annual return after tax equal to the cost of capital. Assume some competitor can borrow at 10% (same as return rate) and deduct the

interest so that after tax cost of interest is 10%*(1-35%) or 6.5%. Table 4, following, shows that given the tax benefits, the competitor can make as little as $87 a year or 4.9% return and still have enough to bear the costs of interest. The investment in Table 4 makes 4.9%, hence loses 51% of its real interest cost at 10% in absence of tax. Tax has given sufficient incentive to allow a wasteful investment, losing over half of its capital costs.

Table 4. Break even Pretax Cash Flows Given Four Tax Preferences (IDC, Pool of Capital, Percentage Depletion and Domestic Production).

year:	0	1	2	3	4	5	
1. Pretax cash flows with a found revenue to yield enough to pay interest cost.	($379)	$87	$87	$87	$87	$87	
2. less 15% depletion allowance		$85	$85	$85	$85	$85	
3. less 6% of rw 2 for domestic manufacturing exclusion	.	$80	$80	$80	$80	$80	
4. Tax on row 3. at 35%		$28	$28	$28	$28	$28	
5. Expensing of row 1. saving tax at 35%	($133)						
6. After tax cash flow. {rw 1 less rws 4 & 5.}	($246)	$72	$72	$72	$72	$72	sum:
7. Present value at debt cost 6.5% IRR. {Row 6./(1+IRR)^n} Row 7. sums to zero at 6.5% discount rate	($246)	$63	$55	$48	$42	$37	$0

The pretax cash flows in row 1 yield a return of only 4.9% annually.[10]

Allowing an investment like that shown in Table 4 wastes capital. The assumed cost of capital is 10% and the annual return at 4.9% wastes 51% of the cost. Absent showing of special merit in the budget process, a pretax money-losing investment is a bad investment that should not be made.

If the advantage of low tax or subsidy from the oil and gas preferences is passed on to customers, then customers get a false sense of the true costs of oil and they adapt to the falsely cheap prices by over-consuming oil. Cheap oil to consumers is especially dangerous now because we rely on foreign sources from dangerous parts of the globe for our oil,[11] and because

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[10] The 4.9% is the discount rate that makes costs and revenues have the same future value, hence 4.9% is the internal rate of return from the investment

(1) $\$379 = \$87.24 * \frac{1-(1+i)^{-n}}{i}$

using i (discount rate) of 4.9% and n (number of years) of 5

[11] *See, e.g.* William M Vandenburgh, *Raise Federal Tax Now or Pay OPEC Later*, 122 TAX NOTES 532 (Jan. 26, 2009) (arguing for increased tax on oil and gas to reduce dependence on foreign oil).

the over-consumption of oil contributes to global warming. Cheap oil undercuts conservation and the development of alternative energy sources. Consumers need to start now to adapt to the future when oil will become very expensive, because the adaptation will take considerable time.

If the subsidy from tax preferences for oil is not passed on to customers, then the subsidy just contributes to the net worth of taxpayers holding oil interests. Given the impending desperate revenue needs, a basic sense of fairness suggests that those with equal ability to pay tax should pay equal taxes whether they are in oil or in some other industry.

Ending the tax-preference subsidies to the extractive industries would improve the efficiency of consumer choices because prices will then reflect real, unsubsidized costs. In general in a capitalist system, the decisions reached by supply and demand and evidenced in unsubsidized price are presumed to represent the best decisions as to use of our limited resources. If Congress decides to subsidize oil and gas investments, it should do so only by way of a competitive budget for government spending.

III. Proposed Reforms of Oil & Gas Tax Preferences.

This section describes the most important tax preferences available for oil and gas investments under current law, the reasons for change, and then describes the remedy proposed here.

A. Soft Money, Upfront Benefits.

1. Intangible Drilling Cost.

Under current law, a taxpayer may deduct the costs of drilling for oil, as if it were a worthless or lost cost as soon as it is made, even when the drilling program is highly successful.[12] The deduction arises from a congressional resolution adopted to reverse a decision by the Fifth Circuit holding that intangible drilling costs were indeed investments and capital expenditures.[13] Costs eligible for expensing under section 263(c) must be costs that cannot be salvaged when the drilling is over.[14] An integrated oil company must reduce its expensed intangible drilling costs by 30% and amortize that 30% over five years.[15] In computing alternative minimum tax, the intangible drilling cost is amortized over five years.[16]

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[12] IRC §263(c).

[13] FHE Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir.) reh'g denied, 149 F.2d 238, second reh'g denied, 150 F.2d 857 (1945). See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶26.1.1 (2009).

[14] Harper Oil Co. v. United States, 425 F.2d 1335 (10th Cir. 1970) (Blackmun, J.) (drilling casings held not intangible drilling cost); Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) (accord); Exxon Corp. v. United States, 547 F.2d 548 (Ct. Cl. 1977) (construction of offshore platforms held not intangible drilling cost).

[15] IRC §291(b).

[16] IRC §56(g)(4)(D)(1), §312(n)(2)(A).

Immediate expensing for an investment, as noted, means that tax does not reduce the pre-tax internal rate of return from the investment. Combined with other preferences the tax rate is negative or subsidy. The subsidy has never been subjected to a competitive budgeted process for government spending, which is the primary process by which government evaluates its costs. The deduction creates a tax expenditure estimated to be worth $3.5 billion for 2007-2011.[17]

The price of oil provides the necessary incentive for oil and gas exploration. If the price is not sufficient to induce supply, the price will go up. In the impending revenue crises, the best source of revenue is the tax exempt and negative tax investments, such as those in oil and gas.

The proposed remedy would capitalize the costs of drilling for oil and allow recovery of the cost by cost depletion as the barrels of oil are extracted. Costs of an entire program would be capitalized, and recovered as oil from the entire program is extracted. Regulations would define the program unit, but the program needs to be defined as broadly as possible so that basis comes as close to value as possible. Costs of the entire program would be capitalized even if some of the wells within the program are dry. Costs would be recovered by cost depletion as oil from the program is extracted.

2. Pool of Capital doctrine.

Oil and gas ventures benefit from a low effective tax rate in part because they are able to pay many of the costs of the drilling without capitalizing their costs. As noted, the ability to make an investment out of untaxed soft money is a privilege ordinarily equivalent to zero tax on the investment profit. Under the pool of capital doctrine, a drilling enterprise may pay many of the costs of drilling by giving out an economic interest in the well, without either the enterprise or the provider of goods or services paying tax. In 1941, the IRS ruled that when the venture pays the landowner for the rights to explore and develop the deposit, pays the drillers, equipment suppliers, and the investors who contribute materials and services in connection with the development of a mineral property by giving them an economic interest in such property, the receipt of the economic interest does not result in realization of compensation or income. The contributors are viewed as not performing services for compensation or selling goods or inputs, but as making a contribution to a common pool and receiving an interest in that pool in return.[18] The venture is not considered to have disposed of assets of value by giving up the economic interest in the successful deposit. Absent the pool of capital doctrine, receipt of the interest in payment for goods and services would be ordinary income immediately, measured by the value of the interest.[19] Absent the pool of capital doctrine, the developer paying with a property interest would also need to recognize gain on the property transferred, measured by appreciation

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[17] JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES 2007-2011, (JCS 3-07) at 47.

[18] G.C.M. 22730, 1941-1 C.B. 214.

[19] The general rule is that a taxpayer who receives any oil interest as compensation must include the fair market value of the interest as ordinary income. See, e.g., Leland J. Allen v. Commissioner, 5 T.C 1232 (1945) acq 1946-1 C.B. 1.

of its cost in the transferred asset over its value.[20] Under the pool of capital doctrine, paying with economic interests results in recognition to neither the transferor nor the recipient.

In 1971, the IRS ruled that the pool of capital doctrine was limited to services and capital related directly to the drill site for which an economic interest was given.[21] The tax planners responded by giving out profits interests in partnerships, called carried interests.[22] Giving partnership income interests continues the privileges of nonrecognition to both the transferor and recipient that was allowed under the pool of capital doctrine.[23]

To impose an income tax at the statutory tax rates on extractive industries, costs would have to be capitalized until the taxpayer's basis is equal to the fair market value of its investment, determined using internal rate of return as the discount rate to calculate future cash flows. "Income" in financial economics is the interest on a bank account that matches the investment under examination. An income tax can identify the interest from an investment, and reduce it by the statutory tax rate, only if the bank account balance of the bank account that describes the investment is equal to the taxpayer's adjusted basis. Alternatively stated, a tax system can reduce an investment's pretax income by the statutory tax rate if and only if the taxpayer has an adjusted basis at the end of each year equal to the value of the investment.[24]

The remedy proposed here would be to treat the exchange of economic interests for goods, services and for the right to drill as taxable to both sides, so that adjusted basis of the investment reaches its value. Paying for royalties, goods and services with carried interests should be considered to be a taxable exchange of the underlying assets. Treating the exchange of goods and services for oil interests as taxable is a reform that needs to be extended outside of the oil industry into the imitators who picked up the carried interest idea from the oil patch. But the nontaxation of paying for necessary goods and services started in the oil patch and it can be fixed first in the oil patch.

3. Working Interest Exemption from Passive Activity Loss Limitations.

The Tax Reform Act of 1986 was a treaty across the aisle to reduce tax rates and end tax shelters as they were then known. Both in reducing rates and attacking shelters, the Act

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[20] Rev. Rul. 83-46, 1983-1 C.B. 16; Rev. Rul. 77-176, 1977-1 C.B. 77.

[21] Rev. Rul. 77-176, 1977-1 C.B. 77.

[22] Frank M. Burke, Jr., *Oil and Gas Taxation from 1972 to 1992: A Study in Questionable Tax Policy and Administration,* 57 TAX NOTES 871 (Nov. 12, 1992).

[23] Rev. Proc. 2001-43; 2001-2 C.B. 191 (transfer of a profits interest for services is taxable to neither new partner nor partnership); Notice 2005-43; 2005-24 I.R.B. 1221 (saying that IRS intends to issue proposed regulations that will exempt receipt of partnership interest if the recipient would receive nothing in liquidation if the partnership were liquidated immediately).

[24] The argument arises from Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964). *.See.e.g,* Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles,* 121 TAX NOTES 1289 (Dec. 15, 2008), http://www.utexas.edu/law/faculty/calvinjohnson/effective-tax-ration.pdf].

improved the economic efficiency of the tax system. The Tax Reform Act of 1986 would not have been able to reduce maximum tax rates from 50% to 28%, except because the passive activity loss ("PAL") limitations of new section 469 of the Code so effectively contained the use of the artificial accounting losses in tax shelters.[25] The PAL limitations suspend losses from an activity outside the taxpayer's normal business until the taxpayer reports gain from that and similar activities or until the taxpayer abandons the investment so that the cash in and out can be totaled without relying on artificial accounting. The rule is based upon skepticism that normal accounting rules are able to ensure that losses are not artificial. If, however, the taxpayer "materially participates" in the activity, spending more than roughly a quarter of a full time working year on the activity, then the activity is no longer considered to be a "passive activity" subject to the PAL limitations.[26]

On enactment in 1986, Congress gave an exemption from the PAL limitations to working interests in oil and gas.[27] A working interest qualifying for the exemption must be burdened with the obligation to share in the expenses of drilling and operations of the oil and gas extraction.[28] The investment vehicle must be a general partnership or co-venture that does not limit the liability of the taxpayer.[29] Under the working interest exemption, the taxpayer may use the artificial losses generated by the intangible drilling costs without putting in any of the time that material participation would need. The exemption allows outsiders with income they need to shelter, but without any oil mud on their hands, to buy into the artificial losses from oil and gas.

Tax accounting in the oil and gas area, as illustrated, can generate artificial loss deductions even for ventures that are in fact profitable. The PAL limitations remain the most effective over-riding limitations on the use of artificial accounting losses. The PAL limitations are not draconian: They allow losses to be used against the first income from any passive activity including unrelated projects. The PAL limitations also allow all losses proved up by counting cash at the end of the transaction to be deducted against salary and other normal sources of income. The limitations are neither draconian nor are they pure of theory, but they have unexpectedly effective for the last 23 years. The exemption from PALs for working interests was never consistent with the necessary rationale for PAL limitations. It is proposed to repeal section 469(c)(3) so that oil and gas working interests would be subject to the normal PAL limitations rules.

4. Rapid Write-offs for Geological and Geophysical Costs.

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[25] See, e.g., Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation?,* 67 TEXAS L. REV. 591 (1989).

[26] Treasury Reg. § 1.469-5T(a)(1).

[27] IRC §469(c)(3)

[28] STAFF OF THE JT COMM. ON TAXATION, GEN. EXPLANATION OF THE TAX REFORM ACT OF 1986, at 251 (1987).

[29] *Id.*

Under current law, a taxpayer may write off the geological and geophysical ("G&G") costs of identifying promising properties over two years.[30] The large integrated oil companies, however, must write off G&G costs over seven years. As a matter of economics, however, the deposits located by the G&G costs can last for 30 years. Using a 3 year straight line depreciation schedule for a G&G investment on that assumption that it lasts for 30 years means that the effective tax rate (IRR-reducing tax) for the G&G investment drops from the normal 35% down to 9.45%.[31] Using a 7 year straight line schedule for G&G costs that last 30 years reduces the effective tax rate from 35% statutory tax rate down to 15.4%.[32] In combination with other benefits accorded to oil and gas, the short amortization schedules contribute to an increase in the negative tax subsidy inappropriately awarded to oil and gas.

Under the proposal, geological and geophysical costs would be allocated to the deposits of oil and gas successfully discovered by the taxpayer and affiliates over the following three years, according to the relative size of the proven reserves. No deduction would be allowed for the three years after the geological and geophysical costs are incurred, and the costs would allocated to proven reserves of oil at that time. The point of exploration costs is not the dry wells, although they happen, but rather the successful wells. An exploratory or wild cat program might hit oil in only one out of 10 drillings and yet the costs are well justified by the deposits that

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[30] IRC § 167(h)(1).

[31] The following spreadsheet assumes a $100 investment that gives annuity with 10% return over 30 years (row 1). The columns for years 5 through 29 are dropped out of the presentation but they are identical to the column for year 4 (except for present value).

Impact of 3-year Amortization on Effective tax Rate						
year:	0	1	2	3	4 ...	30
1. Pretax cash flows, set up to give 10% IRR.	($100)	$10.61	$10.61	$10.61	$10.61	$10.61
2. less amortization of cost over three years		($33.33)	($33.33)	($33.33)	0	0
3 Taxable income		($22.73)	($22.73)	($22.73)	$10.61	$10.61
4. Tax on row 3. at 35%		($7.95)	($7.95)	($7.95)	$3.71	$3.71
6. After tax cash flow. {rw1 less rws 4}	($100)	$18.56	$18.56	$18.56	$6.90	$6.90
7. . Present value at found 9.05% IRR. Sum=0.	($100)	$17.02	$15.61	$14.31	$4.87	$0.51

The present values in row 7 sum to zero, proving that 9.05% is the after tax discount rate on the investment. The statutory tax rate (row 4) is 35%, but a tax that reduces the internal rate of return from 10% to 9.05% has an effective tax rate of $(IRR_{pretax} - IRR_{post\text{-}tax})/IRR_{pretax}$ or here, (10%-9.05%)/10% or 0.95%/10% or 9.5%). The logic is the same as shown in, *supra*, Table 3.

[32] The spreadsheet like that in *supra* note 31, but for 7 year amortization, allows $14.29 deduction in row 2 for seven years, rather than $33.33 for three years. The found return after tax is 8.46%, which represents a 15.4% reduction in IRR from the given pretax 10%.

are found. The costs allocated to a deposit would be recovered by cost depletion which allows the recovery as barrels are extracted.

A simplification would be to allow the taxpayer to elect to recover the costs over 50 years or 2% of geological and geophysical costs per year. This is a longer period than the deposits found might well last, but taxpayers should be able to achieve simplicity as long as simplification is achieved without shifting the tax burden onto other taxpayers.

B. Unwarranted Exclusions.

1. Percentage Depletion Allowance.

Under the percentage depletion allowance, the holder of an economic interest in oil may exclude from tax 15% of its revenue from the extraction of oil. Percentage depletion is disguised as a means for recovery of capital, but the exclusion depends on revenue not cost or basis, and the 15% percent exclusion continues even after all the taxpayer's basis has been fully recovered. Moreover, in oil and gas drilling, the taxpayer's basis in the economic interest for which percentage depletion is allowed has commonly already been fully recovered or mostly recovered because of prior expensing of intangible drilling costs, pool of capital doctrine and short period amortization. Percentage depletion is commonly a double deduction of costs already deducted. Farmers and ranchers rarely have any basis for recovery against their royalty incomes because their cost of land can be allocated against royalties only if they bought the land knowing of and paying for the oil deposits.[33] Service providers who receive interests not taxed under the pool of capital doctrine have no basis in the economic interest they receive for their services. A 15% exclusion would not be a generous rule if tax basis reflected the true cost of drilling,[34] but a continuing 15% exclusion is important part of the negative tax subsidy for oil extraction because of the already low basis and because the exclusion continues after basis has been fully recovered.

The percentage depletion allowance arose out of an early misperception that the "capital" that had to be recovered to calculate income was the discovery value of an oil deposit rather than its cost. Senator David Reed of Pennsylvania was the floor manager of the 1925 act that created percentage depletion, and he argued on the floor of the Senate on behalf of percentage depletion that if "[I discovered a gold mine, basing depletion on cost] would not allow me an adequate return on my 'real capital.' "[35] "Real capital" meant to Reed, the extraordinary value of the gold mine when discovered, not the invested costs in the gold mine. Reed's error also fit within an existing conceptual framework early in the income tax, under which it was it was commonly thought that to compute income, one had to subtract the *value* of property as of the commencement of the period under consideration, rather than just its cost.[36] In fact to reflect

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[33] *See, e.g., Plow Realty Co. v. Commissioner*, 4 T.C. 600 (1945).

[34] On one set of assumptions, cost depletion would be better than percentage depletion if basis equaled all investment costs, only if the deposit lasted for more than almost 67 years. Calvin H. Johnson, *Percentage Depletion of Imaginary Costs*, 122 TAX NOTES 1619, 1623 (Mar. 30, 2009)

[35] 67 CONG. REC. 3766 (Sen. David Reed, R. Pa.).

[36] Calvin H. Johnson, *supra* note 31, at 1620-21.

income, only costs need to be subtracted. Percentage depletion in excess of cost allows deductions for imaginary costs. One should not be confident of the wisdom of congressional engineering when the decision to allow percentage depletion was based upon erroneous understanding of "capital" and upon imaginary costs.

The OPEC oil embargo of the 1970s quadrupled oil prices, and Congress in reaction restricted access to percentage depletion. Since 1975, the integrated oil companies that refine and retail oil must use cost depletion, which is a sensible accounting method that reasonably allocates costs to the related revenue as oil and gas are extracted. Percentage depletion is also not available for foreign production.[37] Independent domestic oil drilling, however, continues to be able to use percentage depletion, up to a level, now at about $24 million per taxpayer per year.[38]

The proposal would amend section 612, which authorizes depletion, to limit total depletion deductions, whether under percentage or cost depletion, to the taxpayer's adjusted basis. Percentage depletion in excess of cost are no more justified for minerals other than oil and gas, so the proposal would affect all depletion allowances, not just oil and gas.

2. Exclusion as to Domestic Manufacturing.

Current law allows a deduction of 6% of income from domestic oil and gas production.[39] While the deduction is 6% in 2009, it is scheduled to rise to 9% of domestic income in 2010.[40] The deduction is limited to taxable income in the year and so does not carryover to past or future tax years. The deduction is also limited to 50% of the domestic wages reported on W-2 forms,[41] but that ceiling is primarily of symbolic value, because it will come into play only if domestic wages are under roughly 1.2% of total costs.[42]

The deduction of 6-9% of domestic production contributes the negative tax subsidy accorded to oil and gas. The market price of oil will give sufficient incentive to the production of oil because it always meets supply at the market clearing price. If more incentive is needed, price will increase. The increase in price will give incentives to conservation of fuel and alternative non-fossil energy sources. Government should get out of the job of oil and gas

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[37] Tax Reduction Act of 1975, P.L. 94-12, § 501, 89 Stat. 36.

[38] IRC § 613A(c) (exemption) and (c)(3) (limitation of exemption to 1,000 barrels a day or 365,000 barrels a year). At $75 per barrel for oil, the exemption allows the full 15 percent percentage depletion on up to $24million in revenue per year.

[39] IRC §199(a)(2).

[40] IRC §199(a)(1)(A).

[41] IRC §199(b).

[42] For example assume a 10% income per year, so that $100 will produce $10 income. The 6% of income exclusion is 60 cents. If the taxpayer pays domestic wages reported on W-2 form of $1.20, the ceiling of half of domestic wages will allow the full 60 cents to be deducted. The $1.20 is only 1.2% of the $100 invested cost.

subsidies because it gives incentive to waste of capital on investments that cannot be justified in absence of a subsidy.

Subsidy of domestic production, moreover, means that we drain domestic supply before we use cheaper oil overseas. A smart program on homeland security would punish domestic production to preserve domestic supply for some future emergency and use cheaper overseas oil while is available to us.

The proposal would end the section 199 deduction for domestic oil and gas production.

3. Repeal LIFO inventory accounting for oil and gas.

Inventory accounting allows the deduction of the cost of units that have been sold or lost by the taxpayer, but not the costs of units taxpayer retains on hand at the end of the year. Whether the costs are still in basis or are sold or lost deductible costs is determined by counting the units still on hand in closing inventory.

Oil and gas units extracted or bought at different times have different costs, but since the units are fungible, it is makes no difference outside of the accounting whether the taxpayer is considered to have sold the old cheap units or kept the oldest and cheapest units. Costs are assigned by an arbitrary ordering convention, usually FIFO or LIFO.

The First In First Out ("FIFO") convention treats the oldest costs as sold first, so that there are no old costs are left in closing inventory. FIFO accounts leave the basis of the closing inventory at levels approximately equal to the current market value that it would take to replace the inventory.

The Last In- First Out ("LIFO") convention, by contrast, identifies the most recent, usually higher costs with the units that are sold and deductible and identifies the lowest costs with the units that have been retained and remain as nondeductible basis. LIFO maximizes unrealized appreciation, and minimizes tax, often quite dramatically.

A taxpayer that employs LIFO carries its closing inventory at the cost of units of the oldest purchases, starting when taxpayer first adopted inventory accounting and adopted the LIFO convention. If, for instance the taxpayer started a business 50 years ago in 1959, it would carry its oldest inventory at $3 a barrel (the 1959 price), notwithstanding that the taxpayer is now selling oil at $72 a barrel.[43] The $69 difference is treated as unrealized appreciation and not taxed until the taxpayer shrinks its inventory to use up the last of the old costs. Shrinking inventory back to oldest price will happen only when the corporate taxpayer is contracting at the end of its life. Avoiding tax on the $69 appreciation is the point of LIFO convention. LIFO has no nontax purpose.

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[43] For 1959 price, Financial Trend Forecaster, http://www.inflationdata.com/inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp. For current price http://www.bloomberg.com/energy/ (accessed Aug. 25, 2009).

Notwithstanding the LIFO convention, the oil firms have long ago pushed 1959 oil out of their system and they have no 1959 oil left. They sold their $3 oil for cash and realized their accession to wealth that resulted from the increase in real prices. Accession to wealth turned into cash would normally be taxed. For a firm, for instance, with $10 billion in oil and gas inventory the difference between LIFO and FIFO ordering convention is material. One estimate put the difference between LIFO and FIFO for publically traded companies at $600 billion of taxable income.[44]

The function of LIFO is said to be used to adjust for inflation so that that fictive inflationary gains are not taxed.[45] Inflation is mostly just an excuse in LIFO for oil and gas because oil and gas has benefited from such real price improvements in realized wealth. The 1959, $3 price, for example, would be adjusted to $20.22 to account for inflation,[46] leading to an exclusion of $17.22, not an exclusion of $69,which is actually allowed. Oil and gas have had real increases in value since 1959, to the extent of 75% of the gain. The LIFO convention excludes real gains from tax, on the basis of the argument that 25% of the gain is inflation caused.

Inflation, moreover, cannot coherently be adjusted for some kinds of investments but not others without creating distortions in the allocation of resources. Interest deductions, moreover, must symmetrically be taken away to the extent the interest just offsets inflation; to the extent of inflation, interest paid is not even a cost. Inflation exclusions for assets without adjustment as to to liabilities creates artificial losses in the tax accounting.

As noted, moreover, tax accounting can identify the real interest from an investment, and make the economic effective tax rate equal to the statutory tax rate only if the adjusted basis for assets is equal to the present value of the assets.[47] Reporting basis – the bank account -- at 3/72 or 4% of its real value is tantamount to an effective tax rate that is only 4% of the statutory tax rate.[48] No justification has ever been offered for tax rates on oil gain that is that trivial a percentage of the statutory tax rate.

The proposal would require additions to closing inventory be calculated by the current replacement cost of oil and gas. Existing inventory would also be restated at current fair market value prices, but the gain on existing inventory, so long delayed already, would be brought into income over four years.

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[44] Edward Kleinbard, et. al. *Is it Time to Liquidate LIFO,* 113 TAX NOTES 237 (Oct. 16, 2006).

[45] *See, e.g.,* Amity Leather Products Co. v. Commissioner, 82 T.C. 726, 732 (1984); Hamilton Industries, Inc. v. Commissioner, 97 T.C. 120, 130 (1991).

[46] Financial Trend Forecaster, http://www.inflationdata.com/inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp

[47] Section IIB. Finding Economic Income, text after *supra* note 5.

[48] Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles,* 121 TAX NOTES 1289 (Dec. 15, 2008).

C. Repeal the Tax Credits Made.

Congress has in recent years provided two subsidies for oil drilling for special cases where it was perceived that market price alone might not provide sufficient incentive. In 1990 Congress enacted a 15% tax credit giving subsidy for enhanced oil recovery techniques, including preparation of Alaska natural gas, and the injections of various liquids into the deposit to help extract oil.[49] In 2004, Congress enacted a tax credit of $3 subsidy per barrel of oil for marginal wells.[50]

Both credits disappear when the market price is high enough to give sufficient incentive to undertake the higher cost drilling. The enhanced recovery credit is phased out over a $6 per barrel range when the price of oil exceeds a threshold originally set at $34 per barrel,[51] but with inflation adjustments now at $41 per barrel.[52] With oil now at $72 a barrel,[53] the enhanced recovery credit is now unavailable. The marginal well credit has never been available because the price of oil shot up above its phase out level before it could come into effect.[54]

The price of oil provides a sufficient free-market incentive to explore for and extract oil and gas, not just when the price exceeds the phase out line for marginal wells and enhanced recovery, but in every case. No further subsidy is needed beyond the wisdom of supply and demand.

The tax credits were never a good idea even when they were available. The decision making process for tax credits and other tax expenditures is not good enough.[55] Congress apparently does not consider the money in tax expenditures for oil and gas to be real money.

IV. Conclusion.

Congress needs to adopt best tax accounting practices for oil and gas that will make taxable income describe real economic income. To make tax accounting for oil and gas investments describe economic income, it is proposed that Congress repeal (1) the intangible

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[49] IRC §43 added by Omnibus Budget Reconciliation Act of 1990, PL, P.L. 101-508 §11511.

[50] IRC §45I added by American Jobs Creation Act of 2004, P.L. 108-357 §341

[51] IRC §43(b)(1) .

[52] U.S. TREASURY DEP'T., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 60 (May 2009).

[53] http://www.bloomberg.com/energy/ (accessed Aug. 25, 2009)

[54] U.S. TREASURY DEP'T., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 60 (May 2009). IRC §45I(b)(2)(A) set the phase out to begin at $18 but with inflation adjustments.

[55] For a recent criticism of the decision making process with respect to tax subsidies, see Edward Kleinbard, *How Tax Expenditures Distort our Budget and Our Political Processes,* 123 TAX NOTES 925 (May 18, 2009).

drilling expense deduction (2), the pool of capital doctrine, and (3) the exemption from passive activity loss limitations for working oil and gas interests. Congress should (4) limit percentage depletion to basis, (5) repeal the domestic production exclusion, (6) allow recovery of geological and geophysical costs under cost depletion, (7) repeal LIFO for oil and gas inventories, and (8) repeal the enhanced oil recovery and marginal wells tax credits.

The government should get out of the business of giving tax preferences for oil and gas investments. The free market laws of supply and demand will give all the incentives that are needed.

* * *

Question for the Record
Mr. Calvin H. Johnson, Andrews & Kurth Centennial Professor of Law,
The University of Texas School of Law, Austin, TX
Senate Finance Committee Hearing
September 10, 2009
"Oil and Gas Tax Provisions: A Consideration of the President's FY2010 Budget Proposal"

Question from Senator Hatch

Based on an article that you wrote, "The Terrible State of the Tax Base," it appears that the "shelf project" is designed to develop a perfect tax accounting system for all business and individual taxation. The ability of the oil and gas industry to expense their intangible drilling costs is the equivalent of the deduction for mining and development costs for the mining industry and expensing of research and development costs for all manufacturers.

Do you support repealing those deductions as part of creating this perfect tax accounting system?

Answer

Calvin H. Johnson, *Omnibus Capitalization Proposals*, 124 TAX NOTES 1121 (Sept 14, 2009), http://www.utexas.edu/law/faculty/calvinjohnson/Omnibus-Capitalization.pdf, proposes that costs of exploring and developing mines and mineral deposits would be capitalized, and for the following reasons.

We are coming into an extraordinary revenue crises. After next year, the country will need to close the $1.6 trillion deficit. Improvements to the tax base that are politically impossible in ordinary times become political necessities in the impending revenue crisis.

Immediate expensing of investment costs means the tax does not reduce the pretax returns from the investment. The equivalence of expensing and exemption is foundational in tax economics but not always reflected in policy decisions. Expensing of the costs of exploration and development of mines and mineral deposits was adopted without any indication that the Congress then understood, that it was giving an extraordinary privilege akin to no tax on profit. The privilege was adopted during the Korean War because of concerns about a deficiency in metals and minerals during that "present emergency." The Korean War emergency is over, but the costs of expensing have never been tested by careful budgeting or cost benefit analysis. It will reduce the harm that tax does to the private economy if mining and mineral deposits are brought up to a level playing field and taxed equitably like other investments.

The Omnibus Capitalization proposal was part of the Shelf Project, which offers proposals to raise revenue by defending the tax base. The purpose of the Shelf Project is to keep the tax rates as low as feasible. It is a consensus across the political aisle that low rate, broad, unavoidable tax system does less damage than high tax rates, many loophole system. Indeed, the best way to raise revenue in the impending revenue crisis, both parties agree, is go after the loopholes and the low tax items, which would include mining and mineral deposits.

I suspect that we will have "this perfect tax accounting system" only in the next life. But on this earth, we need to get the best possible tax accounting that we can. Tax accounting is like lab data, and like lab data, the tax accounting needs to be honest and accurate, no matter how important the experiment.

ipaa
America's Oil & Gas Producers

Testimony

Of

Buddy Kleemeier

On Behalf Of The

Independent Petroleum Association of America

Before

Committee on Finance

U.S. Senate

September 10, 2009

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Statement of Buddy Kleemeier
For The
Independent Petroleum Association of America,

the International Association of Drilling Contractors (IADC), the International Association of Geophysical Contractors (IAGC), the National Stripper Well Association (NSWA), the Petroleum Equipment Suppliers Association (PESA), and the following organizations:

Arkansas Independent Producers and Royalty Owners Association
California Independent Petroleum Association
Coalbed Methane Association of Alabama
Colorado Oil & Gas Association
East Texas Producers & Royalty Owners Association
Eastern Kansas Oil & Gas Association
Florida Independent Petroleum Association
Illinois Oil & Gas Association
Independent Oil & Gas Association of New York
Independent Oil & Gas Association of Pennsylvania
Independent Oil & Gas Association of West Virginia
Independent Oil Producers Agency
Independent Oil Producers Association Tri-State
Independent Petroleum Association of Mountain States
Independent Petroleum Association of New Mexico
Indiana Oil & Gas Association
Kansas Independent Oil & Gas Association
Kentucky Oil & Gas Association
Louisiana Independent Oil & Gas Association
Michigan Oil & Gas Association
Mississippi Independent Producers & Royalty Association
Montana Petroleum Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas Association
New Mexico Oil & Gas Association
New York State Oil Producers Association
North Dakota Petroleum Council
Northern Alliance of Independent Producers
Ohio Oil & Gas Association
Oklahoma Independent Petroleum Association
Panhandle Producers & Royalty Owners Association
Pennsylvania Oil & Gas Association
Permian Basin Petroleum Association
Petroleum Association of Wyoming
Southeastern Ohio Oil & Gas Association
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Independent Producers and Royalty Owners Association
Utah Petroleum Association
Virginia Oil and Gas Association

Mr. Chairman, members of the committee, I am Buddy Kleemeier, President and Chief Executive Officer of Kaiser-Francis Oil Company and Chairman of the Independent Petroleum Association of America (IPAA). Today, I am testifying on behalf of the IPAA and several national, state and regional organizations. Collectively, these groups represent the thousands of independent oil and natural gas explorers and producers, as well as the service and supply industries that support their efforts, that will be the most significantly affected by these legislative proposals. Independent producers drill about 90 percent of American oil and natural gas wells, produce over 65 percent of American oil, and more than 80 percent of American natural gas. American natural gas is a clean, abundant, affordable energy source that should be part of any clean energy agenda; American natural gas and oil should be part of any national energy security initiative.

Today's hearing is examining a critical issue confronting American natural gas and petroleum production – the role of the tax code with regard to the enhancement or deterioration of American exploration and production of natural gas and petroleum. The federal tax code plays an integral part in providing access to the capital essential to develop American resources – both natural gas and petroleum.

Federal tax policy has historically played a substantial role in developing America's natural gas and petroleum. Early on, after the creation of the federal income tax, the treatment of costs associated with the exploration and development of this critical national resource helped attract capital and retain it in this inherently capital intensive and risky business. Allowing the expensing of intangible drilling and development costs and percentage depletion rates of 27.5 percent are examples of such policy decisions that resulted in the United States extensive development of its petroleum.

But, the converse is equally true. By 1969, the depletion rate was reduced and later eliminated for all producers except independents. However, even for independents, the rate was dropped to 15 percent and allowed for only the first 1000 barrels per day of petroleum produced. A higher rate is allowed for marginal wells which increases as the petroleum price drops, but even this is constrained – in the underlying code – by net income limitations and net taxable income limits. In the Windfall Profits Tax, federal tax policy extracted some $44 billion from the industry that could have otherwise been invested in more production. Then, in 1986 as the industry was trying to recover from the last long petroleum price drop before the 1998-99 crisis, federal tax policy was changed to create the Alternative Minimum Tax that sucked millions more dollars from the exploration and production of petroleum and natural gas. These changes have discouraged capital from flowing toward this industry.

Independent producers historically reinvest over 100 percent of American oil and natural gas cash flow back into new American production. Lower natural gas and oil prices and the tight credit market are limiting investment capital; drilling activity is down dramatically since a year ago. Drilling rig counts are roughly half of what they were at this time last year.

Natural gas and oil provide 65 percent of America's energy. New wind energy and solar energy require new natural gas turbines to run when the wind doesn't blow and the sun doesn't shine. American natural gas is essential to meeting any clean energy agenda associated with global climate. American natural gas and oil are essential to any energy security plan.

- In just the last three years, U.S. natural gas producers have made revolutionary gains in the exploration and extraction of shale gas, and an ocean of energy beneath our feet is now available. The lower 48 states have a wide distribution of these shale gas reservoirs that alone have increased

America's natural gas potential by more than 50 percent (Navigant Consulting).

- The U.S. possesses a total natural gas resource base of 1,836 trillion cubic feet (Tcf) and a total available future supply of 2,074 Tcf, equaling about 100 years of supply. Americans consume an average of 22 Tcf per year (AGA/PGC).
- According to studies, America's known resources of natural gas would provide nearly 100 years of supply at current U.S. consumption levels– and we are finding more every day (Navigant Consulting).
- U.S. onshore natural gas production has grown rapidly over the past three years, an accomplishment most energy experts thought impossible a few years ago (EIA).
- From 2006 to 2008, the U.S. saw a near 50 percent rise in number of wells delivering more than 5 Mmcf/d - a huge turnaround in the nation's gas productivity profile (IHS).
- Natural gas use is efficient. While more U.S. homeowners and businesses use natural gas each year, total greenhouse gas emissions from residential and commercial natural gas customers declined 11.7 percent between 2000 and 2006 (NGC).
- Oil provides 40 percent of America's energy, and energy is what drives the U.S. economy. The U.S. currently imports 65 percent of its oil, much of it from foreign, unstable countries. If America's independent producers are

> allowed to responsibly develop more American resources, it could stimulate the U.S. economy by increasing American supplies of energy, creating more American jobs, generating new revenue for the state and federal treasuries and reducing reliance on foreign energy resources.

The Obama Administration's budget request would strip essential capital from new American natural gas and oil investment by radically raising taxes on American production. American natural gas and oil production would be reduced. It runs counter to the Administration's clean energy and energy security objectives. Following is a review of the Obama Administration proposed changes to natural gas and oil taxation.

Intangible Drilling and Development Costs (IDC) – IDC tax treatment is designed to attract capital to the high risk business of natural gas and oil production. Expensing IDC has been part of the tax code since 1913. IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers will have significant effects on their capital development budgets. A recent Raymond James analysis reports that the loss of IDC would result in capital drilling budgets being reduced by 25 to 30 percent. This compares with anecdotal information provided to IPAA by its members indicating that drilling budgets would be cut by 25 to 40 percent. Regardless of the exactness of the assessments, clearly, the consequences would be significant. And, the consequences would soon be evident. Roughly half of America's current natural gas production is provided by wells developed during the past four years. American producers are already facing significant reductions in their capital budgets.

Layering loss of IDC on top of these limitations or imposing it as the commodity and credit markets recover will only worsen the consequences for American production.

Percentage Depletion – All natural resources minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926. Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers and for royalty owners, only available for the first 1000 barrels per day of production, limited to the net income of a property and limited to 65 percent of the producer's net income. Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. These wells – that account for 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable economically. Input to IPAA from its operators who take percentage depletion indicates that the combined effect of the Obama Administration proposals on IDC and percentage depletion would reduce drilling budgets in half. At this lower rate, new production will not offset the natural decline in production from existing wells. For example, one producer now drills ten wells per year; without IDC and percentage depletion, this producer could only drill five wells per year. A five well program will not replace declining production in existing wells and the small business company will have to shutdown. Congress' choice is straightforward: reduce American oil production by 20 percent and its natural gas production by 12 percent or retain the current historic tax policies that have encouraged American production.

Passive Loss Exception for Working Interests in Oil and Gas Properties – The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. The Tax Reform Act exempted 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 AMT restrictions apply to IDC of individual working interest investors, the application of the passive loss rules to those investors is unnecessary and excessive – as this committee itself decided in 1986. 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.

Geological and Geophysical (G&G) Amortization – G&G costs are associated with developing new American natural gas and oil resources. For decades, they were expensed until a tax court case concluded that they should be amortized over the life of the well. After years of consideration and constrained by budget impacts, in 2005, Congress set the amortization period

at two years. It also simplified G&G amortization by applying the two year amortization to failed as well as successful wells; previously, failed wells could be expensed. Later, Congress extended the amortization period to five years for large major integrated oil companies and then extended the period to seven years. Early recovery of G&G costs allows for more investment in finding new resources. Four years ago, Congress recognized that America benefitted if capital used to explore for new natural gas and oil could be quickly reinvested in more exploration or production of American resources, it was in the national interest. Nothing has changed to alter that conclusion. If anything, current capital and credit limitations enhance the rationale to get these funds back into new investment.

Marginal Well Tax Credit – This countercyclical tax credit was recommended by the National Petroleum Council in 1994 to create a safety net for marginal wells during periods of low prices. These wells as stated above account for 20 percent of American oil and 12 percent of American natural gas. They are the most vulnerable to shutting down forever when prices fall to low levels. Congress enacted in this countercyclical tax credit in 2004 after ten years of consideration. It concluded that the nation benefitted if these marginal operations were supported during times of low prices, that the production from these wells were – in effect – a national resource reserve that would be lost forever if the wells had to be shutdown and plugged during difficult economic times. No different conclusion is now warranted. A year ago, as America faced high energy prices, the clear risk of foreign energy dependency was all too evident; America's marginal wells are a first defense against more foreign imports. Fortunately, to date, the marginal well tax credit has not been needed, but it remains a key element of support for American production – and American energy security.

Enhanced Oil Recovery (EOR) Tax Credit – The EOR credit is designed to encourage oil production using costly technologies that are required after a well passes through its initial phase of production. Conventional oil well production declines regularly after it begins production. However, millions of barrels of oil remain in formations when the initial production phase is over. The 2001 National Energy Report indicated that "anywhere from 30 to 70 percent of oil, and 10 to 20 percent of natural gas, is not recovered in field development. It is estimated that enhanced oil recovery projects, including development of new recovery techniques, could add about 60 billion barrels of oil nationwide through increased use of existing fields." For example, one of the technologies is the use of carbon dioxide as an injectant. In 2006, the Department of Energy studied the potential for using carbon dioxide enhanced oil recovery (CO_2-EOR) and concluded that: "Ten basin-oriented assessments- four new, three updated and three previously released- estimate that 89 billion barrels of additional oil from currently 'stranded' oil resources in ten U.S. regions could be technically recoverable by applying state-of-the-art CO_2-EOR technologies." Given the increased interest in carbon capture and sequestration, CO_2-EOR offers the potential to sequester the carbon dioxide while increasing American oil production. Currently, the oil price threshold for the EOR tax credit has been exceeded and the oil value is considered adequate to justify the EOR efforts. However, at lower prices EOR becomes uneconomic and these costly wells would be shutdown. The EOR tax credit was enacted in 1990 and provides the potential to maintain important US oil production by supporting the development of these wells in low price periods.

Manufacturing Tax Deduction – Congress enacted this provision in 2004 to encourage development of American jobs. All US manufacturers benefitted from the deduction until 2008 when the oil and natural gas industry was restricted to a six percent deduction while other

manufacturers grow to a nine percent deduction. While many producers' deductions are capped by the payroll limitation in the law, it is another tax provision that provides capital to America's independent producers to invest in new production.

Federal Tax on Gulf of Mexico Production – American independent producers hold 90 percent of the OCS leases in the Gulf of Mexico. Offshore federal lands produce 27 percent of America's oil and 15 percent of America's natural gas. Producers pay royalties as high as 18.75 percent on their production. A portion of this production is produced without royalty payments until it reaches a set volume that was designed to encourage -- and effectively so – development of deep water areas. Creating a new tax on US offshore development will drive producers from the US offshore reducing new American production of natural gas and oil. Moreover, to the degree that this proposed tax tracks prior proposals that have been considered in the Senate, it raises substantial administrative questions. For example, prior versions have provided for a deduction of royalty payments against the tax. The federal royalty-in-value process is complex and subject to constant controversy; producers are regularly audited but the audits are not specific to a year, more likely they relate to production fields. Consequently, producers' tax returns will need to be revised annually. Similarly, in recent years the federal government has used royalty-in-kind for some royalty payments – a far simpler process. But, to deduct these payments, they would have to be valued creating the same administrative mess. Much of the rationale for creating this tax relates to contractual failings in the deep water Gulf of Mexico, but this tax would be imposed on all producers in all depths.

Taken together, these tax changes are projected to strip about $36 billion from US natural gas and oil production investment over a nine year period from 2011 through 2019. The Administration justifies its proposals based on two flawed rationales. First, the provision

"... like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system." Second, to the extent that the provision "... encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program."

The first issue neither is unique to natural gas and oil tax provisions nor to the tax code generally. For natural gas and oil production, these tax provisions are intended to encourage the development of American resources; they were never intended to be neutral. More broadly, these provisions reflect business tax policy that is consistent with comparable treatment of other energy sources. In its report, *Federal Financial Interventions and Subsidies in Energy Markets 2007*, the Energy Information Administration (EIA) assesses the federal government's support for energy sources. As the following tables show, EIA demonstrates that natural gas and oil federal treatment is comparable to other major energy sources on a total basis and is well below other sources on a unit basis. The Obama Administration's first justification is simply an inaccurate characterization of the nature of federal energy tax policies that have been crafted over decades by the Congress.

Beneficiary	Direct Expenditures	Tax Expenditures	Research & Development	Federal Electricity Support	Total
2007 Subsidies					
Coal	-	290	574	69	932
Refined Coal[1]	-	2,370	-	-	2,370
Natural Gas and Petroleum Liquids	-	2,090	39	20	2,149
Nuclear	-	199	922	146	1,267
Renewables	5	3,970	727	173	4,875
Electricity (Not fuel specific)	-	735	140	360	1,235
End Use	2,290	120	418	-	2,828
Conservation	256	670	-	-	926
Total	2,550	10,444	2,819	767	16,581

Table 36. Energy Subsidies Not Related to Electricity Production: Alternative Measures

Category	Fuel Consumption (quadrillion Btu)	Alternative Measures of Subsidy and Support: FY 2007 Subsidy and Support (million 2007 dollars)	Alternative Measures of Subsidy and Support: Subsidy per million Btu (2007 dollars)
Coal	1.93	78	0.04
Refined Coal	0.16	214	1.35
Natural Gas and Petroleum Liquids	55.78	1,921	0.03
Ethanol/Biofuels	0.57	3,249	5.72
Geothermal	0.04	1	0.02
Solar	0.07	184	2.82
Other Renewables	2.56	360	0.14
Hydrogen	-	233	NM
Total Fuel Specific[1]	60.95	6,237	0.10
Total Non-Fuel Specific	NM	3,597	NM
Total End-Use and Non-Electric Energy	NM	9,834	NM

Table 35. Subsidies and Support to Electricity Production: Alternative Measures

Fuel/End Use	FY 2007 Net Generation (billion kilowatthours)	Alternative Measures of Subsidy and Support: Subsidy and Support Value 2007 (million dollars)	Alternative Measures of Subsidy and Support: Subsidy and Support Per unit of Production (dollars/megawatthours)
Coal	1,946	854	0.44
Refined Coal	72	2,156	29.91
Natural Gas and Petroleum Liquids	919	227	0.25
Nuclear	794	1,257	1.58
Biomass (and Biofuels)	40	38	0.99
Geothermal	15	14	0.92
Hydroelectric	258	174	0.67
Solar[1]	1	14	24.34
Wind	31	724	23.37
Landfill Gas	8	8	1.37
Municipal Solid Waste	9	1	0.13
Unallocated Renewables	NM	37	NM
Renewables (subtotal)	390	1,008	2.80
Transmission and Distribution	NM	1,228	NM
Total	4,091	6,247	1.35

The Administration's second rationale is similarly irrational. Production of American oil and natural gas serves the nation's goal of improving its energy security. Production of American oil and natural gas has been regulated to assure that wells are limited to volumes that conserve the long term production of its reservoir. These limitations have been entrenched since the mid-1930s. Current production reflects the need for American production to be maximized and nothing suggests that it should not be. Similarly, the Administration's climate goals of reducing carbon emissions and encouraging the use of renewable energy sources are enhanced by American natural gas and oil production. Natural gas is a clean, abundant, affordable and American resource that must be a part of any climate initiative. Oil will continue to be a key component of America's energy supply for the foreseeable future and any policies should rely first on American oil rather than foreign sources.

The Administration's revenue estimates raise significant and unanswered questions. Two of them, in particular, stand out. For example, the IDC revenue estimate shows significant revenue changes over the estimating period. The 2011 revenue number is $1.399 billion but by 2019 the number is $113 million. Perhaps, this reflects the dramatic reduction in American drilling activity that IPAA's members have projected. If so, substantial questions need to be answered regarding the impact on American production, the issue raised earlier in this testimony.

Similarly, the estimates on revenues related to eliminating percentage depletion show increases from $351 million in 2011 to $1.215 billion by 2019. Given that the primary revenue sources for these taxes are small businesses producing from marginal wells, these estimates are wholly inconsistent with the reality that the loss of IDCs and percentage depletion would force these wells to be shutdown.

And, this reality raises more fundamental questions about the broader implications of these tax proposals. Over the nine year period of this proposal, the revenues from all of these provisions would average approximately $4 billion annually. In August 2009, the Energy Policy Research Foundation, Inc. (EPRINC) released an analysis, *Do Higher Oil and Gas Taxes Pose a Threat to U.S. Energy Security?*, that addresses issues related to the Obama Administration tax proposals. It concludes, in part, that:

> Using existing U.S. government evaluations of the financial cost of imported oil, increased tax revenues forecasted from the removal of upstream production incentives will be offset through lost domestic production as a result of lower investment in domestic exploration and development. Much of the production loss occurs from the accelerated closure of marginal wells, which are particularly reliant on free cash flow to sustain operations, as a result of the repeal of percentage depletion. The tax proposals will also lead to greater emissions of GHGs as domestic natural gas production is curtailed in favor of greater coal use in the generation of electricity – at least in the very near term. Finally, recent reforms in corporate tax treatment to place U.S. manufacturers on a level playing field with foreign manufacturers would be repealed for the

> petroleum sector only. These new taxes would assist foreign refiners in gaining greater market share of the domestic market. The share of the U.S. gasoline market now claimed by foreign refiners has doubled over the last nine years and likely will continue to grow as refiners face higher costs from the loss of the manufacturers tax credit.

In the analysis, EPRINC indicates that "the incremental benefit of reducing oil imports by 1 barrel is worth $14.70." Thus, if American oil production is reduced by about 745,000 barrels per day as a result of these tax provisions, the cost to the nation of the increased imports would offset the increased revenues. EIA estimates that marginal oil wells produced 844,000 barrels per day in 2006; this production would be lost. Clearly, the economic consequences of the Administration's tax proposals forcing the closure of America's marginal oil wells – *without even addressing the impacts of losing America's marginal natural gas wells and the reduction in drilling affecting new production* – would exceed the revenue expectations of the total tax changes. Moreover, the revenues benefits would be less than projected because of lower US production.

As President Obama has said:

> The energy challenges our country faces are severe and have gone unaddressed for far too long. Our addiction to foreign oil doesn't just undermine our national security and wreak havoc on our environment – it cripples our economy and strains the budgets of working families all across America.

America needs an energy policy that recognizes the roles that all forms of energy supply can play. American natural gas and oil are essential elements – natural gas should be part of any

clean energy initiative; natural gas and oil should be part of any energy security strategy. The Administration's budget request could cripple the American producers that are pivotal in developing US natural gas and oil.

Question for the Record
Mr. Henry G. Kleemeier, Chairman, Independent Petroleum Association of America, Tulsa, OK
Senate Finance Committee Hearing
September 10, 2009
"Oil and Gas Tax Provisions: A Consideration of the President's FY2010 Budget Proposal"

Question from Senator Cornyn:

Question #1

Please explain the effects the tax increases, particularly the repeal of expensing for Intangible Drilling Costs (IDC) and percentage depletion, will have on small independent energy businesses, who drill 90% of the wells and produce 82% of American natural gas and 68% of American oil?

Response

Taken together, the Administration proposals would dramatically affect independent oil and natural gas producers because they strip essential capital from these American producers. Because independent producers derive their investment revenue through the sale of their natural gas and oil production – investing 150 percent of their US cash flow back into US projects in recent years – tax changes that take a higher portion of their revenue will directly reduce investment in American production. And, therefore, it will reduce American natural gas and oil supply. Not only will these increased tax proposals result in lost US production, they will compel increases in foreign imports and will fail to generate the expected revenues assumed by the budget proposals. America will lose three ways – lost production, more imports, less revenue.

Following are more details on the two specific tax provisions mentioned in the question – intangible drilling and development costs and percentage depletion – and the larger economic implications.

Intangible Drilling and Development Costs (IDC) – IDC tax treatment is designed to attract capital to the high risk business of natural gas and oil production. Expensing IDC has been part of the tax code since 1913. IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers will have significant effects on their capital development budgets. A Raymond James analysis reports that the loss of IDC would result in capital drilling budgets being reduced by 25 to 30 percent. This compares with anecdotal information provided to IPAA by its members indicating that drilling budgets would be cut by 25 to 40 percent. Regardless of the exactness of the assessments, clearly, the consequences would be significant. And, the consequences would soon be evident. Roughly half of America's current natural gas production is provided by wells developed during the past four years. American producers are already facing significant reductions in their capital budgets.

Layering loss of IDC on top of these limitations or imposing it as the commodity and credit markets recover will only worsen the consequences for American production.

Percentage Depletion – All natural resources minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926.[1] Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers and for royalty owners, only available for the first 1000 barrels per day of production, limited to the net income of a property and limited to 65 percent of the producer's net income. Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. These wells – that account for 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable economically. Input to IPAA from its operators who take percentage depletion indicates that the combined effect of the Obama Administration proposals on IDC and percentage depletion would reduce drilling budgets in half. At this lower rate, new production will not offset the natural decline in production from existing wells. For example, one producer now drills ten wells per year; without IDC and percentage depletion, this producer could only drill five wells per year. A five well program will not replace declining production in existing wells and the small business company will have to shutdown. Congress' choice is straightforward: *reduce American oil production by 20 percent and its natural gas production by 12 percent or retain the current historic tax policies that have encouraged American production.*

The Administration's revenue estimates raise significant and unanswered questions. For example, the estimates on revenues related to eliminating percentage depletion show increases from $351 million in 2011 to $1.215 billion by 2019. These estimates are wholly inconsistent with the reality of the consequences that the tax changes will create. As described above percentage depletion is so constrained for natural gas and oil production that it is largely limited to small businesses producing from marginal wells. The loss of IDCs and percentage depletion would force these wells to be shutdown. Estimates showing increased tax revenues from an ever decreasing tax base are completely unrealistic. By 2019, the production base will be so decimated that revenues would be miniscule.

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[1] The creation of percentage depletion in the tax code reflects the realization that cost depletion fails to provide adequate incentive for the development of mineral resources. It is described in Oil & Gas Taxation in Nontechnical Language (Frank M. Burke, Jr. & Mark L. Starcher, 1993):

> In the first Federal income tax law enacted in 1913, depletion was limited to a recovery of the cost of the property, thereby encouraging the purchase of existing production in order to be able to recover the true value of oil and gas reserves as a deduction for Federal income tax purposes. Cost depletion is similar in concept to depreciation, recognizing the diminution in value of mineral reserves over time through development. Cost depletion, however, fails to compensate the oil and gas developer for exploration and development risk. The value of the deduction is tied to the cost of acquisition of existing reserves and tends to detract from new drilling and exploration. The financial risk of failure in drilling for new reserves is not adequately rewarded by simply allowing a deduction for the costs incurred.
>
> By 1918, the need for an incentive to encourage exploration became apparent. In that year, a new provision called "discovery value" depletion was enacted. ... However, because of the difficulties in valuing new properties, discovery value depletion led to controversies between the Internal Revenue Service (IRS) and the industry.
>
> By 1926, it had become clear that a different mechanism was needed. In that year, percentage depletion was enacted to replace discovery value depletion.

This reality raises more fundamental questions about the broader implications of these tax proposals. Over the nine year period of this proposal, the revenues from all of these provisions would average approximately $4 billion annually. In August 2009, the Energy Policy Research Foundation, Inc. (EPRINC) released an analysis, *Do Higher Oil and Gas Taxes Pose a Threat to U.S. Energy Security?*, that addresses issues related to the Obama Administration tax proposals. It concludes, in part, that:

> Using existing U.S. government evaluations of the financial cost of imported oil, increased tax revenues forecasted from the removal of upstream production incentives will be offset through lost domestic production as a result of lower investment in domestic exploration and development. Much of the production loss occurs from the accelerated closure of marginal wells, which are particularly reliant on free cash flow to sustain operations, as a result of the repeal of percentage depletion. The tax proposals will also lead to greater emissions of GHGs as domestic natural gas production is curtailed in favor of greater coal use in the generation of electricity – at least in the very near term. Finally, recent reforms in corporate tax treatment to place U.S. manufacturers on a level playing field with foreign manufacturers would be repealed for the petroleum sector only. These new taxes would assist foreign refiners in gaining greater market share of the domestic market. The share of the U.S. gasoline market now claimed by foreign refiners has doubled over the last nine years and likely will continue to grow as refiners face higher costs from the loss of the manufacturers tax credit.

In the analysis, EPRINC indicates that "the incremental benefit of reducing oil imports by 1 barrel is worth $14.70." Thus, if American oil production is reduced by about 745,000 barrels per day as a result of these tax provisions, the cost to the nation of the increased imports would offset the increased revenues. EIA estimates that marginal oil wells produced 844,000 barrels per day in 2006; this production would be lost. Clearly, the economic consequences of the Administration's tax proposals forcing the closure of America's marginal oil wells – *without even addressing the impacts of losing America's marginal natural gas wells and the reduction in drilling affecting new production* – would exceed the revenue expectations of the total tax changes. Moreover, the revenue benefits would be less than projected because of lower US production.

The Obama Administration tax proposals fail at all levels. The tax revenues are overstated. There is no recognition of the American production consequences. The nation would ultimately pay more as it required additional imported oil and natural gas.

Statement of Alan B. Krueger
Assistant Secretary for Economic Policy and Chief Economist, US Department of Treasury
Senate Committee on Finance
Subcommittee on Energy, Natural Resources, and Infrastructure

September 10, 2009

Good afternoon Chairman Bingaman, Ranking Member Bunning, and members of the Subcommittee. Thank you for inviting me to testify before your Subcommittee today. I appreciate the opportunity to discuss the Obama Administration's FY 2010 Budget proposals that focus on the oil and gas industry.

In my testimony I will discuss several aspects of the proposals in the Obama Administration's FY 2010 Budget that are related to the oil and gas industry. First, I will briefly discuss the Administration's environmental and energy policy in order to provide context for the oil and gas related proposals. Second, I will describe the Administration's proposals related to the oil and gas industry. Third, I will evaluate why, from an economist's perspective, these proposals are good tax policy. Fourth, I will analyze the potential effects of removing these subsidies on consumer prices, productivity and domestic jobs. Finally, I will address possible concerns that removing these tax subsidies will affect our energy security.

Overview of the Administration's Environmental and Energy Policy

The Obama Administration believes that our nation must build a new, clean energy economy, reduce our dependence on oil and limit the emissions of greenhouse gases (GHG). The Intergovernmental Panel on Climate Change's (IPCC) best estimate is that global average air temperature will increase by more than 7 degrees Fahrenheit in this century if we proceed with fossil fuel-intensive energy technology development.[1] The costs of such an increase would likely be very significant, as higher temperatures would devastate many ecosystems and negatively impact agricultural output and productivity in many parts of the world. The Administration believes that it is no longer sufficient to address our nation's energy needs by finding more fossil fuels, and instead we must take dramatic steps towards becoming a clean energy economy. These include encouraging the use of, and investment in, clean energy infrastructure and energy efficient technologies.

The Congress took an important step in that direction by providing $16.8 billion in funding for energy efficiency improvement and renewable energy in the American Recovery and Reinvestment Act of 2009.[2] In addition, the Congress recently passed, and the President signed,

[1] Intergovernmental Panel on Climate Change, "Climate Change 2007: Synthesis Report," 2008
[2] Examples of this include: $5 billion for low-income home weatherization projects; $6.3 billion for state and local renewable energy and energy efficiency efforts; $2 billion in competitive grants to develop the next generation of

legislation that will increase fuel economy for all new cars and trucks sold in the United States. As a result, we will save 1.8 billion barrels of oil over the lifetime of the program – the projected equivalent of taking 58 million cars off the road for an entire year. The Administration's Budget further promotes these objectives by investing in a variety of renewable sources of electrical generation, by investing to accelerate deployment of energy conservation measures, and by providing Federal assistance for state-level programs related to clean energy and energy conservation.

In addition to direct investments in clean energy, the Administration's Budget proposed a cap-and-trade program that would provide incentives for firms to reduce GHG emissions and to invest in new, cleaner lines of business. The proposed cap-and-trade program holds the promise of creating new industries and jobs; decreasing our dependence on oil; and limiting the release of pollutants that threaten the health of families and communities and the planet itself.

The Administration's Proposals Related to the Oil and Gas Industry

With this as background, let me turn to the Obama Administration's proposals to eliminate several subsidies that likely benefit oil and gas companies. More details on each proposal can be found in the appendix.

Repeal existing oil and gas preferences

Current law provides a number of credits and deductions that are targeted towards certain oil and gas activities. The Administration proposes to repeal the following tax preferences that are currently available for certain non-integrated oil and gas firms: (1) the use of percentage depletion with respect to oil and gas wells; (2) the exception to passive loss limitations provided to working interests in oil and natural gas properties; and (3) two-year amortization of non-integrated producer's geological and geophysical expenditures, instead allowing amortization over the same seven-year period as for integrated oil and gas producers.[3] Eliminating these three tax preferences is projected to raise revenues by approximately $10.3 billion from 2010 to 2019.

The Administration proposes to repeal the following tax preferences that are currently available for both integrated and non-integrated oil and gas firms: (1) the expensing of intangible drilling costs; (2) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; (3) the ability to claim the domestic manufacturing deduction against income derived from the production of oil and gas. Eliminating these three tax preferences is projected to raise revenues by approximately $20.3 billion from 2010 to 2019.

Finally, the Administration proposes to repeal the following tax preferences that are not currently taken by any oil and gas firms because the price of oil exceeds the phase out price: (1) the

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batteries. ARRA also included additional renewable energy incentives. These include extending the production tax credit (PTC) to 2012 for wind and 2013 for other renewable sources of energy; creating a new grant program for clean energy projects; and providing $2.3 billion in credits for investment in advanced energy manufacturing facilities.

[3] A non-integrated company is one that receives nearly all of its revenues from production at the wellhead. The definition contained in the IRS code is that a firm is non-integrated if its refining capacity is less than 50,000 barrels per day on any given day or their retail sales are less than $5 million for the year.

enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; and (2) the credit for oil and gas produced from marginal wells. Eliminating these two tax preferences is projected to have no impact on revenue from 2010 to 2019 because oil prices are projected to remain above the phase out price for the coming ten years.

Levy tax on certain offshore oil and gas production

According to a review of several existing studies by the Government Accountability Office in 2007, the return received by the federal government from oil production in the Outer Continental Shelf is lower than the return from oil production received by many foreign governments.[4] In the interest of advancing important policy objectives, such as providing a more level playing field among producers, raising the return to the taxpayer, and encouraging sustainable domestic oil and gas production, the Administration is working with Congress to develop a proposal to impose an excise tax on certain oil and gas extracted offshore in the future.

Repeal last-in, first-out (LIFO) method of accounting for inventories.

Under the LIFO method of accounting for inventories, it is assumed that the cost of the items of inventory that are sold is equal to the cost of the items of inventory that were most recently purchased or produced. The Administration proposes to repeal the use of the LIFO accounting method for Federal tax purposes, effective for taxable years beginning in 2012. Assuming inventory costs rise over time, taxpayers required to change from the LIFO method under the proposal generally would experience a reduction in their deductions for cost of goods sold and a corresponding increase in their annual taxable income as older inventory with a lower purchase price is taken into account in computing taxable income. In the context of oil and gas this would apply to stocks of already extracted oil and gas stored by refiners and other users of crude product, but not to unextracted stores of oil and natural gas. Upon enactment, taxpayers required to change from the LIFO method also would be required to report their existing inventory at its first-in, first-out (FIFO) value in the year of change, causing a one-time increase in taxable income that would be recognized ratably over eight years.

An Economist's View of Tax Policy for the Oil and Gas Industry

Next, I will outline a few economic principles of good tax policy and evaluate the current tax subsidies for oil and gas production in light of those principles.

Tax Policy Should be Neutral Across Industries

In a competitive market, a tax system free of subsidies will promote investment decisions that reflect an investment's economic returns rather than its tax benefits. Differences in tax treatment across industries give rise to differences in after-tax returns for investments that would otherwise have the same pre-tax returns. These differences in after-tax returns drive important changes in investment and output. For example, tax subsidies that are not designed to correct an existing distortion or market failure lead to an over allocation of resources to the tax-favored industries

[4] Government Accountability Office, "Oil and Gas Royalties: A Comparison of the Share of Revenue Received from Oil and Gas Production by the Federal Government and Other Resource Owners," May 1, 2007

and an under allocation of resources to other industries. These distortions in resource allocation result in inefficiency and generally reduced economic growth. Maintaining neutrality in economic policy, absent a strong reason otherwise, is a long standing principle that was emphasized by George Washington, who said in his farewell address, "even our Commercial policy should hold an equal and impartial hand: neither seeking nor granting exclusive favours or preferences…".

The tax subsidies that are currently provided to the oil and gas industry lead to inefficiency by encouraging an over investment of domestic resources in this industry. In 2005 the Congressional Budget Office (CBO) estimated that the effective marginal tax rate on investment in petroleum and natural gas structures was 9.2 percent.[5] This is well below the average effective marginal tax rate for all asset types (26.3 percent). The size of the distortion – equal to the difference between the effective marginal tax rate for investment in the oil and gas industry and the average effective marginal tax rate – is quite large for the oil and gas industry and removing this distortion would improve overall economic efficiency.

In addition to subsidizing an inefficient amount of investment in the oil and gas industry, the tax subsidies result in distortions within the industry by favoring investment in nonintegrated firms. A 2009 study estimated that percentage depletion and the favorable tax treatment for intangible drilling costs, which are available only for individuals and non-integrated firms, reduced the effective marginal tax rate for investment in oil drilling to -13.5 percent for non-integrated firms, compared to 15.2 percent for integrated firms that cannot claim percentage depletion and cannot expense all of their intangible drilling costs.[6] Because of the large subsidy provided by percentage depletion and full expensing of intangible drilling costs, the size of the distortion for non-integrated firms is especially large.

Addressing Externalities through Tax Provisions

Tax provisions that encourage investment in a specific industry may be justified in cases where they address a positive externality associated with either production or consumption of certain goods. Private market decisions can be inefficient when market prices do not reflect the full social costs. Oil and natural gas prices, for example, do not reflect the environmental harm caused by the release of greenhouse gases in the atmosphere associated with oil and gas production and consumption. In addition, the price of oil does not reflect the risks associated with U.S. oil dependency or the costs of traffic congestion. Tax provisions can address this problem by incorporating the social costs into the price of the resources.

However, the current set of tax subsidies for oil and gas production work against the goal of reducing the negative externalities associated with oil and gas production. The Administration proposes to address the negative externalities associated with GHG production through the use of

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[5] The effective marginal tax rate is equal to the difference between the before- and after- tax return divided by the before-tax return on the last dollar of investment.

[6] Gilbert Metcalf, "Taxing Energy in the United States: Which Fuels Does the Tax Code Favor?" Center for Energy Policy and the Environment, 2009. If an investment has a negative effective marginal tax rate, then the benefit from that investment exceeds the tax-free economic return from that investment (i.e. the tax code provides for a net subsidy).

a cap-and-trade system, which provides certainty on the reduction of GHG production in the future. To the extent that removing the current tax subsidies for oil and gas production increases energy prices, the Administration's proposals would move prices closer to appropriately reflecting the negative externalities associated with oil and gas production. However, as I discuss in more detail below, the effect on prices of these tax proposals is unlikely to be sufficient to address the social costs of oil and gas production.

Oil Prices and Percentage Depletion

Under the current tax system, percentage depletion causes tax subsidies to increase as oil and gas prices increase, which lowers the overall effective tax rate when commodity prices are high. This is because the size of the deduction under percentage depletion is equal to a fixed percentage of revenue, and as oil prices rise and revenue increases (assuming the demand elasticity for oil is less than 1) the amount of the deduction also rises, which reduces the effective tax rate on the original investment. There is no rationale for a tax system that reduces the effective marginal tax rate when the price of the good sold increases. Removing percentage depletion will make the tax treatment of this industry more neutral with respect to changes in price.

Economic Impacts of Removing Favored Treatment

In analyzing the impact of repealing oil and gas tax preferences, we consider the impact on firms' costs and how that might impact prices. We also consider how repealing oil and gas tax preferences may impact output and employment in the oil and gas industries and output and employment in the broader economy.

Tax preferences reduce a firm's cost of doing business, and by lowering costs they can lead to an increase in the firm's production and employment. Whether or not the price of the good produced by a firm is affected by an increase in production depends on the size of the increase in production relative to the market as a whole and on how much a price increase would reduce consumption. To the extent a tax subsidy does not cover an entire industry, production may simply shift from unsubsidized firms within the industry to subsidized ones, without affecting price.

Oil

Impact on Prices: The domestic price of oil is determined by global supply and demand because oil is an internationally traded commodity. Although the U.S. does constitute a large share of world demand, the U.S. contribution to world oil supply is relatively small: U.S. petroleum production accounts for about 10 percent of the world annual total, and U.S. proved crude oil reserves represent less than 2 percent of the world total.[7] The relatively small U.S. share of global production means that any change in U.S. domestic oil production will have a limited impact on the world supply of oil. Based on parameters in the literature, we estimate that world supply would fall by less than one-tenth of one percent due to the elimination of these tax

[7] Energy Information Agency, "International Energy Statistics 2005-2009: Production of Crude Oil including Lease Condensate and Crude Oil Proved Reserves"

subsidies proposed in the Obama Administration's budget.[8, 9] Because we expect little or no effect on the world supply of oil, removing these subsidies would have an insignificant effect on world oil prices.

If the world oil price does not change, U.S. consumers would feel no impact at the pump from removing these tax preferences. *Even if* the full additional cost to domestic oil companies was passed on to consumers through higher gasoline prices, which is highly unlikely because prices are set on the world market, the cost would be equivalent to less than one cent per gallon. To put this in context, consider that since 2000 retail gasoline prices have fluctuated between $1.14 and about $4.10, and over this period crude oil has accounted for only about 50 percent of the price of gasoline.[10] Thus, even in the unlikely case that costs of removing the subsidies were passed on directly to consumers, the increase in prices would certainly be trivial compared to normal fluctuations.

Impact on Domestic Output: Because the price of oil will almost surely not change as a result of eliminating these tax preferences, consumers will not change their demand for petroleum products. On the supply side, a change in domestic producer costs could cause production to shift from domestic non-integrated producers to integrated domestic or foreign suppliers. According to estimates made by the Office of Economic Policy at the Department of Treasury, removing the subsidies for the oil industry would be equivalent to increasing total oil finding and lifting costs by less than 2 percent.[11] Of course, the increase in costs would not translate into a one-for-one decrease in production. Based on estimates of short and long run supply elasticities, we estimate that the decrease in domestic production due to these proposals will be less than one half of one percent, even in the long run.[12]

We have also considered the impact of higher oil prices on macroeconomic outcomes. The economics literature suggests that large increases in energy prices can lead to meaningful reductions in GDP.[13] However, even upper bound estimates suggest that any change in prices due to removing the tax subsidies would be trivial, and as a result the impact on GDP of the Administration's proposals will likely be too small to measure. On the other hand, over the long term, reducing tax preferences will result in a more efficient allocation of capital, which will tend to increase national output.

Impact on Employment: Because domestic crude oil output is not expected to change appreciably, employment in the oil extraction sector would likewise not be expected to change

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[8] Oil supply elasticities used here are from Salvatore Lazzari, "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy," Congressional Research Service, March 9, 2006; and Caldwell and Gordon, "Federal Oil Subsidies: How Can They Best Be Targeted?" May 2004 (prepared for the National Commission on Energy Policy).

[9] The cost associated with eliminating LIFO is excluded from this analysis because eliminating LIFO will have little impact on production at the margin, and to the extent it does have a marginal impact, the impact will be very small.

[10] Energy Information Agency. "A Primer on Gasoline Prices," 2009

[11] Estimates based on U.S. Energy Information Agency, "Performance Profiles of Major Energy Producers 2007," December 2008, which contains data on a large portion of the oil and gas industry.

[12] Congressional Research Service, "The Crude Oil Windfall Profit Tax of the 1980s: Implications for Current Energy Policy," March 2006

[13] Crane et. al, "Imported Oil and U.S. National Security," RAND, 2009.

by a significant amount. A rough assumption would be that employment in oil production could fall in the same small proportion as the decline in output (less than one half of one percent).

In terms of the overall economy, it is also important to note that the oil and gas industry is about ten times more capital intensive than the U.S. economy as a whole. Consequently, subsidizing oil industry production is not an effective policy for raising labor demand. As noted above, over the long term, reducing tax preferences will result in a more efficient allocation of capital and labor, which will tend to increase national output..

Natural Gas

Impact on Prices: Unlike oil, a large majority of the natural gas consumed in the U.S. is domestically produced, and global trade in natural gas has a small impact on domestic prices. As a result, changes in domestic natural gas production costs have the potential to influence U.S. prices. To yield an upper bound estimate of the effect on prices, we could assume the full cost of the eliminated tax preferences are passed through to consumers in the price of natural gas. According to estimates made by the Office of Economic Policy at the Department of Treasury, the costs of the subsidies for the natural gas industry are equal to about one percent of average total revenues for natural gas over the last two years. Thus, in the upper bound case, removing the tax subsidies might result in about a one percent increase in natural gas prices. Taking into account the demand response if costs increase, any price increase would likely be less than one percent in equilibrium. For context, consider that since 2000, prices for residential natural gas have fluctuated an average of plus or minus 6 percent per month. Thus, the potential effect on prices from removing the tax subsidies for gas production would be small relative to normal price fluctuations, even in the upper bound case.

Impact on Domestic Output: This small increase in price may cause consumers to respond by decreasing their consumption of natural gas. However, the effect is likely to be small: the demand elasticities in the literature suggest that a one percent increase in natural gas prices might result in a reduction in natural gas consumption and production of less than half a percentage point over the long term.[14]

Impact on Employment: Over the long term, employment in the natural gas production and supply industry could change by an amount similar to the change in production. As in the case of oil, eliminating the distortionary influence of the tax preferences for natural gas will result over time in new jobs being created in other sectors. And like oil production, the natural gas industry is highly capital intensive relative to the U.S. economy as a whole, suggesting these tax subsidies are not effective means for domestic job creation.

The Impact of Tax Preferences on Energy Security

Some proponents of tax subsidies for the oil and gas industry suggest that encouraging exploration of domestic resources will improve our energy security. Concerns about our energy security are focused on the possibility that a sudden and lasting disruption in oil supplies would

[14] Calculation using long-term residential demand elasticity of -0.41 from Steven Wade, "Price Responsiveness in the AEO2003 NEMS Residential and Commercial Building Sector Models."

lead to a substantial increase in the price of oil. Such an increase in prices could have ripple effects throughout our economy by leading to a decline in output in energy intensive industries, by raising unemployment if real wages do not adjust to higher oil prices, and by making energy intensive capital stock obsolete. These proponents argue that encouraging domestic production may limit our vulnerability to such an oil price shock.

However, as I discussed above, the domestic price of oil will be determined by the world price of oil, and the size of our domestic production has little or no influence on the world price of oil. As such, current tax subsidies that encourage domestic production are very unlikely to affect the domestic price of oil and do not significantly promote our energy security. Policies that reduce our dependence on oil, such as a cap-and-trade system or investing in clean technologies, are a more effective way to reduce our vulnerability to an oil price shock and promote energy security.

Conclusion

To the extent that current tax subsidies for the oil and gas industry encourage the overproduction of oil and natural gas, they divert resources from other, potentially more efficient investments and they are inconsistent with the Obama Administration's goals to reduce GHG emissions and build a new, clean energy economy. Furthermore, as discussed above, removing these subsidies will have a very small effect on the price of oil and gas, the production of oil and gas, and domestic jobs. In fact, removing these subsidies could actually make our economy more efficient by reducing distortions in the tax code. The possibility to promote our broader energy goals at a very low cost – in terms of prices, productivity, and jobs – makes removing these subsidies sound economic and public policy.

Mr. Chairman, this concludes my prepared testimony. I will be pleased to answer any questions you or other members of the Subcommittee may have.

APPENDIX:
GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS RELATED TO THE OIL AND GAS INDUSTRY

LEVY TAX ON CERTAIN OFFSHORE OIL AND GAS PRODUCTION

Current Law

No Federal tax is imposed on the production of oil and gas on the Outer Continental Shelf (OCS).

Reasons for Change

According to the Government Accountability Office, the return to the taxpayer from OCS production is among the lowest in the world, despite other factors that make the United States a comparatively good place to invest in oil and gas development. An excise tax on OCS production would advance important policy objectives, such as providing a more level playing field among producers, raising the return to the taxpayer, and encouraging sustainable domestic oil and gas production.

Proposal

The Administration is developing a proposal to impose an excise tax on certain oil and gas produced offshore in the future. The Administration will work with Congress to develop the details of this proposal.

Revenue Estimate

This proposal is projected to raise $5.3 billion in revenue from 2010 – 2019.

REPEAL CREDIT FOR ENHANCED OIL RECOVERY (EOR) PROJECTS

Current Law

The general business credit includes a 15-percent credit for eligible costs attributable to EOR projects. If the credit is claimed with respect to eligible costs, the taxpayer's deduction (or basis increase) with respect to those costs is reduced by the amount of the credit. Eligible costs include the cost of constructing a gas treatment plant to prepare Alaska natural gas for pipeline transportation and any of the following costs with respect to a qualified EOR project: (1) the cost of depreciable or amortizable tangible property that is an integral part of the project; (2) intangible drilling and development costs (IDCs) that the taxpayer can elect to deduct; and (3) deductible tertiary injectant costs. A qualified EOR project must be located in the United States and must involve the application of one or more of nine listed tertiary recovery methods that can reasonably be expected to result in more than an insignificant increase in the amount of crude oil which ultimately will be recovered. The allowable credit is phased out over a $6 range for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds an inflation adjusted threshold. The credit was completely phased out for taxable years beginning in 2008, because the reference price ($66.52) exceeded the inflation adjusted threshold ($41.06) by more than $6.

Reasons for Change

The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the credit encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The investment tax credit for enhanced oil recovery projects would be repealed for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $0 billion in revenue from 2010 – 2019.

REPEAL CREDIT FOR PRODUCTION FROM MARGINAL WELLS

Current Law

The general business credit includes a credit for crude oil and natural gas produced from marginal wells. The credit rate is $3.00 per barrel of oil and $0.50 per 1,000 cubic feet of natural gas for taxable years beginning in 2005 and is adjusted for inflation in taxable years beginning after 2005. The credit is available for production from wells that produce oil and gas qualifying as marginal production for purposes of the percentage depletion rules or that have average daily production of not more than 25 barrel-of-oil equivalents and produce at least 95 percent water. The credit per well is limited to 1,095 barrels of oil or barrel-of-oil equivalents per year. The credit rate for crude oil is phased out for a taxable year if the annual average unregulated wellhead price per barrel of domestic crude oil during the calendar year preceding the calendar year in which the taxable year begins (the reference price) exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are $3.00 and $15.00 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit rate for natural gas is similarly phased out for a taxable year if the annual average wellhead price for domestic natural gas exceeds the applicable threshold. The phase-out range and the applicable threshold at which phase-out begins are $0.33 and $1.67 for taxable years beginning in 2005 and are adjusted for inflation in taxable years beginning after 2005. The credit has been completely phased out for all taxable years since its enactment. Unlike other components of the general business credit, the marginal well credit can be carried back up to five years.

Reasons for Change

The credit, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the credit encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the credit must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The production tax credit for oil and gas from marginal wells would be repealed for production in taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $0 billion in revenue from 2010 – 2019.

REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS

Current Law

In general, costs that benefit future periods must be capitalized and recovered over such periods for income tax purposes, rather than being expensed in the period the costs are incurred. In addition, the uniform capitalization rules require certain direct and indirect costs allocable to property to be included in inventory or capitalized as part of the basis of such property. In general, the uniform capitalization rules apply to real and tangible personal property produced by the taxpayer or acquired for resale.

Special rules apply to intangible drilling and development costs (IDCs). IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. In addition, IDCs include the cost to operators of any drilling or development work (excluding amounts payable only out of production or gross or net proceeds from production, if the amounts are depletable income to the recipient, and amounts properly allocable to the cost of depreciable property) done by contractors under any form of contract (including a turnkey contract). IDCs include amounts paid for labor, fuel, repairs, hauling, and supplies which are used in the drilling, shooting, and cleaning of wells; in such clearing of ground, draining, road making, surveying, and geological works as are necessary in preparation for the drilling of wells; and in the construction of such derricks, tanks, pipelines, and other physical structures as are necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Generally, IDCs do not include expenses for items which have a salvage value (such as pipes and casings) or items which are part of the acquisition price of an interest in the property.

Under the special rules applicable to IDCs, an operator (i.e., a person who holds a working or operating interest in any tract or parcel of land either as a fee owner or under a lease or any other form of contract granting working or operating rights) who pays or incurs IDCs in the development of an oil or gas property located in the United States may elect either to expense or capitalize those costs. The uniform capitalization rules do not apply to otherwise deductible IDCs.

If a taxpayer elects to expense IDCs, the amount of the IDCs is deductible as an expense in the taxable year the cost is paid or incurred. Generally, IDCs that a taxpayer elects to capitalize may be recovered through depletion or depreciation, as appropriate; or in the case of a nonproductive well ("dry hole"), the operator may elect to deduct the costs. In the case of an integrated oil company (i.e., a company that engages, either directly or through a related enterprise, in substantial retailing or refining activities) that has elected to expense IDCs, 30 percent of the IDCs on productive wells must be capitalized and amortized over a 60-month period.
A taxpayer that has elected to deduct IDCs may, nevertheless, elect to capitalize and amortize certain IDCs over a 60-month period beginning with the month the expenditure was paid or incurred. This rule applies on an expenditure-by-expenditure basis; that is, for any particular taxable year, a taxpayer may deduct some portion of its IDCs and capitalize the rest under this provision. This allows the taxpayer to reduce or eliminate IDC adjustments or preferences under the AMT.

The election to deduct IDCs applies only to those IDCs associated with domestic properties. For this purpose, the United States includes certain wells drilled offshore.

Reasons for Change

The expensing of IDCs, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent expensing encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of IDCs would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

Expensing of intangible drilling costs and 60-month amortization of capitalized intangible drilling costs would not be allowed. Intangible drilling costs would be capitalized as depreciable or depletable property, depending on the nature of the cost incurred, in accordance with the generally applicable rules.

The proposal would be effective for costs paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $6.9 billion in revenue from 2010 – 2019.

REPEAL DEDUCTION FOR TERTIARY INJECTANTS

Current Law

Taxpayers are allowed to deduct the cost of qualified tertiary injectant expenses for the taxable year. Qualified tertiary injectant expenses are amounts paid or incurred for any tertiary injectant (other than recoverable hydrocarbon injectants) that is used as a part of a tertiary recovery method. The deduction is treated as an amortization deduction in determining the amount subject to recapture upon disposition of the property.

Reasons for Change

The deduction for tertiary injectants, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent expensing encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Capitalization of tertiary injectants would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

The deduction for qualified tertiary injectant expenses would not be allowed for amounts paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $62 million in revenue from 2010 – 2019.

REPEAL PASSIVE LOSS EXCEPTION FOR WORKING INTERESTS IN OIL AND GAS PROPERTIES

Current Law

The passive loss rules limit deductions and credits from passive trade or business activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to credits. Suspended deductions and credits are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses and credits from a passive activity are allowed in full when the taxpayer completely disposes of the activity.

Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate. An exception is provided, however, for any working interest in an oil or gas property that the taxpayer holds directly or through an entity that does not limit the liability of the taxpayer with respect to the interest.

Reasons for Change

The special tax treatment of working interests in oil and gas properties, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent this special treatment encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the working interest exception for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy. Eliminating the working interest exception would subject oil and gas properties to the same limitations as other activities and reduce economic distortions.

Proposal

The exception from the passive loss rules for working interests in oil and gas properties would be repealed for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $49 million in revenue from 2010 – 2019.

REPEAL PERCENTAGE DEPLETION

Current Law

The capital costs of oil and gas wells are recovered through the depletion deduction. Under the cost depletion method, the basis recovery for a taxable year is proportional to the exhaustion of the property during the year. This method does not permit cost recovery deductions that exceed basis or that are allowable on an accelerated basis.

A taxpayer may also qualify for percentage depletion with respect to oil and gas properties. The amount of the deduction is a statutory percentage of the gross income from the property. For oil and gas properties, the percentage ranges from 15 to 25 percent and the deduction may not exceed 100 percent of the taxable income from the property. In addition, the percentage depletion deduction for oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income (determined before the deduction and with certain other adjustments).

Other limitations and special rules apply to the percentage depletion deduction for oil and gas properties. In general, only independent producers and royalty owners (as contrasted to integrated oil companies) qualify for the percentage depletion deduction. In addition, oil and gas producers may claim percentage depletion only with respect to up to 1,000 barrels of average daily production of domestic crude oil or an equivalent amount of domestic natural gas (applied on a combined basis in the case of taxpayers that produce both). This quantity limitation is allocated, at the taxpayer's election, between oil and gas production and then further allocated within each class among the taxpayer's properties. Special rules apply to oil and gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). Only marginal well production can qualify for percentage depletion at a rate of more than 15 percent. The rate is increased in a taxable year that begins a calendar year following a calendar year during which the annual average unregulated wellhead price per barrel of domestic crude oil is less than $20 by one percentage point for each whole dollar of difference between the two amounts. In addition, marginal wells are exempt from the 100-percent-of-net-income limitation described above in taxable years beginning during the period 1998- 2007 and in taxable years beginning in 2009. Unless the taxpayer elects otherwise, marginal well production is given priority over other production in applying the 1,000-barrel limitation on percentage depletion.

A qualifying taxpayer determines the depletion deduction for each oil and gas property under both the percentage depletion method and the cost depletion method and deducts the larger of the two amounts. Because percentage depletion is computed without regard to the taxpayer's basis in the depletable property, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire and develop the property have been recovered.

Reasons for Change

Percentage depletion effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would

occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Cost depletion computed by reference to the taxpayer's basis in the property is the equivalent of economic depreciation. Limiting oil and gas producers to cost depletion would place them on a cost recovery system similar to that employed by other industries and reduce economic distortions.

Proposal

Percentage depletion would not be allowed with respect to oil and gas wells. Taxpayers would be permitted to claim cost depletion on their adjusted basis, if any, in oil and gas wells.
The proposal would be effective for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $9 billion in revenue from 2010 – 2019.

REPEAL DOMESTIC MANUFACTURING DEDUCTION FOR OIL AND GAS PRODUCTION

Current Law

A deduction is allowed with respect to income attributable to domestic production activities (the manufacturing deduction). For taxable years beginning in 2009, the manufacturing deduction is equal to 6 percent of the lesser of qualified production activities income for the taxable year or taxable income for the taxable year, limited to 50-percent of the W-2 wages of the taxpayer for the taxable year. For taxable years beginning after 2009, the deduction is computed at a 9 percent rate, except that the deduction for income oil and gas production activities is computed at a 6 percent rate.

Qualified production activities income is generally calculated as a taxpayer's domestic production gross receipts (i.e., the gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of qualifying production property manufactured, produced, grown, or extracted by the taxpayer in whole or significant part within the U.S.; any qualified film produced by the taxpayer; or electricity, natural gas, or potable water produced by the taxpayer in the U.S.) minus the cost of goods sold and other expenses, losses, or deductions attributable to such receipts.

The manufacturing deduction generally is available to all taxpayers that generate qualified production activities income, which under current law includes income from the sale, exchange or disposition of oil, natural gas or primary products produced in the United States.

Reasons for Change

The manufacturing deduction effectively provides a lower rate of tax with respect to a favored source of income. The lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Proposal

The proposal would exclude from the definition of domestic production gross receipts all gross receipts derived from the sale, exchange or other disposition of oil, natural gas or a primary product thereof for taxable years beginning after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $13.2 billion in revenue from 2010 – 2019.

INCREASE THE AMORTIZATION PERIOD FOR GEOLOGICAL AND GEOPHYSICAL COSTS TO SEVEN YEARS

Current Law

Geological and geophysical expenditures are costs incurred for the purpose of obtaining and accumulating data that will serve as the basis for the acquisition and retention of mineral properties. The amortization period for geological and geophysical expenditures incurred in connection with oil and gas exploration in the United States is two years for independent producers and seven years for integrated oil and gas producers.

Reasons for Change

The accelerated amortization of geological and geophysical expenditures incurred by independent producers, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system. To the extent accelerated amortization encourages overproduction of oil and gas, it is actually detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program. Moreover, the tax subsidy for oil and gas must ultimately be financed with taxes that result in underinvestment in other, potentially more productive, areas of the economy.

Increasing the amortization period for geological and geophysical expenditures incurred by independent oil and gas producers from two years to seven years would provide a more accurate reflection of their income and more consistent tax treatment for all oil and gas producers.

Proposal

The proposal would increase the amortization period from two years to seven years for geological and geophysical expenditures incurred by independent producers in connection with all oil and gas exploration in the United States. Seven-year amortization would apply even if the property is abandoned and any remaining basis of the abandoned property would be recovered over the remainder of the seven-year period. The proposal would be effective for amounts paid or incurred after December 31, 2010.

Revenue Estimate

This proposal is projected to raise $1.2 billion in revenue from 2010 – 2019.

REPEAL THE LAST-IN, FIRST-OUT (LIFO) METHOD OF ACCOUNTING FOR INVENTORIES

Current Law

The Internal Revenue Code (Code) permits a taxpayer with inventories to determine the value of its inventory and its cost of goods sold using a number of different methods. The most prevalent method is the first-in, first-out (FIFO) method, which matches current sales with the costs of the earliest acquired (or manufactured) inventory items. As an alternative, a taxpayer may elect to use the last-in, first-out (LIFO) method, which treats the most recently acquired (or manufactured) goods as having been sold during the year. The LIFO method can provide a tax benefit for a taxpayer facing rising inventory costs, since the cost of goods sold under this method is based on more recent, higher inventory values, resulting in lower taxable income. If inventory levels fall during the year, however, a LIFO taxpayer must include lower-cost LIFO inventory values (reflecting one or more prior-year inventory accumulations) in the cost of goods sold, and its taxable income will be correspondingly higher. To be eligible to elect LIFO for tax purposes, a taxpayer must use LIFO for financial accounting purposes.

Reasons for Change

The repeal of LIFO would eliminate a tax deferral opportunity that is available to taxpayers that possess inventories whose costs increase over time. In addition, LIFO repeal would simplify the Code by removing a complex and burdensome accounting method that has been the source of controversy between taxpayers and the IRS.
International Financial Reporting Standards do not permit the use of the LIFO method, and their adoption by the Security and Exchange Commission would cause violations of the current LIFO book/tax conformity requirement. Repealing LIFO removes this possible impediment to the implementation of these standards in the United States.

Proposal

The proposal would not allow the use of the LIFO inventory accounting method for Federal income tax purposes. Taxpayers that currently use the LIFO method would be required to write up their beginning LIFO inventory to its FIFO value in the first taxable year beginning after December 31, 2011. However, this one-time increase in gross income would be taken into account ratably over the first taxable year and the following seven taxable years.

Questions for the Record –

Hon. Alan Krueger, Assistant Secretary for Economic Policy, U.S. Department of the Treasury, Washington, DC

Senate Finance Committee Hearing

September 10, 2009

"Oil and Gas Tax Provisions: A Consideration of the President's FY2010 Budget Proposal"

ANSWERS TO QUESTIONS FROM SENATOR HATCH

Question #1

Mr. Krueger, in your testimony, you first acknowledge the President's environmental and energy policy that includes $16.8 billion for funding for renewable energy, fuel economy standards that will save 1.8 billion barrels, and further investments in a variety of renewable sources of electrical generation. In addition, you illustrate the President's cap-and-trade proposal that would provide incentives for firms to reduce carbon emissions and invest in new, cleaner lines of business. Then later on in your testimony, you cite George Washington as saying "commercial policy should hold an equal and impartial hand; neither seeking nor granting exclusive favours or preferences." How do you explain the contradiction of saying we need to create a level playing field for all energy sources by eliminating tax preferences for oil and gas exploration, but we should also favoring renewable energy through government subsidies?

Answer

Private market decisions can be inefficient when market prices do not reflect the full social costs of production or consumption. When negative externalities, such as pollution, are present, the market price is lower than the social cost, and when positive externalities are present, the market price is higher than the social cost.

Tax subsidies that encourage investment in a specific industry may be justified in cases where there are positive externalities, as the subsidies will lower the market price of goods from the favored industry, bringing prices more in line with the social costs. Renewable energy produces much lower greenhouse gas emissions than fossil fuels and enhances our energy security, and yet these positive externalities are currently not reflected in the market price. The Administration's policies to support renewable energy are intended bring the consumption of renewable energy closer to where it would be if all externalities were appropriately priced.

In contrast to renewable energy, the production and use of oil and natural gas leads to negative externalities by releasing greenhouse gases, which contributes to climate change and causes environmental harm. Because the negative externalities render the market price lower than the social cost, consumption exceeds the optimal level and policies to further lower the market price

through subsidies for oil and natural gas production are not justified based on the presence of externalities. Therefore, the Administration proposes to remove the tax subsidies to reduce the inequity with other industries.

In their recent Summit meeting in Pittsburgh, G20 leaders recognized the importance of this distinction and stated in their Leaders' Statement that, "Inefficient fossil fuel subsidies encourage wasteful consumption, reduce our energy security, impede investment in clean energy sources and undermine efforts to deal with the threat of climate change."

Question #2

One of the proposals included in the President's budget, which affects not only oil and gas production firms but also those in many other industries, is the proposal to repeal the last-in, first-out or LIFO method of accounting. As I understand it, LIFO has been an acceptable method of accounting since 1938. Hundreds of thousands, if not millions, of businesses use it. The Treasury's Green Book indicates that the Administration's rationale for this proposal is that LIFO creates a tax deferral opportunity and that it is complex. Is it not true that LIFO also creates the possibility of tax increases as well as tax deferral? And is it not also true that no one is forced by the tax code to use the LIFO method? So, any complexity that the method brings is by the consent of the taxpayer, right? If we were to repeal every provision in the tax law that is complex and burdensome or has been a source of controversy between taxpayers and the IRS, there would not be much left, would there?

Answer

As noted in the *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (the "Green Book"), a LIFO taxpayer could face a higher tax liability than a FIFO taxpayer if inventory levels fall during a given tax year. In that case, a LIFO taxpayer must include lower-cost LIFO inventory values (reflecting one or more prior-year inventory accumulations) in the cost of goods sold, and taxable income for that year would be correspondingly higher than that of a FIFO taxpayer. Even in this case, however, the LIFO taxpayer has enjoyed a tax deferral, since the reduction in the cost of goods sold merely reflects the same amount that would have been taken into account by a FIFO taxpayer in an earlier year.

The deferral provided under the LIFO method is inconsistent with general income tax principles in that those principles require increases in wealth to be taxed on an annual basis to the extent those increases are realized and recognized. The gains deferred under the LIFO method are not only attributable to changes in inventory cost due to general inflation, but also include price changes attributable to technological modifications and other market forces. Moreover, the deferral under the LIFO method may be for extensive periods, despite the fact that inventory sales are realized and recognized annually in the form of cash transactions.

Our analysis with respect to the number of taxpayers that use the LIFO method is not in the range of hundreds of thousands or millions of taxpayers, as your question suggests. In fact, among corporations with ending inventory values in excess of $1 million, fewer than 12,000 use

LIFO in computing their taxable income, based on 2006 data. This number represents approximately 10 percent of such taxpayers. Another six to seven thousand corporations with inventories of less than $1 million also utilize LIFO. Inventory amounts computed using the LIFO method constitute about 23 percent of the total inventory value reported on corporate tax returns. (Please see Matthew Knittel, "How Prevalent is LIFO? Evidence from Tax Data." *Tax Notes.* March 30, 2009, p. 1587.) These data indicate that the LIFO tax benefit is concentrated amongst the larger holders of inventory.

Tax complexity has at least two components. There is complexity of compliance, and there is tax administrative complexity. While a LIFO-election is voluntary, it nevertheless creates additional complexity for electing taxpayers. It also imposes additional rulemaking requirements on the Internal Revenue Service, as well as additional (administrative and judicial) enforcement costs. Lastly, LIFO may create or add to the perception that taxpayers who are well-positioned and large enough to take advantage of a complicated provision of the tax law, such as LIFO, are given an unfair, or unwarranted, competitive advantage.

Question #3

Mr. Krueger, in your testimony, you concluded that removing these tax subsidies for oil and gas production will have a very small effect on the price of oil and gas, the production of oil and gas, and domestic jobs. I would like to hear from some of the other panelists about Mr. Krueger conclusion. Would anyone like to dispute this claim?

Answer

As stated in my testimony, the tax subsidies for oil and natural gas represent a small share of industry costs and revenue, and in the case of oil, the United States' small share of world oil output makes it highly unlikely that these subsidies could measurably impact consumer prices. Small changes in costs and prices would lead to a very small impact on production and employment.

These results are consistent with those of Stephen Brown, who also testified at the Committee hearing. In his written testimony, Dr. Brown estimates that eliminating these tax preferences would increase the world oil price by about 6 cents per barrel (less than one-tenth of one percent at current prices and equivalent to less than 0.2 cents per gallon of gasoline) and increase domestic natural gas prices by about 2.4 cents per million Btu (an increase of less than one percent). According to Dr. Brown, domestic oil production could fall by 0.36 percent and natural gas production by about 0.25 percent. Dr. Brown also finds it unlikely that eliminating these tax preferences will have a significant impact on overall U.S. employment.

A 2007 study by Gilbert Metcalf of Tufts University also concluded that tax subsidies for oil and gas have at most a very small impact on prices and production. Professor Metcalf estimated that the price and production impacts of those subsidies would be equal to 0.4 percent and 0.2

percent, respectively.[1] Given that the value of the subsidies in the Administration's proposal is roughly one percent of the value of domestic crude oil production, Professor Metcalf's estimates suggest that the change in prices and production might be less than one-tenth of one percent. (Gilbert E. Metcalf, "Federal Tax Policy Towards Energy." *Tax Policy and the Economy*. August 2007, p145.)

[1] Metcalf calls this a "high estimate," citing a Government Accounting Office study that found a broader set of oil and gas tax subsidies than considered here were equivalent to about two percent of the value of crude oil and gas production in FY2003, when prices were much lower than today.

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

September 8, 2009

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%	4,252	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	291,267	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	7.5%
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	6.5%

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.

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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.

March 2009

energy API

AMERICAN PETROLEUM INSTITUTE

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.

May 2009

energy API

AMERICAN PETROLEUM INSTITUTE

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

energy API

AMERICAN PETROLEUM INSTITUTE

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.

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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.

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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

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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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October 15, 2009

Honorable Max Baucus, Chairman
United States Senate
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Questions for the Record

Dear Chairman Baucus,

Larry Nichols, Chief Executive Officer of Devon Energy Corporation and the Chairman of the American Petroleum Institute (API), appreciated the opportunity to come before the Senate Finance Subcommittee on Energy, Natural Resources and Infrastructure to testify on the various oil and gas tax proposals contained in President Obama's FY2010 budget. Tax policy is a vital issue to API members and it is important for Congress to understand the real effects of such proposals.

As part of the hearing, Senators Hatch and Cornyn had some specific written questions for Mr. Nichols and I am pleased to respond on his behalf. In addition to the written questions, Subcommittee Chairman Bingaman also raised two specific issues with the witnesses, the answers to which merit additional comment.

Specific Questions from Senator Hatch:

Hatch Question #1

I was interested in your assessment that these tax proposals would cost American Jobs. And those job losses are in addition to job losses you would expect if a cap and trade proposal was forced on Americans by Congress. Could you elaborate on these job losses, and help us understand what types of jobs we would be giving up with President Obama's proposals?

Answer – Hatch #1

A recent report by PricewaterhouseCoopers (PWC), "The Economic Impacts of the Oil and Natural Gas Industry on the U.S. Economy: Employment, Labor Income and Value Added" estimates that the US Oil and Gas Industry directly and indirectly supports 9.2 million jobs nationwide. These jobs are created both within the oil and gas sector itself, and over a wide swath of other sectors as the oil and gas industry makes significant capital and intermediate

goods purchases from other sectors in order to provide the US with the energy that it currently needs and to secure the energy it will need over the coming decades. A breakdown of employment by state for the top 15 states from the PWC report is given in the table below. We note that the oil and gas industry supports directly or indirectly 4.7% of the state workforce in Utah.

Total Operational Impact of the Oil and Natural Gas Industry, 2007
Top 15 States, Ranked by Employment Share of State

State	Employment*		Labor Income**		Value Added	
	Amount	Percent of State Total	($ Million)	Percent of State Total	($ Million)	Percent of State Total
Wyoming	71,063	18.8%	4,060	24.3%	8,432	29.4%
Oklahoma	348,627	16.3%	22,550	24.7%	47,839	31.3%
Louisiana	330,053	13.4%	18,449	16.6%	35,986	20.6%
Texas	1,772,335	13.1%	140,941	19.5%	293,760	24.2%
Alaska	43,454	9.8%	3,143	13.5%	6,064	16.6%
New Mexico	88,814	8.1%	4,307	9.5%	8,292	12.2%
West Virginia	60,891	6.7%	2,740	7.4%	5,412	9.4%
Kansas	119,051	6.5%	6,738	8.8%	14,029	11.4%
Colorado	190,408	6.0%	12,438	7.7%	24,099	9.3%
North Dakota	27,914	5.7%	1,346	7.6%	2,773	9.6%
Mississippi	83,820	5.5%	3,609	6.5%	7,244	8.4%
Montana	34,210	5.3%	1,584	7.0%	3,324	8.9%
Utah	76,188	4.7%	3,960	5.9%	7,822	7.6%
Arkansas	69,640	4.4%	2,884	4.9%	5,589	6.0%
Nebraska	49,784	4.0%	2,743	5.6%	5,112	6.7%

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.

The additional taxes on the oil and gas industry proposed by the Administration, by some estimates reaching $85.6 billion over the 2011 – 2019 period, will reduce the capital available for exploration, development and production of oil and natural gas. If enacted, these taxes will result in a decline in future production of oil and natural gas, and ultimately fewer jobs, both within the oil and natural gas sector. In addition, these impacts will be felt across the economy as a whole, as the oil and gas sector demands fewer intermediate and capital goods from other sectors due to its declining investment and production. The table below indicates which sectors of the economy, in addition to the oil and gas industry, would be adversely affected if these tax proposals are implemented.

The Direct, Indirect, and Induced Impacts Impact of the Oil and Natural Gas Industry to the U.S Economy, 2007

Sector Description	Employment*	Labor Income** ($ million)	Value Added ($ million)
Direct Impact of the Oil and Natural Gas Industry	**2,123,291**	**199,344**	**456,971**
Indirect and Induced Impact on Other Industries*:**	**7,114,090**	**358,916**	**580,089**
Operational Impact	***5,695,146***	***277,905***	***458,399***
Agriculture	104,549	1,850	4,412
Mining	9,268	873	1,755
Utilities	22,523	3,695	12,637
Construction	207,528	10,507	12,964
Manufacturing	397,299	27,821	42,778
Wholesale and retail trade	892,854	35,359	57,983
Transportation and warehousing	206,629	10,341	14,012
Information	124,081	10,896	21,481
Finance, insurance, real estate, rental and leasing	708,422	40,399	124,795
Services	2,834,634	123,227	151,073
Other	187,359	12,937	14,510
Capital Investment Impact	***1,418,944***	***81,012***	***121,690***
Agriculture	17,993	343	785
Mining	1,630	164	313
Utilities	3,749	614	2,015
Construction	13,395	678	758
Manufacturing	283,535	22,115	30,544
Wholesale and retail trade	281,908	14,352	22,932
Transportation and warehousing	69,863	3,551	4,734
Information	41,778	4,310	7,843
Finance, insurance, real estate, rental and leasing	120,482	7,088	19,507
Services	564,840	26,235	30,647
Other	19,771	1,562	1,612
Total Economic Impact	**9,237,381**	**558,260**	**1,037,060**

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

* 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.

*** Indirect and induced impacts on other industries exclude NAICS codes grouped under the oil and natural gas industry.

Hatch Question #2

You talked about how these proposals would reduce our domestic production of oil and natural gas. And the administration has talked about favoring more efficient, green alternatives. Diesel for trucks and trains, jet fuel for our planes, and natural gas for home heating are all key elements of our nation's energy supply. For each one of these, can you tell me about an alternative source that is cheaper, more efficient, and more green?

Answer – Hatch # 2

The simple answer to your question, Senator Hatch, is that there are currently no substitutes for gasoline, diesel fuel, jet fuel or natural gas that are cheaper and available at the scale needed to meet market demand over the coming decades.

To make that point more clearly, the first table below gives the projected consumption of transportation fuels and natural gas forecast by the Department of Energy. The second table below gives the projected supply of alternative fuels for gasoline and diesel, also forecast by the Department of Energy. Comparing the two tables illustrates that the projected supply of alternative fuels over the coming decades is a very small fraction of what will be needed in the transportation sector and in markets where natural gas is used.

Projected Delivered Energy Consumption for all Sectors						
Quadrillion Btu per year						
	2007	2010	2015	2020	2025	2030
Motor Gasoline	17.70	17.33	16.64	15.95	15.12	14.90
Jet Fuel	3.23	3.00	3.15	3.42	3.74	4.12
Distillate Fuel Oil	8.94	8.38	9.17	9.49	10.11	11.17
Natural Gas	14.79	14.86	15.30	15.34	15.60	15.73
Source: EIA/Annual Energy Outlook 2009, Reference Case, Table A2						

Projected Supply of Alternative Fuels						
Quadrillion Btu per year						
	2007	2010	2015	2020	2025	2030
Ethanol	0.45	0.84	1.07	1.28	1.68	1.91
Biodiesel	0.03	0.06	0.10	0.10	0.12	0.13
Liquids from Coal	0.00	0.00	0.06	0.10	0.18	0.26
Liquids from Biomass	0.00	0.00	0.01	0.07	0.24	0.33
Source: EIA/Annual Energy Outlook 2009, Reference Case, Table A11						

Specific Questions from Senator Cornyn:

The tremendous growth in natural gas production as a result of shale plays like the Barnett Shale in Texas is a game changing domestic energy success story. Independent oil and gas producers stand to be hardest hit by the proposed tax increases, which will substantially reduce their capital available for drilling budgets.

Cornyn Question #1

How will the Administration's tax proposals affect continued investment in these shale plays for a company like yours?

Answer – Cornyn #1

To frame the issue from a broad perspective, the new tax liability on the oil and gas industry over the period 2011-2019 attributable to the administration's budget proposal totals an estimated $85.6 billion. This new liability decreases the funds available to the industry for re-investment back into natural gas and oil projects by an average of $9.5 billion annually for the 2011-2019 period.

TAX ITEM	Estimated Liability (billion $)
Repeal LIFO tax treatment	24.4
Repeal manufacturing tax deduction	13.3
Repeal expensing of IDCs	7.0
Reform tax treatment of foreign income including dual capacity taxpayer rules	16.4
Apply new excise tax to crude oil and gas produced in GOM	5.3
Repeal percentage depletion	9.0
Increase amortization period for G&G costs	1.2
Reinstitute the Superfund tax	9.0
Total increased tax liability	85.6

More specifically, for an Independent producer, such as Devon Energy, that typically reinvests 100 percent of cash flow back into exploration and drilling, the effect of the administration's tax proposals would be devastating. Devon estimates the administration's tax proposals would reduce its working capital over $700 million in the first year. Nearly $600 million of that would come from the repeal of the Intangible Drilling Cost (IDC) deduction alone. A reduction of that magnitude in its working capital would shrink drilling budgets by nearly 20%, the equivalent of drilling 230 Barnett Shale natural gas wells.

Cornyn Question #2

What will the long term effect (estimate of reduction) be on domestic natural gas resources, if these proposals were to be adopted?

Answer – Cornyn #2

According to the latest data from the Energy Information Administration[1], the average cost of finding and developing a barrel of oil equivalent in 2005-2007[2] was $23.45. This is convertible to units of dollars per mcf of natural gas by multiplying that number by 0.178, which yields $4.17 per mcf. At this cost, reduced investment of $85.6 billion would reduce supply of natural

[1] US Department of Energy, EIA [2008]. *Performance Profiles of Major Energy Producers, 2007.*
[2] US DOE, *op cit., page 26.*

gas by as much as 20.5 TCF over the 2011-2019 period, or 2.2 TCF annually. To put that into perspective, 2.2 TCF represents about 10 percent of the nation's annual natural gas consumption.

Cornyn Question #3

What will be the loss of American jobs to overseas production?

Answer – Cornyn #3

The loss of jobs as a result of the administration's tax proposals could be significant to our industry, at a time when this country can least afford it. Using data from answer # 2 above, the loss of 2.2 TCF of production annually, at an average price of $6.43 per mcf [3], represents lost domestic sales of $14.1 billion. Using the IMPLAN[4] model to assess the loss of domestic jobs triggered by this lost output, the impact of the loss in annual sales would be 107.7 thousand jobs, broken down as follows:

	Jobs
Direct jobs in the oil and gas industry	19,200
Indirect jobs in industries supplying the oil and gas industry	23,300
Induced jobs in other sectors stimulated by incomes earned in direct and indirect oil and gas industry jobs	65,200
Total	107,700

Follow-up on Items Raised by Subcommittee Chairman Bingaman:

I also wish to provide additional information in response to two items that were raised by the Chairman of the Subcommittee during the hearing.

Item #1

The first item concerned a question on the "real" effective tax rate for the industry and noted that there was confusion on this issue.

Supplemental Answer #1

When business leaders contemplate effective tax rates, they associate the term with the income tax charge they incur against their business earnings. In other words, they consider the effective tax rate to be the amount of tax paid or incurred on a company's business operations for a specific period of time. This is why Mr. Nichols responded that his company's effective tax rate as reported to shareholders and the SEC was around 32%. That is the tax cost that Devon charged to its earnings and reflects its actual income tax obligation to various governments.

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[3] Average Lower 48 wellhead value of natural gas estimated over the 2011-2019 period, from US Department of Energy [2009]. *Annual Energy Outlook, 2009.*

[4] Model licensed to API by Minnesota Implan Group, Inc., Stillwater, Minn.

Other witnesses, though, responded that the effective *marginal* rate on the industry was much lower or even negative on oil and gas operations. An effective marginal rate analysis calculates the tax rate on a hypothetical dollar invested in a specific project using certain tax assumptions to determine the after-tax cash flow of that investment. With respect to the oil and gas industry, the marginal rate calculation can take into account percentage depletion, IDC deductions and other issues. The marginal tax rate on an investment decreases in relation to the statutory tax rate to the extent the Internal Revenue Code allows taxpayers to recover their investment costs more quickly or provides investment credits.

However, we believe the real effective rate paid by the industry over its entire slate of operations is represented by what is actually paid or incurred on the sum of its investments, rather than hypothetical models covering a specific operation. In fact, oil and gas companies typically incur fairly high effective rates (e.g. a 34% tax rate on U.S. investment for 2007 according to EIA) rather than the hypothetical rates suggested by some of the testimony.

Item #2

The second item raised the point of whether companies acknowledged that they did not need tax "breaks" or "subsidies" in order to operate.

Supplemental Answer #2

This issue is generated from a November 2005 joint hearing of the Senate Committee on Commerce, Science and Transportation and the Senate Committee on Energy and Natural Resources where the CEOs of the five largest U.S. oil and gas companies testified on a variety of issues associated with the rise in oil and gasoline prices. During the questioning, Senator Wyden raised a response that President Bush had made in April 2005 when asked a question on the pending energy bill, to which he replied, "I will tell you with $55 oil we don't need incentives to oil and gas companies to explore. There are plenty of incentives." Senator Wyden then asked the CEOs if they concurred with that statement. The CEOs generally concurred that the President was correct and Senator Wyden went on to ask specifically about the need for the "$2.6 billion of brand new tax breaks" in the pending energy bill. The general response given by the CEOs to that question was that those incentives would have a negligible impact on the major oil companies.

In considering President Bush's statement in context, it is clear he was talking about the new incentives that were included in the then pending energy legislation rather than the existing tax or royalty structure for oil and gas companies. In speaking with those companies, the responses of the CEOs to Senator Wyden's statement was with respect to those new incentives. This point is further supported in some of the written responses submitted by these witnesses after that hearing. Comments made by those CEOs should not be applied across the board to any oil and gas tax provision that existed at that time and may be the subject of a current repeal proposal from the administration.

Again, we appreciate the opportunity to come before the Subcommittee to discuss these provisions and their impact on our industry. We stand ready to help you or the committee should there be any additional questions on these issues.

Sincerely,

Michael L. Platner
Director of Taxation

C: Senator Jeff Bingaman, Chairman, Senate Finance Subcommittee on Energy, Natural Resources and Infrastructure
Senator Jim Bunning, Ranking Member, Senate Finance Subcommittee on Energy, Natural Resources and Infrastructure

COMMUNICATIONS

PREPARED STATEMENT

OF

AD HOC DEEP WATER EXPLORATION AND PRODUCTION COALITION

SUBCOMMITTE ON ENERGY, NATURAL RESOURCES, AND INFRASTRUCTURE
COMMITTEE ON FINANCE

"OIL AND GAS TAX PROVISIONS: A CONSIDERATION OF
THE PRESIDENT'S FY 2010 BUDGET PROPOSAL

September 10, 2009

Chairman Bingaman, Ranking Member Bunning, and Members of the Subcommittee:

We appreciate the opportunity to provide these comments for the hearing record. For the reasons set forth below, the members of the coalition believe that enacting an excise tax on OCS deep water leases issued at sales held in 1996-2000, such as proposals put forward in the 110th Congress, would put oil and gas production at risk, would discourage inward foreign investment, would put U.S. investment abroad at risk, and would create huge potential liabilities by taking property without just compensation. Congress should reject this kind of price threshold legislation as bad policy. Instead, to help achieve the Obama Administration's goal of decreasing our Nation's dependence on foreign sources of oil, Congress should look at new ways to encourage the industry to invest in the science and technology that can help our Nation enjoy enhanced energy security.

Background. In 1995, Congress enacted the Outer Continental Shelf Deep Water Royalty Relief Act to encourage industry to invest billions of dollars to explore for and produce oil and gas in the deep waters of the Gulf of Mexico. Aware of the very high costs, risks, and technical challenges of deep water exploration and development and of the Interior Department's prior limited success in attracting exploration companies in such frontier areas, Congress offered royalty relief incentives to encourage companies to bid for certain leases. For deep water leases issued at sales held in 1996-2000, the Act provided that companies making commercial discoveries of oil or gas could produce up to certain set volumes free of royalties.

Consistent with the royalty relief provided in the statute, leases issued in 1998 and 1999 did not contain price thresholds. In acquiring these leases, companies paid a premium of approximately $1.5 billion in bonus bids to the U.S. Government. In addition, companies buying leases in the open market paid substantially more to acquire them from third parties. Because Congress wisely put the right incentives in the Act, companies have since invested tens of billions of dollars to find and produce oil in depths of up to 2 miles. To illustrate, a single exploration well in 10,000 feet of water would cost approximately $150-200 million and, assuming success, the production platforms for 10 wells and the infrastructure needed to get the oil to shore would cost another $3.5-5.0 billion. As a result of these kinds of investments--which carried no guarantee of success--significant volumes of new supply already have entered the market, with much more in the development phase.

Unfortunately, given the collapse in world oil prices and the cyclical nature of the market, these producers face much the same economic environment as they confronted in 1995. Faced with

very high production costs and low prices, they are laying off employees, delaying new projects, and deferring investments on existing projects.

On January 26, President Obama said: "It will be the policy of my administration to reverse our dependence on foreign oil." The last thing our Nation needs now is for Congress to enact legislation that would impose price thresholds or other financial burdens on the industry and thus discourage future production in the United States. Imposing discriminatory price thresholds or any other penalty on the companies that developed deep water OCS leases in good faith would upset investment decisions and negate the sanctity of contracts entered into by the U.S. Government. In the current economic environment, the U.S. Gulf could again become relatively less attractive than other lower-cost production areas throughout the world, moving us further away from the President's goal.

Santa Fe Snyder and Kerr-McGee Decisions. The Interior Department has twice tried to rewrite the plain words of the Act. In 2004, in *Santa Fe Snyder v. Norton,* the Fifth Circuit Court of Appeals unanimously held that the Interior Department had no authority to effectively suspend royalty relief for new leases at production volumes below those set by Congress in section 304 of the Act. In January 2009, in *Kerr-McGee v. Allred,* the Fifth Circuit Court of Appeals, again speaking through a unanimous panel, held that Congress did not give the Department any authority to establish a price threshold that would trigger future royalty payments on leases issued in 1996, 1997, or 2000. Finding the words of the statute "unambiguous," the appellate court reaffirmed the decision of the district court, which had found that the Interior Department's "action is unlawful because it contradicts the plain, unambiguous text of the statute." On April 14, the court rejected the government's request to re-hear the case. The government has since filed a petition for certiorari with the Supreme Court, asking it to reverse the Fifth Circuit's decision.

Two district court judges and two panels of the Fifth Circuit have now confirmed the clear meaning of the law: The Interior Department did not make a "mistake" in failing to include price thresholds in '98-99 OCS leases. Instead, it made a fundamental mistake in thinking it had the authority to include price thresholds in '96, 97, and 2000 OCS leases. As these decisions make clear, no mistake now needs rectifying by Congress.

Potential OCS Price Threshold Legislation. Last year, the House and the Senate considered legislation that effectively would have required '98-99 OCS lease holders to renegotiate their leases to include price thresholds. In its Budget Submission, the Administration indicated that it would support an excise tax on certain oil and gas produced offshore in the future.

Like an earlier version of H.R. 6, excise tax legislation and other price threshold legislation put forward in the 110th Congress would effectively force companies that took the risks inherent in deep water exploration to pay more than they contracted for. As *The Washington Post* said in an editorial on H.R. 6, "[t]his heavy-handed attack on the stability of contracts would be welcomed in Russia, Bolivia and other countries that have been criticized for tearing up revenue-sharing agreements with private energy companies." But it should not be welcome here.

❖ Enactment of price threshold legislation would unfairly confiscate an important property interest of leaseholders and thus would be subject to legal challenge as an unconstitutional "taking" without just compensation under the Fifth Amendment, as well as a breach of contract.

❖ Assistant Secretary of Interior Allred testified last year that "if an affected company went to court and a judge were to enjoin future lease issuance, the resulting impacts would be

significant . . . . A 3-year delay, for example, could reduce production over 10 years by 1.6 billion barrels of oil equivalent and cumulative revenue by $13 billion."

❖ Enactment of discriminatory price threshold legislation would violate numerous international trade agreements, which prohibit the taking of property without just compensation. The Ambassadors of Australia, Canada, France, Norway, and Spain have expressed concerns about the adverse precedent this would establish generally and the impact such a measure would have on companies that made substantial investments in reliance on the explicit terms of the leases,

❖ Enactment of price threshold legislation would deter foreign investment in the United States. As investors take into account this lack of deference to contractual provisions that induced bidders to invest billions of dollars, concern over what other binding contracts could be voided in other sectors will necessarily lead to less foreign investment.

❖ If enacted, the legislation would embolden resource-rich countries throughout the world to take similar action to break valid contracts relied upon by companies that have invested hundreds of billions of dollars. As the Ambassador of Spain said last year in a letter to the leadership of the Congress, "Our governments have a shared interest in ensuring that this does not occur."

Thank you again for the opportunity to share these comments.

Subcommittee on Energy, Natural Resources, and Infrastructure of the Committee on Finance

Oil and Gas Tax Provisions: A Consideration of the President's FY10 Budget Proposal

September 10, 2009 at 2:15pm in 215 Dirksen Senate Office Building

Statement for the record: Submitted by the National Association of Royalty Owners (NARO)

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We are the National Association of Royalty Owners (NARO) and represent the concerns of an estimated 8.5 million American private owners of oil and gas mineral and royalty interests. We live and vote in all 50 states, even though our producing minerals may be in Arkansas, New Mexico, North Dakota, Oklahoma, Pennsylvania, Texas, Utah, Wyoming or any other of the 22 producing states. NARO has been educating and advocating for mineral/royalty owners since our original incorporation 29 years ago in 1980.

The average NARO member is over 60 years old, widowed, and receives less than $500 in monthly royalties as a supplement to their social security retirement income.

The majority (something over 70%) of the minerals in the U.S. are owned by individuals and leased to companies for development. Thanks to the efforts of one of our members, we recently took a snap shot of one "marginal" oil well (producing less than 15 barrels of oil per day) in Grady County Oklahoma. This one little well has over 300 individuals in 46 states receiving royalty payments from its production.

Just to give you an idea of how many citizens are royalty owners, if you take our membership in each state as a percentage of a total and then multiply by the estimated 8.5 million royalty owners you get a rough idea of how many royalty owners live in each state. And here are those numbers:

AK 13,600	AL 33,150	AR 255,000	AZ 144,500	CA 510,000
CO 654,500	CT 17,000	DC 17,000	DE 2,550	FL 161,500
GA 85,000	HI 8,330	IA 33,150	ID 35,700	IL 76,500
IN 27,200	KS 147,900	KY 11,050	LA 125,800	MA 30,600
MD 35,700	ME 5,525	MI 44,200	MN 47,600	MO 110,500
MS 39,100	MT 47,600	NC 67,150	ND 24,650	NE 19,550
NH 13,600	NJ 47,600	NM 161,500	NV 44,200	NY 127,500
OH 30,600	OK 1,691,500	OR 51,000	PA 119,000	RI 5,525
SC 22,100	SD 5,525	TN 59,500	TX 2,975,000	UT 39,100
VA 85,000	VT 2,550	WA 39,100	WI 39,100	WV 19,550
WY 30,600			Total nationwide: 8,440,755.	

Remember, these are estimated numbers of *royalty* owners. The total number of *mineral* owners is much greater, as vast areas are unproductive or have not yet been explored and developed.

All of the proposed tax law changes that affect oil and gas industry decisions to drill -- such as no longer being able to expense intangible drilling costs – affect owners of undeveloped minerals, by rendering their properties valueless. Elimination of credits for marginal wells and tertiary recovery would result in the plugging of thousands of older wells and a subsequent loss of vital supplemental income for countless retirees.

One of the changes you are contemplating in the 2010 budget will directly impact every one of the nation's millions of royalty owners. Under current law, each royalty owner is allowed to take 15% of their gross royalty income as a deduction on their income tax returns. This allowance was put into law in the 1920s to accommodate the fact that minerals are a non-renewable asset, and to provide for the "cost" of these diminishing assets as an expense against the mineral owners' income. This deduction is the Percentage Depletion Allowance; and contrary to some Congressional comment and misguided public discussion, percentage depletion is allowed on over 200 minerals from our earth and should continue since, unlike trees (also classed as depletable by tax code), oil and gas are non-renewable and once extracted are exhausted assets. Royalty owners currently pay property tax, ad valorem tax, severance tax, state income tax, local tax, non-resident income tax, federal income tax . . . on their producing minerals. Does your income get taxed this much?

Several of our royalty owner accountants have looked at how the elimination of the depletion allowance will impact our elderly, low-income, royalty owners. We have found that in many instances, the elderly folks with incomes less than 50,000 dollars annually will now have their Social Security benefits become taxable because of the elimination of the depletion allowance. This will lay an undue burden on these folks, to not only pay additional tax because of

eliminating the depletion allowance, but they will be forced to pay additional tax on currently, non-taxable Social Security benefits. We do not believe that your intent is to put this tax burden on our elderly, royalty owners.

We are teachers, farmers, ranchers, homemakers, accountants, firemen, plumbers, retirees, bankers, dentists, small business owners, factory workers, engineers, pet groomers, widows, roofers, lawyers, policemen, florists, architects, carpenters, secretaries, bricklayers, members of Congress . . .We are ordinary citizens, not multi-national corporations. We consider our mineral estates as assets to be managed and protected with responsible stewardship. For the majority of us, our minerals are part of a family legacy acquired through the hard work and sacrifices of our forebears. Royalty income pays to educate our children, care for aging parents, and supplement salaried and Social Security income. We spend our money in our communities, give to our local charities and save for the future. Our financial benefits come solely from the mineral interests we own – deep under American soil. When those resources have been exhausted, the royalty income ends.

In closing I want to provide the following letter to NARO members as posted on the NARO-Arkansas message board in September 2006. This is a very typical royalty owner story.

> "I would have liked to have been at the Convention and Lord willing, I will be at the next one. My absence related to the health of my mother, a 20 year quadruple survivor of cancer. 2 years ago she was once again diagnosed with the disease and elected not to use aggressive treatments. She was given some 3 months to live. I was blessed with 2 years of her continued presence and she was able to live by herself until about one month ago. My niece, my girl friend, my brother, and I were able to stay with her around the clock until Sept. 6th when we moved her to a nursing home. On Sept. 10th she passed away being lucid until just hours before dying.
>
> It is not unusual to die, my grandfather was fond of saying that it was the most natural thing about living. But I bring up the subject for another reason. The last check my mother received Sept 1 from our Family General Partnership was about $700, that and spousal SS benefits were all she had to live on. Without her royalty income, she could not have remained in her own home which she had lived in since 1944. Quite recently she remarked that without that check she could never have afforded the several hundred dollars per month in medicine that she took in her battle with cancer. In my mother's case, that royalty interest, reserved in 1938 by the foresight of my grandfather in a county which had no oil or gas production, was the difference between living an independent life and living as a ward of the state. . ." *signed by Terrel Shields NARO-Arkansas Member.*

Written Statement of

Charles T. Drevna
President
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on

"Oil and Gas Tax Provisions: A Consideration of the President's FY 2010 Budget Proposal"

before the

Senate Finance Committee
September 10, 2009

NPRA, the National Petrochemical and Refiners Association, appreciates the opportunity to reflect on the direction of national tax policy proposed in President Obama's 2010 budget. Today's important hearing occurs at a time when American consumers are openly expressing their concerns over the role of government in the markets and their increasing fears of a jobless recovery that, in other words, might boost the Dow but not national employment figures.

NPRA's members play a critical role in the American economy, perhaps even more than you might be aware. Aside from operating virtually all domestic refineries, large and small, that supply the average driver, farmer and trucker with a safe, reliable supply of transportation fuels, our members also provide the basic "building block" chemicals and materials used to manufacture products ranging from pharmaceuticals to fertilizer to soap and Kevlar. In doing so, the refining and petrochemical community also directly provides jobs to tens of thousands of workers, many of whom are union members, with good benefits and hourly wages 50 percent higher than the national average.[1]

NPRA believes that the tax provisions contained within the President's proposed 2010 budget would only lead to the decline of another key economic contributor: the domestic refining and petrochemical community. Sound, fair tax policies are in the best interests of our members' businesses, employees and consumers. These policies should encourage the expansion of American businesses and strengthen their standing globally, not discourage production, drive more jobs overseas, and increase imports of foreign energy supplies. The proposals being discussed today, in the midst of a deep recession, would only contribute more to the challenges our economy faces, not resolve them. They are clearly inconsistent with your stated objectives for putting more Americans back to work, keeping costs for consumers low, and enhancing our nation's energy security by reducing dependence on imports.

The President's proposals run counterproductive not only to the interests of our members' businesses and their employees, but ultimately to those of American consumers who rely on the products they make. We are concerned about the message being sent to NPRA members, businesses that have not required or requested taxpayer dollars to remain afloat, that they are not an integral part of the U.S. economy and are not welcome here. Regardless of the Administration's or Congress' views or desires concerning the oil and refining industry, there should be much concern about what the effects of these policy proposals would be on the Americans who are currently employed at our facilities or with businesses across the country that supply those facilities with various goods and services.

Every sector of our national economy has felt the pinch of the recession, including our own. Refiners have been challenged by declining consumer demand, an expanded Renewable Fuel Standard (RFS) that is based on an uncertain supply of nascent technologies, volatile crude oil prices, and tightening credit markets. Consumption declined 6.1 percent between 2007 and 2008, and the Energy Information Administration (EIA) predicts an additional 4.1 percent drop in 2009.[2] As a result of this precipitous decline in demand and the financing and liquidity challenges, domestic refiners have delayed 430,000 barrels-per-day (b/d) worth of capacity

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[1] Department of Labor, Bureau of Labor Statistics.
[2] EIA, "Short Term Energy Outlook," August 11, 2009, http://www.eia.doe.gov/emeu/steo/pub/contents.html.

expansion projects.[3] Our margins have also sharply declined. Between the third quarter of 2008 and 2009, the average margin for independent refiners dropped 121 percent. During the same time, the average margin for integrated refiners declined 71 percent. Logic should dictate that increasing our businesses' tax burden will not encourage capacity expansion or increased domestic production.

American refiners already face high levels of taxation. Our effective tax rate was 40 percent in 2007, and 39.17 percent in 2008.[4] The average global corporate tax rate is only 25.9 percent,[5] and the average American corporate tax rate was 36.4 percent in 2007. An additional tax burden would simply be counterproductive and significantly limit our global economic competitiveness.

The President's proposed budget plan would rescind, for oil and gasoline producers only, critical manufacturing deductions provided economy-wide under the American Jobs Creation Act of 2004 (P.L. 108-357). These Section 199 deductions allow refiners to remain competitive globally, particularly at a time when foreign refiners are significantly expanding their own capacity to further their reach into the U.S. markets for refined products. The deductions encourage increased domestic production and provide additional employment opportunities across the country as our facilities either expand capacity or purchase more goods and services from their contractors and vendors.

Between 2005 and 2008, refiners added more than 700,000 b/d of production capacity. From 2001 to 2004, before the Section 199 deduction became effective, refiners added 299,000 b/d of capacity. In 2008, Asia's refining capacity expanded by 269,000 b/d, while North American capacity declined by 7,500 b/d.[6] Asia, led by India and China, also exported 750,000 b/d of finished petroleum products to Europe and North America, an amount expected to grow to one million b/d by next year.[7] A study by Deloitte projects that American refining capacity could decline by as much as two million b/d once relevant federal regulations are fully enacted, and this supply need would be filled by foreign "export" refiners who are not subject to the "costly regulations affecting refiners in the United States and Europe."[8] EPRINC also projects that a petroleum sector-only repeal of the Section 199 deduction will assist foreign refiners by increasing their share in American markets, which has doubled over the last nine years and will

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[3] Brett Clanton, "Poor market delays completion of refinery expansion," *Houston Chronicle*, March 17, 2009, http://www.chron.com/disp/story.mpl/business/energy/6316340.html.

[4] An average of the effective tax rates of Valero Refining, Exxon Mobil, Conoco Phillips, Marathon, Chevron, Tesoro, Flint Hills Resources, Frontier Oil, Hess, Murphy Oil, Occidental, Wyoming Refining and CVR Energy.

[5] "Corporate oil booms in low-tax Switzerland," Reuters, March 12, 2009, http://www.reuters.com/article/rbssEnergyNews/idUSL312427120090312?feedType=RSS&feedName=rbssEnergyNews&rpc=22.

[6] "Worldwide refining capacity growth rises again in 2008," *Oil and Gas Journal*, Volume 106, Issue 48, December 2008, http://www.ogj.com/index/article-display/348555/s-articles/s-oil-gas-journal/s-volume-106/s-issue-48/s-processing/s-worldwide-refining-capacity-growth-rises-again-in-2008.html.

[7] "Asian oil exports threaten U.S. refineries," UPI, August 24, 2009, http://www.upi.com/Energy_Resources/2009/08/24/Asian-oil-exports-threaten-US-refineries/UPI-63121251133204/.

[8] "A Tsunami of Change bearing down on the refining industry," Deloitte, August 2009, http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_er_TsunamiofChange_071509.pdf.

grow with increasing domestic costs.[9] To strengthen and preserve the stake of American businesses in our own marketplace, NPRA opposes the repeal of our businesses' Section 199 deductions.

The President also proposes to repeal the "Last In, First Out" (LIFO) accounting method, which is equally as troubling. LIFO allows manufacturers, wholesalers and retailers to accurately determine both book income and tax liability. Repealing LIFO would only increase the tax liabilities of American businesses. In the event of rising inventory costs (inflation), LIFO is a more accurate means for businesses to measure financial performance and calculate taxes. A repeal of LIFO and the resulting tax increase would be felt by businesses both large and small, and should be dismissed from consideration, particularly under the current economic circumstances.

We appreciate the deserved attention your committee is giving to these and numerous other issues that will determine the success or failure of the nation's economic recovery. As this debate progresses, NPRA and its members stand ready to work with you and your colleagues to help grow the economy and create more opportunities for hardworking Americans.

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[9] "Do Higher Oil and Gas Taxes Pose a Threat to U.S. Energy Security?", EPRINC, August 2009, http://www.eprinc.org/pdf/administrationtaxesfy2010.pdf