

"We don't believe it makes sense to significantly subsidize the production and use of sources of energy (like oil and gas) that are dramatically going to add to our climate change (problem)."

U.S. Secretary of the Treasury Timothy Geithner

Statement to the Senate Finance Committee

March 4, 2009

- The natural gas and oil industry is able to deduct the cost of its business, which is in line with every other manufacturing industry in America. These are not subsidies or loopholes as the administration suggests, and to categorize them as such is dishonest.
- Policies that increase taxes on the domestic natural gas and oil industry are counter to the goals of the Obama Administration and Congress to reduce U.S. dependence on foreign sources of energy, tackle climate change, and enable renewables.
- Tax increases will have the perverse effect of giving coal an economic advantage over natural gas, which produces much less greenhouse gas emissions than coal.
- Taking steps to develop alternative energy sources should not be done by making the production of traditional sources of energy more difficult and America less energy independent.
- In these uncertain economic times, policies that increase taxes on domestic natural gas and oil producers will divert investment capital overseas, compromise American jobs, decrease energy security, and lead to higher energy prices for consumers.
- Independent producers typically reinvest over 100% of their cash flow back into American projects. Consequently, policies that increase taxes take capital away that could otherwise be invested in projects to stimulate the economy, create American jobs, and produce American energy.
- The exploration for natural gas and oil has a very high degree of risk and U.S. income tax policy has evolved over the last two decades to align with this economic risk.
- Increased taxes will render many domestic natural gas drilling projects in the U.S. uneconomic at today's forward prices. As a result, production will plummet and prices will spike, since about half the current U.S. gas supply comes from wells drilled in the last three to four years. This will force more LNG imports, further outsourcing jobs and widening the balance of payments.
- It is unwise to promote tax policies that will result in less energy supply, higher energy costs, massive domestic job losses, bankruptcy of more U.S. companies and increased dependence on foreign energy sources.
- The fundamentals of global energy have not changed even though prices have declined in the last year. Global oil production cannot keep up with global oil demand. A coordinated energy policy that includes domestic natural gas as part of the solution is a must.

Details¹

- **Intangible drilling costs (IDC)** are all costs incident to drilling a well, including drilling contractors, ground-clearing work, hauling, and supplies, and are typically 65 – 80% of the cost of a well. Without the deduction, the domestic natural gas industry would have 30% to 50% less cash flow available for investment in producing American energy. Over the past several years, natural gas producers have spent billions on a massive R&D effort aimed at advanced drilling and completion technologies. Losing the tax deduction for these costs would cut the return by a third, effectively eliminating the incentive to continue the R&D activities. IDC expensing has been part of the tax code since 1913.
- **Geological and Geophysical (G&G)** expenses include the costs incurred for geologists, seismic surveys, and the drilling of core holes. G&G cost treatment was changed in the Energy Policy Act of 2005 to rationalize the structure by allowing faster recovery of G&G costs to encourage domestic exploration and production. These costs are similar to R&D costs, and thereby an ordinary and necessary cost of doing business. For other industries, R&D costs are not only deductible, a tax credit is available. Early recovery of G&G costs allows for more investment in finding new resources. Extending the amortization period would remove over \$1 billion from efforts to find and develop new American production.
- **Percentage depletion** was specifically intended to encourage the participation of small natural gas and oil producers. The deduction has been part of the tax code since 1926, and is only available on the first thousand barrels of oil equivalent per day. By allowing for the recovery of capital investment over time, it is essential for meeting the costs of operating marginal wells.
- **Section 199 deduction** was initiated by the JOBS Act of 2004 to make additional capital available to American production and American jobs. This deduction is available to all other manufacturing and production industries. Consequently, removing this deduction would discourage investment and make American natural gas and oil projects less competitive with foreign ones.
- A repeal of the **working interest exception** would remove the individual investor from the natural gas and oil industry. Small working interest owners pay their proportionate share of costs for the operation of well or wells. They are taking on risk that is disproportionate to other “passive” investors. Many of these small business owners have been part of some of the largest discoveries of hydrocarbons in the United States.
- **Marginal well tax credit:** There are 650,000 marginal or ‘stripper’ wells in the U.S., defined as a well producing fewer than 15 barrels or 90 mcf per day. Although they provide a small amount per well, they add up to a sizeable portion of America’s domestic energy supply. Removing the credit would make most marginal wells uneconomic, thereby removing 25% of America’s crude oil (roughly equivalent to our imports from Saudi Arabia) and 10% of natural gas supply.

Punitive Taxes – A History: In 1980, the federal government enacted a crude oil windfall profits tax (WPT). The WPT was actually an excise tax imposed on the difference between the market price of oil and an adjusted base price. The WPT resulted in: \$80 billion in gross revenues, significantly less than the \$393 billion projected; reduced domestic oil production by about 8.0%; and increased dependence on foreign oil as imports grew 13%. The WPT was repealed in 1988 because it reduced oil and gas jobs by about one-third and increased the United States’ dependence on foreign oil.

¹ IPAMS used information from IPAA and the Energy Exchange <http://www.enex.com/Taxadvantages.html>.