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The Honorable Jim Gerlach
Chair, Manufacturing Working Group
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

The Honorable Linda Sanchez
Vice Chair, Manufacturing Working Group
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

The Honorable Peter Roskam
Member, Manufacturing Working Group
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Gerlach, Mrs. Sanchez, & Mr. Roskam:

Thank you for your letter dated March 18, 2013 in which you posed a series of questions regarding the effect of tax reform on U.S. manufacturers. We very much applaud your interest in understanding the potential benefits and pitfalls of tax reform for U.S. manufacturers, and appreciate your reaching out to me for our comments. They are as follows.

Manufacturing vs. Production

As an initial comment, we consider the definition of manufacturing to be very broad. We certainly believe that it covers the nation's refining and petrochemical businesses. But, like the definition currently used for section 199, it includes extraction activities as well. There is no reason for the tax system to distinguish between these activities, which are conducted around the globe under the pressures of competition. Our tax system should create a climate in which companies engaged in manufacturing or production can flourish in the United States and in which U.S. companies can fairly compete in any market.

Developing a tax regime is difficult, and focusing on the interaction between that tax system and a particular part of the economy is more difficult still. However, for manufacturers and producers, tax provisions that permit entities to appropriately recover the costs of domestic investment are critically important. Risking capital on new investments generally requires an expected return that justifies the risk and the availability of funds to make the investment. Provisions such as the deduction for drilling costs and accelerated depreciation lead to continued reinvestment by lowering the cost of capital and freeing up cash flow for new projects. Those provisions are the key cost-recovery provisions for the oil

and natural gas industry. Other critical provisions such as LIFO accounting, which affects the refining business (not the production or "upstream" business as many incorrectly assume), provide for a better matching of income and expense in commodities-based businesses. Section 199 represents an explicit effort by the government to boost the competitiveness of manufacturing and production in the United States, and to provide solid middle class jobs in the United States.

Together, these provisions have established an economic environment that supported an annual investment of over $150B in U.S. capital equipment by the oil and natural gas industry between 2008 and 2011, and family-supporting jobs that continue to pay well above average salary in the United States. New drilling technologies developed in our industry have ushered in an era of abundant domestic natural gas and which is now unleashing a U.S. manufacturing renaissance among industries that use natural gas as a feedstock or as low cost energy for their operations.

General Perspective on Tax Reform

The industry's assessment of any tax reform package – and our assessment of which existing tax provisions Congress could eliminate or curtail as an offset for reducing tax rates – depends on the full details of the legislation. In general, all things being equal, a reduced corporate tax rate will increase the competitiveness of domestic production and manufacturing and increase the attractiveness of the United States as a place to invest. But, for our industry and likely other manufacturers and capital intensive businesses, the effect of the rate reduction will be reduced, eliminated, or even overshadowed if it is "paid for" by significant changes to cost-recovery provisions, changes to the LIFO accounting rules, changes to other deductions relied upon by such businesses (e.g., Section 199 and interest expense) or changes in the treatment of foreign income, among others.

The effect of any tax reform measure across industries is another obvious factor to consider. If the legislation targets certain provisions as the primary revenue offset for the reduced rate, the net effect of the bill could easily be negative for some capital-intensive industries like ours but positive for others. As a principle, we believe tax reform should be pro-growth for all industries and it makes little sense for tax reform to have the net effect of disadvantaging domestic manufacturers and producers.

Tax Reform, Competitiveness, and Cost Recovery

From our industry's perspective, a key goal of Congress in revising the tax system should be to maintain or enhance the economic climate in the United States for investment in manufacturing and production. For our industry, that means a climate conducive to investment in drilling, refining, and chemicals manufacturing. Under these circumstances, any tax reform measure that raises the cost of capital for U.S. investments by our company's moves in precisely the wrong direction. At the same time, Congress should have the goal of creating a tax structure that allows U.S. companies to compete successfully around the world.

While a reduced corporate rate achieved in a revenue-neutral tax reform measure may spur certain investment, the actual effect depends on the mix of base-broadeners selected to offset the cost of the rate cut. Both the tax rate and the tax base impact the cost of capital calculation that is instrumental to a taxpayer's decision to invest and commit to the United States as a manufacturing or production location. Some observers point out that a cut in the tax rate increases the return from both old and new investments and thus lowers the cost of capital for new investments while rewarding old investments at

the same time. Revenue-equivalent cutbacks in cost recovery provisions, by contrast, affect only new investments; such cutbacks are therefore more targeted and may have the practical effect of eliminating the benefits of a rate reduction[1]. A tax-reform bill that has the net effect of raising the cost of capital for manufacturers and producers for new investments will not enhance the economic climate in the United States for such important industries, a key goal as noted above.

Capital cost recovery provisions support capital spending by freeing up cash flow and reducing the present value costs of such investments. Some observers point out that capital cost recovery provisions affect the timing of deductions and not the amount and that, therefore, preservation of such provisions should not be of great concern to publicly traded companies that can recognize deferred tax deductions up front for purposes of reported earnings. However, for industries like oil and natural gas, whose economic livelihood comes from up-front capital expenditures, the ability to continue to make such investments year after year depends on the availability of cash flow and the expected return on such investments. Capital cost recovery provisions generate that cash flow since deducting the cost of drilling wells today helps to generate the cash to allow wells to be drilled tomorrow. Further, capital cost provisions directly affect the internal rate of return on an investment, a key factor in determining whether an investment will in fact be made.

Companies in industries that are not capital intensive routinely deduct most of their costs up front – such as labor, advertising, marketing, transportation, etc. But companies in capital-intensive industries cannot always deduct their costs up front. As the result of decisions made by Congress long ago, in the early years of the income tax, the tax code delays deductions for some expenditures considered capital in nature. However, there is no immutable principle of income taxation precluding up-front deductibility of capital expenditures; the current Administration has pushed for, and with bi-partisan support Congress has enacted, bonus depreciation rules to achieve this precise result.

While drilling costs, like research costs, are made with the goal of producing returns in the future, the tax code has long permitted both types of costs to be deducted when incurred (with the exception of a requirement that certain oil companies amortize a portion of drilling costs over five years). Deductibility of drilling costs encourages taxpayers to incur costs to undertake risky investment in oil and natural gas deposits, and thereby increase the world's energy security—just as the deductibility of research costs encourages taxpayers to undertake scientific inquiry that will increase the world's knowledge base in general. In other words, deductibility in both cases encourages companies to take on exploratory or research activity that benefits the greater society through energy security and innovation. For oil and natural gas companies, the deduction for drilling costs puts those companies on a roughly level playing field with other research-intensive companies. Just as research companies depreciate the tangible equipment used in their research, oil and gas companies also depreciate the tangible equipment used in exploration and development activities (e.g., the drill pipe). The deduction for "intangible drilling costs" simply reflects the proper treatment of costs that do not equate to a tangible asset, again much like the labor costs in scientific research.

With respect to depreciable assets, oil and natural gas companies depend on accelerated depreciation for recovery of the cost of our industry's investments in the hard assets associated with production, refining, and manufacturing. For investments in tangible assets, accelerated depreciation has the

[1] See Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century, U.S. Department of the Treasury (December 31, 2007) pp. 47-50; Viard, "The Quickest Way to Wreck Corporate Tax Reform," RealClearMarkets.com (March 27, 2013).

practical effect of ameliorating what would be the harsh effects of limiting depreciation to the amount recognized for financial reporting purposes (or some other similar amount). Cutbacks in accelerated depreciation will inevitably push investment away from capital intensive investments – and also push such investments abroad.

LIFO Inventory and Section 199

The treatment of LIFO is also an important cash-flow consideration for our industry. As stated earlier, LIFO is a sound accounting convention; it has been accepted by Congress and the IRS for decades. Yet some critics contend not only that the use of LIFO should be precluded for the future, but that past tax-savings resulting from the use of LIFO should be recaptured. As we have pointed out in other submissions to the working group, we believe it will be a mistake if Congress were to end the use of LIFO. More importantly, if Congress did end the use of LIFO, there is no basis in tax policy for requiring the recapture of past tax savings. Such recapture will merely add to reductions in cash flow occasioned by any cutbacks in cost recovery provisions. We understand the difficulty of broadening the tax base sufficiently to achieve meaningful reductions in tax rates, but that does not justify LIFO recapture. When tax legislation changes long-standing tax rules, Congress has never had the practice of going back and attempting to recapture taxes from companies that relied on the old rules; LIFO should not receive different treatment.

Lastly, section 199 is a significant factor in our industry's assessment of the effect of tax reform. Elimination of section 199 precisely targets domestic manufacturers and producers. The oil and gas industry is already subject to discriminatory treatment when compared to non-oil and gas manufacturing, i.e., our industry is only allowed a six percent production activities deduction whereas others are allowed a nine percent deduction. Elimination of the provision would work as an additional tax increase on a particular sector of the economy as a means of "paying for" a tax rate reduction for *all* businesses.

Nondiscrimination and a Level Playing Field

Another factor in our industry's assessment of comprehensive tax reform is the extent to which any reform package maintains neutrality among industries and taxpayers, i.e., avoids policies favoring one industry over another. If the major items used to "pay for" rate reductions for all businesses consist of accelerated cost recovery, LIFO inventory repeal, and elimination of section 199, we believe that domestic manufacturing and production activities—businesses that can provide among the best high paying middle class jobs—will disproportionately bear the brunt of tax reform, and future investment and jobs in those key domestic industries will be lost.

Summary

In summary, the oil and natural gas industry understands the drive to a reduced corporate tax rate – especially in light of how other countries have reduced their corporate rates to below the U.S. rate. We believe, though, that policy makers should consider the potential impacts on how that rate is achieved. A revenue neutral methodology toward corporate tax reform may, by definition, leave the *overall* effective corporate tax rate unchanged. However, that outcome could still lead to a substantial increase in the effective tax rate for the manufacturing and production sector of the economy. Recognizing that increase and understanding its impact should be a focus in any tax reform effort.

Our industry invests billions of dollars each year in the U.S. economy, and tax provisions that let us recover the cost of that investment on a timely basis are as important in the structure of the tax system as the rate. Continued investment depends on cash flow and investment returns, both of which are directly affected by the cost-recovery provisions. In any tax reform measure, we urge Congress not to undo or eliminate the benefit of income tax rate cuts through curtailment of the items noted above. Instead, we urge the Congress to search for ways to lower the tax rate, perhaps over time as many other countries have done, while retaining capital cost recovery rules. Our view, and that of many economists, is that such a combination will actually provide the growth in the economy that these changes will be revenue neutral, or enhancing, once growth effects are appropriately considered. If "pro-growth" tax reform is the goal, as it should be, we urge Congress not to ignore the impacts it seeks to achieve as it designs an improved—and growth oriented-- tax code for the future.

Again, we appreciate your dedication and interest in making the US tax system more efficient and competitive for manufacturers and other producers in today's global marketplace. We look forward to continuing to share our thoughts on tax reform with you and your colleagues.

Should you have any questions, please contact API's Director of Tax & Accounting Policy Stephen Comstock (comstocks@api.org) and Director, Federal Relations (tax) Brian Johnson (johnsonb@api.org).

Sincerely,

Jack Gerard
API President & CEO