April 15, 2013

Comments submitted by:

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Comments submitted to:

The Energy Tax Working Group of
The U.S. House Ways & Means Committee

The Domestic Energy Producers Alliance (DEPA) is pleased to submit comments to the Energy Tax Working Group on issues important to the U.S. domestic oil and natural gas exploration/production sector. DEPA is a nationwide collaboration of oil and natural gas organizations, including state, regional and national groups. DEPA represents a majority of the individuals and companies primarily responsible for the current renaissance in American oil and natural gas production.

In its fifth year of existence, DEPA is comprised of independent oil and gas producers, who drill more than 90 percent of the new oil and gas wells in the United States each year, plus oilfield service companies and royalty owners.

As the domestic energy industry evolves, the distinction between independent oil and natural gas producers and major, integrated companies becomes increasingly important. Integrated oil companies are engaged in America and worldwide in exploration, production, refining, transporting and marketing oil, natural gas and refined petroleum products. Independents are domestic producers that earn substantially all their revenues from exploration and production (E&P). Generally, independent producers have only one opportunity for revenues and/or profit – the well head.

Independent oil and natural gas producers, whether publicly-traded companies or small “mom and pop” operations, have tax issues distinct from the big five major integrated oil companies. The vast majority of independent producers rely heavily on two provisions in the current tax code – Section 263(c) I.R.C. (1986) – intangible drilling costs, and Sections 611, 613, 613A I.R.C. (1986) – percentage depletion. DEPA’s focus is exclusively on preservation of these two provisions of the Code. By contrast, the big five major integrated companies rely on the manufacturing tax deduction and provisions relating to foreign tax credits and other sections of the Code that don't impact independents significantly.

Access to Technology and Capital Are Keys

U.S. independent oil and natural gas producers are primarily responsible for the current boom in domestic energy production, with its attendant economic, employment and national security benefits. Independents point to two primary factors that drive the resurgent domestic oil and natural gas industry:

1) Advancements in the science and technology of drilling and completing oil and gas wells in so-called unconventional (mostly shale) plays, and,

2) Availability of capital sufficient to finance the enterprise.

The current and potential future results of the new domestic discoveries of oil and gas are now well-documented. The idea of North American energy independence – a pipe dream as recently as the turn of the 21st Century – is no longer just a concept, but a tangible, achievable reality. The global implications of a more energy self-sufficient America include major benefits in every facet of our lives, our livelihoods and our governance. The public policy highlights of the so-called Shale Boom in the U.S. have many facets, including:

- Domestic oil and natural gas drilling and production activities are a major positive economic driver in a struggling economy.

- America is no longer as reliant on unstable and/or unfriendly regimes for oil supply. The reality of decreasing reliance on certain OPEC nations for a majority of our crude oil supplies provides new options for the U.S. in foreign affairs and military planning and decision-making.

- The availability and long-term reliability of reasonably priced energy (particularly domestically-produced natural gas) will continue to play a critical role in the resurrection of the U.S. manufacturing sector.

- Finally and most importantly, oil and natural gas drilling activity by domestic independents and the oilfield service/support sector creates and sustains millions of U.S. jobs. This job creation extends to manufacturers (steel mills in Ohio, pump makers in New Jersey, sand miners in Wisconsin) that provide technology, equipment and materials to this burgeoning industry.

IHS Global Insight (USA), Inc. was commissioned by the Independent Petroleum Association of America (IPAA) to assess the economic contributions made by onshore independents. In its report, Economic Contribution of the Onshore Independent Oil and Natural Gas Producers to the U.S. Economy (April 2011), IHS concluded that in 2010 onshore independent oil and gas activities accounted for over 3 percent of all U.S. jobs and 4 percent of domestic GNP. This translated into almost 4 million direct, indirect and induced jobs and $579 billion of economic activity.

Moreover, the upstream activity of independents and the downstream activity attributable to independents' upstream activity resulted in $131 billion in income taxes (federal and state), sales taxes and excises taxes in 2010. All these figures are projected to increase dramatically by 2020, with taxes expected to total $189 billion.

A follow-on report by IHS released in October of 2012, "America's New Energy Future: The Unconventional Oil and Gas Revolution and the U.S. Economy," which focuses on exploration using horizontal drilling and hydraulic fracturing (techniques pioneered by domestic independent producers), noted that in 2012 there were 1.7 million jobs in the unconventional oil and gas industry with estimates that these job numbers would increase to 2.5 million in 2015 and almost 3.5 million in 2035.

The IHS report summarized the remarkable transformation in domestic energy production by noting: "Unconventional oil and natural gas activity is now unlocking new domestic sources of supply. Net petroleum imports have fallen from 60 percent of total consumption in 2005 to 42 percent today. The decline is due, in part, to moderating energy demand during the slow recovery…. However, the decline in imports has also been achieved through significant supply side changes resulting from increased domestic oil production. US oil production … has risen 25 percent since 2008… The largest element of this increase comes from what has become the major new advance in energy development: tight oil." The report puts a fine point on all this: "Unconventional energy development has become an engine of job creation and economic growth."

Preserving the Current IDC and Percentage Depletion Provisions

Section 263(c) I.R.C. (1986) – Intangible Drilling Costs (IDCs) and Section 611, 613, 613A I.R.C. (1986) – Percentage Depletion are essential to the 18,000 domestic independent producers. These two provisions apply only for domestic drilling and/or production activity.

These two provisions are critically important because a massive amount of the capital intensive nature of funding current exploration levels (where horizontal wells in many unconventional plays cost an average of $8-10 million per well). In today's exploration/production industry, most capital for drilling is generated by independent producers internally. However, even in instances when outside investors are involved, these two tax provisions are essential in attracting capital sufficient to maintain the pace and volume of drilling activity necessary to sustain current or increasing demand. Without these two tax provisions, neither large nor small domestic independents would generate the capital necessary for continuing to grow drilling and production activity. Estimates are that the repeal of IDCs and percentage depletion would decrease domestic drilling by at least 30 percent.

Detailed explanations of how these two tax provisions were established, how they have evolved during the past 100 years, and how they are currently employed can be found in the white paper attached to these comments.

To summarize briefly, however, IDCs permit a portion of the costs of drilling a well to be deducted fully in the year those costs are incurred, as opposed to being capitalized. The election to expense intangible drilling and development costs applies to all expenditures made by the operator for "wages, fuel, repairs, hauling supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for production of oil or gas". Examples include costs incurred to (1) drill, shoot, or clean a well (2) prepare the site for drilling, including ground clearing, drainage, road construction, and surveying and geological work and (3) construct the physical facilities necessary to drill and prepare the well for production. This applies only to those drilling and development expenditures that have no salvage value. Equipment of a character that is ordinarily considered as having salvage value is depreciable over a period of years.

Percentage depletion helps independent producers maintain the majority of America's producing oil and gas wells. In fact, by most estimates about 80 percent of U.S. wells in production more than three years fall into the marginal well category. These wells account for approximately 20 percent of domestic oil production. Percentage depletion is limited to 15 percent of gross oil and gas income and also is limited to the first 1,000 barrels per day. The amount deducted for depletion cannot exceed 65 percent of a taxpayer's net income before the deduction. Percentage depletion is akin to typical depreciation taken in other business/industry sectors, except that because of the depleting nature of the (oil/gas) asset, the depletion is available throughout the economic life of the well. Percentage depletion was eliminated for major, integrated energy companies more than 30 years ago and thus is only available to independents and royalty owners.

The 600,000 oil and natural gas wells that fall into the marginal category are America's true Strategic Petroleum Reserve. These marginal wells, many of which produce less than 2 barrels a day, can be operated profitably during periods of relatively strong energy commodity prices. However, the thousands of independent oil and natural gas producers and royalty owners count heavily on the percentage depletion provisions in current law to provide the internally generated capital to do routine maintenance and repairs and to implement affordable technological advancements, especially during periods of depressed prices, such the natural gas sector has experienced since 2007-08.

Not Special Tax Breaks or Loopholes

IDCs represent typical and ordinary business expenses within the oil and natural gas industry. This provision is not a tax subsidy or loophole. In virtually all business and industry settings, taxpayers are allowed to deduct these types of operating expenses in the year in which they are incurred. The availability of these funds enables domestic independent producers to conduct the research and development necessary to meet the technological challenges of modern horizontal drilling and completion in unconventional resource plays.

Percentage depletion differs from depreciation primarily in that historically it has been available, at same level, throughout the economic life of the well. This distinction exists primarily because unlike, for instance, a real estate property, which may have a stable or even increasing value over time, an oil and natural gas producing well declines in value over its economic life to the point that, when it is plugged, it actually has a negative value (plugging liability).

Other relevant information related to both of these crucial oil and natural gas tax provisions may be found in the attached white paper.

Conclusion

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

The Domestic Energy Producers Alliance (DEPA) urges members of the House Ways & Means Committee to maintain these provisions in the Code in their present form. Thank you for the opportunity to offer our perspective.

Respectfully submitted,

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Mike McDonald, DEPA President

DEPA Collaborating Organizations

- Oklahoma Independent Petroleum Association
- Texas Alliance of Energy Producers
- Kansas Independent Oil & Gas Association
- National Stripper Well Association
- Northern Montana Oil & Gas Association
- Illinois Oil & Gas Association
- Permian Basin Petroleum Association
- Independent Oil and Gas Association of West Virginia
- Kentucky Oil & Gas Association
- Ohio Oil & Gas Association
- National Association of Royalty Owners

(See Attachment: DEPA White Paper on IDCs, Percentage Depletion, 2012)