Ways and Means Energy Working Group

Written testimony of Jerry James, President of Artex Oil Company

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Thank you for inviting me to testify. My name is Jerry James, and I am representing independent oil and gas producers filing as individuals on behalf of the Independent Petroleum Association of America (IPAA), the US Oil and Gas Association (USOGA), and the Ohio Oil and Gas Association (OOGA). My testimony will focus on two areas: first, the importance of oil and gas production to the economy and second, the importance of the tax code to promote the production of oil and gas. I will then follow with recommendations for pro-growth tax reform.

As president of Artex Oil Company, I lead an independent oil and gas company in southeast Ohio that employs 25 people. Artex is a subchapter "S" corporation and is a flow-through entity for tax purposes.

Artex is like thousands of other independent producers who drill 95% of the wells in the United States and produce 55 percent of US oil and 85 percent of U.S. natural gas. Although the company can trace its roots back over fifty years, it has accelerated its growth in the last two decades moving from fifty-second to the second largest natural gas and oil producer in the state of Ohio as of 2011. Artex produces enough energy annually to heat over 50,000 homes. The company has improved the local economy by paying landowners tens of millions of dollars in royalties and is currently responsible for the creation of 400 to 500 jobs in our area of operations, while generating significant revenue for local governments.

Importance of Energy to the Economy

The cost of energy is one of the most important factors affecting the United States' economy. Every recession in the last 40 years has been preceded by a spike in energy prices. Therefore, one of the most critical things that can be done to promote a growing economy is to increase the availability and affordability of energy. Oil and natural gas is the lifeblood of our economy.

The modern oil and gas industry grew in my state of Ohio in the late 1800's. Because Ohio had early access to energy, Ohio became an important manufacturing state. While energy was available and affordable from the mid-1800's until the 1970's, Ohio prospered. When the U.S. oil and natural gas production as a whole peaked and then declined in the early 1970's, Ohio's economy, and subsequently the U.S. economy struggled because energy was expensive and in short supply. It is the availability and affordability of energy that will determine our country's future.

Capital recovery and capital formation must be promoted in the tax code to encourage growth in the U.S. economy through the availability of energy. For nearly 100 years, Congress has promoted the concept of capital recovery and encouraged capital to flow to industries that are in the national interest: energy, manufacturing, and technology. These are investments that our country needs to grow the economy, to make products to sell and create good paying jobs for American workers. It is unfortunate that Congress is considering capital intensive industries the same as retail or services industries with regard to tax reform. Why is it in the national interest to treat industries that take risk and make long term investments the same as retail and services? Federal tax policy has historically played a substantial role in developing America's natural gas and petroleum. To withdraw this support in the form of excessive taxation would have a substantial impact on the economy.

We are currently experiencing a renaissance in oil and natural gas production. U.S. natural gas production has reached an all time high. In addition, according to the Energy Information Administration, net oil imports dropped from 60.3 percent of products supplied in 2005 to less than 45 percent in 2011 and an estimated 40.6 percent in 2012. The United States is currently third in the world in crude oil and natural gas liquids production and growing output. The U.S. is one of the only countries in the world where energy security is improving and U.S. fiscal policies should encourage, not discourage, continuing development through excessive taxation.

There are currently three tax issues that significantly impact production of oil and gas: 1) Intangible Drilling Costs, 2) Percentage Depletion, and 3) Passive Loss Exclusion for Working Interests.

The Importance of Tax Treatments of Oil and Gas Expenses to Promote Oil and Gas Production

Tax Issue 1: Intangible Drilling Costs (IDC)

The business of drilling for oil and gas is very risky. Although geologists and geophysicists have technology available to help determine the viability of a drill site, there is really no way to determine the amount of return on investment until the well is drilled. As a result, oil and gas drilling is not a very bankable industry. To drill, producers must invest their own money in the well and/or look for investors. In addition to the drilling risk factor, producers are faced with a declining asset in an oil and gas well. Unlike investments in real estate that results in an appreciating asset, the production of oil and gas from any given well continues to decline over time and the money earned in return on equity is also depleting. At the end of the day, the producer is losing his asset through declining production, and must reinvest to create more assets in the form of drilling new oil and gas wells.

In recognition of the high financial risks involved in drilling wells, since 1913 the Internal Revenue Tax Code has allowed oil and gas companies to expense expenditures known as Intangible Drilling Costs (IDCs). IDCs 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. Examples include drill site preparations, chemicals, drilling mud, cement, etc. Only independent producers can fully expense IDCs on American production. The loss of IDC deductions for independent producers will have significant effects on their capital development budgets and could result in drilling budgets being cut by 25 to 30 percent for most producers.

The following is an illustration of the impact on oil and natural gas investments by the loss of the deduction of intangible drilling costs in the year the expenses are incurred. Normally the largest intangible drilling cost is paying the drilling contractor for his time and expendable material to drill the well. If the drilling costs cannot be deducted against current income, then the income produced by the sale of oil and natural gas used to pay the driller becomes taxable. For example, after $100,000 worth of oil and natural gas is sold, this money is then used to pay for new drilling. Assuming IDCs of $100,000, these costs would result in $0 of cash flow. If the IDCs of $100,000 are not allowed to be deducted in the year the expense occurs, then an additional $40,000 in federal and state taxes would be owed that year on phantom income for which there is no cash to pay the bill. Since smaller independent producers cannot readily borrow money to finance drilling and larger independent producers cannot incur additional debt, expenditures would have to be reduced to pay the taxes. The loss of capital to invest in drilling will mean about 30% less wells will be drilled.

Nearly half of American oil and natural gas production is from wells drilled in the last several years. Decreasing the number of wells drilled by 30% will decrease American oil and natural gas production making America more dependent on foreign sources of energy. If world energy production cannot readily meet the American shortfall, prices will rise dramatically.

Artex grew at a rapid pace as described earlier and required huge amounts of capital. This capital was obtained by investing our cash flow back into the business – creating American energy and jobs. Unfortunately, President Obama’s budget proposes repealing the expensing of the vital costs associated with the development of oil and natural gas. Eliminating this ability will reduce the investment in drilling for U. S. oil and natural gas and greatly impact independent oil and natural gas producers’ ability to help reduce energy costs for everyone through increased production. We urge Congress not to alter this important deduction.

Tax Issue 2: Percentage Depletion

Depletion is an accounting concept used most often in mining, timber, petroleum, or other similar industries. The depletion deduction is a cost recovery system for accounting or tax reporting that allows an owner or operator to account for the reduction of a product's reserves and recover their investments in oil and gas wells through depletion deductions.

According to the US federal tax code, all natural resources minerals are eligible for a percentage depletion income tax deduction. Special percentage depletion rules apply to oil and gas production unlike the generous percentage depletion deductions available for all other resource industries. The oil and natural gas industry's percentage depletion is highly limited but is very important to maintain marginal production.

- It is only available for American production.
- It is only available to independent producers and for royalty owners – many of whom are farmers and retirees.
- It is only available for the first 1000 barrels per day (6000 mcfd of natural gas) of production.
- It is limited to the net income of a property and limited to 65 percent of the producer's net income.

Marginal production is defined as crude oil and natural gas production from a stripper well property producing 15 barrels/day (90 mcfd) or less or from production of heavy oil. Currently the U.S. marginal oil and natural gas base is significant. Approximately 80 percent of oil wells in the U.S. are marginal wells that produce 20 percent of U.S. oil and 67 percent of natural gas wells produce 12 percent of US natural gas. It is important to maintain this marginal oil and natural gas base by permitting small independent producers to continue to take a percentage depletion deduction.

Tax Issue 3: Passive Loss Exception for Working Interests

The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. This 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. Moreover, the passive loss rules apply only to individuals; corporations pass the same deductions to shareholders as part of the overall value of the stock. If income/loss, arising from natural gas and oil working interests, were treated as passive income/loss, taxpayers would be significantly less willing to risk an investment in natural gas and oil development.

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 energy investments. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations.

Key Questions the Committee Should be Asking as it Pursues Comprehensive Tax Reform

1. Does the Committee want to promote capital formation and investment in capital intensive industries that ensure that America has a stable, US energy supply and a vibrant manufacturing base?
2. Should capital intensive industries that make long-term risky investments be treated the same as the retail and other service industries?
3. Does the Committee want to encourage increased production of American oil and natural gas or return to an increasing reliance on imported oil and natural gas from overseas?
4. Does the Committee want to support smaller, independent oil and natural gas producers that do not have the same access to capital as larger companies and who must finance their operations either (1) with their own cash flow or (2) with private investors?

Recommendations for Pro-Growth Tax Reform

Throughout history, drilling for oil and natural gas has been very sensitive to changes in the economy that affect cash flow. To increase taxation on the oil and natural gas industry would greatly impact the tax burden on the industry in comparison to other industries and would result in a loss of capital and subsequently the ability to increase American production. To insure this does not happen, my recommendations are as follows:

1. Promote increased American oil and natural gas production by allowing independent oil and natural gas producers to continue to expense intangible drilling costs in the year those costs are incurred.

2. Maintain the marginal oil and natural gas base in the United States by permitting small independent producers and royalty owners to continue to take a percentage depletion deduction.
3. Encourage private investors to invest capital in American oil and natural gas production by maintaining the passive loss exception for oil and natural gas working interests.

Thank you for your consideration of this testimony.