Statement for the Record
Of
National Association of Royalty Owners (NARO)

Before the United States House of Representatives
Committee on Ways and Means
Energy Tax Reform Working Group

[redacted]

The following testimony describes our concerns that actions to remove the percentage depletion allowance for domestic oil and gas production will be harmful to America's energy policy as a whole, and also to millions of American royalty owners.

While NARO shares several policy concerns with the rest of the energy community, this testimony seeks to focus the Committee's attention more acutely on *percentage* depletion for royalty owners, which is the only tax deduction many NARO members take on their mineral royalty income. As will be discussed, many of the royalty owners which NARO represents do not have the wealth, time, and resources that larger energy and mineral companies do. As a result, they have a more limited ability, compared to the rest of the energy community, to organize and inform legislators of their concerns.

1. Who does NARO represent?

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 of the 33 producing states. NARO has been educating and advocating for mineral/royalty owners since our original incorporation 33 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 around 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.

We estimate the number of royalty owners in each state to be:

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.

2. <u>A look back at the rationale for *percentage* depletion in U.S. history</u>

In 1913, the 16th amendment to the constitution made the Federal income tax a permanent fixture of American life. That same year, mineral/royalty owners, in accordance with the newly minted tax code, began to account for the depreciation of their mineral properties which resulted from the depletion of limited mineral reserves. Congress enacted this tax deduction so that mineral/royalty owners could deduct a "reasonable allowance for depletion of ores and all other natural deposits…" which results from extraction. What follows is an explanation of the conception of *percentage* depletion, and illustrates the continued need for the *percentage* depletion allowance for mineral/royalty owners today.

What is depletion? Put simply, in the context of taxation, it represents the depleting value of a limited reservoir of a non-renewable resource such as Natural Gas, Copper, Oil, etc. Tax liability in America has often been dependent on the value of the property being taxed. As the object of taxation changes in value, the tax liability changes accordingly. This is commonly accepted by federal and state governments with regard to all manner of property, whether brick and mortar, automobile value, etc. As an automobile depreciates, the tax rate is lowered in subsequent years. As the minerals are extracted from a given property, the reserves are depleted, and the value of that mineral interest depreciates, as should the tax liability.

Percentage depletion replaced *discovery value* depletion, which had been adopted in 1918 as an incentive to find new oil supplies that were needed in World War I. Under *discovery value* depletion, tax on minerals such as oil and natural gas were assessed at the time the minerals were discovered, but that proved to be an inefficient and unsavory policy for mineral owners, producers, and governmental tax authorities alike. Among *discovery value* depletion's shortcomings; it resulted in lengthy, not to mention expensive, quarrels between taxpayers and tax administrators over the predicted quantity and value of the minerals, and the subsequent amount of depreciation that would occur from the depletion of reserves.

Even if the quantity and composition of minerals in the ground can be known with relative certainty, the markets for energy sources like natural gas and oil are volatile. This has been abundantly demonstrated with the dramatic price fluctuations of oil and natural gas in recent

years. These turbulent markets make it difficult to predict the overall value of mineral reserves, especially beyond one year.

Beyond unpredictable markets, there were additional problems with *discovery* depletion. Even today, the science of interpreting seismic data and the drilling of exploration wells remain something of an art, albeit to a lesser extent than in previous decades. The accuracy of pre-extraction predictions on the quality and quantity of minerals can prove disappointing. However, the inability to know with certainty the total future value of oil or gas from a given mineral interest, and the quantity which is likely to be producible, results from more than just the imperfections of geological data analysis. The 'producible' quantity underground is unpredictable due to unknowable, yet inevitable changes in technology. The recent advances in horizontal drilling, and the impact it has had on hydraulic fracturing technology are a great example.

In the last decade, horizontal drilling innovations have allowed us to more cheaply use hydraulic fracturing in layers of shale rock where natural gas was previously unreachable due to the cost of recovery. Due to these technological improvements, hydraulic fracturing in shale has grown at an almost stunning pace. These innovations have freed up so much previously unrecoverable gas that the U.S. is now sitting on an estimated 100 years supply of clean burning natural gas at current consumption levels. The U.S. is currently in serious contemplation about ways to ensure that our energy policies are environmentally responsible for our children's future. The rapid leap forward in shale drilling technology, and the resulting massively increased quantities of clean burning, locally abundant natural gas, are game changers for U.S. energy policy. Additionally, the horizontal drilling technology coupled with hydraulic fracturing have reversed the course of U.S. oil imports from a high of around 60% a few years ago to less than 40% today.

Because of the impossibility, both for taxpayer and tax administrator, of predicting the nature and timeline of technological advances, and the difficulty for both parties of defending variables like quantity of reserves, quality of reserves, and projected market value, Congress eventually abandoned the practice of determining the *discovery value* of minerals for purposes of the depletion allowance. In 1926, congress simplified the process by allowing mineral/royalty owners the option to claim *percentage* depletion.

"To figure percentage depletion, you multiply a certain percentage, specified for each mineral, by your gross income from the property during the tax year." This simplified procedure has proved essential to encourage the production of dozens of different minerals, both energy related and not. The percentage of income from a producing mineral property which one can claim as a deduction to account for depletion is currently 15% for oil and natural gas, and higher for certain other minerals. For example, the current rate for sulfur, uranium, asbestos, lead ore, zinc ore, nickel ore, and mica is currently 22%. These flat percentages save on compliance costs for both tax payer and administrators, because it prevents the potentially lengthy battle with each individual mineral owner over the value of depletion for their particular property.

3. <u>Effects of the proposed eliminations on royalty owners</u>

Under current policy, if the mineral owner feels that the depletion percentage specified by statute is unfair for their property's particular mineral profile, then they can still alternatively file for

cost depletion. Large mineral interest owners such as energy companies are more likely to file for the *cost* depletion deduction. The reason for this is that they have already incurred the cost of a complex analysis of their mineral holdings as part of the process of exploration.

Larger mineral interest owning entities have incentive to be reluctant to share information with smaller or individual mineral owners from whom they may need to lease or re-lease mineral rights. They consider this information proprietary and necessary to compete in the marketplace. When compelled by statute to share information, they still have an incentive to under-represent the value of the minerals to these smaller mineral owners because they want to pay them the smallest royalty that can be negotiated.

If small 'mom and pop' mineral owners have to rely exclusively on the energy companies to which they lease their minerals in order to obtain the estimated value of their minerals, then a common result would be an undervaluing of the minerals, resulting in an undervaluing of the cost of the depletion of their minerals. *Percentage* depletion acts as a hedge that protects these smaller royalty owners from the potential double disadvantage of receiving an undervalued royalty from an energy company and then having that loss compounded by a subsequent undervaluing of the cost of depletion

As previously mentioned, the average NARO member's royalty income is $500 per month, with many getting considerably less. While collectively the minerals they own are of vast value, the minerals owned by a single individual are often relatively small in amount. A geological & reservoir assessment can be very costly for these small royalty owners. Geologists and engineers bill on an hourly basis, plus expenses, and it is hard to estimate the time an adequate assessment can take. Royalty owners cannot afford to see their income eaten up by the cost of independent geological & reservoir assessments, attorney's fees, and accounting fees that can quickly accrue in the pursuit of claiming *cost* depletion.

Also, as previously mentioned, the average NARO member is over 60 years old, and widowed. Some are apprehensive about the process of negotiating leases with energy companies. *Percentage* depletion is one tool that encourages these mineral owners to more strongly consider leasing their minerals for development.

While *percentage* depletion is of primary concern for NARO members, we realize secondarily that ALL of the proposed tax law changes in the administrations budgets for the past four years would 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. We additionally realize that 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.

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 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 Congress's intent is to put these additional tax burdens on our elderly royalty owners, many of whom already struggle to pay their current property tax, ad valorem tax, severance tax, state income tax, local tax, non-resident income tax, and federal income tax on their producing minerals. Regardless of intent, the proposed tax increases (via deduction eliminations) WILL have that effect on many!

Royalty owners are teachers, farmers, ranchers, homemakers, accountants, firemen, plumbers, retirees, dentists, small business owners, factory workers, engineers, pet groomers, widows, roofers, lawyers, policemen, florists, carpenters, bricklayers, and 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 forbearers. 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.

Royalty owners are for "all of the above" sources of energy. In fact many mineral and surface owners receive oil and gas royalty income as well as wind turbine royalties for wind farms on their property. However we are realists and believe in formulating our energy policies and budget, we would be wise to heed the old idiom: don't put the cart before the horse. We must have viable alternatives BEFORE we consider abandoning the energy workhorses of our economic security. Putting the "green" 'cart' before the energy 'horse' is precisely what our energy policy would do if we simply fund research for, as of yet, unreliable energy sources, and simultaneously pull the rug out from under our conventional domestic energy industry. Which has been proposed by some policymakers.

B. Facing the facts as they are, not as some may wish them to be

Throughout the winter season (2009-2010), wind turbines in Britain produced only 20% of their capacity due to lower than average wind resulting from a colder than average weather pattern. They currently rely on wind for less than 10% of their total power, but have been planning to rely on it to meet a quarter of their power demand within the next 10 years, due in part to pressure from the E. U. If the U.K. had been reliant on wind for 25% of its demand during the '09-'10 winter, then the wind generation deficit wouldn't just be an eyebrow raising note of caution, it would be an outright crisis, with dramatic, real, and painful human costs.

Wind and solar/photovoltaic energy combined account for just 0.605% of our total energy consumption. Fossil fuels currently provide 83.436% of our energy consumption. Even if you remove the technological limitations and reliability issues from the equation (i.e. the wind intermittently not blowing or the sun not shining) you're still left with a sobering fact: to replace fossil fuels, our wind and solar/PV generating capacity would have to be 137.91 times what it is today.

4. <u>The Need for Energy Independence</u>

The American public, our national security interests, and our economy have long demanded, and still demand three results from the energy policy of our elected officials: an abundant, affordable, and uninterrupted energy supply. The more secure our energy supply is, the safer we feel, and in fact, the safer we are. Certain policy analyses recently expressed by administration officials leave some room to question whether those three things are fully understood by our leaders.

Americans are going to purchase fuel for their vehicles somewhere, whether that supply is domestic or from abroad. Administration officials have repeatedly talked about the need to break our addiction to foreign oil. An obvious step would be to maximize our domestic oil production.

In testimony submitted to the Senate Finance *Subcommittee on Energy, Natural Resources, and Infrastructure* on Sept. 10, 2009, Alan B. Krueger, Assistant Secretary for Economic Policy and Chief Economist, U.S. Treasury department, said that "The domestic price of oil is determined by global supply and demand because oil is an internationally traded commodity." He continued, saying "The relatively small U.S. share of global production means that any changes in domestic U.S. oil production will have a limited impact on the world supply of oil."

His focus on the "world" supply of oil myopically focuses on mathematical equations that in no way account for very real, legitimate national security concerns. The American people, and historically Congress as well, have recognized the importance of maximizing the independence of an *American* supply. Although he painted a relatively rosy picture of the negative impact on domestic production that the proposed elimination of deductions will bring, he does concede that "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" of oil.

Assistant Secretary Krueger's basic conclusion, all things being equal, was that the "world" supply of oil and gas and therefore the supply available in the U.S. should only be negligibly affected by any decline in domestic production resulting from the elimination of percentage depletion and other deductions. It is understandable how a trained economist could arrive at this result. The first thing learned in any economics class is the Latin phrase: *Ceteris Paribus*, meaning "All other things being equal." Economists are trained to analyze hypothetical mathematical situations independently of harder to quantify human variables. *Ceteris Paribus* may be a useful academic exercise that assists with the understanding of certain economic philosophies (via studying them in a vacuum); but in this situation, all things are regrettably not equal.

Oh what a few years can do. It's been just about four years since Secretary Krueger made these comments and we have gone from a country that was running out of natural gas (and looking at imports) to one with perhaps the largest natural gas reserves on the planet. Natural gas prices have fallen from $12/mcf to under $4/mcf due to the abundance of supply. We have also gone from a country importing 60% of its oil to less than 40% over the same time frame all due to on shore, lower 48 domestic production on private lands. It is estimated that with removal of percentage depletion and intangible drilling cost deductions the domestic industry would drill about 30% fewer wells. That net effect would reduce the income for every royalty owner, reduce local, state and federal taxes on production and most likely result in increased prices of oil and gas commodity prices as they become less abundant.

There seems to be a decent level of bipartisan agreement that we need to break our addiction on foreign oil, though there are disagreements on the most prudent way to do that. As discussed, the ability to maximize our domestic oil production is a very positive, and in light of the technological immaturity and expense of wind and solar, natural gas currently seems like the only viable alternative, and for several reasons.

The EPA has stated that "natural gas is the cleanest alternative transportation fuel commercially available today." The group *NGV America* says that the U.S. presently has around 1100 natural gas vehicle fueling stations, with about 50% open to the public. Around 1.5 million miles of natural gas pipelines are already in place throughout the country. This pre-existing infrastructure would make it easier to deliver supplies to newly constructed filling stations well beyond those currently available. Also, natural gas is significantly cheaper, costing between half to one third the cost of gasoline.

According to a report from the Edison Electric Foundation and the Brattle Group, building new combined-cycle natural gas plants to generate electricity is significantly cheaper in dollars per kilowatts of capacity added than building new plants for utilizing nuclear, solar, wind, or new coal-combustion (CSS). The report says building a new combined-cycle natural gas plant would cost $1000/KW of capacity added. The most expensive type of new plant would be solar, costing $6,600 for the same capacity increase.

98% of the natural gas the U.S. uses comes from the U.S. and Canada. As stated earlier, there is likely enough in the U.S. for up to 100 years. There is relatively low cost for converting a conventional gasoline engine to run on it. It also burns much cleaner than petroleum and "twice as clean as coal" when burned for electricity.

6. Conclusions

In 1952, the President's Materials Policy Commission examined percentage depletion, and concluded that:

> "…no alternative method of taxation has come to the Commission's attention or could be devised by the Commission which, in its judgment, promises to overcome these limitations and still achieve the desired results, particularly not without seriously dislocating well established capital values and other arrangements in the industries concerned, with highly adverse effects on supply. Taking the practical situation as it finds it, the Commission believes that any radical alteration of existing tax arrangements would be undesirable."

The "limitations" they referred to are the imperfect allotments of the cost of depletion that can occur under percentage depletion. "Desired results," in this case, refers to encouraging the production of American minerals in order to provide the energy to grow our economy and to provide a greater measure of independence and security.

We believe the U.S. would presently be better served by maximizing domestic oil and natural gas production. We believe this because natural gas is cheap, locally abundant in supply, clean burning, and efficient. As a transportation and electricity generating fuel, it can work in tandem

with currently imperfect and experimental technologies like wind and solar. When the wind isn't blowing, the sun isn't shining, or yet to be invented experimental energy storage systems malfunction, natural gas can provide us the uninterrupted electricity we rely upon, cheaply, and cleanly. Investing in the natural gas industry will buy us the time we need for the market to truly perfect alternative energy systems that are presently unreliable. Additionally, we believe the continued and expanded development of domestic oil supplies are in fact a game changer for our energy policy and the trend of reversing our reliance oil imports should be encouraged by every American.

We take exception to suggestions that propose to raise the tax burden on what are currently America's only reliable energy sources which will slow domestic development. Those provisions include raising the tax burdens on many of America's most vulnerable retired royalty owners. In our pursuit of an energy policy that encourages domestic production, we must not allow the smallest participants in America's energy production to go unprotected.. The protection that *percentage* depletion provides to them must, itself, be protected.

Any decision to eliminate the *percentage* depletion deduction used by 'the little guy,' (AKA: small time royalty owners) while leaving the *cost* depletion deduction used by big energy companies untouched would be a promise broken to the American people. *Percentage* depletion is an important incentive for domestic energy development, which helps supply the energy we need to drive our economy while making us less dependent on foreign sources of energy. It does this while simultaneously protecting small time royalty owners, who unlike 'big energy' corporations, can't afford to file *cost* depletion.