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Governmental Affairs  
Washington, DC

The Honorable Kevin Brady  
U.S. House of Representatives  
301 Cannon Building  
Washington, DC 20515

The Honorable Mike Thompson  
U.S. House of Representatives  
231 Cannon Office Building  
Washington, DC 20515

Dear Chairman Brady and Vice-Chair Thompson;

In response to the February 13, 2013 announcement from Ways and Means Chairman Dave Camp and Ranking Member Sander Levin of the formation of working groups to review current tax law within the Committee's jurisdiction, the National Stripper Well Association is submitting this letter and accompanying attachment to the Energy Working Group as both stakeholder and practitioner feedback.

The National Stripper Well Association is a nonprofit trade association representing producers and operators of marginally economic crude oil and natural gas wells in the United States. By way of background, a marginal well is an oil well that produces 15 barrels per day or less, or a gas well that produces 60 thousand cubic feet (mcf) per day or less. A stripper well by contrast produces 10 barrels per day or less under the IRS definition.

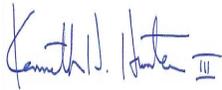
The NSWA was established in 1934 to represent the interests of the marginal well producers and operators before Congress, the Administration, and federal agencies. It also represents affiliated professionals and stakeholders, including: consulting geologists, petroleum engineers, landmen and lease brokers, drilling and workover contractors, bank and other financial institutions, accountants, attorneys, and royalty owners.

America's stripper wells make up approximately 80% of all domestic wells, producing almost 20% of US oil and natural gas. In fact, US stripper wells collectively produce 1.2 million barrels per day – as much as we import from Saudi Arabia. Over 300,000 jobs are directly or indirectly dependent upon marginal or stripper oil and gas wells. The United States is the only country with significant production from stripper wells. NSWA believes it is essential to protect an industry that makes such a significant contribution to the nation's economic security and energy independence.

First among the many benefits currently provided to private industry, depletion is a fundamental principle in natural resource development and mineral extraction. For marginal and stripper wells, percentage depletion is a critical deduction that dozens of other minerals receive. Without it, the independent oil and gas industry could not continue to economically produce oil and gas from marginal and stripper wells. Even proposals to lower the corporate tax rate and pay for it by limiting or eliminating deductions like percentage depletion will severely damage the industry because tax rates cannot be set low enough to offset the loss of the deduction. Furthermore, as independent producers, we do business in a variety of different business forms; reductions in the corporate rate will not benefit the majority of our members in over 35 states. IDC's are also an important tax provision to members of our organization.

We at the National Stripper Well Association applaud your leadership on tax reform issues and are eager to serve as a resource to your working group and the Committee as you gather information on the present provisions with an eye toward creating a fairer, simpler tax code that leads to more jobs instead of fewer.

Sincerely,



Ken Hunter



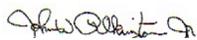
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Bob Sullivan



Mark Thomas



Nelson Wood



Nick Powell

Attachment

Cc: Chairman Camp, Ranking Member Levin, and Reps. Boustany, Griffin, Reed, and Kelly

## Percentage Depletion:

### **What Is Percentage Depletion and Who Receives It:**

Percentage depletion is a 15% deduction utilized by small independent producers and royalty owners within the United States. It is limited to the first 1,000 barrels a day of cumulative production by a single company. Thus, the elimination of percentage depletion would directly affect the small businessmen and women of the domestic oil and gas industry in America where the average company size is 11-15 employees and less than 1,000 barrels per day of production. The large, major oil companies cannot use percentage depletion because of this barrel limitation. Congress eliminated percentage depletion for major oil companies more than 30 years ago.

### **Why Percentage Depletion is Important:**

Percentage depletion has been available to small, independent producers since 1954 as an incentive to stimulate continued investment in a high-risk industry. It provides the capital and outside investment small producers need to drill more wells. More than 18,000 independent producers drill 95% of the country's domestic oil and natural gas wells (onshore only), and make up 67% of U.S. domestic production (Energy Information Agency).

Of those wells, marginal wells (oil wells that produce 15 barrels per day or less and gas wells that produce less than 60 mcf's per day or less) make up 80% and produce almost 20% of U.S. domestic production. These wells collectively produce more than 1.2 million barrels per day. For every \$1 million directly generated by marginal/stripper well production there is more than \$2 million of economic activity produced elsewhere in the economy. There are approximately 400,000 marginal wells in the United States (Interstate Oil and Gas Compact Commission).

### **Effects of Eliminating Percentage Depletion on Marginal Wells Alone (Oil Wells that Produce 15 Barrels Per Day or Less and Gas Wells That Produce 60 MCF's Per Day or Less):**

- Could result in the loss of over 260 million barrels of domestic oil production and over 2 trillion cubic feet of natural gas production; (IOGCC)
- Would cause widespread abandonment of thousands of marginal (stripper) wells that would result in almost 100,000 direct job reductions and loss of workers earnings totaling over \$7.5 billion; (IOGCC)
- Could result in an additional 227,000 indirect job losses from those industries supporting marginal well production, \$12 billion in employee earnings and \$60 billion in related industry income; (IOGCC)
- Depress an important segment of the American economy that is growing, thus would make us more dependent on foreign oil. (IOGCC)

\*Please note – the independent domestic oil and gas industry is just one of many industries that receive percentage depletion.

## **Percentage Depletion – A Brief Rationale:**

To encourage capital investment in tangible property like machinery, vehicles, equipment, and buildings, taxpayers that acquire assets are eligible for an income tax deduction known as depreciation. Depreciation allows taxpayers to recover the cost of the property while recognizing wear and tear, deterioration, or obsolescence of the property. The payback from depreciation allowances substantially reduces the risk premium for investment in equipment – in other words, investments would have to earn much higher returns to justify the higher risks incurred by taxpayers were they not eligible for depreciation.

Like depreciation, the depletion deduction is designed to encourage capital investment in property, but it acknowledges that certain property behaves differently. When a taxpayer invests in an item like a plant or equipment, the property might decrease in value as it depreciates but at the end of its depreciable life the taxpayer still has a tangible property that retains some value. In simple terms, when real property like a building is fully depreciated, it still has value. Wasting assets like mineral deposits, however, diminish as they are developed, so the value of a mine or an oil well is constantly decreasing as the taxpayer works to produce a return on investment by extracting these minerals. Furthermore, when a well or mine is depleted, not only is all value gone, there are sizeable costs associated with responsible well or mine closure.

Depletion is determined at the election of the taxpayer either according to cost depletion or percentage depletion. Cost depletion is calculated on the basis of initial capitalization costs. Over the life of the well, it allows for a portion of these costs to be recovered each year based on the percentage of the production for the year as compared to the estimated recoverable oil and gas reserves at the beginning of the year. Percentage depletion is calculated on the basis of the income from the property rather than capitalization costs.

Percentage depletion has been part of the tax code for nearly 100 years and is used for most mineral resources, but the deduction is already limited in a number of ways for oil and gas production. Only the first 1,000 barrels of oil or 6,000 mcf of natural gas of cumulative daily production from a single taxpayer are eligible for percentage depletion, and only 15% of the revenue from this production is eligible for the deduction. The deduction is further limited to 65% of net taxable income, which is calculated on a property-by-property basis.

Percentage depletion is sometimes criticized for allowing taxpayers to recoup more than 100% of their initial capitalization costs of acquiring properties like oil wells. However, if marginal oil and gas producers were only able to claim cost depletion instead of percentage depletion, there would be little to no incentive for them to fully develop their marginal properties. Cost depletion encourages production from a marginal well only up to the point that capitalization costs for that well are recouped; after that point, it becomes more economical for the taxpayer to cement in and abandon that particular well and acquire new properties. Percentage depletion encourages small producers to fully extract and realize their oil and gas resources, incentivizing them to drill and rework wells using their own capital and outside investment. Percentage depletion also allows for the expenditures necessary to cover cleanup and plugging costs when a well has reached its economic limit.

In short, percentage depletion encourages producers to tap the resources that we already know exist, providing a clear energy independence and national security benefit to the country.

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