Oil and Natural Gas Taxation and Tax Reform

Why should a mature industry like oil and natural gas production need special tax deductions? **First**, oil and natural gas production tax provisions are comparable to those in other manufacturing and mining industries; they have been part of the tax code since the early years of its creation. Fossil fuel opponents characterize these deductions as subsidies or special provisions to imply that the deductions are inappropriate. Unfortunately, many tax analysts do not distinguish between different tax provisions – deductions, subsidies, credits – causing further confusion. **Second**, while oil and natural gas production has been part of the energy mix for 150 years, the use of horizontal drilling, sophisticated hydraulic fracturing, deepwater offshore technology and other advanced development technologies are as cutting edge as any industry in the world. The need to generate the capital to find and produce American energy is as compelling today as it has ever been. Federal tax policies can enhance or impair American oil and natural gas production; repealing existing tax deductions would impair America's energy future.

Why should the oil industry get subsidies? **Oil and natural gas production tax deductions are not subsidies.** Tax subsidies are written to provide a deduction or credit for a specific outcome, such as the tax credit for research and development expenditures. Other subsidies involve direct federal payments to specific industries. Oil and natural gas producers get no direct subsidies from the federal government.

What are Intangible Drilling Costs? Since 1913, a drilling and development costs deduction has been allowed as an ordinary and necessary business expense for those costs where there is no remaining equipment to value (salvage value) when an oil or natural gas well is completed. Because there is nothing tangible to value, these costs are generally called "intangible drilling costs" or IDCs. IDCs can be deducted in the year they are incurred.

Why is the tax treatment of Intangible Drilling Costs important? Independent producers invest their American cash flow back into new American production projects, historically as high as 150 percent of cash flow. Reinvestment is essential to maintain and grow US production; without it, US production would decline rapidly because wells deplete as they are produced. Independent producers' cash flow comes from selling product; increasing taxes reduces cash flow and thereby new investment. IDCs account for 65 percent to 80 percent of the costs of drilling a new oil or natural gas well. Repealing the existing tax treatment of IDCs would mean a loss of investment in new US production.

What is Percentage Depletion? All minerals – oil, natural gas, coal, sulfur, gold, sand, gravel – are allowed a tax deduction to reflect the depletion of the minerals as they are produced. Cost based depletion has been in the tax code since 1913. In 1918, Congress added value based depletion; in 1926 percentage depletion – using a percentage of income to calculate depletion – was created to simplify the calculation. A tax payer must use the higher of cost depletion or percentage depletion.

Why is the tax treatment of Percentage Depletion important? For oil and natural gas, percentage depletion is a small business and royalty owner issue. Royalty owners are the people who own the oil and natural gas resource – e.g., farmers, ranchers. Oil and natural gas percentage depletion is limited unlike other minerals. It is available only to independent producers and royalty owners, limited to the first 1000 barrels/day (6000 mcf/day) of production, limited to the net income of the well and limited to 65 percent of the net income of the taxpayer. Most of these small businesses file taxes as individuals, not corporations. Most of the wells affected by percentage depletion are "marginal wells" – 15 barrels/day

(90 mcf/day). However, the average marginal oil well produces about 2.9 barrels/day and the average marginal natural gas well produces about 24.6 mcf/day. Over 85 percent of US oil wells and more than 73 percent of US natural gas wells are marginal wells. As operating costs for these small wells increase, the percentage depletion deduction is important to keep them operating because once they are shut down, they can never be started up again.

Can Percentage Depletion exceed the cost of the well? Percentage depletion can exceed the cost of the well because Congress recognized in 1918 that cost depletion alone was leading to the early abandonment of valuable national resources. For example, marginal oil wells account for 19 percent of US oil production and marginal natural gas wells account for more than 12 percent of US natural gas production. Early loss of this production would adversely affect America's energy supply.

Will the government benefit from the repeal of oil and natural gas production tax provisions? The Administration proposes to repeal or revise all tax provisions related to American oil and natural gas production. It claims that these changes will raise $4 billion/year in new federal revenues. True or not? The Administration calculates that repeal of the IDC provision would increase federal revenues by $13.9 billion over a ten year period. Currently, the onshore independent producer industry pays approximately $36.3 billion in federal taxes (corporate and personal) with an expectation that these tax payments will grow to $53.4 billion in 2020. However, changing the IDC tax deduction will lower capital investment. Federal taxes would be reduced by more than $22 billion over the ten year period from just onshore independent producers alone. If midstream and downstream impacts as well as offshore independent producers are considered, lost federal revenues would exceed $38 billion. At the same time, state and local tax revenues would fall by over $30 billion imposing greater burdens on communities and subsequently on the federal treasury. It hardly seems likely that the federal treasury wins under the Administration's strategy.

What would happen if Congress repeals oil and natural gas production tax provisions? Because independent producers develop new projects from the revenues they receive from selling oil and natural gas, eliminating tax deductions reduces investment capital. Repealing the current tax deduction for IDC would reduce independent producers' capital budgets by about 25 percent. For small independents the loss of the IDC and percentage depletion deductions would reduce their capital budgets by around 30 percent. Because independent producers develop over 90 percent of US wells, produce more than 80 percent of US natural gas, produce over 50 percent of US oil and employ over 2.1 million Americans, the loss of this investment adversely impacts America's energy future.

What would happen if Congress lowers corporate taxes at the same time? Several plans to reduce corporate tax rates are under discussion. Each one percent reduction in corporate tax rates loses about $100 billion over ten years; a ten percent reduction in corporate tax rates would require $1 trillion in offsetting revenue increases. Despite the rhetoric suggesting that oil and natural gas production tax reforms are significant, the Administration proposal to eliminate IDC and percentage depletion deductions would theoretically raise about $25 billion over ten years. However, this estimate is based on the current corporate tax rate and current development activity. At a lower tax rate the revenue estimate would diminish to closer to $15 billion over ten years. In either case, changing oil and natural gas production tax policy would be insignificant against the $1 trillion that is needed. But, the loss of the IDC deduction under a lower corporate tax rate would reduce independents' capital budgets by about 20 percent. Additionally, most independents file as individuals (pass through entities) and could see higher tax rates on their smaller budgets if individual tax policy is not revised.