United States Senate

WASHINGTON, DC 20510

July 26, 2013

The Honorable Max Baucus
Chairman
Senate Committee on Finance
United States Senate
Washington, D.C. 20515

The Honorable Orrin Hatch
Ranking Member
Senate Committee on Finance
United States Senate
Washington, D.C. 20515

Dear Chairman Baucus and Ranking Member Hatch:

We write in response to your "Dear Colleague" letter of June 27th requesting comments on specific tax expenditures that should be preserved in a reformed tax code because they help "grow the economy, make the tax code fairer, or effectively promote other important policy objectives." We ask that the Senate Finance Committee retain current law regarding intangible drilling costs (IDCs), percentage depletion, and the passive loss exception for working interests in oil and natural gas properties (I.R.C. §263(c), I.R.C. §613(c), and I.R.C. §469(c) respectively). The small businesses that make-up the independent oil and gas industry in America rely on these provisions as a means of securing access to the capital needed to continue promoting the domestic production of oil and natural gas, which is essential to accomplishing our mutual energy security policy goals and creating the good-paying jobs sustained by the domestic oil and gas industry.

Increased domestic oil and natural gas production, spurred by horizontal drilling and hydraulic fracturing, which unlock energy supplies from hard-to-reach shale formations, has vastly increased U.S oil and natural gas reserves and significantly reduced our reliance on imported oil in recent years.

Without these important tax provisions in place, producers would not be able to sustain long term development of their existing wells, nor would they be able to access the capital they need to maximize their pursuit of domestic exploration and production opportunities. The recent growth in domestic production has significantly contributed to a reduction in the nation's reliance on imported oil, which is now at forty percent of consumption, down from sixty percent in 2005.

The use of IDCs, percentage depletion, and the passive loss limitation exception has also significantly contributed to economic growth and improved small businesses' ability to access the capital needed to promote unconventional oil and gas domestic production. In October 2012, IHS Global Insight issued a report, "America's New Energy Future: the Unconventional Oil and Gas Revolution and the US Economy,"[i] that found:

- Employment attributed to upstream unconventional oil and natural gas activity will support more than 1.7 million jobs in 2012, growing to some 2.5 million jobs in 2015, 3 million jobs in 2020 and 3.5 million jobs in 2035.

- In 2012, unconventional oil and natural gas activity will contribute nearly $62 billion in federal, state, and local tax receipts. By 2020, total government revenues will grow to just over $111 billion. On a cumulative basis, unconventional oil and natural gas activity will generate more than $2.5 trillion in tax revenues between 2012 and 2035.

In addition, last month, *The Wall Street Journal* reported, "[i]n the latest sign of the shale revolution remaking world energy markets, crude (oil) production in the U.S. jumped 14% last year to 8.9 million barrels a day... last year's U.S. production gain of 1.04 million barrels a day surpassed the earlier biggest annual increase of 640,000 barrels per day, recorded in 1967."

Continued domestic exploration requires significant capital investments. One recent report by Wood MacKenzie reported that if that tax treatment for IDCs is ended, then daily oil and natural gas production would be 3.8 million barrels of oil equivalent lower in ten years than it would be if the provision were left untouched. Other sources have indicated that total drilling activity would decrease by thirty percent if current tax treatment of IDCs, percentage depletion, and the passive loss exception were ended.

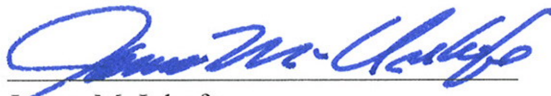
IDCs represent necessary and ordinary business expenses, which the tax code allows for all industries. This provision is not a tax subsidy or a loophole. IDCs permit a portion of the costs of drilling a well to be deducted fully in the year those costs are incurred, rather than being capitalized over several years. Under current law, full expensing of IDCs is available only to independent producers.

Percentage depletion is akin to typical depletion taken by other industries, except that the depletion is available throughout the economic life of a well because of the depleting nature of oil, gas, and other extracted minerals. While percentage depletion has been long been a part of the tax code, over time, Congress has gradually reduced the availability of percentage depletion such that it is now only available to independent producers and royalty owners. This makes percentage depletion particularly important to maintaining production from older wells.

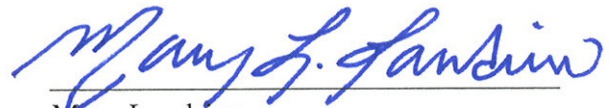
The exception to the passive loss limitation rules for individuals, trusts and certain closely-held C-corporations with interests in working oil and gas projects is vital to encouraging those investors to invest in independent producers' projects. The provision formally recognizes the long standing practice that working interest holders in oil and natural gas leases are materially involved in the ongoing operations on that lease. It is an important capital raising mechanism, particularly for smaller oil and natural gas companies who do not have access to the financial markets and cannot get loans from banks.

The Joint Committee on Taxation (JCT) estimates the five-year (2013-2017) cost of retaining current law on IDCs and percentage depletion, and to be $6.2 billion and $5.7 billion, respectively. JCT did not provide an estimate for the passive loss limitation exception for working interests in oil and gas, but the President's FY2014 budget placed the figure at $42 million over five years. In view of the forgoing, we are confident that the costs related to retaining these provisions in a reformed code is more than justified by the how these provisions increase job creation, tax revenue, and accelerated achievement of our common goal of energy independence and urge you to retain them in any comprehensive tax reform legislation.

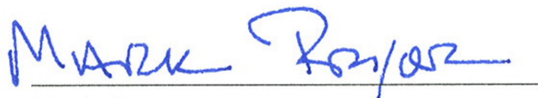
Sincerely,



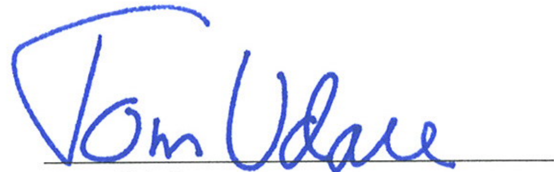
James M. Inhofe
United States Senator



Mary Landrieu
United States Senator



Mark Pryor
United States Senator



Tom Udall
United States Senator

[i] The term "unconventional" for purposes of the Report and this letter refers to "major new advances in extraction technology, in the oil and natural gas industry, that allow access to resources not technically or economically recoverable. The report focuses on "unconventionals" with respect to oil and natural gas that is produced using a combination of horizontal drilling and hydraulic fracturing.