ipaa
America's Oil & Gas Producers

Increasing Taxes on America's Independent Natural Gas and Oil Producers – A Bad Idea

Increasing taxes on independent oil and natural gas producers will cost American jobs, reduce tax and royalty revenue to American governments, hurt American retirees and harm American energy security – Proposals to eliminate historic oil and natural gas production tax provisions will result in increased taxes on independent producers and thereby reduce investment in American oil and natural gas production.

> **Lost capital investment means fewer jobs.** The exploration and production portion of the industry employs about 500,000 workers at a wage rate over 50 percent higher than the average of all manufacturing. In the current economic situation in the U.S. these are jobs America needs – not jobs it should discard.
>
> **The oil and natural gas industry provides more revenue to the federal government than any source other than income taxes.** It pays federal taxes at a rate of 48 percent and pays substantial state and local taxes as well. Lost capital investment will reduce these tax payments – not increase them.
>
> **Seventy percent of the investors in publicly traded oil and natural gas companies are mutual funds, pension plans and Individual Retirement Accounts.** Increasing taxes will diminish the value of these companies hurting American retirees.
>
> **Lost capital investment means less American production.** Half of today's American natural gas production comes from wells drilled in the last four to five years. Taking away U.S. investment will drop production quickly, making the U.S. more dependent on foreign energy sources. Increasing taxes on small marginal well producers will mean that they will not have the investment capital to replace their declining production – putting at risk America's marginal oil and natural gas production over the next decade.

The oil and natural gas industry is mature but it must continually reinvent itself– Developing today's American resources is vastly different than 100 or even 10 years ago. Today's industry must be at the technological edge in finding and producing natural gas and oil. Developing techniques to evolve with changing landscapes is a hallmark of the production industry. American producers have emerged as leaders in creating the technology that is used worldwide. However, the costs to develop American resources are higher than those in other countries. Consequently, American producers have much greater challenges to produce U.S. resources and reinvest in new American production. Failing to continue these investments in the development of America's resources will only deepen the nation's reliance on imports, creating energy security risks and costing American jobs.

Does the oil and natural gas industry receive tax subsidies? – Generally, taxes on businesses apply to income after deductions for *ordinary and necessary business expenses* and, in specific instances, targeted tax incentives to encourage investments. A *tax subsidy* is a tax reduction that government gives a business for a particular purpose, usually to create jobs. Oil and natural gas production are not subsidies. The principal exploration and production (E&P) tax provisions are deductions for *ordinary and necessary business expenses* – drilling cost expensing and percentage depletion. These deductions have been a part of the tax code for over 80 years.

Are the oil and natural gas industry's earnings excessive? – Oil and natural gas industry earnings are consistent with other industries. For example, the U.S. production industry in 2007 had a return of 15.2 percent compared to all of the energy industry at 15.6 percent and to all S&P Industrials at 22 percent.[1]

Why should these big companies get support? – In reality, the oil and natural gas production industry is diverse and independent producers are a key component. American production activities are dominated by independent producers. Comprised of thousands of companies, independents range from small businesses to some of the world's largest companies. The average independent, however, employs about 11 people, but develop 90 percent of U.S. wells, produce 72 percent of U.S. natural gas and 44 percent of U.S. oil. Historically, independent producers reinvest as much as 150 percent of their American cash flow back into new American production.

What are drilling costs? – Current tax law allows independent producers to expense drilling costs that have no salvage value in the year they are spent. Similar to research and development costs – drilling costs are funds spent without any certainty that the expenditure will result in a successful outcome and where there is no salvage value.[2] These drilling costs are 20 to 35 percent of the capital expenditure budgets of independent producers, meaning without the ability to expense these costs, an independent would have to reduce their drilling budgets by as much as one-third almost immediately.

What is percentage depletion? – All mineral resources are allowed to use percentage depletion as a way to reflect the decreasing value of the resource as it is produced. Percentage depletion provides a simple way to calculate these reduced values and was added to the tax code in the 1920's after other calculation methods proved too inaccurate or too cumbersome to use. For oil and natural gas, ***only*** independent producers and royalty owners are allowed percentage depletion, and only on U.S. production. Further, the deduction is limited to the first 1000 barrels/day of production (along with other limits) thereby making it a provision that is largely used by small businesses producers and royalty owners. Small business producers are the primary operators of America's marginal oil wells (19 percent of U.S. production) and marginal natural gas wells (12 percent of U.S. production).

---

[1] Return on investment is measured as net income divided by net investment in place

[2] Salvage value is a value that exists when the project ends