

Testimony
Of
Buddy Kleemeier
On Behalf Of The
Independent Petroleum Association of America
Before
Committee on Finance
U.S. Senate
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**Statement of Buddy Kleemeier
For The**

Independent Petroleum Association of America,

the International Association of Drilling Contractors (IADC), the International Association of Geophysical Contractors (IAGC), the National Stripper Well Association (NSWA), the Petroleum Equipment Suppliers Association (PESA), and the following organizations:

Arkansas Independent Producers and Royalty Owners Association
California Independent Petroleum Association
Coalbed Methane Association of Alabama
Colorado Oil & Gas Association
East Texas Producers & Royalty Owners Association
Florida Independent Petroleum Association
Illinois Oil & Gas Association
Independent Oil & Gas Association of New York
Independent Oil & Gas Association of Pennsylvania
Independent Oil & Gas Association of West Virginia
Independent Oil Producers Agency
Independent Oil Producers Association Tri-State
Independent Petroleum Association of Mountain States
Independent Petroleum Association of New Mexico
Indiana Oil & Gas Association
Kansas Independent Oil & Gas Association
Kentucky Oil & Gas Association
Louisiana Independent Oil & Gas Association

Michigan Oil & Gas Association
Mississippi Independent Producers & Royalty Association
Montana Petroleum Association
National Association of Royalty Owners
Nebraska Independent Oil & Gas Association
New Mexico Oil & Gas Association
New York State Oil Producers Association
North Dakota Petroleum Council
Northern Alliance of Independent Producers
Ohio Oil & Gas Association
Oklahoma Independent Petroleum Association
Panhandle Producers & Royalty Owners Association
Pennsylvania Oil & Gas Association
Permian Basin Petroleum Association
Petroleum Association of Wyoming
Southeastern Ohio Oil & Gas Association
Tennessee Oil & Gas Association
Texas Alliance of Energy Producers
Texas Independent Producers and Royalty Owners Association
Utah Petroleum Association
Virginia Oil and Gas Association

Mr. Chairman, members of the committee, I am Buddy Kleemeier, President and Chief Executive Officer of Kaiser-Francis Oil Company and Chairman of the Independent Petroleum Association of America (IPAA). Today, I am testifying on behalf of the IPAA and several national, state and regional organizations. Collectively, these groups represent the thousands of independent oil and natural gas explorers and producers, as well as the service and supply industries that support their efforts, that will be the most significantly affected by these legislative proposals. Independent producers drill about 90 percent of American oil and natural gas wells, produce over 65 percent of American oil, and more than 80 percent of American natural gas. American natural gas is a clean, abundant, affordable energy source that should be part of any clean energy agenda; American natural gas and oil should be part of any national energy security initiative.

Today's hearing is examining a critical issue confronting American natural gas and petroleum production – the role of the tax code with regard to the enhancement or deterioration of American exploration and production of natural gas and petroleum. The federal tax code plays an integral part in providing access to the capital essential to develop American resources – both natural gas and petroleum.

Federal tax policy has historically played a substantial role in developing America's natural gas and petroleum. Early on, after the creation of the federal income tax, the treatment of costs associated with the exploration and development of this critical national resource helped attract capital and retain it in this inherently capital intensive and risky business. Allowing the expensing of intangible drilling and development costs and percentage depletion rates of 27.5 percent are examples of such policy decisions that resulted in the United States extensive development of its petroleum.

But, the converse is equally true. By 1969, the depletion rate was reduced and later eliminated for all producers except independents. However, even for independents, the rate was dropped to 15 percent and allowed for only the first 1000 barrels per day of petroleum produced. A higher rate is allowed for marginal wells which increases as the petroleum price drops, but even this is constrained – in the underlying code – by net income limitations and net taxable income limits. In the Windfall Profits Tax, federal tax policy extracted some \$44 billion from the industry that could have otherwise been invested in more production. Then, in 1986 as the industry was trying to recover from the last long petroleum price drop before the 1998-99 crisis, federal tax policy was changed to create the Alternative Minimum Tax that sucked millions more dollars from the exploration and production of petroleum and natural gas. These changes have discouraged capital from flowing toward this industry.

Independent producers historically reinvest over 100 percent of American oil and natural gas cash flow back into new American production. Lower natural gas and oil prices and the tight credit market are limiting investment capital; drilling activity is down dramatically since a year ago. Drilling rig counts are roughly half of what they were at this time last year.

Natural gas and oil provide 65 percent of America's energy. New wind energy and solar energy require new natural gas turbines to run when the wind doesn't blow and the sun doesn't shine. American natural gas is essential to meeting any clean energy agenda associated with global climate. American natural gas and oil are essential to any energy security plan.

The Obama Administration's budget request would strip essential capital from new American natural gas and oil investment by radically raising taxes on American production. American natural gas and oil production would be reduced. It runs counter to the

Administration's clean energy and energy security objectives. Following is a review of the Obama Administration proposed changes to natural gas and oil taxation.

Intangible Drilling and Development Costs (IDC) – IDC tax treatment is designed to attract capital to the high risk business of natural gas and oil production. Expensing IDC has been part of the tax code since 1913. IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers will have significant effects on their capital development budgets. A recent Raymond James analysis reports that the loss of IDC would result in capital drilling budgets being reduced by 25 to 30 percent. This compares with anecdotal information provided to IPAA by its members indicating that drilling budgets would be cut by 25 to 40 percent. Regardless of the exactness of the assessments, clearly, the consequences would be significant. And, the consequences would soon be evident. Roughly half of America's current natural gas production is provided by wells developed during the past four years. American producers are already facing significant reductions in their capital budgets. Layering loss of IDC on top of these limitations or imposing it as the commodity and credit markets recover will only worsen the consequences for American production.

Percentage Depletion – All natural resources minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926. Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers, only available for the first 1000 barrels per day of production, limited to the net income of a property and limited to 65 percent of the producer's

net income. Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. These wells – that account for 20 percent of American oil and 12 percent of American natural gas – are the most vulnerable economically. Input to IPAA from its operators who take percentage depletion indicates that the combined effect of the Obama Administration proposals on IDC and percentage depletion would reduce drilling budgets in half. At this lower rate, new production will not offset the natural decline in production from existing wells. For example, one producer now drills ten wells per year; without IDC and percentage depletion, this producer could only drill five wells per year. A five well program will not replace declining production in existing wells and the small business company will have to shutdown. Congress' choice is straightforward: reduce American oil production by 20 percent and its natural gas production by 12 percent or retain the current historic tax policies that have encouraged American production.

Passive Loss Exception for Working Interests in Oil and Gas Properties – The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. The Tax Reform Act exempted working interests in natural gas and oil from being part of the passive income basket and, if a loss resulted (from expenditures for drilling wells), it was deemed to be an active loss that could be used to offset active income as long as the investor's liabilities were not limited. Natural gas and oil development require large sums of capital and producers frequently join together to diversify risk. Additionally, natural gas and oil operators have sought individual investors to contribute capital and share the risk of drilling wells. Most American wells today are drilled by small and independent companies, many of which depend on individual investors. There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in this system. Moreover,

Congress applied the passive loss rules only to individuals and not to corporations. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations. There is no apparent reason why Congress would or should favor corporate ownership over individual ownership of working interests. Furthermore, since AMT restrictions apply to IDC of individual working interest investors, the application of the passive loss rules to those investors is unnecessary and excessive – as this committee itself decided in 1986. In sum, to qualify for the exception, the taxpayer must have liability exposure and definitely be at risk for any losses. If income/loss, arising from natural gas and oil working interests, is treated as passive income/loss, the primary income tax incentive for taxpayers to risk an investment in natural gas and oil development would be significantly diminished.

Geological and Geophysical (G&G) Amortization – G&G costs are associated with developing new American natural gas and oil resources. For decades, they were expensed until a tax court case concluded that they should be amortized over the life of the well. After years of consideration and constrained by budget impacts, in 2005, Congress set the amortization period at two years. It also simplified G&G amortization by applying the two year amortization to failed as well as successful wells; previously, failed wells could be expensed. Later, Congress extended the amortization period to five years for large major integrated oil companies and then extended the period to seven years. Early recovery of G&G costs allows for more investment in finding new resources. Four years ago, Congress recognized that America benefitted if capital used to explore for new natural gas and oil could be quickly reinvested in more exploration or production of American resources, it was in the national interest. Nothing has changed to alter

that conclusion. If anything, current capital and credit limitations enhance the rationale to get these funds back into new investment.

Marginal Well Tax Credit – This countercyclical tax credit was recommended by the National Petroleum Council in 1994 to create a safety net for marginal wells during periods of low prices. These wells as stated above account for 20 percent of American oil and 12 percent of American natural gas. They are the most vulnerable to shutting down forever when prices fall to low levels. Congress enacted in this countercyclical tax credit in 2004 after ten years of consideration. It concluded that the nation benefitted if these marginal operations were supported during times of low prices, that the production from these wells were – in effect – a national resource reserve that would be lost forever if the wells had to be shutdown and plugged during difficult economic times. No different conclusion is now warranted. A year ago, as America faced high energy prices, the clear risk of foreign energy dependency was all too evident; America's marginal wells are a first defense against more foreign imports. Fortunately, to date, the marginal well tax credit has not been needed, but it remains a key element of support for American production – and American energy security.

Enhanced Oil Recovery (EOR) Tax Credit – The EOR credit is designed to encourage oil production using costly technologies that are required after a well passes through its initial phase of production. Conventional oil well production declines regularly after it begins production. However, millions of barrels of oil remain in formations when the initial production phase is over. The 2001 National Energy Report indicated that “anywhere from 30 to 70 percent of oil, and 10 to 20 percent of natural gas, is not recovered in field development. It is estimated that enhanced oil recovery projects, including development of new recovery techniques, could add about 60 billion barrels of oil nationwide through increased use of existing fields.” For example,

one of the technologies is the use of carbon dioxide as an injectant. In 2006, the Department of Energy studied the potential for using carbon dioxide enhanced oil recovery (CO₂-EOR) and concluded that: “Ten basin-oriented assessments- four new, three updated and three previously released- estimate that 89 billion barrels of additional oil from currently ‘stranded’ oil resources in ten U.S. regions could be technically recoverable by applying state-of-the-art CO₂-EOR technologies.” Given the increased interest in carbon capture and sequestration, CO₂-EOR offers the potential to sequester the carbon dioxide while increasing American oil production. Currently, the oil price threshold for the EOR tax credit has been exceeded and the oil value is considered adequate to justify the EOR efforts. However, at lower prices EOR becomes uneconomic and these costly wells would be shutdown. The EOR tax credit was enacted in 1990 and provides the potential to maintain important US oil production by supporting the development of these wells in low price periods.

Manufacturing Tax Deduction – Congress enacted this provision in 2004 to encourage development of American jobs. All US manufacturers benefitted from the deduction until 2008 when the oil and natural gas industry was restricted to a six percent deduction while other manufacturers grow to a nine percent deduction. While many producers’ deductions are capped by the payroll limitation in the law, it is another tax provision that provides capital to America’s independent producers to invest in new production.

Federal Tax on Gulf of Mexico Production – American independent producers hold 90 percent of the OCS leases in the Gulf of Mexico. Offshore federal lands produce 27 percent of America’s oil and 15 percent of America’s natural gas. Producers pay royalties as high as 18.75 percent on their production. A portion of this production is produced without royalty payments until it reaches a set volume that was designed to encourage – and effectively so – development

of deep water areas. Creating a new tax on US offshore development will drive producers from the US offshore reducing new American production of natural gas and oil. Moreover, to the degree that this proposed tax tracks prior proposals that have been considered in the Senate, it raises substantial administrative questions. For example, prior versions have provided for a deduction of royalty payments against the tax. The federal royalty-in-value process is complex and subject to constant controversy; producers are regularly audited but the audits are not specific to a year, more likely they relate to production fields. Consequently, producers' tax returns will need to be revised annually. Similarly, in recent years the federal government has used royalty-in-kind for some royalty payments – a far simpler process. But, to deduct these payments, they would have to be valued creating the same administrative mess. Much of the rationale for creating this tax relates to contractual failings in the deep water Gulf of Mexico, but this tax would be imposed on all producers in all depths.

Taken together, these tax changes are projected to strip about \$36 billion from US natural gas and oil production investment over a nine year period from 2011 through 2019. The Administration justifies its proposals based on two flawed rationales. First, the provision "... like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investment in the oil and gas industry than would occur under a neutral system." Second, to the extent that the provision "... encourages overproduction of oil, it is detrimental to long-term energy security and is also inconsistent with the Administration's policy of reducing carbon emissions and encouraging the use of renewable energy sources through a cap-and-trade program."

The first issue neither is unique to natural gas and oil tax provisions nor to the tax code generally. For natural gas and oil production, these tax provisions are intended to encourage the

development of American resources; they were never intended to be neutral. More broadly, these provisions reflect business tax policy that is consistent with comparable treatment of other energy sources. In its report, *Federal Financial Interventions and Subsidies in Energy Markets 2007*, the Energy Information Administration (EIA) assesses the federal government's support for energy sources. As the following tables show, EIA demonstrates that natural gas and oil federal treatment is comparable to other major energy sources on a total basis and is well below other sources on a unit basis. The Obama Administration's first justification is simply an inaccurate characterization of the nature of federal energy tax policies that have been crafted over decades by the Congress.

Beneficiary	Direct Expenditures	Tax Expenditures	Research & Development	Federal Electricity Support	Total
2007 Subsidies					
Coal	-	290	574	69	932
Refined Coal ¹	-	2,370	-	-	2,370
Natural Gas and Petroleum Liquids	-	2,090	39	20	2,149
Nuclear	-	199	922	146	1,267
Renewables	5	3,970	727	173	4,875
Electricity (Not fuel specific)	-	735	140	360	1,235
End Use	2,290	120	418	-	2,828
Conservation	256	670	-	-	926
Total	2,550	10,444	2,819	767	16,581

Table 36. Energy Subsidies Not Related to Electricity Production: Alternative Measures				Table 35. Subsidies and Support to Electricity Production: Alternative Measures			
Category	Fuel Consumption (quadrillion Btu)	Alternative Measures of Subsidy and Support		Fuel/End Use	FY 2007 Net Generation (billion kilowatthours)	Alternative Measures of Subsidy and Support	
		FY 2007 Subsidy and Support (million 2007 dollars)	Subsidy per million Btu (2007 dollars)			Subsidy and Support Value 2007 (million dollars)	Subsidy and Support Per unit of Production (dollars/megawatthours)
Coal	1.93	78	0.04	Coal	1,946	854	0.44
Refined Coal	0.16	214	1.35	Refined Coal	72	2,156	29.81
Natural Gas and Petroleum Liquids	55.78	1,921	0.03	Natural Gas and Petroleum Liquids	919	227	0.25
Ethanol/Biofuels	0.57	3,249	5.72	Nuclear	794	1,267	1.59
Geothermal	0.04	1	0.02	Biomass (and Biofuels)	40	36	0.89
Solar	0.07	184	2.82	Geothermal	15	14	0.92
Other Renewables	2.50	360	0.14	Hydroelectric	258	174	0.67
Hydrogen	-	230	NM	Solar ¹	1	14	24.34
Total Fuel Specific ¹	60.95	6,237	0.10	Wind	31	724	23.37
Total Non-Fuel Specific	NM	3,597	NM	Landfill Gas	6	8	1.37
Total End-Use and Non-Electric Energy	NM	9,834	NM	Municipal Solid Waste	9	1	0.13
				Unallocated Renewables	NM	37	NM
				Renewables (subtotal)	360	1,008	2.80
				Transmission and Distribution	NM	1,235	NM
				Total	4,091	6,747	1.65

The Administration's second rationale is similarly irrational. Production of American oil and natural gas serves the nation's goal of improving its energy security. Production of American oil and natural gas has been regulated to assure that wells are limited to volumes that conserve the long term production of its reservoir. These limitations have been entrenched since the mid-1930s. Current production reflects the need for American production to be maximized and nothing suggests that it should not be. Similarly, the Administration's climate goals of reducing carbon emissions and encouraging the use of renewable energy sources are enhanced by American natural gas and oil production. Natural gas is a clean, abundant, affordable and American resource that must be a part of any climate initiative. Oil will continue to be a key component of America's energy supply for the foreseeable future and any policies should rely first on American oil rather than foreign sources.

The Administration's revenue estimates raise significant and unanswered questions. Two of them, in particular, stand out. For example, the IDC revenue estimate shows significant revenue changes over the estimating period. The 2011 revenue number is \$1.399 billion but by 2019 the number is \$113 million. Perhaps, this reflects the dramatic reduction in American drilling activity that IPAA's members have projected. If so, substantial questions need to be answered regarding the impact on American production, the issue raised earlier in this testimony. Similarly, the estimates on revenues related to eliminating percentage depletion show increases from \$351 million in 2011 to \$1.215 billion by 2019. Given that the primary revenue sources for these taxes are small businesses producing from marginal wells, these estimates are wholly inconsistent with the reality that the loss of IDCs and percentage depletion would force these wells to be shutdown.

And, this reality raises more fundamental questions about the broader implications of these tax proposals. Over the nine year period of this proposal, the revenues from all of these provisions would average approximately \$4 billion annually. In August 2009, the Energy Policy Research Foundation, Inc. (EPRINC) released an analysis, *Do Higher Oil and Gas Taxes Pose a Threat to U.S. Energy Security?*, that addresses issues related to the Obama Administration tax proposals. It concludes, in part, that:

Using existing U.S. government evaluations of the financial cost of imported oil, increased tax revenues forecasted from the removal of upstream production incentives will be offset through lost domestic production as a result of lower investment in domestic exploration and development. Much of the production loss occurs from the accelerated closure of marginal wells, which are particularly reliant on free cash flow to sustain operations, as a result of the repeal of percentage depletion. The tax proposals will also lead to greater emissions of GHGs as domestic natural gas production is curtailed in favor of greater coal use in the generation of electricity – at least in the very near term. Finally, recent reforms in corporate tax treatment to place U.S. manufacturers on a level playing field with foreign manufacturers would be repealed for the petroleum sector only. These new taxes would assist foreign refiners in gaining greater market share of the domestic market. The share of the U.S. gasoline market now claimed by foreign refiners has doubled over the last nine years and likely will continue to grow as refiners face higher costs from the loss of the manufacturers tax credit.

In the analysis, EPRINC indicates that “the incremental benefit of reducing oil imports by 1 barrel is worth \$14.70.” Thus, if American oil production is reduced by about 745,000 barrels per day as a result of these tax provisions, the cost to the nation of the increased imports would offset the increased revenues. EIA estimates that marginal oil wells produced 844,000 barrels per day in 2006; this production would be lost. Clearly, the economic consequences of the Administration’s tax proposals forcing the closure of America’s marginal oil wells – *without even addressing the impacts of losing America’s marginal natural gas wells and the reduction in drilling affecting new production* – would exceed the revenue expectations of the total tax changes. Moreover, the revenues benefits would be less than projected because of lower US production.

As President Obama has said:

The energy challenges our country faces are severe and have gone unaddressed for far too long. Our addiction to foreign oil doesn't just undermine our national security and wreak havoc on our environment – it cripples our economy and strains the budgets of working families all across America.

America needs an energy policy that recognizes the roles that all forms of energy supply can play. American natural gas and oil are essential elements – natural gas should be part of any clean energy initiative; natural gas and oil should be part of any energy security strategy. The Administration’s budget request could cripple the American producers that are pivotal in developing US natural gas and oil.