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On February 1, 2010, the Obama administration released its proposed Fiscal 2011 Federal Budget. In this budget it proposed eliminating what it called “Oil and Gas Company Preferences” which would raise over \$36.5 billion of revenue over the ensuing ten years. The changes would fall most heavily on the independent oil and natural gas producing sector.

America’s independent oil and natural gas producers produce 68% of American oil, 82% of American natural gas, and drill over 90% of new American wells. Historically, independent producers reinvest over 100% of their cash flow from the production of oil and natural gas back into new exploration and production ventures. These proposed tax increases would directly reduce the amount of cash available for energy exploration and would provide a disincentive for capital sources outside of the energy industry. This would result in reduction of oil and natural gas production, a reduction of American jobs, and a greater dependence on foreign sources of supply. All of these results run counter to the administration’s stated goals.

Percentage Depletion - Depletion is a tax deduction which allows the recovery of capital investment over time. Percentage depletion is used by nearly all mineral resources including oil and natural gas. This is a tax deduction calculated by applying the allowable percentage (15%) to the gross income from the property. Percentage depletion has been a part of the tax code since 1926. Current law limits the use of percentage depletion in several ways. First, percentage depletion is not available to integrated oil companies and is available to independent producers and royalty owners only to the extent of 1,000 barrels of oil or 6,000 MCF of natural gas per day. Further, it is limited to the net income produced by each producing property and it is limited to 65% of each taxpayer’s taxable income. Because of these limitations, the proposal would fall disproportionately on the smaller independent producers and royalty owners. It is estimated that over one third of the tax increases would be born by royalty owners.

Percentage depletion provides capital to keep the current marginal wells producing and capital to be reinvested in new oil and gas ventures in the United States. Eliminating percentage depletion would remove over \$8 Billion which would have been invested in developing American production.

Intangible Drilling and Development Costs (IDC) - IDC's include expenditures that lack a salvage value made by an oil or natural gas producer incident and necessary for the drilling of wells in preparation of wells for the production of oil and natural gas. The drilling of new wells is necessary to replace reserves of oil and natural gas which were otherwise produced. In recognition of this, the tax code provides for current income tax deductions for IDC's as these are an ordinary and necessary expense of oil and gas exploration and production operations. Under current law a producer may elect to expense or capitalize these costs. If the producer has elected to expense these costs, an independent producer has a further election available to amortize these costs over a 60-month period. Without an election to expense or to amortize IDC's, they are recovered over the life of the property through cost depletion. The IDC deduction is allowed to provide a mechanism to attract capital for the high risk business of exploring for and developing American oil and natural gas. Without expensing IDC, it becomes far more difficult to attract the drilling capital and it is estimated that over \$3 Billion of new drilling activity would not occur.

Geological and Geophysical (G&G) Amortization – G&G costs include those expenses incurred for geologists, seismic surveys and the drilling of core holes. Improved technology has increased the usage of G&G costs as an exploration tool which has greatly reduced the risk associated with drilling exploratory wells. As these costs are incurred before the drilling of a new well they are in the nature of an ordinary and necessary expense. These costs are similar to research and development costs for other businesses. For those industries those costs are not only deductible, a tax credit is available in certain circumstances. Under current law, G&G costs incurred by independent producers are to be amortized over two years. The amortization period for major integrated oil companies has been extended to seven years. The proposal would extend the amortization period to seven years for independent producers as well. Extending the amortization period would remove over \$1 Billion from efforts to find and develop new American production.

Manufacturer's Deduction – In 2004 Congress created a new tax deduction related to qualifying domestic production activities. This provision came about as a means to enable a wide range of U.S. industries to remain competitive in world markets. The deduction is strictly tied to U.S. wages and U.S. production. The deduction applies to a income from the sale of property which is manufactured, produced, grown or extracted. It includes construction activities and other mining activities. Indeed, nearly all energy produced in America whether that be coal, wind or ethanol, is eligible for the deduction. During 2008, the oil and natural gas industry was restricted to a 6% deduction while other manufacturers' deductions will grow to 9%. The proposal would eliminate this deduction in its entirety only with respect to oil and natural gas production, putting this industry at a competitive disadvantage compared to competing energy sources.

Passive Loss Exemption Exception for Working Interest in Oil and Gas Properties – During 1986 the tax law divided income and expense activities into three categories, active, passive and portfolio. This law categorized working interests in oil and natural gas as being part of the active category provided that the taxpayer's liabilities were not limited in any way. The proposal would re-categorize the oil and gas working interest activities as passive which would be subject to limitations based upon the passive income of each taxpayer. Those losses would be

deferred until such time as the taxpayer disposed of the passive activity or had offsetting passive income. The loss of this income tax incentive would severely diminish the willingness of individuals to risk an investment in oil and gas exploration.

Enhanced Oil Recovery Tax Credit and Marginal Well Tax Credit - Both of these tax credits are designed to encourage production using either costly technologies to extend the life of an oil and gas well after its initial phase of production or to provide a safety net for marginal wells during periods of low prices. These projects and these wells are vulnerable to becoming uneconomic during periods of low prices. Currently prices remain above the threshold for either credit to become effective. However, both remain key elements in support of American production and American energy security.

American oil and natural gas are important components to an energy policy that recognizes the need for multiple forms of energy to meet future increases in energy demands. These proposals would decrease American exploration and production, American energy security and American jobs.

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