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Comments submitted by:

Illinois Oil & Gas Association (IOGA)

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Comments submitted to:

**U.S. Senate Finance Committee/U.S. House Ways & Means
Committee Business Tax Working Group**

The Illinois Oil & Gas Association (IOGA) is pleased to submit comments to the Energy Tax Working Group on issues important to the U.S. domestic oil and natural gas exploration/production sector. IOGA represents the interests of the Illinois oil and gas industry. With over 800 members, IOGA is the lead state and national advocate for the Illinois oil and gas industry.

In its 80th year of existence, IOGA is comprised of independent oil and gas producers plus allied service and supply companies. The upstream oil and natural gas industry in Illinois supports over 16,000 direct jobs, over \$750 million in family income, and over \$420 million in state and local tax revenue. The small businesses that make up the American independent oil and gas industry drill more than 90% of the new oil and gas wells in the United States each year.

For the purposes of these comments, it is important to note the distinction between independent oil and natural gas producers and major integrated oil companies. Integrated oil companies are engaged in America and worldwide in exploration, production, refining, transporting and marketing oil, natural gas and refined petroleum products. Independents are domestic producers that earn substantially all their revenues from exploration and production (E&P). Generally, independent producers have only one opportunity for revenues and/or profit – the well head.

Independent oil and gas producers have tax issues distinct from the big major integrated oil companies. The vast majority of independent producers rely heavily on two provisions in the current tax code – Section 263(c) I.R.C. (1986) – intangible drilling costs, and Sections 611, 613, 613A I.R.C. (1986) – percentage depletion. IOGA's focus is exclusively on preservation of these two provisions of the Code.

Intangible Drilling Costs: Intangible drilling cost deductions (IDCs) allow a portion of the costs of drilling a well to be fully deducted in the year those costs are incurred, rather than being capitalized. This applied to expenditures such as wages, fuel, repairs, hauling supplies, and other necessary costs for the drilling and preparing wells for oil and gas production. IDCs generally represent between 60-80% of the cost of a well. The immediate expensing of IDCs has been allowed under the IDC since 1918 to encourage companies to develop more domestic oil and gas wells. Currently, domestic producers (non-integrated companies) can deduct IDCs for regular tax purposes in the year in which the expense was incurred, instead of amortized over time. The IDC deduction is not a subsidy, and the tax code does not allow the industry to modify the amount expensed, only the time period over which the IDCs are expensed. The ability to expense IDCs when incurred should be retained.

Percentage Depletion: Percentage depletion helps small independent producers produce the majority of America's producing oil and gas wells. In fact, 80% of U.S. wells in production more than 3 years fall into the marginal well category. These wells account for approximately 20% of domestic oil production. Percentage depletion is akin to typical depreciation taken in other business/industry sectors, except that because of the depleting nature of the (oil/gas) asset, depletion is available throughout the economic life of the well. Percentage depletion matters most significantly to the smallest producers, often family-owned businesses. Repealing percentage depletion could lead to higher consolidation within the oil and gas industry, including the loss of jobs. The percentage depletion allowance should be retained for independent producers to ensure the continued production of marginal wells which are crucial for domestic oil and gas production. Percentage depletion was eliminated for major,

integrated energy companies more than 45 years ago and thus is only available to independents and royalty owners.

By contrast, the big major integrated companies rely on the manufacturing tax deduction and provisions relating to foreign tax credits and other sections of the Code that don't impact independents significantly.

Tax Policy

Tax policies, particularly those designed to punish the energy sector, only serve to raise costs to consumers while limiting opportunities for growth and development. Any proposed modifications to the tax code regarding American energy policy must recognize the critical role capital formation and capital recovery play for our nation's oil and natural gas industries. It is key for our industry that Congress retains necessary and ordinary business tax treatments critical to capital recovery and redeployment. We also support any efforts to lower the overall tax liability for American companies, allowing for a greater degree of investment and growth. America's oil and natural gas producers continue to reinvest capital at a rate well over 100% of their U.S. cash flow, hiring employees, purchasing equipment, and exploring new energy frontiers. Sound tax policy regarding the oil and natural gas industry has been a significant reason the U.S. is a leader in energy production and is poised to remain there for years to come.

U.S. independent oil and natural gas producers are primarily responsible for the increase in domestic energy production, with its attendant economic, employment and national security benefits. Independents point to two primary factors that drive the resurgent domestic oil and natural gas industry:

- 1) Advancements in the science and technology of drilling and completing oil and gas wells in so-called unconventional (mostly shale) plays, and,
- 2) Availability of capital sufficient to finance the enterprise.

The current and potential future results of the new domestic discoveries of oil and gas are now well-documented. The idea of North American energy independence – a pipe dream as recently as the turn of the 21st Century – is no longer just a concept, but a reality. The global implications of a more energy self-sufficient America include major benefits in every facet of our lives, our livelihoods and our governance. The public policy highlights of U.S. oil and gas development include:

- Domestic oil and natural gas drilling and production activities is a major positive economic driver.

- America is no longer as reliant on unstable and/or unfriendly regimes for oil supply. The reality of decreasing reliance on certain OPEC nations for a majority of our crude oil supplies provides new options for the U.S. in foreign affairs and military planning and decision-making.
- The availability and long-term reliability of reasonably priced energy (particularly domestically-produced oil and natural gas) will continue to play a critical role in the resurrection of the U.S. manufacturing sector.
- Finally and most importantly, oil and natural gas drilling activity by domestic independents and the oilfield service/support sector creates and sustains millions of U.S. jobs. This job creation extends to manufacturers (steel mills in Ohio, pump makers in New Jersey, sand miners in Wisconsin) that provide technology, equipment and materials to this burgeoning industry.

According to studies from IHS Economics onshore independent oil and gas activities accounted for over 3% of all U.S. jobs and 4% of domestic GNP. This translates into almost 4 million direct, indirect and induced jobs and \$579 billion of economic activity.

Moreover, independent oil and gas producer activity resulted in \$131 billion in income taxes (federal and state), sales taxes and excises taxes. All these figures are projected to increase dramatically.

Preserving the Current IDC and Percentage Depletion Provisions

Section 263(c) I.R.C. (1986) – Intangible Drilling Costs (IDCs) and Section 611, 613, 613A I.R.C. (1986) – Percentage Depletion are essential to domestic independent producers. These two provisions apply only for domestic drilling and/or production activity.

These two provisions are critically important for the small businesses that make up the American oil and gas industry. In today's exploration/production industry, most capital for drilling is generated by independent producers internally. However, even in instances when outside investors are involved, these two tax provisions are essential in attracting capital sufficient to maintain the pace and volume of drilling activity necessary to sustain current or increasing demand. Without these two tax provisions, neither large nor small domestic independents would generate the capital necessary for continuing to grow drilling and production activity. Estimates are that the repeal of IDCs and percentage depletion would decrease domestic drilling by at least 30%.

The 700,000+ oil and gas wells that fall into the marginal category are America's true Strategic Petroleum Reserve. Many of these marginal wells produce less than 2

barrels a day. However, the thousands of independent oil and gas producers and royalty owners count heavily on the percentage depletion provisions in current law to provide the internally generated capital to do routine maintenance and repairs and to implement affordable technological advancements, especially during periods of depressed prices.

Not Special Tax Breaks or Loopholes

IDCs represent typical and ordinary business expenses within the oil and gas industry. This provision is not a tax subsidy or loophole. In virtually all business and industry settings, taxpayers are allowed to deduct these types of operating expenses in the year in which they are incurred. The availability of these funds enables domestic independent producers to conduct the research and development necessary to meet the technological challenges of modern drilling and completion operations.

Percentage depletion differs from depreciation primarily in that it has been available throughout the economic life of the well. This distinction exists because unlike, for instance, a real estate property, which may have a stable or even increasing value over time, an oil and gas producing well declines in value over its economic life to the point that, when it is plugged, it actually has a negative value (plugging liability).

Conclusion

Domestic oil and natural gas exploration and production industry is propelling the U.S. to an energy-dominant position. A key driver of this American energy dominance is the activity of the small businesses that make up the American independent oil and gas industry. Fundamental factors in providing capital for current drilling and production activity are the long-standing tax provisions relating to deductibility of IDCs and the availability of percentage depletion.

The Illinois Oil & Gas Association (IOGA) urges members of the Senate Finance Committee and the House Ways & Means Committee to maintain these provisions in the Code in their present form. Thank you for the opportunity to offer our perspective.

Respectfully submitted,

A handwritten signature in black ink that reads "Edward P. Cross". The signature is written in a cursive, slightly stylized font.

Edward Cross, CEO
Illinois Oil & Gas Association