Contact: Tim Charters, Vice President of Regulatory & Governmental Affairs

National Stripper Well Association

Office: [redacted]
Mobile: [redacted]

[redacted]

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Submission for the Senate Finance Committee

Tax Reform Working Groups

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About National Stripper Well Association

The National Stripper Well Association is the only national trade association which represents producers and operators of marginally economic crude oil and natural gas wells in the United States. Our membership and America's stripper wells make up approximately 80% of all domestic wells, producing almost 20% of U.S. oil and natural gas making a significant contribution to the nation's economic security, and our local communities. Worldwide it should be noted that the United States is the only country with significant production of stripper wells, and one of the few countries in the world with private mineral rights that makes it possible. Nationwide, approximately 400,000 jobs are directly or indirectly dependent upon marginal or stripper oil and gas wells. In fact, U.S. stripper wells collectively produce 1.2 million barrels per day and NSWA is the only national association that represents solely the interests of the marginal well producers and operators before Congress, the Administration and the Federal bureaucracies. Established in 1934, NSWA has been at the forefront of advocacy before Congress to promote domestic industry, control the regulatory and economic burden of the federal government and protect the interests of the family business that make up NSWA's membership.

Tax Reform Should Promote Domestic Industry

In drafting tax reform legislation, Congress should not impose a massive tax increase on U.S independent oil and gas operations in the form of eliminating or reducing the percentage depletion tax allowance. This tax increase would raise the cost of doing business for U.S. producers and would threaten millions of U.S. jobs. Moreover, because oil prices, and natural gas prices to a growing extent, are established in world commodity markets, U.S. producers cannot easily pass on higher tax costs in the form of higher prices. A likely result of eliminating the percentage depletion allowance would be reduced American employment, increased electricity prices and increased reliance on foreign producers for the materials used for fuel, manufacturing, chemical production and other industries throughout our economy.

American Competitiveness

The United States oil and gas industry has been in a boom period for the last half decade as new regions and resource development technology has been developed. Even though the boom cycle has recently slowed significantly, America's stripper wells have remained constant in the production needed to fuel our nation, and remain highly competitive in the world economy. In addition, it is important to note that stripper wells require significant up-front financial commitments to produce small quantities of oil and gas at marginally-economic levels.

Under the current tax structure, the U.S. tax burden on stripper wells allow domestic stripper producers to find a competitive role in the world energy marketplace. Challenged by large domestic producers, multinational corporations, and foreign state sponsored entities America's stripper well producers remain a foundation of American production contributing nearly 20% of our domestic production and continuing to serve as a major job creator, but tax increases would jeopardize that hiring.

PERCENTAGE DEPLETION, IHS STUDY AND FINDINGS

The premise that changes in the tax code would result in significant impacts to small domestic producers was recently proven in a study conducted by IHS, a leading global economic research firm. The IHS study, commissioned by NSWA, found that eliminating the percentage depletion tax provision for U.S. oil and gas producers would cut into economic growth, cost jobs and labor income, and cost the federal government a net $2.5 billion in tax revenue by 2025, and another $1.1 billion in royalty revenue from oil and gas produced on federal land. Over the next decade (2015-2025), the economic impact of eliminating the percentage depletion deduction from the tax code would cost the United States economy $184.5 billion in gross value-added, an average of 178,000 jobs per year and $115 billion in earned labor income the report said.

<u>Although NSWA members are not the only ones who use the tax provision, the IHS report found that small independent producers who operate marginally-economic wells would be disproportionately affected by elimination of the percentage depletion deduction.</u> In addition, the report found that by the end of the forecast period, the number of producing wells would decrease by 4.2 percent, and new wells drilled would decrease by 23.5 percent. Daily oil production would decrease by nearly four percent and daily gas production by two percent. The production cutback would result in more than 37,000 wells not drilled and 644 million barrels of oil, and 2.8 tcf of natural gas, not produced.

In assessing the impacts of changing the tax code Congress must be aware of the "unintended consequences" of any change in tax policy that eliminates the percentage depletion allowance for oil and gas producers. Such radical changes would be costly for the American economy and the consequences get worse over time as investment in new wells, which would otherwise have been drilled under the current policy, are not made.

Adding to the economic damage is the fact that most small operators are concentrated in mature, largely conventional, oil- and gas-producing areas and consequently, more than 75 percent of the loss of producing wells, and two-thirds of the loss of new wells can be attributed to these areas. Almost every state is affected, IHS found, whether fossil fuel production exists in the state or not, although Texas is predicted to absorb more than half the drilling losses and about 45 percent of the production losses. However, historically significant oil and gas regions like Oklahoma, Ohio and Colorado face significant impacts as a result of elimination of the percentage depletion provisions in the tax code.

PRIVATE ROYALTY OWNERS

In addition to significant impacts on small producers, the report found that there would be significant impacts to private royalty owners who lease mineral rights for production and who have gotten a share of the revenue from the production of the wells in return can also claim the percentage depletion deduction. The report noted that eliminating the percentage depletion deduction affects royalty owners in two ways. First, because it lowers the incentive it means that leasing mineral rights or lending investment capital for new wells seen as riskier investments will likely be forgone; and, secondly marginal wells will produce less or go offline, diminishing the amount of production revenue and lowering royalty owners' earnings. Overall, private royalty owners are expected to earn $34.3 million less over the decade-long forecast period.

INTANGIBLE DRILLING COSTS (IDCS)

The expensing of intangible drilling costs (IDCs), which are only available for wells drilled in the United States, permits producers to deduct full costs in the year they are incurred. This provision is only fully available to domestic independent producers and is critical to the ability of producers to recoup costs. As discussed before, domestic production of oil and natural gas can have very high up -front development costs which require significant access to capital to continue production. Stripper well operators are not immune to this need. If the ability to expense IDCs in the year they are incurred is removed, stripper well operators would face a significant decline in available capital, leading to reductions in drilling, investment, and potentially the premature closure of wells.

PASSIVE LOSS LIMITATIONS

Access to capital is one of the biggest ongoing challenges in the oil and gas industry. Passive loss allows small family operators to share some of the burden of investments similar to the operations of larger corporate entities. In small communities, small operators need the ability to join with passive partners to obtain the capital and investment needed to keep high-cost business operating. Unfortunately, the oil and gas industry is not always profitable, especially at today's low prices. Without the ability to share the losses among the investor's capital in the oil and gas industry would be significantly harder to secure. This provision allows Americans of all stripes to join into the small oil and gas industry in the hopes of hitting it rich, but protects them should the projects not always turn out to be profitable.

SUMMARY

Stripper well producers like many in America's oil and gas industry have for decades been in an economic struggle with international forces beyond our control bent on setting the world price of oil. Much of the internationally traded oil of the world is controlled by a combination of foreign governments and state run corporations who collude together to drive the price of oil up and down to benefit their own agendas, with little or no regard for the impact on the American people or businesses.

America's oil and gas sector has undergone a tremendous renaissance in the 21st Century. Technology advancements have changed the international dynamic of energy reasserting America as the world leader in energy development. These tremendous scientific achievements, along with billions and billions in domestic investment, are taking place all across the oil and gas industry. This includes our nation's stripper wells, which have benefited from advancements in well design, fracturing and flooding that are enhancing recovery of both old and new wells. The reality is all across the oil and gas sector America has just started to open a new era of energy abundance.

Now is not the time for Congress to radically change the tax structure that governs our oil and gas industry, particularly the provisions that support the smallest of our domestic producers. The percentage depletion deduction, along with the ability to expense IDCs in the year they are incurred, and retention of the passive loss limitations, are vitally important to U.S. stripper well operators and royalty owners and must be preserved through corporate/comprehensive tax reform.