The largest US independent exploration and production companies: Leaders in finding and developing secure energy supplies throughout North America

Intangible Drilling Costs:
Crucial Underpinning of Affordable US Energy Supply

Overview

The ability of oil and natural gas exploration and production companies to currently deduct intangible drilling costs (IDCs) - just as other businesses deduct ordinary and necessary business expenses - remains a key element in attracting investment in the development of this nation's oil and natural gas resources via those large, high, up-front-risk projects that provide affordable and secure supplies of domestic energy to American consumers and reduce our dependence on foreign imports.

Even if these exploration and production projects prove to be successful and hydrocarbons are found, there may be no recoupment of the investment for years, particularly in the case of deep water oil and natural gas projects. Proposals to eliminate the deduction for IDCs would drastically increase the costs associated with these high risk projects and would result in fewer wells drilled and ultimately less domestic production of oil and natural gas.

What are IDCs?

Intangible Drilling Costs are actually misnamed because they are anything but “intangible”. They are quite simply the actual ordinary and necessary expenses incurred in drilling and completing oil and natural gas wells that have no salvage value, such as costs of ground clearing and surveying for the preparation of a drilling location and wages, fuel, repairs, drilling mud and other ordinary and necessary expenses incurred in the drilling and completion process. These costs generally amount to between 60 and 80 percent of the cost of drilling and completing a well.

Tax Treatment of IDCs

Because these costs, by definition, have no salvage value, the mining and oil and gas industries are allowed to treat them as expenses. As such, they are deductible in the year in which they are incurred, as is the case with ordinary and necessary expenses incurred by all businesses.

Despite significant advances in geological and geophysical technology, drilling a well is still the only means of determining with absolute certainty the presence of hydrocarbons.

Even today, investing in oil and gas exploration and production remains an inherently risky business, but the IDC deduction has provided independent oil and gas exploration and production companies the means to fund the discovery and development of new “technology frontier” plays such as the Bakken, Barnett, Eagle Ford, Niobrara and Marcellus shale plays. Adequate capital for the development of these projects would simply have been unavailable absent the current tax treatment.

How Would a Change Affect Independent Exploration and Production Companies?

The large independent exploration and production companies lead the way in this sector by continually applying innovative technology and by annually spending the billions of dollars necessary to discover and produce the domestic oil and natural gas supplies necessary to fuel our economy. These independents routinely spend more than they earn in finding and producing domestic energy supplies. **In 2012 the 32 independent exploration and production companies that are AXPC members, on average, reinvested in excess of 130% of their domestic cash flow in US drilling.** The ability to invest at these rates is directly tied to cash available. Increased taxes reduce available cash and reduce the ability of these companies to continue to reinvest in the US economy and in job creation.

The 32 AXPC member companies employ over 72,000 individuals and had a collective 2012 exploration and production budget of in excess of $82 billion in support of our nation’s continuing quest to become more energy independent while still generating cleaner energy. Changes in the ability to currently deduct IDCs would have a direct and negative impact on the ability of our members to continue this level of domestic activity. Using a combined federal and state effective income tax rate and an average cost to drill a domestic exploration well, **AXPC estimates that the proposals to eliminate the current deductibility of IDCs, as are described in President Obama's current budget, would force just the 32 AXPC member companies to drill 4,000 fewer wells in the first year alone.** Such a result would have an immediate adverse impact on the supply of domestic energy, resulting in American consumers paying more for gasoline and higher utility and food bills and in the loss of large numbers of good jobs.

Conclusion

Any efforts to eliminate or curtail the current expensing of IDCs or other ordinary and necessary expenses should be opposed. Our nation cannot afford the higher energy prices, the reduction in jobs, the decline in overall economic activity and the negative impact on energy independence and national security that would certainly result from such an ill-advised policy.