Natural Gas Supply and Price:
Tax Policy Change Proposals Can Cause Damage

Background

This winter natural gas consumers (residential, commercial, industrial and agricultural) are on borrowed time. Mild weather is masking a delicate supply/demand balance. Those responsible for buying natural gas, whether by signing longer-term contracts or making "spot" purchases, are watching the market closely in order to acquire adequate supplies at the best prices.

Natural gas producers – especially the large U.S. independent exploration and production companies *that invest two or more times their annual earnings* – are going all-out to find and develop new North American natural gas supplies from our very large resource base – with positive results beginning to be seen. Drilling has been at record highs. Reserves are growing. Price volatility has diminished and price levels have declined as weather has cooperated and exploration and production activity continues at a strong pace.

Problem

Proposals to change tax policies that underpin exploration and production efforts send wrong signals to the natural gas market, potentially leading to decisions to lock in gas supplies at higher prices.

If enacted, proposed changes would have a real effect on the investments needed to meet projected natural gas demand, much less grow supplies.

Solution

Tax policy changes that will have even unintended adverse natural gas supply effects should be avoided.

Such proposals include: elimination of deductions for drilling costs (or IDCs), elimination of the manufacturing deduction for domestic natural gas and oil production, and two-year amortization of geologic and geophysical costs.

Discussion

Independents, exploration and production (E&P) companies that are not "integrated" with refining and marketing arms, drill most of the wells in the United States and throughout North America.

The large independents lead the way in this sector by applying their advanced technology and providing the billions of dollars in capital spending necessary to provide natural gas supplies. These independents routinely spend more than they earn in finding and producing energy supplies. (Reinvestment data through 2005 is provided on the attached chart from J.S. Herold.) They can do this because they incur debt and have high cash flows.

The ability to invest at these rates is directly tied to cash available. Increased taxes reduce investment ability. That is why proposals to reduce this investment ability, even inadvertently, by tax policy changes will have adverse natural gas supply and price effects and should be avoided.

Problem proposals include:

Elimination or reduction of the ability to take a tax deduction for drilling costs (IDCs)

Part of the underpinning of the American oil and gas industry *for some 90 years*, IDCs are technically called "intangible" drilling costs. However, they are anything but intangible. They are actually cash outlays (that may be made many years in advance of natural gas or oil production from very long lead-time projects) for goods and services that include laborers, technicians, contractors, testing, rigs, pipe, tubing, casing, well cement and leased equipment needed to drill wells.

The ability to deduct these costs has been for decades, and remains, a key element in attracting investment in large up-front-risk projects that may see no commercial feasibility or resulting revenue. If they are successful, there may be no recovery of investment for many years, or even a decade or longer in the case of deep water and other frontier projects.

Elimination of manufacturing deduction (under Section 199 of the American Jobs Creation Act of 2004).

Designed to create jobs in domestic manufacturing sectors, this provision has clearly had the intended effect in the exploration and production sector by increasing the ability to put more investment into energy projects. Employment in the E&P sector is strong, with decades-high demand for skilled workers and professional geoscientists and others. Training programs are increasing and the newly-energized workforce is making a difference in producing natural gas and oil for the country.

Elimination of two-year amortization of geologic and geophysical costs (G&G).

Geologic and geophysical costs are equivalent to the research and development costs of the E&P industry.

Put in place only in 2005 as part of the Energy Policy Act, two-year amortization was a compromise away from proposed full immediate deduction that would have allowed G&G costs to be treated like other business expenses (an approach supported by the Clinton Administration Treasury Department as a tax simplification measure).

G&G costs include the high-tech seismic data collection and supercomputing analysis that allow geophysicists, geologists and engineers to "see" geologic formations and potential natural gas and oil zones deep beneath the earth's surface, often also beneath thousands of feet of water. They allow today's improved targeting of exploratory drilling and then more selective development efforts – and eventually fewer and more efficient surface facility locations.

Conclusion

Tax policy changes that reduce exploration and production investment will have adverse natural gas supply and price effects and should be avoided.

Energy Industry Reinvestment Rates

J.S. Herold Historical Data ($ Millions)

	1999 - 2005					2005				
	Total Investment Activity	Net Earnings	Investment/ Earnings %	Acquis/ Earnings %	Inv w/o Acquis/ Earnings %	Total Investment Activity	Net Earnings	Investment/Earnings %	Acquis/ Earnings %	Inv w/o Acquis/ Earnings %
GLOBAL INTEGRATED OILS	387,907	374,162	**104%**	9%	**94%**	47,893	75,540	**63%**	8%	**56%**
OUTSIDE NORTH AM. INTEG./DIV. OILS	451,569	234,595	**192%**	12%	**181%**	33,462	17,531	**191%**	21%	**170%**
U.S. INTEGRATED OILS	101,321	58,121	**174%**	38%	**137%**	18,794	18,601	**101%**	3%	**98%**
CANADIAN INTEGRATED OILS	44,908	27,632	**163%**	11%	**152%**	10,706	7,970	**134%**	1%	**134%**
SUPER E&Ps	190,293	77,063	**247%**	40%	**207%**	45,961	27,525	**167%**	17%	**150%**
LARGE U.S. E&Ps	49,486	11,094	**446%**	174%	**272%**	16,799	3,964	**424%**	215%	**209%**
MID-SIZED U.S. E&Ps	24,611	6,248	**394%**	51%	**343%**	7,399	2,261	**327%**	37%	**291%**
SMALL U.S. E&Ps	17,906	1,994	**898%**	103%	**795%**	5,793	940	**617%**	78%	**538%**
LARGE CANADIAN E&Ps	4,556	1,745	**261%**	10%	**251%**	800	544	**147%**	4%	**143%**
MID-SIZE & SMALL CANADIAN E&Ps	23,176	7,062	**328%**	109%	**219%**	4,765	1,960	**243%**	113%	**130%**
OUTSIDE NORTH AMERICA E&Ps	30,820	17,165	**180%**	24%	**156%**	4,830	2,404	**201%**	18%	**183%**