Intangible Drilling Costs:
Crucial Underpinning of an Abundant and 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 their ordinary and necessary business expenses - remains a key element in attracting investment capital for the development of this nation's oil and natural gas resources via the large, high-cost and high up-front-risk projects that provide affordable and secure supplies of domestic energy to American consumers and reduce our dependence on foreign imports. This particular provision has been in the tax code since its inception and is a critical element in our nation's march toward energy independence. Moreover, this provision enables companies to generate the capital necessary to fund the large investments required to unlock our unconventional oil and natural gas resources, and for that reason, we now find ourselves with abundant, long-term domestic supplies of energy.

The fact of abundance of domestic energy supplies was further demonstrated by the recent report of the Potential Gas Committee (headquartered at the Colorado School of Mines) to the effect that the estimated potential supply of natural gas in the United States has increased by 26% in just the past two years. This is an incredible achievement made possible in no small part by current tax policy providing for the ability to expense the ordinary and necessary business expenses as incurred in the search for domestic energy resources. The elimination of the ability to expense these costs would directly reduce, on at least a dollar-for-dollar basis, the capital available to AXPC companies to undertake the investments necessary to provide energy to our nation's individual and industrial consumers. Proposals to eliminate the current expensing of IDCs would drastically increase the costs associated with these high-risk and high-cost projects and would result in fewer wells drilled, fewer jobs created, reduced revenues to federal, state and local governments and ultimately less domestic production of oil and natural gas. None of these results are good for our nation's economy.

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 exactly as what they are – ordinary and necessary business expenses. As such, they are deductible in the year in which they are incurred, as is the case with such expenses incurred by all businesses.

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, Marcellus and several other shale plays. Adequate capital for the development of these projects would simply have been unavailable absent the current tax treatment. In industries where access to capital is an essential element to the ability to unlock domestic energy resources, it is fundamentally bad economic policy to raise taxes on capital. In fact, the objective of tax reform should be just the opposite. Our national economic and tax policies should enable access to capital. Without capital there is no new investment and soon the energy resources either dry up or decline precipitously. We cannot afford such a result when it comes to our domestic energy resources. There is simply too much at stake.

As a result of current tax policies and the technological innovation and risk taking these policies encourage, independent exploration and production companies have unlocked game-changing amounts of domestic energy resources. US manufacturing is competitive once again. In fact, we have such a significant competitive advantage when it comes to energy prices that businesses from other nations are re-locating their manufacturing facilities to the US. This was unthinkable 5 years ago.

How Would a Change Affect Independent Exploration and Production Companies?

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 over 130% of their domestic cash flow in US drilling.** The ability to invest at these rates is directly tied to cash available, i.e investment capital. Increased taxes reduce available cash and reduce the ability of these companies to continue to reinvest in the US economy and in job creation. Because these companies run their businesses from cash flow and continually re-invest this cash flow in the constant search for more domestic energy resources, it is obvious that any increase in taxes results in at least an equal decrease in available cash for re-investment.

AXPC's 32 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 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 over 4,000 fewer wells in the first year alone.** Such a result would have an immediate and adverse impact on the supply of domestic energy, resulting in American consumers paying more for gasoline, utilities and food and in the loss of thousands of well-paying jobs. There are also serious national security and energy independence aspects to the negative results of such a change in tax policy.

Conclusion

The 26% increase in the potential supply of natural gas in the US over the past two years and 30% increase in the daily production of oil in the US since 2008 is the direct result of current tax policies providing for the current expensing of ordinary and necessary business expenses incurred in the discovery and development of America's energy resources. As noted above, these policies enabled the risk taking and technological innovation necessary to accomplish these stunning results. No government subsidies or tax credits were necessary or involved in this achievement.

Independent exploration and production companies drill over 90% of the wells drilled in the US in any given year. The elimination or curtailment of the current expensing of IDCs and other ordinary and necessary expenses would result in 25%-35% reduction in the number of wells drilled in the US

in year one. The short term consequences of this would be an immediate and sharp reduction in overall economic activity in the US followed by higher energy prices, likely leading to even less economic growth. The independent oil and natural gas exploration and production companies have risked their capital, developed innovative technologies and, through new discoveries, are developing game-changing amounts of domestic energy. It is an ill-advised policy that would discourage the continued expansion of this incredible achievement by making the task even more risky, challenging and expensive. Our nation cannot afford the higher energy prices, the reduction in jobs, and the decline in overall economic activity, not to mention the negative impact on energy independence and national security, that would certainly result from the elimination or limitation of the ability of independent exploration and production companies to currently deduct, as all other businesses are able to do, their ordinary and necessary business expenses.

Tax policy should not be about picking winners and by default losers. Rather, it should be pro-growth and should continue to encourage innovation and the growth of our critical domestic energy supplies. The results of the current tax policy as it applies to independent oil and gas exploration and production companies meets this critical test and the results certainly speak for themselves. The current deductibility of ordinary and necessary business expenses should not be eliminated for this or any other industry.