



Intangible Drilling Costs: Crucial Underpinning of an Abundant and Affordable US Energy Supply

Overview

The ability of independent 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 inception and is a critical element in our nation's march toward energy independence. Moreover, this provision enables these 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.

According to the United States Energy Information Administration 2016 was the fifth consecutive year for the United States to be the world's leading producer of petroleum and natural gas hydrocarbons, once again surpassing Saudi Arabia and Russia. The fact of abundance of domestic energy supplies was further demonstrated by the report of the Potential Gas Committee (headquartered at the Colorado School of Mines) released in April 2015 to the effect that the estimated potential supply of natural gas in the United States has increased by 6% in just the past two years, this despite significant increases in consumption over that same time period. Taken together, these and many other similar recent energy-related developments represent an incredible, game-changing 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.

Increased taxes that would result from the elimination or the significant reduction of the ability to currently expense these costs would directly reduce the capital available to AXPC companies to undertake the investments necessary to provide energy to our nation's individual and industrial consumers. As discussed in greater detail below, the elimination of 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 90 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 all ordinary and necessary expenses incurred by all businesses.

Even today, investing in oil and gas exploration and production remains an inherently risky business, but the current deductibility of IDCs 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 Permian, Bakken, Scoop/Stack, Barnett, Eagle Ford, Niobrara, and Marcellus, and several other nonconventional shale plays. Adequate capital for the development of these projects would simply have been unavailable absent the current tax treatment. In an industry 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 facilitate access to and generation of 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 direct result of current tax policies and the technological innovation and risk taking such policies encourage, independent exploration and production companies have unlocked game-changing amounts of domestic energy resources. By 2018 the US is expected to be a net exporter of natural gas and the abundance of inexpensive domestic natural gas has led to a revival of the US petrochemical industry. US manufacturing is again competitive. In fact, we have such a significant competitive advantage when it comes to energy prices and

reliability of energy supplies that businesses from other nations are relocating their manufacturing facilities to the US. This was unthinkable 5 years ago.

How Would a Change in Tax Treatment of IDCs 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 reinvest amounts greater than their cash flow in finding and producing domestic energy supplies. **In 2017 the 33 independent exploration and production companies that are AXPC members, on average, plan to reinvest in excess of 113% of their domestic cash flow in US drilling.** The ability to invest at these rates is directly tied to available cash 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 reinvest amounts in excess of this cash flow in the constant search for more domestic energy resources, it is obvious that any increase in taxes would result in a decrease in capital available for reinvestment in excess of the tax increase.

AXPC's member companies employ over 46,000 individuals in 2017 and have a collective 2017 planned exploration and production budget of in excess of \$42 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. Based on this amount of actual capital spending and using a combined federal and state effective income tax rate and an average cost to drill a domestic exploration well, **AXPC estimates that should proposals to eliminate the current deductibility of IDCs become law the cash flow available for investment by AXPC member companies in 2017 would be reduced by over \$10,000,000,000 and these companies would be forced to reduce the number of wells drilled in 2017 by over 1,600.** 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, not to mention 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 incredibly positive trends discussed above reflect developments in the U.S. economy that must be encouraged, not stifled by short-sighted, punitive policies. We are witnessing a manufacturing renaissance in our country and are experiencing a profound geopolitical change in our energy

independence status, both as a direct result of the domestic energy revolution. Current tax policies providing for the immediate expensing of ordinary and necessary business expenses incurred in the discovery and development of America's energy resources have played a significant role in encouraging this energy revolution. 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 rather remarkable achievement.

Independent exploration and production companies drill over 90% of the wells drilled in the U.S. in any given year. The elimination or curtailment of the current expensing of these ordinary and necessary expenses would result in a 25%-35% reduction in the number of wells drilled in the U.S. in year one. The short-term consequences of this would be an immediate and sharp reduction in overall economic activity in the U.S. 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 or otherwise limited for this or any other industry.

July 2017