AXPC American Exploration & Production Council

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

IRC Section 199: Manufacturing Deduction
Tax Policy Change Proposal That Would Damage America's Energy Future

AXPC member companies that routinely invest multiples of their annual earnings and 100% of their cash flows know that an increase in income taxes – through changes being proposed to IRC Section 199 "manufacturing deduction" – especially at a time when this country is facing a delicate energy supply/demand balance – would have extremely damaging effects on the Nation's domestic supply of natural gas and crude oil and, ultimately, the price to consumers of heating their homes and driving their cars.

Background

In October 2004, Congress passed the American Jobs Creation Act ("AJCA") which included a provision that allows for a deduction associated with domestic production activity. This deduction is available to U.S. manufacturers, including the oil and gas industry, and is equal to 3% of "qualified production activities income" ("QPAI") for the years 2005 and 2006, increasing to 6% for the years 2007 through 2009 and increasing to 9% for years 2010 and after.

Unintended Consequences

The large independent oil and gas companies lead the way in this sector by applying their advanced technology and providing the billions of dollars in capital spending necessary to provide oil and natural gas supplies. <u>These independents routinely spend more that they earn in finding and producing energy supplies.</u> They can do this because they incur debt and have high cash flows.

The oil and gas exploration and production business, like many others, is a rate of return business. If the economics of drilling a given oil or gas well do not meet a company's minimum required rate of return, that well is not drilled. Worse yet, in many instances, the capital available to drill and equip this well may instead be re-directed to other more profitable areas – sometimes in international locations. The manufacturing deduction available to the large independents has undoubtedly resulted in more wells "becoming economic" since AJCA and the country has greatly benefited from the increased oil and gas supply.

The proposal to "freeze" the manufacturing deduction at 6% for large independent oil and gas producers will unfortunately result in fewer oil and gas wells being drilled domestically. At a point in time not too far removed from record gasoline and heating fuel prices, the reduced supply resulting from this proposal is likely to again put further pressure on these prices to increase. This would come at a time when both current presidential candidates are of a view that this country needs to become more energy sufficient.

The large independents lead the way by applying their advanced technology and providing the billions of dollars in capital spending. These independents routinely spend more than they earn in finding and producing energy supplies. The ability to invest at these rates is directly tied to cash available. Any increase in taxes through "freezing" the manufacturing deduction at 6% for independent oil and gas companies would reduce that investment ability.