Eliminating Oil and Gas Tax Allowances May Have Unwanted Consequences

Travis Dewitz - Oil & Gas Photographer - travisdewitz.com/crude-oil - Travis is a contributor to the Bakken Oil Business Journal.

by CHRIS BISCHOF

As always, the battle over corporate taxation rages on, especially when the debate involves taxing the US petroleum industry aka "Big Oil".

Critics of the energy industry, a group that includes the President, are quick to claim that oil and gas companies are rewarded with generous tax deals, which they usually describe as "loopholes", subsidies or special favors. Additionally, they assert tax rules for oil and gas companies put billions of dollars in the hands of businesses not needing the extra subsidies. However, a look at the impact of the proposed changes suggests the sacrifices outweigh the gains.

In his recent State of the Union address, the President included comments about the oil and gas industry as well as taxes or lack of them paid by them. He acknowledged that domestic exploration and production of crude oil and natural gas was up and oil imports were down. But, nevertheless, we should strive to become a nation relieving itself for the need of fossil fuels as our main energy producer, a goal, he asserts, we can achieve by imposing higher taxes on the oil and gas industry.

What does his administration have in mind? There are eight energy tax laws it hopes to repeal. However, due to the revenue involved, the following three stand out.

Manufacturing Tax Deduction (Section 199)

The Obama Administration has proposed the elimination of the domestic manufacturing tax deduction, known as Section 199, which was enacted in 2004 to increase employment among US manufacturers as part of the American Jobs Creation Act. The act covers companies with production, manufacturing and extractive operations, which includes the Oil & Gas industry.

Section 199 is specifically aimed at inducing US companies to increase both employment and output at domestic operations even though lower labor costs are available in other countries. The goal is achieved by permitting the deduction of a percentage of wage costs. For most industries the allowance was set at 9%.

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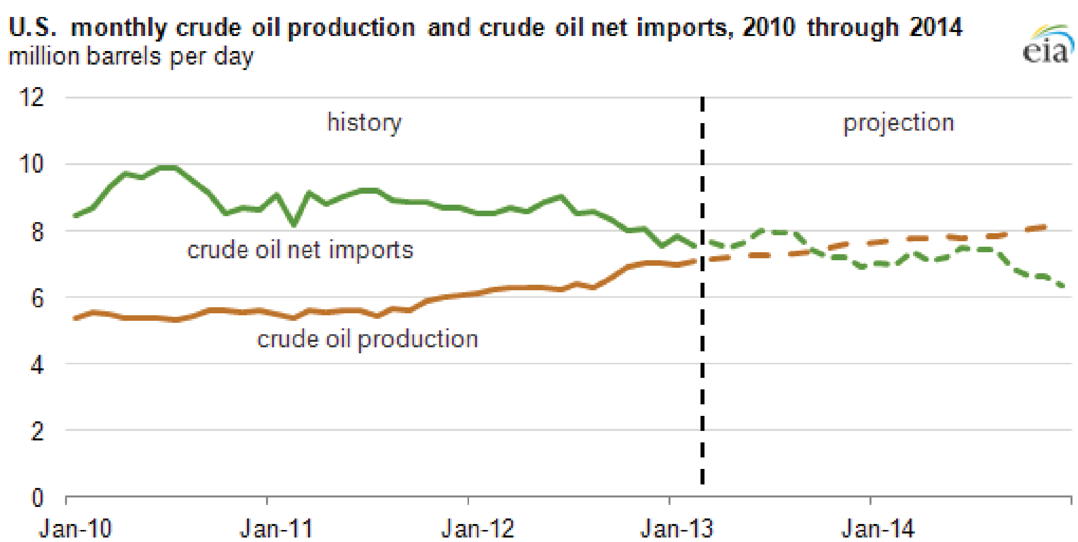

Source: U.S. Energy Information Administration, March 2013 Short-Term Energy Outlook.
Monthly crude oil production in the United States is expected to exceed the amount of U.S. crude oil imports later this year for the first time since February 1995. The gap between monthly U.S. crude oil production and imports is projected to be almost 2 million barrels per day (bbl/d) by the end of next year—according to EIA's March 2013 Short-Term Energy Outlook.

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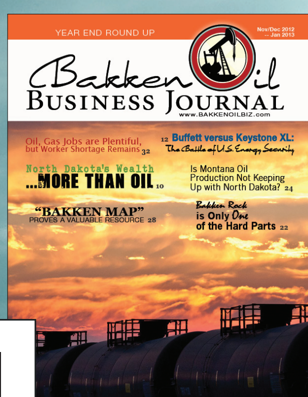

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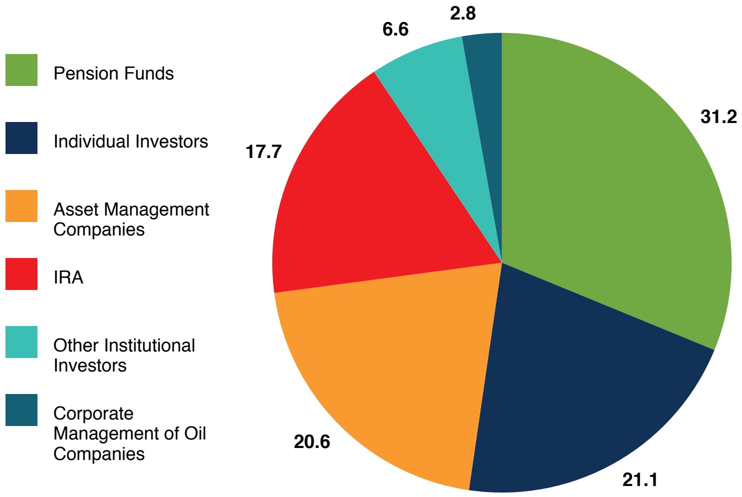
WHO OWNS BIG OIL? ... WE DO!



SOURCE: Who Owns America's Oil and Natural Gas Companies. SONECON. October 2011

However, for the Oil & Gas Industry, the deduction was capped at a less generous level of 6%.

The administration estimates the elimination of this tax deduction would increase Oil & Gas Industry tax payments by $11.6 billion over the next decade. However, industry sources estimate a higher tax burden. They project a tax increase of $14.8 billion over the same period.

Is the repeal harmful to employment? Clearly, the answer is: "Yes!". A study by Wood Mackenzie estimates the loss of almost 60,000 jobs in the first year this deduction is eliminated. Moreover, the areas of the country most likely to experience immediate losses are the Rocky Mountain and Mid-Continent regions with equipment manufacturers of oil exploration equipment. Furthermore, the study suggests the loss of the deduction might reduce crude oil and gas production by as much as 600,000 barrels of oil per day. It seems remarkably misguided to impose tax regulations that would reduce the number of well-compensated workers and cut production, which would result in fewer fees and royalty payments sent to Federal and state governments.

Expensing of Intangible Drilling Costs

The federal tax code has also permitted the expensing of Intangible Drilling Costs for the last century.

Briefly, Intangible Drilling Costs are the outlays generally incurred while drilling exploratory wells. Those outlays include ground clearing, surveying, wages, supplies, drilling mud, chemicals, and cement needed to begin drilling. They most closely resemble the deductible Research & Development costs that arise in other industries. These costs typically account for 60 to 80% of drilling outlays. Allowing the expensing of these costs is meant to attract capital to what has been a high-risk activity by permitting quicker investment returns through lower tax payments.

In recent years, advanced seismic analysis and horizontal drilling have made costly "dry holes" less likely. But even though these advances have increased the range of exploration and production capabilities, the risks remain substantial, especially for smaller competitors.

Despite the realities, the FY2013 budget proposal includes the repeal of the existing rule and offers an alternative based on a less beneficial cost recovery scale.

The Obama Administration estimates that repealing the expensing of Intangible Drilling Costs would increase tax revenue by about $14 billion over the next 10 years ($3.5 billion in the first year). However, the administration has offered no estimate of the reduction in drilling and job cuts that might result from the termination of this deduction. According to the Independent Petroleum Association of America, the repeal might reduce spending on oil projects by as much as $3 billion in the first year alone. That figure represents a lot of lost jobs and forgone purchases

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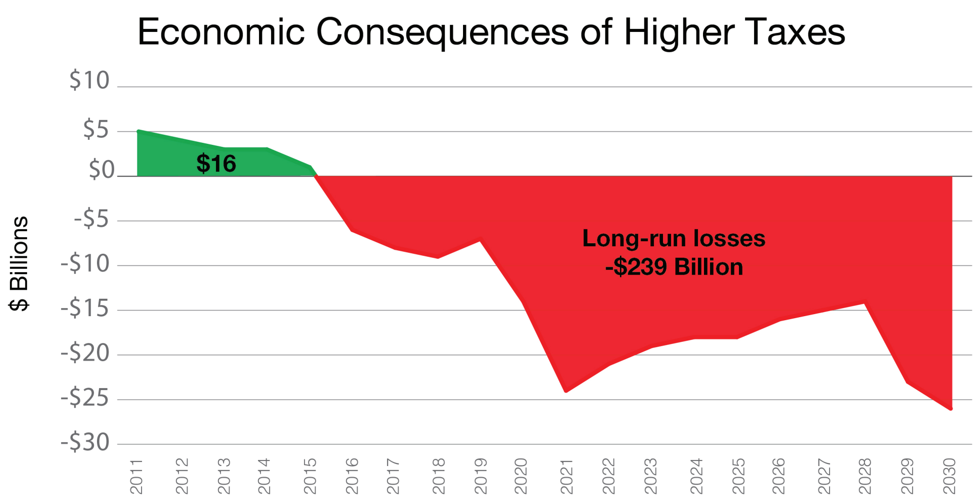
Photo courtesy of Travis W. Cooksey



Source: Wood Mackenzie, "Energy Policy at a Crossroads: An Assessment of the Impacts of Increased Access versus Higher Taxes on U.S. Oil and Natural Gas Production, Government Revenue, and Employment," January 2011.

of capital equipment.

Repeal of Percentage Depletion Allowance

For almost a century Oil and Gas companies, as well as Timber and Mining companies, have been permitted to reduce their gross income by an amount tied to their annual production. The Percentage "Depletion Allowance" is analogous to the more generally known accounting treatment of depreciation, a standard deduction for every corporation. Both principles account for the declining values of assets and both result in the recovery of investment costs. Currently, the allowable depletion rate is 15%.

What would its repeal mean? Without the allowance, it's estimated that energy companies would pay an additional $11.5 billion in taxes through FY 2022. However, as with

all tax increases, there would be job losses, especially among smaller companies. The current administration has repeatedly stated it supports small businesses, but its tax proposals run counter to its rhetoric.

In Sum

At a time when the Oil & Gas Industry is predicting it may well create a million new jobs – high-paying jobs – it seems counterproductive to impede its growth, an outcome assured by raising taxes. Given the extraordinary production increases owing to hydraulic fracturing combined with horizontal drilling, it appears far more likely the Energy Industry can single-handedly raise the nation's Gross Domestic Product. By paying more Americans to produce more energy here we would increase tax revenue in the best possible way – by enlarging the nation's economic, which could be the best formula for our future success in our country becoming energy secure. ●

Chris Bischof studied mechanical engineering before starting a career on Wall Street where he began in securities sales, then moved into stock analysis. He also became a bond analyst and financial writer covering several industries and segments of the securities markets. Chris is a regular contributor to the Bakken Oil Business Journal and enjoys jogging, weight training, reading and living in New York City.

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Photo by Renae Mitchell, Life Through the Lens - renaemitchell.com
Renae is a contributor to the Bakken Oil Business Journal.