POLICY POSITION

8. Rejection of the Tax Plan Proposed by the United States Treasury Department (Opposition to Treasury Department Plan on Oil Production Costs)

Background

In January 1985, the Treasury Department proposed a tax simplification plan that would result in the loss of about nine billion barrels of oil equivalent reserves by 1992. The plan would decrease production by the equivalent of one million barrels per day by 1990 and by an additional 500,000 barrels per day by 1995. These losses would result primarily from two provisions in the Treasury Department's tax plan: the repeal of the percentage depletion allowance and current year expensing of intangible drilling costs. An additional provision would repeal the deduction for the cost of qualified tertiary injectants such as chemicals and carbon dioxide.

Repeal of the percentage depletion allowance - The most significant initial impact of repealing the percentage depletion allowance will be the reduction of stripper well production. Stripper wells are wells that produce ten or less barrels of oil per day. The United States has approximately 600,000 producing oil wells, of which 440,000 are stripper wells. In 1983, United States stripper wells produced 462 million barrels of oil, accounting for nearly fifteen percent of all United States oil production. Remaining reserves of United States stripper wells at the end of 1983 were nearly 4.6 billion barrels.

The Interstate Oil Compact Commission estimates that 850 million barrels of reserves would be lost from stripper wells during the first year after the repeal of the percentage depletion allowance. These reserves would be lost because without the percentage depletion allowance, producers would be forced to plug one out of every twelve stripper wells in the United States. These reserves would be shut-in because the cost of operating the stripper well would exceed the income generated from the sales of the oil.

Repeal of expensing of intangible drilling costs - Enactment of the Treasury Department's proposal to repeal expensing of intangible drilling costs would force independent producers to reduce their drilling budgets by twenty-five percent, resulting in at least 8,000 fewer wells the first year. Major company drilling programs also would be hurt by the weakening of independents. Most major companies rely heavily on independents through farm-outs and partnerships in high risk ventures to evaluate acreage individual companies are reluctant to explore alone.

Repealing expensing of intangible drilling costs would not only seriously jeopardize national security, but would fail to achieve the goal of increasing tax revenues. In fact, repealing expensing of intangible drilling costs will reduce the tax revenues to the federal treasury. In 1983, the accounting firm of Price Waterhouse performed a study for the American Petroleum Institute. Price Waterhouse concluded that the increased production that results from expensing of intangible drilling costs generates considerable tax revenues for the federal government.

The study showed that in fiscal 1983, each dollar of income tax reduced because of the deduction induced additional drilling activity by corporations and individuals. That additional drilling generated tax revenue of as much as $3.24 for corporations and as much as $4.52 for individuals for each dollar deducted.

Repeal of deduction for tertiary injectants costs - Qualified tertiary injectant expenses are the amounts paid for any tertiary injectant, other than a recoverable hydrocarbon injectant, that is used as part of an enhanced recovery process. The expenses are subject to the generally applicable recapture rules upon disposition of the property. Currently, they may be deducted in the year paid or incurred. The Treasury Department proposes to repeal the deduction, after which expansion of existing tertiary recovery projects would be regarded as the initiation of new projects. The cost of the injectants would be capitalized.

The Interstate Oil Compact Commission estimated capital cost treatment for tertiary injectants would result in the loss of about 1.8 billion barrels of enhanced oil recovery production and 1.3 billion dollars in federal income tax. Further, the loss in enhanced oil recovery production from 1986 onward would cause reductions of $2.25 billion in equipment purchases, almost $10.4 billion in royalty payments to private citizens, $2.2 billion in property and severence tax payments and $635 million in state income tax payments.

Recommendation

The Southern Legislative Conference calls upon Congress to recognize that both the security and economic well-being of our nation depend on a strong domestic oil industry providing secure supplies of domestically produced oil. In order to maintain adequate reserves of domestic oil, large amounts of capital are required to stimulate production. Repeal of expensing of intangible drilling costs, percentage depletion allowances, and deduction for tertiary injectants would significantly reduce the investment capital available for exploration; reduce production; shut-in reserves; and increase imports of oil. Therefore, the Southern Legislative Conference strongly urges the Congress to reject the Treasury Department's proposals to eliminate the tax incentives necessary to achieve our energy independence.

Lengthening the period over which intangible drilling costs are recovered would cause a substantial decline in domestic oil drilling activity. A change in existing law to deny percentage depletion could make many stripper wells unprofitable on an after-tax basis and result in their early abandonment. A decline in domestic production would increase the United States' dependence on foreign energy sources, exacerbate the problem of the trade deficit, and again make the United States vulnerable to concerted political or market action by foreign producers.

Although the Administration's second draft tax reform plan recognized the importance of a strong domestic oil industry by retaining the current year deduction of intangible drilling expenses and a slower phase-out of the percentage depletion allowance, Congress is ultimately responsible for tax reform.

Therefore, the Southern Legislative Conference joins with the Southwest Regional Energy Council in urging Congress to recognize that the clear national security interest in maintaining energy independence supports both retaining cost recovery rules for intangible drilling costs that provide an incentive for domestic energy production and retention of the percentage depletion allowance for oil and gas stripper well production.

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