TESTIMONY OF

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Senator Landrieu and members of the Committee, thank you for inviting me to testify at today's hearing. My name is Stephen Landry I am a partner in the National Tax Practice at Ernst & Young, LLP (EY). I serve in the Oil & Gas industry group. From 2007 through April 2013, I was the Vice President of Tax at Marathon Oil. The views expressed in this testimony are my own and not those of EY.

Growth in domestic production of oil and gas in the last five years has been well documented. This production growth is the direct result of increased capital spending. A recent American Petroleum Institute (API) publication indicates that capital spending for U.S. projects in 2013 was approximately $350 billion. This capital spending was by businesses of all sizes. According to the Independent Petroleum Association of America (IPAA), the overwhelming majority of wells drilled in the US are drilled by independent producers, most of which are small businesses.

One of the general principles underlying our tax laws for the last century has been that in order to determine taxable income for the year, businesses are allowed to deduct 100% of the ordinary and necessary business expenses they've paid or incurred during the year. Intangible drilling costs (IDCs) are the ordinary and necessary business expenses of the oil and gas industry. IDCs are certainly not "intangible", although they've been called that in the tax code for the past 100 years. IDCs include all expenditures for wages, fuel, repairs, hauling, supplies, and similar expenses without salvage value that are incident to and necessary for the drilling of wells and the preparation of wells for production. The deduction for IDCs has also often been analogized to the deduction (under Code section 174) for the

costs for developing new drugs incurred by pharmaceutical companies. Pharmaceutical companies are permitted to deduct 100% of these costs in the year incurred, even though, like an oil well, the new drug may generate a stream of income for a number of years.

Current law allows an election for independent producers to deduct 100% of these costs in the year incurred (integrated producers are permitted to deduct 70% in year one, with the remaining 30% capitalized and amortized over five years).

Rates of return on oil and gas wells are directly influenced by the timing of cash outflows and inflows related to the project. Therefore, any significant delay of the timing of the tax deductibility of drilling costs will reduce the discounted cash flow and rates of return that such projects will generate. A requirement that all oil and gas producers recover their IDCs over five years, as has been proposed in the Senate Finance Committee Cost Recovery and Accounting Tax Reform Discussion Draft, would reduce the capital cost recovery value of IDCs incurred by independent producers by as much as 8%.[1]

This reduction in cost recovery value occurs using a real discount rate of only 3.5%.[2] The cost of capital for small businesses is often much higher than this conservative discount rate. A higher discount rate will make the negative impact on the cost of capital for small independent producers even more pronounced.

This reduction in the cost recovery value of IDCs (using the conservative rates discussed above) will raise the cost of capital for investments in oil and gas wells by more than 3%. A change in expected returns of this magnitude is significant enough to change investment decisions and could make investments in some oil and gas wells uneconomic. Large integrated producers that are choosing among alternative investments might simply allocate their capital to other projects and jurisdictions that offer better rates of return. Small companies for whom cost of capital is a large barrier to entry into a business might not enter at all or might be forced to grow at a slower rate. Because more than 60% of IDCs are wages, such a reduction in the rate of return on investments in oil and gas wells could have an immediate impact on workers in oil producing states. IDCs relate to jobs because the ability to deduct these expenses in the year in which they are incurred provides the capital used by independent producers to drill the next well. The negative economic impact of their repeal could be substantial. States may see a decline in the creation of new jobs, and could experience a lower wage base for existing jobs. Over the next ten years, the industry could also experience significant job losses relative to what would occur under present law. The effect might be felt, eventually, by the entire economy given the importance of low-cost energy throughout the country, especially at this point in the country's economic recovery.

Other provisions in the tax code also affect the cost of developing oil and gas. The industry already has a reduced percentage for the Section deduction for 199 domestic manufacturing activity costs versus other manufacturers. Depletion and the amortization of geological and geophysical (G&G) costs, like IDCs, are capital cost recovery allowances. Depletion is a form of depreciation for oil and gas and

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[1] Stephen J. Entin, "The Tax Treatment of Capital Assets on Growth, Expensing, Depreciation, and the Cost Recovery in the Tax System", *A tax foundation background paper*, No. 67 (April 2013)

[2] Ibid

mineral resources that allows for a deduction from taxable income to reflect the declining production of reserves over time. G&G costs are expenses incurred in connection with tests done to identify oil and gas prospects and independent producers are currently allowed to deduct these costs over two years. Several recent proposals would repeal percentage depletion and require independent producers to capitalize G&G expenses and deduct them over five years. These changes will further reduce the rates of return for drilling oil and gas wells in the US.

In closing, tax policy reforms that increase the cost of capital for America's oil and gas industry could have several negative effects for the overall economy. Fewer wells drilled and decreased energy investment would cause domestic oil and natural gas production – one of the bright spots in our economy over the past several years – to fall significantly below current projections, making the goal of attaining US energy independence over the next decade more difficult to reach. Taxes paid by the industry to the federal government could fall significantly. In addition, the effects could include lower earnings and fewer jobs for America's small businesses and oil field laborers.