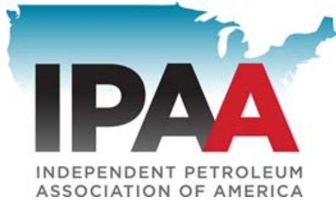


TESTIMONY

OF

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Immediate Past Chairman, Independent Petroleum Association of American

To

Senate Committee on Small Business

Hearing on “Fueling America – Enabling and Empowering Small Businesses to Unleash Domestic Production”

Lafayette, Louisiana

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Chairman Landrieu, thank you for inviting me to testify and participate in this very important hearing on independent producers and oil and natural gas tax provisions. My name is Gigi Lazenby. I am the managing member, chief executive officer and 100 percent shareholder of Bretagne LLC, an oil and gas production company that I founded in 1988. Bretagne's properties are in the Big Sinking Field of Kentucky. My company's operations include primary and enhanced recovery operations as well as development and field extension drilling.

I am the immediate past Chair of the Independent Petroleum Association of America (IPAA). IPAA represents thousands of independent oil and natural gas explorers and producers, as well as the service and supply industries that support their efforts, which will be significantly affected by changes to the tax code. Independent producers develop 95 percent of American oil and natural gas wells, produce 54 percent of American oil and produce 85 percent of American natural gas. The average independent has been in business for 26 years and employs 12 full-time and three part-time employees.

Additionally, IPAA is the primary national Trade Association representing smaller independent natural gas and oil producers, many of which are marginal well operators. Marginal wells are those with average production of not more than 15 barrels of oil or 90 Million cubic feet (Mcf) of natural gas, per day. However, in reality, an average marginal oil well in the United States produces about 2 barrels/day. Approximately eighty percent of all American oil wells are marginal wells, but they provide about twenty percent of American oil production. More than two-thirds of all American natural gas wells are marginal wells, providing twelve percent of American natural gas production.

According a recent study by IHS Global Insight, onshore independents supported 2.1 million jobs in 2010, making one out of every 62 jobs in the U.S. attributable to the independents' upstream activities. Independents contributed over $320 billion of U.S. GDP in 2010, a figure that will rise to over $466 billion by 2020. This figure could be even greater if Congress does not inhibit capital growth. If just the onshore independents' economic activity were a state, it would rank 15$^{th}$ in value creation for that same period.

Individual states are realizing similar impacts. In Louisiana, for example, IHS determined that unconventional gas activity contributed value-added economic impact of $10.7 billion in 2012. Also noteworthy is the fact that the annual average wage in the State of Louisiana is $57,600 compared to the average wage of direct jobs in unconventional gas activity, which is $108,700. Unconventional gas employment generated over $1.2 billion in state and local government taxes in Louisiana in 2012, which is equivalent to fourteen percent of the state's total budget.

Since independent producers' revenues are derived from selling produced natural gas and oil, federal government actions that reduce the amount of this revenue thereby reduces the investment capital independents can make in production activities will result in

significant reduction in American energy production and the economic machine it fuels. Tax reform proposals being contemplated in Congress pose serious risks to independent producers' ability to produce oil and natural gas in Louisiana and across the United States.

Much of the discussion surrounding tax reform in Congress has involved eliminating business deductions and in order to lower marginal rates. While there has been talk of comprehensive tax reform – reforming both the individual and corporate sections of the tax code - nearly all of the congressional focus has been on corporate taxation and the need to lower corporate marginal rates. Tax reform along these lines poses big risks for independent producers.

First, independent oil and natural gas producers are not tax rate driven. Instead, independent producers are concerned with the need to generate capital and recover costs to reinvest in American operations. Independent producers historically have reinvested as much as 150 percent of their American cash flow back into new American projects. Changes that limit this capital will affect the millions of jobs associated with just America's independent onshore investments.

Second, a significant majority of IPAA's producer members are not organized as C-Corporations. As such, these businesses would see no benefit to only lowering the corporate tax rate. In fact, if deductions are eliminated to pay for a reduction in the corporate tax rate, then these small businesses would realize a tax increase.

Political rhetoric describes tax provisions related to oil and natural gas production as "loopholes" or "subsidies." Three key issues that affect independent producers are the expensing of intangible drilling costs (IDC), the percentage depletion deduction and the passive loss exception for working interest in oil and gas operations. These are neither loopholes nor subsidies. They are mechanisms – like depreciation – that provide for capital recovery; they are normal business deductions.

Expensing IDC has been part of the tax code since 1913. IDC generally include any cost incurred that has no salvage value and is necessary for the drilling of wells or the preparation of wells for the production of natural gas or oil. Only independent producers can fully expense IDC on American production. Loss of IDC for independent producers will have significant effects on their capital development budgets. Information provided to IPAA by its members indicated that drilling budgets would be cut by 25 to 40 percent if the ability to expense IDC were eliminated by Congress. This could result in nearly one-quarter fewer wells drilled per year.

Additionally, changes to IDC expensing could be perilous for smaller independent producers. Unlike larger oil and natural gas companies, most smaller independent producers are unable to attract financing from institutional investors or even community banks. The advent of Dodd-Frank has increasingly made lending to smaller producers insignificant. As such, smaller producers must finance their drilling operations with cash

flow generated from the wellhead or from private investors. Changing the ability to immediately expense IDC will drastically curtail drilling budgets for all independent producers and will be especially impactful for smaller producers.

The percentage depletion deduction is truly a small producer issue. All natural resources minerals are eligible for a percentage depletion income tax deduction. Percentage depletion for natural gas and oil has been in the tax code since 1926 after Congress determined that relying solely on cost depletion was leading to the loss of important American mineral resources. Unlike percentage depletion for all other resources, natural gas and oil percentage depletion is highly limited. It is available only for American production, only available to independent producers and for royalty owners, only available for the first 1000 barrels per day (6000 mcfd of natural gas) of production, limited to the net income of a property and limited to 65 percent of the taxpayer's net income.

Therefore, as with IDC expensing, percentage depletion is critical for smaller independent producer's ability to maintain existing production and to finance drilling operations from cash flow. Percentage depletion provides capital primarily for smaller independents and is particularly important for marginal well operators. Input to IPAA from its operators who take percentage depletion indicates that the combined effect of eliminating IDC and percentage depletion would reduce drilling budgets in half. At this lower rate, new production will not offset the natural decline in production from existing wells. For example, if a producer now drills ten wells per year, without IDC and percentage depletion, this producer could only drill five wells per year. A five well program will not replace declining production in existing wells and the small business company will have to shutdown.

Finally the passive loss exception for working interests in oil and gas properties is also an important smaller independent producer issue. The Tax Reform Act of 1986 divided investment income/expense into two baskets – active and passive. The Tax Reform Act provided an exception for working interests in natural gas and oil from being part of the passive income basket and, if a loss resulted (from expenditures for drilling wells), it was deemed to be an active loss that could be used to offset active income as long as the investor's liabilities were not limited. Natural gas and oil development require large sums of capital and producers frequently join together to diversify risk. Additionally, natural gas and oil operators have sought individual investors to contribute capital and share the risk of drilling wells.

Most American wells today are drilled by small and independent companies, many of which depend on individual investors. There is no sound reason for Congress to enact tax rules that would discourage individual investors from continuing to participate in this system. Moreover, Congress applied the passive loss rules only to individuals and not to corporations. The repeal of the working interest rule, therefore, would senselessly drive natural gas and oil investments away from individuals and toward corporations. There is no apparent reason why Congress would or should favor corporate ownership over

individual ownership of working interests. As mentioned, in today's banking climate, smaller producers find banks uninterested or incapable of providing capital; taking private investors away will further exacerbate the challenge of raising capital to sustain American marginal well production.

So far, only the Administration has formally proposed eliminating all oil and natural gas tax provisions for all producers. The Obama Administration's budget request – and recurring advocacy statements on an almost daily basis – would strip essential capital from new American natural gas and oil investment by radically raising taxes on American production. American natural gas and oil production would be reduced.

Senate Finance Committee Chairman Max Baucus (D-MT) recently released a discussion draft regarding cost-recovery provisions in the tax code. The Baucus draft proposes substantial changes to IDC and percentage depletion – to the detriment of American oil and natural gas production. Further, the Baucus draft only proposes changing cost-recovery tax provisions – there is no discussion of rate reduction or impacts to individual filers.

To date, there has not been a proposed tax reform formulation that would not result in a tax increase for independent producers.

In summary, independent producers invest their American cash flow back into new American production projects. Reinvestment is essential to maintain and grow U.S. production; without it, U.S. production would decline rapidly because wells deplete as they are produced. If the United States wants to continue to increase national energy security and further the economy, more drilling will be required, not less. I would urge Congress support those actions that enhance that future and reject the ill-advised calls for adverse restrictions to capital. I look forward to your questions.