AXPC American Exploration & Production Council

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

Intangible Drilling Costs: Crucial Underpinning of Affordable US Energy Supply

Overview

The ability by oil and natural gas exploration and production companies to deduct intangible drilling costs (IDCs) has been for decades, and remains, a key element in attracting investment in large up-front-risk projects that provide secure supplies of domestic energy – especially natural gas -- to American consumers.

If these exploration and production projects are successful and hydrocarbons are found, there may be no recovery of investment for years, or even a decade in the case of deep water oil and natural gas wells. Proposals to eliminate or reduce the ability to deduct IDCs would drastically alter the costs associated with these high risk projects and would result in fewer wells drilled and ultimately less domestic production of oil and natural gas.

This is especially problematic since natural gas demand is expected to rise as more focus is placed on climate change policy and more exploration and production focus will be required on our large North American natural gas resources.

What are IDCs?

Intangible Drilling Costs are perhaps misnamed because they are anything but “intangible”. They are specific and real drilling cost outlays associated with oil and gas operations. Examples of IDCs range from the clearing of ground, draining, and surveying work to prepare for the drilling of wells to wages, fuel, repairs, supplies, drilling muds, chemicals and cement incident to and necessary in the drilling and preparation of wells for the production of oil and gas. Generally speaking, expenditures are classified as IDC if they have no salvage value.

Tax Treatment of IDCs

Because these drilling cost items have no salvage value, mining operations (including oil and gas drilling) long have been allowed to treat them as expenses. As such, they could be currently deductible in the year in which they were incurred rather than recovered over the productive life of the property through a depreciation allowance.

Despite great advances in geological and geophysical know-how and technology, drilling a well is still the only means of determining with absolute certainty the presence of hydrocarbons in reservoir rock or sand and, even today, nearly half of the wells drilled are classified as dry holes.

Given the extreme risks of investing in oil and gas production – demonstrated by the continuous discovery and exploration of new "technology frontier" plays like the Barnett Shale onshore and the Deep Tertiary Trend offshore -- it is highly unlikely that adequate capital would be available without the existence of such tax treatment. In fact, the only sort of capital investment that carries anywhere near the degree of risk associated with oil and gas exploration is research and development. Yet, research and development expenses may be taken in full as a tax deduction in the year incurred, are considered a current expense rather than being recovered over several years, as capital expenditures are, and are not subject to the alternative minimum tax.

How Would a Change Affect Independent Exploration and Production Companies?

The large independents lead the way in this sector by applying their advanced technology and providing the billions of dollars in capital spending necessary to provide domestic oil and natural gas supplies. These independents routinely spend more than they earn in finding and producing energy supplies. They can do this because they incur debt and have high cash flows. The ability to invest at these rates is directly tied to cash available. Increased taxes reduce investment ability.

The independents also make investment decisions based on a rate-of-return concept. The loss of IDCs as a current deduction would most certainly result in a reduction of their projected rates-of-return, a reduction in domestic drilling budgets to offset higher tax costs, a corresponding number of domestic wells drilled, and in many cases a reallocation of their capital to foreign operations (where their projected rates-of-return can be achieved).

In fact, the 25 independent natural gas and oil producers represented in AXPC have budgeted to spend an estimated $20.8 billion for IDCs in 2009 in an effort to contribute to our nation's quest to become more energy independent while still generating cleaner energy. Changes in the ability to deduct IDC's for tax purposes would have a direct and negative impact on the ability of our members to do so. Using a combined federal and state effective income tax rate and an average cost to drill a domestic exploration well, we estimate that this change in tax treatment could easily result in over 2,800 fewer wells drilled this year alone. Such a result would have an almost immediate, negative impact on the supply of clean, domestic natural gas with the result surely being felt by consumers in higher energy and utility bills and the cost of food as well as the significant job losses that would occur.

Conclusion

Proposals to reduce investment ability, even inadvertently, by tax policy changes will have adverse consequences, especially on natural gas supply and the price consumers pay for this environmentally preferable fuel.