

# MONTANA PETROLEUM ASSOCIATION ISSUE BRIEF



## TAX POLICY

### *FEDERAL TAX POLICY CHANGE THREATENS MONTANA ENERGY INDUSTRY:*

#### INVESTORS RELY ON INTANGIBLE DRILLING COSTS EXPENSING

**Raising taxes on our energy companies discourages development and production in Montana, shrinks jobs and revenues, and makes America more dependent on foreign oil.**

*While (oil and natural gas) production is concentrated in the eastern and northern parts of the state, over \$450 million in taxes and revenues feed into state and county budgets, which benefits everyone.” –Scott Rickard, Ph.D. Center for Applied Economic Research, Montana State University-Billings.*

More than half of Montana’s counties have at least some oil and natural gas production. Despite the pain the recession has inflicted on energy companies, along with other American businesses, oil and natural gas remains the second largest industry in Montana, after agriculture. It is responsible for approximately 4,500 direct jobs in exploration and production, refining and transportation.

Through production taxes and royalties, the petroleum industry contributes significant revenue to the state, to the counties where oil and gas are produced, to public schools and to landowners and mineral rights owners. Over the past decade, oil and gas companies paid nearly \$1.5 billion in production taxes alone.

Tough economic conditions have resulted in fewer new wells and less production. After steady annual increases for the past six years, taxes and royalties paid by the Montana oil and natural gas industry in 2009 were less than in 2008.

#### **Federal tax proposal threatens Montana energy development**

The Obama administration’s fiscal year 2011 budget includes several provisions that appear to be punitive and intended to hurt to an industry already reeling from the triple whammy of a decline in oil and natural gas prices, tight credit, and the recession. One of the most damaging provisions of the proposed budget would roll back investors’ abilities to expense intangible drilling costs – those non-recoverable costs associated with drilling and completing a well. According to Dr. Scott Rickard, Center for Applied Economic Research, Montana State University-Billings, “a change in how intangible drilling costs (IDCs) are treated could significantly reduce Montana oil drilling activity for up to five years after enactment, producing an \$850 million reduction in economic activity in the oil sector.”

The federal tax code has a significant effect on investors’ inclinations to invest in domestic development of oil and natural gas – by definition an uncertain and risky prospect. Over the years, federal policy has steadily eroded the reasonable treatment of exploration and production costs, dampening the ability of companies to attract necessary

capital. With an average price tag of \$4 million to develop a modern horizontal well, the upfront costs are considerable. Lower market prices for oil and natural gas and a tight credit market are already limiting investment capital. Drilling activity is down dramatically from early 2009. Since oil and natural gas provide 65 percent of America's energy, this trend should alarm policymakers in Washington, D.C. who should look for ways to encourage, not restrict, domestic oil and natural gas exploration and production.

We already import a large share of our petroleum – 65 percent – from overseas sources including some countries ruled by hostile, anti-American dictators. Discouraging continued investment in domestic oil and gas is not a smart national security policy.

### **No IDC expensing = fewer new wells in Montana = more unemployment**

The administration proposal would roll back the current tax treatment of intangible drilling and development costs (IDC), which has since 1913 allowed investors to expense non-recoverable costs related to drilling and completing wells.

The investment and financial services firm, Raymond James, issued a report that predicted the loss of IDC would result in a 25 to 30 percent reduction in capital drilling budgets. That is consistent with the findings of Dr. Rickard, who reported that an estimated 190 wells were drilled in Montana in 2007. "At a cost of \$4.6 million per well, \$874 million was spent in oil drilling expenditures," he noted. "If instead developers faced the change in IDC taxation and reduced their drilling by the full amount of their reduction in cash flow, nearly 20 percent fewer wells would have been drilled and \$170 million less spent in drilling activities that first year."

Rickard's bleak projection is borne out by concerns of Montana oil producers.

*"The repeal of the passive loss exception for oil and gas producers in Montana will make it less attractive for investors to invest capital in exploration and development projects that will bring new production, jobs, and revenue to the State. My business owns non-operated working interests in many wells in Montana. Our desire to invest in new prospects in Montana is contingent on the ability to capture intangible drilling costs as active losses and deduct them in the year they are incurred. Without the passive loss exception, I would invest my money in other businesses with less risk. Oil and gas is a risky business and dealmakers need every advantage they can get when they are competing with lower risk industries for capital dollars. Repealing the passive loss exception will result in fewer dollars invested in Montana." -- Robert L. Nance, Nance Resources, Inc., Billings*

*"The loss of the ability to expense Intangible Drilling Cost and the passive loss exemption rule would dissuade potential investors from putting up the risk money to drill these geological concepts. I personally would cease generating these projects if these tax provisions, vital to the domestic energy business, ceased to exist." -- Frank Haughton, Nisku Royalty, Billings*

*"I have been credited with identifying the Elm Coulee Bakken Field in Montana... characterized as the largest onshore discovery in the lower 48 States since 1954. Elm Coulee would not have been discovered and the resulting Bakken play would not exist without the investors behind my company. Any investor capable of investing for potentially high rewards in the high risk, high cost oil industry realizes that the entire investment could be a total loss and must have some benefit of a tax incentive in the form*

*of timely write-offs to continue investing in companies like mine.” -- Richard L. “Dick” Findley, Prospector Oil, Inc., Billings*

For producers in Montana and the rest of the U.S. who are already facing significant reductions in their capital budgets, a sudden adverse tax treatment of their investors would choke off capital for a long time.

The chain of events that would be set in motion by an IDC rollback will have serious consequences for America’s energy security. For Montana’s economy, reliant as it is upon oil and natural gas jobs and revenues, the effect would be catastrophic.

Most wells in the U.S. are drilled by small, independent companies. Profits from producing wells are invested in drilling new wells. By cleaving available capital for new drilling, the administration proposal would send more Montanans to the unemployment line and depress state and local revenue collections below the 2009 nadir.

Oil and natural gas companies are some of the largest taxpayers in the U.S. According to the Energy Information Agency, in 2007, the effective income tax rate of the major industry producers was 40.4% (based upon income tax expense of almost \$85 billion), which was significantly higher than the statutory U.S. tax rate of 35%. Additional taxes and fees, such as production taxes, import duties, and property taxes, paid by major industry producers in 2007 amounted to another \$12 billion of revenue for various governments.

### **Industry is a major state taxpayer**

The State of Montana’s policies toward oil and natural gas taxes and mineral royalties is competitive with other states while realizing significant revenues for Montana and producing counties.

The oil and natural gas industry contributes significant revenues in the forms of taxes and royalties on mineral production, property taxes on the value of industrial equipment, and income taxes on corporate profits. Employees of oil and natural gas companies and consulting firms pay income taxes on their wages, and property owners of productive oil and gas lands pay taxes on their mineral production royalties.

Oil production and natural gas taxes paid to Montana and producing counties totaled approximately \$243 million in 2007. Nearly half of these taxes ended up back in the producing counties where they fund school districts, school retirement obligations and transportation. Approximately \$122 million was returned to the state. \$105 million was placed in the general fund where it represented five percent of the total fund.

With state budgets facing serious cutbacks and unemployment at a 26-year high, now is not the time for new policies – federal or state – that hamper investment in oil and natural gas and slow the pace of recovery in Montana and the U.S.

FOR MORE INFORMATION CONTACT:  
MONTANA PETROLEUM ASSOCIATION  
406-442-7582

[MPA@MONTANAPETROLEUM.ORG](mailto:MPA@MONTANAPETROLEUM.ORG)  
[WWW.MONTANAPETROLEUM.ORG](http://WWW.MONTANAPETROLEUM.ORG)

