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Testimony to

U.S. House of Representatives Committee on Small Business
Subcommittee on Rural Development, Energy, and Supply Chains

Highlighting the Role of Small Businesses in Domestic Energy Production

Room 2360

Rayburn House Office Building

Washington, DC

**Edward P. Cross, (P.G., M.B.A.) President
Kansas Independent Oil & Gas Association**

March 29, 2023

Chairman Hunt, Ranking Member Perez and members of the subcommittee. I am Edward Cross, President of the Kansas Independent Oil & Gas Association (KIOGA). KIOGA represents



thousands of independent oil and natural gas explorers and producers, as well as allied service and supply companies. In Kansas, small independent producers account for 92% of the oil and 63% of the natural gas produced. Nationally, independent producers drill about 90% of American oil and natural gas wells; produce about 54% of American oil, and more than 85% of American natural gas. With nearly 3,000 members across Kansas, KIOGA is the lead state and national advocate for the Kansas independent oil and natural gas industry.

I am delighted to share my thoughts about the role of small businesses in domestic energy production and regulatory and policy hurdles that threaten American energy independence.

Who are Independents?

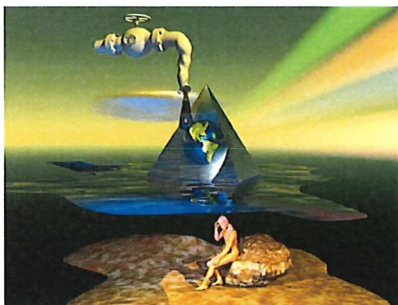


Independent producers are small oil and gas companies operating marginal wells across the U.S. Marginal wells are defined by the Interstate Oil & Gas Compact Commission (IOGCC) as an oil well producing less than 10 barrels of oil per day (BOPD) or a natural gas well producing less than 60 thousand cubic feet of natural gas per day (Mcfpd). Small independent producers that drill and produce marginal wells do not generate or market end-products. They sell the oil and natural gas produced to purchasers. Small independent producers generate their capital through production, not by tapping equity markets or other corporate measures.

In 2022, the Kansas oil and gas industry generated nearly \$3.6 billion in output, put tens of thousands of people across Kansas to work, and pumped hundreds of millions of dollars into the state's economy. While the average oil well in Kansas produces 2 barrels of oil per day (BOPD) and the average natural gas well produces 23 thousand cubic feet of per day (Mcfpd), the industry supports more than 100,000 jobs, \$3 billion in family income, and \$1.4 billion in state/local tax revenue. The industry is consistently in the top three Kansas industries in terms of gross state product and is an important element of the Kansas economy today and will be a critical part of the economy going forward.

Nationally small independent producers' employees paid \$30.7 billion in income taxes (federal & state), sales tax, and excise tax last year. The entire direct/indirect/induced economics of small independent producers generated \$131 billion of federal and state taxes last year, a figure that is expected to increase to \$189 billion this year. Every \$1 million of capex for independents results in \$1.1 million of total taxes generated along with the creation of 39 jobs. Every \$1 million of capex for independents results in \$2.4 million of direct and \$5.1 million of overall contribution to GDP.

Federal Energy Policy/Regulatory Overreach is Hurting Small Businesses in the Domestic Oil & Natural Gas Industry



As we have seen over the past few years, the choices our nation makes regarding energy policy will have a huge impact on America's economy and our international position. If America does not pursue a thoughtful energy policy, the nation will suffer economically. Efforts by the Biden Administration to suppress U.S. oil and natural gas production are counterproductive and do not serve the best interests of

our nation. Energy is a geopolitical issue, and it not only benefits the United States, but the entire world when America is an energy superpower.

Additionally, natural gas production and use has created the cleanest air quality the nation has seen in two decades. The United States is the envy of nations around the globe for our dedication to reliable, affordable, responsible energy production. The continued growth of America's oil and natural gas renaissance is essential and can be done with even greater efficiency and technological acumen. KIOGA and the thousands of men and women who work in the Kansas oil and gas industry stand ready to help you ensure America has a strong and vibrant energy economy for years to come.

We believe there are several issues that are key to helping the United States remain at the forefront of energy development in the coming years. We look forward to working with you during the 118th Congress.

Tax Policy



Tax policies, particularly those designed to punish the energy sector, only serve to raise costs to consumers while limiting opportunities for growth and development. Any proposed modifications to the tax code regarding American energy policy must recognize the critical role capital formation and capital recovery play for our nation's oil and natural gas industries. It is key for our industry that Congress retains necessary and ordinary business tax treatments critical to capital recovery and redeployment. We also support any efforts to lower the overall tax liability for American companies, allowing for a greater degree of investment and growth. America's oil and natural gas producers continue to reinvest capital at a rate well over 100% of their U.S. cash flow, hiring employees, purchasing equipment, and exploring new energy frontiers. Sound tax policy regarding the oil and natural gas industry has been a significant reason the U.S. is a leader in energy production and is poised to remain there for years to come.

Contrary to what some in politics and the media have said, the oil and natural gas industry currently enjoys no unique tax credits or deductions. Since its inception, the U.S. tax code has allowed corporate taxpayers the ability to recover costs and to be taxed only on net income. These cost recovery mechanisms or tax provisions, also known in policy circles as "tax expenditures", should in no way be confused with "subsidy", i.e., direct government spending. Cost recovery measures, like the percentage depletion deduction and the intangible drilling costs (IDCs) deduction, are neither subsidies nor loopholes but tax provisions critical for American oil and natural gas producers to sustain capital availability and formation. By improving cash flow, these cost recovery measures allow the small businesses that make up the America oil and

natural gas industry to invest more money into creating jobs and producing the energy that our economy needs.

Percentage Depletion – The percentage depletion deduction is a cost recovery method that allows taxpayers to recover their lease investment in a mineral interest through a percentage of gross income from a well. Percentage depletion is available to all extractive industries (gold, iron, etc.) in the U.S. and is in no way unique to the oil and gas industry. In fact, this depletion method is limited for the small businesses that make up the independent oil and gas industry and not available at all for major integrated companies.

Intangible Drilling Costs (IDCs) – The IDC deduction is a cost-recovery mechanism that allows for the deduction of drilling costs, such as labor costs, associated with exploration activities. IDC is a deduction, not a credit or government spending outlay and is no different than the policy behind the treatment of R&D cost deduction available to other industries. The IDC deduction is utilized by independent oil and gas producers most of the time and is only available to the major integrated companies on a reduced basis.

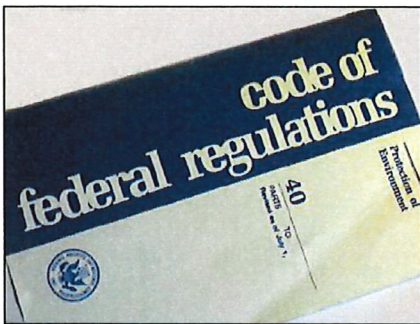
Percentage depletion and IDCs are cost recovery mechanisms similar to those used by other industries. These tax provisions are critical for independent oil and gas producers to sustain capital availability and formation. Market-created jobs, rather than those directly created and supported by the government, is a key benefit of increased activity by the small businesses that make up the American independent oil and natural gas industry. These jobs are stable, high-paying, and often in rural areas of the country that are struggling for opportunity. These tax provisions are neither “loopholes” nor “subsidies” but rather methods very similar to real estate depreciation in accounting for capital expenditures.

Carbon Tax – Taxing carbon to tackle climate change may sound like a good idea. All too often proposals to tax carbon directly or launch new carbon tax schemes have much more to do with raising revenue than helping our environment. However, taxing carbon only takes more resources from the private sector to support swelling state and federal government.

U.S. Doesn't Need a Carbon Tax – Even if the U.S. imposed some kind of carbon tax, it would not make a difference to global climate. In 2018, U.S. carbon emissions were around 5,100 billion metric tons from all sources, an almost 20% drop below emissions in 2007. While U.S. greenhouse gas emissions have been falling in recent years, world carbon emissions keep increasing by an average of more than 300 gigatons each year for the last decade, driven primarily by China's and India's increasing demand for energy. Together, these two countries now account for one-third of world carbon emissions. China and India are not going to impose a carbon tax on themselves. Doing so would increase their energy costs and reduce their economic growth.

Methane

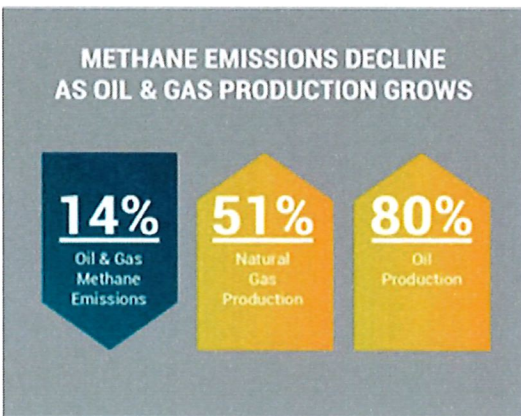
Addressing an onslaught of prohibitive federal regulations is a growing challenge and has become a primary priority for KIOGA. As Americans continue to face a fragile economy, it is important to pull back the curtain on the ideological-driven processes the EPA and other federal regulatory agencies are using to justify an avalanche of costly rules.



requirements for small oil and gas wells.

The Biden administration is strengthening its plan for limiting methane emissions from oil and gas wells after environmentalists said an earlier version was too weak. The Environmental Protection Agency (EPA) advanced the supplemental proposed rule on November 11, 2022. The proposed regulation, which isn't set to be finalized until later this year (2023), responds to criticism by environmentalists by strengthening leak-detection-and-repair (LDAR)

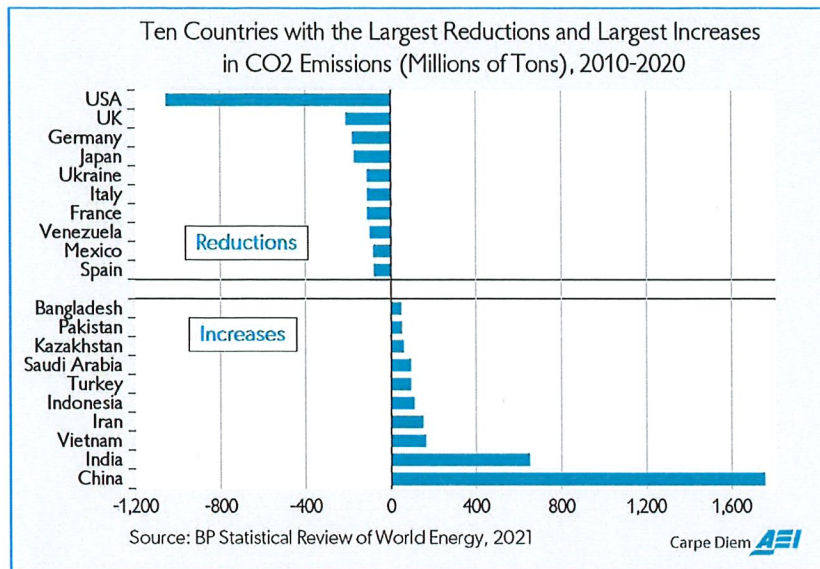
Methane (CH₄) is a more potent greenhouse gas than carbon dioxide (CO₂), though CH₄ is far less prevalent than CO₂ and has a much shorter atmospheric life. The real reason methane



has become an obsession of environmental activist groups is that it sometimes leaks in nominal amounts when extracting or transporting oil and natural gas. Thus, methane can be a pretext for interfering with and raising the costs of drilling. But this means willfully ignoring the plunge in U.S. methane emissions. According to the EPA, methane emissions from oil and gas operations declined by 14% from 1990-2017. According to the EPA, oil and gas methane emissions account for only 1.22% of total U.S. greenhouse gas emissions.

Methane is a greenhouse gas, emitted both by natural sources and from human activity. Methane is also the largest component of natural gas, the product that companies sell. Operators have every incentive to capture and sell as much of this product as possible to American consumers, rather than letting it escape into the atmosphere.

In fact, the United States leads the world in the reduction of carbon emissions, even as the production of U.S. oil and natural gas continues to increase. Our success in lowering carbon emissions in the U.S. is not because of additional regulations, but because of the increased use of natural gas.



The EPA released their first oil and gas methane rule proposal in November 2021. The November 2021 EPA proposal did not require ongoing emission monitoring at well sites that emit less than 3 tons per year (TPY).

In 2022, the Department of Energy (DOE) completed a report on the emissions profile of low production wells. The DOE report offers insights into understanding the nature of methane emissions from these operations. The report shows that the primary emissions at low production sites come from storage tanks and some separators. Well sites producing less than 6 barrels/day or 6-15 barrels/day with 5 or fewer pieces of equipment fall below thresholds that EPA has considered as low emitting sites.

On November 11, 2022, the EPA advanced their supplemental proposed rule to regulate oil and gas methane emissions. The EPA largely ignored the third-party DOE study on low-production well emission profiles. Instead, the EPA responded to criticism from environmental groups by strengthening LDAR requirements for small oil and gas wells and establishing requirements for abandoned facilities.

Our experience is that EPA often underestimates the cost of compliance and overestimates the benefits provided by proposed regulations. We solicited quotes for combustion devices prescribed to meet compliance with proposed EPA oil and gas methane regulations. A certified combustion device that will meet gas flow rate requirements and gas quality will cost owners/operators \$12,000 – \$22,000 to purchase and an additional \$8,000 to install, for a total installed cost of \$20,000 – \$30,000 per well. A conventional oil well in Kansas may cost \$300,000 to \$600,000 to drill and complete. Installation of a combustion system could add 5% to 10% to the total cost of the project.

In addition, proposed EPA requirements for LDAR emissions testing using EPA Method 21 or a forward looking infrared (FLIR) camera is cost prohibitive. Each FLIR camera could cost more than \$90,000 and requires training to properly operate the equipment. Utilizing EPA Method 21 requires each operator to pay an outside contractor to visit each location with monitoring equipment and produce a report of leaking components. In addition, Method 21 also requires each facility to have a drawing of each fugitive gas emission component, and have each component tagged and labeled on the drawing. Both options are very expensive for small operators with limited budgets. The additional compliance cost will eliminate projects from being implemented.

If the cost of compliance was only \$405 (as cited by the EPA), we would agree with EPA that the costs are not exorbitant; or “more than the industry can bear and survive”. We find that compliance costs will be considerably greater than the estimates that have been provided. We estimate that the compliance costs could exceed 15% of the capital cost to drill a well. These costs are significant and could drive many small operators out of business. We disagree with EPA’s assessment that the industry can bear the cost and survive.

Also, the EPA has said they want implementation of the new proposed oil and gas methane rule to be implemented by state agencies. However, many state agencies have commented to the EPA that implementation of such a rule would be enormously costly. The Kansas implementation agency said the cost to implement the proposed EPA oil and gas methane rule would be “enormous”. West Virginia stated in their comments that it would cost \$40 million annually and require the hiring of 373 additional full-time equivalent employees. These cost estimates far exceed the state agency’s entire budget.

Well-structured, cost-effective regulations are essential to manage methane emissions while assuring that American oil and natural gas producers can provide the energy demanded by the U.S. and world economies. At the same time, technology to manage emissions is evolving and the regulatory process needs the flexibility to allow energy innovators to utilize new technology. Rather than mandate a “one-size-fits-all” system of rules and regulations, the EPA and other federal regulatory agencies need to embrace evolving information and technologies to address issues surrounding the management of methane.

One key aspect of the independent component of the American oil and natural gas production industry is its breadth – spanning from large publicly traded companies to small business and from large, high production wells to marginal production wells. Of the roughly one million active oil and natural gas wells in the U.S., about 750,000 are low production wells. However, these low production oil wells produce about one million barrels/day and low production natural gas wells account for 8% to 10% of U.S. production. Yet, collectively, these wells only account for 1.2% of GHG inventory CO₂ equivalent emissions. The regulatory structure

to address methane emissions applied to low production wells is significant because their viability is dependent on their cost of operation.

An important point is that the EPA-proposed oil and gas methane rule is contrary to congressional intent as the *Inflation Reduction Act of 2022* (P.L. 117-169) exempted smaller wells from regulation. It appears the EPA is engaged in the practice of changing, altering, and amending laws after the fact. They say that their role and responsibility at the agency level is to improve upon a statute if they disagree with it. This creates a lot of regulatory uncertainty.

Congress needs to engage the EPA to ensure the agency develops a cost-effective regulatory program that encourages energy innovators to address methane and other issues. The 2022 DOE report presents information that can be a guide to cost effective management of methane. EPA should look for ways to provide flexibility in its regulatory regime and encourage innovation in addressing these important issues.

Endangered & Threatened Species

Ensuring the protection of species and their ecosystems is an important component of American oil and natural gas exploration. However, the Endangered Species Act (ESA) continues to be used by opponents of American energy production to stymie needed energy projects across the nation. Leadership is needed to ensure listing decisions under the ESA are done in an open and transparent manner and are designed to achieve a positive outcome that will ensure protection of species while at the same time allowing important energy projects to move forward.

Unfortunately, the ESA has evolved into a litigation tool used by some to advance an agenda that impedes American oil and natural gas production – destroying economic growth and job creation while diverting hundreds of millions of taxpayer dollars away from species recovery.

Despite the significant amount of taxpayer dollars spent in the name of the ESA, the law has failed at its underlining mission of recovering and delisting species. Less than **2%** of all listed species have been removed from ESA protection since 1973.

Independent oil and natural gas producers are good stewards of the land and are committed to protecting the environment. Energy production and species conservation can go hand in hand.

In Kansas, the U.S. Fish & Wildlife Service (USFWS) listed the lesser prairie chicken (LPC) as a “threatened” species effective March 27, 2023. For oil and gas operators, big or small, the ESA is becoming a huge problem. Operating or just living within the area of an endangered or

threatened species' habitat becomes hazardous because your operations may impact a protected animal that could result in enforcement actions that include criminal liability. You might conduct oil field or farming operations that create sounds that disturb lesser prairie chickens or engage in field operations too early in the morning. Nearly any activity that could disturb the animal and its habitat becomes a jurisdictional hurdle.



The best scientific and commercial information available demonstrates that the LPC does not meet the ESA's definitions of either a threatened or endangered species. None of the five factors utilized by the USFWS under the ESA to determine if a species is endangered or threatened are present in the case of the LPC in the northern distinct population segment. In short, there is no basis for action under the ESA and its implementing regulations. Through a combination of public and private efforts, the LPC is now better protected than at any previous time. A listing as threatened or endangered will not provide any additional conservation benefits above what already exists.

Energy Infrastructure

Expanding and modernizing America's energy infrastructure are critical components of continuing our increased production of oil and natural gas, increased reliance on natural gas for electricity generation and reduced greenhouse gas emissions. Groups opposed to fossil fuel production have seized upon opposition to infrastructure to stymie production. If natural gas can't be transported to markets, it won't be produced. The Federal Energy Regulatory Commission (FERC) remains the key regulator for approving interstate natural gas pipeline projects. Unfortunately, FERC has become increasingly polarized with the Democrats on the commission voting against projects not based on their merits, but to simply halt much needed natural gas projects. KIOGA urges Congress to conduct robust oversight of FERC and the entire federal system for approving natural gas pipelines to ensure the system is not used to stop needed infrastructure projects to placate environmental extremists.

Crude Oil Releases from the Strategic Petroleum Reserve

The Strategic Petroleum Reserve (SPR) is meant to protect Americans against emergency supply disruptions, not be a tool for politicians. KIOGA has long believed that the SPR should not be used to manipulate the crude oil market. The SPR is America's first line of defense against a

major disruption in domestic petroleum supplies. Releasing oil from the SPR is a short-term fix for prices at best. It not only reduces our capacity to protect ourselves in case of a true emergency, but also increases America's reliance on politically volatile countries around the globe.

Policy makers should oppose all non-emergency sales of oil from the SPR. Rather than looking for a quick fix, the Biden Administration should promote the production of oil and natural gas in the U.S. Exploring for more oil and natural gas at home will not only increase our nation's energy supply but will also create jobs and increase government revenues through taxes and federal royalties.

Access to Capital Markets

Over the past several years, there have been concerted efforts to use government actions to prevent investment in American oil and natural gas production and use. Some of these have surfaced in legislative actions such as those that were thwarted in the legislation to respond to the COVID pandemic, proposals that would have prevented oil and natural gas producers from accessing recovery funds designed to assist all Americans. Other efforts have been created in the Administration to use financial agencies, like the Treasury Department, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency and others, to develop regulations and policies designed to inhibit investment in the industry. These are attempts to use non-legislative ways to impose perceived climate costs and raise the price of energy. By employing environmental, social and governance (ESG) standards, some financial institutions and government agencies espouse policies prioritizing a focus on factors unrelated to a company's bottom line. ESG forces investors and company managers to view company operations through the eyes of a vocal set of stakeholders, for whom a company's climate reputation is of equal or greater importance than a company's financial performance. These actions need to be scrutinized and prevented.

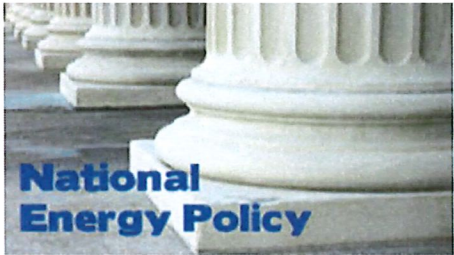
Labor Market Challenges



Labor is a critical issue for the Kansas oil and gas industry. Tight labor markets make it difficult to find qualified workers. Tight labor markets are caused by demographics (baby-boomer exits), overly heated economy (increased competition among employers), and friction within the labor market (time needed to develop new skills for new processes).

The oil and gas industry has lived through several ugly downturns before, and we know that patience, persistence, insight, and innovation pay off. We move forward together in 2023 to focus on value reconstruction and prepare for brighter days ahead.

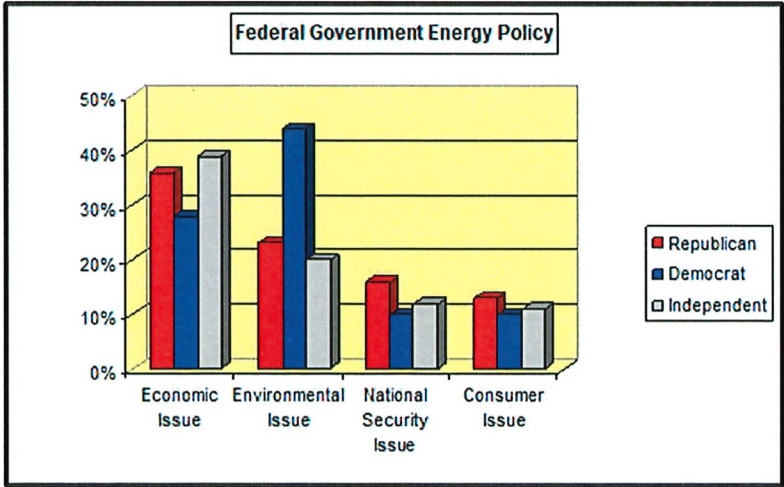
Energy Policy



One area where Republicans and Democrats can work to find a compromise is around energy policy. During times of economic recession and recovery, the public’s priorities revolve around improving the economy. This extends to energy legislation. According to several recent public opinion reports, the public supports moving to renewable energy, but is concerned about the impact to the lives and finances of the American consumer. The U.S. public wants Congress to provide energy legislation that will help bolster the economy, protect the environment, and require very minimal personal sacrifice by the consumer.

While not all segments of the population are ready for a transition to renewable fuels to begin, it is clearly an expectation for the future. We expect the 118th Congress to propose energy initiatives that not only promote renewable energy but protect the economic benefits currently provided by fossil fuel industries.

Recent polling indicates the public primarily sees energy policy as an economic issue or environmental issue. The energy policy challenge for the 118th Congress will be to mediate these opposing viewpoints to create policy that is beneficial to the economy and the environment.



The federal government has a variety of issues to address, and for some energy policy is not a top priority in comparison to inflation, healthcare, reducing the deficit, improving education, and ensuring national security. However, for many, energy policy is a top priority issue that needs to be addressed.

The public is divided as to whether U.S. energy policy is an economic or environmental issue. Essentially, the public wants a strong economy while improving environmental standards.

The general public is supportive of policy initiatives that expand renewable energy sources, but they are not as supportive of penalizing the oil and natural gas industry. Less than half of the general public supports a tax on carbon emissions. While Democrats are largely supportive of taxing carbon emissions, Republicans are likely to oppose such initiatives. The public seems far more supportive of incentivizing companies to pursue renewable fuel sources rather than penalizing industries.

Many folks across the nation are not financially secure enough to deal with rising energy costs and unwilling to make significant changes to their lifestyle. Republicans and Democrats will need to work together to improve energy policy. This will be difficult due to the competing interests of industries and environmental organizations. Environmental organizations want policies that utilize the highest environmental standards and industry wants policy that has minimal impact to the economy. If energy legislation does not serve the best interest of the public, it offers no incentive for the public to make significant changes in their lifestyle.

Is energy policy that creates a compromise of all interested parties and public expectations better than no energy policy at all? That is a question the 118th Congress may have to answer. One thing is certain. The public places a high priority on energy policy and will continue to be dissatisfied with the direction of energy policy unless progress is made.

Just a few years ago, no one would have imagined the U.S. could increase production of oil and natural gas while cutting greenhouse gas emissions, which are now near 25-year lows. The oil and gas industry has proven that over the long-term, it is possible to lead in energy production and environmental stewardship.

By focusing on more efficient use of energy, it is possible to lower emissions without imposing a carbon tax or even more environmental restrictions. Energy policy that values innovation over regulation can turn energy policy challenges into great opportunities for economic growth and energy security. This approach is not just good business, it's good stewardship and a much better strategy for improving the quality of life for all.

Energy prices affect all corners of the economy, and keeping up with demand is essential for maintaining a high standard of living. Thankfully, that doesn't require abandoning efforts to

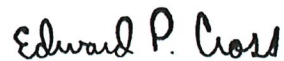
protect the environment, because newer technology is cleaner technology. The key is to avoid placing unnecessary political or legal obstacles in the way of innovation and expansion.

Conclusion

America's independent oil and natural gas producers stand at the forefront of energy use and development in the coming years. We look forward to working with you and your colleagues to develop innovative solutions to address America's energy challenges in the coming years.

For further information or any questions, please contact Edward Cross, President, Kansas Independent Oil & Gas Association, 800 SW Jackson Street, Suite 1400, Topeka, Kansas (785-232-7772; email: ed@kioga.org).

Sincerely,

Handwritten signature of Edward P. Cross in black ink.

Edward P. Cross, President

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2(a) Description of Current Tax Expenditure

Title of Tax Expenditure: Excess of percentage over cost depletion, fuels (oil and gas)

Estimated Cost (2018-2022): \$2.3 billion

Internal Revenue Code Section: Secs. 613 and 613A

Description of Current Law:

Depletion is available to any person having an economic interest in a producing oil and gas property. There are generally two types of depletion – cost and percentage depletion. Cost depletion is limited to the taxpayer's basis in the property, whereas percentage depletion is not limited by the basis but is subject to limitations on net income derived from the property and taxable income.

Percentage depletion for producing oil and gas property (15 percent rate) is available only to independent producers and royalty owners. Special rules apply to oil and gas production from marginal wells (generally, wells for which the average daily production is less than 15 barrels of oil or barrel-of-oil equivalents or that produce only heavy oil). In no event may the rate of percentage depletion exceed 25% for any taxable year.

Also, perhaps most notably, percentage depletion is limited the first 1,000 barrels of oil (or equivalent) of daily production, some many larger independents receive this tax treatment for only a small percentage of their production.

2(b) Description of Current Tax Expenditure

Title of Tax Expenditure: Expensing of exploration and development costs, fuels (oil and gas)

Estimated Cost (2017-2022): \$6.2 billion

Internal Revenue Code Section: Sec. 263(c)

Description of Current Law:

Federal law provides special rules for the treatment of intangible drilling and development costs (IDCs). Under these rules, an operator or working interest owner who pays or incurs IDCs in the development of an oil or gas property in the United States may elect either to expense or capitalize those costs. If an election to expense IDCs is made, the taxpayer deducts the amount of the IDCs as an expense in the taxable year the cost is paid or incurred. IDCs include all expenditures made by an operator for wages, fuel, repairs, hauling supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. The election to deduct IDCs applies only to those IDCs associated with domestic properties.

Reason to Keep Percentage Depletion and IDCs in the Tax Code:

Continued domestic exploration requires significant amounts of capital. In today's exploration/production industry, most capital for drilling is generated by independent producers internally. However, even in instances when outside investors are involved, these two tax provisions (percentage depletion and IDCs) are essential in attracting capital sufficient to maintain the pace and volume of drilling activity necessary to sustain current or increasing demand. Without these two tax provisions, neither large nor small domestic independents would generate the capital necessary for continuing to grow drilling and production activity. Estimates are that the repeal of IDCs and percentage depletion would decrease domestic drilling by at least 30 percent.

3. How does this Tax Expenditure Grow the Economy?

Domestic oil and natural gas drilling and production activities are major positive economic drivers in a struggling economy. U.S. independent oil and natural gas producers are primarily responsible for current domestic energy production, with its attendant economic, employment and national security benefits. More than 18,000 independent producers drill about 95% of US oil and natural gas wells and account for 67% of US oil and gas production.

Independents point to two primary factors that drive the domestic oil and natural gas industry:

- 1) Advancements in the science and technology of drilling and completing oil and gas wells and,
- 2) Availability of capital sufficient to finance the enterprise.

As mentioned earlier, without these two tax provisions (percentage depletion and IDCs), neither large nor small domestic independents would generate the capital necessary for continuing to grow drilling and production activity.

A recent study conducted by the Wood Mackenzie consulting firm found that if intangible drilling costs could no longer be expensed, an average of 225,000 jobs per year would be lost, of which an estimated 65,000 would be jobs in the oil and gas industry. The same study concluded that investment through the drilling and development of oil and gas resources would decline by \$407 billion over the period 2017 to 2026.

4. How does this Tax Expenditure Make the Tax Code Fairer?

Percentage Depletion

Percentage depletion provides capital to keep current marginal wells producing and capital to be reinvested in new oil and gas ventures in the United States. In addition, percentage depletion acts as a hedge that cushions small royalty owners against the time of ultimate recovery of all commercial oil and gas production. According to the National Association of Royalty Owners, the typical royalty owner in the U.S. is over 60 years of age, widowed, and receives less than \$500 in monthly royalties.

Intangible Drilling Costs

It takes several years and millions of dollars to drill the exploration and production wells that eventually extract oil/natural gas and generate revenue. Even in shale plays, there is no guarantee that a company will produce oil/gas when it drills exploration wells. Today's domestic E&P industry deals with both exploration risk (dry holes) and especially economic risk (completed, producing wells may never produce sufficient hydrocarbon value to return the initial investment costs). Allowing a current tax deduction for IDCs helps to alleviate the tremendous costs and risks involved in exploration, completion and production.

5. How do these Tax Provisions Help Other Important Federal Policy Objectives?

The idea of North American energy independence – a pipe dream as recently as the turn of the 21st Century – is no longer just a concept, but a tangible, achievable reality. America is no longer as reliant on unstable and/or unfriendly regimes for oil supply. The reality of decreasing reliance on certain OPEC nations for a majority of our crude oil supplies provides new options for the U.S. in foreign affairs and military planning and decision-making.

In addition, the availability and long-term reliability of reasonably priced energy (particularly domestically-produced natural gas) will continue to play a critical role in the resurrection of the U.S. manufacturing sector.

Finally and most importantly, oil and natural gas drilling activity by domestic independents and the oilfield service/support sector creates and sustains millions of U.S. jobs (estimated at 9.2 million by recent industry surveys). This job creation extends to manufacturers (steel mills in Ohio, pump makers in New Jersey, sand miners in Wisconsin) that provide technology, equipment and materials to this burgeoning industry.

6. Should this Tax Expenditure be Repealed or Reformed, and if so how?

No. Current law provisions for percentage depletion and expensing of intangible drilling costs should be retained, so that domestic, independent oil and gas producers and royalty owners are allowed to continue to deduct their ordinary business expenses, just as do other U.S. businesses and industries.

7. How does this Tax Expenditure benefit Kansans?

Kansas remains one of the major oil and natural gas producing states ranking 11th among 31 oil producing states and 14th among 32 natural gas producing states. Over 2,100 licensed oil and natural gas operators produce over 28 million barrels of oil and over 167 billion cubic feet of natural gas annually.

After many decades of productive stewardship, oil and natural gas resources continue to play an important part in the livelihoods of Kansans throughout the state. The Kansas oil and natural gas industry puts tens of thousands of people all across Kansas to work each day and pumps hundreds of millions of dollars into the state's economy each year; money that helps support families, fund schools, and build roads.

A recent University of Kansas study, the oil and natural gas industry in Kansas supports an average annual estimated 118,000 jobs, over \$3 billion in family income, and add over \$1.4 billion in state and local tax revenue. The average annual pay in the Kansas oil and natural gas industry is \$60,000. In areas where oil and natural gas are found, the industry represents a quarter of the jobs in some counties. High paying jobs are essential for economic development.

Mineral leases and royalty payments provide additional income to Kansas residents. According to the National Association of Royalty Owners, Kansas royalty owners received over \$258 million last year.



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Summary of Oil & Gas Tax Provisions

Repealing current oil and gas tax provisions would have an estimated \$4.3 billion negative impact on the Kansas economy within four years of enactment. The tax provisions are important to small, independent oil and gas producers and royalty owners – NOT “Big Oil.” Independents produce 92% of the oil and 63% of the natural gas in Kansas.

Most independents are small, privately-held companies, and they invest large sums of **personal money in personal risk**. In order to find more oil and natural gas, independents use their money and, to a lesser extent, raise capital from investors. **Percentage depletion**, which has been in the tax code since 1926, helps offset some of the high risks of exploration, and helps the “mom-and-pop” producers keep small (one to two barrels per day) wells active. There are already limits on percentage depletion which is 15% of gross oil and gas income as follows: (1) limited to first 1,000 barrels per day of production; (2) limited to the net income of a property for non-marginal properties (15 barrels per day or more); and (3) after the above limitation, the amount deducted for depletion cannot exceed 65% of the taxpayers income before the depletion deduction.

While percentage depletion applies to production, **intangible drilling costs (IDCs)** is the cost of drilling a well. This cost is paid to a drilling company that pays wages and buys goods and services. Once the well is drilled it has no value, because all you have is a hole in the ground. Currently, IDCs can be expensed in the year they are paid or incurred by independents. This allows companies to recover their costs quickly so they can drill more wells faster. This encourages more production of oil and gas in the U.S. Expensing of IDCs has been in the tax code since 1913.

Other important oil and gas tax provisions include:

(1) **passive loss exception for working interests in oil and gas properties** - Investors in drilling programs are called working interest owners and they must share in the costs of the risky venture. The tax code, in effect, allows working interest owners who have a loss to be classified as an active loss that could be used to offset any type of active income instead of being treated as a passive loss.

(2) **geological and geophysical (G&G) amortization** - G&G costs are incurred in the beginning of the exploration process, and are very expensive with no guarantee of recouping the costs if the venture fails. Like IDCs, the faster the independent can recapture his G&G costs the more wells he can drill and find more oil and gas. Currently, G&G costs must be amortized over two years for independents and seven years for major oil companies, but the change would increase amortization to seven years for everyone. Again, it is the independent that gets hurt.

Every change negatively impacts small independents, not Big Oil, and decrease drilling and production of oil and natural gas in Kansas and in the nation. If percentage depletion and IDC tax provisions were taken away, the drilling rig count would decline to its lowest level in history within 12 months (488 rigs running nationwide in March 1999 when oil was \$6 per barrel). Oil and gas production would drop and the state of Kansas would lose approximately \$140 million in state taxes over four years.



Economic Impact of Independent Oil & Gas Industry to Kansas and the Nation

Kansas

- Kansas Oil & Gas Industry is a \$3.6 billion industry
- Employs annual average of 13,800 employees paid \$814 million
 - Average salary of nearly \$60,000 per year
- In areas where oil and natural gas are found (rural Kansas), the industry represents a quarter of the jobs in some counties and 60% - 70% of the property tax.
- Add in indirect oil and gas industry service sector jobs and the number of jobs grows to 28,000 with payroll of \$1.4 billion and state and local taxes of \$403 million.
- Throw in every Kansas job touched by the oil and gas industry, such as refinery workers, fuel haulers, etc. and the number of employees swell to 118,000, payroll to \$3 billion and taxes to \$1.4 billion.
- Eliminate percentage depletion and intangible drilling costs (IDCs) would strip essential capital from independent oil and natural gas producers. Small independent producers (who drill 94% of the wells in the U.S.) generate their capital through their production, not by tapping equity markets or other corporate measures. In Kansas, small independent oil and natural gas producers produce 92% of the oil and 63% of the natural gas. **Eliminating percentage depletion and IDCs would result in an estimated direct loss to Kansas of over \$140 million annually of investment capital, an estimated loss of over 4,000 jobs, and an estimated \$4.3 billion negative impact on the Kansas economy within four years of enactment.**

National

- Small independent oil and gas producers support nearly 4 million jobs and contributes \$579 billion to U.S. GDP.
- Independent's employees pay \$30.7 billion in income taxes (federal & state), sales tax, and excise taxes.
- The entire direct/indirect/induced economics of small independent producers generated nearly \$190 billion of federal and state taxes in 2019.
- Every \$1 million of capital expenditures (capex) for independents result in \$1.1 million of total taxes generated by independents.
- Every \$1 million of capex invested by independents results in 6 direct and 33 total jobs.
- Every \$1 million of capex for independents results in \$2.4 million of direct and \$5.1 million of overall contribution to GDP.

For questions or more information, please contact KIOGA at 785-232-7772 or visit www.kioga.org

Comparison Of Tax Provision For Majors and Independents

Tax Provision	Major Integrated Company	Independent producer
Expensing of intangible drilling costs	Able to expense 70% of U.S. drilling costs and capitalize 30% over 5 years. Majors raise much of their drilling capital internally.	Able to expense drilling costs in the year incurred. Important to smaller companies that have to drill with personal money, because the quicker costs recouped the more wells they can drill.
Percentage depletion	Has not been available to majors for more than 44 years.	Helps small producers keep marginal wells (15 barrels or less per day) producing. Percentage depletion is limited to 15% of gross oil and gas income. Also limited to first 1,000 b/d. Limited to net income from marginal properties. Amount deducted for depletion cannot exceed 65% of taxpayers income before the deduction.
Repeal of passive loss exception for working interests	Does not apply.	Working interest owners are investors who share the costs in drilling and production. Current tax law allows WI owners to be classified as an active, rather than passive, investor if they do not have limited liability.
Geological and geophysical costs	Majors must amortize costs over 7 years.	Independents currently must amortize G & G costs over 2 year period. The economic life of a property for independent is considerably less than 7 years, which is the new proposal.
Marginal well tax credit	Never been in effect because prices have never reached the trigger point since enacted.	Never been in effect because prices have never reached the trigger point since enacted.
Enhanced Oil Recovery (EOR) tax credit	Available to majors, but has been rarely used.	Available to independents, but not many have decided to apply for the credit because of bureaucratic red tape and the costs to implement.
Manufacturing tax deduction	Designed to encourage creation of jobs in U.S. rather than taking employees overseas.	This is a current benefit to independents but it is insignificant.
Excise tax on Gulf of Mexico production.	Majors are still active in the Gulf of Mexico somewhat, but most are pulling out.	Independents are drilling most of the new wells in the Gulf today. They would be hit hardest by a new tax.

Key points to remember: Independents raise capital from U.S. sources – most of it personal – while majority of majors’ income comes from foreign sources.

Independents drill 95% of the wells in the U.S. Proposed tax changes would drive most small independents out of business, because they would not be able to raise capital for new ventures. Dry hole costs must be deductible. If not, no one will risk drilling dry holes looking for new production.

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DOE Report Points Toward Potential Paths to Manage Low Production Oil and Natural Gas Well Methane Emissions

The recently released Department of Energy Report, [Quantification of Methane Emissions from Marginal \(low Production Rate\) Wells](#), presents information that can be a guide to cost effective management of methane emissions from these facilities. The Report points to the nature and sources of emissions at marginal well facilities. Knowing these facts can be used to develop a targeted, more cost-effective approach to managing these emissions.

Key Points from DOE Marginal Well Emissions Report

- Marginal – or low production – oil and natural gas wells are defined as wells producing ≤ 15 barrels/day of oil (≤ 90 mcf/d of natural gas). There are 783,000 marginal oil and natural gas wells in the U.S. – 79% of all U.S. oil and natural gas wells. They account for 7%-9% of U.S. production. For oil production, marginal wells account for about 900,000 barrels/day – roughly equivalent to the amount of daily releases from the Strategic Petroleum Reserve managed by the Biden Administration to influence the oil marketplace.
- Marginal well emissions occur at the wellhead (the actual point of production), separators (where oil, gas and water are separated), and tanks (where oil, natural gas liquids and water are stored). No emissions were detected at 55-65% of sites. Ninety percent of observed emissions were less than 2.4 tons/year.
- The top 10% of emitting sites accounted for 90% of emissions. The predominant sources of routine emissions occurred at tanks and separators. Large wellhead site emissions were related to non-routine events like damaged facilities, equipment failures or operational events.
- The DOE Report concludes that the 783,000 marginal wells collectively account for approximately 50% of oil and natural gas production methane emissions – about 1.0 million tons/year of the total production emissions of about 2.06 million tons/year. This estimate is well below the inflated 4.0 million tons/year methane emissions for marginal wells by environmental lobbyists like the Environmental Defense Fund.
- While the definition of marginal (low production) wells is ≤ 15 boe/day, 83% of marginal wells produce ≤ 6 boe/day. In its November 2021 regulatory initiative, EPA proposes that well sites emitting 3 tons/year or less should be subjected to a different, less intense Leak Detection and Repair (LDAR) requirement. The Report shows that marginal well sites with production less than 6 boe/day clearly fall below the 3 tons/year threshold and smaller sites (those with ≤ 5 pieces of equipment) and 6-15 boe/day of production do as well.
- LDAR programs are predicated on the concept that leaks must be found and then repaired. The Report demonstrates that the emissions locations at low production well sites are predictable – tanks, separators and improperly maintained well head equipment.
- The Report provides a perspective for an effective low production well leak management program that is far less costly than the expensive optical gas imaging (OGI) programs that are currently required by EPA.
 - Routine AVO (Audio-Visual-Olfactory) inspections of tanks to eliminate open thief hatches and deteriorated seals and of separators to assure proper operation for control valves.
 - Routine AVO inspection of wellheads to assure proper operation of equipment and valves.
 - Periodic simple testing like soap bubbles to check of leaks.
 - Use of production rates and equipment counts to determine that applicability of the program rather than costly emissions calculations that are not currently done for low production wells.