USA Federal Budget 2014 – President's Proposal

What it would mean for the Oil & Gas Industry?

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The USA Federal Budget – President's proposal - documents released on April 10th, identify a number of measures that, if authorized by Congress, will impact the oil and gas sector beginning in 2014.

Federal oil and gas management reforms include a package of legislative reforms to bolster and backstop administrative actions being taken to reform the management of the Department of Interior's (DOI's) onshore and offshore oil and gas programs, with a key focus on **improving the return to taxpayers.**

Proposed statutory and administrative changes fall into three general categories:

(1) advancing royalty reforms;
(2) encouraging diligent development of oil and gas leases; and,
(3) improving revenue collection processes.

(1) Royalty reforms include:
- (a) establishing minimum royalty rates for oil, gas, and similar products;
- (b) increasing the standard onshore oil and gas royalty rate;
- (c) piloting a price-based sliding scale royalty rate; and,
- (d) repealing legislatively mandated royalty relief for "deep gas" wells.

(2) Diligent development requirements include:
- (a) shorter primary lease terms;
- (b) stricter enforcement of lease terms; and,
- (c) monetary incentives to move leases into production (e.g., a new statutory per-acre fee on nonproducing leases).

(3) Revenue collection improvements include:
- (a) simplification of the royalty valuation process;
- (b) elimination of interest accruals on company overpayments of royalties; and,
- (c) permanent repeal of DOI's authority to accept in-kind royalty payments.

The budget documents identify a number of corporate income tax related reforms.

Geological & Geophysical Expenditures: The two-year amortization of *independent* producers' geological and geophysical expenditures will be repealed. These expenditures will instead be amortized over the same seven-year period as for *integrated* oil and gas producers.

Exploration and development costs: Under the baseline tax system, the costs of exploring and developing
oil and gas wells would be capitalized and then amortized (or depreciated) over an estimate of the economic
life of the well. This insures that the net income from the well is measured appropriately each year. In contrast to this treatment, current law allows *intangible* drilling costs for

successful investments in domestic oil and gas wells (such as wages, the cost of using machinery for grading and drilling, and the cost of unsalvageable materials used in constructing wells) to be deducted immediately, i.e., expensed. Because it allows recovery of costs sooner, expensing is more generous for the taxpayer than would be amortization. Integrated oil companies may deduct only 70 percent of such costs and must amortize the remaining 30 percent over five years.

Percentage depletion: The baseline tax system would allow recovery of the costs of developing certain oil and mineral properties using cost depletion. Cost depletion is similar in concept to depreciation, in that the costs of developing or acquiring the asset are capitalized and then gradually reduced over an estimate of the asset's productive life, as is appropriate for measuring net income. In contrast, the Tax Code generally allows independent fuel and mineral producers and royalty owners to take percentage depletion deductions rather than cost depletion on limited quantities of output. Under percentage depletion, taxpayers deduct a percentage of gross income from mineral production. In certain cases the deduction is limited to a fraction of the asset's net income. Over the life of an investment, percentage depletion deductions can exceed the cost of the investment. Consequently, percentage depletion offers more generous tax treatment than would cost depletion, which would limit deductions to an investment's cost.
Eliminate fossil fuel tax preference: Current law provides a number of credits and deductions that are targeted towards certain oil, gas, and coal activities. In accordance with the President's agreement at the G-20 Summit in Pittsburgh to phase out subsidies for fossil fuels so that the Nation can transition to a 21st century energy economy, the Administration proposes to repeal a number of tax preferences available for fossil fuels.

The following tax preferences available for oil and gas activities are proposed to be repealed beginning in 2014:

(1) the enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project;
(2) the credit for oil and gas produced from marginal wells;
(3) the expensing of intangible drilling costs (already noted above);
(4) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method;
(5) the exception to passive loss limitations provided to working interests in oil and natural gas properties;
(6) the use of percentage depletion with respect to oil and gas wells (already noted above); and,
(7) the ability to claim the domestic production manufacturing deduction against income derived from the production of oil and gas.

The Budget also identifies measures related to increased inspections, USA-Mexico cooperation, h*azardous substances, and Carbon capture.*

Increased Inspections - Bureau of Land Management (BLM) - Public lands oil and gas lease inspection fees: The Budget proposes new inspection fees for oil and gas facilities that are subject to inspection by BLM. The fees would be based on the number of oil and gas wells per facility, providing for costs to be shared equitably across the industry.

According to agency data, BLM currently spends more than $40 million on managing the compliance inspection program. Inspection costs include, among other things, the salaries and travel expenses of inspectors. In 2014, the Budget proposes a $10 million increase in funding to strengthen the BLM inspections and enforcement program, with these costs to be offset by higher fees on industry users.

In addition, in 2014, the Budget proposes to charge industry users fees to offset $38 million in existing inspection and enforcement program costs, resulting in a $38 million reduction in general fund appropriations for BLM. The proposed fees will generate approximately $48 million in 2014, thereby requiring energy developers on Federal lands to fund the majority of compliance costs incurred by BLM.

USA-Mexico Cooperation - Implement U.S.-Mexico Agreement on Transboundary Hydrocarbon Reservoirs: The Budget proposes to authorize the United States to undertake activities to implement the Agreement between the United States of America and the United Mexican States Concerning Transboundary Hydrocarbon Reservoirs in the Gulf of Mexico (Agreement), signed by representatives of the United States and Mexico on February 20, 2012. Implementing the Agreement would establish a framework for the cooperative exploration and development of hydrocarbon resources that cross the United States-Mexico maritime boundary in the Gulf of Mexico. The proposal would also end the moratorium on development along the boundary in the Western Gap. It would make an area along the U.S.-Mexico boundary in the Gulf of Mexico that is roughly the size of Delaware more accessible for oil and gas exploration and production activities. That area is estimated to contain up to 172 million barrels of oil and 304 billion cubic feet of natural gas. Making these resources accessible is expected to increase receipts from upcoming lease sales in 2014.

Increase Oil Spill Liability Trust Fund financing rate by one cent and update the law to include other sources of crudes: An excise tax is imposed on: (1) **crude oil received at a U.S. refinery**; (2) imported petroleum products entered into the United States for consumption, use, or warehousing; and (3) any domestically produced crude oil that is used (other than on the premises where produced for extracting oil or natural gas) in or exported from the United States if, before such use or exportation, no taxes were imposed on the crude oil.

Under current law, the tax does not apply to crudes such as those produced from bituminous deposits as well as kerogen-rich rock. The tax is deposited in the Oil Spill Liability Trust Fund. Amounts in the trust fund are used for several purposes, including the payment of costs associated with responding to and removing oil spills.

The tax imposed on crude oil and imported petroleum products is eight cents per barrel, effective for periods after December 31, 2008, and before January 1, 2017, and nine cents per barrel, effective for periods after December 31, 2016. The Administration proposes to increase these taxes by one cent per barrel, to nine cents per barrel for periods after December 31, 2013, and to 10 cents per barrel for periods after December 31, 2016. In addition, the Administration proposes to update the law to include other sources of crudes such as those produced from bituminous deposits as well as kerogen-rich rock. The tax would cover, at the applicable rate, other sources of crudes received at a U.S. refinery, entered into the United State, or used or exported as described above after December 31, 2013.

Hazardous Substance Superfund - Reinstate Superfund taxes: The Administration proposes to reinstate the taxes that were deposited in the Hazardous Substance Superfund prior to their expiration on December 31, 1995. These taxes, which contributed to financing the cleanup of the nation's highest risk hazardous waste sites, are proposed to be reinstated for periods (excise taxes) or tax years (income tax) beginning after 2013, with expiration for periods and tax years after 2023.

The proposed taxes include the following: (1) an excise tax of 9.7 cents per barrel on crude oil and imported petroleum products; (2) an excise tax on specified hazardous chemicals at rates that vary from 22 cents to $4.87 per ton; (3) an excise tax on imported substances that use the specified hazardous chemicals as a feedstock (in an amount equivalent to the tax that would have been imposed on domestic production of the chemicals); and (4) a corporate environmental income tax imposed at a rate of 0.12 percent on the amount by which the modified AMT income of a corporation exceeds $2 million. Consistent with the Administration's proposal regarding taxes deposited in the Oil Spill Liability Trust Fund, the Superfund excise tax on crude oil and petroleum products would cover other sources of crudes such as those produced from **bituminous deposits** as well as kerogen-rich rock.

Carbon Capture - Industrial CO2 capture and sequestration tax credit: The baseline tax system would uniformly tax all returns to investments and not allow credits for particular activities, investments, or industries. In contrast, the Tax Code allows a credit of $20 per metric ton for qualified carbon dioxide captured at a qualified facility and disposed of in secure geological storage. In addition, the provision allows a credit of $10 per metric ton of qualified carbon dioxide that is captured at a qualified facility and as a tertiary injectant in a qualified enhanced oil or natural gas recovery project. While these credits would be eliminated, others would be provided under advanced energy and manufacturing.

Advanced Energy & Manufacturing - Provide additional tax credits for investment in qualified property used in a qualified advanced energy manufacturing project: ARRA – American Recovery and Reinvestment Act - provided a 30-percent credit for investment in eligible property used in a qualified advanced energy manufacturing project. A qualified advanced energy manufacturing project reequips, expands, or establishes a manufacturing facility for the production of: (1) property designed to be used to produce energy from the sun, wind, geothermal deposits, or other renewable resources; (2) fuel cells, microturbines, or an energy storage system for use with electric or hybrid-electric motor vehicles; (3) electric grids to support the transmission of intermittent sources of renewable energy, including the storage of such energy; (4) property designed to capture and sequester carbon dioxide; (5) property designed to refine or blend renewable fuels (excluding fossil fuels) or to produce energy conservation technologies; (6) new qualified plug-in electric drive motor vehicles or components that are designed specifically for use with such vehicles; or (7) other advanced energy property designed to reduce greenhouse gas emissions as may be determined by the Department of the Treasury. Eligible property must be depreciable (or amortizable) property used in a qualified advanced energy project and does not include property designed to manufacture equipment for use in the refining or blending of any transportation fuel other than renewable fuels. The credit is available only for projects certified by the Department of the Treasury (in consultation with the Department of Energy); the total amount of credits certified may not exceed $2.3 billion. The Administration proposes to provide an additional $2.5 billion in credits, thereby increasing the amount of credits certified by the Department of the Treasury to $4.8 billion.