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Obama Budget Proposal Could Squeeze Small Energy Producers

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A U.S. budget proposal repealing long-standing tax breaks for oil and natural-gas companies is troubling small producers who fear that key investment sources may dry up.

In late February, the Obama administration proposed a new 2010 budget that would eliminate tax breaks on intangible drilling costs such as fuel, labor and repair costs, which help attract capital to high-risk oil and gas drilling. Removing these incentives would bring the U.S. Treasury at least \$31.5 billion in extra revenue, but could thin the ranks of small, independent energy producers and stymie drilling activity.

"I think the administration was trying to aim their shot at Big Oil but what they did was hit independents right between the eyes," said Mike Terry, president of the Oklahoma Independent Petroleum Association, adding that the proposal could force some small independents out of business.

The OIPA membership is made up of mostly small oil and gas companies but includes larger independents such as Chesapeake Energy Corp. and Devon Energy Corp.

Firms like these, which account for most of the oil and gas output in the U.S., are already pinched by tight credit markets and low commodity prices. Natural gas prices have fallen to their lowest in more than six years, with the front-month contract on the New York Mercantile Exchange falling more than 70% since peaking in July at \$13.694 a million British thermal units. The price of oil has dropped about 68% since hitting an all-time high above \$145 a barrel last summer.

Drilling activity has plunged in response to lower prices. The number of rigs exploring for oil and natural gas in the U.S. has declined by 45% since peaking in September at 2,031 rigs.

Erasing tax breaks could make an eventual return to oil and gas fields more difficult, perhaps threatening a spike in energy prices when the economy comes back, said Dave Pursell, an energy analyst with Houston-based Tudor, Pickering, Holt & Co. Securities.

"If the economics of a well are impacted by a regulatory tax change, higher commodity prices are needed to offset that change," Pursell said.

Pinched Producers

Independent energy companies explore for and produce oil and gas, but don't own refining or retail operations. These firms, often small, drill 90% of U.S. oil and gas

wells, and account for nearly two-thirds of domestic oil and 82% of domestic natural-gas supplies.

Small privately held independents can't access credit as easily as larger, publicly traded companies and often rely on each other or individual investors to finance the cost of multi-million-dollar wells. For these firms, new taxes would compound the problem of low energy prices.

Bob Sullivan, owner of the Tulsa, Okla.-based independent oil and gas producer Sullivan and Co., said the company drilled 36 wells last year and has no plans to drill in 2009 because of the decline in commodity prices.

Still, Sullivan, a former secretary of energy for Oklahoma, made a recent trip to Washington, D.C., to meet with democratic lawmakers and to protest the budget proposal.

"In order to ramp up production, we need to take the risk," Sullivan said, adding that if the budget proposal passes the energy industry will not be as aggressive in finding new reserves.

Jeffrey McDougall, owner of Oklahoma City-based JMA Energy Co., said his company has cut drilling because of lower commodity prices but the proposed change could reduce his company's output.

"It is a survival decision to slow down. It is an economic decision to start back up," he said.

Bigger independents also see the tax-break repeal as a major problem.

Devon, the nation's largest U.S. independent oil and gas producer, said repealing the tax breaks would ultimately lead to less supply across the energy industry.

"A consequence of reduced drilling is lower production," Chip Minty, a Devon spokesman, said.

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