Energy Tax Summit
Discussion highlights
Regulatory decisions made by state and federal governments will play a major role in determining just how far the US can go in reaching energy independence and in meeting current and future energy needs. To help clients better understand trends in energy taxation and regulation, Ernst & Young LLP hosted the first Energy Tax Summit for senior leaders in oil and gas and power and utility companies. Industry leaders discussed how best to balance growth and taxes, with attendees sharing their own insights.

Background
The rapid growth of unconventional energy sources – made possible by technology – has the potential to transform the US into a net energy exporter in the coming years. As energy companies unlock previously unrecoverable domestic reserves of oil and natural gas, governments are responding in a variety of ways to what was unthinkable just a short time ago – a US energy boom.

The industry is positioning itself for continued domestic growth and the eventual exporting of North American production. Will governments provide an effective energy policy framework that makes that level of growth possible? Decisions made in 2013 will likely provide clues for the energy industry’s strategic approach over the next decade or more. The panelists and speakers at Ernst & Young LLP’s “Taxes and Energy Industry: A Look Ahead” seminar, held in Washington, DC, in December 2012, shared their unique perspectives on what the industry can expect in the months ahead.
The convergence of tax and energy policies – what is the best approach?

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Panelists:
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President

“Right now, it is important to focus on energy security ... for the US to take advantage of our own resources. We can do this by investing in labor, manufacturing and infrastructure, all of which benefit the US in the short and long term and enable more security of supply.”

The future of the domestic energy industry boils down to a simple question: Will politics or technology prevail? Will the industry be allowed to pursue domestic reserves using hydraulic fracturing and related technologies – and deliver economic development and jobs growth – or will the need for tax revenues and government control curtail production?

At the federal level, there has been little recent movement on energy issues. Although energy was discussed in the 2012 presidential campaign more than in past years, Congress has little incentive to enact energy-related legislation at this point. “Members of Congress are focused on re-election and not on complex bills,” one panelist said. “Most members of Congress have minimal, if any, knowledge or understanding of energy issues. They are basically polarized along party lines.”

That’s why the speakers from Ernst & Young and the energy industry felt that cap and trade is a non-issue.

“Cap and trade is dead,” said a panelist. “This Congress can’t agree on anything, so it’s likely that nothing will happen. The only possibility is a revival of the carbon tax idea, which could be used as a way to further regulate the industry and raise revenue.”

At the state level, however, the situation is vastly different.

“The states have been aggressive on shale development because it directly benefits their local economies and provides job growth,” a panelist said. “Pennsylvania is a prime example of a state that is being very thoughtful about the opportunities presented by shale. Leadership is enacting legislation that allows development, while ensuring safety of resources and people. With the right mix of technology and politics, we can achieve energy independence.”

“The energy industry and state governments are working together well and being very responsible about ethically developing shale resources. They want to ensure its long-term viability.”

The initial rapid progression of shale development was possible because the resources were on private lands and the industry worked directly with state regulators to identify rules in a commonsense manner. Most state regulations to date are balanced between issues of environmental/worker safety and economic viability.

“The last thing anyone wants is a major incident, which would halt development across the country,” said one panelist. The current approach also minimizes the influence of the EPA, which to date has not been involved in developing nationwide rules around hydraulic fracturing.

“Most states are opting for a ‘fragile balance’ in wanting to increase revenue without driving away energy development.”

Even in non-traditional producing areas, most state government officials understand the economic value of shale development and are hesitant to limit growth through excessive taxation. “Even progressive governors have held back from taxing shale development because they want to encourage the energy companies to do business in their state as opposed to taking their business elsewhere,” one panelist said. “Those who are looking for direct revenue are considering charging ‘impact fees’ as opposed to outright taxes on production. It’s a balancing act.”

Another factor behind the rapid growth of shale is the shared revenue from production. “Shale plays are very popular because there is money for everyone,” said a panelist. “Once the royalty checks start arriving to build parks and other communal areas for states and cities, and people see the economic boom that benefits everyone, then support for development goes way up.”
“Both the Obama Administration and Congress agree on the need for tax reform ... but they have different goals and areas of focus.”

As 2013 begins, there is clear agreement that the deficit must be addressed and that taxes require a new approach, but Congress is divided on the specifics. What isn’t clear, however, is the best approach for doing so. A range of issues are driving the debate in Washington, DC:

- Large deficits and rising debt
- International competitiveness
- Major but temporary components of the tax code
- Tax complexity

There are three main areas available for tax reform – corporate, international and individual taxes. Republicans and Democrats differ substantially on how they should be handled.

The Administration has said it wants to cut the corporate tax rate to 28%, implement a number of incentives for manufacturers, modify international taxes and simplify the tax code for small businesses. “That plan is revenue neutral,” said a panelist, “but $250 billion is needed to make permanent the temporary provisions included in the tax code.”

To help pay for these revisions, the Administration is looking for additional revenues from the energy industry, primarily by:

- Eliminating the expensing of intangible drilling costs
- Eliminating percentage depletion for oil and natural gas
- Eliminating percentage depletion for hard mineral fossil fuels
- Increasing the geological and geophysical amortization period for independent producers to seven years
- Repealing capital gains treatment for royalties

The cancellation of these incentives is expected to reduce the deficit by $41 billion over the next 10 years. But it would also, of course, have a direct impact on the oil and gas industry, especially the repeal of expensing intangible drilling and development costs, the panel said.

There are possible indirect impacts, too, such as the reinstatement of Superfund taxes, repeal of the “last in, first out” (LIFO) treatment and modification of rules for dual capacity taxpayers. “The repeal of LIFO could greatly impact the downstream segment,” one speaker said.

The panel recommended that energy companies get involved by determining how these proposals would impact their individual businesses and communicating those impacts to Congress.

“The lines are being drawn, but there’s still opportunity to engage,” one speaker said.
“State governments have experienced a slow recovery from the recession. At the same time, costs have remained low, and revenues are rebounding due to a variety of factors, including higher tax rates and, in some cases, reduced tax rates that have attracted new corporate revenue.”

Any federal tax reform will have an impact on state taxes, in part because many states use the standards for federal taxable income as a starting point for their own state income taxes. Today, many states are considering proposals to broaden their tax base while implementing simultaneous rate reductions.

The last time this occurred on a large scale, in 1986, many states wound up with revenue windfalls. “Companies would be wise to pay attention to federal base broadening proposals and work with the states where they do business to modify state tax rates,” said one panelist.

Trends under way at the state level include adopting economic nexus standards, moving away from cost of performance to market-based sourcing, adopting ultimate destination rules, and using tangible property regulations.

These changes raise a number of concerns. For example, energy trading activities such as hedging, book-outs and other financial transactions raise nexus and apportionment concerns, and different states are developing different standards. Several states across the country are moving to revise manufacturing and mining exemptions from sales and use taxes, as well.
Discussion highlights

Power and utilities – tangible property regulations update

Speakers:

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National Tax Department

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Executive Director  
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“The IRS anticipates that final regulations surrounding tangible property will be published sometime in 2013 and will apply to taxable years beginning on or after January 1, 2014. It is important to note there will be no further extension of these rules.”

The changes to tangible property rules – overseeing materials and supplies, acquisitions, improvements, and depreciation and dispositions – will amend existing temporary regulations and will include procedures for obtaining automatic consent to change a method of accounting.

Among the changes included will be new rules for compliance with Section 263A, also called UNICAP. These revisions will impact:

• Improvements and other self-constructed property – improvements will include capitalized repairs.
• The allocation of costs in addition to invoice price, including the allocable portion of the department that negotiates prices and supervises work performed, as well as the allocable portion of support departments such as payroll or HR.
• Inventory – companies may be able to eligible to file under automatic procedures, but for now scope is not waived.

“These changes will require utilities to develop a thorough implementation plan, which should begin with an assessment of the company’s current state of accounting methods and elections as well as the systems and processes that support them,” one panelist said.

Following that assessment, the company should develop a full understanding of new regulations, how those rules will impact federal and state taxes, prioritize issues and develop solutions, and ensure there are proper resources for implementation.

The group agreed that the IRS/Treasury would soon release guidance impacting power generation assets, defining the unit of property and perhaps a “safe harbor” for repair versus capital. It is likely the “unit of property” definition will follow the example that is included in the temporary regulations. The group also believes the “unit of property” will be more granular than that used by many of the participants in the breakout session who had done studies on their power generation facilities in the past. Accordingly, adoption of the new guidance may give rise to mixed results for the group.
Oil and gas – global hot spots

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“Dollars are mobile, and we need to look for investments that are safe but which allow us to be competitive.”

The global search for oil and gas reserves never stops, and several hot spots around the world are garnering increased attention from exploration and production (E&P) companies. In South America, Brazil has very attractive reserves and a market that has recently become more open to foreign investment – but royalties and development contracts, both at the state and national level, can impact profitablity.

“One presenter said. “There are too many opportunities to overlook the market entirely, but there are also a lot of risks – litigation, more taxing jurisdictions than many other locales, and lots of regulation.”

The key to success in Brazil, the panelists agreed, was for companies to take a long-term approach and work hard to understand the legal and financial particulars of the market. Local content is also critical, especially labor and manufacturing, and companies must strive for a balance between hiring local employees and vendors and external companies that have extensive global industry experience.

One panelist said that Brazil’s highly controlled energy business offers a cautionary tale to US regulators.

“The US should use Brazil as an example of how not to regulate and decrease economic opportunities. Consider the lessons learned and what can happen to overall investment when you try to control the industry.”

Other burgeoning hot spots include Canada – which is opening up after many years of resisting foreign investment in hopes of boosting employment and increasing government revenues – and Angola and Kurdistan. But some of these markets have risks, the panelists said.

“On a cash-adjusted basis, you make a lot less revenue in the US than almost any other jurisdiction, but there are a lot more risks to manage in some of these countries,” a panelist said. “In some countries, the government doesn’t even know the rules. But these new frontiers offer a lot of opportunities and strong levels of return, and they can help balance out a company’s reserve portfolio, especially those that are heavily invested in countries with stable, predictable revenue flow. Putting a 10% to 30% portion of their investment capital in emerging energy markets can pay off for E&P companies looking for large returns.”
“Oil and gas companies need to be aware of three major areas of change for 2013 and beyond – the FASB lease project, the FASB revenue project and accounting for income taxes.”

The FASB board issued a joint executive directive (ED) with the IASB in 2010 to ensure that lease contracts were recorded on balance sheets. Because of significant changes to the proposed model, the boards decided to re-expose the rule, and a second ED is expected in the first quarter of 2013. The new rule is expected to impact the leasing of items such as drilling rigs, rights-of-way, storage tanks, pipelines and gathering systems.

The proposal contains a different lease classification model than current standards. Lessees and lessors would distinguish between two types of leases based primarily on the nature of the underlying asset being leased, and the classification would be used to determine the method of recognizing lease revenue and expense.

The final standard of the revenue recognition project is expected in the first half of 2013. Its guiding principle is to ensure that companies recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Contracts with customers and the sale of some nonfinancial assets that are not an output of the company’s ordinary activities (for example, the sale of property, plant and equipment or intangibles) are within the scope of the change. The new standard will also impact accounting for imbalances, take or pay contracts, and natural gas liquids processing agreements, but it should not create any changes to production sharing contracts, production payments or buy/sell arrangements.

Congress may also take up income tax reform in 2013. “Companies should monitor the status of legislative action but only account for the final legislation, if and when enacted,” one speaker said.
Electric and gas utilities currently have in excess of $2.9 billion in requested rate increases, with a return on equity range of 9.8% to 10.8%. If we apply the achieved rate increase from 2010 to 2012 of 49% of the amount requested, these entities will receive $1.4 billion of the requested amount.

The number of rates cases has increased in recent years, with 59 filed in 2011 compared with just 22 in 1997, and 78 filed or pending in 2012 through late November. But as the number of cases has increased, the return on equity has fallen for both electric and gas utilities.

In this regulatory environment, utilities must take into account a number of considerations for tax planning – including the treatment of temporary/timing differences other than accelerated depreciation including bonus depreciation - that require normalization accounting in setting rates. Accounting issues include mixed service costs, repair vs. capitalization, and the capitalization of research and development expenditures. Rate regulators may look to flow through the benefits of these latter tax deductions that can give the utility an earnings benefit but increase the risk of recovery if tax deductions are later denied.

Tax planning must also include a recognition of utility-owned assets not included in the rate base, such as land or idle plants; how the gain or loss from a sale will be treated for rate-making purposes; and the consolidated tax savings adjustments available via affiliates and state and local taxes.

“Today, 30 states have some form of renewable energy portfolio standards.”

These standards require a number of tax-planning initiatives. Does the utility own its renewable energy generation, or does it buy renewable energy? Is renewable energy in or out of the rate base? Does the utility receive investment tax credits, which are required to be normalized, or Treasury grants, which are not?
"With the pending sunset of renewable energy tax credit incentives for wind energy and lapsing of the Treasury grant program, renewable energy development is looking to drop significantly in the coming year. Developers will be looking to the renewable portfolio standards imposed in over 30 states as a means to stay competitive with traditional fossil fuels."

Unless the production tax credit is extended, Section 45 for wind-generated electric power will sunset at the end of December 2012. Existing facilities placed into service on or before December 31, 2012, will continue to earn their tax credits for the remaining term (typically 10 years). These facilities will have economic value to tax credit investors with the capacity to utilize the tax credits. It is anticipated that, although new construction will likely be curtailed, there will continue to be a market for facilities that are generating tax credits. Hence there will likely be a good deal of merger and acquisition activity in the industry in the coming year.

The Treasury grant program under Section 1603 of the American Recovery and Reinvestment Act (ARRA) has expired, but those eligible facilities in which construction started in 2011 will be eligible to obtain grant proceeds (30% of eligible costs) as long as the assets are placed into service before the relevant sunset period for the tax credit; for example, in the case of a wind project, December 31, 2012.

Even though the Obama Administration favors renewable energy incentives, the prevailing view of the participants was that the tax credits and incentives for renewable energy were not likely to be extended in light of the budget issues facing the Federal Government. Even if extended, the extension would be for only a short period. There was a great deal of discussion around the value that the US has gotten from the renewable energy incentives programs and whether the incentives have proven to be a cost-effective program.

The question is how will renewable energy ultimately become cost effective and compete with traditional fossil energy? Renewable portfolio standards imposed by the states will help drive renewable energy consumption, but is that enough to foster ongoing development? It is clear that renewable energy must become more commonplace to drive down the cost of development and thereby make it cost competitive with fossil fuels.

There was also discussion of the impact that carbon and related climate change legislation on renewable energy development. If fossil fuels become burdened with a carbon tax, then renewable energy will naturally become more competitive. However, the group tended to agree that it was not likely the US would enact a carbon tax or carbon trading mechanism in the near term.

Since this event, Congress has in fact extended the provisions discussed at the event.
About the Ernst & Young LLP Energy Tax Summit

The Energy Tax Summit is designed to bring together tax leaders from the oil and gas, power and utilities, chemicals, and mining and metals industries to network and discuss key policy and legislative issues and industry trends. The summit addresses the issues and the challenges senior tax executives encounter operating in complex industries while enabling peer networking.

Save the date: 2013 Energy Tax Summit
The next Energy Tax Summit is scheduled for December 2013, in Houston, Texas.

Energy Tax Summit Advisory Council
We’d like to thank the following individuals for their guidance and contributions to planning the 2013 Ernst & Young Energy Tax Summit:

- **Keith Butler**, Duke Energy Corporation
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- **Jeff Quinn**, Peabody Energy Corporation
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