



OIL INDUSTRY PROFITABILITY, INVESTMENT AND TAX POLICY: WHAT ARE THE FACTS?

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Background:

A recent article by Daniel Weiss of the Center for American Progress tries to make the case that because the net income of large, integrated U.S. oil companies has risen in recent years, these companies should lose the federal income tax provisions they currently use.¹ A quick look at Weiss's article reveals several serious analytical and methodological flaws which make his conclusions about how tax reform should impact the oil and gas industry inappropriate and, in fact, harmful to U.S. job and economic growth.

Oil Industry Profits: How Do They Compare with Other Industries?

Profits are the signal that tells a company that it is meeting the market test and provide the incentive and the wherewithal to invest, expand, increase employment and allow for dividends to be paid to shareholders. The appropriate way to measure an industry's profitability is to compute the annual rate of return on total invested capital (both debt and equity). A new API analysis compares the return on total investment in the oil and gas industry with that of the SP 500 Industrials over the 1999-2012 periods (see Figure 1).² In every year except 2006, the average return on investment in the oil and gas sector is lower than for the Industrials. Another analysis comparing the rate of return on investment in integrated and petroleum producing companies to that of all industries shows that in recent year's oil industry rates of return are very similar to those of other industries.³ From January 2011-January 2014, the

average return on investment for integrated petroleum companies was 11.7%, for producing companies, 12.8% and for all industries it was 12.5% (see Table 1). Petroleum industry profits, when measured correctly, are no higher than those in other industries over the long run.

Thus, Weiss's claim that because oil industry net income has risen in recent years (as has net income in many other industries), the oil industry should lose its current law tax provisions is based on the false premise that net income measures true profitability. Net income for multinational companies of all types tends to be large because of the scale of their operations but this has no necessary correlation with their profitability. The U.S. oil and gas industry is capital intensive and makes billions of dollars of new investment annually on which it must earn a normal rate of return in order to remain in business. Thus the existence of growing net income in the petroleum industry is not a good measure of their profitability and should not be used as an indication that the income tax provisions utilized by the industry should be removed.

Investment Performance in the Oil and Gas Industry

As mentioned above, the oil and gas industry is a major source of new capital investment in the U.S., adding new assets to their balance sheets each year on which a normal return must be earned. According to a recent study by the Progressive Policy Institute, five of the top 12 non-financial companies investing in the U.S. in 2012 were oil and gas companies (see Table 2).⁴

Together ExxonMobil, Chevron, Occidental Petroleum, ConocoPhillips and Hess spent \$41.2 billion dollars domestically in new plant and equipment in 2012. Historically each \$1 billion in investment is associated with 23,200 new jobs in the United States. Thus, the \$41.2 billion of new investment by the five oil and gas companies may have produced over 900,000 new U.S. Jobs in 2012.

Another way of gauging the impact of the oil and gas industry on the U.S. the energy producing states is to compare personal income and job growth to the U.S. as a whole. Since the end of the recession in 2009, personal income has grown by over 20 percent in energy states (and by 56% in North Dakota) but by only 17.3% in the U.S.(see Table 4). Not surprisingly, the unemployment rates in energy producing states have also remained lower than that for the U.S. as a whole (see Table 3).

Tax Rates in the Oil Industry: High or Low?

Major integrated petroleum companies often have operations abroad because that's where the resources are and where they are able to secure the rights to drill. As a result, they pay substantial taxes to foreign governments. Thus, their effective tax rate needs to include these taxes as well as taxes paid to federal, state and local governments in the U.S.

In contrast to CAP's statement that major oil companies pay "far lower federal effective tax rates than advertised" and that Chevron, ConocoPhillips and ExxonMobil paid effective federal tax rates of less than 20%, an analysis by the *New York Times* found that oil companies have overall tax rates that are substantially higher than those in many other industries.⁵ Using data from S&P Capital IQ, the Times calculated effective corporate income tax rates, including federal, state, local and foreign taxes for the period 2007 to 2012. According to the Times, ConocoPhillips's effective tax rate was 74%, Marathon Oil Corporation's was 58%, Hess paid 52%, Chevron paid 39% and ExxonMobil paid a 37% effective tax rate.

Federal Tax Incentives for Energy: Who Gets the Most?

The CAP article states that "the oil and gas industry has been the largest beneficiary of federal financial support for the energy sector". This statement is patently false.

According to a series of reports by the nonpartisan Congressional Research Service, the vast majority of federal energy tax provisions do not go to fossil fuels. For example, CRS notes in its recent report that of the \$87.7 billion projected revenue cost of federal energy tax provisions over the 2013-2017 period, only 24 percent goes to fossil fuels while 78 percent goes to renewables, energy efficiency, alternative technology vehicles and other special provisions.⁶

Federal Tax Provisions Used by Oil Companies: Are They Subsidies?

A "subsidy" is defined as tax deduction not available to all industries. In contrast to the allegations in the CAP article, federal tax provisions used by the oil and gas industry such as the Section 199 manufacturing deduction and the foreign tax credit are available to all industries and are thus legitimate deductions from taxable income. Deductions for intangible drilling costs are not "subsidies" since IDCs are largely the labor costs of locating and drilling for oil and have no salvage value to recover. IDCs for the oil and gas industry are analogous to the deductions that a retailer takes for wages paid to employees.

How Should Federal Tax Reform Treat the Petroleum and Other Industries?

When considering tax reform options, policymakers need to heed the Hippocratic Oath for physicians, "First, do no harm". CAP's suggestion that policymakers eliminate legitimate tax provisions used by the petroleum industry would violate that oath by raising the cost of capital for new investment in the industry. As a result, the industry's investment would slow, as would job growth and federal and state tax revenues. Instead, policymakers should consider a moving toward a consumed income tax under which all new investment is expensed in the first year and all saving is deductible. A substantial body of scholarly research concludes such a system would raise U.S. investment, job and GDP growth.⁷

Table 1: Profitability of the Petroleum Industry Compared to All Industries (January 2011-January 2014)

	Return on Invested Capital				
	Jan-11	Jan-12	Jan-13	Jan-14	Average
Petroleum (Integrated)	9.4%	10.1%	14.7%	12.6%	11.7%
Petroleum (Producing)	11.2%	13.5%	15.0%	11.5%	12.8%
All Industries	12.2%	12.2%	12.9%	12.7%	12.5%

Source: Damodaran Online, Aswath Damodaran, <http://pages.stern.nyu.edu/~adamodar/>

**Table 2. U.S. Investment Heroes:
Top 25 Nonfinancial Companies by Estimated U.S. Capital Expenditure**

Rank	Company	Estimated 2012 US Capital Expenditure ² (in \$ mns)	Rank	Company	Estimated 2012 US Capital Expenditure ² (in \$ mns)
1	AT&T ³	19,465	14	Union Pacific ³	3,738
2	Verizon Communications ⁴	15,000	15	General Motors	3,650
3	Exxon Mobil	12,157	16	Enterprise Products Partners ³	3,622
4	Chevron	10,738	17	Time Warner Cable ³	3,095
5	Intel	8,769	18	Microsoft	3,044
6	Walmart Stores	8,257	19	Amazon ⁶	2,945
7	Occidental Petroleum	7,592	20	CenturyLink ³	2,919
8	ConocoPhillips ⁵	6,079	21	Ford Motor ⁷	2,693
9	Exelon ³	5,789	22	Walt Disney	2,671
10	Comcast ³	5,714	23	FedEx	2,575
11	Duke Energy	5,407	24	Apple	2,553
12	Hess	4,740	25	Target	2,345
13	Sprint Nextel ³	4,261	Total		149,817

Source: PPI estimates based on 2012 and 2013 company financial reports & filings. Totals do not include R&D, only capital expenditures in plants, property, and equipment.

1. Universe includes nonfinancial Fortune 150 companies from 2013

2. For all but six companies, fiscal year 2012 was calendar year 2012. For Walmart, Microsoft, Walt Disney, FedEx, Apple, and Target, we used the most recent fiscal year statement as of August 2013

3. Predominately U.S. Operations

4. Reduced total capital expenditures by the share of international employment, to adjust for global investment activities

5. May include a small amount of investment in Latin America

6. Includes Canadian investment, but our assessment finds this amount was minimal

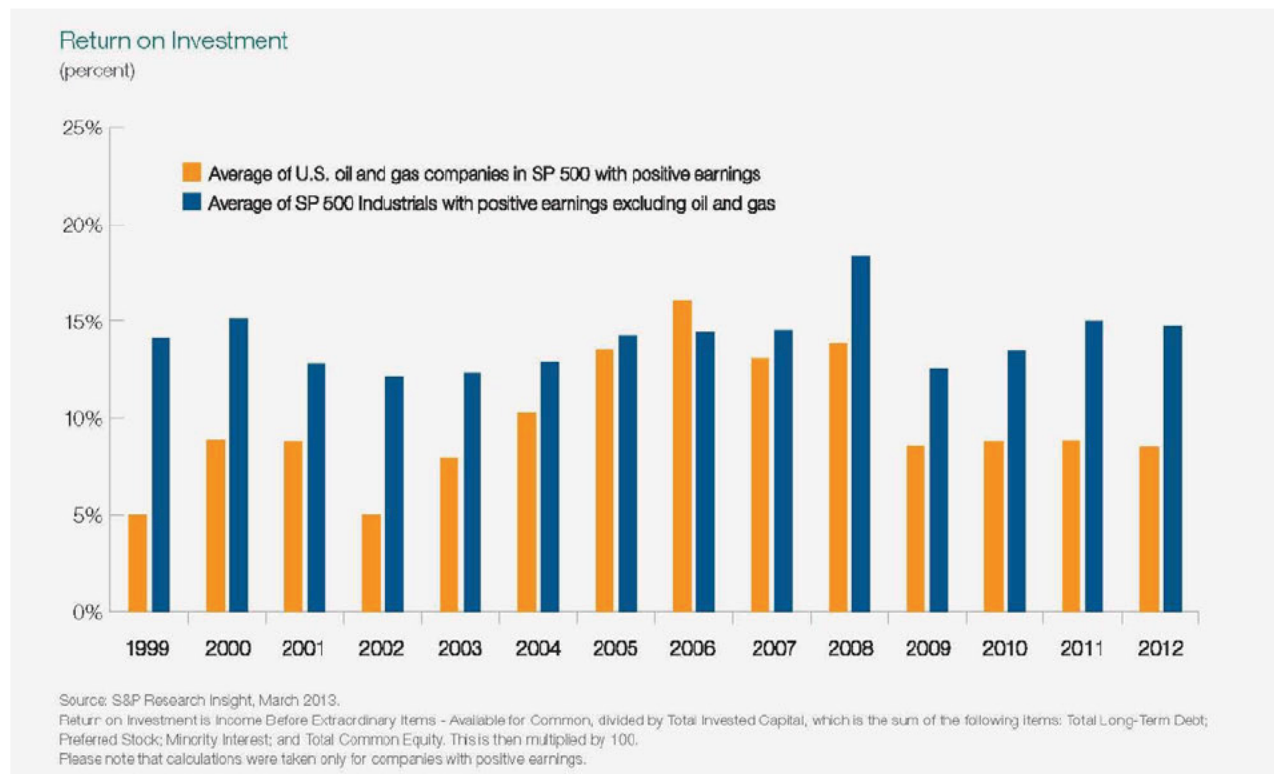
7. Adjusted for net investment in operating leases by removing it from long-lived assets in proportion to the country share Source: "U.S. Investment Heroes of 2013: The Companies Betting on America's Future," Diana G. Carew and Michael Mandel, Progressive Policy Institute, September 2013, http://www.progressivepolicy.org/wp-content/uploads/2013/09/2013.09-Carew-Mandel_US-Investment-Heroes-of-2013.pdf

Table 3. Personal Income Growth and Unemployment Rate in Energy Producing States Compared to the U.S. as a Whole (From the End of Recession to Present)

	Personal Income (millions of dollars)		Percent Change	Unemployment Rate	
	2009 Q2	2013 Q3	09 Q2-13 Q3	June-09	Sep-13
Colorado	206,163	247,634	20.1%	8.5%	6.9%
Montana	33,089	40,147	21.3%	6.0%	5.3%
North Dakota	26,436	41,354	56.4%	4.1%	2.8%
Oklahoma	128,628	161,272	25.4%	7.0%	5.4%
South Dakota	31,526	39,593	25.6%	5.3%	3.7%
Texas	914,920	1,160,139	26.8%	7.6%	6.3%
Wyoming	24,400	29,942	22.7%	6.4%	4.5%
United States	12,089,349	14,180,492	17.3%	9.5%	7.2%

Source: Bureau of Economic Analysis and Bureau of Labor Statistics

Figure 1.



Source: "Putting Earnings into Perspective: Facts for Addressing Energy Policy," December 2013, API, <http://www.whoownsbigoil.org/~media/Files/Statistics/EarningsPerspective/earnings-perspective-high-res.pdf>

Endnotes

- 1 http://www.realclearpolitics.com/articles/2014/01/17/big_oil_big_profits_big_tax_breaks_121262.html
- 2 <http://www.eia.org/oil-and-natural-gas-overview/industry-economics/~media/Files/Statistics/Earnings-Perspective/earnings-perspective-high-res.ashx>
- 3 Data compiled by Professor Aswath Damodaran at the Stern School of Business at New York University, see http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/roe.html
- 4 http://www.progressivepolicy.org/wp-content/uploads/2013/09/2013.09-Carew-Mandel_US-Investment-Heroes-of-2013.pdf
- 5 <http://www.nytimes.com/interactive/2013/05/25/sunday-review/corporate-taxes.html?smid=tw-share&r=5&>
- 6 <http://www.fas.org/sgp/crs/misc/R43206.pdf>
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