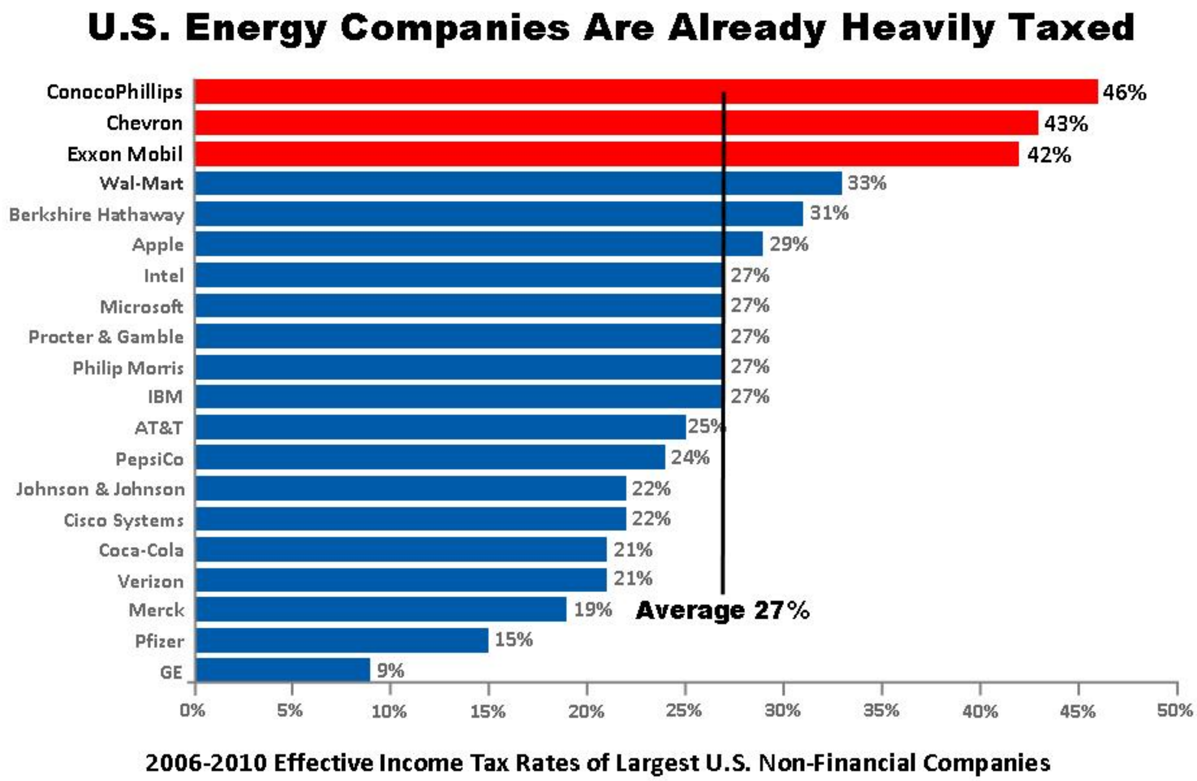
Written Testimony of James J. Mulva
Chairman and Chief Executive Officer, ConocoPhillips

Good morning Chairman Baucus, Ranking Member Hatch and members of the Committee. My name is James J. Mulva. I am Chairman and Chief Executive Officer of ConocoPhillips. I am particularly pleased to be here today to tell our side of the story in this important debate, which I believe will help shape the future of our industry and our country. Naturally, I am very concerned about the misinformation being circulated about our industry and my company in particular – especially the misinformation surrounding our corporate tax liabilities and attempts to use these false impressions to justify further increases in our company's tax burden. I feel that it is imperative to make you aware of the impacts that the tax proposals will have, not only on our company, but on American jobs, energy consumers and national energy security.

While there is much discussion about high energy prices and proposals to increase taxes on oil and natural gas companies like ConocoPhillips, there seems to be far less information about the rest of the story -- how much we pay already in taxes. As depicted in this chart, our industry already has one of



Source: Bloomberg, calculated as financial tax divided by pre-tax income, Top 20 of Fortune 500 companies by market cap, excludes financial institutions.
Fiscal year-end dates differ by company.
2008 ConocoPhillips earnings adjusted for write-down of goodwill and LUKOIL investment ($32.9B); effective tax rate, including these items, was 66% for the five-year period.

the highest tax rates among all U.S.-based businesses. Of the top 20 Fortune 500 non-financial companies (ranked by market capitalization), the three U.S.-based oil and gas companies represented here today are the top taxpayers on the list. In fact, ConocoPhillips tops the entire list, with a 46 percent effective tax rate. By comparison, the top 20 companies together pay an average effective rate of 27 percent. While there have been some media reports on our industry's actual tax burden, this fact seems to be consistently and unfortunately overlooked in the debate inside the Beltway.

The Obama Administration, in its 2012 Budget Proposal, recommended more than $40 billion in tax increases over the next 10 years, specifically aimed at the oil and natural gas industry. The Administration has further proposed other tax increases which would cost the industry an additional estimated $50 billion over the ten-year period. The hyperbole surrounding this debate typically consists of those who would raise our taxes describing all these items as oil and gas tax "subsidies" or "loopholes" or other such characterizations. Many in Washington and beyond have chosen to use this language and accept, as a foregone conclusion it would seem, that tax deductions or credits when used by an oil or natural gas producer must automatically be characterized as tax subsidies; even when these deductions or credits apply well beyond the industry and are widely available to a broad range of other businesses and industries. These mischaracterizations do nothing to inform the public of the true nature of the issues. Worse yet, they fuel the misinformation that precludes a responsible debate on the issues.

Tax Reform and the Broader Debate

Before moving to the specifics of the various tax issues, I would like to comment on the process of tax reform. We believe that the U.S. corporate tax system can and should be improved. It is widely recognized that the United States has one of the world's highest corporate tax rates – both when comparing marginal and effective tax rates. The U.S. system is overly complex and is designed to play favorites among industries, activities, taxpayers and special interests. It is my hope that, by describing the tax items applicable to our industry and pointing out that, when the dust has settled, we pay higher tax rates across the board than any other industry, it will become clear that we are already highly taxed and should not be targeted for further increases that will only threaten jobs and national energy security. It is my further hope that the members of the Senate Finance Committee, who are charged with responsibility for developing sound and rational tax policy for our country, will see through the rhetoric and get it right.

In short, large oil and natural gas producers like ConocoPhillips do not get special tax subsidies. The items identified as "subsidies" to oil and natural gas companies either: a) are not applicable to the largest producers, like ConocoPhillips; or b) are not limited to oil and natural gas companies, but are widely available to all U.S. manufacturers and producers. These hardly sound like "special industry subsidies" to me.

Specific Provisions of Concern

My submission will focus upon those tax issues of greatest importance to ConocoPhillips, whether or not they are identified as "oil and gas tax" items. Those items, followed by a more detailed discussion of each, are as follows:

Dual Capacity Taxpayer Rules.
The pending modification to the dual capacity taxpayer rules, which has been proposed multiple times in the past, and which we understand is currently under consideration again in the Senate, is a proposal to impose double taxation on the income of oil and natural gas companies. This provision would change the way in which U.S.-based oil and natural gas companies treat taxes paid to foreign governments, under the foreign tax credit rules of the Internal Revenue Code. It is important to note that this provision, as currently being considered, would ONLY have a material tax impact on the three U.S.-based firms appearing today (ConocoPhillips, ExxonMobil and Chevron). These proposed additional restrictions to the foreign tax credit rules for energy companies would render U.S.-based companies less competitive in the global market, at a time when we are already competing every day against national oil companies and other non-U.S. companies for critical resources. This provision will result in lost opportunities around the globe and lost jobs here in the U.S. As we lose projects and opportunities to foreign competitors, many of those jobs will necessarily disappear. These foreign tax credit restrictions may well result in a reduction in overall investment in U.S. energy production, transportation and refining. But the real impact will be that future investment by U.S. firms, which provide and support a proportionately greater number of domestic

jobs than foreign competitors do, will be significantly reduced. In fact, we believe that this provision alone will substantially increase the level of foreign investment in the U.S. oil and gas sector, because U.S. companies will be heavily penalized by this provision, while their foreign competitors will not. For companies based in Europe, Asia or elsewhere, this provision will not impose an additional tax burden on their investment of funds in U.S.-located projects.

Some of the facts about the dual capacity and foreign tax credit rules follow:

- The current rules for dual capacity taxpayers already serve as a restriction or limitation on U.S.-based oil and natural gas companies' ability to claim foreign tax credits (FTCs) for foreign taxes paid. These rules provide a strict regime for determining whether a foreign payment constitutes a payment of income tax (which is creditable), or another type of payment, e.g., a royalty (which is not creditable). Contrary to erroneous assertions that U.S. oil and natural gas companies received foreign tax credits for "royalty payments," the existing tax rules specifically prohibit us from claiming FTCs for such payments.
- All other U.S. industries and companies that earn income in foreign countries may claim FTCs on their tax returns, yet they do not face the same existing limitations currently in place for dual capacity taxpayers.
- Our company is under constant audit by the Internal Revenue Service, which vigorously reviews these payments to determine whether they are properly reported under the law.
- Dual capacity taxpayer provisions have never been identified by the Joint Committee on Taxation as a "tax expenditure," which means that the Joint Committee does not consider these provisions to be a subsidy.

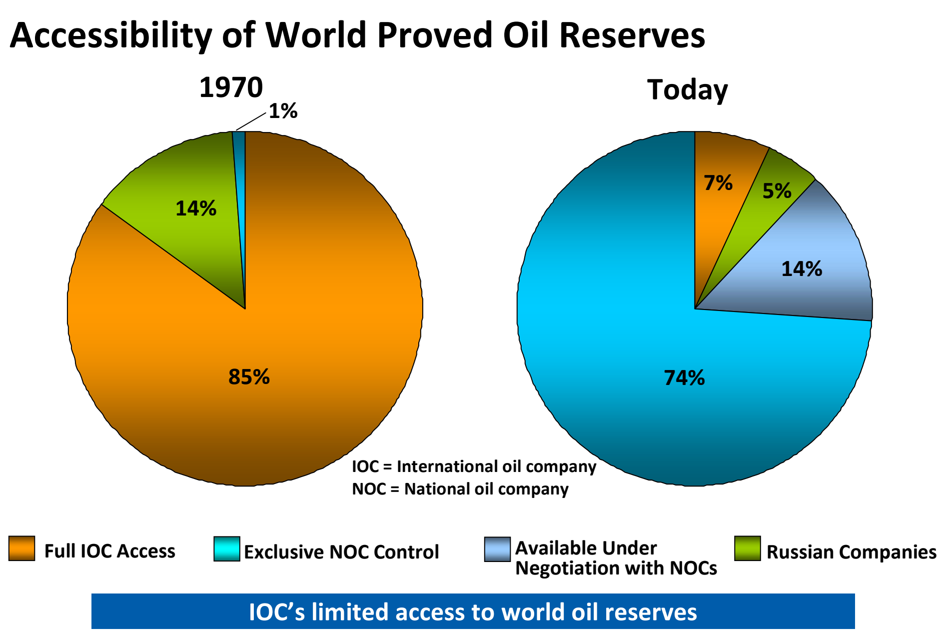
Some facts about our foreign income and tax credit positions:

- ConocoPhillips has a U.S. work force of approximately 20,000 people, and we estimate that about 3,000 of these U.S. jobs exist to support our international operations.
- Among the companies at this hearing, ConocoPhillips has the largest U.S. domestic presence, as a percentage of our total investment portfolio.
- In spite of that, ConocoPhillips still earns approximately 60 percent of its income outside the United States.
- ConocoPhillips returns virtually all of that income to the United States to help fund its capital investment programs, both here and overseas. This is contrary to the practices of many U.S. multinational companies in other industries, which are heavily incentivized to leave foreign earnings overseas in order to avoid the onerous additional burden of U.S. tax on that income.
- Some in Washington are proposing a "tax holiday" on foreign earnings, which would allow U.S. companies to return their profits to the United States at a lower-than-normal tax rate, to provide an incentive to bring those earnings home. While we understand the interest in such a provision, we would not benefit since we already bring our earnings home.
- The proposed changes to our foreign tax credits will mean that we would be penalized for bringing our profits home. So rather than spending those profits on job creation, reinvestment and returns to shareholders (actions otherwise recognized as contributing to U.S. economic growth), we will face the dilemma of leaving those earnings overseas or paying dramatically higher taxes on them.
- The fact that some foreign countries may possibly have lower taxes is not a primary factor in determining where we choose to operate. We must go where oil and natural gas exist. From a tax perspective, it would be attractive to produce hydrocarbons in low-or-no-tax jurisdictions, but such places don't have much oil and natural gas, so we're not drilling in them.

Typically, we pay foreign taxes at rates equal to or in some cases above the U.S. tax rate. Some would argue that because it is common for producing countries to charge oil and natural gas companies higher tax rates than other industries, that the portion above the general tax rate must not be a tax at all, but a payment for some form of benefit, such as a royalty. On that point, the Joint Committee on Taxation agrees with us that such an argument doesn't stand up under the facts. The Joint Committee's description of the dual capacity taxpayer proposal contained in the Administration's Budget Proposal for Fiscal Year 2011 states:

> Furthermore, a fundamental assumption behind the proposal, that countries generally seek to impose an equal tax burden on all taxpayers and therefore any additional tax burden imposed solely on dual-capacity taxpayers reflects payment for a specific economic benefit, is arguably incorrect. Taxing jurisdictions often impose different levels of tax burden on different industries according to various factors including the relative mobility of a particular industry. [Footnote omitted.] A taxpayer in a relatively immobile industry, such as a company engaged in a natural resource extraction industry, is compelled to operate within the natural resource's jurisdiction notwithstanding a relatively high tax rate.[1]

Gaining access to resources around the world has become increasingly challenging, due in large part to the rising role of national oil companies (NOCs). In this environment, international oil companies (IOCs) find it increasingly difficult to compete for access to critical resources. A recent study has shown that U.S.-based companies are particularly challenged, due in part to the already-existing limitations imposed by the U.S. tax system.[2] The charts below help illustrate just how unfavorably the landscape has changed for IOCs in the competition for resources. From having full access to 85 percent of world resources in 1970, they can now directly access only 7 percent.



Source: PFC Energy, Oil & Gas Journal, BP Statistical Review 2010

Additionally, the next chart shows the massive scale of the NOCs, some of which are a dozen times larger than the IOCs in terms of hydrocarbon reserves. The NOCs include such massive entities as the National Iranian Oil Company, Saudi Aramco, Petroleos de Venezuela SA (PDVSA) and a number of others.

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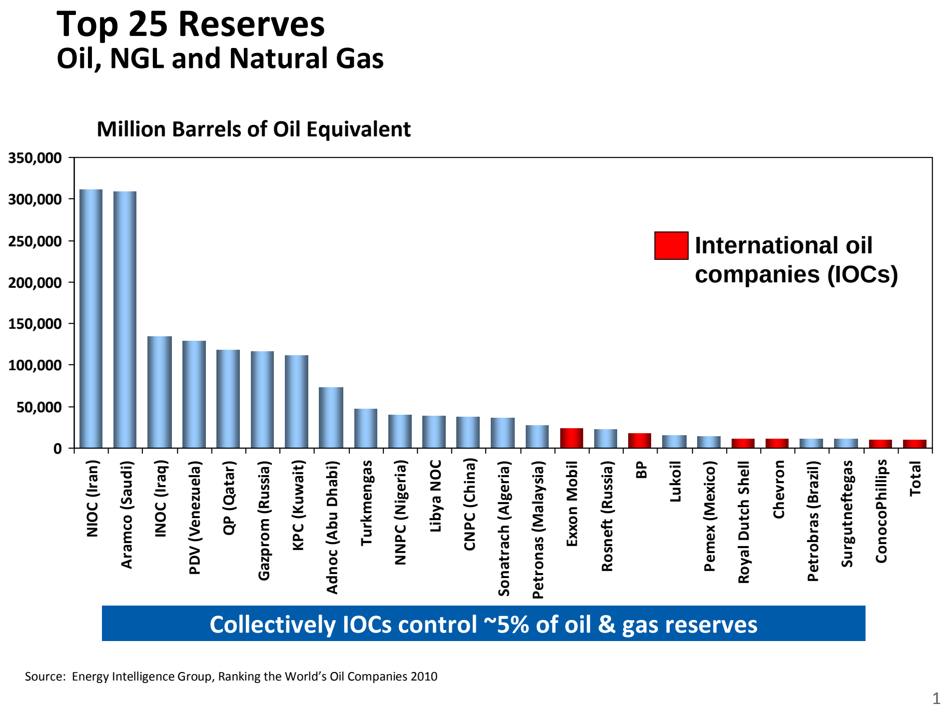
[1] Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2011 Budget Proposal*, Page 319.

[2] *Fiscal Fitness, How Taxes at Home Help Determine Competitiveness Abroad,* 2010 HIS CERA, Inc., Page 4.



As the role of NOCs in global markets increases, additional impediments to the ability of U.S.-based IOCs to compete, in the form of modifications to the dual capacity rules, will only exacerbate this problem, further threatening U.S. jobs and energy security.[3] In summary, this proposal would:

- Destroy high-paying U.S. jobs;
- Hand over to foreign interests an even greater share of America's energy investment and national security;
- Punish domestic oil and gas companies for returning their profits to the U.S.; and
- Reduce overall investment in energy production at a time when we need more, not less energy.

Section 199 Deduction for Domestic Production Activity.
Current and proposed legislation, along with the Administration's Budget Proposal for the 2012 fiscal year, would eliminate the tax deduction provided by Section 199 of the Internal Revenue Code for oil and gas companies. In some cases, only the five largest oil and natural gas companies operating in the United States would be subject to this elimination. Section 199 is consistently and erroneously identified as one of the so-called "oil and gas tax subsidies," as part of efforts to raise taxes on the industry.

The truth is that the Section 199 deduction is available to all U.S. producers and manufacturers, and is not limited to oil and natural gas producers, although efforts to repeal the provision seem to have targeted this industry alone. Another fact regarding this provision is that oil and natural gas producers are already limited in their ability to claim this deduction, compared to other domestic industries. Although the deduction under Section 199 is generally calculated as 9 percent of domestic production income,[4] oil and

[3] Economic and Foreign Policy Implications of the Administration's Dual Capacity Taxpayer Proposals, Split Rock International, Inc., July 2010
[4] Internal Revenue Code, Section 199 (a)(1)

natural gas companies are limited, under the provisions of the Emergency Economic Stabilization Act of 2008, to a deduction of only 6 percent.[5]

Section 199 was added to tax law by The American Jobs Creation Act of 2004[6] in order to stimulate job growth in the production/manufacturing sector. After its enactment, oil and natural gas industry employment grew substantially, as intended, as our industry put the provision to work and created jobs. During the period after 2007, as the U.S. struggled through the financial crisis, our industry maintained steady employment figures, rather than shedding jobs. Again, as applied to our industry, the provision worked, helping maintain robust employment. It would be an unfortunate mistake for Congress to eliminate our use of Section 199.

Deduction for Intangible Drilling and Development Costs.
The deduction for intangible drilling and development costs, commonly referred to as IDCs, was included in the Internal Revenue Code in recognition of the fact that drilling oil and natural gas wells is a high-risk business, with uncertain chances of success. Even when drilling succeeds, the costs that comprise IDCs are largely "intangible," meaning they don't result in a physical asset. IDCs do not include the costs of "tangible," or physical production assets placed on the well site, once a commercially viable oil or natural gas well has been drilled. It is these facts that make the expensing of such costs appropriate, in precisely the same manner that a company that conducts extensive research and development (R&D) may deduct the costs of those efforts. As with R&D, the outcome or commercial success of those expenditures is far from certain when the costs are incurred. It is only after considerable cost and effort that a determination can be made on whether a drilling venture has discovered a commercially viable oil or natural gas well.

While the nature of the expenditure for IDCs is closely analogous to R&D, clearly the tax treatment afforded is far less generous, especially for integrated oil and natural gas producers such as ConocoPhillips. For them, the current deduction is already limited to 70 percent of the amount spent, with the remaining 30 percent capitalized and amortized over five years. Once again, as one examines the facts of this particular tax item, it becomes clear that, rather than being an oil and natural gas tax subsidy, the IDC deduction already provides a more limited cost recovery method than those enjoyed by other taxpayers and industries.

The impact of IDC repeal would be immediately felt throughout the oil and natural gas industry, costing thousands of jobs and harming domestic energy security. The ability to deduct IDC has a direct relationship to the number of wells drilled in the United States, and the number of jobs associated with that drilling activity. A typical evaluation regarding the decision whether to drill a well, or not to drill, will necessarily include an analysis of the costs (including tax costs) versus the possible cash flow, in the event the well is successful. If the net cash flow is evaluated and estimated to be positive on a present-value basis, that conclusion goes a long way toward an affirmative decision to drill a well. As the present value of the tax cost is increased by such factors as eliminating the current deduction of IDCs, the likelihood of a projected positive cash flow is diminished, thus increasing the likelihood that no well will be drilled. As more and more project evaluations are made, and applying the higher tax cost of non-deductible IDCs, more and more drilling projects will be abandoned. That will result in substantially less domestic drilling activity, and fewer American jobs associated with that activity.

This same type of analysis applies:

- Regardless of whether the company performing the analysis is a large integrated company, such as those attending this hearing today, or a small, independent producer;
- Regardless of whether the company doing the analysis has significant resources at its disposal, or must borrow against the potential success of each well, in order to fund the next;
- Regardless of how much a company has earned in its previous year, and because each drilling project must stand on its own in order to be successful, as the tax cost of that drilling project increases, the likelihood that the project will proceed decreases.

[5] P.L. 110-343, Division B, §401(a):
[6] P.L. 108-357

In short, this direct tax increase on U.S. drilling will reduce both drilling activity levels and energy production, and cost U.S. jobs.

Other Provisions.
While there are numerous other tax provisions erroneously identified by industry opponents as "oil and natural gas tax subsidies," the provisions listed above are among the more egregious from the perspective of ConocoPhillips. In general, we oppose any effort to single out a specific industry, or a select few companies within a single industry, for tax increases. Such actions are simply bad tax policy – especially in cases in which the proposed increases all relate to measures utilized by a broad range of industries and taxpayers, and for which our company is already limited in its ability to utilize those tax attributes. Such actions are not "tax reform" or "elimination of tax subsidies." Instead, they come at the expense of the American workers who rely upon our industry for their livelihoods.

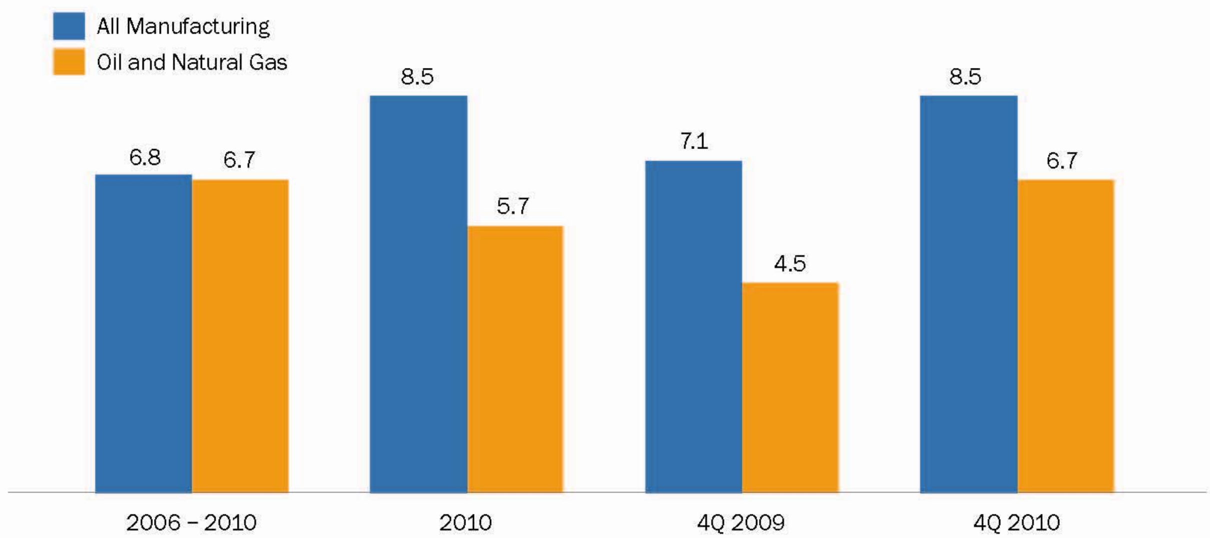
Industry Earnings and Profitability.

There is a common misperception that the absolute dollar amount of major oil company earnings is indicative of the industry's profitability. Rather, its earnings reflect the industry's enormous scale and the substantial capital investment needed to replenish depleting supplies. Constrained resource access at home and abroad has required international oil companies to undertake increasingly large, complex and risky projects that host governments may not have the financial strength, skills or technology to undertake themselves. A typical large ConocoPhillips exploration and development project requires several billion dollars of initial investment and may not generate revenues for more than a decade following project sanction. Deep water developments in the Gulf of Mexico can cost from $6-$16 billion, depending on the field size and other factors. A current project to produce and deliver liquefied natural gas may cost between $5-$13 billion, depending on its size, location and complexity. The proposed Alaska natural gas pipeline is expected to cost $30-45 billion. Only large companies with substantial financial capacity and technical resources can effectively develop these projects, while sufficiently diversifying the number of projects and geographies to manage the risk. As the charts below illustrate, whether one examines earnings in the form of pennies per dollar of sales or return on investment, the U.S. oil and natural gas industry's earnings are comparable to those of other U.S. industries, or actually lag behind.

The first chart shows that earnings per dollar of sales for the oil and natural gas industry consistently lag the return on sales of all manufacturing industries for various periods from 2006 through 2010.

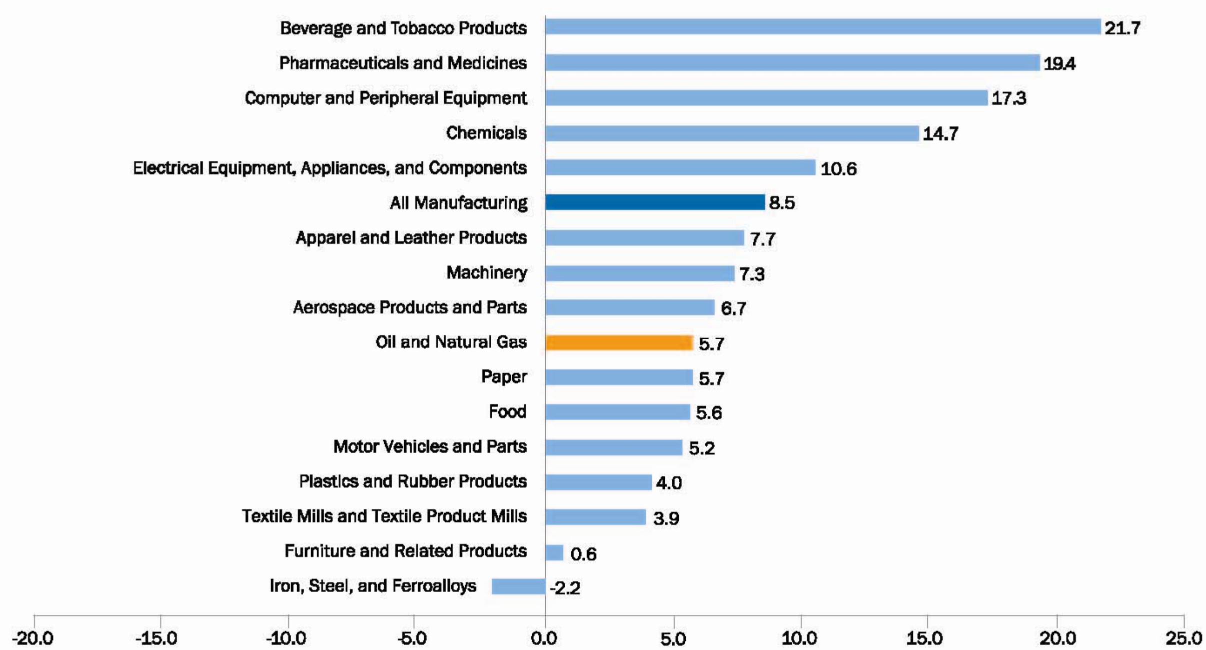
The second chart utilizes this same metric in comparing earnings on an industry basis during 2010. The earnings of the oil and natural gas industry lagged below the all-industry average (5.7 cents per dollar of sales for the industry vs. an average of 8.5 cents for all manufacturers). The leading industries (beverage and tobacco products, pharmaceuticals, computers, chemicals and others) had earnings far higher than those of the oil and natural gas industry.

Earnings (cents per dollar of sales)

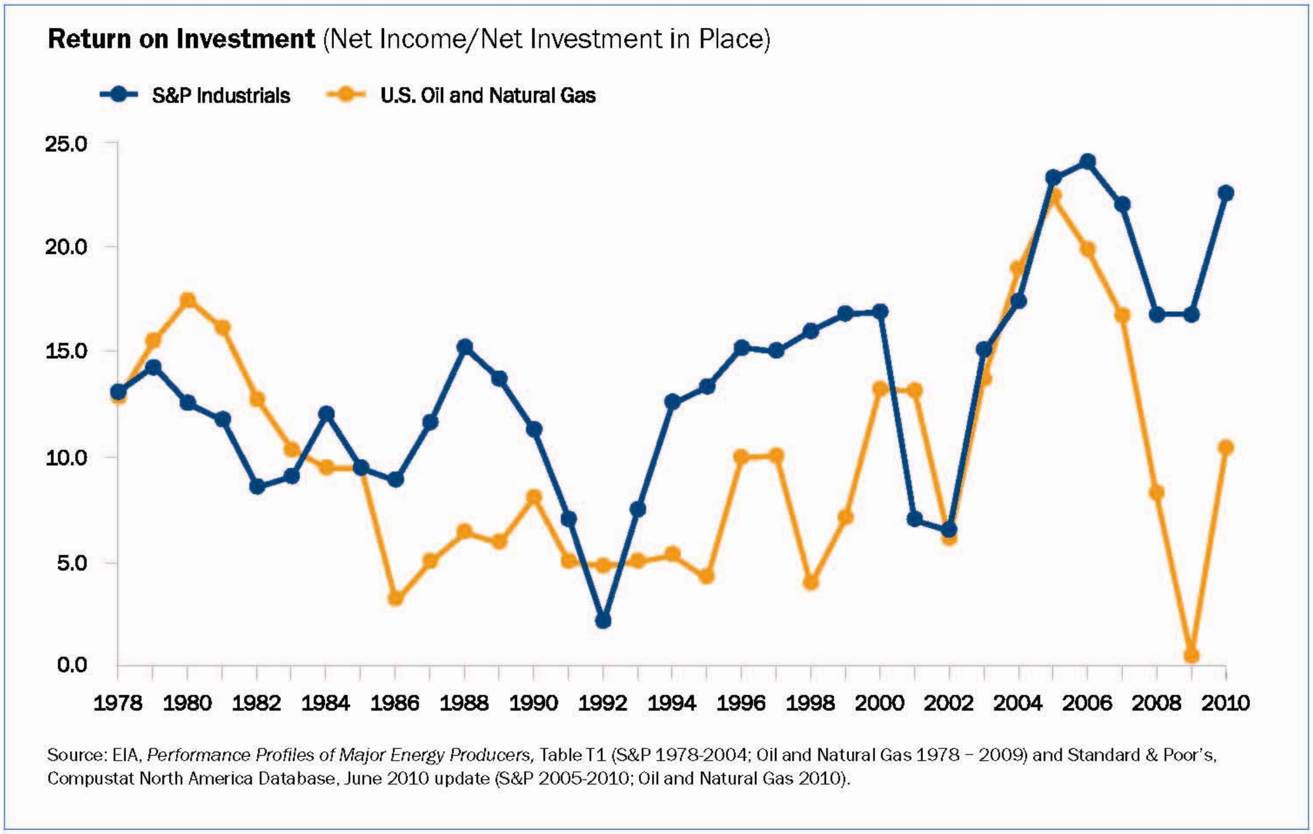


Source: U.S. Census Bureau for U.S. manufacturing and *Oil Daily* for the oil and natural gas industry.

2010 Earnings by Industry (cents of net income per dollar of sales)



Sources: Based on company filings with the federal government as reported by U.S. Census Bureau and *Oil Daily*.



Conclusion – Raising Industry Taxes is the Wrong Policy at the Wrong Time

Once again, when the facts are made clear, proposals to use earnings to justify tax increases do not make sense in the case of an industry that is not only clearly already heavily taxed, but actually pays effective tax rates that far exceed those paid by other U.S. industries.

For a Congress and Administration that speak of the need to enhance U.S. competitiveness in global business, enacting the tax proposals currently under consideration would be counter-productive. They would penalize U.S. workers as well as the millions of Americans who invest in the targeted companies either directly as shareholders, or indirectly by participating in mutual funds, pension plans, insurance policies and other institutions that own our shares. Further, the proposed tax provisions would severely hamper the financial capabilities of the very companies that must help carry our nation into the energy future through continued investment in vital oil and natural gas, as well as in renewable energy resources.

These impacts cannot truly be the intent of Congress, or the desire of the American public.

ConocoPhillips calls upon Congress to dispassionately consider the facts on oil industry taxation, and reject the current proposals in light of the imperative need to create more U.S. jobs, enhance national energy security, and preserve and improve the ability of U.S.-flagged companies to succeed in the intensely competitive global energy business.

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