ConocoPhillips

Senate Finance Committee
Comments of ConocoPhillips to the
International Tax Working Group
April 15, 2015

About ConocoPhillips:
ConocoPhillips is headquartered in the United States and is the world's largest independent oil and natural gas exploration and production company, based on production and proved reserves. ConocoPhillips employs about 18,000 people worldwide. We operate around the globe, exploring for, producing and transporting light oil, heavy oil, oil sands, natural gas liquids, conventional natural gas, coalbed methane, shale gas and oil, and liquefied natural gas (LNG).

On Tax Reform Generally:
At ConocoPhillips, we believe that tax reform can be achieved without harming our economy or the important federal programs that depend, in part, upon funding provided by income taxes. Ideally, tax reform would promote economic growth across our economy. Specifically, we believe that:

- tax reform should be done in a way which does not discriminate against specific industries, but instead creates a tax system which is applied consistently among industries;
- a reformed federal tax system should create a level playing field for U.S. companies competing in the global marketplace and avoid double-taxation of foreign earnings; and
- if done properly, tax reform can help our economy grow and lower the corporate tax rate, without discouraging new investment by capital-intensive industries, thus providing even more opportunities for all Americans to prosper.

ConocoPhillips, along with the oil and natural gas industry generally, is subject to income tax rates on worldwide income that are among the highest across all industries. In addition, we are subject to U.S. taxation on foreign earnings. In the global marketplace, we compete with foreign-based and nationally owned oil companies. These companies are generally not subject to incremental taxation on foreign earnings. Therefore, it is critical that our foreign earnings are not subject to double taxation in order for us to successfully compete. Currently, we rely on a robust foreign tax credit system to avoid incremental U.S. tax. In the United States, we pay significant other, non-income taxes and royalties to federal, state and local governments, in addition to income taxes, while investing billions in the U.S. economy. Some of our key tax-related concerns, as we move forward toward comprehensive tax reform, are outlined as follows:

Double Taxation:
Double taxation in the U.S. harms the ability of U.S.-based companies, like ConocoPhillips, to compete globally. In the current international tax reform dialogue, there is discussion about a minimum tax approach (although it may be called different things). We understand the policy concern is that certain foreign income, which is subject to little or no tax, should be subject to some level of tax in the United States, even in an exemption-type tax system. If this approach is adopted, we believe that the design of an international tax system should adhere to two fundamental principles. First, care should be taken to avoid harming companies that have immovable businesses, such as those in the oil and gas industry. Oil and gas companies must locate their business operations in jurisdictions where the resources are located and pay taxes in those jurisdictions. Second, double taxation of foreign earnings must be avoided.

A global minimum tax can result in double taxation of high-taxed foreign income:

- Our income is subject to high rates of tax outside the US. The nature of our business involves significant capital investments (billions) and several years of spending prior to start-up of long-term operations.
- The cost recovery periods in foreign countries are often much shorter than the U.S. recovery periods for foreign related expenditures. These differences can yield temporarily low foreign effective tax rates on income ultimately subject to high foreign statutory rates.
- These differences in timing would result in double taxation of ultimately high-taxed income, if a global minimum tax were applied on a per country basis without the ability to use foreign tax credits to offset that tax.

Dual Capacity Taxpayer Modifications:

- About 1 of every 4 of our U.S.-based employees, works in support of our overseas operations. This means there are more than 2,000 high-paying American jobs that would not exist, if their U.S.-based employer, ConocoPhillips, could not effectively compete overseas
- ConocoPhillips pursues overseas oil and gas projects based upon where we can economically recover oil and gas reserves. Because natural resources are immobile, we must invest where the resources are located, and until the recent shale revolution in the United States, a much larger portion of that investment opportunity existed outside the U.S.
- Recent proposals to modify the dual capacity taxpayer rules would result in double-taxation of oil and natural gas companies including ConocoPhillips, and would impose an additional layer of tax on our already-high tax liabilities. The global energy marketplace requires us to compete against non-U.S.-based companies, which are not subject to an additional home-country tax. We must also compete against companies which are owned or effectively controlled by their home-country governments. Given the global economic environment of the oil and gas business, double-taxation on foreign earnings will make U.S. multinationals, including ConocoPhillips, less competitive, as higher taxes means higher cost of business compared to foreign-based competitors. An “uneven playing field” will have a cost in terms of reduced U.S. jobs, energy development and energy security.
- Currently, about two-thirds of ConocoPhillips’ oil and natural gas earnings come from outside the United States; whereas an increasing part of our spending plans are targeted at domestic development. Even in the current, lower price environment, in which we have reduced our overall capital spending plans, our plan calls for a 50% increase in capital development programs in North America, primarily related to development of unconventional resources. We believe this shows a clear connection between our ability to cost-effectively repatriate our foreign earnings and our contributions to domestic job growth, infrastructure development, and improved U.S. energy security. Changes to the dual capacity taxpayer rules would impose double-taxation and would substantially restrict our ability to maintain such a significant repatriation of earnings, and would, therefore, hurt our ability to invest domestically.
- To help illustrate the impact of the oil and gas industry’s earnings repatriations, one only need look at the repatriation holiday enacted in 2004. Section 965 of the Internal Revenue Code, enacted as part of the American Jobs Creation Act in 2004 [Pub L 108-356, §271, 118 Stat 1418], provided U.S. corporations with an 85% dividends received deduction on earnings from foreign subsidiaries, resulting in a reduced rate on profits repatriated from overseas. Based on the effective date of IRC § 965, and the applicable period of the election to apply it, most repatriations occurred during 2005. The American Council for Capital Formation (“ACCF”) has analyzed IRS repatriation data for the years 2000 through 2009.[1] The link to the report online is as follows: http://accf.org/news/publication/why-do-u-s-dual-capacity-rules-matter-ten-qs-as.
    - The analysis clearly shows that total repatriations increased dramatically during 2005, per the provisions of IRC § 965. In that year, total repatriations, across all industries, increased seven-fold, compared to the yearly average of the previous five years. Oil and

[1] *Why do U.S. Dual Capacity Rules Matter? Ten Q’s & A’s*, Pinar Cebi Wilber, Ph.D., American Council for Capital Formation, November 2012, Pg. 6.

gas industry repatriations also increased during 2005, although they fell as a percentage of total repatriations - not because oil and gas companies reduced their repatriations but because other industries dramatically increased their repatriations. During the five years prior to 2005, oil and gas repatriations ranged between 11 and 21 percent of total repatriations. In the four years shown on the table since 2005, oil and gas repatriations have ranged between 19 and 31 percent of total repatriations. This clearly shows that the oil and natural gas industry, including ConocoPhillips, is returning its cash to the U.S., investing in new domestic energy projects, creating U.S. jobs, and improving America's energy security.

- The same ACCF report which contains the repatriation analysis also includes a useful example of how the double-taxation resulting from proposed dual capacity modifications would impact a U.S.-based company, versus its foreign-based competitor, when vying for a similar project in the same foreign country.[2] In that example, taken from a real-world fact pattern, the U.S. company's overall tax burden would increase, under the proposal, from 35% to 51%; and the rate applicable to its foreign competition would remain at 35%.

Intangible Drilling Costs:

- The ability to deduct costs associated with drilling new wells, generally referred to as "intangible drilling and development costs," or "IDC's", has always been one of the most important tax issues within the oil and natural gas industry. More than half of our U.S.-based employees are directly impacted by our exploration and production drilling activities. Given that drilling new wells is the effective "life-blood" of our company, one could say that every job in our company is at least indirectly impacted by our drilling activity.
- We spend billions on IDC's each year. The term "intangible" drilling costs is sometimes confusing. IDC's are real costs, comprised of wages, fuel, repairs hauling and other "non-salvageable" expenses associated with drilling oil and natural gas wells, and generally represent the majority of costs associated with drilling activities. IDC's do <u>not</u> give rise to depreciable capital assets, or tangible property – hence the use of the word "intangible" in the description. For companies engaged in exploring for, and producing oil and natural gas, IDC's are an ordinary and necessary business expense.
- Other, non-oil and gas, extractive industries are allowed to deduct their exploration and development costs, which is appropriate for all such depletable resources. Depletion of natural resources is analogous to technology obsolescence. The start of the decline is immediate, and, accordingly, continuous investment is required to replace that which is being produced, in the case of oil and gas reserves, or that which is becoming outdated, in the case of technology. Oil and natural gas companies must, therefore, incur IDC's to remain competitive and viable, as their reserves are depleted, A failure to find and develop new reserves would have the same potentially negative result as a failure to find new product lines or update obsolete product lines.
- While there are many factors that go into the decision to drill oil or natural gas wells, projected future after-tax cash flow is one of the most critical. Decisions to invest in drilling new oil and natural gas wells are made on the basis of an analysis of projected costs and projected potential future revenues from each new drilling project. Those costs and revenues are then analyzed to produce a projected cash flow analysis for the project. During the exploration and development phase, cash flows are negative, as money is spent on the drilling process. If the project is successful, positive cash flows from the project are only realized, in many cases, after several years. Because the early years of a drilling project are always "cash-negative" and positive cash flow is only realized later in the life of the project, the discounted present value of those future positive cash flows must overcome the burden of recovering the significant "up-front" cash expenditure required by a drilling project. For that reason, anything which increases the cost of that up-front expenditure, such as an increase in cash taxes, due to a disallowance of the deduction for IDC's, will increase the likelihood that the project will never be able to provide an adequate future cash flow to recover that significant up-front investment and provide a competitive return. This will be true in many cases, even if the marginal tax rate is significantly reduced to compensate for the loss of an up-front deduction for IDC's, because the tax cost of the

[2] Ibid., Pg 3.

lost deduction is accelerated, whereas any tax benefit from a rate reduction is deferred until much later in the life of the project, thereby significantly diminishing the value of the lower rate, on a net present value basis. In short, such a change will result in significantly less drilling, fewer jobs and reduced domestic oil and gas development.

- Several studies have shown that a change in the tax treatment for IDC's, to require capitalization and amortization of such costs, will jeopardize many thousands of jobs in the oil and natural gas industry. ACCF's Dr. Margo Thorning cites Department of Commerce and Bureau of Labor Statistics data, in support of the assertion that "[e]ach additional $1 billion in investment is associated with 23,000 new jobs…." [3] We believe that the ability to treat IDC's as ordinary and necessary business expenses has a clear connection to the level of capital investment in our industry, and that the level of capital investment in our industry has a clear connection to jobs.
- Studies have also estimated that if deductibility is denied for IDC's, lost domestic production could reach 600,000 barrels of oil per day and $130 billion in capital investment would be lost to the economy over the next ten years.[4] This lost domestic production would result in the significant job losses mentioned above.

Tangible Capital Costs:

- In addition to drilling costs, or "IDC's" as described above, the oil and gas industry also incurs substantial capital costs for tangible, depreciable property. For Federal income tax purposes, the modified accelerated cost recovery system ("MACRS"), allows annual depreciation deductions with respect to certain types of tangible property used in the U.S.
- Cost recovery through deprecation allows taxpayers to recoup the cost of business assets and redeploy cash for continued investment. In capital intensive industries, like the oil and natural gas industry, extending cost recovery periods and slowing the depreciation recovery method, e.g., from MACRS to straight-line recovery, will have a significant impact on continued investment in the U.S., and will lead to reduced domestic energy production, jobs and economic activity.
- While the potential economic harm from a change in cost recovery methods or a lengthening of recovery periods for tangible property may be partially offset by a reduction in the marginal income tax rate, for capital-intensive industries, the reduced rate may not prevent a reduction in capital spending and the jobs and broader economic activity associated therewith.

Summary:

- At ConocoPhillips, we believe that a comprehensive pro-growth approach to tax reform will help stimulate our economy, bring greater certainty to the tax system and can be a catalyst for future prosperity.
- We have concerns related to the taxation of our foreign operations, not only under the current system of worldwide taxation with foreign tax credits, but also in the context of tax reform. Any system focused on taxing certain forms of low-tax income should be designed in a manner to avoid double taxation on high-tax income. In addition, a modification of the dual capacity taxpayer regulations, whether enacted in a discrete targeted measure or included in any tax reform effort, would be a punitive tax increase on U.S.-based companies. Double taxation impairs our ability to compete with non-U.S. companies in the global marketplace for access to resources, both at home and abroad.
- While we believe that a reduction in the marginal corporate tax rate is an important element of tax reform, we also believe that the ability to deduct ordinary and necessary business expenses, such as IDC's and the availability of robust capital cost recovery provisions are key to continued strong investment and job creation.

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[3] *Beware Tax Reform That Raises Taxes on Capital*, Margo Thorning, Ph.D., American Council for Capital Formation. WallStreetJournal.com, April 3, 2013.
[4] *Evaluation of Proposed Tax Changes on the US Oil and Gas Industry,* Wood Mackenzie, August 2010.