Committee on Ways and Means
Energy Working Group
April 12, 2013

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. After our repositioning in 2012, which resulted in the spinoff of our refining, marketing, chemicals and gas processing businesses into a new, independent company (Phillips 66), we are now positioned to focus exclusively on oil and natural gas exploration and production. ConocoPhillips employs about 17,000 people worldwide, and 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. 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;
- We believe that 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
- We believe that, 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 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:

Dual Capacity Taxpayer Modification:

- Of our approximately 8,000 U.S.-based employees, almost 1 out of every 4 works in support of our overseas operations. This means there are almost 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.
- Over the past six years, about two-thirds of ConocoPhillips' oil and natural gas earnings have come from outside the United States; whereas an increasing part of our spending plans are targeted at domestic development. 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. In a recent report, the American Council for Capital Formation ("ACCF") 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 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. Almost half of our approximately 8,000 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. IDC's are 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 not 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, and many taxpayers across a broad range of industries are permitted to deduct their research and development (R&D) costs. For companies that rely heavily upon R&D costs, the comparison to companies that rely upon IDC's is clear. Oil and natural gas companies must incur IDC's to remain competitive and viable, as their reserves are depleted. Just as technology companies must replace their existing product lines with new products, oil and natural

[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.
[2] Ibid., Pg 3.

gas companies must replace their depleted oil and gas reserves with new reserves. 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 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, and slow the realization of the shale renaissance in the United States.
- 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. In a recent editorial, 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 increase America's dependence on foreign sources of energy, rather than continuing the current trend toward significant reductions in our dependence on foreign sources of oil and natural gas. The related loss of capital investment would also result in the significant job losses mentioned above.

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. If the proposed dual capacity taxpayer modifications are enacted in a discrete targeted measure or included in any tax reform effort, the result would be a punitive tax increase on U.S.-based companies that must 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, is a key to robust 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.