The oil and natural gas industry is one of the world’s largest and most capital-intensive industries. It has to be to effectively compete for global energy resources. The industry’s earnings make possible the huge investments necessary to help ensure America’s energy security. The earnings allow companies to reinvest in the facilities, infrastructure and new technologies that keep America going strong well into the future while generating returns that meet shareholder expectations. API has assembled this primer to help consumers and policymakers better understand how the earnings of the oil and natural gas industry compare with other industries, who benefits, and where the money is going.

### Earnings

- Who Owns “Big Oil”? .......................................................................................................................... Page 1
- Earnings by Industry ....................................................................................................................... Page 2
- Earnings: Compared to Manufacturing .......................................................................................... Page 3
- Largest Oil and Gas Companies .................................................................................................... Page 4
- Capital Spending for U.S. Projects .................................................................................................. Page 5
- Return on Investment .................................................................................................................... Page 6
- Investments to Reduce Emissions .................................................................................................. Page 7
- Share of Net Income ...................................................................................................................... Page 8
- Taxes Paid by the Oil and Natural Gas Industry ............................................................................. Page 9
- Effective Tax Rates Among Industries .......................................................................................... Page 10
- Economic Consequences of Higher Taxes ................................................................................ Page 11
When politicians talk about taxing “Big Oil” or taking their “record profits,” they should think about who they really would be hurting.

If you’re wondering who owns “Big Oil,” chances are good the answer is “you.” If you have a mutual fund account, and 57 million U.S. households do, there’s a good chance it invests in oil and natural gas stocks. If you have an IRA or personal retirement account, and 46 million U.S. households do, there’s a good chance it invests in energy stocks. If you have a pension plan, and 61 million U.S. households do, odds are it invests in oil and natural gas.

Contrary to popular belief, and what some politicians might say, America’s oil companies aren’t owned just by a small group of insiders. Only 2.9 percent of industry shares are owned by corporate management. The rest is owned by tens of millions of Americans, many of them middle class.

A strong oil and natural gas industry is a vital part of the retirement security for millions of Americans. State pension fund investments in oil and natural gas companies are providing strong returns for teachers, firefighters, police officers, and other public pension retirees, according to a Sonecon study.\(^1\) Returns on oil and natural gas assets in the top two state funds in 17 states, which include more than half of all the people covered by state and local pension plans in the U.S., averaged $2.30 for each dollar invested compared to just $1.68 for other assets in these funds from 2005 through 2013.

The oil and natural gas industry is a major contributor to the health of these funds, many of which face huge future payout obligations. While oil and natural gas stocks made up 4 percent of public employee pension plan holdings, they accounted for 8 percent of the returns, outperforming other investment classes by two-to-one. During good economic times, or challenging ones, oil and natural gas investments far outperformed other public pension holdings.

\(^1\) Robert J. Shapiro and Nam D. Pham, “The Financial Contribution of Oil and Natural Gas Investments to Public Employee Pension Plans in Seventeen States, Fiscal Years 2005-2013,” SONECON, April 2015.
Earnings by Industry

Profit margins provide one useful way to compare financial performance among industries of all sizes.

Earnings by Industry, 2011-2015 Average
(cents of net income per dollar of sales)

Oil and natural gas earnings are typically in line with the average of other major U.S. manufacturing industries, but not recently. Published data for 2011 to 2015 shows the oil and natural gas industry lost on average 3.9 cent for every dollar of sales in comparison with all manufacturing which earned on average 8.7 cents for every dollar of sales.

Growth in the world’s supply of crude oil has outpaced the growth in global demand, which has led to sharply lower prices, and lower earnings.
Earnings: Keeping America going strong.

Over the last five years, average earnings for the oil and natural gas industry have been below the rest of the U.S. manufacturing industry, averaging about 4 cents for every dollar of sales compared to nearly 9 cents for manufacturing. By the second quarter of 2015, the average for the oil and gas industry fell to minus 21.9 cent on the dollar compared to 7.1 cents on the dollar for all U.S. manufacturing as the price collapse of crude oil took its toll on U.S. oil producers.

Like other industries, the oil and natural gas industry strives to maintain a healthy earnings capability. It does so to remain competitive and to benefit its millions of shareholders, across the country and in all walks of life. Healthy earnings also allow the industry to invest in innovative technologies that improve our environment and increase production to keep America going strong – even as it leads the search for newer technologies, and new sources of energy that will provide a more secure tomorrow.
Even the largest U.S. based international investor owned company accounts for just a small fraction of the world’s oil and natural gas production. This limits U.S. oil companies’ influence on world crude oil prices. U.S. based international investor owned companies face stiff competition for the world’s natural gas market share. But this is tempered by the fact that the natural gas market is more regional in nature than the global crude oil market.
To understand the oil and natural gas industry one must recognize it as an industry characterized by long lead times, huge capital requirements and returns realized only decades later in the face of very real investment risks.

Significant oil and gas discoveries that are announced today often result from investments begun by companies as far back as a decade or more ago. Since the year 2000, our industry invested over $3 trillion dollars in U.S. capital projects to meet the growing demand for oil and natural gas. The worldwide economic downturn, along with lower oil and natural gas prices and tight credit markets, caused some oil and natural gas producers to cut their capital budget plans in 2009.

Planning and investment cannot be turned on and off like a spigot, without entailing huge, potentially non-recoverable costs and delaying urgently needed projects. Because the industry must plan and operate under these long lead times, it is hypersensitive to minimizing risk over the course of its investments. It is crucial for an industry that must manage such huge risks that government provide an energy policy and tax framework that encourages investment, rather than discourages it.

The Oil & Gas Journal estimates capital spending on U.S. projects will decline again in 2015 as the value of oil has fallen almost in half over the past year leaving many companies with less to invest.\(^2\)

\(^2\) Oil & Gas Journal, “Companies slash capital budgets as oil price drop cuts cash flows,” April 6, 2015.
The return on investment for the industry turned sharply lower than the returns for the S&P Industrials during the recent downturn in the economy.

Because the oil and natural gas industry is massive and requires huge investments, its earnings contribute greatly to the American economy and way of life. They allow companies to reinvest in the facilities, infrastructure and new technologies that keep America going strong well into the future while generating returns that meet shareholders’ expectations.

These costs remain huge, regardless of whether earnings are high or low – as was the case throughout most of the 1990s and during other industry downturns. The return on investment (net income/net investment in place) for the oil and natural gas industry has been sharply lower than the returns for the S&P industrials.
The U.S. oil and natural gas industry is spending billions of dollars developing new advanced energy technologies to reduce greenhouse gas emissions and meet future energy needs.

End-Use: America’s oil and natural gas companies are investing in efficiency improvements and alternatives and are advising companies in other industrial sectors how to use energy more efficiently. Through such end-use technologies as combined heat and power – using excess heat from refinery processes to produce additional energy – refiners are becoming more energy efficient, reducing both energy use and emissions.

Between 2000 and 2014 the industry invested $50 billion in end-use technologies, including advanced technology vehicles, efficiency improvements, combined heat and power, gas flare reduction technologies and carbon capture and sequestration. This represents approximately 30 percent of all the investments made in these technologies in North America.

Non-Hydrocarbon: We are a major provider of the green jobs that are in the news today. The oil and natural gas industry accounts for about one out of every six dollars of all the investments made in non-hydrocarbon fuels since 2000. The industry’s top investments are in wind and biofuels. Expenditures were also made in solar, geothermal, and landfill digester gas.

Fuel Substitution: The oil and natural gas industry has spent nearly $25 billion developing substitute and less carbon intensive fuels, such as liquefied natural gas and reducing fugitive gas emissions. This investment in fuel substitution technologies represents 51 percent of the total invested in this technology class.
The oil and natural gas industry is very capital intensive and devotes the largest share of its earnings to add new property, plant and equipment to its upstream and downstream operations.

When companies repurchase stock, they are supporting the equity value of the company. This in turn helps the owners of the companies – retirees, future retirees and millions of Americans who have invested their hard-earned savings on the expectation of a reasonable return on their investment.

It is the responsibility of company officials to build value for shareholders; one way to do this is through stock repurchases. Earnings are also used for paying dividends which additionally benefit shareholders.

While the share of stock repurchases in the oil and gas industry has increased in recent years, it has averaged nearly half of that for the S&P industrial group. For the last 15 years, the oil and gas industry spent an average of 28 percent of net income on stock repurchases while the rate for the S&P industrials was 51 percent.
U.S. oil and natural gas companies pay their fair share of taxes and are a tremendous source of public revenue.

Over the past ten years U.S. oil and natural gas companies have paid considerably more in taxes than the average manufacturing company. From 2011 to 2015 income tax expenses (as a share of net income before income taxes) averaged 37 percent, compared to 25.8 percent for other S&P Industrial companies.

The U.S. oil and natural gas industry also pays the federal government significant rents, royalties and lease payments for production access – totaling more than $119 billion since 2000. In fact, U.S. oil and natural gas companies pay tens of millions of dollars to the federal government in both income taxes and production fees every single day.

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Source: Compustat North America Database.

* Oil and Natural Gas Companies: GICS Industry Group Code 1010.
** S&P Industrials are extracted from the S&P 1500 by excluding companies in the Financials (GICS Sector = 40), Utilities (GICS Sector = 55), and Transportation (GICS Industry Group = 2030).

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**Notes:**

1. GICS Industry Group Code 1010.
2. S&P Industrials are extracted from the S&P 1500 by excluding companies in the Financials (GICS Sector = 40), Utilities (GICS Sector = 55), and Transportation (GICS Industry Group = 2030).
Effective Tax Rates Among Industries

The high effective tax rates associated with the oil and gas industry are a function of the nature of the business.

With the high effective tax rates associated with the oil and gas industry are a function of the nature of the business. U.S.-based oil and gas companies must structure their operations and invest substantial capital where the resource is found rather than where the best tax regime is located. As a result, U.S.-based oil and gas companies' overseas income is often subject to very high effective tax rates. In addition, operations in the U.S. generate separate state and federal income tax obligations or payments, causing the industry to have an effective tax rate above the federal statutory rate of 35 percent.

Retailers are placed in a similar situation as they must naturally align their locations with customers, which can lead to higher effective tax rates. Other industries, however, may have greater flexibility on where they locate their physical capital or other operations to meet their customer needs. As a result, they may be able to establish activities in locations with lower effective tax rates.
Economic Consequences of Higher Taxes

Raising taxes on the oil and natural gas industry will not lower the price of fuel.

The Administration has proposed over $90 billion in additional taxes and fees on the oil and natural gas industry over a 10-year period. According to the Congressional Research Service, the proposals “…would make oil and natural gas more expensive for U.S. consumers and likely increase foreign dependence.”

In the long run, the negative economic consequences of higher taxes more than offset any short-term tax revenue gains. An additional $5 billion in new, annual taxes – similar to what’s been proposed by the Administration, or some in Congress – could actually decrease cumulative government revenue by $29 billion by 2020 according to an economic analysis by Wood Mackenzie. And even worse, higher taxes could result in the loss of tens of thousands of jobs between now and 2020.

There is a better way than saddling a troubled economy with new taxes and fees that hurt consumers and workers. The oil and natural gas industry should be allowed to develop the vast energy resources that belong to the American people. If we open areas that are currently off-limits to development, and partner with Canada to develop resources, we could create more than one million jobs throughout the economy and generate an additional $127 billion in government revenue by 2020.

We can either take momentum away from recovery or put it behind American prosperity.

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