

## >: How a "Windfall Tax" On Big Oil Can Hurt You

Thursday, June 12, 2008 / Dylan Jovine

LET ME START OFF BY SAYING THAT IT FEELS GREAT TO BE BACK.

Although it's only been a month since I last wrote an article in *The Tycoon Report*, so much has happened in the last 30 days that I feel like I've been away much

Let's see ...

In the last 30 days the Democrats finally settled on a nominee. Oil has zoomed from \$100/barrel to \$135/barrel. The financial markets have gone from "desperate panic" to "sigh of relief" and back to "desperate panic" again ...

And today we've officially launched the new and (vastly) improved *ETF Master Trader* system, featuring "Completely Automated Sector Hunter" (C.A.S.H.), the world's first fully automated ETF trading system. (Please forgive the hype here on this one, but we think the new *ETF Master Traders* system is going to blow you away. I have to admit -- we're REALLY proud of this).

### THE IMPACT OF GOVERNMENTAL POLICIES ON YOUR PORTFOLIO

As many of you correctly observed last week, we are not a political newsletter, nor would we ever want to be. But as investors, we would be foolish not to consider the impact that governmental policies could have on the economy, the capital markets and, of course, your portfolio.

Let's face it folks -- we all know the stakes are high this coming election. I don't know of one reasonable person who believes we don't need to have some serious discussions about serious issues.

Our challenge here at *The Tycoon Report*

is to discuss these serious matters with you in a way that is thoughtful and free of ideology. To discuss the very serious issues we face in the "Red State/Blue State" fashion of recent elections would be wasting a tremendous opportunity to think through some of the issues we face together, as Americans.

### "POLICY" NOT "POLITICS"

From this point forward it is the editorial policy of *The Tycoon Report* to analyze, discuss and debate "policy," as it relates to the economy and the capital markets ... not "politics."

"Politics," the discussion of political parties, individual candidates, and any of that "Red State/Blue State" back-and-forth, shall no longer be a topic we concern ourselves with. As serious investors we cannot afford to cloud our minds with concerns such as party affiliation. Let the pundits on television, print or radio discuss those issues. Our primary objective is to cut through the partisanship and analyze the meat of the issues.

"Policy," on the other hand, is only concerned with a reasonable discussion of issues themselves. Health care. Trade. The Budget Deficit. Taxation. Defense Spending. Medicare. Medicaid. These are legitimate policy issues that will not only have significant ramifications for our generation but for future generations to come. In other words, we owe it to our children to discuss these issues openly and honestly.

Before I go further, please accept the following caveats to our new editorial policy here at Tycoon:

1. The only reason we plan to occasionally discuss policy matters is because of a profound belief that we would be doing you a disservice as a financial and investing letter if we did not. It was not, nor has it ever been, our objective to discuss matters like this. But as I mentioned earlier, the stakes are high and the more informed decisions we can make the better off we'll all be.
2. The only reason we feel we can even discuss these matters with the *Tycoon Report* community is because we never cease to be amazed by the intelligence, drive and quest for self-improvement we find when we speak with you. We believe most *Tycoon Report* readers prize intellectual honesty above ideology, facts above sound bytes.
3. And last but not least, we believe that the overwhelming majority of our readers know that simply pointing out problems in our system is the easy part. Who doesn't believe our health care system can be improved? Or our education system? No, pointing out the problems isn't the hard part. What's difficult is coming up with SOLUTIONS to the problems. That's where most people differ.

Once again, this is an investing and finance newsletter. We are not a political newsletter, and will not discuss politics. To the extent that we do discuss governmental policies, it will be through the lens of how the impact may affect the economy, the markets and ultimately your portfolio.

*But successful investing is all about the ability to see "past the headlines" and use cold-blooded facts to judge a situation. It often requires standing alone in a room full of people who disagree with you (and in some cases hate you for it), comfortable in the belief that social acceptance runs a*

"ideology for the sake of ideology ... and if you are interested in helping in thinking through SOLUTIONS to our country's problems instead of just simply pointing our obvious problems ... then please, read on.

Perhaps it's just the last vestiges of my youthful naivete speaking, but I think -- at the very least -- our discussions on the impact government policies can have on the markets will be revealing. At the most, perhaps we can set an example for some of the national political leaders who I'm told read *The Tycoon Report*.

Are you ready? OK.

## **WHY I BELIEVE A "WINDFALL PROFITS" TAX ON OIL COMPANIES IS A TERRIBLE IDEA**

I was going to speak today about our national budget, and discuss discretionary versus non-discretionary spending. But I decided to put that article aside for another time and address something that Congress voted on this week: CREATING A WINDFALL PROFITS TAX ON BIG OIL.

This is a tricky first subject to write about. Many of you may automatically think I'm taking a position that is anti-Democrat or pro-Republican. But my position has to do with neither party -- it has to do with business and economics first, and a desire not to hurt us, second. Sometimes the cure is worse than the disease, and in this case I see it no differently.

I know the price of oil is having a terrible impact on many families. Indeed, every time I fill up my tank the absurdity of the gas prices I pay jump right out at me. Add to that the fact that the price of food has skyrocketed (I can't believe a gallon of milk costs 5 freaking bucks these days!) and many Americans are feeling a terrible squeeze.

Having grown up on welfare and food stamps, I know what it's like to be poor. I know what it's like to eat macaroni and cheese dinners every night. I know what it's like to choose between gas in the car and meat at the dinner table. It's shocking, it stinks, and it has got to stop.

But creating a windfall tax on big oil companies is not the answer (in fact, I thought it was just politicking until Congress actually voted on the bill -- I couldn't believe it!).

Let me explain why I believe this, using everybody's favorite Bad Guy these days, ExxonMobil (SYM:XOM). I'm going to go over a list of common reasons good friends of mine have used when debating with me recently:

### POPULAR REASON #1: \$40 BILLION IS A "WINDFALL PROFIT" WHICH DESERVES A "WINDFALL TAX"

Yes, it is true that XOM earned an astounding \$40 billion profit in 2007. Even more astounding when I think about it is that they earned that money on over \$350 BILLION in revenue. But a closer look at the numbers reveals a company whose profit of \$40 billion is far from a "windfall" by any definition of the word you want to use.

For 2007, Exxon's profit margin was 11.3% of sales. That means that for every dollar in revenue the company generated, they earned 11.3 cents in profits.

How does that compare with the rest of corporate America? If you look at the numbers, it's clear that Exxon's performance -- regardless of the eye popping number of \$40 Billion -- was... well, quite average.

For every \$1 in sales, Google (SYM: GOOG) earned 25.3 cents in profit. Apple Computer (SYM: AAPL) earned 14.6 cents per share for every \$1 in sales. Microsoft (SYM: MSFT) earned 30 cents in profit for every \$1 in sales, as did Warren Buffett's Berkshire Hathaway (SYM: BRK).

Clearly, each of the companies above earns far more in profits for every dollar in sales than Exxon does. But how does Exxon compare with the rest of corporate America? Its profit of 11.3% is actually slightly less than the average profit of all companies in the S & P 500: 12%.

That's right -- even with oil skyrocketing this year, the company's profit margin is actually expected to DECLINE to the 10% range as costs increase for the business as a whole and profits decline.

From Exxon's point of view, an 11.3% profit margin is great -- especially when compared to the 5% profit margins it earned throughout the 1990's when oil hovered between 10 and 20 bucks a barrel for the better part of the decade.

Takeaway: For 15 of the past 20 years, Exxon earned profits less than half that of the average company in America. If profitability is the measure of how we define "windfall profits," then there are far more companies that can be taxed at "whatever rate we choose." This is a slippery slope to me that could quickly turn into a corporate witch-hunt.

### POPULAR REASON #2: A "WINDFALL PROFITS" TAX ON EXXON CAN BE USED TO GIVE RELIEF TO DRIVERS

Who would decide what % of Exxon's \$40 Billion in profits is fair to take? How would that decision be made? If the government decided that 25%

of the total profits -- or \$10 Billion -- was to be taken as a "penalty" for "windfall profits," where would that money go? How much of an impact would that have on our lives? Would it mean that every driver in America gets 5 gallons of gas for free, one time?

Secondly, if Exxon has less profit to invest in its business, that means it will have less profit to plow into finding new sources of oil or investment into alternative energies. We've already seen how incredibly expensive oil has become due to excessive demand -- do we need any more pressure on the companies trying to find additional supply?

Last but not least: Does anybody know who even owns the stock in Exxon? 99% of the company is owned by large investors like pension funds and mutual funds. Most of you reading this right now probably have Exxon stock in a retirement account through your 401(k) and don't even know it.

In short, a "windfall profits" tax on Exxon would be like robbing your left hand to pay your right hand. It just simply doesn't make any sense to me whatsoever.

The less money Exxon has in profits, the less capital it will have to be able to compete and drill for new oil. And with countries like Venezuela kicking the company out last year (and reducing 10% of Exxon's output) they have a lot of catching up to do!

### POPULAR REASON #3: EXXON ACTUALLY GOT TAXPAYER BREAKS, SO THEY SHOULD GIVE SOME BACK!

Of all the conversations I have with folks, this seems to upset them the most. And that's understandable. But there are a couple of points I must make here that are critically important:

Exxon doesn't compete with mom and pop operations anymore. That world is long gone. Today, Exxon's biggest competitors are international oil companies, often owned by FOREIGN GOVERNMENTS.

So yes, on the surface it seems absurd that the US Government would give tax breaks to this company when they're making all this money. But consider this: Exxon competes against Russia's Gazprom, Saudi Arabia's Aarmco, China's Cnooc and many other very large and very well funded competitors.

And unlike Exxon, which gets relatively small tax breaks from our government, these competitors are actually divisions of their own respective governments! So Exxon isn't competing directly against corporations in a fair way -- it's now competing with government sponsored oil companies from Russia, Saudi Arabia and China, and each government is pouring all of the resources at its disposal to make sure their companies have a competitive advantage over Exxon.

The tax breaks our government gives Exxon are paltry compared to what countries like Russia are doing to fund and support oil giant Gazprom. (For an example of just how much backing Gazprom gets from Russia, check out the stories this week about how the government is trying to help them take British Petroleum's \$60 Billion properties away from the company and hand them to Gazprom.)

In short, the international battlefield for natural resources is going to be incredibly tough for a very long time to come. Anything we do to cripple Exxon -- which is, in a way, our national oil company -- would put them at a serious disadvantage against these well funded giant competitors.

And if you believe that oil and national security are closely aligned, we simply cannot allow that to happen.

### POPULAR REASON #4: BIG OIL COMPANIES LIKE EXXON LOVE IT WHEN OIL PRICES ARE SO HIGH

Sure, oil companies like it when oil prices rise. But they certainly don't like it when they rise as much as they have, so fast!

You see, oil companies and oil producing states have this formula clocked to a science. If you can imagine a supply/demand curve, you can visualize a point on the chart where the optimal price meets optimal demand. In other words, it's the price where you can sell the most amount of oil and gas to the most amount of people for the longest period of time.

I know this is a hard one, but stick with me folks: oil companies know that for an average consumer, oil should not exceed a certain percentage of their total expenses. Let's say for example that oil companies know that once oil and gas costs exceed 5% of a family's budget, demand will drop off as the family changes its habits, cars, etc.

Whenever oil becomes too expensive for consumers, a couple of things happen that oil companies hate: (1) demand drops off (as witnessed by the 40% drop in SUV sales last month, and (2) competing forms of energy become economically feasible.

Put yourself in the shoes of the oil company (as hard as that sounds) for a second: would you rather get paid big money for only 5 - 10 years (if you consider 11.3% profit margins big money in a corporate sense of the word) OR would you rather make 8% profit margins for the next 25 years?

It's kind of like the drug industry. They never invent the cure, they only look to treat these illnesses. The same goes with oil firms: the higher the price of oil stays, the more likely we'll find a "cure" in the form of alternative energy. And that's something that they simply do not want.

### POPULAR REASON #5: HIGH OIL PRICES ARE ALL ABOUT THE ECONOMIC GROWTH COMING FROM CHINA AND INDIA

And there was nothing they could do about it -- it was just a new fact of life: America was a new economic powerhouse and the demand it created was going to send prices higher until the market could adjust to meet the new demand.

But there's something else that's been nagging me recently every time I go fill up my gas tank. It's the fact that I, like many Americans, drive a gas guzzling SUV.

So these days, as I've driven past empty Hummer and SUV showrooms, I've started to wonder what part my desire to drive an SUV played in this whole affair.

15 years ago America was still shaking off the oil shock of the 1970's, and most of our cars were still small. But since then it seems that not only have we added many new cars to the road, but the cars we did add we SUPER-SIZED.

Double the cars at double the size. Regardless of the impact of India and China, I have to believe that I and many of my friends who bought large trucks must have played some part in the increase of demand.

Nope, friends, my feeling on this one is that while oil is overvalued in the short-run (remember it's priced in dollars and dollars are declining and demand is finally starting to seriously dry up), in the long-term we're going to have to seek more permanent solutions to our dependence on oil.

And no, I do not own stock in Exxon, nor have I been paid to say what I just said. I just don't see making Big Oil pay a "windfall tax" as a serious solution to a very serious problem.

And if there's one thing I'm sick of at this point in my life, it's being looked in the face by politicians and being told that there are actual solutions to our problems that don't require any pain.

If we keep believing stories like that, we'll never be able to say we were able to carry the baton handed to us by the "Greatest Generation."



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