

Capital Intensive Firms and the Risk of Increased Tax Payments in a Recession

EXECUTIVE SUMMARY

Through accelerated depreciation deductions, capital intensive firms are able to postpone or defer the payment of significant amounts of income taxes. Provided they continue their capital spending, these taxes can be deferred indefinitely, providing companies with what is essentially a long-term, interest-free loan from the federal government. However, when capital expenditures are reduced for an extended period, required tax payments will grow as deferred tax liabilities decline and tax payments postponed from prior years become due. Our expectation is that in a deep and continuing recession, as is being experienced currently, firms will reduce capital spending. As a result, capital intensive firms may begin to experience increases in tax payments, resulting in cash payments for taxes that exceed the amount of income tax expense reported on the income statement.

In this research report we use data for 2007 to identify capital intensive firms with significant deferred tax liabilities. The sample firms are divided into two groups: firms with increasing capital expenditures and deferred tax liabilities and firms with decreasing capital expenditures and deferred tax liabilities. While all of the firms are at risk for increased tax payments resulting from an extended period of reduced capital expenditures, the firms in the latter group are more likely to see higher tax payments. Investors may not be expecting such higher tax payments, especially during a recession.

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts unbiased research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times, our research may look at stock prices generally, though from a fundamental and not technical point of view.

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Companies Named in this Report

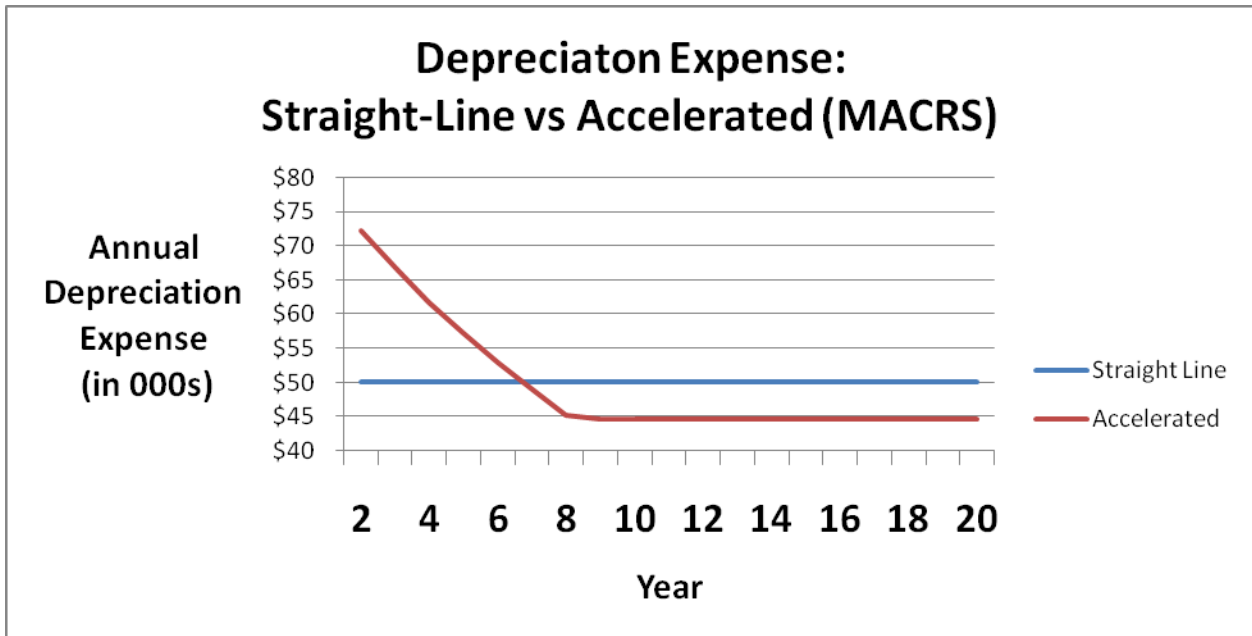
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Deferred Tax Liabilities and Increased Tax Payments

A common attribute of capital intensive firms is that they report sizable, and typically growing, deferred tax liabilities. Deferred tax liabilities (DTLs) represent income taxes to be paid on future taxable income. DTLs are caused by differences that arise between taxable income as reported on a company's income tax return and pre-tax book income as reported on its GAAP-based income statement. Differences in depreciation charges between taxable and book income are the single largest contributor to deferred tax liabilities. In order to encourage firms to increase capital spending, when computing taxable income, the U.S. tax code permits companies to depreciate long-lived or capital assets on an accelerated basis. This accelerated method of depreciation, referred to in the tax code as MACRS (Modified Accelerated Cost Recovery System), allows firms to depreciate more of a capital asset's cost in the early years of its life than in the later years. Typically, these same assets are depreciated on a straight-line basis, that is, with equal annual depreciation charges, when computing pre-tax book income for purposes of reporting to shareholders. The net result is higher depreciation charges on the tax return than on the books in the early years of a capital asset's life. Higher depreciation charges lower taxable income below pre-tax book income and lower current tax expense, the amount of income taxes currently due and payable per the income tax return below total tax expense, the amount of income tax expense reported on the income statement.

Over the lifetime of a capital asset, the cumulative amount of depreciation expense recorded on the tax return and on the income statement must be the same. Accordingly, in later years depreciation expense recorded on the tax return will decline, pushing taxable income higher than pre-tax book income. Thus, such depreciation-related differences between taxable income and pre-tax book income are referred to as temporary differences because the differences disappear over time. Lower taxable income in early years due to higher tax-related depreciation charges is replaced with higher future taxable income as depreciation charges decline. In the process, income taxes deferred in the early going become due and payable later.

An example of the mechanics of a depreciation-related temporary difference is demonstrated in Figure 1. Note that while depreciation expense is a higher amount in earlier years under MACRS, the accelerated depreciation method used for tax purposes, the depreciation deduction declines as the capital asset ages. Straight line depreciation, which is used for book purposes, is the same amount each year. Such a straight-line method is more representative of how the asset's utility is consumed over time than accelerated depreciation. Thus, in early years accelerated depreciation exceeds straight-line depreciation. In later years, straight-line depreciation exceeds accelerated depreciation.



The Benefits of Deferred Tax Liabilities

Deferred tax liabilities offer obvious tax benefits. In effect, a deferred tax liability represents an interest-free loan from the federal government to be repaid later when depreciation differences between the tax return and books reverse. Of course, if capital-intensive firms were to continue making capital expenditures and growing their capital asset base, then declining depreciation charges for tax purposes could be offset with new accelerated depreciation charges, postponing the payment of taxes indefinitely or at least until capital expenditures declined.

Consider, for example, SkyWest, Inc., a capital intensive firm with growing deferred tax liabilities. SkyWest reports capital expenditures that ranged between 7.9% and 16.7% of revenues for the period 2005 to 2007. As a comparison, during that same period, the average company reported capital expenditures of about 4.4% of revenue. From the 2007 annual report we see the following:

From the SkyWest, Inc., income statement (amounts in thousands):

Taxes on Income Statement	2007	2006	2005
Income before Income Taxes ^a	\$250,321	\$240,027	\$179,626
Provision for Income Taxes ^b	\$91,129	\$94,221	\$67,359
a – Income before Income Taxes is also known as Pre-tax Income			
b – Provision for Income Taxes is also known as Total Tax Expense			

From the SkyWest, Inc., income tax note (amounts in thousands):

Total Tax Expense Breakdown	2007	2006	2005
Current Tax Provision (Benefit) ^a			
Federal	(\$14,355)	(\$41,914)	\$45,714
State	(\$736)	(\$8,419)	\$5,798
Current Tax Provision (Benefit)	(\$15,091)	(\$50,333)	\$51,512
Deferred Tax Provision ^b			
Federal	\$99,026	\$123,646	\$13,124
State	\$7,194	\$20,908	\$2,723
Deferred Tax Provision	\$106,220	\$144,554	\$15,847
Provision for Income Taxes ^c	\$91,129	\$94,221	\$67,359
a – Current Tax Provision is also known as Current Tax Expense			
b – Deferred Tax Provision is also known as Deferred Tax Expense			
c – Provision for Income Taxes is also known as Total Tax Expense			

Deferred Tax Assets and Liabilities Breakdown	2007	2006
Deferred Tax Assets		
Accrued Benefits	\$20,134	\$16,560
Net Operating Loss Carry forward	\$25,738	\$55,332
AMT Credit Carry forward	\$24,511	\$2,266
Deferred Aircraft Credits	\$45,531	\$31,795
Accrued Reserves and Other	\$7,739	\$9,779
Total Deferred Tax Assets	\$123,653	\$115,732
Deferred Tax (Liabilities)		
Accelerated Depreciation	(\$490,134)	(\$355,103)
Maintenance and Other	(\$8,989)	(\$29,879)
Total Deferred Tax (Liabilities)	(\$499,123)	(\$384,982)
Net Deferred Tax (Liability)	(\$375,470)	(\$269,250)

Referring to the data above we see that in 2007, SkyWest's effective tax rate, which measures the percentage of pre-tax income that is subject to tax and is calculated as the ratio of total tax expense / pre-tax income, is \$91,129,000 / \$250,321,000, or 36.4%. However, for the same period, the current tax rate, which measures the percentage of pre-tax income that actually results in income taxes paid or payable during the period and is calculated as current tax expense /

pretax income, is $-\$15,091,000 / \$250,321,000$, or -6.03% . A negative current tax rate, as is the case here, indicates that the company is getting a tax benefit, that is, a refund of taxes paid in a previous year. Note that the difference between total tax expense of $\$91,129,000$ and current tax expense of $-\$15,091,000$ is deferred tax expense of $\$106,220,000$. This deferred tax expense represents income taxes for the year for which payment has been postponed to future time periods. While SkyWest expensed $\$91,129,000$ in total tax expense for the year, $\$106,220,000$ was deferred leaving a current refund of $\$15,091,000$ as the difference. Also note that the difference between the net deferred tax liability in 2007 and 2006 is deferred tax expense for 2007 ($\$375,470,000$ minus $\$269,250,000$, which is $\$106,220,000$.) During 2007 the company recorded deferred income tax expense of $\$106,220,000$, which causes an increase in a net deferred tax liability on the balance sheet representing taxes to be paid in future years.

The cumulative total amount of taxes deferred by the company, reported as net deferred tax liability, is also shown in the income tax footnote. SkyWest reports a net deferred tax liability of $\$375,470,000$, consisting of gross deferred tax liabilities of $\$499,123,000$ less deferred tax assets, which are tax savings to be derived from future tax deductions and are primary the result of expenses reported on the books in advance of their deduction for tax purposes, of $\$123,653,000$.

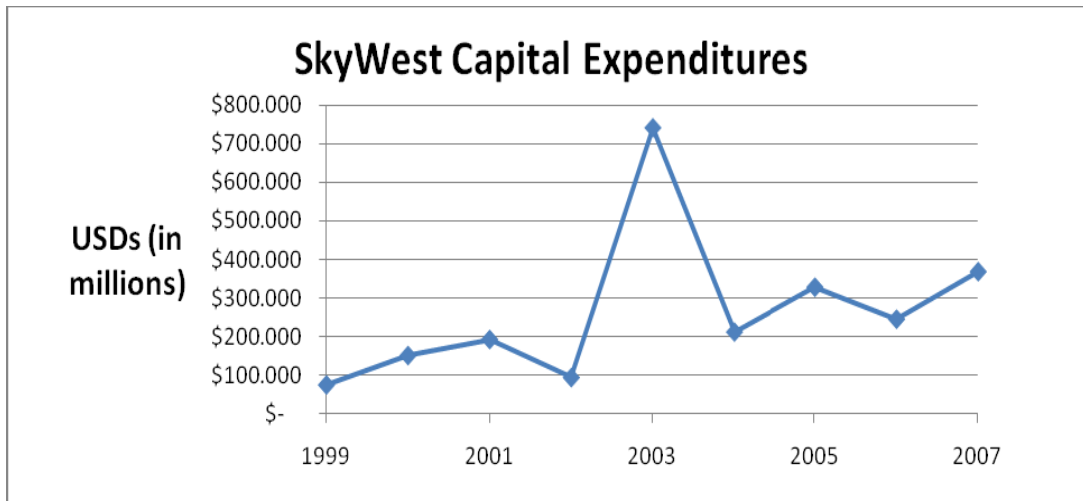
Note that Accumulated Depreciation is the single largest item causing SkyWest to report a net deferred tax liability. The $\$490,134,000$ deferred tax liability is measured as the income tax rate times the cumulative excess of accelerated depreciation expense computed for tax purposes over straight-line depreciation computed for income-statement purposes. The depreciation-related temporary difference is supported by the company's significant and growing capital expenditures. For example, as seen in the following excerpts from the company's statement of cash flows, capital expenditures at SkyWest increased to $\$368,392,000$ in 2007 from $\$245,512,000$ in 2006.

From the SkyWest, Inc., statement of cash flows (amounts in thousands):

Cash Flows from Investing Activities	2007	2006	2005
Acquisition of Property and Equipment			
Aircraft and Rotable Spare Parts	(\$298,519)	(\$206,426)	(\$214,164)
Deposits of Aircraft	(\$32,326)	(\$416)	(\$101,345)
Buildings and Ground Equipment	(\$37,547)	(\$38,670)	(\$12,745)
Total Capital Expenditures	(\$368,392)	(\$245,512)	(\$328,254)

Brackets “()” denote outflows of cash.

Evidence of the company's longer-term commitment to capital spending can be seen in the following graph.



SkyWest, Inc. is a capital intensive firm with significant and growing capital expenditures. As long as the company remains committed to capital spending, its depreciation-related temporary differences should continue to grow, enabling the firm to maintain a growing balance in deferred tax liabilities. The question that arises, however, is what happens to deferred tax liabilities when capital spending is reduced?

The Dangers of Deferred Tax Liabilities

When capital expenditures are reduced, depreciation-related temporary differences will decline, resulting in reductions in deferred tax liabilities. Income taxes, the payment of which was deferred in previous periods, will then come due, resulting in higher tax payments. Such increased tax payments may occur during difficult economic times as companies deal with slack demand by reducing capital spending. Consider, for example, the financial statement excerpts for Bob Evans Farms, Inc.

From the Bob Evans Farms, Inc. statement of cash flows (amounts in thousands):

Cash Flows from Investing Activities	2008	2007	2006	2005	2004
Purchase of property, plant and equipment	\$(120,955)	\$(84,242)	\$(112,860)	\$(139,587)	\$(141,037)

Brackets “()” denote outflows of cash.

At Bob Evans, capital spending trended downward to \$84,242,000 in 2007, from as high as \$141,037,000 in 2004. Such a reduction in capital expenditures will gradually lead to reversing depreciation-related temporary differences and increasing income taxes paid. The increase in capital expenditures in 2008 will, however, help to mitigate rising income taxes paid.

Evidence of increasing income taxes paid at Bob Evans Farms can be seen in the excerpts from the income statements and income tax footnotes provided below.

From the Bob Evans Farms, Inc. income statements (all amounts in thousands):

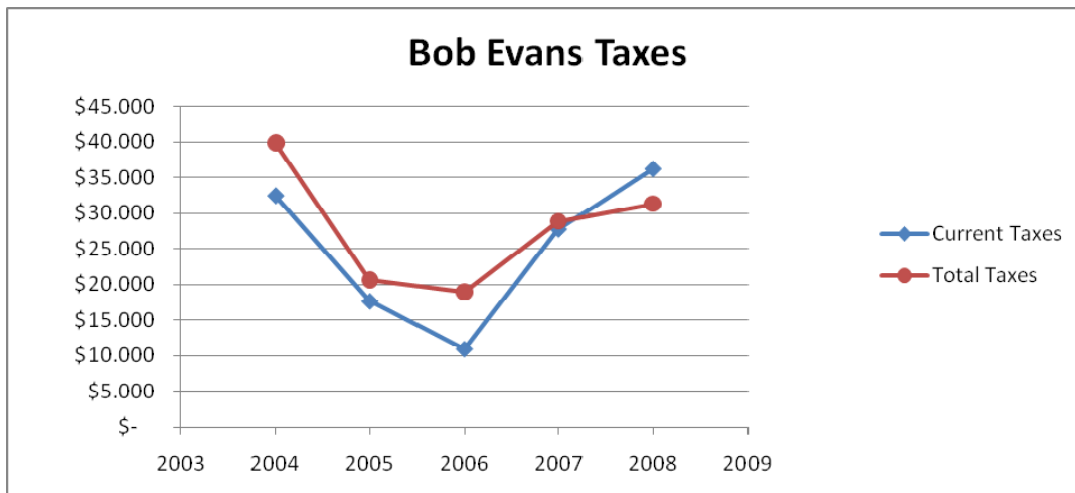
Taxes on Income Statement	2008	2007	2006	2005	2004
Income before Income Taxes ^a	\$96,250	\$89,427	\$73,712	\$57,672	\$111,990
Provision for Income Taxes ^b	\$31,374	\$28,885	\$18,938	\$20,704	\$39,955
a – Income before Income Taxes is also known as Pre-tax Income					
b – Provision for Income Taxes is also known as Total Tax Expense					

From the Bob Evans Farms, Inc., income tax note (all amounts in thousands):

Total Tax Expense Breakdown	2008	2007	2006	2005	2004
Current					
Federal	\$31,674	\$23,332	\$6,527	\$14,779	\$29,590
State	\$4,560	\$4,472	\$4,479	\$2,919	\$2,894
Total Current Tax Expense	\$36,234	\$27,804	\$11,006	\$17,698	\$32,484
Deferred, primarily federal	(\$4,860)	\$1,081	\$7,932	\$3,006	\$7,471
Total Tax Provisions ^a	\$31,374	\$28,885	\$18,938	\$20,704	\$39,955
a – Total Tax Provisions are also known as Total Tax Expenses					

From the income statement data provided above it can be seen that as pre-tax income increased, the provision for income taxes also increased, to \$31,374,000 in 2008, up from \$28,885,000 in 2007 and \$18,938,000 in 2006. Each year, however, through 2007, because of deferred income taxes, current tax expense was actually less than the provision for income taxes. Consider, for example, 2007, a year when the tax provision was \$28,885,000, current tax expense was \$27,804,000. Similarly, in 2006, the income tax provision was \$18,938,000 and current tax expense was only \$11,006,000. However, in 2008, owing at least partially to reversing depreciation-related temporary differences, current tax expense of \$36,234,000 exceeded the income tax provision of \$31,374,000 by \$4,860,000. That year, total tax expense was 32.6% of pre-tax income ($\$31,374,000 / \$96,250,000$) while current tax expense was 37.6% of pre-tax income ($\$36,234,000 / \$96,250,000$).

The following graphical display shows that while income tax expense at Bob Evans Farms (referred to as total taxes) exceeded current tax expense each year for the period 2004 – 2007, in 2008 total tax expense was exceeded by current tax expense.



As seen in the breakdown of deferred tax assets and liabilities for Bob Evans Farms presented below, deferred tax liabilities related to accelerated depreciation declined in 2008 to \$81,644,000 from \$82,613,000 in 2007. That decline indicates that reversing temporary differences for depreciation added \$969,000 to income taxes due and payable in 2008.

From the Bob Evans Farms, Inc., incomes tax note (all amounts in thousands):

Deferred Tax Assets and Liabilities Breakdown	2008	2007	2006	2005	2004
Deferred Tax Assets					
Loss on impaired assets	\$7,611	\$7,566	\$7,546	\$7,456	\$7,546
Self-insurance	\$6,941	\$6,912	\$7,089	\$7,861	\$6,453
Vacation pay	\$1,817	\$1,755	\$1,842	\$1,755	\$1,381
Stock and deferred compensation plans	\$15,647	\$12,894	\$9,634	\$8,740	\$7,385
Accrued bonus	\$839	\$116	\$105	\$210	\$440
Tax credits	\$2,884	\$4,520	\$6,925	\$10,525	0
Deferred rent	\$5,777	\$5,239	\$4,228	\$6,233	0
Inventory and other	\$1,331	\$1,389	\$1,281	\$797	\$595
Total deferred tax assets	\$42,847	\$40,391	\$38,650	\$43,667	\$23,800

Deferred tax liabilities					
Accelerated depreciation / asset disposals	\$81,644	\$82,613	\$79,900	\$75,607	\$52,992
Intangible assets	\$20,756	\$22,209	\$22,073	\$22,392	0
Other	\$59	\$41	\$68	\$1,127	\$1,379
Total deferred tax liabilities	\$102,459	\$104,863	\$102,041	\$99,126	\$54,371
Net deferred tax liabilities	\$59,612	\$64,472	\$63,391	\$55,459	\$30,571

Bob Evans is paying more taxes in 2008 than the amount of income tax expense accrued on its income statement. These higher tax payments are due, at least in part, to the reversal of taxes deferred from prior years. These deferred tax liabilities are coming due because capital expenditures have been declining. The purpose of this study is to identify other companies who may be more likely to see increasing income taxes paid in a continuing economic downturn.

Data Set

For our data we used the Compustat (North American) database for fiscal year 2007 with the following criteria:

- No financial services firms (NAICS < 520000 and NAICS >= 530000)
- Revenues in excess of \$100 million USD
- Positive earnings (pre-tax income > 0)
- Capital expenditures / revenue > sample mean of 4.4%
- Gross deferred tax liabilities / total assets > sample mean of 3.0%.
- Net deferred tax liabilities > 0 (Net deferred tax liabilities are net of deferred tax assets).

We then separated the firms into two categories:

- Group 1 – The No DTL Reversal Group (2007). Capital expenditures are increasing and gross deferred tax liabilities are increasing. Specifically, the sample is comprised of firms where:
 - The % Δ in Capital expenditures > 0 (firms with increasing capital expenditures) and
 - The % Δ in Gross DTL > 0 (firms with increasing gross deferred tax liabilities).

We identified the 50 firms with the largest % increase in Gross DTL. These firms were then sorted on Net DTL / Total Assets, from highest to lowest.

Group 1 consists of capital intensive firms with significant deferred tax liabilities. With increasing capital expenditures, these firms are taking the steps necessary to continue growing their deferred tax liabilities. At present, those deferred tax liabilities are showing no signs of reversal, and, as such, the companies are continuing to postpone the payment of taxes deferred from prior years. Importantly, as long as the firms in this group continue to increase their capital spending, they are in no danger of reversing deferred tax liabilities. However, with the decline in business conditions witnessed in 2008 and expected for 2009, it may be difficult for these firms to continue increasing their capital spending.

The Group 1 firms are presented in Table 1. Note how significant the net deferred tax liabilities are for these firms. For some, the future tax liability ranges as high as \$9.7 billion (Union Pacific Corp.) and as much as 25.9% of total assets (Yamana Gold, Inc.)

- Group 2 – The DTL Reversal Group (2007). Capital Expenditures are decreasing and gross deferred tax liabilities are decreasing. Specifically, the sample is comprised of firms where:
 - The % Δ in Capital expenditures < 0 (firms with decreasing capital expenditures) and
 - The % Δ in Gross DTL < 0 (firms with increasing gross deferred tax liabilities).

There were 42 firms that met these criteria. We sorted them on Net DTL / Total Assets, from highest to lowest.

Group 2 also consists of capital intensive firms with significant deferred tax liabilities. However, these firms reduced their capital spending in 2007 and were experiencing decreasing gross deferred tax liabilities. For these companies, taxes deferred in prior years are coming due and increasing the firms' tax burdens. Given the amount of the deferred tax liabilities reported by these companies, the taxes due in future years could be substantial. For example, referring to Table 2, firms on the list show net deferred tax liabilities that range as high as \$10.1 billion and as much as 20.8% of total assets (Anadarko Petroleum Corp.). Of course these companies can avoid the payment of taxes deferred from prior years by increasing their capital spending. But that is a tall order to fill in the middle of a serious economic recession.

Table 1. Group 1 - No DTL Reversal Group (2007) Capital Expenditures Increasing and DTLs Increasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
YAMANA GOLD INC	27.29%	722.27%	24.56%	\$ 2,567.37	25.94%
UNION PACIFIC CORP	26.42%	3.65%	11.33%	\$ 9,714.00	25.54%
BURLINGTON NORTHERN SANTA FE	27.31%	3.31%	11.62%	\$ 8,194.00	24.40%
NORFOLK SOUTHERN CORP	26.45%	0.44%	13.84%	\$ 6,241.00	23.87%
HARRY WINSTON DIAMOND CORP	24.80%	11.10%	53.12%	\$ 329.54	22.06%
COEUR D'ALENE MINES CORP	21.62%	3256.60%	46.61%	\$ 569.28	21.47%

Table 1 (continued). Group 1 - No DTL Reversal Group (2007) Capital Expenditures Increasing and DTLs Increasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
PANHANDLE OIL & GAS INC	23.34%	10.83%	22.81%	\$ 16.83	21.43%
ULTRA PETROLEUM CORP	20.61%	41.22%	39.05%	\$ 341.41	19.22%
LIN TV CORP	25.01%	0.38%	12.63%	\$ 374.55	18.90%
CABOT OIL & GAS CORP	21.99%	28.02%	19.21%	\$ 411.40	18.63%
P.A.M. TRANSPORTATION SVCS	19.56%	3.53%	42.33%	\$ 58.62	18.32%
FREEMPORT-MCMORAN COP&GOLD	21.44%	854.09%	600.49%	\$ 7,359.00	18.10%
MCGRATH RENTCORP	19.83%	11.20%	0.28%	\$ 115.89	18.04%
PLAINS EXPLORATION & PROD CO	21.49%	339.96%	21.45%	\$ 1,729.54	17.84%
EOG RESOURCES INC	18.04%	31.52%	30.50%	\$ 2,146.75	17.76%
AGNICO EAGLE MINES LTD	17.70%	432.15%	181.19%	\$ 478.21	17.48%
NOBLE ENERGY INC	20.06%	6.73%	4.24%	\$ 1,853.26	17.11%
COCA-COLA ENTERPRISES INC	19.32%	0.17%	6.35%	\$ 3,984.00	16.57%
CANO PETROLEUM INC	18.64%	3.05%	700.26%	\$ 32.37	16.07%
QUESTAR CORP	16.78%	17.01%	52.64%	\$ 947.30	15.94%
PUBLIC SERVICE ENTRP GRP INC	19.95%	8.34%	32.81%	\$ 4,454.00	15.69%
CONSOLIDATED EDISON INC	19.83%	5.98%	4.29%	\$ 4,386.00	15.47%
NEWFIELD EXPLORATION CO	21.19%	12.72%	52.46%	\$ 1,069.00	15.30%
SWIFT ENERGY CO	15.68%	6.73%	16.70%	\$ 294.25	14.94%

Table 1 (continued). Group 1 - No DTL Reversal Group (2007) Capital Expenditures Increasing and DTLs Increasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
MGM MIRAGE	15.66%	1.21%	54.85%	\$ 3,353.21	14.75%
PETROHAWK ENERGY CORP	17.79%	6.44%	159.26%	\$ 669.11	14.32%
SOUTHWESTERN ENERGY CO	21.98%	48.20%	78.57%	\$ 514.65	14.21%
WESTAR ENERGY INC	18.42%	1.13%	115.68%	\$ 899.60	14.07%
RANGE RESOURCES CORP	17.59%	16.20%	56.25%	\$ 563.88	14.04%
CNX GAS CORP	16.56%	46.09%	131.58%	\$ 189.68	13.74%
XTO ENERGY INC	14.53%	19.21%	141.49%	\$ 2,590.00	13.69%
EDISON INTERNATIONAL	19.92%	1.27%	11.44%	\$ 5,029.00	13.39%
ENCANA CORP	13.54%	1.78%	32.38%	\$ 6,208.00	13.22%
SEACOR HOLDINGS INC	14.38%	8.57%	40.84%	\$ 470.52	13.18%
APACHE CORP	13.76%	8.57%	3.71%	\$ 3,711.52	12.96%
CHESAPEAKE ENERGY CORP	14.23%	16.24%	11.22%	\$ 3,965.00	12.90%
PIONEER NATURAL RESOURCES CO	17.22%	8.28%	46.99%	\$ 1,111.34	12.90%
QUICKSILVER RESOURCES INC	13.86%	73.84%	70.83%	\$ 355.70	12.81%
SOUTHERN CO	18.75%	1.87%	18.40%	\$ 5,857.00	12.79%
GREAT PLAINS ENERGY INC	17.32%	0.20%	9.19%	\$ 605.00	12.53%
HELMERICH & PAYNE	13.07%	30.60%	69.07%	\$ 351.98	12.20%
MEADWESTVACO CORP	16.19%	5.85%	14.90%	\$ 1,186.00	12.06%

Table 1 (continued). Group 1 - No DTL Reversal Group (2007) Capital Expenditures Increasing and DTLs Increasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
GREY WOLF INC	13.14%	24.44%	11.68%	\$ 145.50	12.04%
MDU RESOURCES GROUP INC	14.72%	16.93%	9.69%	\$ 660.97	11.82%
METHANEX CORP	14.00%	2.59%	424.10%	\$ 338.60	11.80%
RAM ENERGY RESOURCES INC	19.16%	425.10%	43.30%	\$ 67.27	11.59%
ALLIANT ENERGY CORP	14.52%	12.89%	47.40%	\$ 824.00	11.46%
EMPIRE DISTRICT ELECTRIC CO	14.04%	10.39%	52.57%	\$ 166.37	11.30%
HELIX ENERGY SOLUTIONS GROUP	13.32%	51.62%	101.15%	\$ 611.70	11.22%
WILLIAMS COS INC	13.79%	0.71%	12.23%	\$ 2,797.00	11.16%

^aGross DTL / Total Assets – Gross DTL is not net of deferred tax assets.

Table 2. Group 2 - DTL Reversal Group (2007) Capital Expenditures Decreasing and DTLs Decreasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
ANADARKO PETROLEUM CORP	23.50%	-21.33%	-7.07%	\$ 10,087.00	20.81%
MARTEN TRANSPORT LTD	19.12%	-5.76%	-38.64%	\$ 70.07	17.20%
HUNT (JB) TRANSPRT SVCS INC	17.73%	-3.54%	-24.76%	\$ 301.63	16.19%
NSTAR	17.75%	-1.73%	-15.49%	\$ 1,224.93	15.79%
GATX CORP	17.41%	-5.46%	-37.82%	\$ 722.80	15.30%
D & E COMMUNICATIONS INC	15.84%	-5.54%	-7.26%	\$ 69.60	13.89%
WERNER ENTERPRISES INC	19.49%	-3.60%	-66.76%	\$ 170.26	12.89%
SPRINT NEXTEL CORP	17.18%	-9.85%	-16.33%	\$ 8,242.00	12.86%
WEYERHAEUSER CO	16.89%	-10.56%	-7.56%	\$ 2,968.00	12.47%
EMBARQ CORP	14.86%	-6.44%	-10.18%	\$ 1,054.00	11.84%
DOMINION RESOURCES INC	15.78%	-10.77%	-1.97%	\$ 4,302.00	11.00%
PIKE ELECTRIC CORP	14.42%	-7.77%	-36.08%	\$ 53.63	9.83%
SOUTHWEST GAS CORP	11.12%	-0.08%	-1.29%	\$ 340.53	9.28%
FISHER COMMUNICATIONS INC	11.50%	-23.80%	-39.91%	\$ 44.49	9.16%
SPEEDWAY MOTORSPORTS INC	10.60%	-6.19%	-35.03%	\$ 140.42	8.90%
DUKE ENERGY CORP	10.94%	-34.81%	-7.57%	\$ 4,323.00	8.70%
NICOR INC	10.32%	-1.86%	-7.58%	\$ 362.90	8.53%

Table 2 (continued). Group 2 - DTL Reversal Group (2007) Capital Expenditures Decreasing and DTLs Decreasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
ENTRAVISION COMMUNICATIONS	12.93%	-0.90%	-35.50%	\$ 111.90	8.19%
AVIS BUDGET GROUP INC	11.03%	-33.62%	-36.55%	\$ 970.00	7.78%
UNITIL CORP	10.32%	-6.08%	-3.39%	\$ 33.40	7.04%
DOLLAR THRIFTY AUTOMOTIVE GP	13.56%	-3.40%	-17.13%	\$ 267.41	6.87%
ST JOE CO	8.99%	-56.58%	-5.71%	\$ 83.54	6.61%
TELEPHONE & DATA SYSTEMS INC	6.60%	-45.22%	-3.17%	\$ 555.59	5.62%
CAMBREX CORP	7.57%	-29.53%	-32.20%	\$ 18.86	5.05%
PRIMEDIA INC	4.77%	-82.98%	-23.95%	\$ 12.26	4.77%
IOWA TELECOM SERVICES INC	12.83%	-23.61%	-4.33%	\$ 35.52	4.27%
SUREWEST COMMUNICATIONS	7.53%	-15.90%	-2.83%	\$ 20.25	4.18%
BUCKEYE TECHNOLOGIES INC	11.03%	-1.50%	-0.86%	\$ 37.13	3.90%
HEADWATERS INC	7.17%	-0.89%	-8.26%	\$ 61.55	3.72%
INTERNATIONAL COAL GROUP INC	16.80%	-4.33%	-3.16%	\$ 47.36	3.63%
TRONOX INC	10.18%	-6.15%	-10.82%	\$ 53.50	3.10%
MOLSON COORS BREWING CO	7.54%	-5.31%	-4.04%	\$ 371.17	2.76%
ENERGY PARTNERS LTD	10.15%	-4.03%	-7.19%	\$ 20.88	2.56%
POLYMER GROUP INC	4.21%	-49.09%	-10.92%	\$ 17.77	2.37%
PEABODY ENERGY CORP	14.21%	-3.48%	-1.11%	\$ 216.97	2.24%

Table 2 (continued). Group 2 - DTL Reversal Group (2007) Capital Expenditures Decreasing and DTLs Decreasing (dollar amounts in millions)

Company Name	Gross DTL / Total Assets ^a	% Δ in Gross DTL	% Δ in CapEx	Net DTLs	Net DTLs / Total Assets
RUBY TUESDAY INC	7.03%	-1.04%	-7.08%	\$ 22.90	1.80%
MERIDIAN RESOURCE CORP	9.30%	-17.01%	-17.55%	\$ 8.07	1.67%
CABLEVISION SYS CORP -CL A	13.45%	-3.48%	-11.85%	\$ 93.75	1.03%
SIRIUS XM RADIO INC	12.55%	-6.64%	-34.62%	\$ 12.77	0.75%
BARRICK GOLD CORP	6.26%	-2.62%	-3.77%	\$ 119.00	0.54%
SIX FLAGS INC	14.23%	-10.86%	-5.66%	\$ 14.90	0.51%
LIBBEY INC	5.71%	-7.65%	-41.41%	\$ 3.61	0.40%
^a Gross DTL / Total Assets – Gross DTL is not net of deferred tax assets					

Conclusions

To encourage capital spending, Congress provided increased tax deductions for accelerated depreciation based on a company's investment in capital assets. Accelerated depreciation permits firms to postpone or defer the payment of income taxes to the future. Further, as long as capital spending is maintained, these taxes can be deferred indefinitely, providing what is effectively a long-term, interest-free loan from the federal government. There is a catch, however. If capital expenditures are reduced, taxes deferred in prior years come due and can dramatically increase a company's income tax bill.

The purpose of this report is to identify capital intensive companies who have benefitted substantially from accelerated depreciation deductions. We think that these companies are at risk for increased income taxes from reductions in capital spending that may arise from a slowing economy. We looked at data in 2007. We first identified firms who were growing capital expenditures and were continuing to enjoy increasing deferred tax liabilities. At present, these firms are not significantly at risk for increased tax payments. However, that prospect would change with a protracted reduction in capital spending. In a second group we identified firms who in 2007 had begun to reduce their capital spending and were seeing a reversal of their deferred tax liabilities. If they continue to reduce their capital expenditures, these firms could see substantial tax payments coming due in future years.

During our analysis we noticed that the capital intensive companies in both groups clustered in three general categories. For example, in one category there were firms with large distribution networks. Firms in this category included electricity distributors (Duke Energy Corp. and Consolidated Edison, Inc), gas distributors (NICOR, Inc and Southwest Gas Corp.), telecom providers (Sprint Nextel and Iowa Telecom Services, Inc.) and broadcast radio and TV networks (Fisher Communications and LIN TV Corp.). The second major category is comprised of firms involved in the extraction, processing and distribution of natural resources. Firms in this category include mining operations (AgNiCo Eagle Mines Ltd and International Coal Group) and oil and gas exploration, production and distribution (Cano Petroleum Inc, Anadarko Petroleum Corp. and Williams Companies, Inc.). Our final category was characterized by companies that maintain large fleets, whether they are trucking firms (JB Hunt Transportation Services, Inc), railroads (Burlington Northern Santa Fe) or businesses with large truck fleets (Coca-Cola Enterprises Inc.).

All of these companies are very capital intensive and have very large deferred tax liabilities, implying that future tax payments could be substantial. The firms could continue their capital spending and avoid a reversal of deferred tax liabilities. However, given the severity of the current recession, such a development is not likely for all of the firms in our two groups.

The timing of the payment of deferred taxes is difficult to gauge. One year of reduced capital spending typically does not result in a reversal of deferred tax liabilities. The assets being depreciated are long-lived and it takes time for lower capital expenditures to translate into an overall reduction in depreciation charges for tax purposes. Accordingly, for the firms in Table 1, a reduction in capital spending in 2008, even if continued into 2009 may not result in an increase in income taxes paid. The companies listed in Table 2, however, are already seeing a reversal of their reported deferred tax liabilities. A continued reduction in capital expenditures in 2008 and 2009 is more likely to result in increased income tax payments.