TESTIMONY ON THE NATURAL GAS SEVERANCE TAX PROPOSAL

PRESENTED TO THE HOUSE APPRORIATIONS COMMITTEE, SUBCOMMITTEE ON FISCAL POLICY

BY

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Good morning, I am Michael Wood, Research Director for the Pennsylvania Budget and Policy Center. The Pennsylvania Budget and Policy Center is a non-profit, non-partisan research project. PBPC provides budget and fiscal analysis and public education in support of policies that improve the economic and social well-being of low and middle income Pennsylvanians.

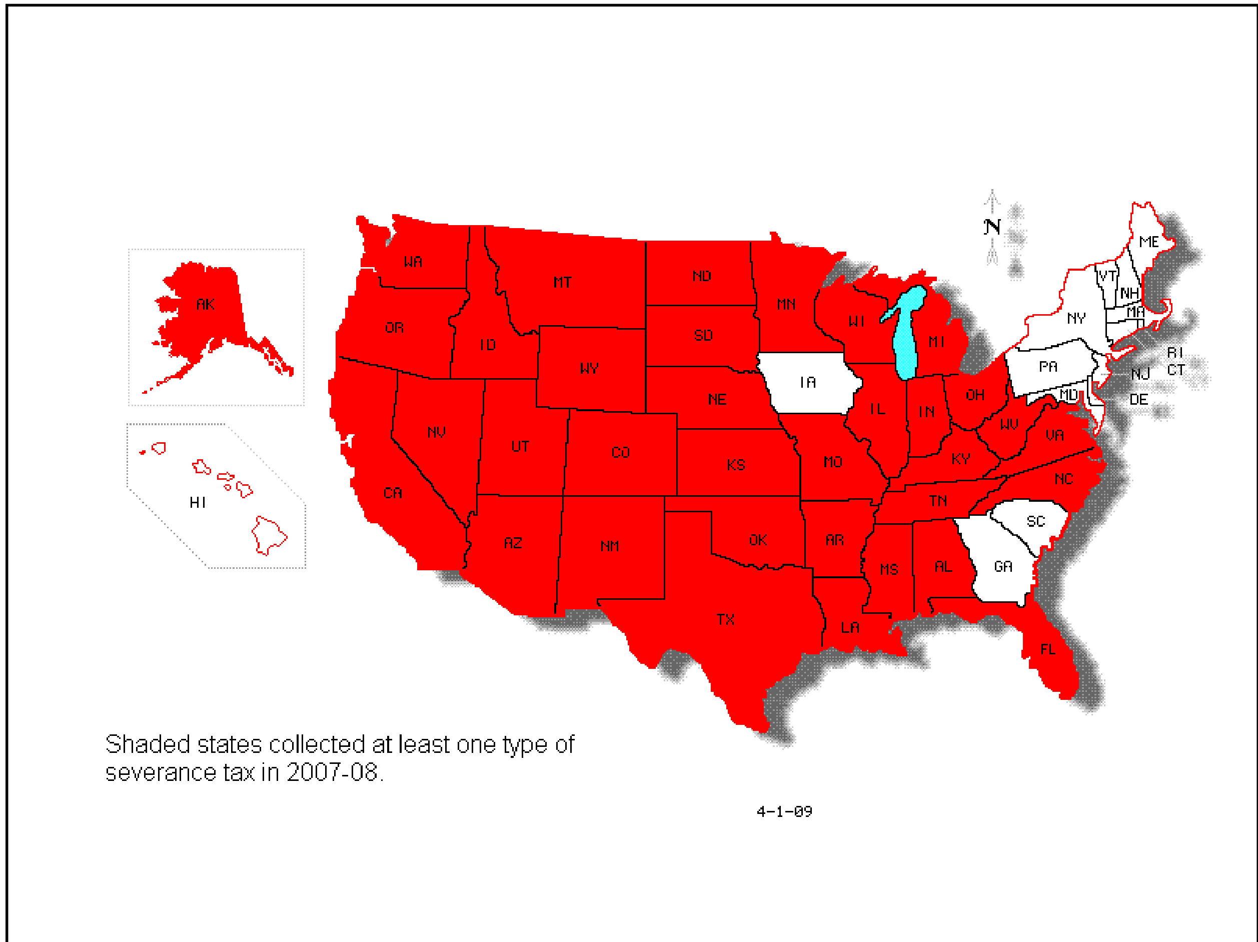
The purpose of my testimony is to briefly describe the use of severance taxes across the United States, look more closely on severance taxes on natural gas production, describe how the funds are used by states, and what this means for Pennsylvania.

Severance taxes are common

Severance taxes are a common part of state revenue systems. According to data from the U.S. Census, thirty-five states collect some amount of severance tax (these states can be seen in Figure 1). Severance taxes can be on renewable (timber, fish) or non-renewable (oil, natural gas, coal) resources and often depend on the resources available in the state. For example, the coal rich states of Kentucky and West Virginia levy a severance tax on coal production.

States impose severance taxes because the harvesting of these resources imposes costs on society that are not adequately recaptured through profit-based taxes.

Figure 1. Severance Taxes are Common.

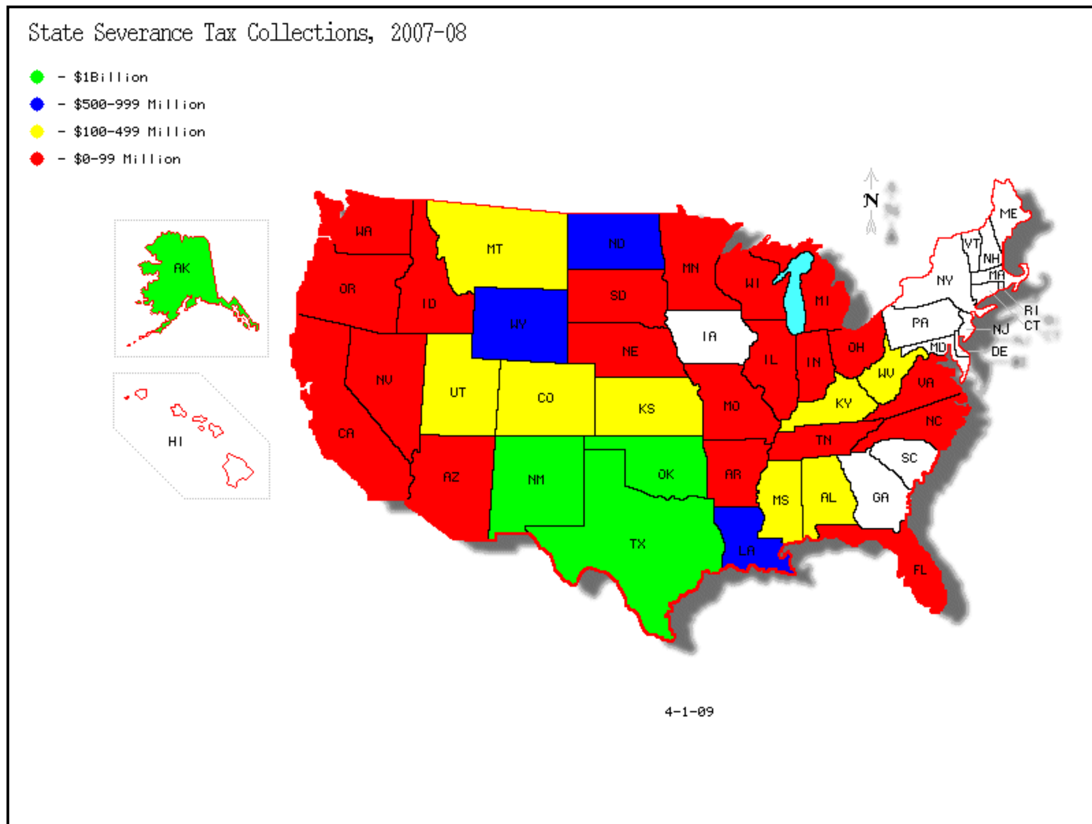


Source. U.S. Census, Quarterly *Summary of State and Local Government Tax Revenue*.

Severance taxes provide a significant revenue source for states

According to the U.S. Census, thirty-five states collected severance taxes of some type in 2007-08, collecting $16.7 billion (for a breakdown of the amount of severance tax collected by state, see Figure 2). This accounts for 3.1% of the taxes these states collect. The states collecting the most severance taxes are the Western energy producing states – Alaska, Texas, Oklahoma, New Mexico, and Wyoming. Their severance tax collections come primarily from oil, coal, and natural gas.

Figure 2. 35 States collected $16.7 billion in severance taxes in 2007-08.



Source. U.S. Census, Quarterly *Summary of State and Local Government Tax Revenue*.

<u>Severance and business taxes in leading natural gas producing states</u>

Thirty-two states produced measurable amounts of natural gas in 2007. Pennsylvania ranked 15th among natural gas producing states, yielding 182 billion cubic feet of marketed production. This accounts for 0.9% of total U.S. production. [1]

Twenty-seven of thirty-two states that produce natural gas charge a severance tax on its production. Of the fourteen states with greater production than Pennsylvania, all but California levy a severance tax. California charges a small environmental fee that is used to help offset the state's well inspection costs. The states and tax rates can be found in Table 1.

Natural gas severance tax rates are normally a percentage of the price of the natural gas sold or a fixed rate per unit sold, typically per thousand cubic feet (MCF). Taxes with rates based on price fluctuate with the market, but typically bring in more dollars than per unit taxes, as energy prices tend to increase faster than the actual production volume. Fixed per unit taxes often are more predictable, as states

[1] U.S. Energy Information Administration, Natural Gas Annual 2007, http://www.eia.doe.gov/neic/experts/natgastop10.htm

tend to produce similar amounts of natural gas from year-to-year. Using a combination of the two tax rate types, as is done in West Virginia, yields characteristics of both.

Of the larger natural gas states, most base their natural gas tax on market prices.[2] Tax rates in these states range from a low of 2% in Colorado to 9.5% in New Mexico. Louisiana uses a per thousand cubic feet rate that is set each year. Alaska is in a unique situation and levies a unique tax, with a top rate of 50% of net income.

In the top fourteen natural gas producing states, it is very common for producers to pay both severance and corporate taxes. Wyoming is the only one of these states that does not. It is interesting to note that eight of these states also use combined reporting when figuring their corporate tax.

In Pennsylvania, critics of the governor's proposal to impose a severance tax claim that producers here are already subject to the 9.99% Corporate Net Income Tax (CNIT) and the Capital Stock and Franchise Tax. While it is true that some producers may be subject to CNIT, it is not known how many actually pay the tax. Department of Revenue statistics show that 71% of corporations who filed CNIT returns paid no tax.[3]

A review of well count reports issued by the Department of Environmental Protection shows that many of the companies operating wells in Pennsylvania are organized as limited liability companies (LLC), meaning they aren't subject to CNIT, but pay the Personal Income Tax rate of 3.07% - the same tax rate as a cashier at the grocery store pays.

Corporate entities and LLCs are subject to the Capital Stock and Franchise Tax, but that tax is scheduled to be phased out by 2011.

[2] Comparing rates between states is difficult, as states use different calculations to arrive at the amount of a taxable sale.

[3] Pennsylvania Department of Revenue, Tax Year 2004 Statistics on Capital Stock/Franchise Tax and Corporate Net Income Tax.

Table 1. Severance Tax Rates and Corporate Taxes in the Top 15 Natural Gas Producing States.

Rank	State	2007 Natural Gas Production	Current Severance Tax Rate	Corporate Taxes
1	Texas	6,091,724	7.5% of market value of gas produced	Franchise Tax*
2	Wyoming	1,923,224	6% of taxable value (gross sales minus certain processing and transportation costs)	No
3	Oklahoma	1,744,393	7% of average monthly price of gas plus 0.095% excise tax	Income Tax
4	New Mexico	1,544,830	8.67-9.5%, depending on county and school district	Income Tax
5	Louisiana	1,363,538	$0.269 per MCF	Income Tax
6	Colorado	1,242,571	2% to 5% based on gross income	Income Tax*
7	Alaska	433,485	25% to 50% of net income	Income Tax*
8	Utah	376,409	5% when gas over $1.50 MCF	Income Tax*
9	Kansas	365,877	4.33%	Income Tax*
10	California	307,160	Conservation fee of $0.0079076 per MCF	Income Tax*
11	Alabama	270,407	8%	Income Tax
12	Arkansas	269,886	5%	Income Tax
13	Michigan	264,907	5.75%	Income Tax*
14	West Virginia	231,184	5% + $0.047 per MCF	Income Tax*
15	Pennsylvania	182,277	None	Income Tax

Sources. U.S. Energy Information Administration and state tax department websites.

*- Indicates that the state uses combined reporting for corporate taxation.

What do states do with severance tax collections?

All thirty-five states that collect severance taxes use some portion of the tax for current operating expenses. Many, though, earmark a portion of the tax for specific purposes. The most common dedicated use of severance tax collections is sharing a portion of the tax with local governments (done in fifteen states).[4] The amount of state/local split varies widely from state to state. Neighboring West Virginia transfers about 6% of its severance tax collections to counties – with 75% of the local share going to coal producing counties and the remaining 25% divided among all counties based on population.

Ten states direct severance tax dollars to environmental cleanup or conservation programs.[5] Ohio uses approximately two-thirds of its coal severance tax for mine remediation and reclamation programs.

Eight states use a portion of their severance tax collections to aid public schools.[6]

Finally, four states invest severance tax proceeds in a "permanent fund" – most notably, Alaska, Wyoming, and New Mexico.[7] Permanent funds are created to provide a source of revenue to help replace severance taxes as the non-renewable resources are exhausted. As the name implies, the balance of the permanent fund (or corpus) cannot be spent. However, the earnings from the fund can be used for various purposes, including operating expenses, bond repayments, reinvestment in the permanent fund, and dividends to citizens.

Lessons from other states

Pennsylvania can learn several lessons from the experiences other states have had with their own severance taxes.

The first lesson is that if a state sets a severance tax rate too low it can be a lot of administrative work without much fiscal benefit. More commonly, if the rate is not reviewed periodically, the state could be losing significant revenues when production increases. Arkansas recently went through a boom in natural gas development – much like is starting to happen in the Marcellus Shale. Up until this year, the rate in place was very low, 0.3 cents per thousand cubic feet. This rate was originally put in place in 1957. When the state's Joint Committee on Economic and Tax Policy reviewed the rate in 2006 and compared their tax yield to what would have been collected had they used neighboring Texas' rate of

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[4] Judy Zelio and Lisa Houlihan, *State Energy Revenues Update*, National Conference of State Legislatures, June 2008.

[5] Judy Zelio.

[6] Judy Zelio

[7] Judy Zelio.

7.5% of the sales price, they were astounded. Had they used Texas' rate, they would have collected $99 million in tax revenue, rather than collecting the $620,000 that they actually received.[8]

The second lesson is to keep the tax simple. Making the computation of the tax as simple and transparent as possible makes the tax significantly easier for producers to comply with and tax administrators to manage. The more special rates are set for certain types of wells, deductions are allowed from the sales, and exemptions from tax are created makes the tax more complicated for everyone involved. This narrowing of the tax base forces the stated tax rate higher in order to bring in the same amount of revenue. Alabama's severance tax is a classic case of this problem. Alabama's stated rate seems high at 8%, however many items are deductable from the selling price – including things like administrative overhead. [9] This reduces the efficiency of the tax and makes it difficult to determine if all producers are paying what they should by law.

Ambiguous legislative language can also reduce collections. In Utah, ExxonMobil was able to significantly reduce its tax liability by being able to pay tax on the gas it removed based on its value coming directly out of the well (even though it was never sold in that form), rather than its actual sales price due to the way the law was worded.[10]

When looking at severance taxes across the states, University of California, Riverside economist, Dr. Mason Gaffney remarked, "the most backward systems allow low rates or exemptions for stripper wells, and perhaps for low volume or high cost wells." [11]

Local taxes

Mineral rights, including the value of production from oil and gas leases, are commonly subject to local property taxes. In many communities, these assets are an important part of the local tax base, allowing rates to be lower than they would be with a narrower base. In Pennsylvania, this is the case with coal, gravel, and other types of mines.

The Pennsylvania Supreme Court ruled in 2002 that oil and gas interests were not subject to property taxes.[12] This eliminated a significant revenue source for many rural Pennsylvania counties, municipalities, and school districts. Not only have the property tax rates paid by other taxpayers have to be raised to make up the needed revenue, but also these remaining taxpayers had to foot the bill for

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[8] Bond Buyer.com, "Natural gas tax: too tiny?" *Southwest Bond-Watch*, Bond Buyer.com, October 9, 2007.

[9] Alabama Department of Revenue, *Oil and Gas Severance Tax Rules*, 810-8-6.-.01.

[10] Justice Wilkins, ExxonMobil Corporation v. Utah State Tax Commission, 2003 UT52, November 23, 2003.

[11] Samuel Western, "Does Wyoming Get Enough for Its Mineral Riches? Severance Tax Reform in the Cowboy State," WyoFile.com: Wyoming Politics and Policy, February 8, 2009.

[12] Independent Oil and Gas et al v. Fayette County Board of Assessment Appeals.

increased demand for public services (such as road maintenance, police and fire protection, and access to health care facilities) due to increases in drilling activity. This inequity remains today.

In a few states, local governments are allowed to levy severance taxes directly. Coal producing counties in western Maryland are an example of this.

Pennsylvania has a mixed legacy with natural resource development

Much of Pennsylvania's history is intertwined with the development of natural resources. From the timber boom, to the oil boom, to the coal boom, Pennsylvania communities have seen their wealth and size swell as the resources are being harvested. When the resources ran out or the market disappeared, these same communities withered away - with the state often left on the hook to replant the forests, clean up the streams, and plug the abandoned mines (see Figure 3).

Figure 3. Historical forest damage and modern acid mine drainage (AMD)

Source. Pennsylvania Lumber Museum

Source. Art Rose

The problem that often happens is that resource extraction by its very nature requires that the environment be changed. These changes often have side effects that are not readily apparent, such as acid mine drainage resulting from coal mining. It is expected to cost the taxpayers $15 billion to fix Pennsylvania's acid mine drainage problems.[13] Economists call these sorts of costs "externalities" as they created by economic activity, but not paid for by the firms receiving the economic benefit. Severance taxes can be an effective mechanism for helping to internalize these costs.

[13] Pennsylvania Department of Environmental Protection, Bureau of Abandoned Mine Reclamation, *Pennsylvania's Abandoned Mines: Problems and Solutions*.

Improvements in technology and environmental regulations have made the drilling process safer and cleaner, but there may be damage we do not know about – such as permanent changes in runoff patterns or the accidental discharge of wastewater.

In closing, a well –structured severance tax can:

- Help repay governments for increased costs due to natural resource development
- Provide funding for cleanup – today and in the future
- Help communities transition once the resource “boom” is over.

Thank you for the opportunity to present this information and provide our comments.