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Budget and Policy Center

Testimony regarding Impact Fees and the Marcellus Shale
before the Marcellus Municipal Co-op
Canonsburg, PA

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Thank you Representative White, Marcellus Municipal Co-op members, and the League of Women Voters for sponsoring this public hearing and for inviting our participation. Also, thanks to the many people who took time to attend tonight. The responsible development of the Marcellus Shale is an important issue for all Pennsylvanians and will likely remain so for many years.

I don't need to come from Harrisburg and tell you about the impacts of the Marcellus Shale. People here are living with the good and the bad every day. From instant millionaires, to jobs, to truck traffic, to "no vacancy" signs, to water consumption and pollution, you see signs of rapidly growing shale development.

What I'm here to talk about is developing the shale as responsibly as we can – and how a drilling fee fits in with this concept.

Under the current system, the benefits of shale development are largely concentrated in the hands of a few, while the risks are largely being shared by the public. This is due to what economists call "externalities" – costs associated with economic activity that aren't reflected in the price being charged for that good or service. In the case of shale gas development, the externalities include road congestion and damage (if not repaired); air, water, and land pollution; habitat impairment; adverse impacts on public health and safety; and loss of affordable housing for long-time residents.

How do you fix this? By shifting costs back to where they belong – on those who reap the most benefit from the activity. Taxes and fees are commonly used to do these things. They also enable the general public to enjoy some of the benefits of the development.

At the Pennsylvania Budget and Policy Center, we have been studying the Marcellus Shale development since 2008 and have consistently taken the following positions:

- There needs to be some type of drilling tax or fee on the shale gas development;
- Reasonable, consistent rates need to be set;
- Exemptions should be limited;
- A portion of the proceeds should be directed to offset local costs and for environmental protection and conservation.

<u>Why do we need a tax or fee?</u> As I briefly said earlier, drilling activity produces costs that are currently <u>not included in the price of natural gas</u> as it is produced and sold in Pennsylvania. Some say that providing a "tax haven" for the drilling activity is good public policy, or that our existing tax structure

gathers enough benefits from drilling, or that imposing a drilling fee will kill the golden goose. The experiences of other energy-producing states shows these positions are not accurate.

All other major gas-producing states have levied taxes on drilling activity without impeding development. There is no reason to think Pennsylvania would be uniquely different.

Without a fee or tax on drilling activity, all other taxpayers – both state and local – will be paying for the social, environmental and infrastructure costs related to drilling.

Pennsylvania's state and local tax systems do not do a good job of taxing drilling activity. Federal domestic production incentives significantly reduce taxable income for active drillers. This reduces state taxable income to the point where an industry study concludes, "many companies have sufficient deductions that they pay no CNI [corporate net income] tax."[1] Even if companies do have income, many of them are incorporated as limited liability companies (LLCs) or Limited Partnerships (LPs) allowing them to pass taxes onto the owners, often at the 3.07% personal income tax (PIT) rate.

The drilling companies pay sales tax on some purchases, but Pennsylvania's liberal definition of "manufacturing" exempts most equipment and supplies used in gas development from being taxed.

Landowners pay PIT on royalties they receive from gas companies, and suppliers pay taxes on their net profits from business with the drillers, but this activity, itself, produces little state business tax revenue.

These are some of the many reasons other energy-producing states have enacted severance taxes or fees.

The Corbett Administration recently claimed that Marcellus Shale drillers have paid $1.2 billion in taxes since 2006. This number is padded by a number of things. First, drilling didn't really take off until 2009, so any figures before that aren't likely to be Marcellus Shale related. The figures also include not only the drillers who would pay the tax, but also any company they are related to. Much of the tax, 70% to 80% comes from these non-drilling companies. The taxes they count include taxes withheld from their employees and sales taxes collected from their customers.

Drilling down to the business taxes paid by the gas producers, the ones who would be subject to a drilling tax, shows much more modest collections, ranging from $20 to $48 million per year from 2006 to 2010.[2]

Local Pennsylvania governments have even fewer tools available to benefit from drilling activity. Property taxes cannot be levied on oil and gas deposits in Pennsylvania due to a 2002 Pennsylvania Supreme Court decision,[3] and the Pennsylvania Legislature has, so far, failed to grant locals such authority. Property taxes are currently imposed on other mining industries, such as coal and gravel. A

[1] Timothy Considine, Robert Watson, Rebecca Entler, and Jeffrey Sparks, *An Emerging Giant: Prospects and Economic Impacts of Developing the Marcellus Shale Gas Play*, July 24, 2009, p. 30.
[2] Pennsylvania Budget and Policy Center calculations based on data provided to the Pittsburgh Post-Gazette and the Harrisburg Patriot-News.
[3] *Independent Oil & Gas Association v. Board of Assessment of Fayette County*, 572 Pa. 240, 814 A.2d 180 (2002) ("*IOGA*").

local assessment expert has pegged the lost local revenue for schools, counties, and municipalities in 2014 from this ruling at over $600 million, with schools losing in excess of $400 million.[4]

Allowing local governments and schools to assess property taxes on reserves may be the best strategy for municipalities to recover drilling-related costs.

Unlike in many other gas-producing states, equipment and personal property aren't subject to property taxes, either.

When income taxes are levied locally, they are assessed most often only on "earned" income, so royalties and investment income aren't subject to tax.

Enacting a drilling fee also provides an effective incentive for state and local authorities to maintain tighter regulation of gas well operations. Stronger regulation will protect Pennsylvanians, our communities, our environment, and our economy.

<u>Setting a reasonable and consistent rate is important.</u> Gas production declines rapidly from when wells are drilled, with half of a well's gas production occurring in the first eight years, according to EQT.[5] Some proposals reduce tax rates or fees in the early years, leading to significantly less revenue. However, tax rates or fees should not be lower in the initial years of production because that is when the most drilling takes place.

Several early proposals called for a lower rate in the initial years of production to "recover capital costs more quickly." This tax break is unnecessary and costly. The federal government provides significant tax breaks for domestic energy production – most notably allowing companies to fully deduct drilling costs in the year they are incurred, rather than over the productive life of the well. Studies have shown that state incentives do little to stimulate drilling that would not otherwise occur.[6]

Fees should be related to the volume and price of gas produced.

<u>Limiting the exemptions permits a lower rate and greater efficiency.</u> Allowing deductions for things like processing and transportation can limit the effectiveness of a tax or fee. As many Pennsylvania royalty owners are finding out, allowing deductions from the gross selling price can reduce revenue significantly.[7]

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[4] Sean Hamill, "2002 court case proved windfall for shale drillers," *Pittsburgh Post-Gazette*, September 29, 2010, http://www.post-gazette.com/pg/10272/1091045-455.stm.
[5] EQT Corporation, "Marcellus Decline Curve," (accessed June 16, 2011) http://ir.eqt.com/common/download/download.cfm?companyid=EQT&fileid=432813&filekey=aa9796cf-3b6f-459f-92b5-d7bcc7a0ffdd&filename=Marcellus%20Decline%20Curve%20Data%20-%20for%20web.xls
[6] See Shelby Gerking, et al, *Mineral Tax Incentives, Mineral Production and the Wyoming Econom*y, December 2000 or Headwaters Economics, *Energy Revenues in the Intermountain West*, October 2008.
[7] According to Ross Pifer, Director of the Penn State/Dickinson School of Law's Agricultural Law Resource and Reference Center, over 70 landowners have filed lawsuits due having their royalties reduced due to post-production costs, http://law.psu.edu/_file/aglaw/Natural_Gas/Drake_Meets_Marcellus-formatted_for_Website.pdf.

Like any other tax, the more you reduce the tax base, the higher the rate has to be to get the same level of revenue. A classic example of this in Pennsylvania can be seen with the personal income tax and the corporate net income tax. For most individuals, it is difficult to get out of paying the 3.07% PIT, the lowest "top" tax rate of all of the states with income taxes. On the other hand, the corporate net income tax rate of 9.99% is the second highest in the U.S., but three-quarters of corporations do not pay it.[8]

Finally, the distribution of drilling fee/tax proceeds should be split between state, local and environmental protection efforts. Lately, much of the debate in Harrisburg has been centered on the distribution of the funds. It is important for policymakers to establish a reasonable distribution of revenue, but let's not get the cart before the horse here. Dividing up a poorly designed fee or tax may mean less revenue for those affected, no matter what share of the proceeds you get.

Local governments – townships, boroughs, cities, counties, and school districts – feel the most direct impact of drilling and have to deal with costs imposed on them. Anecdotally, there have been many reports of increased local costs for public safety, social services, traffic control, road repair, zoning and other costs. It seems logical that a portion of the drilling fee goes to local governments, particularly with the exemption of gas reserves from their primary revenue source, property taxes.

These costs are not limited to those municipalities directly hosting wells, but are borne by neighboring communities, often boroughs and cities, that are population centers for workers and facilities. Likewise, revenues should be shared between host and non-host jurisdictions.

It seems practical to limit local shares to counties with drilling activity, although other areas are likely to feel drilling impacts as well.

Fee revenue should also be used to strengthen environmental protection efforts. Even with strict regulation, increased natural gas development will introduce industrial activity to many new and remote areas of Pennsylvania – and this will have an impact on our environment. Cuts through forestland to reach pad sites and for pipelines will fragment wild spaces and affect water flows. Drilling fee funds could be used to help mitigate and minimize these negative impacts. This could be through the upgrading of water and sewer treatment facilities, protecting forest and farmland, cleaning up brownfields, remediating acid mine drainage and plugging abandoned oil and gas wells.

The impacts of pollution will affect areas downstream and downwind of the drilling sites, so it makes sense to use environmental funds on a more statewide basis than the local share.

Some share of the drilling fee, whether it is directly to the General Fund or for offsetting statewide costs, should go to the Commonwealth. Of late, there seems to be an aversion to providing drilling fee revenues to the state government. We feel this is a mistake for a number of important reasons.

State government, rather than local governments, is responsible for maintaining the state's most used roads and bridges. These are not likely to be covered by drillers' road bonds, even if used extensively.

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[8] Pennsylvania Department of Revenue, *Statistical Supplement to the Pennsylvania Tax Compendium, Fiscal Year 2009-10*, October 2010, http://www.portal.state.pa.us/portal/server.pt/document/930060/2009-10_stat_supp_xls.

In many areas of the state, particularly the rural areas where much of the drilling is taking place, the Commonwealth is the primary police force (through the State Police). Funding for many social services, workforce development and training comes out of state coffers, while much of the environmental monitoring and protection is done by state personnel and paid for out of state funds.

Using a portion of a drilling tax or fee for other statewide uses isn't a bad thing. It could help pay for schools, healthcare and keeping tuition at our public colleges in check.

Additionally, by spending the collected revenue, state and local governments will create jobs. A study the Penn State Institute for Research in Training & Development report found that every $100 million raised in drilling taxes from gas producers in Pennsylvania would result in a net gain of more than 1,100 jobs, even after factoring in higher production costs to the industry.[9]

Responsibility for cleaning up the inevitable damage from shale development is laid at the feet of the Commonwealth, not local governments. This could happen now or in 50 years. Some states have addressed this by creating "permanent funds" to safeguard a portion of resource extraction revenue to benefit future generations, address clean up needs, and help re-orient local communities once the minerals are gone and the developers leave.

Without a share going to these statewide uses, increased costs due to shale development will be effectively shifted to the state's other taxpayers.

I believe Article 1; Section 27 of the Pennsylvania Constitution says it best:

The people have a right to clean air, pure water, and to the preservation of the natural, scenic, historic and esthetic values of the environment. Pennsylvania's public natural resources are the common property of all the people, including generations yet to come. As trustee of these resources, the Commonwealth shall conserve and maintain them for the benefit of all the people.[10]

We as Pennsylvanians owe it to ourselves and future generations to ensure that the Marcellus Shale is developed in the most responsible manner possible. Enacting a sensible and effective drilling fee is a critical safeguard to conserve and protect these resources and the interests of everyday Pennsylvanians – today and in the future.

[9] Rose M. Baker and David Passmore, *Benchmarks for Assessing the Potential Impact of a Natural Gas Severance Tax on the Pennsylvania Economy*, September 13, 2010 http://www.personal.psu.edu/dlp/remi2010/#/.
[10] Constitution of the Commonwealth of Pennsylvania, http://www.pahouse.com/pa_const.htm.