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HOUSE FINANCE COMMITTEE

CHAIRMAN'S report

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Natural Gas Severance Tax: The National Perspective

According to the U.S. Energy Information Administration, 32 states produced measurable amounts of natural gas in 2007. Pennsylvania ranked 15th among the natural gas producing states, yielding over 182 billion cubic feet of marketed production. This accounts for almost 1% of the total U.S. production. **Among the 32 states that produce natural gas, 27 charge a severance tax on its production. Of the 14 states with greater production than Pennsylvania, all but California levy a severance tax.**

In Pennsylvania, critics of the proposal to impose a severance tax claim that producers are already subject to the Corporate Net Income Tax (CNIT) and the Capital Stock

and Franchise Tax. However, it should be noted that in the top 14 natural gas producing states, it is common to pay both severance and corporate taxes. In fact, Wyoming is the only one that does not. **Moreover, a review of well count reports issued by the Department of Environmental Protection shows that most of the companies currently operating wells in Pennsylvania are organized as Limited Liability Companies (LLC). LLC's are not subject to the CNIT, but instead pay the Personal Income Tax rate of 3.07%, the same tax rate as their employees who man the rigs.** Both corporate entities and LLCs are subject to the Capital Stock and Franchise Tax, but that tax is scheduled to be phased out by 2011.

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 ⁸⁵	Income Tax
5	Louisiana	1,363,538	\$0.269 per MCF ⁸⁶	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 ⁸⁷	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 Web sites.

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

What has Pennsylvania Proposed?

The governor's proposed rate is 5% of value of the natural gas at the wellhead plus 4.7 cents per thousand cubic feet of natural gas severed. This would match the current severance tax structure in neighboring West Virginia. The governor's proposal is projected to take effect on October 1, 2009, and is expected to generate \$107 million in Fiscal Year 2009-10. It is anticipated that revenues could generate as much as \$632 million by 2013-14.

The governor's original proposal calls for the entire revenue to be distributed into the General Fund. As consideration of legislation that would enact a severance tax in Pennsylvania moves forward, it will be critical that we ensure portions of the revenue be distributed to at least the following areas:

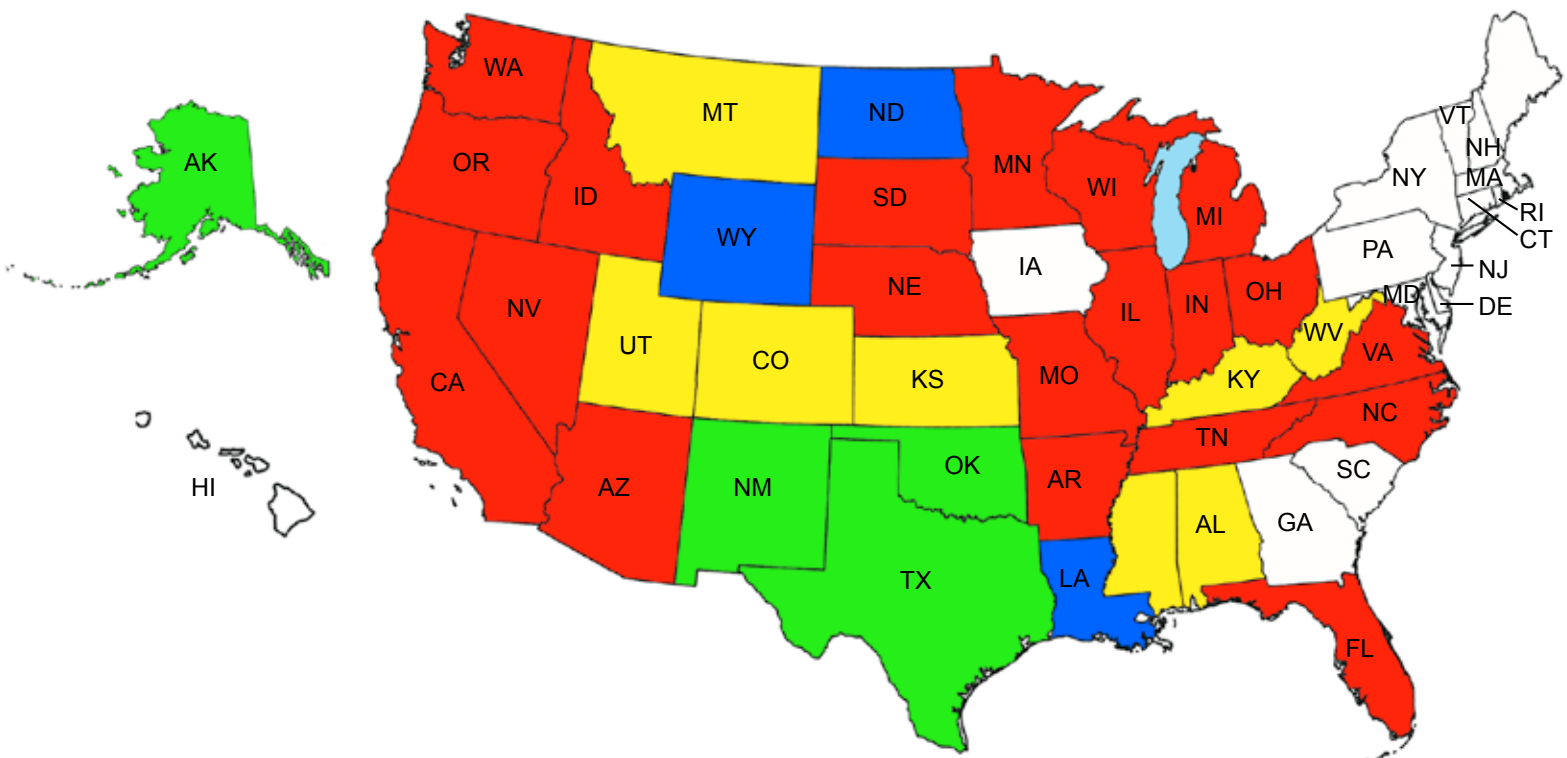
The General Fund – to both offset the state's current budget shortfalls and provide a new source of revenue.

A Dedicated Environmental Impact Fund – to ensure funding for projects that will be needed to address long and short term environmental issues that arise as a result of the increased drilling operations across the state.

Local Revenue Sharing – A dedicated revenue stream that will allow local governments to address the numerous infrastructure impacts of the drilling industry, as well as reduce the burden of property taxes.

State Severance Tax Collections, 2007-08

- \$1 Billion
- \$500-999 Million
- \$100-499 Million
- \$0-99 Million



Why Assess a Severance Tax?

Severance tax revenue would compensate the state and its citizens for removal of this non-renewable resource, as well as assisting to offset new permitting, monitoring, and compliance costs the Commonwealth faces as the industry grows.

The drilling process has the potential to contaminate both surface and groundwater. Water usage and treatment will have to be monitored for many years. Counties and townships will need to build or upgrade roads to accommodate heavy truck traffic and upgrade first-responder capacity to respond to the emergency demands of this often dangerous enterprise. Development will attract new workers to the region, many with families and children. Even though job creation is an encouraging facet of the new industry, it also creates greater demands for schools and other public services. Disrupted habitats will need to be rehabilitated, developed sites will need to be remediated, and local economies will have to be repositioned after the natural gas and developers are gone. If the severance tax is not in place and appropriately distributed, state and local taxpayers will ultimately bear the bulk of these costs.

Natural gas producers cannot be permitted to reap substantial economic benefits without paying their fair share of taxes. As previously noted, many producers will pay the personal income tax rate as LLC's, rather than the higher corporate tax rate. These enterprises pay virtually no tax to compensate for their costs to local governments, as oil and gas wells **are exempt from property tax** – a benefit not afforded to other mining businesses, or residential and commercial taxpayers.

The “Myth”: A Severance Tax would make Pennsylvania less competitive.

Pennsylvanians currently import four times more gas than we produce. Natural gas produced in Pennsylvania would have a natural price advantage over western states in the lucrative Northeastern market – even with a severance tax – due to significantly lower transportation costs than the western competitors. In fact, almost 50% of the price paid by consumers for natural gas is due to transportation and distribution costs – not the resource itself. Simply put, Pennsylvania has a unique opportunity to become the closest and largest supplier of natural gas to satisfy the immense demands of the northeastern states.

Numerous studies have shown that increasing a state's severance tax has little to no effect on production or employment. Wyoming, currently the 2nd largest natural gas producing state in the country, conducted a study to determine if production would increase by lowering their current 5.7% tax rate. The study found that lowering the tax rate by as much as 2% would increase production by less than 1% over 60 years. A comparable study in Utah found similar results. Further, by structuring the tax rate equivalent to that of neighboring West Virginia, we also decrease the opportunity for regional industry competition.

Although oil and natural gas drilling is not foreign to Pennsylvania, the industry's desire to move on the Marcellus Shale “gold rush” is only in its infancy. The severance tax should be enacted before contracts with landowners, pipelines, and distributors are finalized. By enacting a severance tax before contracts are finalized, the drilling companies will have the ability to build the tax into their business model.

What has the opposition proposed?

The proposal introduced by the opposition to a severance tax seeks to lease an additional 390,000 acres of state forest land over a three year period. A minimum bid payment of \$2,000 per acre and a minimum royalty payment of 16% would be established. According to the Conservation and Natural Resources Advisory Council, this is in addition to the nearly 600,000 acres of state forest lands that have already been leased for Marcellus Shale drilling and does not include the recent 74,000 acres of land that was leased in August of 2008. The total makes up more than ¼ of all state forest lands that are already available for this use.

Currently, of the already leased state forest lands, only two well sites have actually been drilled into the Marcellus Shale formation. Pennsylvania needs these already-leased lands to be developed first, evaluate the impacts of the development process, and allow the financial markets to improve so that future lease sales will generate the maximum amount of income for the Commonwealth.

Raiding the Oil and Gas Lease Fund:

The General Assembly created the Oil and Gas Lease Fund in 1955, establishing a landmark and farsighted policy of taking the money from the sale of nonrenewable oil and gas resources owned by the state and reinvesting this money into public conservation assets benefiting all Pennsylvanians. Money from this fund has purchased land for many of Pennsylvania's state parks, acquired critical tracts for state forests and helped to maintain an estimated \$3 billion parks and forestry infrastructure.

Under a current proposal by Senator Mary Jo White (SB 490), which has already passed the Senate, \$174 million of the approximate \$184 million in the fund would be transferred to the General Fund in FY 2009-10. Not only is there already about \$100 million worth of projects that are currently without needed funding, but this raid of the Oil and Gas Lease Fund would completely contradict the specific purpose of conservation established when the fund was enacted. Perhaps, a reasonable agreement can be reached regarding the transfer of some of the monies in the Oil and Gas Lease Fund, but the current proposed amounts in SB 490 are unacceptable.

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