Severance Tax Educational Forum
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CAC/CNRAC Hosts
Richard Manfredi, Chairman, Citizens Advisory Council
C. Allen Sachse, Chairman, Conservation and Natural Resources Advisory Council

Presenters

Michael Wood, Research Director, PA Budget and Policy Center, provided an overview of the use of severance taxes in other states, how revenues can be used, and the pros and cons of implementing a severance tax in Pennsylvania.

- Thirty-five states have at least one severance tax; these 35 collected $16.7 billion in 2007-08.
- All 35 use at least part of the revenues for their general funds; some share locally, finance environmental cleanups, fund public education, etc. Four invest in a "permanent fund."
- He cited West Virginia and Arkansas as evidence that changing severance tax rates has had little impact on production or drilling.
- In other states, property taxes on oil and gas are an important source of local revenue; in Pennsylvania, a 2002 court case eliminated that option, as gas is not fixed in place like coal.
- Lessons learned:
  - Set reasonable rates that provide adequate revenues.
  - Keep the tax simple (i.e., limit deductions, exemptions and exclusions).
- If implemented carefully, a severance tax can help repay government costs for increased costs due to natural resource development, provide funds for unanticipated cleanups, help impacted communities transition once the boom is over, and augment declining environmental funding.

Could you give examples of how a severance tax can help a community transition from a "boom" cycle to an "after-boom" cycle?

- Money can be used to pay off bonds from schools that now have downsized, as well as hospitals.
- The tax could be used for training programs for ancillary jobs after the major work has been done.

Has there been any research done on any other states in the west related to severance taxes where there are many federal lands?
Some states don't have a severance tax. They don't have the resources, like oil or natural gas that would be profitable enough to tax.

Does any one know why anyone in the northeast has not imposed an extraction tax?
Many of the other states do not have the known resources.

Is there a matrix that explains all the different layers in taxation involved in natural gas extraction?
There have been attempts to development a matrix that would compare "apples to apples" taxation in other states. It's in the Pennsylvania Budget and Policy Center Report.

Are there any comparisons of the impact of imposing a severance tax vs. not imposing one on the amount of business it would bring into the state?
A study was done in Wyoming that was considering production sites. The result of their study was that a severance tax had very little to do with production decisions. The result of one study actually led to an increase in a severance tax by 2%.

It was stated by industry in Pennsylvania that a severance tax financed through the extraction of natural gas from shale could cause a 30% drop in natural gas production.

<u>Mark Morton, Director of West Virginia's Tax Department's Legal Division</u>, provided a historical overview of the West Virginia severance tax, which is the model being considered in Pennsylvania.

- Severance tax has been a part of the state general revenue since 1921. But local property taxes generally represent the single largest source of tax revenue.
- In West Virginia, gas severance tax is NOT tied to environmental remediation; it is just a revenue source from a resource that is being depleted.
- Currently, the rate is 5% of the gross value at the wellhead; plus 4.7 cents per MCF.
- It is based on gross receipts measured at the wellhead price. Producers can subtract transportation costs from the market price; use a Federal Energy Regulatory Commission (FERC) ceiling price; use the average purchase price from the same pool or field; or they can subtract a straight 15% (most do the latter). Auditors accept any of these methods.
- In 2005, Workers' Compensation Severance Taxes were added; this generates $8 million to $9 million a year.
- This tax is in addition to other taxes and fees, which includes income tax, franchise tax, and purchases made for direct use in natural resource production, and are exempt from West Virginia state sales tax.
- Historically, the severance tax has generated $15-80 million a year, 90% of which goes to the general fund and 10% is shared with local governments. The annual yield ranges over the past few years from $50 million to $80 million. The Temporary Unit Tax or the Worker's Compensation Replacement Tax generates from $8 million to $9 million per year.
- Ninety percent of the revenues from this tax go to state general revenue. Ten percent goes to local governments. The special temporary tax goes to Worker's Compensation.

What is West Virginia's severance tax formula?
Five percent is intended to be used on gross receipts; 4.7% per MCF, which is a temporary tax, was intended to be there only for as long as it takes to pay off the Workers' Compensation shortfalls.

What has been the effect of this tax on this industry?
It varies; one key factor for the natural gas industry is consumer demand. If demand is down, less natural gas is produced. The tax yield from the gross receipts then falls with the price of the gas.

In the West Virginia experience where a severance tax and workers compensation severance tax generate about $100 million a year; how does this amount compare to revenues generated just through a property tax?
In West Virginia there is 40% more income generated from property tax than severance tax. About $140 million of that is contributed to local government. West Virginia's state budget is $13.9 billion,

but the part that is funded within the General Fund is $4 billion. Natural gas generates about $100 million/year, and coal generates an additional approximate $450 million.

If you were in charge of West Virginia's severance tax program are there any amendments that you would recommend to the process?
There is presently a minimum $500 production limit for taxation. Get rid of the existing $500 exemption credit—it creates a large loophole.

Dan Hassell, Acting Secretary, Pennsylvania Department of Revenue, provided an overview of how a severance tax might be implemented in Pennsylvania, and how much revenue is projected under the model laid out in HB 1489.

- Pennsylvania used to have a severance tax on anthracite, but it was repealed during the depression.
- Pennsylvania is the 15th largest gas producer, and the only large producer without a severance tax.
- Severance tax is different from a sales tax; it is a tax applied at the source rather than the destination.
- HB 1489 would apply a 5% tax plus 4.7 cents / MCF, just as West Virginia does. Producers would make monthly payments to the state; stripper wells (less than 60 MCF/day) would be exempt. It is projected to generate $72 million in the first ¾ year; revenues would be allocated to the General Fund, local government, and environmental funds.

It was stated that 70% of the gas industry paid a personal income tax and 30% paid a corporate tax. Why would corporations choose to pay the corporate tax rate as opposed to the personal income tax rate?
Limited Liability Corporations (LLCs) work very much like partnerships. Partners pay a personal income tax on their share of the profits, but partnerships, have limited access to capital. If you need to be able to go to the stock market, sell stock, and raise capital – you don't want to be in a partnership, you want to be a corporation.

What is the dollar value breakdown from an imposed natural gas severance tax in HB 1489 (PN 2241)?
HB 1489 imposes a severance tax of 5% of the gross value of every MCF of gas produced at the wellhead plus 4.7 cents per MCF. The bill exempts gas wells that produce less than 60,000 cubic feet of gas per day from the tax, appropriates the proceeds from the tax to various entities, and requires DEP to accredit laboratories to certify meters required by the bill.

The bill would distribute tax revenues as follows:

- 60% to the General Fund
- 15 % to the Environmental Stewardship Fund
- 5% to the Liquid fuels tax fund (distribute equally to all counties)
- 4.5% to municipalities where gas wells are located based on number of wells
- 4.5% to counties where gas wells are located
- 4% to the Hazardous Sites Cleanup Fund
- 3% to Pennsylvania Department of Public Welfare for LIHEAP

- 2% to Pennsylvania Fish and Boat Commission
- 2% to the Pennsylvania Game Commission.

The first year it is estimated to generate $72 million:

- General Fund would receive $30 million
- Environment Stewardship Fund would receive $7.5 million
- Department of Public Welfare would receive $2 million
- Liquid Fuel Tax Fund would receive $2.5 million
- Affected municipalities would get $2.2 million
- Affected counties would get $2.2 million
- PA Game Commission would receive $1 million
- PA Fish and Boat Commission would also receive $1 million

How much of the money will go back to DCNR to help monitor public lands?
The amount was not known at the time.

What kind of industry input has your office sought?
The administration has been meeting on a regular basis over the past year with much discussion of regulatory issues and the severance tax.

What are the effects of the different layers of taxes in terms of accumulation that would be incurred by the typical private property owners who enter into a lease agreement if the severance tax were added to the taxes that they now pay?
It would offset their municipal property tax, although at the moment the value of the natural gas does not affect the property tax.

Severance tax is a paid source and paid by the seller means that there are a number of different entities that are involved in this transaction – from the producer to the party who starts this process to getting the drilling rights from the landowners. Often another company is hired to do the drilling who pays the cost to take it through the pipeline, etc. The buyer might be a utility, etc. This is a tax on the producer on the actual production that the well has, etc. This requires a monthly bill.

Is there any chance that folks have done research on a severance tax in other states on other extraction type activities such as for timber/coal/etc.? Are these types of extractive activities being considered as part of an extraction tax in Pennsylvania?
I have not heard of anybody pushing that idea.

If there is a violation of water quality by frac water, will the company that is responsible be held accountable for cleaning it up?
Four states involved in severance tax have taken a portion of their revenues and invested a portion of revenues generated for addressing unanticipated environmental clean-ups.