A fair and adequate severance tax

By Wendy Patton

A legislative committee created in the new state budget is to propose a severance tax plan for oil and gas by early fall. Oil and gas production has grown in Ohio despite tough industry conditions. Pipeline capacity is growing, allowing Ohio production to reach external markets.[1] Growing productivity of wells and ongoing investment indicate long-term interest in the Utica Shale formation of eastern Ohio. Policy Matters Ohio looks forward to a fair and adequate severance tax proposal. Here are eight recommendations for the 2020 Tax Policy Study Commission to consider.

Recommendations for a strong severance tax

1) Keep it simple: Subject all oil and gas produced by stimulated wells to a single severance tax based on value at the wellhead, without deductions or exemptions
2) **Make it adequate**: Funds are needed for industry oversight, reclamation, infrastructure, emergency response, housing, public health and safety in places where fracking is occurring. Moreover, many public services have not been fully restored since the recession. Needs are high. The severance tax rate should be no less than 5%.
3) **Create savings**: A legacy fund for after the boom is a great idea, but it needs sufficient revenue to build for the future. Establish a trigger point (possibly based on production or price) at which to add a 2.5 percent fee to finance a legacy fund for long-term benefits.
4) **Avoid tax breaks and tax holidays**: Tax breaks to encourage fracking are leftover policies from other states and earlier times: Hydraulic fracturing of shale is not a new technology anymore. Tax holidays leave the state out of the well's most productive phase.
5) **Don't eliminate other business taxes**: The oil and industry has been subject to the Commercial Activity Tax (CAT) and the corporate franchise tax before it while it also paid the severance tax. Other industries subject to the severance tax also pay the CAT.
6) **Target and sunset tax breaks for landowners**: When drilling started in Ohio, some oil and gas firms assigned severance tax liability to the landowner in leases for mineral rights. These lease terms were bad, but taxpayers should not cover the fallout of bad contracts.
7) **Use funds to meet needs and to strengthen the state:** Designate up to half of a 5 percent severance tax for local governments and impacted communities but define impact broadly. Trucking of water and supplies, pipelines, waste injection and other activities impact communities across the state just as drilling does.
8) **Don't use the severance tax to cut the income tax.** This volatile revenue source should not be used for income tax cuts. The tax cuts would be negligible for the average Ohio family and will decline as resources are depleted.

If an adequate severance tax had been collected from the start

Billions of dollars of Ohio oil and gas has been extracted through fracking since the boom began in 2011.[2] Ohio's current severance tax is a dime per barrel of oil and half a nickel per thousand cubic feet of natural gas. In 2013, Ohio collected $2.8 million in severance tax on total oil and gas production with a dollar value of $1.355 billion (representing a 92 percent jump from prior year production and the highest dollar value ever recorded).[3] The effective severance tax rate was 0.21 percent of value.[4] A severance tax of 5 percent of the value, placed only on the value of oil and gas produced by fracking, and without deductions, exemptions or holidays, would have provided an estimated $35 million in that year.

Table 1 looks at what a 5 percent severance tax would have generated on the value of oil and gas produced from shale in Ohio since 2011. It also estimates what an additional 2.5 percent fee for a legacy fund would have yielded. The severance tax would have yielded almost $140 million to meet state and local needs. A nest egg of about $70 million would be in the bank for a legacy fund.

Table 1

Revenues that could have been collected on shale production with a 5% severance tax and a 2.5% fee for a legacy fund

	Severance Tax	Legacy Fund
2014	$98,932,638	$49,466,319
2013	$35,170,690	$17,585,345
2012	$4,761,485	$2,380,742
2011	$756,772	$378,386
TOTAL	$139,621,585	$69,810,792

Source: Policy Matters Ohio based on analysis of ODNR shale production database. Price of natural gas and oil taken from the ODNR 2013 Ohio Oil and Gas Summary and for 2014, the EIA – WTI and Henry Hub spot prices. .(2014 price for natural gas is based on Henry Hub price adjusted to account for difference with Appalachian Basin prices.) These figures are net of severance taxes that collected during this time frame and that might be due on legacy (conventional) wells.

Costs associated with the economic development in the drilling-impacted counties alone have grown rapidly. On January 22, 2014, local officials from eastern Ohio described the infrastructure needs of their communities in testimony presented to the House Ways and Means Committee. They described specific infrastructure of more than $170 million for roads, bridges and water and sewer treatment plants required to allow new development in their communities.[5] Funds are needed to facilitate ongoing economic growth associated with the industry and spin-off from the industry in these counties and places where the brine trucks roll, pipelines run and waste is injected.

Ohio's valuable oil and gas resources can only be harvested once. It is time for Ohio to join other producing states and establish a severance tax that can help with the external costs of fracking and create a base for a strong economic future when the oil and gas are gone.

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[1] According to the Energy Information Administration, "Utica Region natural gas production growth was constrained before July 2013 because of limited natural gas processing capacity in the area. As a number of processing plants have

been built and brought into service over the past year, more natural gas is being gathered from wells and processed to meet pipeline specifications, allowing the gas to flow on interstate pipelines." Today in Energy, August 12, 2014 at http://www.eia.gov/todayinenergy/detail.cfm?id=17511

[2] Value of shale production based on production figures in the ODNR shale production database (http://oilandgas.ohiodnr.gov/production#ARCH1), prices in the 2013 Ohio oil and gas summary. Prices for 2014 taken from EIA. natural gas Henry Hub price adjusted downward to reflect difference with the Appalachian Basin (EIA at http://www.eia.gov/todayinenergy/detail.cfm?id=18391; MMBtu converted to Mcf).

[3] Ohio Department of Natural Resources, 2013 Ohio Oil and Gas Summary at http://oilandgas.ohiodnr.gov/portals/oilgas/pdf/2013%20Ohio%20Oil%20&%20Gas%20Summary.pdf

[4] Production value taken from the 2013 Ohio Oil and Gas Summary of the Ohio Department of Natural Resources. Severance tax collection taken from the annual report of the Ohio Department of Taxation.

[5] Testimony to the 130th Ohio General Assembly's House Ways and Means Committee January 22, 2014 at http://www.ohiohouse.gov/committee/ways-and-means. Cited in Wendy Patton, "Severance tax does not meet Ohio's needs," Policy Matters Ohio, June 17, 2014 at http://www.policymattersohio.org/hb375-june-9-2014