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Senate Passes Severance Tax for Unconventional Well Gas

Summary: The Senate has inserted a severance tax into their revenue bill (HB 542) to help shrink the size of the budget deficit. While this is a sop to the governor and others who have been after such a tax for years, it will do little to solve the fact that general fund revenue can't keep up with ever expanding general fund spending. It will serve as a strong signal to current or potential Pennsylvania businesses that they too will be targets when the state needs money.

A recent *Policy Brief* (*Volume 17, Number 34*) documenting the 2016 unconventional well impact fee revenues noted that since enactment in 2012, it has brought in over $1.2 billion. This revenue has been distributed to counties, municipalities, state agencies, and a legacy fund to deal with environmental issues related to the natural gas drilling industry. But in a state facing huge revenue shortfall as spending continues to grow faster than revenues, the impact fee, whose proceeds do not go into the general fund, has not been enough to quell the desire of many legislators and the governor to get more tax revenue from the unconventional gas wells.

Ever since he was a candidate, the governor has been pushing for a severance tax on gas from Pennsylvania's shale formations (see *Policy Brief Volume 17, Number 10*). In a recent bill (HB 542) aimed at producing more general fund revenue, the state Senate decided to give in to the governor's desire for a severance tax. They are trying to backfill the previous fiscal year's budget shortfall of about $700 million, as well as to fund an even more ambitious spending plan in the current fiscal year. The bill has been sent to the state House where its passage has been deemed questionable.

The Senate severance plan will impose a tax on each thousand cubic feet (Mcf) of gas removed from wells. Much like the impact fee, which is to be left in place, the tax rate will be set according to the price of natural gas, both measured on a per Mcf basis, on the commodities market as follows: if the trading price of natural gas is less than $2.25, the tax rate will be 1.5 cents; if it is greater than $2.25 but less than $3.00, which it was for 2016 ($2.46), the tax rate will be 2.0 cents; if the selling price falls between $3.00 and $4.99 the tax rate increases to 2.5 cents; between $4.99 and $6.00 it will be 3.0 cents; and anything greater than $5.99 triggers the top rate of 3.5 cents.

Through the first six years since the impact fee was implemented, the average price of natural gas ranged from a high of $4.42 (2014) to a low of $2.46. In 2012, 2015 and 2016 the tax rate would have been 2.0 cents. In the other years, it would have risen to 2.5 cents.

There can be no illusions that the Senate's severance tax plan will do very much to close the budget the deficit created by the rise in spending above last year's level, a pace that was already faster than the revenue being generated. For example, 2016's production level of 5.095 billion Mcf (the highest volume to date) from unconventional wells multiplied by a tax rate of 2.0 cents per Mcf, would generate $101.9 million in tax revenue—hardly a dent in the projected $2-$3 billion gap the state faces. At this output level even the highest rate of 3.5 cents would generate only $178 million.

Indeed, much higher prices and much greater output would be required to produce substantial revenue. At double the 2016 production level and with a price of $6 per Mcf, the severance tax would bring in only $357 million. In that price and production scenario, the state's income tax and very likely the impact fee revenue would also rise. The problem is that while gas production and prices are being depressed by market forces any additional taxes on the industry will represent a new burden for companies that are already struggling to stay in the black. Should that occur, the addition of the severance tax will have a discouraging effect on exploration and production activity.

Another point of emphasis is that the law which established the impact fee has a subsection (2318) which rescinds the impact fee if a severance tax is implemented. While the Legislature certainly has the power to amend Act 13 of 2012 to eliminate that provision and keep the impact fee intact along with a severance tax, which HB 542 intends to do, it would send a powerful message to this—and any other fledgling industry—that despite promises made, the state's need for revenue will not exempt them from additional taxation.

The impact fee is doing what it was designed to do, i.e., provide financial help to those communities most affected by the drilling industry along with helping the state deal with the environmental impact. It has also benefitted communities who have not been touched by the industry. While its annual collections will vary according to economic conditions, it is funding many programs in the commonwealth.

Briefly stated, an add-on severance tax brings too many potentially negative and harmful short- and long-term consequences to Pennsylvania to be considered seriously as a viable way to deal with the state's formidable budget issues. There must be many places in the budget to cut spending and do some major belt tightening. The poor decisions made years ago about pensions should not be allowed to wreck the economy.

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