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Governor Pitches Severance Tax Proposal

While stumping for the governorship, the current Governor made a Marcellus Shale severance tax a key campaign promise. And true to his promise, now that he occupies the seat, he has officially proposed a five percent severance tax on the value of natural gas coming from the Marcellus Shale formation. While most observers were sure this proposal was coming (*see Policy Brief Volume 14, Number 59*) they did not see the added twist coming—a flat fee of 4.7 cents per thousand cubic feet (Mcf) of gas extracted.

As we wrote in that *Policy Brief*, a five percent severance tax was not going to raise $1 billion based on recent production and gas price levels. At 2014's average trading price ($4.13 based on the formula from Act 13 that created the impact fee) and production rates (approximately 3.99 billion Mcf from unconventional wells) a 5 percent severance tax would have generated $822.2 million. At recent lower prices—gas closed at $2.75 on Tuesday February 17th, down from $5.80 from this date one year ago—there is no chance of raising $1 billion from the severance tax alone; unless there is an enormous and unexpected surge in production.

This no doubt explains the add-on flat 4.7 cents per Mcf to the tax proposal. This combined tax proposal follows West Virginia's scheme of a five percent severance tax plus the 4.7 cents per Mcf. The latter was added in 2005 to provide money for a worker compensation fund. However, a major difference is that West Virginia also allows deductions for annual industry operating expenses—a feature not included in the Governor's proposal.

Taking 2014's production rate as a base, the 4.7 cents per Mcf would raise another $187.4 million. When added to the five percent severance tax, which would have generated $822 million, had it been in place in 2014, the two taxes together just top the $1 billion mark. This matches the campaign talk of generating $1 billion to be spent on education.

Remember that to get to a billion dollars in revenue it was necessary to use last year's production and prices—and the add-on flat fee. At the recent price, $2.75 as of February 17th and, assuming last year's production, the two new taxes would produce just under $735.5 million. If prices and production fall from where they are now, estimated revenue from the proposed tax scheme would fall further.

Keep in mind too, that these revenue predictions assume no reaction from the industry. When costs rise that cannot be passed along to buyers in the form of higher prices, it could negatively impact production and specifically new well drilling. Thus, depending on market conditions, there could well be contraction in the industry, particularly from the smaller companies who were operating with very thin margins when the price of natural gas was significantly higher in 2014.

We were already hearing of drillers holding back on tapping new wells when the price started to fall earlier this January. 2014's production levels from unconventional wells (Marcellus Shale) were 28.5 percent higher than in 2013. But this represents a decline from the growth in 2013 when production was up 52 percent above 2012, which in turn was 92 percent better than 2011. The production growth rate could well slow further or stop altogether if the Governor's tax proposal is enacted. Thus, it is important to have a much better and clearer sense of the industry's probable reaction when making revenue projections.

In addition, there are other considerations to be weighed before the tax proposal gets very far in the General Assembly. For instance, will the levying of the taxes have a chilling effect on talks with complimentary industries or businesses the Commonwealth is trying to lure to the state—such as the cracker plant which separates the chemical compounds in natural gas for use in the manufacturing of other products?

Second, bear in mind that passing a severance tax would—as required in Act13—rescind the current impact fee and do away with substantial revenue presently being shared by municipalities, counties and state programs. The impact fee over its first three years has generated more than $632.4 million in revenue at an average over $210.8 million per year. Therefore, any money collected by the proposed severance tax will have to backfill Act 13 promises to these entities. It is unlikely the current recipients of the impact fee money will sit still and watch those dollars disappear. This is especially true of the counties with heavy concentrations of rigs that receive significant payouts from the impact fee revenue.

If the Governor is looking for an additional $1 billion to fulfill his campaign promises, he will almost certainly need to raise more than $1.2 billion to do that *and* replace the impact fee. Given our estimations above, using 2014's production report and the current gas price, the net gain to state coffers (total severance tax revenue minus impact fee obligations) would be just shy of $525 million. Certainly well off the billion dollar mark trumpeted on the campaign trail.

While the Governor has made good on his campaign promise to propose a severance tax, it is not clear how it will be received by the Legislature. In areas where the impact fee money has had a positive effect, and drilling had boosted employment and local tax coffers, this will be a tough sell. The Governor was quoted in the news media as saying "The alternative is not really no tax. It's no drilling, a ban, as in the case of New York." Does he really mean to imply that he would recommend a ban? If so, that will be a total non-starter and a very poor choice of words considering the large economic benefit this new industry has produced for the Commonwealth.

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