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Another Punitive Wrinkle to Severance Tax

In his first budget address the newly inaugurated Governor carried through with his promise to go for a severance tax on Marcellus Shale gas production. He has proposed a five percent severance tax on the value of natural gas being pumped from the Marcellus Shale formation in Pennsylvania plus a 4.7 cent tax per thousand cubic feet (Mcf) fee. As we outlined in previous *Policy Briefs* (*Volume 15, Numbers 10 and 14*) there are questions as to whether a net of one billion dollars in revenue will be forthcoming from the tax scheme and, just as important, whether using Marcellus tax revenue to fund huge increases in education spending without first proving the additional funds will improve education quality should be a non-starter in the General Assembly.

As we demonstrated in the earlier *Briefs* the problem is quite simple: the price of natural gas has been on a downward trend since late 2014 and does not seem to be coming back up anytime soon, with the Henry Hub price closing at $2.72 on March 23rd—38 percent lower than its trading price one year ago. In one *Brief* (*Volume 15, Number 10*), using 2014's unconventional well production of just under 4 billion Mcf, and the average Henry Hub price for 2014 ($4.13) and factoring the per cubic foot fee, the estimated amount generated will be about $1 billion. However, in mid-February, that price had fallen to $2.75 and the amount realized would be around $735.5 million. With the most recently recorded trading price at about the same level, our revenue estimate would be essentially unchanged.

Here it is important to note that the price used in the above calculations is the Henry Hub price as mentioned in Act 13 which is used to set the price for the impact fee schedule. Henry Hub is a natural gas pipeline hub in Louisiana that is the national benchmark, as traded on the New York Mercantile Exchange, but it is not necessarily the price at which natural gas is sold in Pennsylvania. Pennsylvania has its own hubs where drillers bring gas to the market. Hubs in the southwest, near Pittsburgh, such as the Dominion South, are a little closer to Henry Hub. But for the Transco-Leidy Hub in Potter County, the selling price is much lower due to the oversupply being brought to the market and the inadequate pipeline infrastructure in moving it out to other regions. News reports note that at the Dominion South hub, the selling price as of March 20th was $2 per Mcf, while at Transco-Leidy, the price was $1.49.

Of course the problem the severance tax proposal faces is that prices do in fact fluctuate. The original announcement said the tax would be five percent of the value of gas produced. And then we learned that an updated proposal included a 4.7 cent per thousand cubic feet add on fee. And now that prices have continued to stay low and revenue forecasts are not moving higher, we are learning through the media that an updated severance tax proposal will set an arbitrary minimum gas price for tax calculation purposes at $2.97 per Mcf. This is obviously an attempt to get more money when prices are low and add stability to revenue. But this would create a serious problem when prices are as low, or lower, than they are now.

Setting a minimum price near $3 per Mcf means that for producers who are getting half that price the severance tax rate would be much higher than five percent. And the flat 4.7 cents per Mcf adds to the total tax rate. Consider a producer with a monthly volume of one million Mcf selling at a price of $1.50 per Mcf. The value of the produced gas is $1.5 million. At five percent, this producer would pay a tax of $75,000 and another $47,000 from the 4.7 cent per Mcf add-on for a total of $122,000 per month—an 8 percent tax rate. However, with the artificial price floor of $2.97, the severance tax will be based on $2.97 million in value and this producer would pay $148,500. On top of that the company would still pay $47,000 in the per Mcf fee for a total of $195,500 in taxes that month. That is a total tax rate of 13 percent of actual market value. At that level, the tax becomes extremely punitive.

Of course, the tax paid will reduce the profit by that amount and will lower the corporate income tax somewhat but it will also lower the amount available for royalty payments and reduce the rate of return on investment. In effect, the tax is an added cost on production. When costs go up and cannot be passed on in prices, it hurts investment and production. The ramifications for the future of this industry in Pennsylvania need to be weighed carefully before this tax grab is even considered seriously by the Legislature. And where is the proposal to apply the severance tax to shallow wells? Note that conventional vertical wells tapping into the Marcellus formation are also subject to the tax, but they represent a very small fraction of total production.

Finally, the Governor's stated purpose for levying this tax is to use it for education. As we have shown in an earlier *Brief* (*Volume 15, Number 14*) adding dollars to education spending without demonstrating how they will improve education is folly. For the most part, advocacy for more money is special interest pleading by the education establishment that cares little or not at all about cost management. There is never a willingness to entertain significant reforms such as ending teacher strikes or creating a voucher system that would let children get out of failing public schools. Any discussion of meaningful pension reform, a main driver of higher education costs, is met with derision. The General Assembly should demand some concessions on these points before it considers increasing spending for education. It should also ask why some districts can achieve sterling academic results while spending well below the state average per pupil and some districts spend far more than the state average and have dreadful academic results. And it would be useful to critically review spending in other areas as well.

A “left leaning” think tank spokesman advocating the severance tax said that Pennsylvania is the only gas producing state with no severance tax and it is high time we had one. Perhaps the spokesman might consider that several states do not have a personal income tax, does that mean Pennsylvania should get rid of its personal income tax? Twenty-five states have a right to work law, including important recent additions in Michigan, Indiana and Wisconsin. Should Pennsylvania not have a right to work law as well?

Only three states have significant numbers of teacher strikes and only eleven even allow teacher strikes. Pennsylvania for years has led the nation in teacher strikes. Should we not outlaw teacher strikes as well? Moreover, only two states, one of which is Pennsylvania, have state owned liquor stores. Should the Commonwealth not join the 20th century and 48 other states and privatize its stores?

If Pennsylvania is out of touch with better economically performing states, it is because of its outdated laws regarding public unions, pension crises, prevailing wages, liquor stores, antiquated property assessment laws and so much more. The severance tax arguments are a red herring to take people’s minds off the real fundamental structural problems the state is beset with and cannot bring itself to deal with. And it is also an effort to make people believe there are easy and quick fixes to the state’s financial woes that can be dumped on the backs of the Shale industry.

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