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Governor Proposes Severance Tax—Again

Summary: The Governor's third budget address did not ask for increases in personal income or sales taxes to patch over the State's budget deficit, but he did trot out an old favorite of his—the severance tax on extracting gas from the Marcellus Shale formation. It is widely assumed to be a non-starter with the Legislature, but it has been put on the table and as such must be analyzed.

This year's budget proposal calls for a severance tax of 6.5 percent on Marcellus Shale gas production to go into effect July 1, 2017 (the start of the new fiscal year). In the past two budgets the severance tax proposal called for a five percent levy on the value of the gas coming from Marcellus Shale wells (also called unconventional wells) plus an add-on of 4.7 cents per thousand cubic feet (Mcf) (see *Policy Brief Volume 15, Number 10*).

While proponents of the severance tax are quick to point out that Pennsylvania is the only major gas producer without a tax on the value of gas produced, they fail to mention that the Commonwealth is the only state with an impact fee.

We have written extensively on the impact fee which was instituted by Act 13 of 2012 (see *Policy Brief Volume 12, Number 11*). The impact fee is to be paid on any well drilled within the Marcellus Shale formation. The amount of the fee depends upon a few things: (1) the trading price of natural gas on the New York Mercantile Exchange (NYMEX)—the higher the price, the greater the fee; (2) the age of the well—there is a gradual reduction in the fee as a well ages; and (3) the volume produced with wells producing less than 90,000 Mcf per day would be exempt as are any wells that are subsequently capped.

A key difference with the impact fee compared to the severance tax is that most of the money is returned to the communities where the activity is taking place, both at the municipal and county level. However, some money is distributed to all counties (with or without wells), and seven state agencies. None of the money goes back to the general fund.

In his first two budget proposals, the Governor stated that producers would still be responsible for paying the impact fee as well as the severance tax. In this proposal (FY

2017-18) he is offering a credit against the severance tax for any impact fees paid. Act 13 stipulates that if a severance tax is enacted, it voids the impact fee. While laws can be amended so that both can exist, what would be the point of having both? If the severance tax is passed, eliminate the impact fee. Take the amount the impact fee would have generated (the average for the first five years is $213.3 million) and distribute it to those communities and state agencies receiving impact fee money in the same ratios.

As proposed the Governor's severance tax, along with the impact fee credit, is projected to net $293.8 million in FY 2017-18. How much gross revenue would the 6.5 percent severance tax produce? Of course the answer depends upon the trading price of natural gas and the volume produced by unconventional wells. Production has been steadily growing in the Commonwealth with 5.09 billion Mcf reported in 2016. This is up from 4.6 billion Mcf removed in 2015 and the 4.07 billion in 2014. Thus, the rate of increase has slowed sharply—2016's production is up 10.6 percent over 2015 which was 13 percent higher than 2014 while 2014 was 31.2 percent higher than in 2013.

The price of natural gas, as measured by the Henry Hub price (the terminal out of Louisiana, traded on NYMEX and the basis for the impact fee) has fluctuated over the past few years. In 2016, the average annual price of natural gas fell to its lowest point over the last five years ($2.46 per Mcf). The high point was $4.46 per Mcf in 2014 and the average since 2011 is $3.16.

Thus, had a severance tax of 6.5 percent been in place for 2016, and using the Henry Hub price, it would have grossed $814.1 million—5.09 billion Mcf multiplied by an average selling price of $2.46 gives a market value of $12.5 billion. But as we mentioned in *Policy Brief Volume 15, Number 16*, while the Henry Hub price is the basis for calculating the impact fee, Pennsylvania natural gas producers sell their gas at five local hubs in the state such as the Transco-Leidy hub in Potter County and the Dominion South hub near Pittsburgh. At these hubs the prices have been lower than those of the Henry Hub, due in large part to the expanding supply being removed from the Marcellus Shale and lack of pipeline capacity. As a result the actual value of production and the tax revenue will likely be far less than if calculated using the Henry Hub price. And under the Governor's proposal the net from the severance tax would be reduced by crediting companies with the amount of the impact fee paid—that fee has been around $200 million a year.

If the severance tax passes at the proposed rate, Pennsylvania would go from not having such a tax to having one of the highest rates in the nation. Neighboring Ohio's rate is 2.5 cents per Mcf while West Virginia charges five percent of market value. West Virginia had an add-on of 4.7 cents per Mcf which had been dedicated to paying off a workers' compensation debt, but that debt has been paid off and the add-on has been dropped (July 2016). There is also a bill in committee that would reduce the severance rate to four percent and three percent over the next two years. Thus at a time when Pennsylvania is looking to impose a severance tax, West Virginia is looking to lower theirs.

A final point to consider is the effect the severance tax will have on royalty payments received by mineral rights holders in Pennsylvania. In states with severance taxes, producers are allowed to deduct the amount of the tax from royalty payments. These deductions would in turn reduce the royalty payments to Pennsylvanians, implying lower income tax revenue to the state.

In 2006, before the Marcellus Shale boom in Pennsylvania, the state recorded 246,889 returns that claimed income from a category called "rents, royalties, patents, and copyrights". The amount claimed came in at $3.6 billion. In 2014 (the most recent data available), the state recorded 342,889 returns—an increase of 39 percent in eight years. The accompanying income claimed was $6.9 billion—nearly double the 2006 amount. At the personal income tax rate of 3.07 percent, remittances to the state would have risen from $109.4 million to $211 million.

Unfortunately, the proposal to enact a severance tax on Marcellus Shale gas production is once again on the table. It would place Pennsylvania from being the only major gas producer not levying a severance tax, to having one of the highest in the nation. Another question is what to do with the impact fee. After all Pennsylvania is the only state with an impact fee. The current proposal is to give the producers a credit against the severance tax. But it will further underscore Pennsylvania's status as an unfriendly to business state and lower the profitability of gas production in Pennsylvania and the incentives to produce gas in the state as more business friendly states get a bigger share of expanding production. For example, Ohio and West Virginia have lower tax rates and also sit on the Marcellus Shale and Utica Shale formations. At a time when the industry is just recovering from low prices and a subsequent reduction in its workforce and drilling activity, there needs to be encouragement for growth, not more disincentives as represented by a severance tax.

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