Severance Tax
June 2012

INTRODUCTION

Governor Kasich has introduced a proposal that would make significant changes in the Ohio severance tax system that applies to oil and natural gas wells in exchange for lowering Ohio's income tax. The proposal would increase taxes on horizontal wells and provide a tax reduction or no change in taxes on production from vertical or conventional wells. In addition, the proposal calls for the new tax revenue generated from horizontal wells to pay for reductions in income tax rates.

This document reviews the framework of the Governor's proposal, answers some common questions, provides the positions of various stakeholders on this issue and suggests items that may be considered during current policy deliberations.

ISSUE / BACKGROUND

Previously, oil and gas wells in Ohio were vertical wells; the well was drilled in a vertical direction only. Oil and gas drilling in the shale formations use a horizontal drilling method. When it is extracted from the ground, natural gas is "wet;" it contains a number of additional liquids, such as butane, ethane, propane and natural gasoline, that have to be removed before the gas is marketable. These liquids are known as "condensate." Natural gas from which these liquids have been removed is known as "dry" gas.

Because the amount of gas in most vertical wells in Ohio is not great, these additional liquids have not typically been commercially significant to the producer. However, it is believed that the natural gas reserves in the shale formation are so extensive and a horizontal well makes accessing the gas comparatively easier that these liquids will become commercially important.

Proposed Impact Fee for Horizontal Wells:

The proposal requires that those who receive a permit to drill a horizontal well pay an impact fee of $25,000 to the county in which the well is located. The fee would be deposited into a specified fund to be distributed by the host county's budgeting committee to communities demonstrating need due to the presence of the well in the community. Distribution of the funds is not mandatory and if no distribution were made, the funds would be divided with 60% going to the county and 40% going to the township in which the well is located. The company will then receive a dollar-for-dollar property tax credit equal to the $25,000 impact fee at a later date.

Current Severance Tax and Proposed Severance Tax:

Currently, severance tax is imposed upon the extraction, or severance, of certain natural resources including oil and natural gas from the soil. Natural gas liquids are not subject to tax as natural resources. The following chart shows the proposed tax changes:

Resource	Current Law	Proposed Law
Crude Oil – Vertical Well	$.10 per barrel (plus $.10 fee)	$.10 per barrel (plus $.10 fee)
Crude Oil – Horizontal Well	No provision	4% of price of metered volume produced (1.5% in first year)
Natural Gas – Vertical Well	$.025 per MCF (plus $0.005 fee)	Lesser of $.03 per MCF or 1% of price of metered volume produced; no tax if production averages <10,000 CF per day
Natural Gas – Horizontal Well	No provision	1% of price of metered volume produced
Condensate	No provision	4% of price of metered volume produced

Current law levies a $0.10 per barrel severance tax on crude oil and a $0.10 per barrel "cost recovery fee" on crude oil ($0.005 per MCF on natural gas). It is using these two combined figures that equal the $0.20 per barrel in severance tax that has been widely reported. Technically, the second ten cents per barrel and half of a percent per MCF is not a tax, but a fee levied on the *owner* of a well. Under current law, this amount may be paid by the producer of the well, but the producer has the right to collect the fee from the owner. This fee was added to Ohio law in 2010 under SB 165.

The taxes and cost recovery fees from non-horizontal wells are dedicated to various ODNR funds in both current law and the proposed law. The proposed new taxes on horizontal wells, however, are dedicated to a new fund entitled "shale resource income tax relief fund"

Proposed Income Tax Reductions:
Under the proposal, if, by October 5th of each year, the balance of the shale resource income tax relief fund exceeds the current year's income tax by thirty-five-one-hundreths of one percent (0.0035%) the fund balance will trigger a reduction in the income tax rates for the following year, according to the existing schedule for income tax reductions. Note: Ohio law already provides for income tax rebates if the balance of the state's surplus exceeds a certain amount. The proposed reduction would follow that same formula. Estimates suggest that this income tax refund could reach 5%, although that amount could vary based on a variety of factors.

Other Existing Taxes:
In addition to actual severance tax, there are other taxes in Ohio which may have an impact on the oil and gas industry and landowners including:

- State and Local Sales and Use Tax
- Commercial Activities Tax (CAT)
- *Ad Valorum* tax (property taxes)
- Severance Taxes

While it is difficult to accurately compare the tax situation in one state to the tax situation in another state because states have a wide variety of taxes and tax credits that may not perfectly correlate, we have been able to identify taxes in a handful of states that are either geographically close to Ohio or that have significant drilling activity. A comparison of these taxes follows in the included table.

Tax	Ohio	Ohio Proposed	Texas	New York	West Virginia	Pennsylvania
Sales & Use	State rate 5.5%, local rate up to 3% Exemption for items used directly in production of crude oil and natural gas.	No Change	State rate 6.25%, local rate up to 2% Exemption for items used in extraction	State rate 4% local rate up to 5.5% Exemption for items used directly and predominantly in mining or extracting	State rate 6%; local rate up to 1% Exemption for items used directly in the production of oil and gas	State rate 6% Exemption for items used predominantly in mining
Entity Level Tax (FT, IT, GRT)	Commercial Activity Tax on gross receipts; $150 on first $1mm, 0.26% on receipts over $1mm	No Change	Margins tax, 1% on least of (i) total revenue less cost of goods sold; (ii) total revenue less compensation paid; or (iii) 70% of total revenue	Net income tax; 7.1% of net income Alternative taxes on business capital, minimum taxable income, or fixed dollar minimum	Income/Franchise tax Income tax at 8.75% FT at 0.55% of capital, phased out by 2015	Capital Stock (2.89 mills of value of stock, being phased out) or Corporate Income tax, 9.9% of net income, applies to owners of LLCs
Property/ Mineral	Value of reserves multiplied by real property tax rate; condensate not separately taxed	Taxation of oil and gas reserves unchanged; condensate taxed in same manner		Value of reserves multiplied by real property tax rate	Special rules exist for the valuation of natural resource property, which includes oil and gas property.	
Severance/ Production	$.10/barrel of crude oil (plus $0.10 fee) $.025/MCF of natural gas (plus $0.005 fee) No tax on condensate	Vertical wells unchanged for oil; for gas, tax is lesser of $.03/MCF or 1% of value of gas produced. Horizontal wells 4% of value of oil and condensate, 1% of natural gas	Production tax at 4.6% of value of oil; 4.6% of value of condensate; 7.5% of natural gas		5% of value of natural resource severed, applies to oil and gas	
Other			Oil Well Service Tax, 2.42% on services such as cementing, fracturing, surveying & testing Taxes tangible personal property at 100% of value		Tangible personal property tax at 60% of true value	

Frequently asked questions related to the proposed tax framework:
As Farm Bureau members consider the proposal and react to the discussion, which to this point has been very robust, a few questions have frequently come up. Below, we will review some of those questions and share the information that we have received relative to the answer.

What is Ohio Farm Bureau Policy on the proposed tax framework?
Ohio Farm Bureau policy does not contemplate the specifics of this proposal. However, OFBF does have policy on specific aspects of property taxes, CAT tax, and income tax. Attached are the policies that OFBF staff has identified as generally related to our position on taxes that could be useful when considering this proposal.

Are the proposed taxes paid by drilling companies or landowners?
How any taxes and fees are paid very much depend on how the lease between landowner and the drilling company are written. This is a good reminder to always seek experienced legal advice when entering into a lease or other contract.

In general, we have found that most leases in Ohio fall into one of three categories: old leases that have most likely been recently purchased by a larger drilling company, new leases that were individually signed, and new leases that were negotiated as part of a landowner group. For the most part:

> <u>Old Leases</u>: Many older leases seem to require that the landowner share in the taxes paid with the drilling company in an amount that is proportional to the royalty percentages. Some also pay royalties *after* the company has deducted certain fees and taxes (may be identified as “net royalty” in the lease).
> <u>New Leases</u>: Many newer leases that are signed on individual properties seem to contain provisions that the landowner will share in the taxes that are levied, in an amount that is proportional to the royalty percentages (Example: If the lease provides a 12% royalty, the landowner would be responsible for 12% of the taxes).
> <u>Landowner Group Negotiated Leases</u>: Many newer leases that are signed as part of a large landowner group seem to contain provisions that require the drilling company to pay all taxes and fees. Why? The bargaining power of a larger group is stronger and can negotiate these sorts of concessions.
> <u>My Lease (If Applicable)</u>: Remember that the above points are simply generalizations based on what we have seen and what has been reported to us. Your lease will determine how taxes and fees are paid, just as it will determine royalty payments. If your lease is unclear or if you would like some clarification, you should seek the advice of legal counsel.

Note: Some individuals have advocated for a change in Ohio law to require the drilling companies to pay all taxes regardless of the lease structure. Ohio law cannot change a valid contract, but could establish new guidelines for future leases.

How much would my income tax be reduced if this were to go into effect?
The proposed income tax rebate rate will go into effect if the amount generated by the tax exceeds 0.0035% of the income tax collected. Assuming the necessary amount is generated, the tax reduction is going to depend on your total tax liability. The Governor’s fact sheet estimates that income tax cuts could reach $500 million annually. In terms of the median Ohio household, rebate estimates have ranged from $40 to $70 annually, depending on who is doing

the calculating. However, for Ohioans with a higher state tax liability, the rebate would be more. For Ohioans with a lower state tax liability, the rebate would be less. The Governor argues that in general, income tax relief will help inject new capital into the economy and generate increased economic activity.

Would this proposal reduce my royalty payments under my existing lease?
That is a possibility and would depend on how your existing lease is written.

What is Ohio Farm Bureau's position on this proposal?
Ohio Farm Bureau has not taken a position at this time. We have had considerable discussions with a wide variety of interested parties, including the Governor and the oil and gas industry.

Positions of Various Stakeholders:
While we want to be cautious about expressing opinions that others have stated, proponents of the proposal (including Governor Kasich) have generally argued that Ohio's income tax rate makes our state less competitive in drawing in business and economic development, which could be improved by an income tax reduction. They have also generally argued that the industry does not pay taxes that are competitive with those paid in other states or when considering their profits and that the existing investment by the oil and gas companies means that they will not leave the state.

Opponents of the proposal (including the oil and gas industry) have generally argued that the proposed tax will make drilling in Ohio uncompetitive in terms of taxation, that the proposed taxes are actually very high because they are based on gross receipts and not revenues, that they will dissuade their industry from continuing to invest here in Ohio at this time, and that the proposal may have the effect of driving the horizontal wells out of the state.

Other interested parties (including an OSU Swank Program Report "Making Shale Development Work for Ohio") have weighed in that an increase of the severance tax may make sense but that the increased revenue should be used to cover the short-term costs of extraction, including infrastructure, amenities and public services and the possible long-run costs of providing increased levels of education and maintaining a diverse local economy that does not rely so heavily on a single source of revenue. The argument is that this would help prepare local areas for the possible volatility that occurs in regions rich in natural resources.

Other interested parties believe that the severance tax should not be increased. This includes those who fundamentally oppose increases in any taxes and landowners where wells are located who believe that based on their contract they will pay increased taxes.

OHIO FARM BUREAU FEDERATION STATE POLICY
Policy 145 Oil and Gas Exploration/Leasing (entire section)
OFBF supports:
1. Strengthening the ODNR Division of Oil and Gas Resources Management to enforce all rules governing drilling, hydro fraction and related activities.
2. Collaborative efforts between ODNR, state agencies, energy service providers, local government leaders and rural residents to inspect, repair, remediate and restore on farm resources and public infrastructure impacted by drilling, transportation, storage, and production activities. 3. State and federal governments creating additional financial resources for local communities to address economic, logistic, social and service issues as large oil and gas exploration projects get underway in many neighborhoods.

4. Strategies that balance conservation of farm and community resources with the need to eliminate physical constraints and network interconnections required to get new energy supplies to refineries and markets.
5. Preservation of current rules governing oil and gas exploration that protect soil and water resources, as well as recognize implied covenants created through Ohio court decisions that give landowners with lease agreements guaranteed provisions to ensure repair, remediation and compensation on the impact of oil and gas exploration on their property.

Policy 481 State and Local Taxes (selected)
We oppose any excessive and unfair taxes. While we are opposed to gross revenue taxes (Commercial Activity Tax), we also recognize that increases in income tax rates, increases in property tax rates, loss of CAUV, and/or loss of sales tax exemptions are equally unacceptable. We also oppose any rate increases in the current Commercial Activity Tax (CAT), as well as any increases in the administrative fee. We recommend the administrative fee threshold be raised to $500,000. We support exempting all farms from the CAT that are required to pay the Ohio Income Tax. (page 4-15)

We believe in fiscal responsibility in state government. If the CAT generates revenue beyond the estimated total of $1.594 billion per biennium, we support the current provision in law that places half of the excess funds into a rainy day fund and half applied to an overall rate reduction. (page 4-16)

Income received from fees and assessments from an agency or program shall not be returned to general purpose or general revenue funds. (page 4-15)

Policy 484 Income Tax
Additional revenue, if needed, should come primarily from the personal income tax and, under some circumstances, from an increase in sales and use tax rates, rather than from eliminating exemptions. (page 4-18)

Policy 552, Reclamation of Strip Mines (selected)
We support the concept of federal legislation to extend the severance tax on coal for the purpose of reclaiming abandoned mine lands. Such severance taxes should be fully allocated to strip mine reclamation programs. As an alternative to federal legislation, we support a state severance tax in a like amount to be used for reclamation of abandoned mine lands. (page 5-15)
**OFBF does not have specific policy on the oil and gas severance tax. However, the above policy relates to our position on coal severance taxes, and may be noted.*

DISCUSSION QUESTIONS
Given the above information, it may be helpful for your policy development committee to consider if OFBF should have more policy regarding oil and gas taxes generally and/or policies specific to the Governor's proposal. A few questions to guide you:

- *Are Ohio taxes generally too high? Will this proposal make Ohio more attractive to businesses?*

- *Do we feel that the existing tax structure on oil and gas production is correct? Should it be increased? Decreased? If the existing tax structure on oil and gas production should be increased, is the current proposal the right amount of an increase?*

- *Do we feel that a tax increase on oil and gas production, if levied, should go to reduce income taxes in Ohio? Is this a good use of the money, or should it be directed to another source such as education funding, property tax reduction, local government funds, providing services, or general budget needs of the state? Is there another expenditure not listed above that makes more sense?*

- *How does an increase in severance tax fit into our overall policy on what Ohio tax structure should be?*

- *How does the Governor's proposal of increasing severance tax to reduce overall income tax fit into our overall policy on what Ohio tax structure should be?*

- *Are there any things we've not considered that should be further explored during the policy development process?*