The INSTITUTE for

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A partnership among Keystone College, King's College, Luzerne County Community College, Marywood University, Misericordia University, Penn State Wilkes-Barre, University of Scranton, & Wilkes University

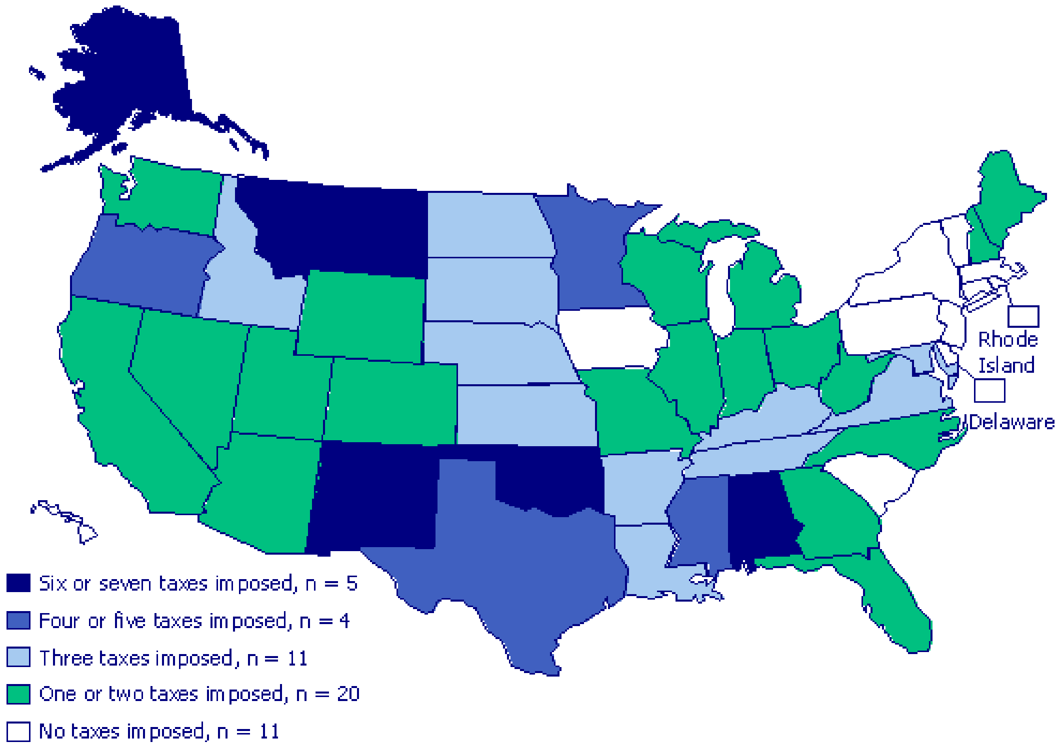
Severance Tax

In our spring 2008 newsletter, The Institute reported on natural gas exploration in the region's shale deposits, and the opportunities challenges that come with this discovery. In June, The Institute issued two reports detailing the importance of Marcellus shale to our region and the economic impact similar natural gas findings have had in other parts of the country. In continuing our efforts to research this subject, in this newsletter we examine "severance tax" – the latest buzz term surrounding Marcellus shale.

A severance tax is a levy on natural resources "severed" from the land. Most of the country's largest natural gas producing states, including Texas, Arkansas and West Virginia, among others, institute a severance tax. In Pennsylvania, however, the State Legislature, has not yet considered legislation to allow for such tax. The Institute believes that Pennsylvania should enact a severance tax on natural gas commodities in order to reap all the benefits of the Marcellus shale play. Further, implementation of a severance tax will allow for appropriate regulations to allow for environmental and other protections.

There are two schools of thought on the severance tax issue. On one side, some believe that Pennsylvania should reap the benefits of and collect a tax on this natural resource extracted from the land. On the flip side, others believe the severance tax would hinder exploration activities and drive away natural gas companies. It should be noted, however, that the latter scenario has not been the case in other states where shale exploration has occurred.

The map below demonstrates the states, which impose a severance tax. As illustrated, Pennsylvania is one of few states that does not impose a severance tax.



Source: National Conference of State Legislatures

Many states dedicate severance tax revenues to specific purposes. Below are some of the most common benefactors:

- Counties and other local governments (Colorado, Florida, Kansas, Kentucky, Louisiana, Mississippi, Montana, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, West Virginia, Wyoming)

- Conservation, reclamation and remediation (California, Colorado, Florida, Louisiana, Montana, New Mexico, Ohio, Oklahoma, West Virginia, Wyoming)

- Schools (Minnesota, Montana, Nebraska, North Dakota, Oklahoma, Oregon, Texas, Utah).

Texas and Arkansas shale have been highlighted in prior The Institute reports. Both states contain shale similar to Marcellus shale, and each provides solid examples of severance tax laws and regulations.

Texas

Because it is such a large oil and natural producer, Texas has had a severance tax system in place for decades. Texas has restructured its severance tax system several times in an effort to pursue tax incentives or exemptions for natural gas drilling. The Texas Railroad Commission is the state's oil and natural gas industry regulator; the commission believes that reduction or elimination of state severance taxes provides operators with various economic incentives to produce oil and gas resources that otherwise might remain uncovered. Providing such severance tax reductions or exemptions, in effect, lowers production costs. These incentives are factored into decisions regarding whether or not to drill a well, initiating an enhanced recovery project, or servicing a well to increase its production.

Texas' natural gas severance tax code places a 7.5% levy on the market value of natural gas. Natural gas market value is determined at the mouth of the well from which it is produced. Natural gas tax receipts are expected to total $3.5 billion in 2008-09 — down 15.1% from $4.1 billion collected in 2006-07. In addition to billions of dollars in economic activity, the Texas received an estimated $165.4 million in 2006 and $212.1 million in 2007 in severance taxes from Barnett shale activity.

Arkansas

Due to its Fayetteville shale play, for the first time in 50 years, the Arkansas Legislature recently increased the state's natural gas production severance tax. The tax was raised from .3% per 1,000 cubic feet of natural gas to 5% of the market value of the natural gas; in addition, Arkansas implemented severance tax reductions for some natural gas wells.

The increase, which becomes effective Jan. 1, is expected to generate about $57 million next year and an estimated $100 million by 2013.

Conclusion

Pennsylvania should impose a severance tax on natural gas as it is extracted from the well. The tax should be based on market rate of natural gas. By imposing this tax, Pennsylvania is then forced to more judiciously regulate the industry so as to ensure that protects the environment, the landowner, and is more conducive to ongoing business. As a result however, Pennsylvania should consider lowering the corporate income tax as it is one of the highest in the US. Whether it lowers it for the gas producing firms or all businesses is another issue. However, lowering the corporate income tax across the board could be conducive for more business development opportunities.