Severance tax on natural gas threatens Marcellus Shale development, conventional natural gas drillers

By **Lesley Smith**

Drilling in the Marcellus Shale holds tremendous economic potential for the Commonwealth. But before full-scale development has even occurred, the Rendell administration and some state lawmakers are already looking to the fledgling industry as a quick fix to fill state budget holes.

As part of his 2009-10 General Fund budget proposal, Gov. Ed Rendell is looking to generate $107 million from a new severance tax on natural gas extracted from the Marcellus Shale. The proposed rate is 5 percent of the value of the natural gas at the wellhead plus $0.047 per thousand cubic feet of natural gas severed.

The PA Chamber and those in the industry believe the Commonwealth's rush to tax the industry will do more economic harm than good, and that the severance tax is not a realistic remedy to address the Commonwealth's current budget deficit, which is expected to top $2 billion by the end of the fiscal year.

"A few years away" is the assessment by Steve Rhoads, president of the Pennsylvania Oil & Gas Association (POGAM), of the severance tax's ability to generate significant revenue for the state.

Rhoads said the industry needs time to be fully "up and running."

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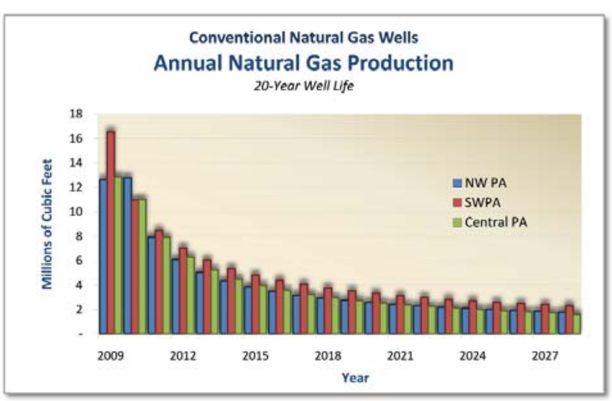
> **Steve Rhoads**, president of the Pennsylvania Oil & Gas Association

While the state Department of Environmental Protection expects to process thousands of Marcellus Shale permits in 2009, Rhoads said there are currently only about 270 wells that have been drilled into the geological formation. And those drills are mostly vertical exploratory wells, not high-output horizontal drills, which have opened up the industry's potential in Pennsylvania by making it less cost-prohibitive to extract the gas lying nearly 4,000 to 8,500 feet below the surface.

Another factor that could impact available revenue is the unpredictability of natural gas and oil prices, which have declined to one-third of the level of last year's prices.

"The Marcellus shale offers Pennsylvania a wonderful economic opportunity, but the development of the resources is still in its infancy," Rhoads explained. There is very little Marcellus Shale gas being produced today, and we do not expect to see significant production for five to seven years in the future. Consequently, the administration's revenue projections are pure fiction. There won't be any severance tax flow from the Marcellus for some time to come."

Rhoads fears that if the governor is seeking a natural gas severance tax to fill budget holes, the burden will fall on Pennsylvania's conventional natural gas industry.



Source: Historical Production Data from PA Independent Producers

Pennsylvania's independents produce oil and gas in 31 of the state's 67 counties. Most of the crude oil is produced in McKean, Warren, Forest and Venango counties. Natural gas is produced in all 31 counties. According to a 2008 Pennsylvania Economy League report, the Commonwealth's traditional oil and gas industry provides more than 26,500 jobs.

Rhoads said conventional natural gas drilling is a historically low-yielding and marginally economic industry. It is only with careful cost control and minimal operating expense that these wells attract any investment.

"A five percent severance tax on gross production would amount to a full 30 percent to 35 percent tax on the lifetime net income of a typical well, and it would be imposed in addition to other taxes already paid by the industry," Rhoads said. "No industry can survive such a burden, even in good economic times."

As an alternative to the severance tax, POGAM and the Independent Oil & Gas Association of Pennsylvania say the state can realize needed revenue for the upcoming budget from leasing a portion of state forest lands for Marcellus Shale development.

"The dollars that could be generated from a carefully crafted natural gas development program would far exceed the funds that a severance tax could bring to the Commonwealth at this time," Rhoads said.

At the very least, Rhoads said the state should delay discussion of a severance tax to give the industry time to develop so that Marcellus Shale gas reserves and production are understood. Doing so would also allow the Commonwealth to consider a rational tax structure with meaningful revenue projections.

"Drilling costs in the Marcellus Shale are significantly higher than those in other natural gas shale regions due to Pennsylvania's regulatory burdens," he offered. "The administration frequently makes note of the severance tax West Virginia placed on drillers in that state as justification for a tax in Pennsylvania. However, it costs at least $1 million more to permit and drill a well in Pennsylvania than in West Virginia, and the Department of Environmental Protection is promulgating new rules to raise well permit fees by more than 3,000 percent.

"In light of this high cost burden in an unproven, yet promising industry, a severance tax now on Marcellus Shale drillers would drive capital away from Pennsylvania toward more economical shale plays in other parts of the country," Rhoads stressed. "The last thing Pennsylvania should do is derail this economic train before it leaves the station, jeopardizing job creation and capital investment."

John Callahan, government affairs director who handles tax issues for the PA Chamber, agrees.

"With the relatively small cost margins associated with the extraction of oil and gas from Pennsylvania soil, over-taxation of this industry could effectively shut down its development," he stressed. "We need to ensure that taxation does not mean extinction of this fledgling industry."

"Few doubt the economic opportunities the Marcellus Shale holds for Pennsylvania. We need to ensure those opportunities become a reality," Rhoads concluded. "A severance tax sends the wrong message to companies looking to invest billions of dollars in Pennsylvania and threatens the efficient development and job creation potential of Marcellus Shale."

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