Natural Gas Severance Tax Proposals

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Act 46 of 2010, more commonly known as Pennsylvania's 2010-2011 budget bill, contained a commitment by the General Assembly to pass a natural gas severance tax by October 1, 2010, with an effective date of no later than January 1, 2011. This article will provide a brief summary of things to watch for as the General Assembly "makes the sausage" this month.

Severance taxes throughout the United States are generally based on the volume of gas extracted, the value of gas extracted, or a combination of the two. In the case of a tax based on the volume of gas extracted, there is a flat rate in terms of cents per thousand cubic feet (MCF). The gas is simply metered through the well as it is extracted. The problem with the volume method is that it does not take into account the value of the gas being extracted. For instance, when gas prices are very high, the taxing jurisdiction will not share in the increased revenues. Conversely, when gas prices are very low, the tax may be a severe impediment to extracting the gas at all.

The alternative is to tax the value of gas extracted "at the wellhead," which means before any deductions are made for transportation and distribution costs. The downside of this type of tax is that it is difficult to forecast for state budgeting purposes. It is also more difficult to enforce the tax, because sales and prices must be monitored and audited, rather than simply reading a volume meter at the wellhead.

A balance would be to enact a "hybrid" tax that takes into account both volume and value. A hybrid tax spreads the risk by imposing a tax on the volume extracted, as well as a tax on the value of gas extracted. The hybrid method allows budget makers some certainty, doesn't overly burden producers when prices are low, and allows the state to benefit when prices are high.

Governor Rendell proposed a hybrid tax based upon the West Virginia model. Several other bills in the General Assembly also propose to impose tax on a hybrid method. All but one of the pending bills impose a tax of 5 percent at the wellhead and an additional 4.7 cents per MCF extracted—the same rate imposed by West Virginia. One bill in the House is more aggressive in its imposition, using 8 percent at the wellhead and 8 cents per MCF extracted as its formula.

Several volume-based bills also have been introduced and vary from imposing 25 cents per MCF extracted to a high of 35 cents per MCF extracted. All of these bills contain provisions allowing the state to benefit when prices are high by adjusting the rate based on pricing determined by the New York Mercantile Exchange.

Various exemptions have been proposed. Most of the bills that have been introduced contain a "Stripper Well" exemption which would exempt wells producing less than 60,000 cubic feet per day from tax. Another common exemption is for shallow wells, which typify most of the "pre-Marcellus Shale" wells. Finally, the producers have been arguing for a phase-in period which would allow them to recapture some development costs before becoming subject to tax.

The pending bills also vary somewhat in how the revenues from the tax would be used. Potential recipients include the General Fund, local governments and the Game Commission, among others. How the Commonwealth decides to use the revenue is likely to be just as contentious as the fight over what form the tax is to take. We will provide a summary of whatever passes in a future newsletter.