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Shale and taxes are a volatile mix in Columbus

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Just as we begin to feel the cooler breezes on these late summer evenings, things are beginning to heat up at the Statehouse.

A quiet but bitter battle is being fought over potential changes to the Ohio severance tax on the emerging shale industry in exchange for a cut in Ohio's income tax.

Let's start with the basics of what the actual proposal looks like:

Severance taxes are levied by states on many extracted or mined natural resources. Currently, natural gas and oil are taxed volumetrically in Ohio; 20 cents on a barrel of oil and 3 cents per thousand cubic feet (MCF) of natural gas. There is no specific tax on natural gas liquids.

The proposed changes to the severance tax will be based on the sale price of the resource. For natural gas, the tax rate will be 1%. For oil and natural gas liquids, the rate will be 1.5% for the first year, rising to 4% in year two or three depending on the rate at which the driller is able to recover the initial capital costs of the well. (If cost are not recovered in the first year, the imposition of the 4% rate will be delayed a year.)

But who pays the new severance tax rates is where it gets a little complicated. Conventional wells, generally defined as vertical wells, will continue to pay the old rates. Only the higher-volume, horizontally-drilled wells will be subject to the new rates.

The final twist to the new tax rates is that a well producing less than 10 MCF of natural gas per day will pay no severance tax. Interestingly, this eliminates severance taxes on nearly 45,000 wells representing about 90% of the current wells in Ohio.

Not overly complicated, the new severance tax proposal is termed a modernization. The new high volume, horizontal well industry is barely a decade old in the region and less than five years old in Ohio. In addition, the proposal addresses the issue of natural gas liquids (ethane, butane, propane) not here to for part of the tax structure, and expected to be in abundance in the Ohio shale play. In fact, it is the liquids that most analysts cite as the key reason for growth in the Utica and Point Pleasant shale play.

Gov. John Kasich's proposal is then focused on devoting this new revenue source to a reduction in the overall Ohio income tax rate. It is this usage of the new revenue to reduce the income tax rate that garnered a neutral stance by the powerful conservative group, American's for Tax Reform. Through spokespeople, ATR has said that the governor's plan doesn't violate the "no new taxes" pledge that so many Republican candidates and officials have signed.

Even *The Wall Street Journal* has jumped into the mix with a late-summer editorial praising the Governor's concept as "a creative Ohio plan to trade levies on income and energy."

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However, a new group to the political scene is attempting to put up credible opposition to the governor's plan. Ohio Rising has proposed a new tax pledge for legislators who pledge to vote against any changes to Ohio's severance tax.

The group has not released the names of their organizers or financial supporters, but their key spokesman has been the head of Ohio's Tea Party movement. Interestingly, Americans for Tax Reform are also linked to Ohio Rising despite the fact that they are on record as saying that those who have signed their own “no-new-taxes” pledge are free to support the governor's proposal. To date, the group has yet to release the name of any legislators to take this new tax pledge; in the meantime, stories have surfaced about legislators who won't be supporting Ohio Rising's efforts.

Across the aisle, a number of key Democrat leaders have been talking about an imposition of the tax, but instead of reducing the income tax (which they say would unfairly help the highest income earner most) they are talking about diverting the tax to make up for other budget cuts the governor has made, specifically for local governments. Not an endorsement of the governor's plan by any means, it is interesting to see the discussion centered not around a ban on drilling and the process of hydraulic fracturing as in New York, New Jersey and Vermont but rather the opportunity presented by new tax revenue. Although outnumbered and nearly irrelevant at the Statehouse at vote-counting time, they may potentially cast some key votes before the end of the year.

The argument continues that a regulatory or tax structure out of sorts with the industry could slow the growth. So are these policy debates in Columbus having an impact in the field?

It may be too soon to tell, but drilling permit counts continue to increase and completed wells are on a steady rise. In November 2011, 61 total horizontal permits had been issued by the state with a handful of actual wells drilled. As of last week, there were 352 horizontal permits and 125 wells drilled.

Although some may say the numbers are still small, a 600% increase in less than a year is one indicator that the looming possibility of a severance tax (first raised in March 2012) and recent swath of new regulatory measures (passed in July) are having little damper on the industry in the field.

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