Governor John Kasich's Claims on His Severance Tax Hike Plan: "Exorbitant Overestimates" Drive Bad Policy

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Kasich Claim #1: Ohio has oil and gas recoveries of $1 trillion or more.[1]

Fact: As reported in the *Cleveland Plan Dealer*, experts say this claim is an "exorbitant overestimate." As the report states: "I think he's way off base. My best estimate is he's probably wrong by a couple of zeroes," said Arthur Berman, a Texas-based petroleum geologist and independent energy consultant. In fact, the *Plain Dealer* noted: "At current oil prices, that figure represents more than four times U.S. oil production last year. Viewed another way, every drop of oil produced in America for the next four years will be worth roughly $800 billion, based on current prices and production rates."[2] Why does this matter? Because the only compelling element of Governor Kasich's plan is the state income tax cut. If his estimates are "exorbitantly overestimated" then the amount of the tax cut has to drop quite a bit. That means all this time and money spent trying to ram his tax hike plan through the legislature may result in a small state income tax reduction.

Kasich Claim #2: The cost per well is $5 million.[3]

Fact: Governor Kasich got this figure from the Ohio Chamber of Commerce report "An Analysis of the Economic Potential for Shale Formations in Ohio."[4] The problem with this figure is it is only an estimate. The field test wells are costing more than twice as much to get running, coming in around $10 million. Why does this matter? First, producers, landowners, and farmers don't start paying the severance tax until they recover their costs. That means it may not be a year or two before Ohioans get a tax cut; it may be years in the future. Secondly, it works in conjunction with Claim #3 by significantly impacting the profitability and, therefore, the attractiveness of Ohio. Chesapeake Energy, the largest investor in Ohio's Utica Shale formation,

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[1] Governor John Kasich made this claim to WCMH-NBC4 in March 2012. See Associated Press, "Experts question Kasich's estimate on oil and gas revenues," August 2, 2012 available at http://www.cleveland.com/business/index.ssf/2012/08/experts_question_kasichs_estim.html.
[2] Ibid.
[3] Governor Kasich's projections are contained in a document his administration produced titled, "Estimated New Severance Tax Revenue and Gross Production Income (2012-2016)." A copy of this document can be viewed at http://www.opportunityohio.org/wp-content/uploads/2012/06/Estimated-New-Severance....pdf.
[4] Ohio Chamber of Commerce, "An Analysis of the Economic Potential for Shale Formations in Ohio," February 28, 2012, pages 1-2, 16, and 31, available at http://www.ohiochamber.com/dococc/HOMEPAGE/-pdf/study.pdf.

recently announced that its capital investment in Ohio would drop to only 8 percent for 2013.[5] In the last two weeks, Anadarko removed its drilling rig from Ohio, and Devon Energy reported that results from two wells "were not encouraging."[6]

Kasich Claim #3: The revenue per well is $75 million.[7]

Fact: For this claim, we will focus on oil production because gross income from oil production makes up 95.8 percent of the revenue from which Governor Kasich expects to get his severance tax proceeds.[8] Governor Kasich's estimate for 2012-2016 projects each well will produce between $24.7 million and $29.4 million in oil depending on the price per barrel. Once gross income from natural gas and natural gas liquids are added to the gross income from oil over the entire estimated 25-year life of the well, the estimated revenue per well hits $75 million.

Most of the figures contained in Governor Kasich's projection come out of the Ohio Chamber of Commerce report. Specifically, Governor Kasich's average annual production numbers are identical to the numbers in Table 1, "Average Anticipated Annual Production Per Well (after processing)." The only difference is that he separates the liquids between oil and natural gas liquid.[9] Similarly, Governor Kasich uses the numbers in Table 3, "Projection of Wells Drilled," for a couple of the years in his estimate.[10]

The field test wells, however, are producing a lot less than $75 million worth of product. It looks like the production per well for 2012-2016 will be closer to $6.2 million to $7.4 million in oil depending on the price per barrel. The public records released so far include two sources of production. First, Chesapeake Energy released its 2011 Utica Shale Production covering nine active wells. When the oil produced from each well is prorated for a year's worth of production (365 days), the average oil production per well equates to 22,371 barrels.[11]

The second source comes from a newspaper report in which EV Energy Partners LP notes that its Frank well "is producing 515 barrels of energy equivalents per day."[12] This data, however, is test data covering only a short period of time and not extended production data. Of the 515 barrels, only 40 percent, or 202 barrels, is oil, which equates to a yearly total of 73,730 barrels of oil. This figure is much higher

[5] Mark Passwaters, "Chesapeake pins 2013 hopes on Eagle Ford, Anadarko Basin," SNL, July 16, 2012, available at http://www.snl.com/Interactivex/article.aspx?CdId=A-15298604-13352.
[6] Bob Downing, "Company reports shed more light on Utica shale drilling in Ohio," Akron Beacon Journal, August 9, 2012, available at http://www.ohio.com/business/company-reports-shed-more-light-on-utica-shale-drilling-in-ohio-1.325896?utm_source=8-20-2012+Pipeline&utm_campaign=8%2F20%2F12+Pipeline&utm_medium=email.
[7] See footnote 3.
[8] See footnote 3.
[9] Ohio Chamber of Commerce, at 15.
[10] Ibid, at 17.
[11] Ohio Department of Natural Resources, "2011 Utica Shale Production," undated, available at http://ohiodnr.com/portals/11/oil/pdf/Utica_Production_2011.pdf.
[12] Bob Downing, "Oil well's production touted as Texas-like," Columbus Dispatch ,D3, August 19, 2012.

than the Chesapeake Energy results, but still much lower than Governor Kasich's average for <u>all</u> wells. If the Frank well results are added to the nine Chesapeake Energy wells, the average would rise from 22,371 to 27,507.

Table 1 contains Governor Kasich's estimate for oil production:

Table 1: Governor John Kasich's Estimated New Severance Tax Revenue and Gross Production Income (2012-2016)

Annual Production Per Well (barrels)	2012 (wells producing)	2013	2014	2015	2016
89,100	172	559	925	1,192	1,290
62,100		172	559	925	1,192
48,600			172	559	925
40,500				172	559
34,200					172
Total Production	7,662,600	35,584,650	84,281,850	144,679,500	204,969,600
Gross Income at $90/BBL	$689,634,000	$3,202,618,500	$7,583,361,750	$13,018,200,120	$18,444,853,440
Estimated Severance Tax Revenue	$10,344,510	$48,039,278	$132,558,626	$272,073,152	$441,941,152
				Total Severance Tax Revenue	$904,956,718

If Governor Kasich's exaggerated annual production figures are replaced with the actual average production results and subsequent years decline in production at the same rate as Governor Kasich used, the total severance tax plummets to $227 million as highlighted in Table 2. The revenue from 2016, which Governor Kasich relies upon to claim nearly $500 million in state income tax cuts per year, decreases from $442 million to $111 million.

Table 2: Estimated New Severance Tax Revenue and Gross Production Income (2012-2016) with Actual Results

Annual Production Per Well (barrels)	2012 (wells producing)	2013	2014	2015	2016
22,371	172	559	925	1,192	1,290
15,592		172	559	925	1,192
12,202			172	559	925
10,169				172	559
8,587					172
Total Production	1,923,906	8,934,503	21,161,271	36,325,759	51,463,243
Gross Income at $90/BBL	$173,151,540	$804,105,259	$1,904,514,416	$3,269,318,284	$4,631,691,831
Estimated Severance Tax Revenue	$2,597,273	$12,061,579	$33,291,279	$68,326,936	$110,975,955
				Total Severance Tax Revenue	$227,253,022

Finally, if the costs per well are twice as much as Governor Kasich estimates, it likely will take four years or more instead of two years for the higher severance tax to kick-in. That means Ohioans will wait longer to get their state income tax cut and the amount of the cut will be smaller than Governor Kasich is promising.

Table 3: Estimated New Severance Tax Revenue and Gross Production Income (2012-2016) with Actual Results and Four-Year Cost Recovery

Annual Production Per Well (barrels)	2012 (wells producing)	2013	2014	2015	2016
22,371	172	559	925	1,192	1,290
15,592		172	559	925	1,192
12,202			172	559	925
10,169				172	559
8,587					172
Total Production	1,923,906	8,934,503	21,161,271	36,325,759	51,463,243
Gross Income at $90/BBL	$173,151,540	$804,105,259	$1,904,514,416	$3,269,318,284	$4,631,691,831
Estimated Severance Tax Revenue	$2,597,273	$12,061,579	$28,567,716	$49,039,774	$80,962,867
				Total Severance Tax Revenue	$173,229,210

Table 3 shows that the total severance tax after five years totals just $173 million, an 81 percent decline for Governor Kasich's estimate in Table 1. As a result, the average state income tax cut Ohioans will receive won't happen for at least four years <u>and</u> the amount will be roughly $16, enough for a large pizza with a few toppings from your local pizza shop.

Another important flaw in Governor Kasich's estimate is that it anticipates 172 wells in production in 2012. As of July 1, 2012, only 14 wells were online. This substantial variance will compound in future years. That means Ohio is way behind in ramping up production, further delaying any state income tax cut into the end of the decade. Anecdotally, one has to ask if the delay is due to the weak results being reported and the impact the higher severance tax will have on those weaker results.

Why does that matter? It matters because higher costs and higher taxes on lower producing wells pushes the 7 percent after tax margins of energy companies down even further.[13] Because many investors can obtain a greater return in other states or in other businesses, it will be harder for energy companies in Ohio to grow and continue to operate. That means lost jobs.

Kasich Claim #4: Ohioans won't pay the severance tax; instead out-of-state oil companies and their shareholders will pay it.[14]

Fact: Lots of Ohioans will pay the tax, including most of the farmers and landowners under whose land the oil and gas is located, as well as the 2,250 Ohio-based small business energy entrepreneurs and their companies who will be subject to the severance tax hike.[15] Almost all leases signed so far require farmers and landowners to pay the severance tax.

[13] Ohio Oil and Gas Association, "Severance Tax Presentation," undated, available at http://ooga.org/wp-content/uploads/OOGASeveranceTaxPresentation.pdf.
[14] Office of Governor John Kasich, "The Income Tax Cut: Key Points," undated, available at http://www.opportunityohio.org/wp-content/uploads/2012/06/Income-Tax-Cut-Key-Points.pdf.
[15] Ohio Oil and Gas Association, "Ohio's Crude Oil and Natural Gas Producers Stand Against Tax-Increase Proposal," March 26, 2012, available at http://ooga.org/wp-content/uploads/OhiosCrudeOilandNaturalGasProducersStand-PR-032612-22.pdf.

Additionally, most of Ohio's government pension plans hold stock in energy companies that will be subject to the severance tax hike.[16] For example, as Jason Hart reported, "with Ohio's public pension funds holding a sum of more than 15 million shares of Exxon common stock, even a trivial reduction in Exxon's per-share dividends would further weaken what are already flimsy balance sheets at OPERS, STRS, SERS, and OHPRS."

Finally, lots of Ohioans own stock directly in energy companies subject to the severance tax hike or have invested in mutual funds that hold stock in energy companies.

Kasich Claim #5: Higher taxes will result in more energy activity in Ohio.[17]

Fact: As free market economist Milton Friedman and President Ronald Reagan both noted, if you want less of something, then tax it. It simply defies common sense that Ohio will get <u>more</u> oil and gas activity by increasing the taxes on that activity – even if this one tax remains lower than other states. If Ohio wants more oil and gas activity, it should leave the tax rate at its current level to ensure the gap between Ohio and other states remains as big as possible. Why risk chasing away energy companies, the jobs they will create, and the economic activity in hotels, restaurants, hardware stores, and other secondary goods and services providers? A Fraser Institute survey of energy company executives showed that Ohio fell from #2 to #14 in terms of attractiveness for energy exploration because of Governor Kasich's severance tax hike plan.[18]

Kasich Claim #6: Kasich's severance tax hike plan has broad support.

Fact: Other than a couple of the big city chambers whose members won't get hit with it, few groups support the severance tax hike plan. Those opposed to the tax hike include the National Taxpayers Union, Americans for Tax Reform, Americans for Prosperity Ohio, the Ohio Liberty Coalition, several regional farm bureaus, and several local chambers of commerce. In a statewide survey of Ohioans, a plurality of 44 percent indicated opposition to Governor Kasich's severance tax hike plan.[19]

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[16] Jason Hart, "Kasich severance tax plan could harm 4 of 5 state pension funds," August 3, 2012, available at http://ohio.mediatrackers.org/2012/08/03/kasich-severance-tax-plan-could-harm-4-of-5-state-pension-funds/.

[17] This claim is implied in Governor Kasich's severance tax hike plan.

[18] Bob Downing, "Ohio slip in oil-gas investment outlook, survey says," Akron Beacon Journal, July 2, 2012, available at http://www.ohio.com/blogs/drilling/ohio-utica-shale-1.291290/ohio-slips-in-oil-gas-investment-outlook-survey-says-1.317775.

[19] Magellan Strategies, "Ohio General Election Survey", Opportunity Ohio, July 25, 2012, available at http://www.opportunityohio.org/wp-content/uploads/2012/06/Ohio-General-Election-Survey-Topline-Results-Release-072512.pdf.

Kasich Claim #7: Kasich's severance tax hike plan is simple modernizing a 40-year old law.[20]

Fact: On July 1, 2010, Senate Bill 165 became law, extensively modernizing Ohio's oil and gas exploration laws.[21] For a detailed analysis of Senate Bill 165, please see the Ohio Legislative Service Commission's "Final Analysis."[22]

Kasich Claim #8: Ohio's state income tax is among the highest in America.[23]

Fact: According to the most recent tax data, Ohio has the 33rd highest state tax burden in America. The major tax burden on Ohioans is local taxes, which are the 6th highest in America.[24] The severance tax hike does nothing to lower local taxes in Ohio. The best-case scenario for Governor Kasich based on actual data is that the severance tax hike results in a slight reduction in state income tax rates. Such a small reduction certainly isn't going to unleash a torrent of economic activity among the tens of thousands of small business owners who get a tax cut of $250 or less. In contrast, the roughly 2,250 small business energy entrepreneurs who fund the income tax reduction could be pushed out of business by the sixteen-fold increase in their taxes. A better and more secure source to fund a small income tax cut is by reducing state government spending, which has outstripped inflation by 2 percent every year on average from 1990 though 2013. When asked, 49 percent of Ohioans felt the most effective way to pay for a state income tax cut was "cutting government spending" (the next closest option of using the government surplus, if any, earned just 11 percent support and only 7 percent supported taxing one industry).[25]

Kasich Claim #9: The severance tax hike won't be passed on to Ohioans.

Fact: Even Governor Kasich admits, "oil companies pass on their costs of doing business—including the cost of taxes—to whomever buys their products."[26] The Ohio Chamber of Commerce report upon which Governor Kasich gets the figures used in his estimate approvingly cites a report that notes:

> That annual savings resulting from the substitution of locally-produced gas for fuel purchased from non-Ohio sources would amount to $718 million – not counting $30 million per annum that would no longer go to interstate pipeline fees. Additionally, Ohio consumers would benefit because the increased availability of local

[20] See footnote 14.
[21] Ohio General Assembly, Substitute Senate Bill 165, July 1, 2012, available at http://www.legislature.state.oh.us/bills.cfm?ID=128_SB_165.
[22] Eric Vendel, "Final Analysis," Ohio Legislative Service Commission, June 30, 2010, available at www.lsc.state.oh.us/analyses128/10-sb165-128.pdf.
[23] See footnote 14.
[24] Greater Ohio Policy Center, "2012-2013 State Budget Response," undated, available at www.greaterohio.org/files/pdf/go-budget-response-2011.pdf.
[25] Magellan Strategies, at 3.
[26] See footnote 14.

> natural gas would reduce storage costs…while also helping to insulate gas-buyers from price fluctuations.[27]

Ohioans and their businesses buy oil and gas to heat and run their homes, businesses, cars, and other assets.[28] When asked, 72 percent of Ohioans agreed "taxes are just passed on to consumers."[29]

Kasich Claim #10: The oil and gas industry pay "disproportionately low taxes" compared to other Ohio industries.[30]

Fact: Most industries in Ohio <u>only</u> pay the Commercial Activity Tax (CAT) of 0.26 percent on gross receipts. The oil and gas industry pay <u>both</u> the current severance tax of roughly 1 percent on gas and 0.2 percent on oil <u>and</u> the CAT. Governor Kasich's severance tax hike would drive the severance tax up to 4 percent. One has to ask: what Ohio industries does Governor Kasich refer to when he claims that Ohio's oil and gas producers pay "disproportionately low taxes"?

<u>Bottom Line:</u> Governor Kasich's severance tax hike plan is based on erroneous estimates and risks undermining continued investment and exploration in Ohio, which will hurt job creation. If he wants to cut the state income tax, the primary source to fund the cut should come from reductions in state government spending. Equally important, we once again call on Governor Kasich to launch a state and local tax summit to develop a comprehensive tax plan that lowers the total state and local tax burden on <u>all</u> Ohioans. The continued shifting of tax burdens from the state to local governments or from one group and area of Ohio to other groups and areas of Ohio is nothing more than flawed redistributionist tax policy that hurts rather than helps Ohio's competiveness and prosperity. Ohioans and the businesses seeking to grow in Ohio deserve better.

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[27] Ohio Chamber of Commerce, at 22.
[28] Greater Ohio Policy Center, at 1.
[29] Magellan Strategies, at 2.
[30] See footnote 14.