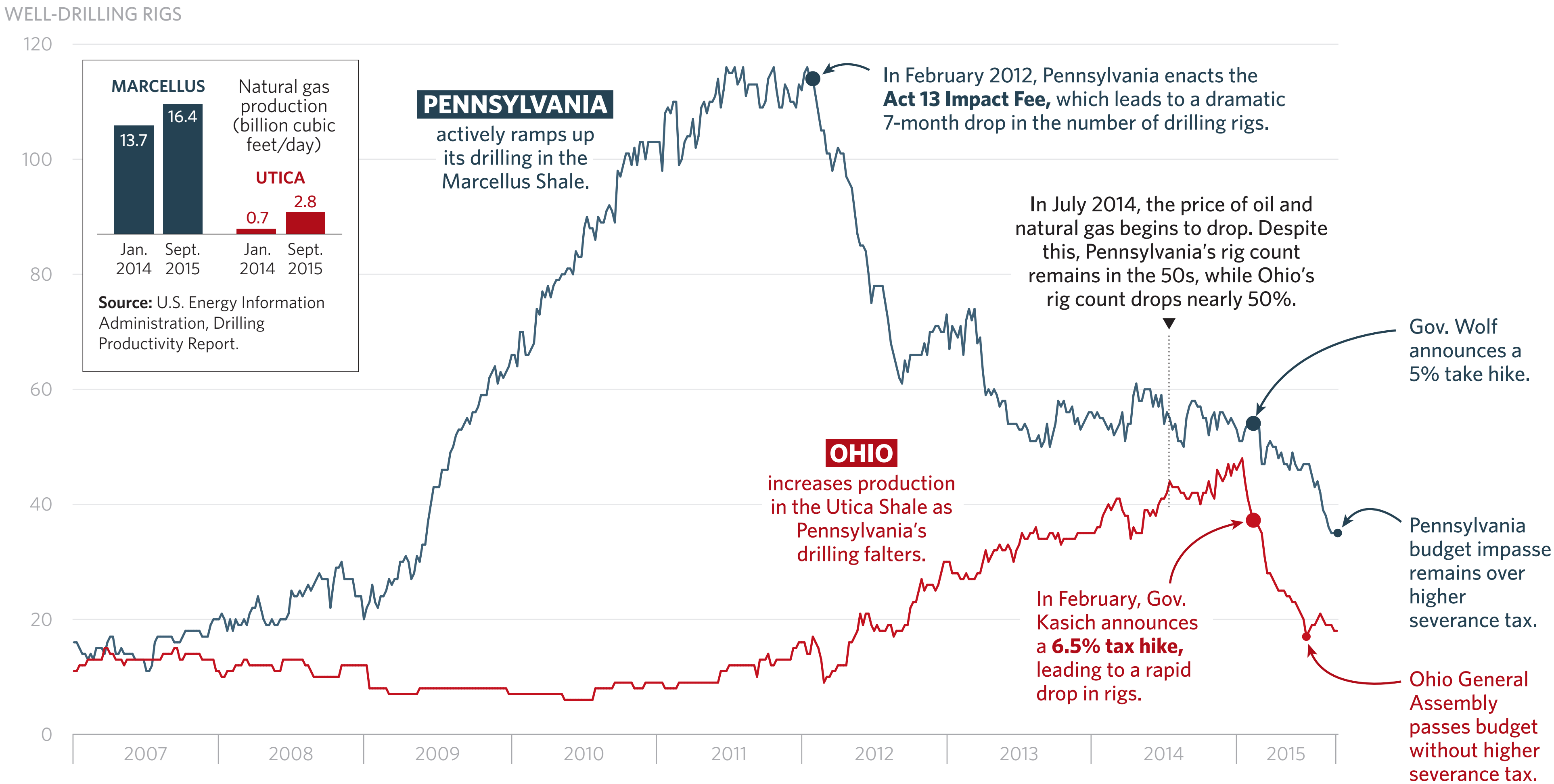
Geology Matters, but So Do Taxes

Ohio and Pennsylvania serve as stark examples on how new taxes and fees can severely inhibit energy production. An impact fee and threat of a high severance tax has twice resulted in a drop in the number of well-drilling rigs in production in Pennsylvania. Ohio was picking up rigs after the impact fee drop in Pennsylvania until Gov. John Kasich introduced a large severance tax hike, prompting wary developers to pull back on operations here. With uncertainty in both states on higher taxes, energy producers will decide where to go once prices start rising again. Ohio should keep its current tax advantage over Pennsylvania, especially given its natural gas deposits aren't as appealing as those just across the border.



Sources: Baker Hughes, Rig Count, http://www.bakerhughes.com/rig-count, and Opportunity Ohio research.

OPPORTUNITY Ohio

Conditions on the Ground Warrant a Continued "Do No Harm" Approach on Ohio's Severance Tax

by Matt A. Mayer
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If only Ohio possessed natural gas, then the tax rate really wouldn't matter, as energy companies would be forced to pay the tax to extract natural gas to meet supply needs. Unfortunately for Governor John Kasich and pro-tax hike proponents, natural gas exists in rock formations all over America (and the world).

As noted in a *Wall Street Journal* article on September 1, 2015, **"Drillers Unleash 'Super-Size' Natural Gas Output,"** energy companies are getting very positive results in Louisiana's Haynesville Shale, which, after Pennsylvania's Marcellus Shale, is America's second-largest natural gas deposit:

> So far, the impressive results have been confined to a small area in a single Louisiana parish near the Texas border. But if the approach works across the giant Haynesville Shale, which spans 120 miles across both states, the era of low American gas prices could extend for decades into the future, experts say. …
>
> The field produces 8% of the nation's natural gas, making it the second largest after the giant Marcellus Shale in the Northeast. Because it is located in Louisiana, near several interstate pipelines, potential export facilities and industrial consumers, an increase in gas production in the Haynesville has an outsize impact on gas prices across the entire country.

Pay particular note on the attractiveness of Haynesville Shale given its proximity to key transmission and export infrastructure.

Speaking of Pennsylvania, Ohio's biggest competitor for natural gas, the Republican-controlled legislature remains locked in a budget battle with Democrat Governor Tom Wolf over Wolf's demand for a severance tax hike. Pennsylvania's legislative leaders know that higher taxes will make drilling and production in the Marcellus Shale less attractive compared to lower cost states. Ohio's severance tax is currently a smidge lower than Pennsylvania's impact fee, so pushing Ohio's severance tax higher just isn't a smart move. This reality is even more critical because the Utica Shale isn't as productive as the Marcellus Shale, so energy companies face higher costs and longer returns on investment horizons.

That means marginal costs increases—like higher taxes—matter, especially when profits are still years away. Keep in mind, over the last nine months, the number of drilling rigs operating in Ohio plummeted from 48 down to 17—a 65 percent drop in drilling rigs. Of course, some of that drop is due to the reduction in energy prices, but not all of it. The drop correlates closely with Governor Kasich's demand for a higher severance tax in his budget, followed by a small increase in drilling rigs after the Ohio General Assembly passed a budget without a severance tax hike. In fact, the rig count reached a low of 17 on June 26 and climbed back to 21 in the weeks following passage of the budget. The accompanying chart details the impact higher taxes have on energy activities.

It gets worse.

As a second *Wall Street Journal* article noted on September 14, 2015, **"Write-Downs Abound for Oil Producers,"** scores of energy companies are writing down the value of their energy holdings, pushing profitability even further into the future. Specifically:

> Write-downs, or impairments, are taken by companies when the value of assets falls below the value on its books. For energy fields, that can mean that the price of leasing land, drilling and installing pipelines exceed the worth of whatever oil and gas is unearthed.
>
> Anadarko Petroleum Corp., Chesapeake Energy Corp., and Devon Energy Corp. are among the large energy companies that have taken multibillion-dollar impairments this year, while dozens of smaller companies have made proportionally large write-downs.
>
> Writing down assets can shrink the pool of oil-and-gas reserves that are used as collateral for loans. Because many oil-and-gas producers spend more than they make selling commodities, abundant credit is crucial to them being able to keep going. These companies' shares are often valued on forecast production growth more than current profitability.
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> …
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> At those prices, very few U.S. drilling properties, particularly shale fields, produce profits, analysts and bankers say.

These write-downs also make it harder to secure capital for future energy activities. Again, unfortunately, several of the companies engaging in the largest write-downs are the biggest players in the Utica Shale formation: Anadarko and Chesapeake.

Policymakers should do nothing to make it even harder or more costly for energy companies to engage in activities in Ohio. With Ohio's private sector shedding thousands of jobs since June and energy prices remaining low, holding firm against higher taxes is the right call.

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