Ohio Legislative Service Commission

Bill Analysis

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H.B. 375

130th General Assembly
(As Introduced)

Reps. Huffman, Batchelder, Hall, Grossman, Conditt, Sears, Hayes, Boose, Beck, Stebelton, Hill, Wachtmann, Amstutz, Landis, Scherer, Baker, Buchy, Retherford, Rosenberger

BILL SUMMARY

- Levies a new severance tax on oil and natural gas severed through use of a horizontal well, to be paid by the owner of that well or the severer on the basis of the owner's net proceeds from selling that oil or natural gas.
- Imposes the tax at the rate of 1% for the first five years of production and at 2% thereafter.
- Authorizes a reduced rate for oil and natural gas severed by low-producing horizontal wells.
- Allocates incremented revenue from the new severance tax to fund income tax reductions through the Income Tax Reduction Fund, and allocates the remainder to oil and gas regulatory and geological survey activities of Department of Natural Resources (DNR).
- Exempts oil and natural gas subject to the new tax from existing volume-based severance taxes.
- Reduces the existing severance tax rate on natural gas extracted through use of a nonhorizontal well.
- Repeals a cost recovery assessment imposed on oil and gas well owners.
- Creates a nonrefundable income tax credit equal to the amount of horizontal well severance tax paid by an owner or severer.
- Authorizes the credit to be claimed by working or royalty interest holders in the owner's horizontal well.

- Excludes from the tax base of the commercial activity tax gross receipts from the sale of oil or natural gas subject to the new severance tax and severed through use of a horizontal well.

- Requires DNR to use 50% of any revenue in excess of the amount appropriated from the fund to be used to fund corrective actions and idled or orphaned well plugging.

- Takes effect April 1, 2014.

CONTENT AND OPERATION

Severance taxation of oil and natural gas

The bill distinguishes between horizontal and nonhorizontal wells for the purposes of imposing different severance tax rates and bases on oil and natural gas produced from each type of well. It also earmarks the revenue from oil or natural gas produced from each type of well for different purposes. The bill reduces the rate of the severance tax levied on natural gas severed through use of a nonhorizontal well.

Current law levies a tax on any person that severs oil or natural gas in Ohio. The tax equals 10¢ per barrel of oil and 2½¢ per MCF (1,000 cubic feet) of natural gas. It is paid four times per year in quarterly tax periods. (Under current law, a separate "cost recovery assessment" is levied on a well's owner in the additional amount of 10¢ per barrel of oil or ½¢ per MCF of natural gas for all oil and gas wells, except very low volume wells.)

Horizontal versus nonhorizontal wells

The bill distinguishes between horizontal wells and nonhorizontal wells for severance tax purposes. Horizontal wells are wells drilled to produce oil or gas with a wellbore that reaches a horizontal or near horizontal position in the Point Pleasant, Utica, or Marcellus formation and that is stimulated to produce.[1] Stimulation is defined as a "process of enhancing well productivity, including hydraulic fracturing operations."[2]

Rate reduction for natural gas severed by non-horizontal wells

Beginning April 1, 2014, the bill reduces the rate of the severance tax levied on natural gas severed through use of nonhorizontal wells from 2½¢ per MCF of natural

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[1] R.C. 1509.01(GG) (not in bill).

[2] R.C. 1509.01(Z) (not in bill).

gas to 1½¢ per MCF.[3] The rate reduction is in addition to the repeal of the cost recovery assessment addressed below (see "**Cost recovery assessment**," below).

Horizontal well severance tax

Beginning April 1, 2014, the severance of oil or natural gas from a horizontal well is taxed at special rates based on the sale value of the oil or gas, and is no longer subject to continuing law's volume-based severance tax.

Taxpayer

Unlike continuing law's oil and natural gas severance tax, but similar to current law's cost recovery assessment, the new tax is levied on a horizontal well's owner rather than the severer, though the severer may be the taxpayer under certain circumstances (see "**Alternative taxpayers: designated severers**," below). The owner must pay the new tax in the same manner as a severer that is required to file a severance tax return.[4] An owner is the person that holds the right to drill, produce from, and appropriate resources extracted from a well.[5]

Tax base

Unlike continuing law's oil and natural gas severance tax and current law's cost recovery assessment, the new tax for horizontal wells is not levied according to the volume of oil or natural gas severed, but according to the owner's net proceeds from the sale of the oil or natural gas. The owner's net proceeds are the owner's gross receipts from the sale of that oil or natural gas minus the owner's post-production costs related to that sale. Post-production costs are defined to include the costs related to gathering, processing, transporting, fractionation, and delivery, and related shrinkage adjustments.[6]

Rates

For the first five years of a horizontal well's production, the bill levies the tax on oil and natural gas at a rate of 1% of the owner's net proceeds.[7] The first day of a well's production is the first day the well produces oil or natural gas, excluding any natural

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[3] R.C. 5749.02(B)(6).

[4] R.C. 5749.02(C).

[5] R.C. 1509.01(K) (not in bill).

[6] R.C. 5749.01(K) and (L). It is not clear whether other costs could be regarded as post-production costs, as the bill's definition is phrased as including certain costs but not necessarily excluding other costs.

[7] R.C. 5749.02(C)(1)(a).

gas flared for testing the well.[8] After the fifth year, the rate increases to 2% of the owner's net proceeds.[9] However, if the well's production of oil does not exceed 17 barrels per day in a calendar quarter, then the rate on that oil becomes 1% of the owner's net proceeds from selling the oil.[10] Similarly, if the well's production of natural gas does not exceed 100 MCF per day in a calendar quarter, then the rate on that natural gas becomes 1% of the owner's net proceeds.[11]

Alternative taxpayers: designated severers

Though the bill levies the new horizontal well severance tax on a well's owner, the bill authorizes the owner to designate the severer to remit the new tax on the basis of the owner's net proceeds, instead of the owner ("designated severer"). The severer is required to reflect this designation on each of the severer's quarterly returns with which the severer remits tax on the owner's behalf. After paying the tax, a designated severer is entitled to claim a nonrefundable income tax credit for the amount so paid (see, "**Income tax credit for horizontal well severance tax paid**," below). The bill expressly allows a designated severer to recoup from the owner the amount of tax the severer pays on the owner's behalf to the extent the severer did not recover that amount by claiming the tax credit.[12]

Horizontal well severance tax proceeds

The bill allocates horizontal well severance tax revenue to fund temporary income tax reductions and the oil and gas regulatory and geological survey activities of Department of Natural Resources (DNR).

Under current law, all revenue collected from the severance tax on oil and natural gas, less any refunds, is divided between the Oil and Gas Well Fund (90%) and the Geological Mapping Fund (10%). Under continuing law, revenue credited to the Oil and Gas Well Fund is used to fund the activities of DNR's Division of Oil and Gas Resources Management, to pay critical and necessary expenses to protect health and safety associated with oil and gas drilling, and to pay costs associated with corrective actions and plugging orphaned and idled oil and gas wells. Revenue credited to the Geological Mapping Fund funds the activities of DNR's Division of Geological Survey.

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[8] R.C. 5749.01(J).

[9] R.C. 5749.02(C)(1)(b).

[10] R.C. 5749.02(C)(1)(d).

[11] R.C. 5749.02(C)(1)(c).

[12] R.C. 5749.02(C)(2).

The bill requires all horizontal well severance tax revenue to be credited to a fund called the Horizontal Well Tax Fund. By September 15 each year, the Tax Commissioner is required to calculate and certify to the Director of Budget and Management the tax that would have been collected in the preceding fiscal year from oil and natural gas severed through use of horizontal wells if that oil and natural gas been taxed under current law's rates of 10¢ per barrel of oil and 2½¢ per MCF of natural gas rather than the rates imposed under the new horizontal well tax. By September 25, the Director of Budget and Management must transfer 90% of the certified amount to the Oil and Gas Well Fund and 10% to the Geological Mapping Fund, mirroring the revenue distribution of current law's oil and natural gas severance tax. By September 30, the Director must transfer any amount remaining in the Horizontal Well Tax Fund from the tax collected in the preceding fiscal year to the Income Tax Reduction Fund.

Under continuing law, the Income Tax Reduction Fund consists of surplus revenue (in general, revenue beyond that which is necessary to fully fund the Budget Stabilization Fund and cover certain inter-year carrryovers) for the purpose of providing a one-year reduction in income tax rates.[13]

Cost recovery assessment

Current law imposes a regulatory cost recovery assessment on the owner of a well that extracts oil or natural gas. The owner must pay the assessment in the same manner as a severer that is required to file a severance tax return. All money collected from the assessment is deposited in the Oil and Gas Well Fund. The assessment is levied to ensure that even low-producing wells pay a minimum amount to fund the state's regulatory activities. Specifically, the assessment assures that when it is added to the severance tax (10¢ per barrel of oil and 2½¢ per MCF of natural gas), each well owner's wells generate at least $15 on average. It is in addition to severance taxes levied on oil and gas.

The bill, beginning April 1, 2014, repeals the cost recovery assessment and removes related cross-references.[14]

Income tax credit for horizontal well severance tax paid

The bill authorizes an owner or designated severer to claim a nonrefundable income tax credit equal to the amount of horizontal well severance tax paid by the

[13] R.C. 131.44 (not in bill).

[14] R.C. 1509.02(A), 1509.34, 1509.50, 5703.052, 5749.02(D), 5749.03, 5749.06, 5749.07, 5749.08, 5749.10, 5749.12, 5749.13, 5749.14, and 5749.15.

owner or severer during a taxable year. Any unused credit may be carried forward for up to seven years. If the owner or severer is a pass-through entity, the owners of the entity may claim the credit according to each owner's proportionate share of the entity. The credit may be claimed for taxable years beginning on or after January 1, 2014.[15]

Transferability to designated taxpayers

In lieu of an owner or designated severer claiming the credit directly, the owner or severer may designate on the owner's or severer's quarterly severance tax returns one or more taxpayers holding working or royalty interests in the owner's or severer's horizontal well to claim the credit. Before allocating the credit to one or more "designated taxpayers," the owner or severer is required to consider any contract with those designated taxpayers allocating severance tax liability between them. However, the owner or severer may allocated the credit in differing proportions than the severance tax liability. A designated taxpayer may claim the credit on the basis of all or a portion of the horizontal well severance tax paid by the owner or severer, as allocated to the designated taxpayer by the owner or severer.[16]

Working and royalty interests are two types of interests arising from an oil or gas lease. A working interest would generally be held by a well's owner, while a royalty interest would generally be held by a landowner. Specifically, a working interest gives its holder, generally a lessee, the right to drill for and produce oil and gas on the leased property and requires the interest holder to pay a share of the drilling and production costs. The holder of a working interest is entitled to the proceeds of the well, minus any amount required to be paid to holders of royalty interests. A royalty interest gives its holder the right to receive a portion of the production from the leased property or of the proceeds of the sale of resources produced from the well, without requiring the owner to pay any of the drilling or operating costs.[17] Elsewhere in continuing law, "royalty interest" refers to the interest held by a fee holding lessor.[18]

Commercial activity tax exclusion for horizontal well receipts

The bill excludes from the taxable gross receipts base of the commercial activity tax (CAT) the receipts realized from the sale of oil or natural gas by a severer or owner

[15] R.C. 5747.63 and 5747.98.

[16] R.C. 5747.63(C).

[17] "Glossary of Oil and Gas Terms," http://mineralmanagers.com/glossary.html.

[18] R.C. 1509.01(L) (not in bill).

that paid the new horizontal well severance tax on the basis of that oil or natural gas.[19] The exclusion applies to tax periods ending on or after April 1, 2014.[20]

Appropriation of excess revenue credited to the Oil and Gas Well Fund

If, in any fiscal year, the amount credited to the Oil and Gas Well Fund exceeds the amount appropriated from the Fund for that fiscal year, the bill requires at least 50% of that excess to be used to fund corrective actions, orphaned and idle well plugging, and land restoration in the succeeding fiscal year.[21] Under continuing law, at least 14% of the revenue credited to the Fund must be used for corrective actions and orphaned and idled well plugging. This provision is exempted from the referendum and takes immediate effect.

Under continuing law, DNR has a duty to plug wells that have been abandoned or for which the bond has been forfeited ("idle and orphaned wells"), restore land affected by drilling or extraction, and take corrective actions to avoid imminent health or safety risks at an idle and orphaned well or a well for which the owner cannot be contacted.

Effective date

The bill takes effect April 1, 2014. Several provisions of the bill are not subject to referendum.[22]

HISTORY

ACTION	DATE
Introduced	12-04-13

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[19] R.C. 5751.01(F)(2)(jj); Section 4.

[20] Section 3.

[21] R.C. 1509.02(B) and 1509.071; Section 5.

[22] Section 3.