Ohio Legislative Service Commission

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Fiscal Note & Local Impact Statement

Bill: H.B. 375 of the 130th G.A. **Date**: January 8, 2014

Status: As Introduced **Sponsor**: Rep. Huffman

Local Impact Statement Procedure Required: Yes

Contents: Modifies the severance tax on oil and gas, repeals a cost recovery assessment imposed on oil and gas well owners, creates an income tax credit, and excludes from the commercial activity tax certain oil and gas gross receipts

State Fiscal Highlights

STATE FUND	FY 2014	FY 2015	FUTURE YEARS
General Revenue Fund			
Revenues	- 0 -	Up to $8.5 million loss	More than $8.5 million loss annually, amounts will grow in future years
Expenditures	- 0 -	- 0 -	- 0 -
Oil and Gas Well Fund (Fund 5180)			
Revenues	- 0 -	Up to $3.1 million loss	$3.1 million loss or more
Expenditures	- 0 -	- 0 -	- 0 -
Geological Mapping Fund (Fund 5110)			
Revenues	- 0 -	Up to $0.1 million loss	$0.1 million loss or more
Expenditures	- 0 -	- 0 -	- 0 -
Horizontal Well Tax Fund (created by the bill)			
Revenues	- 0 -	Gain of millions of dollars	Gains to grow in future years
Expenditures	- 0 -	Transfers out equal to revenues	Transfers out equal to revenues
School District Property Tax Replacement Fund (Fund 7047)			
Revenues	- 0 -	Up to $1.1 million loss; but loss to be offset by GRF subsidy	Potential loss in millions of dollars per year; but loss to be offset by GRF subsidy
Expenditures	- 0 -	- 0 -	- 0 -
Local Government Property Tax Replacement Fund (Fund 7081)			
Revenues	- 0 -	Up to $0.5 million loss; but loss to be offset by GRF subsidy	Potential loss in millions of dollars per year; but loss to be offset by GRF subsidy
Expenditures	- 0 -	- 0 -	- 0 -

Note: The state fiscal year is July 1 through June 30. For example, FY 2014 is July 1, 2013 – June 30, 2014.

- Revenue to the new Horizontal Well Tax Fund will be used to partially offset revenue losses to certain non-GRF funds, with the remaining proceeds to be transferred to the Income Tax Reduction Fund (ITRF) (Fund 4R80).
- Changing the existing severance tax and repealing the cost recovery assessment reduces revenues to the Oil and Gas Well Fund (Fund 5180) and Geological Mapping Fund (Fund 5110), funds in the Department of Natural Resources (DNR). Although the bill requires those two funds to receive the same amount of horizontal well severance tax revenues as they would collect under existing law, transfers to Fund 5180 and Fund 5110 from the new Horizontal Well Tax Fund would not replace severance tax losses from nonhorizontal wells or the receipts from the cost recovery assessment, repealed by the bill.
- Creating a nonrefundable personal income tax (PIT) credit beginning in tax year (TY) 2014 for severance taxes paid from horizontal wells will reduce GRF revenues beginning in FY 2015, when tax returns for TY 2014 will be filed.
- Excluding from the tax base of the commercial activity tax (CAT) those gross receipts realized from the sale of oil or natural gas by a severer or owner that pays the new horizontal well severance tax will reduce CAT receipts beginning in FY 2015.
- A reduction in CAT receipts will lower revenues to the three funds that receive CAT revenues, but two of those funds, the School District Property Tax Replacement Fund (Fund 7047) and Local Government Property Tax Replacement Fund (Fund 7081), will not have a net revenue loss because current law requires a GRF subsidy if CAT distributions to the funds are insufficient for the required reimbursements. Any balance in either fund may be transferred to the GRF every year-end, hence the GRF would bear the CAT revenue loss regardless of whether CAT receipts meet or exceed required expenditures.

Local Fiscal Highlights

LOCAL GOVERNMENT	FY 2014	FY 2015	FUTURE YEARS
Counties, municipalities, townships, and public libraries (LGF and PLF)			
Revenues	Loss of tens of thousands of dollars	Loss up to $0.3 million	More than $0.3 million loss annually, amounts will grow in future years
Expenditures	- 0 -	- 0 -	- 0 -

Note: For most local governments, the fiscal year is the calendar year. The school district fiscal year is July 1 through June 30.

- Creating a nonrefundable PIT credit for severance taxes paid from horizontal wells and creating a CAT exclusion for gross receipts from horizontal wells will reduce Local Government Fund (LGF) and Public Library Fund (PLF) revenues by tens of thousands of dollars in calendar year (CY) 2014 and up to $0.3 million in CY 2015. Revenue losses in future years will increase as the amount of oil and gas severed from horizontal wells grows. The LGF and PLF each receive 1.66% of GRF tax receipts; all PIT revenues and half of CAT revenues are desposited into the GRF.

- The LGF and PLF will not incur losses as a result of personal income tax cuts enabled by the ITRF balance. The Revised Code requires that the OBM Director make transfers from the ITRF to the GRF, LGF, and PLF in a manner that offsets revenue reductions caused by the tax rate reductions to the LGF and PLF created by the ITRF tax cuts.

Detailed Fiscal Analysis

H.B. 375 creates a distinction between horizontal wells and nonhorizontal wells for severance tax purposes. It reduces taxes on nonhorizontal wells and imposes a different tax on horizontal wells. A portion of revenues will be used to partially offset revenue losses to two DNR funds, with remaining revenue to be used to fund a personal income tax cut. A personal income tax credit and an exclusion from the CAT for horizontal well receipts will reduce GRF revenues.

Severance tax changes and cost recovery assessment repeal

Currently, the severer of oil or natural gas must pay 10¢ per barrel of oil and 2.5¢ per MCF of natural gas. Additionally, the owner of the well from which oil or natural gas is severed must pay a cost recovery assessment equal to 10¢ per barrel of oil and 0.5¢ per MCF of natural gas (with exceptions for low volume wells). The cumulative cost of the tax and assessment is 20¢ per barrel of oil and 3.0¢ per MCF of natural gas.

H.B. 375 reduces, beginning on April 1, 2014, the rate of the severance tax levied on natural gas severed through use of nonhorizontal wells to 1.5¢ per MCF of natural gas. The existing cost recovery assessment on oil and natural gas wells is repealed (for both horizontal and nonhorizontal wells). The cumulative cost of the proposed tax and assessment on nonhorizontal wells is 10¢ per barrel of oil and 1.5¢ per MCF of natural gas.

The bill replaces the current severance tax rate structure with a new taxation method for oil and natural gas severed from horizontal wells. Beginning April 1, 2014, the owner of a horizontal well must pay a 1% rate on the owner's net proceeds from the sale of oil or natural gas. "Net proceeds" are the gross receipts less any "post-production costs" related to the sale of the oil or natural gas; both terms are defined in the bill.[1] After 20 calendar quarters, the 1% tax rate escalates to 2% of the owner's net proceeds unless the horizontal well does not meet production benchmarks specified in H.B. 375.

Disposition of revenue

H.B. 375 creates the Horizontal Well Tax Fund, which receives all of the severance tax receipts from horizontal wells. Current law allocates 90% of oil and gas severance collections to DNR's Oil and Gas Well Fund (Fund 5180) and 10% to DNR's Geological Mapping Fund (Fund 5110). The bill requires the Tax Commissioner to annually calculate what Fund 5180 and Fund 5110 would have received from horizontal wells under current law (as it existed on December 31, 2013), and certify those amounts to the OBM Director.

[1] R.C. 5749.01(K) and (L).

The proposed law requires the OBM Director to make transfers from the Horizontal Well Tax Fund every September beginning in calendar year (CY) 2014. By the 25th day of each September, the Director must transfer the certified amounts to Fund 5180 and Fund 5110. By the 30th day of each September, the Director must transfer any remaining money in the Fund to the Income Tax Reduction Fund (ITRF), (Fund 4R80).

H.B. 375 includes a codified appropriation for Fund 5180 requiring at least 50% of amounts credited to the fund in excess of the appropriation in the most recent biennial budget be used to fund corrective actions, including orphaned and idle well plugging and land restoration, in the succeeding fiscal year.

Income Tax Reduction Fund

Current law (R.C. 131.44, unchanged by the bill) requires the OBM Director each year to determine the percentage that the balance in the ITRF is of the amount of revenue that the Director estimates will be received from the PIT in the current fiscal year. If that percentage exceeds 0.35%, the Director must certify the percentage to the Tax Commissioner no later than July 31. The statutory tax rates must be reduced by the percentage prescribed in that certification for taxable years beginning in the calendar year in which that certification is made to the Tax Commissioner.

Am. Sub. H.B. 59 of the 130th General Assembly, the FY 2014-FY2015 operating budget, contains a provision that states, "Notwithstanding section 131.44 of the Revised Code, cash shall not be transferred to the Income Tax Reduction Fund prior to July 1, 2015."

Commercial activity tax exclusion

H.B. 375 excludes from the taxable gross receipts base of the CAT the receipts realized from the sale of oil or natural gas by a severer or owner that paid the new horizontal well severance tax on the basis of that oil or natural gas. The exclusion applies to tax periods ending on or after April 1, 2014.

Receipts from the sale of oil or natural gas severed from a nonhorizontal well will remain subject to the CAT under H.B. 375. However, the CAT is a business privilege tax measured by gross receipts sitused to Ohio, so the gross receipts from nonhorizontal wells are not subject to the CAT to the extent that the oil and natural gas are delivered out of state. In general, for the sale of property, gross receipts are only considered taxable if the property is delivered to a location in this state.

Current law requires that a small portion (0.85%) of CAT receipts be dedicated to the Tax Reform System Implementation Fund, and the remaining revenues are distributed to the GRF (50%), the School District Property Tax Replacement Fund (35%), and the Local Government Property Tax Replacement Fund (15%). Any balance in either replacement fund may be transferred to the GRF every year-end. Also, current law requires a GRF subsidy to the replacement funds if CAT revenues are insufficient for the required expenditures; hence the GRF would bear the CAT revenue loss regardless of whether CAT receipts meet or exceed required expenditures.

Personal income tax credit

H.B. 375 authorizes a horizontal well owner or "designated taxpayer" to claim a nonrefundable PIT credit equal to the amount of horizontal well severance tax paid by the 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.

The term "designated taxpayer" is defined in the bill to mean a taxpayer that "has a working interest or royalty interest in the designating taxpayer's horizontal well." The designating taxpayer is the owner of the well and therefore the taxpayer that is liable for the severance tax (although the well owner may designate a severer to pay the tax on the owner's behalf). Any designation arrangements must be in writing and be included with each quarterly severance tax return filed on behalf of the horizontal well owner.

Fiscal effect summary

Changing the severance tax structure by distinguishing between horizontal and nonhorizontal wells will increase severance tax collections to the new Horizontal Well Tax Fund. However, those additional revenues do not represent a net gain in state receipts. Revenues will be used to partially offset revenue losses to two DNR funds. Any remaining horizontal well severance tax receipts will be transferred to the ITRF to fund a reduction in PIT rates. Although these rate reductions could occur every year, the frequency and the magnitude of the recurring rate cuts depends on the amount of oil and gas severed. Estimates for this FY 2014-FY 2015 analysis rely upon the DNR horizontal well production report for the third quarter of CY 2013. Amounts severed in future years will grow, but the drilling and severing activities are dependent upon commodity prices, pipeline and processing infrastructure, and other factors.

Establishing a nonrefundable PIT credit for severance taxes paid from horizontal wells will reduce GRF revenues beginning in FY 2015. Because the PIT credit can be carried forward for up to seven years, the GRF losses resulting from this credit will likely not grow in a linear fashion. The utilization of the credit will vary depending on annual taxpayer liabilities as well as the magnitude and profitability of oil and gas drilling activities. Although the GRF revenue loss will likely be less than $10 million in FY 2015, the annual revenue loss could be up to tens of millions of dollars in future years. These GRF losses will be accompanied by corresponding losses to the LGF and PLF.

The CAT exclusion will reduce GRF revenues beginning in FY 2015, but the actual amount is highly dependent on how much oil and gas is delivered to in-state purchasers. Although the GRF revenue loss will likely be less than $5 million in

FY 2015, the annual revenue loss could be in excess of $10 million per year in future years if drilling activity, infrastructure, and consumer demand permit. Although Fund 7047 and Fund 7081 will be held harmless, the GRF losses will reduce revenues to the LGF and PLF. In some years, the revenues to Fund 7047 and Fund 7081 have exceeded the required expenditures for those funds; the OBM Director has transferred the excess amounts to the GRF. Reducing revenues to Fund 7047 and Fund 7081 reduces the potential excess revenue that can be transferred into the GRF at the end of a given fiscal year.

The severance tax reduction for natural gas severed from nonhorizontal wells constitutes a revenue reduction for Fund 5180 and Fund 5110. By lowering the rate from $0.025 per Mcf to $0.015, severance tax receipts will decrease by $0.8 million in FY 2015. Fund 5180 will bear 90% of those revenues losses and Fund 5110 will bear the remaining 10%.

The repeal of the cost recovery assessment, which is $0.10 per barrel of oil and $0.005 per Mcf of natural gas, represents a revenue loss to Fund 5180, which receives 100% of the cost recovery assessments. In FY 2015, the revenue loss to Fund 5180 from both horizontal and nonhorizontal wells would be approximately $2.4 million. Loss amounts in future years will grow as increasing quantities of oil and gas are severed from Ohio wells.

Local government funds

All PIT revenues and half of CAT receipts are deposited into the GRF, and the LGF and PLF each receive 1.66% of GRF receipts. Creating a nonrefundable PIT credit for severance taxes paid from horizontal wells and creating a CAT exclusion for gross receipts from horizontal wells will reduce the LGF and PLF by tens of thousands of dollars in CY 2014 and up to $0.3 million in CY 2015. The loss amounts would increase in future years as additional oil and gas is severed and more PIT credits are claimed.

The LGF and PLF will not incur losses as a result of personal income tax cuts enabled by the ITRF balance. The Revised Code requires that the OBM Director make transfers from the ITRF to the GRF, LGF, and PLF that offset the revenue reductions caused by the tax rate reductions created by the ITRF tax cuts.

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