Client Alert: Oil and Gas Tax Provisions Contained in the "As Introduced" Version of House Bill 59

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On February 12, 2013, the Ohio General Assembly released the "As Introduced" version of House Bill 59 (the Bill), which is the operating budget bill for state fiscal years 2014 and 2015. The Bill contains significant tax reform elements. If enacted, the Bill would, among other things, vastly expand the sales and use tax base – beyond that of perhaps any other state – by subjecting to the sales and use tax not only sales of tangible personal property (current law), but also all sales of services and all sales of intangible personal property, unless specific exemptions apply. The Bill also would reduce state and local sales and use tax rates, reduce the state personal income tax rate and provide a new personal income tax deduction for owners of pass-through entities. The Bill includes key provisions that are targeted to the oil and gas industry and that significantly affect the taxation of oil and gas producers and other oil and gas-related entities. Those provisions are briefly described below. This client alert does not address the impact of the non-targeted provisions (e.g., the expansion of the sales tax base to include the sale of all non-exempted services and intangibles) on the industry.

Horizontal Well Fee and Repayment

The Bill would require the payment of a $25,000 fee for each horizontal well to be drilled, which would be deposited into an oil and gas escrow fund to be created by affected county treasurers. The initial fee would be paid prior to construction of the well pad, and a separate fee would need to be paid for each subsequent well, even if multiple wells are included on the same well pad, prior to commencing drilling for each subsequent well. Because the fee is due prior to construction of the well pad, and – for subsequent wells – prior to the commencement of drilling, it would apply even in the event of a dry hole and could apply even if, ultimately, the well is never drilled at all.

Not later than 40 days after the deposit of monies in the oil and gas escrow fund, the county budget commission is required to hold a hearing regarding the use of those funds. The budget commission is required to notify all affected taxing units at least 30 days prior to the hearing. If no taxing unit responds, the budget commission may cancel the hearing and distribute the money in the oil and gas escrow fund under a default method – 60% to the county and 40% to the township. If taxing units do participate in the hearing, the budget commission is required to distribute the funds based on the relationship of each taxing unit's request to the overall impact of the horizontal well or wells on the taxing unit and the estimate of the cost to defray that need.

The Bill contains repayment provisions. Once per tax year, any taxing unit that receives money from the oil and gas escrow fund is required to pay to the producer an amount equal to 50% of the property taxes paid by the owner and received by the taxing unit for the preceding tax year in respect of the owner's horizontal well until the sum of such payments equals the amount that the taxing unit received from the oil and gas escrow fund for that owner's horizontal well. Of course, if there is a dry hole, or there are other problems with the well or its production, there is a significant risk that the producer would not be fully repaid with respect to that horizontal well.

Real Property Taxes

Under current law, oil and gas reserves from producing wells are valued pursuant to Ohio Revised Code (R. C.) Section 5713.051 based on a discounted cash flow method. The Bill would make two significant changes to R.C. Section 5713.051. First, the Bill would amend R.C. Section 5713.051 to make it clear that "oil" includes condensate (i.e., liquid hydrocarbons that were originally in the gaseous phase in the reservoir), and that "gas" includes all hydrocarbons that are in a gaseous state in the reservoir.

Second, for gas, the Bill would provide for a different "gross price" for purposes of the discounted cash flow calculation, depending on its heating content (measured in British thermal units (BTUs)). For gas with a BTU content equal to or less than 1,050 per cubic foot, the gross price in place under current law (a five year average) would continue to apply. For gas with a BTU content of greater than 1,050 per cubic foot, the Bill provides for a higher gross price that takes into account the price of natural gas liquids (NGLs), with the "price" based on the value determined by the Ohio Tax Commissioner for severance tax purposes. The NGL price is more heavily weighted in the calculation of the gross price for gas with a higher BTU content. Given the expected NGL levels in gas produced from the Utica shale formation, the Bill would likely result in a significant increase in the real property taxes applied to mineral interests.

Severance Tax

Under current law, the severance tax is levied based on the volume of natural resources severed from the ground in Ohio, and the proceeds of the tax are deposited into various regulatory funds. Under the Bill, the severance tax applied to non-horizontal wells would remain virtually unchanged from current law, with two notable exceptions. First, the tax rate on gas produced from non-horizontal wells would be changed from three cents per thousand cubic feet (MCF) severed to the lesser of three cents per MCF and 1% of the market value of the gas. Second, under the Bill, any non-horizontal well that produces less than 10 MCF of gas per day in a quarterly period would not be subject to tax.

The Bill provides for a quarterly, value-based tax for oil and gas severed through a horizontal well. Like with the real property tax, the Bill would use BTUs to estimate the NGLs present in the gas stream in an attempt to tax certain assumed values of the NGLs. For gas with a BTU content equal to or less than 1,050 per cubic foot, the severance tax rate is equal to 1% of the market value of the gas. For oil and condensate, and for gas with a BTU content of greater than 1,050 per cubic foot, the Bill would apply a severance tax rate of 1.5% of market value for the first year, and 4% of market value in all subsequent years. As with the real property tax, the NGL market value is more heavily weighted for gas with a higher BTU content. Market values would be determined on a quarterly basis by the Ohio tax commissioner based on certain indices specified in the Bill. The change to a value-based tax, along with the BTU-based method for estimating the volume of NGLs, is likely to result in a significant increase in severance taxes paid, especially for the NGL-rich gas in the Utica shale formation.

Conclusion

If enacted, the Bill would result in a significant change in the manner in which oil and gas producers and other oil and gas-related entities are taxed in Ohio. Vorys will continue to follow these important developments. If you have any questions about the issues discussed in this Client Alert, please contact Scott J. Ziance – (614) 464-8287, sjziance@vorys.com – or Chris L. Connelly – (614) 464-8244, clconnelly@vorys.com.