Insight

Severance Taxes Prove to be a Poor Choice

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Executive Summary

- Many agencies and programs at all levels of government receive revenue from the royalty payments of private energy developers.
- Both state agencies and the Department of Interior have recently reduced royalties to aid developers struggling financially due to the COVID-19 pandemic.
- Government agencies' reliance on royalties poses a risk to the stability and predictability of state and federal budgets and is contributing to the difficulties recovering from COVID-19.

Introduction

Federal, state, and even local governments impose severance taxes on the extraction of natural resources, such as oil and natural gas.[1] These taxes vary in their implementation. Generally, the value is assessed based on the volume extracted, the market value of the resource, or a combination of the two. In addition, authorities impose fees and grant exemptions and exceptions to encourage producers to extract using specific techniques.[2] The funds resulting from taxation are termed royalties.

The dependence of government budgets on this revenue source varies. All are subject to the volatility of the market, however, which determines the value of the commodity outright and the demand, or lack thereof, impacting the volumes produced. This unpredictability leaves governments with little insight into expected revenues, while the incentives created by the royalty regime interfere with producers' ability to use extraction techniques as they see fit.

State Policies

Thirty-four states have imposed severance taxes. More important, for a handful of these states the revenue generated represented a significant portion of the annual own-source general revenue, or that which excludes federal transfers. In 2017, severance taxes contributed most to the own-source revenue of North Dakota (22 percent), Wyoming (8 percent), and Alaska (7 percent).[3]

Alaska is particularly dependent on its severance tax revenues.[4] The severance tax revenue generated by Alaska from year to year highlights the risk associated with depending on oil and gas production, as can be seen in the table below.

Year	Severance Tax Revenue	Percentage of Total State/Local Own-Source Revenue
2012	$6 billion	40%
2013	$4 billion	33%

2014	$2 billion	23%
2015	$636 million	8%
2016	$337 million	4%
2017	$585 million	7%

Market conditions determine the price of commodities, such as oil and natural gas. This reality means that market fluctuations dramatically affect states where a higher percentage of revenue is derived from a severance tax. The price of oil declined between 2014 and 2016 from over $100 per barrel to as low as $30 and remained relatively low until 2018.[5] As a result, Alaska's severance tax revenue declined dramatically.

Policymakers are also tempted to manipulate severance taxes, exacerbating the problems with this tax practice. When both demand and prices dropped to historic lows during the COVID-19 pandemic, production in the United States declined for months, only rebounding recently.[6] The producers who proved to be a major source of both tax revenue and employment for some states suggested that the conditions posed an existential threat. In response, states as well as the federal government modified the collection of severance taxes. States such as Texas, Oklahoma, and North Dakota, where much of America's natural gas and oil are produced, allowed producers to delay royalty payments without penalty or temporarily cease production at wells which may otherwise be required to produce continuously.[7]? These allowances have resulted in deferred collections and lost revenue at a time when states' budgets are already strapped.

Even when economic conditions are fair legislators find themselves trying to manipulate severance taxes to make the most of a poor policy. To encourage the development of new wells, the Wyoming state Senate considered cutting severance tax rates from 6 percent to 3 percent for wells in their third and fourth years of production. Similarly, Mississippi provides tax exemptions and incentives to high-cost gas wells, inactive wells, and discovery wells to help encourage production. Texas, on the other hand, provides incentives for the operation of low-producing gas wells to ensure developers continue extracting beyond the economic life of a well. These various policies attempt to manipulate market conditions to drive tax revenue as each state aims to maintain its various programs and funds, often in the face of historically growing budget deficits.[8]

Federal Programming

The federal government owns and manages both public lands, such as national forests, and offshore land. These lands may be subject to leasing that allows developers to drill for oil or natural gas, mine for coal, or erect renewable energy facilities. The extracted resources are subject to severance taxes in addition to the lease conditions.

The Department of Interior's (DOI) Bureau of Land Management (BLM) administers the largest area of public land, over 245 million surface acres largely located in the western states and Alaska.[9] In 2019, BLM collected $2.4 billion in royalties, of which half was provided to the states where the wells are located.[10] In an effort to aid producers during the COVID-19 pandemic, BLM permitted producers to apply for rate reductions that reduced the percentage of revenue subject to collection from 12.5 percent to as low as 0.5 percent. As of July 7, 2020, BLM has reduced rates in 336 cases impacting over 110,000 acres. This reduction results in a loss of revenue for not only federal programming but the states where energy development predominantly occurs and where the dependence on severance taxes is greatest.[11]

DOI's Bureau of Safety and Environmental Enforcement (BSEE) oversees offshore drilling and determines discretionary relief of royalty payments.[12] BSEE administers a program that requires producers to formally apply for reductions that, if approved, are revisited on a monthly basis. Currently, new offshore leases require producers to pay 18.75 percent on the value of oil produced in deep water, and 12.5 percent in shallow water. Thus far, BSEE has approved the reduction of royalties for 12 producers due to the impacts of the COVID-19 pandemic. The extent of the reductions is unknown.[13]

Recent Legislation: The Great American Outdoors Act

The Land and Water Conservation Fund (LWCF), which relies on offshore royalty revenues as a source of funding, supports the programming at DOI's BLM, National Park Service (NPS), and Fish and Wildlife Service (FWS), and the Department of Agriculture's Forest Service (FS), as well as the purchase of additional land for federal programming. In addition, the fund supports various state and local efforts to conserve forests, endangered species, and other notable landmarks. Per its founding legislation, the fund is to receive $900 million annually from surplus property sales, motorboat fuel taxes, appropriations from Treasury, and in the case these prove insufficient, offshore royalties.[14]

The Great American Outdoors Act (GAOA),[15] which was signed into law by President Trump in August, aims to permanently stabilize the allocation of funding within the LWCF and create and fund the National Parks and Public Land Legacy Restoration Fund (NPPLLRF). The new fund addresses the maintenance backlog of the NPS, the FWS, the BLM, the FS, and the Bureau of Indian Education. The NPPLLRF, however, is also dependent on royalties. For each of fiscal years 2021 through 2025, 50 percent of all energy development revenues due from oil, gas, coal, or alternative or renewable energy development on federal land and water "deposited as miscellaneous receipts" from the preceding fiscal year will be deposited into NPPLLRF. Miscellaneous receipts are proceeds from federal activities from myriad sources, including royalties, that are not otherwise committed to fund other programs.[16] By far the largest source of "miscellaneous receipts" to the Treasury is the Federal Reserve.[17] An average of $4.9 billion in revenue from combined onshore and offshore energy extraction has been collected and deposited with the Treasury general fund – miscellaneous receipts – annually since 2009.[18] Nominally, this sum would ensure adequate funding for the NPPLLRF, though given that the United States is running a budget deficit, this new spending would effectively be financed through additional borrowing.

Both onshore and offshore extraction generate royalties, lease collections, and other revenue, but a significant share of these collections are earmarked for other programs, including disbursements to state and local governments, the Reclamation Fund, and the LWCF.[19] And the GAOA makes clear that the appropriations for NPPLLRF will not impact appropriations for other existing programs and funds.[20]

Conclusion

Severance taxes prove to be variable in practice because they subject government programming to the fluctuations of the market. The unreliable nature of the tax makes it difficult for governments to predict future revenue and is problematic for legislators who must shift the tax's provisions to ensure adequate revenue as the market shifts. The tax also creates planning challenges for industry, as there is little certainty regarding incentives.

[1] https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-severance-taxes-work

[2] https://www.ncsl.org/research/energy/oil-and-gas-severance-taxes.aspx#dist

[3] https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-severance-taxes-work

[4] https://www.taxpolicycenter.org/briefing-book/how-do-state-and-local-severance-taxes-work

[5] https://www.wsj.com/market-data/quotes/futures/CL.1/advanced-chart?mod=md_cmd_chart_advanced

[6] https://www.americanactionforum.org/insight/addressing-oil-supply/

[7] https://www.eenews.net/energywire/stories/1062955529/search?keyword=royalty+cuts

[8] https://www.ncsl.org/research/energy/oil-and-gas-severance-taxes.aspx#dist

[9] https://reports.blm.gov/reports.cfm?application=LR2000

[10] https://subscriber.politicopro.com/article/2020/05/trump-administration-cuts-royalty-payments-for-oil-companies-1939444

[11] https://westernpriorities.org/tracker-trump-administration-oil-and-gas-handouts-during-global-pandemic/?utm_source=Master+Press+List+2.0&utm_campaign=6cd34a805d-EMAIL_CAMPAIGN_2020_06_11_08_37&utm_medium=email&utm_term=0_79fad8be67-6cd34a805d-84303649

[12] https://www.boem.gov/oil-gas-energy/energy-economics/royalty-relief/royalty-relief-information

[13] https://www.reuters.com/article/us-usa-offshore-drilling-royalties/u-s-has-granted-12-royalty-cuts-for-struggling-offshore-drillers-idUSKBN23I2I0

[14] https://www.nps.gov/ncrc/programs/lwcf/lwcf_act.pdf

[15] https://www.govtrack.us/congress/bills/116/s3422

[16] https://www.whitehouse.gov/wp-content/uploads/2018/06/a11.pdf

[17] https://www.whitehouse.gov/wp-content/uploads/2020/02/spec_fy21.pdf

[18] https://revenuedata.doi.gov/downloads/disbursements/disbursements.xlsx

[19] https://revenuedata.doi.gov/how-it-works/#disbursements

[20] https://www.congress.gov/bill/116th-congress/senate-bill/3422/text