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Long-term growth of severance tax unlikely

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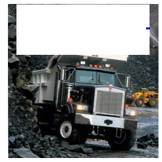
By Taylor Kuykendall, Reporter - email



Rising coal prices and increased natural gas potential have a lot of West Virginia officials excited, but low gas prices and decreasing Appalachian coal production threaten continued growth of the state's severance tax collections.

State Deputy Revenue Secretary Mark Muchow said, in the long run, the state is expecting higher collections from increased natural gas drilling, but decreasing revenues from the larger coal severance tax.

"For the moment, the severance tax collections are still trending higher because, at the end of January, our receipts are running about 17 percent higher than last year," Muchow said. "Most of that … is attributable to higher coal prices, particularly in the international market."

Patriot Coal and Alpha Natural Resources both recently announced they would idle mines in West Virginia's southern coalfields due to market conditions.

West Virginia, Muchow said, is seeing a trend of coal mines moving from traditional southern coal counties such as Logan, Lincoln, Mingo and Boone counties to the northern region of the state. That means lower severance tax collections for the southern counties and more for the northern region.

In the northern part of the state, increased drilling activity in the Marcellus shale also has officials optimistic about increased tax collections, but low natural gas prices prevent more significant gains in severance tax collections.

"While coal has been going up, natural gas has been going down since about 2008," Muchow said. "We've seen the downward trend due to lower prices on natural gas."

Variations can make for difficult county planning and budgeting.

In Wetzel County, one of several counties where gas activity is high and where oil and gas severance taxes make up a significant part of the budget, revenues went up from about $100,000 in 2006 to more than $200,000 in 2011 — increasing the county's budget by 2.5 percent in a few years.

"The distribution of severance taxes is a very important part of our budget," said Wetzel County Commission President Don Mason.

"But this year, what we'll have to do is just wait to see at the end of the fiscal year what we get," Mason said. "I would assume with gas prices dropping to $2.50 (per million British thermal units, or mmBtu), it should be lower, but it depends on the production. Maybe with higher production it'll be about the same."

Potentially affected are the county's ambulance service, which Mason said gets 35 or 40 percent of the severance tax revenues, as well as libraries and other programs.

The high amount of production from shale gas has been one of the factors keeping natural gas so low. Coupled with the mild winter and other factors, natural gas storage has seen record highs.

The low prices have caused many drillers to slow production. The average price per mmBtu of gas was about $8 in 2008. Following a boom in shale gas activity, natural gas prices now hover around $2.50 per mmBtu.

"We have natural gas actually increasing over time, but that's going to depend on price recovery," Muchow said. "Right now, we do not see a whole lot of price recovery on the near-term horizon."

Chesapeake Energy, producer of about 9 percent of natural gas in the U.S., recently announced it would be cut production by about 8 percent.

The matter is complicated by the composition of natural gas. Methane, the chemical traditionally associated with natural gas and utilized as fuel, is increasingly less valued over some of the "byproducts" of drilling for the gas.

"Wet gas," found in certain regions of the Marcellus shale and other shale gas plays, contains valuable chemicals such as propane and ethane, a potential feedstock for the manufacturing industry.

While West Virginians wait to see if the Marcellus shale gas play lives up to expectations, the state continues to receive record collections on coal tax revenue.

"We just sent out a distribution in January that was probably one of the highest I've ever seen," Muchow said.

He added that about $10.3 million was distributed to local counties from coal tax severance collections in January, the second highest quarterly distribution of coal severance taxes. A portion of the collections are returned to the counties based on where the taxes were collected, and another portion is directed to the state's general revenue fund.

Natural gas severance taxes are distributed annually and represent a much smaller amount of total severance tax revenue. The annual distribution in 2011, just over $6 million, was distributed to counties from oil and gas severance taxes.

According to an analysis by the West Virginia Center on Budget and Policy, West Virginia's severance tax collections comprised about 11.1 percent of the state's general revenue budget. As a share of state revenue, West Virginia ranks 7th in the nation for dependence on severance tax collections.

In 2013, counties will begin to get a bigger share of severance tax collected within their borders, while less will go into the state's general revenue fund, Muchow said.

"That may be enough to basically hold their revenues about the same," Muchow said.

The amount that will be dedicated to each county, of course, will be varied.

"Getting into counties, that's going to depend on where you're located," Muchow said. Some counties will continue to see coal production increases and some will see decreases, he said.

"Follow where the mine reductions are being announced. That's where you're going to start seeing a softening or reduction in severance money."

A decline in Appalachian coal production has largely been offset by an increase in the cost of coal.

"We're producing less coal today than we did 15 years ago, but the amount of money that is sent to counties is increased compared to 15 years ago," Muchow said. "We probably sent them twice as much money in terms of distribution to counties."

In 2006-2007, Muchow said, West Virginia was producing about 150 million tons of coal; now that number has dropped to about 130 to 135 million tons. Despite that, double the amount of severance tax is going to counties and into the state's general revenue fund.

European markets play a significant role in determining the price of and demand for West Virginia coal.

"Nearly 40 percent of our coal exports go to Europe," Muchow said. "With uncertainty in the European economy, we're probably going to have some softness in the export markets."

Another challenge is that thick seams of coal are increasingly difficult to find. The thinner seams, while taxed at a lower rate, are more expensive to mine.

Overall, Muchow said, West Virginia probably can't rely on continued growth of severance tax collections it has experienced in the past six years.

"We're expecting prices to soften up a bit and activity to decline a little bit," Muchow said. "We're hoping that will be offset by increases in natural gas, but ultimately we're probably not looking at a whole lot of growth in severance tax. In fact, we may see some years where severance tax revenues will decline instead of grow."

Muchow said severance tax collections have been up $266 million since 2006, an increase that has softened the blow of state tax cuts.

"To put that in perspective, the Legislature, since about 2006, has enacted about $400 million worth of tax reductions," Muchow said. "So far, we've digested about $200 million of those tax reductions. We have about$200 million to go. Higher severance tax collections have made tax cuts easier to digest."

Pam Kasey contributed to this story.