



# Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

## Energy economics

Oklahoma has a storied history of boom and bust, with much of it tied to the oil and gas industry. With one-third of the state's economy directly linked to the energy industry, Oklahoma's political leaders have long sought to encourage its expansion and protect its health.

One of the more important areas of focus, especially over the past 20 years, has been drilling incentives designed to foster growth and ensure the continued function of arguably the state's most vital economic engine.

The standard gross production tax is

seven percent of the sales price of oil and natural gas. During the oil boom of the 1980s, Oklahoma government depended heavily on the gross production tax. Tax policy changes further grew dependence.

When the bust hit in 1982, state government funding was decimated. For the next several years, deep spending cuts were made and income and sales taxes were raised as the revenue pie was rebalanced to reduce dependence on the gross production tax.

Also as a result, the state constitution

was changed to establish a rainy day fund, place strict limits on government growth and spending, and to ensure rational methods were used to estimate revenues.

### Landmark incentives

First enacted in 1963, Oklahoma's gross production tax statute has been amended more than two dozen times, including at least once each year since 1999. The most significant changes were made in 1994 with passage of drilling incentives

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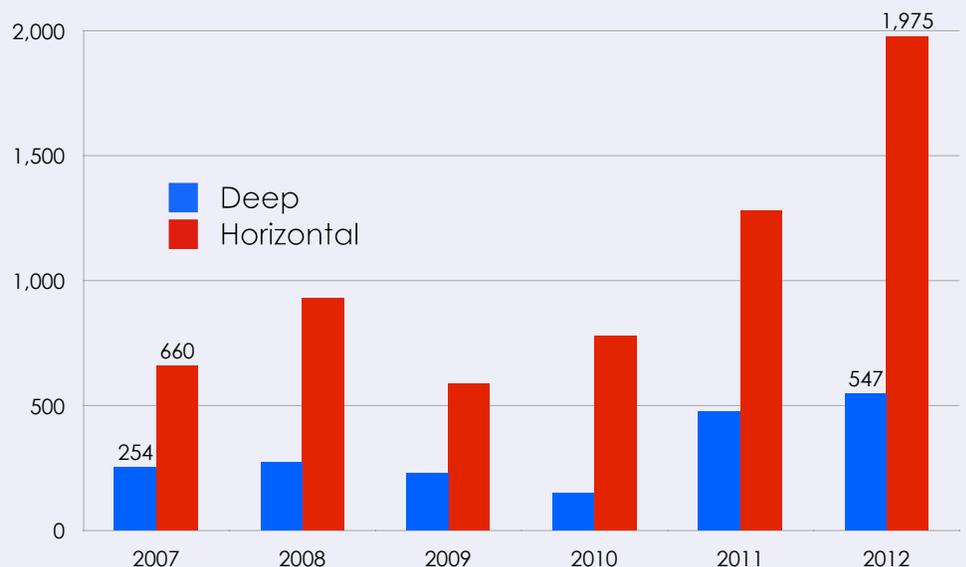
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### Deep & Horizontal Well Completions



Source: Oklahoma Corporation Commission



## Treasurer's Commentary By Ken Miller, Ph.D.

### Striking energy equilibrium

Oklahomans are proud of the many contributions our state and people have made to our nation. Perhaps there is no greater contribution to our national and economic security than our rich natural resources.

Oklahoma's oil and gas companies have long been good corporate citizens in our state and beyond. The industry accounts for about one-third of the Oklahoma's \$150 billion economy, contributing hundreds of millions in direct taxes on severance and corporate income and even more in indirect taxes on consumption and personal income.

For decades, the state of Oklahoma has incentivized both marginal and high-cost wells to encourage economic activity. When cost factors prohibit oil and gas severance, our state's natural endowment is not of use to anyone: family incomes, company profits and state tax collections are the worse for it.

The recent close of the fiscal year and the accompanying reduction in severance tax collections has renewed the discussion on one energy tax provision. House Bill 2432, passed in 2010, has been cited as the reason for declining state revenues, but with incomplete and, in some cases, incorrect information.

As the principle house author of the bill, perhaps I can offer additional information on the content, intent and effect of the bill.

Despite a few claims to the contrary, the bill did not lower the tax rate on horizontal wells from 7 to 1 percent; that incentive took effect in 1994. The incentivized rate was applied for a period of 24 months or "project payback," should that come first. The term was extended to 48 months or payback in 2002, presumably because payback was occurring beyond 24 months.

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**“There are three main contributing factors to the gross production revenue decline: rebates, quantity and price.”**

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The payback provision was removed in 2010 when state and industry leadership worked together to both honor previous commitments on tax policy and boost state revenues during the depths of the Great Recession. At that time, the horizontal provision was extended to 2015 and changed away from a rebate while



suspending and deferring payments for two years.

Regardless, neither the incentive rate nor its term could explain the current reduction in year-over-year revenues because the rate already existed and no newly-spudded wells have been in existence long enough to take advantage of the payback change.

Rather, there are three main contributing factors to the gross production revenue decline: rebates, quantity and price.

Seemingly lost in this discussion has been the effect of suspending incentive payments for two years. House Bill 2432 was designed to mitigate the effects of the worst downturn since the Great Depression on the General Revenue Fund. It met that intended purpose.

If not for the two-year suspension, gross production's contribution to the GRF would have been \$300

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## Commentary

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million lower during the difficult budget years of FY-11 and FY-12. Beginning in FY-13, not only did the incentives on current production resume, the state began repayment of \$300 million in deferred incentives, twice the fiscal impact estimated by the tax commission.

While the suspension aided budgeting efforts during a time of extreme fiscal distress, it is now negatively impacting the budget and distorting year-over-year comparisons. Though dealing with this provision is difficult today, it helped the state through an even more difficult yesterday.

The quantity of horizontal wells spudded

is a second reason for the variance. When the state began incentivizing horizontal drilling, the technology was new and expensive and its practice was the exception. Now it has become the rule. The boom in horizontal wells from 663 in FY'10 to 1,935 in FY'13 surprised the tax commission and legislators alike.

A third reason gross production contributions to the GRF are off their historical averages is due to the low price environment sustained over the last few years. Gas prices have risen modestly, but have stayed well below their norm, causing producers to switch exploration to oil.

With the provisions of HB 2432 set to expire in 2015, there is yet another

opportunity to examine costs and benefits. Such examination may show incremental changes to the current incentive rate or term are needed. Or it could reveal that comprehensive changes in energy tax policy would better provide stability for increasingly mobile capital. Another option for lawmakers could be to simplify and unify severance taxes by lowering the gross production tax rate on all oil and gas production, rather than continue to incentivize what has become the rule.

As this timely discussion continues, there is little doubt that policymakers will work with the anchor industry that so well supports our state to enact responsible energy tax policy that will continue to improve the economic well-being of the state and its citizens.

## Energy

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intended to stimulate Oklahoma's energy industry, many of which remain in place today, though they have been modified and expanded over the years.

The two primary incentives created then were for deep and horizontally-drilled wells. For deep wells, the gross production tax was temporarily discounted by three percentage points. For horizontal wells, the tax was reduced temporarily by six percentage points.

Senate Bill 841 received unanimous approval in both the House and Senate in the waning days of the 1994 session. The bill's authors hailed it as a job saver and economic stimulator. Advocates said it would help the state's energy

industry compete for investment dollars with other states that had implemented incentive packages.

Among the changes made since 1994 was a doubling of the maximum time for the horizontal drilling incentive. In 2002, again with unanimous legislative approval, the limit was changed from 24 months to 48 months.

### Desperate times

When the Great Recession struck Oklahoma in early 2009, the tightly contracting economy sent state revenue collections plummeting. Through a combination of spending cuts, rainy day fund allocations and use of federal stimulus money, state leaders worked to keep the budget balanced; but more needed to be done.

Drilling incentives were put on the table to add more money to the state budget. During the final days of the 2010 legislative session, House Bill 2432, which delayed payment of the drilling incentives for horizontal and deep wells for fiscal years 2010 and 2011, was overwhelmingly approved by both chambers.

The measure committed the state to repaying the deferred incentives over a three-year period, beginning at the start of fiscal year 2013. It was estimated the delay in paying the incentives would yield an additional \$85 million for the state budget in FY-11.

At the time, tax officials expected the three-year payback would total \$150 million, but in early 2012, it was

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## Energy

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determined the payment would be closer to \$300 million – with an almost \$100 million per year impact on the budget.

The bill included a change in the exemption period for horizontal wells. Since 2002, the exemption lasted for 48 months or until drilling costs were recovered, whichever came first.

HB 2432 removed the cost-recovery language. Since that change only applies to wells placed into production after July 1, 2011, not enough time has passed to have any effect on revenue collections. The tax commission is unable to determine if the change will have any future impact on state revenues.

HB 2432 also changed how the incentives were paid, away from a post-production rebate to the front-end.

As with its predecessors, the 2010 bill received overwhelming bipartisan support.

### Extenuating circumstances

As the national and state economy recovered from the 18-month recession, natural gas prices dropped dramatically in 2011 due to mild winter weather and historically large amounts in storage. It was a classic lesson in supply and demand as supply peaked and demand fell.

As gas prices remained low, producers in Oklahoma switched from primarily

drilling gas wells to a renewed effort to bring oil wells into service.

The result of the low prices was a sharp drop in gross production collections, which dipped below prior year collections for 18 consecutive months. Gross receipts of the extraction tax didn't again exceed prior year collections until May 2013.

The tax commission reports the effective gross production tax rate is 5.5 percent for oil and 5.3 percent for natural gas, reflecting a reduction of about 22 percent from the full rate. Tax officials also note that the incentives are temporary. Once expired, the tax rate on deep and horizontal wells returns to the full seven percent.

The incentive payback and lower gross collections are now presenting a temporarily-distorted picture of the gross production tax's impact on the state budget. If not for the \$100 million paid for the delayed reimbursement in FY-13, gross production would have accounted for almost six percent of General Revenue Fund collections. Instead, the gross production contribution was four percent in FY-13.

### National perspective

Severance taxes defray costs associated with the extraction of a natural resource, such as wear and tear on roads and environmental protection efforts. Not every state is blessed with oil and gas reserves, but of those that are, all but

one assess some form of severance tax.

Pennsylvania is the only gas-producing state that does not assess a severance tax, an issue state leaders have debated for years. In 2012, Pennsylvania enacted an "impact fee" on every gas well drilled in the Marcellus Shale formation, with the amount tied to the price of gas. Unlike most states, which direct the majority of oil and gas tax revenue to help fund state government, Pennsylvania distributes the fee revenue among counties and municipalities impacted by drilling.

Comparing any two states' oil and gas taxes is difficult due to the differences and intricacies in each state's provisions. In 2012, the Montana Department of Revenue attempted to compare its gross production tax policy to North Dakota's. The analysis found that while the effective tax rate over the life of the well was higher in North Dakota, it didn't distinguish between owners.

As a matter of policy, Montana treats differently the taxes paid between two ownership interests recognized by the state. Working owners, who put their own capital at risk, are taxed at a lower rate than non-working, or royalty owners, who are passive recipients of oil income. Montana's effective tax rate for royalty owners was nearly five percent higher than North Dakota's flat rate, but more than four percent below North Dakota's effective tax rate on working owners.

Texas, the nation's top energy-producing state, offers nine oil and gas incentive programs. Among the severance tax incentives is one for enhanced

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**“The incentive payback and lower gross collections are now presenting a temporarily-distorted picture.”**



## Energy

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oil recovery. In place since 1989, it sets a tax rate of 2.3 percent of the production’s market value – half the standard rate – on oil produced from an approved new enhanced oil recovery project or expanded existing project. The discounted tax rate remains in effect for 10 years after certification.

Also, Texas offers the “high-cost gas incentive,” a tax reduction on gas extracted from wells defined as high-cost. The reduction level is dependent on drilling and completion costs.

Surprisingly perhaps, since Texas is by far the nation’s largest producer of both crude oil and natural gas, taxes derived from oil and gas production make up only eight percent of the state’s annual revenue used to fund government. In contrast, 20 percent of Wyoming’s general revenue comes from extraction taxes.

With the economic importance of the state’s energy industry, any discussion on changing Oklahoma’s gross production tax policy should include an examination of policies in peer states.

### Moving Forward

Oklahoma policymakers currently face a balancing act to determine the best long-term tax policy to properly incentivize the industry during market dips while fairly offsetting the state’s investments in infrastructure that benefit the industry.

As the methods and costs of drilling change, it is reasonable to expect that drilling incentive laws might also be changed to ensure that balance is maintained.

## No rainy day fund deposit this year

The Oklahoma Constitutional Reserve Fund, also known as the rainy day fund, did not receive a deposit at the start of

the new fiscal year in July.

Tapped for \$45 million following the

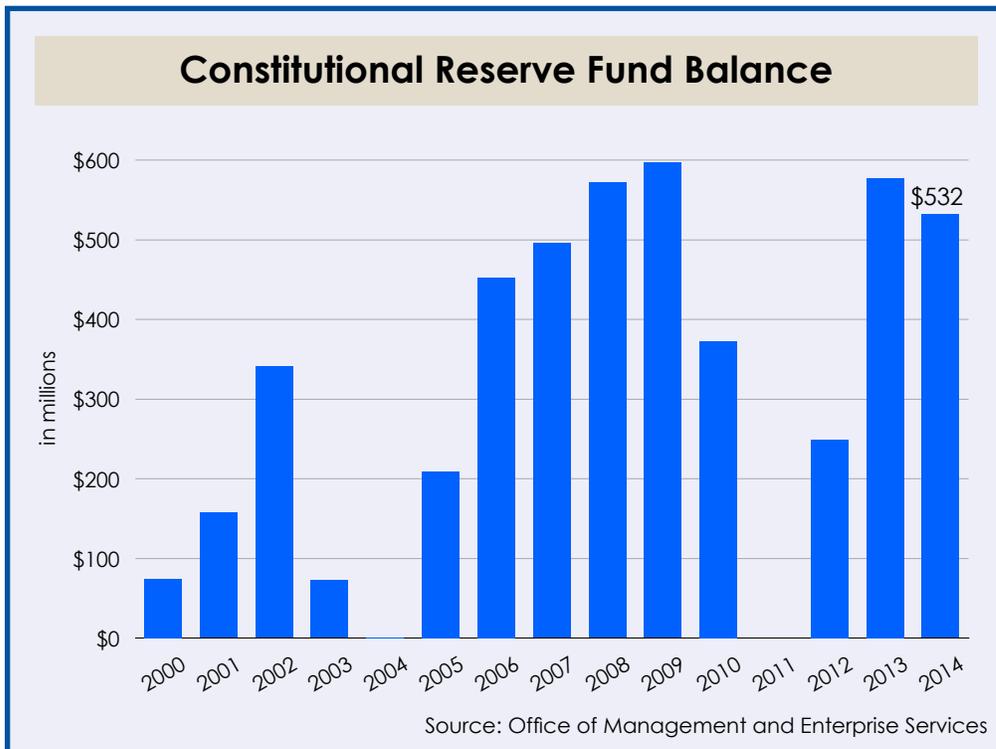
May tornadoes, the balance of the fund now stands at \$532 million.

Following two years of large deposits in which General Revenue Fund collections far exceeded the official estimate as certified by the State Board of Equalization, allocations fell just short of the FY-13 estimate and no deposit was made at the start of FY-14.

Of the major tax categories, net income tax, a combination of personal and corporate income tax allocations, exceeded the estimate by more than 10 percent.

Sales tax allocations were below the estimate by 1.2 percent for the year, while motor vehicle and gross production tax allocations fell below the estimate by 15.7 percent and 41.2 percent respectively.

Total allocations were reported as missing the estimate by 0.5 percent for the fiscal year.





## Gross receipts & General Revenue compared

The Treasurer's July 2 gross receipts to the treasury report and the Office of Management and Enterprise Services' General Revenue Fund (GRF) report have several differences.

Fiscal Year 2013 gross receipts totaled \$11.23 billion, while the GRF received \$5.56 billion or 49.7% of the total.

In the month of June, the GRF received 54.2% of the gross. The percentage varied from 32.2% to 57.3% during the prior 12 months.

From FY-13 gross receipts, the GRF received:

- Personal income tax: 60.5%
- Corporate income tax: 71.8%
- Sales tax: 45.2%
- Gross production-Gas: 17.9%
- Gross production-Oil: 39.5%
- Motor vehicle tax: 28.5%
- Other sources: 46.1%

Fiscal year GRF allocations missed the official estimate by \$26.5 million or 0.5%. In June, collections fell short of the estimate by \$61.5 million or 10.4 percent

For the year, insurance premium taxes totaled \$222.7 million.

Tribal gaming fees generated \$128.1 million during the year.

## Fiscal year collections up, but June gross receipts drop below prior year

Gross receipts to the Oklahoma treasury finished the fiscal year ahead of the prior year, but down slightly for the month, State Treasurer Ken Miller announced.

of Oklahoma's economy," he said. "Broad indicators show there is still reason to be optimistic about our state's financial course."

Gross receipts for Fiscal Year 2013 total \$11.23 billion, reflecting growth of \$240.5 million, or more than two percent compared to FY-12. June receipts topped \$976 million, down by almost \$19 million or 1.9 percent from June 2012, Miller said.

**“Broad indicators show there is still reason to be optimistic about our state’s financial course.”**

The tax commission reports that June had one less business day than last year, which could account for the slight difference in collections.

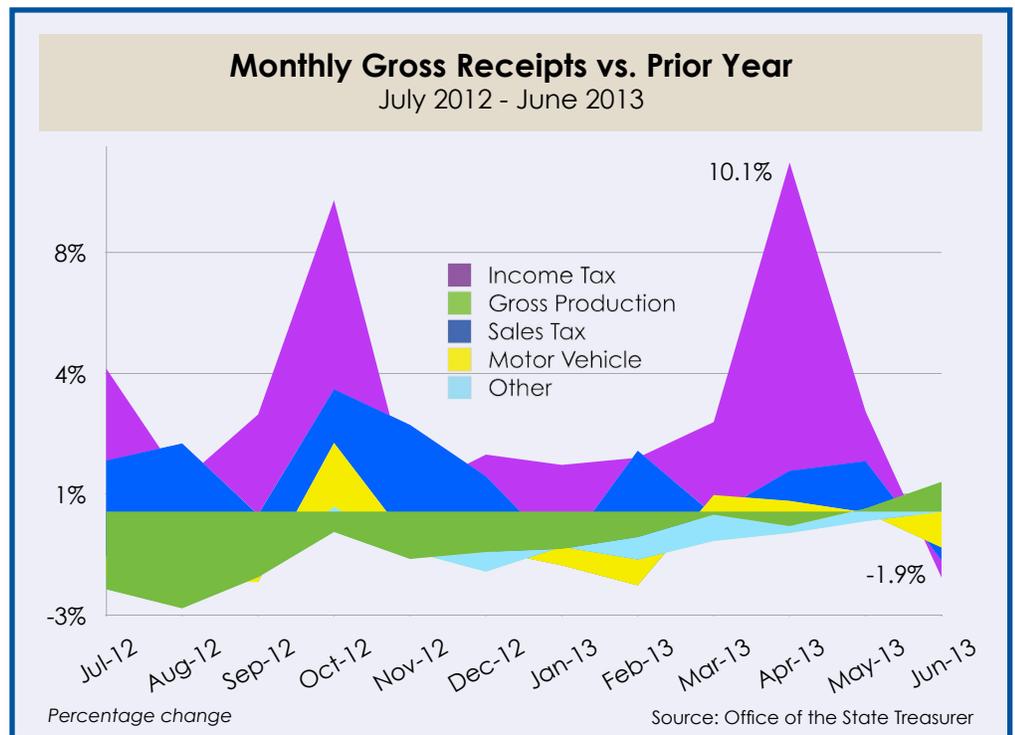
Sales tax collections, generally viewed as an indicator of

consumer confidence, are up by more than four percent for the past 12 months, but down by one percent in June.

However, Miller pointed out that June sales tax collections are more than \$31

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“While our monthly numbers are down slightly, the broader picture of annual collections indicate moderate expansion





## June unemployment rises; May jobless rate revised upward

Oklahoma's unemployment rate was listed at 5.2 percent in June by the Oklahoma Employment Security Commission, up one-tenth of one percentage point from the revised May rate.

Reports show state employment shrank by 4,790 jobs during the month, while the jobless number rose by 2,960. The labor force decreased by 1,840 from May.

The U.S. jobless rate was set at 7.6 percent in June.

State Unemployment				
OKLAHOMA	Unemp. rate*	Labor force*	Employment*	Unemployment*
Jun '13	5.2%	1,816,200	1,721,350	94,860
May '13	5.1%	1,818,040	1,726,140	91,900
Apr '13	4.9%	1,812,950	1,724,070	88,870
Mar '13	5.0%	1,814,740	1,723,940	90,790
Feb '13	5.0%	1,817,380	1,726,140	91,240
Jan '13	5.1%	1,818,740	1,726,380	92,360
Jun '12	5.2%	1,798,180	1,704,330	93,850

\* Data adjusted for seasonal factors Source: OESC

## Revenue

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million higher than the five-year June average, ahead by almost 10 percent.

In an odd twist, Miller pointed out that for the fiscal year all of the major tax

categories except gross production are in positive territory; in June, it's just the opposite with the only positive number from gross production.

“The upturn in gross production collections indicates the industry is

continuing to rise out of the revenue trough it reached in August of last year,” Miller said.

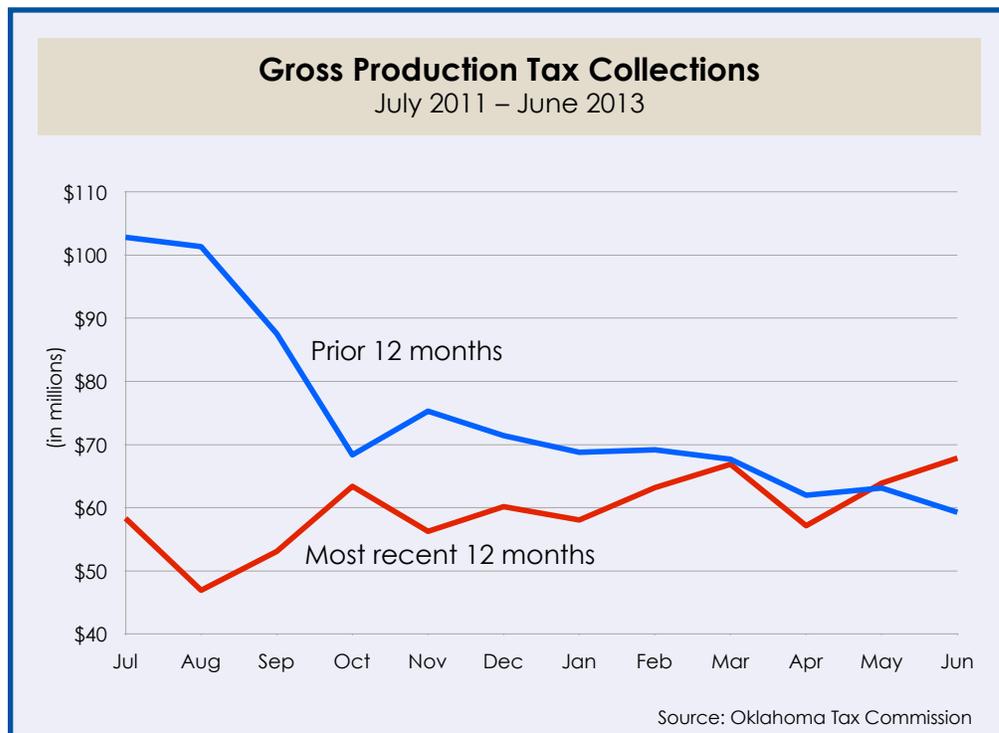
Miller noted that natural gas prices at the Henry Hub have generally risen since April 2012, while crude oil prices at Cushing have moderated below \$100 per barrel since that same time.

“Natural gas prices have almost doubled from the lows of last year, reflecting the fact that the amount of natural gas in storage has been cut by more than 17 percent,” he said.

“The spot price for oil hasn't topped \$100 in more than 14 months, but has hovered just below that point for most of the past six months. Industry reports indicate ample supply is keeping the price down,” Miller said.

Baker Hughes currently reports 173 active development wells in Oklahoma, with 155 for oil and 18 for natural gas.

The Business Conditions Index for Oklahoma in June anticipated continued economic growth with the index climbing to 59.6 from May's 55.6.

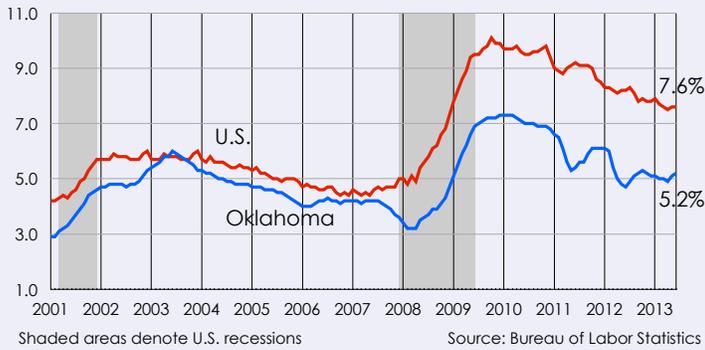




## Economic Indicators

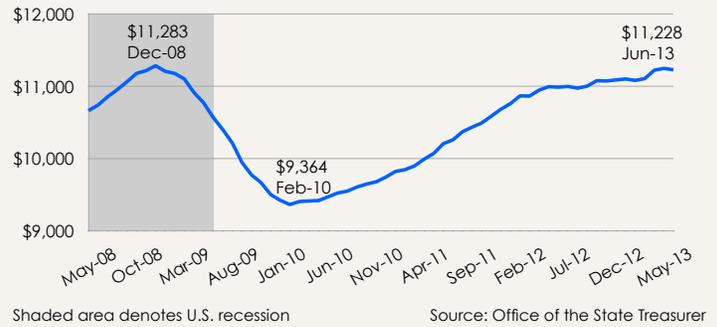
### Unemployment Rate

January 2001 – June 2013

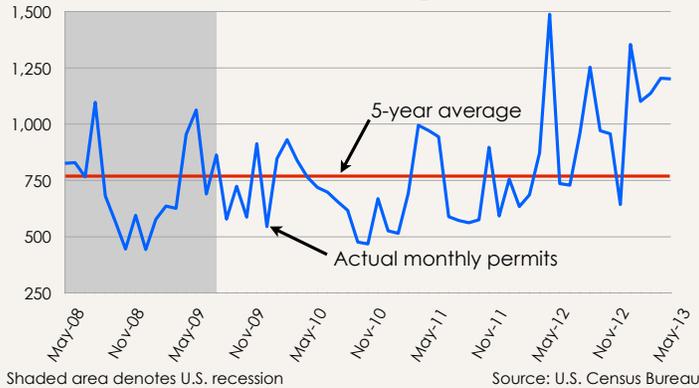


### Oklahoma 12-Month Gross Receipts

May 2008 - June 2013  
(in millions)

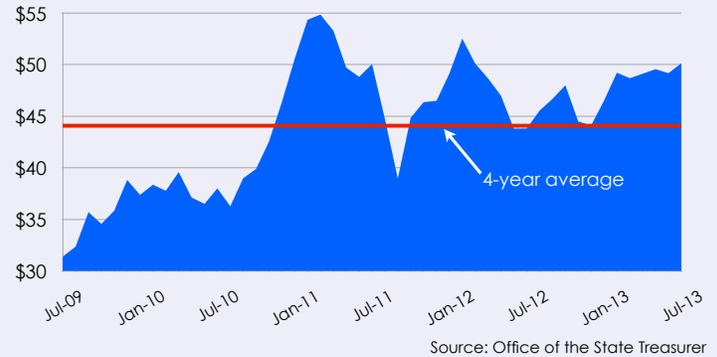


### Oklahoma Building Permits

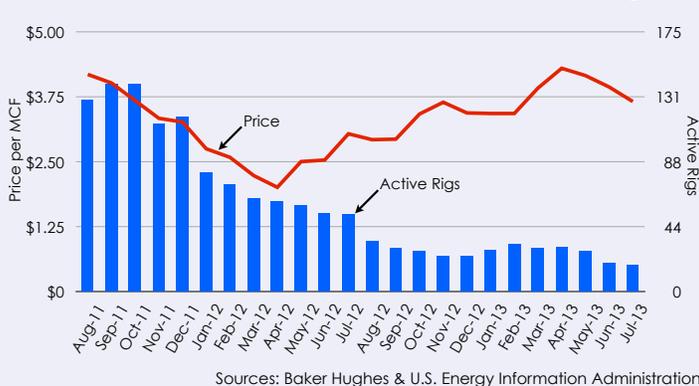


### Oklahoma Stock Index

Top 25 capitalized companies



### Oklahoma Natural Gas Prices & Active Rigs



### Oklahoma Oil Prices & Active Rigs

