FORM for PUBLIC TESTIMONY
BEFORE THE SCR103 REVENUE STUDY COMMISSION

Testimony Form to be used by any interested party testifying on their own behalf or on that of a client with respect to a specific tax expenditure.

Meeting date: Thursday, January 17, 2013

Tax expenditure: Item 7: Horizontal Wells Natural Gas Suspension

Name of witness: Jan Moller, Louisiana Budget Project

Agency, persons or organizations on whose behalf the testimony is being submitted:

* * * * * *

Please respond to the following questions using up to 4 additional pages. Where appropriate, include within each response the methodology, assumptions and data sources utilized in its confection:

1. Will your testimony before the commission be in support of continuing the tax expenditure or for changing, reducing or eliminating the tax expenditure?

2. Is there evidence of beneficial or detrimental economic or other activity specifically resulting from the tax expenditure?

3. What are the specific interests and parties which would be directly impacted by any change in this tax expenditure?

4. Do you have recommendations relative to any data, model or other form of measurement which would aid in the analysis of the efficacy of the tax expenditure?

******Please use this page as a cover page for your submission.******

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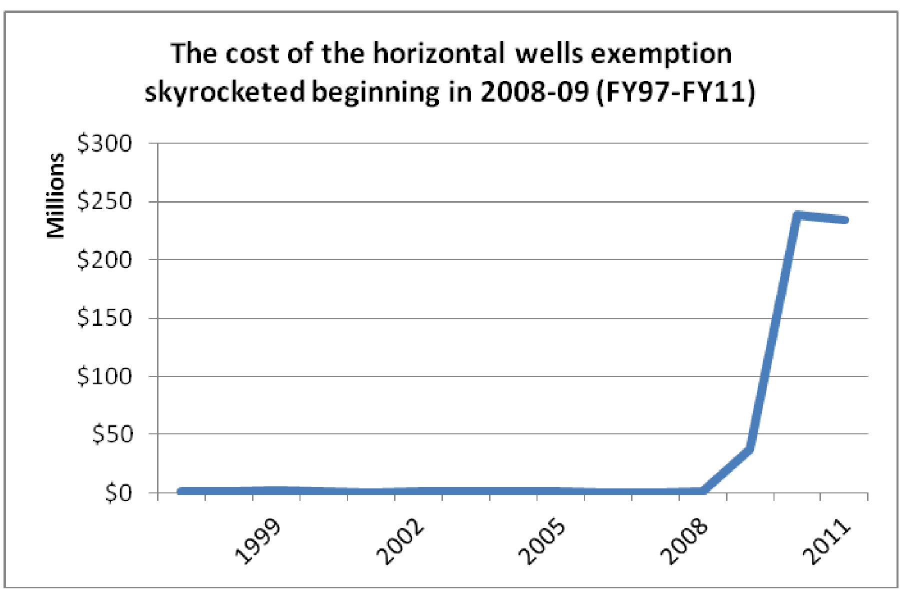
Written Testimony Regarding Horizontal Wells Natural Gas Suspension (Item No. 7)
Submitted to SCR103 Revenue Study Commission
Submitted on January 15, 2013

Dear Honorable Legislators,

The Louisiana Budget Project (LBP), a nonpartisan and nonprofit research and analysis organization, is submitting testimony regarding the state's Horizontal Wells Natural Gas Suspension severance tax exemption. Oil and gas drilling is incredibly important to Louisiana's economy, but the current horizontal wells suspension is an outdated and costly tax exemption that is not a good deal for state taxpayers and is in need of reform. The exemption is not a deciding factor in whether drilling for natural gas takes place in Louisiana, but it does cause massive revenue loss to the state and gives drillers a major windfall. In the following testimony, we identify the main problems with the current exemption and recommend a number of policy options that could protect state taxpayers while still supporting the oil and gas industry.

*Problem 1: Cost of exemption has skyrocketed*

The revenue loss due to the horizontal wells natural gas exemption was very modest over its first decade, rarely surpassing $1 million a year. Improvements in technology, the increased use of horizontal drilling and the Haynesville Shale gas boom caused the cost to spike to more than $254 million in FY11, according to the Department of Revenue. This single exemption now causes more revenue loss than all other severance tax exemptions combined. Over the five year period FY08-FY12, total revenue loss due to the horizontal wells exemption is likely to be in the neighborhood of $750 million (finalized FY12 data has not been publicly released yet).



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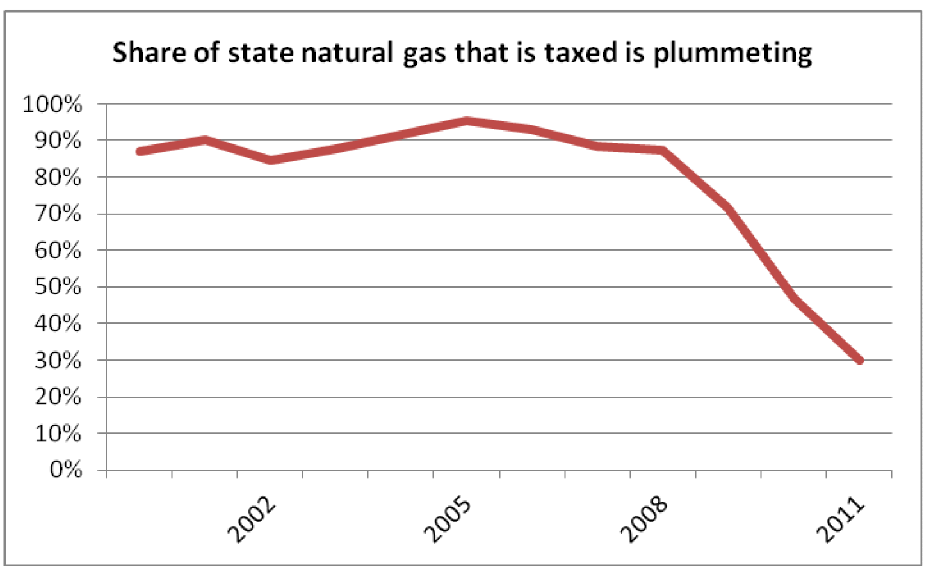
One of the factors driving such a high level of revenue loss is that the exemption is incredibly generous: suspension of severance tax owed for 24 months or until payout of well costs is reached (whichever comes first). The exemption is so lucrative because, for an average well in the Haynesville Shale, the vast majority of natural gas is extracted within the first year.

Problem 2: Exemption is outdated, purpose has been achieved

The purpose for which the exemption was created in 1994 —"to encourage the use of horizontal wells"—has been achieved, making the exemption obsolete. In its current form, the exemption is actually harmful to state taxpayers who are asked to subsidize drillers even when prices and profits are high.

When the exemption was created, natural gas production in Louisiana was declining and the drilling of horizontal wells—which employ hydraulic fracturing or "fracking" methods—was not widespread. Technological improvements and the discovery of large natural gas plays like the Haynesville Shale that could only be accessed through horizontal drilling changed the landscape dramatically. Today, horizontal wells and hydraulic fracturing are in heavy use on an industry-wide basis and statewide production is increasing.

Due solely to the exemption, this underlying shift in technology has resulted in significant revenue loss for the state. Data from the Department of Natural Resources shows that only 30 percent of the natural gas produced in Louisiana is currently taxed, down from nearly 90 percent just a few years ago. Not only is the state missing out on revenue from Haynesville Shale production, but the previous "base" of taxable gas production is eroding. As production shifted to the Haynesville Shale, where tax-exempt horizontal drilling methods are used, the amount of gas produced via other, taxable methods decreased.



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Problem 3: Exemption is unnecessary given Louisiana's competitive advantages

Louisiana has several intrinsic advantages, starting with the substantial oil and gas resources that are located here and can only be extracted here. The Haynesville Shale is the largest deposit of natural gas in the Gulf Coast region, and the second largest deposit in the country (surpassed only by the Marcellus Shale in Ohio, Pennsylvania and West Virginia). Louisiana also has an industry-friendly regulatory regime and permitting process, is located within a well-developed pipeline and transportation network that helps cut down on costs, and has an able and experienced oil and gas workforce.

Additionally, important developments in the future of natural gas are taking place right here in Louisiana—including the Sabine Pass and Sasol projects—making the state even more attractive.

Furthermore, Louisiana's severance tax rates are generally in line with neighboring states such as Texas and Arkansas, making it unlikely that drillers will "flee" Louisiana if the exemption is scaled back. Tax incentives are but one consideration in the decision to drill, and of secondary importance at best. A recent survey of drillers by Oklahoma City University cited estimated reserves, price and cost, location and technology as more important factors in the decision to drill than tax incentives, which ranked last of 10 factors. The bottom line is that most oil and gas drilling activity in Louisiana, especially during the Haynesville Shale boom years, would have likely occurred with or without the horizontal wells exemption.

A survey asked oil & gas producers to rank what most affected the decision to drill.	
1	Estimated recoverable reserves
2	Geology of area
3	Estimated cost to drill & complete well
4	Price in the futures market
5	Location of well (familiarity with area)
6	Current price
7	Accessibility (roads & pipeline)
8	Drilling rig availability
9	Location of well (other factors)
10	**State tax incentives**

The need to reform the exemption has never been greater, because the Tuscaloosa Marine Shale in central Louisiana could end up being as productive, and even more profitable, than the Haynesville Shale in the coming years. Preliminary reports are that the Tuscaloosa Marine Shale contains significant deposits of oil as well as natural gas, as opposed to the gas-heavy Haynesville area. This makes the Tuscaloosa Marine Shale a very attractive opportunity for drillers.

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The presence of large oil reserves that can only be accessed with horizontal drilling methods also highlights the need for reforming the Horizontal Wells Oil Suspension (Item No.14) that was created in 1994 alongside the natural gas suspension. Last year, the oil suspension only cost the state $1.25 million. But the Haynesville experience suggests that the cost could skyrocket once the market changes.

Reform would improve exemption, support drillers and protect taxpayers

Louisiana's severance tax is being severely undermined due to the horizontal wells exemption, with only 30 percent of all natural gas produced in Louisiana subject to severance taxes. A natural resource like natural gas can only be severed from the ground and profited from once. But a well-designed severance tax can allow the state to benefit from that one-time event by translating it into long-run investments in education, health-care and infrastructure—the building blocks of long-term prosperity. There are several ways that Louisiana can recapture some of the revenue that's being lost due to this outdated tax break:

Option #1: Eliminate the severance tax exemption on horizontal drilling. This exemption may have made sense when horizontal drilling was an experimental procedure. But drilling technology has advanced greatly since 1994, and there is no longer a rationale for granting a generous tax break based on a specific drilling method.

Barring a full elimination, there are several steps the Legislature can take to limit the cost of this exemption and ensure that all citizens are getting some benefit from this valuable natural resource:

Option #2: Limit either the value or volume of gas or oil that can be exempt for each horizontal well, or create a temporary reduced rate instead of a full suspension. A specific value or volume cap would limit the state's revenue loss exposure in an efficient and equitable way. Texas, for instance, caps its "high cost wells" exemption at 50 percent of well costs, while Arkansas sets a lower severance rate for the first 36 months of production before the full severance rate takes effect.

Option #3: Tie the exemption to a "price trigger" or implement a "sliding-scale" severance tax rate that will offer drillers support when natural gas prices drop below a level that makes it too difficult to remain profitable, but ensures that drillers pay their fair share when prices are high and production is booming. This recognizes that drilling is an expensive and risky endeavor that is highly susceptible to changes in price, but also protects state taxpayers from unnecessarily subsidizing drilling when high prices lead to record profits. Mississippi used to have a number of severance tax exemptions that allowed drillers to pay a reduced rate if certain requirements were met, with the exemption being both time-limited and contingent on the price of gas staying below a certain threshold (these exemption have since expired and natural gas from horizontal wells is currently taxed at the full statutory rate).

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Option #4: Target the exemption to incentivize new production in specific geographic areas. The Haynesville Shale is fairly well developed after years of increasing production. However, the Tuscaloosa Marine Shale is a less sure deal. Providing a limited number of exemptions to drillers in the Tuscaloosa Marine Shale area on a "first come" basis would provide a tax incentive for those who take a risk and lead the way in developing new resources. Incentivizing horizontal drilling in new areas of the state would also help spur more economic development.

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