



THE MARCELLUS SHALE FORMATION: PENNSYLVANIA LAWMAKERS FACE SEVERANCE TAX HURDLE

On November 2, 2010, Pennsylvania elected Republican State Attorney General Tom Corbett as its 46th Governor, leaving Democratic Governor Ed Rendell a lame duck in the final weeks of his term. In addition, control of the House shifted to Republicans, establishing Republicans as the majority in both the Pennsylvania House and the Senate. During his campaign, Governor-elect Corbett signed the Americans for Tax Reform pledge¹ and repeatedly stated that he would not raise any taxes if elected.

Toward the end of 2010, the General Assembly, divided by party lines in a gubernatorial election year, was embroiled in a fierce debate over whether the Commonwealth should enact a severance tax on natural gas that parallels the tax imposed by other shale-gas-producing states. In Act 46, representing

the Commonwealth's fiscal code for the year ending June 30, 2011, the Pennsylvania General Assembly set, but subsequently missed, an October 1 deadline to pass a natural gas severance tax. In the coming year, with Republicans in control of the General Assembly, it remains to be seen what, if any, compromise can be reached.

PENNSYLVANIA'S SEVERANCE TAX OUTLOOK UNDER NEWLY ELECTED REPUBLICAN LEADERSHIP

With record unemployment, a loss of public trust in state government, and major budget issues, Governor-elect Corbett assumes office on January 18, 2011 challenged to revitalize Pennsylvania's economy and reduce the size and cost of state government. Pennsylvania is facing a looming pension crisis, deficits in its Unemployment Compensation Trust Fund, declining stimulus funds, rising health care costs, and an uncompetitive business tax structure.

¹ The Americans for Tax Reform pledge, which Tom Corbett signed, states "I, Tom Corbett, pledge to the taxpayers of the state of Pennsylvania, that I will oppose and veto any and all efforts to increase taxes."

As part of his campaign platform, Governor-elect Corbett disclosed his views on a potential natural gas severance tax. Governor-elect Corbett believes that Pennsylvania's natural gas and renewable energy resources are critical to restoring a vibrant economy and sustainable job growth. He fully supports the exploration, distribution, and transmission of natural gas from the Marcellus Shale formation in an environmentally sound manner. "Tom Corbett believes that a punitive tax on the industry at this stage would reduce capital investment in the commonwealth and reduce the potential for new jobs, tax revenues and other economic benefits associated with the development of the Marcellus Shale."² While there may be room to negotiate a "nonpunitive" tax, Governor-elect Corbett is clear that any tax must not interfere with job growth related to the Marcellus Shale industry.

Based on Governor-elect Corbett's strong anti-tax statements, it remains to be seen what options are still on the table to raise state funds from the Marcellus Shale drilling activity boom. Just prior to the election, Senate Republicans outlined a severance tax proposal. With Republicans controlling both the House and the Senate when the new General Assembly reconvenes on January 4, 2011, it is possible that a tax closely mirroring this proposal could be enacted. While the proposed tax rate is substantially lower than the tax that passed the House at the end of September, it would still generate revenue to help the Commonwealth overcome its significant financial burdens.

Now that it is clear that Senate Bill 1155 will not pass the General Assembly and has no chance of clearing Governor-elect Corbett's desk, perhaps more Democrat legislators will be willing to sign on to the Senate Republican Proposal. As an added incentive, the Republican proposal includes several increased environmental and water protection measures. For

example, the proposal would expand distance and duration of rebuttable presumption in cases of contamination of drinking water to reflect the expanded ranges of unconventional drilling techniques. The proposal would also increase and clarify the permitting authority of the Department of Environmental Protection ("DEP") over wells and fracturing chemicals.

Another area of debate within the Pennsylvania legislature is the distribution of severance tax proceeds. Governor Rendell's initial proposal was to put 90 percent of the revenues into the Commonwealth's general fund. Many Democrats and Republicans alike disagree with that plan. These legislators argue that more money should go to specific environmental programs to offset the damage caused by the increased drilling and to local municipalities to cover additional expenses such as road damage and emergency response that will accompany the new industry. This distribution debate continues to be a key point of negotiation.

At least one prominent Republican Senator, Joe Scarnati, has said he would consider creating impact fees that could be assessed in place of a severance tax. As opposed to a tax, impact fees would be charged to shale drilling companies in an effort to recoup the environmental and community costs to the localities from the drilling activity. These fees would pay to mitigate environmental impacts, widen roads, boost emergency services, and monitor air and water emissions. Impact fees would have the benefit of avoiding the "tax" label, satisfying Governor-elect Corbett's pledge. In addition, the impact fees should be limited to offsetting direct costs of the drilling, thereby satisfying demands to limit the revenue from being added to the Pennsylvania general fund. However, the question remains how the troubled budget will be balanced without help from a natural gas extraction tax.

2 www.tomcorbettforgovernor.com/issues/faq/.

LOOKING AHEAD TO 2011

Governor-elect Corbett has named approximately 400 people from a wide variety of industry, environmental, community, and government groups to 17 different transition committees. While it is not yet known who will emerge from these committees as the next Secretary of the DEP or the Department of Revenue, these committees, particularly the Energy & Environment Committee, will help shape Pennsylvania's natural gas industry and revitalize its economy.

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This Commentary is part II of a series dedicated to the Pennsylvania natural gas industry. A more comprehensive Jones Day Commentary on the Pennsylvania severance tax controversy is available at www.jonesday.com/marcellus_shale_formation.

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