Before the

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House Ways and Means Committee

The Honorable Peter A. Beck
Chair

Proponent Testimony on:

House Bill 375

Presented By:

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Chairman Beck, Ranking Member Letson and members of the House Ways and Means Committee, thank you for the opportunity to offer Proponent testimony regarding House Bill 375. I am David R. Hill, President of David R. Hill, Inc., an Ohio-based exploration and production company. I also serve this year as the President of the Ohio Oil & Gas Association (OOGA), a statewide trade association representing 3,172 members who explore for, develop and produce Ohio's crude oil and natural gas resources.

Today's hearing focuses on House Bill 375, a proposal to reform Ohio's severance tax in light of recent activity to develop Ohio's resource shale play. I am here today to offer insights on specific issues that have emerged during debate on the proposed legislation

David R. Hill, Inc. is based in Byesville, Ohio. I am the second generation in my family to be involved in the exploration and development of oil and gas resources. I received a Bachelor of Science degree from Muskingum College in 1980 majoring in Geology. I have been drilling for oil and gas in Ohio for 34 years. I drilled my first well in Coshocton County at the age of 22.

I have been a member of the Ohio Oil and Gas Association and a member of the American Association of Petroleum Geologists (AAPG) for 34 years. I served several terms on the ODNR Technical Advisory Council under Governors Taft, Strickland and Kasich. I am the past Chairman of the Ohio Oil and Gas Energy Education Program (OOGEEP). I have also been recently selected to serve as the Regional Director for the Independent Petroleum Association of America (IPAA).

My company has drilled for oil and gas across the state of Ohio to reservoirs that require technically advanced exploration techniques in order to achieve commercial success and that are often located deeper than the now-famous Utica Shale formation. My company also operates oil and gas properties in multiple states. I also partner with companies who have come to Ohio bringing massive capital investment dollars and technical expertise necessary to develop the Utica Shale. So, I am an Ohio producer who is developing the Utica Shale. To those that suggest a proposed tax is levied against out-of-state producers, I say, here I stand today.

I've been reading reports that some parties are urging punitive taxation on my industry siting views that there are negative impacts that result from resource shale development in Ohio. In contrast to that, let me tell you how my colleagues and I add value to Ohio.

I invest my earnings back into the ground to develop Utica Shale resources in eastern Ohio. Together with others doing the same thing in Ohio and throughout the United States, we have created enormous benefits for American society. Because of shale development, the U.S. Department of Energy reports that, since 2010, proven reserves of American crude oil and natural gas have increased by the highest amounts ever recorded. Last year, U.S. crude production grew by greater than one million barrels of oil per day. This represents the largest production increase in the world, the largest increase in U.S. history, beating Russia and Saudi Arabia in growth. The result is that oil supplies are being freed up globally. Since the Arab Embargo days and before, every presidential administration has committed to lessening our dependence on foreign oil supplies. Renowned energy expert Dan Yergin said recently that a better-supplied world is a safer world. Today, because of industry investment and ingenuity, Americans are achieving that goal.

Because of shale development, natural gas supplies are robust leading to a 60 percent decline in the commodity price. According to research firm Mercator Energy, this supply is saving Americans $32.5 billion in heating costs. This research shows that citizens who are economically challenged (and who spend four times more of their income on heating costs when compared to others) saved $10 billion in their natural gas costs during 2012. This in comparison to the Federal Low-Income Home Energy Assistance Program (LIHEAP) assistance program that delivers $3.4 billion of assistance.

According to IHS CERA, in 2012, the energy boom supported 2.1 million jobs, added almost $75 billion in federal and state revenues, contributed $283 billion to the gross domestic product and lifted household disposable income by more than $1,200. Additionally, the competitive advantage for U.S. manufacturers from lower fuel prices will raise industrial production by 3.5 percent by the end of the decade.

In Ohio because of shale development, unemployment has significantly dropped in the five most active eastern counties. Local governments in these counties are also experiencing sales tax revenue growth from $15.5 million in 2011 to $22.9 million in 2013, an increase of nearly 50 percent.

Yet organizations such as Policy Matters Ohio (PMO) argue that somehow my industry is diminishing Ohio and should be levied retributory taxation. However, efficient and reliable supplies of energy, further augmented by being produced locally, provide the single most crucial element necessary to sustain and grow an advanced job-creating economy. What good is having the potential of native energy resources if someone doesn't first invest risk capital to explore for, find and produce those supplies?

Oil and gas producers are not diminishing Ohio; we're creating critical value. Oil and gas producers are not the one's burning the energy, consumers are. Last week, Representative Becker succinctly summarized PMO's testimony: increased taxation, increased spending and wealth redistribution. PMO offered no policy that will provide Ohio consumers more affordable or reliable energy.

Finally, PMO incorrectly stated that the H.B. 375 proposal would diminish funding to the ONDR oil and gas regulatory program. During 2010, the industry strongly supported Senate Bill 165; a proposal that, in part, doubled the severance tax in order to provide enhanced funding to the ODNR oil and gas program. However at the time, Governor Strickland could not support a tax increase. Therefore, the only way to politically achieve the enhanced funding was to instead create a fee – that acted exactly like a severance tax. Combined with fee adjustments, the result was to increase regulatory funding from $3.5 million to $7.1 million.

H.B. 375 does indeed propose to reform the severance tax model, including the elimination of the regulatory cost recovery fee, a political device of convenience no longer necessary. However, H.B. 375 dramatically increases overall severance tax receipts. If enacted there will be nearly $74 million in the first year of the tax, growing higher going forward as more wells are drilled and production increases, from which to draw funds to base regulatory funding, including more robust funding for the idle and orphan well plugging program. The suggestion that H.B. 375 will degrade funding for the oil and gas regulatory program is false, disingenuous, and unworthy of this legislature's attention. The OOGA has an extensive public policy record for supporting this vital regulatory program. Nothing has changed that.

Revenue Projection Assumptions: Since the second hearing on H.B. 375 before this committee, there have been questions raised concerning the revenue projection model contained in Dr. Ben Thomas' testimony, particularly concerning the assumption of 1,000 wells on average per year being drilled over a ten-year period.

The Utica Shale play is mirroring other significant shale plays exhibiting dramatic growth beginning with the third year after initial activity. Though the aerial extent of the Utica is less than shale plays in Pennsylvania and Texas, Ohio is poised to replicate relative growth in rig activity that would suggest that 1,000 wells drilled per year on average is conservative. When we examine other U.S. shale plays, we see that activity peaked in the Barnett Shale (3,594 wells), Eagle Ford Shale(3,288 wells and still growing) and the Marcellus Shale (1,975 wells) along this timeframe. According to those within the industry, the Utica Shale play in Ohio will reach a critical mass for exploration sometime during 2014 or 2015.

Currently, there are 44 rigs running in the Utica. Under current conditions, one rig can drill a well on average every 22 days. Based upon this assumption, 726 wells would be projected to be drilled to Ohio's Utica formation during 2014. However, one must also account for advanced technology and experience that is driving drilling efficiencies and shortening the time frame for drilling Ohio's Utica formation. As we have seen with other shale plays, the timeframe to drill a well has been dramatically reduced with technology and experience. For example, wells drilled in the Barnett or Bakken Shales now take 14 days to drill. If we assume that Utica wells were to be drilled on average every 14 days, we can project 1,146 wells to be drilled using the current rig count.

Experts following rig movements and demand are forecasting up to 53 rigs in Ohio by the fourth quarter of 2014. Most of this activity will be in the wet gas window. As technology "cracks the code" to opening up the oil window, rig count will expand. Dr. Bob Chase, head of the Marietta College School of Petroleum Engineering, recently stated at a conference that he believes that potentially 30,000 well locations exist in the delineated wet gas fairway. The assumption of 1,000 wells per year on average over ten years accounts for 33% of Dr. Chase's prediction. Internal research by oilfield supply companies, done to gauge the level of activity and thus project pipe and equipment sales, reports that 39 companies plan to drill 1,128 wells in 2015.

Finally, in an interview with Dix Communications published on January 1, 2014, James Zehringer, Director of the Ohio Department of Natural Resources pointed to "staggering" production results from new wells. He stated that the Department projects the wells to be drilled in Ohio will take a big jump in 2014, with 1,180 wells drilled. He pointed out that the activity is expected to "go through the roof". In anticipation of this activity, the ODNR has beefed up its regulatory staff.

Regarding the commodity assumption, the commodity price used for the Thomas revenue model is based on an average of $4.00 per MMBtu of natural gas. This is the price assumption used to value total well production expressed in terms of natural gas equivalents (combining the value of natural gas, crude oil and condensates into a single unit of measurement). Energy commodities are always volatile. However, a review of natural gas futures contracts traded at the New York Mercantile Exchange (NYMEX -the pricing platform for all U.S. natural gas transactions), as of January 20, 2014, shows that the average of all monthly futures contracts over ten year period is $4.36 per MMBTu, the highest monthly contract is $6.12 per MMBTu and the lowest monthly contract is $3.94 per MMBtu.

Clearly the evidence shows that the assumptions of future well activity and pricing are conservative. We believe the revenue model is the best available to provide a reasonable projection of future well growth and thus severance receipts looking forward ten years.

Gross Receipts Tax: Much has been made about the actual point of taxation. This is probably due to the unique nature of the oil and gas production business that is very different from most other commercial activity and not well understood by those outside of the energy business. The intent of H.B. 375 is to levy on a producer a gross receipts tax on the sale value of his product, be it oil, natural gas or natural gas liquids.

Think of this in terms of a generic example using natural gas. The producer can directly sell his natural gas from a well into a pipeline and receive $4.00 per MMBTu. In this transaction the producer will capture the energy heat content value of the gas in gaseous phase. But before he sells the natural gas, the producer could also capture additional value by sending his gas through a processing plant and stripping out the natural gas liquids. If he does that, he will add more value to the well's production prior to any sales transaction taking place - about $2.00 of additional value per unit produced. But, the producer will invest about $0.50 to CREATE that value before any sale takes place. Thus he can sell all of his gas for $4.00 or he can go one step further, before any sale takes place, and achieve $5.50 of value per unit eventually sold. Therefore a gross receipts tax will be imposed on the units sold multiplied by $5.50.

H.B. 375 does not allow a producer to deduct costs for drilling or equipping a well or for costs in the production of a well. Also, oil and gas produced from a well is the first point of production, nothing else precedes it.

H.B. 375 will impose a gross receipts tax on the total gross value of the proceeds received by the producer – the severer – from a buyer of the product at the point of the first sale of the product from the well.

In conclusion, as an Ohio citizen and an Ohio-based oil and gas producer, H.B. 375 if enacted will have a fundamental impact on my business going forward. It is very important to my industry that this reformed tax first and foremost provides adequate funding to Ohio's oil and gas regulatory program so that Ohio citizens have faith and trust in the regulatory process. The members of the OOGA have agreed to seek resolution for the ongoing debate on severance taxes. Our goal is to establish clarity and resolution going forward. We seek tax fairness that also encourages the widest possible opportunity to explore for this resource across the entirety of the Utica Shale Play.

I urge the Committee to favorably report H.B. 375 to the floor of the Ohio House of Representatives. Thank you Chairman Beck and members of the House Ways and Means Committee. I will now make myself available to answer any questions that the committee would have.

Respectfully submitted,

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