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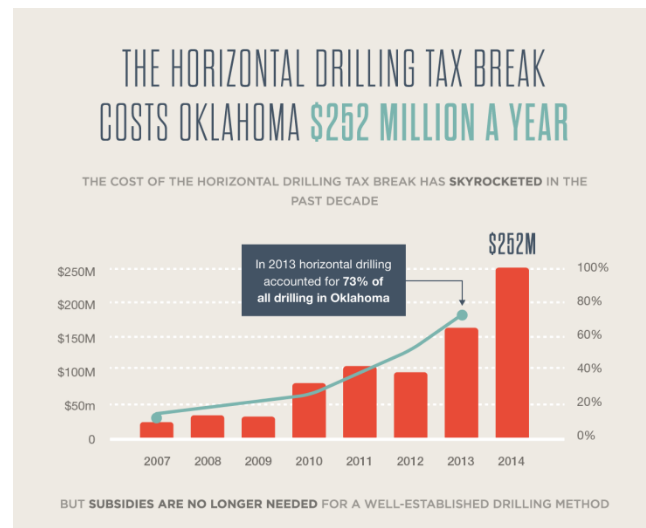
It's time to end the horizontal drilling tax break



In a year's time, a temporary tax break that reduces the tax paid on horizontal oil and gas production from 7 percent to 1 percent for 48 months is set to expire. Executives from the three largest Oklahoma-based companies that engage in horizontal drilling — Chesapeake, Devon and Continental — have threatened to cut their Oklahoma investments in half if the tax break is eliminated. Under a plan developed by the three oil giants, the gross production tax would be lowered permanently to 2 percent for all production for four years.

Here are five reasons why extending and expanding the tax break for horizontal drilling is not in Oklahoma's best interest:

1. The original reason for the tax break is no longer relevant

When the legislature first enacted a tax break for horizontal drilling two decades ago, the technology was new, experimental, and highly risky. Now horizontal drilling is standard industry practice in Oklahoma and across the nation. In 2013, 73 percent of all completed wells in Oklahoma were horizontal and over 90 percent of active oil and gas rigs are now drilling horizontally.

As Secretary of Finance Preston Doerflinger stated last summer, "Any fiscally responsible policymaker needs to seriously consider at what level government should incentivize something that is now standard practice." State Representative Pat Ownbey (R-Ardmore) echoed this sentiment: "The tax break was given over a period of time so they could experiment with horizontal drilling, and it worked. It has done a great job, but the period of experimentation is over. … The companies are coming to Oklahoma because the oil is in the ground."

2. Drilling in Oklahoma is just as profitable as in other states

A very recent argument being made by some who benefit from the tax break is that drilling in Oklahoma is more expensive or less profitable than in other states. "While we have a lot of opportunity, Oklahoma does not have the best rock. We have good rock, but not the best rock," Chesapeake CEO Doug Lawler told the Oklahoman. "The rock is not equal. Don't turn us away."

This argument is a red herring, because these same energy companies say something very different when talking to their investors. They calculate a "rate of return" for wells in different areas, which incorporates all issues of drilling cost and profitability. Continental, for example, shows expected rates of return of 74 percent in the SCOOP oil play in Southern Oklahoma, compared to 47 percent for the Bakken wells in North Dakota. Newfield shows Oklahoma wells generating rates of return over 50 percent compared to 30 – 50 percent for plays in North Dakota (Bakken and Three Forks).

In a 2013 earnings call with investors, Continental Senior Vice-President Richard E. Muncrief had this to say when asked how the economics of SCOOP in Southern Oklahoma compare to North Dakota's Bakken oilfield:

"From an economics standpoint, we think that the SCOOP economics are – range from the high 30s up to 80% type rate of return. And you compare that with the Bakken. In a lot of cases, it compares quite favorably to the Bakkens. And so we're just real excited about what we're seeing down there."

Is it credible to believe that companies would walk away from reserves worth billions and 30 to 80 percent rates of return in Oklahoma because their costs increase by the equivalent of 2 to 3 percent over the life of a well?

3. Oklahoma's gross production taxes are well below other states

A study by Headwater Economics found that Oklahoma's taxes on horizontal production of oil and gas are among the nation's lowest and would remain relatively low even after the state eliminated tax breaks for horizontal drilling. The study found that without the tax break, Oklahoma's effective gross production tax rate on oil would rank sixth among seven peer producing states and third (along with Texas) among seven natural-gas producing states.

In a 2014 study for Tax Analysts comparing state severance taxes, Jennifer Carr singled out Oklahoma for providing an overly generous subsidy. "Oklahoma's policy of exempting production from horizontal wells for up to four years goes way beyond encouraging innovation and reducing investment costs and exempts wells that oil and gas producers would drill and develop even without the exemption," she wrote. Carr concluded: "The length of Oklahoma's exemption is unjustified."

4. Tax rates have little bearing on the decision to drill

A 2009 survey of energy companies by Oklahoma City University Business professor Steven Agee found that state tax incentives have the least bearing on companies' decision to invest, falling well below price, cost, reserves, location, and other factors. As Kaiser-Francis Oil Company CFO Don Millican has said, "If the margin is so thin for the tax rate to make a difference, you're simply not going to drill that well anyway."

If state tax policy was an important factor in determining where energy companies chose to invest, we'd expect that states with the lowest tax rates would see more growth in horizontal drilling, while states with the highest tax rates would see less. Instead, data comparing state effective tax rates and growth in horizontal drilling shows that no such correlation seems to exist.

5. The excessive horizontal drilling tax break hurts Oklahoma's economy

As an increasing share of production has come from horizontal wells, the cost of the 48-month horizontal drilling tax break has skyrocketed from $4 million a decade ago to $252 million in 2014, according to Oklahoma Tax Commission projections. Even in the midst of a national drilling boom, Oklahoma is suffering budget shortfalls that are set to inflict a new round of budget cuts on services that never fully recovered from the Great Recession. Without adequate severance tax revenues, our investments in education, health care, infrastructure and other foundations of our economy will continue to lag.

The bottom line

Oklahoma companies have been drilling actively and profitably at a 7 percent tax rate for decades. If we end the subsidy, Oklahoma will remain an attractive location to drill due to our ample reserves, existing levels of production, skilled workforce, light regulations, and established infrastructure. The energy industry will continue to prosper in Oklahoma if we allow this unnecessary tax break to expire, and we can invest a fair share of that prosperity into a brighter future for our families and communities.