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Drilling down for an answer: Will lower tax rates on horizontal wells hurt or help state budget?

By: Dale Denwalt April 17, 2015 0

Horses graze near a pump jack operated by Pedestal Oil Co. Inc. at 5930 E. Coffee Creek in Edmond. (Photo by Brent Fuchs)

OKLAHOMA CITY – If House Bill 2177 is made into law this session, it will allow horizontal drillers to operate closer to existing vertically produced reservoirs.

Aside from the debate on whether the bill is unfair to mineral rights holders, there's another question: Will the state's budget win or lose?

Vertical wells in Oklahoma that are pumping out product now are taxed at 7 percent. If new horizontal wells come on-line as expected, producers will pay 2 percent on gross production for the first 36 months of operation.

Russell Evans, executive director of the Steven C. Agee Economic Research and Policy Institute at the Meinders School of Business, said it then becomes a question of whether the state wants the money now or later.

"Increases in production today that come at the expense of production in the future may be preferable for the state if they have a high discount rate," Evans said.

He said divining the best answer for state revenue would require data on existing well production, expected well life spans and the political answer for whether the state wants those dollars today.

Oklahoma Oil and Gas Association President Chad Warmington said it's hard to estimate the return on state budget dollars. Still, he said, there ought to be a boost.

"A lot of these old stripper wells are producing less than 10 barrels a day," he said. "You bring on a modern, horizontal well in one of these non-shale formations and you're looking at 700, 800, 1,000 barrels a day. The math is easy."

Horizontals are able to pull out a significantly greater amount of their product before the first three years, which is when the higher tax rate kicks in. That means that for most of the oil and gas claimed by these new wells, the state would receive 2 percent.

Mike Cantrell is an independent producer from Ada. He said that if horizontal drillers are allowed to hydraulically fracture and produce in reservoirs that are already claimed, the horizontal wells will overtake the resources in that area.

"What's a better use of the state's interest, to get that (extra) 5 percent, or get 2 percent in a hurry?" he said. "It's a finite resource. Once it's gone, it's gone."

Warmington counters that type of argument by pointing to how efficient modern wells are. A vertical, he said, could never match the amount of resources collected by a horizontal.

"That's why this bill is so good for the state, is because you're going to unlock reserves that aren't economically feasible to develop without the ability to do long, multi-unit horizontals," he said.

Still, there may not be a benefit to rushing product out of the ground, noted economist Jeremy Oller.

"The horizontal wells are very fast, and there's going to be a high depletion of the resource," said Oller, a department chair and energy economics professor at the University of Central Oklahoma. "If you have a policy like this, it almost creates a race to extract. That can create some very poor incentives, as well."

He referred to this as the tragedy of the commons, where each producer is following its own interest but could lower the value of the resource because it is in a hurry.

"They're not doing anything wrong, and they're not behaving irrationally," said Oller. "I would be nervous if I were in the industry. It may be in the firm's best interest to pull it out faster, but it might not be in the best interests of the industry as a whole."

Versions of HB 2177 have passed both the House and Senate, but the House must accept changes that were made in the Senate or send it to conference committee.

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