



# Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

## Natural gas: beneath the surface

It seems that each day brings another story of record low natural gas prices and record high supplies. A warmer-than-normal winter in the United States drove down natural gas demand this year at a time when prices usually rise and supplies are reduced.

As a result, natural gas in storage is at or near record levels while prices are at their lowest in more than a decade. The U.S. Energy Information Administration (EIA) estimated natural gas in storage at

the end of March at 2.48 trillion cubic feet, about 57 percent higher than at the same time last year.

According to Bloomberg, the average spot price in April at the Henry Hub in Louisiana was \$1.99 per thousand cubic feet (mcf) as of April 27.

### Budget concerns

In February, the State Board of Equalization certified estimated collections from the gross production tax on natural gas at \$188 million for the General Revenue Fund during Fiscal Year 2013. The estimate assumed an

average price for natural gas of \$3.64/mcf.

At that time, board members expressed concerns that the price estimate was overly optimistic, but ultimately agreed to approve the estimate as compiled by the Oklahoma Tax Commission and Office of State Finance using statutory guidelines.

Those urging passage argued the constitutionally-mandated five-percent difference between appropriations authority and anticipated revenues would provide enough flexibility to keep

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#### Contributors

Regina Birchum, Deputy Treasurer for Policy

Paul Ackerman, CPA

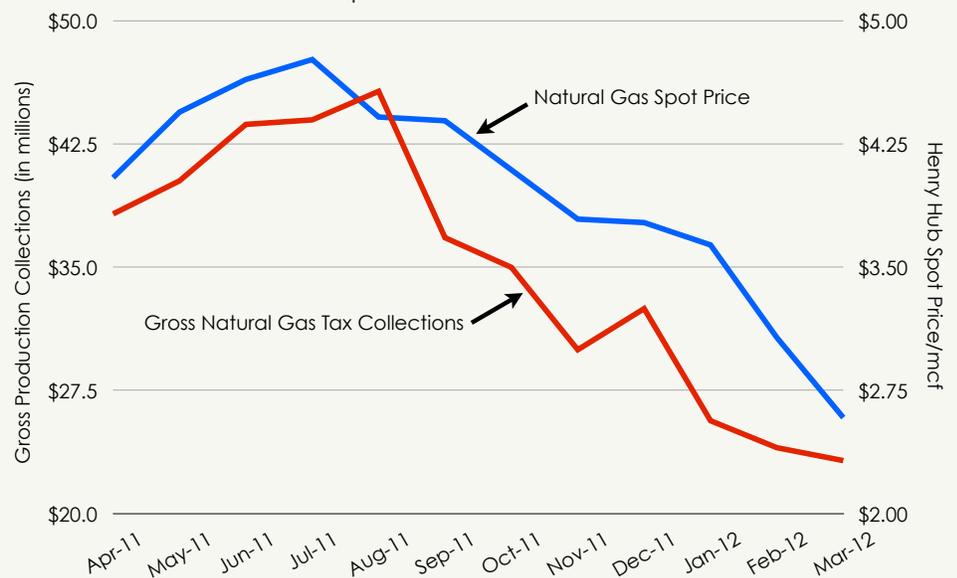
Maxim Salitra, Treasury Intern

#### Editor

Tim Allen, Deputy Treasurer for Communications

### Natural Gas Prices and Taxes

April 2011 - March 2012



Note: Spot prices are from production months, two months prior to listed date of tax remittance.

Sources: Oklahoma Tax Commission, Bloomberg



## Treasurer's Commentary By Ken Miller, Ph.D.



### Functional finance

One comment often heard in political conversations is that the state should budget like a family. Another is that government should be run like a business. Of course, families and firms are very different from each other and from governments.

Families save for golden years and firms seek profits. But, there are similarities. All try to get the most out of every dollar and each requires capital that extends beyond its current ability to pay.

Families want a home to call their own, but don't typically have the money for one without financing the investment with a mortgage. Most families work with lending institutions to qualify for loans that match their ability to pay over 15-30 years.

Corporations often finance investments from external funds obtained through two basic tools of corporate finance: debt and equity. Like families, firms use external financing for investment because internal funds are usually not available. And they typically prefer low rate debt financing to avoid share-diluting equity financing.

Of course, governments can't sell stock and rarely have internal funds to front expensive capital projects, leaving debt as the only viable option for financing capital investment. Debt is an appropriate tool for household, business and government use provided, of course, the balance sheet can support it.

Currently, there are many capital investments projects under consideration by the Legislature. With the budget discussions underway, there are several points to keep in mind.

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**“Debt in moderation is not inherently bad, as those with a mortgage or trying to grow a business can attest.”**

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The state of Oklahoma does not have the massive debt problem present at the federal level because it does not use debt for current expenditures. At 38<sup>th</sup>, Oklahoma ranks among the states with the lowest net tax-supported debt with a debt-to-GDP ratio below 1.5%.

The state continues rapid repayment of its outstanding tax-backed obligations

and is on track to repay 61.3 percent of principle in 10 years, 93.4 percent in 20 years and 100 percent in 30 years while maintaining flexibility in structuring debt to provide for level annual debt service requirements.

However, not all debt metrics are positive. Public pension obligations represent a form of debt even though these bills don't carry specific payment dates for interest and principal, like bonds. Combining unfunded pension obligations with net tax-supported indebtedness increases Oklahoma's debt burden, but provides a more complete picture of total long-term obligations and the revenues required to service them.

This notwithstanding, Oklahoma can operate like families and businesses by judiciously financing escalating capital needs that will benefit taxpayers long after the note is retired. Oklahoma's balance sheet is in relatively good shape and

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## Commentary

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getting better thanks to quick repayment schedules and recent pension reforms. Even greater improvement in the balance sheet

would come by selling unnecessary state assets and dedicating a portion of surplus revenues to retiring long-term obligations.

Debt in moderation is not inherently

bad, as those with a mortgage or trying to grow a business can attest. With a strong state credit rating, historic low interest rates and pressing infrastructure needs, there is no time like the present.

## Debt reduction plan

A legislative proposal to commit excess funds to reducing the state’s debt obligations is moving forward. Senate Bill 1264 would create the “Oklahoma Debt Reduction Fund,” which would receive 30 percent of surplus funds that exceed the limit for the immediately preceding fiscal year, after the state’s

Rainy Day Fund has reached its maximum balance.

The fund would be used to reduce the unfunded liability of any one or combination of state pension systems with funded ratios of less than 80 percent. Once each pension system

reaches the minimum funded status, the excess funds would be used to reduce the state’s bonded indebtedness.

The bill has been approved by the Senate and the House on Third Reading, and is pending final approval from both chambers.

## Natural gas

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the budget in the black next fiscal year.

The five-percent cushion amounts to approximately \$250 million.

### Tax rates and timing

For most natural gas wells, the gross production tax rate is seven percent. However, if the average price for a month drops below \$2.10/mcf, the tax rate is cut to four percent. If the average price falls below \$1.75/mcf, the rate is set at one percent.

The rate, however, is set month-by-month and gauging the potential fiscal impact requires an understanding of the difference between timing of production and tax remittance to the state.

Remittance of gross production taxes is made two months after the production occurs, which means, for example, that

May collections will reflect production and prices from March.

Spot prices from the Henry Hub are used as a general benchmark of natural gas prices, but don’t necessarily equal prices paid for Oklahoma-produced natural gas due to a number of factors including contracted rates.

to the lower rate of four percent would be pulled. Assessment of that lower rate would then be made on production during the next month, June, with remittance made in August. The lower rate would remain in effect until reports reflect an average monthly price at or above \$2.10/mcf.

Due to the timing of gross production tax reporting, there would be a three-month lag between reports triggering the lower rate and remittances at that reduced percentage.

### Ball-parking the impact

Arriving at an exact number of what the impact of low natural gas prices will be on the state budget is nearly impossible. A total of 85.72 percent of collections from regular production wells, taxed at seven percent, is collected by the state with the remainder passed down to counties and schools.

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**“... a budgetary impact is possible if prices don’t rebound.”**

However, should the average price paid for Oklahoma-produced natural gas match or come close to the March average price of \$2.06/mcf at the Henry Hub, the state would see those reports and remittances in May and the trigger



## Oklahoma jobless rate drops

Oklahoma's unemployment rate dropped to 5.4 percent in March according to preliminary figures released April 20 by the Federal Bureau of Labor Statistics.

March's rate is 0.5 percentage point less than the rate of 5.9 percent in March 2011.

The figures show Oklahoma total

employment is 21,460 higher than in March of last year.

The number of unemployed was set at 96,750 in March, down by 8,010 from the same month last year.

## Natural gas

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Three-fourths of collections from deep gas wells, taxed at four percent, flow to the state. The one percent collected on horizontal wells provides no funding for the state. Also, revenue estimates are based in part on production volumes, which vary greatly as prices rise and fall.

A glimpse, however, at potential bad to worst-case scenarios shows a budgetary impact is possible if prices don't rebound.

Should natural gas prices during FY-13 be one dollar lower than the estimated rate of \$3.64/mcf, the loss to the state budget would be approximately \$70 million. If prices for the entire fiscal year averaged \$2.00/mcf, when the top tax rate would be four percent, the negative impact to the budget would be approximately \$175 million.

In the worst-case scenario, with prices below \$1.75/mcf at a tax rate of one percent for a full fiscal year, the state would be required to pay back to the natural gas industry more than is collected to account for payments due from deferred tax credits.

### Spillover effects

Natural gas production doesn't just provide direct gross production revenue

to the state. It provides thousands of jobs and hundreds of millions of dollars of economic activity as well.

Should prices stay in the cellar for an extended time, it could also mean the loss of jobs and economic activity. As a result, income tax collections (personal and corporate) could be impacted, along with consumption taxes such as sales and motor vehicles.

### Oil offset

Higher than estimated crude oil prices could make up for some anticipated losses from low natural gas prices. A quick analysis shows it could make a difference.

The FY-13 revenue estimate anticipates an average price of crude oil at \$96.92 per barrel with contributions to the General Revenue Fund of \$188.6 million.

However, should prices average \$10 more per barrel than the estimate (\$106.92/bbl) during the coming fiscal year, ballpark calculations show it would add approximately \$40 million to the General Revenue Fund.

In April, the spot price at Cushing for West Texas Intermediate crude oil averaged \$103.27/bbl.

In brief, it appears that higher crude oil prices could offset some but not all of the losses experienced by low

natural gas prices, but by exactly how much depends on too many variables to calculate with any degree of certainty.

### Guessing the future

The EIA issues a monthly *Short-Term Energy and Summer Fuels Outlook* in which it forecasts, among other things, the price of oil and natural gas.

In its March *Outlook*, the EIA estimated the average natural gas price for 2012 at \$3.27/mcf and the price for 2013 at \$4.08/mcf. The April report, however, lowered those expectations with the 2012 price forecast at 21 percent less, \$2.59/mcf, and the 2013 price reduced by 14 percent at \$3.50/mcf. The EIA estimates crude oil at \$106/bbl this year and next.

The EIA uses a calendar year for its estimates, while the state's fiscal year includes the last six months of one calendar year and the first half of the next.

Because the energy industry is one of the bigger drivers of Oklahoma's economy, many are hoping the EIA estimates are accurate. If so, it means Oklahoma will avoid facing the worst-case scenario. But even so, it appears unlikely the state will realize the gross production collections originally estimated in February and questions linger of what the impact will be overall to the state economy, related jobs and total tax collections.



## Oklahoma tobacco settlement funds distributed

Oklahoma received its annual settlement payment from the tobacco industry in April with \$77.4 million transferred to the state in two payments on April 16 and April 18.

As mandated by the state constitution, 75 percent, or \$58.1 million, of the payment was placed into the Oklahoma Tobacco Settlement Endowment Trust Fund.

The remaining funds were split between the Attorney General’s Evidence Fund and another fund that has historically been used by the Legislature to supplement appropriations to the Health Care Authority. The evidence fund received \$14.5 million, or 18.75 percent, and the other fund was left \$4.8 million, or 6.25 percent.

The deposit reflects a 478 percent increase from the prior year in tobacco funds transferred to the Attorney General’s evidence fund.

The increase was made possible due to legislation enacted at the request of the Office of the Attorney General, which abolished a cap on deposits to the fund.

The Attorney General’s evidence fund is used to pay litigation-related expenses to defend the state in all litigation matters for more than 300 state agencies including deposition costs, expert witnesses, discovery costs and attorney salaries.

These funds are also used for expenses related to arbitration of the Master Settlement Agreement to defend Oklahoma’s portion of the annual payment to the states from the tobacco industry.

The balance in the evidence fund is

subject to re-appropriation by the Legislature, should it see fit.

Prior to this year, tobacco settlement funds available to the Legislature for health care appropriations ranged from \$13.1 million to \$37.1 million annually.

The amount in the fund for health care appropriation this year is 71 percent less than the prior year.

Previously, the evidence fund received annual deposits from the tobacco settlement ranging from \$900,000 to \$2.9 million.

Without the cap, the attorney general’s office explains, the fund is allowed to receive up to 25 percent of all

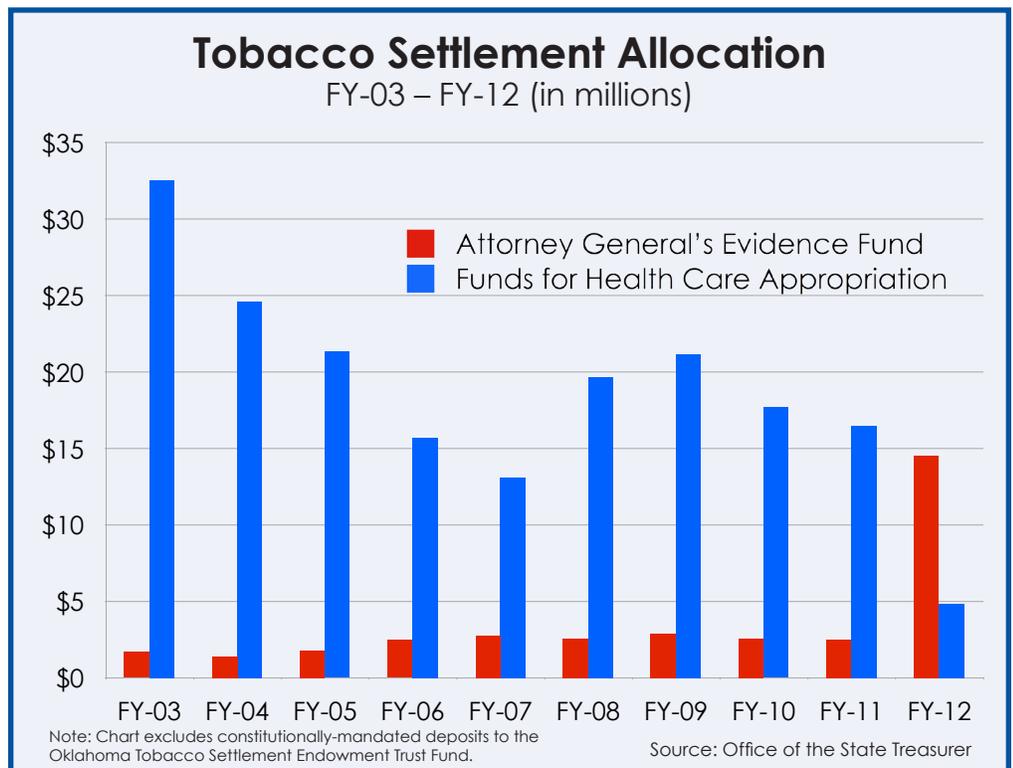
settlements, with the exception of tobacco settlement money. In that case, the fund is allowed to receive a maximum of 18.75 percent.

The national Master Settlement Agreement was announced in November 1998. It imposed sweeping changes in tobacco advertising, banned tobacco companies from targeting children, allocated funding for tobacco education efforts and provided

annual payments based on the number of cigarettes sold in the country.

Payments received by Oklahoma so far top \$978 million and will continue so long as cigarettes are sold.

**“Payments received since 2000 total almost \$1 billion.”**





## March by the numbers: Gross receipts vs. General Revenue Fund

A comparison of the Treasurer's April 3 Gross Revenue Report and State Finance's April 10 General Revenue Fund (GRF) report illustrates fundamental differences.

March gross receipts totaled \$920.6 million, while the GRF received \$434.5 million or 47% of the total. Last month, the GRF received 35% of the gross.

The GRF received between 35% and 58% of monthly gross receipts during the past 12 months, highlighting the value of using total collections rather than the GRF subset to gauge state economic performance.

From gross receipts in March, the GRF received:

- Personal income tax: 45.1%
- Corporate income tax: 70.7%
- Sales tax: 45.3%
- Gross production-Gas: 76%
- Gross production-Oil: 0%
- Motor vehicle tax: 31.6%
- Other sources: 59.8%

GRF collections for the month were below the official estimate by \$6.4 million or 1.5 percent.

Insurance premium taxes totaled \$20 million in March.

Tribal gaming fees generated \$10.6 million during the month.

Gross production has fourth month of reduction

## Two-year revenue growth streak ends as collections fall

Oklahoma's two-year revenue growth streak has come to an end as total revenue collections in March fell slightly lower than collections from the same month last year, State Treasurer Ken Miller said as he released the March gross receipts report.

Total collections for the month were \$920.6 million, down by about \$2.6 million or 0.3 percent from March of last year. Miller said the biggest drop among the major sources of revenue came from the gross production tax, which fell by more than one-third.

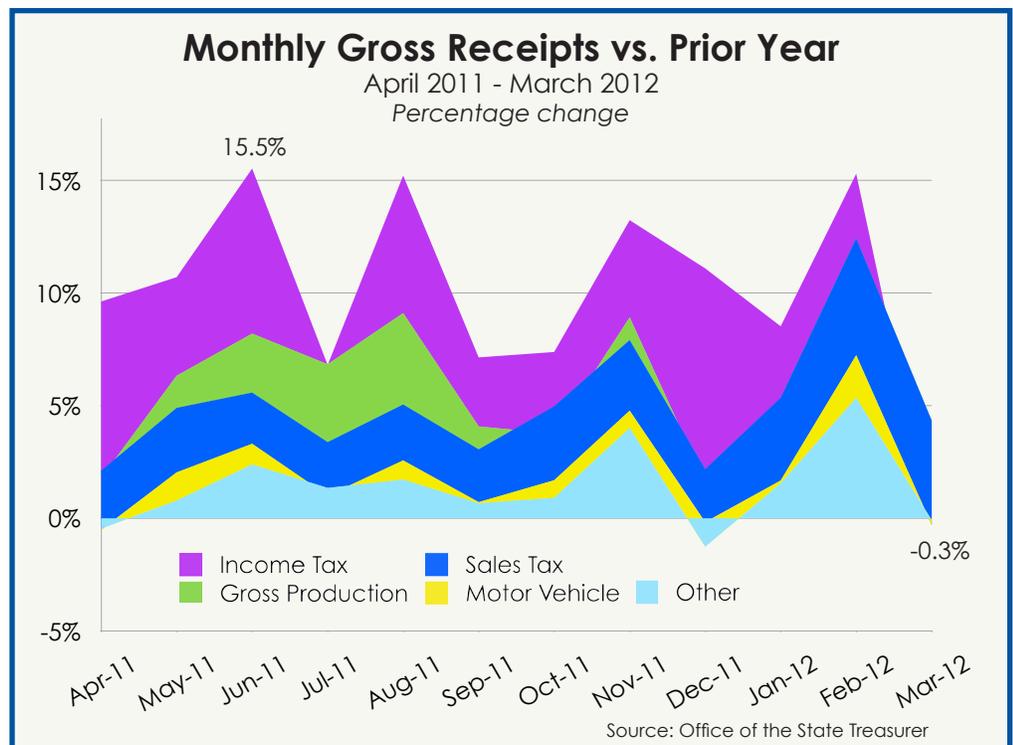
Income tax collections were lower for the first time in eight months with negative corporate income tax

collections weighing down the slightly positive personal income tax receipts.

**“We should expect a period of shrinking natural gas tax collections until prices rebound.”**

Sales tax receipts are the only major revenue source that outperformed the previous year with collections surging 15 percent compared to March 2011.

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## Revenue

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### Watching the energy sector

“In the coming months, we will closely watch the energy sector as it is a leading sector of Oklahoma’s economy,” Miller said.

Gross production collections were down in March for a fourth consecutive month, reflecting the impact of low natural gas prices.

On Monday, April 2, the spot price of natural gas closed at its lowest point for the year, below \$1.90 per thousand cubic feet (mcf), at the Henry Hub in Louisiana, the benchmark for natural gas prices.

“While one month does not a trend make in overall revenue collections, four continuous months of decreasing gross production collections is getting trendy,” Miller said.

“And due to the timing of gross production collections, March receipts reflect market activity from January. We should expect a period of shrinking natural gas tax collections until prices rebound, especially if the price triggers a lower extraction tax rate.”

Miller said state financial authorities will keep a close eye on natural gas prices.

“Next year’s official revenue estimate reflects natural gas at \$3.64 per mcf,” he said. “In addition, state law mandates

the currently assessed tax rate of seven percent be lowered to four percent if the average monthly price falls below \$2.10 per mcf.”

Miller said the energy sector, which helped bolster Oklahoma’s recovery from the national recession, is tied to approximately one-third of the state’s economic activity.

“Undoubtedly, the strong price of crude oil is helping to compensate for the downturn in natural gas prices,” he said.

In March, approximately 34 percent of gross production revenue was generated by natural gas. This follows a trend of the past several months. In October, it was 51 percent. In February, it was 35 percent.

## Year-to-date collections top estimate

Allocations to the General Revenue Fund (GRF) through the third quarter of Fiscal Year 2012 are higher than the estimate, according to the Office of State Finance.

GRF allocations for the July-March period total \$3.941 billion, which is \$340.7 million or 9.5 percent higher than the estimate.

Net income taxes top the estimate by \$281.9 million or 21.6 percent.

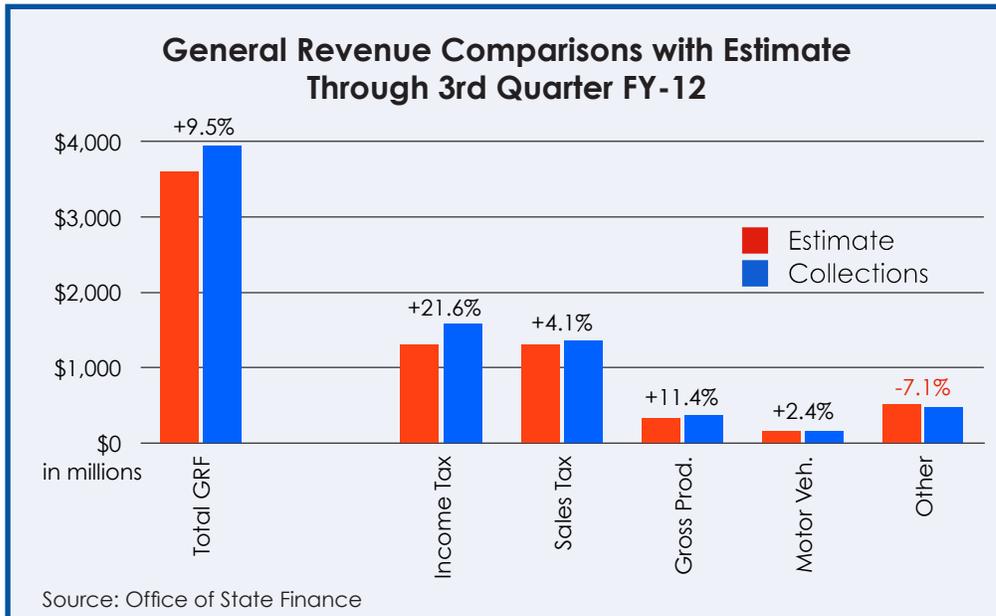
Sales taxes exceed the estimate by \$53.1 million or 4.1 percent.

The gross production tax is \$38 million or 11.4 percent above the estimate.

Motor vehicle taxes top the estimate by \$3.8 million or 2.4 percent.

Other sources are \$36 million or 7.1 percent less than the estimate.

Starting with March allocations, collections from the gross production tax on crude oil are not included. A total of \$92.6 million is set to be reassigned during the remainder of the fiscal year to education, public safety, the medical examiner and the state emergency fund. In March a total of \$33.97 million was reallocated from gross production oil collections.





## Economic Indicators

