



Oklahoma Economic Report™

News and analysis of Oklahoma's economy

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

Running on energy

In 1953, General Motors President Charles Watson declared before Congress at a hearing assessing his qualifications to become Secretary of Defense, “What was good for the country was good for General Motors and vice versa.” In the decades following, Watson’s legendary quote has taken on a life of its own, and has since morphed into a succinct declarative: As General Motors goes, so goes the nation.

In Oklahoma, a similar mutually-beneficial relationship exists between the state and the energy sector. This relationship remains the backbone of Oklahoma’s economy, even as the state

has grown its non-energy sectors. The recent announcement made by Google to expand its data center in Pryor provides an example of how the state has continued to diversify its economy. Even as the state welcomes and courts new industry, the declarative, though revised, holds true: As energy goes, so goes Oklahoma.

Oklahoma entrepreneurs have driven the expansion of Oklahoma’s energy sector the past two decades, making conscientious decisions to establish, build, grow and sustain their companies in Oklahoma. When speaking of Oklahoma’s economic vitality, the

importance of independent energy giants such as Devon, Chesapeake, Continental, SandRidge, Williams, Chaparral and many smaller exploration and production companies cannot be overstated. Their contribution to the state has been substantial.

A study commissioned by the Oklahoma Energy Resources Board finds the oil and natural gas industry is responsible for \$52 billion, or about one-third, of Oklahoma’s gross state product. In the past two years, the industry has added nearly 12,000 jobs, including almost 4,000 jobs to the self-employed.

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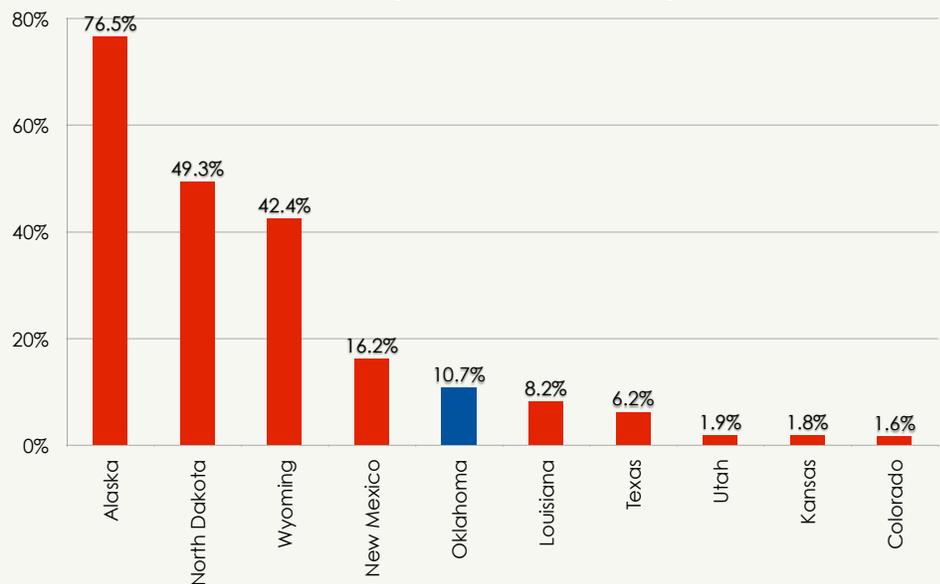
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Oil and Gas Severance Taxes as Percentage of State Budgets



Source: US Census Bureau, State Government Tax Collections 2011



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



Tax reform revisited

Oklahoma is doing more than fine with unemployment three percentage points below the national average, the third best job creation rate, and fourth highest growth in per capita income. Even so, we could better encourage entrepreneurial activity, productivity and growth by reforming our entire tax code. Unfortunately, some are singularly focused on the personal income tax.

A May 15 Wall Street Journal editorial lamented the Oklahoma Legislature's recent failure to eliminate the state income tax, asking: "Do

Republicans stand for economic growth and tax reform or not?" Tax reform should not be confused with simply eliminating the state's largest revenue source on a wing and a prayer. Tax cut promises are easy to make when necessary cuts in spending and tax incentives are ignored. Financing tax cuts with assumed future growth revenue works well at the margins, not as

well with incremental changes around the median, and not at all if current rates lie outside the prohibitive range, as demonstrated by the Laffer curve.

In a May 29 WSJ opinion piece, editorial writer Stephen Moore surmised that Oklahoma conservatives are angry about the missed opportunity based on comments from an employee of the think tank that hired his and Art Laffer's firm to develop the income

tax elimination plan. Moore unfairly lays much of the blame at the feet of Senate President Pro Tem Brian Bingman. Rather than cave to special interests, as Moore suggests, it is Bingman who demanded the tax cut be paid for with incentive cuts and

wisely rejected the use of triggers, which are more about politics than sound economic policy.

One editorial pointed to Texas' lack of an income tax as proof that Oklahoma shouldn't have one either. It stated that Texas pays its bills with a sales tax, but ignored its property tax burden is about three times higher than in Oklahoma. Interestingly, Oklahoma has had positive

“Most of Oklahoma's main revenue sources can be lower and fairer if made broader and flatter.”

in-migration from Texas for three years running and a per capita income growth rate that has outpaced most no-income tax states during the last decade.

Moore and Laffer often contend that America's nine no-income tax states maintain superior economic performance, yet their book, *Rich States/Poor States*, shows the state with the highest marginal personal income tax rate, New York, outperformed two no-income tax states in gross state product growth over the last 10 years. They awarded Utah, also an income tax state, the best economic outlook for the fifth consecutive year. Their rankings suggest recognition there is not a one-size-fits-all approach to tax policy due to the economic and cultural differences that exist throughout states and nations.

It is this conservative economist's contention that the ideal tax structure would generate a stable and

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Commentary

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diversified revenue stream that sufficiently funds core services while retaining the profit motive that drives entrepreneurship. It would not unfairly burden property owners, discourage consumption or reward idleness.

Surely, one can be fiscally conservative and favor a diverse revenue structure that includes a low and flat tax on income – even Laffer, the father of supply-side economics, advocates for such on the federal level.

Rather than lament the missed opportunity and play the blame game, policymakers can carry forward the

recent momentum to design a tax code that is best for our state. Most of Oklahoma’s main revenue sources can be lower and fairer if made broader and flatter. Focusing on the state personal income tax at the exclusion of government spending, inefficient incentives and all other revenue sources falls woefully short of real tax reform.

Energy

FROM PAGE 1

The flurry of investment in America’s oil and natural gas industry during the past three years has persevered despite depressed natural gas prices. The historic decline in natural gas prices can be attributed to technological advances in drilling techniques that unlocked an abundant supply of natural gas in the United States. This trove has been described by political and energy officials as an “ocean” –the vastness of which includes the future opportunity of the resource.

“Our best opportunity to address the economic and environmental challenges we have faced for more than five decades is to use more American-produced gas and oil harvested from shale formations across the country,” State Treasurer Ken Miller said. “As we have seen in Oklahoma, a robust energy sector can be a major driver in creating quality jobs and substantial revenues.”

Lower prices have made natural gas more economically viable and sparked industrial resurgence in America. Oklahoma-based M-D Building Products manufactures a series of products used in weatherization and has taken advantage of the low costs in its production processes. The same

benefits are being realized by fertilizer, steel, chemical and electricity generating companies across the nation.

In April, The Wall Street Journal carried a comment from Chesapeake Energy Chairman and CEO Aubrey McClendon, summarizing how American-produced natural gas served as the catalyst for another industrial revolution.

“Natural gas,” McClendon said, “is a feedstock in basically every industrial process, and the price of gas in the U.S. is a fraction of what it is in Europe or Asia. This country has an incredible

advantage headed its way as Asian labor costs rise, as the cost to transport goods from Asia to the U.S. rises, as oil prices rise, as American labor costs have stagnated or gone down in the last 10 years.”

In the past five years, energy companies have discovered vast natural gas reserves in shale reservoirs deep beneath American soil. Estimates put these reserves at more than two quadrillion cubic feet of natural gas, which more than doubles previous

estimates of America’s natural gas reserves and provides an almost 200-year supply of this clean, affordable energy source. U.S. natural gas reserves hold more energy than Saudi Arabia’s approximately 264 billion barrels of oil reserves.

The enviable position the U.S. has secured as the world leader in shale gas exploration and development

occurred because of old-fashioned American ingenuity. The marriage of advanced horizontal drilling technology with high-volume, multi-stage hydraulic fracture stimulation technologies - an

**“This renaissance is capable of restoring American energy independence.”
– Harold Hamm**

innovative improvement to a process used for more than 60 years - cracked the code for economically developing large-scale onshore shale plays in the early nineties.

Devon Energy Corporation CEO Larry Nichols praised the innovation. “We’re in the midst of going through a revolution that’s going to change things dramatically in terms of power generation in this country,” he told

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Energy

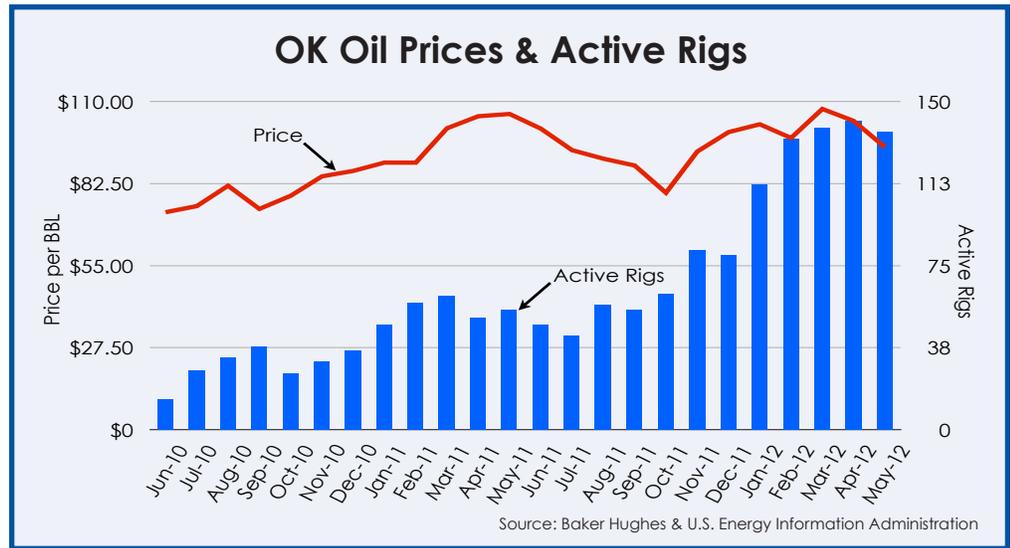
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members of the Legislature.

Moreover, as natural gas prices drop to levels below the marginal cost of production, making drilling sub-economic, independent operators and producers are shifting toward finding and extracting liquids to take advantage of the huge disparity in the global price of oil versus dry gas. This is good news for Oklahoma, as for three years running, drilling activity has continued to increase in the promising Mississippian Play in north central Oklahoma.

The increase in the exploration and production of shale oil in Oklahoma is softening the impact of lower natural gas prices on the state. It's very possible that America could see a proliferation of shale oil production in the next several years that would greatly decrease oil imports from the OPEC cartel.

Natural gas and oil shales represent a modern, advanced technological breakthrough of global proportions. If

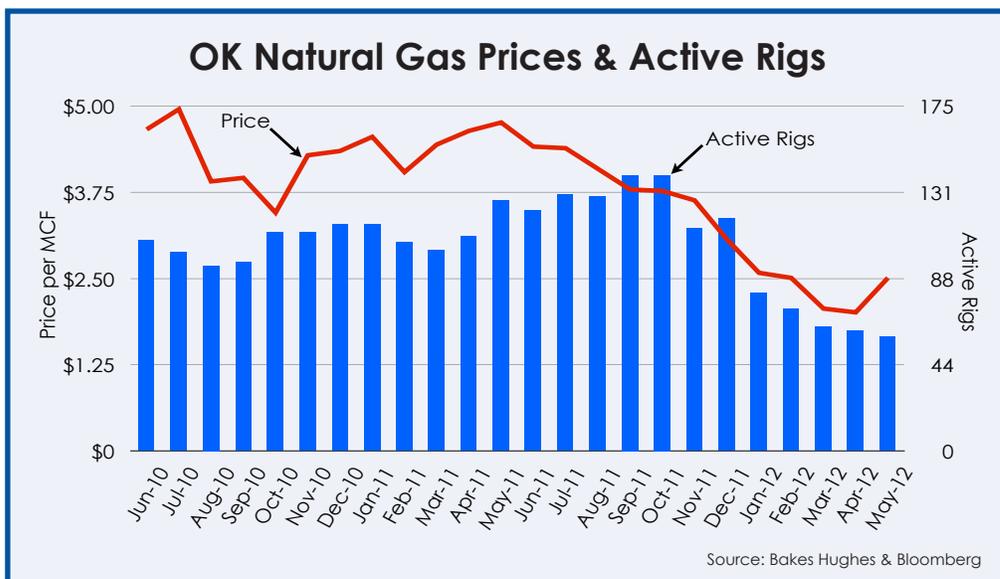


America is awash with shale gas and shale oil, you can bet there are other places around the world also sitting atop substantial reservoirs and reserves. There is good reason to believe that the global exploration of shale gas and oil could lead to greater economic and security stability worldwide. Oklahoma's innovative independent energy companies stand to play a role as they continue refining the technologies connected with horizontal drilling and hydraulic fracturing to ensure the safe and efficient extraction of oil and gas.

Without a doubt, domestically produced natural gas has enormous potential to displace foreign oil and grow the economy of Oklahoma and America. Moreover, the prospects of developing more oil from American shale and reducing our dependence on imported OPEC oil become clearer every day.

As CEO of Oklahoma-based Continental Resources, one of the more active explorers and producers of oil, Harold Hamm sees firsthand the potential. "If you are opposed to the continued use of fossil fuels in the world, then you are not in the position to embrace the modern-day renaissance of oil and natural gas in America. This renaissance is capable of restoring American energy independence. The challenge is huge, but achievable."

Oil will remain critical to America, but the future of natural gas is bright. Thanks to game-changing innovations, energy independence is no longer an empty slogan, but a tangible, achievable reality. As energy takes center stage, Oklahoma's importance as an exporter of oil and gas continues to rise nationally and globally.





10 things you should know about the Keystone XL Pipeline

By Brydon Ross, CSG Director of Energy & Environmental Policy

1. Jobs. While opponents and supporters hotly debate total job numbers, an independent study conducted on behalf of project owner TransCanada estimated that Keystone XL would create 20,000 direct jobs and, potentially, 120,000 indirect jobs. The State Department has estimated that approximately 5,000 construction jobs would be created over a two-year period to construct the pipeline.

2. Bottlenecks. The 1,700-mile project is designed to bring 830,000 barrels per day of Canadian heavy crude oil to Gulf Coast refineries and alleviate the glut of crude oil supplies at Cushing, Okla., the storage hub, origination and terminus of our nation's oil pipeline network. Historically, the oil pipeline network is designed to run from Gulf Coast refineries in the South to Northern markets. Declining imports of heavy crude oil from Venezuela and Mexico, and a lack of pipeline capacity, have created bottlenecks at Cushing that have ripple effects across energy markets.

3. Siting. Before the permit debate, few knew the State Department was in charge of the siting process for oil pipelines crossing international borders. A 2004 executive order directs the State Department to review all permit applications for oil pipelines and consult with at least eight federal agencies to determine if a project is in the national interest. Typically, interstate oil pipeline projects are sited on an ad hoc basis in each state.

4. Production. The Keystone XL pipeline is expected to transport 100,000 barrels of crude oil from Montana and North Dakota each day.

5. Previous Approval. The Obama administration approved two oil sands pipeline projects before the Keystone XL decision. Alberta Clipper was approved in 27 months in 2009 and the first phase of the Keystone pipeline was approved in 23 months in 2010.

6. Oil Imports. Canada is the largest supplier of imported oil to U.S. markets, providing 25 percent of the nation's overall imports. According to a study commissioned for the U.S. Department of Energy, the Keystone project could reduce imports from the Middle East and Venezuela by 40 percent.

7. Oil Sands. The Canadian oil sands, from which the pipeline would originate, are a mixture of sands, clay, water and bitumen, which is heavy, thick oil that must be heated or diluted before pumping it into a pipeline. Oil sands are recovered in two ways: surface mining or in situ—Latin for “in place”—drilling that injects heat into the formation and sends the bitumen into wells. Canada has 174 billion barrels in total reserves, second only to Saudi Arabia, and 97 percent of those reserves are oil sands.

8. Greenhouse Gas Emissions. Environmental advocates are strongly opposed to oil sands development because of the large amount of energy used during the extraction process that increases greenhouse gas emissions. Last summer, Environment Canada—the nation's environmental regulator—estimated that greenhouse gas emissions from oil sands operations would triple from 33 million tons in 2005 to 101 million tons by 2020. Oil sands production now makes up about 6.5 percent of Canada's overall greenhouse gas emissions.

9. The Sandhills. This fragile area in Nebraska has an important groundwater resource, the Ogallala Aquifer, which stretches across eight states and where the original route of the Keystone project was planned. Objections by many elected leaders in Nebraska to the proposed route formed the basis of state legislative action to direct the company to reroute the project.

10. Status. The Obama administration originally delayed a final decision on the Keystone project until the first quarter of 2013 based largely on objections raised by Nebraska. This came after more than 40 months of review. Congress included a provision in the payroll tax extension in December 2011 to force a decision on the presidential permit within 60 days. The administration rejected the application due to the short review period. TransCanada resubmitted its application for the project with the State Department for the segment crossing the international border, but the company recently announced its intention to construct a 435-mile leg that will run from Cushing, Okla., to the Gulf Coast, which needs no federal permit. The company expects the entire project to be completed by 2015.

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April numbers: Gross receipts vs. General Revenue Fund

A comparison of the Treasurer's May 2 Gross Revenue Report and State Finance's May 15 General Revenue Fund (GRF) report illustrates fundamental differences.

April gross receipts totaled \$1.2 billion, while the GRF received \$611 million or 52.8% of the total. Last month, the GRF received 47.2% 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 April, the GRF received:

- Personal income tax: 61.9%
- Corporate income tax: 71.6%
- Sales tax: 45.7%
- Gross production-Gas: 75%
- Gross production-Oil: 0%
- Motor vehicle tax: 34.2%
- Other sources: 48.7%

GRF collections for the month exceeded the official estimate by \$12.9 million or 2.2 percent.

Insurance premium taxes totaled \$37.7 million in April.

Tribal gaming fees generated \$11 million during the month.

Revenue collections resume rise in spite of gross production decline

Oklahoma's total revenue collections resumed their upward trajectory in April after slipping slightly in March, while gross production taxes continued to shrink, State Treasurer Ken Miller said as he released the monthly gross receipts report.

"Oklahoma's economy is reflecting health and resilience in spite of the low price environment for natural gas," Miller said.

Total collections for the month were \$1.16 billion, up by almost \$83 million or 7.7 percent from April of last year. Miller said all major sources of revenue saw growth over the prior year except for gross production, which fell by more than 20 percent.

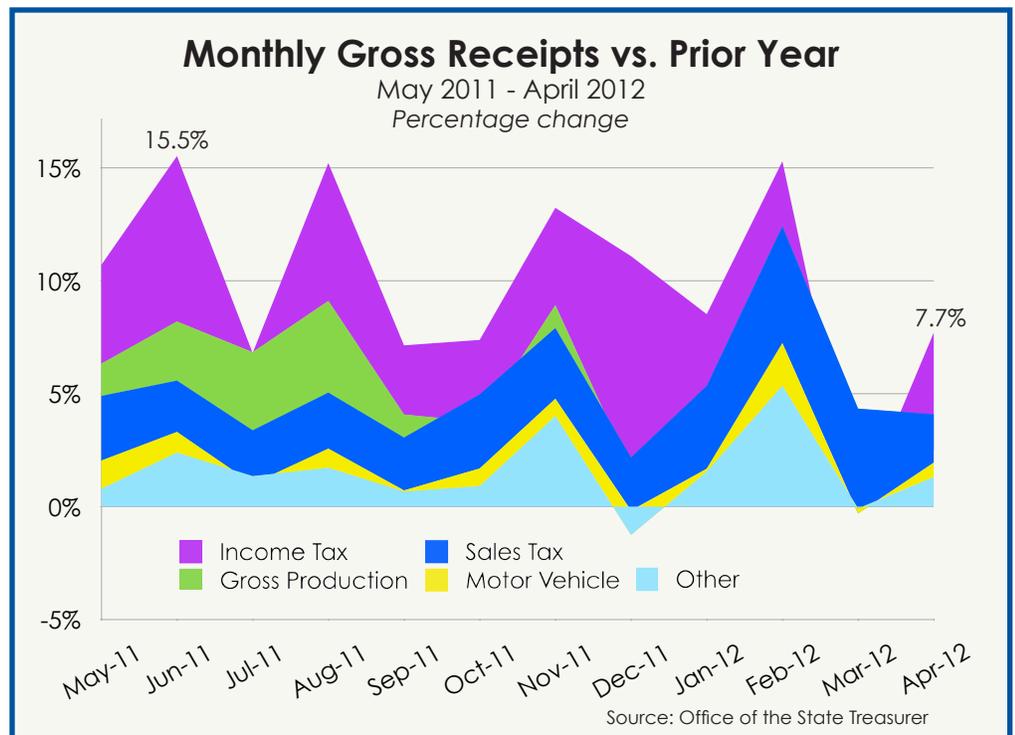
Income tax collections jumped by more

than 10 percent from the prior year and accounted for almost 50-cents of every dollar collected in April, the tax-filing deadline month.

“Consumers appears confident in the direction of Oklahoma's economy with sales still climbing . . .”

Sales tax collections, up by 7.1 percent, moderated slightly in April following months of double-digit growth.

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Revenue

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Gradual erosion

In April, collections from gross production taxes on oil and natural gas were less than the same month of the prior year for a fifth consecutive month, and for the sixth time in seven months.

During those months, the percentage of gross production taxes generated by natural gas production has steadily decreased as prices have fallen.

In October, 51 percent of gross production collections came from gas extraction. By March, the amount had fallen to 34 percent. The proportion of the tax produced by natural gas in April shrank to 32 percent.

Gross production collections in April reflect prices and production from February, when the spot price for natural gas at the Henry Hub in Louisiana, considered a benchmark for gas prices, averaged \$2.51 per thousand cubic feet. Since then, prices have dropped even further, averaging less than \$2 per thousand cubic feet in April.

“We will closely monitor falling natural gas prices in the coming months to gauge any impact,” Miller said. “Right now, the Oklahoma economy looks good and free of any spillover effects.”

State economy weathering well

Miller said the state’s economy appears to be “weathering well the challenge” as it shows continued improvement.

“Collections in all revenue categories

are up except for gross production,” he said. “Consumers appear confident in the direction of Oklahoma’s economy with sales still climbing, though at half the rate seen in March.”

Since hitting the trough on revenue collections from the recession in February 2010, 12-month collections have increased by almost \$1.6 billion and are now only \$336 million below the peak in December 2008.

Miller pointed to the latest reports on state unemployment as another bright spot.

“At 5.0 percent, the April unemployment rate is very good news,” he said.

“Reports show the number of jobs has grown by 2.5 percent in the past year, adding more than 38,000 to the ranks of the employed.”

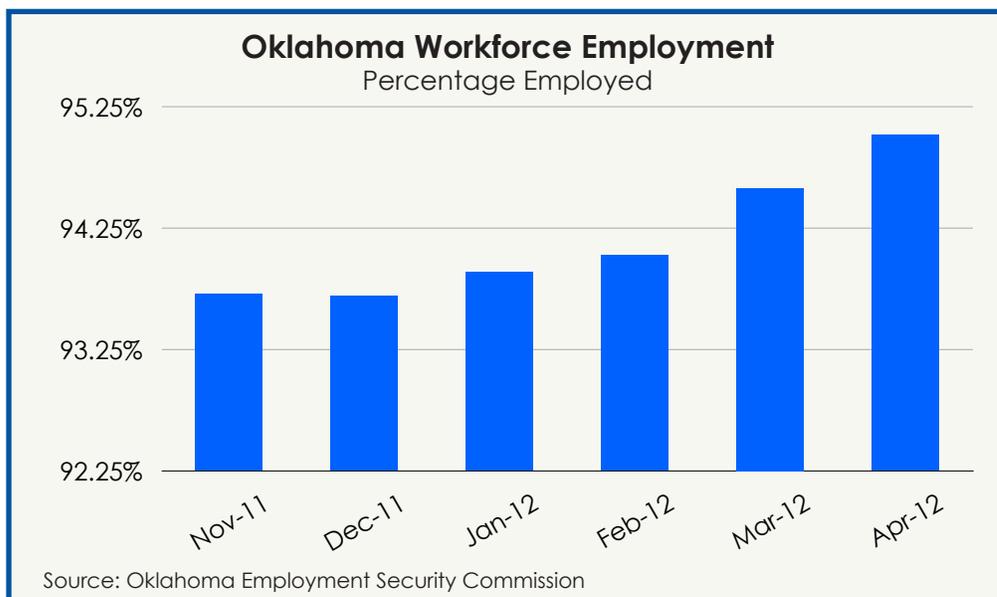
State unemployment at lowest level since 2008

In April, Oklahoma’s unemployment rate dropped to its lowest level since December 2008, figures released May 18 by the Oklahoma Employment

Security Commission show.

While the national unemployment rate is set at 8.1 percent, Oklahoma’s April rate

is reported as 5.0 percent, a decrease of 0.4 percentage points from March 2012 and 0.9 percentage points from April of last year.



The number of unemployed in Oklahoma is reported as 89,110, while those with jobs is set at just less than 1.7 million.

In the past year, the state has gained 38,500 jobs. That is an increase of 2.5 percent.

The last time Oklahoma’s unemployment rate was this low was in December 2008 when the rate was set at 4.7 percent. In January 2009, the rate was reported as 5.1 percent.

The numbers from OESC reflect non-farm employment and are seasonally adjusted.



Economic Indicators

