

2016/17 BUDGET BRIEFING

Report on Key Issues
HOUSE APPROPRIATIONS COMMITTEE (D)



JOE MARKOSEK, DEMOCRATIC CHAIRMAN

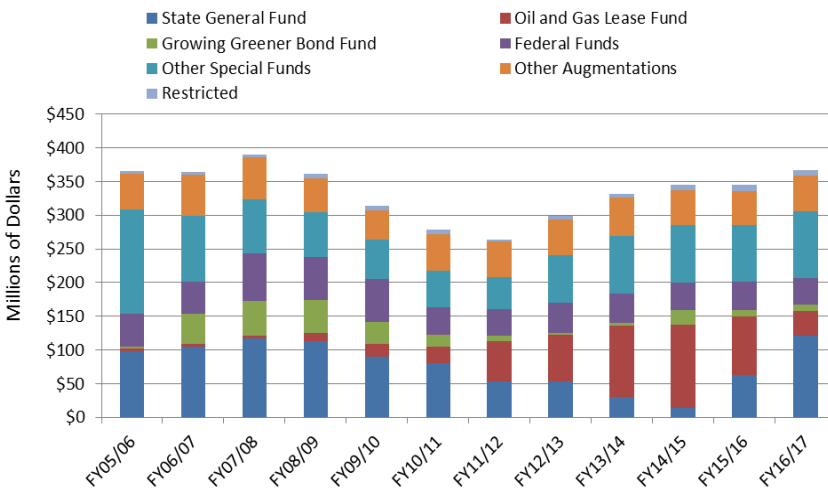
May 16, 2016

Oil and Gas Lease Fund

The 2015/16 budget marked a critical shift in how the Department of Conservation and Natural Resources (DCNR) is funded. Beginning in 2009/10, Oil and Gas Lease Fund (OGLF) revenues were diverted to DCNR to fund the department's operational expenses. Rather than invest these revenues into conservation projects or to further bolster DCNR's mission, the OGLF essentially replaced state General Fund support for the agency. As a result of low natural gas market prices, due to an oversupply, revenues for the OGLF have fallen precipitously. The drop in revenue prompted the Wolf Administration to change the funding policy for DCNR, in order to keep the OGLF solvent. Figure 1 shows the funding sources for DCNR over the past 10 years, as well as the steady shift from the state's General Fund (blue) to oil and gas revenues (red) to support DCNR, and vice versa beginning in 2015/16.

Figure 1:

DCNR Funding By Source



increases to \$35.00 per acre in the fifth year and beyond. Rental rates may vary based on the terms of the lease. However, the largest portion of payment to DCNR comes from royalties. The lessee is required to pay either \$0.35 per thousand cubic feet (Mcf) or 18 percent of the market value of natural gas drilled, whichever is higher (the first shale-gas specific lease set the royalty rate at 16 percent, while subsequent leases were set at 18 percent).

Purpose of Oil and Gas Lease Fund

The Commonwealth of Pennsylvania issued its first oil and gas lease of state forest land in 1947. A few years later, Act 256 of 1955 established the Oil and Gas Lease Fund as the depository for the rents and royalties collected through the oil and gas leases of commonwealth-owned land (with the exception of rents and royalties from land owned by either the Pennsylvania Game or Fish and Boat Commissions).

Rent is currently set at \$20.00 per acre in the second through fourth years, after an initial bonus rental payment that represents what companies bid for during the competitive lease auction. Rent

The act states that the **Oil and Gas Lease Fund revenues, in turn, "shall be exclusively used for conservation, recreation, dams, or flood control** or to match any federal grants which may be made for any of the aforementioned purposes."

Prior to 2008/09, the revenues deposited into the OGLF only amounted to about \$4 million each year. This relatively small sum was typically used to purchase state park lands, acquire mineral rights, improve trails and other infrastructure, restore habitats, develop recreational areas, purchase equipment and support the operations of DCNR. However, in more recent years, as a result of the expansive growth of the natural gas industry, the

substantial revenues for the OGLF have been used for other purposes, and replaced state General Fund dollars.

The Marcellus Shale Impact on OGLF Revenues

The rapid growth of the natural gas industry led to a sizable increase in revenue for the OGLF. In 2007/08 the fund collected \$5 million in rents and royalties. The following year rents and royalties topped \$164.6 million. On average, the fund has received \$129 million annually since 2008/09. To date, the commonwealth has collected \$954.4 million in rent and royalties.

Over the past few years, as natural gas prices dropped precipitously, the OGLF has faced a significant revenue problem. In 2015 the OGLF collected \$93.2 million, a decrease of \$54.3 million, or 37 percent, compared to 2014. The impact of this decline can be seen in Figure 2.

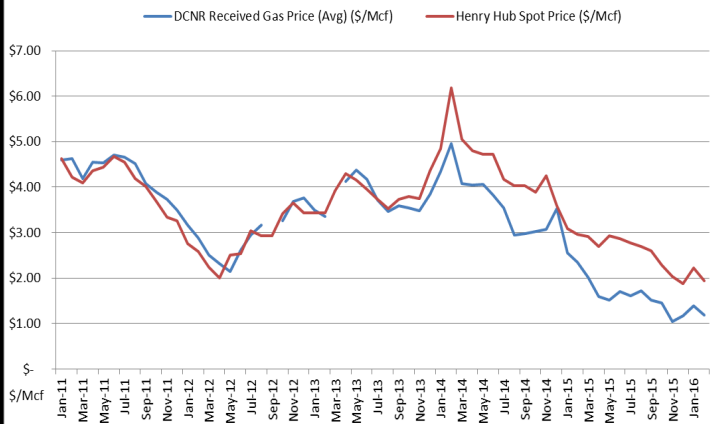
Figure 3 shows natural gas spot prices from 2011 to present, comparing the average price received by DCNR and the Henry Hub Spot Price average, a commonly used benchmark for tracking market prices. After approaching low averages between \$2.00-\$2.35 per thousand cubic feet (Mcf) in early 2012, natural gas market prices rose steadily over the next two years, resulting in more significant royalty payments and revenue for the OGLF. Prices peaked around February 2014, at about \$4.96 for DCNR prices and \$6.18 for the Henry Hub Spot Price average. Since then natural gas prices plummeted, weakening the revenue stream for the OGLF. Table 1 shows the count of DCNR royalty wells and private wells. Currently, there are 591 natural gas wells producing royalties for the OGLF.

A Declining State Contribution

As Figure 4 illustrates, the state General Fund contribution for state parks and forests began to significantly decline in 2009/10 and was drastically cut in the following years. The largest cut came in 2013/14, under the Corbett Administration, when appropriations for state parks and state forests operations were reduced by a combined \$27 million, or 83 percent, compared with the prior year.

However, as Figure 1 depicts, DCNR's total funding has steadily increased since 2011/12, (increases made possible by substantial reliance on the OGLF). In 2010/11, the OGLF provided \$24 million in support for DCNR operations, representing 8 percent of DCNR's \$278 million total budget for that year.

Figure 3 Natural Gas Market Price Comparison



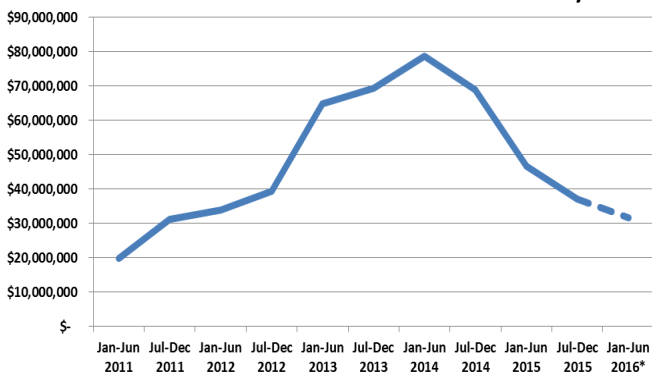
Source: House Appropriations Committee Democrats analysis of Henry Hub Spot Price reported by the U.S. Energy Information Administration and a sample of Average Prices Reported to DCNR provided by PA DCNR.

Table 1: Number of DCNR Approved Shale Wells By Year

Year	DCNR Royalty Wells	Private Wells (No Royalty Owed)	Total Approved Wells
2008	10	11	21
2009	136	43	179
2010	244	59	303
2011	264	51	315
2012	64	12	76
2013	59	20	79
2014	37	10	47
2015	6	0	6
Total:	820	206	1026

Notes: DEP has issued permits to 1,047 wells on state forest land; 651 wells have been drilled. Of the DCNR royalty wells, 591 of the 820 approved are reporting royalty production.

Figure 2 Oil and Gas Lease Fund Revenue History



* Estimate based on available information.

By 2014/15, as a result of state General Fund cuts and increases in OGLF revenues to the department, the OGLF provided \$122.5 million to DCNR, representing 35 percent of its \$344 million total budget for that year. Figure 5 tracks the disbursements of OGLF revenues to DCNR over the same period.

Transfers and Strain on the OGLF

In addition to supporting conservation and related programs under DCNR, the OGLF was used for other purposes through fund transfers. Act 13 of 2012 mandated transfers from the OGLF to the newly created Marcellus Legacy Fund. These transfers, \$20 million in 2013/14 and rising to \$50 million by 2016/17, coupled with natural gas well impact fee revenue, support the Environmental Stewardship Fund, the Hazardous Sites Cleanup Fund, as well as other environmental and infrastructure investments across the commonwealth.

Fund transfers from the OGLF have become commonplace in recent years.

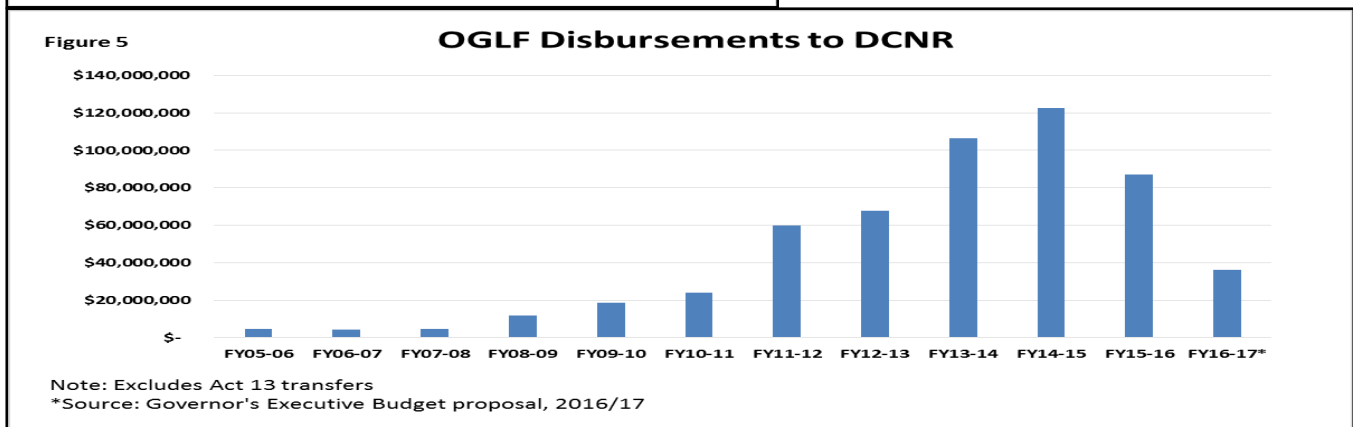
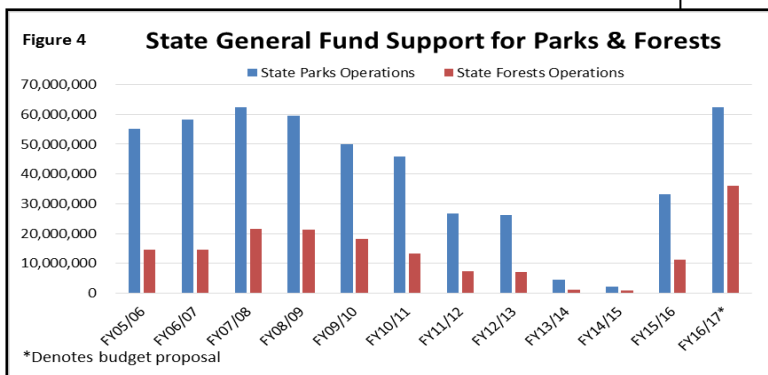
- In 2009/10 \$203 million was transferred from the OGLF to the state General Fund. The fiscal code bill for 2010/11 authorized a \$180 million transfer to the state General Fund.

- Act 50 of 2009, the fiscal code bill for that year, provided for an annual transfer of up to \$50 million from the OGLF to DCNR, subject to availability of money in the fund.

Additionally, in 2014/15, Governor Tom Corbett sought to use the OGLF to balance the budget. The plan stemmed from the governor’s lifting of the moratorium on drilling on state park and forest lands, as long as the activities did not create additional surface disturbances. The administration estimated that this ‘non-surface impact leasing’ plan would generate \$95 million in revenues, and the budget authorized this transfer from the OGLF to the General Fund. While this transfer did not materialize, it represents another example of using oil and gas revenues collected in the OGLF for purposes contrary to those defined in law.

The Shift Back to State General Fund support

In 2010, Governor Rendell issued a moratorium on the additional leasing of state forest land, which would disturb surface areas and negatively impact forest ecosystems. However, for reasons discussed earlier, in 2014 Governor Corbett replaced the Rendell moratorium with an order that would permit oil and gas development so long as it did not create any additional surface disturbance in state parks or forests. Upon entering office, Governor Tom Wolf signed Executive Order 2015-03, reestablishing an absolute moratorium on additional leasing of state park and state forest land for oil and gas development.



Governor Wolf, in his first budget, acknowledged the strain on the OGLF in light of dismal revenues and sought to reverse the policies of his predecessor by restoring state General Fund support for DCNR operations. The 2015/16 budget reduced OGLF transfers to \$87 million, a reduction of \$35.5 million or 29 percent, compared with 2014/15. In 2016/17, Governor Wolf proposed reducing oil and gas revenues to DCNR further, from \$87 million in 2015/16 to \$36 million. This reduction would bring the OGLF as a percentage of DCNR's total budget from 35 percent in 2014/15 (\$122.5 million of a total budget of \$344.4 million) to just 9 percent in 2016/17 (\$36 million of a total budget of \$367.2 million). Again, Figure 1 depicts the shifting of fund sources, with state General Fund support in blue and OGLF support in red.

While OGLF transfer reductions have helped to sustain the fund, further action is needed. Originally, Act 13 of 2012 authorized the transfer of \$40 million from the OGLF in 2015/16, including \$35 million for

the Environmental Stewardship Fund and \$5 million for the Hazardous Sites Cleanup Fund. These transfers are completed through the Marcellus Legacy Fund. The most recent Fiscal Code bill (House Bill 1589) reduced the annual OGLF transfer to the Environmental Stewardship Fund from \$35 million to \$20 million in 2015/16. Future of the Fund

In recent years, the Oil and Gas Lease Fund has become an 'oversubscribed' fund, subjected to transfers to balance the budget and support DCNR. In light of seriously reduced revenue, the fund has cut disbursements accordingly. With natural gas prices expected to remain low for the foreseeable future, it is expected that disbursements from this fund will remain constrained for some time. Assuming financial support for DCNR is maintained in the state General Fund, the Oil and Gas Lease Fund can return to its intended purpose, as prescribed in law. This will yield sustained progress for conservation and flood control projects, and a more proactive environmental policy position.

House Appropriations Committee (D)

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