F I S C A L I M P A C T R E P O R T

SPONSOR Strickler **ORIGINAL DATE** 01/26/16 **LAST UPDATED** 02/04/16 **HB** 107

SHORT TITLE Reduced Tax Rate for Certain Oil and Gas Wells **SB**

ANALYST Alejandro

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY16	**FY17**	**FY18**	**FY19**	**FY20**		
($0.0)	($15,900.0)	($18,200.0)	($19,700.0)	($20,800.0)	Recurring	General Fund
($0)	($17,100)	($20,000)	($21,600)	($22,900.0)	Recurring	Severance Tax Bonding Fund
($0.0)	**($33,000.0)**	**($38,200.0)**	**($41,300.0)**	**($43,700.0)**	**Recurring**	**Total**

Parenthesis ( ) indicate revenue decreases

SEVERANCE TAX BONDING CAPACITY (dollars in millions)

Estimated Impact							
FY16	**FY17**	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	
$198.1	$293.5	$301.3	$325.4	$339.8	$352.5	$374.2	**Baseline**
$198.1	$285.4	$285.3	$307.3	$320.4	$332.4	$354.5	**After HB 107**
$0.0	**($8.1)**	**($16.0)**	**($17.9)**	**($19.4)**	**($20.1)**	**($19.7)**	**Difference**

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
Energy, Minerals, and Natural Resources Department (EMNRD)
State Land Office (SLO)
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

House Bill 107 changes the differential on Severance Tax and Emergency School Tax rates for oil and natural gas from stripper wells, also known as marginal wells, thereby making it easier for such wells to qualify for reduced tax rates at current market prices. A stripper well has an average daily production of less than ten barrels of oil per eligible well, or if a natural gas producing property, an average daily production of less than sixty thousand cubic feet of natural gas.

The existing severance tax rate on natural gas severed and sold is 3.75 percent of taxable value. House Bill 107 reduces that rate for natural gas from a stripper well as follows:

- 1.875 percent if the average annual taxable value of natural gas is equal to or less than $3/mcf (current law is $1.15/mcf).
- 2.8125 percent if the average annual taxable value of natural gas is between $3.01/mcf and $3.50/mcf (current law is between $1.16/mcf and $1.35/mcf).

The existing severance tax rate on oil and other liquid hydrocarbons severed and sold is 3.75 percent of taxable value. House Bill 107 reduces that rate for oil and other liquid hydrocarbons from a stripper well as follows:

- 1.875 percent if the average annual taxable value of oil is equal to or less than $60/bbl (current law is $15/bbl).
- 2.8125 percent if the average annual taxable value of oil is between $60.01/bbl and $65/bbl (current law is between $15.01/bbl and $18/bbl).

Similarly, House Bill 107 changes the alternative emergency school tax rate floor and ceiling. The existing rate on natural gas severed and sold is 4 percent of taxable value. House Bill 107 reduces that rate for natural gas from a stripper well as follows:

- 2 percent if the average annual taxable value of natural gas is equal to or less than $3/mcf (current law is $1.15/mcf).
- 3 percent if the average annual taxable value of natural gas is between $3.01/mcf and $3.50/mcf (current law is between $1.16/mcf and $1.35/mcf).

The existing emergency school tax rate on oil and other liquid hydrocarbons severed and sold is 3.15 percent of taxable value. House Bill 107 reduces that rate for stripper well production as follows:

- 1.58 percent if the average annual taxable value of oil is equal to or less than $60/bbl (current law is $15/bbl).
- 2.36 percent if the average annual taxable value of oil is between $60.01/bbl and $65/bbl (current law is between $15.01/bbl and $18/bbl).

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends. LFC staff recommends a certain effective date of July 1, 2016 for ease of administration.

FISCAL IMPLICATIONS

The imact revenue estimates above represent a correction to the original Fiscal Impact Report dated January 26, 2016. These figures are based on the January Concensus Revenue Estimating Group forecasts for oil and gas prices and volumes through FY20. Additionally, deductions for oil and gas royalties, transporation and processing have been included in order to achieve more accurate taxable value.

Given the recent downward trends in oil and gas prices and the subsequent volatility of the market, it is difficult to estimate the impact of this bill with great certainty. At current prices, the state's active stripper wells would likely qualify for the reduced tax rates immediately upon enactment. The resulting estimated cost would place additional strain on the state's already diminished revenue position resulting in large part from lower than expected oil and gas prices. However, in the absence of reduced rates for stripper wells, it is possible that some may be shut down, resulting in an overall reduction in that revenue stream for the state. Stripper wells currently account for 97 percent of all oil wells in New Mexico and 66 percent of gas wells, while generating 11 percent and 14 percent of output, respectively. It is uncertain how many stripper wells would halt operation in the absence of reduced tax rates.

According to the Tax and Revenue Department, the statute as currently written creates rate differentials for oil and natural gas extracted from stripper wells when natural gas prices are below $1.35 per thousand cubic feet. Rate differentials for oil prices are also available when the price per barrel is below $18. These provisions were enacted in 1999. When adjusting for inflation, $18 in 1999 is equal to $26 in 2015. By setting the price threshold below $60 per barrel, but above $26 per barrel, this proposal would create a tax incentive rather than tax protection for high cost-low yield oil producers. For natural gas producers, the proposal would also create a tax incentive. In the year 1999, $1.35 had the same purchasing power as $1.92 has in 2015. The new price threshold for natural gas of $3.50 per thousand cubic feet is above the inflation-adjusted threshold, and thus would create a tax incentive.

This bill may be counter to the LFC tax policy principle of adequacy, efficiency and equity. Due to the increasing cost of tax expenditures revenues may be insufficient to cover growing recurring appropriations.

Estimating the cost of tax expenditures is difficult. Confidentiality requirements surrounding certain taxpayer information create uncertainty, and analysts must frequently interpret third-party data sources. The statutory criteria for a tax expenditure may be ambiguous, further complicating the initial cost estimate of the expenditure's fiscal impact. Once a tax expenditure has been approved, information constraints continue to create challenges in tracking the real costs (and benefits) of tax expenditures.

SIGNIFICANT ISSUES

EMNRD states that reduced severance and privilege tax rates would improve the economics associated with the production of stripper oil and gas wells, and could allow operators to continue to produce these wells instead of halting production and eventually plugging and abandoning the wells. Once a stripper well is plugged, the costs of re-entering the well may make future production from the well unlikely. According to the State Land Office, this bill could increase the money going into the State's General Fund by encouraging stripper wells to remain active.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the deduction and other information to determine whether the deduction is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

EMNRD's Oil Conservation Division is required to certify each stripper well as meeting the production limits in order for the well to qualify for the reduced tax rate. Sections 7-29-2(P) and 7-29B-3(C) NMSA 1978. Given the number of stripper wells, the certification process could be an increase in OCD's workload.

Further, while the changes proposed would not change the complexity of audits involving the listed tax incentives, it would greatly increase the frequency of occurrence, which is currently zero. This would increase the effort required in audits of impacted properties. In the near term, as prices near the existing thresholds, the impact may not be as big, but the raised thresholds nearly guarantee the lowered rates would take effect.

CONFLICT, DUPLICATION, COMPANIONSHIP, RELATIONSHIP

SB 34 also amends the same section of the Oil and Gas Severance Tax Act, Section 7-29-4 NMSA 1978 to reduce the severance tax rate from 3.75 percent to 1.875 percent of the taxable value of oil for enhanced oil recovery projects that inject carbon dioxide. SB 34 adds a new subsection which creates a conflict with HB 107.

TECHNICAL ISSUES

TRD recommends defining the term "price" for purposes of determining the tax on oil and natural gas pursuant to this section.

This bill does not contain a sunset date. The LFC recommends adding a sunset date.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

According to the State Land Office, because the bill provides an incentive for production under current and foreseeable oil and gas prices, the SLO could lose revenue if this bill is not passed.

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