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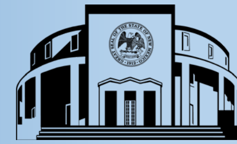
Analysis by the LFC Economists



NEW MEXICO
LEGISLATIVE
FINANCE
COMMITTEE

New Mexico Royalties and State Finances

THIS REPORT provides an overview of oil and gas royalties paid by industry on public lands.

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The exploration and extraction of oil and gas resources continues to contribute significant financial resources to New Mexico state government, counties, and local municipalities. The oil and gas industry pays a variety of taxes (see appendix A); however, a significant contributor to state finances is through the collection of royalty payments. Royalties are payments to the property owners by energy companies in exchange for the right to extract natural resources from the land. In the case of New Mexico, the royalties may be paid to the state, the federal government, private landowners, or tribes. This report is an overview of current oil and gas royalty payments, provides royalty comparisons with other states, and details recent trends in state royalty receipts.

Background

Oil and gas companies pay a royalty to the government, generally a percentage of the value of the oil and gas extracted, on production on federal and state land through a structured framework ensuring the collection of revenues from the extraction and production of the resources. The process typically involves the key steps described in the side bar. Below is a brief discussion of the different royalty frameworks for the vast majority of state oil and gas production that occurs on state and federal land.

Lease Acquisition: companies acquire leases from federal or state governments granting the right to explore and extract natural resources from specific areas. These leases outline the terms and conditions, including royalty payment requirements.

Production Monitoring and Reporting: Oil and gas companies are required to accurately measure and report their production data, including the volume and value of the extracted resources, to the appropriate federal and state agencies on a regular basis. These reports serve as the basis for calculating the royalties owed.

Calculation of Royalties: Based on the lease agreements, royalties are calculated as a percentage of the total value of the extracted resources. The specific royalty rate varies and can be determined by a variety of factors, such as the location of the lease, the type of resource being extracted, and applicable statutes.

Royalty Payment: After the reporting process, oil and gas companies pay the government agencies for the calculated royalty amounts on a monthly or quarterly basis, in accordance with the terms outlined in the lease agreements.

Auditing and Compliance: Federal and state agencies carry out audits and compliance checks to ensure the accuracy and integrity of the reported data and the royalty payments made. These measures help prevent underpayment or evasion of royalties and maintain the transparency and fairness of the system.

Federal Royalties

The Bureau of Land Management (BLM) oversees 245 million acres of federal public lands, including lands that are managed for outdoor recreation; development of oil, gas, coal, and renewable energy resources; grazing and timber production; safeguarding treasured cultural heritage and sacred sites; and supporting wildlife habitat and ecosystem functions. The federal government manages energy and mineral resource development on approximately 245 million acres of federal onshore lands and 700 million acres of subsurface Federal minerals, all of which is guided by the federal Mineral Leasing Act.[1]

The Mineral Leasing Act was passed in 1920 and set royalties at a minimum of 12.5 percent for oil and gas produced from public lands. Over 100 years later, federal leases were still being sold using 12.5 percent rates despite nearly all state and private lands requiring a higher royalty rate. The federal royalty rates are set to increase due to the Inflation Reduction Act passed in 2022 setting a minimum federal royalty rate of 16.67 percent and a cap of 18.75 percent. In June 2017, the federal Government Accountability Office reported

[1] *Report on the Federal Oil and Gas Leasing Program* Prepared in Response to Executive Order 14008. U.S. Department of the Interior. November 2021, available at https://www.doi.gov/sites/doi.gov/files/report-on-the-federal-oil-and-gas-leasing-program-doi-eo-14008.pdf

raising federal royalty rates for onshore oil and gas could "decrease production on federal lands by a small amount or not at all but could increase overall revenue."[2] The first New Mexico lease sale under the new rules was issued at the end of 2022 with an 18.75 percent royalty rate, however a subsequent sale in 2023 was released with the Inflation Reduction Act 16.67 percent required royalty rate.

Royalties paid on production from federal land are received by the federal government that then distributes half of the receipts to the state in which the production occurred. In New Mexico, federal royalties are paid into the general fund and, until recently, contributed to significant revenue and budget volatility as payments were directly tied to the booms and busts of the oil and gas industry's prices and production.

In 2019, the Legislature reformed federal royalty revenue distributions by distributing collections above the five-year average collections for those revenues to instead reach the newly created early childhood trust fund.

In addition to distributions to the early childhood trust fund, Chapter 22 of the 2023 legislative session (senate bill 26) creates a limit on the amount of federal royalties in the general fund equal to FY24 collections. Revenues in excess of the limit and below the five-year average distributions to the early childhood trust fund are to be sent to the severance tax permanent fund. The distribution will then generate an investment and redistribute the proceeds to the general fund in perpetuity so that future generations can benefit from the resources extracted today. The decision tree in Appendix B highlights how funds flow in New Mexico from federal royalty payments.

State Trust Land Bonus Revenue in Relation to Royalties

In addition to royalties on mineral extraction, lessees of trust land also pay a bonus for the right to lease the land through a competitive bid process.

Revenues from nonrenewable use of the trust lands, such as the royalties from oil and natural gas extraction, are deposited into the permanent fund for the specific beneficiary of the land being leased. Together, those beneficiary-specific permanent funds are known as the land grant permanent fund. The fund is invested by the State Investment Council and income is distributed to the beneficiaries each fiscal year in proportion to their share.

Revenue from renewable resource uses—sources that do not deplete the resource, such as lease bonuses and grazing—are distributed through the land maintenance fund to the beneficiaries after the State Land Office covers its own expenses. While distributions from the maintenance fund typically total from $50 million to $70 million, the distributions from the permanent fund are in the hundreds of millions, with the figure consistently above $500 million during the last decade.

The oil and gas industry is by far the largest contributor to state trust land income, accounting for about 95 percent of all revenue, and public schools the biggest beneficiaries, receiving about 85 percent of the income.

Research suggests royalty rates and bonus payment have an inverse relationship. In other words, bonus payments are likely to fall as royalty rates are raised, but the net present value of the change is likely near neutral. Raising royalty rates might mean less bonus revenue today, but more royalty revenue in the future.

State Royalties

Royalty rates on state trust lands range from 12.5 percent to 20 percent. The State Land Office, which manages 12.7 million subsurface acres and 9 million surface acres on behalf of 21 beneficiaries, uses three lease forms, set in statute, based on whether the tract is in a restricted area (where oil and gas production normally occurs) and whether it is classified as "regular" or "premium," based on a formula that looks at oil and gas reservoir volume and value. The royalty rate for restricted, premium tracts, what the office calls the "most productive state trust land oil and gas leasing tracts," can be no lower than 18.75 percent and no higher than 20 percent.

New Mexico Compared With Other States. New Mexico's 20 percent maximum royalty rate for oil and gas leases on trust land, last updated in the 1970s, is higher than those in most other states with trust land but less than that charged by Texas, New Mexico's competitor in the high-production Permian Basin. Information from a 2021 federal Department of Interior report and an informal survey of states with trust lands by LFC staff shows oil and gas royalty rates in trust land states between 12.5 percent 25 percent, with most charging 16.67 or 18.75 percent.

Texas charges as little as 20 percent on some leases but charges 25 percent on leases for tracts in the Delaware Basin, part of the Permian Basin and those

[2] U.S. Government Accountability Office, "Oil, Gas, And Coal Royalties" June 2017, available at https://www.gao.gov/assets/gao-17-540.pdf.

tracts in direct competition with New Mexico's highest value tracts. The State Land Office argues New Mexico leases would be "more industry friendly" than those on trust land in Texas, even if the royalty rate were raised to 25 percent, because New Mexico, among other conditions, offers longer lease terms and charges the royalty on a calculation of proceeds that allows for some deductions, rather than gross proceeds.

North Dakota, the third largest oil producer behind Texas and New Mexico, sets a minimum in statute of 12.5 percent but charges between 16.67 percent and 18.75 percent. The North Dakota counties at the higher rate are all within the high-producing Bakken Formation, although some counties within the formation are at the lower rate.

While New Mexico rates are generally higher than those charged for trust land in other states, rates seem to be increasing. Pheasant Energy, a Fort Worth-based oil exploration and production company, reported in late 2022 royalty rates charged by states and private landowners are on upward trend, with royalties for private lands influenced by those being charged by states.

Oil and Gas Lease Rates for Trust Land in Select States
(in percent)

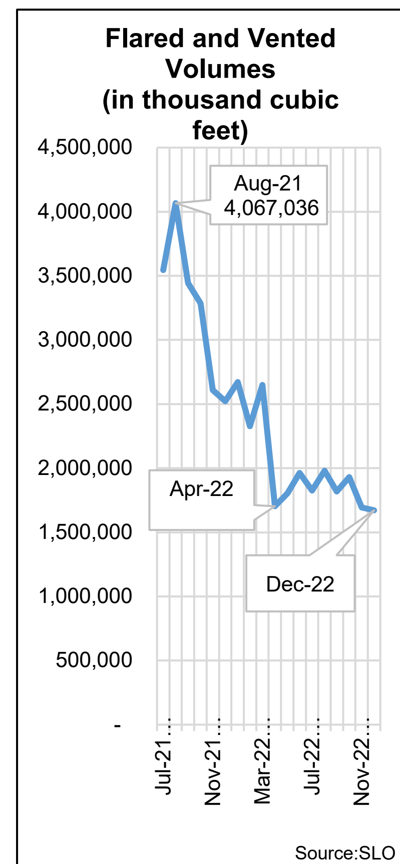
Jurisdiction	Max Rate
Arizona	12.5
South Dakota	12.5
California[1]	16.67
Montana	16.67
Wyoming	16.67
North Dakota[2]	18.75
Oklahoma	18.75
Colorado	20
New Mexico	20
Utah[3]	20
Texas	25

[1]Negotiated lease-to-lease, generally no higher than 16.67 percent
[2]ND sets a minimum of 12.5 percent in statute. Rates range from 16.67 to 18.75 percent.
[3]Utah's standard rate is 16.67 percent but the rate is 20 percent in better-producing areas.
Source: LFC and U.S. Department of the Interior

Royalties on Wasted Oil and Gas. Although several states require producers to pay royalties on oil and gas lost through venting, spills, and other practices, New Mexico does not. Texas includes "non-sales disposition" volumes in its lease agreements, and the federal Bureau of Land Management has proposed a new rule for oil and gas production on federal and tribal lands that would impose royalties on vented or flared natural gas.[3] That rule would impose monthly limits on royalty-free flaring as part of an effort to curb methane emissions.

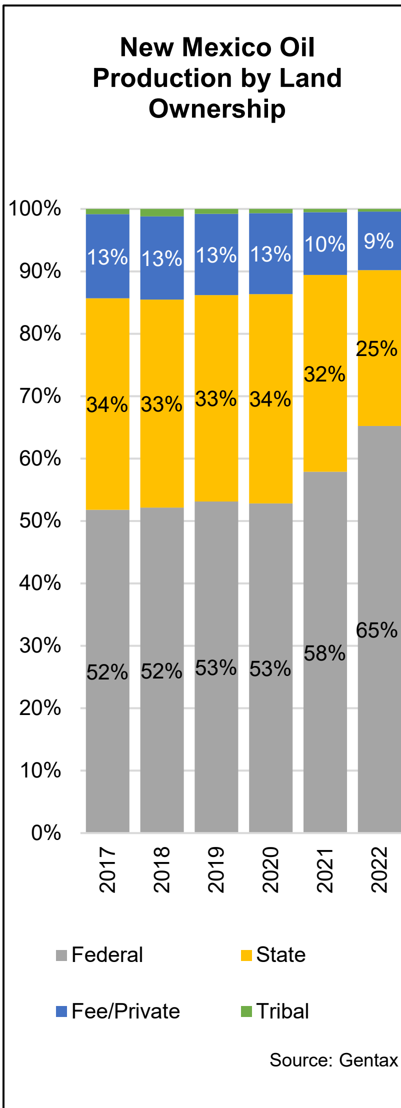
Supporters of charging royalties on wasted oil and gas argue that producers should have to pay for the resources they extract, whether the oil or gas makes it to market or not, and that producers are wasting a resource that could be serving consumers and New Mexicans.

The Earth Observation Group at the Colorado School of Mines reports New Mexico was third in the country, behind Texas and North Dakota, for flaring volumes captured by satellites between 2014 and 2020. However, the State Land Office indicates venting, flaring, and other waste of natural gas has fallen significantly since 2021, when the Oil Conservation Division of the Energy, Minerals and Natural Resources Department implemented methane waste rules in concert with the implementation of new oil-field emissions rules promulgated by the Environment Department.



Lease Availability and Royalty Changes. Despite raising royalty rates at the federal level and proposed legislation to raise rates at the state level, the impact of raising the rates is likely to be relatively minimal. Less than 1 percent of tracts in the high production zone of the State Land Office's Southeast District (see Appendix C), which includes part of the Delaware Basin, remain available for new lease rates. Leases have an initial term of five years but can be held by the lessee for as long as they are productive, meaning new royalty rates are not expected to have significant impacts on production or revenues, as nearly all productive lands are already leased at the lower levels.

[3] https://www.federalregister.gov/documents/2022/11/30/2022-25345/waste-prevention-production-subject-to-royalties-and-resource-conservation



Recent Trends in Royalty Revenues

Federal royalty payments are the other the most volatile revenue source in the general fund following severance taxes and have similarly been subjected to a five-year average cap with payments in excess reaching the early childhood trust fund. Of the total $2.257 billion in federal royalty revenue in FY22, an estimated $1.502 was distributed to the early childhood trust fund. From FY23 to FY26, an additional $3.864 billion of federal royalties is estimated to reach the early childhood trust fund because of the stabilization mechanism. By FY27, the five-year average is expected to be more than federal royalties and will no longer insulate the general fund from swings in collections.

As a result of Chapter 22 (SB 26), an estimated $316.1 million is expected to reach the severance tax permanent fund in FY25 from federal royalty payments, climbing to over $900 million in FY27. Together, these distributions are an inherent buffer for the revenue forecast, as negative impacts on federal royalty revenues first reduces the estimates transfers to the trust fund first or permanent fund and reducing negative effects to the general fund.

Furthermore, production in New Mexico has grown significantly faster on federal land than on state, private, or tribal land. As a result, a growing share of New Mexico's production is subject to federal royalties, which are shared with the state and, unlike production on other land, goes to the general fund following a five-year averages and caps. The result was record federal mineral leasing revenues in FY22 and raised expectations for future general fund revenues from the source. The volatile share of production on federal land has become a significant risk to the forecast, on both the low and high side of the baseline.

Appendix A. New Mexico Tax Rates on Oil and Gas Production

Tax Type	Oil	Gas
Oil and Gas Severance Tax	3.75% of value	3.75% of value
Oil and Gas Emergency School Tax	3.15% of value	4.0% of value
Oil and Gas Conservation Tax	0.19% of value	0.19% of value
Oil and Gas Ad Valorem Production Tax	Based on property tax in the district of production	Based on property tax in the district of production
Oil and Gas Ad Valorem Equipment Tax	Based on property tax in the district of production	Based on property tax in the district of production

EFFECTIVE TAX RATES BY STATE

Based on an LFC Study in 2016 of severance, production and property taxes paid in ratio to taxable valuation of production

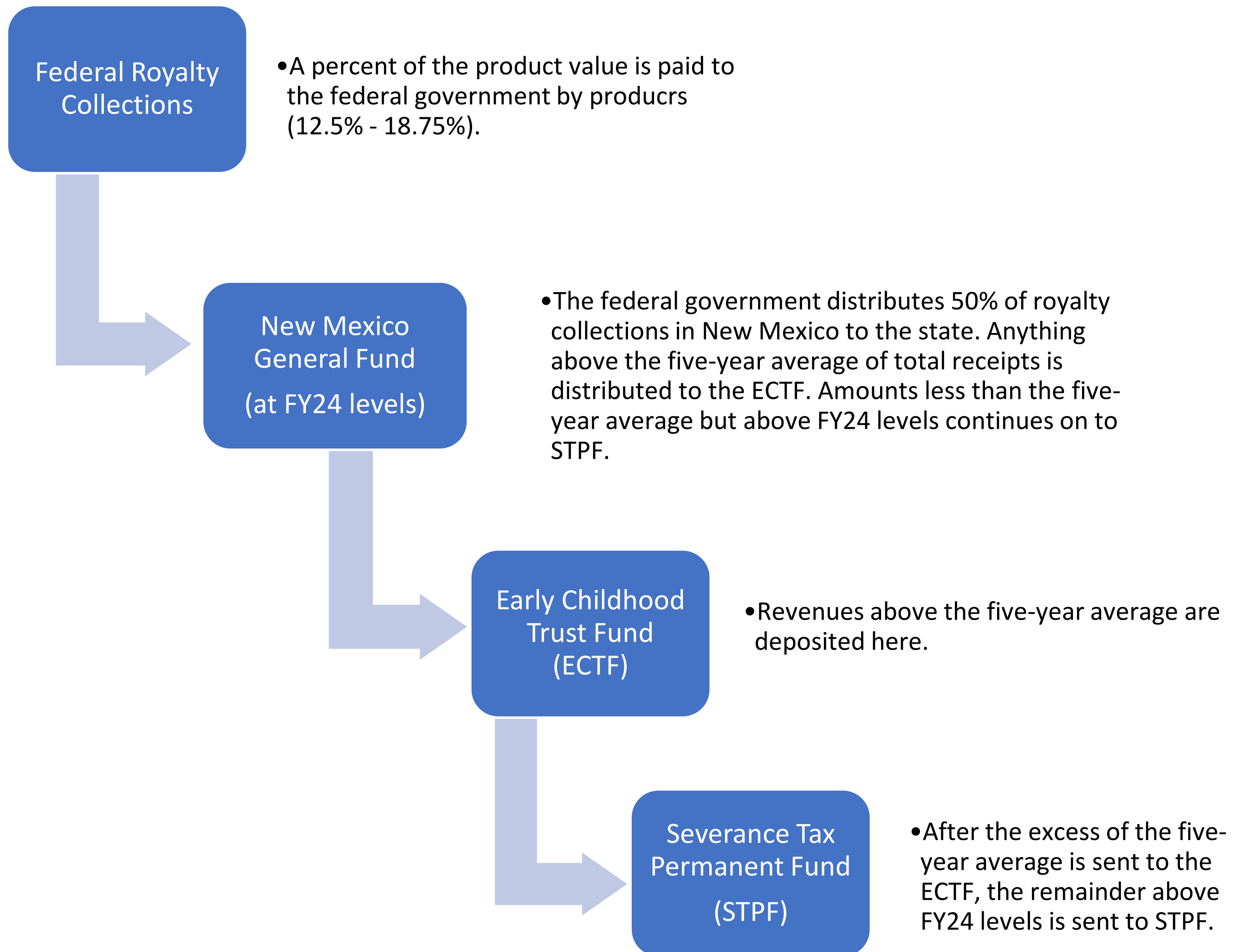
State	Property Tax (Y/N)	Taxable Value (in billions)	Tax Collected (in millions)	Effective Tax Rate
Oklahoma	NO	$11.236	$364.9	3.2%
Idaho	YES	$0.003	$0.1	4.0%
Utah (1)	YES	$1.625	$99.0	6.1%
Texas (1)	YES	$53.491	$4,458.1	8.3%
New Mexico (2)	YES	$6.841	$584.4	8.5%
North Dakota	NO	$14.958	$1,404.8	9.4%
Montana	YES	$0.919	$91.1	9.9%
Alaska	YES	$5.456	$653.8	12.0%
Louisiana	YES	$5.062	$671.2	13.3%
Wyoming	YES	$6.173	$827.6	13.4%
Unweighted average rate				8.8%

(1) Utah and Texas assess an ad valorem property tax on the market value of mineral reserves, and this tax is assessed every year on the remaining value of the reserves.

(2) New Mexico was NOT included in this study; however, LFC staff used similar methodology to calculate the effective tax rate and included NM for reference only. New Mexico assesses an ad valorem tax on production and equipment in lieu of property tax.

Source: Covenant Consulting Group, January 2017

Appendix B. Flow of Federal Royalty Payments to New Mexico



Appendix C. Trust Land Tract Availability

Southeast Restricted District Production Zones, Offered Tracts from 1/2019-6/2023, and Open vs. Leased Lands

Roosevelt Uplift

ROOSEVELT

LINCOLN

CHAVES

Roswell

Tatum Basin

Permian Shelf

LEA

Hobbs

Capitan Reef

Central Basin Platform

EDDY

Carlsbad

OTERO

Delaware Basin

NEW MEXICO

TEXAS

0 10 20 Miles

Sources: Esri, HERE, Garmin, Intermap, increment P Corp., GEBCO, USGS, FAO, NPS, NRCAN, GeoBase, IGN, Kadaster NL, Ordnance Survey, Esri Japan, METI, Esri China (Hong Kong), (c) OpenStreetMap contributors, and the GIS User Community

High Production Zones: 99.2% Leased
Other Production Zones: 47% Leased

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Legend

- County Boundaries
- Geologic Regions
- High Production Zones
- Other Production Zones
- Offered Tracts from 1/2019-6/2023
- Open Lands as of 5/2023
- Oil and Gas Leases
- Potash Outline

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