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FISCAL IMPACT REPORT

ORIGINAL DATE 02/19/11
LAST UPDATED 03/07/11 **HB** 444

SPONSOR Lujan, B.

SHORT TITLE Tax Credit for Certain Oil & Gas Wells **SB** _____

ANALYST Burrows

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Non-Rec	Fund Affected
FY11	FY12	FY13		
	(\$50,000.0- \$75,000.0)	(\$50,000.0- \$75,000.0)	Recurring	Severance Tax Bonding Fund

(Parenthesis () Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

FY11	FY12	FY13	3 Year Total Cost	Recurring or Non-Recurring	Fund Affected
\$0.0	\$125.0	\$125.0	\$250.0	Recurring	TRD Administration

(Parenthesis () Indicate Expenditure Decreases)

Relates to SB 100

SOURCES OF INFORMATION

LFC Files

Responses Received From

State Land Office (SLO)

Energy, Minerals and Natural Resources Dept (EMNRD)

Taxation and Revenue Department (TRD)

Other Responses

The Oil and Gas Accountability Project (OGAP)

SUMMARY

Synopsis of Bill

House Bill 444 proposes to provide a credit against the oil and gas severance tax of 50 percent of expenditures on a closed-loop drilling circulation system used in drilling, stimulation or workover of a new and producing oil or natural gas well. The bill caps the amount of credit per well to \$100,000. Any credit above the annual tax liability *cannot* be carried forward to subsequent tax years. The bill also requires annual reports be submitted by the Taxation and Revenue Department to the revenue stabilization and tax policy committee.

The provisions of this bill are applicable to tax years from January 1, 2011 through December 31, 2016.

FISCAL IMPLICATIONS

TRD reports that estimates are uncertain. According to information from the Oil Conservation Division (OCD), over 1,500 wells were drilled in New Mexico last year, and closed loop systems were applied on a majority of those wells. Estimates assume closed loop systems are applied on 1,000 wells per year and that the average credit per well is \$75,000. There is substantial uncertainty about how taxpayers would determine the amount of credit for which they are eligible. See discussion under Technical Issues.

The GO-TECH database at the New Mexico Institute of Mining and Technology reports an average of 1,000 new wells were spudded in calendar years 2009 and 2010. Assuming two-thirds of this number support closed-loop systems, the estimated revenue impact would be approximately \$50 million.

According to EMNRD, the loss of oil and gas severance tax revenue could be significant depending on the number of qualifying wells and the number of taxpayers claiming the credit. Because, however, there is no way to anticipate the response of oil and gas producers to this credit, it is impossible to estimate the exact revenue loss. Conversely, the credit could provide incentive for increased oil and gas drilling, which would lead to additional tax revenue. Moreover, an increase in the establishment of closed-loop systems could reduce occurrences of environmental contamination associated with the use of reserve pits, and thereby reduce state resources expended on investigation and remediation of such environmental contamination.

Because the severance tax bonding fund is used to fund capital projects through proceeds on bond sales, any potential loss of severance tax revenue could jeopardize future capital outlay. The figure below illustrates the potential loss of bonding capacity as a result of the fiscal impact.

	Current		HB444		Difference	
	FY12	FY13	FY12	FY13	FY12	FY13
Senior Long-Term Issuance	\$180.6	\$180.6	\$180.6	\$180.6		
Senior Sponge Issuance	\$67.3	\$63.1	\$48.5	\$25.6	(\$18.8)	(\$37.5)
Senior STB Capacity	\$247.9	\$243.8	\$229.2	\$206.3	(\$18.8)	(\$37.5)
Authorized Unissued	\$0.0	\$0.0	\$0.0	\$0.0		
Water Project Fund	\$24.8	\$24.4	\$22.9	\$20.6	(\$1.9)	(\$3.8)
Tribal Infrastructure Fund	\$12.4	\$12.2	\$11.5	\$10.3	(\$0.9)	(\$1.9)
Colonias Infrastructure Project Fund	\$12.4	\$12.2	\$11.5	\$10.3	(\$0.9)	(\$1.9)
Net Senior STB Capacity	\$198.4	\$195.0	\$183.4	\$165.0	(\$15.0)	(\$30.0)
Supplemental Long-Term Issuance	\$0.0	\$0.0	\$0.0	\$0.0		
Supplemental Sponge Issuance	\$144.8	\$168.0	\$128.0	\$134.2	(\$16.9)	(\$33.8)
Supplemental STB Capacity	\$144.8	\$168.0	\$128.0	\$134.2	(\$16.9)	(\$33.8)
Total STB Capacity	\$343.2	\$363.0	\$311.3	\$299.2	(\$31.9)	(\$63.8)

The proceeds from senior severance tax bonds (STB) are used to fund capital projects statewide. At the estimated revenue projection, net STB capacity will be approximately \$15 million less than under current law in FY12 and \$30 million less in FY13. The proceeds from supplemental severance tax bonds (SSTB) are used by the Public School Capital Outlay Council to fund capital projects for public schools. The estimated revenue loss for public school capital outlay would be \$16.9 million in FY12 and \$33.8 million in FY13 under House Bill 444.

SIGNIFICANT ISSUES

According to OGAP:

“Challenges associated with conventional reserve pits include volume of drilling wastes; drill site installation and restoration costs; pollution of land and/or surface water due to failure of pits and/or containment systems and associated cleanup costs; and potential for subsurface pollution due to downward migration from pits and/or surface soil permeability.”

Closed-loop drilling, on the other hand, could minimize drilling fluid volumes and dilution by recycling fluids, and thereby reduce drilling waste. Moreover, the combination of equipment used typically results in a “dry” location where a reserve pit is not required, and solid wastes can be landfarmed, hauled off, or injected downhole. OGAP also reports that closed-loop drilling could be more cost-effective than conventional drilling.

TRD notes, however, the credit appears to be high enough that it would offset most if not all of the cost of a closed loop system. This represents a very high rate of subsidy which may not be justified from a cost-benefit standpoint.

ADMINISTRATIVE IMPLICATIONS

According to EMNRD, House Bill 444 requires that the systems be “certified” by the Oil Conservation Division (OCD) of EMNRD (see page 2, line 24). However, there is no mechanism currently in place for the OCD to “certify” closed-loop systems. Rather, pursuant to OCD Rules, the OCD issues permits for the closed-loop system once the OCD has approved the system as having met the criteria set forth in Part 17 of the OCD Rules. The “certification” requirement of House Bill 444 is incongruous with existing procedures for approval of these systems by the OCD.

According to TRD, a system for reporting expenditures will be needed. Since TRD has no particular expertise in evaluating such information, the preferred approach would be to require that expenditure reports be filed with OCD, and that the amount of credit be determined by reference to the amount of expenditures the OCD determines are eligible. OCD should report these amounts to TRD, as well as the original date of production from the qualified well.

TRD also notes that the proposal cannot be implemented within the current oil and gas severance tax processing system. To prevent disruption of the current system, the new credits would have to be processed through some type of offline request and refund process that only involves the operator of the closed-loop system that incurred the initial expenditure. Assuming the proposal affects 1,000 wells per year, this is a substantial increase in administrative complexity.

CONFLICT

Senate Bill 100 proposes a temporary reduction in the oil and gas severance tax from FY12 through FY14, offset by an equivalent increase in the oil and gas school tax for the same period. If both proposals are passed, there could be a serious negative impact to the STB capacity and state's ability to fund capital projects.

TECHNICAL ISSUES

TRD notes the following technical issues:

1. The proposal does not tie the credit to tax liability from the same well. Thus, a taxpayer could apply a closed loop system on one well and claim the credit on tax liabilities arising from other wells.
2. It is unclear how the credit would be allocated among the different interest owners in a well. For example, it would seem appropriate that the credit would be allocated in proportion to the allocation of the expenditures among the different interest owners in a well. Documenting these transactions will create complexity and possibly disputes between taxpayers and the Department.
3. The bill uses terms relating to annual tax years such as 'taxable year'; 'carry forwards'; 'tax years'. O&G severance tax is a tax on products severed and sold that is reported and paid monthly. In this context, terms like "taxable year" are not meaningful. An alternative would be to allow credits against monthly tax liability arising from sales of products from a well on which a closed loop system has been installed for each of the twelve months following completion of installation.
4. Although the bill states that credits cannot be carried forward, O&G severance taxpayers currently have up to four years to amend their tax returns with regard to a particular product sale. The bill might clarify whether taxpayers will be allowed to apply credits to these amended liabilities.
5. The proposal does not define what expenditures will qualify for the credit and how these will be measured and reported. This leaves room for substantial disagreements between the Department and taxpayers.
6. The bill is silent as to what effective date is to be used for determining if a newly drilled well qualifies. To clarify its application, the Department would recommend that this tax credit apply to new wells from which production originates on or after July 1, 2011.
7. Does the Department have the right to audit the "expenditures"? What happens if the audit results in denial of some of the expenditures after the credit has been issued? Does the "credit" need to be refunded with interest and penalty?
8. Taxpayers report severance taxes at the production unit level, not the well level. A process and transaction would need to be implemented and taxpayers trained to report this at the qualifying well level.

OCD notes:

1. Subsection C, on page 2, line 20, refers to a "division-approved landfill." However, as defined in the Oil and Gas Severance Tax Act, §7-29-2, the "division" is the Taxation and Revenue Department (TRD). TRD does not have the expertise to "approve" landfills for the disposal of drilling fluids. In contrast, pursuant to Part 17 of the OCD Rules, the Oil Conservation Division (OCD) does, as part of its regulatory duties, approve surface waste *facilities* (of which landfills are one type) for the disposal of drilling fluids.

2. No definitions are provided for the terms setting the criteria – “stimulation” and “workover.” Both of these words are subject to various interpretations by the oil and gas industry...A “workover” of a well, in and of itself, indicates that the well is *not* “new.” Conversely, a previously drilled well that is being “re-entered” can sometimes be considered “new” depending on the circumstances. Thus, the elements of the standard as established by subsection A are conflicting and unclear and are likely to be problematic for operators and agencies.

OTHER SUBSTANTIVE ISSUES

The State Land Office (SLO) reports that House Bill 444 is related to the OCD regulation 19.15.7, better known as the “Pit Rule,” which prohibits the use of unlined pits for oil field waste, and requires the increase of lining thickness from 12 mills to 20 mills. The Pit Rule also requires that pit waste be removed to a landfill and that the pit be restored.

The SLO also expresses concern that the credit is not available for workover on existing wells, or for expenses in drilling dry holes.

AMENDMENTS

EMNRD suggest the following amendments:

Page 2, lines 19-20:

19 and contains them in sealed bins, which are removed to a
20 oil conservation division-approved facility landfill. This process provides an

Page 2, line 24:

24 ~~certified~~ permitted pursuant to OCD Rules and approved by the oil conservation
division of the

OGAP emphasizes the need for accountability and suggests the bill be amended to include the following statement under subsection B: “Any taxpayer who claims the tax credit set forth in subsection A shall report to the Department any fiscal savings resulting from the expenditures.”

To ensure further accountability, a potential amendment could include an aggregate annual maximum on the dollar amount of credits that can be claimed.

WHAT WILL BE THE CONSEQUENCES OF NOT ENACTING THIS BILL

Oil and gas producers would not receive credits against the oil and gas severance tax for implementing closed-loop drilling systems.

LKB/bym:svb

The Legislative Finance Committee has adopted the following principles to guide responsible and effective tax policy decisions:

- 1. Adequacy:*** revenue should be adequate to fund government services.
- 2. Efficiency:*** tax base should be as broad as possible to minimize rates and the structure should minimize economic distortion and avoid excessive reliance on any single tax.
- 3. Equity:*** taxes should be fairly applied across similarly situated taxpayers and across taxpayers with different income levels.
- 4. Simplicity:*** taxes should be as simple as possible to encourage compliance and minimize administrative and audit costs.
- 5. Accountability/Transparency:*** Deductions, credits and exemptions should be easy to monitor and evaluate and be subject to periodic review.

More information about the LFC tax policy principles will soon be available on the LFC website at www.nmlegis.gov/lcs/lfc