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

SPONSOR	Strickler/Scott/Nibert/ Brown/Bandy	**ORIGINAL DATE** **LAST UPDATED**	2/4/19 2/11/19	**HB**	353
SHORT TITLE	Reduce Certain Oil and Gas Tax Rates			**SB**	
				ANALYST	Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
(See Fiscal Implications*)					Recurring	General Fund
(See Fiscal Implications*)					Recurring	Severance Tax Bonding Fund

Parenthesis ( ) indicate revenue decreases

* If oil prices fall short of projections, this bill could have a significantly negative impact on the general fund and the severance tax bonding fund – into to the tens of millions. See fiscal implications for more detail.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY19	FY20	FY21	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total	$21.0	$21.0	$0	$42.0	Nonrecurring	TRD

Parenthesis ( ) indicate expenditure 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)
Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

House Bill 353 amends a section of the Oil and Gas Severance Tax Act, Section 7-29-4 NMSA 1978, and a section of the Oil and Gas Emergency School Tax Act, Section 7-31-4 NMSA 1978, to reduce the price threshold for which stripper wells to qualify for reduced tax rates.

The proposed reduced rates are as follows:

Taxes on Oil	CURRENT RATES Net Price of Oil ($/bbl)			PROPOSED Net Price
	Under $15	$15 to $18	Over $18	Under $38
Oil and Gas Emergency School Tax	1.58%	2.36%	3.15%	1.58%
Oil and Gas Severance Tax	1.875%	2.8125%	3.75%	1.875%

Taxes on Natural Gas	CURRENT RATES Net Price of Natural Gas ($/mcf)			PROPOSED Net Price
	Under $1.15	$1.15 to $1.35	Over $1.35	Under $2.00
Oil and Gas Emergency School Tax	2.00%	3.00%	4.00%	2.00%
Oil and Gas Severance Tax	1.875%	2.8125%	3.75%	1.875%

The effective date of this bill is July 1, 2019.

FISCAL IMPLICATIONS

The December 2018 consensus revenue estimates do not forecast oil or natural gas prices reaches the levels proposed in this bill. However, if prices fall short of expectations, this bill could have a negative revenue impact in the tens of millions, affecting the general fund (for the emergency school tax) and the severance tax bonding fund and severance tax permanent fund (for the severance tax).

The Taxation and Revenue Department (TRD) points out this bill could amplify the effect of state revenues losses caused by an oil and natural gas price decline. In other words, at a time when general fund and severance tax bonding fund revenue would dramatically decreased if prices were to fall, the bill would exacerbate the revenue shortfall by providing an additional tax subsidy to some oil and gas producers.

According to Oil Conservation Division (OCD) records, there are currently approximately 15,737 active stripper oil wells in New Mexico (wells that produce less than 10 barrels of oil per day), and approximately 15,636 active stripper gas wells in New Mexico (wells that produce less than 60 MCF of gas per day). Based on OCD production data for these wells provided by the Energy, Minerals and Natural Resource Department (EMNRD), state revenues could fall by $14 million if New Mexico oil prices fell to $37 per barrel (bbl) and could fall by $3 million if the state's average natural gas prices fell to $1.95 per thousand cubic feet (mcf). The Department of Finance and Administration (DFA) analysis of this bill estimated a similar impact if prices were to fall below the proposed thresholds.

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.

SIGNIFICANT ISSUES

The Department of Finance and Administration (DFA) notes that if oil or natural gas prices fall below the proposed thresholds, the state would already be facing a major reduction in tax revenues from oil and natural gas activities. Should the proposed tax cuts come into effect, revenues would fall that much more, making New Mexico tax revenues more volatile overall.

While this bill only changes the price threshold for the reduced tax rates for stripper wells, there are several issues with the way current law structures the trigger for the reduced rates. First, wellhead prices for oil and natural gas must average at or below the threshold price for entire calendar year before the reduced tax rates kick in. While oil prices dipped below $38 for several months during the price crash in 2015-2016, the calendar year average never fell below the threshold. Therefore, stripper wells would not have qualified for the reduced tax rate during this time (see chart below).

Month	NM Oil Price	NM Gas Price
Jan-15	$42.36	$3.11
Feb-15	$43.78	$2.98
Mar-15	$41.91	$2.96
Apr-15	$48.07	$2.81
May-15	$53.66	$2.76
Jun-15	$54.56	$2.86
Jul-15	$47.40	$2.83
Aug-15	$39.83	$2.81
Sep-15	$42.86	$2.83
Oct-15	$43.72	$2.69
Nov-15	$38.64	$2.37
Dec-15	$31.97	$2.32
2015 Avg	**$44.24**	**$2.78**
Jan-16	$27.18	$2.24
Feb-16	$26.58	$2.13
Mar-16	$32.88	$1.94
Apr-16	$36.08	$2.05
May-16	$42.07	$2.35
Jun-16	$44.88	$2.53
Jul-16	$41.08	$2.90
Aug-16	$40.98	$2.88
Sep-16	$41.15	$3.03
Oct-16	$45.68	$3.19
Nov-16	$42.12	$2.87
Dec-16	$48.58	$3.69
2016 Avg	**$39.19**	**$2.67**

Source: GenTax

Secondly, since the trigger for the reduced tax rate is based on an average calendar year price, tax relief to small producers could be significantly delayed and may not prevent halts in production or the temporary shut-in of wells. The reduced tax rates would not be effective until the following fiscal year, when prices may have recovered.

Lastly, it is possible for the average annual price to fall below the threshold even if the price actually remains below that threshold for just a few months. Moreover, if the threshold is triggered, stripper well producers will see a tax benefit for the entire following year until the next calculation is made by the department.

DFA reiterates these timing concerns in their analysis, stating the structure of the thresholds for the reduced tax rates "may not provide the tax relief when producers need it, or it may provide tax relief when producers don't need it."

Additionally, DFA provides the following discussion for consideration:

> "[The] proposed bill significantly reduces a revenue stream that bondholders invest in. While the estimated reduction in revenues calculated by DFA and LFC may seem relatively minor in terms of its effect on the State's outstanding severance tax bonds, reducing pledged revenues could raise a red flag to the investment market. Such an action as proposed in the bill would establish a legal precedent that could negatively impact bondholder interests in the future. Bondholders may be concerned that the State is not exacting the same diligence in oversight of sufficient bond reserves, and that taxes on resources may be reduced even further in the future."

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 claiming the reduced tax rate and other information to determine whether the tax expenditure is meeting its purpose.

ADMINISTRATIVE IMPLICATIONS

The bill proposes new severance and emergency school tax rates on oil and natural gas removed from stripper wells based on reaching a price threshold level. These rate changes will require changes to forms, notifying taxpayers and reprogramming to the GenTax system. Implementing this bill has a moderate impact on TRD's Information Technology Division requiring $42,000 and 4 months to implement the rate changes in GenTax. TRD states the effective due date of 7/1/19 may not be feasible, and a more feasible effective date would be 10/1/19.

The 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 per Sections 7-29-2(P) and 7-29B-3(C) NMSA 1978.

Does the bill meet the Legislative Finance Committee tax policy principles?

1. **Adequacy**: Revenue should be adequate to fund needed government services.
2. **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.
3. **Equity**: Different taxpayers should be treated fairly.
4. **Simplicity**: Collection should be simple and easily understood.
5. **Accountability**: Preferences should be easy to monitor and evaluate

Does the bill meet the Legislative Finance Committee tax expenditure policy principles?

1. **Vetted**: The proposed new or expanded tax expenditure was vetted through interim legislative committees, such as LFC and the Revenue Stabilization and Tax Policy Committee, to review fiscal, legal, and general policy parameters.
2. **Targeted**: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.
3. **Transparent**: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies.
4. **Accountable**: The required reporting allows for analysis by members of the public to determine progress toward annual targets and determination of effectiveness and efficiency. The tax expenditure is set to expire unless legislative action is taken to review the tax expenditure and extend the expiration date.
5. **Effective**: The tax expenditure fulfills the stated purpose. If the tax expenditure is designed to alter behavior – for example, economic development incentives intended to increase economic growth – there are indicators the recipients would not have performed the desired actions "but for" the existence of the tax expenditure.
6. **Efficient:** The tax expenditure is the most cost-effective way to achieve the desired results.

LFC Tax Expenditure Policy Principle	Met?	Comments
Vetted	✘	
Targeted		None stated, intent appears to be to provide tax relief to small producers in low price environments to avoid temporary shut-ins or the plugging or abandoning of small wells.
Clearly stated purpose	✘	
Long-term goals	✘	
Measurable targets	✘	
Transparent	✘	No reporting required.
Accountable		
Public analysis	✘	
Expiration date	✘	
Effective		See significant issues section. The bill may not provide the tax relief when producers need it, or it may provide tax relief when producers do not need it.
Fulfills stated purpose	?	
Passes “but for” test	?	
Efficient	✘	See significant issues section. The bill may not provide the tax relief when producers need it, or it may provide tax relief when producers do not need it.
Key: ✓ Met ✘ Not Met ? Unclear		

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