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

ORIGINAL DATE 2/25/19
SPONSOR Lente **LAST UPDATED** ___ **HB** 398

SHORT TITLE Oil, Gas & Vented Gas Royalties **SB** ___

ANALYST Iglesias

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY19	**FY20**	**FY21**	**FY22**	**FY23**		
$0.0	Indeterminate, likely positive (see fiscal implications)				Recurring	Land Grant Permanent Fund (LGPF)

Parenthesis ( ) indicate revenue decreases

SOURCES OF INFORMATION
LFC Files

Responses Received From
State Land Office (SLO)
Energy, Minerals and Natural Resources Department (EMNRD)
New Mexico Attorney General (NMAG)
Economic Development Department (EDD)

SUMMARY

Synopsis of Bill

House Bill 398 amends Section 19-10-4.3 NMSA 1978 which prescribes a form of oil and gas lease used by the Commissioner of Public Lands. The proposed amendments (1) allow for an increased royalty of 25 percent when production of oil or gas reaches levels determined under a new section of this bill, and (2) require the lessee to use all reasonable means to prevent the waste of oil and gas, including venting and flaring, and require a royalty for all wasted oil or gas including vented, flared, spilled or stolen oil or gas.

The proposed new section (19-10-4.4) establishes thresholds for when the 25 percent royalty applies to premium development leases. From July 1, 2019 to June 30, 2020, the threshold is 20 thousand barrels of oil or 75 million cubic feet of gas per month. Beginning July 1, 2020 and thereafter, the threshold will be set by the Commissioner by rule promulgated in accordance with Section 19-10-21 NMSA 1978.

There is no effective date of this bill. It is assumed that the effective date is 90 days after this session ends.

FISCAL IMPLICATIONS

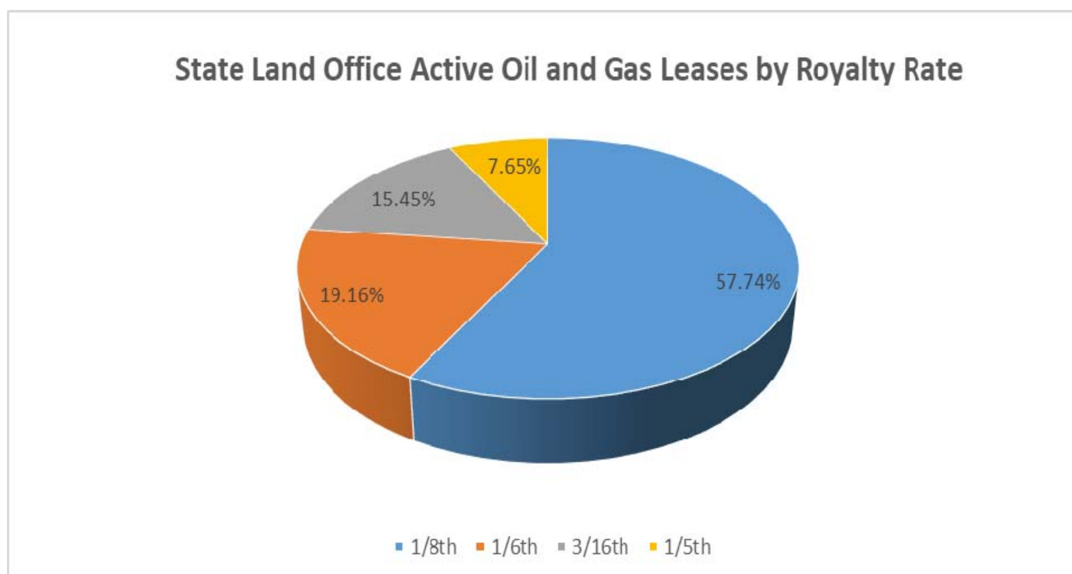
Because the bill's proposed increased royalty rate for high-producing leases would only apply to new leases, it is difficult to estimate the fiscal impact of this bill. The State Land Office (SLO) states it is difficult calculate with precision how many leases will go to auction, when they will begin production, market factors such as price that may impact development timelines, how new technologies may effect production levels and other related variables. Furthermore, since the legislation enables the threshold trigger for the increased royalty rate to be adjusted by public rulemaking in future years, revenue projections are subject to change.

Since the bill only applies to new leases issued after July 1, 2019, and most leases do not begin production for 2-3 years, SLO expects any revenue increases from this bill to likely begin in FY22. SLO estimates that the bill would eventually result in an average annual increase in revenue of $50 million to $84 million from the bill's royalty rate increase if production levels exceed 20 thousand bbls of oil and 75 million cubic feet of gas on the most productive new leases (this does not include investment returns from the State Investment Council over the decades the leases would be in effect). SLO derived this estimate by evaluating wells completed within the past five years and considering a royalty rate at 25 percent rather than 20 percent. The estimates also included a $52 average price per barrel of oil and a $2.84 average price per thousand cubic feet (mcf) of gas. Estimates also took into account production equaling 7 million barrels of oil and 30 billion cubic feet of gas. Of the approximately 7,100 active oil and gas state trust leases, SLO finds approximately 100 leases would be impacted by the 20,000 bbls/75,000 mcf triggers if this bill was in effect over the last five years (about 6 percent of all development leases and 1.5 percent of all active leases).

Additionally, SLO states ensuring payments on wasted vented or flared gas would result in an estimated increase in royalty payments. For example, between 2016 -2018, SLO reports the annual average vented and flared gas amounted to 11.6 billion cubic feet on state trust lands, which if royalties were collected on would amount to approximately $12 million over this period (applying an average price of $2.39 with an average royalty rate of 14.87 percent).

Considering that the bill only applies to new leases and only to those leases that are the most productive, as well as the fact much of the Permian Basin is already leased, SLO believes the fiscal impact on the oil and gas industry would be marginal. SLO reports most of the Permian Basin is already leased and the terms (including lower royalty rates) of existing leases stay in place as long as the wells are producing in paying quantities. As such, many very old leases, which can date back to the 1920s, are still in effect. Therefore, of the 7,180 active oil and gas leases on state trust lands, only 549 (7.65 percent) are at the 20 percent royalty rate and 4,146 (57 percent) of the leases are at the 12.5 percent rate.

The land office states that, if the legislation had been in place over the last five years, of all active leases, the proposed trigger thresholds would have only impacted about 1.5 percent of all active leases and 6 percent of development leases.



When considering any possible changes to the state's royalty rates, there is a potential trade-off. Higher royalty rates, which add to producers' long-term cost considerations, may result in lower upfront bids (bonuses) to secure land leases. This tradeoff has important policy implications. For New Mexico, bonus payments for state land leases go directly to the general fund for that fiscal year, while royalty payments for production on state lands flow to the land grant permanent fund. Permanent fund distributions provide New Mexico with a large and stable revenue stream that is less exposed to price and market value fluctuations. Therefore, increased royalty payments could lead to lower short-term bonus revenue but provide more stable revenues over time through the permanent fund distributions. However, because producers consider comparative royalty rates in the cost of doing business, overly burdensome rates could shift production activity to other areas.

SIGNIFICANT ISSUES

State and federal leasing policy has several, sometimes competing, objectives: to promote timely development of resources, return economic rents to the public (the resource owners), to protect the environment, and to promote competition in private industry.

Current law requires that the Commissioner of Public Lands, in issuing oil and gas leases for state trust lands, use one of three statutory forms.[1] The particular form of lease depends on whether the lands are within a statutorily established restricted district[2] and whether the tract within a restricted district is categorized as "premium" or "regular." Categorizing a tract as "regular" or "premium" involves an assessment of the following statutorily prescribed factors relating to the tract: (1) oil and gas trends; (2) oil and gas traps; (3) reservoir volume and recovery rating; (4) lease bonus rating; and (5) exploration and activity.[3] The statutory factors are more specifically defined in the state land office's oil and gas leasing rule.

The royalty rate under the existing statutory oil and gas lease[4] is as follows:

[1] Section 19-10-4 NMSA 1978.
[2] See Section 19-10-16, NMSA 1978.
[3] See Section 19-10-3 NMSA 1978; and 19.2.100.11 NMAC.
[4] See Sections 19-10-4.1 to 19-10-4.3 NMSA 1978; and 19.2.100.13 NMAC.

Exploratory Form	1/8 (12.5%)
Discovery Form	1/6 (16.66%)
Development Form	3/16 (18.75%) – 1/5 (20%)

This bill would revise the statutory form of oil and gas "development lease" issued by the State Land Office for lands classified as restricted lands and categorized as "premium".[5] The changes would only apply to new leases issued on or after July 1, 2019 and to leasing areas of demonstrated production.

Under current law, the royalty rate under a development lease must be not less than three-sixteenths (18.75 percent) nor more than one-fifth (20 percent). The revised form of the lease would set the royalty at one-fourth (25 percent) for all oil and gas produced and saved after a well on the leased premises produces more than a threshold amount of either oil or gas as set in accordance with Section 2 of the bill. Starting July 1, 2019, the threshold amount of oil would be 20 thousand barrels per month and the threshold amount of gas would be 75 million cubic feet per month. Starting July 1, 2020, the threshold amounts would be set by rule promulgated by the commissioner of public lands after public notice and comment.

Royalty revenues are different from taxes in that the state and federal government (and the taxpayers) are owners of the land and are entitled to a share of production value from activities occurring on that land, similar to private land owners who also receive royalty payments for oil and gas production activities. SLO similarly points out that state royalties represent the share of the profit the Trust receives for a resource owned by the state. SLO believes it to be "sound policy" to stipulate that if companies are making a higher profit off of a highly-productive oil and gas lease that the beneficiaries of the Trust, such as public schools, receive a higher profit margin.

The Energy, Minerals and Natural Resources Department (EMNRD) states the land commissioner, in setting the threshold under section 2 of this bill, will need to consider the impacts of the higher royalty when the production of the well declines. The provision for the imposition of the 25 percent royalty provides that once the threshold is exceeded for any month, the 25 percent royalty will apply for the remaining term of the lease regardless of how much the production may decline in the future.

TECHNICAL ISSUES

The lease form in Section 19-10-4.3 refers to the threshold in Section 19-10-4.4; however, Section 19-10-4.4 applies to the lease in Section 19-10-4.2.

Waste is defined in the Oil and Gas Act as including both "underground waste" and "surface waste" and those terms are further defined in Section 70-2-3 NMSA 1978. However, this bill refers to "underground or above-ground waste".

EMNRD suggests the following technical changes:

On page 7, line 23, delete "above-ground" and insert "surface";
On page 16, line 23, delete "19-10-4.2" and insert "19-10-4.3";
Insert a new Section 3 with an effective date of July 1, 2019.

[5] See Section 19-10-3 NMSA 1978.

The New Mexico Attorney General's Office (NMAG) points out the following issues with the bill as drafted:

> The proposed language imposing the one-fourth royalty rate provides that "if any well on the leased premises produces in excess of [the specified threshold amount] barrels of oil per month or in excess of [the specified threshold amount] m.c.f. gas per month, the royalty on oil and gas shall be one fourth, to be taken or paid as set forth above for the remaining term of the lease."
>
> Read literally, this would mean that the one-fourth royalty rate would apply to both oil and gas if either one them exceeded the applicable monthly production threshold, though it is not clear that this is the intent. In addition, it is not clear if the one-fourth royalty would apply to all oil and gas from the lease, or only to that produced from the well that exceeds the threshold.
>
> The requirement to use "all reasonable means" (p. 7, lines 22-25) to prevent waste and avoid venting and flaring is vague, which may contribute to undue disputes and litigation. For example, it is not clear what specific equipment requirements (low-bleed pneumatic controllers, zero emissions pumps, etc.) would constitute "reasonable means," and what if any efforts at leak detection and repair would be required. The commissioner is authorized to waive royalties due for gas necessarily vented or flared at her or his sole discretion, which allows for case-by-case determinations of what is reasonable, but the expectations for preventing waste might benefit from regulatory elaboration.
>
> Relatedly, "waste" is not defined in the bill or elsewhere in Chapter 19, though the term does have common understanding in the industry as codified at 19.15.2.7 (W) NMAC. Existing Section 19-10-48 provides that: "Nothing herein [19-10-45 to 19-10-48 NMSA 1978] contained shall be held to modify in any manner the power of the oil conservation commission under laws now existing or hereafter enacted with respect to the proration, and conservation of oil or gas and the prevention of waste." Therefore, the waste provisions of [this bill] might be found to be preempted by regulations of the oil conservation commission, should such regulations conflict with the provisions of the bill.

OTHER SUBSTANTIVE ISSUES

On January 18, 2019, the New Mexico Tax Research Institute along with Moss Adams presented a cross-state comparative report on oil and gas revenues to the House Appropriations and Finance Committee. One of the report's key findings was that New Mexico receives more land income revenue – bonuses, rents, and royalties – as a percentage of total production value than the other nine states in the analysis. Regarding this finding, it is important to note New Mexico receives more land income revenue *because* of the significant portion of production in New Mexico that occurs on state and federal lands. Consideration of the magnitude of production on public land is particularly important for comparing New Mexico's government revenues to those of other states. While state and federal governments own about 40 percent of New Mexico's total land area, Taxation and Revenue Department data shows about 80 percent of all oil and gas production occurs on state and federal lands. This compares to states like Texas where less than 2 percent of the state's total area is owned by state and federal governments (see Appendix A).

The State Land Office provides the following additional discussion:

> "The Commissioner of Public Lands has a fiduciary responsibility to ensure that the state land trust receives appropriate value for the resources being leased to oil and gas operators. Under the Constitution and by statute, the Commissioner has jurisdiction over and is entrusted with the management, care, custody, control and disposition of state trust lands in accordance with the Enabling Act. N.M. Const. art. XII, § 2; NMSA 1978 § 19-1-1 (1912). The commissioner's responsibility is as a fiduciary serving the long term interests of the Enabling Act trust and the supported institutions to ensure that the land is managed solely for the long term support of those institutions. Furthermore, the State as a whole has a trust responsibility to ensure that state trust lands serve their intended purposes; i.e., providing the maximum support to the trust land beneficiaries. See Lassen v. Arizona Highway Dept., 385 U.S. 458, 463 (1967) (noting that the Enabling Act restrictions indicate Congress' concern the state trust land grants provide the most substantial support possible to the beneficiaries)."

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APPENDIX A

Land Ownership – Public/Private

Percent Production Volume by Land Ownership Type

State	Product	Production on Private Land	Production on State Land	Production on Federal Land
New Mexico	Natural Gas	18%	19%	63%
New Mexico	Crude Oil	13%	34%	53%
Colorado	Natural Gas	46%	15%	39%
Colorado	Crude Oil	80%	16%	4%
Kansas	Natural Gas	98%		2%
Kansas	Crude Oil	100%		0.4%
Montana	Natural Gas	70%	6%	24%
Montana	Crude Oil	80%	6%	14%
Oklahoma	Natural Gas	80%	22%	1%
Oklahoma	Crude Oil	78%	8%	0.4%
Texas	Natural Gas	82%	18%	0.4%
Texas	Crude Oil	91%	9%	0.03%

Oil and Gas Revenue Comparison, Presentation to the New Mexico House Appropriations and Finance Committee