FISCAL IMPACT REPORT

		LAST UPDATED	
SPONSOR	Griggs	**ORIGINAL DATE**	2/4/24
SHORT TITLE	Severance Tax Exemption for Certain Projects	**BILL NUMBER**	Senate Bill 64
		ANALYST	Torres, Ismael

REVENUE*
(dollars in thousands)

Type	FY24	FY25	FY26	FY27	FY28	Recurring or Nonrecurring	Fund Affected
Severance Tax		($4,300.0)	($4,300.0)	($4,300.0)	($4,300.0)	Recurring	Severance Tax Bonding Fund
Severance Tax		Losses of at least ($3,600.0)	Losses of at least ($3,600.0)	Losses of at least ($3,600.0)	Losses of at least ($3,600.0)	Recurring	Senior Capital Outlay Capacity
Severance Tax		Losses of at least ($1,800.0)	Losses of at least ($1,800.0)	Losses of at least ($1,800.0)	Losses of at least ($1,800.0)	Recurring	Supplemental Capital Outlay Capacity
Severance Tax		Losses dependent on capital outlay	Losses dependent on capital outlay	Losses dependent on capital outlay	Losses dependent on capital outlay	Recurring	Severance Tax Permanent Fund
Investment Distributions		Losses dependent on capital outlay and investment earnings	Losses dependent on capital outlay and investment earnings	Losses dependent on capital outlay and investment earnings	Losses dependent on capital outlay and investment earnings	Recurring	General Fund

Parentheses ( ) indicate revenue decreases.
*Amounts reflect most recent analysis of this legislation.

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT*
(dollars in thousands)

	FY24	FY25	FY26	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
EMNRD		$200.0	$200.0	$400.0	Recurring	General Fund

Parentheses ( ) indicate expenditure decreases.
*Amounts reflect most recent version of this legislation.

Sources of Information

LFC Files

Agency Analysis Received From
Taxation and Revenue Department (TRD)
New Mexico Attorney General (NMAG)

SUMMARY

Synopsis of Senate Bill 64

Senate Bill 64 (SB64) provides for an exclusion to the Oil and Gas Severance Tax for oil and natural gas severed from a stripper well and sold from a production compliance project during the first 10 years of production following the completion of the project, or until the date the total amount of tax that would have been imposed but for this exemption equals the cost of the production compliance project, whichever occurs first.

The bill defines a "production compliance project" as a procedure undertaken by oil or natural gas well operators in order to comply with rules of the Oil Conservation Division (OCD) on or after January 1, 2022, to reduce the venting and flaring of natural gas from wells and production equipment and facilities and of natural gas from natural gas gathering systems or by the environmental improvement board to reduce ambient ozone concentrations.

The bill also includes this definition of a production compliance project in the existing Natural Gas and Crude Oil Production Incentive Act (Section 7-29B NMSA 1978) and amends the act to include provisions by which OCD shall approve a natural gas or crude oil well as a production compliance project. The well operator must apply to the division in accordance with the provisions of the act and associated rules within 12 months of completion of the project, and the project must have been undertaken in order to continue production of the well. The well must also be certified by OCD as a stripper well, and the operator's total production in the state is no more than 1,000 barrels of oil equivalent per day. The bill also specifies the type of equipment that the production compliance project was implemented to install, upgrade, or replace. OCD is required to notify the Taxation and Revenue Department immediately upon certification of the date that a production compliance project has been completed.

The provisions of the bill are applicable to production compliance projects completed on or after July 1, 2024.

FISCAL IMPLICATIONS

SB64 would provide a new exemption from the Oil and Gas Severance Tax for stripper wells, which are currently defined in statute as wells with an average daily production of less than 10 barrels (bbls) per day of oil or less than 60 thousand cubic feet (mcf) per day of natural gas. The Oil and Gas Severance Tax is one of four existing production taxes imposed on the taxable value of oil and natural gas production in New Mexico. The existing Severance Tax rate is 3.75 percent, with reduced tax rates applicable for stripper wells if natural gas prices fall below $1.15/mcf or if oil prices fall below $18/bbl (along with reduced tax rates for certain other types of wells if the price of oil and natural gas is very low).

Based on data from OCD, New Mexico had over 13 thousand active stripper oil wells and over 14 thousand active stripper natural gas wells in 2021. While stripper wells make up over 20 percent of all active wells in the state, due to their low-producing nature, stripper wells accounted for less than 1.5 percent of total oil production and less than 6 percent of total natural gas production in 2021.

Additionally, SB64 requires the exemption only apply to operators that produced less than 1,000 barrels of oil equivalent per day; therefore, larger operators in the state are presumably ineligible for the exemption, even if they have active stripper wells in their inventory.

The estimates provided in the fiscal impact table use data from OCD's 2021 report for oil and natural gas production from stripper wells to estimate the potential impact of the bill's severance tax exemption. To approximate the applicability of the exemption to smaller operators, the OCD report data was filtered to focus only on those wells in which the well's operator produced a total of less than 1,000 barrels of oil equivalent per day on average.

About 28 percent of the state's active stripper oil wells were produced by such operators, and these operators accounted for about 12 percent of the state's active stripper natural gas wells. Production from these wells totaled about 1.1 million barrels of oil and about 9.7 billion cubic feet of natural gas in 2021. Assuming the oil and natural gas prices estimated in the December 2022 consensus revenue estimate, this would equate to about $4 million per year in severance taxes that would be paid for this subgroup of stripper well production. Therefore, this amount is the assumed fiscal impact of the bill.

However, the uncertainty of this estimate is significant given the reliance on historical data, the applicability of the exemption, and the uncertainty regarding the number of operators that would both apply and be approved for the exemption.

The reduced revenue to the severance tax bonding fund would result in at least a proportional reduction in capital outlay funding each year and reduced inflows into the severance tax permanent fund (STPF). The current statutory allocation of severance tax revenues is 86.2 percent for capital outlay and 13.8 percent to the STPF.

The estimates on page 1 reflect LFC analysis of the reduced revenue impact to the bonding fund and its impacts on senior and supplemental severance tax bonding capacity.

From a similar analysis of an identical bill proposed in the 2023 legislative session (SB443), the Energy, Minerals and Natural Resources Department estimates that an additional 2 FTE would be necessary to support the total costs reflected in the table on page 1.

This bill creates a tax expenditure with a cost that is difficult to determine but significant. LFC has concerns about the risk to state revenues from tax expenditures. The committee recommends the bill adhere to the LFC tax expenditure policy principles for vetting, targeting, and reporting.

SIGNIFICANT ISSUES

Overall, the legislation would incentivize marginally producing wells to continue operations rather than being plugged. Because stripper wells create more environmental and fiscal legacy concerns for the agency, the bill could result in future financial liability for the State Land Office with respect to the plugging and remediation of these wells when companies are unable or unwilling to close out operations and appropriately cleanup sites. Plugging, remediation, and reclamation costs at times could exceed the minimal additional royalty revenue received by the agency.

The bill would have a negative but indeterminate impact to the land maintenance fund due to potential risk of needing to absorb plugging and remediation costs in the event the operators of those wells become insolvent at some point after enactment of the bill. The bill would also have an indeterminate but minimal positive fiscal impact to the land grant permanent fund due to wells that would otherwise have been plugged continuing to generate marginal state royalty revenue.

In an analysis of the duplicate bill proposed during the 2023 regular legislative session (SB443), the New Mexico Environment Department noted concerns about compliance and the ability to receive the credits despite falling out of compliance. The department suggests adding claw back provisions for those facilities in violation of the substantive compliance requirements.

Similarly, the Energy, Minerals and Natural Resources Department highlighted significant concerns in 2023:

> [The bill] follows upon the rules adopted by the OCC to greatly reduce the venting and flaring of natural gas in oil and gas production activities, 19.15.27, .28 NMAC, and by the EIB to reduce ambient ozone concentrations. 20.2.50 NMAC. The OCC rules prohibit the ordinary venting and flaring of natural gas and require the capture and transport or use of the gas. The rules are performance based and require operators to measure their current emissions and then reduce them over time. The OCC rules are not technology based and therefore do not dictate the type of equipment that an operator must install to achieve the goals. These rules apply to oil and gas production facilities (wellhead and associated facilities) and natural gas gathering systems which gather (through gathering lines) and treat the gas and which end with a processing plant or transmission or distribution system.
>
> The EIB rules do have specific standards for the equipment that would be installed to reduce ozone concentrations. The EIB rules also have lesser requirements for "small business facilities" which would likely apply to many of the stripper well operators covered by [the bill] (20.2.50.125 NMAC)…
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> [The bill] requires the Division to review and approve the production compliance project as part of the tax credit certification process. The Division would be required to determine if a project was required not just for adherence to OCC rules but also for adherence EIB rules for which the Division has no expertise. The EIB rules also contain specific standards for the equipment which the Division is also not familiar with.

The State Land Office added:

> The Oil and Gas Severance Tax Act and the Natural Gas and Crude Oil Production Incentive Act (Acts) already confer generous and extensive tax exemptions and tax reductions on marginally producing oil and gas properties. For instance, the Acts provide a ten-year tax exemption for reworking low-producing wells, called a "production restoration project" exemption. NMSA 1978, § 7-29-4 (no severance tax due on natural gas or oil removed from a wellhead where the producer conducted a "production restoration project"). Production restoration projects" include re-entry into wells to drill deeper or sidetrack to a different location, recompletion, fracturing, and other reworking operations, NMSA 1978, § 7-29-2, and producers are eligible for the tax exemption if the restoration work is performed on a well with negligible production, *id.* § 7-29b-3(A)(2) (eligible wells have less than 30 days of production in the preceding two years).

In addition, the Acts give favorable tax treatment to production from stripper wells, which are very low-producing wells (defined as wells producing an average daily production of less than 10 barrels per day for the preceding calendar year, or an average daily production of less than 60 mcf of gas per day for the preceding calendar year), *id*. § 7-29b-L; for production from "well workover projects," which are defined broadly to mean "<u>any</u> procedure undertaken by [a well operator] … that is intended to increase the production from the well," NMSA 1978, § 7-29b-2(O) (emphasis added); and for and for oil or gas produced from wells where an "enhanced recovery project" is performed, defined under the Oil and Gas Severance Tax Act to include wells produced through pressure maintenance or waterflooding, *id*. § 7-29-2(M).

Stripper well production is only taxed at between 1.875 percent and 2.1875 percent, *id*. § 7-29-4(A)(6)-(8), oil or gas produced from a well involved in a well workover project is only taxed at between 2.45 percent, *id*. § 7-29-4(A)(4)-(5), and oil and gas produced from wells under qualified enhanced recovery projects at 1.875 percent, *id*. § 7-29-4(A)(3). This compares to a default excise tax rate of 3.75 percent for oil and gas production. *Id*. § 7-29-4(A)(1)-(2)…

The State Land Office manages over 6,300 active oil and gas leases spread across some 13 million acres of mineral estate. Almost 60 percent of oil and gas wells on state trust land are stripper wells as defined by the Oil and Gas Severance Tax Act, NMSA 1978, § 7-29-2(P), and the Natural Gas and Crude Oil Production Incentive Act, *id*. § 7-29b-2(L)…

The State Land Office continues to observe demonstrable trend of larger, well-capitalized oil and gas companies divesting stripper wells to smaller, less capitalized companies. By conferring a tax exemption on production from extremely low-producing stripper wells that have been retrofitted to comply with recently promulgated OCC and EIB rules to reduce methane and ozone precursor pollutants, the bill would artificially prolong the life of those wells that otherwise would no longer be economically feasible to operate. New Mexico taxpayers, and the public beneficiaries on whose behalf the Commissioner of Public Lands manages state trust lands, would bear the risk and likely the cost of plugging and remediating an unknown but likely significant number of additional stripper wells.

TECHNICAL ISSUES

SB64 refers to rules that were promulgated by the OCC and the EIB "on or after January 1, 2022." While the EIB rules were promulgated in 2022, the OCC rules were promulgated in 2021 and became effective on May 25, 2021. Therefore, SB64 as currently written would not apply to the OCC rules.

OTHER SUBSTANTIVE ISSUES

In assessing all tax legislation, LFC staff considers whether the proposal is aligned with committee-adopted tax policy principles. Those five principles:

- **Adequacy**: Revenue should be adequate to fund needed government services.
- **Efficiency**: Tax base should be as broad as possible and avoid excess reliance on one tax.

- **Equity**: Different taxpayers should be treated fairly.
- **Simplicity**: Collection should be simple and easily understood.
- **Accountability**: Preferences should be easy to monitor and evaluate.

In addition, staff reviews whether the bill meets principles specific to tax expenditures. Those policies and how this bill addresses those issues:

Tax Expenditure Policy Principle	**Met?**	**Comments**
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.	✖	
Targeted: The tax expenditure has a clearly stated purpose, long-term goals, and measurable annual targets designed to mark progress toward the goals.		
Clearly stated purpose	✖	
Long-term goals	?	
Measurable targets	?	
Transparent: The tax expenditure requires at least annual reporting by the recipients, the Taxation and Revenue Department, and other relevant agencies	?	
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.		
Public analysis	✖	
Expiration date	✖	
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.		
Fulfills stated purpose	?	
Passes "but for" test	?	
Efficient: The tax expenditure is the most cost-effective way to achieve the desired results.	?	
Key: ✓ Met ✖ Not Met ? Unclear		

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