SUBJECT: Temporary oil and gas severance tax exemption for low-producing wells

COMMITTEE: Ways and Means — favorable, without amendment

VOTE: 10 ayes — Oliveira, McCall, Bonnen, Craddick, Heflin, Hilbert, Keffer, T. King, Ramsay, Sadler

0 nays

1 present, not voting — Y. Davis

SENATE VOTE: On final passage, February 9 — 25-1 (Shapleigh), 4 present, not voting (Bivins, Moncrief, Ogden, Whitmire)

WITNESSES: For — Bill Ash, Breckenridge ISD; Wanadee Box, National Association of Royalty Owners; Gary W. Boyd, Kilgore College and City of Kilgore; Ray Brazzel, International Association of Drilling Contractors; Morris Burns, Permian Basin Petroleum Association; Kenneth V. Huseman, Key Energy Services Co., Inc. and Association of Energy Services Companies; William Stanton McDonald, Texas Independent Producers and Royalty Owners; Leonard K. Moore, Jr., Association of Energy Servicing Contractors; Ruben C. Ramirez, LULAC Council # 4650; Bill Stevens, West Central Texas Oil and Gas Association and North Texas Oil and Gas Association; Paul B. Covert; James Gullion; Rickey Smith; Vernon T. Stokes

Against — Richard Lavine, Center for Public Policy Priorities

On — Tony Garza, Texas Railroad Commission; Billy Hamilton, Comptroller of Public Accounts; Gerald Higgins, Comptroller of Public Accounts; James LeBas, Comptroller of Public Accounts; Charles Matthews, Texas Railroad Commission

BACKGROUND: The state of Texas collects severance taxes on the production of oil and natural gas at the rate of 4.6 percent for oil and 7.5 percent for gas. The tax is assessed on the price the producer receives.

DIGEST: SB 290 temporarily would exempt qualifying oil and gas wells from the severance tax under certain market conditions. Wells qualifying for the exemption could produce no more than an average of 15 barrels of oil or 90,000 cubic feet (Mcf) of gas per day. The exemptions would be triggered for periods during which the average price of oil dropped below $15 a barrel

or gas dropped below $1.80 per million British thermal units (MMBtu). The exemption would expire on September 1, 1999, or the last day of the month that the total amount of taxes exempted reached $45 million, whichever was earlier.

The Texas Railroad Commission would certify which oil leases, on average, produced 15 barrels or fewer per well per day for the three-month period between October 1, 1998, and December 31, 1998. For gas leases, the maximum production would be 90 Mcf per well per day. Only these leases would qualify for the exemption.

The exemption for oil would be triggered for any month following three consecutive months when the average price fell below $15 per barrel. The comptroller would determine the months that the average closing price of West Texas Intermediate crude oil on the New York Mercantile Exchange (NYMEX) fell below the $15-per-barrel trigger price. The first three-month period would begin on November 1, 1998, and end on January 31, 1999 and apply to oil produced during February. For gas, the exemption would be triggered for any month following three consecutive months when the comptroller determined the average closing NYMEX price fell below $1.80 per MMBtu.

An operator qualifying for an exemption and who had already paid the severance tax could apply to the comptroller for a credit against severance taxes already paid. The severance tax exemptions granted by this bill specifically would not exempt operators from any other taxes or fees.

SB 290 would take immediate effect if finally passed by a two-thirds record vote of the membership of each house.

SUPPORTERS SAY:

SB 290 would provide temporary, emergency relief to small, independent producers who have been hardest hit by the worldwide downturn in oil prices. Petroleum prices are at their lowest level since the mid 1980s, which was an economically disastrous time for Texas. While Texas no longer relies as heavily on the oil and gas industry, it remains a key component of the state economy.

Over 80 percent of Texas oil wells, accounting for about one-third of Texas oil production, would be exempt from the oil severance tax under SB 290. For small producers operating near the break-even point, the bill would allow a needed reduction in costs that would help prevent many marginal wells from being plugged.

Granting a temporary tax exemption while petroleum prices are unprofitably low would be a wise investment, allowing the state to continue to receive revenue from these wells as soon as prices recover. If wells are shut-in, the state will lose severance taxes anyway. If shut-in wells are abandoned, the state even may have to spend tax dollars to pay for proper plugging. When wells are plugged, the state loses revenue permanently because it is not economical to re-drill marginal wells.

Once prices rise, operators could no longer claim the exemption. In no event would the state lose more than $45 million, revenue it may lose anyway if these wells are shut-in or abandoned.

Many school districts depend on tax revenues from producing wells. The comptroller has estimated that school districts could lose between $125 million and $145 million in fiscal 2000 due to declining oil prices. This bill would help keep small producing wells on the local property tax rolls.

Oil and gas producers pay sales, property, and franchise taxes like other industries. They also pay ad valorem taxes on mineral wealth in the ground, plus severance taxes as the resource is removed from the ground. This industry already contributes more than its fair share. Without this temporary limited relief, the industry soon may be able to contribute nothing if operators are forced to plug wells operating at a severe loss due to very low prices. Also, lost domestic oil production increases the nation's dependence on imported oil and increases the risk to our national security from oil supply shocks.

The bill would benefit small businesses, not large oil companies. Nearly all marginal wells are owned by small, independent companies. Furthermore, the benefits from this tax exemption would have a ripple effect on local economies. Royalties would still be paid to many Texas families who derive a substantial portion of their income from small wells, oil field workers would keep their jobs, and well service companies would stay in business.

The governor declared the bill an emergency because these small operators and their employees need immediate assistance. If SB 290 passes with only a majority, but short of the 100 votes needed for immediate effect, the bill would not take effect until August 30, too late to accomplish its purpose.

A tax exemption is the best way the state can address needs of producers, because it would immediately decrease costs and provide an incentive to keep wells operating. A tax exemption is preferable to deferring the tax. Deferral

would force operators to pay a large, lump-sum tax payment if prices rebound. In addition, merely deferring taxes would not provide a sufficient incentive for operators to keep money-losing wells in service. A temporary exemption also would allow the Legislature time to study more permanent solutions while dealing with an emergency that exists today.

OPPONENTS SAY:

This special subsidy for the oil and gas industry would drain up to $45 million from state revenue that could be used for other priorities. Rather than granting a tax exemption and losing the revenue forever, the Legislature should at least consider allowing payment of severance taxes to be deferred until prices rebound and small wells are profitable again. Deferring the taxes would still reduce costs to producers now, when prices are low, but would require them to pay the deferred taxes to fund other state priorities in the next biennium, when prices are expected to recover.

The exemption at least should be scaled back to ensure that only the smallest marginal producers receive assistance. Setting the qualifying level at an average 15 barrels per month would cover 80 percent of all oil wells, which may include many large producers who can afford to ride out the current period of low prices without special help from the state.

Oil is not the only industry that has been hurt in Texas. Agriculture, fishing, manufacturing, and mining also have experienced hardship caused by global price downturns, cheap imports, droughts, and floods. The oil and gas industry, though important, should not receive a special tax break before the Legislature considers how other ailing industries should be helped.

OTHER OPPONENTS SAY:

No temporary relief measure should be considered without determining a long-term state policy for the oil and gas industry. The comptroller has predicted oil prices will be barely above $15 per barrel mark until the third quarter of fiscal 2001, so producers could remain in the same dire situation through the next biennium. A short-term exemption that would expire September 1may not be enough to convince marginal operators that it would be worth keeping their wells in production.

Severance taxes are a discriminatory anachronism and should be abolished. The tax has become an added cost of production for an industry that pays the same taxes as other businesses in addition to the severance tax. It no longer makes sense to assess a special tax on oil and gas production when Texas producers no longer have the power to affect their own prices in a global market.

NOTES:

The Ways and Means Committee by 5-6 rejected a committee substitute offered by Rep. Sadler that would have exempted the first 250 barrels of oil produced per month on any lease. The exemption would have remained in effect until the end of the fiscal 2000-01 biennium. The substitute would not have changed the natural gas portion of the bill.

The Comptroller's Office has projected that the market price of natural gas will likely remain above the trigger price in SB 290. Oil prices are projected to rise above the trigger price of $15 a barrel beginning this fall and to remain above that price through the fiscal 2000-01 biennium.