ECONOMIC DEVELOPMENT TAX INCENTIVE STUDY - OIL AND GAS GROSS PRODUCTION AND OIL EXTRACTION TAX EXEMPTIONS

Pursuant to North Dakota Century Code Section 54-35-26, created by Senate Bill No. 2057 (2015), a variety of economic development tax incentives must be reviewed by a Legislative Management interim committee every 6 years. The purpose of the review is to ensure economic development tax incentives are serving their intended purposes in a cost-effective and equitable manner. This memorandum is provided to assist in the review of oil and gas gross production and oil extraction tax exemptions and provides an explanation of the exemptions, the perceived goals of the Legislative Assembly in creating or altering the exemptions, and the data and testimony that will be required to conduct an effective analysis of the exemptions.

EXPLANATION OF OIL AND GAS GROSS PRODUCTION AND OIL EXTRACTION TAX EXEMPTIONS

Oil and Gas Gross Production Tax

Pursuant to Chapter 57-51, a gross production tax of 5 percent of the gross value at the well is levied upon all oil produced in the state except a royalty interest in oil produced from an interest held by an organized Indian tribe or produced from a state, federal, or municipal holding. A gross production tax is levied upon all gas produced in the state and is calculated by multiplying taxable production by an annually adjusted flat rate per thousand cubic feet.

Production exempt from gross production tax includes:

- Gas used on the lease for production purposes and any royalty interest from gas produced from a state, federal, or municipal holding, or from an interest held by an organized Indian tribe.
- Shallow gas produced during the first 24 months of production following the date gas was first sold from a shallow gas well and gas produced from a shallow gas well during testing, but prior to well completion, or during connection to a pipeline.
- Gas burned at the well site to power an electrical generator that consumes at least 75 percent of the gas from the well.
- Gas collected at the well site by a system that intakes at least 75 percent of the gas and natural gas liquids volume from the well for beneficial consumption.

Oil Extraction Tax

The oil extraction tax is levied on the extraction of oil from the earth pursuant to Chapter 57-51.1. As originally enacted, the tax rate was established at 6.5 percent of the gross value of oil at the well, subject to full or partial exemptions. Beginning January 1, 2016, the oil extraction tax rate was reduced from 6.5 to 5 percent and is subject to change depending on the average price of a barrel of crude oil. If the average price of a barrel of crude oil exceeds the trigger price of $90 for 3 consecutive months, the rate increases to 6 percent on all oil extracted. The rate remains at 6 percent until the average price of a barrel of crude oil falls below the trigger price of $90 for 3 consecutive months, at which time the rate reverts to 5 percent on all oil extracted.

Production exempt from oil extraction tax includes:

- Liquids produced from a collection system employed to avoid flaring, which are exempt for a period of 2 years and 30 days from the time of first production;
- Production that is exempt from the gross production tax imposed by Chapter 57-51;
- Production from stripper well property or an individual stripper well;
- Incremental production from a secondary recovery project for 5 years from the date incremental production begins;
- Incremental production from a tertiary recovery project for 10 years from the date incremental production begins, or 20 years from the date incremental production begins or certified injection begins if the project injects more than 50 percent carbon dioxide produced from coal and is located outside the Bakken or Three Forks Formations; and
- Incremental production from a tertiary recovery project from a horizontal well drilled and completed within the Bakken and Three Forks Formations for 5 years from the date incremental production begins, or 10 years from the date incremental production begins or certified injection begins if the project injects more than 50 percent carbon dioxide produced from coal and is located within the Bakken or Three Forks Formations.

The first 75,000 barrels of oil produced during the first 18 months after completion of a well drilled and completed outside the Bakken and Three Forks Formations and 10 miles or more outside an established field that includes either formation are subject to partial exemption in the form of a reduced tax rate of 2 percent on the gross value at the well of oil extracted.

PERCEIVED GOALS OF THE LEGISLATIVE ASSEMBLY IN CREATING OR ALTERING OIL AND GAS GROSS PRODUCTION AND OIL EXTRACTION TAX EXEMPTIONS

Oil and Gas Gross Production Tax

The exemption provided in Section 57-51-02 for gas used on the lease for production purposes and any royalty interest from gas produced from a state, federal, or municipal holding, or from an interest held by an organized Indian tribe was enacted in Senate Bill No. 41 (1953). Only minor grammatical changes were made to the exemption following its enactment.

The exemption provided in Section 57-51-02.4, which exempts shallow gas produced from a new or recompleted shallow gas well during the first 24 months of production, was enacted in House Bill No. 1145 (2003). The perceived goal of the Legislative Assembly in creating the exemption was to attract investment in the state's natural resources by encouraging gas well production. It was estimated the exemption would reduce gross production tax revenues by $40,000 during the 2003-05 biennium. The fiscal note assumed 20 new wells and 20 expanded wells would qualify for the exemption. The only changes to the exemption following its enactment were by House Bill No. 1279 (2007), which removed the exemption's July 1, 2007, expiration date.

The exemption provided in Section 57-51-02.5 for gas burned at the well site to power an electrical generator that consumes at least 75 percent of the gas from the well, was enacted in Senate Bill No. 2413 (2009). The perceived goal of the Legislative Assembly in creating the exemption was to reduce flaring and generate electricity from gas that might otherwise be wasted. The fiscal impact of the exemption could not be determined during the 2009 legislative session. The exemption has not been amended since its enactment.

The exemption provided in Section 57-51-02.6 for gas collected at the well site by a system that intakes at least 75 percent of the gas and natural gas liquids volume from the well for beneficial consumption was enacted in House Bill No. 1134 (2013). The perceived goal of the Legislative Assembly in creating the exemption was to encourage the use of gas that might otherwise be flared. It was estimated the exemption would reduce gross production tax revenues by $16 million during the 2013-15 biennium. The exemption has not been amended since its enactment.

Oil Extraction Tax

The limited duration exemption provided in Section 57-51.1-02.1 for liquids produced from a collection system employed to avoid flaring was enacted in House Bill No. 1134 (2013). The perceived goal of the Legislative Assembly in creating the exemption was to encourage the use of gas that might otherwise be flared. The fiscal impact of the exemption could not be determined during the 2013 legislative session. The exemption has not been amended since its enactment.

The exemption provided in Section 57-51.1-03(1) for oil that is exempt from the gross production tax imposed by Chapter 57-51 was enacted by Initiated Measure No. 6, which was approved by the voters at the general election held on November 4, 1980. The exemption has not been amended since its enactment.

The exemption provided in Section 57-51.1-03(2) for production from stripper well property or an individual stripper well was enacted by Initiated Measure No. 6, which was approved by the voters at the general election held on November 4, 1980. No substantive changes have been made to the exemption since its enactment.

The exemptions provided in Section 57-51.1-03(3) for incremental oil produced from secondary and tertiary recovery projects were enacted in House Bill No. 1414 (1991). The perceived goal of the Legislative Assembly in creating the exemption was to provide an exemption to encourage the enhanced recovery of oil that might not otherwise be produced. It was estimated the exemption could range from a reduction of $324,000 in gross production revenues to an increase of $243,000 in gross production tax revenues during the 2013-15 biennium. The estimated reduction in revenue assumed the economic activity would have taken place even if the exemption was not offered and the estimated increase in revenues assumed the economic activity only would take place as a result of the exemption. The estimate was arrived at by assuming three enhanced oil recovery projects would qualify for the exemption during the 2nd year of the biennium.

The enhanced oil recovery exemptions were amended several times following their enactment. Senate Bill No. 2150 (1995) removed the expiration date for the Industrial Commission to certify a secondary recovery project as a qualified project. Senate Bill No. 2034 (2009) provided an exemption for incremental production from a tertiary recovery project that uses carbon dioxide for enhanced recovery. Senate Bill No. 2015 (2015) provided incremental production from a tertiary recovery project from a horizontal well drilled and completed within the Bakken and Three Forks Formations is not exempt from July 1, 2015, through June 30, 2017, and is thereafter exempt for a period of 5 years. House Bill No. 1439 (2019) expanded the oil extraction tax exemption for incremental production from a tertiary recovery project from 5 to 10 years from the date incremental production begins for a tertiary recovery project drilled within the Bakken and Three Forks Formations and from 10 to 20 years from the date incremental production begins for a project drilled outside the Bakken and Three Forks Formations if the project injects more than 50 percent carbon dioxide produced from coal.

The partial exemption in the form of a reduced 2 percent tax rate on the gross value at the well of the first 75,000 barrels of oil produced during the first 18 months after completion of a well drilled and completed outside the Bakken and Three Forks Formations, as provided in Section 57-51.1-03(4), was enacted in Senate Bill No. 2397 (2007). The perceived goal of the Legislative Assembly in creating the exemption was to foster a competitive tax environment to encourage industry to continue to develop oil resources in the state. It was estimated the exemption would reduce oil extraction tax revenues by $3,127,000 during the 2007-09 biennium. The exemption was amended by House Bill No. 1235 (2009) to place a cap on the amount of oil exempted per well at 75,000 barrels of oil produced or the first $4,500,000 of gross value at the well, whichever is less.

DATA AND TESTIMONY REQUIRED TO CONDUCT AN EFFECTIVE ANALYSIS OF OIL AND GAS GROSS PRODUCTION AND OIL EXTRACTION TAX EXEMPTIONS

Data pertaining to the following items will need to be collected to effectively analyze the exemptions:

1. The number of claimants;
2. The fiscal impact of the exemptions;
3. Employment opportunities, business growth, or diversity in the state's economy resulting from the availability of the exemptions;
4. Negative impacts created as a result of the exemptions; and
5. Benefits that flow to out-of-state concerns resulting from the exemptions.

Testimony will need to be solicited from the following parties to effectively analyze the exemptions:

1. The Department of Commerce;
2. The Tax Department;
3. The North Dakota Economic Development Foundation; and
4. Oil and gas industry representatives.