Prepared by the North Dakota Legislative Council
staff for the Taxation Committee
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OIL EXTRACTION TAX - BACKGROUND MEMORANDUM

The chairman of the Legislative Management assigned to the Taxation Committee an additional study assignment of the feasibility and desirability of oil extraction tax rate reductions and elimination of selected exemptions which would take effect at certain levels of increased production and revenue. Attached as an appendix is a copy of the letter from the chairman making the study assignment.

OIL AND GAS TAXES

Oil and Gas Gross Production Tax

As enacted in 1953, the oil and gas gross production tax was a tax of 4.25 percent of gross value at the well of oil and gas. In 1957 the rate of the tax was increased to the current rate of 5 percent of gross value at the well of oil and gas. The total net proceeds collected from the gross production tax increased from $306,000 in fiscal year 1954 to more than $730 million (estimated) in the 2009-11 biennium.

From 1957 to 1981 the distribution formula for proceeds of the gross production tax remained the same in North Dakota Century Code Section 57-51-15. During that time, the first 1 percent of gross value at the well of oil and gas produced was credited to the state general fund. After deduction of the state general fund's 1 percent share in each county, the balance was distributed as follows:

1. The first $200,000, 75 percent to the producing county and 25 percent to the state general fund.
2. The next $200,000, 50 percent to the producing county and 50 percent to the state general fund.
3. All remaining revenue, 25 percent to the producing county and 75 percent to the state general fund.

In 1981 the Legislative Assembly amended the distribution formula. This amendment did not change the disposition of the state general fund's 1 percent share. Remaining tax revenue from oil and gas produced in each county was distributed as follows:

1. The first $1 million, 75 percent to the producing county and 25 percent to the state general fund.
2. The next $1 million, 50 percent to the producing county and 50 percent to the state general fund.
3. All remaining revenue, 25 percent to the producing county and 75 percent to the state general fund.

The overall effect of the 1981 amendment was to give each producing county an increase of up to $600,000 per year.

In 1981 caps, or maximums, were introduced to restrict revenues producing counties could receive from the gross production tax for each year of the 1981-83 biennium. The caps were based on the population of each county and increased in the second year of the biennium. At the close of fiscal year 1983, these caps were scheduled to expire. The amounts allocated to a county which exceeded the cap imposed were instead deposited in the state general fund. The maximum amount that a producing county could receive in fiscal year 1983 was:

1. For counties with a population of 3,000 or fewer - $3.8 million.
2. For counties with a population from 3,001 to 5,999 - $4 million.
3. For counties with a population of 6,000 or more - $4.5 million.

The manner in which revenues received by a county are allocated within the county was also changed in 1981. Before 1981, Section 57-51-15 provided for allocation of 40 percent of county revenues to the county road and bridge fund, 45 percent to school districts within the county, and 15 percent to incorporated cities within the county. After the 1981 amendment, county revenues were distributed 45 percent to the county general fund, 35 percent to the school districts within the county, and 20 percent to the incorporated cities within the county. The 1981 amendment also imposed caps upon revenues that may be received by school districts and cities. School districts were limited to a maximum of 70 percent of the county per student cost times the number of students in attendance or in the school census, whichever was greater, unless the district had an average daily attendance or school census fewer than 400, in which case that district could receive up to 120 percent of the county average per student cost times the number of students in attendance or in the school census, whichever was greater. Incorporated cities were limited to a distribution not exceeding $500 per capita in any fiscal year. Amounts exceeding the caps for school districts or cities reverted to the county general fund.

In 1983 caps for county revenues from oil and gas gross production taxes were extended through the 1983-85 biennium, and the maximum amounts that a producing county could receive in a fiscal year were adjusted as follows:

1. For counties with a population of 3,000 or fewer - $3.9 million.
2. For counties with a population from 3,001 to 5,999 - $4.1 million.
3. For counties with a population of 6,000 or more - $4.6 million.

A 1985 amendment made the caps on county revenue from oil and gas gross production taxes permanent at the rates established set in the 1983 bill.

A 1989 amendment allocated up to $5 million per biennium from the first 1 percent of oil and gas gross production tax revenues to the oil and gas impact grant fund and provided a continuing appropriation of the amount for allocation by the Energy Development Impact Office to oil and gas-impacted political subdivisions.

A 2005 amendment increased the oil and gas gross production tax allocation for the oil and gas impact grant fund from $5 million to $6 million per biennium beginning with the 2007-09 biennium.

In 2007 the Legislative Assembly amended the distribution formula in Section 57-51-15. This amendment did not change the disposition of the state general fund's 1 percent share. Remaining tax revenue from oil and gas produced in each county was distributed as follows:

1. The first $1 million, entirely to the county.
2. The second $1 million, 75 percent to the producing county and 25 percent to the state general fund.
3. The third $1 million, 50 percent to the producing county and 50 percent to the state general fund.
4. All remaining revenue, 25 percent to the producing county and 75 percent to the state general fund.

The overall effect of the 2007 amendment was to give each producing county an increase of up to $750,000 per year.

A 2007 amendment allowed a county that reaches the annual cap on oil and gas gross production tax revenue to receive an additional $1 million in revenues if the county levies a total of at least 10 mills for county road and bridge, farm-to-market and federal aid road, and county road purposes. Any of the additional $1 million received by the county is not for allocation to political subdivisions within the county but must be credited entirely to the county general fund.

The $500 per capita per year limit on city allocations was eliminated in 2007. A $750 per capita per year limit on city allocations was created in 2009. The $750 per capita per year limit on city allocations was eliminated in 2011.

A 2009 amendment by House Bill No. 1304, as amended by House Bill No. 1324, significantly increased allocation of oil and gas gross production taxes to political subdivisions and the oil and gas impact grant fund. From the tax equal to the first 1 percent of gross value at the well of oil production, a direct allocation of $500,000 was created for a city in an oil-producing county which has a population of 7,500 or more and more than 2 percent of its employment engaged in the mining industry. The allocation was increased to $1 million if the city's population exceeds 7,500 and employment in the mining industry exceeds 7.5 percent of its employment. Also from the tax equal to the first 1 percent of gross value of oil produced, the biennial allocation to the oil and gas impact grant fund was increased from $6 million to $8 million per biennium. The bill made several changes in allocations of oil and gas gross production tax revenue to political subdivisions. The bill increased from $1 million to $2 million the initial amount of tax revenue allocated 100 percent to the producing county. The bill removed the caps on tax revenue allocations to counties but provided that any amount exceeding $18 million of annual revenue to a county is allocated 10 percent to the county and 90 percent to the state general fund. The bill required a county to levy at least 10 mills for county road and bridge, farm-to-market and federal aid road, and county road purposes to receive any allocation of oil and gas gross production tax revenues. The bill restructured allocation of revenues within counties to hold school district allocations at approximately the level provided under existing law and established a county infrastructure fund for deposit of funds exceeding $5,350,000 allocated to the county. Revenues allocated to a county infrastructure fund were allocated to the county and to cities in the same proportion as existing law, but the 35 percent share allocated to school districts under prior law was instead allocated to the board of county commissioners to provide grants to or for the benefit of townships or school districts. Grants were to be available on the basis of applications by townships for funding to offset oil and gas development impact to township roads or other infrastructure needs or applications by school districts for repair or replacement of school district vehicles necessitated by damage or deterioration attributable to travel on oil and gas development-impacted roads. For unorganized townships within the county, the board of county commissioners was allowed to expend an appropriate portion of county infrastructure fund revenues to offset oil and gas development impact to unorganized township roads or other infrastructure needs. The bill provided that within 60 days after the end of each fiscal year, the board of county commissioners of a county that has received oil and gas gross production tax revenue allocations must file a report with the Tax Commissioner showing the amount received by the county, the amount expended for each purpose to which the funds were devoted, the share of county property tax revenue expended for each of those purposes, and the amount of unexpended funds remaining at the end of the fiscal year. The report must also show the amount available in the county infrastructure fund, the amount allocated to each organized township or school district and the amount expended from that allocation by that township or school district, the amount expended on behalf of unorganized townships, and the amount in the county infrastructure fund which remained unexpended at the end of the fiscal year. The bill required the Tax Commissioner to compile the information from the reports and provide a report to

the Legislative Management. The Legislative Management has assigned to the interim Taxation Committee the responsibility of receiving this report.

Oil Extraction Tax

On November 4, 1980, the voters of the state approved initiated measure No. 6 on the general election ballot and established an oil extraction tax as a companion tax to the oil and gas gross production tax that existed since 1953. The oil extraction tax rate was established at 6.5 percent of the gross value of oil at the well and has remained at that rate, except for full or partial exemptions. The initial extraction tax law provided exemptions for oil exempt from gross production taxes, up to 100 barrels per day of oil owned by a royalty owner, and oil from a stripper well, defined as a well producing 10 barrels or less of oil per day.

In 1987 the 10-barrel per day limitation for stripper well properties was left in place for wells of a depth of 6,000 feet or less, but the limit was increased to 15 barrels per day for wells of a depth of 6,000 feet to 10,000 feet and 20 barrels per day for wells of a depth of more than 10,000 feet. For wells drilled and completed after April 27, 1987, and for qualifying secondary or tertiary recovery projects, the rate of tax was reduced from 6.5 percent to 4 percent of gross value at the well. In addition to the rate reduction, production from new wells completed after April 27, 1987, was given a full extraction tax exemption for the first 15 months of production. A trigger provision was included so that the rate would return to 6.5 percent if the average price of crude oil between June 1 and October 31 of any year is $33 per barrel or more. The royalty owner exemption was eliminated in 1987.

In 1989 an exemption was created for production during the first 12 months after a well has been worked over. The exemption required filing of a notice of intent to begin a workover project with the Industrial Commission before beginning the project. A qualifying project was required to have a cost of at least $65,000, which was reduced to $30,000 if production increased by at least 50 percent during the first two months after completing the project. The exemption was limited to wells producing no more than 50 barrels of oil before beginning the project. The trigger mechanism was applied to the workover exemption.

In 1991 the trigger mechanism was adjusted to provide that if the oil price exceeded $33 per barrel for any period of five consecutive months, the exemptions and rate reductions would not apply, rather than being based on June to October prices. A reverse trigger was also instituted to reinstate the reduced rates and exemptions when the price for a barrel of crude oil is less than $33 for any consecutive five months. Other 1991 legislation provided for a 5-year exemption for oil produced from a secondary recovery project and a 10-year exemption for oil from a tertiary recovery project. The legislation required Industrial Commission certification of the project as qualifying for the exemption. The exemptions apply only to incremental production, defined as the total amount of oil produced minus the amount of oil that had been produced prior to the recovery project.

In 1993 the exemption for the first 12 months of production after a workover project was amended to eliminate the minimum investment of $30,000 if production is increased at least 50 percent in the first two months after completing the project. The change retained the $65,000 level of spending that would qualify the project for exemption if production is increased by less than 50 percent. The bill also reduced the tax rate from 6.5 percent to 4 percent for production from a workover well after the 12-month exemption period.

In 1995 a 24-month oil extraction tax exemption was created for production from a horizontal well. The bill created a 10-year exemption for production of oil from a well that has been inactive for two years and a nine-month exemption for production from a horizontal reentry well. The inactive well and horizontal reentry well exemptions were made subject to the trigger mechanism. The limit on stripper well classification for wells deeper than 10,000 feet was increased from 20 barrels to 30 barrels per day. Other 1995 legislation required certification by the Industrial Commission of qualifying status for wells eligible for exemptions or rate reductions.

In 1997 legislation was enacted to grant a five-year extraction tax exemption for production from new wells within the boundaries of an Indian reservation on tribal trust lands or land owned by a tribe.

In 2001 the trigger provision for exemptions and rate reductions was amended to clarify when the trigger was to become effective. All rate reductions and exemptions subject to the trigger provision would become ineffective if the average price of a barrel of crude oil exceeded the trigger price for each month in any consecutive five-month period. Average price was defined as the monthly average of the daily closing price for a barrel of West Texas intermediate Cushing crude oil minus $2.50. Trigger price was defined as $35.50 per barrel, as indexed for inflation.

In 2003 an Oil and Gas Research Council was created and an oil and gas research fund was established with a continuing appropriation provided. A temporary exemption from gross production tax was provided for gas produced from shallow gas wells, with an expiration date of June 30, 2007. The two-year inactive well exemption was amended to clarify the definition of a two-year inactive well and to provide an 18-month provision to qualify the well for an exemption to be consistent with other oil extraction tax exemptions. The workover well exemption was amended to remove the requirement that a notice of intention must be filed before a workover project is commenced to qualify for an exemption.

In 2005 the Legislative Assembly provided for a sales and use tax exemption for carbon dioxide used for the enhanced recovery of oil or natural gas.

Legislation in 2007 provided an oil extraction tax reduction to 2 percent for the first 75,000 barrels of oil during the first 18 months after completion from a horizontal well drilled and completed in the Bakken Formation from July 1, 2007, through June 30, 2008. The gross production tax exemption for shallow gas was made permanent for the first 24 months of production. An increase was provided from $1.3 million to $3 million per biennium in the amount of oil extraction tax revenues to be deposited in the oil and gas research fund.

The Governor was given authority by 2007 Senate Bill No. 2419 to enter agreements with the Three Affiliated Tribes of the Fort Berthold Reservation relating to taxation and regulation of oil and gas exploration and production within the boundaries of the Fort Berthold Reservation. The statutory provisions require the state oil and gas gross production tax must apply in full to all wells within the Fort Berthold Reservation and the state oil extraction tax for trust lands on the Fort Berthold Reservation may not exceed a 6.5 percent rate but may be reduced through negotiation of the agreement. All revenues and exemptions from all oil and gas gross production and oil extraction taxes attributable to production from trust lands on the Fort Berthold Reservation must be evenly divided between the Three Affiliated Tribes and the state. For production from non-trust lands on the Fort Berthold Reservation, the state must receive 80 percent and the Three Affiliated Tribes must receive 20 percent of total oil and gas gross production tax collections in lieu of application of the Three Affiliated Tribes' fees and taxes related to production on such lands. The state's share of revenue under the agreement is subject to allocation among political subdivisions within the boundaries of the reservation. The first $700,000 of the state's share of tax revenues from oil produced from wells within the exterior boundaries of the Fort Berthold Reservation must be transferred to the permanent oil tax trust fund. The Governor entered an agreement with the Three Affiliated Tribes in compliance with the statutory requirements, effective July 1, 2008. It appears the legislation and agreement have had the desired effect. Before July 1, 2008, there was no drilling activity on the Fort Berthold Reservation. In the first 13 months after the agreement was entered, 163 drilling permits were issued and 131 wells were completed.

A 2009 amendment by House Bill No. 1235 provided a contingent rate reduction in the oil extraction tax which reduced the oil extraction tax rate for horizontal wells from 6.5 percent to 2 percent during the time the rate reduction is in effect. Existing law provides a complete oil extraction tax exemption that triggers into effect if the price of oil for five consecutive months remains below the trigger price. April 2009 would have been the fifth consecutive month below the trigger price, but the average price for April rose to an amount exceeding the trigger price which meant that the exemptions under existing law did not trigger into effect. Because the exemptions did not trigger into effect, the rate reduction provided by House Bill No. 1235 became effective May 1, 2009, and remained in effect through October 2009. The rate reduction can trigger into effect again if the average price for a month drops below $55. The rate reduction applies to oil produced during the first 18 months after completion for a horizontal well and is limited to the first 75,000 barrels or the first $4.5 million of gross value at the well of oil produced from the well. If the rate reduction is effective on the date of completion of a well, the rate reduction applies to production from that well for up to 18 months after completion, even if the price of oil rises to more than $70. If the rate reduction is ineffective on the date of completion of a well, the rate reduction does not apply to production from that well at any time. The triggered rate reduction was scheduled to expire June 30, 2012, but the expiration date was extended to June 30, 2013, by 2011 House Bill No. 1467.

Oil Extraction Tax Allocation

In 1980 initiated measure No. 6, oil extraction tax revenues were to be allocated 45 percent to the state general fund, 45 percent to education funding, and 10 percent to water pipeline and resources trust fund uses. The allocation formula was amended in 1981 to allocate 30 percent to the state general fund, 60 percent to education funds, and 10 percent to water pipeline and resources trust fund uses. In 1983 the formula was amended to allocate 90 percent to the state general fund and 10 percent to education funds. In 1995 the allocation was changed to 60 percent to the state general fund, 20 percent to education funding, and 20 percent to water pipeline and resources trust fund uses.

In 1997 a permanent oil tax trust fund was established. The provision required that all general fund revenue from oil and gas gross production tax and oil extraction tax exceeding $71 million in a biennium must be transferred to the permanent oil tax trust fund.

In 2003 an oil and gas research fund was established to be allocated up to $500,000 in the 2003-05 biennium. The fund was to be allocated up to $1.3 million per biennium after the 2003-05 biennium. In 2007 the allocation to the fund was increased to a maximum of $3 million per biennium, and in 2009 it was increased to $4 million per biennium.

In 2007 a constitutional amendment was placed on the 2008 general election ballot to make the permanent oil tax trust fund a constitutional trust fund. The measure would have provided that any general fund revenue from oil and gas taxes exceeding $100 million during a biennium must be deposited in the permanent oil tax trust fund. The measure would have required a vote of three-fourths of the members elected to each house of the Legislative Assembly to approve expenditures from the permanent oil tax trust

fund. The measure was disapproved by the voters, with about 64 percent voting for disapproval.

In 2009 a constitutional amendment (House Concurrent Resolution No. 3054) was placed on the 2010 general election ballot to establish the legacy fund as a constitutional trust fund. The measure was approved by about 65 percent of the voters and became effective for oil and gas production after June 30, 2011. The measure is now Article X, Section 26, of the Constitution of North Dakota, and requires 30 percent of total revenue derived from taxes on oil and gas production or extraction to be transferred to the legacy fund. The principal and earnings of the legacy fund may not be expended until after June 30, 2017. An expenditure of principal after June 30, 2017, requires a vote of at least two-thirds of the members elected to each house of the Legislative Assembly and not more than 15 percent of the principal of the legacy fund may be expended during a biennium. The measure provides for transfer of earnings of the legacy fund accruing after June 30, 2017, to the state general fund at the end of each biennium.

Senate Bill No. 2129 (2011) makes statutory changes to implement the requirements of Article X, Section 26, of the Constitution of North Dakota, requiring deposit of 30 percent of all oil and gas tax revenue in the legacy fund. Under this bill, political subdivisions are held harmless against allocation reductions because of the legacy fund deposit, and each political subdivision is to receive the same proportion of oil and gas gross production tax revenues as it received before the legacy fund was established. The entire amount of the deposits in the legacy fund is to be deducted from the state's share of oil and gas gross production taxes and oil extraction taxes.

OTHER 2011 OIL AND GAS TAX LEGISLATION

House Bill No. 1013 increases from $8 million to $100 million per biennium the amount to be deposited in the oil and gas impact grant fund from the first one percentage point of the oil and gas gross production tax. The bill also changes the name of the Energy Development Impact Office to the Energy Infrastructure and Impact Office. The bill transfers the authority to make grants for oil and gas impact from the Energy Development Impact Office to the Board of University and School Lands. The Energy Infrastructure and Impact Office is to make recommendations to the board on grants to political subdivisions. The recommendations are to include recommendations for 35 percent of impact funding to go to cities of 10,000 or more population and the remainder to go to smaller cities and counties, school districts, and other political subdivisions impacted by oil and gas development.

House Bill No. 1451 eliminates the permanent oil tax trust fund and provides for biennial revenues from oil and gas taxes designated for deposit in the state general fund to be deposited as follows:

1. The first $200 million into the state general fund;
2. The next $341,790,000 into the property tax relief sustainability fund;
3. The next $100 million into the state general fund;
4. The next $100 million into the strategic investment and improvements fund;
5. The next $22 million into the state disaster relief fund; and
6. Any additional revenues into the strategic investment and improvements fund.

Proposed Amendments to 2011 Engrossed House Bill No. 1467

Proposed amendments offered to Engrossed House Bill No. 1467 were not adopted by the Senate Finance and Taxation Committee. However, the amendments follow a format similar to the one described in the study assignment to the interim Taxation Committee.

The proposed amendments would have provided for immediate elimination of most existing extraction tax exemptions and a substantial change to the stripper well exemption. The 6.5 percent oil tax extraction tax rate would have been reduced by one-half percentage point when statewide daily production reaches 425,000 barrels per day, 500,000 barrels per day, 575,000 barrels per day, 650,000 barrels per day, and 700,000 barrels per day. At statewide daily production of 700,000 barrels per day the extraction tax rate would be 4 percent and would remain at that rate. At the 425,000 barrels per day production level, the stripper well exemption would not apply to new wells drilled on a Bakken pool stripper well property until production from that well declines to a level that meets the statutory requirements for an individual stripper well.

ATTACH:1