OIL AND GAS TAX ALLOCATION STUDY - BACKGROUND MEMORANDUM

This memorandum provides information on the study of oil and gas tax allocations, including oil tax rates and allocation formulas.

STUDY OVERVIEW

Section 6 of 2015 House Bill No. 1176 (Appendix A), provides for a Legislative Management study of oil and gas tax revenue allocation formulas. The study must include consideration of the allocations to political subdivisions. The responsibility of this study was assigned to the Energy Development and Transmission Committee.

OIL TAX RATES

Oil and Gas Gross Production Tax - Rates

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 tax was increased to 5 percent of gross value at the well of oil and gas. In 1991 the tax on gas was changed from 5 percent of the gross value at the well to an annually adjusted rate per thousand cubic feet (Mcf) of gas. The current gross production tax rates are 5 percent of the gross value of oil produced at the well and $0.1106 per Mcf for fiscal year 2016.

Oil Extraction Tax - Rates

As enacted through an initiated measure in 1980, the oil extraction tax rate was 6.5 percent of the gross value of oil at the well. In 1987 provisions were added based on a trigger price to provide an exemption period followed by a reduced tax rate of 4 percent. These provisions became known as the "large trigger." Exemptions for qualifying workover projects and incremental oil recovery projects were added in 1989 and 1991. In 1997 the Legislative Assembly created a 60-month exemption period for oil production on an Indian reservation. The 2009 Legislative Assembly created the "little trigger," which provided for a tax rate of 2 percent on the first 75,000 barrels of oil if the average price of oil was below $55 for one month. In 2013 the 60-month exemption period for oil production on an Indian reservation was eliminated. The 2015 Legislative Assembly removed the provisions of the "large trigger" and reduced the oil extraction tax rate from 6.5 percent to 5 percent beginning January 1, 2016.

ALLOCATION FORMULAS

Oil and gas tax revenue collections are allocated by the State Treasurer to political subdivisions and state funds pursuant to North Dakota Century Code Sections 57-51-15, 57-51.1-07, 57-51.1-7.3, and 57-51.1-7.5. A summary of estimated 2015-17 biennium oil and gas tax revenue allocations is attached as Appendix B.

Oil and Gas Gross Production Tax - Formulas

Allocations to the County

From 1957 to 1981, the oil and gas gross production tax allocation formula provided that 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 first 1 percent of tax revenue in each county, the remaining 4 percent of the 5 percent tax was allocated:

1. Of the first $200,000, 75 percent was allocated to the county and 25 percent to the state.
2. Of the next $200,000, 50 percent was allocated to the county and 50 percent to the state.
3. All remaining revenue was allocated 25 percent to the county and 75 percent to the state.

The 1981, 2007, and 2009 Legislative Assemblies amended the allocation of the 4 percent of the 5 percent tax to change the allocation thresholds resulting in an increase in allocations to counties. In 2013 the Legislative Assembly amended the allocation formula to provide for the current allocation of the 4 percent of the 5 percent tax as follows:

1. The first $5 million is allocated entirely to the county.
2. All remaining revenue was allocated 25 percent to the county and 75 percent to the state.

The 2015 Legislative Assembly increased the allocation of all revenue over $5 million by 5 percent to provide an allocation of 30 percent of all revenue over $5 million to the county. The increased allocation to the county resulted in a 5 percent decrease to the state's allocation, from 75 percent to 70 percent related to the revenue over $5 million.

Distributions to Political Subdivisions - Formulas

Before 1981, the oil and gas gross production tax revenue that was allocated to the county was distributed 40 percent to the county road and bridge fund, 45 percent to school districts within the county, and 15 percent to incorporated cities within the county.

From 1981 to 2009, the oil and gas gross production tax revenue that was allocated to the county was 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 Legislative Assembly provided distribution limits for school districts and cities, and any amounts exceeding the limits were credited to the county general fund.

For the 2009-11 biennium, the first $4.6 million of oil and gas gross production tax revenue that was allocated to the county was 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. Any revenue above $4.6 million was distributed to a county infrastructure fund, of which 45 percent was credited to the county general fund, 35 percent to or for the benefit of townships within the county, and 20 percent to the incorporated cities within the county. Of the 35 percent distributed to school districts from the first $4.6 million, approximately $1.61 million was credited to school districts and approximately $2.99 million was credited to the county infrastructure fund. The 2011 Legislative Assembly increased the distribution threshold from $4.6 million to $5.35 million, but the distribution formula remained the same for the 2011-13 biennium.

For the 2013-15 and 2015-17 bienniums, the oil and gas gross production tax revenue that is allocated to the county is distributed 45 percent to the county general fund, 35 percent to the school districts within the county, and 20 percent to the cities within the county for a county that received less than $5 million in the prior state fiscal year. For a county that received $5 million or more of oil and gas gross production tax allocations, the revenue is distributed 60 percent to the county general fund, 5 percent to the school districts within the county, 20 percent to the cities within the county, 3 percent equally among all the townships in all the counties that received $5 million or more of oil tax allocations, 3 percent to the townships within the county on the basis of road miles, and 9 percent to three hub cities.

Historical information provided by the Tax Department related to oil and gas tax distribution formula changes from 1957 to 2011 is attached as Appendix C.

Distributions to Political Subdivisions - County Distribution Limits

In 1981 the Legislative Assembly introduced distribution limits on the amount of annual revenue a county could receive from the oil and gas gross production tax collections. Any revenue allocations in excess of the distribution limits were distributed to the state. The 1983 Legislative Assembly amended the distribution limits, and from 1983 to 2009 the distribution of annual revenue allocations to a county was limited to the following:

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

A 2007 amendment allowed a county that reached the annual distribution limit to receive an additional $1 million in revenues if the county levied at least 10 mills for county road and bridge, farm-to-market and federal aid road, and county road purposes. The county distribution limits were removed in 2009.

Other Allocations - Oil and Gas Impact Grant Fund

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. The $5 million biennial allocation remained the same through the 2005-07 biennium. The amount allocated to the oil and gas impact grant fund was increased from $5 million to $6 million for the 2007-09 biennium, from $6 million to $8 million for the 2009-11 biennium, from $8 million to $100 million for the 2011-13 biennium, and from $100 million to $240 million for the 2013-15 biennium. The 2015 Legislative Assembly provided for an allocation of up to $140 million to the oil and gas impact grant fund for the 2015-17 biennium and an allocation of up to $100 million per biennium in subsequent bienniums.

Other Allocations - Hub City and Hub City School Districts

In 2009 the Legislative Assembly amended the oil and gas gross production tax allocation formula to provide an annual allocation of $500,000 to each city in an oil-producing county with a population of 7,500 or more and more than 2 percent of its employment engaged in the mining industry from the first 1 percent of the 5 percent tax. The annual allocation was increased to $1 million if the city had more than 7.5 percent of its employment engaged in the mining industry. Although the 2009 Legislative Assembly did not define hub cities, these allocations to select cities became the basis for the allocations to hub cities in subsequent bienniums.

The 2013 Legislative Assembly provided an annual allocation of $375,000 per full or partial percentage point of employment engaged in the mining industry to each hub city from the first 1 percent of the 5 percent tax. A hub city is a city with a population of 12,500 or more and more than 1 percent of its employment engaged in the mining industry. The 2013 Legislative Assembly also provided an annual allocation of $125,000 per full or partial percentage point of employment to each hub city school district, which is the school district with the highest student enrollment within the city limits of a hub city.

The 2015 Legislative Assembly changed the portion of the definition of a hub city related to employment percentages from employment in the mining industry to oil- and gas-related employment. However, the definition change applies only for the 2015-17 biennium. The 2015 Legislative Assembly also clarified that the hub cities' allocation percentages be updated annually. In House Bill No. 1176, the 2015 Legislative Assembly provided the following allocations:

1. $375,000 per full or partial employment percentage point to hub cities located in oil-producing counties based on oil- and gas-related employment for the 2015-17 biennium and based on mining employment after the 2015-17 biennium;
2. $250,000 per full or partial employment percentage point to hub cities located in non-oil-producing counties based on oil- and gas-related employment for the 2015-17 biennium and based on mining employment after the 2015-17 biennium; and
3. $125,000 per full or partial employment percentage point to hub city school districts located in oil-producing counties and excludes hub city school districts located in non-oil-producing counties from allocations. The allocations are based on oil- and gas-related employment for the 2015-17 biennium and based on mining employment after the 2015-17 biennium.

Other Allocations

From the first 1 percent of oil and gas gross production tax revenues, the 2013 Legislative Assembly allocated 4 percent to the North Dakota outdoor heritage fund with a limit of $15 million per fiscal year. The 2015 Legislative Assembly increased the allocation to the North Dakota outdoor heritage fund to 8 percent with a limit of $20 million per fiscal year.

The 2013 Legislative Assembly allocated 4 percent of the 1 percent of the 5 percent tax to the abandoned oil and gas well plugging and site reclamation fund with a limit of $5 million per fiscal year. In House Bill No. 1032, the 2015 Legislative Assembly increased the allocation limit from $5 million to $7.5 million per fiscal year and increased the fund balance limit from $75 million to $100 million. However, the changes by the 2015 Legislative Assembly are contingent upon the "large trigger" not being in effect for the first six months of the 2015-17 biennium.

The 2015 Legislative Assembly provided a total allocation of $1.5 million per fiscal year to each county that received more than $5 million, but less than $30 million of oil and gas tax allocations for distributions to school districts, excluding hub city school districts. School districts in the following six counties will receive distributions from this allocation: Billings, Bottineau, Bowman, Burke, Divide, and Stark.

Beginning in the 2011-13 biennium, 30 percent of oil and gas tax collections are allocated to the legacy fund from the state's share of the collections pursuant to Article X, Section 26, of the Constitution of North Dakota (see the **Oil Extraction Tax - Formulas** section for more detail).

Oil and gas tax revenue allocated to the state under the 4 percent of the 5 percent tax along with any remaining oil and gas tax revenue under the 1 percent of the 5 percent tax is available for allocation to the oil and gas research fund and for allocation pursuant to the state share (see the **Oil Extraction Tax - Formulas** section).

Oil Extraction Tax - Formulas

Constitutional Allocations

Pursuant to Article X, Section 26, of the Constitution of North Dakota, 30 percent of all revenues derived from taxes imposed on oil and gas, including the oil and gas gross production tax and the oil extraction tax, must be transferred to the legacy fund. During the 2011-13 and 2013-15 bienniums, the legacy fund also received revenue from contingent transfers of oil and gas tax revenue from the strategic investment and improvements fund (see the **State Share Allocation** section).

Article X, Section 24, of the Constitution of North Dakota provides that 10 percent of oil extraction tax revenues must be deposited in the common schools trust fund and 10 percent in the foundation aid stabilization fund.

The resources trust fund was created pursuant to the passage of Measure No. 6 in the November 1980 general election, which provided that 10 percent of oil extraction tax revenues be allocated to the resources trust fund. In June 1990, the Constitution of North Dakota was amended to establish the resources trust fund as a constitutional trust fund and to provide that the amount of oil extraction tax allocated to the fund would be set by the Legislative Assembly. The 1995 Legislative Assembly increased the allocation from 10 percent to 20 percent. The 2013 Legislative Assembly, in Senate Bill No. 2014, authorized the following transfers from the resources trust fund to other state funds:

- 5 percent of the amount of oil extraction tax revenue credited to the resources trust fund must be transferred to the renewable energy development fund, limited to $3 million per biennium; and
- One-half of 1 percent of the amount of oil extraction tax revenue credited to the resources trust fund must be transferred to the energy conservation grant fund, limited to $1.2 million per biennium.

Historical information provided by the Tax Department related to oil extraction formula changes from 1980 to 2011 is attached as Appendix C.

Oil and Gas Research Fund Allocation

Section 57-51.1-07.3 (2003 Senate Bill No. 2311) establishes the oil and gas research fund. The section provides that 2 percent of the state's share of the oil and gas gross production tax and oil extraction tax revenues, up to $10 million per biennium, is to be deposited into the oil and gas research fund. All money deposited in the oil and gas research fund is appropriated as a continuing appropriation to the Oil and Gas Research Council.

State Share Allocation

The 2011 Legislative Assembly created a new section to Chapter 57-51.1 to provide for the allocation of the state's share of oil and gas tax revenues designated for deposit in the general fund under Chapters 57-51 and 57-51.1. In the 2011-13 and 2013-15 bienniums, the allocations were as follows:

- The first $200 million is deposited in the general fund;
- The next $341.79 million is deposited in the property tax relief sustainability fund;
- The next $100 million is deposited in the general fund;
- The next $100 million is deposited in the strategic investment and improvements fund;
- The next $22 million is deposited in the state disaster relief fund; and
- Any remaining revenue is deposited in the strategic investment and improvements fund.

In House Bill No. 1377, the 2015 Legislative Assembly changed the allocation of the state's share of oil and gas tax revenue to provide the following allocations for the 2015-17 biennium:

- The first $200 million is deposited in the general fund;
- The next $300 million is deposited in the tax relief fund;
- The next $100 million is deposited in the general fund;
- The next $100 million is deposited in the strategic investment and improvements fund;
- The next $22 million is deposited in the state disaster relief fund, but not in an amount that would bring the unobligated balance to more than $25 million; and
- Of any additional revenues, 70 percent is deposited in the strategic investment and improvements fund and 30 percent is deposited in the political subdivision allocation fund.

Section 15-08.1-08, enacted by the 2011 Legislative Assembly in House Bill No. 1451, provided that if the unobligated balance of the strategic investment and improvements fund exceeds $300 million at the end of any month, 25 percent of any revenues received for deposit in the strategic investment and improvements fund in the subsequent month must be deposited instead into the legacy fund. The 2015 Legislative Assembly amended Section 15-08.1-08 to remove this contingent transfer.

STUDY PLAN

The following is a proposed study plan for the committee's consideration of its study of oil and gas tax allocation formulas:

1. Receive information from state agencies, including the Tax Department and the State Treasurer, regarding oil and gas tax allocation formulas as well as historical and current allocations.
2. Receive information from political subdivisions regarding their use of oil and gas tax allocations and their infrastructure and other funding needs.
3. Receive information from representatives of the oil and gas industry regarding their perspective on current oil and gas tax formulas and the infrastructure issues challenging the development of the oil and gas industry.
4. Receive testimony from interested persons regarding the study.
5. Develop recommendations and any bill drafts necessary to implement the recommendations.
6. Prepare a final report for submission to the Legislative Management.

ATTACH:3