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OIL TAX-RELATED INFORMATION FOR THE 2011-13 BIENNIUM

This memorandum provides information regarding statutory provisions relating to oil and gas gross production tax, oil extraction tax, the oil and gas research fund, and the oil and gas impact grant fund; the legacy fund; oil prices and production; and oil tax revenue projections for the 2011-13 biennium.

OIL AND GAS GROSS PRODUCTION TAX (NORTH DAKOTA CENTURY CODE CHAPTER 57-51)

The gross production tax on oil is 5 percent of the gross value at the well on oil produced. The gross production tax on gas is four cents times the gas base rate adjustment for each fiscal year as calculated by the Tax Department. Shallow gas produced during the first 24 months of production from and after the date of first sales of gas from a well completed or recompleted in a shallow gas zone after June 30, 2003, is exempted from the gross production tax. The oil and gas gross production tax is distributed per formula to the legacy fund, the oil and gas research fund, oil and gas impact grant fund (up to $100 million per biennium under current law), the state general fund, and political subdivisions within producing counties.

OIL EXTRACTION TAX (CHAPTER 57-51.1)

The oil extraction tax rate is 6.5 percent, but the rate may be reduced or oil may be exempt as determined by a trigger price. The trigger price is defined in statute as $35.50 as indexed for inflation. The current trigger price is $50.07. If the average price of a barrel of oil exceeds the trigger price for each month in any consecutive five-month period, the oil extraction tax is 6.5 percent. If the average price of a barrel of oil is less than the trigger price for each month in any consecutive five-month period, the tax rate is reduced or oil is exempted for the following activities:

- For oil produced from any well drilled and completed as a vertical well after April 27, 1987, there is no extraction tax levied for the first 15 months, and thereafter the rate is 4 percent.
- For oil produced from any well drilled and completed as a horizontal well after April 27, 1987, there is no extraction tax levied for 24 months, and thereafter the rate is 4 percent.
- For incremental production from qualifying secondary recovery projects that have used up the five-year exemption from the date incremental production begins, the rate is 4 percent.
- For incremental production from qualifying tertiary recovery projects that do not use carbon dioxide which have used up the 10-year exemption from the date incremental production begins, the rate is 4 percent.
- For oil produced from a qualifying well that was "worked over" there is no extraction tax levied for 12 months, beginning with the first day of the third calendar month after the completion of the workover project, and thereafter the rate is 4 percent.
- For oil produced from a certified two-year inactive well there is no extraction tax levied for 10 years after the date of receipt of certification, and thereafter the rate is 6.5 percent.
- For oil produced from a certified horizontal reentry well there is no extraction tax levied for nine months after the date the well is completed as a horizontal well, and thereafter the rate is 6.5 percent.

The following activities are specifically exempt from the oil extraction tax without regard to the trigger price:

- Production from stripper wells.
- Incremental production from a qualifying secondary recovery project is exempt for five years from the date incremental production begins.
- Incremental production from a qualifying tertiary recovery project that does not use carbon dioxide is exempt for 10 years from the date incremental production begins.
- Incremental production from a qualifying tertiary recovery project that uses carbon dioxide is exempt from the date the incremental production begins.
- The initial production of oil from a well is exempt from any oil extraction tax for a period of 60 months if it meets any of the following conditions:

  Is located within the boundaries of an Indian reservation;

  Is on lands held in trust for an Indian tribe or individual Indian; or

  Is on lands held by an Indian tribe as of August 1, 1997.

Under the July 1, 2008, agreement between the Governor and the Three Affiliated Tribes of the Fort Berthold Reservation, wells on trust lands are subject to a tax of 11.5 percent and wells on nontrust lands are subject to a tax of 5 percent. Tax revenue from wells on trust lands are divided evenly between the tribe and state, and tax revenue from wells on nontrust lands are allocated 80 percent to the state and 20 percent to the tribe. The effect of the agreement is to allow the exemption only for wells on nontrust lands within the reservation.

A contingent rate reduction in the oil extraction tax, which can only go into effect if the trigger price rate reduction is not in effect, reduces the oil extraction tax rate for horizontal wells from 6.5 percent to 2 percent during the time the rate reduction is in effect. The rate reduction becomes effective on the first day of the month following a month for which the average price of a barrel of crude oil is less than $55. The contingent rate becomes ineffective on the first day of the month following a month for which the average price of a barrel of crude oil exceeds $70. The contingent rate reduction applies to oil produced during the first 18 months after completion for a horizontal well drilled and completed after April 30, 2009, 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 contingent rate reduction was in effect from May 1, 2009, through October 31, 2009. During October 2009, the average price of a barrel of crude oil exceeded $70. North Dakota Century Code defines the average price of a barrel of crude oil used to determine the trigger and contingent rate reduction to be the monthly average of the daily closing price for a barrel of West Texas intermediate Cushing crude oil minus $2.50.

The oil extraction tax is allocated as follows:

- Thirty percent to the legacy fund beginning July 1, 2011.
- Twenty percent to the resources trust fund for water development projects.
- Ten percent to the foundation aid stabilization fund.
- Ten percent to the common schools trust fund.
- Thirty percent to the state general fund after allocation to the oil and gas research fund.

LEGACY FUND

The Legislative Assembly in 2009 enacted House Concurrent Resolution No. 3054, which was approved by North Dakota voters in the 2010 general election and which creates a new section to Article X of the Constitution of North Dakota to create a new North Dakota legacy fund. The measure became effective July 1, 2011. The constitutional measure provides that 30 percent of all revenues derived from taxes imposed on oil and gas be transferred to the legacy fund. The principal and earnings of the legacy fund accruing prior to June 30, 2017, may not be expended until after June 30, 2017, and then may only be spent upon a two-thirds vote of the members elected to each house of the Legislative Assembly. Expenditures from the fund are limited to 15 percent of the principal during a biennium. Earnings of the fund accruing after June 30, 2017, will be transferred to the state general fund.

Section 15-08.1-08, enacted by the Legislative Assembly in 2011 House Bill No. 1451, provides 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.

OIL AND GAS RESEARCH FUND (SECTION 57-51.1-07.3)

Section 57-51.1-07.3 (2003 Senate Bill No. 2311) establishes the oil and gas research fund. Section 57-51.1-07.3 provides that 2 percent of the state's share of the oil and gas gross production tax and oil extraction tax revenues, up to $4 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.

OIL AND GAS IMPACT GRANT FUND

Section 57-51-15 (1989 House Bill No. 1302) establishes the oil and gas impact grant fund for deposit of revenue from oil and gas gross production taxes. Section 57-51-15 provides that from the tax equal to the first 1 percent of the gross value of oil at the well of oil production, up to $100 million per biennium, is to be deposited into the oil and gas impact grant fund. Money in the oil and gas impact grant fund is disbursed by the Land Department as grants to local units of government affected by oil and gas development activity. The Energy Infrastructure and Impact Office is to make recommendations to the Land Department on grants to local units of government. The recommendations are to include recommendations for 35 percent of impact funding to cities of 10,000 or more population and the remainder to smaller cities and counties, school districts, and other political subdivisions impacted by oil and gas development.

Senate Bill No. 2371 (2011) provides a contingent transfer of $30 million from the general fund to the oil and gas impact grant fund. The Office of Management and Budget may transfer this funding only if the Tax Commissioner certifies that total oil and gas tax revenue collections for the period July 1, 2011, through February 29, 2012, exceed oil and gas tax revenue collection projections for that period by at least $48 million. The transfer is to be used for a one-time appropriation of $30 million from the oil and gas impact grant fund to the commissioner of University and School Lands for providing oil and gas impact grants in accordance with Sections 57-62-03.1 and

57-62-05. For these funds, the commissioner is to give priority to approving grants related to emergency services.

Senate Bill No. 2371 also provides a one-time transfer of $5 million from the general fund to the oil and gas impact grant fund. This transfer is to be used for an appropriation of $5 million from the oil and gas impact grant fund to the commissioner of University and School Lands to allow for distributions of $1.25 million for each new major oil-producing county after November 2011 to address the impact from new oil and gas development. A major new oil-producing county is one that produced less than 100,000 barrels of oil in November 2011 and subsequently has more than four rigs operating in the county.

DISTRIBUTION OF OIL AND GAS GROSS PRODUCTION TAXES TO POLITICAL SUBDIVISIONS

Oil and gas gross production taxes are apportioned to the state and counties pursuant to Section 57-51-15. From the tax equal to the first 1 percent of gross value at the well of oil production, a direct allocation of $500,000 is provided 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 is increased to $1 million if the city's employment in the mining industry exceeds 7.5 percent of its total employment. Also from the tax equal to the first 1 percent of value of oil produced is a biennial allocation to the oil and gas impact grant fund up to $100 million. Any amounts remaining from the first 1 percent are allocated first to provide for deposit of 30 percent of all oil and gas gross production tax collected to the legacy fund and the remainder to the state general fund.

After deduction of the amounts provided for above, remaining annual revenue from the tax is allocated as follows:

1. The first $2 million is allocated to the county.
2. The next $1 million is allocated 75 percent to the county.
3. The next $1 million is allocated 50 percent to the county.
4. The next $14 million is allocated 25 percent to the county.
5. All annual revenue remaining after the above allocations is allocated 10 percent to the county.

After allocations to the counties, the amount remaining is allocated first to provide for deposit of 30 percent of all oil and gas gross production tax collected to the legacy fund and the remainder to the state general fund.

ALLOCATION OF STATE GENERAL FUND SHARE

Section 57-51.1-07.5 (House Bill No. 1451) provides that biennial revenues from oil and gas taxes designated for deposit in the general fund are 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.

OIL AND GAS TAX REVENUE DISTRIBUTION FLOWCHART

Based on the February 2011 revised revenue forecast for the 2011-13 biennium, the state's share of total oil and gas tax collections are estimated to be $682 million. The forecasted oil tax revenue collections are based on a number of factors, including tax rate incentives and exemptions, oil prices, oil production, etc. The February 2011 legislative forecast estimated oil prices of $72 per barrel in the first year of the 2011-13 biennium and $75 per barrel in the second year. The estimated average daily production rate is approximately 404,625 barrels for the 2011-13 biennium. Actual prices, production, and other factors throughout the 2011-13 biennium could increase or decrease actual oil tax revenue collections.

Attached as an appendix is a flowchart reflecting the estimated distribution of oil and gas tax revenues for the 2011-13 biennium based on current law.

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