



Montana Communities Cannot Afford the Oil and Gas Tax Holiday

Tax breaks for energy companies are costing Montana millions

November 2012

Years ago, the legislature created a tax break for oil and gas companies. At the time, proponents of the tax break claimed that it would encourage economic development in Montana's resource-rich areas, a claim unsupported by the facts. In reality, oil and gas companies will operate where there is oil and cannot afford to base their decisions on state taxes, which are just a small fraction of their total costs.

In addition, this tax break now costs the state and communities impacted by resource development tens of millions of dollars per year. As resource development expands in Montana, cities, towns, and their residents have begun to feel the strain on their public services and structures. The money given to oil and gas companies as a tax break would be better spent maintaining public structures like education; public sewers and water systems; good roads and healthy communities that help Montana retain and grow jobs now and into the future. In short, the oil and gas tax holiday is ineffective and is costing Montana valuable revenue for public services and infrastructure. It's time to take a hard look at the effectiveness of this corporate tax break.

Severance Taxes

A tax on oil, gas or other resource extraction is called a severance tax because it is a tax on severing a nonrenewable resource from the earth. In other words, this tax applies to resources that we cannot recover or use again.

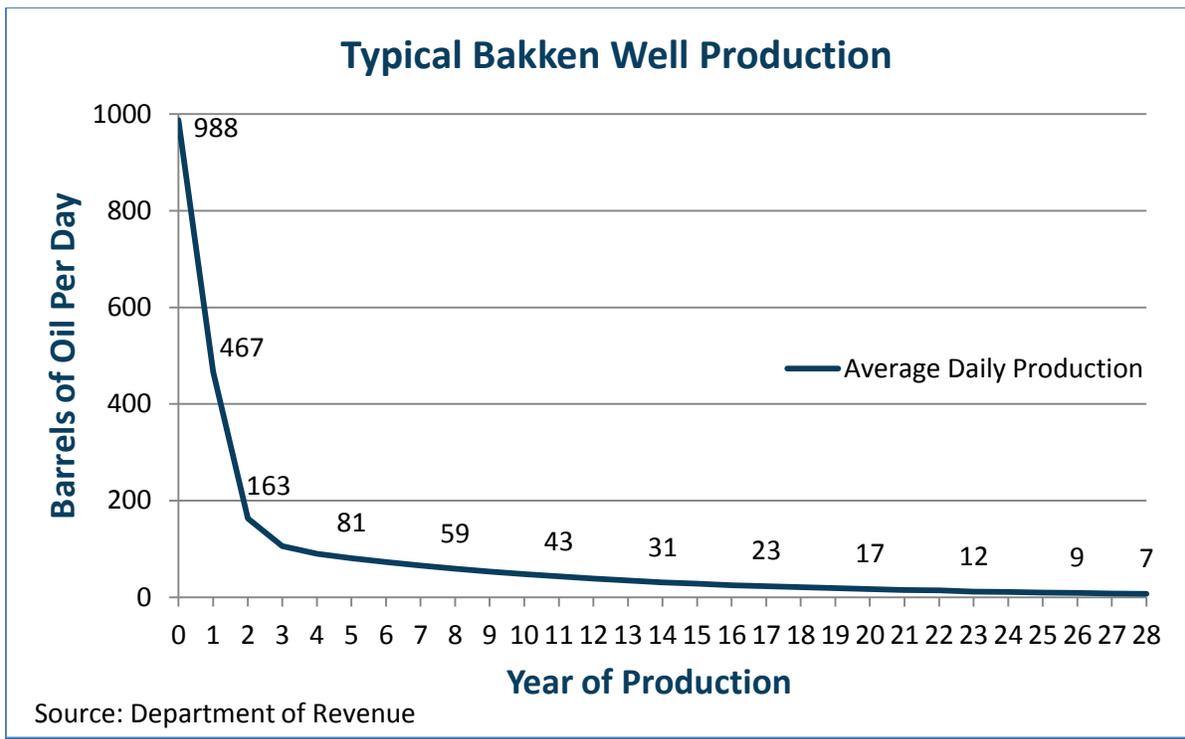
Severance taxes reimburse communities for the permanently reduced value of their land. There is broad agreement today that the severance tax represents good tax policy. The underlying principle is that private companies should compensate Montana for irreversibly removing natural resources from the state.

Severance taxes are based on the value of the resources extracted. The value of the resource varies with the price of the resource and therefore so does the amount of severance tax collected. In Montana, the severance tax on oil and gas extraction is called the oil and gas production tax.¹

Oil and Gas Tax Holiday

Newly drilled wells in Montana are not subject to the same oil and gas production tax as older wells. Newly drilled wells are taxed at 0.76 percent, a much lower rate than the standard 9.26 percent.² The time period in which wells are subject to the lower tax depends on the type of well drilled. Vertical wells benefit from the lower tax rate for twelve months, and horizontal wells for 18 months.³ This period of substantially lower tax rates has become known as a tax "holiday."

Taxing oil and gas at a significantly lower rate at the beginning of production is particularly problematic because wells produce significantly higher amounts at the beginning of their lifetime. The following graph from the Department of Revenue shows the average daily production of oil in the Bakken Oil Fields.⁴



Cost of the Tax Holiday to Montanans

In a five-year period, from 2008 to 2012, the tax holiday cost the state and counties \$152 million in revenue (Table 1).⁵ Revenues are split approximately 52/48 between the state and counties, and approximately 90% of the state's share goes to the state general fund.⁶ Consequently, the general fund lost approximately \$71 million over the five-year period. Local governments experienced a loss of \$73 million.

Table 1: Cost of Oil and Gas Tax Holiday, 2008-2012

Fiscal Year	Oil and Gas Taxable Production (Working Interest Value)	Tax Collected on Working Interest Value	Potential Revenue Without Holiday	Revenue Lost Due to Holiday
2008	\$769,339,961	\$5,846,983	\$71,240,880	\$65,393,897
2009	\$300,248,015	\$2,281,885	\$27,802,966	\$25,521,082
2010	\$131,916,874	\$1,002,568	\$12,215,502	\$11,212,934
2011	\$249,185,971	\$1,893,813	\$23,074,621	\$21,180,807
2012	\$339,069,854	\$2,576,931	\$31,397,869	\$28,820,938
5-Year Total	\$1,789,760,675	\$13,602,180	\$165,731,838	\$152,129,658

Source: Department of Revenue

The cost of the holiday to the general fund for the 2013 biennium is estimated to be over \$22 million. Over that same time period, counties are expected to lose over \$21 million.⁷

The issue of lost revenue is especially important in the communities that have felt the greatest impact of the oil and gas boom. In Eastern Montana, the development of the Bakken region has meant over-

burdened schools, a strained police force, heavy use of local roads, and little to no affordable housing. However, because of the tax holiday, local counties and cities do not receive the revenue they need to meet the increased infrastructure and service demands during the initial period of drilling, the time when the community feels these impacts the most.⁸ Furthermore, “spillover counties” that have little to no oil and gas production, but feel the effects of increased demands on their housing, roads, and school systems are not receiving the funding they need because the distribution formula does not direct funds to spillover counties.

The Oil and Gas Tax Holiday is Ineffective Policy

One argument used to justify the oil and gas tax holiday has been that it will encourage more development. However, a comparison of the effective tax rates of our neighboring states casts doubt on that claim. While actual tax rates vary due to numerous factors--like the length of time a well has been in operation--the effective rate is the average tax rate paid on all extraction. Montana’s effective rate of taxation on oil and gas, 10.4%, is significantly lower than both Wyoming’s 15.9% and New Mexico’s 15%. Yet Wyoming and New Mexico have higher total production value. In 2008, Wyoming saw \$19.2 billion in oil and gas production. New Mexico’s production totaled \$14.5 billion. Both of these figures are substantially higher than Montana’s \$3.1 billion total for the same year. In other words, the amount of production does not appear to be related to the effective tax rate.⁹

Likewise, when comparing the tax rates of a typical well in the Bakken formation, North Dakota has a tax rate of 10.6%, higher than Montana’s rate of 7.4%.¹⁰ Despite this higher tax rate, North Dakota still ranked in the top five of oil and gas producing states in 2011. Montana, however, did not.¹¹ Although North Dakota also has an oil and gas tax holiday, it does not go into effect unless oil prices are below \$52.57 per barrel, preserving revenue for the state when production value is high.¹²

The evidence continues to mount that repealing the oil and gas tax holiday would not harm, and may actually help, the Montana economy. Three studies in particular are relevant when considering the impact the holiday has had on Montana’s economy.

- The Montana-based Headwaters Economics’ historical analysis of Montana’s tax shows that lower rates have not improved the production in Montana relative to other states. Montana had the smallest growth in production of the five Intermountain states studied after reducing the state’s oil and gas rates in 1999.¹³ Montana production grew by \$2 billion, while production in Wyoming, with a tax rate 50% higher, grew by \$10 billion.¹⁴
- University of Utah Professor of Economics Gabriel Lozada studied Utah’s exemptions on oil and gas for development of new wells, and found that eliminating the tax holiday for new wells would result in a less than 1% reduction in new wells. However, severance tax collections would increase by 15-16%. In addition, he asserts that because the additional tax revenue dollars would be spent on other activities within the state, there should be no reduction in economic activity in the state.¹⁵
- A study commissioned by the Wyoming legislature of Wyoming’s oil and gas tax rate found that tax decreases would lead to a very small increase in the number of wells and a large decrease in the amount of revenue to the state.¹⁶

It is not surprising that oil and gas taxes have little effect on the amount of resources extracted in a state. Both common sense and research tell us that oil and gas companies will operate where there is oil and cannot afford to base their decisions on state taxes, a small fraction of their total costs and profits.

Oil and Gas as Economic Development

Oil and gas production can create well-paying jobs in rural communities. Even so, relying on the extraction of oil and gas for economic development alone is not a good overall strategy for communities..

Counties with extractive resources love the boom-times, but fear the bust. In the long-run, these counties are often poorer and have slower job growth than their peers that don't have oil and gas resources (and even recent booms can't measure up to growth occurring in other counties).¹⁷ Extraction counties tend to lack characteristics that will make them competitive in the long run. They have:

- Less economic diversity and resilience,
- A less educated workforce,
- High levels of net outmigration (more people move out than in), and
- Greater disparity in household income levels.¹⁸

These counties still need jobs, and oil and gas will continue to be part of the mix. But giving these resources away means forgoing other investments that will lead to future prosperity. Responsible taxation retains jobs (the booms will still come), but will allow oil and gas counties to better weather the busts and begin diversifying their economies.

Reexamining the Holiday – Policy Solutions that Work for Montana

Montana policymakers have several viable options for addressing the oil and gas tax holiday and using the resulting revenue to boost Montana's economy while helping affected communities deal with the impacts of oil and gas development. One possible solution is to repeal the holiday outright, which would simply ensure that newly drilled wells are taxed at the same rate as older wells. An alternative to completely repealing the oil and gas tax holiday is implementing a trigger price at which the holiday would go into effect. Creating this trigger would make Montana's tax code more similar to North Dakota, which has a trigger set at \$52.57 per barrel.¹⁹ If Montana adopted the same trigger, and the price of oil dropped below \$52.57 (West Texas Intermediate), the oil and gas tax holiday would go into effect. Creating a trigger price at which the repeal goes into effect makes sure that Montana is fairly compensated for our resources when prices are high, while at the same time allows us to remain competitive in the energy market when resource prices fall.

In either case, repealing the oil and gas tax holiday or instituting a trigger could change the way Montana's vital oil and gas revenues flow. Rather than benefitting large corporations, this revenue could benefit the state and local communities. Proper investment of this funding could build the region for years to come by addressing both immediate and long-term needs. For example, a portion of the recovered revenues could be used to:

- Establish an Eastern Montana Trust Fund. This trust fund would help to provide long-term support for the region after the initial boom ends. The trust fund could be used to provide business loans, support infrastructure projects, and support other development that creates long-term and diverse economic growth.
- Create an impact fund to support both spillover counties and counties whose oil and gas tax revenues are not sufficient to meet the rising service and infrastructure demands of the resource boom.

By creating both an impact fund and a trust, the tax holiday repeal or trigger would help to address short- and long-term issues created by the oil and gas boom, while avoiding redirecting funds away from any of the current beneficiaries of the oil and gas production tax. This approach would ensure that the state general fund, cities, and counties would not experience a reduction in their funding.

Conclusion

Communities across Montana have lost millions of dollars through this exclusive tax break for oil and gas companies – money that could be invested in the local communities to create conditions for reliable, long-term development.

Furthermore, research has shown that oil and gas tax breaks do not substantially influence the amount of drilling that occurs, and that drilling alone is not a reliable means to grow the economy over the long run. State taxes are unlikely to influence oil and gas companies' decisions to drill new wells because companies have to drill where the oil exists, and state taxes are a small share of total production costs.

Montana cannot afford the oil and gas tax holiday. Our state would be better served by using these revenues to invest in communities where our children can learn, grow, prosper, and stay to raise their own families well into the future.

Endnotes

1. Some have argued that the term "production tax" is a misnomer. See, for example, Gabriel Lozada, "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry," December 18, 2008 ("On a final note, "production" of oil and gas is in a sense a misnomer. Oil and gas were produced millions of years ago; none are produced today. The oil and gas industries extract these products today, and if their activity is reduced, more oil and gas will remain in the ground for future generations of Americans to use. So diminishing "production" of oil and gas from Utah today is properly understood not as decreasing the total amount of oil and gas ever extracted from the state, but instead as shifting extraction from today to the future.")
2. These rates apply to the working interest entities on wells drilled after 1999. Entities with a working interest are those that do the work to extract the oil or gas from the ground. In addition to the working interest entity, there is the royalty interest entity that owns the mineral rights, but does not invest in the extraction. There is no tax holiday for royalty interest entities.
3. The current definition of newly drilled wells was created in 1999; severance tax rates were also lowered at that time from 12 percent on oil and 15 percent on natural gas to 9 percent on both. Generally Revise the Taxation of Oil and Natural Gas Production, SB530, Montana Legislature, 1999 Regular Legislative Session (1999).
4. Department of Revenue, "Oil and Gas Production Tax Comparison: Montana and North Dakota," September 13, 2013. http://revenue.mt.gov/content/committees/legislative_interim_committee/OilandGasProductionTaxComparison-MontanaandNorthDakota.pdf
5. Department of Revenue, unpublished on file with author.
6. Vern Fogle, "Analysis of Oil and Natural Gas Tax Production Incentives for Production In Calendar Years 2003 through 2007," Montana Department of Revenue, Office of Tax Policy Research, September 2, 2008.
7. This is based on the fiscal note for SB 258, which would have eliminated the oil and gas tax holiday when the prices reach certain thresholds. It was estimated that the price of oil would reach the threshold in all 8 quarters of the 2013 biennium and that gas would reach the threshold in 5 of the 8 quarters. Thus this is a low estimate of the cost of the holiday. Governor's Office of Budget and Program Planning, "SB 0258 Fiscal Note 2011 Biennium," February 3, 2009, <http://data.opi.mt.gov/bills/FNPDF/SB0258.pdf>.
8. Ed Kemmick. "The Bakken Boom," Spring 2012, <http://www2.umt.edu/montanan/s12/The%20Bakken%20Boom.asp>.

9. Headwaters Economics, "Energy Revenue in the Intermountain West: State and Local Government Taxes and Royalties from Oil, Natural Gas and Coal," October 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyRevenue.pdf.
10. Department of Revenue, "Oil and Gas Production Tax Comparison: Montana and North Dakota," September 13, 2013. http://revenue.mt.gov/content/committees/legislative_interim_committee/OilandGasProductionTaxComparison-MontanaandNorthDakota.pdf
11. "Crude Oil Production from Shale Formation Jumps in 2011," March 29, 2011, <http://www.instituteforenergyresearch.org/2012/03/29/crude-oil-production-from-shale-formations-jumps-in-2011/>.
12. The trigger is actually set at \$50.07. North Dakota subtracts \$2.50 from the West Texas Intermediate (WTI) price and compares this amount to the trigger. For simplicity, we are referring to the trigger as comparing the WTI price to the trigger plus \$2.50. Department of Revenue, "Oil and Gas Production Tax Comparison: Montana and North Dakota," September 13, 2013. http://revenue.mt.gov/content/committees/legislative_interim_committee/OilandGasProductionTaxComparison-MontanaandNorthDakota.pdf
13. The intermountain states studied were Colorado, Montana, New Mexico, Utah and Wyoming.
14. Headwaters Economics, "Energy Revenue in the Intermountain West: State and Local Government Taxes and Royalties from Oil, Natural Gas and Coal," October 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyRevenue.pdf.
15. Gabriel Lozada, "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry," December 18, 2008.
16. Shelby Gerking, et. al., "Mineral Tax Incentive, Mineral Production and the Wyoming Economy." December 1, 2000, <http://eadiv.state.wy.us/mtim/StateReport.pdf>.
17. "As measured by average annual job growth, only one of 26 [energy-focusing] counties ranks among the top 30 economic performers in the West, while during the last energy boom half were top performers. In addition, more than half of EF counties are losing population in the midst of today's energy surge." Headwaters Economics, "Fossil Fuel Extraction as a County Economic Development Strategy: Are Energy-Focusing Counties Benefiting?" September 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyFocusing.pdf.
18. Headwaters Economics, "Fossil Fuel Extraction as a County Economic Development Strategy: Are Energy-focusing Counties Benefiting?" September 2008, http://www.headwaterseconomics.org/energy/HeadwatersEconomics_EnergyFocusing.pdf.
19. Department of Revenue "Oil and Gas Production Tax Comparison: Montana and North Dakota," September 13, 2013. http://revenue.mt.gov/content/committees/legislative_interim_committee/OilandGasProductionTaxComparison-MontanaandNorthDakota.pdf