Mineral Revenues in Louisiana

Response to Comments from the Louisiana Midcontinent Oil and Gas Association (LMOGA) and the Louisiana Oil and Gas Association (LOGA)

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James A. Richardson
LSU Department of Public Administration

Gregory B. Upton Jr.
LSU Center for Energy Studies

Introduction

In March of 2020, a report titled "Mineral Revenues in Louisiana" (hereafter "the Report") was released by the LSU Center for Energy Studies and Department of Public Administration. The Report was in response to Senate Concurrent Resolution 4 of the 2018 second extraordinary session (hereafter SCR4) and was a continuation of work from the Task Force on Structural Changes in Budget and Tax Policy created by House Concurrent Resolution 11 of the first extraordinary session of 2016. The goal of the Report was to take a broad and long-term look at Louisiana's severance tax system and make specific recommendations to the Legislature while balancing specific stated goals. The report concludes with the following recommendations:

1. Institute an equivalent volumetric tax rate for oil and natural gas with rate to be established semi-annually;
2. Remove exemptions associated with horizontal drilling, tertiary wells, and deep wells for new activity;
3. Implement recommendations (1) and (2) simultaneously while maintaining revenue neutrality with respect to the current severance tax projections;
4. Implement the new severance tax rates for oil and gas production from new activity; activity originated before tax law change will comply with the current tax structure.

These recommendations are consistent with the stated goals within SCR4 as well as the broad-based and low-rate philosophy, revenue neutrality for severance tax collections, and administrative efficiency.

Since the release of the Report, we have conducted meetings with stakeholders from both industry and state government in preparation for our third and final deliverable requested by the resolution: specific bills drafted to implement these recommendations. Written comments were provided by the two organizations that represent the oil and gas industry in the state: the Louisiana Mid-Continent Oil & Gas Association (LMOGA) and the Louisiana Oil & Gas Association (LOGA).

Both organizations oppose an increase in the tax rate for natural gas, even if increasing the rate on natural gas were implemented alongside a reduction in the severance tax rate on oil. As outlined in the report, Louisiana has the highest severance tax rate for oil of any state in the continental United States: 12.5 percent of its value at the time and place of severance [R.S. 47:633(7)a]. The Report recommends reducing this tax rate to be more in line with other states while achieving revenue neutrality by (1) increasing the tax rate on natural gas from new wells and (2) removing exemptions for new activity. These changes, if enacted, would impact individual companies and landowners in different ways. Notably, the Haynesville Shale region in northern Louisiana produces natural gas and takes advantage of the horizontal drilling exemption.

Several industry stakeholders voiced their concerns with the recommendations of the Report[1]: "If we were to create a severance tax system from scratch, the system you propose makes a lot of sense. But the political reality is that proposing a tax increase on *anyone* will make it difficult for an industry association to support the proposal, even if the result is a broad-based, low-rate, and simple tax system aimed at bringing in the same amount of revenue for the state." This sentiment is discussed in Section 10.3.1 of the Report.

> *Any tax changes that are meant to be revenue neutral will by definition increase tax liability for some taxpayers and decrease tax liability for others. Therefore, a position that taxes must not increase for any taxpayer is inherently contradictory to the fundamental concept of broad-based, low-rate, and revenue neutral tax reform. Tax reform that lowers taxes for some taxpayers and does not increase taxes for others will inherently reduce revenues for the state. In this specific context, leveling the tax rate for oil and natural gas will by definition increase the rate for natural gas and decrease the rate for oil. Producers that focus on oil will be impacted differently than those that focus on natural gas.*

With this in mind, we have made every effort to address the concern that producers could be negatively impacted in the short-run, while still allowing the Legislature to achieve the long-run objectives of a broad-based and low-rate simplified tax system that were requested in SCR4.

The proposed legislation attempts to mitigate short-term changes in the tax burden on individual companies in two ways. **First, existing wells continue to pay the current tax rate.** In other words, a producer who has made an economic decision to drill a well will not experience a change in the tax rate for production from that well. **Second, new wells drilled in regulatory units with existing wells receiving the horizontal, tertiary, and deep well exemptions will be grandfathered.** In combination, these two provisions begin a deliberate transition toward a simplified tax system, while mitigating the tax impact to individual companies. Any change in the tax code can have transitional costs which is why we recommend implementing the proposed changes over time.

Response to LMOGA Comments:

The LMOGA letter was prepared by the natural gas committee. So, unless explicitly stated otherwise, responses will presume that the comment is related to the taxation of natural gas, in lieu of oil.

First, LMOGA comments that comparing the tax rate of natural gas to Oklahoma and Texas is not an apples-to-apples comparison. This is because these other states value natural gas for severance tax purposes based on the market price received less a deduction of marketing costs, while Louisiana assesses a volumetric rate that does not include a deduction for marketing costs. They comment that it is the *tax burden*, not the *tax rate*, that is the most relevant data point when comparing the tax structures of states. Section 4 of the Report discusses

[1] Paraphrasing anonymous comment. This sentiment was expressed generally throughout conversations.

Louisiana's tax structure and comparison with other states. Section 4.1 focuses on the severance tax rate and provides comparisons to other states. Section 4.2 provides a discussion of the deductibility of transportation costs for oil compared to natural gas that is taxed at a volumetric rate. Section 4.5 discusses the overall competitiveness of Louisiana's tax structure, focusing on the tax burden in lieu of the tax rate. A more detailed discussion of the inherent tradeoff between a value-based rate allowing for deductions compared to a volumetric rate indexed to a market price is discussed in Section 8. We agree that a simple comparison of tax rates is not sufficient to fully assess the tax burden and our report recognizes the complications of simple comparisons.

Second, LMOGA comments on property taxes as follows: "Although the Constitution prohibits the direct taxation of reserves and below-ground equipment, the taxation of the cost to drill and equip a well effectively serves as a means of levying tax on reserves and below-ground equipment." We appreciate this perspective; however, the Report does not recommend changes to the property tax assessed on oil and gas equipment. Notably, a Constitutional amendment was passed in November of 2020 allowing for a well's oil and gas production to be considered when valuing it for property tax assessment.[2] This amendment was passed after the release of the Report and was supported by LMOGA.

Third, LMOGA comments that the state and local sales tax rate in Louisiana is higher than surrounding states. This Report's scope is limited to severance taxes. The Task Force on Structural Changes in Budget and Tax Policy recommended a reduction in the sales tax rate as well as a broadening of the sales tax base[3] and generally acknowledged that Louisiana has a higher combined state and local sales tax rate relative to other states.[4] The state and local sales tax applies regardless of how oil and gas is taxed. We are focusing on improving the taxation of oil and gas.

LMOGA expresses a concern about the potential ramifications of disassociating production taxes from production value in favor of a volume-based tax, stating: "Specifically, if gas prices drop, an operator would see its revenue drop, but not its tax burden. In extreme cases, the tax burden could exceed the revenue from the production until the next rate calculation takes place."[5] It is important to note that under current law the tax for natural gas is based on a volumetric rate. Section 8 of the Report discusses the inherent tradeoff between a volumetric and value-based rate. We are not proposing significant changes to this structure for natural gas. The Report recommends increasing the frequency of the volumetric rate adjustment for this very reason.

Finally, the LMOGA comment expresses concern "about the potential for rapid property and asset devaluations in gas-rich regions if gas severance taxes significantly increase over a short period of time." It is further noted that "because this will have potentially significant impacts on future revenue, property owners and

[2] Amendment 2 on the November 3, 2020 ballot. This amendment permits the production of oil and gas to be included in the determination of the fair market value of a well. The ad valorem tax does not apply to the oil and gas reserves.
[3] In keeping with a broader sales tax base in states such as Texas.
[4] Louisiana's Opportunity. Comprehensive Solutions for a Sustainable Tax and Spending Structure. Prepared by The Task Force on Structural Changes in Budget and Tax Policy. Final Report. January 27, 2017.
[5] Louisiana has been using the volumetric-rate related to the price of natural gas since 1990 and this extreme case has never occurred.

leaseholders will realize impacts to the present value of their assets – assets in which companies and individuals invested using the current tax regime as the basis for their financial analysis." We have addressed this explicitly in the proposed legislation. Specifically, if implemented, existing wells will continue to pay the current tax rate. Thus, a property owner with currently producing wells will not be impacted in this way. Second, new wells drilled in regulatory units that are currently receiving the horizontal, tertiary, and deep well exemptions will be grandfathered. Thus, a company that is actively developing a field utilizing one of these exemptions will not suddenly see the removal of the exemption for future wells.

Response to LOGA Comments:

First, LOGA points out that the Report recommends increasing the tax rate on natural gas and states that "it is critical to remember that the Haynesville Shale is currently the only economic bright spot in all of Louisiana's upstream industry." Concerns about Haynesville Shale are addressed in two ways in the proposed legislation. First, if implemented, existing wells continue to pay the current tax rate. Thus, all currently producing wells in the Haynesville will not be impacted in this way. Second, new wells drilled in regulatory units that are currently receiving the horizontal, tertiary, and deep well exemptions will be grandfathered.

Second, LOGA requests clarification on what is meant by "revenue neutral." Specifically, LOGA poses the following question: "Using the proposed logic in your recommendations, if the state's revenue on oil continues to decline over the next few years, will we just keep raising the rate on gas again, and then again and again?" The answer to this question is "no." Use of the term "revenue neutral" here indicates that the state will bring in approximately the same amount of revenues in the future with the proposed tax regime compared to the existing tax regime.

Next, LOGA comments that with current market prices, the state's tax revenues should rebound on their own without having to needlessly harm the Haynesville Shale companies. A stated goal of the Report, as specifically requested in SCR4, is to preserve or improve the competitiveness of the oil and gas extraction sector in Louisiana while simultaneously holding constant or increasing mineral revenues for the state. Thus, while we are hopeful that market conditions will lead to increases in profits for companies and increases in severance tax revenues for the state, the purpose of our recommendations is not to increase revenues, but instead recommend an improved tax regime that will bring in approximately the same amount of revenues under given market conditions.

LOGA also comments that neighboring states like Texas and Oklahoma allow for natural gas companies to deduct marketing costs, including gathering, processing, transporting, and fees charged by marketing companies. As previously mentioned, in response to a similar comment from LMOGA, the value of natural gas for severance tax purposes in these other states is based on the market price received less marketing and transportation costs, while Louisiana assesses a volumetric rate that does not include a deduction for marketing costs. A discussion of these differences can be found in Section 4 of the Report, and a more detailed discussion of the inherent tradeoff between a value-based rate allowing for deductions compared to a volumetric rate indexed to a market price is discussed in Section 8. For this and other reasons, we agree that a simple comparison of tax rates is not sufficient to fully assess the tax burden.

LOGA comments that "these other states tax their producers on the amount they receive in the field, not Henry Hub strip (your recommendation uses Henry Hub strip)" and that "the combination of marketing costs and the price differential on gas can cut proceeds by a significant amount, historically as much as 50 percent." The LOGA comment further states that "another significant key component to consider is that gathering, processing and transportation costs are fixed meaning they do not go down with pricing . . . [t]hus the tax rate under your proposal would increase as a percentage of revenue as the price goes down." We again agree that that a simple comparison of tax rates is not sufficient to fully assess the tax burden but note that this comment describes the <u>current</u> tax structure for natural gas. We are <u>not</u> recommending a fundamental change in how natural gas is valued for tax purposes. The Report recommends increasing the frequency of the volumetric rate adjustment for this very reason.

LOGA comments that mineral reserves are subject to property tax in Louisiana, citing a Louisiana Constitutional amendment that passed in November of 2020 allowing for a well's oil and gas production to be considered when valuing it for property tax assessment.[6] This amendment was passed after the release of the Report and was supported by LOGA; however, the Report does not recommend changes to the property taxes. LOGA also comments that sales taxes are higher in Louisiana than surrounding states. While the Report's scope is limited to severance taxes, the Task Force on Structural Changes in Budget and Tax Policy recommended a reduction in the sales tax rate and generally acknowledged that Louisiana has a higher combined state and local sales tax rate relative to other states.[7]

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[6] Amendment 2 on the November 3, 2020 ballot. This amendment permits the production of oil and gas to be included in the determination of the fair market value of a well. The ad valorem tax does not apply to the oil and gas reserves.

[7] Louisiana's Opportunity. Comprehensive Solutions for a Sustainable Tax and Spending Structure. Prepared by The Task Force on Structural Changes in Budget and Tax Policy. Final Report. January 27, 2017.