

# STATES PASS MEASURES TO HELP PRODUCERS DURING TOUGH TIMES

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The chronic U.S. oil production decline which began in the 1970s, the economic deterioration that followed collapse of the artificially high world oil price in mid-1980, the shifting of exploration and production investments abroad, and downsizing by majors and large independents in the 1990s have steadily squeezed the public and private sectors of the major oil and gas producing states.

Those states most dependent on oil and gas have experienced the most persistent discomfort, but the economic dislocations visited on the "oil patch" have been as serious as those associated with the decline of any major industry in any region of the United States in recent history.

To illustrate: When the double whammy of deep recession and effective foreign competition hit the domestic auto industry in the early 1980s, Michigan's employment in motor vehicle production fell by about 30% between its peak year of 1978 and its low in 1982. In response, from 1980 to 1985 (its low year) Michigan's population declined by a little more than 2%. Then it started to slowly grow, and by 1991 Michigan's population was larger than it was in 1980.

When the erosion and collapse of the world oil price hit Louisiana's economy in the 1980s, E&P employment fell from a high of almost 100,000 to less than 50,000 within 7 years. The migration of job-seekers that followed reduced the state's population by more than 4% between 1985 and 1990, and in 1991 Louisiana's population was still only 96.4% of its 1980 level.<sup>1</sup>

The public sector problems resulting from this economic trauma were mostly financial. Major oil and gas states have long relied on severance taxes on production, as well as the royalty, rental, and bonus payments associated with production, for a substantial proportion of their public revenues. Moreover, oil and gas producers are significant payers of state and local government property, sales, and corporate taxes.<sup>2</sup>

As energy-based revenues fell,

states had to look elsewhere, primarily to nonenergy sources, for funds, and they did so. Over the decade of the 1980s, for example, the state of Texas estimated that without new tax legislation, state revenues in 1989 would have been at about the same level that they were in 1981. In fact, however, three major tax bills were passed by the Texas legislature, and revenues in 1989 were about 75% higher than they were in 1981.<sup>3</sup>

However, the more fundamental effects of declining domestic production, falling prices, and the migration of E&P investments abroad fell directly on those dependent on the oil patch economy itself. These pure, private sector economic effects—jobs lost in E&P and derivative jobs in oil service sector as well as the general economy—were both more serious and harder to deal with.

### Traditional objections

Programs intended to cushion repercussions from changing world markets have been regularly adopted to help industries ranging from mohair to motor vehicles. But, until recently, nothing of consequence was done for oil and gas.

Legislative proposals that would help the domestic oil and gas industry have foundered at the federal level because they have been perceived to increase costs for energy consumers in the populous states of the Northeast and Midwest—a perception that also has stopped some actions at the state level, such as the attempt to revive meaningful prorationing when gas prices took a dive in 1993.

But equally inhibiting has been the conventional wisdom at both the state and federal levels that: 1) any politically feasible incentives would prove to be economically inconsequential given the fluctuations in oil and gas prices that had been experienced in the past and were expected in the future, and 2) any economically consequential incentives would prove politically infeasible because they would entail too large a reduction in already tight public rev-

enues.

Thus it is not surprising that neither state nor the federal governments made much of an attempt to revive the steadily shrinking indigenous oil and gas industry—even in energy producing states.

### Incentive legislation

Very recently, however, some major energy producing states have enacted incentives for expanded oil and gas production, and efforts continue to marshal pressure for incentives at the federal level.

The state-level momentum began in September of 1993 when Texas enacted a series of targeted production incentives. The Texas initiative quickly inspired legislatures in Louisiana, Mississippi, and Oklahoma to pass similar packages in the first half of 1994. (Kansas also passed legislation which lowered severance taxes on a phased-in basis, but this was largely to neutralize a previous increase in property taxes, not to provide incentives for new production).

All of the state programs involve reductions in severance taxes for specific types of wells. In each state, proponents were able to persuade the legislature that such targeted incentives would not reduce revenues and stood a reasonable chance of increasing them (i.e., would be at worst "revenue neutral" and hopefully "revenue positive"). After Texas passed its incentive package, neighboring states were also able to argue that they needed similar incentives to remain regionally competitive.

While the legislation passed in Texas, Louisiana, Mississippi, and Oklahoma have many similarities, there are some important differences (see table).

### Reentering wells

Texas' initiative clearly inspired the other states. Conceptually, Texas showed how economically consequential incentives could be created without unacceptable risk to the state's public revenues by carefully targeting

# Independent Operations

## WHAT STATES HAVE DONE TO ENCOURAGE PRODUCTION

State	Enhanced oil recovery	Inactive wells	New field discoveries	Other
Texas	Extended deadline for 50% severance reduction on incremental oil from Dec. 31, 1993, to Dec. 31, 1997.	Wells inactive for 36 months and brought on line are excluded from severance for 10 years. Window of opportunity from Sept. 1, 1993, to Aug. 31, 1995.	Not company-specific but industry-specific. Base level of 421 discoveries. If 521 discoveries then everyone gets \$10,000/discovery well. At 721 discoveries \$25,000/well, etc.	
Louisiana	Reduction already existed—none added.	Wells inactive for 24 months and brought on line are excluded from severance tax for 5 years. Window of opportunity from July 31, 1994, to June 30, 1996.	Company-specific. New discovery wells receive 2 year exemptions from severance or until payout, whichever is less. Window of opportunity from Sept. 30, 1994, to Sept. 30, 1996.	1. No severance on stripper oil when severance price is \$20/bbl or less. 2. No severance for 2 years or until payout, whichever is less, for horizontal wells and all deep (15,000 ft true vertical depth) wells.
Mississippi	Severance reduction of 50% from incremental oil produced Apr. 1, 1994, no limits.	Wells inactive for 24 months and brought on-line are excluded from severance for 3 years. Five year sunset and repealed when oil exceeds \$25/bbl and gas \$3.50/Mcf.	Company-specific. New discovery wells after Apr. 1, 1994, receive 5 year severance exemption.  Same sunset and repeal price as inactive wells.	1. A 3D seismic credit of 50% of oil severance for 5 years on wells drilled in association with 3D seismic. Same sunset and repealer prices. 2. Development wells—if associated with discovery wells drilled after Jan. 1, 1994, receive a 50% severance exemption for 3 years. Same sunset and repealer prices.
Oklahoma	Extended existing reduction and liberalized payback period from not to exceed 3 years to not to exceed 10 years.	Wells inactive for 24 months and brought on-line are excluded from severance except for 1%, for 28 months. Window of opportunity from July 1, 1994, to July 1, 1997. Repealed if oil is \$20/bbl or gas is \$2.50/MMBTU	Not included.	1. Deep wells (15,000 ft and greater)—same as inactive wells. 2. Production enhancement—incremental oil same as inactive wells.

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the incentives on specific wells—especially inactive ones.

But probably more "inspirational" were the financial results Texas achieved under its inactive well provisions during the first year of operation.

By January 1994, Texas released data showing that its inactive well program had resulted in more successful well reentries in the first 4 months of the program's operation than in the entire preceding 12 month period. From a revenue perspective, the increase in sales taxes collected from purchases associated with the new reentries alone exceeded the potential revenue lost to the state as a consequence of the severance exemption.

Soon after the release of the Texas data, Louisiana Gov. Edwin Edwards asked his Energy Commission to examine the applicability of Texas' legislation to Louisiana and to analyze other incentives that, as a package, would be at least revenue-neutral and, hopefully, revenue-positive.

The analysis (conducted by the authors), concluded that the inactive well program probably had as much or more potential in Louisiana than in Texas.

Texas' resource base had several characteristics which made the inactive well incentive look promising. Texas had a larger percentage of its production in oil and a proportionately larger number of inactive wells. It also was generally believed that the state had more fields (absolutely and

proportionally) that had high potential for successful reentry.

On the other hand, Louisiana's oil severance tax rate was substantially higher: 12.5% vs. 4.5% (thus, the severance tax exemption was worth considerably more to the operator). Louisiana's sales tax was more comprehensive and featured higher rates (thus, sales taxes generated by additional activity would be more likely to offset the forgone severance taxes). And many of the inactive wells eligible for the incentive were located on state leases (thus, as the royalty owner the state would enjoy a direct revenue benefit from any increased production).

Other considerations led Louisiana to make modifications to the Texas model. Louisiana reduced the inactive period from 36 to 24 months. The reduction increased Louisiana's revenue risk by 8% (the base number being the estimated severance taxes from the wells that would have been reentered without the incentive), but it also increased the number of eligible wells, reduced the probability of inactive wells being plugged and abandoned, and, in the longer run, put wells into the program more rapidly.

Louisiana also reduced the period during which production would be exempt from severance tax from 10 years to 5 years. Ten years was regarded as both politically unacceptable and economically unnecessary since investors and operators use consider-

ably shorter payout periods when making drilling and production decisions.

Mississippi and Oklahoma also adopted inactive well programs with a 24 month inactive period required to qualify. In Mississippi, the severance exemption period is 3 years, whereas in Oklahoma it is 28 months. Both Mississippi and Oklahoma also added a repeater to the exemption, which is tied to the price of oil and gas.

### Political appeal

The inactive well programs are the centerpieces of the respective states' incentives legislation and are projected to have the most positive revenue impact. Politically, the inactive well programs had other important attributes, including:

- Rapid impact. Historically, tax incentives rarely have an immediate impact. But the effects in Texas were almost instantaneously positive. Only time will tell if this will persist over the longer haul, but it clearly has been a political plus for legislators facing near-term elections.

- Small-operator-friendly. With the widespread sale by majors of old fields to smaller independent companies, the perception is that the inactive well programs will largely benefit small, independent operators. Small operators are a more "politically correct" group as they are usually perceived to be locally owned and operated. Economically, however, it is still the larger companies that have the eas-