MINUTES

MONTANA HOUSE OF REPRESENTATIVES
51st LEGISLATURE - 2nd SPECIAL SESSION

COMMITTEE ON TAXATION

Call to Order: By Chairman Harrington, on May 22, 1990, at 10:00 a.m.

ROLL CALL

Members Present: 21

Members Excused: Rep. Driscoll

Members Absent: None

Staff Present: Lee Heiman, Legislative Council

Announcements/Discussion: Chairman Harrington asked for roll call and said we would hear House Bill 5 first.

HEARING ON HOUSE BILL 5

AN ACT GENERALLY REVISING LOCAL GOVERNMENT SEVERANCE TAXES; ESTABLISHING A BASE YEAR FOR THE DISTRIBUTION OF LOCAL GOVERNMENT SEVERANCE TAXES; DISTRIBUTING LOCAL GOVERNMENT SEVERANCE TAXES TO ELIGIBLE TAXING UNITS; PROVIDING FOR A PERCENTAGE DISTRIBUTION MECHANISM FOR LOCAL GOVERNMENT SEVERANCE TAXES UNDER CERTAIN CONDITIONS; CLARIFYING THE APPLICATION OF THE LOCAL GOVERNMENT SEVERANCE TAX TO NATURAL GAS STRIPPER WELLS; CLARIFYING THAT LOCAL PRODUCTION TAXES ON OIL, NATURAL GAS, AND COAL ARE INCLUDED IN THE GUARANTEED TAX BASE CALCULATION; CLARIFYING THE DEFINITION OF THE GUARANTEED TAX BASE; AMENDING SECTIONS 15-36-112, 15-36-121, AND 20-9-366, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE AND A RETROACTIVE APPLICABILITY DATE.

Presentation and Opening Statement by Sponsor:

REP. EUDAILY, House District 60, Missoula, said House Bill 5 is a safety net bill. If all else fails, the Legislature could pass HB 5 and still have accomplished something. House Bill includes six considerations of HB 28 that were outlined in the call for the special session. Five considerations are in Rep. O'Keefe's bill and in SB 1. Section 1 of HB 5 clarifies the term taxing districts by using the term taxing units. The bill also replaces the unit value distribution formula to a percentage base formula and establishes the base year. The base year is identical in all these bills.

Section 2 eliminates the exemption for stripper wells and sets the percentage at 7.625%, which is the same percentage that those that were non-exempt were paying under the bill.

Section 3 clarifies some definitions. This is a cleanup bill that puts HB 28 in the form most legislators thought it was in when it was passed. This bill, unlike any of the others, does not address revenue neutrality. This committee and the Legislature can consider any of the other proposals, and it will not affect this bill. This bill and SB 1 are identical bills. He urged the passage of House Bill 5.

Testifying Proponents and Whom They Represent:

Dennis Burr, Montana Taxpayers Association

Janelle Fallan, Montana Petroleum Association

Proponent Testimony:

DENNIS BURR said this bill solves the problem with stripper gas, and it does nothing else. This is what the Legislature should do. There is a lot of attention being paid to revenue neutrality, especially the base year, whether it is neutral for 1989, 1988, 1987. If 1986 were the base year, discussion right now would be about lowering rates rather than raising them. The base year has overshadowed tax policy, and Montana's rates on oil and gas are higher than surrounding states. This is a declining industry, and the Legislature should fix the problem on stripper gas only and resolve the remaining problems with HB 28 at the 1991 regular session. There are companies that have planned for and paid royalties and costs based on the rates that were adopted at the last legislative session. The Legislature might now repeat the situation where people are put on the losing side of the situation because of the changing rates. This bill should be approved, and the rates set last session should remain in effect at least until the next session.

JANELLE FALLAN said she would only comment on the aspects of the bill that address the stripper gas exemption. They do believe this was an error; HB 28 was sent back to drafting at least once last summer because the industry was aware of the possibility that certain stripper wells could be exempt from taxation. This was one of the things that just happened in the codification process; nobody intended that certain producers should get a $1.7 million or $1.8 million tax reduction. Many producers in Montana have been paying that tax. They assumed they would have to pay it retroactively, so they have just gone ahead and paid it this year.

Testifying Opponents and Whom They Represent:

Gregg Groepper, Office of Public Instruction (OPI)

Opponent Testimony:

GREGG GROEPPER said that OPI is a reluctant opponent. Most of what Rep. Eudaily is doing in this bill is good and necessary, but the bill does not go far enough. OPI's threshold for revenue neutral -- or whatever it is called -- in education is about $35.9 million. With last summer's great compromise in HB 28, school districts assumed that HB 28 would generate enough revenue from the flat tax so that additional mill levies on the remainder of the taxpaying public would not be necessary. If the Legislature only fixes the stripper exemption they will not achieve what was OPI's estimation of that compromise. The remainder of the bill needs to be resolved in one form or another, but some effort is needed at adjusting the rates from this source sufficient to avoid additional mill levies on the taxpaying public.

Mr. Groepper offered one technical amendment, which they will offer on all these bills, on how OPI uses nontax revenue to calculate guaranteed tax base. OPI's administrative rules ignored revenue sources that were less than a threshold percentage, and this new oil tax was included in that. They do not have a quarrel with using the new production revenues to calculate a school district's standing and guaranteed tax base. But by directing them to do it now, effective July 1, they must get a chunk of information from county treasurers. So OPI suggests delaying the implementation of the new production figure as a nontax revenue for 1 year. That will allow OPI time to get the information from the county treasurers and include that in the guaranteed tax base calculations for FY 1992. They do not have trouble with the concept; they would like to have time to get all that information from the treasurers.

<u>Questions From Committee Members:</u>

REP. GOOD asked Rep. Eudaily if this is just a "plain Jane, stripped down version" of what legislators were sent here to do. Rep. Eudaily said that was his interpretation.

REP. KADAS asked Rep. Eudaily if he didn't believe the Legislature was here to resolve the revenue neutrality issue. Rep. Eudaily said yes. Rep. Kadas asked if this bill is revenue neutral. Rep. Eudaily said it is not. The reason is that he has been around a few years and he knows how some things do or do not happen. He would not want the Legislature to go home and say they did absolutely nothing. Passing HB 5, legislators could say they did something to the tune of about $2 million. His fear was that they would get wrapped up in this and wind up doing nothing, even with the stripper well exemptions.

Rep. Kadas asked Rep. Eudaily why he thought they would not be able to resolve the revenue neutrality issue, since it has been a genuine concept of the industry and most people involved in the issue for the past year. Rep. Eudaily said he was not saying they cannot; he just has a fear that they will not resolve it. He attended a couple of meetings, one in Missoula and one here. There were people who had great doubts about where to set rates, whether they would be constitutional if they were not set evenly, etc. He began to get concerned that legislators might not get anything done. He believes the Legislature needs to do something, but is not sure they will.

REP. KADAS asked Ms. Fallan about her understanding of the revenue neutrality concept. She answered that her understanding is that in the 1989 special session, flat tax was to be revenue neutral to 1987 production. 1987 was chosen because that was the most recent year for which there was any data. Rep. Kadas asked if this bill is revenue neutral to 1987. Ms. Fallan said it would be within 5% to 6% of revenue neutral. Rep. Kadas asked if her definition of revenue neutral was a figure within 5% to 6% either way. She said she would not define that; it would not be revenue neutral on her checking account. Rep. Kadas asked if she was saying 5% to 6% is good enough for her. She said, as an association, they don't believe that is what they promised to do last summer. Rep. Kadas asked what the association believed they did promise to do last summer. Ms. Fallan said they promised to come up with a flat tax that would be with rates that were revenue neutral compared to net proceeds payments on 1987 production.

Rep. Kadas said he felt he was going in a circle with these questions. They are 5% or 6% out; everyone agreed to be revenue neutral; and Ms. Fallan is saying that 5% to 6% is really close enough. Does she agree that they would have to get closer than 5% to 6%? Ms. Fallan answered yes, and that Rep. Kadas probably questions why she supports Rep. Eudaily's bill. Rep. Kadas said he could understand why she was supporting this bill, but he was considering offering some amendments to make this bill revenue neutral, and wondered if she would support that. Ms. Fallan answered that it would depend on what the rates were. Rep. Kadas said as he understood it, rates to make the bill revenue neutral, utilizing the state's structural laws, would make the rates about 8.57 for oil and half of that for stripper and 18 for gas and half of that for stripper. Ms. Fallan said, no, she could not support that. Asked why not, she said because it increases the taxes. She said there are a lot of different facets here, a lot of different taxpayers: regular oil, stripper oil and owners of royalties, regular gas, stripper gas, and owners of royalty. All must be looked at, at how they are affected in the shift from net proceeds to a flat tax. If legislators just want to raise $40 million, they could leave everybody where they are now and just raise the tax on natural gas and get it that way. Or legislators could just raise the tax on the oil producers, but she did not feel that is fair.

Rep. Kadas asked when they discussed the issue last summer, was the issue of making a separate rate for royalty owners ever a part of the discussion? Ms. Fallan answered that it was not a part of the discussion with the Legislature. She said a couple of producers foresaw, from their own calculations, something of a shift in tax liability from the royalty to the working interest. She said two things happened. First, nobody realized how big a shift it would be or what the dollar impact would be. Secondly, they were dealing with such an immensely complex issue that it did not seem politically feasible to come around the middle of July and say "wait a minute, we've just realized we are working on this huge tax shift and we didn't think it was a huge tax shift." Rep. Kadas said last summer then, you did not understand the full impacts but were willing to accept them in order to gain the benefit of a flat tax instead of a net proceeds tax. Ms. Fallan answered yes, but now they have more information. Producers have not changed their minds. They are still willing to work on revenue neutrality to 1987, the same as they said last summer, but more information on tax shifts has become available. Rep. Kadas asked, but the industry recognized there would be a shift in burden at that time? Ms. Fallan answered that they were not aware of the extent of it.

REP. REAM mentioned that Rep. Eudaily had said this bill puts HB 28 in the form they all thought it was in when it passed last summer. Getting to the issue of revenue neutrality, he certainly didn't think it was in that form. Yet everyone thought we all thought this was going to be revenue neutral, and yet Rep. Eudaily does not deal with that in this bill. Rep. Eudaily said he believes he has in his bill what we all thought we had in the bill before. His bill does not address revenue neutrality. He is concerned about it, but there are other bills before the Legislature that will take care of that. Rep. Ream asked if this bill is in the same form as SB 1 that came out of Senate Taxation. Rep. Eudaily said his understanding is that it is identical.

REP. GILBERT asked Rep. Eudaily if he saw this as two distinct problems: the gas stripper tax exemption, which he felt was noncontroversial, and the other being the oil and gas rate adjustments which can probably be termed as greatly controversial. He asked if it was Rep. Eudaily's intent to address the noncontroversial portion of these two problems in a bill that should be passed by this committee because it is addressed to the one issue. Rep. Eudaily said that was correct, with the opportunity to change to revenue neutral in Rep. O'Keefe's bill or an amendment to any bill. Rep. Gilbert said this bill is revenue neutral with regard to gas stripper exemption. Rep. Gilbert asked if he was willing to address or introduce another bill that deals with the rate problem. Rep. Eudaily said he would encourage it.

CHAIRMAN HARRINGTON asked why the Administration is neither opposing nor supporting this bill. Dennis Adams, Department of Revenue (DOR), acknowledged that he was representing the Administration. Mr. Adams said there are more bills around right now. Sen. Gage on the Senate side was the one they had been working with as the bill was put together, so that was the bill they had analyzed and agreed was designed to be revenue neutral and dealt with all the issues that were in the Governor's call. That is why DOR is providing a an analysis of all the other bills. However, DOR is letting the process proceed. Rep. Harrington asked if Mr. Adams testified yesterday in Senate Taxation Committee on Sen. Gage's bill. Mr. Adams answered yes, they testified at that time, so far as providing information on the bill, as well as in the joint meeting with the Finance Committee and Senate Taxation. Rep. Harrington asked if DOR testified as a proponent or an opponent. Mr. Adams said they just did resource. Rep. Harrington said that was his problem and asked what does the Administration want. Mr. Adams said they support what Sen. Gage had introduced and the amendments that were made on the rate to keep the revenue neutral, which Sen. Gage supported also. The DOR believes that 1987 was the revenue neutral base year. Rep. Harrington asked Mr. Adams if the Administration felt they had a responsibility to come in and testify in favor of a bill. Mr. Adams said they are just trying to find out where they are at on these bills. He said they are waiting to see how the bill is coming across from the Senate. They felt that by now there might be one coming out of the Senate. Mr. Adams said they support all of the provisions that are included in Rep. Eudaily's bill. The only issue that is not included that they believe needs to be addressed is the revenue neutrality portion.

REP. KADAS asked, "would you acknowledge that this bill is not revenue neutral?" Mr. Adams answered yes, that is correct. Rep. Kadas asked by how much this bill is not revenue neutral. Mr. Adams said, based on 1987 net proceeds tax, it is not revenue neutral by $2.1 million.

REP. GILBERT asked Mr. Adams if they had any objection to two bills, one by Rep. Eudaily and perhaps another. Mr. Adams said that provided the issue is addressed, they are not opposed to addressing them in separate bills.

REP. PATTERSON asked if eventually there would be a fiscal note with this bill. Rep. Eudaily said none was requested because he felt all the information was included in all the other bills. He said the stripper wells might need one, but thinks it was included in Ms. Cohea's report she handed out.

REP. SCHYE said Rep. Gilbert mentioned the experience of Rep. Schye's bill, HB 28, in the last special session. The amendments on revenue neutrality were put in the bill in the subcommittee and Rep. Schye had tried to split it out and make it two separate bills for the same reasons Rep. Eudaily is saying now. At that time Rep. Eudaily felt the issues should be together, and Rep. Schye questioned why the change. Rep. Eudaily said he guessed you just get a little wiser as you get older.

REP. REAM said we are making light of this, and he was getting more and more angry about the whole thing. The Legislature stayed here weeks and weeks last summer, partly because this flat tax was added into the bill, as Rep. Schye said. Now Rep. Gilbert and Rep. Eudaily say they can split them apart. Rep. Ream said he was not going out of here with them split apart. This is one issue, and they are going to deal with it. Last summer they were told by the sponsor of the flat tax proposal and by the oil industry, "trust us, it will be revenue neutral". Yesterday, SB 1 was stripped of the amendment that would have made it revenue neutral. There was considerable discussion about whether the revenue neutrality should come on the backs of the royalty holders or the industry. That is where the real issue is, not whether or not it should be revenue neutral. He was not going to vote for this bill as it is, unless legislators deal with that issue. He asked how they could justify saying they should split it in two. If that is done, the second will never see the light of day, this will go out, and the other will never be passed. Let's get realistic.

Rep. Eudaily said he had been trying to get realistic. In case something happened that the other part of it did not get out, the Legislature would at least have done something to the tune of $2 million. There are some things in the bill besides the stripper well issue that need to be addressed.

Closing by Sponsor:

REP. EUDAILY said he recognizes the problems being expressed, and knew they have not solved all the problems with this bill. He had not attempted to do so. He just tried to solve part of it, which would be better than nothing. He had a little problem with OPI's amendment because if it is delayed for 1 year it means not including these values in the guaranteed tax base calculations. He felt other schools in the state are going to receive a lesser amount per unit than they would if those valuations were in. He thought the intent was to include them, and someone -- OPI or Department of Revenue -- should have been collecting that information in case of a special session and in case the Legislature wanted it included right now. He recognizes the difficulty in collecting the information. But he wants to be fair to all the schools in the state that will be getting some help from the guaranteed tax base. It is his understanding that none of these counties involved will be getting any of it.

HEARING ON HOUSE BILL 3

"AN ACT REVISING ALL LOCAL GOVERNMENT SEVERANCE TAX RATES TO INCLUDE AN EQUIVALENT 40-MILL TAX RATE ON OIL AND NATURAL GAS BASED ON THE 1989 PRODUCTION YEAR AND FISCAL YEAR 1990 NET PROCEEDS TAX COLLECTIONS; ESTABLISHING A BASE YEAR FOR THE DISTRIBUTION OF LOCAL GOVERNMENT SEVERANCE TAXES; DISTRIBUTING LOCAL GOVERNMENT SEVERANCE TAXES TO ELIGIBLE TAXING UNITS; PROVIDING FOR A PERCENTAGE DISTRIBUTION MECHANISM FOR LOCAL GOVERNMENT SEVERANCE TAXES UNDER CERTAIN CONDITIONS; CLARIFYING THE APPLICATION OF THE LOCAL GOVERNMENT SEVERANCE TAX TO INCLUDE ALL NATURAL GAS STRIPPER WELLS; CLARIFYING THE LOCAL GOVERNMENT SEVERANCE TAX ON OIL STRIPPER WELLS; CLARIFYING THAT LOCAL PRODUCTION TAXES ON OIL, NATURAL GAS, AND COAL ARE INCLUDED IN THE GUARANTEED TAX BASE CALCULATION; CLARIFYING THE DEFINITION OF THE GUARANTEED TAX BASE; AMENDING SECTIONS 15-36-101, 15-36-112, 15-36-121, AND 20-9-366, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE AND A RETROACTIVE APPLICABILITY DATE."

HEARING ON HOUSE BILL 4

"AN ACT REVISING ALL LOCAL GOVERNMENT SEVERANCE TAX RATES ON OIL AND NATURAL GAS BASED ON THE 1989 PRODUCTION YEAR TO BE REVENUE NEUTRAL TO FISCAL YEAR 1990 NET PROCEEDS TAX COLLECTIONS; ESTABLISHING A BASE YEAR FOR THE DISTRIBUTION OF LOCAL GOVERNMENT SEVERANCE TAXES; DISTRIBUTING LOCAL GOVERNMENT SEVERANCE TAXES TO ELIGIBLE TAXING UNITS; PROVIDING FOR A PERCENTAGE DISTRIBUTION MECHANISM FOR LOCAL GOVERNMENT SEVERANCE TAXES UNDER CERTAIN CONDITIONS; CLARIFYING THE APPLICATION OF THE LOCAL GOVERNMENT SEVERANCE TAX TO INCLUDE ALL NATURAL GAS STRIPPER WELLS; CLARIFYING THE LOCAL GOVERNMENT SEVERANCE TAX ON OIL STRIPPER WELLS; CLARIFYING THAT LOCAL PRODUCTION TAXES ON OIL, NATURAL GAS, AND COAL ARE INCLUDED IN THE GUARANTEED TAX BASE CALCULATION; CLARIFYING THE DEFINITION OF THE GUARANTEED TAX BASE; AMENDING SECTIONS 15-36-101, 15-36-121, AND 10-9-366, MCA; AND PROVIDING AN IMMEDIATE EFFECTIVE DATE AND A RETROACTIVE APPLICABILITY DATE."

HEARING ON HOUSE BILL 7

"AN ACT ESTABLISHING UNIFORM TAX RATES FOR THE PURPOSES OF NET PROCEEDS AND LOCAL GOVERNMENT SEVERANCE TAXATION OF OIL AND OF NATURAL GAS BASED ON THE 1989 PRODUCTION YEAR, WHICH RATES ARE TO BE REVENUE NEUTRAL TO FISCAL YEAR 1990 NET PROCEEDS TAX COLLECTIONS; ESTABLISHING A BASE YEAR FOR THE DISTRIBUTION OF LOCAL GOVERNMENT SEVERANCE TAXES; DISTRIBUTING LOCAL GOVERNMENT SEVERANCE TAXES TO ELIGIBLE TAXING UNITS; PROVIDING FOR A PERCENTAGE DISTRIBUTION MECHANISM FOR LOCAL GOVERNMENT SEVERANCE TAXES UNDER CERTAIN CONDITIONS; CLARIFYING THE APPLICATION OF THE LOCAL GOVERNMENT SEVERANCE TAX TO INCLUDE ALL NATURAL GAS STRIPPER WELLS; CLARIFYING THE LOCAL GOVERNMENT SEVERANCE TAX ON OIL STRIPPER WELLS; CLARIFYING THAT LOCAL PRODUCTION TAXES ON OIL, NATURAL GAS, AND COAL ARE INCLUDED IN THE GUARANTEED TAX

BASE CALCULATION; CLARIFYING THE DEFINITION OF THE GUARANTEED TAX BASE; AMENDING SECTIONS 15-23-607, 15-36-101, 15-35-112 15-36-121, AND 10-9-366, MCA, AND PROVIDING AN IMMEDIATE EFFECTIVE DATE AND RETROACTIVE APPLICABILITY DATES."

Presentation and Opening Statement by Sponsor:

REP. O'KEEFE, House District 45, Helena, said he would present all three bills together. He passed around a sheet on Local Government Flat Tax Proposals, Introduced Versions (EXHIBIT 1). Since yesterday SB 1 no longer does what this handout states. This bill is now identical to Rep. Eudaily's bill. He would like to explain what the bills do and then discuss the issues that are at hand.

He will use HB 3 as a basis since many of the issues covered in HB 3 are covered in the other bills with just a change in some of the rates. HB 3 revises the local government severance tax (LGST) rates for oil and gas to generate the equivalent of the net proceeds tax paid by oil and gas producers in FY 1990. That is the difference: the year 1990 plus, in this bill he had included the 40 mills all the other taxpayers in the state pay for the new school equalization bill in HB 3. House Bill 4 is identical so far as the fiscal year goes, but it does not include the 40 mills. The fiscal note shows the proposed rates in HB 3 will generate $43.7 million in FY 1991. Section 1 of the bill sets the LGST rates at 11.9% for regular oil production, and 24.5% for regular gas production. Both incremental oil produced from tertiary recovery projects and stripper oil are taxed at 5.95%, or 1/2 the rate of regular production.

Section 2 of the bill amends 15-36-112 to make consistent use of the terms "taxing unit", "district school district", etc., and is essentially a technical amendment and one of the things in the call of the session. Section 2 also states that if tax collections exceed or fall short of the tax owed by producers, the distribution to each taxing unit will be multiplied by the excess or shortage percentage. He gave the example of the tax collections exceeding the tax liability by 10%, each taxing unit will receive a 10% increase in its distribution, and vice versa. Section 2 also clarifies that local government severance taxes will be distributed to taxing units based on FY 1990 levies, which were set in August 1989. Both of these problems, the distribution and the fiscal year, are two of the other problems in the call of the session, and are identical in all bills before each chamber.

Section 3 corrects the 30 MCF exemption for natural gas stripper production. It also sets the tax rate for natural gas stripper production at 12.25%.

Section 4 requires that the taxable production of new and interim production and coal gross proceeds be included in the calculation of county, district, and statewide mill levies. The taxable value of nonlevy revenue must also be included in the mill value calculations. For FY 1990, nonlevy revenue includes FY 1991 net proceeds tax. In 1992 and beyond, LGST revenues will replace net proceeds in the calculation of the taxable value of nonlevy revenues. That is the same as Rep. Eudaily's and Sen. Gage's bills.

Section 5 is the severability clause. Section 6 gives an effective date, and section 7 gives retroactive applicability.

House Bill 4 differs from HB 3. Since the 40 mills are not in, the LGST rates change and are set at 9.72% for regular oil production; 20.6% for regular gas production; 4.86%, or 1/2 the rate for oil production, and again 1/2 the rate for stripper production. There is no distinction in his bills between royalty owners and producers.

House Bill 7 uses FY 1989 and production year 1988 for the basis of revenue neutrality. In Sen. Gage's bill, the testimony said that under SB 1 there are 27 rates for gas and oil in the state. This bill deals with tax simplicity. Essentially under HB 7, there is a 9% rate for oil whether it be pre-85, post-85, or stripper, and a 15.25% rate for natural gas, regardless of the changes. This is a flat tax. It does away with the distinction between pre-85 and post-85 wells and stripper wells.

What is at issue today and what this committee will be dealing with in all taxation bills this session is some basic philosophical questions. There is the question of the 40 mills for statewide equalization of schools. The oil and gas industry got out of paying the 40 mills in the passage of HB 28. He did not vote for HB 28 and did not like it for a lot of reasons, but this was the major reason. He believes that if oil and gas is to be exempt from the 40 mill statewide school equalization levy, then other taxpayers -- whether small businesses, homeowners, ranchers, or other industry in the state -- will pick up the tab. To him, this was a fairness question. House Bill 4 gets the 40 mills back. A bigger question, perhaps, is in what year revenue levels are to be based, for the industry, to achieve revenue neutrality. Testimony today was that in the 1989 special session, industry agreed to use the best numbers at all possible to put together revenue neutrality. The best numbers they had then were 1987 production numbers. We are living in the information age and this is 1990, not 1989, and there are 1988 production numbers and fiscal year numbers for 1990. Industry wants to go back to the old numbers which would give them a lower tax rate. They have new numbers, they have good numbers, and they are not "honor bound" by any past legislative session. He believes they should work with the best numbers available, and they are the 1988 numbers.

Another issue that will be dealt with is simplicity. House Bill 7 deals with that and reduces the 27 separate rates. The industry has wanted a flat tax and that is about as flat as you can get. A broader question is whether the Legislature needs to ensure revenue neutrality for the oil and gas industry. A lot of the discussion he saw on SB 1 was that the deal was cut and that they would ensure revenue neutrality for the oil and gas industry. This bill tries to ensure that the revenue produced will match, at least, the $35.09 needed for revenue neutrality in the 1988 production and 1989 fiscal year. House Bills 3, 4 and 7 do meet revenue neutrality standards with those revenue bases. In 1989, there was a lot of "trust me" out there. He had heard the comments in the Senate and the questions today. The numbers given in 1989 were to be revenue neutral. They are not revenue neutral. He can guarantee these numbers are revenue neutral because they are not based on estimates; they are based on 1988 production year figures and numbers from FY 1990. They are not projections.

The first argument is that "we made a deal". He did not make a deal, and the sponsor who carried the bill [HB 28] did not vote for the bill. He did not know what deal had been made, but one can be made here. The second argument will be regressivity. They will hear a lot about the regressivity of the taxes they are looking at for the oil and gas industry, and that he had seen those numbers used in almost every tax proposal that had come before them.

Fairness is the other thing they will hear a lot about. He will save his comments on fairness until he finishes this. He has been working on this issue for a couple of weeks and got involved by reading reports that LFA sent out and the Department of Revenue's early reports. He wondered why they were using the 1987 number. It took him 2 weeks to understand oil and gas taxation to the point he does, and he is no expert. There are experts in the room who can help with the difficult decisions. He suggested using them in the question-and-answer period.

CHAIRMAN HARRINGTON said before starting the proponents and opponents of the bill, he asked Terry Cohea to make a statement.

TERRY COHEA, Legislative Fiscal Analyst (LFA), said she was asked to appear here at Rep. Harrington's request to provide information on the comparison of the bills, and that her office is neither proponent nor opponent of the bills. She handed out a revised copy of the sheet that was handed out yesterday (EXHIBIT 2). LFA will be preparing this daily as action is taken on the various bills regarding the LGST. She walked through the reading of the sheet to help the committee in its deliberations. The front sheet shows the various tax rates under the bills. The first column is the 1987 net proceeds average effective tax rate. These are the rates calculated by the DOR on the calendar 1987 production. For example, they found the statewide average effective rate for an operator of a regular oil well was 7.32%. The next column gives the current law under HB 28. Going down the column nearly to the bottom of the page, the exempt stripper is at 0.00% -- the issue that was addressed in the first bill hearing today. The next column shows SB 1 as amended by the Senate Taxation Committee yesterday. And in the next columns are Rep. O'Keefe's bills, heard today. The back side shows the revenue that would be generated on the 1989 production base for each. What they are saying here is if any of these bills were passed and signed by the Governor, this is the amount of revenue that schools and local governments would receive in fiscal 1991. The first one on the left is the current law, what it will produce; then SB 1, as amended, which is now identical to HB 5; and then the amounts of revenue on the next three bills heard today. The second part shows the amounts that would be raised under the new and interim tax. This is not under the LGST; this is the production from wells that were drilled after July 1, 1985, which are taxed under a separate tax structure. They are included in this comparison for two reasons. One is that HB 7 sets one rate for all production, so they would be taxed under the same structure as the pre-1985 production, so for that reason it was included. They have also included it so people can take a look at the whole picture from the point of view of local governments and schools. As LGST declines, as the production of old wells decline, there will be some increased production in the new production area, and those tax rates apply. The middle of the page, where it says new and interim production, shows the amount of new and interim production taxes collected on each of the years production. For example, in calendar 1987, $1.5 million of new and interim production and in CY 1989, $3.42 million was collected. In any discussions of revenue neutrality between 1987 and 1989, the committee will want to consider that increase in growth in new and interim production.

Section C. tries to help in the discussion on revenue neutral, which is a confusing area. There are at least three possible definitions of that. There is the one that Sen. Gage's SB 1 dealt with: the taxes collected on '87 production were $40.4 million, when applied to the '87 production base shown in the right column. In calendar year 1987, the growth value of oil and gas was $437 million. The second possible definition is to try and generate the same amount of revenue, the $40.4 million, but generate it on the 1989 base, which had a gross value of $350 million. The third definition, which is used in Rep. O'Keefe's bill, is to have the tax on the 1988 production, which was $35.9 million, and generate that from the 1989 base of $350 million.

Section C.(4) shows the collections from the new and interim tax. The last section is the tax collection dates. Calendar 1987 production is taxed in fiscal 1989, etc., so they laid out the dates to help with the discussion. Their office has prepared two reports that are available to anyone who would like them. The first was prepared a month ago and is a general discussion of the enactment of the flat tax, the distribution mechanism, etc. This is the report prepared yesterday; it is an analysis of Senate Bill 1, although it has general information about the LGST.

Testifying Proponents and Whom They Represent:

Pat Melby, Underfunded Schools Coalition

Gregg Groepper, Office of Public Instruction

Eric Feaver, Montana Education Association

Terry Minow, Montana Federation of Teachers and Montana Federation of State Employees

Bruce Moerer, Montana Small Business Association

Carl Knudsen, Superintendent, Saco Schools

Proponent Testimony:

PAT MELBY clarified that they did not feel HB 28 was a compromise, so far as they were concerned, although it may have been a compromise with the Legislature itself. In their view, it was a last ditch effort by the Legislature to get something passed so they could go home -- something they could sign. The bill they felt was a compromise was passed by the Legislature and vetoed by the Governor. They were initially opposed to including something like the flat tax in a school equalization bill, and felt it should be done separately. When it became obvious that the flat tax was going to be included in school equalization, they were led to believe it would be revenue neutral. They have maybe one of the 75 definitions of the revenue neutrality that Rep. Gilbert was alluding to. Yesterday in the Senate Taxation Committee, the term was not revenue neutral any longer, it was tax neutral. Apparently revenue neutral depends on whether you are an oil and gas company or a school in the eastern part of the state that gets revenues from the proceeds. To the underfunded schools, revenue neutrality meant that in the first year of implementation of HB 28, there would be the same amount of revenues available from the flat tax on oil and gas as there were from the net gross proceeds tax in 1987. That was approximately the $36 million to $40 million that Mr. Groepper referred to earlier. They support legislation in this special session that will live up to their understanding of what revenue neutrality is. He would caution this is only indicative of one of the many, many problems of HB 28, and one of the many, many problems that will have to be addressed in the future. No matter whose definition of revenue neutrality is adopted, whether 1987 or 1989 production, it is only a 1-year fix, a bandaid. They know the production is going to go down, and whatever rate is fixed in this special session, next year those school districts affected by the flat tax will have less revenues and the year after less, etc. Even in the short run for those school districts, this particular part of HB 28 will be devastating, and it is indicative of many of the problems in HB 28 and why school equalization has to be addressed. The Legislature is going to have to find a way to solve that problem.

GREG GROEPPER said they support all three pieces of legislation that Rep. O'Keefe introduced. All three meet their threshold of their definition of revenue neutral, the $35.9 million figure. He explained why everybody has a stake in $35.9 million as opposed to something else. In the calculation and guaranteed tax base aid, the major solution to school equalization that was passed in the last session, they have to calculate the state's tax wealth. $35.9 million is kind of the break-even figure, and schools are budgeting on that. If the Legislature arrives at a revenue that is less than that amount, the state of Montana's wealth is less. If you are in a district that has oil or gas, you would receive less revenue if a lower rate is set. Let us assume you are a poor district, a district that is eligible for guaranteed tax base aid. Now, because the state's wealth is less because of this legislation, your district would receive less reimbursement for guaranteed tax base aid. You do not have any oil or gas, but this decision-making process going on here not only affects districts that have oil and gas, it affects districts eligible for guaranteed tax base. Because if you don't reach that $35.9 million figure, those districts will receive less aid under guaranteed tax base than they thought they were going to get.

About revenue neutrality, the important thing from their perspective is what they thought they were trading in the 1989 special session compromise was a flat tax on a declining tax base, on a tax base that wouldn't be subject to the 40 mills for statewide equalization, and on a tax base that would be forgiven from any future infrastructure costs--be they water, sewers or school districts. In that trade their expectation was that in the first year of implementation, schools would receive the same amount of money that they would have had if we had not gone to a flat tax, and that is how they arrive at the $35.9 million figure.

Mr. Groepper offered what he considered a technical amendment, which he offered for Rep. Eudaily's bill (EXHIBIT 3) and would like to add a couple of things. When OPI held its administrative rule hearing on which revenues they needed to look at in calculating guaranteed tax base aid, they sent out advance copies to school people and the HB 28 committee, discussed it, and had a public hearing. They received no adverse comment to not using that first year of post-1985 production in this calculation, and it works out to less than a tenth of a percent in the total tax base aid. As a result, he felt it is still a technical thing. In future years, as production goes up, it needs to be included. They do not disagree, but the problem is, to get this done they have two ways to go. They can postpone implementation of this for 12 months, look at it in 1991, and use it then. Or, because they have to get guaranteed tax base numbers out to the school districts by June 15, they will need some sort of relief from that statutory requirement. The problem is they have to go from the new production flat tax, which is money that is reported to the county treasurer and then distributed to the districts. There is no reporting mechanism right now. May is also the month the county treasurers receive all their second-half payments on property tax. If they sent something out to the county treasurers now, they would not see anything from them until they received the second-half collections. They would already have passed the June 15 deadline. This amendment passed unanimously in the Senate hearing yesterday, so he did not believe it was that controversial.

ERIC FEAVER supported all three of Rep. O'Keefe's bills and liked HB 3 because of the revenue it generates and because of the fairness that applies to all taxpayers. They like HB 7 because of its simplicity and would urge simplifying the state's tax structure however and wherever it is possible. They like HB 4 because it keeps the promise of revenue neutrality that we thought this Legislature made in the special session last summer.

TERRY MINOW rose in strong support of all three bills. The Montana Federation is very concerned about the bottom line of this session: assuring that the fiscal impact of the flat tax is revenue neutral. Schools, counties, and state government should not be harmed by the change to a flat tax, a change that was made at the request and on the behalf of the oil and gas industries. She asked the Legislature to use tax rates that will assure that the revenue base for schools, counties and state government is not further depleted by the flat tax. These bills accomplish that goal and asked for strong support from the committee for them.

BRUCE MOERER does not oppose the concept of the flat tax as long as it is revenue neutral. There is a lot of confusion over what revenue neutral is. And if there is confusion now, one can imagine the lack of understanding last year if the issues still need clarification and everyone is still confused. It looks like about $36 million is the revenue neutral figure the schools are looking for. He urged the committee in its consideration of a flat tax amendment that the rates do come in revenue neutral for the schools.

CARL KNUDSEN said theirs was one of the most affected school districts in the HB 28 problem. They are hanging out a couple thousand dollars that are pretty crucial to be fixed. The testimony that was given on HB 28 last summer did reflect addressing the revenue neutral situation the first year, and he hoped they can also include that.

Testifying Opponents and whom they Represent:

William W. Ballard, past President, Montana Petroleum Association; President, Rocky Mountain Oil and Gas Association; and President, Balcron Oil Company

Giles Gregoire, Havre, farmer, rancher, and member of Montana Land and Mineral Owners Association

William H. Tullock, Meridian Oil, Ft. Worth, Texas

Senator Tveit, Senate District 11, Fairview

Gloria Paladichuk, Richland County Commissioner

Opponent Testimony:

WILLIAM BALLARD said the Balcron Oil Company, a small independent company that originated in Billings in 1963, has been trying to generate activity in this state for the past 27 years . They are finding it increasingly difficult, as the committee has heard this morning. He would like to review some of their problems and let the committee put that into the "thinking mill" as it considers this complex problem. First, he opposes all three bills. They have no problem with correcting the exemption on the gas strippers, realizing that was an error, and the industry is totally in favor of correcting it. They also support revenue neutral tax rates. The industry last year, along with, so far as he was concerned, the entire Legislature, was using 1987 as a base year. There was no other number to work from. It was their understanding that these rates would be set up so that the LGST rate would generate the same amount of revenue based on 1987 at the net proceeds tax level. That was their understanding of revenue neutrality and of everyone who voted for the bill. This is what they have been selling as they try to generate additional activity by outside investors they are trying to get into the state to operate with them. This is the understanding the outside investors have. He asked the committee to remember that this affects only pre-1985 production, with the exception of perhaps one of Rep. O'Keefe's bills. This pre-1985 production is a declining asset and will eventually decline to zero. It doesn't make a great deal of sense to keep adding to the tax burden because this declining asset is the revenue base that independents like themselves use to generate new investment capital and new ventures. The answer to the dilemma here is not taxing every little drop of pre-1985 oil to the fullest extent they can produce it in this state. The answer is to get new activity, new wells drilled. He had talked to this committee as well as other bodies of this Legislature concerning the geologic potential of this state and mentioned that Montana is the most underdeveloped compared to neighboring states. He wanted to remind those present of that fact.

Mr. Ballard wanted to also remind the committee that some companies have been trying to honor the commitment they made concerning the incentive bill. He had made a statement before this committee concerning the drilling incentives that were put in place by the Legislature beginning in 1985 and continuing through 1987 and 1989. Balcron then indicated that they would, if those incentives were passed, double the amount of drilling that they would do in this state. This meant exploratory holes since those are the ones that find new reserves. In 1985 and 1986, they drilled 14 wildcat wells in Montana. In 1987 through the beginning of 1989 they drilled 29, so they more than doubled the number they drilled in this state, using those incentives. He wanted to remind the committee, and thought the committee may have seen some of the publicity released through the media concerning a well they are now involved in south of Helena, just out of Townsend. It is in the overthrust going to a depth of 13,500 feet. The objective is large volumes of gas and some oil and will cost $4 million to see if there is any kind of hydrocarbon in that. His company, being a small operator, does not have the cash flow, or type of financial where-with-all to do a project like that, so they had to bring in people from out of state. It took over a year to get other companies to join in the venture. The problems thrown at him were the credibility factor in the way the industry has been treated by state government, that they were afraid things would change even if they began a project, and what is the tax and the net return going to be at the end of the project. It is a situation like this that causes that kind of problem. He asked the committee to consider that as they mulled over the rates we are talking about.

Mr. Ballard referred the committee to some graphs he handed out (EXHIBIT 4). The first had to do with severance and net proceeds taxes paid by the industry. It shows the total tax by adding the two taxes together, beginning in 1980 and continuing through 1989 and then breaks it down between net proceeds and the severance tax. He said the net proceeds tax is the one of most concern here because that's the one that has been converted to LGST. Chart 2 has to do with the gross value of oil and gas produced in Montana by year. In 1981 it was almost $1.2 billion in gross value and has declined to about $350 million in 1989. In comparing the two charts, the time of greatest taxes on the industry was well past the time of greatest value. The industry's income was on a drastic decline when the taxes were on a steep incline. The net proceeds is interesting since in 1986, this was the year that the industry paid the highest net proceeds tax in history and that was the year that the prices hit rock bottom. Their cash flow had declined to a low number and yet they were paying the highest taxes in the net proceeds area of any year in history. This detracts from investment capital that would go into new drilling. Their problems could all be solved by increased activity in this state.

Mr. Ballard said the third chart has to do with the number of exploratory wells that have been drilled through the decade of the '80's. He had done it for Montana, North Dakota and Wyoming. He compared Montana and North Dakota; they were comparable until 1990, and this is the projected number based on the rig count seen from the beginning of the year up to this time. Using the rig counts and projecting through the balance of this year, Montana will drill about 50 wildcat wells (exploratory wells), and North Dakota will drill about 200. In May of this year they had three rigs operating in Montana: two were drilling shallow gas wells in northwest Montana, and one was working in the Lewistown basin. In North Dakota at the same time there were 23 rigs operating. One year ago there were 10 and in Montana 6, so Montana has cut its numbers in half and North Dakota has more than doubled theirs. One would have to ask why, when the states' geology are so similar and particularly when Montana has a much larger area in which to work.

Mr. Ballard referred to EXHIBIT 5, numbers generated by the Montana Petroleum Association (MPA) concerning rates, and a sheet (EXHIBIT 6), which shows the DOR evaluation of what those numbers do as far as generation is concerned. Mr. Ballard also handed in written testimony (EXHIBIT 7). He recommended using the MPA's recommendations and suggested they be used as an amendment to Rep. O'Keefe's rates in his bill. Basically the numbers show that the royalty owners get a break from what they would have paid under the old net proceeds law, and some of the other categories will be paying less tax under this arrangement. The regular oil rate would go up, but the bottom line is that the proposal by the MPA would generate $77,700 more than would have been generated using the net proceeds tax on the 1987 production. This was the standard everyone agreed on last summer; it is not even a year old and already it may be changed. The industry agreed that they should be revenue neutral and adjust the rates to come up to that number. That number is based on what the net proceeds tax would have produced using the 1987 base year and eliminating the stripper exemption. They come up about $2.1 million short of what that would be and some want to adjust those rates. The suggested rates just passed out would do that, and in addition they raise almost $80,000 more than what would be revenue neutral and that would be in the state's favor. They have a terrible public relations so far as the oil industry is concerned. They have asked the Governor and the DOR Director to join with the industry to make a tour to the revenue centers such as Houston, Dallas, Denver, etc. The purpose is to sell the idea that it is possible to come into this state and have a good operation and an economic operation and that there are incentives in place that will enable a company to come in and make a decent profit on their investment. They are going to try it this year; the Governor has agreed to do it. He felt they could get cooperation between the Governor and the industry to work this out so no one gets hurt, and the state would benefit from the increased drilling.

GILES GREGOIRE was interested in the remarks of Mr. Ballard, since many times they found themselves at odds with the industry as they use their surfaces to produce the minerals. It must be recognized that 49% of the gas production in Montana is produced from his area and with the situation as it is they could see this decline. The Legislature has to look at a tax structure that encourages the development of this gas and also makes it competitive with gas from other areas. The major purchaser of gas in their area is a company called Enrod Gas that buys the larger part of their gas. Yet their major source is Texas and Oklahoma. Looking at those states' total production taxes, which are 7.5% and 7.85% respectively, his organization is concerned that Montana's high tax rate might discourage much of the production of this gas. The Land & Mineral Association, representing 1.5 million mineral acres in north central Montana joins with MPA in endorsing Mr. Ballard's proposal in favor of SB 1.

BILL TULLOCK said they are an operator of regular and stripper oil and gas wells and a major royalty owner in this state. He spoke in opposition to the three bills presented by Rep. O'Keefe and spoke about what they thought they had agreed on with the LGST, what they were seeking in going to the LGST, and what their concerns are now with the changes in the rates they see being proposed on the LGST. First, there are a number of wells they operate that they would have been much better off continuing under the old net proceeds because their operating expenses had reached the point where they were paying almost no tax at all when we were allowed to take certain operating expenses off as deductions. They recognize that, and in the case of Meridian, on their regular oil production, their effective rate of tax under net proceeds was under 5%. One wonders why they agreed to go along with an 8.4% tax on LGST. They foresaw tremendous instability in the taxation of these kind of properties they were seeking. The only thing they stood to gain was some stability in what kind of tax burden they could expect these properties to carry in the future. He reiterated a point of Mr. Ballard's: this is a declining resource; it is a property that is not going to be replenished. It is only going to hold production. Revenues are going to continue to go down; production will continue to decline. He had to ask himself, "are we going to be expected to generate $35 million or $40 million in revenue every year on an asset that is declining?" That is the kind of property that is affected by these rates. If they have to pay a higher and higher rate on the properties, they will get to the point where they have to plug them. Unlike Mr. Ballard and some of the independents that are primarily in Montana, Meridian Oil has the flexibility of moving to one of the other states in which they operate when the expenses get so high here they cannot afford to continue production in Montana economically. The higher the taxes get, the closer one comes to the economic limit on these properties, and then everyone loses. He was not saying a 10% increase in LGST is going to put them at that point; it may on some wells but not on the majority. But some of the rates that are being proposed in the O'Keefe bills increase the tax burden by as much as 60% over the current rate, and the LGST applies to the gross revenues they are realizing on these wells. As a company, on net income on regular oil wells in this state, according to statewide numbers, after paying operating expenses but before any taxes are applied, the working interest owner walks away with only 53 cents on a dollar of the gross revenues generated. Looking at a tax burden as high as 20% of that 53%, he asked if the committee knew of any other industry that is bearing that kind of burden. The committee should consider a little reason in the way the properties are taxed. The agreement last year was at least a recognition of a declining type of property, and gave them some stability in the rate of taxes. The revenue neutrality issue was worked on last year. The 1988 production was not even complete; 1987 was all there was to work with, and those numbers are what they worked with.

SENATOR TVEIT explained vertical fractures. Since they ran one way in the ground, they had to drill through the fractures from 100 feet to 2,000 feet. This type of procedure increases the potential of that well 400 to 600 times over a vertical well. Some of the figures from the experts in the business illustrate what potential there is in the Bachan formation. There must be 12 or 15 formations in the Williston basin alone. He used this for an example since Montana has part of that basin. In the Bachan formation there is 92 billion barrels of oil in the pocket in North Dakota and an estimate of 10 billion in Montana. Meridian has drilled 32 wells over there now and got 30 producers out of 32 wells; they are learning a process and doing a good job. Other oil companies are getting involved and are just starting to get involved on the Montana side. This means the expansion of the reservoir to the Montana side, and they said it would take 35 drilling rigs 75 years to drill out the Williston basin, since there is that much oil, just in the pocket, and billions of barrels in other zones accumulative to that effect. Should Montana have a part of that action, or should it all stay in North Dakota? The reason he asked that is that in comparing between the states he felt it was our tax structure. He had been told the Legislature changes the tax structure every time it goes into session, and they do not have to do business in Montana. Oil companies had told him they did not need Montana, but did Montana need them. His point is that in looking at "fair" or "comparing" this and that--what do other states offer? Why does North Dakota have 4 or 5 as many rigs running as we do in Montana? In comparison, North Dakota has an extraction tax and a severance tax of 11.5 maximum, and Montana now has a tax of around 14 on oil. All natural gas in North Dakota is 5% maximum and in these bills today we are looking at 15.9, 20 something, and 24 and that is just the local severance tax and then you add the state 2.6 plus the RIT .7 and that makes it about 28% on gas against 5% in North Dakota. This will tax them out of the state, and they will. They do not have to put up with Montana. They came in on an incentive: 5% the first 15 months and after that 9% until it reaches $33 a barrel. On strippers, redefined in the '87 session, they tax them at 5% and use a calculation of 1 to 5,000 feet, 10 barrels; 5,000 to 10,000 feet, 15 barrels and 10,000 or deeper, 20 barrels. Under these bills Montana will tax, not only the severance part of 3%, on which there is an exclusion for the first 5 barrels, plus tax them at a higher rate than even Sen. Gage's bill. To qualify for oil recovery projects, on the water flood, gas flood etc., they also tax them 9%.

The new production tax, put in on new oil in 1987, means new leases only. In many parts of Montana, like up on the Highline as well as in his area, looking at just the Bachan formation, when they come into an existing lease that has a well on it and has oil there (and also oil runs in ribbons, seams, and certain directions), that they will drill close to or on that lease. That new production goes at the old rate for the old production. Looking at revenue neutral 1987 and what happens? The barrels did not stay the same as in 1987; they fell off 4.5 million barrels from 1987 to 1989, so naturally there will be less revenue. Now the move is to keep raising the taxes on a declining base. He felt in a short time, if the Bachan thing comes into play, there will be a lot of production. The decline is there; Richland County has 202 wells that did not pay any net proceeds tax, and of course they are declining. The question is how long before they shut them off altogether on them? When you talk about fairness you have to look at the whole picture. It is easy to patch up today, but what happens tomorrow with educational funding in Montana, just in this area? It is very narrow vision since what the Legislature is doing today could cost the state hundreds of millions of dollars. The state is sending a message to the oil industry "don't do business in Montana". He knew there was a problem because the oil revenue dropped before the 1985 production. He believes there are other ways to fix that without continually raising taxes to drive this industry out of the state. It is time for the Legislature to look for alternative funding for education purposes in this state.

CHAIRMAN HARRINGTON asked if there were further opponents to the bill.

GLORIA PALADICHUK, Richland County Commissioner served as County Treasurer for 10 years. She believed this had been previously negotiated on a 1987 base year and the 95 mills for school equalization was based on what would be generated from the 1987 base year on pre-1985 production. If the Legislature were to come in now and change that 1987 base year, they should go in and reduce the 95 mills because that would be too high. She could also tell the committee, that from county government, the 95 mills was put on county road, general, bridge, district court, everything. Their percentage of the new production in the motor vehicle tax was reduced considerably, because the amount that is paid has not changed. She had been hoping that perhaps with the LGST, maybe one would wash out the other. But if these bills are passed that definitely will not happen. Schools have been eliminated, or out of I-105, but county government is not. They are still operating under those restraints. If these bills are passed, the Legislature is sending the oil industry a poor message, thereby reducing new production. And that will affect every school district in Montana.

Questions From Committee Members:

REP. SCHYE said he didn't quite understand what Sen. Tveit was trying to say at the beginning. Legislators could come to a number, and assume they agreed on Mr. Ballard's figure, $2.1 million more in revenue to reach revenue neutral. In his testimony, did Sen. Tveit agree with what MPA is saying to put that on the back of the royalties? Sen. Tveit said no. He was agreeing with what happened yesterday in Senate Taxation Committee and how they worked this out. They are still working on how to arrive at neutrality between the industry and the royalty owners on this $2 million. The bill would have an increase of about $1.2 million to the industries and a decrease to the royalty owners of about $1.1 million. Industry is satisfied with that "and so are we". He said that is what it says at the present, but they are working over there. He did not know what is happening on it now. Sen. Tveit supports SB 1 as it was before it was split.

Rep. Schye asked, if they put it on the royalties to make up the difference, will Sen. Tveit support that? Sen. Tveit said they had the $2 million on royalties, so they cut it in half, and at that level, yes.

REP. SCHYE asked Mr. Ballard to clarify. Mr. Ballard said that under the old net proceeds law, the royalty owner would have paid more compared to what the original proposal was under SB 1. The royalty owner would have paid a little over $1 million more than the MPA suggested amendment. The 8.4% is an increase on regular oil, which picks up that difference, and the net effect is that $77,000 surplus. He was asked if this was then changed from SB 1. Mr. Ballard answered yes.

CHAIRMAN HARRINGTON asked Sen. Tveit to enlighten the committee. Rep. Harrington thought the committee had the idea that the Senate was going in and would work on that bill this morning and pass it right out. Sen. Tveit said the Senate convened Sen. Gage requested a recess so the committee could work on the rate structure on the other part of the bill--the part they stripped out yesterday. As to whether they will have one bill or two bills or what, they did not act on the rate portion of the bill. They went back in to come up with rates, and he had no idea as to whether there was one bill or two. But that was the word on the Senate floor.

REP. ELLISON asked Sen. Tveit if these rates are going to go up. Sen. Tveit answered that these are some of the rates that they joshed around in the Senate. Then they were taken out of the bill yesterday. Now they are working the rates and where they are on the percentage of the rates Sen. Tveit did not know.

REP. ELLISON asked Mr. Ballard if they were considering these rates. Mr. Ballard answered that as he understands, from the talk in the hall, they are considering this. Where they are on putting it back together he is not sure. He understands they are putting the bill back together with these rates in them.

REP. REHBERG addressed a question to Rep. O'Keefe. He was having difficulty following the LFA report and the MPA's numbers and their handout. They come up with $40 million, and he could not understand how. Rep. O'Keefe uses 1989 as a base; they are using 1987; their rates are different than Rep. O'Keefe's rates; and they are still coming up with $40 million and he is not. Rep. O'Keefe said on the back of the green sheet (EXHIBIT 2), under subsection C (definitions of revenue neutral), the MPA's numbers on the letterhead (EXHIBIT 6) are using subsection 1 (tax on CY 1987 production applied to FY 1989 tax base), $40.4 million. The numbers he is using are based on subsection 3 (tax on CY88 production applied to the CY89 tax base). For Rep. O'Keefe's bills to reach revenue neutral, they are dealing with different rates. But because of reduced production between 1987 and 1988, in using the 1987 numbers to produce $40 million, they need lower rates than using the 1988 numbers to produce just $35.9 million.

Rep. Rehberg said, understanding then that the MPA's amendments or at least proposed percentages bring it up to what is believed to be revenue neutral, and if they talk about deals that were made, consistency, etc., would their numbers be acceptable to Rep. O'Keefe, using the 1987 base and their percentages, and thereby accomplishing what the Legislature intended, raising the $39 million or $40 million? Rep. O'Keefe answered that the numbers are unacceptable because he does not agree on the base. Their numbers, using his base, produce $31.7 million, using 1988 production versus 1989 base. That is a number the DOR ran yesterday, and maybe the DOR would confirm it. That is about $4 million less than what he is working with for revenue neutrality. It is a question of the definition. If Rep. Rehberg is asking whether he agrees with the CY87 base year--are these numbers good enough--he does not know. Rep. Rehberg said what he is getting at is, with the declining base, will the Legislature come back session after session doing this same thing all over again? So sooner or later they will have to establish a base, and the base they all agreed to and used was 1987. So is the intent to be back next session on this? Rep. O'Keefe said that is not his intent, and he would give his guarantee that if any of his three bills rates go through and are put on the industry he would not carry a bill next time and would support these rates. He said he could not speak for the Legislature; he did not know what they would do next time.

REP. REHBERG addressed a philosophical question to Mr. Ballard. Based on the reputation of this state and its tax policy with the other states, does a high tax rate hurt the state more than tax inconsistencies? Is it better to set the high tax rate and be consistent? Mr. Ballard answered that this fluctuation gets back to the credibility situation. The ink is not dry on the written last summer and yet they are trying to change it. It was agreed to use the 1987 production figures as being revenue neutral. What they have proposed with the rates they have provided legislators accomplishes that. He felt this was what they had agreed to and the Legislature had agreed to last year. If that is changed now, the Legislature is telling the people whom Mr. Ballard deals with that they have no idea what the rates will be in the future; they are subject to the changes and whims of the Legislature. When legislators talk of mill levies, etc., the oil industry is the only one that pays on 100% of value.

Rep. Rehberg clarified what Mr. Ballard said: that inconsistency will do more damage and that Mr. Ballard's association would allow more debate on the tax rates as opposed to changing the structure of the taxes. Mr. Ballard answered "absolutely". In regard to gains and losses, they are talking about what counties in the school system are going to lose from these tax rates as they exist now, and depending on what base year they are talking about. The oil industry, in looking at the handout on valuation from 1987 to 1989, shows a loss of $150 million, and that is $150 million that could have been put back in the ground had they been revenue neutral from 1987. They are asking for consistency on the part of the Legislature. The industry believes they can do their job and help.

CHAIRMAN HARRINGTON asked Terry Cohea to comment on using the different bases and the assumptions in using them. Ms. Cohea believed their role was to present the numbers and that is what they have tried to do here. Perhaps she could clarify some of the statements that have been made. The MPA proposal has been put in SB 4. The Senate Taxation Committee is in recess while that is being prepared, and they will go back in to consider it. As Rep. O'Keefe just mentioned, the sheet that was handed out (EXHIBIT 2) shows a $40.4 million collection is based on the 1987 production year. When that is applied to the 1989 production year, it would generate $31.7 million in revenue.

REP. GILBERT asked if the reason for the difference was the decline in production. Ms. Cohea said that is exactly right. The sheet shows the CY87 gross value is $437 million; the CY89 production is $350 million. So there has been a 22.9% decline in oil production and about a 4% reduction in natural gas production from 1987 to 1989. It is exactly correct to say that there is a declining base on which to apply the rates.

Rep. Gilbert asked, in looking at the numbers in Rep. O'Keefe's bill, wouldn't it appear to Ms. Cohea by those numbers that he is basing his bills on declining revenues to increase taxes to obtain revenue neutrality instead of the base year of 1987 that this legislature agreed to in the 1989 special session? Ms. Cohea said she would not want to make any philosophical statement. Suffice it to say that there are at least three different definitions of revenue neutral that are operating here, and LFA has tried to show them here. Again, under Rep. O'Keefe's bill, he is using definition number 3, trying to generate the same revenue that was generated on the CY88 base from 1988 production when applied to the 1989 base.

REP. GILBERT asked Rep. O'Keefe if he changed the criteria in all three of these bills to obtain his revenue neutrality. Rep. O'Keefe replied that Ms. Cohea said there are three versions of revenue neutrality, and he thought there were 72 other versions floating around. Rep. Gilbert asked if he hadn't changed the criteria in going from a 1987 base to a 1988 base. Rep. O'Keefe answered yes, they did, and the part of the criteria he kept was using the most current numbers available. Rep. Gilbert asked if they hadn't used the most current numbers they had in 1989 when they addressed this situation. Rep. O'Keefe answered that he will agree with that, and he would also agree this is May 22, 1990. Rep. Gilbert said the day did not make any difference, but it appears Rep. O'Keefe's version of neutrality is because he understands the declining production to be declining price, and also understands to address that he needs to raise the tax rates. Isn't that what Rep. O'Keefe has done in all three bills? Rep. O'Keefe answered that it is what he had done in all three bills considering the fact that they are meeting on the call of the Governor to deal with the issue today. He is trying to deal with the issue with today's numbers. That is philosophical, but that is where he is at. Rep. O'Keefe said that Rep. Gilbert's description is probably accurate, but the Legislature is also dealing with everyone else in the state under this equalization bill, and they are trying to plug this piece.

Rep. Gilbert referred to an earlier statement by Rep. O'Keefe saying that he wanted to treat the oil industry the same as everyone else in taxing for schools, property tax, etc. But isn't it odd that everyone else uses a market value and an actual value on their taxes and the oil industry is taxed at 100% of value? Isn't the industry already treated differently? Rep. O'Keefe said he did understand the difference, and he also understands the oil and gas industry asked the Legislature for a flat tax. That is one reason they are treated differently. The discussion here is about setting the rate of that flat tax, not the difference there. They asked for that difference, and they have supported that difference. Rep. Gilbert asked, doesn't Rep. O'Keefe think there is anything unfair in his method of changing the criteria to resolve the problem that was created in 1989 by using different sets of numbers so he can provide more funds for an entity that probably does not deserve the funds under what was agreed to? Rep. Gilbert likened Rep. O'Keefe's bills to raising cattle taxes despite declining cattle prices. Rep. O'Keefe said the comparison is correct.

REP. REAM needed some clarification from Terry Cohea. Yesterday on the handout she had included Sen. Gage's bill, as introduced. Ms. Cohea answered yes. Rep. Ream said, on the second page of that bill LFA shows $36.4 million tax revenue produced in CY89 production from this bill as introduced. Ms. Cohea said she did not have the sheet from yesterday, but believed it was $33.02 million, but when combined at the bottom with the new and interim it would come in with the $36 million. She thought the LGST is $33.02 million. Rep. Ream asked what she had said earlier about the MPA proposal. Ms. Cohea said it would produce $31.7 million on the CY89 production, so that would be comparable to this $33.02 number that SB 1 raised, as introduced.

Rep. Ream said there was also a first version of Sen. Gage's bill. He asked if that is the same as the one proposed? Ms. Cohea answered no. That was the bill that was mailed out by the Governor's office to all Legislators about 10 days ago, and that was the only version that was available when LFA did its analysis. When they prepared yesterday's sheet, they had SB 1 that had been introduced, and LFA included that. On today's sheet, they have taken off the old CL 3, the bill that was mailed to legislators by the Governor's office because that was never introduced. At this point, SB 1 is as shown on this sheet, as it was amended by the Senate Taxation Committee, so it is identical to Rep. Eudaily's bill. They will put out a new sheet if the Senate adopts SB 4, which at this point is having the MPA amendment placed in it.

Rep. Ream asked, it just happened that it was $31.7 million and there is no relationship between that and the MPA proposal? Ms. Cohea answered no, it is just how the numbers worked out.

REP. ELLISON asked Mr. Ballard if he had a production forecast for the next 1, 2, or 3 years? Mr. Ballard said he could speculate and tell the committee what they have picked up from various sources they monitor almost monthly. It looks as though there will be some increases in nationwide drilling activity, and they want to get their share of it. For the committee's benefit, he related a conversation he had with a member of OPEC, an economic adviser to OPEC, whom they have become very well acquainted with over the last year and a half. He met with him about 3 weeks ago in Denver to discuss the forecast from OPEC and the Arabian, Middle Eastern perspective. The advisor said that the world has just experienced a down drop in the price of oil. Mr. Ballard said that from the middle of March until now the price plummeted considerably over what it had been. The advisor said the reason for that is because the Iranian oil workers had announced a strike, and if they did indeed strike, this would remove about 2.6 million barrels a day from the world market, which would then drive up the prices. The Saudi Arabians did not want this to happen, and they opened some of their shut-in wells to overcome this 2.6 million barrels per day perceived shortfall, which did not happen because the strike was settled. This put an excess 2.6 million barrels a day on the market, which drove the price down. As soon as this surplus is used up, the price will go back. He predicted that around the first day of June it would be back to (this is west Texas numbers) about $21 per barrel. If that is put on Montana posted prices, that would be about $2 a barrel less, around $19. This is a couple of dollars more than it is at the present time. The OPEC advisor said that for the year 1990 Montana producers will average $22 a barrel west Texas, which is $20 a barrel in Montana. If that is true, and so far this advisor's predictions have been very close to being exact, they should see some increased activity, provided they can convince investors that Montana is going to maintain some consistency in its tax problems. He thought they would see some increased activity for the balance of the year-- how much will depend on this Legislature. The other thing the OPEC advisor had told him was that he expects to see the prices back in the mid-20's by 1992 to 1993. So Montana can expect $23 and $24 oil by 1993. The OPEC advisor does not expect the price to get to $30 again because the Saudi Arabians will not allow that to happen because it creates too much competition from the American independent. When prices were high, there was more money available, and more wells were drilled. American independents found too much oil and competed with OPEC, and they will not let that happen again. OPEC will control the price. So during the balance of this decade, Mr. Ballard doubted $30 oil would be reached unless something unusual happens that disrupts the productive capacity. If producers could get $23 or $24 oil in Montana and some consistency on taxation, he would expect to see the state increase in activity and the new oil to come along at a much faster pace and replace the declining asset, which is the subject of their argument today.

REP. REAM had a question for Dennis Adams. Rep. Ream said that Mr. Adams said the Administration supported the Gage bill, SB 1 as introduced. Yet it looks like there is about a $2.2 million difference between what the MPA has proposed this morning and what the Administration supports. Mr. Adams said SB 1, as the rates were amended to include the MPA recommended rates, resulted in that $77,000 increase in revenues over and above the net proceeds taxes, and the Administration supported those changes to the MPA rate. Those are the rates they are currently supporting. They have also done an analysis on Rep. O'Keefe's bill similar to what they did on the SB 1 if Rep. Ream is interested in seeing how those rates compare.

Rep. Ream said clarified that the Administration now supports the MPA rates rather than the Gage bill as introduced? Mr. Adams answered that Sen. Gage supported those changes also, and they went along with his recommendation to support the MPA rates.

REP. STANG asked Mr. Ballard to forget revenue neutrality for the time being. He was interested in the consistency approach. It made sense to him that no matter what the production rate is, they should have a stable rate. What rate did Mr. Ballard think would be a fair, stable rate, fair to Montanans that are giving up their natural resources, and fair to the oil companies, to get people to come into this state? Mr. Ballard said to look to our neighboring states of Wyoming and North Dakota. When they worked on SB 384 (or 390?) in 1985, the idea at that time was to make Montana competitive with its neighbors, North Dakota and Wyoming. Wyoming is about the same as Montana's. Adding all the taxes together, it is 12.7% using the new oil tax rates. That is with the RIT included, the commission tax, the severance tax, the flat tax, and the LGST. North Dakota is about 11.5% and Wyoming is about the same as Montana's, maybe 1/10th of a percent more, he was not sure. They can live with those rates. They are competitive with North Dakota and Wyoming, and he believed if they could stay somewhere around those rates they could take the industry forward.

Rep. Stang asked, if Wyoming and North Dakota rates are comparable to ours, then why is production higher there than it is in Montana? Mr. Ballard thought it was because of the consistency problem. He had a recent experience bringing somebody in to a large project here in Montana. Mr. Ballard had visited all the large independents and all the major oil companies and had to go to Canada to find a partner to come down here to do this. They told him they liked Montana's geology but they have a problem with the way they have been treated in Montana. This may not be entirely correct, but it is the perception they have, and it is something they have to battle.

Rep. Stang said he believed Mr. Ballard could understand the problem legislators have: if they set a rate and the production goes down, how do they take care of local governments and school districts in those areas. What would Mr. Ballard suggest for setting a flat rate? Mr. Ballard answered that he would not like to make a suggestion on other types of taxes to this body, but would suggest it is time to start thinking of some of those. If legislators want to keep absolute revenue neutrality on a declining asset base, the very last barrel of oil would be taxed at $40 million. That is a ridiculous way of looking at it but it is the implication. The independents who do most of the drilling in Montana have to rely on cash flow from their existing production as a major portion of their investment dollars. Then every time the tax rates are raised when the decline is going the other way, it decreases the amount of money they have to go to new production.

REP. ELLIOTT asked Mr. Ballard if he was satisfied with the tax rates in Wyoming and North Dakota. Further, did Mr. Ballard believe that because of the stability and the rates there that he could do business in those states? Mr. Ballard said that was true. Rep. Elliott said he had spoken earlier today with Leon West with the North Dakota Commission on Industry (he thought that was the name). Rep. Elliott quoted Mr. West: "The North Dakota oil industry is pressuring the people over there because they say the North Dakota tax rate on oil is too high and that North Dakota does not have enough incentives on oil." So apparently, whoever is drilling over there is not too satisfied with what is going on in North Dakota.

Rep. Elliott asked if they settled on a rate and the industry agreed, and that rate would be in accordance with your amendments to SB 1, would Mr. Ballard at any future date come in and argue that the flat rate be lowered? Mr. Ballard said at this point he could see no reason why they should.

CHAIRMAN HARRINGTON asked Mr. Chris White if he would like to make a comment. Chris White, representing Norfolk Energy, a big gas producer in Montana, said he thought they might have a slightly different situation in regard to the rates on oil and those on gas. If one looks at the competitive situation in respect to gas production, then the competition lives in Texas and Oklahoma. That is where the bulk of the gas that goes to the Midwest and his company's gas ends up. The rates there are only half of the rates on either new or old production in Montana.

REP. KADAS wanted to confirm with Mr. Ballard that he agreed that the base year is 1987 and that without adjusting the rates, the rates are $2.1 million short of being revenue neutral. Mr. Ballard answered yes. They agreed with that, assuming that the stripper problem is eliminated, the $1.7 million. Assuming that will be solved, it leaves $2.1 million, in round numbers, out of balance.

Rep. Kadas said there is general agreement of that number. In Mr. Ballard's handout (EXHIBIT 6), the regular and stripper rates remain the same, and it creates a new rate for nonworking interest of oil and nonworking for gas for royalty rates. Is there also a royalty rate for strippers that would be half of the royalty rate? Mr. Ballard said the nonworking interest is the royalty rate. When they say nonworking interest oil, that is royalty percentages. Rep. Kadas asked if they are also proposing there be a nonworking royalty rate for stripper oil that would be 6.25? Mr. Ballard answered no, they are proposing that the royalty rates be the same, be they stripper or regular. Rep. Kadas asked why. Mr. Ballard answered that the royalty owner, in case of stripper, does not have any investment into any cost involved in the production.

Rep. Kadas said to him it boiled down to, and hopefully what it would boil down to between the House and the Senate, is whether there ought to be a separate rate for royalty owners or whether the revenue should be generated by the four existing rates. Mr. Ballard answered, that is part of the discussion. He reminded Rep. Kadas that under net proceeds, the operators had costs they could balance against their gross revenue, and that was how the net was figured. The net was the determining factor so far as the tax dollar. The royalty owner was receiving a certain percentage of the production. He received the gross dollars for his percentage interest and had no operating cost so he paid the net proceeds on the amount times the mill levy, or on 100% of his earnings. The operator had his work over cost, salaries, and other deductions to deduct from his share before applying the mill levy. Examining revenue neutrality and going back to 1987 the way all entities were being taxed at that time, one sees that the royalty owner got a tremendous tax break when he went to the LGST last summer because he went to a much lower rate than he was paying under the net proceeds. Here, they are trying to split the difference between the two. Royalty owners would be paying less than under net proceeds. The regular oil producers would be paying slightly more, which they have agreed to do in order to pick up the difference and make this thing balance.

Rep. Kadas asked if he had understood all this last summer. Mr. Ballard said he had as much confusion in the beginning as most, but last summer they were dealing with some unknowns as far as what the decline was going to be, and over the 1988 and 1989 figures. Rep. Kadas asked, that does not affect the relationship between the royalty owner and the operator? Mr. Ballard answered that they had missed that part of it, and had not understood how much difference it would make.

Rep. Kadas asked what the downsides are in creating a new tax on royalty owners. Mr. Ballard answered that he did not see how there could be too much of a downside when it was compared to the alternative under net proceeds. They are coming out considerably better. He did not see how they could keep it at the same rate and make it fair to the operating companies. When one figures the royalty deduction and the tax reduction, the operator realizes only about 60% of the revenue from a well and has to pay 100% of the cost of the well out of 60% of the revenue. Rep. Kadas asked, on a percentage basis, how many operators own and have royalty interests as well? Mr. Ballard said that would be hard to answer. Some individuals might, but for the most part the companies are only working interests. Rep. Kadas asked, if there are separate rates for royalty and operating owners, and the royalty rate is higher than the operating rate, what is it that keeps the contract between the operating owner and the royalty owner from giving the royalty owner a minuscule portion of the operating costs and therefore allowing him to apply his burden to the lower rate? Mr. Ballard said this concern had been raised a few times in the Senate discussions yesterday, but said he could be assured this would not happen. The reason is that if a royalty owner assumes a working interest position, he also assumes all the liability that goes with that, which means workers' comp, employee benefits, and he would get into the work overcost, because wells don't just go out and produce without upkeep. Plus, there is a tremendous obligation at the end of the operation in plugging and abandoning that well. Mr. Tullock could give the members some figures about that.

Rep. Kadas referred to Mr. Tullock. Mr. Tullock said he did not have all the numbers with him, but as a royalty owner in this state as well as an operator, there is no way in the world they would trade a percentage of royalty for an equal percent of work interest. The gross revenue they get off royalty is also net, so it would be $1 worth of net for $1 worth of gross before taxes. Rep. Kadas asked how much royalties in the state Meridian controls. Mr. Tullock said it was hard to answer. Probably overall they may have 10% to 12% of the total oil, but that was a guess. There was no way they would trade the dollar in royalty revenue for the 60 cents on the working interest dollar. Rep. Kadas said, then you can't see any legal way Meridian could get around the higher rate on royalties. Mr. Tullock answered, with respect to a higher rate, they would be the first to admit they realized a real windfall with these LGST rates on royalty tax burden. He said this was something he had been concerned with when they worked with LGST, being both a royalty owner and a working interest owner. He knew there was a significant difference between the tax rates he was paying on the same revenue, but unfortunately he did not realize what the impact would be statewide when they ran everything at a flat rate and made no distinction between that royalty revenue tax burden versus the working interest tax burden in Montana. He had a good idea how it affected his company's revenues, and he would be the first to admit they were not asking the state to go in and impose additional taxes on royalty owners. They realized quite a windfall on the rates they were paying on their royalties. To be fair, the royalty effective tax rate should be restored back to the point it was under net proceeds. The numbers they proposed through MPA are slightly lower than what the tax burden was. It is not a new tax on royalty. They are simply saying if they are going to operate on revenue neutrality for all types of ownership on these properties, then this falls in the scenario.

REP. KADAS referred back to Mr. Ballard. Mr. Ballard said last session they were talking about the bonding bill, and that bonding problem has not gone away. Unless that person that wants to convert to working at the side is a very wealthy individual, he cannot get a bond to get on the working side, so that is another reason why there would be very few, if any, attempting to do that.

REP. KADAS said he was sure Mr. Ballard had some good reasons why this could not happen, but let's assume it did. The Legislature returns in a couple of years, and the bill isn't revenue neutral to 1987 production. Would Mr. Ballard be willing to revisit the issue and make a rate revenue neutral? Mr. Ballard said under those conditions, yes they would, but they don't see that as a possibility; they cannot imagine that happening. Rep. Kadas said he was concerned because no one could imagine HB 28 was not revenue neutral. Essentially, legislators took industry's numbers and that is what is in the law now, and it happened. It is not revenue neutral. LFA numbers were closer to being revenue neutral than industry's were, but that is what the Legislature took, and Rep. Kadas does not want to see that happen again.

REP. REAM said he has been on this committee for 8 years and has appreciated Mr. Ballard's openness, candor, and particularly his technical expertise, which has been real helpful. During the session last summer, the Legislature imposed this flat tax, and if they had not imposed it, according to the LFA numbers, the net proceeds tax would have been $40.4 million. When they imposed that flat tax, the arguments were made that it would bring in the same amount of revenue. Legislators were struggling with the school equalization issue where they had to make a commitment to the schools around the state and also to local governments. They are not anywhere near the $40 million and the closest the industry is supporting now is $31.7 million. He felt the trust was broken last summer, particularly supporting a bill that was so far off. Some in the industry have come in supporting a position that would bring the Legislature somewhat closer and Rep. Ream would plead with them: couldn't they come somewhat closer, even splitting the difference halfway between the $40 million the state would have gotten had the flat tax not been imposed, and the $31.7 the industry proposes now. He was not saying they should have a flat tax that should go on at the same rate forever, but they had to assume some base biennium, and that was the current biennium they were in. He had felt there was an agreement.

Mr. Ballard said the agreement was to use 1987 and come as close to producing that kind of revenue given those same conditions, but they don't have those same conditions. Industry has declining price and production, and no one in this room or anyone in the state could have predicted that would happen. Rep. Ream is talking about $31.7 and comparing it to $40.4, and actually it should be compared to $35.9, which is the number. 35.9 versus 31.7 should be the two numbers in question.

Rep. Ream said that Mr. Ballard's charts would have predicted that kind of decline. Mr. Ballard said not at that steep rate. They were expecting to get more drilling to offset the decline to some extent. The problem is that they had this drastic fall in price. There is a chart in the packet (EXHIBIT 4) that shows the average oil price by year. It is the actual price that they received for production. From 1985 to 1986 they had a tremendous drop. In 1987 they saw a slight increase in the price and thought they had turned the corner and were on the way back up. They were allowing for the increase figuring they would be back up in the $20 range and see some increased drilling. And with the tax incentives put in place that year they fully expected that to happen. It turned around again and in 1988 it was as bad or worse than 1986 in terms of price. All they had to work on last year was 1987. It was not the intent of the industry to try to slip one by the people of the state, school systems in particular, and generate less revenue than they would under those 1987 numbers. That was their intent, and it is their intent now. The difference, as they see it, is the $2.1 million, assuming the stripper gas problem is corrected.

Closing by Sponsor:

REP. O'KEEFE closed by saying these bills had good discussion and thanked both proponents and opponents for their expert testimony, and to Rep. Gilbert for bringing fairness into the discussion. He and Rep. Gilbert had different definitions of the word fairness. He said the word fair, to the best of his knowledge, was used a minimum of 66 times in this hearing, and probably with as many definitions. It is a philosophical question and it will not be answered here. He felt when industry asked this committee to make fair fit their definition, they were stepping beyond their bounds. In this bill, the rates only apply to wells that were drilled prior to 1985; they only apply to the old wells that are already out there in the ground. There was a lot of talk about new operators not drilling wells because the rates are going to be 11 and 14 and 20%. No they are not. The rates for oil are going to stay at 7%; the rates for new gas will stay at 12%. These rates do not affect that, so a lot of that exploration talk sort of threw him. They are talking about 385 wells, not new wells. Sen. Tveit talked about new wells on old leases. Rep. O'Keefe had talked to Don Hoffman, who regulates that--one can drill a new well on an old lease and pay the new rate; they are not old wells. There are ramifications outside of what the Legislature is doing, and this bill really does, outside of the narrow issue of what the rates are for oil and gas, have some major ramifications. Putting the flat tax on oil, gas, and coal removed $300 million from the tax base in the state. That is 20% of the tax base. Legislators are dealing from here on out with 80% of the old tax base to reconcile the budget deficit of $100 million that is projected now. The lower these rates are, the bigger that budget deficit is going to be when in the 1991 regular session. If a bill is passed that is any lower than what SB 1 originally envisioned, they are adding to the deficit. They have heard a lot of talk, especially from Mr. Ballard, about the budget problems being solved with increased production. This set of problems may be solved, but there will be a whole other set to deal with. He did not believe the only way to solve the problems was in getting more wells in the ground. Rep. Elliott had some information from North Dakota. Some of the oil and gas people explained what they thought fair rates were: North Dakota at 11.5, Wyoming similar to Montana's. Oil is 7%, gas is 12.0, and there are up to 27 categories. A lot of the information the committee was given was not broken down by up to 27 categories; it was generalized. Committee members should be aware of that before executive session. The rate that is set is going to impact the theory of tax policy and what the industry pays for a long time. There is some indecision by the industry by saying what is wrong here is that the Legislature changes its rates too much. That is how democracy works. Every time the Legislature convenes, it will have bills to change tax rates. The Legislature cannot guarantee the industry that these rates will be fixed in stone. He did not think North Dakota, Wyoming, or South Dakota can guarantee that either, and that is something the industry will have to live with. If the rates stay reduced as industry wanted, there will be an attempt to change them next time. Someone will come in to try to get that lost revenue back, so the stability of keeping the rates low has gone out of the window already.

ADJOURNMENT

Adjournment At: 12:40 p.m.

Dan Harrington

REP. DAN HARRINGTON, Chairman

DH/pmc

0215.min

DAILY ROLL CALL

TAXATION COMMITTEE

DATE May 22, 1990

NAME	PRESENT	ABSENT	EXCUSED
REP. COHEN	✓		
REP. DRISCOLL			✓
REP. ELLIOTT	✓		
REP. ELLISON	✓		
REP. GILBERT	✓		
REP. GOOD	✓		
REP. GRADY	✓		
REP. HANSON	✓		
REP. HOFFMAN	✓		
REP. KADAS	✓		
REP. KOEHNKE	✓		
REP. NELSON	✓		
REP. O'KEEFE	✓		
REP. PATTERSON	✓		
REP. RANEY	✓		
REP. REHBERG	✓		
REP. SCHYE	✓		
REP. STANG	✓		
REP. STICKNEY	✓		
REP. SWYSGOOD	✓		
REP. REAM, VICE-CHAIR	✓		
REP. HARRINGTON, CHAIR	✓		

Rep. O'Keefe - opening statement

EXHIBIT 1
DATE 5/22/90
HB 3,4,7

Local Government Flat Tax Proposals
Introduced Versions

Senate Bill 1 (Gage)

SB 1 revises the local government severance tax rates to generate $33.02 million in fiscal 1991 and uses 1987 price and production figures as the base against which to calculate the rates. The bill lowers the LGST rates for oil producers, raises the rates for gas producers, and creates a separate LGST rates for royalty interests. SB 1 eliminates the 30 MCF exemption for natural gas stripper production.

House Bill 3 (O'Keefe)

HB 3 revises the local government severance tax rates to generate $43.6 million in fiscal 1991 and uses 1989 price and production figures as the base against which to calculate the rates. HB 3 will generate the equivalent of net proceeds taxes paid on mill levies by oil and gas producers in fiscal 1990 plus 40 mills. HB 3 eliminates the 30 MCF exemption for natural gas stripper production.

House Bill 4 (O'Keefe)

HB 4 revises the local government severance tax rates to generate $35.9 million in fiscal 1991 and uses 1989 price and production figures as the base against which to calculate the rates. HB 4 will generate in fiscal 1991 the equivalent of net proceeds taxes paid on mill levies in fiscal 1990 by oil and gas producers. HB 4 eliminates the 30 MCF exemption for natural gas stripper production.

House Bill 5 (Eudaily)

HB 5 eliminates the 30 MCF exemption for natural gas stripper production. No changes are made in the LGST rates. HB 5 will generate $29.7 million in fiscal 1991.

House Bill 7 (O'Keefe)

HB 7 sets one tax rate for oil production and one rate for gas production. Regular, stripper, and new oil production are all taxed at 9 percent. Regular, stripper, and new gas production are all taxed at 15.25 percent. The revenue distribution systems for the local government severance tax and new production taxes remain the same as in current law. HB 7 will generate $39.9 million or the equivalent of fiscal 1990 tax collections on net proceeds (mill levies) and net proceeds taxes paid on new and interim oil and gas production. HB 7 eliminates the 30 MCF exemption for natural gas stripper production.

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TERESA OLCOTT COHEA
LEGISLATIVE FISCAL ANALYST

EXHIBIT 2
DATE 5/22/90
HB 3, 4, 7
Terry Cohea

May 22, 1990 - After Senate Taxation Committee Action

Comparison of Local Government Severance Tax Bills and Definitions of "Revenue Neutral"

A. TAX RATES

Category	1987 Net Proceeds Average Effective Tax Rate	Current LGST	Gage - SB1	O'Keefe HB 7	O'Keefe HB 4	O'Keefe HB 3	Eudaily HB 5
OIL							
Operator							
Regular	7.32%	8.4%	8.4%	9.0%	9.72%	11.9%	8.4%
Stripper	8.22	4.2	4.2	9.0	4.86	5.95	4.2
Incremental	N/A	4.2	4.2	9.0	4.86	5.95	4.2
Royalty							
Regular	14.72	8.4	8.4	9.0	9.72	11.9	8.4
Stripper	14.72	4.2	4.2	9.0	4.86	5.95	4.2
NATURAL GAS							
Operator							
Regular	15.95	15.25	15.25	15.25	20.6	24.5	15.25
Stripper (exempt)	11.25	0.00	7.625	15.25	10.3	12.25	7.625
Stripper (taxable)	11.25	7.625	7.625	15.25	10.3	12.25	7.625
Royalty							
Regular	17.87	15.25	15.25	15.25	20.6	24.5	15.25
Stripper (exempt)	17.87	0.00	7.625	15.25	10.3	12.25	7.625
Stripper (taxable)	17.87	7.625	7.625	15.25	10.3	12.25	7.625
NEW & INTERIM PRODUCTION							
Oil	7.0	7.0	7.0	9.0	7.0	7.0	7.0
Gas	12.0	12.0	12.0	15.25	12.0	12.0	12.0

B. TAX REVENUE PRODUCED ON CALENDAR 1989 PRODUCTION (Millions)

	LGST Current	Gage - SB1	O'Keefe HB 7	O'Keefe HB 4	O'Keefe HB 3	Eudaily HB 5
LGST						
Oil	$22.4	$22.39	$25.75	$25.91	$31.72	$22.39
Natural Gas	5.3	7.32	9.74	9.89	11.76	7.32
Total	$27.7	$29.71	$35.49	$35.79	$43.48	$29.71
NEW AND INTERIM						
Oil	$ 2.09	$ 2.09	$ 2.69*	$ 2.09	$ 2.09	$ 2.09
Natural Gas	1.33	1.33	1.69*	1.33	1.33	1.33
Total	$ 3.42	$ 3.42	$ 4.38	$ 3.42	$ 3.42	$ 3.42
TOTAL	$31.12	$33.13	$39.87	$39.21	$46.90	$33.13

All bills are retroactive for calendar 1989 production on LGST.
*New rates will apply to calendar 1990 production (second quarter) and beyond.

C. DEFINITIONS OF REVENUE NEUTRAL

	Net Proceeds Tax Liability (Millions)	Gross Value of Base (LGST Purposes) (Millions)
1) Tax on CY87 production/applied to CY87 tax base	$40.4	$437.27
2) Tax on CY87 production/applied to CY89 tax base	40.4	350.03
3) Tax on CY88 production/applied to CY89 tax base	35.9	350.03

	Tax on CY Production (Million)
4) New and interim production	
CY87	$ 1.54
CY88	2.19
CY89	3.42

D. TAX COLLECTION DATES

1) Net proceeds and LGST	Production Year	Tax Collected
	CY 1987	FY 1989
	CY 1988	FY 1990
	CY 1989	FY 1991
	CY 1990	FY 1992

2) New and interim production tax	Production Year	Tax Collected
	CY 1987	May 1987-Feb. 1988
	CY 1988	May 1988-Feb. 1989
	CY 1989	May 1989-Feb. 1990
	CY 1990	May 1990-Feb. 1991

TC3:pe:TABLE

EXHIBIT 3
DATE 5/22/90
HB 347
Gregg Groepper

Proposed Amendments to House Bill 3
Office of Public Instruction
May 22, 1990

PURPOSE: To eliminate, for fiscal 1991 only, the requirement that new and interim production taxes be used in the calculation of county, state and district mill values.

Amend House Bill 3 as follows:

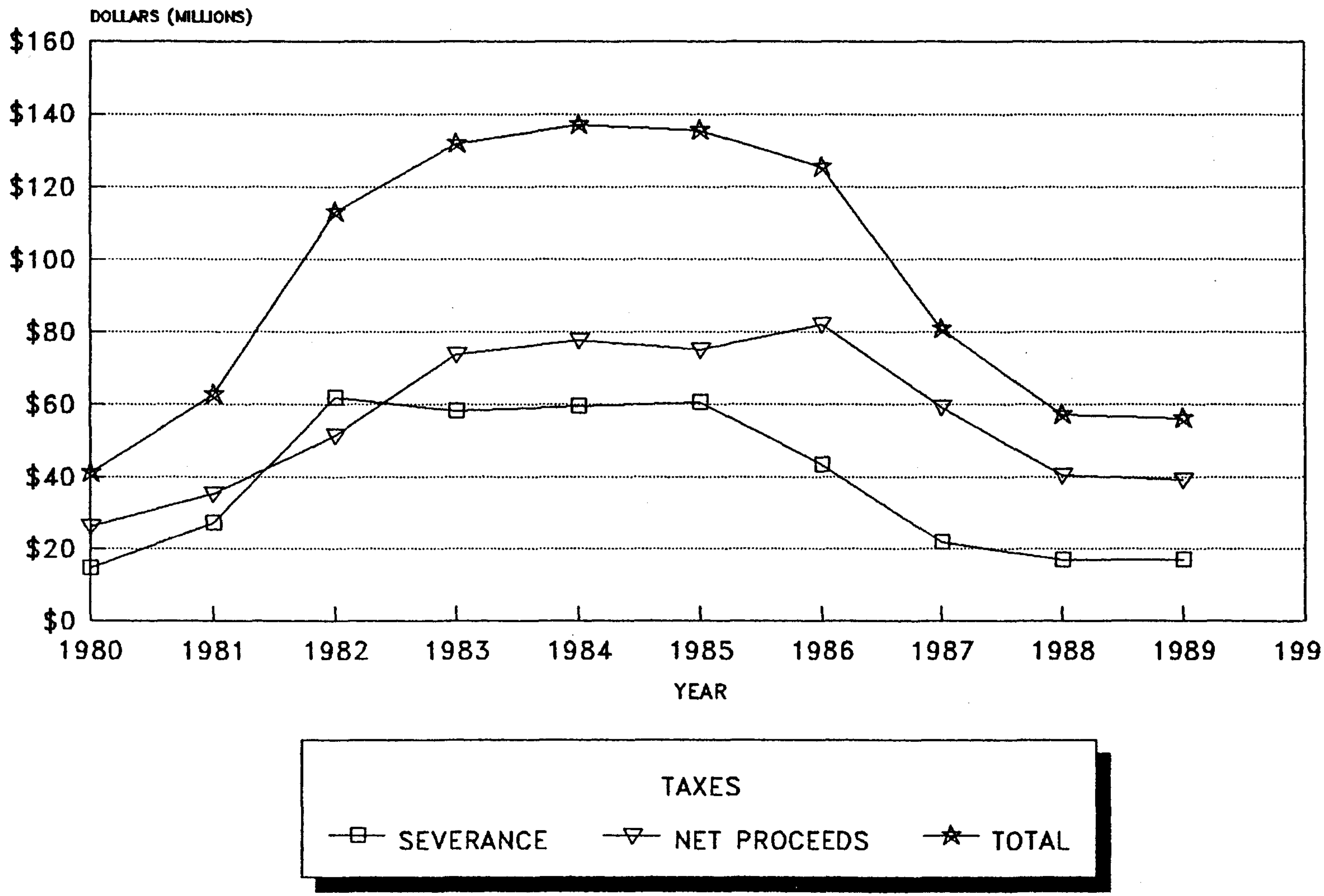
1. Page 13, line 12.
   Following: "15-23-607(4)"
   Strike: "and"
   Insert: "for production after March 31, 1990 plus"

2. Page 14, line 11.
   Following: "15-23-607(4)"
   Strike: "and"
   Insert: "for production after March 31, 1990 plus"

3. Page 15, line 17.
   Following: "15-23-607(4)"
   Strike: "and"
   Insert: "for production after March 31, 1990 plus"

EXHIBIT 1
DATE 5/22/90
HB 3,4,7
Ballard

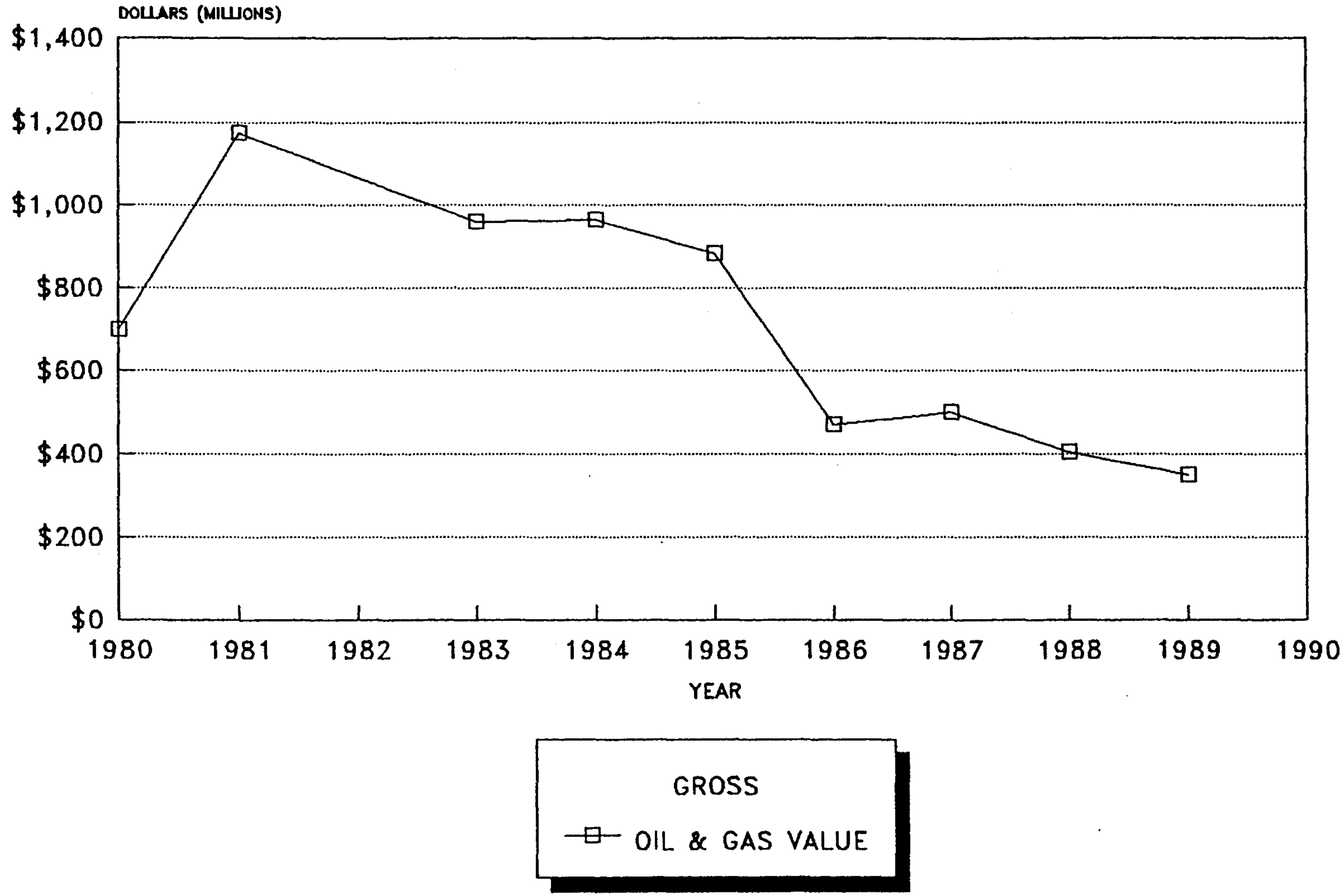
SEVERANCE AND NET PROCEEDS TAXES PAID BY INDUSTRY



(Source Montana Department of Revenue)

Exhibit 4
5/22/90 HB 3,4,7

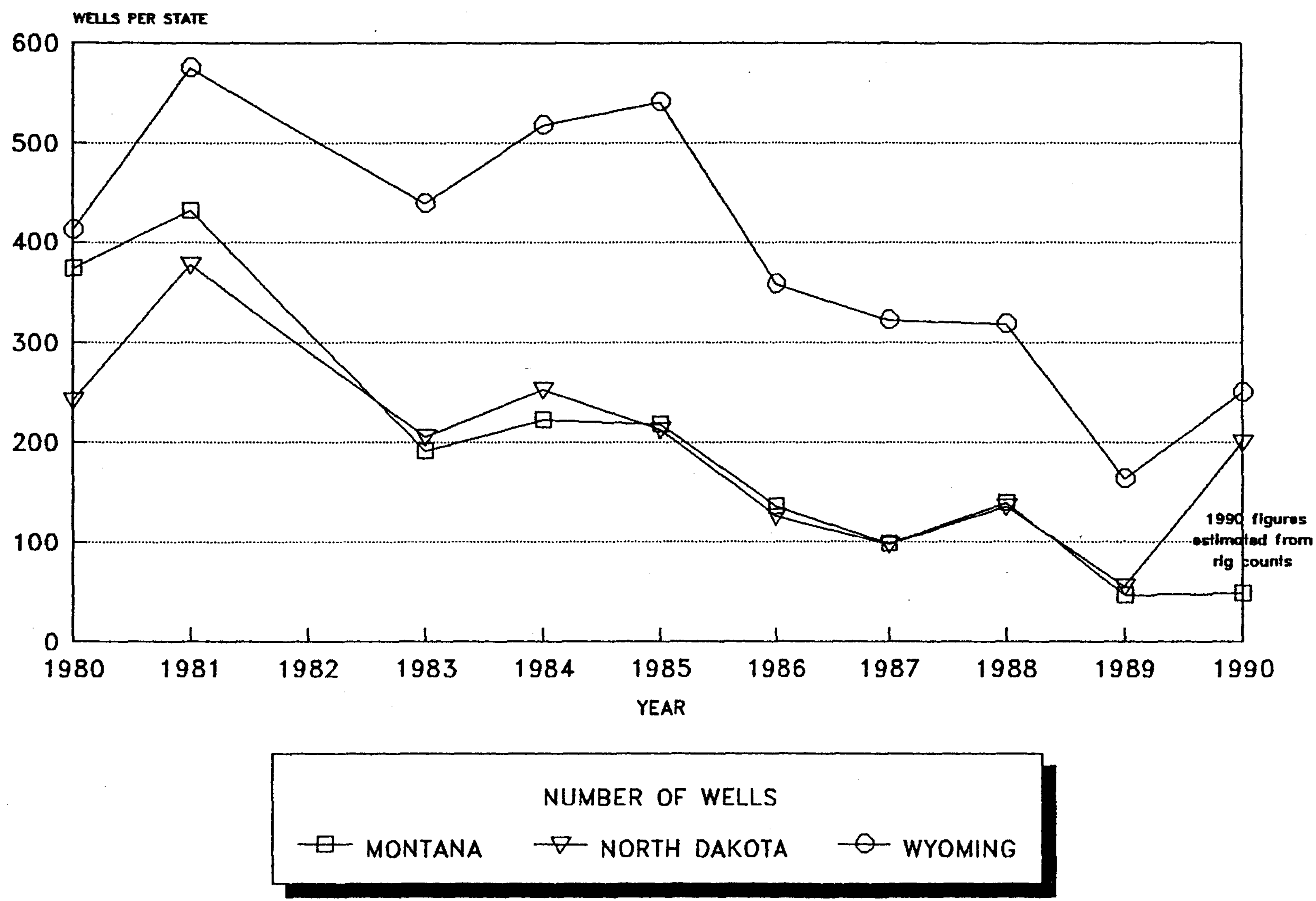
GROSS VALUE OF OIL & GAS PRODUCED IN MONTANA BY YEAR



(Source IPAA Annual Review)

Exhibit 4
5/22/90 HB 3,4,7

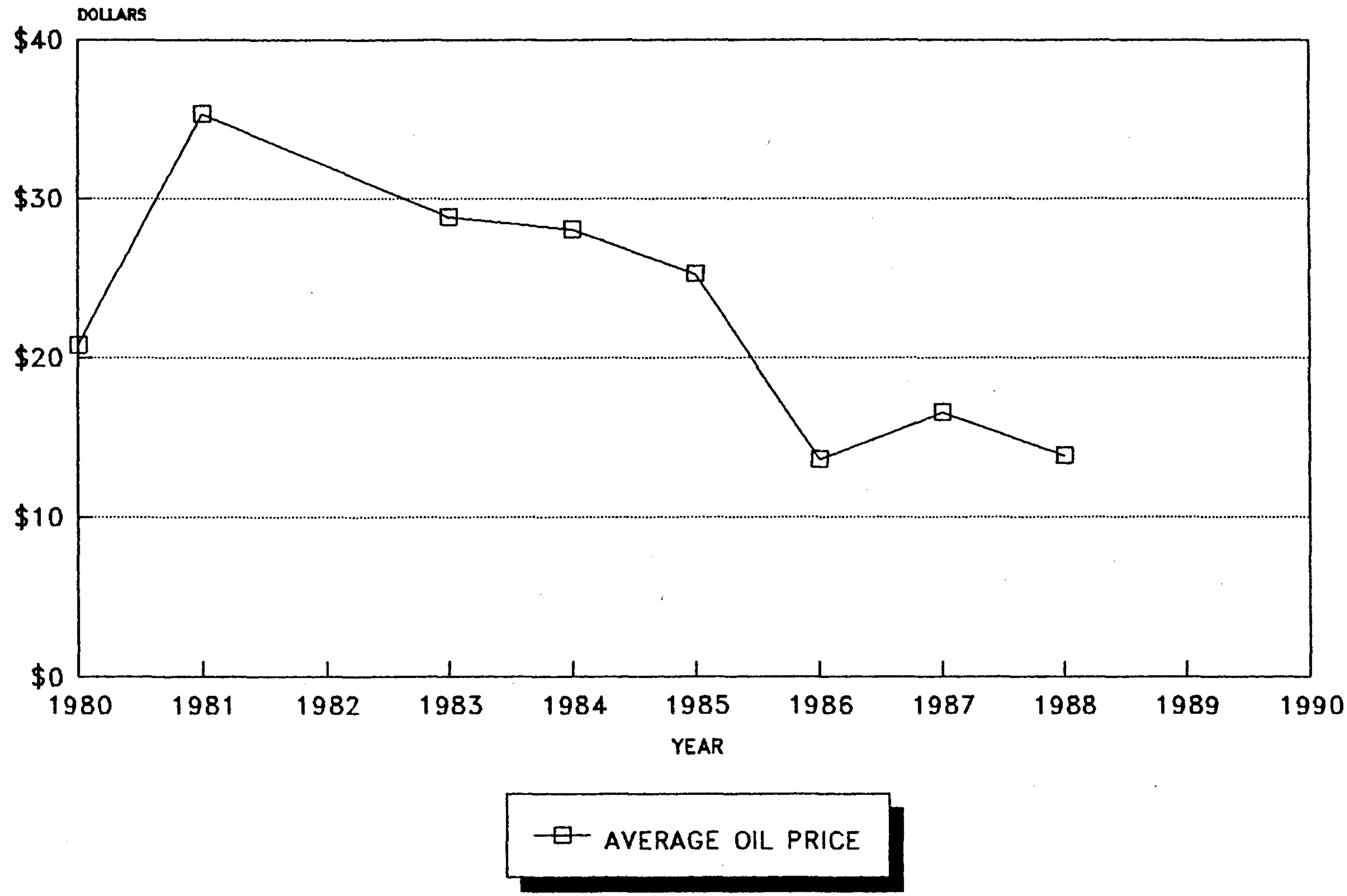
NUMBER OF EXPLORATORY WELLS DRILLED



(Source IPAA Annual Review)

Exhibit 4
5/22/90 HB 3,4,7

AVERAGE OIL PRICE IN MONTANA BY YEAR



(Source IPAA Annual Review)

[redacted]

Exhibit 4
5/22/90 HB 3,4,7

CRUDE OIL PRICE POSTING

CENEX CENTRAL MONTANA

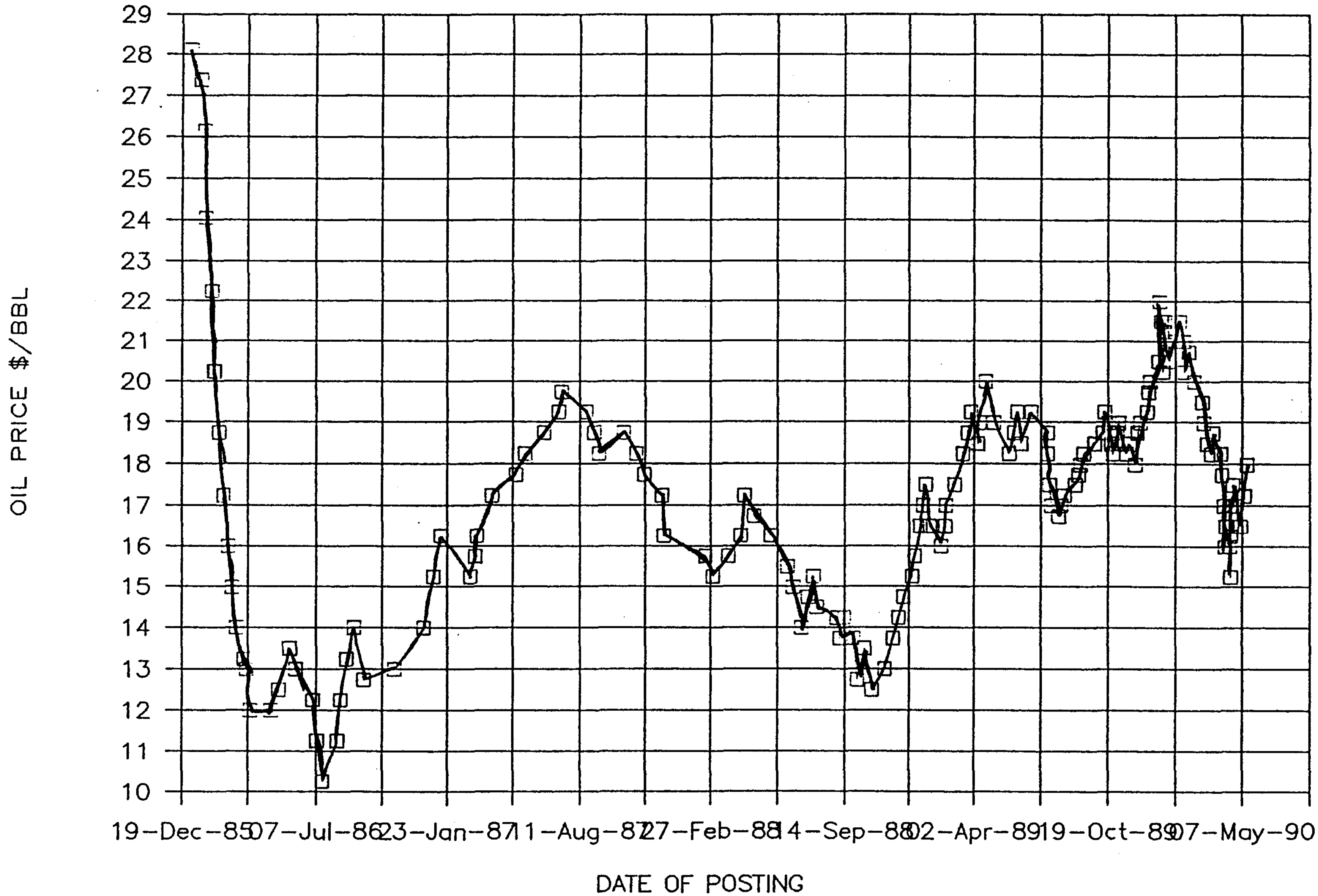
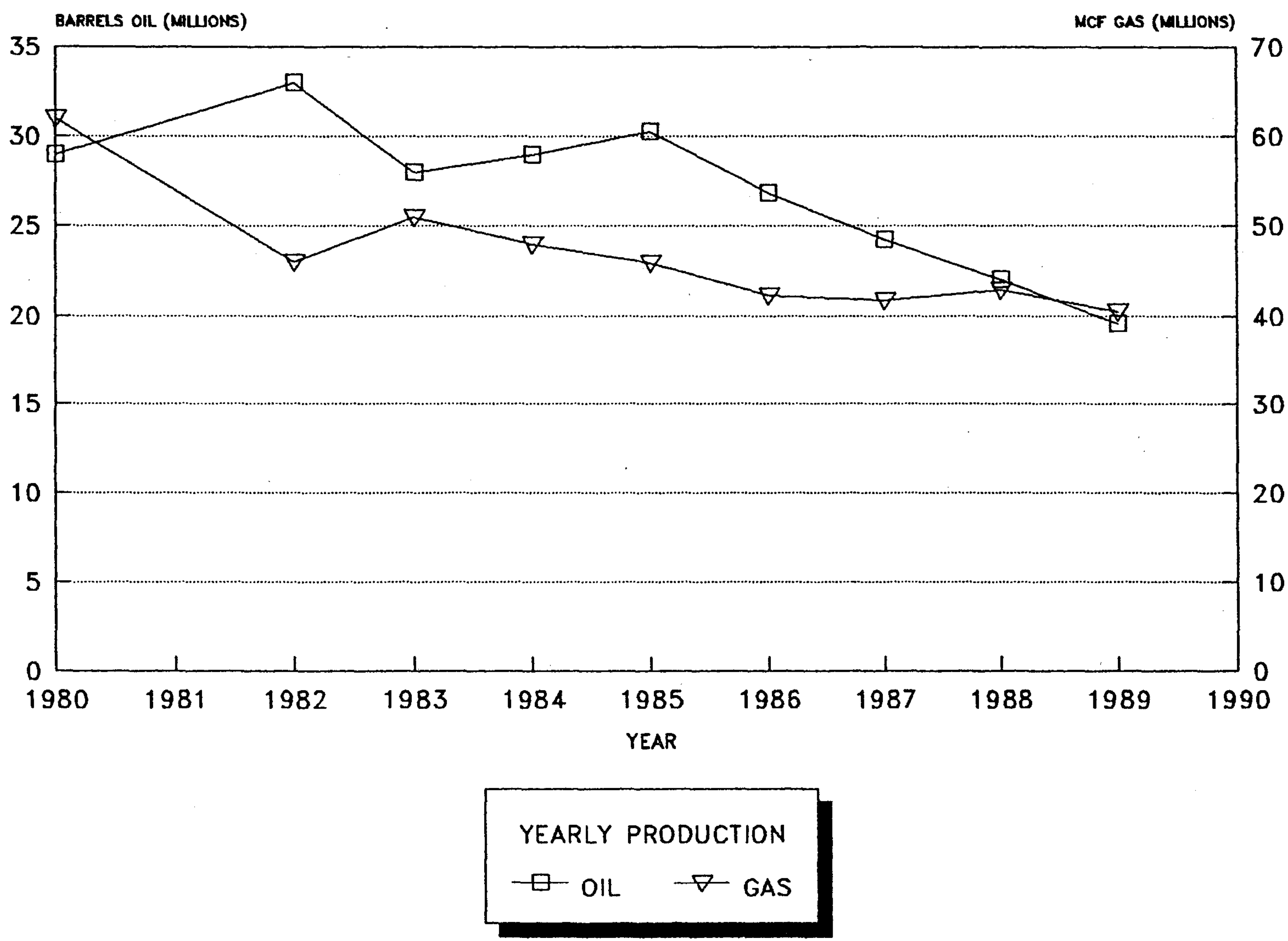


Exhibit 4
5/22/90 HB 3,4,7

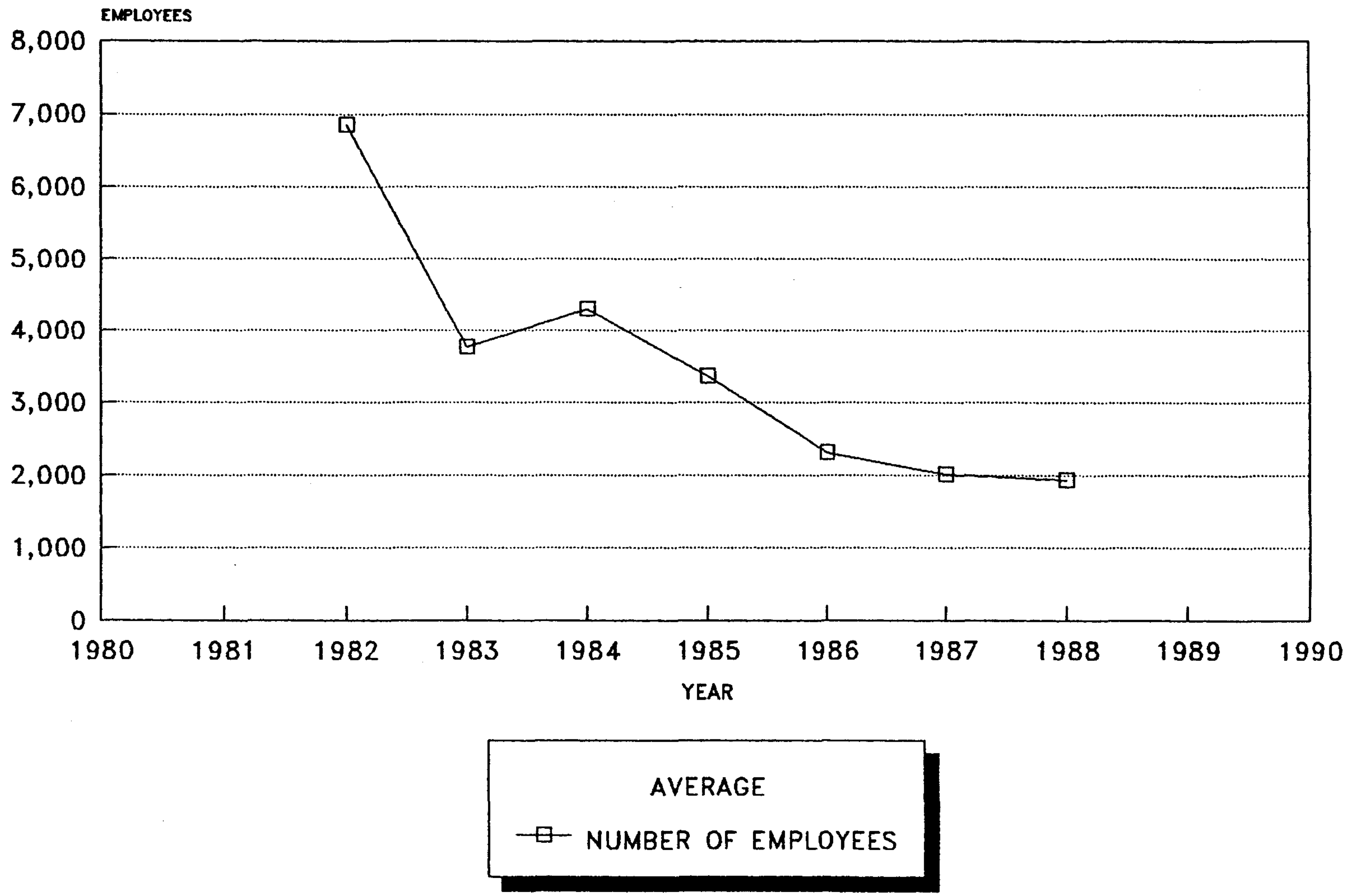
PRODUCTION BY YEAR



(Source IPAA Annual Review)

Exhibit 4
5/22/90 HB 3,4,7

NUMBER OF EXPLORATION AND PRODUCTION EMPLOYEES IN MONTANA



(Source IPAA Annual Review)

EXHIBIT 5
DATE 5/22/90
HB 3,4,7
Ballard

COMPARISON OF NET PROCEEDS TAXES TO SENATE BILL 1 - MPA RATES
1987 PRODUCTION
May 21, 1990

TAX REVENUE		
Fiscal 1989 Oil and Gas Net Proceeds Tax		$40,384,725
Fiscal 1989 Local Government Severance Tax - SB1		40,462,425
Total Revenue Difference		$ 77,700
TAXPAYER		
Royalty Owners -	Stripper Gas Rate	($ 32,329)
	Stripper Oil Rate	(255,132)
	Regular Gas Rate	(199,172)
	Regular Oil Rate	($ 711,550)
	Total Royalty Owners	($1,198,183)
Operators -	Stripper Gas Rate	($ 757,598)
	Stripper Oil Rate	(975,406)
	Regular Gas Rate	(256,736)
	Regular Oil Rate	3,265,624
	Total Operators	$ 1,275,884
Total Taxpayer Difference		$ 77,701

MONTANA PETROLEUM ASSOCIATION
A Division of the
Rocky Mountain Oil and Gas Association

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Billings, Montana 59103
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Fax (406) 252-3871

Janelle K. Fallan
Executive Director

EXHIBIT 6
DATE 5/22/90
HB 3,4,7
Ballard

May 21, 1990

The Montana Petroleum Association supports the following rates on the local government severance tax:

Regular oil -- 8.4%
Stripper oil -- 4.2%
Nonworking interest oil -- 12.5%
Regular gas -- 15.25%
Stripper gas -- 7.625%
Nonworking interest gas -- 15.25%

These rates provide ~~$70,000~~ 72,701 more than revenue neutral based on 1987 production, which was the intent of the flat taxes approved by the 1989 special session.

EXHIBIT 7
DATE 5/22/90
HB 3, 4, 7

HB 3 AND HB 4

TESTIMONY BY: W.W. BALLARD

(Past President, Montana Petroleum Association; President, Rocky Mountain Oil and Gas Association; President, Balcron Oil Co.)

On behalf of the Montana Petroleum Association and as a Montana independent since 1963, I am testifying in opposition to the proposed tax rates in Rep. O'Keefe's bills. Exemption of gas strippers producing less than 30 MCFPD was an error and the industry recognizes it as such. We believe that this exemption should be eliminated. We also support revenue neutral tax rates for the LGST using 1987 as the base year, and oppose these bills as major tax increases on an industry that is already in bad condition.

Please remember that this bill affects only production established before 1985. The 1985 legislature established uniform net proceeds rates state-wide for production established after July of that year. Pre-1985 production is a declining asset that will continue to decline, but until enough new production is found, cash flow from this production is a major revenue source for drilling new wells in the State.

I have testified many times before various bodies of this legislature concerning geologic potential in this state. I made a statement that Balcron would double their drilling activity if the legislature would pass certain incentive bills. During the time period 1985-86, Balcron drilled (or caused to be drilled) 14 wildcat wells in Montana. During the 1987-1989 period, we drilled 29 wildcats. On the development side, we drilled 20 wells in 1985-86 and increased this to 30 during 1987-89. We plan to continue to operate in Montana as long as cash flow and our ability to bring in joint venture partners will permit. This year we will be drilling the most venturesome test in our 27 year history: A well in the overthrust belt near Townsend. This well will be 13,500 feet deep and cost almost 4 million dollars just to get to our objective. Without the incentive bills we could not have brought in the partners necessary to accomplish such an undertaking.

I have supplied you with several graphs to demonstrate the plight of the industry in Montana. I will discuss three here: (1) Severance and Net Proceeds Taxes Paid by Industry; (2) Gross Value of Oil and Gas Produced in Montana By Year; and (3) Number of Exploratory Wells Drilled.

The Severance and Net Proceeds Graph shows income to

Exhibit 7
5/22/90
HB 3,4,7

state and local governments during the 1980's. Note that the peak year for this income was 1984 and comparing 1984 on the Gross Value Graph, it is apparent that the time of greatest taxes was well past the time of greatest value. Note also that 1986 was the year of greatest income from the Net Proceeds Tax and this was the year that oil prices hit rock bottom! (See Price Charts.)

The answer to all our dilemma is found on the graph showing numbers of exploratory wells drilled by year. I chose to plot only exploratory wells because these are the ones seeking new fields. (Development wells are offsets drilled to develop a discovery found by a wildcat [exploratory well]). In order to solve the cash flow problem in which both industry and government find themselves, we simply have to drill more exploratory wells and find more reserves. Government and industry must work together to accomplish this. To raise the LGST above rates that would be revenue neutral on 1987 production, or to return to the old net proceeds method of taxing would be devastating. Montana has a tremendously negative image among the industry as a poor place to do business. This was never more apparent to me than when I travelled from one end of this country to another looking for partners in our overthrust venture.

The Governor, the Director of the DOR and members of the Montana Oil and Gas Industry are planning a public relations effort to convince industry outside of Montana that Montana is a fine place to do business. Please do not pass legislation that will make that effort virtually impossible.

VISITORS' REGISTER

Taxation COMMITTEE

BILL NO. 3, 4, 5, & 7 DATE 5-22-90

SPONSOR

NAME (please print)	RESIDENCE	SUPPORT	OPPOSE
Dennis Adams	DOR		
Janelle Fallan	MPA		
W.W. Ballard	MPA - BALCRON		
Pat Melby	Underfunded Schools		
JOHN ALSTAD	SUNBURST, MT		
Harry Simons	Shelly Mt.		
Jon Ebzery	Nevco		
Giles Gregoire	Havre, MT		
Gordon Morris	MACo.		
Terry Minow	MT Fed of Teachers		
Gloria Hermanson	MT Cultural Adv.		
Madalyn Quinlan	OPI		
[illegible]			
Dennis Burr	MT Taxpayers Assoc	HB5 ✓	
Terry Cohea	LFA		
Walter Webb	Houston Tx		
William Duffield	Fallon Co		
Kitty Brock	Hamilton		
Eric Feaver	MEA		

IF YOU CARE TO WRITE COMMENTS, ASK SECRETARY FOR WITNESS STATEMENT FORM.

PLEASE LEAVE PREPARED STATEMENT WITH SECRETARY.

VISITORS' REGISTER

Taxation COMMITTEE

BILL NO. 3, 4, 5, & 7 DATE 5-22-90

SPONSOR

NAME (please print)	RESIDENCE	SUPPORT	OPPOSE
Bucky Nunn	Houston, Tex		
Carl Knudsen	Saco — 3/4/7	✓	
Rep. Wallin			
Bruce W. Moerer	MSBA		
W. H. Tulloch	Meridian Oil Worth		
Gloria Paladichuk	Richland Co Commissioner		—

IF YOU CARE TO WRITE COMMENTS, ASK SECRETARY FOR WITNESS STATEMENT FORM.

PLEASE LEAVE PREPARED STATEMENT WITH SECRETARY.