



New Mexico Tax Policy Toward the Energy Sector

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Overview

- State and local taxes play an important role at every stage of the process of energy production and consumption.
- In addition to severance taxes, the State imposes significant amounts of Corporate Income and Gross Receipts Taxes on producers of crude oil, natural gas and coal, as well as from electric power producers.
- Property tax incentives have been offered to some electric generation projects, with some unintended consequences for sales & use taxes.
- Numerous incentives for renewable energy production have yet to play an important financial role in the industry.

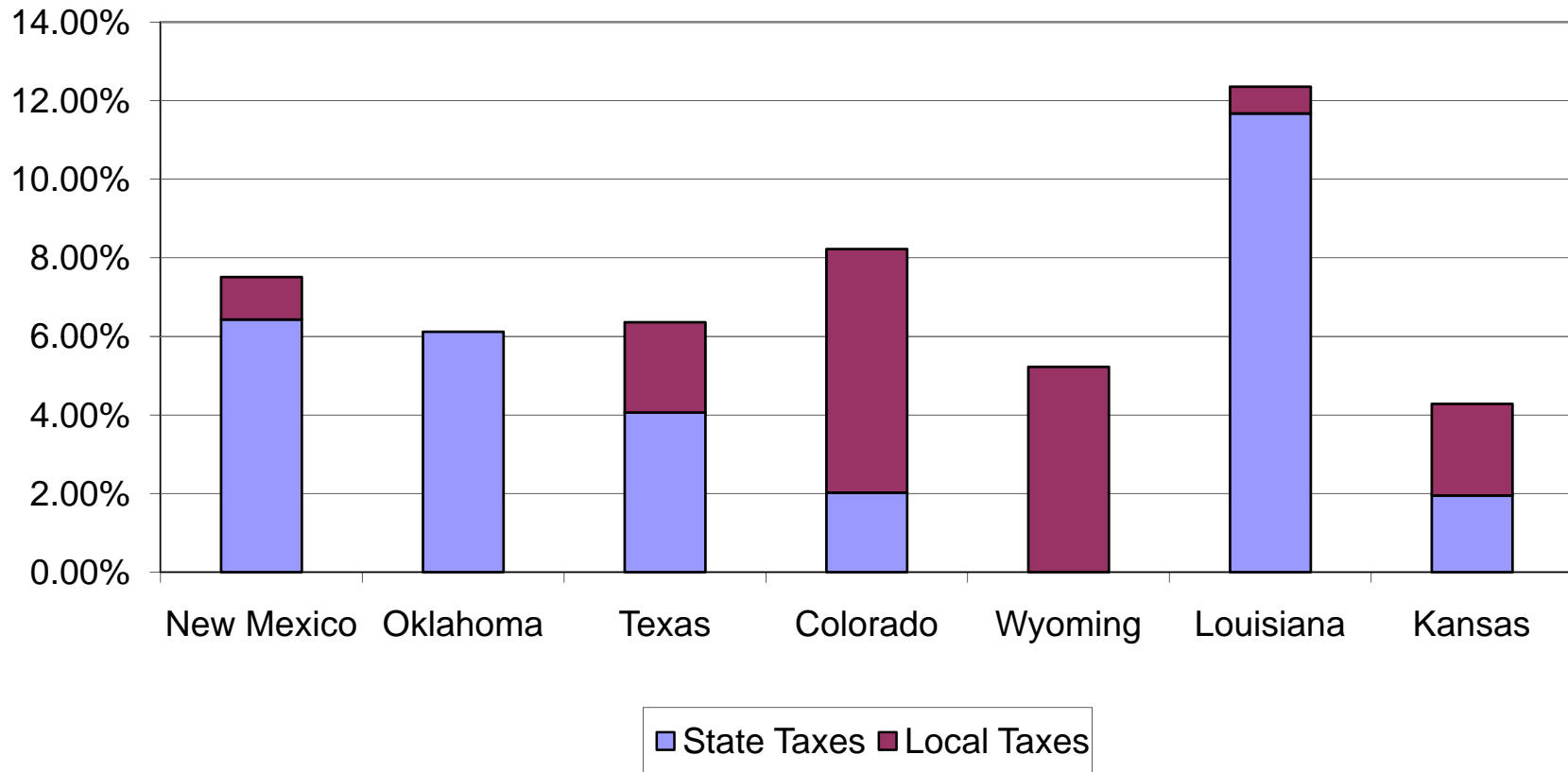
Oil & Gas Severance Taxes

	Statutory rate: Percent of net taxable value	Effective tax rate: Percent of gross sales value	Effective tax rate: Dollars per unit
Natural Gas:			
Emergency school	4.0%	3.2%	\$0.15 per mcf
Severance tax	3.75%	3.0%	\$0.14 per mcf
Conservation tax	0.19%	0.15%	\$0.007 per mcf
Processors tax	0.45%	0.36%	\$0.017 per mcf
Total	8.39%	6.7%	\$0.31 per mcf
Oil:			
Emergency school	3.15%	2.84%	\$1.42 per barrel
Severance	3.75%	3.38%	\$1.69 per barrel
Conservation	0.19%	0.17%	\$0.09 per barrel
Total	7.09%	6.38%	\$3.20 per barrel

Deductions for transportation and certain processing costs and for public royalties reduce average tax rates by about 20% for gas and about 10% for oil. Average prices of \$4.80 for gas and \$50.00 for oil were used to calculate \$/unit.

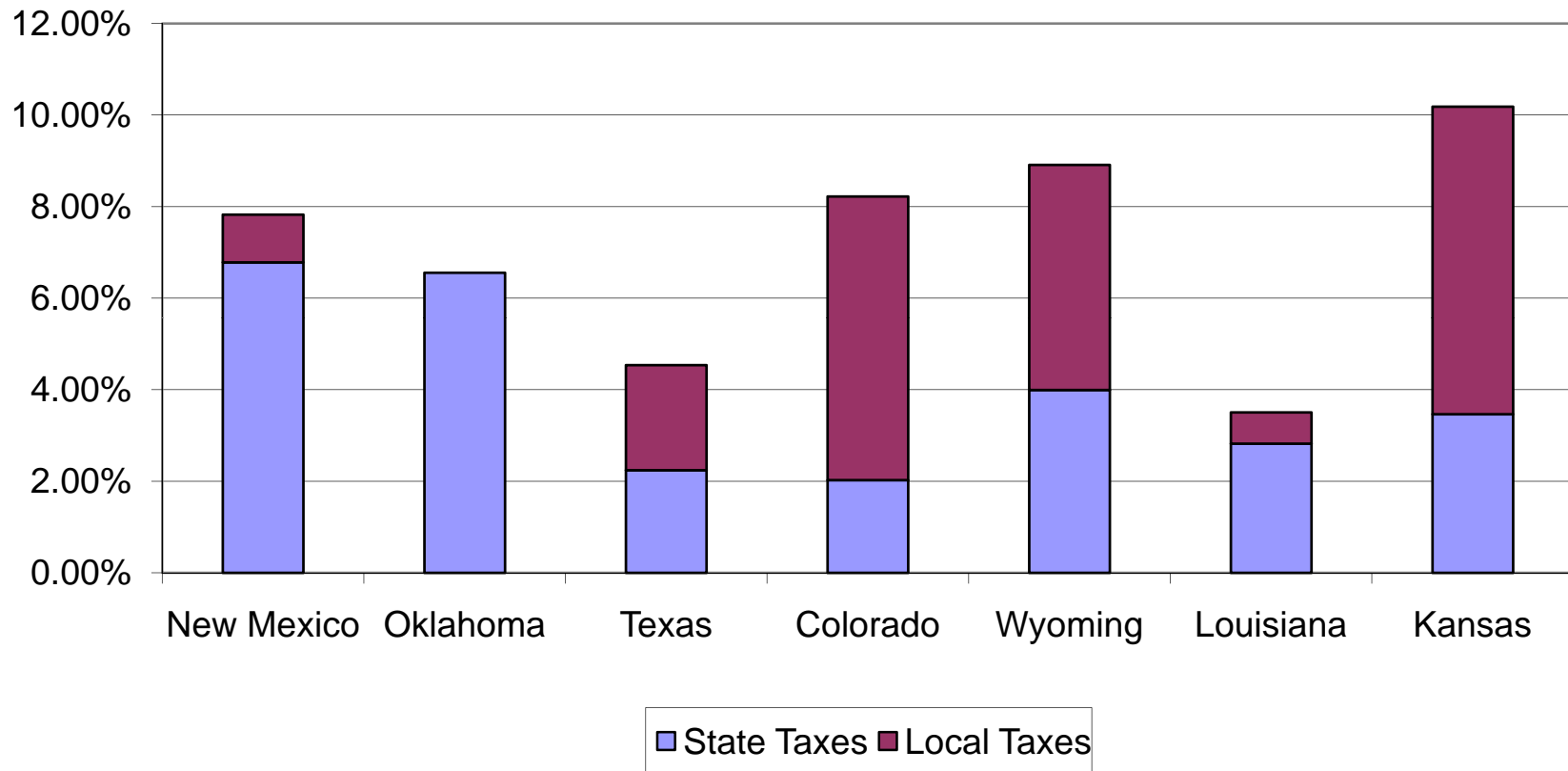
Rates are unchanged in 20 years.

Effective State & Local Tax Rates on Oil Production: 2002



Effective tax rates were calculated by dividing total revenue by total production value. New Mexico ranked third, well below Louisiana but well above Kansas and Wyoming.

Effective State & Local Tax Rates on Gas Production



*New Mexico ranked fourth, well above Louisiana and Texas.
Local taxes play an important role in some other states.*

O&G Severance Tax Incentives

- Enhanced oil recovery: 1.875% rate reduction if WTI less than \$28; Available for maximum 7-year time period.
- Production restoration: 3.75% reduction for 10 years on increased production as long as WTI less than \$24.
- Workover: 1.3% reduction if WTI less than \$24
- Stripper well: 3.5% rate reduction for oil if WTI less than \$15; 3.875% reduction for gas if NM average less than \$1.15; lesser reduction if gas less than \$1.35 or oil less than \$18.
- Intergovernmental credit: 75% credit against lesser of the state or tribal tax owed.

Coal Production Taxes

	Total Collections	Average Rate (\$/ton)	Average Rate (% Sales Value)
Severance Tax & Surtax	\$17.3 million	\$0.68	2.5%
Resource Excise Tax	\$4.6 million	\$0.18	0.7%
Conservation Tax	\$1.2 million	\$0.05	0.2%
Subtotal	\$29.0 million	\$1.13	4.2%
Property Tax	\$6.0 million	\$0.23	0.9%
Gross Receipts Tax*	\$30 million	\$1.17	4.3%
Total	\$65.0 million	\$2.53	9.4%

FY 2007 values:

Total taxable production: 25.6 million tons

Total sales value: \$692.7 million

Average sales price: \$27.09/ton

*Values from FY 2008

Average Effective Coal Tax Rates: Percent of Gross Receipts (1997)

	Utah	Arizona	Colorado	Wyoming	New Mexico	Montana
Sales	0	1.8%	.03%	.1%	5.3%	0
Severance	0	0	2.6%	4.8%	4.7%	10.5%
Property	0.6%	0.8%	0.5%	4.4%	1.3%	1.0%
Other	0	0	0	0	0.8%	3.7%
Total	0.6%	2.6%	3.2%	9.4%	12.1%	15.2%

Source: "Taxation of Coal Production in Western States," K. O'Donnell, T. Clifford, State Tax Notes.

New Mexico has reduced tax on new coal mines significantly – removing severance surtax and providing a tax credit for taxes paid to the Navajo Nation.

Other Production Tax Issues

- Tax exporting:
 - Almost 90% of NM gas is exported; less than half of oil.
 - Tax exporting is limited when prices are set in commodity markets.
 - Burden on suppliers translates into reduced investment , employment and returns to mineral owners.
- Net Value vs. Gross Value production tax base:
 - Net revenue base would reduce disincentives to invest in N.M.
 - Net revenue taxation would be a more efficient, even-handed way to provide incentives for development of marginal resources.

Income Taxes

- Oil and gas producers contribute almost half of NM's corporate income tax (7.6% top rate) – approximately \$150 million annually.
- Interest and royalty owners owe personal income tax (4.9% top rate).
 - Withholding required for on out-of-state royalty owners.
 - 50% exclusion provided for capital gains.
- Incentives for renewable energy production are proliferating, but so far have been of little benefit due to the lack of CIT liability:
 - Production tax credit of up to 4 cents per kWh for wind, solar & biomass.
 - Investment credit for solar panels.
 - Investment credit for sustainable buildings.

NM Corporate Income Tax Pros & Cons

PROS:

- NM generally follows federal rules, e.g. allows percentage depletion, etc.
- No alternative minimum tax is imposed
- Combined filing is allowed but not required

CONS:

- 2nd highest tax rate in the region (CA)
- Some energy producers have no CIT – TX, WY
- Aggressive rules for apportioning income
- Disallowance of net operating loss carrybacks

Potential CIT Changes of Concern to Energy Producers

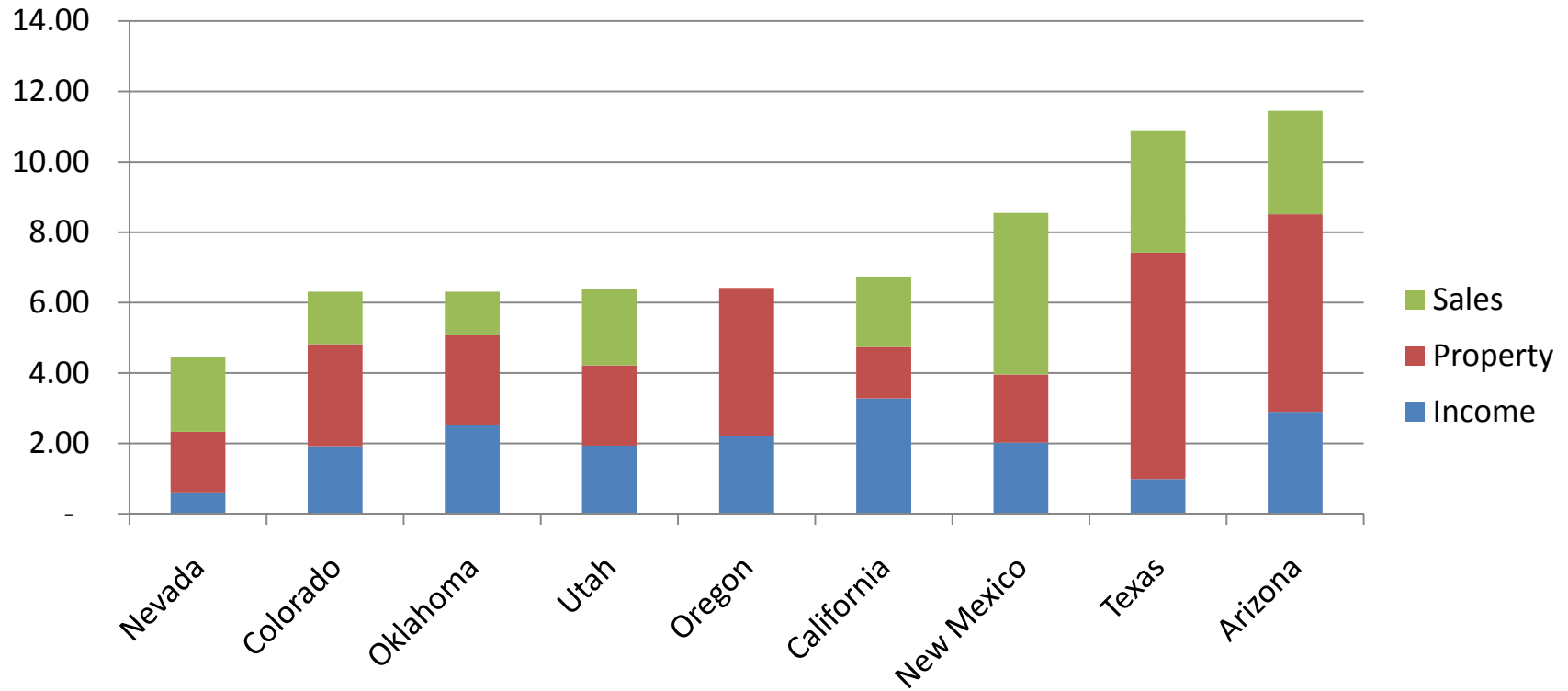
- **Mandatory combined reporting:**
 - Both the separate entity and federal consolidated methods of reporting income would be prohibited
 - Multi-state and income from foreign operations of related parties would be included on the New Mexico return to the extent the combined group has a presence (payroll, property, sales) here.
 - Liabilities could increase or decrease, complexity increases.
- **Franchise tax as alternative minimum tax:**
 - Applies to “C-corporations” and to their non-C related entities.
 - New tax would be a fixed rate time payroll, property & sales
 - Taxpayer would owe the greater of the new tax or their current CIT

Gross Receipts and Compensating Tax

- Broad-based business privilege tax on many business-to-business transactions.
- Tax rate is much higher than other states' business privilege tax.
- Significant amounts of GRT are “pyramided” in the energy sector, increasing overhead and reducing investment:
 - Deductions for exported fuels, power.
 - No deduction for fuel sold to power plants.
 - No deduction for services sold to operators of oil and gas leases.
 - Tax imposed on most construction services.

Effects of Pyramiding on Investment Returns

Effective Tax Rates: Seven Industry Average



1997 Barent's Group study found GRT on business inputs caused a significant loss of competitiveness for New Mexico.

GRT Incentives

- Incentives for energy production:
 - Deduction for wind generators
 - Deductions for uranium enrichment
 - Deduction for biodiesel blending equipment
 - Credit for tax paid to Navajo Nation for coal
 - Deductions for biomass-related equipment
 - Deduction for renewable electricity transmission
 - Deduction solar energy systems
 - Investment credit for advanced energy generating systems solar or coal-based with sequestration)
 - Alternative energy product manufacturers
- Wind energy incentives have saved the industry tens of millions.

GRT Issues of Concern to Energy Producers

- High degree of pyramiding in this industry makes proposals to increase the GRT rate a serious concern.
- Renewable energy production incentives are an implicit acknowledgement the tax is imposing a heavy burden.
- Some new energy projects have received significant GRT/Comp. Tax relief (e.g. L.E.S.), others have been denied (Desert Rock);
- Recent Court decision on “sourcing” of GRT could affect power producers.

GRT/Comp. Tax Issues in Large Electricity Projects

- Determining whether GRT or Compensating Tax applies requires a careful analysis of the terms of the purchase contract, including such issues as whether the seller has “nexus” in New Mexico.
- In electric power projects, large amounts hinge on these issues, e.g. tax on a generator or turbine.
- Some large-scale energy projects have benefitted from Industrial Revenue Bond (“IRB”) financing, which offers substantial property tax relief. Negotiators should be aware that GRT liability – especially for the local option portion – depends crucially on the terms of purchase contracts – e.g. fuel transferred over common carriers may be deemed to have changed hands outside the state, in which case no local option GRT attaches.

Potential Policy Issues: Renewables

- Income tax incentives have seen relatively little use
- Energy producers do not have significant CIT liability in NM
- More proposals feature “transferability” or “disproportionate allocation” of credits
 - Reduced “bang for the buck”
- If renewables do catch on, the State’s revenues could suffer

Property Tax Issues

- In general property taxes are relatively low in New Mexico:
 - Constitution limits rates & debt issues.
 - Commercial assessments increase slowly.
- Some local governments have been willing to issue IRB's, which provide property tax exemption.
- Industry representatives have had a number of disputes with the Property Tax Division over central-assessment methods, e.g. pipelines, transmission facilities.

Conclusions

- Severance taxes are “in the middle” relative to other producing states:
 - Incentives for marginal producers are out of date, of little use.
 - Net income taxation could provide more efficient means of preserving investment in marginal fields.
- Corporate income tax on energy is relatively high:
 - Proposals to further increase tax could have a major impact on the energy sector.
- GRT adds significantly to overhead in the energy sector
 - Pyramiding makes the sector highly vulnerable to tax rate increases.
 - With large amounts at stake, planners should pay close attention to the terms of purchase contracts to determine whether GRT or Compensating Tax applies.
- Income tax incentives for renewable energy, though numerous, have yet to see much activity. GRT incentives have already saved the industry tens of millions