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Texas Oil and Gas Severance Taxes: An Overview of Current Law and New Legislative Changes

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Introduction

In separate statutes, Texas law imposes a production tax, also called a severance tax, on the gross production of oil and gas after it is extracted from the ground. For both oil and gas production, there is a general severance tax imposed on produced oil and gas, but there are a variety of exemptions imposing lower tax rates, or no taxes at all, on certain types and methods of oil and gas production. These exemptions were crafted by the Texas Legislature to incentivize wanted or disincentivize unwanted behavior in the Texas oil and gas market. In the 88th Texas Legislature session, there were a variety of proposals considered that would add or change severance tax exemptions, and by altering the value of oil and gas production through the imposition of increases or reductions in severance taxes, these legislative proposals had the potential to alter oil and gas producer incentives and behavior.

To understand how these severance tax-related legislative proposals may affect Texas oil and gas producers, as well as the implications of possible future severance tax-related legislative proposals, this alert will (1) provide an overview of the existing framework of oil and gas severance taxes in Texas, (2) discuss the policy justifications underlying the severance tax and how the tax revenues are used by the State of Texas, (3) assess the 88th Texas Legislative session's newest exemptions that will affect the severance tax beginning on September 1, 2023, and (4) analyze how this legislation will impact oil and gas producers.

I. Background: *What is the Oil and Gas Severance Tax in Texas?*

<u>*(a) Oil Severance Tax:*</u> For oil produced in Texas, an occupation tax at a rate of 4.6% of the "market value" of oil produced in Texas or 4.6 cents for each barrel of 42 standard gallons of oil produced in Texas is imposed, whichever rate results in the greater amount of tax.[1] "Market value" is statutorily defined as the "actual market value plus any bonus, premium, or other thing of value paid for the oil or that the oil will reasonably bring if lawfully produced."[2] This tax generally applies to all "crude oil or other oil taken from the earth, regardless of the gravity of the oil"[3] and is calculated based on "the total gross amount of oil produced, including royalty and other interests"[4]. Oil severance taxes are due on the 25th day of each calendar month for oil produced during the preceding calendar month.[5] Subject to several exceptions, failure to pay the oil production tax when due results in a forfeiture of 5% of the amount due as a penalty, and if there is no payment within thirty days after the tax is due, an additional forfeiture of 5% is added to such month's total amount of severance tax owed.[6]

As to who is responsible for paying the tax, the oil producer has the primary liability for paying the oil severance tax, but this liability may be passed from the producer to the first purchaser and subsequent purchasers of the oil.[7] Importantly, the tax is levied on *all* owners of direct or immediate interest in the oil actually produced

[1] Tex. Tax Code §§ 202.051, 202.052(a).
[2] *Id.* at § 202.053.
[3] *Id.* at § 202.001(3).
[4] *Id.* at § 202.002(a).
[5] *Id.* at § 202.151.
[6] *Id.* at § 202.301(a).
[7] *Id.* at § 202.251. "Producer" is statutorily defined as "a person who takes oil from the earth or water in any manner, a person who owns, controls, manages, or leases an oil well, or a person who owns an interest, including a royalty interest, in oil or its value, whether the oil is produced by the person owning the interest or by another on his behalf by lease, contract, or any other arrangement." *Id.* at § 202.001(4).

"without regard to the title to the oil either before or after severance; and without regard to any arbitrary classification or nomenclature."[8] This means that the tax must be borne ratably by all interested parties, including royalty interests.[9] For purposes of the statute, a royalty owner is considered a "producer", and thus, the tax is imposed before royalties are applied to production.[10]

(b) Natural Gas Severance Tax: For natural gas produced in Texas, the imposed severance tax rate is 7.5% of the market value of "gas" produced and saved in Texas by the producer.[11] "Gas" includes "natural gas, casinghead gas, or other gas taken from the earth or water, whether produced from a gas well or a well also producing oil, distillate or condensate or both, or other products."[12] The same 7.5% of market value tax rate is also applied to produced "liquid hydrocarbons, other than condensate, recovered from gas produced [in Texas]."[13] Differently, produced condensate is taxed at the same rate as the oil production tax, which is 4.6% of the condensate's market value.[14] For produced gas, the 7.5% tax rate is on "the gross amount of gas taken from the earth or water as determined by meter readings that show 100 percent of the gas taken expressed in cubic feet."[15] Unlike the oil severance tax, the severance tax on gas is due on the 20th day of the second month following the month of production.[16] Failure to timely pay the tax results in the same penalties as failing to timely pay the oil severance tax, as discussed in subpart (a) above.[17]

Similar to the liability for payment of the oil severance tax, while the producer is primarily liable for the payment of the gas severance tax, the first purchaser and subsequent purchasers may also be held responsible for the tax payment.[18] Further, the gas severance tax must also be borne ratably by all parties with ownership interests in the produced gas, including royalty interests.[19] However, unlike the oil severance tax, the first purchaser will not be responsible for paying the gas severance tax when the first purchaser takes delivery off the premises on which the gas is produced. Rather, the producer must report and pay the natural gas severance tax.[20]

II. Policy: *Why does Texas have a Severance Tax, and What are its Revenues Used For?*

Currently, state revenues from oil and gas severance taxes are directly allocated to three different state funds with the following general percentages: 37.5% to the Economic Stabilization Fund (also called the "Rainy Day Fund"); 37.5% to the State Highway Fund; and 25% to the Foundation School Program.[21] Primarily funded by severance taxes, the Economic Stabilization Fund is the state's emergency and one-time-use fund—often used for disaster relief.[22] The State Highway Fund is used for highway construction and maintenance, while the Foundation School Program is a general expense fund for Texas primary and secondary schools.[23] Therefore, levels of oil and gas production taxes are important revenue streams for the State of Texas that are directly tied to funding several state funds.

In fiscal year 2022, Texas collected the most oil and gas severance taxes in its history, with $10.83 billion in

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[8] Sheppard v. Stanolind Oil & Gas Co., 125 S.W.2d 643, 648 (Tex. Civ. App.—Austin 1939), writ refused.
[9] Tex. Tax Code § 202.156.
[10] *Sheppard*, 125 S.W.2d at 648 (holding that the owner of an oil bonus is also subject to the tax).
[11] Tex. Tax Code §§ 201.051, 201.052.
[12] *Id.* at § 201.001(4).
[13] *Id.* at § 201.054(a)–(b).
[14] *Id.* at § 201.055(a)–(b). "Condensate" is statutorily defined as "liquid hydrocarbon that is or can be recovered from gas by a separator, but does not include liquid hydrocarbon recovered from gas by refrigeration or absorption and separated by a fractionating process." *Id.* at § 201.001(2).
[15] *Id.* at § 201.001(6) (quoting from the definition of "Production").
[16] *Id.* at § 201.201.
[17] *Id.* at § 201.351(a); *see supra* note 6 (discussing the penalties for untimely oil severance tax payments).
[18] *Id.* at § 201.251(a).
[19] *Id.* at § 201.205.
[20] *Id.* at §§ 201.251(b), 201.2041.
[21] Tex. Const. art. III, § 49-g(c), (c-1), (c-2); Alex Samuels, *Hey, Texplainer: How does Texas' budget use taxes from oil and natural gas production?*, TEX. TRIBUNE (Jan. 5, 2018), https://www.texastribune.org/2018/01/05/hey-texplainer-how-does-texas-budget-use-taxes-oil-and-natural-gas-pro/.
[22] Samuels, *supra* note 21.
[23] *Id.*

total revenues: $6.36 billion from the oil production tax and $4.47 billion from the gas production tax.[24] This total amount equaled more than double fiscal year 2021's total severance tax revenues and comprised over 13% of the state's total tax revenues for 2022.[25] As a result of this substantial increase in severance tax revenues, there were a number of proposals before the Texas Legislature in its 2023 session addressing severance tax exemptions and revenue allocations.

For example, a House joint resolution, adopted by the House but that failed to pass the Senate, proposed an amendment to the Texas Constitution that would have changed how oil and gas severance tax revenues were allocated by establishing a new "Texas severance tax revenue and oil and natural gas ('Texas STRONG') defense fund."[26] The proposed resolution would have allocated 10% of oil and gas severance tax revenues to the Texas STRONG fund with a $500 million annual cap on funding.[27] Additionally, 1% of revenues would have been given to the oil and gas regulation and cleanup account and another 1% to the Texas emissions reduction plan fund.[28] The purpose of the Texas STRONG fund was to provide funding to "areas of the state that are significantly affected by oil and gas production" for funding state agencies, education grants, health and safety educational opportunities, and workforce preparedness needs.[29] Though adopted by the House, this proposal did not make its way out of the Texas Senate Finance Committee by the end of the 88th Legislative Session.

III. New Legislation: *Changes to the Oil and Gas Severance Tax in 2023*

The primary focus of proposed legislation relating to the oil and gas severance tax in the 88th Texas Legislative Session in 2023 was the creation of incentives to reduce gas flaring. Other House and Senate bills pertaining to restimulation wells, orphaned wells, and high-cost gas wells were proposed but ultimately did not make it out of committee in the House or Senate.

A variety of proposals relating to gas flaring mitigation were considered in the House and Senate with different approaches to reducing gas flaring contained in each. Under current law, flared gas is completely exempt from the severance tax, but the Texas Legislature considered several approaches to alter the current law. For instance, HB 228 proposed a 25% production tax on the market value of any gas produced and flared or vented by a producer, thereby removing flared gas from the items exempted from the oil and gas severance tax.[30] Differently, HB 3321 proposed the creation of a tax credit for gas and sour gas flare mitigation ($1 per million BTU of gas flare mitigation and $2 per million BTU of sour gas flare mitigation).[31] Both bills took different approaches to reducing flaring, with HB 228 providing a negative incentive to reduce flaring by imposing a tax (and removing flared gas's exempted status) and HB 3321 providing a positive incentive to reduce flaring by offering a tax credit for mitigation of gas flared.

However, neither bill received much traction in the House—and neither made it out of committee. Instead, the Texas House passed, and the Senate later approved, HB 591, which provides a much more modest approach to gas flaring mitigation than HB 228 or HB 3321. While HB 228 and HB 3321 contained incentives pertaining to all types of gas flaring, the adopted HB 591 provides a new severance tax exemption that applies *only* on gas produced and consumed on site but would have otherwise been lawfully vented or flared—and only from certain qualifying wells.[32] Particularly, HB 591, as adopted by the House and amended by the Senate, provides that

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[24] *Texas Comptroller Glenn Hegar Announces Revenue for Fiscal 2022, August State Sales Tax Collections*, TEX. COMPTROLLER OF PUB. ACCOUNTS (Sept. 1, 2022), https://comptroller.texas.gov/about/media-center/news/20220901-texas-comptroller-glenn-hegar-announces-revenue-for-fiscal-2022-august-state-sales-tax-collections-1662060818986.
[25] *Id.*
[26] Tex. H.R.J. 111, 88th Leg., R.S. (2023).
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] Tex. H.B. 228, 88th Leg., R.S. (2023).
[31] Tex. H.B. 3321, 88th Leg., R.S. (2023).
[32] Tex. H.B. 591, 88th Leg., R.S. (2023).

"[g]as produced from a qualifying well that is consumed within 1,000 feet of the qualifying well and would otherwise have been lawfully vented or flared is not subject to [the gas severance tax]."[33] A "qualifying well" under the legislation is one that, generally, does not have access to a pipeline in one of three ways: (1) the well is connected to a pipeline on which takeaway capacity is not expected to meet demand for the well; (2) the well is not connected to a pipeline for technical or commercial reasons, but the well operator has contractually dedicated the well's production to a pipeline operator; or (3) the well is not connected to a pipeline, and the well operator has not contractually dedicated the well to a pipeline operator.[34] Notably, if a well qualifies under the first category, the well must first use all available pipeline takeaway capacity before gas produced from the well may receive the exemption.[35]

To obtain this proposed tax exemption under HB 591, the well operator must apply to the Railroad Commission to receive a certificate and then apply to the Texas Comptroller with the Railroad Commission's certificate in-hand.[36] For the Railroad Commission application, the well operator must attest to certain facts being true based on which of the above three "qualifying well" categories the well fits into.[37] For instance, if a well qualifies under the first category, such that it is a well connected to a pipeline that lacks capacity for the well's demand, then the well operator must, in its application to the Railroad Commission, attest to the fact that pipeline takeaway capacity is not expected to meet demand for gas produced from the well.[38] Apart from these attestations, the well operator and the pipeline operator must jointly submit the application if the well falls into categories one or two, while only the well operator must submit the application if the well falls into category three.[39] Additionally, the application must certify that the Texas Railroad Commission "authorized gas from the well to be flared for at least 30 days during the year preceding the year in which the application is filed."[40] Upon a successful application, the Railroad Commission will issue a certificate with an expiration of one year. HB 591 was signed into law by the Governor on June 2, 2023, and it will become effective on September 1, 2023.

IV. Analysis: *How New Severance Tax Legislation May Affect Producers*

Though a variety of bills affecting the oil and gas severance tax were proposed in the 88th Texas Legislature, the only bill to make it out of the Legislature and be signed by the Governor affecting oil and gas severance taxes is HB 591. Therefore, despite proposals that could have substantially changed severance taxes, oil and gas severance tax law remains relatively unaltered following the 88th Texas Legislative Session.

Nonetheless, oil and gas producers in Texas should keep in mind the new exemption from HB 591 that will exempt produced gas that is used onsite but would have otherwise been vented or flared. Without this exemption, gas used onsite in the past was subject to the gas severance tax, even though such gas could have been flared and, therefore, avoid the tax entirely. Thus, the exemption effectively removes the incentive to flare gas that can be used on-site to avoid paying severance taxes. Once HB 591 becomes law on September 1, 2023, producers will not need to consider the tax implications of using versus flaring on-site gas.

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[33] *Id.*
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*