

**Report to the Legislature of the State of Washington**



**A Study of Existing Legislation Affecting the Oil and Natural Gas Industry in Washington,**

**and**

**Recommendations to Improve the Regulatory, Technical, Environmental, and Financial Framework of the Oil and Gas Industry**

Submitted on behalf of the  
Oil and Gas Advisory Committee  
by the  
Washington State Department of Natural Resources



WASHINGTON STATE DEPARTMENT OF  
**Natural Resources**

Doug Sutherland - Commissioner of Public Lands

Division of Geology and Earth Resources  
Ron Teissere - State Geologist

The Honorable Ken Jacobsen, Chair  
Senate Natural Resources, Ocean and Recreation Committee  
P O Box 40466  
Olympia WA 98504-0466

The Honorable Jeff Morris, Chair  
House Technology, Energy, and Communications Committee  
P O Box 40600  
Olympia WA 98504-0600

The Honorable Brian Sullivan, Chair  
House Natural Resources, Ecology and Parks Committee  
P O Box 40600  
Olympia WA 98504-0600

Dear Senator Jacobsen and Representatives Morris and Sullivan:

In accordance with provisions of the 2006 supplemental operating budget legislation (engrossed substitute Senate bill 6386), this report is respectfully submitted to your respective committees.

The members of the Oil and Gas Workgroup wishes to express its appreciation for this opportunity to inform the legislature regarding policy issues that affect the public safety, environmental protection, resource conservation, and economic development of Washington.

Sincerely,

Ron Teissere  
State Geologist  
State Oil and Gas Supervisor

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## **INTRODUCTION**

The 2006 supplemental operating budget legislation (engrossed substitute Senate bill 6386) included a proviso directing the Department of Natural Resources (Department) to establish a work group to study existing legislation affecting the oil and natural gas industry in Chapter 78.52 RCW and Chapter 80.40 RCW, and to make recommendations to that legal framework to improve the regulatory, technical, environmental, and financial framework of the oil and gas industry. The Department was directed to submit its recommendations to the Legislature by December 30, 2006.

The Geology and Earth Resources Division of the Department was charged with forming the committee. Invitations to participate were extended to private companies active in exploration and development in Washington, environmental organizations, nonprofit associations representing landowners, large corporate landowners, the Department's state land managers, and other state agencies with jurisdiction. The target was to have approximately 20 active members who had the time and energy to fully participate in this time-sensitive process. Appendix A lists those who actively participated and those who chose to track the process, but did not actively participate in the committee deliberations.

All of the committee meetings were led by a professional facilitator. This step ensured participation by all members of the committee, and established a clear process for agreement or disagreement on issues. Meetings have been held monthly since July, 2006. All meetings were recorded, and minutes and meeting summaries were distributed after each meeting to those listed in Appendix A.

## **COMMITTEE DELIBERATIONS**

After a wide- ranging discussion, the committee voted to address the following issues, in priority order:

1. Lack of Funding for the Regulatory Program
2. Consistency of Royalties for State and Private Mineral Rights
3. Lack of a State Severance Tax on Minerals
4. Lack of Program for Collection of Drilling Data and Data Preservation
5. Uncertainty of the Process for Pooling Decisions
6. Lack of Spacing Guidance for Exploration Wells
7. Lack of Gas Storage Regulation
8. Lack of Coal Bed Methane Regulation
9. Unnecessary Production Regulation
10. Existence of Obsolete Oil and Gas Conservation Commission Statutory Language

### **Issue 1. Lack of Funding for the Regulatory Program**

#### Background

The regulation of oil and gas drilling and seismic surveys in Washington has no funding and, consequently, no staff, making the oversight of oil and gas activity limited at best. A low level

of activity, usually no more than one or two drilling applications per year and nor more than one or two wells actively being drilled at one time, disguised this problem for several years. Renewed exploration and drilling activity over the past year has stressed the program to the point where proper implementation of the regulations is no longer possible. Currently, 14 applications for drilling permits are being processed, with at least 5 more expected before the end of the fiscal year. Three wells are actively drilling, and another 5 to ten are expected to be drilled or drilling before the end of the fiscal year. The program's activities have traditionally been funded by the state General Fund because the activity has never been sufficient to generate the revenues from fees necessary for the program; this remains true today.

### Discussion

The committee considered a number of possible actions. In the short run, the options include a budget request for state General Fund money and additional authority to extend cost-reimbursement options to post-permitting activities. Current cost-reimbursement language allows recovery of costs for permitting activity, but does not extend to the decisions on development units (well spacing) and pooling agreements that will be necessary for the evaluation and development of any discovery. The regulatory decisions related to development will be the most expensive of the decisions that are necessary during exploration and production. Other options considered by the committee included adopting a permitting fee structure to fund the program, imposing impact fees on these drilling and seismic survey activities, and including language in any severance tax proposal that would earmark a portion of the severance tax revenue for the regulatory program. The committee also considered it important to have a plan for baseline funding to provide some regulatory oversight during low levels of industry activity with options to increase funding quickly to respond to short-term increases of activity. Lastly, the committee recommended the development of a communications strategy to encourage broad support for program funding.

### Recommendations

The final recommendations of the committee were to focus first on expanding and extending the cost-reimbursement language in statute to cover all of the regulatory activities from exploration through production, and to request funding from the state general fund for one permanent FTE in the Division of Geology and Earth Resources to manage cost reimbursement contracts, issue SEPA determinations, oversee the preparation of SEPA documents, and conduct permit compliance activities for active projects.

## **Issue 2. Consistency of Royalties for State and Private Mineral Rights Royalties**

### Background

The concern with royalties arose out of the proposal in the 2006 legislative session for changes to the statutory language governing royalties in state leases. Currently, RCW 79.14.070 requires a production royalty of no less than 12.5 percent. The Board of Natural Resources could set higher royalties by rule. The concern was that the proposed legislation would result in a substantial differential between the royalties required by state leases and the royalties typical of leases with private parties. The committee believes that significant variations in royalty rates would

discourage exploration and development in some areas. The committee also strongly believes that state-land leases should not be mandated to have royalties significantly above or below market rates.

### Discussion

The committee considered a number of actions. The committee believes the state should have the ability to negotiate royalty rates based on market conditions for mineral leases. The committee also believes that the Legislature needs more information on royalty rates including the impact of differential rates on the market, comparisons with other states and industries, potential impacts to gas production in Washington in the marketplace, and the problems of managing differential rates within pooling agreements.

### Recommendations

The committee recommends that no statutory changes be made to the royalty rate structure for state lands and that the Department focus on educating the Legislature on royalty rates and their impact.

## **Issue 3. Lack of a State Severance Tax on Minerals**

### Background

The committee heard a presentation from Jim Thomas of the Department of Revenue regarding mineral taxation in Washington. The summary of his presentation is in Appendix B. Subsequent discussions by the committee focused on the severance tax rate, the distribution of severance tax proceeds, the point in production where the severance tax is imposed, the calculation of the tax, the problems of overcomplicating the process, the uncertainties regarding the tax in Washington and their effect on exploration and development, and the effect of a poor tax policy on sales of gas from Washington in the marketplace.

### Discussion

The committee discussed a number of possible actions. These included setting a fixed tax rate to provide certainty and to encourage exploration in Washington, defining the calculation of the rate so that it is easy to understand, identifying appropriate expectations with regard to imposing the tax and distributing the proceeds, and the possibility of phasing in the tax sometime after production from a particular well or pool begins.

### Recommendations

The specific recommendations of the committee included legislative action on the severance tax in the 2007 legislative session, a tax rate that is fixed but not higher than 6 percent, the exclusion of state and local ad valorem taxes on hydrocarbons, the split of severance tax proceeds among state and local jurisdictions, the imposition of the tax at the point of production, and a phase-in period for new wells.

## **Issue 4. Lack of Program for Collection of Drilling Data and Data Preservation**

### Background

As the title of this issue suggests, there are two separate concerns. The first concern is what data is to be submitted to the agency after a well has been drilled. The second issue is the preservation of that data, the form of preservation, how the data is to be made available to interested parties, and when the data should be made available to the public.

### Discussion

Currently, the Department requires the operator to submit samples of the well cutting, portions of core taken in the well, copies of geophysical logs, and copies of the daily drilling reports and mud logs. All of this data must be submitted to the agency at the conclusion of drilling and can be kept confidential by the agency for a period of one year from the date of filing at the request of the operator. While the current system seems straightforward, the lack of funding for the program compromises the Department's ability to properly collect, catalog, store, and distribute this information. The lack of funds for handling data that the Department already holds and is currently collecting was the initial focus of the committee's concerns. The discussion included the fact that other earth science data being collected in the state would benefit from a comprehensive data collection, storage, and distribution system. The committee also discussed all of the types of data that might be collected in the course of drilling an oil or gas well. The Department has not consistently collected the full spectrum of data discussed by the committee. State's like Kentucky, Ohio, New Mexico, and Utah, among others, have dedicated facilities, staff, and information technology systems to collect, capture, store, retrieve, and distribute a wide variety of geological and geophysical data. Physical samples can be examined at these facilities, and even checked out for more detailed examination in some cases. Most information is now collected as digital records, and paper information is converted to interactive digital information. This information makes a real contribution to the economic development of these states.

### Recommendations

The committee recommended that the Department develop a collection and preservation system for data from oil and gas exploration and production activities with funding from the state general fund and/or fees from data storage and retrieval, and that the Department maintain confidentiality of data from exploration wells for two years from the date of well completion.

## **Issue 5. Uncertainty of the Process for Pooling Decisions and Lack of Spacing Guidance for Exploration Wells**

### Background

Spacing is determined by development unit size. A ‘development unit’ is defined in statute as the maximum area of a pool which may be drained efficiently and economically by one well, where a ‘pool’ is an underground reservoir containing a common accumulation of oil or gas, or both. The term ‘pooling’ means the integration or combination of two or more tracts into an area sufficient to constitute a development unit as prescribed by the Department. The non-consent penalties apply to those mineral interest owners who refuse to join applicable pooling agreements where their share of costs would be covered by the sale of production from the pooled interests.

### Discussion

The current statute and rules adequately address development wells; the initial concern of the committee was driven by the lack of statutory spacing rules for exploratory wells. As these issues were discussed, the committee noted that decisions on pooling and spacing should be a public process, that the process for making these decisions should be fair and scientifically based, and that existing non-consent penalties are not sufficiently punitive. The committee also noted that wells drilled for coal bed methane and for gas storage should be treated differently from convention oil and natural gas wells.

### Recommendations

The committee recommended that spacing rules for exploration wells be established at 640 acres for natural gas wells (excluding coal bed methane and gas storage wells) and 160 acres for oil wells. The committee also recommended that the non-consent penalties for wells deeper than 8,000 feet be increased to 150 percent for surface facilities and 300 percent for drilling operations.

## **Issue 6. Lack of Gas Storage Regulation**

### Background

Chapter 80.40 RCW speaks to gas storage with regard to the use of eminent domain. However, the current statutes and administrative rules do not address the regulation of gas storage, nor does the current statute address the operational differences between the production of in-situ gas and storage gas.

### Discussion

Part of the committee’s discussion was the possible use of administrative rules to deal with gas storage operations. The drilling of the wells is within the existing framework. It is primarily the completion and operation of these wells that sets them apart from conventional wells. The administrative rule-making process allows for more detailed discussion of solutions by all of the stakeholders while remaining focused on the issue at hand. This process would not open the

overall statutory framework for possible revision. Other issues, such as liability for leaking natural gas and the protection of the facility from encroachment by incompatible development might have to be addressed in statute.

### Recommendations

The committee recommended that the regulation of gas storage be addressed by administrative rule rather than legislation to the extent possible. They also recommended that the Oil and Gas Conservation Act be amended to the extent that such changes are required to accomplish a regulation of gas storage.

## **Issue 7. Lack of Coal Bed Methane Regulation**

### Background

The current statutes and administrative rules do not address coal bed methane. The nature of coal bed methane drilling and production is in conflict to some extent with the methods and procedures used to drill for conventional natural gas.

### Discussion

The committee again discussed the merits of using administrative rules to address the special needs of coal bed methane exploration and development. The reason for this preference is the opportunity to discuss these technical issues in detail without opening the broader regulatory framework for discussion.

### Recommendations

The committee again recommended that the regulation of coal bed methane, to the extent it is necessary to distinguish it from exploration and development of conventional natural gas, be regulated by administrative rule rather than legislation. The committee again recommended that the Oil and Gas Conservation Act only be amended to the minimal extent necessary to include coal bed methane within the state's regulatory framework.

## **Issue 8. Unnecessary Production Regulation**

### Background

Statutory and administrative rule language currently provides for the regulation of production from wells drilled in Washington.

### Discussion

Such regulation is a significant administrative burden for which there is no current staff or funding. As long as development units and pooling agreements are based upon the fair application of good science and engineering, state regulation of production is not necessary to protect individual rights. The development of adequate science and engineering must be done by highly qualified and experienced people, and the operators cannot be the sole source of the

analysis. Most of the existing language is a holdover from the now-defunct Oil and Gas Conservation Commission (see Issue 9, below). The public hearing process outlined in existing law and rule does not assure that adequate science and engineering are being considered since the Commission never had qualified state staff support or the funds to contract with qualified people for the required analyses.

### Recommendations

The committee recommends that language relating to the regulation of production be stricken from the statute and from the rules, and that the Department use appropriate process to make development unit and pooling decisions funded by cost reimbursement or by the state general fund.

## **Issue 9. Existence of Obsolete Oil and Gas Conservation Commission Statutory Language**

### Background

The statutes and administrative rules contain extensive language related to the existence of the Oil and Gas Conservation Commission. This commission was eliminated by the Legislature in the early 1990s.

### Discussion

The current lack of production in the state and the limited production likely to come online in the state in the foreseeable future suggests that there is no need to reestablish the Oil and Gas Conservation Commission.

### Recommendations

The committee recommended that language related to the Oil and Gas Conservation Commission and its conduct of business be removed from the statute and the administrative rules. The committee also recommended that a revised public process be developed to ensure that fair and scientifically based decisions are made regarding development units and pooling orders.

**APPENDIX A**

**Oil and Gas Work Group Roster**

*The representatives of the organizations listed in Section 1 are the active members of the work group, unless otherwise indicated. The names listed in Section 2 are those who wished to be kept informed, but were not work group members. [are the members in any particular order? if not, perhaps order alphabetically by organization name?]*

<b>SECTION 1</b>	
Washington State Dept of Natural Resources PO Box 47007 Olympia, WA 98504-7007	Ron Teissere
Sierra Club Cascade Chapter Office 180 Nickerson St Suite 202 Seattle, WA 98109-1631	Craig Engleking <i>Inactive</i>
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Washington Farm Bureau PO Box 2009 Olympia, WA 98507-2009	John Stuhlmiller
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Audubon Washington PO Box 462 Olympia, WA 98507	Heath Packard
EnCana Oil & Gas Inc 370 17 <sup>th</sup> Street Suite 1700 Denver, CO 80202	Pam Roth
Puget Sound Energy 239 Zandecki Rd Chehalis, WA 98532	Mark Anders

Methane Energy Corp 4100 194 <sup>th</sup> St SW Suite 110 Glenwood, WA 98036	Steve Pappajohn
Washington State Dept of Natural Resources PO Box 47007 Olympia, WA 98504-7007	Jed Herman
Washington State Dept of Ecology PO Box 47775 Olympia, WA 98504-7775	Rod Thompson
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**SECTION 2 [UNUSUAL TO HAVE THE  
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## APPENDIX B

### A Brief History of the Consideration or Discussion of Severance Taxes in Washington State

APPROXIMATE YEAR	SUBJECT OR ACTION	ACTION TAKEN	NOTES
1930	State citizens approve amendment to state Constitution to provide "That the legislature may tax mines and mineral resources and lands devoted to reforestation by either a yield tax or an ad valorem tax at such rate it may fix, or by both."	Amendment to Article VII of state Constitution	The effect of the amendment was to provide the Legislature with another way to tax mineral lands in addition to the property (ad valorem) tax
1970s	Severance tax on uranium and thorium production	Tax levied on primarily uranium production in Washington. Tax paid to Department of Social and Health Services Radiation Control Program (Now state Department of Health)	Purpose was to provide funds for stabilization of mine and processing tailings piles to prevent windborne dust from creating downwind health hazards. Tax now reported as inactive
1983, 1984, 1986	Discussion of severance taxes on mineral ores, draft bills (not considered by Legislature) and several introduced bills	Introduced bills never seriously considered by Legislature. Much behind-the-scenes discussion	Interest in severance tax possibly triggered by gold mining in Wenatchee area
1988	Draft severance tax bill on petroleum and gas production	Bill drafted, but not introduced	Purpose of the bill was to forestall offshore oil and gas development. Although drilling might have occurred beyond territorial waters, any crude oil or gas would have been taxed on value per measure

APPROXIMATE YEAR	SUBJECT OR ACTION	ACTION TAKEN	NOTES
			on receipt at on-shore facilities
1989/1990	Legislative study of options to replace property taxes on mines and minerals with some sort of severance tax	Study completed and presented. No action taken by Legislature. Report discussed either specialists valuing mines and minerals for property tax purposes or that the state turn to a severance tax	Purpose of study recognized the difficulty of county assessors in valuing the minerals in the ground. Industrial machinery and buildings are somewhat easier to value than a substance that is a curious mineral one month and marketable ore the next
2006	HB 3084 Called for study of programs (including taxation) to regulate oil/gas industry in Washington	Bill was actively worked in Legislature, but did not pass	Study results may have provided springboard for further legislative actions
2006	HB 3193 Provided for royalties on oil/gas leases in state	Bill did not pass	Would not have comprehensively taxed oil/gas production in Washington
2006	SB 6748 Severance tax on oil/gas produced in Washington	Bill did not pass	Would have comprehensively taxed oil/gas production in Washington

## **Taxes Affecting Mineral, Oil, and Gas Extraction**

The following is a general discussion about how those taxes administered by the Department of Revenue apply to persons extracting oil and other natural resources. It is for use as a general guide only.

Industries extracting natural resources often have unique and complicated business relationships that may involve different liabilities depending upon a unique set of facts and circumstances. Persons having questions about the tax implications of their business activities should seek specific guidance from the Department of Revenue.

### What taxes are administered by the Department of Revenue?

The Department administers the business and occupation (B&O) tax, public utility tax, retail sales and use tax, real estate excise tax, leasehold excise tax, and other miscellaneous taxes. The Department also has oversight of the property tax (both real and personal), which is administered by the counties.

All persons doing business in the state of Washington are subject to the B&O tax, unless a specific exemption exists in law. The tax is imposed on the gross proceeds of the business, gross proceeds of sale, or value proceeding or accruing, as the case may be. There are no deductions for the costs of doing business, unless a specific exemption exists in law. The tax rate is determined by the classification of the business activity performed. It is possible for a person to conduct multiple business activities in the state and, similarly, be subject to multiple reporting classifications.

The state public utility tax applies to business providing public utility services or transportation services in this state. One category of business activity subject to the public utility tax is gas distribution.

The retail sales tax is imposed on those transactions that are within the definition of a retail sale. For the most part, this includes sales of tangible personal property and performing retail services for consumers. The tax is imposed on the buyer; however, the seller is responsible for collecting and remitting the tax. Use tax applies when goods and retail services are purchased without payment of the retail sales tax. Retail services, such as repairs to tangible personal property and real estate improvements performed in this state, are subject to the use tax when the retail sales tax was not paid. The person using goods or services upon which sales tax has not been paid is responsible for remitting the use tax to the state. Retail sales and use tax rates are the same and range from 7.0 to 8.9 percent.

The real estate excise tax is imposed on sales of real property, including an interest in real property for consideration. The tax is imposed on the seller, however, the buyer may be held responsible (or a lien may be placed on the property) if the seller fails to pay the tax. The most common rate for the combined state and local real estate excise tax is 1.53 percent. State and local governments charge a leasehold excise tax in lieu of property taxes on real property leased from federal, state, or local government agencies.

## B&O Tax and Extracting Activities

An extractor is a person who, "from the person's own land or from the land of another under a right or license granted by lease or contract, either directly or by contracting with others for the necessary labor or mechanical services, for sale or for commercial or industrial use mines, quarries, takes or produces coal, oil, natural gas, ore, stone, sand, gravel, clay, mineral, or other natural resource product." WAC 458-20-135. A person who provides the necessary labor or mechanical services under contract with others to perform the same activities is an extractor for hire.

The taking or mining of oil or natural gas is an extracting activity. A person who extracts oil or natural gas is subject to the extracting B&O tax. A person who extracts for hire is subject to the extracting for hire classification as measured by the amount received for the extracting activities. The tax is 0.484 percent

Other businesses may incur state B&O tax liability depending upon specific facts, the nature of their business activities, and their commercial relationships with other companies or persons in Washington.

A person that performs testing for the extractor is taxable under the services and other activities B&O tax classification. If the person performing testing hires a third party to drill and/or install well casing, that is a retail activity.

## Public Utility Tax

Washington imposes a state public utility tax in the place of the state business and occupation tax on certain business activities that are defined as public utilities in state tax law. One of the activities, labeled "gas distribution business", is defined as operating a plant or system for the production or distribution for hire or sale of natural or manufactured gas. Depending upon the circumstances involved in the activity of pumping and delivery of natural gas, it is possible that such activity might be subject to the state public utility tax.

## Retail Sales and Use Tax

In Washington a person or a business is a consumer of all tangible personal property used or consumed in the course of business. The same generally is true for the purchase of services defined as a retail sale. As a consumer, an extractor (and extractor for hire) will owe retail sales tax on its purchases of retail goods or services (except extracting for hire). Tangible personal property that is acquired without payment of this state's retail sale tax is subject to the use tax.

## Real Estate Excise Tax

Depending on the terms of sale, lease, or lease with an option to buy, or other transfer of interest in real property, a person who sells real property may be subject to the real estate excise tax. As previously noted, the tax is imposed on the seller; however, the buyer is liable when the seller does not pay the tax.

The Department's administrative rules WAC 458-61A-111 and 112 provide information about the tax. However, in the case of mining and exploration, imposition of the tax turns on the specific set of facts.

### Leasehold Excise Tax

Lands leased from federal, state, or local governments are generally subject to state and local leasehold excise taxes. These taxes are levied in place of property taxes because property taxes are not levied on publicly owned lands. The combined state and local tax rate ranges from 13 to 19 percent of the value of the lease.

The tax is applied to a "leasehold interest" or the "rights of use or occupancy by others of property which is owned in fee or held in trust by a public corporation, commission, or authority...." However, the term "leasehold interest" shall not include road or utility easements; rights of access, occupancy, or use granted solely for the purpose of removing materials or products purchased from a public owner or the lessee of a public owner; or rights of access, occupancy, or use granted solely for the purpose of natural energy resource exploration. Products are further described in the leasehold excise tax statutes to include "natural resource products such as cut or picked evergreen foliage, Cascara bark, wild edible mushrooms, native ornamental trees and shrubs, ore and minerals, natural gas, geothermal water and steam, and forage removed through the grazing of livestock."