



Kansas Independent Oil & Gas Association
800 SW Jackson Street - Suite 1400
Topeka, Kansas 66612-1216
785-232-7772 FAX 785-232-0917
www.kioga.org

Testimony to Kansas House Tax Committee

House Bill 2264

An Act concerning property taxation; relating to valuation and taxation of certain oil and gas equipment and materials

Edward P. Cross, President
Kansas Independent Oil & Gas Association

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Good afternoon Chairman Kleeb, Vice Chairman Suellentrop, Ranking Minority Member Sawyer and members of the committee. I am Edward Cross, President of the Kansas Independent Oil & Gas Association (KIOGA). KIOGA represents thousands of independent oil and natural gas explorers and producers, as well as allied service and supply companies. Our members account for 86% of the oil and 63% of the natural gas produced in Kansas. With over 4,200 members across the entire state, KIOGA is the lead state and national advocate for the Kansas independent oil and natural gas industry. I am responsible for public policy advocacy and interaction with external stakeholders including elected officials, regulators, governmental decision-makers, and community leaders. I am here this afternoon to offer a neutral discussion of HB 2264.

This committee is considering legislation (HB 2264) to reclassify well service rigs, drilling rigs, etc. as commercial and industrial equipment. HB 2264 would classify certain equipment and material used in operating oil and gas wells and certain equipment and material temporarily used at an oil and gas well site as personal property and assess property taxes as commercial machinery and equipment.

Legislation was passed in 2006 that created a law that provides a property tax exemption for commercial and industrial (C&I) machinery and equipment purchased or leased after June 30, 2006. The exemption does not apply to oil and gas leases including prescribed

personal equipment and oil and gas itemized personal property such as drilling equipment, rigs, pipe, casing, etc. These statutes are found in K.S.A. 79-223.

Moving well servicing rigs, drilling rigs, etc. from itemized personal property to C&I calls for careful evaluation. Currently, all oil and gas property, including drilling rigs and service rigs, are taxed as Schedule 2 property. C&I property (Schedule 5 property) acquired after June 30, 2006 has been exempt from property taxation by an act of the 2006 legislature. In 2009, a drilling contractor in eastern Kansas challenged the classification of rigs as Schedule 2 property arguing that his rigs were also used for non-oil and gas related activities as he also drilled water wells. The Board of Tax Appeals upheld the Kansas Department of Revenue finding that his rigs were Schedule 2 property.

Schedule 2 property is assessed at market value based on a guide issued by the Kansas Department of Revenue Division of Property Valuation. Market value is adjusted based upon current industry and market conditions. Schedule 5 property is assessed based on original cost, less a depreciation allowance.

Arriving at the cost of a drilling rig can be an accounting challenge. While a rig is assessed as one item, in fact it consists of many items which are usually purchased at different times. A drilling rig consists of a rig floor, mast, draw works, several engines, electrical generator, fuel storage facilities, several mud pumps, drill collars, drill pipe, and several trailer-like units to house equipment and personnel. Some of this equipment may have been acquired before July 1, 2006 and some of it afterwards, but all is accounted for as one unit. In addition, as the equipment is replaced in the normal course of business, some companies capitalize the replacement items while others expense these items. The result is two rigs, which are functionally identical, may have capitalized costs that vary by a factor of two or more. These same issues also apply to well service units.

When taxed as Schedule 2 property, there is a general uniformity to taxing similar property due to the market value factor given in the Division of Property Valuation Guide. If this property is taxed as Schedule 5 property, some rigs would be exempt while others would be taxable at widely varying values depending on the rigs particular facts. Some companies would come out as winners under this proposal and others as losers.

Some companies may be supportive of a measure that would allow them to take advantage of C&I tax exemption. The oil and gas industry worked to keep rigs classified as itemized equipment in the late 1980s. The reason was the fear of oil price volatility that resulted in stacked equipment. Keeping the equipment classified as Schedule 2 itemized personal property meant that stacked equipment would be assessed on market value, not salvage value and industry at the time felt they were better served by that classification. Re-classifying rigs as Schedule 5 C&I property would mean rigs purchased or leased after June 30,

2006 would be exempt from property tax. Rigs purchased or leased prior to July 1, 2006 would not be exempt and would be assessed on salvage value (retail cost less a depreciation allowance). Re-classifying rigs as Schedule 5 C&I property may help companies with newer rigs, but may not be so helpful to companies with rigs purchased before July 1, 2006. While tax assessments on rigs purchased before July 1, 2006 may decrease, rigs purchased after July 1, 2006 would be tax exempt. Companies operating older rigs (and there are many in Kansas) may see this as an unfair advantage created by tax policy favoring companies capable of purchasing new equipment.

Finally, re-classifying rigs as Schedule 5 C&I property could shift property tax burden in some counties to other classes of property which concerns some oil and gas producers.

HB 2264 was introduced at the request of the Kansas Association of Well Service Contractors. It was first introduced in 2014, but did not move forward. It was re-introduced in 2015. The bill was carried over to this year's session (2016). KIOGA has been neutral on the issue during the 2014 and 2015 sessions and is neutral again in 2016 as industry is split on whether such a policy change is beneficial. Under HB 2264, some companies come out as winners while others come out as losers.

I encourage this committee to carefully review the idea of re-classification of certain oil and gas equipment and materials to consider the advantages as well as the risks and consequences.

I appreciate the opportunity to provide these comments. Thank you for your time and consideration. I stand for questions.