EQC STUDY SUBCOMMITTE
MEETING DATE: 3/16/06
EXHIBIT 16

SENATE BILL 495 REVISITED

A Report Prepared for the
Legislative Finance Committee

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February 28, 2006

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PURPOSE

This report is presented to the legislature to:

1) Inform new legislators (those elected subsequent to the 2001 legislative session) about SB 495 (enacted by the 2001 Legislature) and the substantial financial impacts it has;
2) Present a new analysis showing the SB 495 plan may end in fiscal 2013 rather than 2031;
3) Provide a heads up to a large general fund budget increase in about 3 biennia; and
4) Offer an opportunity for the legislature to be involved in how the SB 495 plan will play out.

INTRODUCTION

Minerals on common school trust lands are considered part of the corpus of the common school trust. When the minerals are extracted, the mineral royalties, net of amounts to fund Department of Natural Resources and Conservation (DNRC) administration, are deposited to the common school trust as part of the monetary corpus. Earnings from the monetary corpus are distributed 95 percent to public schools and 5 percent to the school trust. However, Senate Bill 495, enacted by the 2001 legislature, resulted in the sale of $138.9 million in net mineral royalties from the common school trust over 30 years to DNRC for a price of $46.4 million. To make this purchase, the department secured a $46.4 million loan from the coal severance tax trust fund. The remaining royalties, after amounts to fund DNRC administration and pay debt service on the loan, are distributed to the guarantee account to be used for public schools. Estimates after enactment of the legislation determined that the total $138.9 million of net royalties would be distributed over a 30-year period, after which the royalties would again be deposited in the common school trust and become part of the corpus.

Montana Constitution, Article X, Section 3.

Public school fund inviolate. The public school fund shall forever remain inviolate, guaranteed by the state against loss or diversion.

In late 2001 and early 2002, the Legislative Fiscal Division analyzed the fiscal impacts of the legislation and produced a two-part report: "Senate Bill 495 – Implementation, Impacts and Implications". The report concluded that at the end of the 30-year period, the common school trust balance would be $94.7 million less under Senate Bill 495 than it would have been. It also concluded that schools would receive additional money until 2012, after which schools would begin to receive less. By the end of the 30-year period, schools would have received $13.5 million less under Senate Bill 495.

DNRC staff have updated applicable assumptions and conclude that the plan could terminate in fiscal 2013, 18 years sooner than the projected 30 years. The new data offer an opportunity for new analysis.

MINERAL ROYALTIES

The oil and natural gas industry in the state has been undergoing major changes. Improved techniques have allowed new fields to be developed and old fields to be more productive. Recent LFD revenue analysis indicated that Montana oil production is nearing levels unseen since the mid 1980s and natural gas production has reached record levels. Prices for oil and natural gas have reached historical highs. Because mineral royalties are based on the amount and value of production, the state has seen an increase in the amount of mineral royalties received from state lands. A large majority of state-owned mineral rights is owned by the common school trust and this trust has seen an increasing amount of mineral royalties. Because of this unexpected increase in mineral royalties from school trust lands and its effect on the SB 495 plan, DNRC staff has revised the mineral royalty assumptions. DNRC now estimates that the $138.9 million of net mineral royalties will be received over 12 years (by fiscal 2013) rather than 30 years (by fiscal 2031).

"HINDSIGHT IS BETTER THAN FORESIGHT BY A DARN SIGHT"

"Changes in the mineral royalty estimates would cause substantial changes in the sale price." "...the difficulties and uncertainties in estimating the present value... make it an inherently speculative process."

LFD report: Senate Bill 495 – Implementation, Impacts, and Implications

The original calculations by Land Board and Department of Revenue staff to determine the purchase price used these assumptions: 1) a discount rate of 9.81 percent; 2) total mineral royalties of $310.5 million over 30 years, increasing from $3.7 million in fiscal 2002 to $8.5 million in fiscal 2031; and 3) total DNRC administration costs of $171.6 million increasing 3 percent a year from $3.7 million in fiscal 2002 to $8.5 million in 2031. Based on these assumptions, the net present value of a stream of $138.9 million in net mineral royalties over 30 years was $46.4 million. Based on the new DNRC assumptions and the same discount rate, the net present value is $74.8 million. This means that if what is known now was known in 2001, the purchase price would have been $74.8 million, $28.4 million more than the actual price of $46.4 million.

Usually in this type of transaction, the entity (the common school trust) selling an asset (the mineral royalties) keeps the earnings from the sale proceeds (the $46.4 million) because the earnings represent the future value of the asset being sold. This is not, however, the case in this transaction since the Montana Constitution mandates that 95 percent of trust earnings are distributed for public schools (the other 5 percent goes to the trust). In essence, SB 495 changed $92.5 million ($138.9 million less $46.4 million) of trust corpus into distributable revenue.

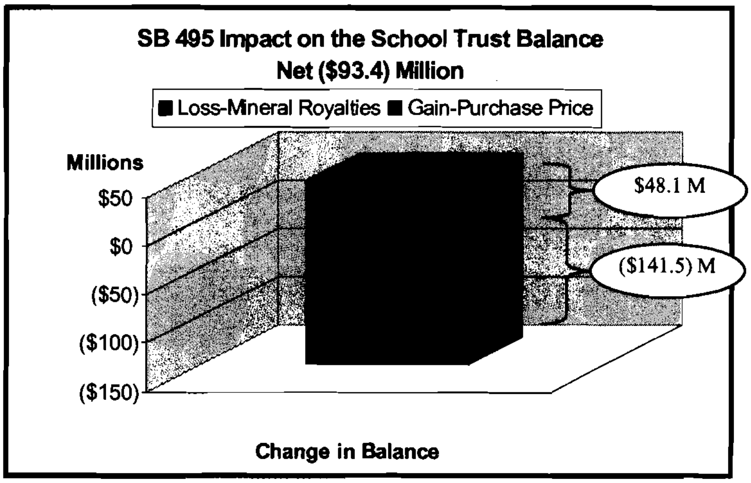
Fiscal 2006 now becomes an interesting point in time. It is during this year that the estimated value of mineral royalties sold from the trust up to that time ($46.5 million) will be about equal to the amount the trust received for the entire $138.9 million of mineral royalties ($46.4 million).

Montana Constitution, Article X, Section 5.

Public school fund revenue. (1) Ninety-five percent of all the interest received on the public school fund and ninety-five percent of all rent received from the leasing of school lands and all other income from the public school fund shall be equitably apportioned annually to public elementary and secondary school districts as provided by law.

TRUST BALANCE

Figure 1



The shortened time frame of the SB 495 plan makes it easier to see the impact on the common school trust balance. At the beginning, the common school trust gained $46.4 million, plus it will gain an additional $1.7 million over 12 years from 5 percent of the earnings that are returned to the trust, for a total of $48.1 million. But, over those 12 years it will also lose $138.9 million in net royalties and, because the trust will not receive 5 percent of the earnings from the $138.9 million, it will lose an additional $2.6 million that would have been returned to the trust, for a total of $141.5 million. Figure 1 shows the net loss to the trust of $93.4 million ($48.1 million less $141.5 million).

ACCELERATED SB 495

The acceleration of the end to the SB 495 plan has one effect that will affect the legislature. Because of the unanticipated large amounts of mineral royalties, the plan can end sooner than anticipated. But this also means that net mineral royalties available for distribution to public schools from the guarantee account are larger than they would have been under the original plan. Under the original plan, the last payment to public schools in 2031 was to be $2.3 million. Under the new plan as calculated by DNRC, the last payment in fiscal 2013 will be $7.1 million (see Scenario 1 below). Because the general fund supplements the guarantee account in funding public schools, the amount of additional general fund the legislature will have to appropriate beginning fiscal 2014 will be substantially more under the new plan than under the original plan. Scenario 2 below offers the legislature a solution to reduce this large and sudden increase in the general fund budget.

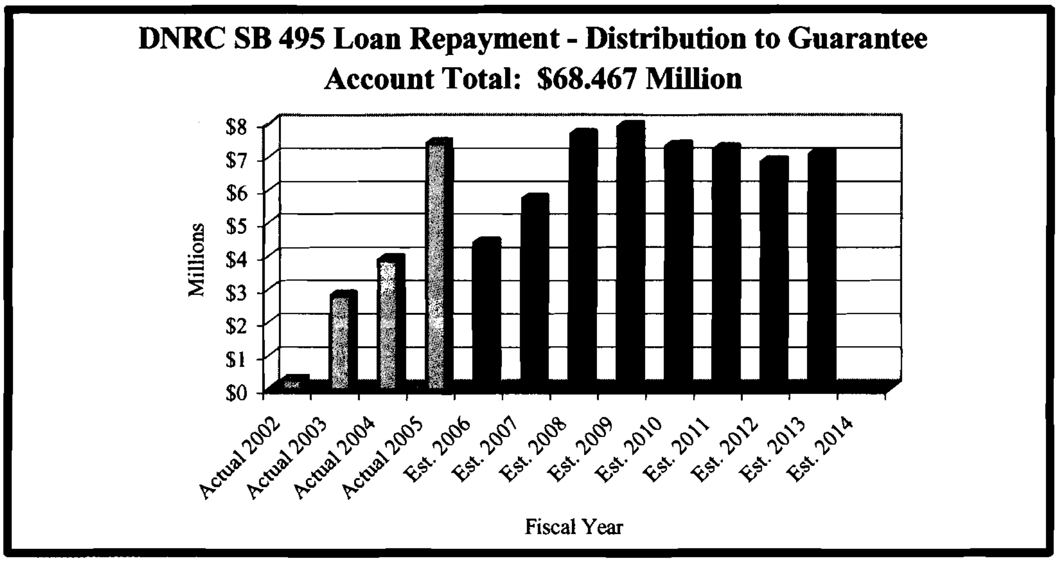
One effect that will not change because of the acceleration to the end of the SB 495 plan is the recovery of the trust fund balance once net mineral royalties are once again deposited in the school trust. The end to the SB 495 plan has both short-term and long-term impacts on the guarantee account and the general fund. In the short-term, the guarantee account will receive less interest earnings from the mineral royalties than the amount of net mineral royalties that had been deposited to the guarantee account. The general fund will pick up the difference. In the long-term, interest earnings from the mineral royalties in the trust will equal and then exceed the amount of net mineral royalties that had been deposited to the guarantee account. The impact of a continuously increasing monetary trust fund balance provides an increasing, reliable source of interest earnings for distribution to public schools to the benefit (savings) of the general fund.

The increase in estimated mineral royalties from common school trust lands provides the opportunity to pay off the loan sooner than anticipated which impacts the amount of money distributed to the guarantee account. The following are three loan repayment scenarios that have different effects on the guarantee account. The legislature has the opportunity to influence the amount and timing of the loan repayments. Although no scenario provides more money for public schools (only the legislature can do this), the source of funding between the guarantee account and the general fund can be changed.

SCENARIO 1

SB 495 sets the minimum percentage of net mineral royalties to be used to repay the loan principal. In its revised calculations, DNRC varies the percentage so that both the last loan payment and the final amount of the $138.9 million in net royalties will occur in the same year, fiscal 2013. Under this scenario, total distributions to the guarantee account would be $68.5 million.

Figure 1

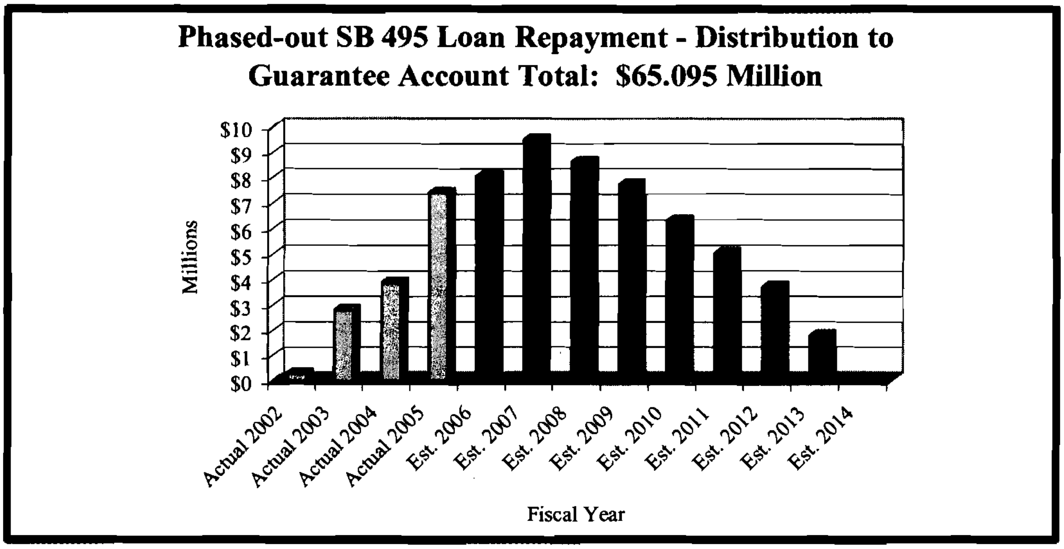


However, since the amount of principal payments can be varied substantially, it is possible to pay off the loan even sooner.

SCENARIO 2

If Scenario 1 above were followed, there would be $7.1 million of mineral royalties distributed to the guarantee account in fiscal 2013. But beginning in fiscal 2014, nothing would be distributed since the SB 495 plan will have ended. Because general fund pays the remaining costs of schools after funding from the guarantee account is exhausted, the general fund budget would have to be increased at least by $7.1 million beginning in fiscal 2014, a substantial one-time increase. If the loan repayment schedule were adjusted beginning fiscal 2006, this impact could be mitigated over the remaining eight years by reducing the amount distributed from the guarantee account by an average of $0.7 million each year. Under one such scenario (see the chart below), the amount distributed to the guarantee account would gradually decrease, thus lessening the general fund budgetary impact in fiscal 2014. The last distribution in fiscal 2013 would be $1.8 million, much less than $7.1 million in Scenario 1 and similar to the $2.3 million under the original plan. The total distribution to the guarantee account would be $65.1 million rather than the $68.5 million in Scenario 1 because of additional interest payments. By requesting DNRC to follow such a scenario, the legislature has an opportunity to influence the amount and timing of the loan repayment to achieve the outcome it desires.

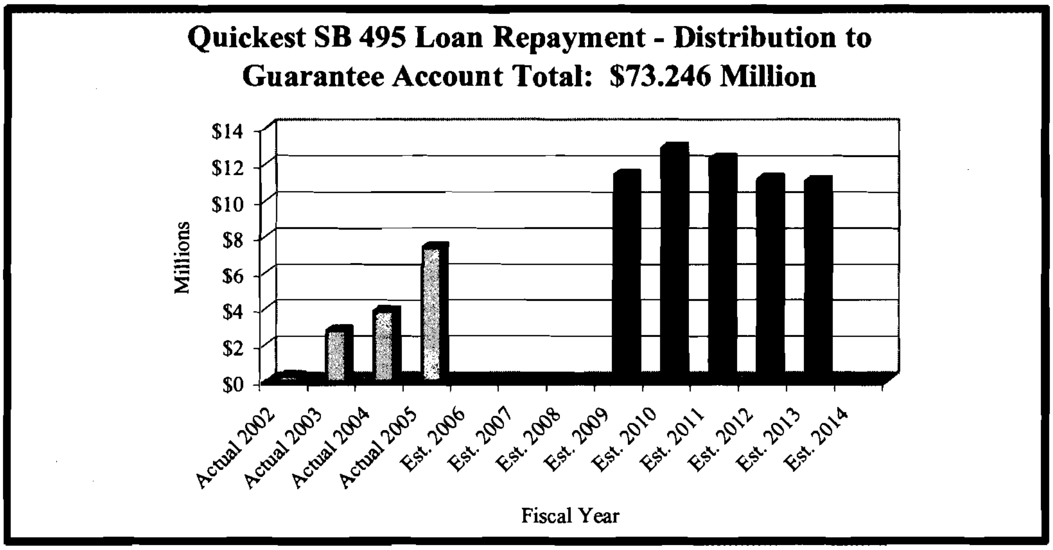
Figure 2



SCENARIO 3

If 100 percent of the net royalties were used to pay debt service on the loan beginning in fiscal 2006, the loan could be repaid by fiscal 2009. Under this scenario, the guarantee account would not receive any money from this source for fiscal years 2006 through 2008 and a lesser amount in fiscal 2009. However, from fiscal years 2009 through 2013 the guarantee account would receive substantially more revenue than under Scenario 1. This is because once the loan is repaid there are no principal and interest payments and all net royalty revenue would go to the guarantee account. Under this scenario, the guarantee account would receive a total of $73.2 million or $4.8 million more in total than calculated by DNRC under Scenario 1 and general fund appropriations would be $4.8 million less. However, the budgetary impact in fiscal 2014 would become $11.1 million.

Scenario 3



SUMMARY

SB 495 makes substantial financial impacts to school funding and the common school trust. Increased production and prices of minerals from common school trust land have increased royalty revenue more than anticipated. The increased revenue allows the SB 495 plan to possibly conclude in fiscal 2013 rather that 2031. It is estimated that when concluded, the common school trust balance will be approximately $93.4 million less than it would have been without SB 495. There are both negative short-term and positive long-term impacts to the guarantee account and the general fund when the SB 495 plan ends. The legislature can influence the timing and amount of the loan repayment to: 1) phase-out the large general fund budget increase that will occur after fiscal 2013; or 2) maximize the amounts distributed to public schools.

OPTIONS

Choose only one:

- Request DNRC to develop a phased reduction in distributions to the guarantee account by varying the loan repayment so that the final payment is less than $2.0 million thus lessening the budgetary impact in fiscal 2014; or
- Request DNRC to pay off the loan as soon as possible thus increasing the amount of funding for public schools from the guarantee account and decreasing the amount of general fund; or
- Do nothing and let the executive determine the loan payoff.

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