JOINT BUDGET COMMITTEE

SUPPLEMENTAL BUDGET REQUESTS
FY 2017-18

DEPARTMENT OF NATURAL RESOURCES

(Division of Reclamation, Mining, and Safety, Oil and Gas Conservation Commission, State Board of Land Commissioners, and Severance Tax Policy)

JBC WORKING DOCUMENT - SUBJECT TO CHANGE
STAFF RECOMMENDATION DOES NOT REPRESENT COMMITTEE DECISION

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DEPARTMENT OF NATURAL RESOURCES

DEPARTMENT OVERVIEW

The Department of Natural Resources is responsible for developing, protecting, and enhancing Colorado's natural resources for the use and enjoyment of the State's present and future residents and visitors. The Department is comprised of the following divisions:

- The DIVISION OF RECLAMATION, MINING, AND SAFETY (DRMS) regulates development and reclamation at mining sites, reclaims abandoned mine sites, and provides safety training for mine operators and employees.

- The OIL AND GAS CONSERVATION COMMISSION (OGCC) promotes the exploration, development, and conservation of Colorado's oil and natural gas resources by issuing permits, conducting inspections, pursuing enforcement actions, and engaging in public outreach efforts.

- The STATE BOARD OF LAND COMMISSIONERS (State Land Board or Land Board) manages agricultural, commercial, mineral, and other leases on state-owned lands to generate reasonable and consistent revenue for public schools and other trust beneficiaries over time.

The four remaining divisions (THE EXECUTIVE DIRECTOR'S OFFICE, THE DIVISION OF PARKS AND WILDLIFE, THE COLORADO WATER CONSERVATION BOARD, AND THE WATER RESOURCES DIVISION) were discussed in a separate staff supplemental briefing on January 18, 2018.

This packet also includes discussion of STATEWIDE SEVERANCE TAX POLICY.

SUMMARY: FY 2017-18 APPROPRIATION AND RECOMMENDATION

Please note: this table is identical to the one provided in the January 18, 2018 JBC staff supplemental briefing.

Department Of Natural Resources: Recommended Changes For FY 2017-18	Total Funds	General Fund	Cash Funds	Reappropriated Funds	Federal Funds	FTE
FY 2017-18 Appropriation						
S.B. 17-254 (Long Bill)	$235,798,998	$30,864,532	$175,117,326	$6,707,593	$23,109,547	1,239.4
Other Legislation	33,984,000	0	33,984,000	0	0	0.0
Current FY 2017-18 Appropriation	**$269,782,998**	**$30,864,532**	**$209,101,326**	**$6,707,593**	**$23,109,547**	**1,239.4**
Recommended Changes						
Current FY 2017-18 Appropriation	$269,782,998	$30,864,532	$209,101,326	$6,707,593	$23,109,547	1,239.4
SNP Annual fleet supplemental	(281,592)	(8,879)	(264,073)	(3,718)	(4,922)	0.0
Recommended FY 2017-18 Appropriation	**$269,501,406**	**$30,855,653**	**$208,837,253**	**$6,703,875**	**$23,104,625**	**1,239.4**
Recommended Increase/(Decrease)	**($281,592)**	**($8,879)**	**($264,073)**	**($3,718)**	**($4,922)**	**0.0**
Percentage Change	(0.1%)	(0.0%)	(0.1%)	(0.1%)	(0.0%)	0.0%
FY 2017-18 Executive Request	**$0**	**$0**	**$0**	**$0**	**$0**	**0.0**
Request Above/(Below) Recommendation	($269,501,406)	($30,855,653)	($208,837,253)	($6,703,875)	($23,104,625)	(1,239.4)

REQUEST/RECOMMENDATION DESCRIPTIONS

SNP ANNUAL FLEET SUPPLEMENTAL: The request includes a decrease of $281,592 total funds, including $8,879 General Fund, for the vehicle lease payments line item. The recommendation is pending Committee action on common policy supplementals.

PRIORITIZED SUPPLEMENTAL REQUESTS

None.

STAFF-INITIATED SUPPLEMENTAL REQUESTS

STAFF-INITIATED: BILL DISCUSSION: SPENDING SEVERANCE TAX IN ARREARS

DEPARTMENT REQUEST: The Department neither made a request to change the severance tax revenue allocation and the timing of its expenditure, nor requested additional resources to address the projected shortfall in severance tax revenues in FY 2017-18. However, JBC staff recognizes the unique opportunity to correct a very difficult budgeting dilemma that has faced the General Assembly for at least two decades. The Department is aware JBC staff will be discussing a potential severance tax bill but has not been provided the details of this briefing at this stage.

STAFF RECOMMENDATION: Staff recommends that the Committee discuss the potential legislation with caucuses and stakeholders.

STAFF ANALYSIS: To frame the discussion, JBC staff has no intention of bringing solutions to change the severance tax statutes that relate directly to how it is calculated or eliminate deductions authorized under law as interpreted by the Supreme Court of Colorado. The focus of this discussion is making the budget process that allocates severance tax revenue more reliable and to eliminate the frequent scramble to reduce the TABOR refund obligation when severance tax revenues are very high or make transfers to or from the General Fund depending on the circumstances.

SEVERANCE TAX REVENUE BACKGROUND[1]

The statutory severance tax rate for oil and gas depends on the gross income of the value of oil and natural gas severed from the earth. Severance tax payments are also made by extractors of coal, metallic minerals, and molybdenum, however, oil and gas operators generate the majority of both the revenue and volatility of the revenue. Gross income is defined as the value of oil or natural gas when it is sold at the wellhead. If the oil and gas is sold at a point beyond the wellhead after transportation, manufacturing, and processing has occurred, those costs are deducted when calculating the gross income from the sale of oil and gas. Statutory severance tax rates for oil and gas production are shown below.

[1] Special thanks to Legislative Council Economist Larson Silbaugh for providing much of the background information in this section in a memo dated January 12, 2018, titled *Effective Severance Tax Rates on Oil and Gas*.

Statutory Severance Tax Rates for Oil and Gas	
Gross Income for all Operator Wells	Rate
Under $25,000	2%
$25,000 to $100,000	3%
$100,000 and under $300,000	4%
$300,000 and over	5%

Source: LCS Memo "Effective Severance Tax Rates on Oil and Gas" 1/12/18

Each year Colorado operators are allowed a tax credit equal to 87.5 percent of the property taxes paid on the prior year's oil or natural gas production as an offset to the current year's severance tax liability. This property tax credit is often referred to as the ad valorem credit, and is available on all oil and gas wells that are not classified as stripper wells. Operators receive these credits on a well-specific basis. The credit is not refundable, however it can reduce severance tax liability to $0 in any given year.

Over the last 9 years, the value of the ad valorem tax credit claimed by oil and gas operators has averaged $181.7 million annually, ranging from a high of $296.9 million in 2015 to a low of $83.0 million in 2016. The ad valorum credit has reduced severance taxes by as little as 38.9 percent in 2008 and by as much as 92.4 percent in 2015.

Property taxes are based on the prior year's production and paid the year after they are assessed. For example, 2016 property taxes are based on 2015 production. Property tax bills for 2016 are mailed in January 2017 and paid in the first half of the year. This schedule causes a lag between when the production occurs and when property taxes are assessed.

Because of this lag in property taxes, assessed values peak in the year following the peak in production. The lag in the property tax system is compounded by the filing status of some taxpayers. Taxpayers filing on an accrual basis claim the credit the year property taxes are assessed. Taxpayers filing on a cash basis claim the credit the year property taxes are paid, effectively two years after the production occurred.

The lag in the property tax system causes the ad valorum credit to increase the volatility of oil and gas severance taxes. In the first few years of production, a producer has little to no ad valorum credits to claim on a well. When the value of oil and gas production is increasing, the ad valorum credit is based on the lower value from the previous year, allowing the oil and gas producer to reduce severance taxes by a relatively small amount. After oil and gas production peaks, the ad valorum credit is based on a higher value from the previous year and allows the oil and gas producer to reduce severance taxes by a relatively larger amount.

Severance Tax Revenue in FY 2017-18

As discussed during the JBC staff briefing in December, severance tax revenue is not keeping pace with initial revenue projections and this trend was reflected in the December 2017 Legislative Council Economic Forecast. The most recent forecast reduced the projected FY 2017-18 severance tax revenue to $54.9 million from the previous projection of $150.4 million. The table below details how the projected revenue changed over the 2017 forecast cycle.

FY 2017-18 SEVERANCE TAX PROJECTIONS IN 2017	
FORECAST	REVENUE (MILLIONS)
March 2017	$142.9
June 2017	147.1
September 2017	150.4
December 2017	54.9

Severance tax revenue is allocated to individual program cash funds via statutory formula or maximum-yearly transfer, depending on the program. Appropriations for programs supported by severance tax revenues in FY 2017-18 authorize expenditures from the specific program cash fund. Appropriations are made before revenue is collected and therefore programs supported with severance tax revenue all have sufficient *spending* authority in the current budget. If the General Assembly wishes to fund programs with General Fund, it can make transfers directly to the individual cash funds for programs and thus do not need a supplemental bill to fund programs via appropriation.

Severance Tax Tier 1 and Tier 2 programs are funded with appropriations or transfers from the Severance Tax Operational Fund. A summary of FY 2017-18 appropriations for the Tier 1 programs is provided in the following table.

FY 2017-18 TIER 1 PROGRAM APPROPRIATIONS	
PROGRAM	APPROPRIATION
Avalanche Information Center	$584,593
Colorado Geological Survey	1,512,812
Oil & Gas Conservation	6,148,067
Reclamation, Mining, & Safety	4,650,548
Water Conservation	1,319,250
Colorado State Parks	2,341,732
Colorado Division of Wildlife	84,744
Total	**$16,641,746**

Severance Tax Tier 2 programs are funded with transfers from the Severance Tax Operational Fund to individual program cash funds. These transfers occur three times per year, July 1, January 1, and April 1. Distribution decisions are made based on the most recent Legislative Council Revenue Forecast, which highlights another pitfall of spending current year revenue. For example, on July 1, 2017, when the forecast was far more optimistic, distributions to Tier 2 program cash funds totaling $5.3 million were made. The transfers represent approximately 14.6 percent of the total authorized transfers even though current projections estimate transfers would be eliminated in FY 2017-18 because it was based on the June 2017 forecast. The following table summarizes the maximum transfer authorized for each program and the amount that was transferred on July 1.

Tier 2 Program Maximum Transfer as Authorized by Statute			
Tier 2 Program	Maximum Transfer Authorized	Amount Transferred on July 1	Difference
Water Supply Reserve Account	$10,000,000	$1,455,776	$8,544,224
Soil Conservation Districts Matching Grants	450,000	65,510	384,490
Water Efficiency Grants	550,000	80,068	469,932
Species Conservation Trust Fund	5,000,000	727,888	4,272,112
LEAP (Total of all three LEAP programs)	13,000,000	1,892,509	11,107,491
Interbasin Compacts	745,067	108,465	636,602
Forestry Grants / Bark Beetle	2,500,000	363,944	2,136,056
Aquatic Invasive Species	4,006,005	583,185	3,422,820
Forfeited Mine Site Reclamation	127,000	18,488	108,512
Total	**$36,378,072**	**$5,295,833**	**$31,082,239**

Keep in mind the previous two tables only present the allocation of 25 percent of severance tax revenue. It does not include the 50 percent transfer to DOLA for distribution to and grants for local governments or the 25 percent transfer that supports the Colorado Water Control Board. If the General Assembly were to completely fund Tier 1 and Tier 2 programs with a transfer of General Fund, it would require $47.7 million. If current projections hold true, Tier 1 programs should be fully funded and therefore not require additional support. Therefore, the General Fund required really depends on which programs are targeted to be supported.

It is also important to note that S.B. 17-260 (Severance tax transfers) is scheduled to transfer $45.7 million from "off-the-top" severance tax to the General Fund on June 30, 2018 (last day of FY 2017-18). Based on the December forecast and current law, only $9.2 million would be available for all severance tax funded programs. Any bill making transfers to severance tax programs should also address this transfer by either reducing or eliminating it. JBC staff requests permission to work with the Department and OSPB to determine by how much the transfer should be reduced.

Preliminary figures for December 2017 indicate that the year-to-date severance tax revenue from all sources totals $17.5 million. After accounting for the July 1 transfer to Tier 2 programs and entering revenue estimates into the severance tax model, current revenue leaves the Tier 1 programs with a shortfall of just less than $3.0 million. Depending on actual revenues, Tier 1 programs may not need additional attention of the General Assembly in FY 2017-18.

JBC staff withheld a recommendation during briefing and wanted to monitor severance tax revenue collections to ensure the first few months of FY 2017-18 were not a fluke. The fact that the Department of Natural Resources did not submit a supplemental budget request leads JBC staff to conclude the Department is also waiting until more data is available before determining a course of action it prefers.

Opportunity

While the above paints a very stark picture for severance tax funded programs, JBC staff believes the current revenue projections present a great opportunity to improve efficiency and accuracy of budgeting severance tax revenues. Tier 2 severance tax programs have been on notice since at least the 2017 budget setting process that proportional reductions of transfers were likely and that there was even a prospect transfers would not occur at all.

One of the most difficult aspects of budgeting severance tax is that current law requires the General Assembly and the Department to make decisions based on forecast data and forecasting such an extremely volatile revenue stream has proven extremely difficult. With other uncertain revenue sources, the General Assembly took lessons learned from severance tax budgeting when it implemented the policy requiring tax revenue generated from marijuana sales to be spent in the year after which it was collected. Since programs funded by severance tax revenue are already operating leanly or have taken other changes to reduce or eliminate expenditures it is the ideal circumstance to target General Fund to critical programs and begin spending severance tax in arrears.

JBC staff recommends the Committee sponsor legislation to make a change to the timing when severance tax is allocated and continue discussions with other members and stakeholders.

Severance tax statutes may also be ripe for a complete overhaul in handing the expenditure of this revenue stream. The tax is named "severance" because it is a tax on minerals, and other natural resources, that are permanently removed or severed from the ground. Once minerals have been severed, the state has realized all revenue it will from the severance tax. This revenue is not renewable. It seems contrary to the name of the tax to spend the revenue before it even is realized, let alone not save it in a permanent trust to benefit future residents or visitors.

JBC staff also recommends the Committee discuss whether now is also the time to ask the voters to amend the Constitution and place all severance tax revenue in a permanent trust fund and restrict the principal in perpetuity. If including this portion of the recommendation in a bill, JBC staff requests permission to work with all departments and programs to determine what resources would be required to make this change and project when investment income on the permanent fund would be sufficient to fund severance programs under current law. While the General Assembly could pass legislation creating a statutory trust for severance tax revenue, amending the Constitution makes it more difficult for future legislatures to tap into the severance tax principal in the event of an economic downtown.

STATEWIDE COMMON POLICY SUPPLEMENTAL REQUESTS

None. Statewide common policy supplemental requests were discussed in the January 18, 2018 JBC staff supplemental briefing.