

MEMORANDUM

TO: Joint Budget Committee

FROM: Scott Thompson, JBC Staff

SUBJECT: Severance tax, BP America v. Department of Revenue and S.B. 16-218 (State Severance Tax Refunds)

DATE: August 1, 2016

This memo will provide a summary of the most recent estimates for the states 2016-17 liability to tax payers as a result of the BP America v. Department of Revenue Colorado Supreme Court decision, the projects identified by the Department of Local Affairs as projects that are critical to moving forward without delay, and any other information provided by the Department of Natural Resources.

HISTORICAL SUMMARY

- On April 25, 2016, the Colorado Supreme Court issued a decision in *BP America v. Colorado Department of Revenue*, in favor of the oil and gas producer and held that the plain language of Colorado severance tax statute authorizes a deduction for any transportation, manufacturing, and processing costs, including the cost of capital.
- Included in the decision is an award for \$2.4 million, however, the estimate of the liability created by precedential effect of the decision and the timing of the refunds have been continuously revised since the end of the 2016 legislative session.
- The tax deduction in question is known as Return on Investment (ROI) and will reduce the taxpayers liability on the severance tax they owe for operating in an extractive industry. Dicta included in the opinion questioned whether the Department of Revenue was properly allowing all deduction allowed as Netback Expense Report Form (NERF).
- Joint Budget Committee Bill S.B. 16-218 (State Severance Tax Refunds) reserved \$77.4 million severance tax collections in FY 2016-17 to prevent expenditure of discretionary funding for programs in the Department of Natural Resources and the Department of Local Affairs until the resulting liability from *BP America* is more certain.
- On August 23, 2016, the Department of Revenue is convening a stakeholder group to discuss whether the Department's interpretation of NERF deductions is fair and the possibility of requesting legislation if needed.

S.B. 16-218 AND THE JUNE 2016 REVENUE FORECASTS

Senate Bill 16-218 (State Severance Tax Refunds) dictates that the amount reserved in the bill can be released in all or in part by a majority vote of the Joint Budget Committee. The restrictions based on department and program area are as follows:

- Severance Tax Operational Fund (Department of Natural Resources) = \$10.0 million
- Severance Tax Perpetual Base Fund (Department of Natural Resources) = \$19.1 million
- Local Government Severance Tax Fund (Department of Local Affairs) = \$43.8 million from the portion of revenue allocated for grants.

For FY 2016-17, refunds resulting from the *BP America* decision will be made from severance tax collections up to a cap of 15.0 percent of gross *monthly* severance tax revenues. If the amount required for refunds exceeds 15.0 percent of gross severance tax revenues in the month, the additional amount will be refunded from income tax revenue diverted from the General Fund. Please note that the overall impact to the General Fund is dependent upon available severance tax revenue, a final determination of total refund liability, and the timing of required refunds. The table below summarizes the frequency with which each month of the fiscal year has exceeded 15.0 percent of gross revenue since FY 2004-05.

FREQUENCY AT WHICH RETURNS EXCEED 15 PERCENT GROSS COLLECTIONS PER MONTH OVER 11 YEAR PERIOD											
July	August	September	October	November	December	January	February	March	April	May	June
63.6%	18.2%	45.5%	63.6%	72.7%	36.4%	45.5%	18.2%	36.4%	9.1%	45.5%	63.6%

Both June Revenue Forecasts from Legislative Council Staff (LCS) and the Governor’s Office of State Planning and Budgeting (OSPB) included an estimate for the General Fund liability as a result of the *BP America* decision and passage of S.B. 16-218. LCS estimates the General Fund diverted will be \$51.4 million and OSPB estimates it to be \$44.4 million. Both forecasts include as a component of their final number a \$39.6 million diversion from the General Fund as a result of refunds the Department has identified as all but certain. The part of the forecasts that diverge from each other is the amount of General Fund that will be diverted as a result of monthly refunds exceeding the 15.0 percent gross receipts.

The \$39.6 million forecasted diversion is not adjusted to reflect whether payment of the refund occurs in a month with less than 15.0 percent of the monthly gross receipts. Both forecasts assumed these refunds would be paid out quickly and therefore exceed the limit in the month they are refunded. To arrive at \$51.4 million, which LCS estimated would be diverted, they took a 5-year average of the monthly average gross receipts that exceed 15.0 percent per year. Legislative Council Staff and JBC Staff agree that this model has simplified a lot of variability and may result in forecasting errors. JBC Staff is unable to discuss the methodologies used by OSPB.

LOCAL GOVERNMENT MINERAL AND ENERGY IMPACT GRANT PROGRAM

At the June Joint Budget Committee meeting, the Committee requested that the Department of Local Affairs provide a prioritized list of projects that are critical to fund to prevent total loss of the project or those that are needed for public health or safety reasons. The Department instead provided a summary table, included as Appendix 1, and a list of all the projects that submitted applications for the August grant cycle is included in Appendix 2. Appendix 1 concludes that to fully fund the August grant cycle for the Local Government Mineral and Energy Impact Grant Program, the Joint Budget Committee would need to release \$19.8 million from the restricted funds.

SUMMARY TABLE FOR FY 2016-17 SEVERANCE TAX BUDGET (MILLIONS)		
	JUNE FORECAST	
	LCS	OSPB
Amount Restricted in S.B. 16-218	\$77.4	
Forecasted General Fund Diversion	(51.4)	(44.4)
S.B. 16-218 Restriction less General Fund Forecasted Diversion	26.0	33.0
Local Government Mineral and Energy Impact--August Grant Cycle	(19.8)	
Amount Restricted remaining if Grant Cycle is Fully Funded	\$6.2	\$13.2

SUMMARY TABLE FOR FY 2016-17 SEVERANCE TAX BUDGET (MILLIONS)		
	JUNE FORECAST	
	LCS	OSPB
OTHER IMPORTANT DATA		
DOR Estimate for potential NERF liability ¹		(67.5)
RESTRICTIONS IN S.B. 16-218		
Severance Tax Operational Fund Restriction (Tier II grants and loans)		(\$10.0)
Severance Tax Perpetual Base Fund Restriction (CWCB grants and loans)		(19.1)
Local Government Mineral and Energy Impact Restriction		(43.8)
Total Restrictions in S.B. 16-218		(\$77.4)

¹This is the Department of Revenue estimate for the worst case scenario if NERF deductions not currently allowed should all be allowed under current law. More concrete information will be available after the stakeholder process is complete. Representatives of the oil and gas industry explained to JBC Staff that operators were already in the habit of making those deductions in calculating the wellhead price and therefore amended returns for those deductions could be minimal.

While the Department of Local Affairs did not provide a prioritized list it did state that if sufficient funding for the August grant cycle is not released and only a portion of it is, the Department will prioritize based on public health and safety, phased projects that will fail if not awarded now, projects heavily dependent on matching funds that are not within the control of the local government, and projects that will otherwise lose leveraged funds committed. The Department will also move forward with accepting applications for the fall grant cycle if sufficient funding for all fall cycle projects is provided.

Other important information was included in the table above to assist the Committee in decision making. The Department of Revenue has identified the worst case scenario if certain NERF deductions currently not allowed by the Department should be allowed under current law, which the Department estimates at \$67.5 million (\$24.4 million are in waiting disposition with the Tax Conferee and \$43.1 million for amended returns not yet received). The last three numbers indicate how much funding for each program is restricted by S.B. 16-218.

POINTS OF DISCUSSION FOR THE JOINT BUDGET COMMITTEE

- JBC Staff does not have a recommendation at this time.
- The Committee may wish to continue restricting all \$77.4 million that is currently restricted because the estimate for unknown NERF deductions, which the Department may be incorrectly denying, have very little evidence to support a conclusive finding. Because this \$67.5 million is not included in either of the June forecasts, it could prove to be a huge unbudgeted cost, or it may be small enough to call de minimis.
- Alternatively, the Committee may wish to release \$20.0 million from the Department of Local Affairs restriction to allow the Department to fully fund the August grant cycle of the Local Government Mineral and Energy Impact Grant Program. If, like the June forecasts, the Committee assumes these unknown NERF deductions will be zero, based on the latest estimates the remaining \$57.4 million would be able to cover the amount of General Fund anticipated to be diverted to refund severance taxpayers. Legislative Council estimates this diversion to be \$51.4 million and OSPB estimates the diversion to be \$44.4 million. The Committee would need to run a bill to prevent General Fund from being diverted and to instead utilize the S.B. 16-218 reserve. If the Committee chooses this course of action, it should provide guidance to the Department on how it should proceed with the remaining grant cycles.
- Finally, the Committee may also choose to release some part of the Department's restriction that is less than \$20.0 million. If this decision is made, the Department will prioritize the projects that have been approved but not awarded based on the factors described above.

APPENDIX %



COLORADO Department of Local Affairs

<u>Broadband</u>	<u>Project Name</u>	<u>Request</u>
08209	Park County Broadband Phase III Fairplay/Alma Middle Mile	\$ 371,857
<u>Parks & Rec</u>		
08201	Fruita Kokopelli Riverfront Trail Construction	\$ 1,200,000
<u>Public Facility</u>		
08186	Greeley City Center Phase I	\$ 2,000,000
08188	Clear Creek County Courts Wing Remodel	\$ 249,770
08198	Lone Cone Library Dist. New Library	\$ 1,500,000
08199	San Juan County Anvil Mountain Workforce Housing	\$ 199,700
08210	Leadville Tabor Opera House Purchase & Feasibility Study	\$ 315,000
<u>Public Safety</u>		
08187	Mountain View FPD Dacono Maintenance Facility	\$ 1,043,243
08196	Cortez FPD Station One	\$ 2,000,000
08197	Ignacio Natural Gas Pipeline Replacement Phase IV	\$ 370,000
08202	Delta County Radio Console Update	\$ 300,000
08206	Hinsdale County Emergency Communications Site Power Supply	\$ 375,000
08234	Trinidad Space to Create Construction Phase	\$ 2,000,000
<u>Road & Streets</u>		
08183	Frederick Tripple Parkway Roadway and Drainage Improvements	\$ 1,433,079
08185	Fort Lupton South Denver Ave. Rehabilitation	\$ 750,000
08193	Las Animas County Roads 53.5, 51.1, 43.5 Improvements	\$ 633,000
08194	La Plata County Road 302 Improvements	\$ 700,000
08203	Mesa County West Divide Road Improvements	\$ 1,080,000
08204	Rifle Enterprise Court Road Reconstruction	\$ 384,375
08205	Moffat County Browns Park Swinging Bridge Rehab	\$ 760,000
08214	Steamboat Springs Yampa Street Curb/Sidewalk Improvements	\$ 600,000
<u>Sewer</u>		
08182	Crook Wastewater Facility Rehabilitation	\$ 750,000
08190	Las Animas City Sanitary Sewer System Improvements	\$ 719,500
08195	Durango Wastewater Treatment Plant	\$ 2,000,000
08200	Grand Mesa Metro. Dist. WW Treatment Plant Improvements	\$ 284,232
08208	Walden Wastewater System Upgrade & Repairs	\$ 693,750
<u>Water</u>		
08189	Eads Water System Improvements	\$ 483,000
08207	Oak Creek Water Distribution System Replacement Phase I	\$ 2,000,000
08211	Salida Water Treatment UV Disinfection Compliance	\$ 775,000
08215	Merino Water System Improvements Phase II	\$ 497,500
Total		\$ 26,468,006



COLORADO

Department of Local Affairs

Project Number	Project Name	Request Amount	Project Total
08182	Crook Wastewater Facility Rehabilitation	\$ 750,000	\$ 2,025,328
08183	Frederick Tripple Parkway Roadway and Drainage Improvements	\$ 1,433,079	\$ 2,866,158
08185	Fort Lupton South Denver Ave. Rehabilitation	\$ 750,000	\$ 1,500,000
08186	Greeley City Center Phase I	\$ 2,000,000	\$ 25,226,465
08187	Mountain View FPD Dacono Maintenance Facility	\$ 1,043,243	\$ 2,610,657
08188	Clear Creek County Courts Wing Remodel	\$ 249,770	\$ 722,540
08189	Eads Water System Improvements	\$ 483,000	\$ 966,000
08190	Las Animas City Sanitary Sewer System Improvements	\$ 719,500	\$ 1,439,000
08193	Las Animas County Roads 53.5, 51.1, 43.5 Improvements	\$ 633,000	\$ 1,266,000
08194	La Plata County Road 302 Improvements	\$ 700,000	\$ 1,400,000
08195	Durango Wastewater Treatment Plant	\$ 2,000,000	\$ 48,495,000
08196	Cortez FPD Station One	\$ 2,000,000	\$ 4,401,312
08197	Ignacio Natural Gas Pipeline Replacement Phase IV	\$ 370,000	\$ 584,199
08198	Lone Cone Library Dist. New Library	\$ 1,500,000	\$ 4,052,212
08199	San Juan County Anvil Mountain Workforce Housing	\$ 199,700	\$ 1,449,700
08200	Grand Mesa Metro. Dist. WW Treatment Plant Improvements	\$ 284,232	\$ 989,258
08201	Fruita Kokopelli Riverfront Trail Construction	\$ 1,200,000	\$ 3,470,000
08202	Delta County Radio Console Update	\$ 300,000	\$ 600,000
08203	Mesa County West Divide Road Improvements	\$ 1,080,000	\$ 2,160,000
08204	Rifle Enterprise Court Road Reconstruction	\$ 384,375	\$ 768,750
08205	Moffat County Browns Park Swinging Bridge Rehab	\$ 760,000	\$ 1,520,000
08206	Hinsdale County Emergency Communications Site Power Supply	\$ 375,000	\$ 879,058
08207	Oak Creek Water Distribution System Replacement Phase I	\$ 2,000,000	\$ 3,500,000
08208	Walden Wastewater System Upgrade & Repairs	\$ 693,750	\$ 925,000
08209	Park County Broadband Phase III Fairplay/Alma Middle Mile	\$ 371,857	\$ 743,715
08210	Leadville Tabor Opera House Purchase & Feasibility Study	\$ 315,000	\$ 630,000
08211	Salida Water Treatment UV Disinfection Compliance	\$ 775,000	\$ 1,550,000
08214	Steamboat Springs Yampa Street Curb/Sidewalk Improvements	\$ 600,000	\$ 1,281,495
08215	Merino Water System Improvements Phase II	\$ 497,500	\$ 995,000
08234	Trinidad Space to Create Construction Phase	\$ 2,000,000	\$ 18,008,903
Total		\$ 26,468,006	\$ 119,016,847

APPENDIX 2

Summary of DOLA Severance Tax Obligations (in millions)		
Cash fund balance – April 26, 2016	213.9	
Commitments		
Payments in Process	(6.3)	Encumbered
Contracted Awards Payable	(109.1)	Encumbered
Program Operating costs (Next FY)	(4.0)	Encumbered (Remaining DOLA overhead)
Contingency	(1.0)	
County/Muni Direct Distributions Payable (ytd)	(13.0)	Statutory
Awards committed with contract in process	(11.5)	Committed, Not Encumbered
Reserve for Administrative Grant Awards	(2.3)	Not Committed or Encumbered
Reserve for Supplemental Awards	(1.7)	Not Committed or Encumbered
Emergency Reserve Policy - CRS 39-29-116(3)(a)	(3.0)	Statutory
Uranium Mill Tailings Set Aside-CRS 39-29-110(1)(b)	(4.0)	Statutory, Use is Sporadic
Transfers/Initiatives - Flood, Alt Fuel, BB, Fed Lands	(3.1)	Not Committed or Encumbered
<hr/>		
Projected Funds Available (06/30/2016)	54.9	
S.B. 16-218 Restricted Funds	(48.3)	
FML Funds Available for August Grant Cycle	1.0	
Net Funds Available (06/30/2016)	7.6	
August 2016 Grant Cycle	(27.4)	
Projected Net Balance (06/30/2016)	(19.8)	

SEVERANCE TAX UPDATE



COLORADO
Department of Revenue

Presented to Joint Budget Committee
August 1, 2016
By Department of Revenue

AGENDA

- BP Opinion Analysis
 - ROI – Return on Investment
 - Fiscal Impact of Opinion
- Taxpayer Survey Results
 - Top 20 Taxpayers
 - Survey Takeaways
- Stakeholder Work Group



BRIEF ANALYSIS ON THE BP OPINION

- The Supreme Court's ruling was focused on ROI – Return on Investment / Cost of Capital
 - The 10th Circuit Court of Appeals, the Colorado Court of Appeals, and the Colorado Supreme Court all defined ROI as the cost of capital
- It discussed the other NERF deductions in dicta, which was not part of the underlying ruling and is neither precedential nor binding.



ROI DEDUCTION

- **ROI – Return on Investment/Cost of Capital** is one type of NERF deduction and was defined by the Appellate Court as the, “opportunity cost of capital investment that an investor could have earned on a similar investment of similar risk” .
- Opportunity cost is not an expense that has been paid. It is the calculation of a perceived loss suffered by not choosing an alternate investment.



FISCAL IMPACT OF BP DECISION

TAX YEARS 2003-2014

(Amounts in millions)

	ROI Deductions	NERF Deductions That Are Likely Allowable Under The Statute
Known Refunds		
BP Refund Paid Out	\$2.4	N/A
Amended Returns Received/Anticipated	\$2.0	\$1.9
Conferee Cases	\$6.8	\$7.1
Subtotal	\$11.2	\$9.0
Total Known Refunds	\$20.2	

The \$9.0 million in likely allowable NERF deductions includes:

- Chemicals, lubricants, and supplies used on-site
- Insurance
- Non-capitalized repairs



REMAINING NERF DEDUCTIONS

- A work group will be convened to address the remaining NERF deductions.
- These do not appear to be allowable as deductions under the statute.



ESTIMATE OF FUTURE POTENTIAL IMPACT OF REMAINING NERF DEDUCTIONS

(Amounts in millions)

	ROI Deductions	Remaining NERF Deductions That Will Be Addressed Through The Stakeholder Process
Future Potential Liability		
Conferee Cases	N/A	\$24.4
Future Severance Tax Returns	\$20.0	\$43.1
Subtotal	\$20.0	\$67.5
Total Potential Liability		\$87.5



Taxpayer Survey Results



COLORADO
Department of Revenue

SURVEY RESULTS OF TOP 20 REMITTERS

Number of Responses	Number That Indicated They Are Planning To File Amended Returns	Detail of Potential Refund Activity
8	5	<ul style="list-style-type: none">• All 5 plan to file for ROI• 3 of the 5 plan to file for NERF

- 3 of the 5 taxpayers could not estimate the size of their refund claims.
- The other 2 taxpayers estimated the size of their refund claims to be \$3.7 million and \$60,000.
- Before conducting the survey, DOR had received another refund claim totaling \$150,000.



SURVEY RESULTS

- 2 of the 8 taxpayers have a case in Conferee.
 - One of these taxpayers indicated that they would not further amend their claim.
 - The other indicated that they may amend their refund claim with a potential impact of \$1 million.
- Generally, taxpayers said they were unsure whether they would be willing to stagger their refund payments.
 - One stated that they would not be willing to stagger their refund.



SURVEY TAKEAWAYS

- Survey results indicate that taxpayers are unsure how to proceed.
- It appears as though the industry is awaiting guidance and does not have any immediate plans to request the remaining NERF deductions.



STAKEHOLDER WORK GROUP

- The Department is facilitating a stakeholder work group with members from industry and other governmental agencies or organizations.
- The work group will evaluate and determine whether or not to recommend regulatory and statutory changes on how severance tax provisions are administered.
- Based on any recommendations made a fiscal analysis of the impact will be provided.



NEW 2015 SEVERANCE TAX RETURN INFORMATION

- In the past weeks, we have received 5 2015 current Severance tax returns independent of the BP opinion.
- In the aggregate, these returns total requested refunds of approximately \$40 million.
- These returns are not related to ROI or NERF deductions but rather are related to the ad valorem tax credit.
- These refunds will likely be processed during the early part of FY 2016-17. This is a normal part of tax administration. We do not audit before issuing refunds because we are required by statute to issue refunds within certain time limits.



COLORADO
Department of Revenue

COMPARISON OF THESE 5 TAXPAYERS 2014 VS. 2015

- Between 2014 and 2015 the income for these five companies has fallen by 43% from \$3.0 billion to \$1.7 billion.
- Conversely, between 2014 and 2015 refunds have increased from \$10.5 million to \$38.9 million.



THANK YOU

Questions?



COLORADO
Department of Revenue