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Torched and Burned: Why Does Colorado Subsidize the World's Most Profitable Industry?

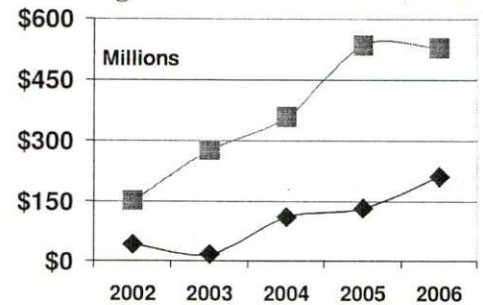
"Fossil fuels resemble capital in the bank. A responsible parent will use his capital sparingly in order to pass on to his children as much as possible of his inheritance. A selfish parent will squander it in riotous living and care not one whit how his offspring will fare."

--Admiral Hyman Rickover, U.S. Navy

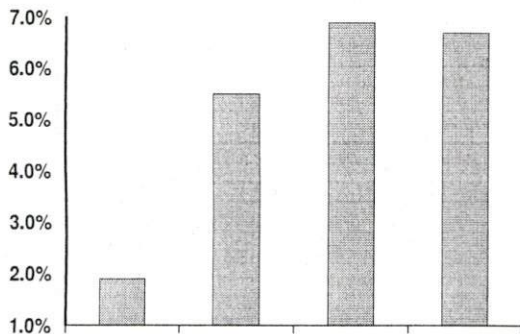


Coloradans pride themselves on being fiscally conservative. In this cash-strapped state, legislators squabble over quarters and governors take deficits for granted. But there's a paradox here: Even as we suffer migraines over how to fund education, transportation, and health care, Colorado has, in effect, left more than one billion dollars on the table since 2002. How is that possible? The lower line in the chart at right shows the oil and gas severance taxes the State collected between 2002 and 2006. **The upper line represents the taxes Colorado oil and gas producers would have paid had their wells been located a few hundred miles to the north in Wyoming. The cumulative difference, over the five years, is \$1,300,000,000.**

Leaving a Billion Dollars on the Table



Because of our low severance tax rates, Colorado has foregone \$1.3 billion since 2002.



Effective severance tax rates are far lower in Colorado than in adjoining states, says the nonpartisan Colorado Legislative Council

Severed From the Earth

In 1977 Colorado imposed a "severance tax" to recapture, for the benefit of future generations, some of the wealth that is "irretrievably lost" when nonrenewable natural resources are extracted from the earth. Although Colorado assesses a nominal 5% severance tax on oil and gas producers, a dizzying array of exemptions and deductions reduces the effective tax rate to 1.9%, about one-third what the petroleum industry pays in neighboring states. **In 2005, for example, Colorado collected \$132 million in severance taxes. In Wyoming, an identical amount of oil and gas production would have raised \$382 million.** In New Mexico, it would have brought in \$479 million. This additional revenue could have been used to redress the negative social and environmental impacts of the energy boom, and to fund the clean energy alternatives that will be needed when the oil and gas is gone.

Their Fair Share

Each year, when filing their taxes, Colorado citizens must pay the State Treasurer 4.6% of their income. Meanwhile, oil and gas operators—including some of the world's richest corporations—pay the State a mere pittance. **Indeed, an astonishing 75% of the state's oil and gas wells pay no severance tax at all.** As our roads crumble and schools decline, Colorado now rivals Mississippi at the bottom of the public investment ladder. Meanwhile, some Wyoming high school graduates are eligible for free college tuition, paid for with severance taxes. **Enough! It's time to reform our severance tax policies, which now subsidize the world's most profitable industry.**

A Byzantine Tax Code

The \$1.3 billion we failed to assess in severance taxes between 2002 and 2006 is gone forever. **Looking ahead, unless we change Byzantine provisions in our tax code, the State may fail to collect an additional \$10 billion or more over the next 30 years.** To put our fiscal house in order, legislators must reform our antiquated severance tax regulations. Unfortunately, current discussions focus on how to fix the Rube Goldberg-like methods we have invented for returning severance taxes to those counties impacted by energy production. This is a critical issue—but rather than squabble over the existing puny pie, doesn't it make more sense to order a bigger one? If Colorado wants to increase its severance taxes, now is the time since energy prices, production, and profits are at record highs.

Let's stop squabbling about how to divvy up the existing severance tax pie, and order up a bigger one.

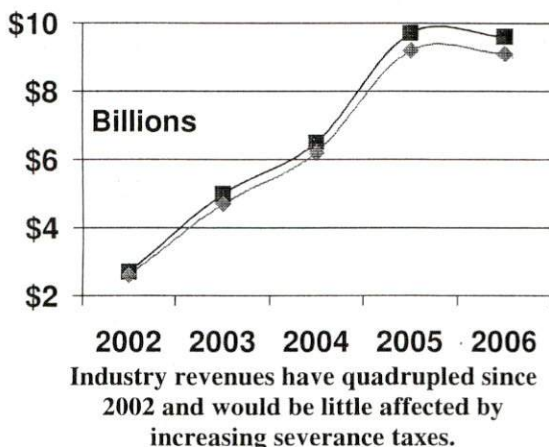
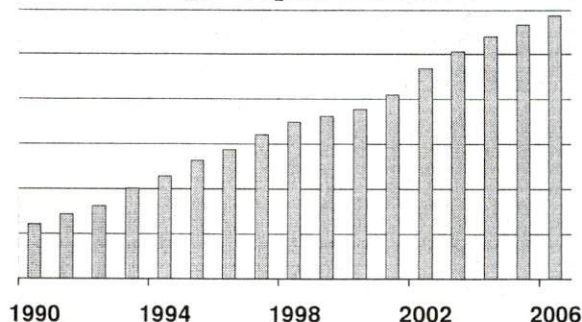
The Big Bonanza

The current drilling frenzy is the biggest boom in state history. Since 1990, Colorado's gas production has increased 500%. **In 2006, oil and gas revenues reached a staggering \$9.6 billion. By 2008, they may exceed \$11 billion.** Experts forecast that 150,000 wells will be drilled here over the coming three decades. During that period, producers of oil, gas, coal, molybdenum, gold, and silver are likely to extract \$400 billion of mineral wealth, a precious windfall that our current tax policies fail to reflect.

Seize the Moment

There are many reasons why it is an excellent time to hike severance tax rates. First, Colorado is the fastest growing gas province in the nation. Second, we are in the early years of what is likely to be a 30-year drilling boom. Third, energy prices are high, and economic fundamentals suggest they are headed higher. (For one thing, **steep declines in existing fields mean that half the nation's gas supply must be replaced with new drilling in the next three years.**) Fourth, oil and gas companies are reaping record profits, and can afford to pay their fair share. Fifth, **most of the natural gas and coal produced in Colorado is exported to heat and power the Midwest, an energy-poor region which will not be able to return the favor later.** Finally, the imminent completion of new pipelines will hike the price our natural gas fetches, thus further enriching energy producers.

Colorado Natural Gas Production Has Quintupled since 1990



Industry Revenues Soar

Paying \$75 for a tankful of gasoline may be painful, but it does not fully communicate how stupendously profitable the energy business has become. **In the next 24 hours, \$30 million of oil and natural gas will be extracted in Colorado. This week, companies will take \$210 million out of the ground. This month, \$900 million.** Who produces this energy? Industry lobbyists refer to "small independents," suggesting mom doing the books, while dad drills in his bluejeans. This is nonsense. The vast majority of Colorado's wells are owned by very large multi-nationals like BP, Exxon, Encana, Williams, Anadarko, and Chevron. In 2006 these companies' global profits exceeded \$90 billion. That's not income, it's *profit*. Could the Big Six afford to pay more in severance taxes? Intuition says yes. What about analysis? In the chart at left, the

upper line is actual industry revenues in Colorado since 2002. The lower line is what industry revenues *would have been* if severance taxes were as high in Colorado as they are in Wyoming. You have to squint to see it, but the difference between the two lines is the \$1.3 billion we failed to collect in the last five years.

The "Ad Valorem" Deduction

Although Colorado's nominal severance tax rate is 5%, the state actually collects less than 2%. There are two primary reasons for the discrepancy. The first is that Colorado—unlike other states—allows energy companies to deduct the county property taxes they pay from their severance tax bill. This loophole—the "ad valorem" deduction—currently costs the state \$200 million or more each year. If it is not closed, the state could lose \$8 billion or more over the coming three decades.

Remarkably, three-fourths of Colorado oil and gas wells pay no severance taxes at all.

Producer's Paradise

This next bit is a stunner: **Three-fourths of the state's wells pay no severance tax at all.** That's because Colorado exempts "stripper wells" from severance fees. Stripper wells produce less than 15 barrels of oil, or 90,000 cubic-feet of natural gas, per day. The exemption is designed to encourage producers to continue operating older, less productive wells. Since it costs \$20,000 per year to maintain a well, this was fair back when oil was \$15 per barrel and natural gas was \$1 per thousand cubic-feet. Since 1999, however, prices have quadrupled. As a result, stripper wells, which provide 60% of Colorado's oil and 20% of its natural gas, have become very profitable, but the state is not sharing in the bounty. In this producer's paradise, some oil wells produce \$400,000, severance tax-free.