

**DEPARTMENT OF REVENUE
JOINT BUDGET COMMITTEE HEARING
SEVERANCE TAX UPDATE**

**AGENDA
Monday, June 20, 2016
1:30 – 3:30pm**

1:30-1:50 INTRODUCTION AND OPENING COMMENTS

1:50-3:30 SEVERANCE TAX PRESENTATION

- Q1. STATUTORY INTERPRETATION
- Q2. DEDUCTIONS ALLOWED UNDER THE COLORADO SUPREME COURT OPINION
- Q3. STATUS OF REFUND REQUESTS MADE UNDER THE OPINION
 - A. SB 218 IMPLEMENTATION
 - B. FUTURE IMPACT ON SEVERANCE TAX REVENUE
- Q4. TAX POLICY INTERPRETATION CHANGES

ADDITIONAL QUESTIONS. GENERAL ASSEMBLY NOTIFICATION PROCESS

Q1: Statutory Interpretation

A: State of the law prior to the Supreme Court Opinion in the BP case

1. It was not at all clear that an ROI/cost of capital deduction should be allowed under the severance tax statute:

- A. As the Colorado Supreme Court BP Opinion makes clear, deductions and exemptions in taxation “are recorded as a matter of legislative grace . . . and they are not allowed unless clearly provided for.” The statute does not specifically provide for an ROI/cost of capital deduction for severance tax. Instead, the parties disputed whether this was contemplated within deductions for any transportation, processing, and manufacturing costs borne by the taxpayer. The Colorado Court of Appeals ruled in the Department’s favor on this very argument, before reversal by the Colorado Supreme Court.
- B. Other jurisdictions that have allowed an ROI/cost of capital deduction have promulgated rules or relied on statutes explicitly allowing a ROI deduction. (In contrast, the Department’s historic interpretation was conveyed through a published FAQ, i.e. that an ROI/cost of capital deduction was not allowed.)
- C. Our General Assembly has specifically allowed cost of capital recovery in other circumstances. *See, e.g.*, § 40-5-101(4), C.R.S. An example of how a statute that allows the recovery of the cost of capital reads is:

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(b) To provide additional encouragement to utilities to pursue the construction and expansion of transmission facilities, the commission shall approve current recovery by the utility through the annual rate adjustment clause of *the utility's weighted average cost of capital*, including its most recently authorized rate of return on equity, on the total balance of construction work in progress related to such transmission facilities as of the end of the immediately preceding year. § 40-5-101(4)(b), C.R.S. (emphasis provided).

- D. A similar clarity does not exist in the severance tax statute at issue in the BP America matter. Thus, prior to the BP America Opinion, it appeared the General Assembly was careful to use “cost of capital” where the intent was to allow the recovery of the cost of capital.
 - E. Thus, because, the cost of capital was not called out clearly as in other statutes, and in light of applicable case law, the Department historically had not allowed the costs of capital as a deduction.
2. The Department’s interpretation was consistent with the analysis of two well-respected courts - the Court of Appeals in the BP matter and the 10th Circuit Court of Appeals in Atlantic Richfield Co. Neither court defined the cost of capital as within the scope of transportation costs.
- A. In Atlantic Richfield Co. v. Farm Credit Bank, 226 F.3d 1138 (10th Cir. 2000), the Tenth Circuit Court of Appeals held that the phrase “cost of transporting” was “decidedly ambiguous.” As a result, the court explained that this phrase “does not expressly include” cost of capital. Before the Supreme Court’s ruling in the BP case, Atlantic Richfield was the only case that we know of that considered whether ROI/cost of capital was a “cost of transporting.” Thus, the Colorado Court of Appeals and the Tenth Circuit Court of Appeals both took a similar position to the one argued by DOR, namely that the courts expected the express inclusion of “cost of capital” within statutes allowing for transportation costs.
 - B. In the BP America Court of Appeals Opinion, the COA provided a statutory analysis:
 - I. The COA recognized that the General Assembly did not provide what types of costs fall within the transportation, manufacturing, and processing costs language of the statute.

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- II. The COA recognized that the deduction for ROI was not specifically provided for in statute.
 - III. The position adopted by the Colorado Supreme Court, that the use of “any” is sufficient to include ROI was considered and rejected by the COA.
 - IV. The court examined costs and adopted the dictionary definition, “expense or price”, whereas they defined ROI as the opportunity costs of capital. The COA stated it was not a cost expended or paid [borne by the taxpayer], but rather a calculation of loss suffered by a party that has selected one investment over a more lucrative alternative.
 - V. The COA also reviewed the legislative history and noted that an opportunity cost is a hypothetical cost of a lost investment opportunity – it is not a cost to transport or process oil or gas. The statutory language only allowed recovery of costs borne by the taxpayer related to transportation, manufacturing and processing.
3. Thus, DOR’s approach was consistent with case law and an historic interpretation. There existed no support for unilaterally determining to allow deductions potentially representing hundreds of millions of dollars without a clear expression by the General Assembly to do so, a clear conflict with case law and without an intervening change in the language of the statute. Instead, the DOR asked the Colorado Supreme Court to provide an answer.

Q2: Deductions allowed under the Colorado Supreme Court Opinion

1. ROI – Return on Investment

- A. ROI/cost of capital is one type of NERF deduction, and was the focus of the case.
- B. It is defined as “the opportunity cost of capital”. An opportunity cost is not a cost that has been expended or paid; it is a foregone opportunity, or a calculation of loss suffered by a party that has invested in one opportunity instead of a more profitable alternative opportunity.
- C. This is not a cost historically borne by the taxpayer, or one clearly related to transportation, processing, and manufacturing.
- D. The Supreme Court also peripherally through dicta addressed all NERF deductions.

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NERF – Net-back Expense Form

- A. The broad scope of the BP Opinion implicates all NERF deductions through dicta defined as an opinion of the judges that does not embody the resolution or determination of the specific case before the court.
- B. NERF deductions are currently allowed by the Property Tax Administrator (PTA) within the Department of Local Affairs pursuant to rules promulgated under the broad discretion provided by the General Assembly to the PTA.
- C. Types of NERF deductions:
 - Chemicals, Lubricants, Supplies Used on Site
 - Cost incurred to sell product
 - Direct G&A, Environmental
 - Environmental Compliance Costs
 - Field Labor (Pumper) Costs
 - Fuel Expense
 - Insurance, Liability and Equipment
 - Lease Rentals
 - Non-capitalized repairs
 - **ROI – Return on Investment/Cost of Capital**
 - Salt Water Disposal/Water Hauling
 - Salaries, Wages, and Benefits
 - Taxes: Personal Property and Improvements
 - Utilities

2. The Department has been evaluating the Supreme Court Opinion

- A. The Supreme Court Opinion was narrowly focused on ROI deductions and the Department is in the process of issuing those refunds.
- B. The Supreme Court Opinion did not give direction on the calculation methodology for the allowance, thus the Department will be promulgating rules to address the methodology.
- C. Because it is unclear how the NERF deductions relate to transportation, processing, and manufacturing costs borne by the taxpayer, the Department will conduct an extensive stakeholder and outreach process, with membership from the industry, local governments, other state departments, and the legislature, before we promulgate rules to address them.

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D. Because the Department did not have specific rules addressing NERF deductions, the Court took guidance from the Property Tax Administrator Guidelines.

Q3: Status of Refund Requests Made Under the Opinion

A: DOR estimates that it could pay out refunds of up to \$107.7 million in relation to the BP Opinion depending on the forward interpretation of the ruling related to allowable deductions. The \$107.7 million figure includes \$9.2 million in actual refunds and \$98.5 million in estimated additional refunds.

Further, the \$107.7 million figure breaks down into \$31.2 in ROI refunds, \$9.2 million of which are actual refunds and \$22 million are estimated refunds and \$76.5 million in other NERF refunds, all of which are estimated refunds. The following table provides more details on these refunds and shows that they fall into three broad categories: Stipulated Payout to BP, Conferee Cases, and Future Amended Severance Tax Returns.

Fiscal Impact of BP Opinion		
Tax Years 2003-2014		
(Amounts in Millions)		
	<i>Actual Refunds</i>	<i>Estimated Refunds</i>
ROI Deductions		
Stipulated Payout to BP	\$2.4	N/A
Conferee Cases	\$6.8	N/A
Future Amended Severance Tax Returns	N/A	\$22.0
<i>Subtotal by Type</i>	\$9.2	\$22.0
Total Actual and Estimated ROI Refunds	\$31.2	
Other NERF Deductions		
Conferee Cases	N/A	\$31.5
Future Amended Severance Tax Returns	N/A	\$45.0
<i>Subtotal by Type</i>	\$0.0	\$76.5
Total Estimated Other NERF Refunds	\$76.5	
Total Actual and Estimated Refunds	\$107.7	

Below is more detail on the three categories of refunds resulting from the BP Opinion.

1. *Stipulated Payout to BP:* As part of the Supreme Court case proceedings, DOR and BP stipulated that that the amount of tax, penalty, and interest in question was \$2.4 million (\$1.3 million in tax and \$1.1 million in penalty and interest) that had been assessed on BP. As a result of the Opinion, DOR will be paying out this \$2.4 million to BP before the end of Fiscal Year 2015-16. All of the \$2.4 million reflects BP's refund claims for ROI deductions.

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2. *Conferee Cases:* At the time of the BP case, DOR’s Tax Conferee was holding several other cases involving refund claims for both ROI deductions and other NERF deductions. These claims involve severance tax remittances from tax years 2003 through 2009. The claims for ROI deductions total \$6.8 million (\$3.2 million in tax and \$3.6 million in penalty and interest). These claims will likely be paid out in Fiscal Year 2016-17.

The claims for other NERF deductions total \$31.5 million (\$18.2 million in tax and \$13.3 million in penalty and interest). At this point, we consider these to be estimated refunds because, as discussed previously, we anticipate conducting rule-making workshops with stakeholders to help determine whether some or all of the other NERF deductions are allowable under current law. The portion of the \$31.5 million actually refunded would depend upon how many of the NERF deductions are determined by this rule-making process to be allowable under current law. For example, if all of the other NERF deductions were determined by the rule-making process to be allowable under current law, then DOR would refund all of the \$31.5 million, likely beginning in Fiscal Year 2016-17.

3. *Future Amended Returns:* DOR expects that the BP opinion will prompt other taxpayers to file amended returns claiming both ROI deductions and other NERF deductions. As discussed at the JBC meeting on May 6, 2016, DOR analyzed the top 11 severance tax remitters, representing about 80 percent of all severance tax collections, and estimated that taxpayers may file amended returns claiming about \$22 million in ROI deductions and \$45 million in other NERF deductions for tax years 2012 through 2014. Tax year 2015 was not analyzed because a significant number of taxpayers have yet to file their 2015 severance tax returns. This estimate was based on an analysis of whether these top taxpayers were likely already claiming the ROI and other NERF deductions. In addition, the \$45 million figure assumes that the rule-making process described above determines that all other NERF deductions are allowable under current law.

As of June 16, 2016, DOR has received one amended return related to the BP opinion. The amended return is claiming the ROI deduction only, and the amount claimed is in line with DOR’s previous estimates of what would be claimed by taxpayers as a result of the BP opinion. DOR will not issue this refund until after reviewing the claim, which will be completed in Fiscal Year 2016-17. DOR will review other refund claims as they are received.

Q3A: SB-218 Implementation

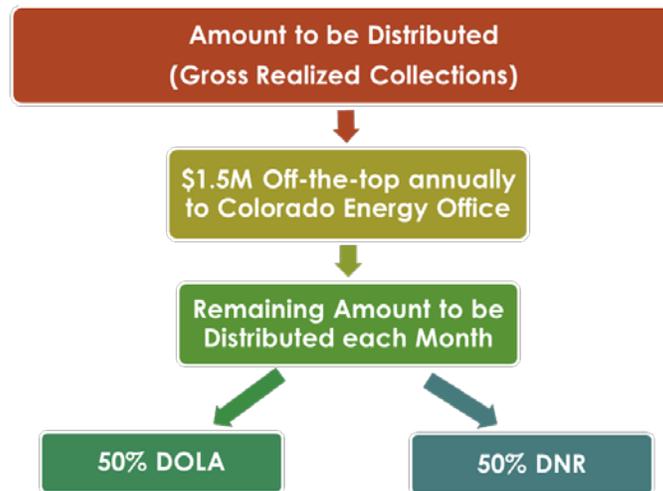
1. Current Process:

- A. DOR collects Severance Tax revenue and processes normal refunds throughout the month.

Total Monthly Revenue (Gross Collections) minus Monthly Refund Total <hr/> Amount to be Distributed (Gross Realized Collections)
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B. Severance Tax Distribution Process



2. FY 2015-16 Process under SB-218: April and May 2016

- A. April and May distributions were frozen pending outcomes from the legislative session related to Severance Tax.
- B. Now that SB-218 has become law, DOR has distributed April and May amounts per usual to DNR and DOLA pursuant to SB-218.
- C. The amounts distributed are as follows:

	April Distribution	May Distribution
DNR	\$ 5.9M	\$ 4M
DOLA	\$ 5.9M	\$ 4M

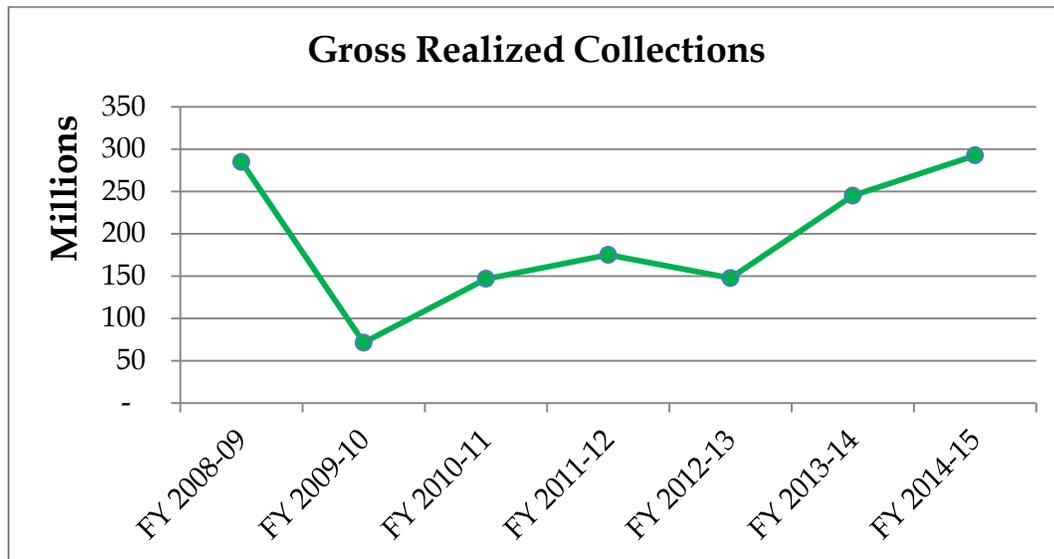
3. FY 2015-16 Process under SB-218: June 2016

- A. The \$2.4M stipulated to in the Supreme Court case will be processed in June as a refund.
- B. The remaining amount will be distributed to DNR and DOLA following the current process.

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Q3B: Future Impact on Severance Tax Revenue

1. Historic Severance Tax revenue



2. Future Revenue Impact

- A. Using an average percent of historic refunds over time will not yield a reliable amount because the total collections vary drastically from year to year based on the industry.
- B. However, there is a range; from: *if ROI is deemed to be the only allowable deduction* to: *if all deductions are deemed allowable*.
- C. The range could be a future annual revenue decrease (all things remaining constant such as industry activity and the price of oil) of 4% up to 12%.

Q4: Tax Policy Interpretation Changes

1. Roles

- A. The Department does not establish tax policy. Rather it implements policy by interpreting statute and case law set by the Legislature and the courts by:
 - I. Reading the plain language of the statute.

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- II. When the language is not clear, employing the canons of statutory construction. Statutory scheme/avoiding absurd results/ legislative history/giving effect to all language, etc.
 - III. Understanding presumptions in construing tax statutes that courts have set forth. Tax imposition is construed in favor of taxpayer and against the taxing authority. Exemptions and deductions are matters of legislative grace and are not granted to taxpayers unless clearly provided for.
 - IV. Reviewing case law from our courts that have interpreted those statutes. A question of law is unsettled until the Colorado Supreme Court speaks.
- B. The Department does evaluate, audit, and enforce policy set by the Legislature and the Courts.

2. Evaluation of Interpretation

- A. Informally, the Department receives thousands of inquiries each year that we must respond to in some fashion.
- B. Since 2010, the Department has formally evaluated its interpretation 425 times through amended regulations and the issuance of Private Letter Rulings (PLRs) and General Information Letters (GILs).
- C. During that time, there have been seven instances when the department has changed its interpretation of tax policy, as follows:
 - I. **Issue:** Conservation Easement Credits for Nonprofits
Date: 2015
Original Position: The Department issued a 2014 PLR that a nonprofit corporation qualified for the conservation easement credit because a nonprofit corporation is a corporation that is "subject to" Title 39, Article 3 (corporate income tax).
Reason for Review: A subsequent PLR request asked that the Department allow credits for a nonprofit owned 90% by a government entity.
Steps Taken: The Department undertook a stakeholder workshop and pursued a rule on the topic.
Outcome & Rationale: The Department adopted a rule that limited the rationale in the initial PLR, allowing the credit for certain nonprofits but ruling that nonprofits that had government entities as shareholders were not eligible for the credit.
 - II. **Issue:** Sales Tax Exemption for Residential Fuel
Date: 2015

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Original Position: The Department's rule on this issue states that residences that receive fuel through a master meter that is classified by the P.U.C. as residential are exempt regardless of how the fuel is actually being used. Master meters classified by the P.U.C. as commercial may be exempt if the residents can prove the fuel was for residential use.

Reason for Review: The rule came up on the Department's rule review agenda.

Steps Taken: The Department initiated its stakeholder process as part of the rule review. In seeking participation for its workshop, the Department expressed to several utility companies that the rule may be inconsistent with statute.

Outcome & Rationale: During the Department's review process, the legislature passed new legislation that clarified the exemption in the statute. As a consequence, the rule is likely to remain unchanged.

III. **Issue:** Boundary Dispute between the City of Fountain and the Pikes Peak Rural Transportation Authority (PPRTA)

Date: 2015

Original Position: In 2009, the City of Fountain asked the Department if a business was required to collect both Fountain sales tax and PPRTA sales tax after Fountain had annexed the land upon which the establishment was located. The land was within the boundaries of the PPRTA. A front-line employee answered the question saying that the PPRTA tax should no longer be collected after the Fountain annexation.

Reason for Review: In 2014, the City of Fountain asked the Department to confirm the 2009 response because another business was going to be in the same position.

Steps Taken: The Department met with all stakeholders to discuss the applicability of the PPRTA tax. The Department concluded that the PPRTA tax was applicable. In order to expedite resolution, the Department waived its administrative process and allowed the taxpayer to proceed directly to district court.

Outcome & Rationale: The Department concluded that the PPRTA tax was applicable. The dispute between PPRTA and Fountain is proceeding in state district court.

IV. **Issue:** Sales Tax Exemption for Food Served in Retirement Homes

Date: 2014

Original Position: The Department issued guidance in 1980 declaring that food served in community settings (college dorms, social lodges, etc.) was exempt from sales tax.

Reason for Review: The Department received a PLR request asking

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whether a meal plan sold by a retirement home to residents was exempt from sales tax.

Steps Taken: The Department reviewed the original guidance and concluded that it was inconsistent with the statute.

Outcome & Rationale: The Department issued a PLR stating that the retirement home's meal plan was taxable. In 2016, the legislature passed an exemption from sales tax for meals served in retirement homes.

V. **Issue:** Sales Tax Exemption for Construction Materials for Affordable Housing

Date: 2014

Original Position: The Department granted sales tax exemption certificates to low income housing authority projects prior to 2012.

Reason for Review: The examiner in charge of issuing these types of certificates retired in 2012. A new examiner reviewed the statute and questioned whether it allowed for the exemption.

Steps Taken: The Department engaged with stakeholders to discuss the statute and its applicability.

Outcome & Rationale: The Department concluded that the relevant statute did not grant a sales and use tax exemption and denied an Exempt Certificate to the applicant. To accommodate industry concerns, the Department held its decision in abeyance until July 1st to allow the housing authority representatives to seek legislative clarification. The 2016 legislature amended the statute to allow a sales tax exemption.

VI. **Issue:** Sales Tax Exemption for Cosmetic Products Such as Dermal Filler and Botox

Date: 2011

Original Position: The Department concluded in a GIL that cosmetic products such as collagen gel used as dermal filler and Botox were not eligible for the sales tax exemption for prescription drugs.

Reason for Review: The Department was asked to reconsider this ruling.

Steps Taken: The Department reconsidered its ruling under a different exemption provision (for materials dispensed by a doctor as part of professional services provided to a patient).

Outcome & Rationale: The Department concluded that the materials could be exempt if the doctor considered that the person receiving the collagen gel or Botox was a patient.

VII. **Issue:** Sales Tax Exemption for Machinery Used in the Production of Electricity

Date: 2006-2014

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Original Position: The Department found in 2001 that a producer of electricity was eligible for the manufacturing machinery exemption for machinery used in the production of tangible personal property.

Reason for Review: In 2004, a subsequent Executive Director determined that the exemption should not have been granted.

Steps Taken: The Department denied Public Service Company's request for a refund related to this issue, and, in 2006, reversed the prior Executive Director's determination.

Outcome & Rationale: In 2014, the Colorado Supreme Court ruled in favor of the Department in a unanimous decision, determining that the statutes did not allow the exemption to producers of electricity.

- D. While the number and percentage of tax policy changes is small, because they have been elevated to level of the General Assembly, it is clear that more comprehensive outreach is needed when this type of change occurs.

Additional Questions: General Assembly Notification Process

A: Following up on the question asked by the JBC at a prior hearing ("why was no notice provided to the JBC about the possible precedential impacts of an adverse BP Supreme Court Opinion,") the Department researched how reporting might be made in similar circumstances to inform policy makers of possible impacts of appellate court Opinions on other tax matters.

Initially, strict taxpayer confidentiality provisions control what information gathered from taxpayer returns can be disclosed. The Department of Revenue and its employees and agents are prohibited by statute from disclosing or releasing any information related to the taxes filed by a taxpayer. The individual who makes an unlawful disclosure is subject to criminal sanctions contained in CRS 39-21-113 and will be dismissed from office. Section 39-21-113(4)(a), C.R.S. reads in relevant part:

(4) (a) Except in accordance with judicial order or as otherwise provided by law, the executive director of the department of revenue and his agents, clerks, and employees shall not divulge or make known in any way any information obtained from any investigation conducted by the department or its agents or disclosed in any document, report, or return filed in connection with any of the taxes covered by this article. The officials charged with the custody of such documents, reports, investigations, and returns shall not be required to produce any of them or evidence of anything contained in them in any action or proceeding in any court, except on behalf of the executive director in an action or proceeding under the provisions of any such taxing statutes to which the department is a party or on behalf of any party to any action or proceeding under the provisions of such taxing statutes when the report of facts shown thereby is directly involved in such action or proceeding, in either of which events the court may require the production of, and may admit in evidence, so much of said reports or of the facts shown thereby as are pertinent to the action or proceeding and no more.

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Nonetheless, there are two existing reports that might be adapted to provide this information to the JBC members. The first is related to the Single Statewide Audit. Each year the Office of the State Auditor evaluates the cases that are under protest in the Tax Conferee's office to determine an estimate of collectability for financial reporting purposes. This process does not appear sufficient to provide lawmakers with the needed information because there is no attempt to estimate the broader precedential value of an adverse court decision. Rather, this process looks at the specific case and estimates the likelihood of success on that case.

Unfortunately, the other process is similar in nature and suffers from the same limitation. Each year the Attorney General's office evaluates active litigation and reports to the state controller cases that have a case specific total financial exposure in excess of \$5 million. Again, in this instance, there is no attempt to estimate the potential precedential value of the case on other tax matters, and, instead, only looks at the actual dollars at risk in the specific case.

One possibility to provide the desired notification is for the Department of Revenue to work with both the Attorney General's office and that of the State Controller to include a notation about the potential precedential value of the case, in addition to that case-specific liability. Such a notation would need to comply with the requirements of Section 39-21-113(4)(a), C.R.S. An example of a possible limitation of this approach is a tax matter that clearly implicates a single or small group of taxpayers – reporting of the possible adverse impact to the state could potentially disclose substantial financial information reported to the Department on that taxpayer's return.

Another potential option is to pass a law that specifically gives the JBC access to this information concerning active litigation for the purposes of planning and budgeting. Section 39-21-113, C.R.S. currently has several exceptions to the confidentiality requirements. For example, there are exceptions that allow the DOR to publish statistics, or to provide County Assessors with ad valorem information, or to provide the unclaimed property fund with information necessary to make refunds. Each exception to the taxpayer confidentiality provisions requires that the party receiving this information hold it in strict confidence, subject to the same criminal sanctions as are DOR employees for improper disclosure of this information. If it is the committee's pleasure, the Department would be happy to work with the Attorney General's office and Legislative staff to draft a bill that would allow the Department or the Attorney General's Office to provide the JBC with information concerning the potential precedential value of the court case.

SEVERANCE TAX UPDATE



COLORADO
Department of Revenue

Presented to Joint Budget Committee
June 20, 2016
By Department of Revenue

AGENDA

- Statutory Interpretation
- Deductions Allowed Under the Supreme Court Opinion
- Status of Refunds
 - ✓ Implementation of SB-218
 - ✓ Future Impact to Severance Tax Revenue
- Tax Policy Summary
- General Assembly Notification Process



Statutory Interpretation

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC MEYER, DEPUTY ATTORNEY GENERAL



COLORADO
Department of Revenue

PRIOR TO THE SUPREME COURT OPINION IN THE BP CASE

- It was not clear that ROI – Return on Investment/Cost of Capital was an allowable deduction.
- Courts have consistently upheld that deductions and exemptions in taxation “are recorded as a matter of legislative grace . . . and they are not allowed unless clearly provided for...” in statute.



LITIGATION HISTORY AND RULINGS

- The Department's interpretation was consistent with the analysis of two well-respected courts. Neither court defined the cost of capital as within the scope of transportation costs.
 - The 10th Circuit Court opinion on Atlantic Richfield (2000)
 - The CO Court of Appeals opinion on BP (2013)
- Until the Supreme Court issued its opinion in 2016, the Department had every indication it had interpreted statute correctly.



Deductions Addressed by the Supreme Court Opinion

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC MEYER, DEPUTY ATTORNEY GENERAL



COLORADO
Department of Revenue

ROI DEDUCTION

- **ROI – Return on Investment/Cost of Capital** is one type of NERF deductions 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.



PRIMARY FOCUS OF THE SUPREME COURT CASE

- ROI – Return on Investment/Cost of Capital was the primary focus of the Supreme Court case.
- Additionally, the Supreme Court through dicta addressed all NERF deductions.



NERF DEDUCTIONS

NERF Deductions– Net-back Expense Report Form

- NERF deductions are currently allowed by the Property Tax Administrator (PTA) within the Department of Local Affairs.



TYPES OF NERF DEDUCTIONS

- Chemicals, Lubricants, Supplies Used on Site
- Cost incurred to sell product
- Direct G&A, Environmental
- Environmental Compliance Costs
- Field Labor (Pumper) Costs
- Fuel Expense
- Insurance, Liability and Equipment
- Lease Rentals
- Non-capitalized repairs
- **ROI – Return on Investment/Cost of Capital**
- Salt Water Disposal/Water Hauling
- Salaries, Wages, and Benefits
- Taxes: Personal Property and Improvements
- Utilities



EVALUATION OF THE OPINION

- The Supreme Court Opinion was narrowly focused on ROI deductions.
- The court provided the allowance for ROI deductions but **NO** direction on the calculation methodology for the allowance.
- DOR will be promulgating rules to provide guidance on a consistent calculation methodology.



ADDITIONAL NERF DEDUCTIONS

- It is unclear how the NERF deductions relate to transportation, processing, and manufacturing costs borne by the taxpayer.
- The Department will conduct an extensive stakeholder and outreach process before we promulgate rules to address them.
- Because the Department did not have specific rules addressing NERF deductions, the Court took guidance from the Property Tax Administrator Guidelines.



Status of Refunds

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR
ERIC JOHNSON, FIELD AUDIT TAXATION DOR



COLORADO
Department of Revenue

FISCAL IMPACT OF BP OPINION

TAX YEARS 2003-2014

(AMOUNTS IN MILLIONS)

	<i>Actual Refunds</i>	<i>Estimated Refunds</i>
ROI Deductions		
Stipulated Payout to BP	\$2.4	N/A
Conferee Cases	\$6.8	N/A
Future Amended Severance Tax Returns	N/A	\$22.0
<i>Subtotal by Type</i>	\$9.2	\$22.0
Total Actual and Estimated ROI Refunds	\$31.2	
Other NERF Deductions		
Conferee Cases	N/A	\$31.5
Future Amended Severance Tax Returns	N/A	\$45.0
<i>Subtotal by Type</i>	\$0.0	\$76.5
Total Estimated Other NERF Refunds	\$76.5	
Total Actual and Estimated Refunds	\$107.7	



TIMING OF REFUNDS

- The Department has no knowledge of potential claims until the taxpayers file a return.
- Therefore there is no way to accurately estimate the potential monetary impact or timing of refunds.
- Returns could be processed in FY 2016-17 and beyond as taxpayers submit returns.



SB-218 Implementation

BARB BROHL, EXECUTIVE DIRECTOR DOR
LORRI DUGAN, CHIEF FINANCIAL OFFICER DOR



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CURRENT MONTHLY SEVERANCE TAX ACTIVITY

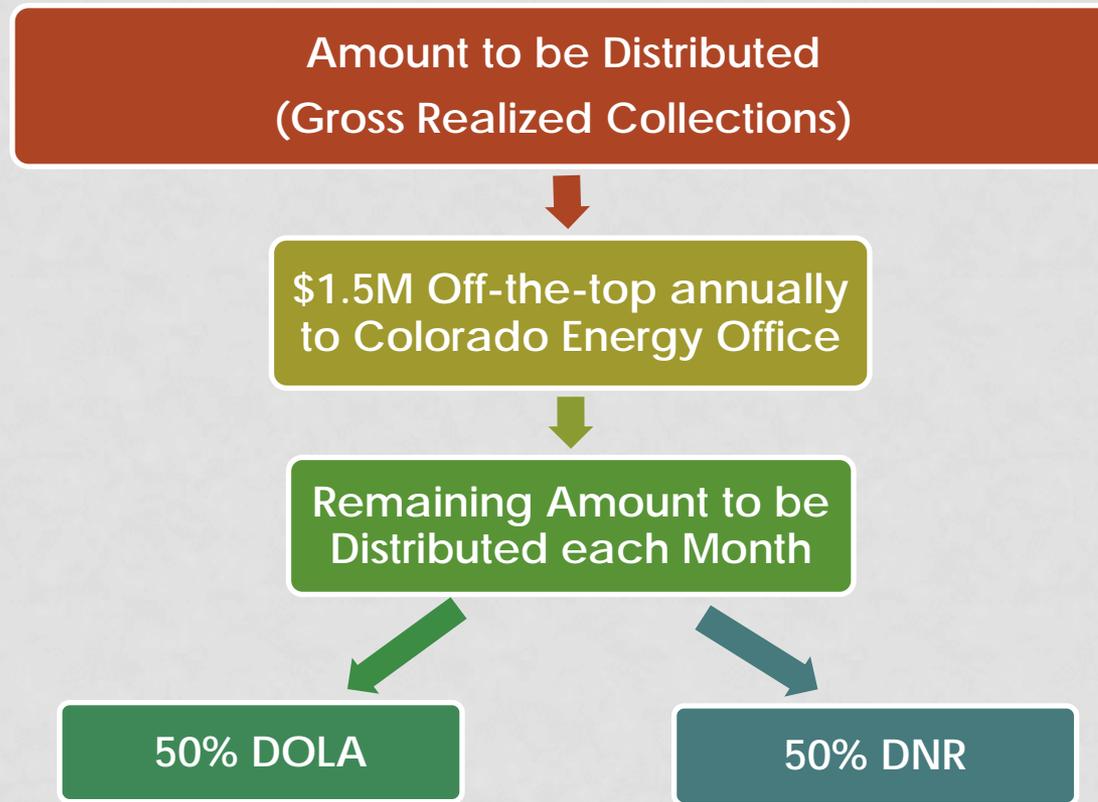
- DOR collects Severance Tax revenue and processes normal refunds throughout the month.

1. Total Monthly Collections (*Gross Collections*)
2. minus Total Monthly Refunds
3.

 Amount to be Distributed (*Gross Realized Collections*)



CURRENT SEVERANCE TAX DISTRIBUTION PROCESS



FY 2015-16 PROCESS UNDER SB-218

APRIL AND MAY

- April and May distributions were frozen pending outcomes from the legislative session related to Severance Tax.
- Now that SB-218 has become law, DOR has distributed April and May amounts per usual to DNR and DOLA pursuant to SB-218.
- Distributed amounts:

	April Distribution	May Distribution
DNR	\$ 5.9M	\$ 4M
DOLA	\$ 5.9M	\$ 4M



FY 2015-16 PROCESS UNDER SB-218 JUNE

- The \$2.4M stipulated to in the Supreme Court case will be processed in June as a refund.
- The remaining amount will be distributed following the current process.



COLORADO
Department of Revenue

FY 2016-17 PROCESS

BEGINNING JULY 1, 2016 THE PROCESS WILL CHANGE

- DOR collects Severance Tax revenue and processes normal refunds throughout the month.

1. Total Monthly Collections (*Gross Collections*)
2. minus Total Monthly Refunds
(capped at 15% of Total Monthly Collections)
3. Amount to be Distributed (*Gross Realized Collections*)

- Any refunds in excess of 15% will be paid for by the General Fund



COLORADO
Department of Revenue

Future Impact on Severance Tax Revenue

BARB BROHL, EXECUTIVE DIRECTOR DOR
ERIC JOHNSON, FIELD AUDIT TAXATION DOR



COLORADO
Department of Revenue

HISTORIC SEVERANCE TAX REVENUE

Gross Realized Collections



Annual revenue is highly volatile



FUTURE REVENUE IMPACT

- Using an average percent of historic refunds over time will not yield a reliable amount because the total collections vary drastically from year to year based on the industry.
- However, there is a range; from if ROI is deemed to be the only allowable deduction to if all deductions are deemed allowable.
- The range could be a future annual revenue decrease (all things remaining constant such as industry activity and the price of oil) of 4% up to 12%.



Tax Policy Summary

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR



COLORADO
Department of Revenue

ROLES

- DOR **does not** establish tax policy.
- DOR does **implement** policy by interpreting statute and case law set by the Legislature and the courts.
- DOR does **evaluate**, **audit**, and **enforce** policy set by the Legislature and the courts.



POLICY

- Since 2010 DOR has formally evaluated policy interpretation 425 times.
- There have been 7 instances when the Department has changed its interpretation of tax policy.



COMMUNICATION

- The number of changes has been small.
- However, the changes have been elevated to the level of the Legislature.
- More comprehensive outreach is needed to communicate when these types of changes occur.



GENERAL ASSEMBLY NOTIFICATION PROCESS

BARB BROHL, EXECUTIVE DIRECTOR DOR
JOHN VECCHIARELLI, SR. DIRECTOR TAXATION DOR



COLORADO
Department of Revenue

CONFIDENTIALITY

- DOR is bound by statute to maintain strict taxpayer **confidentiality**.

C.R.S. 39-21-113 (4) (a) ...the executive director of the department of revenue and his agents, clerks, and employees shall not divulge or make known in any way any information obtained from any investigation conducted by the department or its agents or disclosed in any document, report, or return filed in connection with any of the taxes covered by this article.



CURRENT OPTIONS FOR INFORMATION SHARING

1. Statewide Single Audit

- Office of State Auditor (OSA) annually evaluates tax cases currently under protest and estimates collectability.
- However, the OSA analysis does not consider the precedential impact the individual case could have on other affected taxpayers.

2. Attorney General (AG) evaluation of active litigation

- The State AG analyzes and reports to the state controller cases with financial impact in excess of \$5 million.
- Again, the current approach does not consider a broader precedential impact, although DOR could work with the AG to conduct this type of analysis and incorporate it into this process.



NEW LEGISLATION COULD BE ENACTED

- Revisions to C.R.S. 39-21-113 could be made to grant the JBC access to specific tax information to be used for the purposes of planning and budgeting.
- DOR would be happy to work with the Attorney General's Office and Legislative staff to draft a bill that would allow the Department or the Attorney General's Office to provide the JBC with applicable information.

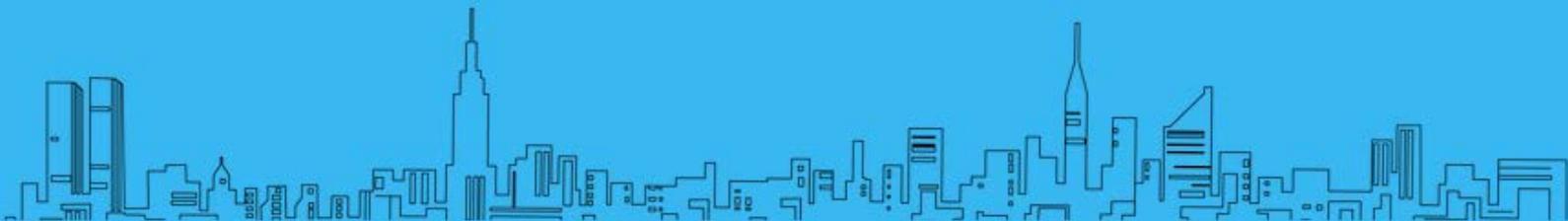


COLORADO
Department of Revenue

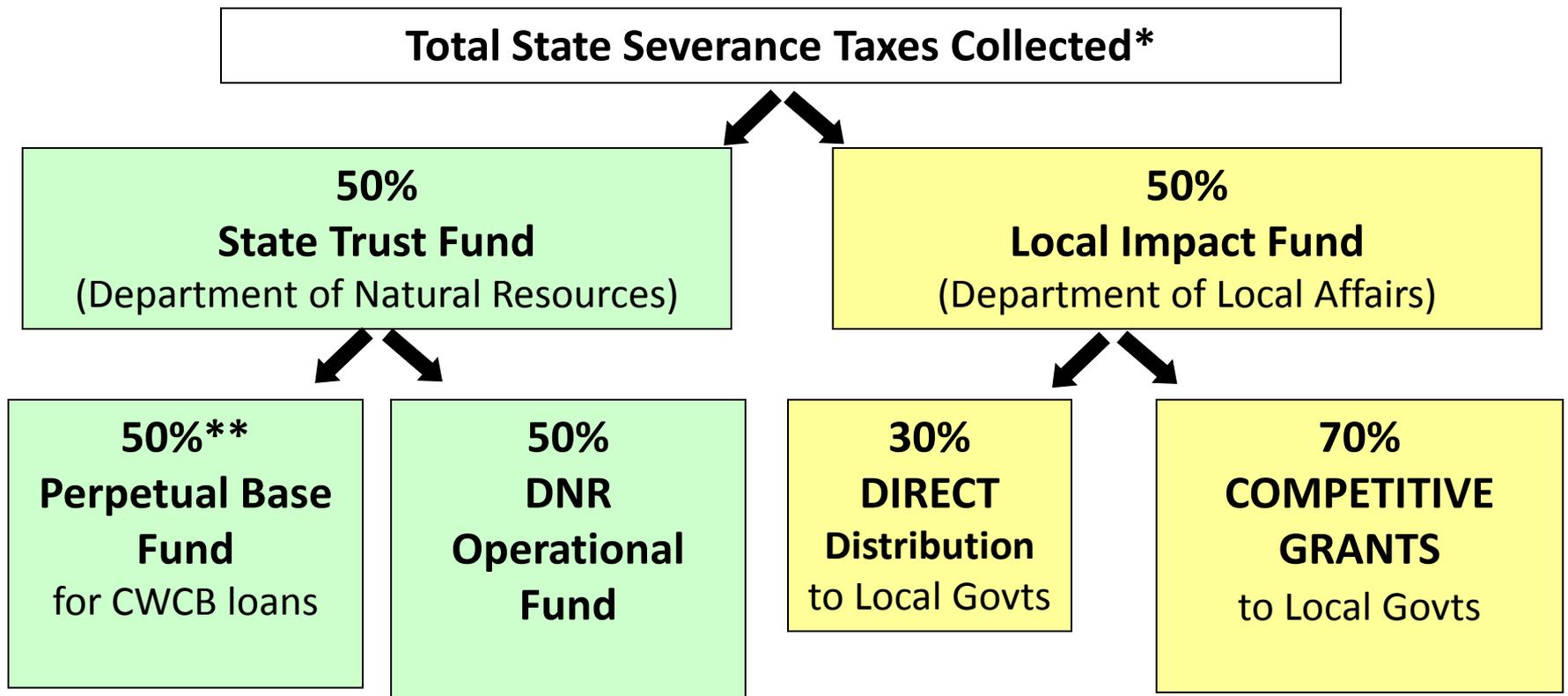
Department of Natural Resources

Severance Tax Update

June 2016



How is Severance Tax Distributed?



* \$1.5 Million of severance tax is taken “off-the-top” and deposited into the Innovative Energy Fund

** If Perpetual Base Fund revenues exceed \$50M; next \$10M flows to CDPHE’s Small Communities Water and Wastewater Grant Fund.)

Perpetual Base Fund

- The Perpetual Base Fund is a \$380 million revolving loan fund which provides low interest loans for raw water supply projects.
- S.B. 16-218 restricts \$19.1 million from the Perpetual Base Fund and directed the Department of Revenue to use first use severance tax revenue in April, May, and June 2016 to help pay severance tax refunds prior to tapping the General Fund Reserve for such refunds.

Perpetual Base Fund (Continued)

- Going forward, CWCB anticipates receiving about \$12 million per year in loan repayments as well as interest on its cash balance. These revenue streams provide some stability to the revenue received by the CWCB loan program.
- If severance tax revenue is reduced going forward by four to twelve percent, the Perpetual Base Fund will still get \$21.6 to \$23.5 million in new severance tax revenue in FY 2016-17 and \$34 to \$37 million in FY 2017-18 (per the March 2016 LCS Forecast).

Perpetual Base Fund (Continued)

- Regardless of whether the \$19.1 million restriction is lifted, \$33 million or more in new funding is expected to become available over the course of FY 2016-17. Further, additional revenue will be earned in the CWCB Construction Fund. As such, CWCB anticipates normal water project loan activity resuming in FY 2016-17 (albeit with less funding available than previously anticipated).

Perpetual Base Fund (Continued)

- Regardless of these severance tax issues, the Colorado Water Plan estimated that the CWCB would need \$100 million per year in additional revenues to address the State's long term water supply needs.
- This need will be largely unchanged by current severance tax revenue issues.

Operational Fund

- For FY 2016-17, the Operational Fund includes \$17.7 million in Tier 1 appropriations to six divisions as well as another \$38.9 million in Tier 2 authorizations contained in statute.
- S.B. 16-218 restricts \$10.0 million from the Operational Fund and directed the Department of Revenue to use first use severance tax revenue in April, May, and June 2016 to help pay severance tax refunds prior to tapping the General Fund Reserve for such refunds.

Impacts to Tier 1

For FY 2016-17, the \$17.8 Million Tier 1 appropriation includes:

- \$7.4 Million for the Oil & Gas Conservation Commission
- \$4.5 Million for the Division of Reclamation, Mining, and Safety
- \$2.6 Million for Colorado Parks and Wildlife
- \$1.4 Million for the Colorado Geological Survey
- \$1.3 Million for the Colorado Water Conservation Board
- \$0.6 Million for the Colorado Avalanche Information Center



Impacts to Tier 1 (Continued)

- The \$10.0 million restriction contained in S.B. 16-218 was designed to leave enough money for Tier 1 programs to continue operating in FY 2016-17 and beyond.
- The \$10.0 million restriction effectively freezes the last \$3.0 million in Tier 2 reserves as well as \$7.0 million in Tier 1 reserves. Outside of these “frozen assets”, there will be \$9 million in unobligated cash balance in the Operational Fund.

Impacts to Tier 1 (Continued)

- So long as this \$9 million in fund balance is supplemented by statewide severance tax revenues of at least \$32 million in FY 2016-17, there will be enough revenue to fully fund Tier 1 programs without the \$10 million restriction being lifted.

Impacts to Tier 2 Programs



Tier 2 Impacts – Let's Not Get Overly Dramatic

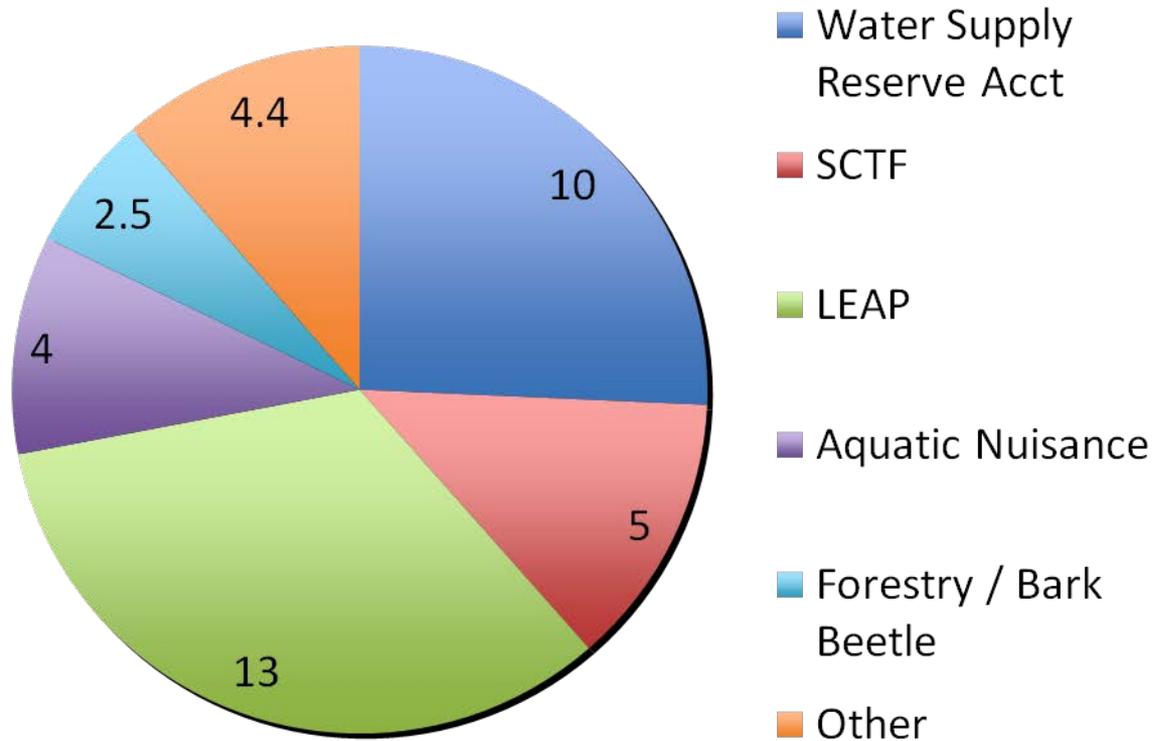
- Prior to the Supreme Court's BP decision – and prior to S.B. 218 – DNR was projecting Tier 2 programs would be funded at 26% of authorized levels.
- With a possible reduction in revenue going forward and with a \$10.0 million restriction, DNR is now projecting that Tier 2 programs will not get funded in FY 2016-17.

Tier 2 Impacts

- If the \$10.0 million restriction were lifted, Tier 2 programs would get funded at almost 22% of authorized levels in FY 2016-17.
- Longer term challenges remain. Funding \$15 to \$18 million in Tier 1 appropriations plus fully funding the current \$37 million in authorized Tier 2 expenditures requires annual statewide severance tax revenue in excess of \$200 million.
- Under current forecasts, significant Tier 2 reductions are likely to again be needed in FY 2017-18.



Severance Tax Tier 2 Programs



Total Authorization for FY 2016-17: \$38.9 million

Water Supply Reserve Fund

(Tier 2 Transfer = \$10.0 Million Per Year)

- Program Description: The Water Supply Reserve Fund is utilized by the nine basin roundtables to address water supply gaps in the respective basins. Roundtables approve grants from basin and statewide accounts and then pass them along to the Colorado Water Conservation Board for final approval. This is the primary source of funding for Basin Implementation Plans as well as efforts to achieve goals and objectives of Colorado's Water Plan at the basin level.
- FY 2016-17 Programmatic Impacts: At this point, roundtables and stakeholders are being warned that the WSRF account will likely receive no additional revenue for FY 2016-17. Basin accounts do have available balances, which vary by basin. The statewide account has an unobligated balance of roughly \$2.3 million. Requests for statewide grants will be considered in September of 2016.

Water Supply Reserve Fund

(Tier 2 Transfer = \$10.0 Million Per Year)

- FY 2016-17 Programmatic Impacts (Continued): Roundtables have begun a rigorous process of additional prioritization and assessment of grant applications in response to this projected revenue shortfall.
- Looking Beyond FY 2016-17: Likely reductions in funding will affect basin roundtables adversely as they work to implement projects that will meet goals and objectives identified in Basin Implementation Plans. Current basin balances will help fund projects which have already been approved, but revenue shortfalls will slow the ability to approve new projects. CWCB has directed staff to evaluate funding for CWCB and the roundtables over the next five years. The Interbasin Compact Committee is also evaluating additional revenue sources for implementation of water projects. However, at this point in time, funding for these types of projects is dependent on Tier 2 transfers.

Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

Program Description: The Species Conservation Trust Fund supports a wide range of research and projects to protect and recover threatened and endangered species – and species that are at risk of such listing – by protecting both species and their habitats. Funded activities and projects aim to minimize Endangered Species Act requirements and restrictions on existing and future land and water use. The program also aims to promote the restoration, recovery, sustainability, and resiliency of endangered, threatened, and imperiled wildlife. Protecting aquatic and riparian dependent species and plants is one of the long-term goals identified in Colorado’s Water Plan.

Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

FY 2016-17 Programmatic Impacts: H.B. 16-1458 authorized \$3.0 million of species conservation projects for FY 2016-17.

Although no new severance tax revenues are expected to be received through Tier 2 transfers in FY 2016-17, the Species Conservation Trust Fund has an estimated \$3.4 million fund balance available to help finance some of these projects. The Department is currently planning to restrict half of the \$3.0 million in authorized projects. This will help support the most important projects, while also maintaining some fund balance to support the program in future times of revenue volatility.

Species Conservation Trust Fund

(Tier 2 Transfer = \$5.0 Million Per Year)

Program	FY 2016-17 Base	FY 2016-17 Adjusted
Native Terrestrial Wildlife Conservation	\$778,135	\$277,985
Native Aquatic Wildlife Conservation	\$321,865	\$172,015
Native Species Management, Monitoring, and Propagation	\$700,000	\$450,000
Gunnison River Basin Selenium Management Plan	\$250,000	\$100,000
Upper Colorado River Recovery Program	\$550,000	\$100,000
Grand Valley Power Plant Repair and Improvement	\$400,000	\$400,000
Grand Total SCTF Spending	\$3,000,000	\$1,500,000

Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

- Looking beyond FY 2016-17, spending on Species Conservation Trust Fund projects is likely to remain below the \$5.0 million continuation level so long as severance tax revenues remain low.
- Colorado Parks and Wildlife will prioritize spending on: (1) continuing ongoing management projects to prevent future listings, and; (2) ongoing research studies (for example, previous investments in a study looking at long-term population trends might be damaged if CPW were to stop collecting population data during this revenue downturn).

Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Eastern Plains Native Fish Work

- What gets done: Population surveys and biological assessments of 35 native fish species, 11 of which are state listed as threatened or endangered.
- Funding cut impacts: Halt Eastern Plains native fish evaluations.
- Why it matters: Continued work is critical as relatively little is currently known about these species. Federal listing of any of these species would have a serious economic impact on the \$7 billion dollar agriculture industry in the area.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Aquatic Projects

- What gets done: These programs are targeted for research, monitoring, management and recovery/conservation of native cutthroat, boreal toad, and the “3-species”.
- Funding cut impacts: Expected funding shortfall will eliminate research, monitoring, on-the-ground management, and conservation efforts targeted to secure the status of vulnerable native species.
- Why it matters: Will result in greater risk of federal listing for boreal toad, increase vulnerability of listing petition for 3-species, and increase the vulnerability of federal listing of Rio Grande and Colorado River cutthroat trout, and could result in an endangered listing for greenback cutthroat trout.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Inventory on rare species

- What gets done: Inventory and monitoring work on rare species such as:

- Reptiles

- Raptors

- Mollusks



- Colorado fish native to west slope and eastern plains

- Funding cut impacts: Prevention of needed inventory work to evaluate abundance of these species.
- Why it matters: Lack of information on these species can lead to Federal listing decisions and the associated economic consequences.

Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Native Cutthroat Trout Studies

- What gets done: Re-establishment of wild native cutthroat populations and hatchery brood stock development.
- Funding cut impacts: Fewer new populations can be established on the landscape.
- Why it matters: Failure to recover these sub-species results in reduced opportunity for anglers to catch Colorado's native trout species, and Federal listing of additional sub-species becomes more likely.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Boreal Toad Translocation and Monitoring Work

- What gets done: Establishment and/or re-introduction of toads to create additional breeding sites. Survey work to identify suitable sites for translocation, and look for additional occupied sites.
- Funding cut impacts: Significantly reduced ability to monitor success of introductions currently underway, and to find new potential translocation opportunities.
- Why it matters: The Boreal Toad is a candidate for federal ESA listing. Reintroductions are a primary strategy to avoid listing.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Black-footed ferret site management

- What gets done: Annual burrow dusting to prevent plague outbreaks on private land reintroduction sites and fall survival surveys.
- Funding cut impacts: No dusting or surveys.
- Why it matters: As untreated colonies eventually die out, 11 private landowners will potentially lose federal incentive funding for participation in the reintroduction program and habitat for the Endangered black-footed ferret will be threatened.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Native bat acoustic monitoring

- What gets done: Annual acoustic monitoring of native bat species throughout the state to develop baseline population information.
- Funding cut impacts: No surveys or disease detection after 2016.
- Why it matters: White-nose Syndrome has devastated bat populations in North America. Surveys provide important baseline information and early detection of disease arrival in Colorado.

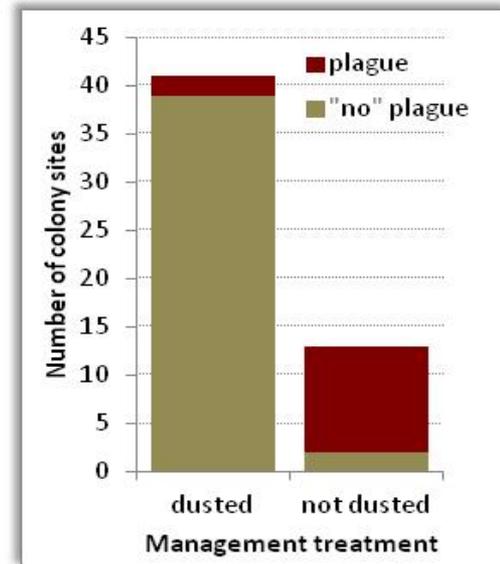


Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Plague control in prairie dogs

- What gets done: Annual burrow dusting or vaccination to prevent plague outbreaks on 3,000–5,000 acres.
- Funding cut impacts: Fewer & fewer colonies & acres treated each year.
- Why it matters: As untreated colonies eventually die out, federal listing of Gunnison's prairie dog becomes more likely.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Plains reptile surveys

- What gets done: Native reptile survey methodology development. 2016-2017 is the final year of a 5-year project.
- Funding cut impacts: No funding for final year of project, which includes data analysis and report writing.
- Why it matters: Two Colorado reptile species have been petitioned for federal listing in the recent past and this methodology will provide better responses to such petitions.





Species Conservation Trust Fund

Impacts of Tier 2 funding cuts



Native seed production for sagebrush habitat restoration

- What gets done: Bulk purchase, storage and distribution of seeds of native plants that are important for wildlife (e.g., sage-grouse and mule deer) habitat restoration and enhancement projects statewide.
- Funding cut impacts: Purchases will be delayed, and program capacity severely diminished by end of FY 2016-17; fewer acres will be treated with native plant seed. Warehouse likely to close entirely in 2018.
- Why it matters: To maintain robust wildlife communities, CPW and state/federal partners need a ready supply native seed to re-establish and improve sagebrush habitats damaged by fire, development, and invasive plants.

Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

Grand Valley Power Plant - The Grand Valley Power Plant (GVPP) project was rated by CWCB as the highest priority SCTF project. The project is expected to be matched at least 3:1 by federal funds. The GVPP is instrumental in the delivery and legal protection of water along the Colorado River, providing critical habitat to four species of endangered fish. The Upper Colorado River Recovery Program has strongly focused on flow regimes for recovery of these endangered fish species, and the GVPP is a crucial piece of many agreements and protection strategies.

Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

Gunnison River Basin Selenium Management – The USFWS has determined that high selenium levels in the Uncompahgre and Gunnison Rivers are limiting the recovery of several Colorado River endangered fish species. By meeting targets in the State’s Selenium Management Plan (developed jointly with the federal government and other parties), historical water uses are protected. Failure to meet goals in the Plan, due to funding limitations, could have adverse impacts on both the endangered species and regulatory certainty of affected watersheds.

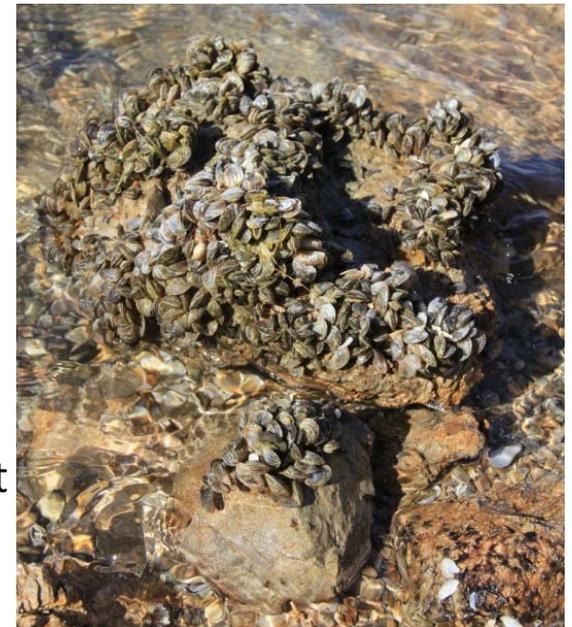
Species Conservation Trust Fund (Tier 2 Transfer = \$5.0 Million Per Year)

- Upper Colorado River Recovery Program – Nonnative fish control activities and water protection activities will proceed at a slower pace. Installation of a net at Ridgway Reservoir to address nonnative species threats in the Gunnison River basin would be delayed. Sufficient progress is required for the program to continue to provide ESA compliance for existing water users.
- Platte River Recovery Program – Colorado is required to provide a certain amount of funding to this program over a specified number of years. Colorado has made sufficient contributions in past years to allow a hiatus in funding through FY 2017-18. Funding will be required by FY 2018-19 or FY 2019-20. Lack of funding could delay program progress, which could limit the ESA compliance provided for existing water users.

Aquatic Nuisance Species (Tier 2 Transfer = \$4.0 Million Per Year)

Aquatic Nuisance Species (ANS)

- What gets done: Over 425,000 watercraft inspections and decontaminations (WID) at 71 reservoirs to prevent infestation of mussels and other detrimental aquatic invaders. Monitoring of 200 sites for established ANS.
- Funding cut impacts: Elimination of WID at majority of reservoirs, and substantial reduction to education, monitoring, and coordinated regional program.
- Why it matters: Greater risk of invasion and establishment of detrimental aquatic species, including zebra and quagga mussels, resulting in potential infrastructure damage, disruption of reservoir fisheries, and decrease in water-based recreation.



Species Conservation Trust Fund

Impacts of Tier 2 funding cuts

Aquatic Nuisance Species (ANS) – FY 2017-18 and Beyond:

- Over the longer term, reduced program revenue will lead to less watercraft inspections and decontaminations.
- Without an inspection program, some private waters may become closed to boating recreation.
- Colorado Parks and Wildlife may seek new revenue streams so that a sufficient watercraft inspection and decontamination program may be sustained and public impacts related to aquatic nuisance species can be minimized.



Healthy Forests and Vibrant Communities (Tier 2 Transfer = \$2.355 Million Per Year)

Program Description: The Healthy Forests and Vibrant Communities Act provides resources to the Colorado State Forest Service (CSFS) to increase the technical and outreach capabilities necessary to guide and support wildfire risk mitigation, watershed restoration, and economic development. This includes:

- Development, review and implementation of Community Wildfire Protection Plans to help communities reduce risk and prepare for wildfire
- Forest business loans, wildfire risk mitigation/forest restoration grants and Good Neighbor Projects
- Local wood products business support, development and job creation through implementation of forest treatments
- Increased GIS web applications and Colorado Wildfire Risk Assessment Portal
- Enhanced aerial surveys to assess forest condition and incorporate pathology information

Healthy Forests and Vibrant Communities (Tier 2 Transfer = \$2.355 Million Per Year)

HB09-1199 authorized annual severance tax payments for two program areas:

- **Forest Restoration Grants and Good Neighbor Projects**
\$1,000,000
- **Healthy Forests and Vibrant Communities**
\$1,355,000

These annual payments were later reauthorized in 2012 by HB12-1032 with Tier 2 funding. Without reauthorization, funding for these programs end July 1, 2017.

Interbasin Compact Committee Operations (Tier 2 Transfer = \$745,000 Per Year)

Program Description: H.B. 05-1177 created nine basin roundtables to analyze existing water supplies and estimate future water supply needs in each of Colorado's major water basins. Basin roundtables meet to build consensus and develop solutions to Colorado water supply needs. Funding for this program supports:

- Meeting expenses and other operating costs of the Interbasin Compact Committee to address statewide water supply issues
- Meeting expenses and other operating costs of individual basin roundtables to address basin-specific water supply issues
- The salary of the IBCC Chairman

Interbasin Compact Committee Operations (Tier 2 Transfer = \$745,000 Per Year)

FY 2016-17 Outlook: Utilizing available cash fund balances, the Interbasin Compact Committee (IBCC) and Basin Roundtables should be able to operate with minimal impacts in FY 2016-17. To better manage available revenue and reduce expenses, the Colorado Water Conservation Board may consider funding a reduced schedule of IBCC and/or roundtable meetings.

FY 2017-18 and Beyond: Over the longer term, reduced revenue will require a reduction in the number of meetings funded. Given revenue reduction and volatility, the CWCB may need to explore alternatives to financing the IBCC Chair's salary from Tier 2 revenues.

Water Efficiency Grant Program (Tier 2 Transfer = \$550,000 Per Year)

Program Description: The Water Efficiency Grant Program is utilized by water providers and others to develop water efficiency plans and to implement water efficiency projects. In a broad sense, the program helps to achieve water efficiency goals and objectives contained in Colorado's Water Plan.

FY 2016-17 Impacts: The program will continue using an unobligated cash balance of over \$1 million. Given the revenue shortfall, CWCB staff have begun a prioritization process to focus on foundational water efficiency measures and projects that best align with the goals and objectives of Colorado's Water Plan.

Water Efficiency Grant Program (Tier 2 Transfer = \$550,000 Per Year)

- FY 2017-18 and Beyond: The Program will be negatively affected by continued lower revenues. The release of the Colorado Water Plan has focused the efforts of water providers on implementation of water efficiency measures to meet goals and objectives identified in water efficiency plans.
- For FY 2016-17, there are 12 water efficiency plan revisions scheduled. Additionally, there are 76 approved water efficiency plans that contain water efficiency projects eligible for program funding. Funding the growing demand for planning assistance and project implementation beyond FY 2017-18 will be unsustainable without additional revenue.

Reclamation of Forfeited Mine Sites (Tier 2 Transfer = \$127,000 Per Year)

Program Description: Severance tax revenue is used to reclaim mine sites where permits have been revoked and financial bonds by themselves are insufficient to cover reclamation costs. Many forfeited sites involve operator bankruptcy and/or abandonment of the site. Severance tax funds 0.3 FTE of project management costs. No other funds in the Inactive Mines Program can be used to reclaim permitted sites (the Program receives federal funds to address “pre-law” sites that existed prior to state regulation).



Reclamation of Forfeited Mine Sites (Tier 2 Transfer = \$127,000 Per Year)

FY 2016-17 Impacts: Each annual increment of funding is allowed to be spent over three fiscal years. As such, an estimated \$188,000 in unspent funding will roll into FY 2016-17 to continue priority reclamation projects. With no new funding received in FY 2016-17, progress in addressing issues at forfeited mine sites in Colorado will be slowed.



Reclamation of Forfeited Mine Sites (Tier 2 Transfer = \$127,000 Per Year)

Impacts Beyond FY 2016-17: With limited program revenue, reclamation performed at each site will be limited to the available forfeited bond amount. Without adequate reclamation, some forfeited sites will be left with persistent issues such as soil erosion and noxious weeds that can cause further off-site impacts to water quality and adjacent lands. Landowner conflicts and lawsuits could result.

Given a lack of funding, progress in cleaning up Colorado's current backlog of seven forfeited mine sites will be slowed. With two high dollar sites in the backlog (including a \$500,000 project) and with two to four new sites being added to the list each year, the backlog of forfeited mine sites is likely to grow over the coming years.

Appendix

Impacts to Tier 2 Severance Tax Programs
Outside of
the Department of Natural Resources

Department of Agriculture

ACRE Program (\$500,000 Year)

The ACRE program promotes the development and implementation of renewable energy and energy efficiency projects for Colorado's agricultural producers and processors under the direction of the Colorado Agricultural Value-Added Development Board.

As Colorado's principal source of state-level support for agricultural energy management, the ACRE program provides financial and technical assistance and education to help agricultural producers and processors cut energy costs, develop their own energy resources, and create markets for agriculturally-derived energy and fuels.

The ACRE program is supported by one FTE and retains a fund balance which will allow operations to continue during FY 2016-17 without additional transfers. This transfer repeals June 30, 2017, so the Department will be pursuing a legislative agenda item during the 2017 session in order to renew the transfer.

Department of Agriculture

Matching Grants to Districts (\$450,000 Year)

Do they contain fund balances that would allow them to continue operations? Not very long beyond calendar year 2016. The program has set aside funding in anticipation of the severance shortfall in order to sustain operations at a minimum level through most of FY 2016-17.

The two programs comprising the “Matching Grants to Districts” line item for the Department of Agriculture, Conservation Board section are the District Conservation Technician (DCT) program and the CSCB Matching Grants (MG). Both programs employ people. The DCT program provides funding for 30+ (depending on seasonal/part-time staff) technicians in rural communities to assist with planning conservation practice installations on private lands. These technicians are a vital resource to landowners and provide a technical career trajectory for otherwise employment-depressed areas of Colorado's rural communities. This program receives priority funding in times of shortfalls to ensure continued employment for the technicians.

Department of Agriculture

Matching Grants to Districts (\$450,000 Year)

The MG program provides funding for installing conservation practices on private lands and for educational activities. In addition to providing funding for conservation projects, the MG program typically employs 7+ Watershed Education Coordinators and other educational staff (full- and part-time) to provide conservation education to adult and youth-oriented programs (Envirothon and various conservation curricula incorporating math and science into school gardens). Small acreage and Farming Evolution workshops are increasingly requested as the nature of agriculture in our state is evolving to smaller plots and toward more sustainable practices. These educational staff provide a learning environment unlike any other.

Low Income Energy Assistance Program (LEAP) (Tier 2 Transfer = \$13,000,000 Per Year)

LEAP is the Low Income Energy Assistant Program funded by the Severance Tax Operational Fund, Energy Outreach Colorado, and the Federal Department of Health and Human Services, Office of Energy Assistance. The program provides heating assistance, furnace repair and replacement, and weatherization assistance to households at or below 150% of the Federal Poverty Level.

In FY 2015-16 the program served 79,023 people and provided \$30,706,920.75 in client benefits as of 6/17/2016.

Low Income Energy Assistance Program (LEAP) (Tier 2 Transfer = \$13,000,000 Per Year)

What is the impact in FY 2016-17 based on the passage of SB 16-218?

- Based on the Department's projections the passage of SB 16-218 will not affect FY 2016-17 benefit amounts which range between \$200 - \$700 per client.
- The Program is able to carry forward unspent federal funds from its FY 2015-16 block grant which will help to offset the loss of funding from the Severance Tax Operational Account.
- If additional Severance Tax Operational Account funding is received additional benefit payments could be made to LEAP recipients.

Low Income Energy Assistance Program (LEAP) (Tier 2 Transfer = \$13,000,000 Per Year)

What is the impact in FY 2017-18 and beyond?

- The Department projects a 40% reduction in Severance Tax Operational Account funding in FY 2017-18 as compared to FY 2015-16.
- Based on the anticipated usage of the federal funds in FY 2016-17, the Department does not anticipate having additional excess federal funds available in FY 2017-18 to offset reductions in severance tax funding and is not certain what level of federal funds will be received.
- As a result, the Department anticipates re-evaluating benefit levels for FY 2017-18, which could result in a reduction of benefits (cash assistance) and/or a reduction of grants to other entities for weatherization and emergency furnace replacement.

Thank You



Energy Impact Grant Process Plan for FY16-17 (DOLA)

Bottom Line Up Front: SB16-218 “freeze” of \$48M in Energy Impact (EI) Reserves will begin to affect Colorado’s communities this summer. DOLA is prepared to complete the current grant cycle (Apr-Jul) if sufficient funds are made available, and will postpone the following cycle (Aug-Nov) while awaiting further JBC action in the Fall.

Background: For FY15-16, DOLA granted EI of \$107M for a total projects value of \$303M. Grant projections for FY16-17 (before the Supreme Court BP decision) were \$65-70M, anticipating reduced severance and Federal Mineral Lease (FML) revenues.

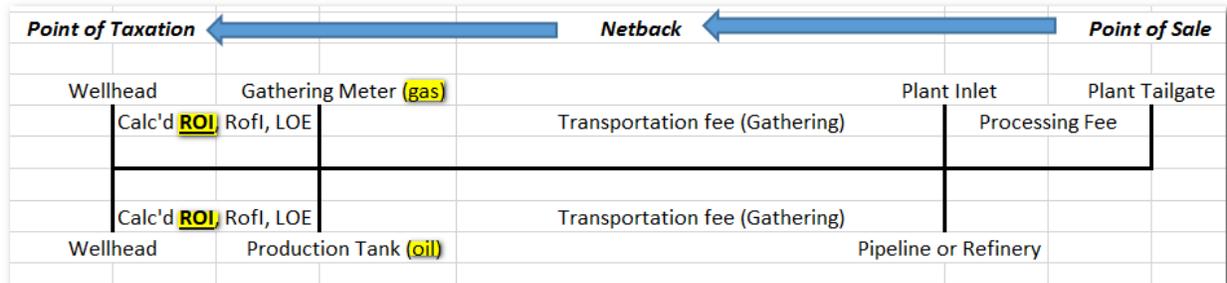
There are three EI grant cycles per FY beginning in April, August, and December. The cycles begin with grant applications, then staff evaluations, and EI Advisory Board review (July, November, and March.) Executive Director’s final determination completes the cycles.

For the current cycle, DOLA has continued the normal process and will complete in late July. Actual grants will only be made if there are sufficient funds available. The projected amount available before the Court decision (which includes \$1M in FML funds) was \$28.5M for the cycle. Below are the categories and amounts requested. If approved as requested, total value of projects would be over \$119M.

Tier I & II Requests	Project Categories	# of Requests	Match/Leverage
\$6,859,015	Roads	11	\$14,799,140
\$5,884,130	Water	12	\$12,888,172
\$4,863,777	Public Facilities	8	\$38,078,819
\$4,601,243	Waste Water	6	\$9,231,519
\$4,124,505	Public Safety	6	\$9,147,839
\$1,512,500	Parks & Recreation	4	\$4,213,174
\$396,857	Broadband	2	\$793,715
\$395,208	Health & Human Services	2	\$1,529,748
\$123,985	Planning	2	\$210,600
\$ 28,761,220	Grand Total	53	\$ 90,892,726

Recent revenue receipts have resulted in approximately \$7M for the EI grant fund. Combined with the FML funds, an additional \$20.5M would be required to complete the cycle as originally projected.

Going Forward: DOLA has informed communities of our plan regarding the current cycle. DOLA has also postponed the August application deadline until September pending further information. Additionally, we are monitoring DOR’s assessment of the impacts on future grants due to the anticipated reduction in severance receipts.



Background – Colorado Severance Tax on Oil & Gas

- Oil & gas is severed from the earth at the wellhead, which is the point of taxation.
- Prior to the deregulation of oil & gas pipelines in the 1980s and 1990s, Producers sold exclusively at the wellhead. Regulated pipeline companies performed all of the steps downstream in a somewhat monopolistic fashion.
- Deregulation resulted in the unbundling of the various downstream steps which may now be performed by multiple parties.
- Today the Producer often sells production at some point downstream of the wellhead. Therefore the sales price must be adjusted to approximate the wellhead value.
- Generally, the formula for gas is $sales\ price - processing\ fee - transportation\ fee - [ROI + Rofl + LOE] = wellhead\ value.$
- Generally, the formula for oil is $sales\ price - transportation\ fee - [ROI + Rofl + LOE] = wellhead\ value.$
 - Note that it is common for oil to sell directly at the production tank with a resulting formula of $sales\ price - [ROI + Rofl + LOE] = wellhead\ value.$
- Royalty owners typically take only the processing and transportation fees as these are the only costs they bear.
- ROI = Return on Investment is applicable only to the pipe and equipment not covered by a fee
- Generally the ROI formula is $depreciated\ investment \times rate$ (e.g., BBB Bond Rate of 4.32% for ad valorem).
- Rofl = Return OF Investment = depreciation.
- LOE = Annual lease operating expense for the pipe and equipment not covered by a fee.

Key Takeaways

- Severance tax is an excise tax on the gross REVENUES of the well, not on the INCOME of the well.
- In many ways Colorado’s system appears to operate with an income tax mentality which confounds taxpayers and practitioners.
- As commodity prices fall year-over-year tax receipts often fall precipitously. The opposite is true when prices increase year-over-year.
- The state benefits from deregulation because Producers likely would not incur the additional transportation and processing costs unless the additional sales value exceeded the additional costs (results in a higher taxable value).
- The process described above is regularly used to value the mineral estate in Colorado under its ad valorem tax regime. The process has been vetted through the courts, utilized for over a decade, is administered by each county assessor with clear and extensive guidance from the Division of Property Taxation and is generally acknowledged to provide equitable property tax valuations.

BP Case – Narrow Applicability

- Applies to Taxpayers that:
 - own facilities not covered by a transportation fee, and
 - had their ROI deduction disallowed under audit, or
 - never claimed the ROI deduction
- Note that the “fees” already contain an ROI component.
- While “... all costs means all costs...”, they would never include costs upstream of the wellhead, those associated with transportation and processing that is otherwise covered by a fee, or costs downstream of the point of sale.
- Unless the taxpayer has pending litigation or open audits that suspend the statute of limitations, refund claims would be allowed for the prior three tax years only.
- The state experienced a dramatic decrease in 2015 severance tax collections (one of the three open years). Any refund claim would be limited by the amount of tax actually paid.
- Caveat: the case likely will prompt all taxpayers to review their returns to insure that allowable deductions of all types were actually taken.

Examples of Current Provisions that Complicate the System

- The point of taxation is often unnecessarily confused by the language of §39-29-102 (7), which misuses the common Industry term “gathering” and is a throwback to a time when technology did not allow wells to be centrally located near initial separation equipment. Production is severed from the earth at the wellhead. Industry measures and identifies the production at each wellhead (in addition to other places), a step that serves as the basis of allocating otherwise fungible products.
- Since the same barrels of oil and same mcfs of gas are subject to both ad valorem and severance tax, Colorado’s ad valorem tax credit against severance tax is fundamentally logical. It is also essential due to the State’s unique ad valorem tax structure. Specifically, Colorado has a broad range of ad valorem tax rates, ranging from as low as ~3% to well over 20%. Without the credit wells in certain parts of the state could bear a >25% tax burden (>20% + 5%), which is excessive by any definition, and disadvantages those areas.
- The language contained in §39-29-105 (2) (b) which says of the credit, in part, “...an amount equal to eighty-seven and one-half percent of all ad valorem taxes **assessed** during the taxable year in the case of **accrual basis** taxpayers or **paid** during the taxable year in the case of **cash basis** taxpayers...” results in a mismatch of production years between the two taxes.
- Also, the distinction between cash vs. accrual unnecessarily complicates the producer’s requirement to report to their interest owners on form DR-21W. This is another example of applying income tax mentality to an excise tax. Imagine requiring banks or brokerage houses to issue 1099’s for interest and dividends on both the cash and accrual basis.



COLORADO PETROLEUM
ASSOCIATION



Severance Tax Netback

