June, 2016

COLORADO
Colorado Water
Conservation Board
Department of Natural Resources

1313 Sherman Street, Room 718
Denver, CO 80203

Funding Challenges, Impacts, and the Future

Summary

- April 2016: Colorado Supreme Court case decision requires State of Colorado to refund oil and gas companies an estimated $125 million
- May 2016: Senate bill 16-218 passes in Colorado legislature and addresses where refund money comes from. Places restriction on certain Department of Natural Resources (DNR) funds:
    - $19.1 million from the severance tax perpetual base fund
    - $10 million from the severance tax DNR operational fund
- Result: no new funding will come into DNR Tier 2 programs as of FY 16-17, which includes the Water Supply Reserve Account (WSRA) program
- Basin roundtable accounts will not receive additional funding in FY 16-17 and will need to rely on the current account balances, which vary in each basin
- The WSRA statewide account has a current balance of $2.3 million and will not receive additional funding in FY 16-17
- May 2016: The CWCB Board directed CWCB staff to investigate a creative five-year funding plan. Conceptual plan proposes:
    - $50 million one-time investment in a repayment guarantee fund
    - $10 million annually to the WSRA
    - $5 million annually to the Watershed Restoration Program
    - $10 million annually to non-reimbursable programs
- July 2016: CWCB staff will present conceptual five-year funding plan to CWCB Board for approval to add to the CWCB Projects Bill that will be reviewed by the legislature in 2017

Colorado Supreme Court Case Decision
On April 25, 2016 the Colorado Supreme Court published the ruling on the *BP America vs. Colorado Department of Revenue* case that began in 2008. The case centered on whether the cost of capital is a valid deduction from revenue generated by natural gas extraction. The Colorado Department of Revenue argued that the cost of capital is not a deductible cost because it is not an actual cost. The Colorado Supreme Court ruled in favor of BP America stating the severance tax statute authorizes a deduction for any transportation, manufacturing, and processing costs, and the cost of capital is a deductible cost that resulted from investment in transportation and processing facilities.
To view the ruling:
https://www.courts.state.co.us/userfiles/file/Court_Probation/Supreme_Court/Opinions/2013/13SC996.pdf

What Does the Decision Mean?
The effect of this decision is that the State of Colorado is liable to refund these deductions to the oil and gas companies that apply for them. In essence, the State of Colorado was collecting too much tax from oil and gas companies and now needs to refund that amount. Oil and gas companies can file amended returns for the current year and previous three years to receive the refund on these deductions. The State of Colorado's refund liability could be as much as $125 million dollars depending on how many companies apply for the refund. This is the state's current best estimate.

There is not a set timeline for submitting amended tax information, but the Department of Revenue anticipates that many companies will submit within the next 90 days so they do not lose the ability to amend taxes for the three previous years. Hopefully, the state will start to see a firmer picture of refund liability by the end of summer.

Senate Bill 16-218 to Address the Decision
Senate Bill 16-218 passed through the legislature at the end of the 2016 legislative session and addresses where the money for these refunds will come from. The Department of Natural Resources supported this bill. The bill restricts $40.3 million from DOLA's local government severance tax fund, $19.1 million from the severance tax perpetual base fund, and $10 million from the severance tax DNR operational fund. These funds are restricted until the JBC (joint budget committee of the legislature) releases the restriction on some or all of the money. The JBC can release the restricted funds at any time; they do not need to wait for a legislative session. Total restricted funding is approximately $70 million. Refund money will come out of the general fund reserve, as stated in the legislation.

Impacts for DNR & CWCB
The bill has significant impacts on the DNR and the CWCB. Senate bill 16-218 restricts $19.1 million from the severance tax perpetual base fund. This fund is used to finance

loans for state water projects administered by the Colorado Water Conservation Board. This restriction is a significant amount that could have aided important water projects in Colorado, but the account still has funding for future water projects.

Senate bill 16-218 also restricts $10 million from the DNR operational fund, which is generally used for programs administered by DNR, divided into Tier 1 and Tier 2 programs. This restriction results in no new funding coming into Tier 2 programs as of the next fiscal year, starting July 1, 2016. The JBC will evaluate future state revenue forecasts in the coming months, and then determine if there will be any new funding coming into Tier 2 programs.

Tier 2 programs include the Water Supply Reserve Account Grant Fund, the Interbasin Compact Committee, and the Species Conservation Trust Fund. Each has an account balance that will assist funding the programs until the end of FY 2017. However, future funding after FY 2017 is uncertain and prioritization of funding will be important.

What this means for WSRA funding and the Basin Roundtables

The WSRA program is utilized by the nine basin roundtables to address water supply gaps in the respective basins. Roundtables pass along approved grants out of basin and statewide accounts to the CWCB Board for final approval. The WSRA program is the primary source of funding available for implementation of Basin Implementation Plans, as well as efforts to achieve goals and objectives of Colorado's Water Plan at the basin level.

The Water Supply Reserve Account is a Tier 2 program and will not receive any additional funding in the FY 16-17. Due to efficient stewardship, each basin roundtable account has an available balance, which varies between basins. The statewide account balance is approximately $2.3 million, though this is expected to decline after the September CWCB Board meeting, one of two meetings where requests for statewide funds may be considered.

Severance Tax Looking forward

Severance tax revenue is volatile and difficult to predict. Regardless of the Colorado Supreme Court case decision and Senate Bill 16-218, severance tax revenue was projected to be less than previous years. The WSRA program was projected to receive only 18-20% of the normal funding. Further, due to this Colorado Supreme Court ruling affirming future deductions for oil and gas companies, the state expects a reduction in severance tax revenue of 12.5%, depending on the result of companies taking deductions going forward. This is the state's current best estimate.

Funding Concepts

At the CWCB Board meeting and IBCC meeting in May 2016, the members discussed these issues. CWCB staff presented some creative funding concepts. The CWCB Board charged CWCB staff with formulating a five-year funding plan, examining the initial concepts presented.

This funding plan contemplates utilizing unreserved funds from CWCB accounts and investing them into existing programming, with some additional programs potentially being created. The CWCB is in a unique position, due to good stewardship of finances by CWCB staff and Board. The momentum behind the Basin Implementation Plans and the final Colorado's Water Plan should be encouraged, despite declining severance tax revenues, and the restrictions stemming from the Colorado Supreme Court decision.

The funding plan proposes four major elements for more in-depth investigation by CWCB staff. These elements are not a certainty, but the Board has directed staff to study these elements in more detail to assess feasibility and practicality:

- First, a $50 million investment in a repayment guarantee fund. This fund would likely be administered through an agreement with the Colorado Water Resources and Power Development Authority. This fund has been discussed by the CWCB and IBCC, and seeks to homogenize risk among multiple project partners through state guarantee.
- The staff will also be examining a potential $10 million annual transfer to the Water Supply Reserve Account. IBCC members, roundtable members, and CWCB members have all emphasized the role of this account in promoting grassroots efforts to meet the goals and objectives of Colorado's Water Plan and the Basin Implementation Plans. This infusion would ensure that the WSRA funds keep $10-$20 million available annually for projects and methods identified by the basin roundtables, depending on future severance tax revenues. The CWCB has directed staff to work with the WSRA Criteria and Guidelines Committee to ensure that this program is being administered efficiently, with well defined metrics for success, and transparency in grant awarding.
- An additional $5 million annually is contemplated for the Watershed Restoration Program. This established program will administer these funds for the benefit of the environment and recreation though stream management plans, watershed restoration plans, and the implementation of projects and methods to meet these plans and established goals.
- An additional $10 million will be contemplated by the Board annually for additional non-reimbursable programming. These funds will be utilized for other crucial elements identified in Colorado's Water Plan such as agricultural viability, education and outreach, water efficiency, alternative transfer methods, or other Board-identified priorities.

This conceptual funding proposal would be reviewed and approved annually by the CWCB for inclusion in the annual Projects Bill. These proposals will not affect the existing CWCB loan program, as that program distributes $40-$60 million on average. With the existing obligations of loan borrowers, revenues from federal mineral lease, and remaining severance tax revenues, the program will be able to continue this distribution of loan funds.

CWCB members and staff will be examining this plan for feasibility and practicality over the coming months, with presentations at roundtable meetings and other public events to keep stakeholders apprised.