

Colorado Water Conversation Board

Severance Tax Update

November 2016

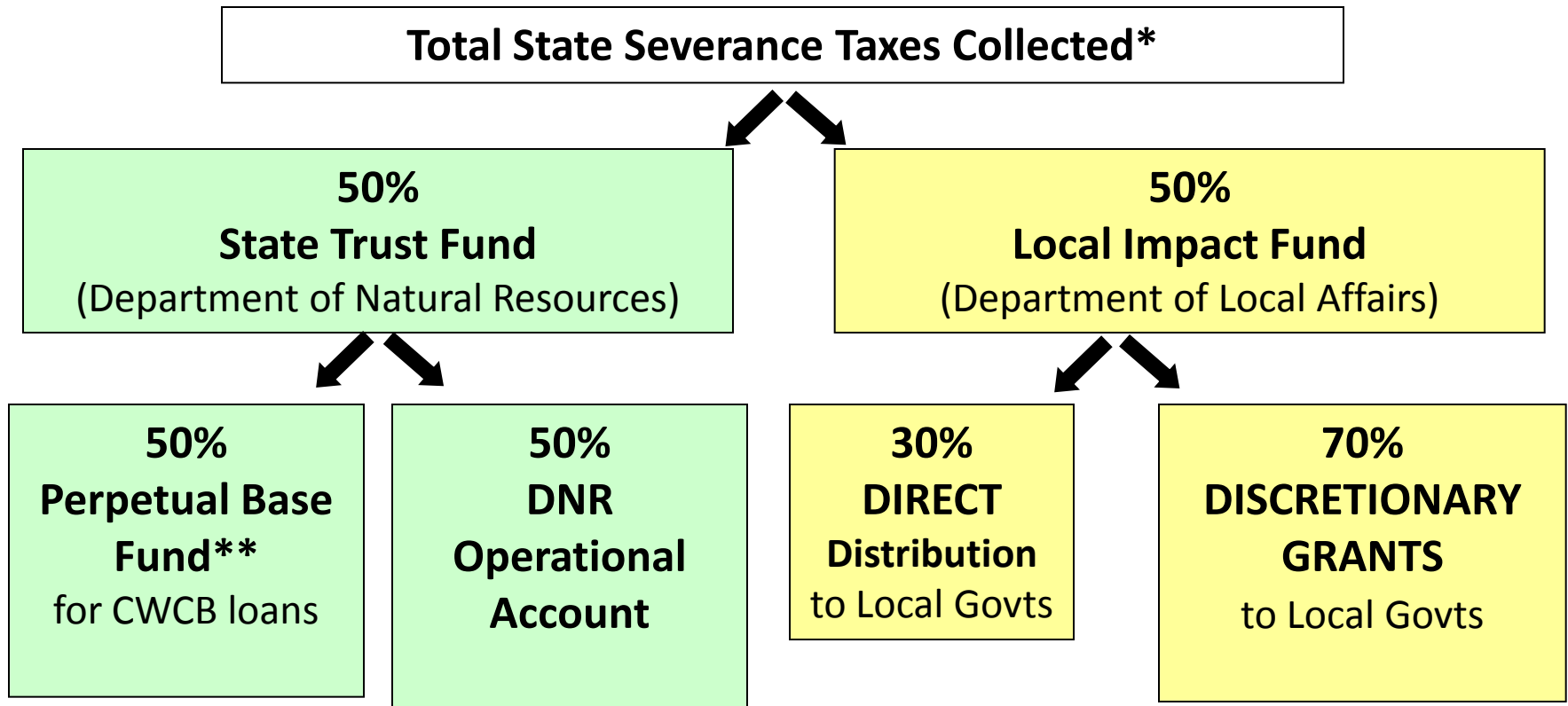
What is Severance Tax?

- Severance Tax is a tax on nonrenewable minerals as they are “severed” from the earth.
- There are separate severance taxes on oil and gas, coal, metals, and oil shale
- By statute, the General Assembly intends that a portion of severance tax be used for public purposes, a portion be held in perpetual trust, and a portion be made available to local governments to offset the impacts of resource development

What is Severance Tax *Really*?

- There is no severance tax revenue generated from Oil Shale
- Severance tax from Metals and Moly averages about \$2.0 million per year over the last five years (comprising about 1.1% of the severance tax revenue stream).
- Severance tax revenue from Coal has averaged about \$7.1 million per year over the last five years (comprising about 3.9% of the severance tax revenue stream).
- Severance tax revenue from Oil and Gas development has generated 95% of the severance tax revenue over the last five years.

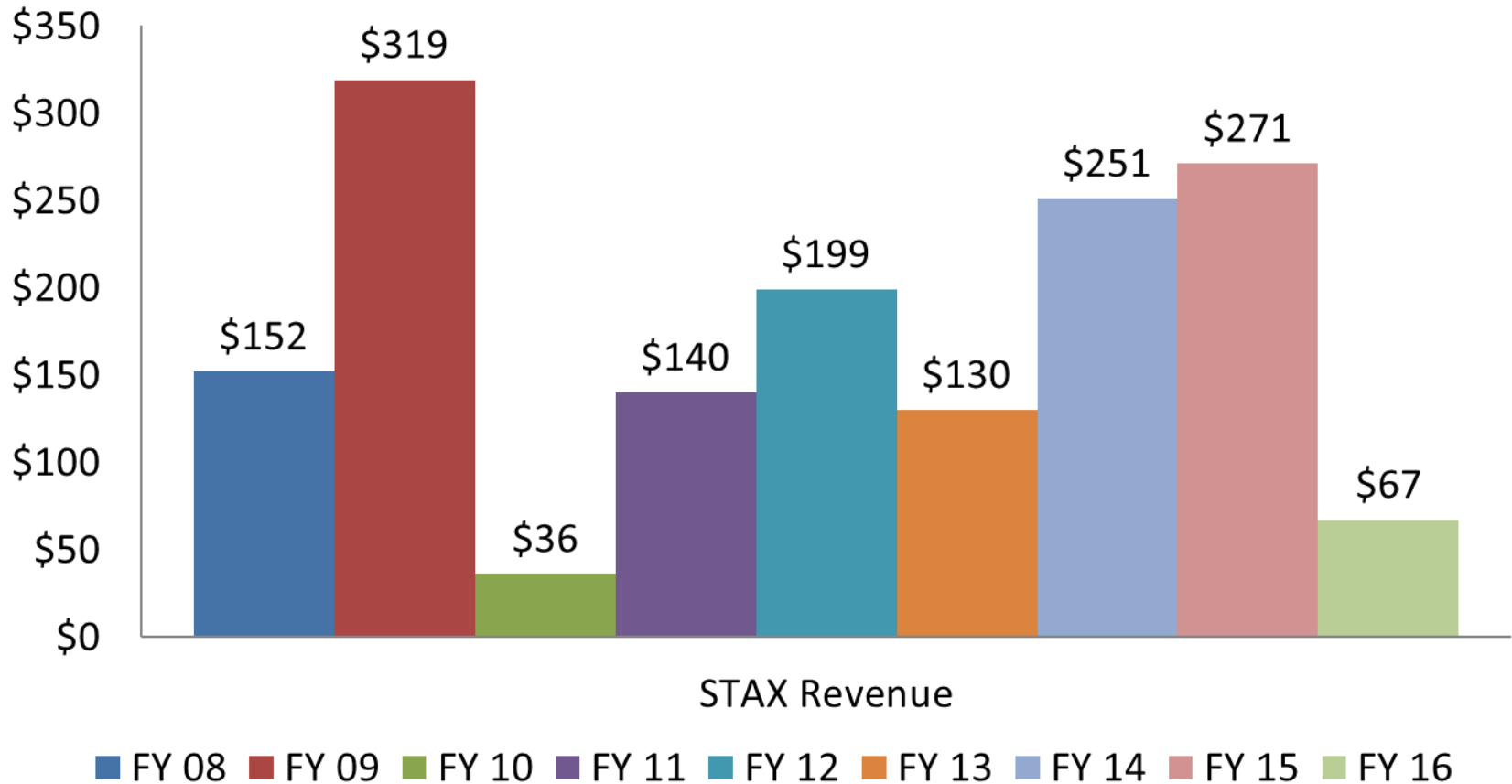
How is Severance Tax Distributed?



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

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

History of State's Severance Tax Revenue



So if Energy Prices Got Cut in Half, Why Did
Severance Tax Revenue Go Down by 75%?



Impact of the Ad Valorem Offset

- Colorado law provides a credit equal to 87.5% of the ad valorem taxes that may be applied to oil & gas related severance tax liabilities.
- The ad valorem offset is reflective of conditions two years ago. In this regard, the ad valorem offset increases revenue volatility.
- There is no ad valorem credit in the first year or two of production on a mineral estate.

Variance of Various Oil & Gas Related Revenue Streams

(Revenue Shown in Millions of \$)

[illegible]

Not Just Volatile, But Unpredictable

Recent Revenue Forecasts by OSPB

| | FY 10 | FY 11 | FY 12 | FY 13 | FY 14 | FY 15 | FY 16 | AVG |
|----------------|--------|-------|-------|-------|-------|--------|-------|-------|
| Dec Forecast | \$64 | \$145 | \$198 | \$115 | \$219 | \$350 | \$78 | \$167 |
| Actual Revenue | \$48 | \$149 | \$208 | \$139 | \$269 | \$280 | \$71 | \$166 |
| Variance (\$) | (\$16) | \$4 | \$10 | \$24 | \$50 | (\$70) | (\$7) | \$26* |
| Variance (%) | (25%) | 3% | 5% | 21% | 23% | (20%) | (8%) | 15%* |

Not Just Volatile, But Unpredictable

Recent Revenue Forecasts by LCS

| | FY 10 | FY 11 | FY 12 | FY 13 | FY 14 | FY 15 | FY 16 | AVG |
|----------------|--------|--------|-------|-------|-------|--------|-------|-------|
| Dec Forecast | \$85 | \$177 | \$171 | \$122 | \$182 | \$312 | \$75 | \$161 |
| Actual Revenue | \$48 | \$149 | \$208 | \$139 | \$269 | \$280 | \$71 | \$166 |
| Variance (\$) | (\$37) | (\$27) | \$37 | \$16 | \$86 | (\$31) | (\$4) | \$26* |
| Variance (%) | (44%) | (15%) | 22% | 13% | 47% | (10%) | (5%) | 18%* |

BP America v. CO Dept. of Revenue



Supreme Court Ruling on the BP Case

- The Colorado Dept. of Revenue has historically not allowed producers to claim a return on investment (ROI) as a valid deduction against severance tax liability
- ROI is defined as the opportunity cost of a capital investment that an investor could have earned on a similar investment of similar risk.
- Opportunity cost is not an expense that is actually paid by the investor.

Supreme Court Ruling on the BP Case

- The Colorado Supreme Court ruled that state statute clearly allows the deduction of “any transportation, manufacturing, and processing cost”, including ROI.
- The Supreme Court ruling did not establish how exactly ROI should be calculated.
- ROI was the primary focus of the Supreme Court case but may have implications on other Netback Expense Report Form (NERF) deductions. NERF Deductions, including ROI, are allowed by the Property Tax Administrator.

Cost of Supreme Court Decision

Refund Owed to British Petroleum: **\$2.4 million**

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Cost of Supreme Court Decision

| | |
|--|------------------------------|
| Refund Owed to British Petroleum: | \$2.4 million |
| Similar ROI-Related Conferee Cases: | \$6.8 million |
| <u>Amended Tax Returns Related to ROI:</u> | <u>\$22.0 million</u> |
| Total Refunds: | \$31.2 million |

Cost of Supreme Court Decision

In addition, there are other potential costs:

- (1) The Cost of ROI Deductions Going Forward
- (2) The Cost of Other Netback Expense Report Form (NERF) deductions which might be allowed in the future.

S.B. 16-218 Basics

- Created a mechanism for paying severance tax refunds in FY 2016-17. Total monthly severance tax collections are the first source of paying severance tax refunds, capped at 15% of total monthly collections.
- Refunds in excess of 15 percent of gross monthly severance tax collections are paid from the General Fund.
- Restricted over \$77 million in moneys in severance tax related cash funds in case revenue was needed to help pay severance tax related refunds.

S.B. 16-218 Basics (Continued)

- Restricts DNR's Operational Fund by \$10.0 million
- Restricts CWCB's Perpetual Base Fund by \$19.1 million
- Restricts the Dept. of Local Affairs' Local Government Severance Tax Fund by \$48.3 million (although this amount was later reduced by \$19.9 million).

S.B. 16-218 In Action

- S.B. 16-218 did not distinguish between severance tax refunds related to the BP case and refunds that would have occurred regardless of the BP case.
- In FY 2015-16, a total of \$56.8 million in General Fund revenue was used to pay for severance tax refunds. Of this amount, \$17.8 million was used for refunds related to the Supreme Court ruling and \$39 million was outside of the BP case (largely related to large ad valorem credits).

S.B. 16-218 In Action

- From July to October of 2016, over \$45.4 million in severance tax refunds had been paid. Of this amount, \$3.2 million was covered by monthly severance tax revenue. The remaining \$42.2 million in refunds was paid from the General Fund.

S.B. 16-218 (Continued)

- By the end of FY 2016-17, it is estimated that the General Fund will have provided over \$100 million of support towards paying severance tax refunds.
- This support of severance tax refunds comes at a time when there is intense pressure on the State's General Fund Budget.

State of Colorado's General Fund Budget

| Item | Amount | Source of Requirement |
|---|------------------|------------------------------------|
| K-12 Education – New Enrollment and Inflation | \$243.5 M | State Constitution |
| TABOR Refund | \$195.0 M | State Constitution |
| Refill Budget Reserve from FY 2016-17 | \$190.8 M | State Statute / Policy |
| H.B. 09-228 Transportation and Capital | \$164.0 M | State Statute |
| <u>New Medicaid Costs</u> | <u>\$142.8 M</u> | <u>Federal & State Statute</u> |
| Total New Spending | \$926.1 M | |
| <u>Total Available New General Fund Revenue</u> | <u>\$426.0 M</u> | |
| Minimum Funding Gap | \$500.1 M | |

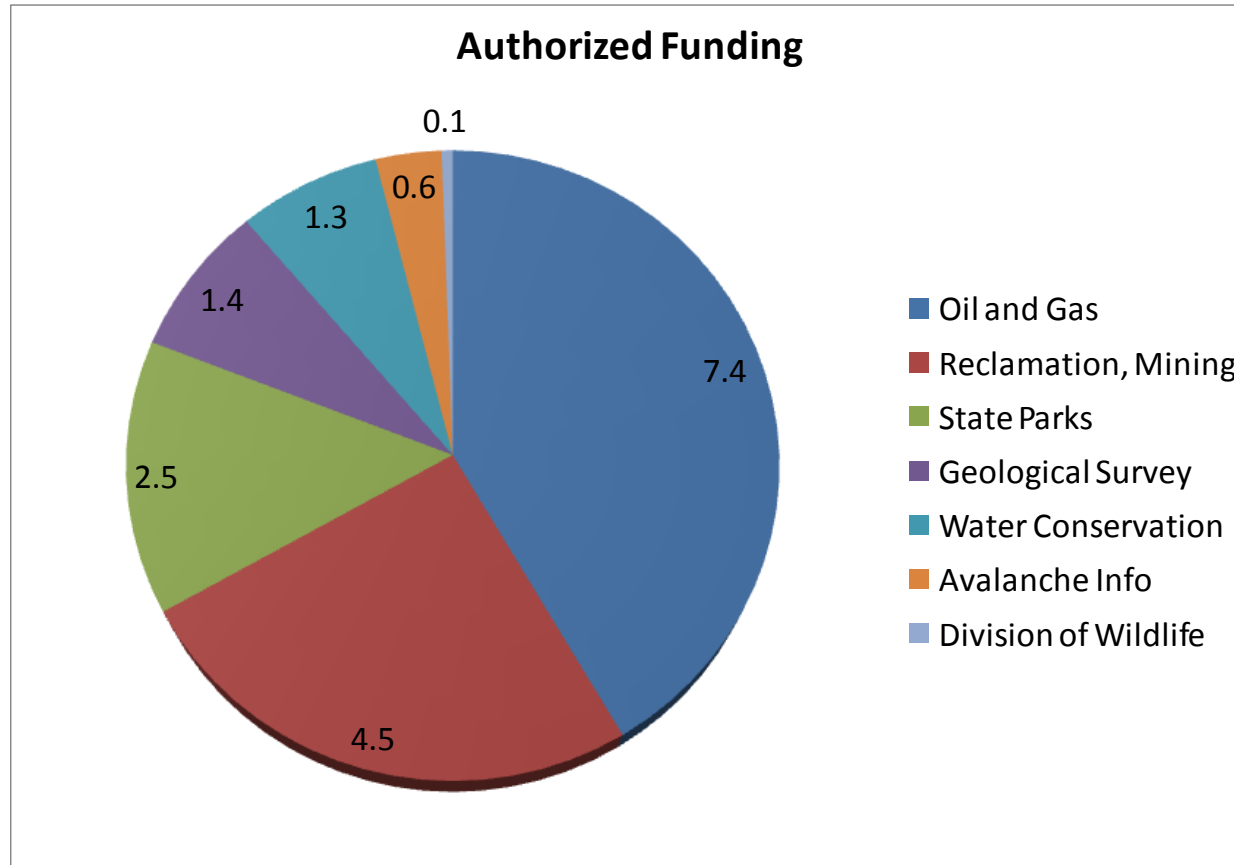
Executive Branch's FY 2017-18 Budget Request

- The Governor's FY 2017-18 Budget Request proposes to transfer \$31.7 million of the \$57.5 million in severance tax funds still restricted under S.B. 16-218 to the State's General Fund.

Outlook for Tier 1 Programs On the Brink?



Operational Fund -Tier 1 program authorizations in FY 2016-17



Severance Tax Operational Fund

Tier 1 Outlook

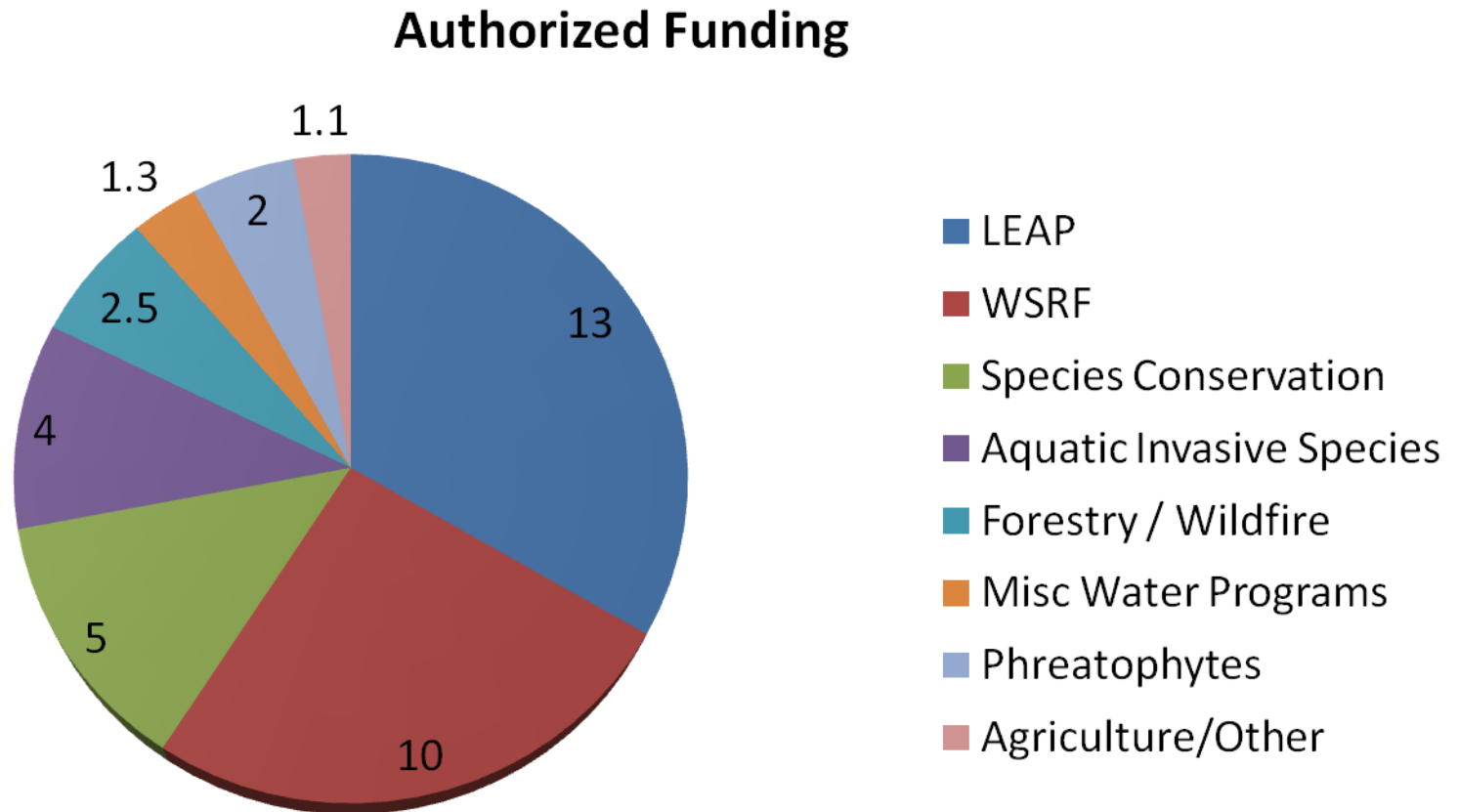
- Under current revenue projections, the Severance Tax Operational Fund is projected to finish FY 2016-17 with a fund balance of **NEGATIVE \$700,000** assuming the entire \$10.0 million restriction remains fully unavailable for Operational Fund programs.
- If revenue came in 25% lower than projected, the Operational Fund would finish the year with a negative balance of about **NEGATIVE \$3.6 million**.
- The Department is considering a request to release a portion of restricted funds to assure the Operational Fund has sufficient funding for Tier 1 programs in FY 2016-17.

Outlook for Tier 2 Programs

Can We Plunge Any Deeper?



Operational Fund -Tier 2 program authorizations in FY 2016-17



Putting it All Together

- Tier 1 appropriations for FY 2016-17 total \$17.7 million
- Tier 2 authorizations for FY 2016-17 total \$38.9 million
- This total spending (\$56.6 million) will be supported by an estimated \$11.9 million in Severance Tax Operational Fund revenue projected for FY 2016-17.

How Tier 2 Works

- By statute, proportional reductions to Tier 2 programs are used to balance revenue and expenditures. This prevents the need for supplemental adjustments.
- A small amount of money (15% of authorized Tier 2 spending) is kept in reserve to be used to offset proportional reductions.

Severance Tax Operational Fund

Tier 2 Outlook

- Tier 2 programs were cut by 9% in FY 2015-16 to help balance revenue and expenditures. This moderate cut required completely draining the Tier 2 reserve.
- Tier 2 programs are not projected to receiving any funding in FY 2016-17 and FY 2017-18 due low projected severance tax revenue.
- If revenue forecasts hold, Tier 2 programs may get funded at about 50% in FY 2018-19. However, the BP lawsuit increases the normal uncertainty in regards to future revenue projections.