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Legislative
Council
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MEMORANDUM

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December 30, 2008

TO: Interested Persons

FROM: Jason Schrock, Economist, 303-866-4720

SUBJECT: Severance Tax and FML Revenue

This memorandum responds to your request for information on the state severance tax. Specifically, it provides information on the structure of the tax, the amount of the tax, and how revenue from the tax is used. The memorandum also provides similar information on federal mineral leasing revenue, which is also derived from energy production in the state.

Summary

The Colorado state severance tax recaptures a portion of the state's mineral endowment that is lost due to the extraction of nonrenewable resources. Severance tax revenue is divided evenly between the Department of Natural Resources (DNR) and the Department of Local Affairs (DOLA). DNR uses the money for water projects and other natural resources-related programs. Some of the money is also used for energy assistance for low-income households and agriculture-related programs. DOLA's half is distributed to local governments to help mitigate the impact of the energy industry in their areas.

The state receives 49 percent of the revenue the federal government collects when individuals or companies lease federal lands for mineral development. This revenue is called federal mineral leasing revenue (FML). FML revenue is allocated to help fund public education, to local governments and school districts, to DOLA for grants to local governments, to the Colorado Water Conservation Board Construction Fund for water projects, to a permanent savings fund, and to fund higher education construction and maintenance projects.

Colorado's Severance Tax

The Colorado state severance tax was officially created in 1977 through the passage of HB 77-1076. The stated intent of the severance tax was: to recapture a portion of the state's wealth endowment that is lost due to the extraction of nonrenewable resources; to provide a source of revenue to the state and local governments; and to be used by the state for public purposes. HB 77-1076 also stated that it was the intent that a portion of the revenue from the tax be held by the state in a perpetual trust fund and that a portion be made available to local governments to offset the impact created by nonrenewable resource development.

Colorado statutes contain provisions regarding severance tax on the production of oil and natural gas, coal, oil shale, molybdenum and other metallic minerals in the state. The tax is mostly paid by energy production and mining companies that extract the minerals. These companies pay other taxes in addition to the severance tax, such as income, sales, and property taxes. Table 1 characterizes the current statutory severance tax structure for each of these minerals.

Table 1
Current Structure of Colorado State Severance Tax

Extracted Mineral	Statutory Provisions
Oil & Natural Gas	<ul style="list-style-type: none"> • Sliding Tax Rate of: <ul style="list-style-type: none"> - 2 percent of gross income under \$25,000 - 3 percent of gross income between \$25,000 and \$100,000 - 4 percent of gross income between \$100,00 and \$300,000 - 5 percent of income above \$300,000 • 87.5 percent tax credit allowed for property taxes paid on oil and gas production (excluding personal property and stripper well production) • Transportation, processing, and manufacturing expenses are deductible from gross income. • Wells that produce 15 barrels/day or less of oil or 90 thousand cubic feet (Mcf)/day or less of natural gas are tax exempt.
Oil Shale	<ul style="list-style-type: none"> • Sliding Tax Rate of: <ul style="list-style-type: none"> - 1 percent of gross income, increasing to 4 percent of gross income over a 4 year period at 1 percentage point per year. • First 15,000 tons/day of shale or 10,000 barrels/day of oil, whichever is greater, is tax exempt.
Coal	<ul style="list-style-type: none"> • The statutory rate changes with the producers' price index. The current rate is about \$0.76 per ton. • First 300,000 tons produced every quarter are tax exempt • 50 percent tax credit allowed for underground coal or lignitic coal production
Molybdenum	<ul style="list-style-type: none"> • \$0.05 per ton of ore • First 625,000 tons produced every quarter are tax exempt
Metallic Minerals	<ul style="list-style-type: none"> • 2.25 percent of gross income over \$19 million

Source: Section 39-29 C.R.S.

In most years, the state receives over 90 percent of its total severance tax revenue from oil and natural gas, with almost all of the 90 percent coming from natural gas. It is important to note that severance tax collections can be highly volatile. For example, the December 2008 Legislative Council Staff forecast for severance taxes anticipates collections of \$220 million in FY 2008-09, but projects collections to decline to \$58 million in FY 2009-10 due to the recent drop in energy prices. The counties that are estimated to pay the most severance taxes to the state are La Plata, Garfield, Las Animas, and Rio Blanco. These counties are estimated to pay over 90 percent of the state's severance tax collections, with La Plata County paying about half. The state receives severance tax revenue monthly.

Allocation of Severance Tax Revenue

Severance taxes are divided evenly between the Department of Natural Resources (DNR) and the Department of Local Affairs (DOLA), per Section 39-29-108 (2), C.R.S.

Department of Natural Resources. DNR's half is deposited into the Severance Tax Trust Fund. Section 39-29-109 (1), C.R.S., states that the Severance Tax Trust Fund is to be "held in trust as a replacement for depleted natural resources, for the development and conservation of the state's water resources, and for use in funding programs that promote and encourage sound natural resource planning, management, and development related to minerals, energy, geology, and water and for the use in funding programs to reduce the burden of increasing home energy costs on low-income households."

Severance tax revenue to the Severance Tax Trust Fund is divided equally between the Perpetual Base Account and the Operational Account.

- The Perpetual Base Account is used to finance loans for state water projects administered by the Colorado Water Conservation Board that construct or improve flood control, water supply, hydroelectric energy facilities, and related recreational facilities, excluding domestic water treatment and distribution systems (Section 39-29-109 (2) (a), C.R.S.).¹
- The Operational Account is generally used for programs administered by DNR (Section 39-29-109.3, C.R.S.). The following programs are referred to as the account's "core" or "tier I" programs:
 - up to 40 percent may be used for programs or projects within the Colorado Oil and Gas Commission, including the plugging and abandonment of wells, site reclamation, regulatory and environmental programs, and emergencies;

¹ If an emergency drought designation or a disaster emergency has been proclaimed due to drought, up to \$1.0 million in the Perpetual Base Account annually is continuously appropriated to make loans and grants for emergency drought-related water augmentation purposes (Section 37-60-123.5, C.R.S.).

- up to 20 percent may be used for programs within the Colorado Geological Survey;
- up to 25 percent may be used for programs within the Division of Minerals and Geology;
- up to 5 percent may be used for programs within the Colorado Water Conservation Board;
- up to 5 percent may be used for programs within the Division of Wildlife; and
- up to 5 percent may be used for programs within the Division of Parks and Outdoor Recreation.

In the last several years, with the increase in state severance tax revenue, money in the Operational Account has also begun to be used to fund various programs, such as water-related programs, agriculture-related programs, clean energy development, soil conservation, wildlife conservation, the control of invasive species, and for low-income energy assistance. These programs are referred to as the account's "tier 2" programs. HB 08-1398 requires that the money allotted to these tier 2 programs each year be transferred in three separate installments throughout the year and it requires the transfers to be reduced if there is insufficient severance tax revenue to make the full transfers.

Department of Local Affairs. DOLA's half of severance tax revenue is deposited into the Local Government Severance Tax Fund and distributed to local governments (Section 39-29-110, C.R.S.).

- 70 percent is available for discretionary loans and grants to local governments that are socially or economically impacted by the mineral extraction industry and to compensate local governments for the loss in property taxes resulting from the deduction of severance taxes in the determination of the valuation for assessment of producing mines. Local governments apply to DOLA for the loans and grants at three different times during the year. DOLA is assisted by a 12-member Energy and Mineral Impact Assistance Advisory Committee in making funding decisions. The money must be used for the planning, construction, and maintenance of public facilities, and for the provision of public services;² and
- 30 percent of the money received each fiscal year is distributed directly to local governments by August 31 of the following fiscal year based on weighted measures of the following three factors:
 - ▶ the proportion of energy industry employees within a given county to the total number of energy industry employees residing in the state;
 - ▶ the proportion of mine and well permits issued within a given county to the total number of such permits issued within the state; and

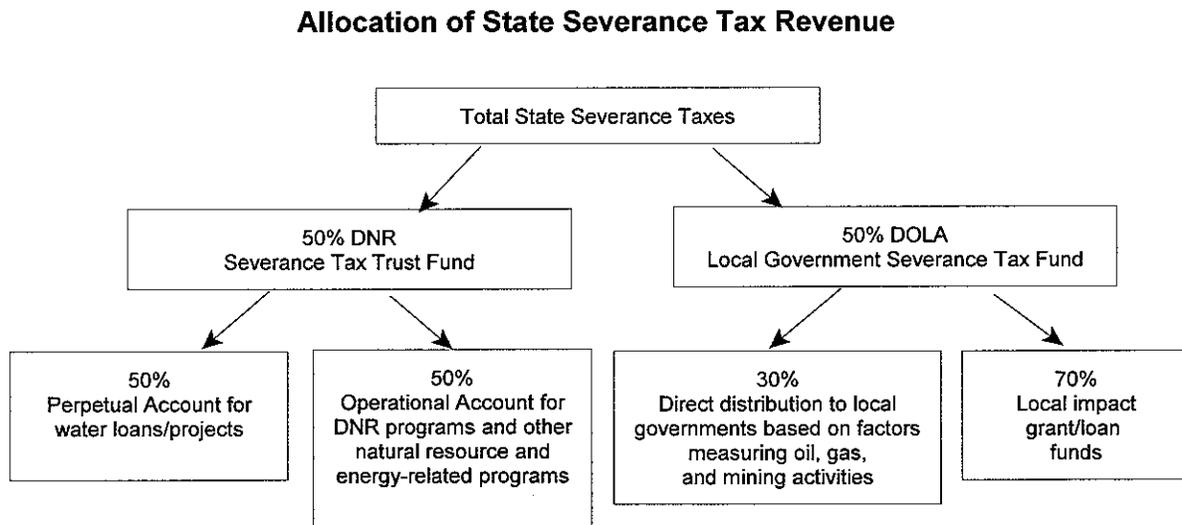
² The 70 percent portion of DOLA's half of severance tax revenue can also be used for wastewater and water treatment-related projects, for activities regarding uranium mill tailings in the state, such as the monitoring and cleanup of uranium mill tailings, and to help volunteer fire departments in energy production areas purchase fire fighting equipment (Section 39-29-110 1 (b) (II), (III), and (IV), C.R.S.

- ▶ the proportion of the overall mineral production within the county to the overall mineral production within the state.

For the FY 2008-09 money distributed by August 31, 2009, the three aforementioned factors receive weights of 50 percent, 25 percent, and 25 percent, respectively. For FY 2009-10 and thereafter, each of the factors will be given a weight of 30 percent, and DOLA will determine, based on recommendations from the Energy and Mineral Impact Assistance Advisory Committee, how the remaining 10 percent will be allocated among the three factors. The 30 percent portion of money distributed to local governments is further allocated within each county based upon energy industry employee residence and the proportion of county population and road miles in unincorporated areas.³

Prior to FY 2008-09, the 30 percent portion was distributed directly to local governments based only on the proportion of mining employment in the region. HB 08-1083, which was a bill that originated in the 2007 Interim Committee to Study the Allocation of Severance Tax and Federal Mineral Lease Revenues, changed the distribution to the aforementioned formula.

The following diagram provides a general illustration for how severance tax revenue is allocated under current law.



Federal Mineral Leasing (FML) Revenue

When individuals or companies lease federal lands for mineral development, the federal government collects revenue from those leases, which are partially shared with the states in which production occurred. Three forms of revenue are collected by the federal government. Lease holders competitively bid and initially pay a "bonus" to use the land. Lease holders also pay rent

³ How the money is allocated statewide within each county, based on the proportion of energy industry employees, total population, and road miles, is determined by DOLA, based on recommendations from the Energy and Mineral Impact Assistance Advisory Committee. The allocation within an individual county can also be determined through a memorandum of understanding between a county and all of its municipalities that is accepted by DOLA.

for the right to develop mineral production on these lands. Finally, if minerals are extracted and sold, the federal government receives a royalty (or percentage) from the production. FML revenue is currently distributed 49 percent to the state within which production occurred, and 51 percent is distributed to the federal government.⁴

Section 34-63-102 (1) (a) (I), C.R.S., states that FML revenue is to be used by state agencies, public schools, and local governments for planning, construction, and maintenance of public facilities and for public services. The Minerals Management Service, within the Department of the Interior, is responsible for collecting and disbursing revenue from mineral production on federal lands. Table 2 illustrates the current structure of federal mineral leases for onshore production, excluding leases on the National Petroleum Reserve or on American Indian lands.

**Table 2
Current Structure of Federal Mineral Leases**

Extracted Mineral	Provisions in Public Law
Onshore Oil & Natural Gas Leases (competitively bid)	<ul style="list-style-type: none"> • For leases issued after December 22, 1987, royalty rate of: <ul style="list-style-type: none"> - 12.5 percent in amount or value of production • For leases issued after December 22, 1987, rental rates of: <ul style="list-style-type: none"> - \$1.50 per acre for first five years, - \$2.00 per acre for subsequent years, and bonus paid at issuance of the lease. • Certain transportation and processing expenses are deductible from the value of production. • Primary term of lease is 10 years, which can be continued if commercially producing; maximum size of lease is 2,560 acres.
Coal	<ul style="list-style-type: none"> • For leases issued after August 4, 1976, royalty rate of: <ul style="list-style-type: none"> - 12.5 percent of the value of production for surface mines - 8.0 percent of the value of production for underground mines • For leases issued after August 4, 1976, rental rates of: <ul style="list-style-type: none"> - \$3.00 per acre, not credited against royalty payments • Certain transportation and processing expenses are deductible from the value of production. • Primary term of lease is 20 years, which can be continued in 10-year increments if producing; maximum size of lease is 75,000 acres in one state and no more than 150,000 total acres in the U.S.

Source: Minerals Management Service.

Over the past six years, total distributions of FML revenue to Colorado have grown substantially as energy production on federal lands has increased. In FY 2001-02, Colorado received \$44.6 million in FML revenue. In FY 2007-08, the state received \$153.6 million

⁴ Until the 2007-08 federal fiscal year, states received 50 percent of FML revenue. However, the federal government reduced the state's share of FML revenue to 49 percent. It is unknown whether and when the share allocated to states will be modified back to the original formula.

Like severance taxes, the generation of FML revenue is highly concentrated in a few counties, most notably Garfield, Rio Blanco, Moffat, and Montezuma counties. In FY 2007-08, these counties generated about 70 percent of total FML revenue, with Garfield County generating about 27 percent of the total.

Allocation of FML Revenue

Section 34-63-102 C.R.S., provides for how FML revenue is distributed to various programs and entities.⁵ SB 08-218, another bill that originated in the 2007 Interim Committee to Study the Allocation of Severance Tax and Federal Mineral Lease Revenues, changed how the state's portion of FML revenue is allocated beginning in FY 2008-09. The new formula allocates the bonus payments portion of FML revenue differently from the rest of FML revenue (rents and royalty payments).

Bonus Payments. Bonus payments are distributed quarterly:

- 50 percent to the Local Government Permanent Fund. Money in this fund cannot be expended for any purpose except when the amount of FML revenue projected to be received by the state is 10 percent less than the amount received in the previous fiscal year. If this occurs, money from the permanent fund can be appropriated to DOLA for direct distributions of FML revenue to local governments.⁶
- 50 percent to the Higher Education Maintenance and Reserve Fund. The interest and income earned on the principal in this fund is for controlled maintenance projects included in the Colorado Commission on Higher Education's 5-year capital improvements program. The principal in this fund is required to remain in the fund unless General Fund revenue is projected to be insufficient to maintain the state's required 4 percent reserve. If this occurs, the General Assembly can make supplemental appropriations to offset reductions in General Fund appropriations for operating expenses of state public institutions of higher education.

Appendix A provides a diagram of how FML bonus payments are distributed.

Other (non bonus) FML Revenue. Other FML revenue, excluding bonus payments, is distributed quarterly to the:

- State Public School Fund, which is used to help fund public education in the state;
- Colorado Water Conservation Board Construction Fund to support loans and grants for water storage projects; and

⁵ FML revenue received from the production of oil shale is distributed differently from FML revenue from other energy production-related activities (Sections 34-63-102 (1) (a) (II), and 34-63-104, C.R.S.). However, the state currently does not receive any FML revenue from oil shale production and is not expected to receive any in the near future.

⁶ The amount of money that may be appropriated to DOLA through this mechanism is capped at the difference between the previous year's direct distributions to local governments and the current year's projected direct distributions.

- Local Government Mineral Impact Fund. Money transferred to this fund is split between DOLA direct distributions to local governments and school districts in areas impacted by energy production, and discretionary grants provided to local governments.
- Direct distributions to local governments of the FML revenue generated each fiscal year are made by August 31 of the following fiscal year to impacted counties based on the proportion of FML money derived from each county and the share of energy industry employees living in each county. The money is further allocated to the county and to each municipality within the county based on the proportion of energy industry employees, total population, and road miles within the unincorporated areas and municipalities within the county.⁷
- FML money directly distributed to school districts is distributed proportionately to counties that receive the direct distributions, and allocated within the county among schools according to student enrollment.
- Money provided through the discretionary grant program is distributed with priority given to communities most directly impacted by mineral production on federal lands for planning, construction, and maintenance of public facilities and for public services.

The amount of FML revenue allocated to the State Public School Fund, Colorado Water Conservation Board Construction Fund, and school districts is capped at a certain amount each year – \$65 million for the State Public School Fund, \$14 million for the Colorado Water Conservation Board Construction Fund, and \$3.3 million for school districts. These caps are increased annually by 4 percent.⁸

All non-bonus FML money in excess of these caps, up to \$50 million, is transferred to the Higher Education FML Revenues Fund. Money in this fund may be annually appropriated by the General Assembly to directly pay for, or pay for the costs of financing capital construction projects at state institutions of higher education and area vocational schools.⁹ Any money above the \$50 million annual cap is transferred to the Higher Education Maintenance and Reserve Fund, which is discussed under the "Bonus payments" paragraph above.

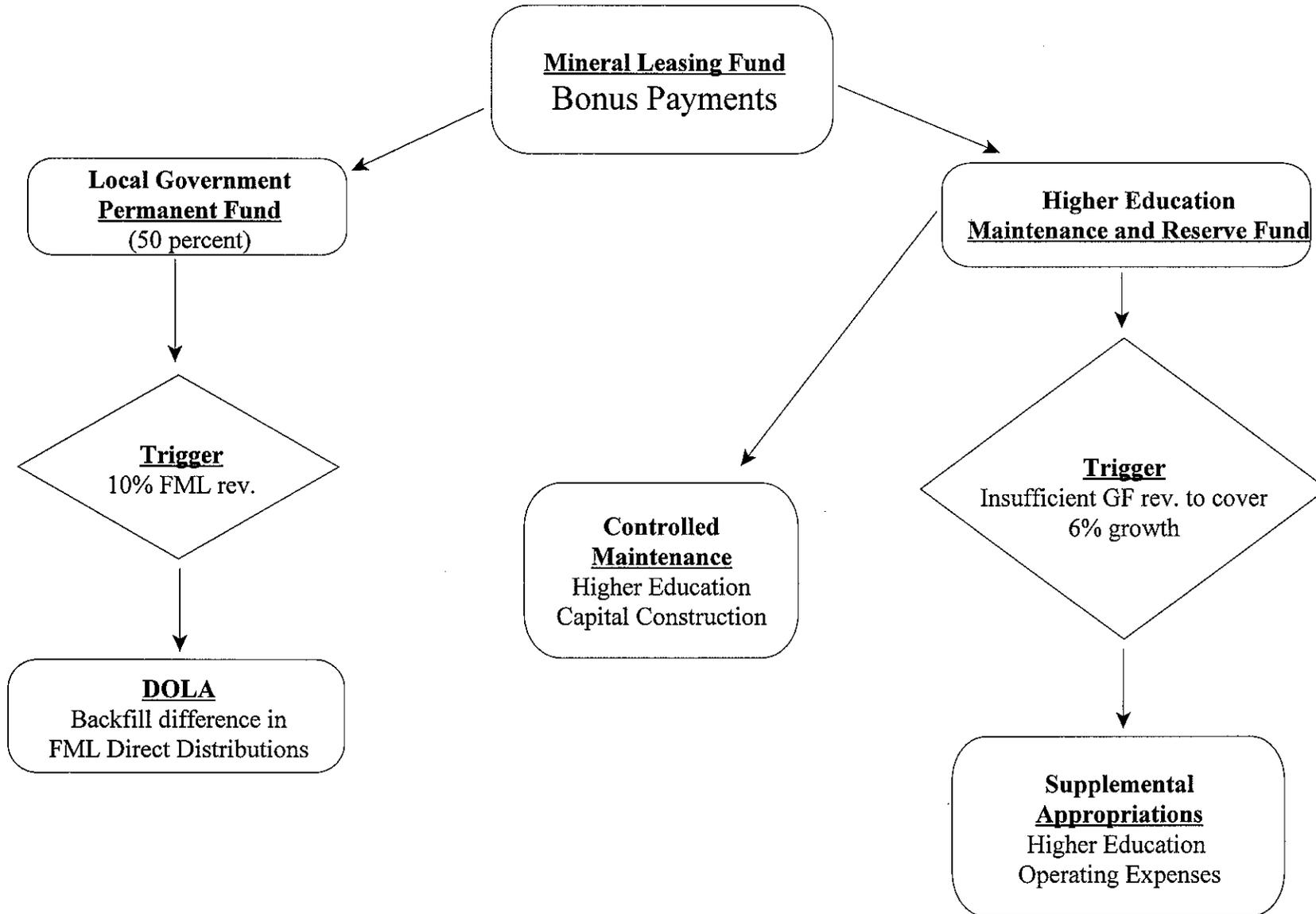
Appendix B provides a diagram for how the non-bonus portion of FML revenue is distributed.

⁷ The percentages applied to the factors that determine how the FML revenue is directly distributed to local governments, including how the money is allocated within each county, is determined by DOLA, based on recommendations from the Energy and Mineral Impact Assistance Advisory Committee. For the initial distribution to counties as a whole, the factor using the share of energy industry employees living in each county can have a weight of no more than 35 percent. How the money is allocated within an individual county based on the proportion of energy industry employees, total population, and road miles can also be determined through a memorandum of understanding between the county and all of its municipalities that is accepted by DOLA.

⁸ The 4 percent increase to the caps begin with FY 2009-10, except for the cap on FML revenue to the State Public School Fund. This cap begins increasing by 4 percent annually starting with FY 2011-12.

⁹ The state issued certificates of participation to finance 12 higher education construction projects in November of 2008. The annual state payments for the financing of these projects will primarily come from the Higher Education FML Revenues Fund.

Appendix A: Distribution of Bonus Payments



Appendix B: Distribution of Other (non-bonus) FML Moneys

