Colorado Department of Local Affairs

SEVERANCE TAX CREDIT STATUTE
Study Group HB-08-1084 REPORT
January 31, 2009

Colorado Department of Local Affairs

Message from the Executive Director
Susan Kirkpatrick

This report is a summary of the work of the severance tax credit study group which was directed by HB-08-1084 to review the uses and barriers of the statutory tax credit.

Between 1980 and 1994 fifty-five agreements were submitted for tax credits and forty were approved, totaling $7.5 million. For a variety of reasons there have been no formal applications submitted since 1994.

The Severance Tax credit was originally enacted to encourage local governments and mineral producers to embark on public improvements early in the mineral project development process. The statute provides that contributions made by an energy/mineral producer to finance local government infrastructure can be used to reduce future severance tax liability of the taxpayer.

This report is the culmination of the work of the study group and includes discussions outlining the context and history of the credit, perspectives from the energy industry and local governments, deliberation of problems with the current statute, and recommendations for its potential modernization.

After wide ranging dialogue, the parties generally agree that because the existing impact assistance grant and direct distribution programs have been significantly enhanced since HB 08-1084 was initiated, **there is no need to change or modernize the statute to increase its use.** The use of the credit is possible but not probable because of the problems identified in this report.

I would like to thank sincerely the participants in the severance tax study group and the staff members at DOLA who contributed to this effort. The contributors are listed in Exhibit G.

SEVERANCE TAX CREDIT STATUTE HB-08-1084 REPORT

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Introduction

House Bill 08-1084 directs the Departments of Local Affairs (DOLA), Revenue, and Natural Resources, along with the Energy Impact Assistance Advisory Committee, Colorado Municipal League, Colorado Counties Inc., and other stakeholders, to review the existing severance tax credit statute and determine how to make better use of the credit for major infrastructure needs of communities impacted by the energy and mineral industry. The Bill further requires submission of a final report to the Agriculture, Livestock, and Natural Resources Committee of the House of Representatives and the Agriculture, Natural Resources and Energy Committee of the Senate, or any successor committees, no later than January 31, 2009. In order to thoroughly and accurately examine the Severance Tax Credit, DOLA convened the severance tax credit study group.

The study group, comprised of government, industry and other stakeholders, met six times from June to December 2008 to receive and provide information, and openly discuss perceived issues related to the severance tax credit. DOLA facilitated the meetings, which featured presentations about the historical use of the credit, specific problems encountered, and potential future uses of the credit. Representatives from local governments who previously utilized the tax credit tool shared their experiences. The study group also heard perspectives from coal mining industry representatives who reflected on the tax credit's use in the 1980s. Oil and gas industry stakeholders weighed in on current issues specific to that industry.

Background

In 1980, the severance tax credit provision was put into statute along with a similar tax credit for corporate income and property taxes. The statute (CRS 39-29-107.5) provides for a credit against severance tax liability for industry contributions to local government infrastructure costs. Proposed credit contributions must be structured in a written agreement between the parties, and the agreement must be approved by the executive director of the Department of Local Affairs.

The purpose of the severance tax credit statute is to encourage taxpayers (i.e., energy and mineral developers) to make contributions to local governments prior to a mineral extraction project development or expansion. The credit encourages risk assumption by the mineral project developers for some of the costs that local governments incur in anticipation of a new or expanding mineral development project. Importantly, the process of developing the credit agreements enables local governments to build partnerships with mineral producers in the planning and financing of needed public infrastructure.

The credit may be used in planning, design and construction, or in expansion of public facilities. Between 1980 and 1994, fifty-five credit agreements were proposed to the Department of Local Affairs. Of those fifty-five, forty were approved, totaling $7.5 million. Most of the forty credits went toward infrastructure projects, (see Exhibit D).

Current Tools Used to Address Impacts

DOLA Energy & Mineral Impact Assistance Program (Grants)

The purpose of the Energy and Mineral Impact Assistance Program is to assist political subdivisions that are socially and/or economically impacted by the development, processing, or energy conversion of minerals and mineral fuels. Funds come from the state severance tax on energy and mineral production and from a portion of the state's share of royalties paid to the federal government for mining and drilling of minerals and mineral fuels on federally-owned land. The program was created by the legislature in 1977.

To assist local governments with the public facility and service improvements needed to accommodate energy and mineral development, the Energy and Mineral Impact Assistance Program provides technical assistance in financing and planning, grants and loans for local government projects, direct distributions of funds for general local government operations and review and approval of severance tax credit agreements.

Entities eligible to receive these technical assistance, grants, loans and credit agreements include municipalities, counties, school districts, special districts and other political subdivisions and state agencies. The kinds of projects that are funded include, but are not limited to, water and sewer improvements, road improvements, construction/improvements to recreation centers, senior centers and other public facilities, public safety buildings and equipment and local government planning.

The department is assisted by a twelve-member Energy and Mineral Impact Assistance Advisory Committee, which meets three times each year to consider applications for grants and low-interest loans. Seven members are appointed by the Governor to four-year terms, while the remaining five are state department executive directors or their designees. Final funding decisions are made by the executive director of DOLA.

To facilitate use of the grant program in the larger and more dynamic energy and mineral development projects we have seen in recent years, the allocation of funds has been segmented into three tiers with established evaluation criteria, match requirements and administrative procedures to reflect the varied needs of local governments.

Tier I includes grant awards of up to $200,000. These grant funds can be used for a variety of public purposes including planning, engineering and design studies, and capital projects requiring a limited level of financial assistance.

Tier II includes grant awards from $200,000 up to $2,000,000. This grant program is intended to support a wide variety of community development projects to improve quality of life in communities.

Finally, the Tier III category includes grant awards from $2,000,000 to $10,000,000. This grant program is intended to help political subdivisions with regional or multi-jurisdictional projects intended to mitigate major impacts associated with energy/mineral industries (dependent upon revenue availability). Tier III is expected to be implemented summer of 2009. Tiers I and II have three grants cycles per year, while Tier III has one.

Direct Distribution Program

In addition to the grants program, DOLA directly distributes to eligible local governments revenue derived from energy and mineral extraction. These revenues originate from State Severance Tax receipts and Federal Mineral Lease non-bonus payments. DOLA receives fifty percent of State Severance Tax funds, thirty percent of which go to Direct Distribution. Forty percent of the state’s Federal Mineral Lease funds are forwarded to DOLA, fifty percent of which go to Direct Distribution. A separate distribution of Federal Mineral Lease funds is reserved for school districts. In total, 1.7 percent is mandated for direct distribution to school districts.

Perspectives

Local Government Perspective

Ford Frick of the BBC consulting firm reprised the comprehensive public facilities and services needs study for Northwest Colorado titled the Northwest Colorado Socioeconomic Analysis and Forecasts. The recently completed report was contracted in response to the surge in oil, gas, shale, power plant and other energy development projects proposed and underway in that region.

Ongoing local government discussions throughout the meetings of the study group focused on large scale, risk, and multi-jurisdiction problems they faced with public facilities and services development required due to existing and proposed mineral and energy projects.

A number of local government representatives noted that implementing the multi-jurisdictional and regional planning and prioritization processes being discussed would be challenging when multiple local governments and corporate parties are required to reach agreement about use of the credit or other financing.

Local governments provided a number of presentations on their specific experience with the tax credit. For example, Delta County conducted a large multi-jurisdictional severance tax credit process in the 1980's with the coal mines that were being developed in neighboring Gunnison County. The planning coordination and prioritization process developed at that time survives to this day.

A number of counties noted that their needs for financial assistance are ongoing and do not fit the "new and expanded" criteria specified in the credit statute. While their mineral activity appears to have peaked, the need for ongoing public facility improvements and repairs, such as roads and bridges, continues. To address these large infrastructure costs, local governments have attempted to pass mill levy ballot measures which have not been successful. The severance tax credit could be very useful in these situations, by bringing in a large corporate partner to support and advocate for the projects. The credit could also help in alleviating some economic development project costs in such jurisdictions with mature energy projects that do not have a diversified local economy.

Another consideration is the perception that use of the credit is not based on a competitive process: each proposal credit agreement is considered only on its own merits, rather than in competition with other grant applications. Historically, this has been considered a positive by local governments.

A continual concern expressed by local governments is that if the use of the severance tax credit were increased significantly, revenue to both the severance Direct Distribution and the Grant Program would be negatively impacted. They expressed the view that these regularly administered impact assistance programs provide more strategic use of funds to local governments.

Industry Perspective

Representatives from the energy development industry offered comments from their perspective as well. A major barrier to using the credit is the fact that the market has changed. Today, a majority of local impacts is generated by the oil and gas industry. The tax credit statute does not behoove itself to this currently predominant industry.

The severance tax credit statute was written at a time when coal and metals mining reigned. The structure of the statute worked well for the mining corporations by its design: single, large operations whose long-term employees typically resided in those impacted communities.

Unlike the coal mining corporations, the oil and gas developers find the credit agreement process hard to implement. The complex mineral ownership and taxpayer structure, along with properties and rights ownership transfers create complications. Added to that is the diffuse nature of well-service employment ranging over hundreds of square miles. These and other part and parcel industry circumstances make it difficult to structure a proposal.

Both the mining and oil/gas industry representatives stated that the use of the severance credit is an opportunity to partner with local governments on infrastructure improvements that would benefit both. Industry benefits are realized when communities near industry operations improve their facilities and services as a result of a severance tax credit project. Communities benefit from local jobs creation and infrastructure improvements.

One major concern stated by the industry is being caught in the middle of a competition or argument between local governments over project funding choices. In the past, industry waited for a consensus between local governments before acting and making a financial investment through the use of the tax credit.

Industry representatives stated that the infrastructure projects needed in the oil and gas development areas are substantial, and often multi-jurisdictional. As such, the credit option should be structured to meet these larger strategic needs. Further, the industry believes severance tax credit agreements should be structured for regional projects, planning and priorities rather than the local, one-on-one arrangements shown in most prior credit projects.

The original intent of the credit was to split financial risk between local governments and industry. However, industry representatives indicate that they do not want additional risk beyond that already put forth with energy development. Industry wants assurance that the credit will be used against their severance tax liability.

Finally, some industry representatives noted that given the increasing size of impact grants, the need for the severance tax credit has waned. There is no perceived difference between the credit and impact grants.

Problems with the Current Statute (C.R.S. 39-29-107.5)

A number of components in the existing statute are unclear or obsolete. To encourage use of this statute for local government facility costs, the following language needs to be clarified and simplified:

1. Clarify confusing language on timing and amounts of new and increased production prevents use of the credit.

2. Remove confusing and conflicting language in reference to units of local government.

3. Add the Department of Revenue as a formal party to the review of a contribution agreement.

4. Make specific provision for verification of contribution amounts and values after the fact.

5. Remove the extra definition of mineral production that is confusing and unnecessary.

6. Reorganize the description of contribution-for-credit agreements into a single section.

7. Define the taxpayer party to a credit agreement in a manner which facilitates use of the credit statute by the oil and gas industry.

8. Remove the risk to the Department of Natural Resources from the exercise of the tax credit.

Recommendation and Conclusion

The study group's initial analysis favored clarifying language and otherwise modernizing the statute in order to encourage its use by the oil and gas industry (see Exhibit A). However, acknowledging the significant enhancement of the existing grant and direct distribution tools led the group to conclude that there is **no need to modernize and change the statute.** Other notable considerations include the concern of a decrease in direct distribution and grants in the event the credit was more utilized. Impacted jurisdictions, further, would face stiffer competition for grants. The study group concluded that the proposed Tier III grant program will benefit the mineral, oil and gas industry as well as local governments in a much simpler way. The current proposal to use the Tier III grant program seems more flexible and does not requires a statutory change. Finally, the Tier III grant program utilizes a major strength of the tax credit by incorporating the tax credit strategy of requiring multi-jurisdictional collaboration and solution prioritization.

<u>Exhibit A</u>

Severance Tax credit Statute Modernization

Proposed Severance Tax credit Statute Modernization Bill

Purpose of the Statute

The purpose of the severance tax credit statute is to encourage taxpayers to make contributions to local governments prior to a mineral extraction project development or expansion. It encourages risk assumption by the mineral project developers for some of the costs that local governments incur in anticipation of a new or expanding mineral development project. This is done by allowing contributions to local government infrastructure projects to be claimed as a credit against future severance tax liability.

The following pages discuss each proposed statutory change.

PROPOSED STATUTORY CHANGE #1:
Specification of New and Increased Amounts and Timing –

- Clarifying confusing language on timing and amounts of new and increased production prevents use of the credit.

a. The language in the statute regarding the starting of the severance period and the portion of the taxpayer's total liability is unclear. For an operation just beginning, it is understood that the contribution must occur "prior to first severance of such minerals". The amount of the contribution is currently one half of the total severance liability from the new operation over 10 years.

b. With exploratory and evaluation production ("severance") likely in the early phase of a project, it is not clear anyone would qualify under this standard. The liability should be above some baseline of severance tax liability against which the credit can be claimed.

c. The "increased severance" operation section of the statute, under which most credit proposals would be made, only requires that the contributions be made "to assist in solving the impact problems" caused by the expanded operation. The statute does not specify a timer for the contribution relative to the increased production.

d. In addition, the statute defines "increased production" as that "for which increased severance occurs subsequent to June 30, 1980". This would cover just about every producer in the state.

e. The action being measured for "new" and "increased" is described as "severance". This is taken to mean physical extraction of severance taxable minerals. It is sometimes confused with sale of such minerals, or a change in value of production severance tax base due to product price increases, or changes in net severance tax liability. Differentiating the many factors that can lead to an increase in severance tax liability, particularly between price changes, production quantity or quality changes is not easily done.

Solution:
1. Combine the two current definitions, "new operation" and "expanded operation", into one where the base period is defined as the average severance tax net payments of the taxpayer in the five corporate tax years prior to the date of the approved contribution agreement.

2. The 10-year estimation period and severance liability against which the credit can be claimed should start with the tax year following the date of the application for credit. The taxpayer's estimate of their expanded severance tax liability should also become a formal part of the credit agreement for review by the Department of Local Affairs and the Department of Revenue. This estimate would not impact the eventual right to claim credit by the taxpayer.

Pro/Cons:
With oil and gas development operations, the broad and fluid nature of the development is very difficult to specify as an operation under the current statute and inhibits, if not prohibits, use of the credit by this large industry.

This decoupling of the taxpayer credit from a specific mineral extraction operation bothered many of the stakeholders because of the possibility that the credit contribution in one community would reduce the severance payments of the taxpayer in a different region.

PROPOSED STATUTORY CHANGE #2:
Provide a more Specific Definition of the Local Government Partner authorized to enter into a credit Agreement

- Conflicting language on the unit of local government specification is confusing.

1. The "unit of local government" phrase is paired many times in the statute with "or local units of government locally impacted". This later phrase is specifically defined in statute as "units of local government in the geographic area wherein reside employees of the operation . . . determined on the basis of residence as reported in accordance with section 39-29-110(21)(d)".

This restriction was plainly intended to confine contributions to an area on the basis of data rather than supporter's assertions or agency discretion. The use of the statutory employee residence reports is somewhat illogical, since the contribution credit agreement must be made prior to severance by an operation. Therefore there will not be any employee residents to qualify a geographical area under the definition.

2. The statute specifies that "each contribution shall be based on an agreement between or on behalf of the taxpayer and a unit of local government or local unit of government locally impacted." The phrase "on behalf of" may only apply to the taxpayer, indicating that a contribution could be made by an agreement signed with a third party not the taxpayer. It could also apply to the "local government" indicating that one local government can enter into a credit agreement for other local governments.

While the opportunity for multiple taxpayer and/or multiple local government agreements appears beneficial in theory, the practicalities of such a contract are more than can be specified in this statute. Multi-party severance tax credit programs can be orchestrated as a package of two party credit agreements. This was done in Delta County in the 1980's.

This attempt to tie the local government to the operations through statutory definitions and data requirements misses the fundamental point of impacts: they are *speculative, dynamic and subjective*. It also misses the critical point of the state and local government response to impacts: *cooperative public facility* and *service development*. The review of the proposed credit agreement by the Department of Local Affairs and the Energy Impact Assistance Advisory Committee is the place to put the decision as to which local governments are being impacted and which would best serve to mitigate the impacts.

Solution:

- The restrictive definition of impacted local governments on the basis of the employee residence reports should be repealed.
- The term “on behalf of” should be deleted.

Pro/Cons:
This simplifies the statute which makes it more accessible and attractive to industry.

The proposed solution would prohibit multi-jurisdiction tax credit agreements, which have been discussed as part of an effort to get very large infrastructure projects funded.

PROPOSED STATORY CHANGE #3:
Make the Department of Revenue a Formal Party to Review

- The Department of Revenue is currently not a formal party to the review of a contribution agreement, and should be.

The contribution agreement contains a number of pieces of information that the Department of Revenue will need in the evaluation and approval of a credit claim by a severance tax payer.

Solution:
The Department of Revenue should be encouraged to participate in the development phase of these credit agreements and also made a *formal* party to the advisory review *along* with the Energy Impact Assistance Advisory Committee.

Pro/Cons:
There was unanimous agreement that this is a good idea.

The Department of Revenue indicated that they would need to review the possible staff cost fiscal impact of this new responsibility.

PROPOSED STATUTORY CHANGE #4:
Post contribution evaluation and verification

- No provision is made for verification of contribution amounts and values after the fact.

There is no provision in statute for evaluation and verification of the contributions specified in the approved credit contribution agreement.

Solution:
This should be added as a requirement for taxpayer and local government record keeping and an invitation to audit by the Department of Revenue.

Pro/Cons:
There was unanimous agreement that this is a good idea. The Department of Revenue indicated that they would need to review the possible staff cost fiscal impact of this new responsibility.

PROPOSED STATUTORY CHANGE #5:
Added definition of minerals confusing and redundant with specification of taxable minerals at the beginning of the statute.

- Extra definition of mineral production is not necessary

Discussion:
"(4) For the purposes of this section, minerals or mineral fuels shall include, but not be limited to, oil shale, crude oil, natural gas, and oil and gas." This section is redundant, confusing and unnecessary for implementation of this statute. The core definition is severance tax liability, which is contained in the body of the severance tax statutes.

Solution: Repeal this section of the statute.

Pro/Cons:
There was unanimous agreement that this is a good idea.

PROPOSED STATUTORY CHANGE #6:
Clarify the components of the contribution agreement.

- Description of contribution-for credit agreements is disorganized in statute which seems to increase confusion and lack of use of the tax credit.

Discussion:
The various components of the contribution agreement: the parties, the amounts, the amount limits, the required stipulations, are spread throughout the statute. These should be better organized into a list so that the parties can be clear on the required elements of an agreement.

Solution
Break up long statutory sections with contribution definitions, add-ons and limits into a sub section list. Relocate some components to this list.

Pro/Cons:
There was unanimous agreement that this is a good idea.

PROPOSED STATUTORY CHANGE #7:
Definition of Operation

- Lack of sufficient clarity on (who in the oil and gas industry) can claim the credit makes it difficult to use.

1. The credit allowed in statute is issued against severance taxes imposed on an "operation" with new or increased production. This definition is used to set the timing of events and to set a baseline for increased severance liabilities against which the credit can be claimed. However, the process for claiming a tax credit is not clearly defined, making it difficult for operators to navigate their way in proceeding to use the credit.

2. Severance taxes are imposed on "taxpayers" who may have many "operations". Therefore, this credit statute implies that a separate calculation of the operation severance tax liability is required by the taxpayer, and verified by the Department of Revenue. With oil and gas, the

aggregation of a range of severance tax deductions and credits over multiple "operations" may make such a distinction quite difficult.

3. The credit statute calls for the taxpayer to "anticipate" the total new or increased severance liability in the "first ten years of severance from an . . . operation" in order to set the maximum amount of credits allowed. But, C.R.S. 39-29-108(3) requires the Department of Revenue to divert all of the taxpayer's future severance tax payments to the trust fund until the 50% of payments that were denied to the trust fund by the claiming of the credit have been made up. This refunding provision contains no separation of the severance tax payments by "operation", implying that all the taxpayers' severance liability is in play.

4. The end of the statute mentions that "a taxpayer shall be entitled to credit against its severance liability in an amount equal to the total of all contributions made and certified as eligible for credit". This provision also does not contain the constraint "from or for an operation".

Conclusion: All of this leaves the Department of Revenue and the taxpayer with some ambiguity as to the amounts that can be claimed as credit and the liabilities against which they can be claimed. Severance liability information is reported in aggregate by taxpayers, many of which cover multiple counties and "operations". The credit statute implicitly requires that a new calculation be made of severance liability for the separate "operation" for which the contribution was made and the credit agreement was established.

Solution:
To encourage the taxpayers to make contributions for risky projects, make the entity for which the severance is being calculated the whole taxpayer. credits created from one operation should be allowed against increased severance tax liability of the taxpayer from any operation that incurs severance tax liability. The "new or expanded operation" would still be specified in the contribution credit agreement for use by the Department of Local Affairs in evaluation of the appropriateness of the proposed credit, and in the estimates by the taxpayer of the 10 years of severance liability. But this definition of "operation" would have no effect on the actual credit claimed. The objective is simplicity and convenience for the taxpayer.

Pro/Cons:
With oil and gas development operations the broad and fluid nature of the development makes it very difficult to specify the specific severance liability attributable to an operation. Therefore, the current statute and inhibits, if not prohibits, use of the credit by this large industry.

This decoupling of the taxpayer credit from a specific mineral extraction operation bothered many of the stakeholders because of the possibility that the credit contribution in one community would reduce the severance payments of the taxpayer in a different region, and that the ability to use the credit for any liability removed most of the risk to the taxpayer.

PROPOSED STATUTORY CHANGE #8:
Restrict use of the credit to the portion distributed to the Local Government Severance tax Fund.

- Exercise of the tax credit puts the Department of Natural Resources at some risk.

Discussion:

1. Under the current statute the claim of a credit by a severance taxpayer reduces the revenue received by both the Local Fund side and the Trust Fund side of the severance tax distribution.

2. Following use of the credit, that taxpayer's further severance tax payments are diverted to the Trust fund to make up for the losses to the Trust Fund so that, in the end, the Local Fund bears the full reduction from the use of the credit. This process requires an extra accounting process for the Department of Revenue and a potential risk to the Trust Fund that the future severance tax payments might not cover the prior losses.

Solution:
Allow the exercise of the credit only against the Local Fund share of severance tax revenues. This has the effect of limiting the exercise of the credit to half of the net severance tax liability of the taxpayer in any payment made to the Department of Revenue.

- Increase clarity for industry calculation
- Remove the risk to DNR
- Adapt to any change in local share of severance tax.

In its distributions to the state fund, the Department of Revenue would reduce the share to the Local Government Severance Tax Fund by the amount of the credit claimed, and leave the Trust Fund share whole. Repeal the refunding provision in 39-29-108(3).

Pro/Cons:
This would reduce the available pace of credit claims by a taxpayer which could be considered an increase in effective taxation.

This proposal would simplify the financial calculations involved in the credit and leave hold-harmless the state share of severance tax revenues.

Exhibit B:

Combined Statute Edits As Proposed Bill Language

COMBINED STATUTE EDITS AS PROPOSED BILL LANGUAGE

Edit #2 39-29-102(4.5) REPEALED ~~Definitions: "Local units of government locally impacted" means units of government in the geographic area wherein reside employees of the operation producing the minerals and mineral fuels taxed pursuant to this article. The geographic area shall be determined on the basis of residence as reported in accordance with section 39-29-110 (1) (d).~~

Edit #1 39-29-107.5 credit allowed for prior payment of impact assistance.

(1)~~(a) There shall be allowed, as a credit against any taxes imposed by this article on the severance of minerals or mineral fuels from or for a new operation from or for which first severance occurs subsequent to June 30, 1979, an amount equal to the value of approved contributions by the taxpayer made prior to first severance of such minerals or mineral fuels to assist in solving the impact problems of units of local government resulting from the initiation of such new operation.~~

(1)(b) There shall be allowed, as a credit against any **THAT PORTION SEVERANCE TAX INCOME FROM** taxes imposed by this article on the severance of minerals or mineral fuels **AND DISTRIBUTED TO THE LOCAL GOVERNMENT SEVERANCE TAX FUND BY 39-29-108(2) C.R.S.** ~~from or for an operation which has an increase in production from or for which increased severance occurs subsequent to June 30, 1980,~~ an amount equal to the value of approved contributions by the taxpayer made to assist in solving the impact problems of units of local government ~~or local units of government locally~~ impacted by **AN** increase in ~~production of an operation~~. **MINERAL SEVERANCE.** ~~(1)(c) There shall be allowed,~~ **SUCH CONTRIBUTIONS SHALL BE MADE** pursuant to an agreement between the taxpayer and the unit of local government specified in **SUBPARAGRAPH (A)** subparagraph (I) of paragraph (a) of subsection (~~2~~**3**) of this section. ~~as a credit against any taxes imposed by this article on the severance of minerals or mineral fuels,~~

(1)(c) There shall be allowed, pursuant to an agreement between or on behalf of the taxpayer and the unit of local government specified in subparagraph (I) of paragraph (a) of subsection (2) of this section as a credit against ~~any~~ **THAT PORTION DISTRIBUTED TO THE LOCAL GOVERNMENT SEVERANCE TAX FUND BY 39-29-108(2) C.R.S. OF** taxes imposed by this article on the severance of minerals or mineral fuels, in addition to any amounts determined under paragraphs (a) and (b) of this subsection (1) and subsection (2) of this section, an amount equal to three-fourths of one percent per month times the amount of approved contributions by a taxpayer for each month that any approved contribution precedes the month in which said approved contribution is credited against a taxpayer's yearly severance tax liability. Any amounts of approved contributions credited against a taxpayer's yearly severance tax liability shall be applied to reduce the amount, if any, of approved contributions not previously credited, and the additional percentage provided in this paragraph (c) shall apply solely to said reduced amount of approved contributions.

(2)(a) Approved contributions, for the purpose of such credits, shall include the contribution of property or payment of money to units of local government or local units of government locally impacted, for use in planning, including financial, architectural, and engineering services, construction, or expansion of public facilities, including but not limited to county or municipal roads, schools, recreation facilities, water facilities, sewage facilities, police and fire protection facilities, and hospitals, which are deemed to be necessitated by the initiation of a new operation or increase in production of an existing operation.

[Relocated paragraph (1)(c)] (2)(a)(I) In addition, subject to the agreement reached pursuant to paragraph (c) of subsection (1) of this section, approved contributions may also include any loss sustained by reason of the sale of any bonds by the taxpayer who purchased such bonds, the proceeds of which bonds are used in the planning, construction, or expansion of any such public facilities by a unit of local government or local unit of government locally impacted, and any loss by reason of the default on loans made by a taxpayer or satisfaction of a guaranty obligation of the taxpayer arising out of the issuance of such bonds, whether or not such bonds are purchased by the taxpayer. Such losses shall be approved contributions as of the date of the making of a loan, the date of issuance of the bonds, or the date of entering into the guaranty obligation; except that, for purposes of the additional credit allowed pursuant to paragraph (c) of subsection (1) of this section, the date of the approved contribution shall be the date of default on any such loan, the date of loss on any such bond, or the date of satisfaction of any such guaranty obligation.

[New paragraph break] (2)(a)(II) There shall be allowed, pursuant to an agreement between the taxpayer and the unit of local government specified in subparagraph (I) of paragraph (a) of subsection (2) of this section as a credit against **THAT PORTION DISTRIBUTED TO THE LOCAL GOVERNMENT SEVERANCE TAX FUND BY 39-29-108(2) C.R.S. OF** taxes imposed by this article on the severance of minerals or mineral fuels, in addition, subject to the agreement reached pursuant to paragraph (c) of subsection (1) of this section, approved contributions may also include any loss sustained by reason of the sale of any bonds by the taxpayer who purchased such bonds, the proceeds of which bonds are used in the planning, construction, or expansion of any such public facilities by a unit of local government or local unit of government locally impacted, and any loss by reason of the default on loans made by a taxpayer or satisfaction of a guaranty obligation of the taxpayer arising out of the issuance of such bonds, whether or not such bonds are purchased by the taxpayer. Such losses shall be approved contributions as of the date of the making of a loan, the date of issuance of the bonds, or the date of entering into the guaranty obligation; except that, for purposes of the additional credit allowed pursuant to paragraph (c) of subsection (1) of this section, the date of the approved contribution shall be the date of default on any such loan, the date of loss on any such bond, or the date of satisfaction of any such guaranty obligation.

[NEW paragraph break](2)(a)(III) In no event shall the total amount of approved contributions by a taxpayer exceed ~~fifty percent of~~ the **INCREASED PORTION OF SEVERANCE TAX INCOME DISTRIBUTED TO THE LOCAL GOVERNMENT SEVERANCE TAX FUND OF** ~~severance tax liability~~ **FROM TAXABLE MINERAL SEVERANCE ABOVE THE AVERAGE SEVERANCE TAX LIABILITY IN THE PRIOR FIVE YEARS** which the taxpayer anticipates will be incurred during the ~~first~~ ten years of severance **FOLLOWING SUCH CONTRIBUTIONS** ~~from an new operation or fifty percent of the increased severance tax liability which the taxpayer anticipates will be incurred during the first ten years of severance from an expanded existing operation~~ plus the amounts calculated pursuant to paragraph (c) of subsection (1) of this section.

[NEW paragraph break] (3)(a)(I) In order for an approved contribution to qualify for credit, the following requirements shall be fulfilled:

[New paragraph numbering] (3)(a)(II)(A) Each contribution shall be based on an agreement between ~~or on behalf of~~ the taxpayer and a unit of local government or local unit of government locally impacted, specifying the need for such contribution and its nature, value or amount, and purpose **AND A STATEMENT OF THE TAXPAYERS ESTIMATE REQUIRED BY SECTION (2)(a)(III)**;

Edit #3 **(3)(a)(II)(B)** Each contribution must be acted upon for credit and, if approved, a certificate of eligibility issued, within ninety days after joint submission by the taxpayer and the unit of local government, or local unit of government locally impacted, by the executive director of the department of local affairs upon the recommendation of the energy impact assistance advisory committee created by section 34-63-102 (5) (b), C.R.S., **AND THE EXECUTIVE DIRECTOR OF THE DEPARTMENT OF REVENUE**, and failure to act upon the eligibility within said ninety days shall be deemed as approval and certification of the contribution; and

(3)(a)(II)(C) Certification of eligibility for credit of a contribution of a specified value or amount must be transmitted by the executive director of the department of local affairs to the executive director of the department of revenue, the unit of local government or local unit of government locally impacted, and the taxpayer.

[RENUMBER section (3)] ~~(3)~~**(4)** A taxpayer shall be entitled to credit against its severance tax liability in an amount equal to the total of all contributions made and certified as eligible for credit plus the amounts calculated pursuant to paragraph (c) of subsection (1) of this section. The taxpayer may claim such credit by submitting with the annual declarations and returns required by section 39-29-112 the certifications of eligibility for such credit or evidence regarding deemed certification, and in the case of losses sustained by reason of the sale of any bonds purchased by the taxpayer, by reason of satisfaction of a guaranty obligation of the taxpayer arising out of the issuance of bonds, or by reason of loans made by the taxpayer, evidence of such losses. The amount of credit available in any one taxable year, including carry-overs, shall not exceed the taxpayer's severance tax liability in such year. Any excess shall be carried over and shall be available as a credit in the next succeeding year or years subject to the same annual limitation.

Edit #5 39-29-107.5(4) REPEALED

Edit #4 **[NEW Section] 39-29-107.5(5) UPON SUBMISSION OF A CLAIM FOR CREDIT AGAINST SEVERANCE TAX LIABILITY BY A TAXPAYER THE DEPARTMENT OF REVENUE WILL:**

(a) EVALUATE THE HISTORY OF SEVERANCE TAX PAYMENTS BY THE TAXPAYER AND DETERMINE THE ACTUAL PORTION OF THE NET SEVERANCE TAX LAIBILITY THAT IS AN INCREASE OVER THE BASIS AS DEFINED IN THE TAXPAYER’S ESTIMATES MADE UNDER SECTION (2)(a)(III),

(b) CONFIR WITH THE LOCAL GOVERNMENT PARTY TO THE CREDIT AGREEMENT TO VERIFY THAT THE CONTRIBUTIONS HAVE BEEN PROPERLY CONDUCTED, AND,

(c) REPORT TO THE DEPARTMENT OF LOCAL AFFAIRS ON THIS EXERCISE OF A CREDIT IN A FASHION WHICH DOES NOT DISCLOSE CONFIDENTIAL TAXPAYER INFORMATION.

Edit #8 **39-29-108.** (3) REPEALED ~~Effective July 1, 1981, the total gross receipts from any taxpayer who has previously claimed the full amount of the credit for an approved contribution under section 39-29-107.5 shall be allocated solely to the state severance tax trust fund until such time as there is allocated to such fund, in addition to any current allocation to such fund, an amount equal to what would have been allocated to such fund during the time the taxpayer claimed such credit.~~

****

Exhibit C:

Severance Tax credit Overview Presentation - July 15, 2008

Severance Tax Credit Overview

- The current Colorado severance tax statute* provides for the use of a credit against severance tax liability.
- For use in planning, design and construction, or expansion of public facilities due to impacts of new or expanded production.

*CRS 39-29-107.5

Purpose of Severance Tax Credit

1. Provide risk sharing in "front-end finance."
2. Build a partnership between the mineral producers and local governments.
3. Ensure use of funds supports intentions of the statute.
4. Repayment to the Severance Tax Trust Fund cash "borrowed" in the claim of approved severance tax credits by the taxpayer.

History of the Colorado Severance Tax Credit

- In 1980, the tax credit tool established in statute.
- From 1980-1994, 55 tax credit financing proposals submitted to DOLA.
- Forty of the tax credit requests approved, totaling $7.5 million.
- Majority of tax credits were used for infrastructure.

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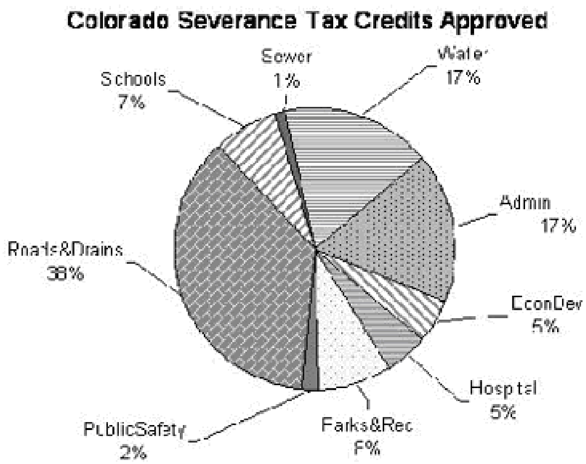
Most of the Credit Contributions Were for Infrastructure



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History of Severance Tax Credit Agreements Sumbitted

	PROJECT NAME	DATE	APPLICANT	Approve	TAXPAYER	TYPE
1	Pioneers Hospital	1980	Rio Blanco County	$40,000	NA	Hospital
2	Canon City School	1980	Fremont School District	$300,000	Amoco Cyprus	Schools
3	Meeker Water Tank	1981	Town of Meeker	$165,000	NA	Water
4	Meeker Road	1981	Town of Meeker	$0	NA	Roads&Drains
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9	Rifle Bypass	1981	Garfield County	$0	NA	Roads&Drains
10	Crawford Water Meters	1982	Town of Crawford	$47,520	ARCO West Elk Coal Mine	Water
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12	Paonia High School Site	1982	Delta School Dist. 50	$76,450	NA	Schools
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15	Craig Golf Course	1982	Moffat County	$30,000	ColoWyo Coal Mine	Parks&Rec
16	Hotchkiss Streets/Drainage	1982	Town of Hotchkiss	$73,000	ARCO West Elk Coal Mine	Roads&Drains
17	Delta County Jail	1982	Delta County	$155,000	ARCO West Elk Coal Mine	PublicSafety
18	Routt County Road #33	1983	Routt County	$956,000	TwentyMile Coal Mine	Roads&Drains
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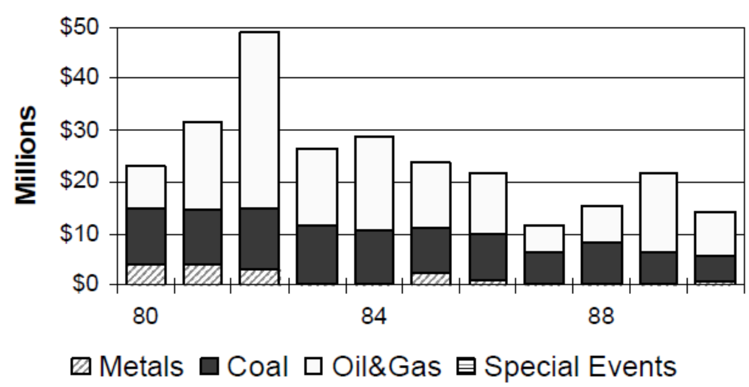
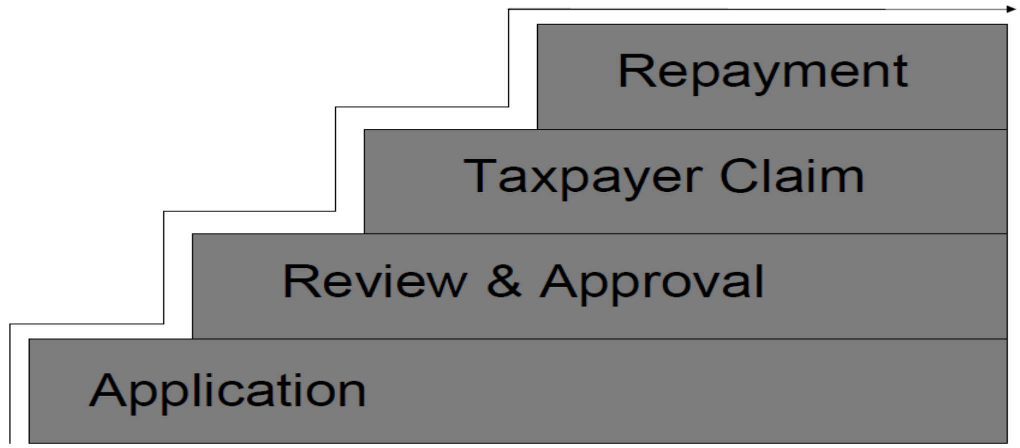
Severance Tax Revenues in the 1980's Were Quite Different from Today

State Total Severance Tax Revenue
by Mineral Type in the 1980's



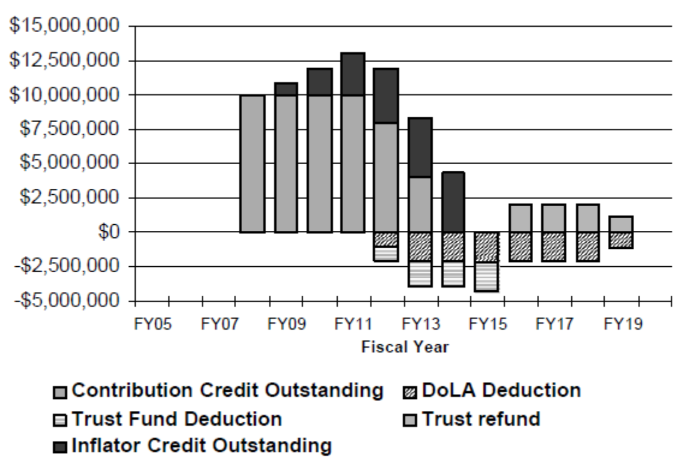
Severance Tax Credit Process: Four Categories



Step 12: Repayment To the Trust Fund

A multi year calculation of the cash flow of severance tax credit. The chart below shows a hypothetical $10 million credit approved in fiscal year 2008.

Severance Tax Credit Sequence of Events



DOLA Tax Credit Evaluation Policy

The focus of the review is on the five items required in the agreement:

- Who?
- Why?
- What?
- How Much?
- When?

Who Is Applying for the Tax Credit?

- Is the local government properly identified and authorized?
- Is the taxpayer's corporate identity defined properly to confine use of the tax credit to severance tax liabilities from the specified operations?
- Have other jurisdictions affected by the taxpayer's operations been considered?
- Has the contribution been reviewed locally and prioritized against pending impact grant applications from the area?

Why is the Local Government Requesting Approval of the Tax Credit?

- Have the jurisdiction and related local government entities considered the full agenda of need due to the taxpayer's operations?
- Is the type of community facility improvement supported by the contribution a relative priority over other types of needed improvements?

What Financing Agreement Has Been Proposed?

- Has the taxpayer and local jurisdiction reached a solid agreement on the specifics of the contribution?
- Does the written agreement clearly define the contribution to assure verification of the outcome in future years when credit is claimed?

How Much Is the Requested Tax Credit?

- Is the potential dollar credit a deduction from severance tax revenue an appropriate scale relative to the need and purpose?
- What portion of the taxpayer's severance tax payments does the credit absorb?
- After the credit agreement, is there sufficient severance liability after the credit is claimed to repay the lost revenue to the Severance Tax Trust Fund?

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When Will the Project Tax Credit Contribution Occur?

- Is the contribution contingent on other events and actions?
- Are the parties clear about the agreement and that the contribution will occur?

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Severance Tax In the State Budget

- Budget Forecasting with Tax Credit
- Impact of Tax Credit use on Direct Distribution and Grant Program
- Severance Tax is not TABOR exempt

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Step 12: Repayment To the Trust Fund

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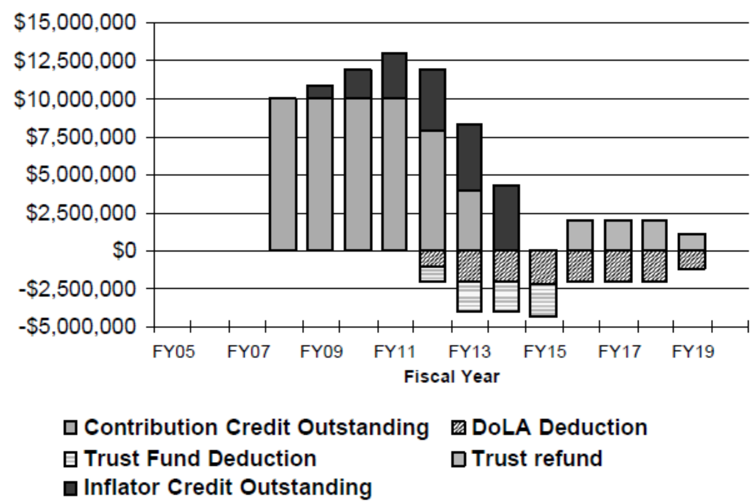

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TABOR Constraints

- Potential Impact of Tabor and Tax Credit Changes - "Net revenue gain"

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DOLA Tier III Grants Program

Large community projects funding option

- Multi-million dollar
- Multi-year
- Multi-jurisdictional

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Study Group Potential Options

1. Use "Tier 3" grants/loan program for the large local government projects and continue the low emphasis on the severance tax credit.

2. Use the existing statute without new legislation and promote use of the severance credit through marketing and policy.

3. Recommend modest statutory changes to modernize the current statute.

4. Recommend major modification of the current statute.

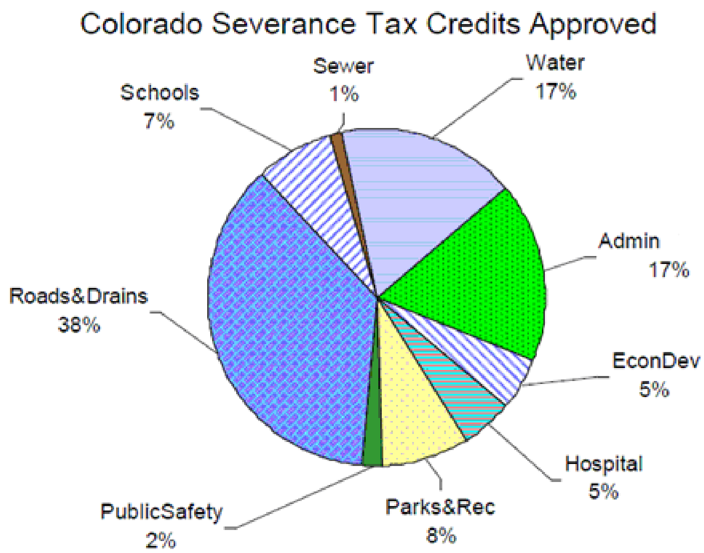
5. Create a new severance tax credit statute.

6. Establish new finance options for large local government projects.

Exhibit D:
History of the Colorado Severance Tax credit

History of the Colorado Severance Tax Credit

Beginning in 1980, the impact assistance credit provision was put into statute. From 1980 to 1994, fifty-five credit agreements were proposed to the Department of Local Affairs. Of those fifty-five, forty were approved, totaling $7.5 million. Most of the forty credits went toward infrastructure projects.



History of Severance Tax Credit Agreements Submitted

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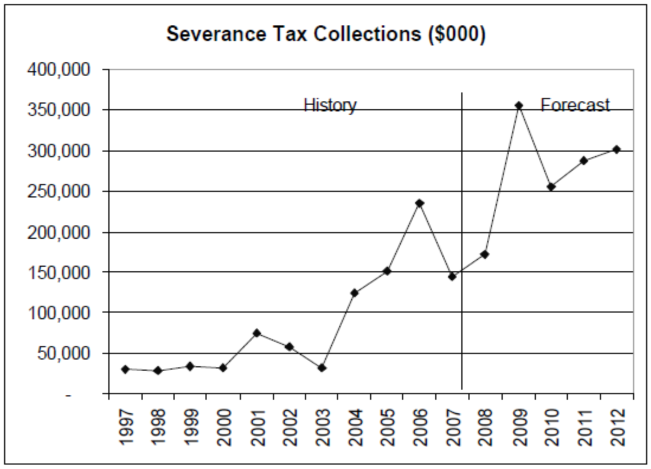
Exhibit E:

Legislative Council Economic Forecast
Presentation - July 15, 2008

History and Forecast of Severance Taxes in Colorado (June 2008, Legislative Council Staff Forecast)

Severance taxes grew from $32 million to $234 million from 2003 – 2006.

Severance taxes are very responsive to changing energy prices.



1

Budget Issues Related to Severance Taxes

Severance taxes are counted as TABOR revenue and account for a growing share of TABOR revenue.

Referendum C allows the state to retain all revenue received from FY 2005-06 to FY 2009-10.

After FY 2009-10, **Referendum C** allows the state to retain an amount equal to the highest amount of revenue received in the five-year time-out period, which grows by inflation and population annually.

Severance taxes add to the base during the five-year time-out period, but could push the state into a TABOR refund situation beyond FY 2009-10.

Severance tax credits reduce the size of the base during the five-year time-out period and reduce the size of future TABOR refunds after FY 2009-10.

The Severance Tax Impact Assistance Credit raises questions concerning the magnitude, timing, and claiming of those credits, which makes forecasting severance taxes more difficult.

2

Exhibit F:

Brief Description of Why Severance Tax is Variable

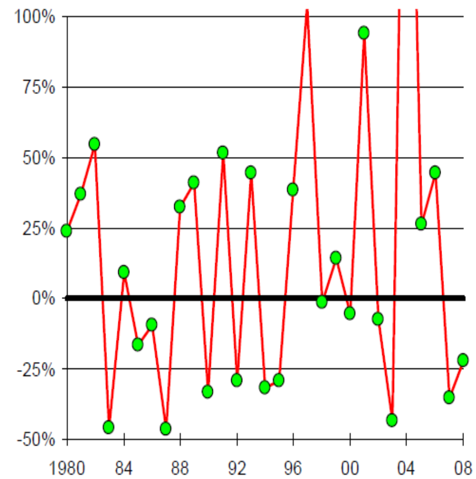
Question: **" Why is the state severance tax revenue so variable?"**

1) Severance tax is highly variable on a monthly and annual basis.

2) Severance tax is collected on the production of coal, metals, oil and gas.

3) Coal and metals provide less than 25% of the severance revenue and are fairly stable.

4) It is the revenue from the value of oil and gas production which provides the bulk of state severance tax revenue and is the source of the large variability.



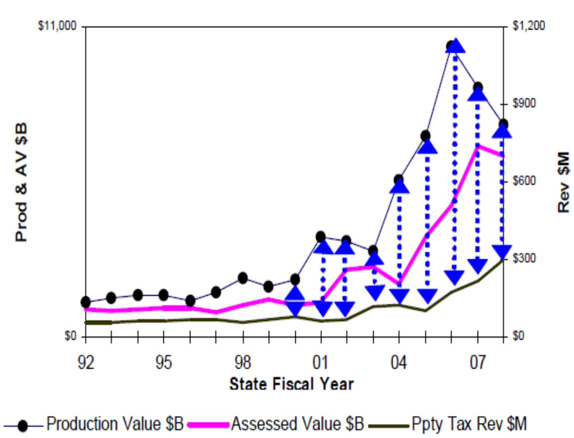
Annual Percent Change in Severance Tax Revenue

5) Severance tax revenue on oil and gas starts with the the value of production. From this the taxpayer deducts any produciton from small wells exempted from the severance tax. The taxpayer then deducts various costs from the remaining wells to get the valuation back to the point of severance. These two deductions combined total about 40% of production value. A 2 to 5% percentage tax rate is applied to the remaining valuation to get the gross severance tax liability. Most production is taxed at the 5% rate. Then the tax law provides for the subtraction of a large credit for property tax payments to determine net revenue paid to the state. Since property taxes in the rural production areas are often at the 50 mills or higher rates (5% of value), these property tax credits are about the same size as the gross severance tax liability. As a result, the property tax credit can frequently reduce the net severance tax liability of a particular producer to zero.

6) The effective tax base for the oil and gas severance tax is not the gross value of production. Rather, it is the GAP between the gross value of produciton and this large credit.

7) As the value of oil and gas production varies, the gross severance tax liability moves in concert. However, the property tax payments by an oil and gas producer are based on the assessment of production by the county assessor in the prior year,

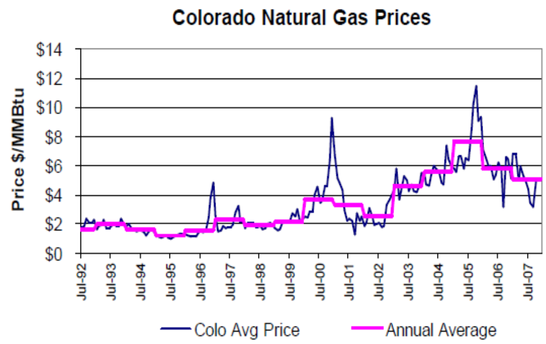
O&G Production Value, Property Assessed Value and Tax Revenue. The Two Year LAG



which is based on the value of production in the year before that. The interaction of this two year LAG in the calculation of the property tax credit with the gross severance tax calculation causes much of the high variability in net severance revenue.

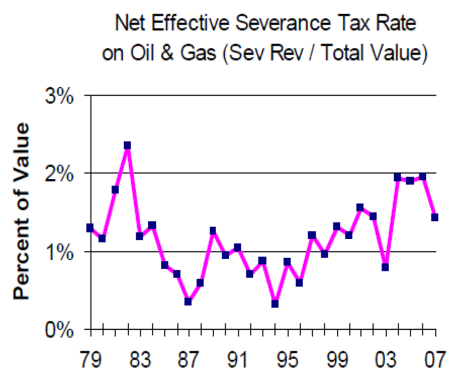
8) This lag in the administration of property taxes produces a gap between the current production value in a year (the black line) and the property taxes owed on production in that same year (the blue line), which are based on production value two years prior.

10) The variability in net state severance tax revenue is triggered by the huge swings in the price of oil and gas. Gas is now more than 80% of the combined oil and gas production value subject to severance tax.



11) The net effect is to have wide swings in the effective severance tax rate on the gross value of oil and gas production.

12) So, in the end we have a volatile tax rate on a volatile tax base. This volatility is structurally built into the severance tax law and into the extraction fuels markets.



March 14, 2008

<u>**Exhibit G:**</u>

Participants in the Study Group

Study Group Participants

Energy Industry:

Kevin Knobl, Freeport-McMoRan
Jamee Allen, Freeport-McMoRan
Rich Atkinson, Rio Tinto Energy/Colorado Mining Association
Jim Cole and Garin Bray Vorthmann, Colorado Oil & Gas Association
Stan Dempsey, Colorado Petroleum Association
Stephen Flaherty, Noble Energy
Dianna Orf, Colorado Mining Association
Pam Roth, Williams Energy Company
Jim Schroeder, Mesa Energy Partners

General Public:

Connie Grider, Colorado Legislative Services, LLC

Finance:

Douglas Houston, George K. Baum
Andrew Harper, George K. Baum

Local Government:

Mike Braaten, City of Rifle
Kevin Brommer, Colorado Municipal League
Carla Distell, La Plata County
Justin Clifton, Energy Impact Committee/Town Manager, Bayfield
Aron Diaz, Associated Governments of Northwestern Colorado
Charles Griego, Energy Impact Committee/City Council, Alamosa
Stephen Loshbaugh, Energy Impact Committee, Mayor, Meeker
Rob Masden, Energy Impact Committee/Weld County Commissioner
Carl Miller, Energy Impact Committee
Ken Parsons, Colorado Counties, Inc. /Rio Blanco County Commissioner
Chris Mendez, Colorado Counties, Inc.
Tim Sarmo, Town of Palisade
Bill Cordone, Las Animas County
Sharon Day, Town of Meeker
Susan Hansen, Delta County
Jesse Smith, Garfield/Montrose Counties

State Agencies:

Susan Kirkpatrick, Colorado Department of Local Affairs
Bruce Eisenhower, Colorado Department of Local Affairs
Tony Hernandez, Colorado Department of Local Affairs
Becky Dorward, Colorado Department of Local Affairs
Don Sandoval, Colorado Department of Local Affairs
Steve Colby, Colorado Department of Local Affairs
Cynthia Thayer, Colorado Department of Local Affairs
Scott Olene, Colorado Department of Local Affairs
Keela Riker, Colorado Department of Local Affairs
Linda Rice, Colorado Department of Local Affairs
Jonathan Marks, Colorado Department of Local Affairs
Jennifer Finch**,** Colorado Department of Transportation
Melissa Nelson, Colorado Department of Transportation
Herman Stockinger, Colorado Department of Transportation
Heidi Van Huysen, Colorado Department of Natural Resources
Mike King, Colorado Department of Natural Resources
Rebecca Swanson, Governor's Policy Office
Esther Van Maurik, Colorado General Assembly Legislative Legal Services
Todd Herreid, Economist, Colorado General Assembly Legislative Council
Jaime Gomez, Colorado Housing and Finance Authority
Kirk Weber, Colorado Department of Education
Tim Weber, Colorado Department of Revenue