ATTACHMENT B

STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capitol Annex
1375 Sherman Street
Denver, Colorado 80203

Bill Ritter, Jr.
Governor

Roxanne Huber
Executive Director

August 29, 2008

Sally Symanski, State Auditor
Office of the State Auditor
200 East 14th Avenue
Denver, Colorado 80203

Dear Ms. Symanski:

The Department of Revenue is in receipt of your letter dated August 11, 2008, requesting a status update on the recommendations noted in the *Severance Tax Collections, Performance Audit, June 2006*. Attached please find the Department's update on the actions taken to implement the recommendations noted in the audit.

If you have any questions regarding this information or the Department's implementation of the recommendations, please contact me at (303) 866-5610.

Sincerely,

Roxanne Huber
Executive Director

Attachment

Office of the State Auditor
Severance Tax Collections Performance Audit June 2006
Update on Recommendations August 2008

Recommendation No. 2:

The Department of Revenue should adopt audit procedures to ensure self-reported oil and gas production data are supported by independent calibration reports. This should include working with the Colorado Oil and Gas Conservation Commission to ensure calibration report data are available and accessible.

Department of Revenue Response:

Agree.
Implementation date: September 2006, pending OGCC rule adoption.

The Department will work with the Colorado Oil and Gas Conservation Commission (OGCC) to obtain independent calibration reports, consistent with rules to be developed by OGCC, to assist its auditors in confirming the accuracy of taxpayer-reported oil and gas production data. In addition, the Department's Mineral Audit Section will strengthen its audit procedures to verify reported gas and oil production by adding an explicit audit step requiring auditors to review independent calibration reports as a basis for determining the reliability of reported production and facilitating appropriate assessments.

Department of Revenue August 2008 Update:

Implemented

Beginning in September 2006, the Department's Mineral Audit Section began requesting independent meter calibration statements as part of their audit documentation requests from severance taxpayers. The auditors review and test for accuracy the statements, to ensure that no material errors in calibration occurred, affecting the volumes and values reported to the state. When conducting audits of mines, the auditors also request the scale certification reports, or stockpile inventory reports, to ensure the accuracy of the volume reports for the mine production. Any errors are addressed with the company and if necessary, an assessment of additional tax due is issued to the company.

Recommendation No. 3:

The Department of Revenue should ensure that all taxpayers subject to severance taxation have filed a return. This should include:

a. Accessing and using production data available through the Department of Natural Resources to verify that those subject to severance taxation have filed a return.

b. Conducting data matches between permit and production data, names of registered oil and gas and mine operators, and tax returns.

c. Verifying, on a sample basis, that royalty owners listed on oil and gas operators' withholding statements have filed a return.

d. Enforcing compliance with filing requirements.

Department of Revenue Response:

Agree.
Implementation date: October 2006.

a. The Department will obtain and use information available from the Department of Natural Resources (DNR) to assist in identifying non-filers, and will follow-up with taxpayers who do not file required returns. In addition, the Department has begun the process of verifying non-filer status for the taxpayers identified by the auditors using DNR data. As noted by the auditors, we are finding that many of these taxpayers either filed under another name or were not required to file. Others are already under audit by the Department. Remaining taxpayers appearing to be non-filers will be contacted by the Department to ensure that required returns are filed and taxes paid.

b. The Department will perform data matches to identify non-filers using information made available by the Department of Natural Resources as well as data from the Department's own databases and other sources, and will include data such as permits and production data, registered names of oil and gas operators and mine operators, and previous tax return data.

c. The Department's Mineral Audit Section will verify on a sample basis that royalty owners listed on oil and gas operators' withholding statements have filed a return, and will follow up with taxpayers who appear to be non-filers.

d. The Department's Fair Share Section has already initiated a pilot program to identify non-filers of oil and gas severance tax, since oil and gas represents almost 90 percent of severance tax revenue. As of this date, inquiry letters have been sent to all potential non-filers, but the results of the project are pending since the response period has not yet expired. When the results of the project are known, the Department will follow up with noncompliant taxpayers and take appropriate steps to increase compliance. The Department will also schedule non-filer projects for other minerals based on relative priority with other Department projects.

Department of Revenue August 2008 Update:
Implemented

a. The Department used the information from Department of Natural Resources and the auditors to identify and contact non-filers. Most taxpayers were cleared because they were not required to file, had filed under another name, or filed in response to our inquiry. Non-filers that did not respond to our inquiry or file returns were issued assessments. At this time all accounts identified have either met the filing requirement, were cleared because they were not required to file, or have been billed.

b. The Department continues to perform data matches to identify non-filers using information made available by the Department of Natural Resources, the Department's own database, and other sources. These reports are used to compare operators to the Department's database. When a discrepancy arises between a listed operator on the Department of Natural Resources' reports and the Department's database, the Department follows up with the taxpayer to determine if a return is required.

c. The Department completed the non-filer project, which began in October 2006. This project resulted in nearly 600 letters sent to non-filers requesting that they file returns. In many cases the taxpayer was able to provide documentation showing that the returns were previously filed under another name or account and were not required to file. Nearly 200 returns were filed which resulted in net revenue collected of $113,000.

   The Department's Mineral Audit Section verifies on a sample basis that royalty owners listed on oil and gas operators' withholding statements have filed a return. The Department follows up with any taxpayer that appears to be a non-filer.

d. Of the 27 Oil and Gas accounts that were billed, two paid for a total of $10,051, and eleven of the accounts remain outstanding for a total of $159,305. The other 14 bills that were issued were voided when returns were filed or when it was determined they did not have a filing requirement.

   The taxpayers in our original Metallic Minerals inquiry that agreed to file, did file returns. No tax was due from these taxpayers. Of the accounts that were billed because of no response, 55% were voided because they filed returns or had no filing requirement. No tax was due on any of the returns filed. The remaining 45% of the bills are outstanding (13 bills) for a total of $280,000.

   Based on the results of utilizing data available from the Oil and Gas Commission and Department of Natural Resources, there does not appear to be any significant evidence of noncompliance. To date the Department has collected $14,994 from the Oil and Gas and Metallic Minerals accounts identified and $113,000 from the royalty owners. The Department has determined that over 89% of the identified taxpayers do not have a filing requirement or do not owe tax.

Recommendation No. 4:

The Department of Revenue should improve its audit selection methodology for severance tax audits by exposing all taxpayers, regardless of tax liability and type of mineral produced, to potential audit, and by reviewing change in ownership information and prior severance tax audits to identify factors contributing to noncompliance. The Department should use these factors to assess risk among all taxpayers.

Department of Revenue Response:

Agree.
Implementation date: October 2006.

The Department's Mineral Audit Section will expand its consideration of risk to ensure that all taxpayers are subject to audit selection. In addition to the actual size of a company, the Department will also consider other risk factors such as: fluctuations in severance tax paid by a company, significant changes (such as operations growth or new Colorado operations, changes in ownership, or mergers/acquisitions), prior audit findings, ad valorem tax credits claimed on returns, as well as companies appearing to be under reporting or non-filers.

Department of Revenue August 2008 Update:

Implemented

The Department's Mineral Audit Section is now selecting audits by examining a number of risk factors such as: size of company, fluctuation in severance tax paid, operations growth, changes in ownership, mergers/acquisitions, new Colorado operations, and prior audit findings, ad valorem tax credits claimed on returns, non-filer projects, and audit referrals received from the auditors.

The Department's Mineral Audit Section has now conducted Severance tax audits on Metallic Minerals, Coal, and Molybdenum, and will continue to include all minerals in the audit selection process in the future.

Recommendation No. 5:

The Department of Revenue should work to improve the quality of its severance tax audit work plans by:

a. Updating its oil and gas audit program to include all necessary steps for testing production and transportation, processing, and manufacturing cost deductions.

b. Developing standardized audit work plans for metallic minerals and molybdenum ore production.

Department of Revenue Response:

Agree.
Implementation date: October 2006.

a. The Department's Mineral Audit Section recently completed efforts that began before the audit to strengthen its oil and gas audit program. More robust audit procedures, including those suggested by the auditors, have been added to the program including specific steps for testing production and transportation, processing, and manufacturing cost deductions.

b. In addition to the existing audit programs for gas and oil audits and coal audits, the Department's Mineral Audit Section will develop standard audit programs for other types of minerals subject to taxation, including solid minerals, oil shale and molybdenum.

Department of Revenue August 2008 Update:

Implemented

a. The Department's Mineral Audit Section is continually examining the audit programs for all types of severance tax audits in order to ensure that all aspects of the return are audited including, production, transportation, processing, and manufacturing cost deductions.

b. The Department's Mineral Audit Section has developed standard audit programs for all types of minerals subject to severance tax. With the exception of oil shale which is not commercially produced in the state at this time, all programs have been used to conduct audits and any additional audit steps that were required to complete the audit, have been added to the programs.

Recommendation No. 6:

The Department of Revenue should better manage its resources to increase the number of severance tax audits it completes. This should include:

a. Considering audit risk and productivity when allocating audit funds, and providing additional funding for severance tax audits, including travel and training.

b. Developing a formal severance tax audit training program and providing this training to all new hires and Department transfers.

c. Obtaining instruction on the effective use of all databases necessary to verify the accuracy of information contained on severance tax returns.

Department of Revenue Response:

Agree.
Implementation date: October 2006.

a. In September 2005, the Department reallocated one other person to the Mineral Audit Section for the purpose of auditing severance tax. In addition, the Department will conduct an analysis of the productivity of all types of audits to determine if a greater portion of audit resources as well as necessary travel funds should be assigned to severance tax audits. Training is addressed in the following section.

b. Agree. Due to its small staff of severance tax auditors, the Department traditionally relied on the formal oil and gas training provided by the federal government for our severance tax auditors. Additional training was provided through on-the-job training. Based on suggestions in this audit, the Department will develop a formal training program that will include PowerPoint presentations, handouts, case study, etc. The training will be video recorded for reference.

c. The Department has already met with the Colorado Oil and Gas Conservation Commission to identify methods to improve our auditors' proficiency in the use of currently available Commission databases. The Department will continue to work with the Department of Natural Resources to improve proficiency in accessing and using any DNR information that will add value to severance tax audits.

Department of Revenue August 2008 Update:

Implemented

a. Beginning in July 2006 additional auditors were assigned to severance tax audits bringing the total number of auditors to 4. Travel funds have also been increased to accommodate the number of audits that are located out of state.

b. The Department's Mineral Audit Section has developed a formal training program for their severance audits. The training program involves a power point presentation, handouts, and case studies. The initial training session was recorded in order to provide training for new auditors to the section.

c. The Department continues to be in contact with the Colorado Oil and Gas Conservation Commission to improve our auditor's proficiency in the use of currently available Commission databases. The most significant improvement is the Department's use of the Access databases with production totals by year, which the Commission builds and makes available every year. This database has been helpful to the auditors in building a spreadsheet that will quickly bring in the production on a well basis. The Department has also worked with DNR to improve proficiency in accessing and using any production reports that are available for different mines located in the state.

STATE OF COLORADO
OIL & GAS
CONSERVATION COMMISSION

DEPARTMENT OF NATURAL RESOURCES
Bill Ritter, Jr., Governor
1120 Lincoln St. Suite 801
Denver, CO 80203
Phone: (303) 894-2100
FAX: (303) 894-2109
www.cogcc.state.co.us

September 8, 2008

Sally Symanski, CPA
Office of the State Auditor
200 East 14th Avenue
Denver, Colorado 80203

RE: Oil and Gas Conservation Commission (OGCC) Audit Recommendation Implementation Status Report for the June 2006 Severance Tax Performance Audit

Dear Ms. Symanski,

The Oil and Gas Conservation Commission (OGCC) has been requested to provide a status report regarding the audit recommendation that was included in the June 2006 Severance Tax Performance Audit. This letter is in response to that request.

For your information, the following is the recommendation from the report, along with the OGCC response:

Recommendation No. 1:

The Colorado Oil and Gas Conservation Commission should strengthen controls over oil and gas production measurement by adopting rules requiring producers to provide evidence of the proper maintenance and calibration of production measurement equipment and by working with the Department of Revenue to ensure calibration report data are available and accessible.

Colorado Oil and Gas Conservation Commission Response:

Agree. Implementation Date: June 2007.

The Colorado Oil and Gas Conservation Commission will work with the Department of Revenue and other stakeholders to review the adequacy of the Commission's production measurement rules and recommend any necessary rule changes. Specific attention will be given to the requirements that meter calibration reports must be included in the records that the oil and gas operators keep on file and available for inspection. The Commission's regulatory authority allows the Commission to assist the Department of

Revenue in their oil and gas severance tax audits. The Commission will evaluate, with the Department of Revenue, the appropriate role for the Commission during the audit and enforcement process. The Commission will implement the appropriate rules and processes to ensure that meter calibration verification issues are identified and resolved.

The implementation status of the OGCC response to Recommendation No. 1 can be categorized as in progress.

The following actions have been taken to implement the response:

In late 2006 and early 2007 the OGCC was engaged in discussions with various stakeholders, including representatives of the Department of Revenue, the oil and gas industry, and royalty owners regarding the adequacy of the Commission's production measurement rules. The OGCC intended to conduct a rulemaking hearing in May, 2007 to adopt rule changes, but the introduction of House Bill 07-1180, with its uncertain impact on the rules, forced a delay in the drafting of the proposed rules. The new legislation, which was enacted on July 1, 2007, required the OGCC to promulgate rules to ensure the accuracy of oil and gas production reporting by establishing standards for wellhead oil and gas measurement and reporting by January 1, 2008. The OGCC was unable to meet the January 1, 2008 deadline due to unforeseen stakeholder concerns; however, rules establishing industry standards for wellhead measurement were promulgated on April 1, 2008 and became effective May 30, 2008.

New rules to ensure that calibration report data are available and accessible for audit purposes have been included in the OGCC's current rulemaking process under Rule 205, Access to Records. Adoption of this rule will provide the Department of Revenue an avenue for acquiring the documentation needed in its audits.

As mentioned in the February 2, 2007 Status Report, the OGCC trained the DOR staff in the use of the Colorado Oil and Gas Information System oil and gas production data. The instruction improved DOR's proficiency in accessing production volumes that are reported to the OGCC by oil and gas operators. The OGCC has a good working relationship with the DOR and has offered to provide ongoing assistance as needed. In addition, the OGCC has provided numerous custom oil and gas production data reports to assist the DOR in its activities.

Please let me know if you need any further information.

Sincerely,

David S. Neslin
Interim Director

Cc: Jonathan Trull – Office of the State Auditor
Harris Sherman – DNR
Mike King – DNR
Wendy Schultz – OGCC
David Dillon - OGCC
Marc Fine – OGCC
OGCC Commissioners

ATTACHMENT E

STATE OF COLORADO

DEPARTMENT OF REVENUE
State Capitol Annex
1375 Sherman Street, Room 409
Denver, Colorado 80261
(303) 866-3091
FAX (303) 866-2400

Bill Ritter, Jr.
Governor

Roxanne Huber
Executive Director

February 16, 2007

Senator Stephanie Takis, Chair
Legislative Audit Committee
C/O Office of the State Auditor
200 East 14th Avenue
Denver, Colorado 80203

Dear Senator Takis:

Attached please find the Department's implementation status update for the State Auditor's recommendations to the Department of Revenue resulting from the Severance Tax performance audit dated June 2006.

If you have any questions regarding these documents or the Department's implementation of the recommendations, please contact me at (303) 866-5610.

Sincerely,

Roxy Huber
Executive Director

Attachment

PROGRESS REPORT
IMPLEMENTATION OF AUDIT RECOMMENDATIONS
Department of Revenue Update
February 12, 2007

Severance Tax Audit
Recommendations to the Department of Revenue

Recommendation #2:

The Department of Revenue should adopt audit procedures to ensure self-reported oil and gas production data are supported by independent calibration reports. This should include working with the Colorado Oil and Gas Conservation Commission to ensure calibration report data is available and accessible.

Department of Revenue Reported Implementation Status:

1. Update audit procedures: <u>Implemented</u>.
2. Work with OGCC: <u>In Progress</u> pending rule adoption.

The Department updated its audit procedures for oil and gas severance tax audits to require a review of available well calibration reports and meter proving reports as a basis to verify the accuracy of self-reported production volumes. The Department's updated procedures now require our auditors to identify any calibration adjustments noted in the meter proving reports and to ensure that adjustments have been accounted for properly in the volume and revenue calculations to arrive at the appropriate severance tax due. Since implementing this review procedure, our auditors have found that, pursuant to industry standards promulgated by the American Gas Association (AGA) and the American Petroleum Institute (API), calibration reports have been available for each property audited. To date, no calibration adjustments have been identified in the reports, therefore no production adjustments have been needed. In the event calibration reports are not available for certain properties in the future, the Department will adjust reported volumes based on the company's highest positive calibration adjustment for proven meters. If the company has no meter proving reports for any of their properties, then we will adjust reported volumes based on the highest industry adjustment or average.

In addition to updating its audit procedures to review calibration data, the Department has been working with the OGCC to ensure that calibration data is available and accessible. As of our most recent meeting with the OGCC on 1/30/07, the OGCC is developing a rule requiring meter calibrations. The rule will require that meters be calibrated periodically, and that calibration reports be made available to our auditors on request. Similar to the Bureau of Land Management, which oversees federal mineral properties, the OGCC will not require that calibration reports be submitted routinely to them, but only at their request. The OGCC expects to finalize the rule by June 2007, with a target effective date of June 2008.

ADDITIONAL INFORMATION: To better understand the risks related to the accuracy of reported production volume, we are providing additional background information below.

As of December 31, 2005, the most recent year available, there were 30,682 producing oil and gas wells in Colorado. Approximately 6,000 new wells were permitted in 2006. According the Colorado Oil and Gas Commission, not all permitted wells are drilled in the calendar year in which they are first permitted, and some are never drilled at all. Permits are valid for one year from the date of issuance. As of 1/4/07, there were 31,096 producing oil and gas wells in Colorado. This statistic helps to demonstrate the extent of permits which do not become producing wells in the initial year, since there was only a net increase of 414 producing wells during 2006 while 6,000 permits were issued.

For purposes of oversight, wells can be categorized in four groups based on location of the well, i.e. federal lands, Indian lands, state lands, or private ("fee") lands. Several federal, state, and local government agencies have prescribed responsibilities. Before a producer drills an oil or gas well on *any* property located in Colorado, they must first obtain permission to drill by obtaining a drilling permit from the Colorado Oil and Gas Conservation Commission (OGCC). Wells drilled on federal and Indian property must *also* obtain a drilling permit from the Bureau of Land Management (BLM). After a well is drilled, industry standards[1] require the operator to hire an independent company to perform orifice meter inspection and calibration services which include repair; measurement equipment installation, gas and liquid sampling; the physical and chemical tests associated with measurement and quality, such as specific gravity, moisture content, carbon dioxide, and hydrogen sulfide concentrations; and gas surveys to determine the volumes and composition of vented separators gas and tank vapors.

Meter locations depend on the production system. Each system is unique. The federal and state permitting agencies, the BLM and the State Land Board (SLB), both require meters at the wellhead and the sales point. The number of meters involved in getting gas and oil to the point of taxation would include a minimum of 2 meters for all wells including fee lease wells. The first meter would be at the well head and the second at the point of sale. From the wellhead, there may be any number of additional meters on the pipeline. For instance, there may be meters at the well head, compressor, gathering location, transportation pipeline, gas plant, and the final point of sale.

Volume differences exist between the wellhead and the sales point due to various reasons such as shrinkage and expansion due to temperature and other factors. The State Land Board, the Bureau of Land Management, and industry standards permit a 2% variance for these factors. Often gas is used to run the transportation and gas processing systems. The Colorado severance tax statutes allow the taxpayers to deduct transportation, manufacturing and processing costs. Part of the cost of running a pipeline is the fuel to perform these functions. Many times the operator will use gas from the various wells to run these facilities. The companies always meter these items in order to support the costs used for the transportation, manufacturing, or processing deductions.

Wellhead meters are owned by the sellers and the buyers own the sales point meters, therefore when there are volume differences in meter readings, the opposing interests of seller and buyer provide an inherent control. Material discrepancies between volume recorded at the wellhead and

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[1] Standards are promulgated by the American Petroleum Institute (API) and the American Gas Association (AGA).

sales point are addressed by requesting a examination of meter calibrations and the source documents for production and sales.. Adjustments are made in the next accounting cycle.

Oil is either measured in tanks by the wells or through a Lease Automated Custody Transfer (LACT) meter. The LACT is very efficient for large producing units. The LACT is able to measure volume, gravity, temperature and basic sediment and water for many leases and wells on a unit. The LACT meter is a continuous flow, digital system that is very accurate. Colorado's largest oil producing unit, the Rangely Weber Sand Unit uses a LACT system. The meter is proven every two weeks and the BLM always witnesses every proving. Approximately 50% of the unit is on federal land and 50% on fee lands, but since the BLM tests for the whole unit whenever federal lands are a part of the unit, the fee land interest holders benefit from the federal oversight.

The other type of measurement is the tank strapping method. This is where the oil in the tank is measured with a measurement stick before and after the oil is released into a truck or a pipeline. The measurement stick factors have been calculated by engineers and approved by the BLM on federal lands. As part of any oil measurement, the oil is tested for quality. It is measured for basic sediment and water, temperature, gravity sulfur, etc. These factors are used in a formula in addition to the oil measurement to arrive at an actual volume on a sequential "run ticket". The run ticket volume is the volume used to calculate sales value. Oil and gas engineers perform these calculations. Auditors use run tickets as a source document in the audit process. Run ticket number sequence is reviewed by auditors to verify that all sales are reported.

Although no state agency is currently charged with verifying meters on fee lands in Colorado, the Department believes that the following controls currently in place provide reasonable assurance that underreporting of oil and gas volumes is prevented or quickly identified.

- Producers/operators are required by contract to report volumes, revenues, and costs to each interest owner in a property. The producers/operators bill the interest owners for their share of the costs tied to the production and the sale of oil and gas. Property owners routinely engage joint interest auditors to review the sellers' records to insure they have received the correct royalties and allocated the correct costs. Thus the opposing economic interests police each other;
- Discrepancies between volumes recorded by the sellers' wellhead meters and the buyers' sales point meters are investigated;
- Industry standards require the operators to hire independent companies to perform meter inspections and meter calibrations. Since the audit all operators reviewed by the Department have had meter calibration reports available.
- Sales contracts contain language requiring periodic meter calibrations by independent testing companies. Since the audit, all sales contracts reviewed by the Department covering fee lease wells have contained such language;
- The Bureau of Land Management (BLM) routinely inspects meters on federal and Indian lands. Many properties in Colorado contain leases for federal, state, and fee interests. The BLM will inspect meters for the entire property, therefore many fee units are included in these meter inspections by federal authorities;
- Volume discrepancies between the sequential run tickets on oil wells using the measurement stick account for production are investigated in an audit. The Department's auditors review run tickets (source documents) to confirm that all volumes are correctly reported in the books and records and subsequently in the returns.

- According to the BLM and OGCC, the majority of gas meters in Colorado are the newer digital electronic flow meters that are very accurate and not subject to the types of errors of the older analog meters.
- The Department's audit procedures require the auditor to 1) review well calibration reports/meter proving reports in all oil and gas audits to confirm self-reported production levels and to make adjustments to reflect accurate production levels if needed; 2) review source documents for production and sales volumes as a basis for determining the appropriate severance tax liability and any audit adjustments needed.

Recommendation #3:

The Department of Revenue should ensure that all taxpayers subject to severance taxation have filed a return. This should include:

a. Assessing and using production data available through the Department of Natural Resources to verify that those subject to severance taxation have filed a return.

b. Conducting data matches between permit and production data, names of registered oil and gas and mine operators, and tax returns.

c. Verifying on a sample basis, that royalty owners listed on oil and gas operators' withholding statements have filed a return.

d. Enforcing compliance with filing requirements.

Department of Revenue Reported Implementation Status:

a. In Progress. As a basis for determining the cost-benefit of reviewing Department of Natural Resources (DNR) permit and production data to identify non-filers owing severance taxes, we reviewed the universe of 227 producer accounts spanning the years 2002 through 2004 provided to the auditors by the DNR during the audit. We reviewed the DNR data as well as our own records for each account and followed up with taxpayers with results to date as described below:

Oil and Gas: 130 Accounts

- 62.3% (81 accounts) had met all filing requirements; the tax returns were located under another name or account number;
- 7.7% (10 accounts) had no filing requirement since they had no working interest;
- 0.1% (1 account) filed a return after our inquiry and paid a tax of $4,628;
- 3.8% (5 accounts) are currently under audit by the Mineral Audit Section as a part of the normal audit cycle;
- 3.8% (5 accounts) communicated an intent to file a return; if the returns are not received, the Department will bill the taxpayers for the maximum estimated tax liability not including any credits that the taxpayer may be entitled to. In the absence of relevant records, the Department bills at this level in an effort to encourage compliance and maximize filings. However, upon receipt of the actual tax returns, the actual liability is usually significantly less than the amount billed, based on our past experience;
- 22.3% (28 accounts) have not yet responded. The Department is in the process of billing the maximum potential liability for these accounts, The actual liability on the tax returns, net of any credits the taxpayer may be entitled to, is expected to be significantly less than the original billing based on our past experience.

Coal: 4 Accounts

Of 4 taxpayers identified by the auditors from DNR records as having a potential coal severance tax liability, the Department found that:

- 2 taxpayers had previously filed;
- 1 taxpayer filed after the Department's inquiry and no tax was due; and
- 1 taxpayer – indicated an intent to file; If returns are not received, the Department will bill the taxpayer for the maximum estimated amount due.

Metallic Minerals: 93 Accounts

The Department made inquiries to 93 taxpayers identified by the auditors from DNR records as having a potential metallic mineral severance tax filing requirement with the following results to date:

- 64.5% (60 accounts) were not required to file, based on various exemptions;
- 1.1% (1 account) filed following the Department's inquiry; no tax was due;
- 4.3% (4 accounts) have agreed to file. If returns are not received, the Department will bill the taxpayer for the maximum estimated amount due or audit as appropriate;
- 30.1% (28 accounts) have not responded and are in the process of being billed for the total estimated amount due. Based on an exemption of $19,000,000 of income allowed on each return, it is unlikely there will be tax due from any of these accounts

Although the auditor's recommendation seems reasonable in concept, results to date of our review of actual data do not support the re-allocation of resources necessary to use DNR permit and production information to identify severance tax non-filers. However, the Department will reassess this option when the final results of this evaluation are available, and will apply our resources to options providing the best assurance that the state is collecting all of the severance taxes due.

b. Implemented. The Department completed a data match between the Department of Natural Resources production, permit and operator data and the Department's tax records to identify potential non-filers. Because of the small population of accounts and the difficulties and costs of implementing an automated matching process and taxpayer follow-up with current tax systems, DNR information was matched manually to the Department's tax records. Follow-up with taxpayers and results to date are described in part a. above.

c. In Progress. To assess compliance with filing requirements using withholding statement information, the Department reviewed all taxpayers having withholding statements (Form DR21W) with revenue greater than $10,000 for calendar years 2003, 2004, and 2005. The Department completed the initial phase of this review and identified 585 accounts as potential non-filers. The Department is now in the process of contacting taxpayers using a series of two letters to make sure that returns are filed if required. The Department will begin assessing the estimated tax due to recipients who fail to respond to the 2nd letter by March 1, 2007.

Of the 585 accounts identified as potential non-filers, settlement of 227 accounts is now complete with results to date as follows:

Of the 227 accounts completed:

- 30 (13.2%) had previously met all filing and payment requirements;
- 154 (67.9.%) subsequently filed a return and received a refund (Total refunds = $107,028);

- 43 (18.9%) subsequently filed a return and paid a tax liability (Total tax paid = $220,515);
- Net revenue = $113,487

Of the remaining 358 accounts still in process:

- 70 (19.5%) are actively working with Department to settle their accounts;
- 5 (1.4%) had returned mail. The Department is continuing efforts to locate these taxpayers;
- 283 (60.9%) awaiting response. The Department will bill the estimated tax amount if there is no response after the 2nd letter.

In addition to reviewing prior year withholding statements filed with the Department, the Department updated its audit procedures to continue monitoring withholding statements on a prospective basis by requiring auditors to verify on a sample basis that recipients of withholding forms (interest owners) have filed returns.

d. In Progress. Based on the preliminary results of utilizing data available from the Department of Natural Resources, evidence of non-filing or underpayment of severance tax appears insufficient to justify a reallocation of resources necessary to review and follow-up on DNR data on a regular basis. However, the Department will continue to monitor the non-respondent population as well as ensure that the companies that indicated they would file actually do so, and will re-evaluate when our review is complete.

Recommendation #4:

The Department of Revenue should improve its audit selection methodology for severance tax audits by exposing all taxpayers, regardless of tax liability and type of mineral produced, to potential audit, and by reviewing change in ownership information and prior severance tax audits to identify factors contributing to noncompliance. The Department should use these factors to assess risk among all taxpayers.

Department of Revenue Reported Implementation Status:

Implemented To implement this recommendation, the Department created relational databases in Microsoft Access to automate the assessment of risk factors for all types of severance taxpayers and for all types of minerals including oil and gas, metallic minerals, molybdenum, and oil shale. Currently, the database incorporates basic factors including size and certain prior reporting inconsistencies such as skip reporting (missing year filings) or large variations in reported tax amounts.

In addition to the basic factors currently in the databases, the Department also considers other indicators of risk in prioritizing and selecting audits, such as:

- Additional prior reporting history factors - including a history of reporting inaccuracies;
- Prior audits – Withholding errors and other audit findings;
- Company changes or problems – Including ownership or other significant changes or known frauds; and

- Referrals to Field Audit from other units in the Department – for various issues identified by other Department units.

The Department will continue to enhance its risk assessment methodology by incorporating additional data elements in the databases, as appropriate, and weighting the factors to score risk.

Recommendation #5:

The Department of Revenue should work to improve the quality of its severance tax audit work plans by:

a. Updating its oil and gas audit program to include all necessary steps for testing production and transportation, processing, and manufacturing cost deductions.
b. Developing standardized audit work plans for metallic minerals and molybdenum ore production.

Department of Revenue Reported Implementation Status:

Implemented. The Department updated its audit programs as follows.
a. The oil and gas audit program now includes tests for production, transportation, processing, and manufacturing cost deductions.
b. The Department developed and implemented audit programs for metallic minerals, molybdenum and oil shale. The audit program for oil shale will be used for the first time when oil shale production starts in Colorado.

Recommendation #6:

The Department of Revenue should better manage its resources to increase the number of severance tax audits it completes. This should include:

a. Considering audit risk and productivity when allocating audit funds and provide additional funding for severance tax audits, including travel and training.
b. Developing a formal severance tax audit training program and providing this training to all new hires and Department transfers.
c. Obtaining instruction on the effective use of all databases necessary to verify the accuracy of information contained on severance tax returns.

Department of Revenue Reported Implementation Status:

a. Implemented. To better align resources based on audit risk and productivity, two additional FTE were transferred from performing field audits to performing audits of state severance tax on August 1, 2006, bringing the total of severance tax auditors to 4.5 FTE. In addition, travel funds totaling $33,000 were added to the Mineral Section's operating budget to perform out-of-state severance tax audits. The Department will evaluate the FTE and audit results for this fiscal year to determine the appropriate resource allocations for next fiscal year.
b. Implemented. All personnel engaged in state or federal mineral auditing (9FTE) attended in-house severance tax training in October 2006. The class was video taped for future use in training new hires and Department transfers. In addition, training provided to

severance tax auditors since the audit include general audit skills, federal fraud training, and audit report writing, and mineral valuation training is scheduled for this month.

c. Implemented. To facilitate the use by Department auditors of available OGCC data, the OGCC provided training to Department personnel on August 22, 2006. Our auditors are now accessing and using the information in OGCC databases in current audits.