DEPARTMENT OF REVENUE
SEVERANCE TAX PAYMENTS

PERFORMANCE AUDIT
ISSUED NOVEMBER 27, 2013

LOUISIANA LEGISLATIVE AUDITOR
1600 NORTH THIRD STREET
POST OFFICE BOX 94397
BATON ROUGE, LOUISIANA 70804-9397

FOR QUESTIONS RELATED TO THIS PERFORMANCE AUDIT, CONTACT EMILY WILSON, PERFORMANCE AUDIT MANAGER, AT 225-339-3800.

Under the provisions of state law, this report is a public document. A copy of this report has been submitted to the Governor, to the Attorney General, and to other public officials as required by state law. A copy of this report is available for public inspection at the Baton Rouge office of the Louisiana Legislative Auditor.

This document is produced by the Louisiana Legislative Auditor, State of Louisiana, Post Office Box 94397, Baton Rouge, Louisiana 70804-9397 in accordance with Louisiana Revised Statute 24:513. Six copies of this public document were produced at an approximate cost of $30.84. This material was produced in accordance with the standards for state agencies established pursuant to R.S. 43:31. This report is available on the Legislative Auditor's website at www.lla.la.gov. When contacting the office, you may refer to Agency ID No. 9726 or Report ID No. 40120021 for additional information.

LOUISIANA LEGISLATIVE AUDITOR
DARYL G. PURPERA, CPA, CFE

November 27, 2013

The Honorable John A. Alario, Jr.,
President of the Senate
The Honorable Charles E. "Chuck" Kleckley,
Speaker of the House of Representatives

Dear Senator Alario and Representative Kleckley:

This report provides the results of our performance audit on the collection of severance tax payments by the Louisiana Department of Revenue (LDR).

The report contains our findings, conclusions, and recommendations. Appendix A contains the department's response to this report. I hope this report will benefit you in your legislative decision-making process.

We would like to express our appreciation to the management and staff of LDR for their assistance during this audit.

Sincerely,

Daryl G. Purpera, CPA, CFE
Legislative Auditor

DGP/ch

LDR-SEVERANCE TAXES 2013

1600 NORTH THIRD STREET • POST OFFICE BOX 94397 • BATON ROUGE, LOUISIANA 70804-9397
WWW.LLA.LA.GOV • PHONE: 225-339-3800 • FAX: 225-339-3870

Louisiana Legislative Auditor
Daryl G. Purpera, CPA, CFE

Department of Revenue - Severance Tax Payments

November 2013

Audit Control # 40120021

Introduction

We determined whether the Louisiana Department of Revenue (LDR) ensured that the state received complete, accurate, and timely oil and gas severance tax payments during fiscal years 2009 through 2012.

Severance taxes are levied on all natural resources removed from the soil or water in Louisiana. According to Louisiana Revised Statute (R.S.) 49:651, LDR is responsible for ensuring that the state collects severance tax payments. During fiscal year 2013, the state received severance tax payments of approximately $731 million for oil and $90 million for natural gas. Because severance taxes comprise approximately 10% of the state's general fund revenues each year, it is important for LDR to ensure these payments are accurate and timely. Appendix A contains LDR's response to this report, Appendix B details our scope and methodology, and Appendix C summarizes background information. Our objective was as follows:

Did LDR ensure that the state received complete, accurate, and timely oil and gas severance tax payments during fiscal years 2009 through 2012?

Objective: Did LDR ensure that the state received complete, accurate, and timely oil and gas severance tax payments during fiscal years 2009 through 2012?

Although LDR ensured that the state received oil and gas severance tax payments on time during fiscal years 2009 through 2012, it needs to improve its current processes to ensure that these payments are complete and accurate. We found that:

- Severance taxes owed but not paid to the state may have gone undetected by LDR over the past three years because LDR turned off the automated program used to detect non-filers due to technical issues with the program.

- LDR does not adequately verify the accuracy of the self-reported data companies use to determine the amount of severance taxes they owe to the state.

- LDR does not adequately track the severance tax audit coverage it achieves through desk audits.

- The amount of unpaid severance taxes identified through field audits decreased by 99.8% from $26 million in fiscal year 2010 to $40,729 in fiscal year 2012 as a result of differences in the criteria used to select companies to audit, differences in audit scope/coverage, and resource shortages.

In addition, part of LDR's responsibility in ensuring that payments are accurate involves ensuring that refund requests, which are primarily a result of severance tax exemptions, are accurate. We found:

- As required by state law, LDR paid companies approximately $23.9 million in interest related to severance tax refunds issued during fiscal years 2009 through 2012. This is primarily due to current program rules which require companies to pay severance taxes to LDR until they submit their exemption application to the Office of Conservation within the Department of Natural Resources. The longer companies take to submit their exemption applications, the more interest they earn.

- LDR's review of severance tax refund requests is inadequate. As a result, LDR auditors identified that the department overpaid at least $12.9 million in severance tax refunds from July 2010 through May 2012.

Our findings are discussed in more detail on the following pages.

Severance taxes owed but not paid to the state may have gone undetected by LDR over the past three years.

Before September 2010, LDR's automated system ("GenTax") automatically detected and sent proposed tax assessments based on past returns to companies that did not file required tax returns ("non-filers"), including severance tax returns. Data provided by LDR shows that for fiscal years 2009 and 2010 the non-filer program identified an average of 1,096 instances of non-filed severance tax returns and proposed assessments totaling approximately $11.7 million per year. However, LDR turned the non-filer program off for all tax types in September 2010 because, according to LDR officials, this program was sending out erroneous assessments and the department was receiving complaints. Since turning the program off, LDR has been correcting issues for each tax type one at a time.

According to LDR, the non-filer program for severance taxes should be turned back on in December 2013.[1] Until the program is turned back on, LDR states that it identifies non-filers through other means such as audits. However, because LDR cannot audit all severance tax filers, the automated non-filer program is more effective and efficient at identifying non-filers. For these reasons, LDR cannot ensure that it is receiving all severance tax payments that it is owed.

> **Recommendation 1:** LDR should ensure that GenTax's non-filer identification program is working properly to identify companies that did not submit severance tax returns and any associated payments.
>
> **Summary of Management's Response:** LDR agreed with this recommendation. See Appendix A for LDR's full response.

LDR does not adequately verify the accuracy of the self-reported data companies use to determine the amount of severance taxes they owe to the state.

Severance tax payments are based on companies' self-reported data such as oil and gas production amounts, sales price, and certain costs they are allowed to deduct from their tax payments. Exhibit 1 shows the calculation companies use to determine the amount of severance taxes owed to the state.

---

[1] According to LDR, it turned the non-filer functions back on for all other types of taxes except severance and excise before June 2013. The tax types were corrected and turned back on one at a time starting with the tax types that generate the most revenue for the state.

Exhibit 1
Oil and Gas Severance Tax Calculations

Oil Severance Tax = [(Barrels Sold x Sales Price) – Transportation Costs] x Tax Rate

Gas Severance Tax = (Gross Gas Production – Exclusions*) x Tax Rate

*Natural gas can be excluded from taxes for certain reasons, such as gas used for fuel in connection with the operation, development, and production of oil or gas in the field.
Source: Prepared by legislative auditor's staff using information obtained from LDR.

If companies under-report production or sales price data, they will miscalculate and underpay severance taxes. To ensure companies pay accurate severance taxes, it is important that LDR verify that companies are reporting accurate production amounts and sales prices. However, when we reviewed a sample of tax payments to determine if they were accurate, we found that LDR did not adequately verify the accuracy of the self-reported data. For example, we randomly selected a total of 29 tax payments from fiscal year 2008 through fiscal year 2012 to determine if they were accurate.[2] We found that eight (28%) of the 29 were inaccurate, resulting in underpaid severance taxes of $41,452, because companies calculated their payments based on inaccurate production data and/or sales price data. While we only reviewed 29 payments due to the complexity of the review and the time involved, LDR processes approximately 500,000 payments each year. As a result, the financial impact of companies using inaccurate data to determine the severance tax amounts they owe the state could be more significant.

According to LDR officials, they rely on "edit checks" within the agency's automated systems and post-payment audits to discover any inaccuracies in severance tax data. However, the edit checks are limited (i.e., check for field size or numerical/alphanumerical data) and are not designed to review the production amount or sales price for accuracy. As a result, LDR only detects inaccuracies in this information through audits *after* companies submit severance tax payments. However, as described in a later section, the number of severance tax field audits conducted each year has decreased. To help ensure the accuracy of severance tax payments, we identified ways the department could verify the accuracy of companies' self-reported oil and gas severance tax data. Specifically, LDR could:

- **Continuously monitor and compare production data reported by companies to the data reported to the Department of Natural Resources (DNR).** DNR receives oil and gas production data from companies and verifies it for accuracy.[3] LDR has an oil and gas production error program within GenTax that is designed to compare its data to DNR's data to identify inaccurate production amounts that may result in underpaid severance taxes. However, according to LDR staff, the program is currently not functioning, but they are working to fix it. When the program was functioning correctly, department staff used it to help identify companies to audit. If LDR used the production error program to continuously

[2] We tested the gas and oil production amount by comparing it to production data reported to DNR, and the oil sales amount by comparing it to average Louisiana oil market rates, per DNR's Minerals Price Survey, during the same time period.
[3] The Office of Conservation within DNR receives production data for all oil and gas wells in Louisiana.

monitor and compare these data sets for all severance tax payments rather than only as an audit selection tool, it could better ensure it is identifying all underpaid severance taxes.

- **Continuously monitor and compare oil sales prices reported by companies to the average market rate.** R.S. 47:633(7)(a) states that companies must pay severance taxes based on the price at which they sold the oil or the posted market rate; whichever is higher. LDR could compare reported rates against average monthly market rates to detect when companies are under-reporting sales prices. If the reported rate is unreasonably lower than the market rate, LDR could then require a company to submit the purchase statement which shows the per barrel amount for which it sold the oil. Currently, LDR only requests these documents if it is conducting an audit.

Recommendation 2: Once LDR fixes the production error program in GenTax, it should use the program to continuously monitor and compare companies' self-reported production data to DNR's data to help ensure the accuracy of oil and gas tax payments.

Recommendation 3: LDR should continuously compare companies' self-reported oil sales prices to average monthly market rates to help ensure the accuracy of oil tax payments.

Summary of Management's Response: LDR agreed with these recommendations. See Appendix A for LDR's full response.

LDR does not adequately track the severance tax audit coverage it achieves through desk audits.

According to LDR officials, they rely on desk audits conducted by their Office Audit Section to identify inaccurate severance tax payments that the department's automated systems do not catch.[4] As stated previously, the department turned off the non-filer program in GenTax in September 2010. The scope of desk audits vary and include areas that field audits do not cover, such as production/volume audits and audits on wells receiving reduced tax rates.

Data provided to us by Office Audit staff shows that they conducted a total of 375 audits and refund reviews resulting in assessments of approximately $38 million from fiscal year 2010 through fiscal year 2012. However, we found this data to be unreliable and incomplete.[5] In addition, the data includes the results of severance tax refund reviews. LDR cannot ensure that the audit coverage it achieves through its desk audit function is sufficiently identifying inaccurate severance tax payments.

[4] Desk audits are similar to field audits (see page 6) but are conducted by LDR staff in the Baton Rouge office. LDR reviews severance tax payments and requests any additional supporting documentation required from companies.

[5] We found that this data does not accurately portray LDR's desk audit coverage because the assessment amounts may not be correct and the data does not include audits that did not result in assessments.

Recommendation 4: LDR should begin tracking its desk audit coverage separately from its reviews of severance tax refunds. Specifically, LDR should track the total number of audits conducted, amount of production audited, percentage of severance taxes audited, scope of each audit, and amount of assessments.

Summary of Management's Response: LDR agreed with this recommendation. See Appendix A for LDR's full response.

The amount of unpaid severance taxes identified through field audits decreased by 99.8% from approximately $26 million in fiscal year 2010 to $40,729 in fiscal year 2012.

In December 2009, the State Commission on Streamlining Government published recommendations to eliminate duplication of services in state government.[6] In an attempt to streamline audit services, LDR transferred its responsibility for conducting severance tax field audits to DNR in fiscal year 2011.[7] According to the 2010 Cooperative Endeavor Agreement between LDR and DNR, DNR agreed to conduct severance tax field audits on companies that paid mineral royalties and any other company as requested by LDR. Field audits are conducted to ensure the accuracy and completeness of severance tax payments. Auditors work on-site at company offices and review supporting documentation such as oil/gas purchase statements, meter statements, and wire transfers to verify the volume and price of oil and gas sold to detect underpaid severance taxes.

Before the transfer, in fiscal year 2010 LDR's Office of Field Audit Services completed 61 severance tax field audits that resulted in the identification of approximately $26 million in potentially unpaid severance taxes ("assessments"). However, from July 2010 to February 2013, DNR only completed approximately 48 severance tax field audits with only one resulting in an assessment of $16,582. Combined with assessments of $24,147 from audits previously initiated by LDR, total assessments identified in fiscal year 2012 were $40,729, a decrease of 99.8% from approximately $26 million in fiscal year 2010. Exhibit 2 shows the number of severance tax field audits and related assessments from fiscal year 2009 through fiscal year 2013.

[6] The December 2009 report can be found here: http://senate.legis.state.la.us/streamline/Presentations/InitialReport.pdf.
[7] Although the commission initially recommended that DNR's field audit function for mineral royalties transfer to LDR, the two agencies later decided that LDR should transfer its field audit function for severance taxes to DNR.

Exhibit 2
Severance Tax Field Audits
Fiscal Year 2009 Through Fiscal Year 2013*

	LDR**		DNR		Total	
Fiscal Year	**Field Audits Completed**	**Audit Assessments**	**Field Audits Completed**	**Audit Assessments**	**Audits Completed**	**Audit Assessments**
2009	41	$10,057,088	N/A	N/A	41	$10,057,088
2010	61	26,386,460***	N/A	N/A	61	26,386,460
2011	9	523,565	2	$0	11	523,565
2012	19	24,147	28	$16,582	47	40,729
2013*	0	0	18	$0	18	0
Total	**130**	**$36,991,260**	**48**	**$16,582**	**178**	**$37,007,842**

*Through February 2013.
**Results shown for LDR field audits completed after FY10 were started by LDR in a previous year.
***According to LDR, audit assessments increased significantly in 2010 because of increased audit coverage and increased assessments related to a transportation deduction.
Source: Prepared by legislative auditor's staff using information obtained from LDR and DNR.

According to LDR and DNR, there were several reasons for the decrease in severance tax field audit coverage since the function transferred. Specifically:

- **DNR only conducted severance tax field audits on companies that paid royalties on minerals severed from state-owned land unless requested by LDR.** As of June 18, 2013, there were a total of 61,879 active oil/gas leases in the state but only 1,188 (1.9%) were state leases. DNR only conducted severance tax field audits on companies that severed oil/gas on privately owned land if those companies also severed oil/gas from state-owned land and therefore owed mineral royalties to the state. If a company did not owe mineral royalties to the state, then DNR did not conduct a field audit on that company's severance taxes unless LDR requested an audit. As a result, severance taxes related to significant amounts of oil and gas production in the state were left out of the audit process when the field audit function transferred from LDR to DNR.

- **LDR only requested that DNR conduct two additional audits between July 2011 and December 2013.** According to the agreement between the two agencies, LDR could request that DNR conduct severance tax field audits on specific companies. Each year DNR sent LDR the list of audits it planned to conduct to see if LDR had any additional requests for audits. According to LDR, it agreed with DNR's list of proposed audits and it requested two additional audits.

- **Differences in how each agency selected companies to audit.** DNR's audit schedule was based on the amount of mineral royalties companies paid DNR, not on the amount of severances taxes paid to LDR. When LDR conducted severance tax field audits, its staff selected companies with the highest production of oil and gas. However, companies that pay a large amount of mineral royalties may not pay a large amount of severance taxes compared to other oil and gas producers. This may be why only one of DNR's 48 severance tax field audits resulted in a significant audit assessment, as mentioned previously.

- **According to DNR, it did not have the information needed to adequately conduct a risk assessment of severance tax payers to determine which companies it should audit.** However, LDR told us that it provided DNR with all the information needed to determine the companies paying the most severance taxes, which were the companies with the highest production of oil and gas.

- **Staffing/Audit Scope Issue.** DNR received two additional positions to cover the increased workload of conducting severance tax field audits. However, DNR conducted full-scope audits (e.g., production, value, transportation credits, and exempt wells) while LDR only conducted limited scope audits before transferring the function. Therefore, DNR's severance tax field audits took longer to complete than those conducted by LDR.

According to LDR officials, when the severance tax field audit function moved to DNR, officials from the two agencies monitored the results and worked together to address any issues, including the resulting decrease in audit assessments. To correct this problem, the two agencies entered into a new agreement to move the severance tax field audit function back to LDR beginning in July 2013. The new agreement, which the two agencies signed in January 2013, gives LDR the primary responsibility of conducting severance tax field audits, but DNR will continue to conduct severance tax field audits when it conducts mineral royalty audits. According to the agreement, LDR and DNR will work together to ensure there is no duplication of audits.

Recommendation 5: Going forward, LDR should monitor severance tax field audit coverage to help ensure the state is receiving all severance tax payments it is owed.

Summary of Management's Response: LDR agreed with this recommendation. See Appendix A for LDR's full response.

As required by state law, LDR paid companies approximately $23.9 million in interest related to severance tax payment refunds during fiscal years 2009 through 2012.

When refunding severance tax payments to companies, R.S. 47:1624 requires LDR to pay companies interest on severance tax payment refunds at the judicial interest rate set by the Office of Financial Institutions.[8] The judicial interest rate for calendar year (CY) 2009 was 5.50%, 3.75% for CY 2010, and 4.00% for CYs 2011-2012.

[8] R.S. 13:4202(B) sets the judicial interest rate, beginning January 1, 2002, for each calendar year as 3.25 percentage points above the discount rate as ascertained by the commissioner of financial institutions.

From fiscal year 2009 through fiscal year 2012, LDR sent 13,818 severance tax payment refunds to companies totaling approximately $384 million. These refunds included approximately $23.9 million in interest. According to LDR, some months it pays out more in severance tax refunds and related interest than it collects in severance tax payments. Exhibit 3 shows the number and amount of refunds and related interest for fiscal year 2009 through fiscal year 2012.

Exhibit 3
Severance Oil and Gas Refunds and Interest
Fiscal Year 2009 Through Fiscal Year 2012

Fiscal Year	Number of Refunds	Refund Before Interest*	Interest	Total Refund Amount
2009	1,396	$16,883,031	$2,240,960	$19,123,991
2010	4,991	67,645,706	7,185,150	74,830,856
2011	3,898	99,472,690	6,359,215	105,831,905
2012	3,533	176,189,156	8,073,687	184,262,843
Total	**13,818**	**$360,190,583**	**$23,859,012**	**$384,049,595**

*In January 2010, LDR stopped giving companies the choice of either receiving a refund or a credit to their account to offset future taxes owed because of issues with the process, including the time involved for LDR staff. Instead, LDR began only refunding overpayments.
Source: Prepared by legislative auditor's staff using information obtained from LDR.

The primary reason these interest payments are high is that current program rules require that companies pay severance taxes to LDR until they submit their exemption application to the Office of Conservation within DNR.[9] Program rules also require companies to submit the total cost for building the wells to DNR with their severance tax exemption applications which results in a lag between companies beginning oil/gas production and applying for and receiving an exemption. For example, we found that for horizontal wells, there is an average lag of over seven months between companies beginning production and submitting their exemption application. Because companies continue to pay severance taxes until they submit their exemption applications, and interest grows as time passes, this lag increases the amount of interest LDR has to pay companies. In turn, this creates an incentive for companies to delay submission of their exemption applications as the longer they wait, the more interest they receive.

In August 2012, LDR instituted a policy to help decrease the amount of refunds and related interest paid by allowing companies to stop paying severance taxes once they submitted an application for an exemption rather than waiting until they received the exemption approval. However, this policy does not require companies to stop paying severance taxes on wells for which exemption approval is pending. In addition, this policy does not address the bigger issue of the lag between production starting and a company submitting its exemption application. Possible program rule changes that LDR and DNR could make to address this lag include:

[9] Act 2 of the 1994 Regular Legislative Session created four severance tax exemptions for oil and natural gas producers based on the type of well. The four exemptions are for horizontally drilled wells, inactive wells, deep wells, and new discovery wells. See Appendix C for more information.

- Requiring companies to submit their completed applications, including well costs, to DNR within a specified period of time after production begins, such as 45 days.

- Creating a two-step application process where companies must submit their initial applications to DNR immediately after production begins. The companies would then submit the costs for completing their wells at a later date when they have gathered this information. In this scenario, companies would stop paying severance taxes when they submit their initial application.

Recommendation 6: LDR should work with DNR's Office of Conservation to change program rules to minimize the amount of severance tax refunds and related interest paid to companies as a result of severance tax exemptions.

Summary of Management's Response: LDR agreed with this recommendation. See Appendix A for LDR's full response.

Matter for Legislative Consideration: The legislature may wish to consider studying whether the judicial interest rate set by state law creates an incentive for companies to overpay severance and other taxes in order to collect large refunds and interest.

LDR's review of severance tax refund requests is inadequate. As a result, from July 2010 through May 2012, LDR identified that it overpaid at least $12.9 million in refund payments to companies.

From fiscal years 2009 through 2012, LDR sent 13,818 severance tax payment refunds to companies totaling approximately $384 million. However, LDR staff does not ensure that all refund requests are accurate before sending them to companies. Before September 3, 2010, LDR reviewed all severance tax refund requests over $50,000. LDR then increased the review threshold to $100,000 until July 13, 2011, when it became $250,000. According to LDR, it increased the review threshold because the number of refund requests increased significantly and it did not have enough staff to review them. LDR stated that this increase was largely due to the horizontal well natural gas exemptions related to the Haynesville Shale. Severance tax payment refund requests of lower amounts are automatically paid by LDR's tax management system.

Beginning in October 2010, LDR's Office Audit staff began conducting reviews of random severance tax refunds *after* the payments were sent to companies. LDR reviewed 461 of the refunds from fiscal years 2009 through 2012 and found that it had overpaid 75 (16%) for a total overpayment of approximately $12.9 million. As of January 2013, agency staff had recouped approximately $3.3 million (25%) of this amount. While instituting back-end reviews helps detect inaccurate payment refunds, this process results in additional work for LDR employees who have to recoup the overpayments. A more effective and efficient process may be for LDR to implement a comprehensive review of requests *before* refunding payments.

Recommendation 7: LDR should increase its coverage to review more severance tax refund requests *before* they are sent out.

Summary of Management's Response: LDR agreed with this recommendation with the qualification that it will perform a cost/benefit analysis on the value of the current "back end" review of severance tax refunds. In addition, LDR stated it will work on identifying and implementing business rules to better target refund requests that should be subject to review, resulting in facilitating timely issuance of valid refunds. See Appendix A for LDR's full response.

APPENDIX A: MANAGEMENT'S RESPONSE

BOBBY JINDAL
Governor

TIM BARFIELD
Secretary

State of Louisiana
Department of Revenue

November 22, 2013

Ms. Nicole B. Edmonson, CIA, CGAP, MPA
Director of Performance Audit Services
Office of the Legislative Auditor
Post Office Box 94397
Baton Rouge, Louisiana 70804-9397

RE: Severance Tax Audit Report: Louisiana Department of Revenue

Dear Ms. Edmonson,

The purpose of this correspondence is to respond to the audit findings as discussed in the performance audit report on the collection of Severance Tax.

Upon review of the findings outlined in this report regarding the LDR's responsibilities, we are in agreement with the results of the audit as it was performed. Specifically, our formal detailed responses to each recommendation are as follows:

Recommendation 1: LDR should ensure that GenTax's non-filer identification program is working properly to identify companies that did not submit severance tax returns and any associated payments.

> Management's response: *LDR has already redesigned and tested the non-filer program for severance tax and it will be placed into production before the calendar year end.*

Recommendation 2: Once LDR fixes the oil and gas production error program in GenTax, it should use the program to continuously monitor and compare companies' self-reported production data to DNR's data to help ensure the accuracy of oil and gas tax payments.

Contributing to a better quality of life

617 North Third Street, Post Office Box 66258, Baton Rouge, Louisiana 70896
Telephone (225) 219-4059 • Fax (225) 219-2708 • TDD (225) 219-2114
www.revenue.louisiana.gov

<u>Management's response:</u> LDR has begun the project to upgrade the GenTax system and the oil and gas production error program for severance tax is included in the functionality of the new software version.

Recommendation 3: LDR should continuously compare companies' self-reported oil sales prices to average monthly market rates to help ensure the accuracy of oil tax payments.

<u>Management's response:</u> LDR will work with DNR to develop an automated process to compare companies' self-reported oil sales prices to average monthly market rates to help ensure the accuracy of oil tax payments.

Recommendation 4: LDR should begin tracking its desk audit coverage separately from its reviews of severance tax refunds. LDR should specifically track the total number of audits conducted, amount of production audited, percentage of severance taxes audited, scope of each audit, and amount of assessments.

<u>Management's response:</u> LDR has already enhanced its system for documenting and tracking audit coverage based on production in order to achieve the appropriate level of voluntary compliance based on targeted audits of high producers.

Recommendation 5: Going forward, LDR should monitor severance tax field audit coverage to help ensure the state is receiving all severance tax payments it is owed.

<u>Management's response:</u> As mentioned in the LLA report, LDR recently assumed the primary responsibility of conducting severance tax field audits and as such will monitor audit coverage.

Recommendation 6: LDR should work with DNR's Office of Conservation to change program rules to minimize the amount of severance tax refunds and related interest as a result of severance tax exemptions.

<u>Management's response:</u> LDR will work with DNR's Office of Conservation to change program rules to minimize the amount of severance tax refunds and related interest as a result of severance tax exemptions.

Recommendation 7: LDR should increase its coverage to review more severance tax refund requests before they are sent out.

<u>Management's response:</u> LDR will perform a cost/benefit analysis on the value of current "back end" review of severance tax refunds. In addition, LDR will work on identifying and implementing business rules to better target refund requests that should be subject to review, resulting in facilitating timely issuance of valid refunds.

I want to thank and commend the staff of the Office of the Legislative Auditor for the professionalism, courtesy, and efficiency exercised and displayed during the course of the audit.

Sincerely,

Natalie Howell

Natalie Howell, CPA, CIA
Undersecretary
Office of Management and Finance
Louisiana Department of Revenue

NH/jjb

c: Tim Barfield
Joseph Vaughn
Beth Heim

Louisiana Legislative Auditor
Performance Audit Services

Louisiana Department of Revenue
Severance Tax Payments
Checklist for Audit Recommendations

Instructions to Audited Agency: Please check the appropriate box below for each recommendation. A summary of your response for each recommendation will be included in the body of the report. The entire text of your response will be included as an appendix to the audit report.

RECOMMENDATIONS	AGREE	DISAGREE
Recommendation 1: LDR should ensure that GenTax's non-filer identification program is working properly to identify companies that did not submit severance tax returns and any associated payments. **(p. 3 of the report)**	✓	
Recommendation 2: Once LDR fixes the production error program in GenTax, it should use the program to continuously monitor and compare companies' self-reported production data to DNR's data to help ensure the accuracy of oil and gas tax payments. **(p. 5 of the report)**	✓	
Recommendation 3: LDR should continuously compare companies' self-reported oil sales prices to average monthly market rates to help ensure the accuracy of oil tax payments. **(p. 5 of the report)**	✓	
Recommendation 4: LDR should begin tracking its desk audit coverage separately from its reviews of severance tax refunds. LDR should specifically track the total number of audits conducted, amount of production audited, percentage of severance taxes audited, scope of each audit, and amount of assessments. **(p. 6 of the report)**	✓	

Recommendation 5: Going forward, LDR should monitor severance tax field audit coverage to help ensure the state is receiving all severance tax payments it is owed. **(p. 8 of the report)**	✓	
Recommendation 6: LDR should work with DNR's Office of Conservation to change program rules to minimize the amount of severance tax refunds and related interest as a result of severance tax exemptions. **(p. 9 of the report)**	✓	
Recommendation 7: LDR should increase its coverage to review more severance tax refund requests *before* they are sent out. **(p. 9 of the report)**	✓*	

* agree with qualification per response.

APPENDIX B: SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes (R.S.) of 1950, as amended. We conducted this audit in compliance with R.S. 24:522, which directs the legislative auditor to complete and publish at least one performance audit for each executive department agency within a seven-year period. Our audit focused on whether the Louisiana Department of Revenue (LDR) ensured that the state received complete, accurate, and timely severance tax payments and covered fiscal years 2009 through 2012. The audit objective was as follows:

Did LDR ensure that the state received complete, accurate, and timely oil and gas severance tax payments during fiscal years 2009 through 2012?

We conducted this performance audit in accordance with generally accepted government auditing standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. To answer our objective, we reviewed internal controls relevant to the audit objective to mitigate the risk of inaccurate data and performed the following audit steps:

- Researched Louisiana Revised Statutes, Administrative Code, Executive Budget documents, and LDR website to understand LDR's legal authority, responsibilities, mission, goals, and objectives.

- Interviewed and observed LDR staff and obtained policies and procedures to document the processes of calculating, reporting, and auditing severance tax data.

- Obtained and analyzed oil and gas severance tax returns/payments and production data to ensure that severance tax payments were accurate, complete, and timely.

- Identified and reviewed LDR's internal controls related to ensuring the completeness, accuracy, and timeliness of severance tax payment and production data.

- Summarized LDR's written policies and procedures related to severance tax refunds.

- Obtained and analyzed severance tax refund data to determine if the refunds were necessary and correct.

- Interviewed staff from LDR audit functions (desk and field) to determine the types of audits conducted and selection process.

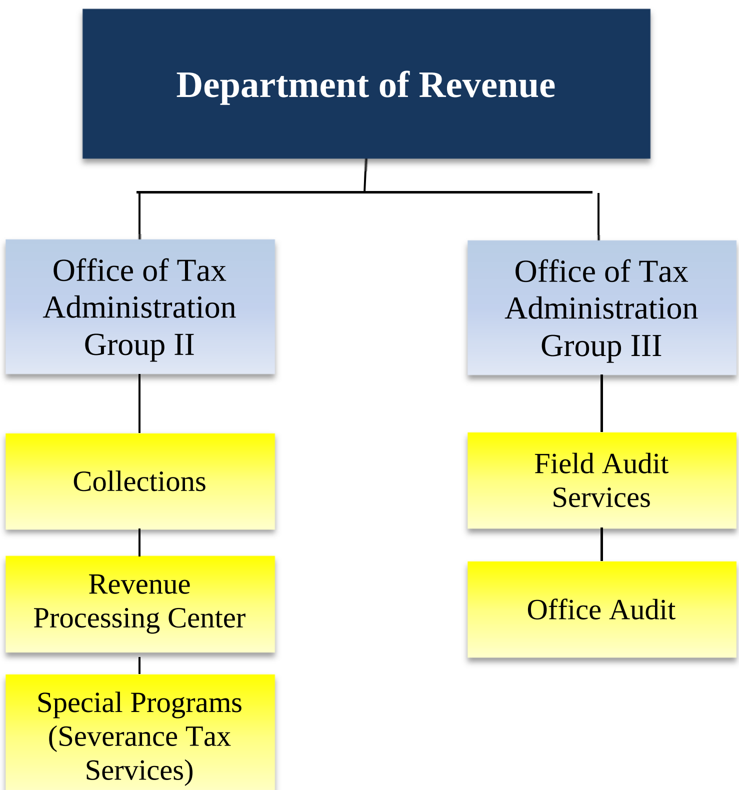
- Obtained data from LDR and the Department of Natural Resources (DNR) related to the number of severance tax field audits conducted and associated findings.

- Interviewed staff from LDR and DNR to determine the communication between these agencies on audit findings.

APPENDIX C: BACKGROUND

Overview of the Louisiana Department of Revenue (LDR). According to the LDR website, its mission, in part, is to fairly and efficiently collect state tax revenue. Louisiana Revised Statute (R.S.) 49:651 grants LDR the authority and power to collect taxes prescribed by law, including severance taxes, which are taxes levied upon all natural resources removed from the soil or water in Louisiana. For fiscal year 2013, the operating budget for LDR was approximately $91 million with 792 authorized positions.

The exhibit below shows a portion of LDR's organizational structure related to severance taxes. The areas highlighted in yellow are involved in the severance tax collection process at LDR.



Source: Prepared by legislative auditor's staff using information provided by LDR.

Severance Tax Payments. R.S. 47:631 authorized taxes to be levied upon all nonrenewable natural resources, such as crude oil, natural gas, minerals, and timber, severed from the soil or water in Louisiana. Companies are required to self-report monthly oil and gas production amounts to the Department of Natural Resources (DNR) and pay severance taxes to LDR based on these same production amounts. State law prescribes the rates of severance taxes for each type of oil and gas well.[10] LDR is responsible for collecting and auditing these severance tax payments to ensure that the state receives accurate, complete, and timely payments.[11]

Severance Tax Revenue. Severance tax payments from oil and gas extractions comprise over 97% of total severances taxes paid to the state over the last four fiscal years. For this reason, this audit only examined severance taxes paid on oil and gas. As shown in the following exhibit, from fiscal year 2009 through fiscal year 2012 the state collected severance tax payments totaling over $2.4 billion for oil and over $835 million for gas.

Severance Taxes Collected by LDR
Fiscal Years 2009 Through 2012

Natural Resource	FY 2009		FY 2010		FY 2011		FY 2012		Total FY 2009 - FY 2012	
Oil	$606,539,579	66.4%	$462,436,755	60.97%	$598,572,113	81.08%	$735,193,564	82.99%	**$2,402,742,011**	72.90%
Gas	291,155,146	31.88	282,430,592	37.24	124,255,520	16.83	137,828,453	15.56%	**835,669,711**	25.35%
Timber	14,007,992	1.53	11,990,850	1.58	13,899,836	1.88	1,328,503	0.15%	41,227,181	1.25%
Minerals	1,694,261	0.19	1,545,930	0.20	1,500,849	0.20	11,537,966	1.30%	16,279,006	0.49%
Total	**$913,396,978**	**100%**	**$758,404,127**	**100%**	**$738,228,318**	**100%**	**$885,888,486**	**100%**	**$3,295,917,909**	**100%**

Source: Prepared by legislative auditor's staff using information obtained from LDR.

Severance Tax Exemptions. Act 2 of the 1994 Regular Legislative Session created four severance tax exemptions for oil and natural gas producers based on the type of well. The tax exemptions allow for a suspension of severance taxes owed on certain types of qualified oil and natural gas wells for a specified period of time. The following chart describes the four types of severance tax exemptions, including the qualification requirements and tax exemption period for each, as well as the total number of each exemption granted from fiscal year 2009 through fiscal year 2012.

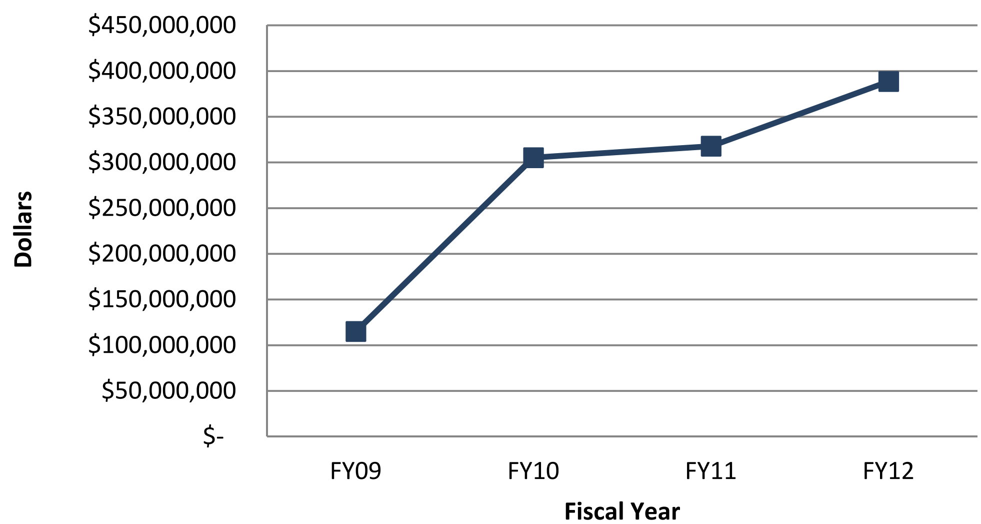
[10] R.S. 47:633 et seq.
[11] For fiscal year 2011 through fiscal year 2012, DNR was responsible for conducting severance tax field audits (see pages 6-8 for more information on severance tax field audits).

Severance Tax Exemptions									
Well Type and Governing Statute	**Exemptions Granted FY 09 – FY12**					**Qualification Requirements**	**Tax Exemption Period**	**Sunset Date**	**Miscellaneous Provisions**
	FY 09	FY 10	FY11	FY 12	Total				
1. Horizontally Drilled Wells **R.S. 47:633(7)(c)(iii)**	43	210	697	598	1,548	Well must be horizontally drilled or recompleted with 80 degrees deviation from the vertical and at least a 50 foot penetration into the sand	24 months or until payout of well completion cost, whichever comes first	None	Defines payout of well cost as cost of completing well to commencement of production, as determined by DNR
2. Inactive Wells **R.S. 47:633(7)(c)(iv)**	305	3485*	23	0	3,813	Well must be returned to service after being inactive for 2 or more years or having 30 or fewer days of production during past 2 years	5 years from date production begins or 90 days from date of application, whichever comes first	Application window ended 6/30/10*	Exemption shall be extended by length of inactivity caused by force majeure
3. Deep Wells **R.S. 47:633(9)(d)(v)**	9	14	10	25	58	Well must be drilled to a depth of more than 15,000 feet	24 months or until payout of well cost, whichever comes first	None	None
4. New Discovery Wells **R.S. 47:648.1 -.4**	0	0	0	0	0	Well must be drilled as a wildcat well and have been completed between 9/30/94 and 9/30/00	24 months or until recovery of payout of well cost, whichever comes first	No filing deadline, but well must have been completed by 9/30/00**	DNR will determine the payout of well cost

*According to DNR staff, the reason for the increase was that the application window ended on 6/30/2010. No new exemptions were accepted after this date even though they may continue to have active exemptions through 2015 because of the five-year exemption period.
**This exemption does not have a sunset provision, but because the well completion deadline was 9/30/2000 DNR has not approved any of these exemptions since fiscal year 2003.
Source: Prepared by legislative auditor's staff based on research of state laws.

Lost Revenue Due to Severance Tax Exemptions. From fiscal year 2009 to fiscal year 2012, severance tax exemptions increased by 238%, from approximately $115 million to approximately $389 million, as shown in the following exhibit. According to LDR, this increase is largely due to the horizontal well natural gas exemptions as it relates to the Haynesville Shale.

Severance Tax Exemptions Claimed
Fiscal Year 2009 Through 2012



Source: Prepared by legislative auditor's staff using information obtained from LDR.