Report Highlights

Oil and Natural Gas Severance Tax Exemptions Program

January 2007

Louisiana Legislative Auditor

Louisiana Revised Statutes (R.S. 47:633 and 47:648.1 through 47:648.4) authorize severance tax exemptions for horizontal, inactive, deep, and new discovery wells operated by oil and natural gas producers. The exemptions allow for a suspension of severance taxes on qualified oil and natural gas wells. The Department of Natural Resource's (DNR's) Office of Conservation certifies wells that are eligible for the tax exemptions, and the Louisiana Department of Revenue (LDR) audits producers to ensure the exemptions are taken properly.

State law [R.S. 51:935.1.A(1)] requires the Division of Administration (DOA) to contract with an independent economist to prepare a "biennial economic development budget report" that measures the impact of various state economic development programs.

This report gives the results of our performance audit of the state's oil and natural gas severance tax exemption program.

Audit Results

Impact of Severance Tax Exemptions

- ✓ The Biennial Economic Development Budget Report required by law has not been issued because DOA cancelled the contract after the hurricanes, then renegotiated it.
- ✓ No state agency measures the economic impact of the oil and gas severance tax exemptions.
- ✓ Fourteen other states offer tax incentives for oil and natural gas operators.

Office of Conservation's Management Controls

- ✓ Agency staff correctly processed all 40 sampled applications and maintained appropriate file documentation.
- ✓ Adopting formal policies and procedures would strengthen controls over certification and help ensure continuity.
- ✓ Promulgating rules and regulations is necessary for effective enforcement.
- ✓ Agency procedures for certifying inactive wells conflict with state law.
- ✓ State laws are inconsistent when referring to the "Office of Conservation."

Department of Revenue's Management Controls

- ✓ Comprehensive written policies and procedures would strengthen management controls over the audit function.
- ✓ Changing audit procedures would increase audit coverage.
- ✓ Maintaining audit data and documentation would enable LDR to evaluate its audit function.

Steve J. Theriot, CPA

Legislative Auditor

Does the state track the economic impact of severance tax exemptions awarded for oil and natural gas production?

- The Division of Administration (DOA), with input from others including the Department of Economic Development (DED), selected an economist at Louisiana Tech University to prepare the Biennial Economic Development Budget Report. However, because of the fiscal impact of hurricanes Katrina and Rita, DOA cancelled the contract, but later renegotiated it. Because of these delays, the biennial report has not yet been completed.
- No state agency measures the economic impact of the exemptions. DED does not collect exemption data because it does not oversee the exemptions. LDR and DED collect data that could be used to calculate the impact, but they do not calculate it.
- Fourteen other states that produce oil and natural gas offer, or have offered in the past, statutory severance tax incentives. Two of these states have implemented incentives for all four well types, as has Louisiana.

RECOMMENDATIONS

√ Once it is completed, DOA and DED should review the final draft of the Biennial Unified Economic Development Budget Report to determine whether it meets the requirements set forth by R.S. 51:935.1(B) through 51:935.1(D).

√ Once it is completed, DED should review the findings of the biennial report and determine what changes, if any, are needed to the programs covered in the report. DED should work with the legislature to implement needed statutory changes.

MATTERS FOR LEGISLATIVE CONSIDERATION

The legislature should:

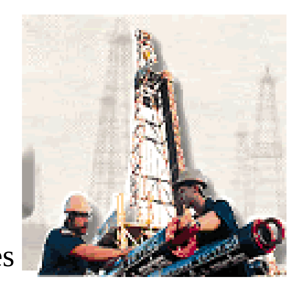
√ Review the findings of the Biennial Unified Economic Development Report (after it is completed) and determine whether the statute creating the inactive severance tax exemption [R.S. 47:633(7)(c)(iv)] should be continued, amended, or repealed.

√ Determine its intended purpose for the horizontal, inactive, and deep well exemptions, then amend R.S. 47:633 (7)(c)(iii), 47:633 (7)(c)(iv), and 47:633(9)(d)(v) to specify that purpose.

√ Amend R.S. 47:633 (7)(c)(iii), 47:633 (7)(c)(iv), and 47:633(9)(d)(v), if it determines the purpose of the severance tax exemptions is to spur economic development, to specify a state agency to oversee the economic aspects of the severance tax exemptions; routinely measure the exemptions' economic impact; and report the results of its analyses to the legislature.

Are the Office of Conservation's management controls adequate to ensure that it certifies wells in accordance with state law and other requirements?

- Agency staff correctly processed all 40 severance tax exemption applications in the sample we reviewed and maintained appropriate documentation in its files.
- Although the office provides some guidance, it should develop a comprehensive set of policies and procedures covering eligibility criteria and the certification process to help ensure that it manages the certification of wells effectively and efficiently.



- The office has not promulgated rules and regulations for certifying exemptions, as required by the Administrative Procedures Act.

➲ In conflict with state law, the office accepted applications allowing exemptions on previously inactive wells after production had commenced. State law [R.S. 47:633(7)(c)(iv)(aa)] requires that applications for exemptions be filed before production commences.

➲ State law refers to the Office of Conservation as both the "Department of Conservation" and the "Office of Conservation." Multiple names can lead to confusion in referring to the agency.

RECOMMENDATIONS

√ The Office of Conservation should develop and adopt a comprehensive set of formal policies and procedures covering all criteria and requirements for the severance tax exemptions and the application certification process. The policies and procedures should address, at a minimum, the following:

- Well certification process
- Well completion costs
- Supervisory reviews of processed applications
- Coordination between the Office of Conservation and LDR

√ After the office develops and adopts a comprehensive set of formal policies and procedures, it should promulgate rules and regulations in accordance with the Louisiana Administrative Procedures Act. The rules and regulations should address issues such as exemption certification criteria and application filing requirements.

√ If the office believes that R.S. 47:633(7)(c)(iv) needs to be amended to allow well operators to file applications after production has commenced, it should report to the legislature the problems it has experienced with implementing the current law. Unless and until the legislature amends the law, however, the office should rescind its memoranda allowing operators to file applications after production begins and follow the current law, which requires operators to file applications before production begins.

MATTER FOR LEGISLATIVE CONSIDERATION

√ The legislature should work with the Louisiana Law Institute to determine what, if any, amendments are needed to the Revised Statutes and Louisiana Administrative Code to eliminate confusion and ensure consistency in the specific name used to refer to the Office of Conservation.

Are LDR's management controls adequate to ensure that severance tax exemptions taken by well operators are proper?

➲ The Office Audit Division does not have written policies or procedures for conducting exempt well audits. According to the division, it is in the process of creating such policies and procedures.

➲ One audit procedure the Office Audit Division employs increases the amount of work staff will need to perform in the future while decreasing the total amount of audit coverage. To alleviate this problem, the staff needs to bill according to the division's informal process flowchart.

➲ The division does not keep adequate documentation to support effective management controls, in particular, monitoring controls. LDR management cannot measure the efficiency and effectiveness of the audit function without the data that documents the process used to conduct the audits. As a result of our audit, however, LDR has begun to track the results of all its audits.

RECOMMENDATIONS

√ The Office Audit Division should continue to work toward developing and adopting formal policies and procedures related to the audit function over severance tax exemptions. The policies and procedures should address, at a minimum, the following:

- Methodology for selecting which exempt wells to audit
- How audits are to be conducted

- Supervisory review of audit work
- Documenting audit work

√ When Office Audit Division auditors find that a well operator has continued to take a tax exemption after the exemption has expired, the auditors should examine tax information for that well up to the current year and bill the operator for all unpaid severance taxes at that time instead of waiting until subsequent years to bill the operator.

√ The Office Audit Division should continue implementing its tracking procedures for audits and begin to keep documentation of all exempt well audits its staff conducts, even when the audits do not result in tax bills. In addition, the division should collect and maintain data on all phases of the audit process. Management of LDR should use this information to evaluate the audits conducted by the division.

√ The Field Audit Services Division should maintain its exempt well audit information in an easily retrievable manner to document which of its audits encompass exempt wells, as well as the results of those audits. The division's data, along with data from the Office Audit Division's audits, should provide a complete picture of LDR's exempt well audits.

Louisiana Legislative Auditor

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Oil and Natural Gas Severance Tax Exemptions Program

Performance Audit

Issued January 31, 2007

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January 31, 2007

The Honorable Donald E. Hines,
President of the Senate
The Honorable Joe R. Salter,
Speaker of the House of Representatives

Dear Senator Hines and Representative Salter:

This report gives the results of our performance audit of the oil and natural gas severance tax exemptions created by Act 2 of the 1994 Regular Legislative Session, which are administered by the Department of Natural Resources, Office of Conservation and the Department of Revenue. The audit was conducted under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended.

The report contains our findings, conclusions, and recommendations. Appendix G contains management's responses. I hope this report will benefit you in your legislative decision-making process.

Sincerely,

Steve J. Theriot, CPA
Legislative Auditor

SJT/dl

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Appendices

EXECUTIVE SUMMARY

Louisiana Revised Statutes 47:633 and 47:648.1 through 47:648.4 authorize severance tax exemptions for horizontal, inactive, deep, and new discovery oil and natural gas wells. The Department of Natural Resources (DNR), Office of Conservation certifies wells for these tax exemptions, and the Louisiana Department of Revenue (LDR) audits producers to ensure the exemptions are taken properly. The results of our performance audit of the severance tax exemptions are as follows:

Performance Audit Findings

Impact of Severance Tax Exemptions

- The Biennial Economic Development Budget Report has not been issued because the contract to complete it was cancelled after the hurricanes, then renegotiated. *See pages 11-12.*
- No state agency measures the economic impact of the oil and gas severance tax exemptions. *See page 13.*
- Other states offer tax incentives for oil and natural gas operators. *See page 14.*

Office of Conservation's Management Controls

- Agency staff correctly processed all sampled applications and maintained appropriate file documentation. *See pages 15-16.*
- Adopting formal policies and procedures would strengthen controls over certification and help ensure continuity. *See pages 16-18.*
- Promulgating rules and regulations is necessary for effective enforcement. *See pages 18-19.*
- Agency procedures for certifying inactive wells conflict with state law. *See pages 19-20.*
- State laws are inconsistent when referring to the "Office of Conservation." *See page 20.*

Department of Revenue's Management Controls

- Comprehensive written policies and procedures would strengthen management controls over audits. *See pages 21-23.*
- Changing audit procedures would increase audit coverage. *See page 23.*
- Maintaining audit data and documentation would enable LDR to evaluate its audit function. *See pages 24-25.*

Audit Initiation and Objectives

Louisiana Revised Statute (R.S.) 51:935.1 requires the Office of Legislative Auditor (OLA) to annually conduct performance audits designed to evaluate the management controls, accuracy, and reliability of the reported information on at least three economic development programs. We commenced these audits in fiscal year 2004 and will continue them in subsequent years. According to the statute, OLA is to select the programs for review.

We originally selected the Oil and Natural Gas Severence Tax Exemptions, created by Act 2 of the 1994 Regular Legislative Session, for our 2005 review period. However, because of the impact of hurricanes Katrina and Rita, we suspended our work until January 2006. At its July 30, 2003, meeting, the Legislative Audit Advisory Council approved economic development program audits as part of our audit plan for fiscal year 2006. Our audit objectives were to answer the following questions:

1. Does the state track the economic impact of severance tax exemptions awarded for oil and natural gas production?

2. Are the Office of Conservation's management controls adequate to ensure that it certifies wells in accordance with state law and other established requirements?

3. Are the Louisiana Department of Revenue's (LDR's) management controls adequate to ensure that severance tax exemptions taken by well operators are proper?

Appendix A contains a summary of our audit scope and methodology. Appendix B contains a glossary of relevant terms used in this report.

Overview of Severance Tax Exemptions

Purpose and Statutory Requirements. R.S. 47:633 and 47:648.1 through 47:648.4 authorize four severance tax exemptions for oil and natural gas producers. Act 2 of the 1994 Regular Legislative Session created the four exemptions. The types of wells that qualify for the exemptions are as follows:

1. Horizontal wells
2. Inactive wells
3. Deep wells
4. New discovery wells

Act 2 was subsequently amended by Act 16 of the 1996 Regular Legislative Session, Act 7 of the 1998 Regular Legislative Session, Act 74 of the 2002 Regular Legislative Session, and Act 492 of the 2005 Regular Legislative Session. The amendments dealt primarily with the number of years that wells are exempt from severance taxes.

Office of Conservation staff refer to this collection of four exemptions as the Severance Tax Relief Program. LDR's staff informally recognizes the exemptions as Act 2 exemptions, after the act that created them. We use the term "severance tax exemptions" throughout this report to refer to the exemptions.

The four tax exemptions allow for a suspension of severance taxes on qualified oil and natural gas wells. The length of time for which wells are exempt from taxation depends on the type of well. Exhibit 1 summarizes the statutes governing the four severance tax exemptions.

Exhibit 1
Statutory Provisions for Severance Tax Exemptions

Well Type and Governing Statute	Qualification Requirements	Tax Exemption Period	Sunset Date	Miscellaneous Provisions
Horizontally Drilled Wells or Horizontally Drilled Recompletion Wells **R.S. 47:633(7)(c)(iii)**	• Well must meet statutory definition of horizontal drilling or horizontal recompletion.* • Production must commence after 7/31/94.	24 months or until payout of well cost, whichever comes first	None	• Defines payout of well cost as cost of completing well to commencement of production, as determined by DNR.
Inactive Wells **R.S. 47:633(7)(c)(iv)**	• 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. • Application must be made to DNR before production commences.	5 years** from date production begins or 90 days from date of application, whichever comes first	Application window ends 6/30/10	• Exemption shall be extended by length of inactivity caused by force majeure.
Deep Wells **R.S. 47:633(9)(d)(v)**	• Well must be drilled to a depth of more than 15,000 feet. • Production must commence after 7/31/94.	24 months or until payout of well cost, whichever comes first	None	None

Exhibit 1 (Cont.) Statutory Provisions for Severance Tax Exemptions				
Well Type and Governing Statute	**Qualification Requirements**	**Tax Exemption Period**	**Sunset Date**	**Miscellaneous Provisions**
New Discovery Wells **R.S. 47:648.1 - 47:648.4**	• Well must be drilled as a wildcat well. • Well must have been spudded after 9/30/94 and completed between 9/30/94 and 9/30/00. • Drilling operator must certify that Louisiana residents were employed to maximum extent during exploration and production of well.	24 months or until recovery of payout of well cost, whichever comes first	No filing deadline, but well must be completed by 9/30/00***	• Purpose of statute is to encourage new discovery well production. • DNR will determine the payout of well cost.
* The statute defines horizontal drilling as high angle directional drilling of bore holes with 50 to 3,000 plus feet of lateral penetration. ** Act 492 of the 2005 Regular Legislative Session amended the statute to allow for a 5-year exemption rather than the 2-year exemption that was in effect. The act allows wells certified as inactive since January 1, 2005 to take the 5-year exemption. ******* DNR still accepts applications for new discovery exemptions; however, from 2003 to 2005, it only received one to three such applications per year. **Source:** Prepared by legislative auditor's staff based on research of state laws and review of DNR data.				

The statutes governing three of the four well types (inactive, horizontal, and new discovery wells) specifically name DNR in some administrative capacity. The statutes provide that DNR will certify inactive wells for the exemptions and determine the costs of completing horizontal wells to the commencement of production. The statutes also provide that DNR will certify new discovery wells and determine the payout of the well cost. Aside from the eligibility rules and mentions of DNR, however, the statutes do not provide for the administration or monitoring of the severance tax exemptions.

DNR's Role in Administering Severance Tax Exemptions. Staff members in the Permits and Reservoir Section of the Engineering Division of the Department of Natural Resources, Office of Conservation[1] certify applications for severance tax exemptions. Applicants (i.e., well operators) submit to the office affidavits stating that certain wells meet the qualifications for the relevant exemptions. The operators also submit various other required documents to the Office of Conservation.

Applications for horizontal, deep, and new discovery well exemptions must be accompanied by well cost statements, which are itemized listings of the actual costs to drill, complete, and equip the wells for production. Office of Conservation staff review the affidavits

[1] State law (R.S. 30:1) creates the "Department of Conservation"; however, other laws refer to the agency as both the "Department of Conservation" and the "Office of Conservation." Because agency staff and others refer to the agency as the "Office of Conservation," we use this term throughout this report. The Office of Conservation has primary statutory responsibility for the regulation and conservation of oil, natural gas, and other natural resources.

and other documents and then consult DNR's information database called Strategic Online Natural Resources Information System (i.e., SONRIS) to verify the data submitted by the applicants. SONRIS contains a wide variety of drilling and production data on all oil and gas wells in Louisiana.

Appendix C contains a flowchart of the Office of Conservation's certification process. Appendix D contains a summary of eligibility criteria, documentation required for certification, and information the Office of Conservation verifies on SONRIS.

LDR's Role in Administering Severance Tax Exemptions. A severance tax auditor within LDR's Office Audit Division conducts audits to ensure that exempt well operators begin to pay severance taxes when their exemption status ends. The auditor also conducts other types of audits, as well.

To conduct an audit, the auditor obtains an oil or gas well's serial number, determines whether the well was certified as exempt by DNR, and then, for horizontal, deep, and new discovery wells, determines whether either the exemption time period has expired or the operator has met payout costs. If the auditor finds that a well operator did not begin to pay severance taxes after its exemption status ended, he bills the well operator. The auditor uses information from LDR's tax processing system, GenTax, and from DNR's SONRIS database during the audits. Appendix E contains a flowchart of the division's audit process for severance tax exempt wells.

LDR's Field Audit Services Division also audits severance-tax-exempt well information. The division audits all major well operators and a majority of mid-level operators. Their audits encompass all severance tax related issues, including exempt wells.

When the Field Audit Services Division auditors begin an audit, they request the Office Audit Division (including the auditor who conducts exempt well audits discussed in the previous paragraph) to stop all corresponding audits it is conducting. The Field Audit Services Division auditors then determine whether the exemption time periods have expired or the operators have met payout costs. They also verify that duplicate and unallowable costs have not been claimed toward the payout costs certified by DNR staff.

Dollar Amount of Severance Tax Exemptions. R.S. 47:1517 requires LDR to prepare an annual tax exemption budget that estimates the revenues directly foregone because of state tax exclusions, exemptions, credits, refunds, preferential tax rates, and deferred tax liabilities administered by LDR. The report does not take into account any increases in state revenue as a direct or indirect result of these mechanisms (e.g., increased jobs, wages, production). Exhibit 2 on the following page shows LDR's estimate of the amount of the four severance taxes taken by oil and natural gas operators for fiscal years 2003 through 2005.

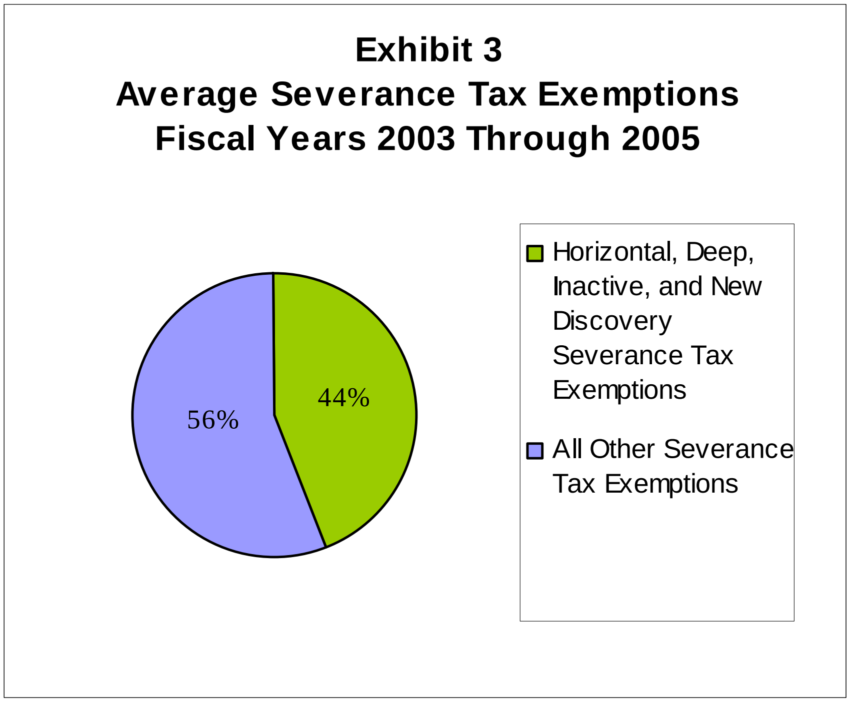
Exhibit 2 Estimated Amount of Oil and Natural Gas Severance Tax Exemptions Fiscal Years 2003 Through 2005			
	2003	**2004**	**2005**
Natural Gas Exemptions			
Horizontal Wells	$1,200,000	$1,050,000	$560,000
Inactive Wells	11,300,000	2,600,000	2,540,000
Deep Wells	10,700,000	9,340,000	15,150,000
New Discovery Wells	1,190,000	1,000,000	Expired*
Oil Exemptions			
Horizontal Wells	$5,200,000	$6,700,000	$2,400,000
Inactive Wells	6,800,000	7,600,000	15,540,000
Deep Wells	8,040,000	3,800,000	3,350,000
New Discovery Wells	1,900,000	1,100,000	Expired*
Natural Gas and Oil Exemptions			
Horizontal Wells	$6,400,000	$7,750,000	$2,960,000
Inactive Wells	18,100,000	10,200,000	18,080,000
Deep Wells	18,740,000	13,140,000	18,500,000
New Discovery Wells	3,090,000	2,100,000	Expired*
Total Exemptions	**$46,330,000**	**$33,190,000**	**$39,540,000**

* Since the new discovery well completion deadline was September 30, 2000, and the suspension was for 24 months from the date of completion, no additional revenue losses are expected.

Source: Prepared by legislative auditor's staff using information from LDR's 2005-2006 Tax Exemption Budget.

LDR's Tax Exemption Budget also estimates revenue directly forgone because of other natural resources severance tax exemptions.[2] As a whole, this exemption category accounts for the fourth largest amount of foregone revenues for the state. Within this category, the exemptions for horizontal wells, inactive wells, deep wells, and new discovery wells account for a large portion of the total exemptions. Exhibit 3 on the following page shows that for fiscal years 2003 through 2005, these four exemptions accounted for an average of 44 percent of total severance tax exemptions.

[2] The report includes statutorily imposed tax exclusions, exemptions, special rates, deductions, and suspensions for oil, gas, and minerals in the severance tax exemptions category.



Source: Prepared by legislative auditor's staff using information from LDR's 2005-2006 Tax Exemption Budget.

DOES THE STATE TRACK THE ECONOMIC IMPACT OF SEVERANCE TAX EXEMPTIONS AWARDED FOR OIL AND NATURAL GAS PRODUCTION?

The state has not routinely tracked or measured the economic impact of the state's oil and natural gas severance tax exemptions.

R.S. 51: 935.1.A(1)(a) requires the Division of Administration (DOA) to contract with an independent economist to prepare a " biennial economic development budget report" that measures the impact of various economic development programs. The inactive well severance tax exemptions comprise one of the programs to be included in the report. However, the report has not been completed.

In addition, R.S. 47:633 and 47:648.1 through 47:648 .4, which authorize the exemptions, do not charge any state agency with overseeing the economic aspects of the exemptions or measuring their economic impact. R.S. 47:648.1 through 47:648.4, which create the exemption for new discovery wells, provide that the purpose of that exemption is to encourage new discovery wells in the oil and gas sector. The statutes creating the other three exemptions do not specify the purpose of the exemptions.

Because the budget report has not been issued, and because no state agency is charged with measuring the economic aspects of the exemptions, their economic impact is not known.

Biennial Report Not Issued Because Contract Cancelled After Hurricanes, Then Renegotiated

R.S. 51: 935.1.A(1)(a) stipulates that DOA is to appoint an economist to prepare the Biennial Economic Development Budget Report after consultation with the Louisiana Economic Development Council and other named entities. An informal review group put together by DOA selected an economist at Louisiana Tech University to prepare the report. The review group also determined that the inactive well severance tax exemptions should be included in the report.

R.S. 51:935.1(B) through 51:935.1(D) provide a detailed listing of the information the biennial report shall contain for each program. This information includes various direct and indirect economic impact data. Some of the economic impact information to be included in the report is as follows:

- The total direct costs of benefits provided under each economic development program for the preceding two fiscal years, together with an estimate of the projected direct cost for the current and next two fiscal years

- The dollar amount of new investment in physical assets in the state
- The actual number and gross payroll of jobs retained as compared to the number and payroll of jobs existing prior to the entry of the employers into a program
- Wage rates and benefits of the new permanent full-time and part-time jobs created, and those of the jobs retained, as compared to the wage rates and benefits existing prior to the entry of the employers into the program
- Comparison of the benefits offered in economic development programs in Louisiana with those offered in the regional states with which the state competes for economic development

According to R.S. 51: 935.1(A)(1)(a), DED was to issue the biennial report beginning November 15, 2005. However, DED could not issue the report because DOA extended the completion dates for the interim and final report drafts because of revisions of other contracted deliverables and then cancelled the contract with Louisiana Tech because of the fiscal impacts of hurricanes Katrina and Rita. At the time DOA cancelled the contract on November 21, 2005, the economist had completed all contracted deliverables except the interim and final drafts of the biennial report and associated progress reports.

To date, the biennial report has not been completed. However, Louisiana Tech University has recently signed a new contract to complete the report. According to the new contract between DOA and the university, the economist will submit the final report of research and findings no later than January 31, 2007.

Recommendation 1: Once it is completed, DOA and DED should review the final draft of the Biennial Unified Economic Development Budget Report to determine whether it meets the requirements set forth by R.S. 51:935.1(B) through 51:935.1(D).

Summary of Management's Response: DOA and DED agree with this recommendation.

Recommendation 2: Once it is completed, DED should review the findings of the biennial report and determine what changes, if any, are needed to the programs covered in the report. In doing so, DED should work with the legislature to implement needed statutory changes.

Summary of Management's Response: DED agrees with this recommendation and will consult with DOA, LDR, and DNR for any other action that may be necessary.

Matter for Legislative Consideration 1: Once it is completed, the legislature should review the findings of the Biennial Unified Economic Development Report and determine whether the statute creating the inactive severance tax exemption [R.S. 47:633(7)(c)(iv)] should be continued, amended, or repealed.

No Agency Measures Economic Impact of Severance Tax Exemptions

DED officials told us that because that department does not oversee the exemptions, it does not collect any data on them. DNR's role is limited to certifying exemption applications. LDR's role is to administer the exemptions, including auditing exempt well tax returns.

Although none of these agencies measure the economic impact of the exemptions, both DNR and LDR collect data that could be used for such analyses. DNR maintains information on all severance tax applications its staff has processed since the inception of the exemptions in 1994. The department also maintains data on all oil and natural gas wells in the state. LDR collects data, including production and well cost data, from tax returns and monthly reports that severance-tax-exempt well operators file.

The Center for Energy Studies (CES) at LSU has conducted three analyses related to the economic impact of severance tax exemptions. Each analysis was conducted at the request of the state legislature or agency officials and was not done as a routine matter. The analyses include an initial economic and fiscal review of the bills that were drafted to create the exemptions, which was completed in 1994. The most recent study, published in the spring of 2005, measured the direct fiscal impact of the inactive well exemption on state severance tax and royalty collections for 1994 through 2004. The report found that the taxable production from "re-entered" wells was nearly twice the base period (1990-1994) amount. DNR and LDR data provided the basis of this analysis.

Although the CES studies are informative, neither CES nor any other state entity measures and tracks the full economic impact of all four exemptions on a routine basis. Without economic impact information, it is impossible to determine whether the exemptions benefit the state's economy. Routine analyses of all four exemptions would provide the legislature with information on whether it is economically favorable to continue offering the tax exemptions.

Matter for Legislative Consideration 2: The legislature should determine its intended purpose for the horizontal, inactive, and deep well exemptions, then amend R.S. 47:633 (7)(c)(iii), 47:633 (7)(c)(iv), and 47:633(9)(d)(v) to specify that purpose.

Matter for Legislative Consideration 3: If the legislature determines that the purpose of the severance tax exemptions is to spur economic development, it should amend R.S. 47:633 (7)(c)(iii), 47:633 (7)(c)(iv), and 47:633(9)(d)(v) to specify a state agency to oversee the economic aspects of the severance tax exemptions, routinely measure their economic impact, and report the results of its analyses to the legislature. In doing so, the legislature should consider the fiscal impact of the resources that will be needed to accomplish the measurement and reporting functions.

Other States Offer Tax Incentives for Oil and Natural Gas Operators

Our research shows that 14 other states that produce oil and natural gas offer, or have offered, statutory severance tax exemptions or other tax incentives for inactive, horizontal, deep, and/or new discovery wells. Some of the other types of incentives these states offer are tax credits, tax reductions, and tax refunds. Two (14.3%) of these states (Florida and Oklahoma) have implemented incentives for all four well types, as has Louisiana. Thirteen (92.9%) of the states have implemented them for inactive wells only.

Although all 14 states are consistent in offering some type of tax incentive, the statutory definitions and requirements of the 14 states vary. For example, the time period of inactivity required for a well to be considered inactive ranges from one year to five years. Other variations are as follows:

(1) amount of time (i.e., "reduction period") for which a tax incentive is given;

(2) whether the state specifies a trigger price at or above which the tax incentive is no longer given; and

(3) whether a tax incentive will statutorily expire (i.e., sunset).

Appendix F provides a summary of Louisiana's and the 14 other states' severance tax incentives.

ARE THE OFFICE OF CONSERVATION'S MANAGEMENT CONTROLS ADEQUATE TO ENSURE THAT IT CERTIFIES WELLS IN ACCORDANCE WITH STATE LAW AND OTHER REQUIREMENTS?

The Office of Conservation has implemented some management controls over the well certification process, but it lacks certain elements that would help ensure that the department certifies all wells in accordance with state law and other established requirements.

Staff from the Office of Conservation correctly processed all severance tax exemption applications we sampled. In addition, the department's files for these applications contained all required documentation. However, we noted the following internal control weaknesses that the department needs to address:

- The Office of Conservation provides some guidance on the certification process to its staff and on certification requirements to well operators who apply for severance tax exemptions. However, DNR has not developed a comprehensive set of formal policies and procedures or promulgated rules and regulations relating to these issues.

- The Office of Conservation's procedures for inactive well applications conflict with state law.

Agency Staff Correctly Processed Sampled Applications and Maintained Appropriate File Documentation

Applications. Staff in the Office of Conservation correctly approved or denied all 40 severance tax exemption applications we sampled from the 608 applications they processed from January 2003 through March 2006. Of these 40 applications, the staff approved 39 (98%) applications because all eligibility requirements were met. They denied only one application.

The staff uses an evaluation form, developed by one of its members, as a checklist when evaluating applications. The form varies for each of the well or exemption types, depending on the requirements for each. The staff records eligibility data on the form, as well as general information about the application, such as receipt date and whether it was approved or denied. The evaluation form is EXCEL based, linked to other spreadsheets and electronic logs, and hard-coded with certain information and formulas that help ensure the accuracy of the certifications. Using these evaluation forms, we were able to review the staff's reasons for approving or disapproving the applications we sampled.

File Documentation. Thirty-nine (98%) of the 40 hardcopy application files we reviewed contained all documents that the Office of Conservation requires applicants to submit when applying for exemptions. For all four exemption types, the office requires applicants to submit a notarized affidavit. The office also requires additional supporting documentation to be submitted with the affidavit, which differs according to the type of exemption. For the file that did not contain all required documents, it was not necessary to include all of the documents because the application was for a dual well,[3] and the documents were included in the file for the corresponding well.

Office of Conservation employees store application data in the department's SONRIS database. After the staff processes each application, they enter information about the application such as receipt date, approval or denial date, date of first production, and well completion costs into SONRIS. SONRIS can be accessed through the department's Web site. The Office of Conservation also has in-house software that can gather and sort application data from SONRIS.

Adopting Formal Policies and Procedures Would Strengthen Controls Over Certification and Help Ensure Continuity

State law sets forth eligibility requirements for the four severance tax exemptions. To fully implement the program, however, the Office of Conservation needs to develop guidelines for implementation and establish criteria not specified in the statutes. Though the Office of Conservation has provided some level of guidance, it has not developed a comprehensive set of formal policies and procedures covering eligibility criteria and the process to be used to certify exemptions. Without formal policies and procedures, the office cannot ensure that the certification process is effectively and efficiently managed.

Since inception of the severance tax exemptions in 1994, management of the Office of Conservation has issued seven memoranda concerning the exemptions. Management developed these memoranda as issues arose. The memoranda establish filing requirements and criteria for certain issues relating to the exemptions. Management has also provided information such as application requirements and general guidelines on well cost statements on its Web site. The memoranda and Web site information do not constitute comprehensive policies and procedures.

According to the U.S. Government Accountability Office, appropriate management controls include establishing policies and procedures for each of an agency's activities or programs. Establishing policies and procedures is essential for achieving effective and efficient program results. In addition, it provides for continuance of a program or activity when key staff turnover occurs. Areas for which the Office of Conservation has limited or no formal written policies or procedures are the well certification process, supervisory reviews of processed applications, well completion costs, and coordination between the Office of Conservation and LDR.

Well certification process. Office of Conservation staff said that the well certification process follows the evaluation form/checklist they use during their review process. The office has no written policies and procedures detailing the certification process. In addition, it has no outline, flowchart, or other documentation that would provide staff with explicit guidance and

[3] A dual well is a well bore containing two separate sets of tubing that extract natural resources from different depths. The oil and/or gas is brought up the well in the separate sets of tubing.

direction on how to certify wells. Although the evaluation form is a control mechanism over the certification process, written policies and procedures outlining the entire process would provide a higher level of management control over the process. They would also help ensure consistency among staff members in the way they process applications so that all applications receive the same type and level of review. Ensuring consistency would make the office's decisions on whether to approve or deny applications more defensible should questions arise later.

Supervisory reviews of processed applications. The Office of Conservation also has no formal policies and procedures concerning supervisory reviews of applications its staff has approved or denied. In practice, management informally reviews some processed applications, although they do not review all of them. The office does not, however, have a policy mandating these procedures. Standard policies and procedures would help ensure that supervisory reviews are done accurately, completely, and consistently. For instance, they could dictate how management should select applications for review and describe what the review procedures should entail and how they are to be done.

Well completion costs. State laws (R.S. 47:633 and R.S. 47:648.3) do not provide any guidance on well completion costs other than defining in general terms "payout of well cost" (i.e., well completion costs) and stating that DNR shall determine the payout of well costs. It is up to DNR, through the Office of Conservation, to determine the criteria for qualified completion costs. It is also the department's/office's responsibility to develop appropriate procedures for its staff to evaluate well completion costs reported by well operators. Determining that reported completion costs are accurate is important because the dollar amounts of horizontal, deep, and new discovery well exemptions will be based on the costs that the Office of Conservation staff approves if the payout of well costs occurs before the expiration of the exemption period (i.e., 24 months).

Management of the Office of Conservation has issued two memoranda that provide guidelines for 3D seismic costs. Management has also placed information concerning well completion costs on DNR's Web site. The Web site lists categories of costs that are and are not allowed on cost statements and provides guidance on how cost statements should be organized. However, management has not developed a comprehensive set of formal written policies and procedures that specify criteria for qualified well completion costs or how staff should evaluate well completion cost statements submitted by operators.

According to Office of Conservation staff, when evaluating cost statements submitted by operators with their applications, they review the statements to determine whether reported costs appear reasonable and conduct further review if any costs appear questionable. They said they have no way of verifying exact costs and that they review cost statements to ensure that certain cost categories, such as miscellaneous costs, do not exceed two percent of total costs. These procedures are not mandated or documented by any department policy.

In addition, regarding the applications we reviewed, we noted that the staff did not always document what, if any, evaluation procedures they had performed. For instance, only three (21.4%) of the 14 applications we reviewed that were for horizontal, deep, or new discovery wells showed evidence that the staff had reviewed the completion costs, including checking the accuracy of total costs reported. Requiring staff to document that they have followed standard office policies and procedures when evaluating the cost statements would provide a stronger level of internal control over the well certification process.

Coordination Between Office of Conservation and LDR. Proper administration of the severance tax exemptions requires coordination between the Office of Conservation and LDR. The Office of Conservation does not have any formal policies or procedures describing the type and level of coordination department employees should maintain with LDR employees. Adoption of formal policies and procedures in this area would help maximize coordination between the two departments.

Recommendation 3: The Office of Conservation should develop and adopt a comprehensive set of formal policies and procedures covering all criteria and requirements for the severance tax exemptions and the application certification process. The policies and procedures should address, at a minimum, the following:

- Well certification process
- Well completion costs
- Supervisory reviews of processed applications
- Coordination between the Office of Conservation and LDR

Summary of Management's Response: The Office of Conservation partially agrees with this recommendation. The Office believes that its current series of memos is sufficient but will consider consolidating them into one policy memo.

Promulgating Rules and Regulations Is Necessary for Effective Enforcement

The Office of Conservation has not promulgated rules and regulations for certifying severance tax exemptions, as required by the Administrative Procedures Act (R.S. 49:950 et seq.). Unlike internal policies and procedures, promulgated rules and regulations have the weight of law. Promulgated rules and regulations are needed for effective enforcement, and they allow for due process for individuals by not allowing agencies to change rules arbitrarily.

R.S. 30:4 provides for the powers and duties of the Commissioner of Conservation, including giving the commissioner rulemaking authority. R.S. 49:952 (2) of the Administrative Procedures Act further requires each agency that engages in rulemaking to "adopt rules of practice setting forth the nature and requirement of all formal and informal procedures available."

Recommendation 4: After the Office of Conservation develops and adopts a comprehensive set of formal policies and procedures for the administration of severance tax exemptions, it should promulgate rules and regulations in accordance with the Louisiana Administrative Procedures Act. The rules and regulations should address issues such as exemption certification criteria and application filing requirements.

Summary of Management's Response: The Office of Conservation disagrees with this recommendation. The Office believes that a consolidated policy memo will be sufficient.

Legislative Auditor's Additional Comments: Regulatory agencies need rules and regulations, not just policies and procedures, to be able to provide effective enforcement actions. In addition, rules and regulations provide a means by which individuals who appeal decisions of regulatory agencies receive due process. Since the Office of Conservation serves a regulatory role over oil and gas severance tax exemptions, promulgating rules and regulations in conformity with the Administrative Procedures Act is both necessary and appropriate.

Agency Procedures for Certifying Inactive Wells Conflict With State Law

The state law that governs the tax exemption for inactive wells requires [R.S. 47:633(7)(c)(iv)(aa)] requires that well operators file their applications for exemptions before oil and gas production commences. The Office of Conservation, however, accepts applications after production has commenced and allows the exemption period to begin at the time production commences. The office's acceptance of applications after production commences is in direct conflict with the law.

The Office of Conservation has set forth its acceptance of applications after production commences in various memoranda it has issued over time. Three memoranda (dated January 5, 1995; July 26, 2002; and December 7, 2005) all state, "Failure to apply for certification prior to commencement of production or within 30 days of commencement of production following a two-year period of inactivity that falls within the time frame mandated will not disqualify the well." This provision means that DNR will accept applications for inactive well exemptions that are filed after the date production commences.

According to Office of Conservation management, it began allowing well operators to apply for certification after the commencement of production because many operators did not find out about the exemptions until after production had already begun. Office of Conservation staff told us that they encourage applicants for all four types of exemption to wait and file their applications after well production commences. According to the staff, if operators apply too early, the exemption period will begin and remain in effect even if the wells do not begin producing as planned. In effect, they said, those operators would not be able to take the exemptions for the full statutory period because the period would have started running before production actually began.

We found that for half of the inactive exemption applications we reviewed, the Office of Conservation allowed well operators to apply for the exemption after production began. Twenty-six of the 40 applications we reviewed were for inactive wells. Of these 26 applications, 13 (50%) were received by DNR after well production had commenced. The median number of days these applications were received after production commenced was 68.

Office of Conservation officials told us that they believe they are following the legislative intent of the law by allowing operators to apply after production commences. However, the legislative intent is clearly expressed in the law, which states, "To qualify for inactive well status, an application for a two-year inactive well certification shall be made to the Department of Natural Resources, before commencement of production." Because the law is clearly stated, other interpretations or assumptions should not be made.

Recommendation 5: If the Office of Conservation believes that the law [R.S. 47:633(7)(c)(iv)] authorizing the inactive severance tax exemptions needs to be amended to allow well operators to file applications for exemptions after production commences, it should report to the legislature the problems it has experienced with implementing the current law. Unless and until the legislature amends the law, however, the office should rescind its memoranda allowing operators to file applications after production begins and follow the current law, which requires operators to file applications before production begins.

Summary of Management's Response: The Office of Conservation disagrees with this recommendation. The Office believes that its current method of processing severance tax relief applications is within the legislative intent of the law.

State Laws Are Inconsistent When Referring to the "Office of Conservation"

As discussed earlier in this report, state law (R.S. 30:1) created the "Department of Conservation." However, other statutes refer to the agency as the "Office of Conservation." When R.S. 30:1 was originally enacted, the Department of Conservation was an autonomous agency. However, when DNR was subsequently created in 1976, the Department of Conservation was transferred to DNR, although it kept much of its autonomy. As we reviewed revised statutes and the Louisiana Administrative Code for this audit, we noted that both names are used when referring to this agency, which can cause confusion for the reader. Amendments to the statutes and the administrative code may be necessary to eliminate confusion and ensure consistency when referring to this agency.

Matter for Legislative Consideration 4: The legislature should work with the Louisiana Law Institute to determine what, if any, amendments are needed to the Revised Statutes and Louisiana Administrative Code to eliminate confusion and ensure consistency in the specific name used to refer to this agency.

ARE LDR'S MANAGEMENT CONTROLS ADEQUATE TO ENSURE THAT SEVERANCE TAX EXEMPTIONS TAKEN BY WELL OPERATORS ARE PROPER?

LDR's Office Audit Division has some management controls in place to help ensure that its exempt well audits determine whether well operators properly took severance tax exemptions. However, the division should take additional steps to strengthen its controls.

Management of the division is primarily focused on billing and collecting unpaid severance taxes uncovered by the audits rather than the methodology and procedures used in conducting the audits. As a result, the controls that are in place do not include written policies and procedures dealing with the audit process. LDR upper management said that it is in the process of developing policies and procedures, and it does have some preliminary documents such as process maps. However, the Office Audit Division does not have a comprehensive set of formal written policies and procedures dealing with the audit process, including how wells are selected for audits, how audits are to be conducted, supervisory reviews of staff auditors' work, and retention of audit data and files. In addition, upper management told us that audit errors are usually uncovered during the claims closeout review. However, supervisors do not review the work of the staff auditor who conducts exempt well audits before notices and assessments are sent to taxpayers. In addition, we did not see any examples of management keeping or using data to assess the performance of the audit process.

Comprehensive Written Policies and Procedures Would Strengthen Management Controls Over Audits

We attempted to obtain written policies and procedures on the Office Audit Division's audit process for exempt well audits so that we could evaluate management controls in this area. Although the division could not produce any formal policies and procedures, upper management indicated that it is in the process of developing formal policies and procedures. As previously stated, the U.S. GAO says that appropriate management controls include the establishment of policies and procedures for each of an agency's activities or programs. Establishing policies and procedures is essential for achieving effective and efficient program results. In addition, written policies and procedures help ensure that entities can continue programs and activities when key staff turnover occurs.

Audit Selection. The division has no policies and procedures detailing how often exempt wells should be audited or the process for selecting which wells to audit. According to division management and staff, prior to 2003 they audited all exempt wells. However, after implementing LDR's new computer system "GenTax" in 2003, they only audited the wells of the top 60 oil and gas producing operators, plus the wells of certain other operators. The auditor who conducts the audits said that he chose the wells of other operators using a non-documented risk-based system. According to the auditor, he is currently back to pre-GenTax auditing levels.

However, because the division does not require that audit work be documented, we could not verify which audits he has conducted since 2002.

Audit Procedures. LDR management provided us with some procedures related to conducting audits that staff used prior to the transfer to the GenTax system. According to LDR management, now that the severance tax accounting function has been moved to the GenTax system, the division is in the process of developing formal written policies and procedures describing how its auditors are to conduct audits. The division has some informal process flowcharts and accompanying outlines describing the systematic steps to be used to determine whether well operators have begun to pay severance taxes once the exemption status for wells has ended. These documents include steps for calculating well payout costs. The severance tax auditor who conducts exempt well audits created the documents for a department-wide process reporting project. According to upper management, the flowcharts and outlines were reviewed by the assistant director and director of that division before they were finalized. However, although they provide a basis for developing formal policies and procedures, management has not formally approved or adopted the information contained in the flowcharts and outlines as division policy.

Supervisory Review. The Office Audit Division does not have written policies and procedures relating to supervisory reviews of the audit process. In practice, management does not review the audit work conducted by the severance tax auditor. The supervisor told us that she only verifies that any severance tax resulting from the audits is collected and only reviews audits if the corresponding tax bills are reduced.

The division did provide us with policies relating to supervisory review of tax bill reductions and claims closures. Upper management said these procedures provide a mechanism for the supervisor to determine if errors were made in the audit process. Implementing standard policies and procedures documenting when supervisory reviews of audits should be conducted would help ensure that the staff conducts the audits properly. For instance, the policies could take into consideration important factors such as the significance of the work and the staff experience level.

Recommendation 6: LDR's Office Audit Division should continue to work toward developing and adopting formal policies and procedures related to the audit function over severance tax exemptions. The policies and procedures should address, at a minimum, the following:

- Methodology for selecting which exempt wells to audit
- How audits are to be conducted
- Supervisory review of audit work
- Documenting audit work

Summary of Management's Response: LDR partially agrees with this recommendation. The department does not feel it would be wise to put in a formal written policy or procedure how it selects returns or exempt wells to audit. However, it agrees that formal written procedures should be developed concerning how audits are to be conducted and what supervisory procedures will be required.

Changing Audit Procedures Would Increase Audit Coverage

We noted that one of the audit procedures the Office Audit Division staff performs increases the amount of work the staff will need to perform in subsequent years and decreases audit coverage. The division's informal process flowchart indicates that if a tax exemption for a particular well has expired or payout has occurred, the auditor must "bill for every period after the expiration/payout date" for which taxes are not paid. In practice, however, the auditor only bills the operator for the year he is currently auditing.[4] The auditor does not review tax information for subsequent years to determine whether the operator erroneously continued to take the exemption. Rather, he waits until the following year and subsequent years when he again audits that exempt well's information to bill the operator for any additional unpaid severance tax.

If the auditor followed the billing procedure shown in the process flowchart and billed operators for every period after exemptions have expired, he would not have to audit the information for those particular wells in following years. This system would allow the auditor to spend more time auditing other wells, thus increasing the division's audit coverage. In addition, the well operators would be billed for all unpaid severance taxes sooner, which should result in payments being collected and deposited sooner.

Recommendation 7: When Office Audit Division auditors find that a well operator has continued to take a tax exemption after the exemption has expired, the auditors should examine tax information for that well up to the current year and bill the operator for all unpaid severance taxes at that time instead of waiting until subsequent years to bill the operator.

Summary of Management's Response: LDR partially agrees with this recommendation. It believes that if all pertinent information is available, the auditor should include all periods for that well up to the current period in the audit, but that it must perform audits for a one-year period to insure that certain tax liabilities do not prescribe.

[4] The Office Audit Division conducts exempt well audits three years behind the current tax year. For instance, during 2006, the division audited 2003 information.

Maintaining Audit Data and Documentation Would Enable LDR to Evaluate Its Audit Function

LDR's Office Audit Division was unable to provide us with certain data and documentation regarding its audit process. This information is essential to assessing the division's audit function. Exhibit 4 provides a description of various data we requested during the audit and the division's responses to our requests.

Exhibit 4
Data Requested for 2003 Through 2005 and Office Audit Division's Responses to Our Requests

Data Requested	Division's Response
Number of producing exempt wells	Cannot provide
Number of tax returns with exempt wells	Can provide, but would not be accurate
Number of operators of exempt wells	Can provide, but would not be accurate
Number of audits conducted on exempt well returns (including those that did not result in tax bills)	Cannot provide because did not keep files for work not resulting in bills
Number of audits that resulted in tax bills*	2003: 28 2004: 40 2005: 22
Dollars billed as a result of audits	2003: $2,023,743.34* 2004: $3,241,896.25* 2005: $1,305,393.40*
Dollars collected as a result of audits	2003: $311,234.75* 2004: $923,673.88* 2005: $127,441.34*
Names of operators/wells that were audited	Cannot provide because did not keep files for work not resulting in bills

***** The division provided these data from production reports kept by its auditor. However, the division said that the data were also available in GenTax.

Source: Prepared by legislative auditor's staff using information received from Office Audit Division and interviews of division staff.

The division was able to provide us with the number of audits that resulted in tax bills and the total dollars billed and collected since 2003. This information is available from the individual auditor's records and GenTax. Information from prior to 2003 can only be produced from the auditor's records.

As Exhibit 4 illustrates, the division was unable to provide us with the total number of exempt well audits it conducted in the years 2003 through 2005. Division staff could not provide the data because they did not track the number of audits the auditor conducted or which returns he audited each year. In addition, they did not keep the files for audits that resulted in a determination that exemptions were properly taken and that well operators did not owe any severance tax. The auditor discarded all audit documentation unless his efforts resulted in tax bills.

The data and documentation the division keeps is not sufficient to support effective management controls, in particular, monitoring controls. That is, management cannot evaluate audit work that has been discarded. In addition, LDR management cannot measure the efficiency and effectiveness of the audit function without the data that documents the process used to conduct the audits. However, as a result of our audit work, LDR recently began to track the results of all audits, regardless of whether or not they resulted in a bill.

Recommendation 8: The Office Audit Division should continue implementing its tracking procedures for audits and begin to keep documentation of all exempt well audits its staff conducts, even when the audits do not result in tax bills. In addition, the division should collect and maintain data on all phases of the audit process. Management of LDR should use this information to evaluate the audits conducted by the division.

Summary of Management's Response: LDR agrees with this recommendation. Because of the importance and emphasis that the legislature has placed on monitoring the exemptions, LDR will keep documentation of all exempt well audits it conducts.

Field Audit Services Division: Another division within LDR, the Field Audit Services Division, conducts audits that include some review of exempt well tax returns. These audits encompass all severance tax related issues, including exempt wells. The personnel in this division maintain the information on their audits. However, they cannot easily extract the exempt well audit data from their audit reports.

Because of the time and effort required to isolate the exempt well data, coupled with the lack of documentation from the Office Audit Division, it was not cost effective for us to ask Field Audit Services to produce audit information for us. The staff indicated, however, that they could begin to track such information in an electronic format, if needed, in the future.

Recommendation 9: The Field Audit Services Division should maintain its exempt well audit information in an easily retrievable manner to document which of its audits encompass exempt wells, as well as the results of those audits. The division's data, along with data from the Office Audit Division's audits, should provide a complete picture of LDR's exempt well audits.

Summary of Management's Response: LDR disagrees with this recommendation. The recommendation would substantially change the manner in which the department conducts field audits, increase the time required to perform the audits, and reduce the number of oil and natural gas field audits conducted. However, LDR will modify its field audit comments form to show which oil and gas severance tax exemptions were examined.

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APPENDIX A: SCOPE AND METHODOLOGY

We conducted this performance audit under the provisions of Title 24 of the Louisiana Revised Statutes of 1950, as amended. We followed the applicable generally accepted government auditing standards as promulgated by the Comptroller General of the United States.

Scope

R.S. 51:935.1(E)(1)(a) directs the legislative auditor to conduct performance audits annually to evaluate the management controls, accuracy, and reliability of the reported information of at least three economic development programs. This audit focused on evaluating the management controls of the two state agencies responsible for administering the four severance tax exemptions created under Act 2 of the 1994 Regular Legislative Session. In addition, we assessed whether the state tracks the economic impact of the exemptions.

Methodology

To complete this audit, we performed the following tasks:

- Reviewed laws governing the four oil and natural gas severance tax exemptions

- Reviewed laws governing the Unified Economic Development Budget Report

- Interviewed a Louisiana Tech University official concerning the Biennial Unified Economic Development Budget Report

- Interviewed personnel of the Division of Administration and the Departments of Economic Development, Natural Resources, and Revenue about the Biennial Unified Economic Development Budget Report and collected data related to the economic impact of the severance tax exemptions

- Reviewed laws and policies from other states with tax incentives similar to Louisiana’s oil and natural gas severance tax exemptions and compared them to Louisiana’s

- Interviewed Office of Conservation staff regarding the office’s managerial oversight process over severance tax exemption certifications; obtained and reviewed the office’s operating memoranda relevant to the certifications; and flowcharted the process

- Selected a sample of 40 severance tax exemption applications that Office of Conservation staff processed from January 2003 through March 2006; developed data collection instruments; and reviewed the office’s files to determine whether management conducted secondary or managerial reviews of the applications and whether staff correctly approved or denied the applications, reviewing additional documentation where necessary

- Using external sources, determined the appropriate management controls for certifying severance tax exempt wells and auditing severance tax exempt well returns

- Interviewed LDR staff concerning the department's process for auditing oil and natural gas severance tax exempt returns, including its managerial oversight process; obtained and reviewed the department's procedures relevant to the audit process; and flowcharted the process

- Interviewed LDR staff concerning data relating to severance tax exemption audits and reviewed supporting documentation where necessary

- Conducted other research, analysis, and procedures, as needed

APPENDIX B: GLOSSARY

Horizontal Drilling	To drill a well from the surface vertically down to a certain level, then to turn at a right angle and continue drilling horizontally within a specified reservoir or interval of a reservoir.
Horizontal Recompletion	Horizontal drilling in an existing well bore.
Payout	The time needed for oil and/or gas production to compensate for (i.e., equal) the costs of drilling, completing, and operating the well up to that time.
Seismograph	A device that detects vibrations in the earth, used in prospecting for probable oil-bearing structures.
Severance Tax	An excise tax upon the privilege of severing natural resources from the soil or water. All resources found in a natural state that are of any commercial value whatsoever are natural resources and are subject to the severance tax.
Spud Date	The date a drill bit pierced the ground (i.e., the actual date that drilling began).
Tax Exemption	An exemption to the tax law in which part of the taxes that would normally be collected from an individual or organization are instead foregone.
Tax Incentive	A tax reduction afforded to individuals or organizations for a particular purpose, used to encourage or discourage an activity.
Well Completion	The activities necessary to prepare a well for production of oil and gas.
Well Serial Number	An identification number DNR assigns to a well upon approval (or renewal of approval) to drill for minerals.
Wildcat Well	A well drilled in an unexplored area.

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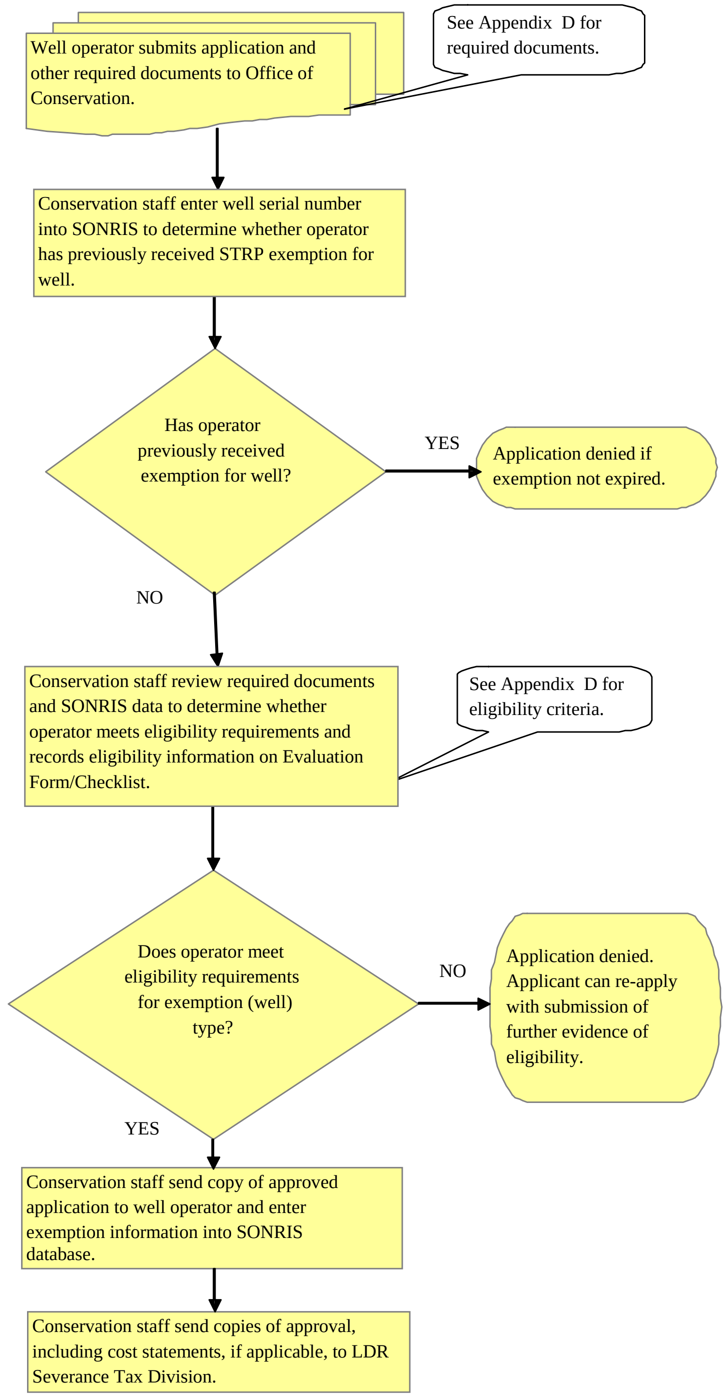
APPENDIX C: OFFICE OF CONSERVATION'S SEVERANCE TAX EXEMPTION CERTIFICATION PROCESS



Note: The certification process for each exemption type varies. This flowchart is a general composite of the certification processes for the four exemption types.

Source: Created by legislative auditor's staff based on DNR documents and interviews with DNR staff.

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APPENDIX D: Summary of Eligibility Criteria, Documentation Required by Office of Conservation, and SONRIS Review for Well Certification

Well Type		Eligibility Criteria	Documents Office of Conservation Requires Well Operators to Submit With Severance Tax Applications	Information Office of Conservation Verifies on SONRIS
Deep Well		• True vertical depth of well is 15,000 feet or more	• Directional survey • Detailed itemized cost statement • Well history form • Well completion form	• Well depth • Date well began producing
Horizontal Well		• Well has incline angle that deviates from vertical axis by at least 80° and penetrates at least 50 feet into horizon	• Directional survey • Detailed itemized cost statement • Well history form	• Evidence of direction and penetration • Date well began producing

New Discovery Well		• Well is first to produce commercially in a new reservoir and was completed by September 30, 2000	• Detailed itemized cost statement
			• Order recognizing new reservoir or letter designating new field discovery
			• Well history form
				• Evidence of initial commercial production in the reservoir
				  • If wildcat well, DNR's Geological Section names field where well is located
				  • If well is located in area near other pre-existing wells, DNR staff determine whether well is first well to reach and produce commercially in sand
				• Date well began producing

Inactive Well		• Well has not produced for two years preceding date of application or
		• Well has produced 30 or fewer days over two-year period
			• List of days well produced if produced 30 or fewer days over two-year period	• Well existed for two years or more
				• Evidence that well did not produce using combination of:
				  • Well test
				  • Production information for lease or unit where well located
				  • Well status/history
				• Date well began producing, if applicable

Source: Prepared by legislative auditor's staff based on interviews with DNR, Office of Conservation staff and review of related policies and procedures.

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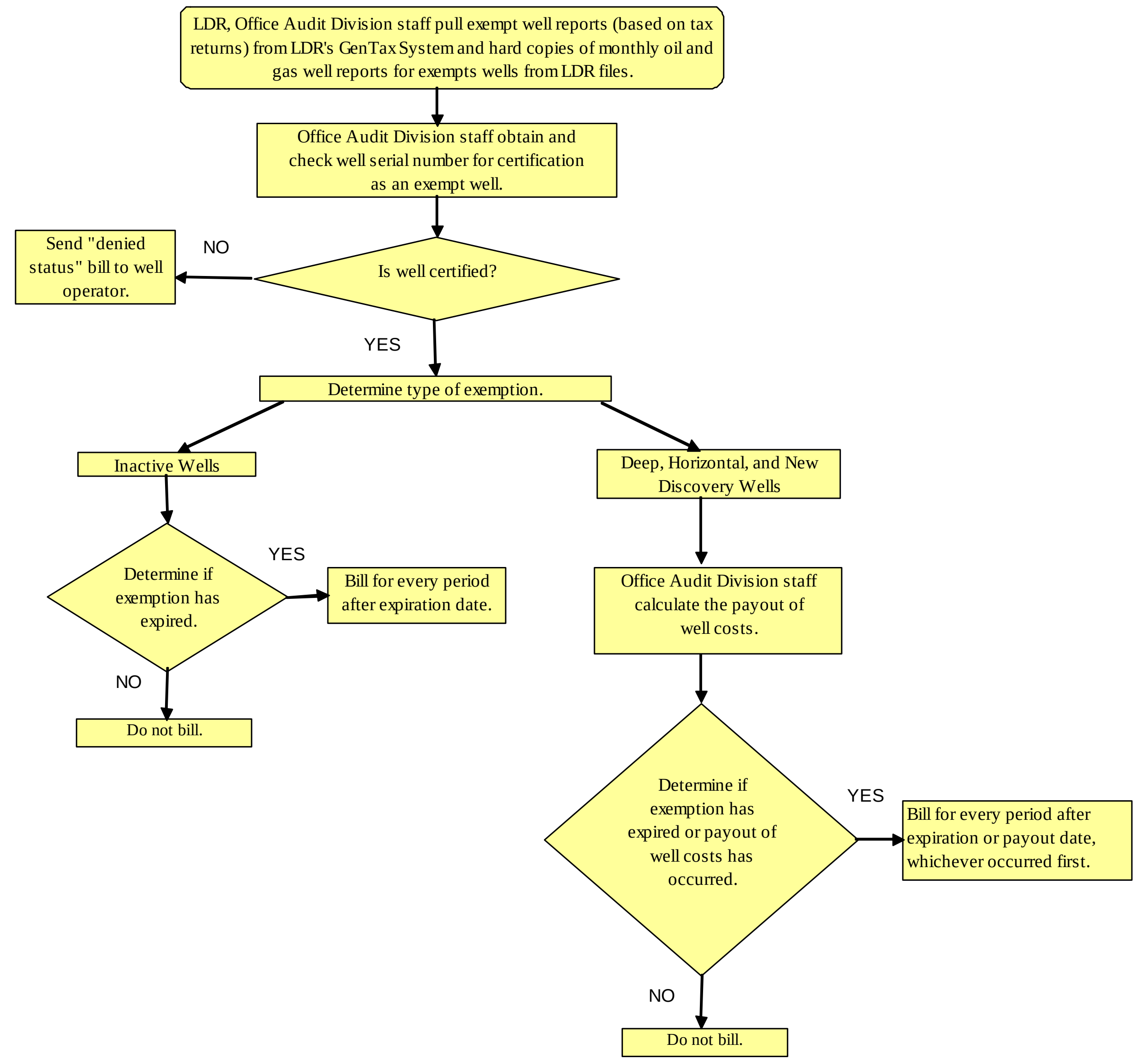
APPENDIX E: LDR, OFFICE AUDIT DIVISION'S AUDIT PROCESS FOR SEVERANCE TAX EXEMPT WELL RETURNS



Source: Created by legislative auditor's staff based on LDR documents and interviews with LDR staff.

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APPENDIX F: SUMMARY OF STATE SEVERANCE TAX INCENTIVES

States With Severance Tax Incentives for Inactive Wells
As of March 15, 2006

State	Type of Tax Incentive	Tax Reduction Period	Inactive Period	Trigger Price	Sunset
Arkansas (oil only)	Exemption	10 years	1 year	None	None
California	Exemption	10 years	5 years	None	None
Florida	Exemption	4 years	2 years	None	6/30/07*
Kansas	Exemption	10 years	3 years	None	Yes**
Kentucky (gas only)	Tax Credit	No time limit	2 years	None	None
Louisiana	Exemption	2 years; 5 years on or after 1/1/05	2 years	None	6/30/10
Mississippi (oil only)	Exemption (Expired)	3 years	2 years	$20/$25	7/1/03
Montana	Reduced Tax Rate	1 year	5 years	None	None
New Mexico	Exemption	10 years	2 years	$24	None
North Dakota (oil only)	Exemption	10 years	2 years	$39.36***	None
Oklahoma	Partial Tax Refund	28 months	1 year on or after 7/1/97	None	7/1/06
Texas	Exemption	10 years	2 years	None	2/28/10
West Virginia	Exemption	10 years	5 years	None	None
Wyoming	Partial Exemption	5 years	2 years	$25	Yes**

* Florida law says that no new exemptions will be granted after June 30, 2002.
** Kansas and Wyoming state laws do not provide for specific sunset dates, but requirements and other provisions set forth in the laws prevent the states from awarding any more incentives.
*** North Dakota's trigger price varies annually.
Source: Prepared by legislative auditor's staff based on research of state laws.

States With Severance Tax Incentives for Deep Wells
As of March 15, 2006

State	Type of Tax Incentive	Tax Reduction Period	Trigger Price	Sunset
Florida	Exemption	5 years	None	6/30/07*
Louisiana	Exemption	2 years or payout of well costs	None	None
Oklahoma	Partial Tax Refund	28 months, 4 years, or 5 years**	None	None

* Florida law says that no new exemptions will be granted after June 30, 2002.
** Oklahoma's tax reduction period varies according to well depth and date well was spudded.
Source: Prepared by legislative auditor's staff based on research of state laws.

States With Severance Tax Incentives for Horizontal Wells As of March 15, 2006				
State	**Type of Tax Incentive**	**Tax Reduction Period**	**Trigger Price**	**Sunset**
Florida	Exemption	5 years	None	6/30/07*
Louisiana	Exemption	2 years or payout of well costs	None	None
Montana	Reduced Tax Rate	1st 18 months of production	None	None
North Dakota (oil only)	Exemption	2 years	$39.36**	None
Oklahoma	Partial Tax Refund	2 years, 4 years, or project payback	None	7/1/06

* Florida law says that no new exemptions will be granted after June 30, 2002.
** North Dakota's trigger price varies annually.
Source: Prepared by legislative auditor's staff based on research of state laws.

States With Tax Incentives for New Discovery Wells As of March 15, 2006				
State	**Type of Tax Incentive**	**Tax Reduction Period**	**Trigger Price**	**Sunset**
Arkansas (oil only)	Tax Credit	5 years or 10 years	None	None
Florida	Exemption	5 years	None	6/30/07*
Kansas	Exemption	2 years	None	None
Louisiana	Exemption	2 years or payout of well costs	None	Yes**
Mississippi (oil only)	Exemption (Expired)	5 years	$25	7/1/03
Oklahoma	Partial Tax Refund	28 months	None	7/1/06
Utah	Exemption	1 year	None	None
Wyoming	Partial Exemption	4 years	None	Yes**

* Florida law says that no new exemptions will be granted after June 30, 2002.
** Louisiana and Wyoming laws do not provide for specific sunset dates, but requirements or other provisions set forth in the laws prevent the states from awarding any more incentives.
Source: Prepared by legislative auditor's staff based on research of state laws.

APPENDIX G: MANAGEMENT'S RESPONSES

DIVISION OF ADMINISTRATION
DEPARTMENT OF ECONOMIC DEVELOPMENT
DEPARTMENT OF NATURAL RESOURCES, OFFICE OF CONSERVATION
LOUISIANA DEPARTMENT OF REVENUE

State of Louisiana
DIVISION OF ADMINISTRATION
OFFICE OF THE COMMISSIONER

Kathleen Babineaux Blanco
GOVERNOR

Jerry Luke LeBlanc
COMMISSIONER OF ADMINISTRATION

November 20, 2006

Mr. Steve J. Theriot
Louisiana Legislative Auditor
1600 North Third Street
Baton Rouge, Louisiana 70802

Dear Mr. Theriot:

By letter of October 30, 2006, David Greer of your staff provided pages 1-23 of your draft audit report on the oil and natural gas severance tax exemption created by Act 2 of the 1994 Regular Legislative Session and asked for a written response on these findings.

Of these pages 2, 4, and 24 were blank and pages 1-10 and 13-24 make no reference to the Division of Administration. Pages 11-12 relate to the Biennial Economic Development Budget Report, which the Division of Administration administers through a contract with an academic economist at Louisiana Tech University. I have no comments on the factual statements in these pages.

With respect to the Recommendation 1 on page 12, I concur with this recommendation. The Division of Administration will work with Louisiana Economic Development to review this report once it is completed and will determine if it meets the requirements set forth by R.S. 51:935.1.B-D.

Given the limited nature and scope of the report as it pertains to the Division of Administration, I do not believe that an exit conference is necessary.

Sincerely,

Jerry Luke LeBlanc
Commissioner of Administration

JLL/rf

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State of Louisiana

DEPARTMENT OF ECONOMIC DEVELOPMENT

Kathleen Babineaux Blanco
Governor

Michael J. Olivier
Secretary

November 14, 2006

Mr. David K. Greer, CPA
Assistant Legislative Auditor and
Director of Performance Audit
Office of Legislative Auditor
Post Office Box 94397
Baton Rouge, Louisiana 70804-9397

Dear Mr. Greer:

RE: Performance Audit Report on the Oil and Natural Gas Severance Tax Exemptions created by Act 2 of the 1994 Regular Legislative Session

The Louisiana Department of Economic Development (LED) concurs with the two recommendations contained in the report pertaining to the department. Once the Biennial Unified Economic Development Budget Report is completed LED will review for compliance with Louisiana Revised Statute 51:935.1B.-D. LED will also consult with the Departments of Natural Resources and Revenue and the Division of Administration for any other action that may be necessary.

We appreciate the efforts of the Legislative Auditor in reporting on the severance tax exemptions created by Act 2 of the 1994 Regular Legislative Session.

Sincerely,

Sharon B. Perez
Undersecretary

SBP:WB:cs

Louisiana Legislative Auditor
Performance Audit Division

Office of the Legislative Auditor – Performance Audit Division
Recommendations Checklist

Instructions to Audited Agency: Please check the appropriate box below for each recommendation. A summary of your response for each of the following recommendations 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 (THAT APPLY TO DED)	AGREE	PARTIALLY AGREE	DISAGREE
Recommendation 1: Once it is completed, DOA and DED should review the final draft of the Biennial Unified Economic Development Budget Report to determine whether it meets the requirements set forth by R.S. 51:935.1.B.-D.	✓		
Recommendation 2: Once it is completed, DED should review the findings of the biennial report and determine what changes, if any, are needed to the programs covered in the report. In doing so, DED should work with the legislature to implement needed statutory changes.	✓		

State of Louisiana

KATHLEEN BABINEAUX BLANCO
GOVERNOR

SCOTT A. ANGELLE
SECRETARY

JAMES H. WELSH
COMMISSIONER OF CONSERVATION

DEPARTMENT OF NATURAL RESOURCES
OFFICE OF CONSERVATION

November 15, 2006

Office of Legislative Auditor
1600 North Third Street
P. O. Box 94397
Baton Rouge, LA 70804-9397
ATTN: Steve Theriot

RE: Performance Audit of the Severance Tax Relief Program (ACT 2 of 1994)

Dear Mr. Theriot:

Upon completion of your recent audit of our Severance Tax Relief Program I was glad to see that no major problems were found and all sampled applications were found to be processed and maintained correctly. In your review several recommendations were suggested to improve the program that this Office would like to address:

Recommendation 3 - suggested that the Office of Conservation "develop and adopt a comprehensive set of formal policies and procedures". The Office of Conservation "Partially Agrees" with that recommendation. This Office believes the current series of memos it has issued concerning the filing and processing of Severance Tax Relief applications has been and continues to be sufficient in applying the certification process. This Office will consider consolidating these memos into one Policy Memo in an attempt to satisfy this requirement.

Recommendation 4 - suggested that the new policies and procedures mentioned in Recommendation 3 be promulgated into rules and regulations. The Office of Conservation "Disagrees" with that recommendation. This Office believes, as outlined in our response to Recommendation 3, that a new consolidated policy memo will sufficiently address the issues of concern.

Recommendation 5 - suggested that the law (R.S. 47:633(7)(c)(iv) authorizing the inactive severance tax exemptions be amended to allow operators to file applications for exemption **<u>after</u>** production commences and in the interim to no longer approve applications filed **<u>after</u>** production begins. The Office of Conservation "Disagrees" with this recommendation. This Office believes that the current method of processing Severance tax relief applications is within the legislative intent of the law and changing this method would diminish the effectiveness of the program.

It was a pleasure working with your auditors and we appreciate your recommendations and look forward to addressing these issues.

Sincerely,

for JAMES H. WELSH
COMMISSIONER OF CONSERVATION

JHW:RTK:lck

cc: Scott Angelle - Secretary DNR

LDR
Louisiana Department of Revenue

November 28, 2006 **Hand Delivered**

Mr. Steve J. Theriot, CPA
Legislative Auditor
1600 North Third Street
Baton Rouge, LA

Dear Mr. Theriot:

The Louisiana Department of Revenue (LDR) welcomes the opportunity to respond to the Office of Legislative Auditor's performance audit report on the oil and natural gas severance tax exemptions created by Act 2 of the 1994 Regular Legislative Session. Below you will find LDR's response to the performance audit report's recommendations 6 through 9:

Recommendation 6:

LDR partially agrees with this recommendation. LDR's response to this recommendation is as follows:

1. LDR does not have sufficient personnel to audit all tax returns that are filed. LDR allocates staff to its auditing divisions based upon its' overall funding level. The auditing divisions within LDR promote voluntary compliance with the tax laws.

   The fact that a taxing jurisdiction has an auditing program and may audit any return at anytime is generally viewed as an encouragement for taxpayers to comply with the tax laws.

   It was recommended that LDR develop and adopt formal policies and procedures regarding the methodology for selecting which exempt wells to audit.

   LDR does not feel that it would be a wise decision to set forth in a formal written policy or procedure how it selects returns or exempt wells to audit. Taxpayers could gain access to such a document and it could potentially affect compliance with the tax laws.

2. LDR does agree that formal written procedures should be developed concerning how audits are to be conducted. These written procedures may be in the form of an audit manual or written policies.

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Baton Rouge, Louisiana 70802
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www.revenue.louisiana.gov

3. LDR does not feel that every audit, audit notice or assessment that is issued to a taxpayer by its' office audit division should be reviewed by a supervisor prior to the audit notice or assessment being sent to the taxpayer. LDR feels that its' management should determine supervisory review procedures. There are many variables that may determine whether or not supervisory review is warranted and/or necessary prior to sending an audit notice or assessment.

   LDR does agree that a certain level of supervisory review is warranted and/or required in auditing processes. LDR will develop a formal policy that will describe and/or outline supervisory review procedures involving exempt well audits.

Recommendation 7:

LDR partially agrees with this recommendation. LDR's response to this recommendation is as follows:

LDR agrees that if all pertinent information is available, the auditor should include all periods for that well up to the current period in the audit. This would be the most efficient use of the auditor's time and should allow the auditor to perform more audits.

However, in order to prevent certain tax periods from prescribing when additional taxes are due, LDR feels that it must perform audits for a one year period. This allows LDR to insure that certain tax liabilities do not prescribe.

Recommendation 8:

LDR agrees with this recommendation. LDR's response to this recommendation is as follows:

LDR's office audit division typically does not maintain documentation of returns that are reviewed or audited and the review or audit results when an audit notice or assessment is not issued to the taxpayer. This is especially true when it relates to reconciling third party information obtained by LDR and amounts reported on taxpayer's returns.

However, due to the importance/emphasis that the Louisiana Legislature has placed on monitoring the oil and natural gas severance tax exemptions created by Act 2 of the 1994 Regular Legislative Session, LDR agrees that it will keep documentation of all exempt well audits conducted by its staff.

Recommendation 9:

LDR disagrees with this recommendation. LDR's response to this recommendation is as follows:

It was recommended that field audits should contain exempt well information in an easily retrievable manner in order to document which of its audits encompass exempt well, as well as the results of those audits.

This recommendation would substantially change the manner in which LDR conducts oil and natural gas severance tax field audits. It would increase the time required to perform these audits and reduce the number of oil and natural gas tax field audits performed by LDR.

Therefore, LDR cannot agree with this recommendation. However, LDR will modify its' oil and natural gas severance tax field audit comments form. LDR will include a section for the auditor to indicate which oil and gas severance tax exemptions created by Act 2 of the 1994 Regular Session were examined during the course of the field audit.

If I can be of further assistance or if you should have any questions, please contact me.

Sincerely,

Kurt Van Brocklin

Kurt Van Brocklin
Assistant Secretary
Group III

c: Secretary Cynthia Bridges

Louisiana Legislative Auditor
Performance Audit Division

Office of the Legislative Auditor – Performance Audit Division
Recommendations Checklist

Instructions to Audited Agency: Please check the appropriate box below for each recommendation. A summary of your response for each of the following recommendations 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 (THAT APPLY TO LDR)	AGREE	PARTIALLY AGREE	DISAGREE
Recommendation 6: LDR's Office Audit Division should continue to work towards developing and adopting formal policies and procedures related to the audit function over severance tax exemptions. The policies and procedures should address, at a minimum, the following:			
• The methodology for selecting which exempt wells to audit			x
• How audits are to be conducted	x		
• Supervisory review of audit work		x	
• Documenting audit work (See No. 8)			
• Coordination with DNR (Will be deleted)			
Recommendation 7: When Office Audit Division auditors find that a well operator has continued to take a tax exemption after the exemption has expired, the auditors should examine tax information for that well up to the current year and bill the operator for all unpaid severance taxes at that time instead of waiting until subsequent years to bill the operator.		x	

Recommendation 8: The Office Audit Division should continue implementing its tracking procedures for audits and begin to keep documentation of all exempt well audits its staff conducts, even when the audits do not result in tax bills. In addition, the division should collect and maintain data on all phases of the audit process. Management of LDR should use this information to evaluate the audits conducted by the division.	x		
Recommendation 9: The Field Audit Services Division should maintain its exempt well audit information in an easily retrievable manner in order to document which of its audits encompass exempt-wells, as well as the results of those audits. The division's data, along with data from the Office Audit Division's audits, should provide a complete picture of LDR's exempt well audits.			x