Proposition 87

Alternative Energy. Research, Production, Incentives. Tax on California Oil. Initiative Constitutional Amendment and Statute.

Background

California Oil Production. In 2005, California's estimated oil production (excluding federal offshore production) totaled 230 million barrels of oil—an average of 630,000 barrels per day. California's 2005 oil production represents approximately 12 percent of U.S. production, making California the third largest oil-producing state, behind Texas and Alaska. Oil production in California peaked in 1985, and has declined, on average, by 2 percent to 3 percent per year since then. In 2005, California oil production supplied approximately 37 percent of the state's oil demand, while Alaska production supplied approximately 21 percent, and foreign oil supplied about 42 percent.

Virtually all of the oil produced in California is delivered to California refineries. In 2005, the total supply of oil delivered to oil refineries in California was 674 million barrels, including oil produced in California as well as outside the state. Of the total oil refined in California, approximately 67 percent goes to gasoline and diesel (transportation fuels) production.

Oil-Related Taxation in California. Oil producers pay the state corporate income tax on profits earned in California. Oil producers also pay a regulatory fee to the Department of Conservation (which regulates the production of oil in the state) that is assessed on production, with the exception of production in federal offshore waters. This regulatory fee is used to fund a program that, among other activities, oversees the drilling, operation, and maintenance of oil wells in California. Currently, producers pay a fee of 6.2 cents per barrel of oil produced, which will generate total revenues of $14 million in 2006-07. Additionally, property owners in California pay local property taxes on the value of both oil extraction equipment (such as drills and pipelines) as well as the value of the recoverable oil in the ground.

Proposal

Severance Tax on Oil Production in California. Beginning in January 2007, the measure would impose a severance tax on oil production in California to generate revenues to fund $4 billion in alternative energy programs over time. (The term "severance tax" is commonly used to describe a tax on the production of any mineral or product taken from the ground, including oil.) The measure defines "producers," who are required to pay the tax, broadly to include any person who extracts oil from the ground or water, owns or manages an oil well, or owns a royalty interest in oil.

The severance tax would not apply to federal offshore production beyond three miles from the coast. The measure is unclear as to whether the severance tax would

apply to oil production on state-owned lands (which includes offshore production within three miles of the coast) or production on federal lands in the state. Additionally, the severance tax would not apply to oil wells that produce less than ten barrels of oil per day, unless the price of oil at the well head was above $50 per barrel. At current prices and levels of production, the tax would apply to about 230 million barrels of oil produced in the state annually if state and federal lands are included, or about 200 million barrels of oil production annually if they are not included.

Tax Rate Structure. The measure states that the tax would be "applied to all portions of the gross value of each barrel of oil severed as follows:"

- 1.5 percent of the gross value of oil from $10 to $25 per barrel;
- 3.0 percent of the gross value of oil from $25.01 to $40 per barrel;
- 4.5 percent of the gross value of oil from $40.01 to $60 per barrel; and
- 6.0 percent of the gross value of oil from $60.01 per barrel and above.

The wording of the measure regarding the application of the tax rates could be interpreted in two different ways. On one hand, it could be interpreted such that the tax would be applied on a *single rate* basis on the *full* gross value of oil per barrel. For example, if the gross value is $70 per barrel, the tax would be applied at a rate of 6.0 percent on the full $70—yielding a tax of $4.20 per barrel. On the other hand, it could be interpreted to apply on a *marginal rate* basis similar to the income tax. For example, if the gross value is $70 per barrel, the first $10 is not taxed, the value from $10 to $25 is taxed at 1.5 percent, and so on—yielding a tax of $2.17 per barrel.

In general, for a given period of time, the single rate interpretation would generate twice as much tax revenue as would the marginal rate interpretation. The issue of the application of the tax would presumably be resolved by regulations adopted by the California State Board of Equalization (BOE) and interpretation by the courts.

Passing Along the Cost of the Tax to Consumers. The measure states that producers would not be allowed to pass on the cost of this severance tax to consumers through increased costs for oil, gasoline, or diesel fuel. The BOE is charged with enforcing this prohibition against passing on the cost of the tax. While it may be difficult to *administratively* enforce this provision (due to the many factors that determine oil prices), economic factors may also limit the extent to which the severance tax is passed along to consumers. For example, the global market for oil means that California oil refiners have many options for purchasing crude oil. As a result, oil refiners facing higher-priced oil from California producers could, at some point, find it cost-effective to purchase additional oil from non-California suppliers, whose oil would not be subject to this severance tax.

Term of the Tax. The measure directs that the new California Energy Alternatives Program Authority (Authority), discussed below, shall spend $4 billion for specified purposes within ten years of adopting strategic plans to implement the measure. The

revenues are to be used for new spending (that is, they cannot be used to replace current spending). Under the measure, the Authority has the ability to raise program funds in advance of collecting severance tax revenues by selling bonds that would be paid back with future severance tax revenues.

The severance tax would expire once the Authority has spent $4 billion and any bonds issued by the Authority are paid off. The length of time that the tax would be in effect will depend on several factors, including the interpretation of the tax rate, the future price and production of oil, and decisions about using bonds. Because the measure directs the new authority to spend $4 billion within ten years, the tax will be in effect at least long enough to generate this amount of revenue and longer if bonds are issued.

Depending on these variables, the term of the tax would range from less than ten years to several decades. For example, the shorter period would result under the single tax rate and/or higher oil prices and production levels. Alternatively, a longer period would result under the marginal tax rate and/or lower oil prices and production.

Tax Revenues to be Deposited in New Special Fund. The proceeds of the severance tax would be deposited in a new fund created by the measure, the California Energy Independence Fund. These revenues would not be eligible for loan or transfer to the state's General Fund and would be continuously appropriated (and thus, not subject to the annual state budget appropriation process).

Reorganized State Entity to Spend the Tax Revenues. The measure would reorganize an existing body in state government, the California Alternative Energy and Advanced Transportation Financing Authority, into a new California Energy Alternatives Program Authority (Authority). This reorganized authority would be governed by a board made up of nine members, including the Secretary for Environmental Protection, the Chair of the State Energy Resources Conservation and Development Commission, the Treasurer, and six members of the public who have specific program expertise, including: economics, public health, venture capital, energy efficiency, entrepreneurship, and consumer advocacy. The Authority is required to develop strategic plans and award funds to encourage the development and use of alternative energy technologies. The board would appoint a staff to administer various programs specified in the measure.

One of the stated *goals* of the measure, to be achieved through the various programs funded by it, is to reduce the use of petroleum in California by 25 percent from 2005 levels by 2017. The *actual* reduction would depend on the extent to which the measure was successful in developing and promoting—and consumers and producers used—new technologies and energy efficient practices.

Allocation of Funds. The funds generated from the severance tax, as well as any bonding against future severance tax revenues, would be allocated as follows, after first covering debt-service costs and expenses to collect the severance tax:

- *Gasoline and Diesel Use Reduction Account (57.50 Percent)*—for incentives (for example, consumer loans, grants, and subsidies) for the purchase of alternative fuel vehicles, incentives for producers to supply alternative fuels, incentives for the production of alternative fuel infrastructure (for example, fueling stations), and grants and loans for private research into alternative fuels and alternative fuel vehicles.
- *Research and Innovation Acceleration Account (26.75 Percent)*—for grants to California universities to improve the economic viability and accelerate the commercialization of renewable energy technologies and energy efficiency technologies.
- *Commercialization Acceleration Account (9.75 Percent)*—for incentives to fund the start-up costs and accelerate the production and distribution of petroleum reduction, renewable energy, energy efficiency, and alternative fuel technologies and products.
- *Public Education and Administration Account (3.50 Percent)*—for public education campaigns, oil market monitoring, and general administration. Of the 3.5 percent, at least 28.5 percent must be spent for public education, leaving a maximum of 71.5 percent of the 3.5 percent (or roughly 2.5 percent of total revenues) for the Authority's administrative costs.
- *Vocational Training Account (2.50 Percent)*—for job training at community colleges to train students to work with new alternative energy technologies.

Fiscal Effects

New State Revenues to Be Used for Dedicated Purposes. Our estimates below are based on 2005 oil production levels and the average price of oil for the first six months of 2006. The severance tax would raise from about $225 million to $485 million annually. The level of revenue generated would depend both on (1) whether the tax was interpreted using the marginal rate interpretation or the single rate interpretation and (2) whether oil production on state and federal lands is taxed. However, *actual* revenues collected under the measure will depend on both future oil prices and oil production in the state. As these variables are difficult to predict, there is uncertainty as to the level of revenue collections.

State and Local Administrative Costs to Implement the Measure. Because programs of the size and type to be overseen by the Authority have not been undertaken before in the area of transportation fuels, the administrative costs to the Authority to carry out the measure are unknown. Under the provisions of the measure, up to 2.5 percent of revenues in the new fund would be available to the Authority for its general administration costs. This would on average set aside from about $5 million to $12 million annually for administration. The amount of administrative funds available would depend both on (1) whether the tax was interpreted using the marginal rate

interpretation or the single rate interpretation and (2) whether oil production on state and federal lands is taxed.

Costs to BOE to collect the severance tax and administrative costs associated with the issuance and repayment of bonds by the Treasurer's Office are not counted as part of the Authority's administration budget and are to be paid from the severance tax revenues. Additionally, in oil-producing counties, local administrative costs would increase by an unknown but probably minor amount, due to increased reassessment activity by local property tax assessors to account for the effects of the severance tax on oil-related property values.

Reduction in Local Property Tax Revenues. Local property taxes paid on oil reserves would decline under the measure relative to what they otherwise would have been, to the extent that the imposition of the severance tax reduces the value of oil reserves in the ground and its assessed property value for tax purposes. Although the exact size of this impact would depend on future oil prices, which determine both the severance tax rate and the value of oil reserves, it would likely not exceed a few million dollars statewide annually.

Reduction in State Income Tax Revenues. Oil producers would be able to deduct the severance tax from earned income, thus reducing their state income tax liability under the personal income tax or corporation tax. The extent to which the measure would reduce state income taxes paid by oil producers would depend on various factors, including whether or not an oil producer has taxable income in any given year, the amount of such income that is apportioned to California, and the tax rate applied to such income. We estimate that the reduction would likely not exceed $10 million statewide annually.

Potential Reduction in State Revenues From Oil Production on State Lands. The state receives a portion of the revenues from oil production on state lands, including oil produced within three miles of the coast. If the measure is interpreted to apply to production on these state lands, then the severance tax would reduce state General Fund revenues by $7 million to $15 million annually, depending on whether the measure is interpreted using the marginal rate or the single rate.

Potential Reductions in Fuel Excise Tax and Sales Tax Revenues. The measure could change both the amount and mix of fuels used in California, and thus excise and sales tax revenues associated with them. For example, to the extent that the programs funded by the measure are successful in reducing the use of oil for transportation fuels, it would reduce to an unknown extent the amount of gasoline and diesel excise taxes paid to the state and the sales and use taxes paid to the state and local governments. These reductions would be partially offset by increased taxes paid on alternative fuels, such as ethanol, to the extent that the measure results in their increased use.

Potential Indirect Impacts on the Economy. In addition to the direct impacts of the measure, there are potential indirect effects of the measure that could affect the level of economic activity in the state.

On the one hand, by increasing the cost of oil production, the severance tax could reduce production, reduce investment in new technologies to expand production, and/or modestly increase the cost of oil products to Californians. This could have a negative impact on the state's economy.

On the other hand, using revenues from the severance tax to invest in new technologies may spur economic development in California. This would occur to the extent that new technologies supported by the measure are developed and/or manufactured in the state. This could have a positive impact on the state's economy.

Taken together, these economic factors could have mixed impacts on state and local tax revenues.