January 31, 2012

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative measure concerning an oil and natural gas severance tax (A.G. File No. 11-0096, Amdt. #1S).

Background

Taxation of Oil and Natural Gas in California. Oil and natural gas producers pay state income taxes. Oil producers also pay a regulatory charge on production in the state or in state waters. Also, property owners pay local property taxes on the value of both extraction equipment such as drills and pipelines and underground oil and gas reserves.

Higher Education Funding. The State Constitution gives the power to appropriate (that is, authorize the spending of state funds) to the Legislature. The Legislature determines each year how much state tax funding to appropriate to the California State University (CSU), the University of California (UC), and California community college districts. Proposition 98 (1988) sets a minimum amount to be provided from state and local funds for school and community college districts each year, but this guarantee does not apply to UC and CSU. By a two-thirds vote of the Senate and the Assembly, the Legislature may suspend the Proposition 98 minimum funding guarantee in any given year.

Proposal

Oil and Gas Severance to Be Taxed at 12.5 Percent. Starting July 1, 2013, this measure would impose a severance tax of 12.5 percent on the value of all oil and natural gas extracted in California or its state offshore waters, which extend out three miles from the coastline. Oil and natural gas produced in federal waters would be exempt from the tax. The tax would be administered by the State Board of Equalization.

Measure Prohibits Pass Through of Tax to Consumers. The measure states the severance tax may not be passed through to consumers in the form of higher prices for oil, natural gas, or related products. The State Auditor (a non-partisan state official that reviews the management of public programs) shall monitor and investigate such price increases. The Superintendent of

Public Instruction (a statewide public official) would be able to instruct the State Auditor to undertake such investigations.

Increased General Fund Revenues. Two-thirds of the severance tax revenues would be deposited into the state's General Fund. General Fund revenues are available to be appropriated for any public purpose. Pursuant to Proposition 98, approximately 40 percent to 50 percent of these new revenues would go to an increased minimum funding guarantee.

Funding for Higher Education. This measure places the remaining one-third of the severance tax revenues into the newly created California Higher Education Fund (CHEF). This fund would be continuously appropriated as follows:

- 50 percent to the CSU system.
- 25 percent to the UC system.
- 25 percent to California community colleges districts.

Financial Aid Requirements. At least 10 percent of the money allocated to CSU would have to be used to increase grants available to California students attending its campuses. The CSU would be required to allocate part of its portion of the CHEF to campuses with nursing programs in the counties determined to have the most need.

Possible Limits on Future Funding Levels for Higher Education. The measure states that money from the CHEF must be used to supplement, not supplant, existing levels of state funding for CSU, UC, and community college districts collectively.

Fiscal Effects

Severance Tax Revenues. Initially, the proposed severance tax would likely generate annually around $3 billion—$2 billion for the General Fund and around $1 billion for the CHEF. A wide range of revenues, however, is possible due to the normal fluctuation in oil and gas prices. Of the General Fund revenues, roughly half would increase the minimum guarantee, likely resulting in additional state funding for schools and community colleges. The remaining General Fund revenues would be available to spend on any public purpose.

Increased Administrative Costs. The state would have increased costs associated with the administration of the severance tax. These likely would total several million dollars annually.

Other Fiscal Effects. Relatively minor economic changes related to the severance tax likely would result in reductions of other state and local revenues such as property and income taxes—perhaps totaling in the low tens of millions of dollars per year. For example, an oil company with lower profits would pay less tax.

Summary of Fiscal Effects. This measure would have the following major fiscal effects:

- Increased state revenues of about $3 billion per year initially, with two-thirds (about $2 billion) going to the state General Fund and one-third (about $1 billion) allocated to specific higher education purposes.

- Of the General Fund revenue increase, roughly half would likely go to higher funding for schools and community college districts, with the remainder available for any state purpose.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance