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January 25, 2006

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the proposed initiative File No. SA2005RF0137, Amendment #2-S, the Clean Alternative Energy Act (version one).

Background

California Oil Production. In 2004, California's onshore and offshore oil production totaled 268 million barrels of oil—an average of approximately 733,000 barrels per day. California's 2004 oil production (excluding federal offshore 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 4 percent to 5 percent per year since then. California oil production supplies approximately 42 percent of the state's oil demand, with Alaska production supplying approximately 22 percent, and foreign oil supplying about 36 percent.

Virtually all of the oil produced in California is delivered to California refineries. In 2004, the total supply of oil delivered to oil refineries in California was 655 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. Currently, producers pay a fee of 5.3 cents per barrel of oil produced, which will generate total revenues of $13.8 million in 2005-06. 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. (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 oil production on state lands (which includes offshore production within three miles of the coast) and would not apply to federal production (offshore production beyond three miles from the coast and 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 ("stripper wells"), unless the price of oil at the well head was above $50 per barrel. At current levels of production, the tax would apply to about 165 million barrels of oil produced in the state annually.

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.
- 6.0 percent of the gross value of oil above $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. Specifically, it is unclear whether the tax would be applied at a constant rate 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) or rather, applied on a marginal 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). The issue of interpretation would presumably be resolved by regulations adopted by the California State Board of Equalization (BOE) and any related litigation.

According to the measure, the cost of the severance tax is to be borne only by the producers of oil. 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. However, it is unclear the extent to which BOE would be able to enforce

this statutory prohibition, given the difficulties in determining what portion of a potential price increase on oil and related products is due to the imposition of the severance tax, as opposed to other costs of 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 subject to the state appropriations limit, 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 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 of the California Environmental Protection Agency, the Chair of the California Energy 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 board would appoint a staff to administer various programs specified in the measure. The Authority is required to develop strategic plans, adopt procedures and standards for awarding incentives to encourage the development and use of alternative energy technologies, and award incentives based on the allocation of the revenues from the new severance tax provided by the measure and discussed below.

The stated *goal* 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, and thereafter to reduce petroleum use by an additional 25 percent every ten years, until petroleum use in California is negligible. The *actual* reduction would depend on the extent to which the measure was successful in promoting, and consumers and producers adopted, new technologies and energy efficient practices.

The Authority would have the power to issue bonds, which would be used to fund the various programs created under the measure, and which would be paid back with future revenues from the severance tax.

Allocation of Funds. The measure authorizes the Authority to spend $4 billion over its first ten years of operation. The funds generated from the severance tax and 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 market-based incentives (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 of petroleum reduction, renewable energy, energy efficiency, and alternative fuel technologies.
- 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 Effect

New State Revenues to Be Used for Dedicated Purposes. The measure creates a severance tax on oil production. Based on current oil production and prices, and depending on how the measure is interpreted, it would raise annually either about $200 million (under the marginal tax rate interpretation) or about $380 million (under the constant tax rate interpretation) in new state revenues. However, *actual* revenues collected under the measure will depend on both oil prices and oil production in the state, and the effects of the initiative on them. As these variables are difficult to predict, there is uncertainty as to the level of revenue collection. The revenues are to be used for new spending (that is, they cannot be used to supplant current spending) for a number of specified incentive programs, including programs intended to reduce energy use in the state, particularly petroleum use.

State and Local Administrative Costs to Implement the Measure. 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. 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 imposed by the measure on the Authority are unknown. 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, local administrative costs would increase, by an unknown amount, in oil-producing counties 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, to the extent that the imposition of the severance tax reduces the value of oil reserves in the ground and therefore their assessed property value for tax purposes. The size of this impact is unknown and would depend on the price of oil, which determines both the severance tax rate and the value of oil reserves. Under certain circumstances, existing law requires the state to offset reductions in property tax revenues experienced by K-14 school and community college districts. To the extent that this measure reduces property tax revenues to these districts, the measure could increase, by an unknown amount, state funding obligations for education.

Reduction in Income Tax Revenues. Oil producers would be able to deduct the severance tax from earned income, thus reducing their income tax liability under the personal income tax or corporation tax. The extent to which the measure would reduce income taxes paid by oil producers is unknown, as it 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.

Potential Reduction in Gasoline and Diesel Excise and Sales Tax Revenues. To the extent that the programs funded by the measure are successful in reducing the use of oil for transportation fuels, it would reduce the amount of gasoline and diesel excise taxes paid to the state. Similarly, it would reduce sales and use taxes paid to the state and local governments, under certain conditions. These impacts would be offset, to an unknown degree, by increased sales and excise taxes paid on alternative fuels, to the extent that the measure results in an increased use of alternative fuels that are subject to these taxes.

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 change the level of economic activity in the state, thereby affecting state and local revenues. For example, by increasing the cost of oil production, the imposition of the severance tax could result in reduced production and/or reduced investment in new technologies to expand production. The impact on oil production and investment would vary depending on each oil producer's rate of return and the measure's impact on it. To the extent that the

measure reduces investment in oil production, the measure could result in a reduction in economic activity, reflected, for example, in a reduction in jobs and/or capital purchases related to the oil industry. Additionally, if the measure results in reduced oil production, over the long term it could increase the price of oil, which could also reduce economic activity. Any negative impact on the economy will potentially reduce state and local revenues through reduced personal income, corporation, and sales taxes.

On the other hand, using revenues derived from the severance tax to invest in new technologies may spur economic development in California. To the extent that new technologies supported by the measure are developed and/or manufactured in the state, the benefits to the economy from this development may offset, to an unknown extent, any negative economic impacts of the measure.

Summary

In summary, the initiative would have the following fiscal effects:

- New state revenues annually—depending on the interpretation of the measure's tax rate provisions—of either about $200 million or about $380 million from the imposition of a severance tax on oil production, to be used to fund a variety of new alternative energy programs.
- Reductions of unknown amounts in: local revenues from property taxes paid on oil reserves, potentially partially offset by state payments to schools to make up their revenue loss; state revenues from income taxes paid by oil producers; and, potentially, state and local revenues from gasoline and diesel excise and sales taxes.

Sincerely,

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Elizabeth G. Hill
Legislative Analyst

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Michael C. Genest
Director of Finance