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Proposition 87
The Clean Alternative Energy Act

LEGISLATIVE ANALYST'S OFFICE

Presented To:
Senate Energy, Utilities and Communications Committee
Hon. Martha Escutia, Chair

Senate Revenue and Taxation Committee
Hon. Mike Machado, Chair

Assembly Utilities and Commerce Committee
Hon. Lloyd Levine, Chair

Assembly Revenue and Taxation Committee
Hon. Johan Klehs, Chair

Assembly Natural Resources
Hon. Loni Hancock, Chair

Summary and Background

Summary

- Proposition 87 would impose a severance tax on oil production in California. The proceeds of this tax would be used to fund a $4 billion program (over time) to support the use of alternative fuels and energy efficiency technologies. The program's goal is to reduce oil consumption in California by 25 percent within ten years.

California Oil Production and Oil-Related Taxation

- In 2005, California onshore oil production totaled 230 million barrels, making California the third largest U.S. producer.
- California oil production peaked in 1985, and has declined on average by 2 percent to 3 percent per year since then.
- California oil production supplied 37 percent of the state's oil demand in 2005, with 21 percent from Alaska, and 42 percent from foreign sources.
- About 67 percent of the oil refined in California is used for gasoline and diesel fuel.
- Oil producers in California pay a regulatory fee to the Department of Conservation of 6.2 cents per barrel, yielding approximately $14 million in 2006-07.
- Oil producers also pay the income or corporation tax (on California profits) and property taxes on the value of both oil extraction equipment (such as drills and pipelines) and oil reserves in the ground.

Proposition 87's Provisions

New Severance Tax

- Proposition 87 would impose a severance tax on oil production in the state, beginning in January 2007.
- The measure would not apply to federal offshore production (beyond three miles from the coast).
- The measure is ambiguous as to whether the tax would apply to production on state-owned lands, including tidelands (between the coast and the three-mile limit), or on federal onshore lands.
- At current levels of production, the severance tax annually would apply to approximately 230 million barrels if state and federal lands are included, or 200 million barrels if they are not.

Severance Tax Rate

- The severance tax would be applied "to all portions of the gross value of each barrel of oil severed" (gross value is generally the sale price of oil at the well head) according to the following schedule:
  - 1.5 percent of the gross value from $10 to $25 per barrel;
  - 3 percent of the gross value from $25 to $40 per barrel;
  - 4.5 percent of the gross value from $40 to $60 per barrel;
  - 6 percent of the gross value from $60 and above.
- "Stripper wells" (wells that produce less than 10 barrels per day) would only be taxed if the price was above $50 per barrel (at a rate of 3 percent).

Proposition 87's Provisions *(Continued)*

☑ ***Ambiguity in the Tax Rate Language.*** The measure is ambiguous as to how the tax will be applied. The interpretation of the tax rate will be determined initially by the Board of Equalization (BOE), with potential intervention by the courts. The tax could be interpreted in two ways:

- **Single Rate.** The same rate is applied to the entire barrel. For example, if the price of oil is $70 per barrel, the tax is 6.0 percent of the full $70, or $4.20 per barrel.
- **Marginal Rate.** The rate is applied in steps, as is the income tax. For example, if the price is $70, the tax is applied in four steps (1.5 percent on the value between $10 and $25, 3.0 percent on the value from $25 to $40, and so on), yielding a total tax of $2.17 per barrel.

☑ ***Prohibition Against Passing Along the Cost of the Tax to Consumers.*** The measure states that the cost of the severance tax may not be passed along to consumers in the form of higher prices for oil, gasoline, or diesel fuel. There are two potential mechanisms that may work to enforce this provision:

- **Regulatory Enforcement.** The BOE is given the responsibility under the measure to ensure that the cost of the tax is not passed along to consumers. However, given the financial complexity of the oil market, it will be difficult to enforce this provision on a regulatory basis.
- **Economic Enforcement.** Given the possibility that refiners could substitute non-California oil that is not subject to this severance tax, California producers may be limited in their ability to raise prices paid by refiners, thereby preventing producers from passing along the cost of the tax.

Proposition 87's Provisions *(Continued)*

- ☑ ***Term of the Tax.*** The measure directs the state to spend $4 billion on alternative energy programs within ten years. The new severance tax will be in effect at least long enough to generate $4 billion, and longer if bonds are sold to finance program expenditures, as is authorized by the measure. The length of time that the tax would be in effect will depend on many factors, including future oil prices, the interpretation of the tax rate, and decisions about using bonds. The term of the tax could range from less than ten years to several decades.

- ☑ ***Tax Proceeds Continuously Appropriated.*** The revenues from the tax and any associated bonds would be deposited into a new special fund, would be continuously appropriated, and would not be available for loan or transfer to the General Fund.

- ☑ ***Revised State Entity to Implement Program Using the Tax Proceeds.*** The measure would revise the existing California Alternative Energy and Advanced Transportation Financing Authority into a new California Energy Alternatives Program Authority. The nine-member board of this new authority would be made up of the Secretary for Environmental Protection, the Chair of the Energy Commission, the Treasurer, and six appointed members of the public who have expertise in specific areas. The new authority is required to award funds to encourage the development and use of alternative energy and energy efficiency technologies.

Proposition 87's Provisions *(Continued)*

Allocation of Tax Proceeds. The tax proceeds, after paying the costs for debt service and collecting the tax, would be distributed for the following purposes:

- **Gasoline and Diesel Use Reduction (57.50 Percent)**—For incentives to purchase alternative fuel vehicles, incentives for producers to provide alternative fuels, incentives for the development of alternative fuel infrastructure, and grants and loans for private research.
- **Research and Innovation Acceleration (26.75 Percent)**—For research grants to California universities to accelerate the commercialization of alternative energy and energy efficiency technologies.
- **Commercialization Acceleration (9.75 Percent**)—For incentives to offset production and distribution start-up costs to accelerate the commercialization of alternative energy and energy efficiency technologies.
- **Public Education and Administration (3.50 Percent)**—For public education, market monitoring, and general administration (2.50 percent of total revenues).
- **Vocational Training (2.50 Percent)**—For job training related to alternative energy technologies at community colleges.

Fiscal Impacts of Proposition 87

- ☑ ***New State Revenues for Dedicated Purposes.*** Based on current levels of oil production and average oil prices for the first half of 2006, the severance tax would raise from $225 million to $485 million annually, depending on how the ambiguities in the measure are interpreted. These revenues would be dedicated to specified alternative energy programs.

- ☑ ***Administrative Costs.*** The administrative budget for the program is limited to 2.5 percent of revenues, or $5 million to $12 million per year. Costs to collect the severance tax are excluded from this cap on administrative costs. In addition, there will likely be minor costs to local property tax assessors in oil producing counties to cover increased assessment activity.

- ☑ ***Reduction in Local Property Tax Revenues.*** The value of oil reserves would decline under the tax, which in turn could reduce local property tax revenues. The impact of the measure will depend in large part on oil prices, but will not likely exceed a few million dollars per year.

- ☑ ***Reduction in State Income Tax Revenues.*** Oil producers could deduct the cost of the severance tax from earned income, reducing their personal income tax or corporation tax liability. The extent of this reduction would depend on each taxpayer's initial tax liability, the extent to which income is apportioned to California, and the tax rate. We estimate the reduction in state tax revenues will not exceed $10 million per year.

- ☑ ***Potential Reduction in State Revenues From Oil Production on State Lands.*** The state receives revenues (in the form of lease and royalty revenues) from oil production on state lands, primarily oil produced from "tidelands" between the coast and the three-mile limit. If the severance tax is applied to state lands, state General Fund revenues would decline by about $7 million to $15 million per year.

Fiscal Impacts of Proposition 87 *(Continued)*

Potential Reductions in Fuel Excise Tax and Sales Tax Revenues. If the measure is successful in reducing the use of oil-based fuels in the state, this would reduce the taxes paid on these fuels. On the other hand, there may be increased revenues from other alternative fuels, to the extent that these alternative fuels are taxed.

Potential Indirect Impacts on the Economy. There could be indirect impacts from the measure that could have mixed impacts on the state's economy, and thus on state and local tax revenues.

- On the one hand, by increasing the cost of oil production, the severance tax could reduce future oil production, reduce investments in new production, and/or modestly increase the cost of oil products in California, all of which could have negative impacts on the state's economy.

- On the other hand, using the severance tax revenues to invest in new technologies may spur economic development in the state, to the extent that these technologies are developed and/or manufactured in the state.