Proposition 87
"Clean Alternative Energy Act"
November 7, 2006 General Election Ballot

STATE BOARD OF EQUALIZATION
LEGISLATIVE AND RESEARCH DIVISION

PROPOSITION SUMMARY

Proposition 87 would impose an oil severance assessment on producers of oil extracted in California at the rate of one and one-half percent (1.5%) to six percent (6%), depending upon the gross value of a barrel of oil. The proposed new assessment would be administered by the State Board of Equalization (Board).

This analysis is limited in scope to the Board's administration of the proposed new assessment.

ANALYSIS

Current Law

Under current law, the following taxes, fees, and assessments relating to oil are imposed:

Regulatory Assessment. The Division of Oil, Gas, and Geothermal Resources of the Department of Conservation imposes a fee on producers of oil, currently at a rate of 6.2 cents per barrel of oil produced. The fees are assessed for purposes of financing the regulatory work of that division. (Article 7 (commencing with Section 3400) of Chapter 1 of Division 3 of the Public Resources Code.)

Property Tax. Under Property Tax Law, with respect to oil in the ground, "proved reserves" are subject to property tax assessment by county assessors (Property Tax Rule 468). In this respect, for property tax purposes, Public Resources Code Section 3234 gives both county assessors and the Board access to monthly production reports related to the regulatory assessment filed with the Department of Conservation by oil well owners pursuant to Public Resources Code Section 3227.

Oil Spill Prevention and Administration Fee. Existing law also imposes an Oil Spill Prevention and Administration Fee of $0.05 per barrel upon persons owning crude oil when it is received at a marine terminal from within the state, which is collected by the marine terminal operator. The fee is also imposed on operators of pipelines transporting oil into the state across, under, or through marine waters. This Board-administered fee is deposited into the Oil Spill Prevention and Administration Fund. (Part 24 (commencing with Section 46001 of Division 2 of the Revenue and Taxation Code.)

Sales and Use Tax. Currently, the Sales and Use Tax Law (Part 1 (commencing with Section 6001) of Division 2 of the Revenue and Taxation Code) imposes a sales or use tax on the gross receipts from the retail sale of, and on the sales price of, tangible personal property, unless specifically exempted by statute. Under existing law, retail sales of motor vehicle fuel (gasoline) and diesel fuel, are subject to sales or use tax.

Existing law expressly includes within the definitions of "gross receipts" and "sales price" the amount of any tax imposed by the United States upon producers and importers, and the amount of any tax imposed by the state under the Motor Vehicle Fuel Tax Law (Part 2 (commencing with Section 7301) of Division 2 of the Revenue and Taxation Code). The law expressly *excludes* from the definitions of "gross receipts" and "sales price" the amount of any tax imposed upon diesel fuel pursuant to the Diesel Fuel Tax Law (Part 31 (commencing with Section 60001) of the Revenue and Taxation Code).

Excise Tax. Under the Motor Vehicle Fuel Tax Law, the state imposes an excise tax of $0.18 per gallon on the removal of motor vehicle fuel (gasoline) at the refinery or terminal rack, upon entry into the state, and upon sale to an unlicensed person.

Under the Diesel Fuel Tax Law, the state imposes an excise tax of $0.18 per gallon on the removal of diesel fuel at the refinery or terminal rack, upon entry into the state, and upon sale to an unlicensed person.

Federal law imposes an additional per gallon tax on gasoline and diesel fuel of 18.4 cents and 24.4 cents, respectively.

Proposed Law

Proposition 87 would enact the "Clean Alternative Energy Act," if approved by voters on November 7, 2006. Specifically, it would amend the Constitution to establish a new state program, the Clean Alternative Energy Program. The program is to be administered by the California Alternatives Energy Program Authority (Authority) which the proposition establishes by adding Division 16 (commencing with Section 26000) to the Public Resources Code. The Authority would be funded by the "California Energy Independence Fund Assessment," which the proposition creates by adding Part 21 (commencing with Section 42000) to Division 2 of the Revenue and Taxation Code. The revenues from the assessments would be deposited into the "California Energy Independence Fund" which this proposition creates.

The Authority would be created by reorganizing the existing California Alternative Energy and Advanced Transportation Financing Authority and adding new members.

Beginning January 1, 2007, the new assessment would be administered by the Board and would be imposed for the privilege of severing oil from the earth or water in California. The oil severance assessment would be imposed at a rate of one and one-half percent (1.5%) to six percent (6.0%), depending upon the gross value of each barrel of oil as specified. Oil from "stripper wells," as defined, that are subject to the assessment, would be assessed at a rate of 3%. The assessment would be due and payable to the Board on a monthly basis. Details of the assessment are noted below.

Imposition of the Assessment. The assessment would be "borne ratably" by any "producer," as defined, for the privilege of severing oil from the earth or water in California for sale, transport, consumption, storage, profit, or use. The assessment would be made regardless of the place of sale or to whom sold or by whom used. Additionally, the assessment would still apply if the oil is delivered outside the state.

Exemptions from the Assessment. The following specific exemptions are authorized:

- **Political Subdivisions of the State.** Oil owned or produced by any political subdivision of the state, including that political subdivision's proprietary share of oil produced under any unit, cooperative, or other pooling agreement.
- **Stripper Wells.** Oil produced by a “stripper well” in any month in which the average value of oil is less than $50 per barrel. A “stripper well” is defined as a well “incapable of producing an average of more than ten barrels of oil per day during the entire taxable month.” This proposition requires the Board to certify such wells. Currently, California oil appears to be selling for more than $50 per barrel; thus, oil produced from these wells would seem to be subject to the assessment.

Definition of Producer. Producer means:

- Any person who takes oil from the earth or water in any manner.
- Any person who owns, controls, manages, or leases any oil well.
- Any person who produces or extracts any oil in any manner.
- Any person who owns an interest, including a royalty interest, in oil or its value, whether the oil is produced by the person owning the interest or by another on his behalf by lease, contract, or other arrangement.
- Any person who acquires the severed oil from a person or agency exempt from property taxation under the Constitution or laws of the United States or under the Constitution or laws of the State of California.

Definition of Oil. Oil includes petroleum, other crude oil, condensate (a byproduct of natural gas), casing head gasoline, or other mineral oil.

Assessment Rate Structure. The proposition states that the assessment, which is due and payable on a monthly basis, 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 from $60.01 per barrel and above.

With respect to stripper wells, the proposition states that the oil produced by a stripper well that is subject to the assessment because the average value of oil is $50.01 or more per barrel, will be subject to the assessment in the amount of 3.0 percent of the gross value of oil above $50.01.

Gross Value of Oil. The proposition defines “gross value” to mean the sale price at the mouth of the well for oil, including any bonus, premium, or other thing in value paid for the oil.

In certain instances, when actual sales price information is not available, the Board is required to determine the value of the oil subject to the assessment based on the cash price paid to producers for like oil in the vicinity of the well. Such circumstances include:

- When oil is exchanged for something other than cash; or
- When there is no sale at the time of severance; or
- When the relation between the buyer and the seller is such that the consideration paid, if any, is not indicative of the true value or market price.

Allocations of Funds. The Board is designated as the agency that would disburse the revenues resulting from the assessment among various funds. However, before the funds are deposited, the Board would be first reimbursed for its administrative expenses. After reimbursement, the Board would be required to first deposit, on a monthly basis, the revenues in an amount as designated in writing by the Authority into the "Debt Service Account of the California Energy Independence Assessment Fund." Following this allocation, the remainder would be disbursed as provided in the proposition. These funds must be deposited at least once per month.

Administration. With respect to the details necessary to administer the assessment, the proposition provides that the Board:

- Has broad discretion in administering the California Energy Independence Fund Assessment.
- May prescribe, adopt, and enforce rules and regulations.
- May prescribe the manner of payments.
- May prescribe forms and reporting requirements.
- May employ auditors, investigators, engineers, and other persons.
- May act on behalf of the people of California.
- May use provisions of either the Sales and Use Tax Law or Timber Yield Tax Law relating to the administration of those tax programs, whichever is more applicable.

Consumer Pass-Through Prohibition. This proposition states that the assessment imposed shall not be passed on to consumers through higher prices for oil, gasoline, or diesel fuel. In addition, it requires the Board, if requested by the Authority, to investigate whether producers or purchasers of the oil have "attempted to gouge consumers by using the assessment as a pretext to materially raise the price" of oil, gasoline, or diesel fuel. In this respect, the Authority is directed to use funds from the Public Education and Administration Account to monitor whether the assessment is being passed on through higher prices and to refer any evidence of such to the Board for investigation.

Legal Challenge. Any legal challenge to the validity of the Act must be filed within six months of its effective date.

Amendments to the Initiative. Amendments to the statutory provisions of this proposition, should the voters approve the proposition, are possible with a two-thirds vote of the Legislature and approval of the Governor. However, neither the Legislature nor the voters may reduce or eliminate the assessment if any bonds or other obligations secured by the assessment remain outstanding.

Assessment Sunset Provisions. The assessment would become inoperative after the Authority has expended four billion dollars, as specified, and after all indebtedness associated with the Clean Alternative Energy Act, as specified, has been paid or otherwise provided.

Background

Numerous legislative bills have been introduced over the last 30 years that would have imposed an oil severance assessment, tax, or fee similar to the assessment imposed by Proposition 87. Most recently, these include AB 336 (Villaraigosa) in 1995 and AB 1693 (Margolin) in 1993. In addition, in 1992, Proposition 67 "The Economic Recovery Tax Relief Act of 1992," included, among its numerous provisions, an oil severance tax. That proposition was not approved by the voters.

California Oil Production. According to the Legislative Analyst's Office (LAO) Analysis of Proposition 87:

> 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.
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> 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.

COMMENTS

1. **Sponsor and Purpose.** The sponsor of this proposition is Californians for Clean Energy. The stated purpose is to generate at least $4 billion in revenues, the proceeds of which would fund various alternative energy programs to enhance energy independence, reduce petroleum consumption, improve the environment, and create new energy industries.

2. **Assessment Rate – Marginal or Flat?** The proposition adds Revenue and Taxation Code Section 42002 to provide that the assessment is 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 from $60.01 per barrel and above.

Proponents of the proposition state that a flat rate is required, as only one rate is triggered since there can only be one market price of oil at a time. Opponents of this proposition state that it should be interpreted to require a marginal assessment rate**.**

The plain reading of the proposition suggests that the flat rate of 6% at the current price of oil would achieve the stated goal of collecting $4 billion over 10 years at $400 million per year. If the proposition is approved by voters, the Board would adopt regulations to clarify this assessment rate issue.

3. **Assessment based on "gross value."** The proposition would impose the oil severance assessment upon the gross value of a barrel of oil. "Gross value" is defined in the proposition as the sales price of the barrel of oil at the mouth of the well. This method of assessment could result in greater uncertainty in assessment liability, as market values change daily and differ according to the type of oil. Board staff is exploring options to address this issue.

4. **Who pays the Assessment.** Revenue and Taxation Code Section 42002 provides that the assessment shall be borne ratably by all persons within the term producer as defined in Section 42001(h). This section defines many persons as "producers." On the other hand also under the proposition, Section 42004(a) indicates that producers or purchasers of oil are authorized and required to withhold from any payment due interested parties the proportionate amount of the assessment due. In addition, Section 42004(b) indicates that the assessment imposed is the *primary* liability of the producer and is a liability of the first purchaser and each subsequent purchaser. The Board would have to clarify this issue.

5. **Exemptions** – **Stripper Wells.** Section 42007(b) states that the assessment does not apply to "oil produced by a stripper well in any month in which the average value of oil is less than $50 per barrel." Section 42001(k) then requires the Board to certify that a well is a stripper well. The Board might be able to contract with the Department of Conservation's Division of Oil, Gas, and Geothermal Resources to make this certification. In 2004, the Division identified 25,622 wells with production of 34,955,831 barrels as stripper wells. With respect to the average value of oil, perhaps the Board could establish a benchmark for a particular field to use.

6. **Exemptions – Political Subdivisions.** Section 42007(a) states that the assessment does not apply to "oil owned or produced by any political subdivision of the state, including that political subdivision's proprietary share of oil produced under any unit, cooperative, or other pooling agreement." However, Section 42001(h) includes as a producer any person who acquires the severed oil from a person or agency exempt from property taxation under the Constitution or laws of the United States or under the Constitution or laws of the State of California. Generally, "political subdivision" means a county, city, city and county, special district, joint powers agency, and any other body created by constitutional and legislative authority to carry out governmental functions. The Board would have to clarify whether the first purchaser provision would apply in this situation or

whether oil severed from these lands would be permanently exempt from the assessment as it changes ownership.

7. **First Purchaser from an Exempt Person or Agency Pays the Assessment.** This concept is similar to provisions in the California Timber Yield Tax Law which specify that, when timber is felled from property that is exempt from the property tax, the subsequent purchaser is liable for the Timber Yield Tax. Specifically, in this tax program, the law provides that either the timber owner "or the first person who acquires either the legal title or beneficial title to timber after it has been felled from land owned by a federal agency or any other person or agency or entity exempt from property taxation under the Constitution or laws of the United States or under the Constitution or laws of the State of California," pays the tax.

8. **Property Tax Exemptions.** Although Section 42001(h) references persons or agencies exempt from property tax, an exemption from property tax applies to the property itself, not to the persons or entities that own the property. Presumably, this provision means that if the oil is severed from land exempt from property tax based on ownership, then the first purchaser would pay the assessment. Property exempt from property tax includes property owned by the federal government or a federal instrumentality, property owned by the state, and property owned by a local government which is located within its boundaries. (If the property is located outside its boundaries, then the property is taxable pursuant to Article XIII, Section 11, if it was taxable when acquired by the local government.)

   The following table summarizes the possible assessment treatment of oil severed from land under different ownership as well as the person responsible for the assessment.

Oil/Land Ownership	Land Exempt From Property Tax	Who Pays Assessment
Private Lands	No	Severer
Federal Lands	Yes	First Purchaser
State Lands	Yes	First Purchaser
Political Subdivisions of the State (County, City, Other)	Yes	Requires Clarification As Noted in Comment # 6
State Offshore (Coast to 3 nautical miles)	Yes	First Purchaser
Federal Offshore (Between 3 and 12 nautical miles)	Not Subject To Property Tax	Not Subject To Assessment
Outside 12 nautical miles	Not Subject To Property Tax	Not Subject To Assessment

9. **Consumer Pass-Through Prohibition.** At the request of the Authority, the Board is required to investigate whether or not a producer, first purchaser, or subsequent purchaser has attempted to "gouge consumers by using the assessment as a pretext to materially raise the price" of oil, gasoline, or diesel

fuel. The Authority would refer to the Board any evidence that it has acquired in its role as an oil market monitor for which funds are dedicated from the Public Education and Administration Account. The Board would then audit or otherwise review this evidence and turn over its findings to the Authority. How the Board can enforce the pass-through prohibition is unclear. Board staff is currently examining options for how to determine whether the cost to industry has been passed on to consumers. For example, one option might be to use cost accounting methods, whereby changes in profit could be estimated based on changes in production costs. Another option might involve comparing industry profits to profits in related or similar industries over time.

Additionally, while there is no specific penalty for violating the anti pass-through provision, it is noted that the Sales and Use Tax laws (Revenue and Taxation Code Sections 7152 to 7153.5) contain various penalty provisions.

10. **Follow-up legislation is necessary to specify certain administrative provisions as well as, instead, reference the Fee Collection Procedures Law.** The proposition does not contain specific administrative provisions for the proposed oil severance assessment. Instead, the proposition provides that the Board may prescribe, adopt, and enforce rules and regulations relating to the application, administration, and enforcement of the proposed assessment, as permitted by Revenue and Taxation Code Sections 6451 to 7176 or Sections 38401 to 38901, whichever are most applicable. These provisions relate to the Sales and Use Tax and Timber Yield Tax laws, respectively.

    It is recommended that basic administrative provisions be incorporated by instead referencing the Fee Collection Procedures Law (Part 30 (commencing with Section 55001) of Division 2 of the Revenue and Taxation Code). In addition, specific provisions not included in the Fee Collection Procedures Law are needed with respect to return and payment due dates and the authority to make necessary refunds. While the assessment is due and payable to the Board on a monthly basis, no due date for the return and payment is specified. Given the numerous taxes and fees the Board currently administers, the best date for the Board would be the 15^{th} of each month in order to balance the workload and avoid unnecessary peaks resulting in overtime. It is anticipated that the first return for the month of January would be due on March 15.

11. **This proposition does not contain administrative start-up cost funding for the Board.** This proposition would impose the assessment beginning January 1, 2007, which is in the middle of the state's fiscal year. In order to properly administer the assessment, notify producers and purchasers, develop computer programs and reporting forms, and hire appropriate staff, reimbursement is required to cover the Board's administrative start-up costs that are not already identified in the Board's 2006-07 budget, should the proposition be approved by the voters.

12. **Distribution of monies among the various funds.** It appears that the Board is designated as the agency that would disburse the revenues resulting from the assessment among various funds. If so, is it the best agency to make these allocations? For example, with respect to the Motor Vehicle Fuel Tax Law, in

Revenue and Taxation Code Sections 8351 to 8360, the Board deposits the funds; and the Controller distributes the funds.

13. **Inoperative Provisions.** This proposition does not specifically provide who would determine when the assessment is to be discontinued and who would officially inform the Board.

COST ESTIMATE

The collection of this oil severance assessment would result in the Board incurring potentially significant costs related to the administration and collection of the assessment proposed by this proposition. These costs would be related to notifying taxpayers, developing returns, programming computers, developing and carrying out compliance and audit efforts to ensure proper reporting, and administering the assessment. These estimated costs are pending.

REVENUE ESTIMATE

As discussed above, there are questions regarding how to apply the assessment rates specified in the Clean Alternative Energy Act as well as determining the amount of oil subject to the assessment. Given these uncertainties, the Legislative Analyst's Office has estimated that the oil severance assessment would raise from about $225 million to $485 million annually. This estimate is based on 2005 oil production levels and the average price of oil for the first six months of 2006. Board staff concurs with this estimate.

The Clean Alternative Energy Act calls for the oil severance assessment to be imposed, until the California Alternative Energy Program Authority has expended $4 billion and after all indebtedness associated with the Clean Alternative Energy Act has been paid or payment has been provided for. The amount of the annual revenues actually realized will depend on the level of oil production in California as well as the future price of crude oil. However, increases in these factors will simply shorten the time that this assessment is operable, and decreases in these factors will lengthened that time.

Revenue Summary

The revenue derived from the Clean Alternative Energy Act will amount to from $225 million to $485 million annually.

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