DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**05/01/14**	Bill No:	**Senate Bill 1017**
Tax Program:	**Oil and Gas Severance**	Author:	**Evans**
Sponsor:	**Author**	Code Sections:	**RTC Part 21 (commencing with Section 42301)**
Related Bills:		Effective Date:	**Upon Enactment**

BILL SUMMARY

This bill imposes an oil and gas severance (severance) tax upon any oil and gas well operator for the privilege of severing oil or gas from the earth or water in this state.

Summary of Amendments

The amendments since the prior analysis, among other things, renumber the Oil Severance Tax Law within the Revenue and Taxation Code (RTC), require amounts collected to be deposited directly into the California Higher Education Fund, and add a January 1, 2015 operative date for the severance tax.

ANALYSIS

CURRENT LAW

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

Regulatory Assessment. Existing law[1] imposes an annual assessment on each barrel of oil and each 10,000 cubic feet of natural gas produced. The law requires oil and gas well operators or persons that own an interest in the production of a well to pay the assessment. The assessment finances the regulatory work of the Department of Conservation's (DOC) Division of Oil, Gas, and Geothermal Resources (Division). The Division set the fiscal year (FY) 2013-14 assessment rate at $0.1426683 per barrel of oil or 10,000 cubic feet of natural gas produced.

Property Tax. Existing Property Tax Law, with respect to oil in the ground, subjects "mineral rights" to property tax assessment by county assessors.[2] For property tax purposes, Public Resources Code (PRC) Section 3234 authorizes both county assessors and the Board of Equalization (BOE) to access well records, which include monthly production reports filed by an operator with the DOC for purposes of the regulatory assessment.[3]

Oil Spill Prevention and Administration Fee. Existing law[4] imposes an Oil Spill Prevention and Administration (OSPA) Fee of $0.065 per barrel upon persons that own crude oil when it is received at a marine terminal from within or outside the state. The

[1] Article 7 (commencing with Section 3400) of Chapter 1 of Division 3 of the Public Resources Code (PRC).
[2] Property Tax Rule 468.
[3] PRC Section 3227.
[4] Government Code Section 8670.40.

terminal operator collects the OSPA fee. Existing law also imposes a fee on operators of pipelines that transport oil in the state across, under, or through marine waters. The OSPA fee is collected by the BOE, which deposits it into the Oil Spill Prevention and Administration Fund.

Oil Spill Response Fee. Existing law[5] requires the BOE to collect an oil spill response fee from specified marine terminal operators, pipeline operators, and refiners in an amount not to exceed $0.25 per barrel of petroleum product or crude oil. The BOE deposits all proceeds into the Oil Spill Response Trust Fund, but only until the fund reaches a maximum of $50 million. No fees are currently being collected since the Oil Spill Response Trust Fund is at its maximum.

Sales and Use Tax. Current law[6] imposes sales tax on the retail sale of tangible personal property (TPP) in this state. Current law[7] also imposes use tax on the storage, use, or other consumption in this state of TPP purchased from any retailer. The sales or use tax is computed on the retailer's gross receipts or purchase price, respectively, unless the law provides a specific exemption or exclusion. Currently, retail sales of crude oil are subject to the tax in the same manner as any other sale of tangible personal property. However, a sale to a refiner of crude oil that is to be refined to produce new products is generally not subject to sales or use tax, as the crude oil sold in such instances is regarded as a sale for resale.

Existing law (Fuel Tax Swap[8]) exempts retail gasoline sales from the state's 5% General Fund rate. The Fuel Tax Swap provisions[9] also increase the sales and use tax rate on retail diesel fuel sales and purchases to offset the loss related to the diesel fuel excise tax rate reduction (discussed below), resulting in the following additional rates:

- 1.87% effective July 1, 2011
- 2.17% effective July 1, 2012
- 1.94% effective July 1, 2013
- 1.75% effective July 1, 2014, and thereafter.

Generally, the total combined sales and use tax rates in California jurisdictions range from 7.50% to 10%, depending on the merchandise sales location. The statewide sales and use tax rate totals 7.50% and is comprised of state and local taxes. Rates may be higher than 7.50% in some areas depending on district taxes that apply.

Excise Taxes and Fuel Tax Swap. The existing Motor Vehicle Fuel Tax[10] and Diesel Fuel Tax Laws[11] generally impose excise tax on motor vehicle fuel (gasoline) and diesel fuel upon:

- The removal (except for aviation gasoline) at the refinery or terminal rack;
- The entry into the state; and
- The sale to an unlicensed person.

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[5] Government Code Section 8670.48.
[6] Article 1 (commencing with Section 6051) of Chapter 2 of Part 1 of Division 2 of the RTC.
[7] Article 1 (commencing with Section 6201) of Chapter 3 of Part 1 of Division 2 of the RTC.
[8] ABx8 6, (Ch. 11, Statutes 2010) and SB 70 (Ch. 9, Statutes 2010). These provisions were reenacted in 2011 by AB 105 (Ch. 6, Statutes 2011).
[9] RTC Sections 6051.8 and 6201.8.
[10] Part 2 (commencing with Section 7301) of Division 2 of the RTC.
[11] Part 31 (commencing with Section 60001) of Division 2 of the RTC.

Under the fuel tax swap provisions, to offset the revenue loss related to the 5% sales and use tax exemption for gasoline sales, the law originally increased the gasoline excise tax rate from $0.18 per gallon to $0.353 per gallon.[12] The law[13] reduced the diesel fuel excise tax rate from $0.18 to $0.13 per gallon to offset the gain from the increased sales and use tax rates.

The fuel tax swap provisions require the BOE to maintain revenue neutrality, so that the revenues realized from the increased excise tax on gasoline and the increased sales and use tax on diesel sales equal the revenues that would have been realized had the gasoline sales and use tax partial exemption and the diesel fuel excise tax reduction, respectively, not occurred.

RTC Sections 7360 and 60050 require the BOE to adjust the gasoline and diesel fuel *excise* tax rates, respectively, either upward or downward, to maintain revenue neutrality.[14]

In addition, federal law imposes additional per gallon taxes on gasoline and diesel fuel of $0.184 and $0.244, respectively.

Natural Gas Surcharge. Existing law[15] imposes a surcharge**[16]** on all natural gas consumed in this state.

The surcharge applies to all natural gas consumption in this state, except natural gas (1) used to generate power for sale, (2) resold to end users, (3) used for enhanced oil recovery, (4) utilized in cogeneration technology, or (5) produced in California and transported by a proprietary pipeline.

PROPOSED LAW

Among other things, this bill adds Part 21 (commencing with Section 42301) to Division 2 of the RTC to enact the Oil Severance Tax Law (OSTL). Commencing January 1, 2015, the OSTL imposes a severance tax upon any oil and gas well operator for the privilege of severing oil or gas from the earth or water in this state at the following rates:

- 9.5% of the average price per barrel of California oil, and
- 3.5% of the average price per unit of gas.

The bill further makes any person that owns an interest, including a royalty interest, in oil or its value, liable for the tax until it has been paid to the BOE.

The bill requires the OSTL to be "in addition to any other taxes imposed by law, including, without limitation, any ad valorem taxes imposed by the state, or any political subdivision of the state, or any local business license taxes that may be incurred as a privilege of severing oil or gas from the earth or water or doing business in that locality."

[12] RTC Section 7360.
[13] RTC Section 60050.
[14] Current gas and diesel fuel tax rates are $0.395 and $010 per gallon, respectively. Effective July 1, 2014, the gas tax rate will decrease to $0.36, while the diesel fuel tax rate will rise to $0.11 per gallon.
[15] Article 10 (commencing with Section 890) of Chapter 4 of Part 1 of Division 1 of the Public Utilities Code.
[16] Natural gas surcharge rates can be found at: http://www.boe.ca.gov/pdf/boe500ng.pdf

Average Price. On or before December 1 and June 1 each year,[17] the Division determines the average price per barrel of California oil and per unit of gas for the six-month period ending on the preceding October 31 and April 30, respectively. The bill bases the price of California oil and gas on the first purchase price for California Midway-Sunset crude oil as determined by the United States Energy Information Administration's (EIA) Domestic Crude Oil First Purchase Report. In the event of an EIA Domestic Crude Oil First Purchase Report delay or discontinuance, the bill authorizes the Division to base its determination on other sources of first purchase prices of California oil and gas.

The Division will notify the BOE of its determinations on or before December 1 and June 1 each year.

Exemptions. The bill exempts from the severance tax oil or gas produced by a stripper well, unless the well produces more than five barrels per month. The bill defines a stripper well to mean a well that the Division certifies as:

- An oil well incapable of producing an average of more than 10 barrels of oil per day during the entire calendar month, or
- A gas well that is incapable of producing more than 60 thousand cubic feet of gas per day during the entire calendar month.

The bill also exempts all oil, gas, or oil and gas that the state or any political subdivision of the state owns or produces, including the public entity's proprietary share of oil or gas produced under any unit, cooperative, or other pooling agreement.

The bill provides no exemption from the payment of an ad valorem tax related to equipment, material, or other property by reason of the payment of the severance tax pursuant to the OSTL.

Reporting and Payment. The bill requires each operator to prepare and file a return in the form prescribed by the BOE containing information as the BOE deems necessary or appropriate for the proper administration of the OSTL. The return is due on or before the last day of the calendar month following the calendar quarter to which it relates, together with a remittance payable to the BOE for the amount of tax due.

Administration. This bill requires the BOE to administer and collect the tax pursuant to the Fee Collection Procedures Law (FCPL).[18] For purposes of the tax, the bill clarifies that, under the FCPL:

- "Fee" includes the severance tax; and
- "Feepayer" includes any person liable for payment of the severance tax.

The FCPL generally provides for the BOE's administration of fee programs. Among other things, the FCPL provides for collection, reporting, return, refund, and appeals procedures, as well as the BOE's authority to adopt regulations related to the FCPL's administration and enforcement. The bill also specifically authorizes the BOE to prescribe, and adopt tax administration and enforcement regulations and emergency regulations.

[17] Beginning December 1, 2013, and June 1, 2014.
[18] Part 30 (commencing with Section 55001) of Division 2 of the RTC.

Tax Proceeds. The bill requires the BOE to deposit all taxes, interest, penalties, and other amounts collected, less refunds and reimbursement for expenses the BOE incurs in the administration and collection of the tax, into the California Higher Education Fund, which this bill creates in the State Treasury.

The bill mandates continuous appropriation of moneys in the fund, without regard to fiscal year, to the California Higher Education Endowment Corporation, which this measure establishes for the purpose of implementing Chapter 8 (commencing with Section 99500) of Part 65 of Division 14 of Title 3 of the Education Code.

The bill further requires reimbursement from the revenues received from the imposition of the severance tax to offset any local property tax reductions that result from the imposition of the severance tax.

Definitions. This bill defines several key terms, including, but not limited to, the following:

- **"Gas"** means all natural gas, including casing head gas, and all other hydrocarbons not defined as oil.
- **"Oil"** means petroleum, or other crude oil, condensate, casing head gasoline, or other mineral oil that is mined, produced, or withdrawn from below the surface of the soil or water.
- **"Operator"** means a person that, by virtue of ownership, or under the authority of a lease or any other agreement, has the right to drill, operate, maintain, or control an oil or gas well in the earth or water in this state, including any person that takes oil or gas from the earth or water in this state in any manner, any person that owns, controls, manages, or leases any oil or gas well in the earth or water of this state, and any person that produces or extracts in any manner any oil or gas by taking it from the earth or water in this state; and includes the first person that acquires either the legal title or beneficial title to oil or gas taken from the earth or water in this state by the federal government or a federal instrumentality.
- **"Severed" or "severing"** means the extraction or withdrawing from below the surface of the earth or water of any oil or gas, regardless of whether the extraction or withdrawal shall be by natural flow, mechanical flow, forced flow, pumping, or any other means employed to get the oil or gas from below the surface of the earth or water, and shall include the extraction or withdrawal by any means whatsoever of oil or gas upon which the tax has not been paid, from any surface reservoir, natural or artificial, or from a water surface.
- **“Stripper well”** means a well that has been certified by the Division as an oil well incapable of producing an average of more than 10 barrels of oil per day during the entire calendar month or a gas well that is incapable of producing more than an average of 60,000 cubic feet of gas per day during the entire calendar month. Once a well has been certified as a stripper well, that stripper well shall remain certified as a stripper well until the well produces an average of more than 10 barrels of oil per day during an entire calendar month or produces more than an average of 60,000 cubic feet of gas per day during an entire calendar month.

Effective Date. As an urgency statute, this bill becomes effective immediately. However, the severance tax becomes operative January 1, 2015.

BACKGROUND

In 2013, the author proposed a similar oil severance tax in SB 241 (Evans). That measure was held on suspense in the Senate Appropriations Committee.

Numerous other bills have been introduced over the last 30 years that would have imposed an oil severance assessment, tax, or fee similar to this assessment. These include AB 1693 (Margolin) in 1993, AB 336 (Villaraigosa) in 1995, ABx3 9 (Nunez) in 2008, and AB 1604 (Nava), ABx6 1 (Nava) and ABx8 41 (Nava) during the 2009-10 Legislative Session. In addition, in 1992, Proposition 167, "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. A similar tax was proposed in 2006, as Proposition 87, the "Clean Alternative Energy Act," which also was not approved by voters.

In 2009, AB 656 (Torrico) proposed a 12.5% severance tax on both oil and gas. That bill was referred to the Senate Committee on Education, but was never heard. In 2011, AB 1326 (Furutani) also proposed a 12.5% oil and gas severance tax. That bill died in the Assembly Committee on Revenue and Taxation.

COMMENTS

1. **Sponsor and Purpose.** This bill is sponsored by the author. According to the bill fact sheet, California is "losing out on billions in revenue, amounting to a massive giveaway to big oil companies. It is time for California to reclaim our natural resources by enacting an oil severance tax and reinvesting the revenue in our state."
2. **The May 1, 2014 amendments** (1) renumber the OSTL within the RTC and make related reference corrections, (2) correct the EIA report name the Division uses to determine the average price per barrel of California oil, (3) require amounts collected to be deposited directly into the California Higher Education Fund, and (4) add a January 1, 2015 operative date for the severance tax. The amendments also make technical, non-substantive corrections to the OSTL, and make revisions to the California Higher Education Endowment Corporation, which is outside the BOE's purview.
3. **Administrative start-up cost funding is essential.** This bill proposes a new severance tax to be imposed commencing January 1, 2015. As a result, the BOE must begin to implement the bill in FY 2014-15. However, the BOE's 2014-15 budget does not include the necessary funding to implement the bill. Consequently, the BOE requires an adequate appropriation to cover administrative implementation costs.

   Upfront BOE implementation cost reimbursement is essential. Thus, BOE staff suggests the bill provide an appropriation for administrative costs from the General Fund (GF). The loan would be repaid from taxes collected.

   Constitutional and statutory provisions prohibit the BOE from using special fund appropriations to support the administration of the proposed severance tax program. Without an appropriation, it may be necessary for the BOE to divert GF dollars to implement the proposed tax program. A GF diversion typically results in a negative impact on GF-supported programs and related State and local government revenues.

4. **Delayed operative date necessary.** To effectively implement this bill, the BOE must: notify and register taxpayers; develop computer programs; hire and train key staff; create necessary forms and schedules; and answer taxpayer inquiries. These functions must take place before the tax becomes operative. The current January 1, 2015, operative date is insufficient. BOE staff estimates it needs a minimum of six months to implement the new program proposed by this bill. To provide the BOE with the necessary 6-month lead time, BOE staff suggests an amendment to delay the operative date to the first day of the first calendar quarter commencing more than six months after the bill is enacted.

5. **Stripper wells.** This measure requires the Division to certify stripper wells and notify the BOE of its findings. BOE staff suggests an amendment to clarify how often the Division notifies the BOE of certified wells and to also require the Division to notify the BOE of wells no longer certified.

   Furthermore, the bill generally defines an oil stripper well to mean a well certified as an oil well incapable of producing an average of more than <u>10</u> barrels of oil per <u>day</u> during a calendar month. However, the bill specifies the exemption shall apply **<u>unless</u>** the well produces more than <u>5</u> barrels per <u>month</u>. Accordingly, an oil stripper well that produces 5 barrels or less per month qualifies for the exemption, and an oil stripper well that produces more than 5 barrels per month does not. The bill exempts from the tax all natural gas a stripper well produces.

   Since BOE staff would have no way of knowing which certified stripper wells are producing more than 5 barrels per month, BOE staff suggests an amendment to require the Division to certify, instead, those oil stripper wells that produce less than <u>5</u> barrels per <u>month</u>.

6. **Ownership interest.** This bill makes any person that owns an interest, including a royalty interest, in oil or its value liable for the severance tax until that tax has been paid to the BOE. However, the bill imposes the severance tax upon an "operator," which does not include *any person that owns an interest, including a royalty interest, in oil*. How would an interest-owner report and pay the tax, or know data that would enable that person to accurately calculate, report, and pay the tax due (barrels of oil severed, or the average price per barrel of oil)? BOE staff further notes that the ownership interest provision applies only to oil, and not to natural gas.

   Thus, the author may want to delete the ownership interest liability provision from the bill.

7. **Suggested amendments.** The BOE suggests the following amendments:

   - **Tax Law Title.** Rename the "Oil Severance Tax Law" to the "Oil and Gas Severance Tax Law."
   - **Average Price Determination.** Clarify when the Division-determined average prices become applicable for purposes of the imposition of the severance tax. Also, require the Division to provide the average price amount to the BOE *at least* 60 days prior to its effective date for purposes of calculating the severance tax.
   - **"Operator" Definition.** The bill defines the term "operator" to include "the first person that acquires either the legal title or beneficial title to oil or gas taken from the earth or water in this state by the federal government or a federal

instrumentality." Does the author intend to limit the "operator" definition with respect to a first person that acquires legal or beneficial title to oil or gas severed by the federal government or federal instrumentality? Or does the author also intend to include a first person that acquires title to oil or gas severed by the state or any political subdivision of the state? If it's the latter, the bill should be amended to clarify that intent.

- **Imposition of Tax.** The bill imposes the severance tax upon any operator at a rate of 9.5% of the average price per barrel of California oil or 3.5% of the average price per unit of gas. The measure clearly states the tax rate and the taxpayer; however it does not specify the taxable unit upon which the severance tax is imposed, or when the taxable event occurs. Is the tax imposed at the time a barrel of oil or unit of gas is severed (or, with respect to "first persons," at the time it is acquired), or when a barrel or unit is sold or otherwise transferred, or at some other point in time?

  Assuming this measure intends to impose the tax on a barrel or unit at time of severance or acquisition, the BOE staff suggests the following amendment to Section 42310(a)(1) to clarify upon what the rate is applied and the event that gives rise to liability for the tax:

  > 42310. (a)(1) Commencing January 1, 2015, an oil and gas severance tax is hereby imposed upon any operator for the privilege of severing oil or gas from the earth or water in this state at a rate of 9.5 percent of the average price per barrel of California oil or 3.5 percent of the average price per unit of gas, as calculated pursuant to this section<u>, for each barrel of oil or unit of gas that is severed from the earth or water of this state or acquired from the federal government or a federal instrumentality, [or from the state or political subdivision of the state,] at the time the barrel of oil or unit of gas is severed or acquired</u>.

COST ESTIMATE

BOE administrative costs related to this bill are substantial. These costs include: taxpayer identification, notification and registration; regulation development; manual and publication revisions; tax return design; computer programming; return, payment, and refund claim processing; audit and collection tasks; staff training; and public inquiry responses. A detailed cost estimate is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The DOC maintains detailed data summarizing oil and natural gas production throughout the state. The U.S. Energy Information Administration (EIA) has historical data for selected prices. *IHS Global Insight* (IHS), a well-respected economic forecasting company, forecasts quarterly average selected oil and gas prices.

- ***Oil Production.*** DOC data indicate that oil production excluding federal offshore production was about 198 million barrels in 2012. Over the past four years production has declined an average of about 2% per year. This revenue estimate begins for FY 2014-15, and assumes that this 2% rate of annual decline will continue from 2013 throughout the forecast period. According to the most recent DOC data, about 6.7% of crude oil production is from off-shore state lands. We have no information as to how much production is derived from on-shore oil production located on state or local government properties. We assume 6.7% of total production is not subject to the severance tax. This is a lower bound estimate since additional production may derive from on-shore state and local lands.

- ***Price of Oil.*** EIA data indicates that California Midway-Sunset Oil prices averaged $101 per barrel in 2013. We do not have access to forecasts of California Midway-Sunset Crude Oil prices. However, we do have forecasts of West Texas Intermediate Crude Oil (WTI) prices from IHS. Historical data indicates that changes in California Midway-Sunset Crude Oil prices tend to be closely related to those of WTI Crude Oil. WTI prices averaged $98 per barrel in 2013. According to IHS, WTI prices are expected to decline about 6% per year over the next two fiscal years before rising in FY 2016-17.
- ***Natural Gas Production.*** DOC data indicates that natural gas production comprised about 222 billion cubic feet in 2012. Natural gas production has declined an average of about 4.2% per year over the past four years. This estimate assumes that this 4.2% rate of annual decline will continue throughout the forecast period. According to the most recent DOC data, about 2.2% of natural gas production is from off-shore state lands. We have no information as to how much production on-shore is from state or local government properties. We assume 2.2% of total production is not subject to the severance tax. As with the analogous crude oil production percentage, this is a lower bound estimate since additional production may derive from on-shore state and local lands.
- ***Price of Natural Gas.*** Beginning in 2011, EIA no longer provides natural gas prices. This estimate uses the Henry Hub cash market price to approximate California natural gas prices. The Henry Hub price averaged $3.72 per thousand cubic feet in 2013. IHS *expects* the Henry Hub price to average $3.92 per thousand cubic feet over the next two fiscal years.

REVENUE SUMMARY

Based on the previous assumptions, the revenue impact of imposing a 9.5% severance tax on oil and a 3.5% severance tax on oil would be $845 million in FY 2014-15 (half-year impacts) and $1.576 billion in FY 2015-16. The following table shows details of these estimates.

Summary of Revenue Estimate

Dollars in Millions

	2014-15	2015-16
Oil Production	831	1,545
Natural Gas Production	14	31
Totals	$845	$1,576

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

Qualifying Remarks. We have several qualifying remarks related to various components of the legislation.

- **Oil Price Volatility.** A key assumption underlying this revenue estimate is the forecasted price of oil, which can be quite volatile. As national macroeconomic forecasts are periodically updated to reflect new employment, output, and other key data, the forecasted price of oil can change significantly, which in turn would impact the revenues raised by this measure. Region-specific reasons for oil price volatility also may exist. As an order of magnitude, if the price of oil averages $5 more/less per barrel than we assume, the resulting revenues would be about $80 million higher or lower.
- **Additional State and Local Government-Owned Lands Exemptions.** As mentioned previously, we have no data for on-shore oil and gas production on state or local government owned lands. If oil prices do not change, these estimates are upper bounds because additional oil and gas production may be exempt.
- **Stripper Well Exemptions.** With respect to oil, "stripper wells" (those which produce less than 5 barrels per month) would be exempt from the tax. Stripper natural gas wells are also defined and exempted. We have no data available to determine how much oil or natural gas is produced by such wells and would be exempt. To the extent that some oil and gas is produced by stripper wells, these estimates are upper bounds because there may be additional exempt oil and gas production.
- **Reduction in Local Property Tax Revenues.** Local property tax revenue derived from oil and gas reserves would decline under the measure to the extent that the severance tax reduces the value of oil reserves in the ground and its assessed property value for tax purposes. While the bill provides for property tax reimbursement resulting from the proposed severance tax, the exact impact is unknown, as it would depend largely on future oil prices.
- **Reduction in State Income/Corporation Tax Revenues.** Oil and gas producers would be able to deduct the severance tax from earned income, thereby reducing their state income or corporation tax liability. The extent of reduced state income taxes paid by producers is also unknown. The impact depends on various factors, including whether or not a producer has taxable income in any given year and the amount apportioned to California.

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