Date Amended:	**01/04/10**	Bill No:	**AB 656**
Tax:	**Oil and Gas Severance**	Author:	**Torrico**
Related Bills:			

This analysis will only address the bill's provisions which impact the State Board of Equalization (BOE).

BILL SUMMARY

This bill would impose an oil and gas severance tax upon any producer for the privilege of severing oil or gas from the earth or water in this state for sale, transport, consumption, storage, profit, or use. The proposed new tax would be administered and collected by the BOE.

SUMMARY OF AMENDMENTS

Since the last analysis, amendments to the proposed Oil and Gas Severance Tax Law, which the BOE would administer, specify a tax rate of 12.5 percent of the gross product and add a definition for the term "political subdivision of the state." Other amendments to the bill are non-substantive and do not materially impact the BOE.

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 each barrel of oil and each 10,000 cubic feet of natural gas produced. Producers of oil and gas are required to pay the fee, which is currently at a rate of $0.0790758. 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 BOE 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 in the state across, under, or through marine waters. This BOE-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.

Excise Taxes. Under the Motor Vehicle Fuel Tax Law, the state imposes an excise tax of $0.18 per gallon on the removal of gasoline at the refinery or terminal rack, upon entry into the state, and upon sale to an unlicensed person. The Diesel Fuel Tax Law also imposes an excise tax of $0.18 per gallon in a similar manner.

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

PROPOSED LAW

Among other things, this bill would add Part 21 (commencing with Section 42001) to Division 2 of the Revenue and Taxation Code to enact the Oil and Gas Severance Tax Law to impose, on and after January 1, 2010, an oil and gas severance tax (severance tax) upon any producer for the privilege of severing oil or gas from the earth or water in this state for sale, transport, consumption, storage, profit, or use. The 12.5 percent tax rate would be applied equally to all portions of the gross value of the product.

The severance tax would be in addition to any other tax that may be imposed with respect to the severing of oil or gas or transactions related thereto, including, without limitation, any ad valorem taxes imposed by the state, or any of its political subdivisions, 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.

Exemptions. The bill would exempt from the severance tax oil or gas produced by a stripper well in which the average value of oil or gas is less than three-quarters of the average gross value of the product as of January 1 of the prior year. A stripper well would be defined to mean a well that has been certified, as described, by the BOE as an oil well incapable of producing an average of more than 10 barrels of oil per day during the entire taxable month.

Also exempted from the tax would be all oil or gas owned or produced by any political subdivision of this state, including that political subdivision's proprietary share of oil or gas produced under any unit, cooperative, or other pooling agreement.

No exemption is provided from payment of an ad valorem tax related to equipment, material, or property by reason of the payment of the gross severance tax pursuant to this part.

Reporting and Payment. The severance tax would be due and payable to the BOE quarterly on or before the last day of the month next succeeding each calendar quarter. The BOE would be authorized to prescribe those forms and reporting requirements as are necessary to implement the tax. This includes, but is not limited to, information regarding the location of the well by county, the gross amount of oil or gas produced, the price paid therefore, the prevailing market price of oil or gas, and the amount of tax due.

Administration. The BOE would administer and collect the severance tax pursuant to the Fee Collection Procedures Law (Part 30 (commencing with Section 55001) of Division 2).

The Fee Collection Procedures Law contains "generic" administrative provisions for the administration and collection of fee programs to be administered by the BOE. It was added to the Revenue and Taxation Code to allow bills establishing a new fee to reference this law, thereby reducing the number of sections within the bill required to provide the necessary administrative provisions. Among other things, the Fee Collection Procedures Law includes collection, reporting, refund, and appeals provisions, as well as providing the BOE the authority to adopt regulations relating to the administration and enforcement of the Fee Collection Procedures Law.

Other BOE Responsibilities. In addition to the collection of the severance tax, the BOE would be required to certify an oil well as a stripper well incapable of producing an average of more than 10 barrels of oil per day during the entire taxable month. It also appears that the BOE would be responsible for determining, with respect to the stripper well exemption, if the average value of oil or gas is less than three-quarters of the average gross value of the products as of January 1 of the prior year.

The BOE would also be required to monitor and, if necessary, investigate any instance where producers or purchasers of the oil or gas attempt to gouge consumers by using the tax as a pretext to materially raise the price of oil, natural gas, gasoline, diesel, or other oil or gas consumable byproducts, such as propane and heating oil. The bill specifically prohibits the severance tax from being passed through to consumers.

Furthermore, the BOE would be required to determine the base indexes from which the rolling 30-day average daily value, as established by the market price of the product, is calculated. This average is a factor in determining the “gross value” of the oil or gas. If the oil or gas is exchanged for something other than cash, if there is no sale at the time of severance, or if 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, then the BOE would determine the value of the oil or gas subject to the tax based on the cash price paid to the producer for like quality oil or gas in the vicinity of the well.

The bill also provides that the BOE may act on behalf of the people of the State of California in all proceedings under the Oil and Gas Severance Tax Law.

Tax Proceeds. All taxes, interest, penalties and other amounts collected, except payments of refunds and reimbursement to the BOE for expenses incurred in the administration and collection of the tax, would be deposited into the California Higher Education Fund, which this bill would create in the General Fund. The BOE’s reimbursement for administrative expenses would be subject to appropriation by the Legislature; however, moneys in the California Higher Education Fund would be continuously appropriated to the California Higher Education Endowment Corporation. The moneys continuously appropriated would be allocated annually by the California Higher Education Endowment Corporation to the California Community Colleges, the California State University and the University of California as prescribed in Chapter 8 (commencing with Section 99500), which this bill adds to Part 65 of Division 14 of Title 3 of the Education Code (The California Higher Education Endowment Corporation).

Definitions. This bill would include the following definitions within the oil and gas severance tax law, which pertain to the BOE:

"Gas" would mean all natural gas, including casing head gas, and all other hydrocarbons not defined as oil.

"Gross value" would mean the sale price at the mouth of the well, including any bonus, premium, or other thing of value, paid for the oil or gas, as determined by a rolling 30-day average daily value as established by the market price of the product.

"Oil" would mean 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 in this state.

"Producer" would mean any person who takes oil or gas from the earth or water in this state in any manner; any person who owns, controls, manages, or leases any oil or gas well in the earth or water of this state; any person who produces or extracts in any manner any oil or gas by taking it from the earth or water in this state; any person who acquires the severed oil or gas from a person or agency exempt from property taxation under the United States Constitution or other laws of the United States or under the California Constitution or other laws of the State of California; and any person who owns an interest, including a royalty interest, in oil or gas or its value, whether the oil or gas is produced by the person owning the interest or by another on his, her, or its behalf by lease, contract, or other arrangement.

"Product" would mean either a barrel of oil, which means 42 United States gallons of 231 cubic inches per gallon computed at a temperature of 60 degrees Fahrenheit or gas, as measured per thousand cubic feet (Mfc) at a base pressure of 15.025 pounds per square inch absolute and at a temperature base of 60 degrees Fahrenheit.

"Production" would mean the total gross amount of oil or gas produced, including the gross amount thereof attributable to a royalty or other interest.

"Severed" or "severing" would mean 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.

This bill would become effective immediately as an urgency statute; however, the oil and gas severance tax would become operative January 1, 2010.

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 AB 656. 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. Most recently, a similar tax was proposed in 2006, as Proposition 87, the “Clean Alternative Energy Act,” which was not approved by voters, and, in 2008, as AB 9 of the Third Extraordinary Session, which died in the Assembly Committee on Revenue and Taxation.

COMMENTS

1. **Sponsor and purpose.** The bill is sponsored by the California Faculty Association and is intended to provide a source of higher education funding to keep up with the growing demand for a skilled workforce, which the General Fund has been unable to sustain.

2. **This measure does not provide enough lead-time to implement a new tax program.** To effectively implement this bill, it would be necessary for the BOE to notify and register producers, develop computer programs, hire and train key staff, create necessary forms and schedules, and answer taxpayer inquiries. These functions should take place before the tax becomes operative. BOE staff estimates that it would take at a minimum six months to implement the new tax program proposed by this bill.

   In order to provide the BOE with the 6-month lead-time necessary to implement the proposed tax program, this bill would have to have been signed into law on or before July 1, 2009. Since we are well past that date, it is suggested that the bill be amended to provide for a delayed operative date to the first day of the first calendar quarter commencing more than six months after the bill is enacted. This would provide the BOE with sufficient lead-time to successfully implement the bill and would be consistent with the quarterly reporting basis proposed by this measure.

3. **Funding for administrative start-up costs necessary.** This bill would impose the severance tax beginning January 1, 2010; however, *it is assumed that the operative date of the tax will be revised.* If the operative date of the severance tax is amended to any date prior to January 1, 2012, the BOE will require an adequate appropriation to cover the BOE's administrative start-up costs not identified in the 2009-10 or 2010-11 budgets. These administrative start-up costs would include notifying producers, developing computer programs and reporting forms, and hiring appropriate staff.

4. **New BOE responsibilities outside of tax administration and collection.** This bill would require the BOE to perform duties outside its purview of tax administration, which could be problematic since such responsibilities are out of the BOE's area of expertise. These duties, in part, are as follows:

   - **Consumer Pass-Through Prohibition.** This bill provides that the proposed tax cannot be passed through to consumers by way of higher prices for oil, natural gas, gasoline, diesel, or other oil or gas consumable byproducts. The BOE would be required to monitor and, if necessary, investigate attempts to "gouge consumers by using the tax as a pretext to materially raise the price" of oil, gasoline, or diesel fuel, or other oil or gas consumable byproducts. It is unclear how the BOE would enforce such a pass-through prohibition. How would the BOE know what portion of a price increase on oil and gas is due to the imposition of the proposed tax, as opposed to other costs of production?

     Additionally, there is no specific penalty for violating the anti-pass-through provision.

- **Gross Value.** The bill defines gross value to mean the sale price at the mouth of the well, including any bonus, premium, or other thing of value, paid for the oil or gas, as determined by a rolling 30-day average daily value as established by the market price of the product. The BOE would be required to determine the base indexes from which the average is calculated. How exactly would this work? BOE staff is concerned with providing taxpayers with timely "gross value" information so that the proper amount of tax is imposed and collected by the producer. It appears that this bill would require the BOE to determine each day the gross value based on a rolling 30-day average. To provide this information timely, the BOE would have to compute and then publish daily the gross value on our web site. Imposing the proposed tax on a gross value amount that changes daily would complicate reporting and likely result in reporting errors, thus requiring additional BOE resources for audit and compliance functions. In addition, it is unclear whether there is a reliable source of information for California's daily crude oil prices, such as a publication, to assist the BOE in determining the gross value for oil and gas. With respect to oil, it appears that a California-specific report for oil would be necessary because of the pricing differential between California's crude oil (characterized as intermediate and heavy crude and generally lower valued) and West Texas Intermediate (WTI) crude oil (light crude), which is the most commonly used pricing benchmark in the United States.

  Furthermore, it should also be noted that each product (e.g. natural gas, casing head gas, crude oil, etc) will have a different price, which would require the BOE to calculate a daily value for multiple products.

- **Stripper Well Certification.** This measure would exempt from the tax oil or gas produced by a "stripper well" in which the average value of oil or gas is less than three-quarters of the average gross value of the product as of January 1 of the prior year. A "stripper well" would be defined to mean a well that has been certified by the BOE as an oil well incapable of producing an average of more than 10 barrels of oil per day during the entire taxable month. It is unclear how the BOE would perform such a certification and may have to contract with the Department of Conservation's Division of Oil, Gas, and Geothermal Resources to make this certification. The author may wish to consider amending the bill to require the Department of Certification's Division of Oil, Gas, and Geothermal Resources to certify stripper wells and notify the BOE of its findings. In addition, the bill should clarify the method of determining the average value of stripper well oil and gas. As discussed previously under "Gross Value," is there a reliable source for this information? Also, is the stripper well exemption an annual exemption, or would the oil or gas produced be subject to the tax if the average value of the product produced is more than three-quarter of the average gross value, as described? And how is the "average value" determined?

5. **Property Tax Exemptions.** Although the definition of "producer" 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 or gas 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 or gas severed from land under different ownership as well as the person responsible for the assessment.

Oil/Gas/Land Ownership	**Land Exempt From Property Tax**	**Who Pays Tax**
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 Tax
Outside 12 nautical miles	Not Subject To Property Tax	Not Subject To Tax

6. **Clarification Needed on Exemptions for Political Subdivisions.** Section 42016 states that the assessment does not apply to "oil or gas owned or produced by any political subdivision of the state, including that political subdivision's proprietary share of oil or gas produced under any unit, cooperative, or other pooling agreement." However, Section 42002(g) includes as a producer any person who acquires the severed oil or gas from a person or agency exempt from property taxation under the Constitution or laws of the United States or under the Constitution or other laws of the State of California. This bill would define a "political subdivision of the state" to mean a county, city, district, public authority, public agency, and any other political subdivision or public corporation in the State, but does not include the State. The BOE would have to clarify whether the first purchaser provision would apply in this situation or whether oil or gas severed from these lands would be permanently exempt from the assessment as it changes ownership.

7. **Suggested technical amendments.** In order to avoid any ambiguity with the administration of the proposed tax, the author may wish to amend the bill to address the following concerns:

   - Tax Imposition. This bill would apply the severance tax equally to all portions of the gross value of the product and be imposed at 12.5 percent rate of the gross product. It is unclear why the imposition of the tax includes language that it applies "equally to all portions?" Also, wouldn't the tax rate apply to the gross value of the product, as defined, not gross product? Is the "equally to all portions" language necessary? In addition, if the term "gross product," rather than "gross value," is the correct term, the bill does not include a definition for "gross product," which should be defined.

- Stripper Well. The definition of stripper well pursuant to Section 42002(k) only references oil wells. Does the author also intend to include gas wells?
- Due Date. This bill provides that the severance tax is due and payable to the BOE quarterly on or before the last day of the month next succeeding each calendar quarter. However, the bill does not specify a due date for the tax return.
- Regulations. This bill should authorize the BOE to prescribe, adopt, and enforce rules and regulations relating to the administration and collection of the Oil and Gas Severance Tax Law. In addition, the bill should also include authorization for the BOE to adopt emergency regulations as necessary to implement the proposed severance tax program.
- Definitions. The bill does not contain a definition for the term "mouth of the well" (or well head price for natural gas)." To avoid any ambiguity as to what constitutes a mouth of the well, it is suggested the bill be amended to define this term.

In addition, the following amendments are suggested:

- 42002.(h) "Product" means either a barrel of oil, which means 42 United States gallons of 231 cubic inches per gallon computed at a temperature of 60 degrees Fahrenheit, or gas, as measured per thousand cubic feet (Mfc) at a base pressure of 15.025 pounds per square inch absolute and at a temperature base of 60 degrees Fahrenheit.
- 42010. On and after January 1, 2010, there is hereby imposed an oil and gas severance tax upon any producer for the privilege of severing oil or gas from the earth or water in this state for sale, transport, consumption, storage, profit, or use. The tax shall be applied equally to all portions of the gross value of the product and shall be imposed at the rate of 12.5 percent of the gross ~~product~~ value.
- 42012. The tax imposed by this part shall be in addition to any other tax that may be imposed with respect to the severing of oil or gas or transactions related thereto, 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~~ for the privilege of severing oil or gas from the earth or water or doing business in that locality. There shall be no exemption from payment of an ad valorem tax related to equipment, material, or property by reason of the payment of the ~~gross~~ severance tax pursuant to this part.
- 42145. The board shall administer and collect the tax imposed by this part pursuant to the Fee Collection Procedures Law (Part 30 (commencing with Section 55001) of Division 2). For purposes of this part, the references in the Fee Collection Procedures Law to "fee" shall include the tax imposed by this part and to "feepayer" shall include a ~~person~~ producer required to pay the oil and gas severance tax.

COST ESTIMATE

The collection of this severance tax would result in the BOE incurring potentially significant costs related to the administration and collection of the assessment proposed by this bill. 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. In addition, there would be significant costs involved in hiring and training BOE employees to carry out those responsibilities outside the BOE's traditional tax collection and administration responsibilities. These estimated costs are pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The California Department of Conservation (DOC) maintains detailed data summarizing oil and natural gas production throughout the state.

- ***Oil Production.*** DOC data indicate that oil production subject to this proposal totaled roughly 218 million barrels in 2007. Oil production in the state has declined since 1992 at an average annual rate of 2.2 percent per year. This estimate assumes that this rate of decline will continue through 2010-11.
- ***Price of Oil.*** West Texas Intermediate (WTI) oil is a type of crude oil used as a benchmark in oil pricing. Over the past nine years, California crude has sold for an average of $9 per barrel less than WTI. This revenue estimate is based on a forecast of WTI from a national macroeconomic forecasting firm that assumes that oil prices will rise through 2011 as the economy recovers from the current recession. Using the historical relationship between the price of WTI and the price of California crude, we assume that the per-barrel price of California crude will average $63 in 2010-11 and $72 in 2011-12. This measure includes a provision that oil produced by a stripper well would be exempt from the tax if its price is less than 75 percent of what it was on January 1st of the prior year. Because we assume that oil prices will rise gradually but consistently through 2011, it is assumed that the output from stripper wells will be subject to the tax.
- ***Natural Gas Production.*** DOC data indicate that natural gas production subject to this proposal has increased since 1993 at an average rate of 0.2 percent per year. This estimate assumes that this slight rate of increase will continue through 2010-11.
- ***Price of Natural Gas.*** We do not have access to a forecast of natural gas prices. Instead, this estimate assumes that the price of natural gas will rise through 2011, following a pattern similar to that of WTI.

REVENUE SUMMARY

Based on our assumptions, the revenue impact of imposing a 12.5 percent oil and natural gas severance tax would be $1.8 billion in 2010-11 and $2.0 billion in 2011-12, detailed as follows:

Dollars in Millions	2010-11	2011-12
Oil Production	$1,586	$1,777
Natural Gas Production	237	268
Total	$1,823	$2,045

Qualifying Remarks

A key assumption underlying this revenue estimate is the forecasted price of oil, whose price can be quite volatile. As national macroeconomic forecasts periodically get 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. As an order of magnitude, if the price of oil averages $5 more or less per barrel than we assume for 2010-11, the resulting revenues would be $100 million higher or lower, respectively.

Reduction in Local Property Tax Revenues. Local property tax revenue derived from oil and gas reserves would decline under the measure relative to what they otherwise would have been, to the extent that the imposition of the severance tax reduces the value of oil reserves in the ground and its assessed property value for tax purposes. The exact size of this impact is unknown, as it would depend 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 tax/corporation tax liability. The extent to which the measure would reduce state taxes paid by producers is also unknown, and would depend on various factors, including whether or not a producer has taxable income in any given year and the amount of such income that is apportioned to California.

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