STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**05/07/07**	Bill No:	**AB 846**
Tax:	**Sales and Use**	Author:	**Blakeslee and Karnette**
Related Bills:	**AB 307 (Hayashi)** **AB 493 (Ruskin)** **AB 1190 (Horton & Huffman)** **SB 74 (Florez)**		

BILL SUMMARY

This bill would establish the Clean Marine Fuels Tax Incentive Act to provide a sales and use tax exemption for low-sulfur fuel products sold to water common carriers and used in either the vessel's auxiliary or main engine, under specified conditions.

SUMMARY OF AMENDMENTS

Since the previous analysis, this bill was amended to clarify some definitions, specify the recordkeeping requirements, and change the sunset provisions.

ANALYSIS

CURRENT LAW

Under current Section 6385 of the Sales and Use Tax Law, sales of fuel and petroleum products to water common carriers, for immediate shipment outside this state, are exempt from tax when used in the conduct of the common carrier's activities after the first out-of-state destination. The exemption for bunker fuel purchased by qualified waterborne vessels is dependent upon the amount of bunker fuel on board the vessel prior to refueling. If the quantity of bunker fuel on board the vessel on arrival at the California port is sufficient to enable the vessel to reach its first out-of-state destination, then the bunker fuel loaded at the California port is entirely exempt from tax. However, if the quantity of bunker fuel needed on the voyage from the California port to the first out-of-state destination and the amount used while in port exceeded the quantity of fuel on board the vessel on arrival at the California port, the amount of that excess is subject to tax.

PROPOSED LAW

Auxiliary engines. This bill would add Section 6357.7 to the Sales and Use Tax Law to exempt from the sales and use tax the sale of low-sulfur fuel products to a water common carrier inside this state for use in a vessel's auxiliary engine for immediate consumption in the conduct of its business as a water common carrier operating in California territorial or internal waters. This section would provide the following definitions:

- "Low-sulfur fuel products" means any fuel, including heavy fuel oil (HFO), marine distillate fuels, marine gas oil (MGO), marine diesel oil (MDO), or any other diesel fuel with a sulfur content no greater than 0.05 percent or 500 parts per million.
- "Auxiliary engine" is an engine, on a vessel, that provides power for use other than propulsion.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

- "Immediate consumption" means that the delivery of the low-sulfur fuel products for use in a vessel's auxiliary engine by the seller is directly into a vessel for consumption by that vessel while in California territorial or internal waters, and is not used for storage by the purchaser or any third party.
- "Territorial or internal waters" means waters within a seaward boundary three geographical miles into the Pacific Ocean measured from the mean low-water mark of the California coast, all interior navigable waterways, and the Monterey Bay, subject to definitions of the United Nations Convention on the Law of the Sea.

Main engines. In addition, this bill would add Section 6357.8 to provide a sales and use tax exemption for sales of "low-sulfur fuel products for use in a vessel's main engine" sold to a water common carrier for immediate consumption in the conduct of its business as a water common carrier until the lesser of the first out-of-state destination or 500 nautical miles beyond California's territorial waters. This section would provide the following definitions:

- "Low-sulfur fuel products" means any fuel, including HFO, marine distillate fuels, MGO, MDO, or any other diesel fuel with a sulfur content no greater than 1.5 percent or 15,000 ppm.
- "Main engine" is any propulsion engine, including, but not limited to, an engine whose main purpose is to provide power for propulsion, regardless of other uses, including a diesel-electric engine.
- "Immediate consumption" means that the delivery of the low-sulfur fuel products for use in a vessel's main engine by the seller is directly into a vessel for consumption by that vessel alone until the first out-of-state destination or 500 miles beyond California's territorial waters and not used for storage by the purchaser or any third party.
- "Territorial waters" means waters within a seaward boundary three geographical miles into the Pacific Ocean measured from the mean low-water mark of the California coast, and the Monterey Bay, subject to definitions of the United Nations Convention on the Law of the Sea.

Recordkeeping. Both Sections 6357.7 and 6357.8 require a water common carrier claiming an exemption to maintain and make available records related to the consumption of low-sulfur fuel, including, but not limited to, the following: (1) a description of the type of low-sulfur fuel used in either the auxiliary or main engine; (2) a description of the use of that low-sulfur fuel; (3) a description of the type of vessel that used the low-sulfur fuel, whether mono-fueled or dual fueled, and the number of auxiliary or main engines used; and (4) a description of the location and destination of the vessel that consumed the low-sulfur fuel while in California's territorial or internal waters.

Repeal provisions. With respect to repeal dates, this bill also amends Section 6385 so that the repeal date is dependent on changes in federal statutes, and otherwise makes permanent the sales tax exemption of fuel and petroleum products to a water common carrier for immediate shipment outside this state when used in the conduct of the common carrier's activities after the first out-of-state destination.

Section 6357.7 is repealed January 1, 2014, with the Legislative Analysts Office (LAO), in consultation with the Board and other affected state agencies, required to prepare

and submit a report to the Legislature by January 1, 2013, on the economic and health impact the exempt sales of low-sulfur fuel products used in a vessel's auxiliary engine have had on California, as well as recommendations on whether the exemptions should be continued or modified.

Section 6357.8 has a similar repeal date (January 1, 2014) and reporting requirement for the LAO, except that the sales and use tax exemption for low-sulfur fuel used in a main engine is alternatively repealed six months from the date the Board submits a finding to the Office of Administrative Law, that the U.S. EPA has done either of the following prior to January 1, 2014:

- established a Sulfur Emission Control Area under the provisions of Annex VI of the International Convention for the Prevention of Pollution from Ships, 1973, as amended at London in February 1978, or
- established vessel air emissions standards consistent with any amendments made by the International Maritime Organization to Annex VI of the International Convention for the Prevention of Pollution from Ships after the enactment date of this act, provided that the air quality benefits in California are at least as great as those from a Sulfur Emission Control Area and the standards are not applied exclusively to United States flagged vessels.

This bill would go into immediate effect, but the provisions of this bill would become operative on the first day of the first calendar quarter commencing more than 90 days after the effective date.

BACKGROUND

The LAO issued a report in 2002 on the effect of the bunker fuel exemption, and concluded "On this tax policy basis, we recommend that the Legislature remove the existing sunset for the current partial (sales and use tax) exemption for bunker fuel sales, and make the exemption permanent. This would result in the (sales and use tax) being levied in the future only on the portion of the fuel purchased in California which is consumed between California and the first out-of-state destination. This action would result in treating bunker fuel sales similarly to other export sales and place California ports on par with other U.S. out-of-state ports." The Pacific Merchant Shipping Association (PMSA) sponsored Senate Bill 145 (Perata) during the 2002 Legislative Session to extend the sunset date for the bunker fuel exemption until January 1, 2013. SB 145 passed the Legislature, but was vetoed by the Governor. As a result of the Governor's veto of SB 145, the sales and use tax exemption for sales of bunker fuel sunset as of January 1, 2003.

SB 808 (Ch. 712, Stats. 2003), which was authored by then Senator Karnette and sponsored by the PMSA and the International Long Shore Workers Union, reinstated the sales and use tax exemption for bunker fuel sold to water common carriers. The Legislature found and declared that in addition to the negative economic impact of not having a sales tax exemption, there was also a health impact related to the increased production of petroleum coke, which is an alternative refining product to bunker fuel.

COMMENTS

1. **Sponsor and Purpose.** According to the author's office, this bill is sponsored by the PMSA. The purpose of this bill is to provide an incentive for oceangoing vessels to use cleaner marine fuels.

2. **The May 7, 2007 amendments** provide a separate definition of "auxiliary engine," clarify the recordkeeping requirements for a water common carrier claiming an exemption, modify and specify certain repeal dates, require the LAO to submit a report to the Legislature, and in addition to the foregoing, make various technical changes related to the "immediate consumption" of low-sulfur fuel products. **The April 9, 2007 amendments** defined "main engine," and deleted a proposed section related to diesel fuel tax refunds.

3. **What kind of engines and fuel types does the industry use now?** According to a 2005 California Air Resources Board report[1], most oceangoing vessels use a single large slow-speed diesel engine for propulsion, and smaller medium-speed auxiliary engines that provide power for non-propulsion uses (i.e. lights, navigation, and other ship-board uses). The main engine primarily uses residual fuels such as HFO, while the auxiliary engine runs on either HFO or marine distillate fuels such as MDO or MGO. Those vessels that use HFO in both their main and auxiliary engines are referred to as mono-fueled (or uni-fueled), while those vessels that use distillate fuels (MDO, MGO) and residual fuels (HFO) are dual-fueled.

   As explained in the report, there are two types of fuels used in ocean going vessels, distillate and residual. The distillate fuels, MGO and MDO, are lower in sulfur content than the residual fuel, and as explained by the sponsor, the distillate fuels cost about twice as much. In general, the residual fuel has a higher sulfur content than the distillates and can be blended with a distillate to make an intermediate fuel oil (IFO). The residual fuel is so called because it is a fuel refined only after automobile, truck, and jet fuels have been refined. When demand or costs dictate, the residual fuel is further refined into petroleum coke, which can be used as an alternative energy source in some countries.

4. **Even if all of the information is provided to substantiate an exemption, this bill still presents a new and more complex challenge.** The current sales and use tax exemption for sales of fuel and petroleum products to water common carriers has been administered by the Board, on and off again, for almost twenty years. Although there are certain administrative sections consistent with current procedures, this bill would present a substantial change to the bunker fuel exemption and the Board's administrative functions. In general, the Board would be impacted to the extent and the timeframe that the industry responds to the incentives. Specifically, the proposed exemptions would add an additional workload and complexity in auditing, appeals, and regulatory functions of the Board.

5. **How would the new exemptions work with the current exemption?** The current sales tax exemption affects the sales of fuel and petroleum products to a water common carrier, for <u>immediate shipment outside this state for consumption</u> in the

[1] State of California, Air Resources Board. "STAFF REPORT: INITIAL STATEMENT OF REASONS FOR PROPOSED RULEMAKING; PROPOSED REGULATION FOR AUXILIARY DIESEL ENGINES AND DIESEL-ELECTRIC ENGINES OPERATED ON OCEAN-GOING VESSELS WITHIN CALIFORNIA WATERS AND 24 NAUTICAL MILES OF THE CALIFORNIA BASELINE." October 2005. http://www.arb.ca.gov/regact/marine2005/isor.pdf

conduct of its business as a common carrier after the first out-of-state destination. In general, proposed Sections 6357.7 and 6357.8 both intend to provide an exemption for the immediate consumption of low-sulfur fuel products used by the water common carrier while in California waters or the lesser of 500 nautical miles or until the first out-of-state destination. The exemptions for bunker fuel purchased by qualified waterborne vessels are dependent upon the amount of bunker fuel on board the vessel prior to refueling. If the quantity of bunker fuel on board the vessel on arrival at the California port is sufficient to enable the vessel to conduct its business in California waters and reach its first out-of-state destination or 500 nautical miles beyond California waters, then the bunker fuel loaded at the California port is entirely exempt from tax. If there is not enough low-sulfur fuel on board for the vessel to conduct its business in California waters, much less carry it to the lesser of the first-out-of-state destination or 500 nautical miles beyond California waters, then the water common carrier would need to retain information related to a vessel's engines, fuel tanks, and sailing schedules in order to justify the exemptions provided by this bill.

6. **Technical amendment**. The recordkeeping provisions in Section 6357.8 should be consistent with the use of the low-sulfur fuel in a main engine. Accordingly, the following language is suggested:

   6357.8 (e)(2)(C) A description of the vessel that used the low sulfur fuel product, including the type of vessel, whether the vessel is mono-fueled or dual-fueled, ~~and~~ the number of main ~~auxiliary~~ engines used by the vessel, and the type of propulsion system used.

   (D) A description of the vessel's locations and destinations for the period the vessel used the low-sulfur fuel product in a main engine until the first out-of-state destination, or 500 nautical miles beyond ~~was in~~ California's territorial ~~or internal~~ waters.

7. **Related legislation.** A number of bills have been introduced to provide a tax incentive for the purchase and use of environmentally-friendly products. **AB 307** (Hayashi) would exempt from the sales and use tax a "fuel cell vehicle," or a "fuel cell system" used exclusively for the purpose of upgrading a fuel cell vehicle, sold or leased to a "qualified person."

   AB 493 (Ruskin) would establish a clean vehicle incentive program that would provide one-time rebates to new motor vehicles that emit low amounts of greenhouse gases and impose surcharges for vehicles that emit large amounts of the same. The Board would be involved in collecting that surcharge and issuing rebates.

   AB 1190 (Horton and Huffman) would establish a clean fuel incentive to encourage the distribution and sale of fuels that have lower emissions of greenhouse gases. The incentives would be offered in the form of "credits" for cleaner fuels to offset the current fuel taxes, and provide a surcharge to be added to the current fuel taxes for fuels with greater greenhouse gas emissions.

   SB 74 (Florez) would provide a sales and use tax exemption for a specified time for biodiesel fuel, and for tangible personal property purchased for use by a qualified person in the manufacturing, processing, or production of biodiesel fuel, as defined.

COST ESTIMATE

A detailed cost estimate is pending. However, some costs would be incurred in revising publications, regulations and the exemption certificate, notifying the affected parties, and carrying out compliance and audit activities to ensure proper reporting.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

This bill would establish the Clean Marine Fuels Tax Incentive Act and would provide a sales and use tax exemption to encourage the use of cleaner burning fuels than the bunker (residual) fuels currently used by ocean going common carriers. This would include vessels engaged, for compensation, in transporting persons or property in interstate or foreign commerce. This exemption is an incentive for the use of low-sulfur fuel products in the auxiliary and main engine.

Auxiliary engines. In relation to auxiliary engines, *low-sulfur fuel products* is defined as any fuel, including heavy fuel oil, marine distillate fuels, marine gas oil, marine diesel oil, or any other diesel fuel, with a sulfur content of no greater than 0.05 percent, or 500 parts per million, that is purchased for use in the operation of an engine, on a vessel, that provides power for use other than propulsion. The product would be delivered directly into a vessel for consumption by that vessel while in California's territorial or internal waters.

Main engines. In relation to main engines, *low-sulfur fuel products* is defined as any fuel, including heavy fuel oil, marine distillate fuels, marine gas oil, marine diesel oil, or any other diesel fuel, with a sulfur content of no greater than 1.5 percent, or 15,000 parts per million, that is purchased for use in the operation of an engine, on a vessel, that provides power for propulsion. The product would be delivered directly into a vessel for consumption by that vessel alone until the first out-of-state destination or 500 miles beyond California's territorial waters, whichever is less.

The Energy Information Administration (EIA) reports fuel sales data for vessel bunkering. In 2005, the following was reported for California:

- Distillate Fuel Oil 129 million gallons
- Residual Fuel Oil 1,412 million gallons

Distillate fuel generally refers to marine gas oil (MGO) or marine diesel oil (MDO) which is mainly used in auxiliary engines. Residual fuel refers to bunker fuel that is generally used in the main engines. According to PMSA, residual fuel has had a price range of $300 to $350 per metric ton and distillate fuels are priced from $600 to $700 per ton. It should be mentioned that bunker price quotes for ocean going vessels are always on a per metric ton basis.

The EIA data is in gallons and the price data provided is in metric tons. PMSA indicated that the conversion from gallon to metric ton depends on the fuel type and gravity, but generally the conversion will be between 280 and 300 gallons per metric ton.

The amount of distillate fuel sold in California, in metric tons, is estimated to be 444,828 metric ton (129 million gallons / 290 gallons per metric ton = 444,828 metric ton). If we assume the price to be $650 per metric ton, sales are estimated to be $289 million (444,828 metric ton × $650 per ton = $289 million).

The amount of residual fuel sold in California, in metric tons, is estimated to be 4,868,966 metric ton (1,412 million gallons / 290 gallons per metric ton = 4,868,966 metric ton). If we assume the price to be $325 per ton, sales are estimated to be $1.6 billion (4,868,966 metric ton × $325 price per ton = $1.6 billion).

The combined sales of distillate and residual fuel to water common carriers are estimated to be $1.9 billion.

PMSA indicated that an estimated ratio of 12% of the fuel purchased in California would be consumed prior to the first out of state destination. If we apply this percentage to the $1.9 billion in sales, then $228 million in residual and distillate fuel sales is estimated to be related to consumption prior to the first out of state destination (12% × $1.9 billion = $228 million).

We have no information on what portion of these sales would be replaced by sales of low-sulfur fuel. PSMA indicated that currently no low-sulfur distillate fuel oil is used in vessel bunkering. We have been unable to find any data on the amount of low-sulfur residual fuel currently being used in vessel bunkering. It does, however, appear that the amount is small.

REVENUE SUMMARY

The immediate revenue impact of this bill would be small as at the present time very little low-sulfur fuel is being purchased for use in vessel bunkering.

However, if 10% of the current taxable purchases of fuel for vessel bunkering were to change to low-sulfur fuel, then the purchases exempted by this proposal would amount to $22.8 million.

	Revenue Effect
State loss (5.25%)	$ 1.2 million
Local loss (2.00%)	0.5 million
Special District loss (1%)*	0.2 million
Total	$ 1.9 million

* Nearly all of the bunker fuel is sold in jurisdictions with a tax rate of 8.25%.

Analysis prepared by:	John Cortez	916-445-6662	05/10/07
Revenue estimate by:	Ronil Dwarka	916-445-0840	
Contact:	Margaret S. Shedd	916-322-2376	

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.