STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**02/17/10**	Bill No:	**AB 1604**
Tax:	**Oil Severance**	Author:	**Nava**
Related Bills:	**AB 656 (Torrico)** **ABx6 1 (Nava)** **ABx8 41 (Nava)**		

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 severance tax upon all producers for the privilege of severing oil 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.

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 (DOC) 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 $0.0880312. 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 DOC 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 Industry Fair Share Act (Act). The Act would impose, on and after January 1, 2011, an oil severance tax (severance tax) upon all producers for the privilege of severing oil from the earth or water in this state for sale, transport, consumption, storage, profit, or use. The severance tax would be imposed at the rate of 10 percent equally to all portions of the gross value of each barrel of oil severed and would be upon the entire production in this state, regardless of the place of sale, or to whom sold or by whom used, or the fact that the delivery may be made to points outside the state.

The severance tax would be in addition to any ad valorem taxes imposed by the state, or any of its political subdivisions, and any local business license taxes that may be incurred as a privilege of severing oil from the earth or water or doing business in that locality.

Exemptions. The bill would exempt from the severance tax oil produced by a stripper well in which the average value of oil as of January 1 of the prior year is less than thirty dollars ($30) per barrel. 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 owned or produced by the state and any political subdivision’s proprietary share of oil 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 the Act.

And lastly, the imposition of tax would be reduced to zero for a period of 10 years for oil produced in this state from a well that qualifies under Section 3251 of the Public Resources Code (“hazardous well” or "idle-deserted well") or which has been inactive for a period of at least the preceding five consecutive years.

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.

Each producer would be required to prepare and file together with the remittance of tax a return in the form prescribed by the BOE. The BOE would be authorized to prescribe those forms and reporting requirements as are necessary to implement the tax, including, but not limited to, information regarding the location of the well by county, the gross amount of oil produced, the quantity sold and the selling price, the prevailing market price of oil, and the amount of tax due.

Any person that fails to timely pay the tax would be required to pay interest at the rate of 1 ½ percent per month, or fraction thereof, from the date on which the tax became due and payable to and including the date of payment. The bill also specifies how payments on delinquent tax payments would be applied, which is as follows:

- First, to any interest due on the tax.
- Second, to any penalty imposed by this part.
- Third, the balance, if any, to the 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.

The BOE would also be authorized to prescribe, adopt, and enforce emergency regulations relating to the administration and enforcement of the Act.

Disposition of Funds. All taxes, interest, and penalties collected by the BOE would be deposited in the General Fund.

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 as of January 1 of the prior year is less than thirty dollars ($30) per barrel.

The bill would also reduce to zero the severance tax rate for a period of 10 years for oil produced from a well which has been inactive for a period of at least the preceding five consecutive years. It appears making the verification of an inactive well would also be the responsibility of the BOE.

The BOE would also be authorized, but not required, to monitor and 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. The pass through provisions would apply when not superseded by federal law.

Definitions. This bill would include the following definitions within the Act, which pertain to the BOE:

"Barrel of oil" would mean 42 United States gallons of 231 cubic inches per gallon computed at a temperature of 60 degrees Fahrenheit.

"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.

"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 or entity that takes oil from the earth or water in this state in any manner; any person who owns, controls, manages, or leases any oil well in the earth or water of this state; any person who produces or extracts in any manner any oil by taking it from the earth or water in this state; any person who acquires the severed oil 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 its value, whether the oil is produced by the person owning the interest or by another on the person's behalf by lease, contract, or other arrangement.

"Production" would mean the total gross amount of oil produced, including the gross amount 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, 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 from below the surface of the earth or water, and shall include the extraction or withdrawal by any means whatsoever of oil 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 a tax levy; however, the severance tax would become operative on January 1, 2011.

BACKGROUND

Numerous legislative bills have been introduced that would have imposed an oil severance assessment, tax, or fee to be collected by the BOE similar to the assessment imposed by this bill. 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. 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 author and is intended to "have oil companies, who continue to make billions in profits, pay their fair share to California, which could help address budget shortfalls that have impacted classrooms, the number of police and firefighters, care for the disabled and elderly, health insurance for children, community clinics, and state parks."

2. **Would the Board have sufficient time to implement the new tax program?** To effectively implement this bill, it would be necessary for the Board 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 fee becomes operative. Board staff estimates that it would take a minimum of six months to implement the new tax program proposed by this bill.

   In order to provide the Board with the 6-month lead-time necessary to implement the proposed tax program, this bill would have to be signed into law on or before July 1, 2010. If the bill is signed into law after 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 proposes a new severance tax to be imposed beginning on and after January 1, 2011. If this measure is signed into law, the BOE would begin to implement the proposed severance tax program no later than July 1, 2010. In order to properly notify producers, develop computer programs and reporting forms, and hire appropriate staff, an adequate appropriation would be required to cover the BOE's administrative costs that would not already be identified in the BOE's 2010-11 budget.

   As an alternative to an appropriation, the author may want to consider amending the bill to move the operative date of the severance tax from January 1, 2011, to January 1, 2012. This would allow the Board to obtain funding for administrative start-up costs through the Budget Change Proposal process.

4. **How would refund payments and ongoing administrative costs be funded?** While the bill provides that all taxes, interest, and penalties collected be deposited in the General Fund, the bill does not specify how payments for refunds and the Board's administrative costs would be funded. The bill should be amended to address this issue.

5. **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 authorized, but not required, to monitor and 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. Should monitoring by the BOE be made mandatory, and, if it is, 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 and market price fluctuations?

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

- **Stripper Well Certification.** This measure would exempt from the tax oil produced by a "stripper well" in which the average value of oil as of January 1 of the prior year is less than thirty dollars ($30) per barrel. 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. The well would remain certified until it produces an average of more than 10 barrels of oil per day during an entire taxable month.

  It is unclear how the BOE would perform such a certification and follow-up, and may have to contract with DOC's Division of Oil, Gas, and Geothermal Resources to make this certification. The author may wish to consider amending the bill to require DOC'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 whether the average value of oil to be determined is that oil specific to that stripper well or the per-barrel price of California oil in general and, if the former, the method of determining the average value of stripper well oil. Is there a reliable source for this information?

- **Hazardous, idle-deserted, and inactive wells.** This measure would reduce the severance tax rate to zero for a period of at least 10 years for a well that is determined by a State Oil and Gas Supervisor to be hazardous or idle-deserted pursuant to Section 3251 of the Public Resources Code. The bill should be amended to require DOC to share information regarding such determinations.

  In addition, the tax imposed upon oil produced from a well that has been inactive for a period of at least the preceding five consecutive years would be reduced to zero. What constitutes an inactive well? How would the BOE verify the period of time such a well has been inactive? Would the 10 years for the reduced rate start upon the date a well is determined to be hazardous or idle-deserted? Would an inactive well rate reduction be reapplied if, during the first five years of a 10-year period reduction, the well is active but is inactive for the last five years?

6. **Would the tax apply to oil acquired from the state or political subdivision?** Section 42008(c) states that the assessment does not apply to "oil owned or produced by the state and any political subdivision's (including any county, city, district, public authority, public agency, and any other political subdivision or public corporation in the State) proprietary share of oil produced under any unit, cooperative, or other pooling agreement." 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. This exemption seems to imply that oil produced by the state or any political subdivision, as defined, would be permanently exempt from the tax as the oil changes ownership.

   However, Section 42002(e) includes as a producer any person who acquires the severed oil 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 laws of the State of California. The severance tax is imposed upon all producers at the rate of 10 percent of the gross value of each barrel of oil severed. Since land owned by the state and any political subdivision, as defined, is exempt from property tax, is this measure intended to impose the severance tax upon any person that acquires the severed oil from the state or political subdivision as a "producer?"

It is suggested clarifying whether the definition of "producer" would apply in this situation or whether oil severed from these lands would be permanently exempt from the severance tax as it changes ownership.

7. **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 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 Tax
Private Lands	No	Producer
Federal Lands	Yes	First Purchaser
State Lands	Yes	Requires Clarification As Noted in Comments #6 & #7
Political Subdivisions of the State (County, City, Other)	Yes	Requires Clarification As Noted in Comment #6 & #7
State Offshore (Coast to 3 nautical miles)	Yes	Requires Clarification As Noted in Comment #6 & #7
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

8. **Interest and application of delinquent payments.** This bill requires any person that fails to pay any tax within the time required to pay interest at the rate of 1 ½ percent per month, or fraction thereof, from the date on which the tax became due and payable to and including the date of payment. The Fee Collection Procedures Law, under which the severance tax would be administered and collected by the BOE, imposes interest at the modified adjusted rate per month, or fraction thereof, established pursuant to Revenue and Taxation Code Section 6591.5. For the 2010 calendar year, the rate is set at 7 percent for deficiencies.

Due to the conflicting interest rate provisions, it is suggested amending the bill to make it clear that the interest provisions set forth in Section 42010(a) prevail. The following language is suggested:

> 42010. (a) Notwithstanding Revenue and Taxation Code Sections 55041, 55042, 55050, and 55061, any~~Any~~ person that fails to pay any tax within the time required shall pay, in addition to the amount of tax owed, interest at the rate of 1 ½ percent per month, or fraction thereof, from the date on which the tax became due and payable to and including the date of payment.

The bill also specifies the application of delinquent severance tax payments to first be applied to the interest due on the tax and second to any penalty imposed. Only then would remaining amounts of the payment be applied to the balance of the tax itself. Currently, Board-administered programs that apply delinquent payments in this order include the insurance tax (collected by the Controller) and motor vehicle fuel tax. In all the other tax and fee programs administered by the BOE, the application of payments on delinquent tax liabilities is uniform: payments are applied first against the tax, then against penalties, and lastly against interest.

It should be noted that applying delinquent severance tax payments in the order proposed by this bill would not reduce the tax liability where partial payments only cover interest and penalty amounts. Under such circumstances, interest would continue to accrue on the full amount of tax due to which future payments would again first be applied, thus making it difficult for taxpayers to reduce their tax liability.

9. **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 each barrel of oil severed. It is unclear why the imposition of the tax includes the language that it applies “equally to all portions?” Is the “equally to all portions” language necessary?
- Definitions. This bill would define "gross value" to mean the sales price of the barrel of oil at the mouth of the well. The bill does not contain a definition for the term “mouth of the well.” 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:

- 42010. (a) Any ~~person~~producer that fails to pay any tax within the time required shall pay, in addition to the amount of tax owed, interest at the rate of 11/2 percent per month, or fraction thereof, from the date on which the tax became due and payable to and including the date of payment.
- 42013. 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 tax imposed by this part.

10. **Related Legislation.** AB 656 (Torrico) would impose an oil and gas severance tax at the rate of 12.5 percent of the gross value of the product. ABx6 1 and ABx8 41, both authored by Assembly Member Nava, are substantially similar to this bill.

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

Oil Production. DOC maintains detailed data summarizing oil and natural gas production throughout the state. DOC data indicate that oil production subject to this bill 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.

The 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 oil. 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 oil 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. The current outlook for oil prices implies that the output from stripper wells would be subject to the tax.

REVENUE SUMMARY

Based on our assumptions, the revenue impact of imposing a 10% oil severance tax would be $634 million in 2010-11 (a half-year effect), rising to $1.4 billion in 2011-12.

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 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 projected revenues raised by this bill. As an order of magnitude, if the price of oil averages $5 more/less per barrel in 2011-12 than we assume, the resulting revenues would be $100 million higher/lower.

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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