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June 4, 2012

Hon. Kamala D. Harris
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Ashley Johansson
Initiative Coordinator

Dear Attorney General Harris:

Pursuant to Elections Code Section 9005, we have reviewed a proposed statutory initiative related to hydraulic fracturing and severance taxes (A.G. File No. 12-0014).

Background

Hydraulic Fracturing. In California, the Division of Oil, Gas, and Geothermal Resources (DOGGR) within the Department of Conservation has broad statutory authority to supervise many different aspects of oil and gas production. For example, under existing state law, an owner or operator of a well is required to submit specific information to the division regarding the drilling of the well (such as the location of such drilling). However, despite its broad statutory authority, DOGGR currently does not regulate or collect information on the specific practice of hydraulic fracturing or "fracking." Hydraulic fracturing is a process that allows oil or natural gas to move more freely to production wells by injecting a mix of water, chemicals, and a propping agent at high pressure into an underground rock formation. According to a 2011 survey conducted by an industry group, hydraulic fracturing was used at approximately 700 oil and gas wells in California (out of a total of roughly 50,000 active wells in the state).

At the federal level, the Environmental Protection Agency's Underground Injection Control (UIC) program currently regulates most of the underground injection of fluids associated with oil and gas production. However, federal law exempts injections done during hydraulic fracturing from the requirements of the UIC program.

Oil and Gas Related Taxation in California. Oil and gas producers pay the personal or corporate income tax depending on their form of organization, and a regulatory charge on production in the state or in state waters. Also, property owners pay local property taxes on the value of both extraction equipment such as drills and pipelines and (unlike most other states) underground oil and gas reserves.

Proposal

New Oil and Gas Severance Tax to Fund Payments to Individuals. The measure imposes a 25 percent tax on the value of all oil and gas extracted in California or its state offshore waters that extend out three miles from the coastline. Oil and gas produced in federal waters would be exempt. Of the revenues raised and placed in a new state account (the California Tax Relief Fund), 0.5 percent would go to DOGGR to oversee oil and gas producers, and the remaining 99.5 percent would fund payments to registered voters over the age of 65 ($50 each year); and to taxpayers who cannot be claimed as dependents and who have income below $95,000 for a single filer or $190,000 for a couple filing jointly, a head of household, or a widow/widower ($380 each year). Registered voters over age 65 who are also under the income threshold would receive $430 each year.

The measure's language suggests that a couple filing a joint return would be treated as one taxpayer and thus get $380 annually instead of $760. The payments would be made on the third Wednesday in March by the Franchise Tax Board (FTB), the state department that administers personal and corporate income taxes.

We note that, while the measure is drafted in a way suggesting these payments are intended only for individuals and couples, it does not explicitly state that corporate taxpayers would be ineligible for the annual payments. Our fiscal analysis below assumes the payments are not made to corporate taxpayers.

Additional Disclosure Requirements for All Types of Well Drilling. This measure would require that the owner or operator of a well submit additional information to DOGGR regarding the drilling of that well. Specifically, the measure would require information on the amount and source of all water used in the exploration or production of oil or gas and the use and method of disposal of any radiological components or tracers injected into the well. Under the measure, owners or operators of wells would also be required to record the contents of trucks transporting water, gas, or oil that is produced in the course of well operation and to track those trucks in real time using a Geographic Information System. Such information must be submitted to DOGGR and then made available to the public.

Disclosure Requirements Specific to Hydraulic Fracturing. This measure would also require owners or operators of wells to disclose whether they used hydraulic fracturing at a well. For those wells that are hydraulically fractured, the owner or operator must keep a record of the chemicals used and the amount and disposition of the water recovered from the well following fracturing operations. The measure requires that DOGGR incorporate this information into the maps of wells in California that it currently maintains on its website.

Increased Fines and Penalties for Violations. The measure would substantially increase the fines and penalties that can be charged to owners or operators of wells for violations relating to oil and gas operations. For example, this measure increases the fine for filing false well log reports from a minimum of $100 to $10,000 and from a maximum of $1,000 to $50,000. In addition, the measure would increase the maximum civil penalty from $25,000 to $150,000 for each violation of the statutes and regulations regarding oil and gas production. As is specified under current law, monies collected from this penalty would be used to support the administration of DOGGR's regulatory programs. Moreover, this measure would also exempt from prosecution any individual who provides evidence of a violation to DOGGR and would prohibit well owners or operators from firing or otherwise discriminating against employees who provide such evidence to DOGGR or other public officials.

Fiscal Effects

Severance Tax Revenue. We estimate that the severance tax would generate roughly $5 billion from oil and $200 million from natural gas in 2013-14, its first full year. This figure could be much higher or lower depending on prices, which are highly volatile. Revenues, therefore, could range between $3 billion and $7 billion annually over the next decade. Holding prices constant, revenue would likely decline over time as oil production has fallen every year since 1997 at an average rate of 2.6 percent and gas production has fallen by an average annual rate of 3.1 percent since 2002.

Effects on Production. Historically the level of oil production in the state has not been responsive to changes in the after-tax price. At the projected 2013 price (which is high by historical standards) we estimate that imposing the tax would result in only a small decline in production. However, if the price were to fall to levels that prevailed before 2005 (less than $40/barrel) it is likely that the tax would push the after-tax price below the cost of operating many of the state's wells, and would thus have a bigger negative effect on production.

Other Tax Revenue Effects. Various financial changes related to the severance taxes may result in reductions of other state and local revenues such as income and property taxes—perhaps totaling in the tens of millions or a few hundred million dollars per year. There also could be other revenue gains or losses due to economic changes that result from the severance tax and the payments to individuals. For example, the payments to individuals would lead to increased disposable income for many Californians, which could result in increased taxable sales. In addition, state personal income tax revenues by individuals and couples on their annual payments received under this measure would total around $200 million per year.

Annual Payments to Individuals. In 2010 (the last year for which we have data) there were 13.8 million income tax returns filed by people who met the income threshold and 2.7 million registered voters over the age of 65. We estimate that in 2013 there will be 14 million filers below the income threshold and 3 million voters over age 65. The estimated cost of these payments in 2013 would be roughly $150 million for voters and $5.3 billion for income taxpayers if joint returns are treated as one taxpayer rather than two. In practice this amount could be somewhat higher or lower as some portion of filers will be claimed as dependents on another taxpayer's return (and thus be ineligible for the payment), while the payment program would also entice some portion of current nonfilers to file. The combined cost of the taxpayer and voter payments might be closer to $5 billion, in the same ballpark as the estimated revenue from the severance tax. Unlike the severance tax revenue, the population eligible for the payments and thus the total amount of the payments would not fluctuate much from year to year.

No Shortfall Provision. The measure does not specify what would happen if the revenue from the severance tax in any year plus available fund balances from prior years is not enough to cover the cost of the payments.

Increased Administrative Costs. This measure would result in additional costs for DOGGR to process, verify, and make public the additional information that owners and operators of wells would be required to submit and for FTB to administer the payment program. The magnitude of the increased costs could reach several million dollars annually. There could also be one-time costs to initiate these programs totaling a few million dollars.

The measure dedicates 0.5 percent of revenues from the oil severance tax to DOGGR to support its administration of the increased disclosure and tracking requirements. These severance tax revenues, and to a lesser degree the revenues from the penalties, are likely to fully offset the above increased administrative costs. In addition, the measure allows part of the severance tax and other revenues related to this initiative to be used to cover FTB administrative costs.

Summary of Fiscal Effects

We estimate that this measure would have the following major fiscal effects:

- Annual state revenue of $3 billion to $7 billion (depending on oil prices) from new severance tax to fund approximately $5 billion of payments to individuals. The measure does not specify what would happen if available severance tax funds are insufficient to make the required payments.
- Decreased collections of various other state and local revenues totaling tens of millions or a few hundred million dollars per year due to financial changes related to the severance tax. This potentially could be offset by increases in some other revenues.
- Increased state administrative costs of several million dollars annually to administer this measure. These costs would be paid from the revenues of the oil severance tax and the increased fines in this measure.

Sincerely,

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Legislative Analyst

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