

COUNTY OF SANTA BARBARA

OIL PRODUCTION TAX PROPOSAL

STAFF REPORT TO
THE BOARD OF SUPERVISORS ON
OIL PRODUCTION TAX OPTIONS



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STAFF REPORT ON OIL PRODUCTION TAX OPTIONS

DETAILS ON POSSIBLE ECONOMIC IMPACTS, POTENTIAL TAX
METHODOLOGIES AND BALLOT MEASURE PREPARATION

BACKGROUND

What is an Oil Production (Severance) Tax?

An oil production tax would be a charge for the right to produce the barrel of oil. This type of tax can be developed under Revenue and Taxation Code Section 7284 as a business license tax which would be a general tax with proceeds flowing to the general fund. This general tax would require a 4/5 vote by the Board of Supervisors (Board) and majority approval by the voters. Additionally, any general tax ballot measure must be on the same ballot as a Board of Supervisors seat.

An alternative would be to create a special tax under authority of Government Code, Section 50077. The structure of this tax as a business tax on the right to produce a barrel of oil would remain the same, but it would be a special tax, rather than a general tax, meaning that the proceeds of the tax would go to a special purpose rather than the general fund. A special tax ballot proposal would require a majority vote by the Board and a 66.67% voter approval. Special tax approval does not require a Board member to be up for election on the same ballot.

Either the general or special tax could be indexed to prevent the tax from becoming out of line due to inflation or price fluctuations. Benchmarking the tax annually against the price in the Department of Labor, Bureau of Labor Statistics Producer Price Index of Crude Petroleum Domestic Production would help keep the tax relevant to the changing market conditions into the future. A choice to index the tax along with designating a base year, price index and frequency of evaluation would need to be a component of the ballot measure considered by the voters.

The tax would take effect 30 days after passage by the voters or at such other date specified in the tax measure.

Santa Barbara County Opportunities of an Oil Production Tax

California is the only major oil producing state that does not charge an oil production tax. Several cities in Los Angeles and Orange Counties currently do tax the oil companies between \$.20 and \$.60 per barrel (42 gallons) of oil. With the price of oil at around \$95 a barrel, that level of taxation is 0.015% of the value of that barrel, at the most. Additionally, some of the cities also charge a “per wellhead” charge as a component of their tax.

With current oil prices hovering just below record highs and demand for domestic production increasing, formerly semi-idled fields onshore have increasingly become economically viable. Price

is the major driver of production. The opportunity therefore exists for increased production from restarting existing onshore semi-idled fields.

The revenue generated by an oil production tax in Santa Barbara County would remain local and spending would be directed by the voters through a special tax measure or by local policymakers through the budget process. The budgeting and use of these revenues would occur locally and would provide for a local economic multiplier effect that supports local businesses providing goods and services. Generating local revenue allows for the support of the services most important to the public here in Santa Barbara County.

Santa Barbara County residents seem concerned about further service reductions after four consecutive years of cuts. In the past four years, the number of County staff has been reduced to a level not seen since 1997. Additionally a wage freeze for managers and executives, wage and benefit concessions from all non-public safety employees, a second tier retirement system for new non-public safety employees, furloughs, business –process streamlining and departmental mergers to improve efficient use of financial resources have all been implemented to close an over \$70 million budget shortfall.. A lot has already been accomplished and even more steps will be taken in the next several budgets to reduce the cost of government services. Yet, cutting costs alone will result actual service level reductions. The revenue potential from an oil production tax could assist in maintaining some critical services at their current levels.

Santa Barbara County Constraints of an Oil Production Tax

The public is also being asked to consider other tax, assessments and bond measures from cities, special districts and school districts. The cumulative impact of other tax proposals may increase the anxiety of voters. Unique from many of the other tax proposals on the ballot direct costs of an oil production tax to County residents are expected to be insignificant. County staff research indicates the price of oil is determined primarily by global markets and the oil production tax will have little or no affect on the price of gas to our residents.

Recently, the oil industry has identified what they believe to be negative impacts an oil production tax would have on the local economy and County residents. These include:

- Oil production taxes will reduce production and jobs.
- Oil production taxes increase the price at the pump.
- Oil industry pays its fair share of taxes.

As each of these is primarily an economic argument, they will be treated in more detail in the Economic Analysis Section later in this report.

Various environmental groups believe that the approval of an oil production tax by the voters would incentivize the approval of additional oil development. As will be noted later in this report, the single most powerful driver for future oil development remains the price available to the producer.

CURRENT TAXES AND FEES PAID BY THE OIL INDUSTRY IN SANTA BARBARA COUNTY

Property Tax - Land, Assessed Mineral Value and Improvements

Each property tax bill includes an assessed value for the land and separately the structures. These two values are combined and the tax is calculated at a rate of 1.0% of the assessed value. Most tax bills also include a number of additional special district assessments and associated other fees. These may total up to another 0.1% (estimate) of the assessed value of the property. In 2010, the County of Santa Barbara collected approximately \$8 million in property taxes from onshore oil production land and infrastructure. These property taxes equal \$2.35 per barrel of oil produced.

County Assessor staff assesses the value of the land, improvements and the value of the right to extract minerals. As with all real property in California, values and assessments are made in accordance with Proposition 13 and assessments are based on the lesser of Proposition 13 factored base value or market value on lien date.

The value of the right to remove or produce oil is a complex calculation of how much oil has been removed over the past year and/or changes in the expectation of future production. The net changes from the prior year of the market value and volume of the oil reserve are used to determine the current value.

Oil production facilities may include structures, out-buildings and pipelines that increase the property value.

Inspection Fees

Currently, oil producers are charged a \$123.31 per well and tank inspection fee by Planning and Development and another \$1,370 per tank battery inspection fee by the Fire Department. In 2011, these brought in \$318,000 of revenue to the County as a direct offset to the cost of performing the inspections. The total of these per well fees amount to \$0.09 per barrel of oil produced.

County assessed property taxes and inspections fees on average are \$2.44 per barrel or 2.6% of a \$95 barrel of crude oil.

ECONOMIC ANALYSIS

The oil industry is complex. It really is multiple industries each with its own supply and demand system coupled together. Oil production, transport, processing and retailing are in essence separate but related industries. Each has its own economic influences. While retail demand at the gas pump does impact price, as we saw four years ago when pump prices increased dramatically, it was speculative demand for crude oil at the processor level that caused the supply to dwindle and prices to rise.

Any economic analysis of the impact of an oil production tax on the Santa Barbara County economy should focus on the impacts to the oil production industry. The most important business decision affecting a local oil producer is how much can oil be sold for to a wholesaler or refinery. The price determines the amount of oil produced. A good example of this is the practice of idling wells still capable of producing when the oil prices no longer support the cost of operating that same well.

Oil Industry Job Impacts

The oil industry stated at the Board hearing in November that an oil production tax would cause job losses locally. They did not offer any specifics. Job losses could theoretically result if some oil production ceased here in Santa Barbara County as a result of an additional tax. As noted earlier in this report, the current local tax burden is less than 3% for the average priced barrel of oil produced.

At the time of Governor Schwarzenegger's 2008 oil production tax proposal, both the oil industry and labor groups funded economic analysis of the job impacts. The Governor had proposed a 9.9% oil production tax. According to the oil industry analysis conducted by LECG, LLC, the proposed 2008 tax would eliminate 9,850 jobs statewide. When the oil industry sponsored research job impacts are extrapolated to Santa Barbara County that would equate to a total of 23 jobs lost. Key to the job loss scenario is that oil at the time was selling for \$58 a barrel. Currently oil is selling for just less than double that price. This would seem to indicate far fewer job losses.

Labor unions concerned about the impacts of state budget reductions also conducted research into the 2008 proposal from the Governor. They asked the Center for Labor at the University of California at Berkeley to conduct comparative job impact analysis of state budget cuts and the oil production tax. According to that research, the job impact to Santa Barbara County oil production would be just under one job.

It is important to note that the oil production tax suggested for a ballot measure in Santa Barbara County is less than 1% of the current price of oil as compared to the 9.9% severance tax proposed by the Governor in 2008.

Oil Production Impacts

As previously mentioned, the most important business driver for the oil production industry is the price for a barrel of oil. Costs of doing business, including taxes, must be managed to generate a profit. The decision to open production, continue or end production on a well is maintaining that reasonable spread between revenues and expenditures. Every other oil producing state and country in the world levies an oil production or severance tax on the oil taken from the ground.

One of the fastest growing oil producing areas of the country is North Dakota. Currently, oil producers in North Dakota pay a combined production/severance tax rate of 11.5%. There are some allowances in the tax structure that makes the effective rate for most producers less than 11.5%. These taxes have been in place since the 1980's, but production has increased 4.5 times since 2004 and nearly doubled since 2009. Clearly the price of crude oil is driving the North Dakota oil production explosion, regardless of the oil severance tax. Recall that the suggested production tax rate would be around 1% and the other property taxes and fees raise that total tax percentage to 3.8 – 4%. With all of the local taxes taken into account, if the tax is successful, Santa Barbara

County producers would be paying only about one-third of the taxes paid by North Dakota's severance taxes.

Gas Pump Price Impacts

The oil production tax is charged to the producer. The price paid is set by the wholesaler or the refinery based on their own supply-demand situation. The producer has very limited or no way to pass the cost of the proposed oil production tax along to the refiner and then cannot be passed along to the consumer at the pump.

Earlier oil production tax proposals back in the 1980s did generate some research that indicated that oil production taxes could impact the price of gasoline by ½ cent per tank of gas. The industry has changed significantly since then with very little vertical integration between oil producer, refiner and retailer industries.

POSSIBLE TAXATION METHODOLOGIES AND REVENUE FORECASTS

Proposed New Severance/Production Tax

The oil production tax for possible placement on the November 2012 ballot would impose a business license tax or a special tax on oil actually produced in the County of Santa Barbara. Two taxation methods or basis are suggested below. A hybrid using a combination of the two tax methods or basis could also be considered.

Volume-based Tax - \$ per barrel

This tax method would assess a tax per barrel of oil produced. For example, if the ballot measure established a \$1.00 per barrel oil production tax and an oil producer pumped 10,000 barrels a year out of their wells, the tax liability would be \$10,000.

The benefit of this method is that the oil industry must currently report these numbers to the state. Reporting the number of barrels produced doesn't cause a significant additional tracking requirement on industry. Additionally, the tax is directly proportional to the amount of oil revenue generated; the more oil produced the more revenue and a larger commensurate tax liability. Finally, oil production follows a fairly natural life cycle; slow at first, followed by a peak and then gradual decline. This life cycle will give the County some predictability of near and intermediate term revenues.

One of the constraints of using this tax methodology is that the relative value of volume-based tax on a barrel of oil may decline over time due to inflation. The City of Long Beach found this to be true. They implemented an oil production tax in 1990 of \$ 0.15 per barrel. By 2007, the price per barrel had increased by 300%. This increase in the producer price of oil had created a circumstance where the tax was worth only 0.1%. A strategy to mitigate the impacts of inflation or deflation is to annually recalculate the tax rate using an index, such as the Producer Price Index or the price of West Texas Intermediate crude, and a base year to keep the value of the tax constant as prices

fluctuate. Our County Assessors already use a similar method to recalculate the basis for the assessed value of the mineral rights.

Wellhead-based Tax - \$ per well

This tax method would assess a per wellhead tax. Oil producers would be taxed based on the number of wellheads they control. For example, a producer with 125 wells and a rate of \$3,750 per well would have a tax liability of \$468,750.

The benefit of this tax method is that it is extremely easy to administer. The County knows where oil wells, idle and producing, are and who controls them. It would be a matter of adding new wells each year to the inventory and recalculating the new year tax liability on a date certain.

Applying the per wellhead tax methodology to producing wells only would create a challenge. Wells move between active and idle status and requiring reports to track those changes would seem burdensome on industry and monitoring the reports to calculate the tax liability would increase the costs of administering this tax method.

Options to consider for either tax

The following options are available for consideration by the Board.

- Hybrid Volume and Wellhead Tax – The Board may direct staff to use a hybrid of the two methodologies to mitigate the total impacts of either the per volume or per wellhead methodology. An important policy suggestion would be to provide staff with a suggested revenue target and then allow staff to analyze various formulas and their related impacts.
- Exclude low volume wells from the taxing requirement – A decision on whether to include or exclude “stripper” (low producing) wells from tax calculations. The exclusion of “stripper” wells, particularly when the tax proposal includes a per wellhead tax method, would minimize the negative economic impacts to the oil producer. An additional policy choice will be to define “stripper” wells for our tax purposes. For example, 10 barrels or less per day is generally accepted as the definition of a “stripper” well. Others define stripper wells within a range from less than five barrels a day to less than twenty barrels per day.
- 10 or 20 year tax “Sunset” – The Board may wish to direct that staff include a “sunset” provision in the tax measure. This would create a revenue short fall at the end of the tax period authorized by the voters.
- Indexed rate – As noted earlier in the report, once a per barrel or per wellhead tax rate is established it can easily fall out of alignment with economic conditions. The ballot measure could include language that allows the tax rate to “float” based on the change in a standard index such as the Producer Price Index or the price of West Texas Intermediate crude oil. The change would be the percentage change from the base year. For example, the ballot measure might use the Producer Price Index for Domestic Oil on July 1, 2012 as the base amount. Each year thereafter, the tax rate would increase or decrease based on the average change back to that July 1, 2012 date. The tax rate would move up or down relative to the

changes in the index. This should keep the tax rate close to the current economic circumstances.

- General Tax or Special Tax – The Board will need to decide whether to write a general tax measure or a special tax measure.

The general tax measure would require a 4/5 vote of the Board to place on the ballot, a member or open seat of the Board on the same ballot and a majority vote from the public. Revenue generated from a general tax would be received into the general fund and budgeted through the standard county budget process.

A special tax measure would require a majority Board approval to place the measure on the ballot and then a 66.67% vote of the public to approve the special tax. No Board member or seat is required on the same ballot. Special tax measures must specifically designate how the tax revenue will be spent and such use of the tax is constrained for the life of the tax and cannot be changed without a further vote of the electorate.

BALLOT MEASURE PREPARATION: SCHEDULE AND COSTS

Timeline

Staff is prepared to begin drafting ballot measure language based on direction from the Board. It will take several weeks to draft the ballot measure. Staff recommends a decision to proceed with preparing and drafting the ballot measure on or before the March 20, 2012 regular meeting of the Board. The Board could decide at any time between now and mid-July to stop preparing and drafting the ballot measure. Another Board action will be required to place the measure on the ballot on or before July 17, 2012.

Cost Estimates

Staff time has included approximately 100 hours of staff time for participation in the Oil Production Tax Working Group. If the Board decides that they would like to proceed with drafting the ballot measure, it is estimated that County Counsel would require approximately 100 additional hours of staff time.

The incremental cost to the County of adding an oil production tax measure would be comprised of two components; 1) the direct costs of printing the measure pages in the sample ballots and 2) the net change in allocated general election costs (including indirect costs), that would have otherwise been recoverable from local agencies (cities, schools, special districts). The currently estimated range of additional incremental costs is \$62,000 to \$108,000. The estimates reflect a range of 7 to 15 pages dedicated to this measure in the sample ballot, representing direct printing costs of approximately \$50,000 to \$96,000. The incremental increase in the allocation of general election costs is expected to be \$12,000.

CEO RECOMMENDED ACTION

The Board of Supervisors directs staff to

Draft a ballot measure that identifies the tax methodology and the nature of the tax, general or special, with a plan to proceed with placing it on the November 2012 ballot.