County of Los Angeles
CHIEF ADMINISTRATIVE OFFICE
713 KENNETH HAHN HALL OF ADMINISTRATION • LOS ANGELES, CALIFORNIA 90012
(213) 974-1101
http://cao.co.la.ca.us

DAVID E. JANSSEN
Chief Administrative Officer

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To: Mayor Michael D. Antonovich
Supervisor Gloria Molina
Supervisor Yvonne B. Burke
Supervisor Zev Yaroslavsky
Supervisor Don Knabe

From: David E. Janssen
Chief Administrative Officer

THE CLEAN ALTERNATIVE ENERGY ACT

This memorandum is intended to respond to a request from several of your Board offices to analyze the Clean Alternative Energy Act (Act). The Act will be on the November 2006 Statewide ballot.

The intent of the Clean Alternative Energy Act is the reduction of petroleum use in California by 25 percent from 2005 levels by 2017 by imposing a severance tax on oil production in California. The tax would not apply to oil production on State lands, including offshore production within three miles of the coast, or on Federal lands including offshore production more than three miles off the coast. Production from wells that produce less than ten barrels a day (stripper wells) would be excluded unless the price of oil exceeded $50 per barrel. The Legislative Analyst's Office (LAO) estimates that the tax would apply to approximately 165 million of the 268 million barrels produced in the State annually. The Act would prohibit the severance tax from being passed on to the consumer.

The amount of the severance tax is tied to the price of oil as follows:

- 1.5 percent of the gross value of oil from $10 to $25 per barrel.
- 3.0 percent of the gross value of oil from $25.01 to $40 per barrel.
- 4.5 percent of the gross value of oil from $40.01 to $60 per barrel.
- 6.0 percent of the gross value of oil above $60.01 per barrel.

Other States also impose oil severance taxes including Louisiana, 12.5 percent; Alaska, 9 percent; and Texas, 4.6 percent.

Due to a drafting ambiguity, it is not clear whether the 6.0 percent rate would apply to the entire value of a $70 barrel or only the marginal amount over $60. For that reason, the LAO's estimate of the severance tax revenue ranges from $200 million to $380 million annually.

Revenues derived from the proposed tax would be deposited into a newly created special fund, the California Energy Independence Fund. The Act authorizes the expenditure of up to $4 billion during the first ten years of the program. Severance tax revenues are to be allocated among five accounts as follows:

- Gasoline and Diesel Use Reduction Account (57.5 percent) - These funds would be used for incentives such as consumer loans, grants, and subsidies directed toward the purchase of alternate fuel vehicles, the production of alternate fuels, and the development of an alternate fuel infrastructure.

- Research and Innovation Acceleration Account (26.75 percent) - These funds would be used to provide grants to California universities to accelerate the commercialization of energy efficient and renewable technologies and to improve their economic viability.

- Commercialization Acceleration Account (9.75 percent) - These funds would be used to fund start-up costs and acceleration of technologies to reduce the consumption of petroleum, and promote the use of renewable and alternate fuels.

- Public Education and Administration Account (2.5 percent) - These funds would be used for public education and administration.

- Vocational Training Account (3.5 percent) - These funds would be used by community colleges to train students to work with alternate energy technologies.

Funds allocated to these accounts would be available across fiscal years, and funds not spent in one year could be rolled over into future years. An advisory committee may be established for each program described above as needed. Compensation for committee members is limited to per diem and expenses.

Fiscal Impact of the Severance Tax

Imposition of a severance tax is expected to reduce the value of oil reserves and the assessed property value for tax purposes because the value of real property includes the value of any oil reserves under the surface. The actual amount of the reduction is unknown because it depends on the price of oil and on the interaction between oil prices and the value of the oil property established under the terms of Proposition 13. For example, when the price of oil increases substantially, the assessed property tax would be limited to the two percent annual increase pursuant to the law. Under these circumstances, a decrease in property value resulting from a severance tax could have limited impact on property tax revenues.

Because future oil prices are unknown and because valuation of oil properties is very complex, estimates of revenue losses attributable to the proposed severance tax are difficult at best. Using the Legislative Analyst's estimate of from $200 million to $380 million as the annual yield from the proposed severance tax, and assuming that oil property assessed values would be reduced by the full amount of the severance tax: Statewide property tax revenue would be reduced by $20 million to $38 million. According to Statewide data from the Board of Equalization (BOE), an average of 17 cents and 56 cents of every property tax dollar is directed to the counties and school districts in the State, respectively. Therefore, of these amounts, approximately $3.4 million to $6.5 million would be from counties, and between $11.2 million and $21.3 million would be from K-14 schools. A disproportionate amount of the reduction will occur in counties with substantial oil reserves such as Kern, Los Angeles, Ventura and Santa Barbara counties. The full impact of these losses is likely to be mitigated over time as the oil is extracted. This reduction also could be offset by the value of the investment of the severance tax funds in alternate energy technology.

In Los Angeles County, it is estimated that 30 million barrels are extracted annually. Based on information from the County Assessor's Office, the assessed valuation for oil bearing property in the County is approximately $2.4 billion. A 5 percent reduction in the assessed valuation of those parcels would result in a $1.2 million property tax reduction. If one were to assume that 33.5 percent of the property tax dollar goes to the County, the decline in assessed value of oil bearing property would represent a $402,000 loss in County property tax revenue. If losses do occur, the State would be required under existing law to offset reductions in K-12 school revenue due to reduced property tax shortfalls. Current law does not require the State to automatically backfill the community colleges for any property tax loss. In addition, Statewide, some K-12 school districts would likely face a unique problem since they have property tax revenues in excess of the Proposition 98 revenue minimum. These districts would not automatically receive a State General Fund backfill for any lost property taxes above the revenue minimum. Current law does not preclude the State from providing full reimbursement to school districts for lost revenues.

The Act would allow oil producers to deduct the cost of the severance tax from earned income. The impact on State income tax revenue would be dependent upon a number of factors including whether the producer has any taxable income in the State. Any losses, however, may be offset by an increase in economic activities from alternate energy technologies. As an area with an existing manufacturing, automotive and energy technology base, the County could benefit from investments in alternate energy and thus generate some offsetting State tax revenue from the resulting employment and consumption of goods.

To the extent that the initiative is successful in reducing the use of petroleum products, it would also decrease the amount of gasoline and diesel excise taxes as well as associated sales taxes. This could be offset by any excise and sale taxes imposed on alternate fuels. In addition, a shift in the use of ethanol from petroleum should result in a reduction in dollars spent on foreign produced energy and an increase in expenditure for fuels that are produced domestically.

Proponent's Arguments

Proponents are attempting to reduce the State's reliance on petroleum through a strategic investment in an alternate energy source. This initiative is sponsored by the Californians for Clean Alternative Energy which includes Vinod Khosla, a venture capitalist who also supported the Stem Cell Initiative. The initiative is intended to encourage the development of the ethanol industry. This is consistent with President Bush's comments in his January 2006 State of the Union speech which called for the country to increase the production and consumption of ethanol fuel as part of the country's energy independence plan.

In Executive Order S-06-06, Governor Schwarzenegger acknowledged the role of bio-fuels, including ethanol in reducing reliance on petroleum fuels, and reducing fuel costs and greenhouse gases. The Executive Order sets targets for the State to increase the percentage of bio-fuels produced within California to 20 percent by 2010, 40 percent by 2020 and 75 percent by 2050. Currently, the State produces only five percent of the ethanol it consumes. In a related press release, the Governor stated that "It is critical that we do everything we can do to reduce our dependence on petroleum based fuels." While the Governor supports increased production of bio-fuels, he does not support the initiative at this time.

Corn is currently the major source of ethanol with about 4 billion gallons produced annually, however, proponents believe that corn will not be the predominant source of ethanol in the future because it is not clear if the economy could support production over 15 billion gallons annually without affecting the food supply. Thus, the initiative envisions the development of an alternate biomass fuel possibly using certain varieties of grasses as a fuel source. This would require the planting of 50 million to 60 million acres, an amount of land that would compare to the 73 million acres currently planted with soybeans and 40 million acres of unplanted land in farm subsidy programs. It is expected that a substantial portion of the plantings would occur in the Midwestern states. According to the proponents, the estimated amounts of planting could be reduced by the use of plant waste or animal wastes. Proponents hope that the

United States could eventually move toward an ethanol dominant fuel market in 20 to 25 years.

The estimated cost to produce one gallon of ethanol in the near term is $1. Due to the lower energy value of this product, the equivalent energy amount for one gallon of gasoline would be $1.25. This would compare to the cost of producing gasoline of $1.60 per gallon. This price differential is expected to increase as the price of ethanol declines with increased production. Proponents hope that the cost of production could eventually be reduced to 60 cents per gallon. Proponents point to the progress in Brazil regarding the conversion to ethanol. In Brazil, the percentage of new vehicles that run on alternate fuels increased from 4 percent to 80 percent between 2003 and 2006. In addition, Brazil has reduced its petroleum use by 40 percent and thereby saved $50 billion a year in oil imports. The cost of production for ethanol is approximately 75 cents a gallon.

Arguments in Opposition

Opposition is led by the Californians Against Higher Taxes Committee (Committee) which includes support from petroleum companies. This group previously opposed Proposition 56 which would have reduced the vote required to pass the State Budget from a 2/3 majority to 55 percent. The Committee states that the severance tax would substantially reduce property values and therefore reduce property taxes to local governments including school districts. No estimates of this decline are available although the opponents argue that the loss to the schools would be equal to approximately 50 percent of the severance tax. This amounts to $1.9 billion over a 10-year period, or approximately $190 million a year. Considering the low property tax rate in California, a severance tax of $200 million to $380 million a year, or $2 billion to $3.8 billion over a 10-year period, would have to reduce the value of the oil by $20 billion to $38 billion, or ten times the cost of the tax.

The impact on school funding of a $190 million property tax reduction would amount to approximately $30 per student based on FY 2003-04 Department of Education enrollment numbers for K-12 schools. This amount compares with the estimated per capita funding of $11,268 for K-12 students from all sources for FY 2006-07 or .27 percent of total funding. While this amount represents a substantially higher forecast of property tax revenue loss than our estimate of $11.2 million to $21.3 million, even if accurate in the first year of implementation of the initiative, the impact should decrease in the future as the oil is pumped from the ground.

Summary

The Alternate Clean Energy Initiative raises a difficult policy question concerning conservation of certain kinds of energy and the pursuit of a healthy environment, and both proponents and opponents have reasonable arguments to advance. For example, the Act proposes the use of oil severance tax revenues to reduce the State's dependence on foreign oil. It proposes to convert from a petroleum based energy system to one that is at least 25 percent ethanol based. Proponents foresee lower energy costs, and an improved environment, and a transfer of energy expenditures from foreign to domestic producers. Opponents believe that the Act would divert funds from government services such as the schools and therefore oppose the tax.

Based on information from the Legislative Analyst's Office and the Board of Equalization, we have estimated the impact of the initiative on the property tax revenues for Los Angeles County and counties Statewide. For the County, the loss is estimated to be $402,000 in the first year. For counties in total, the reduction in property tax revenue is estimated to be from $3.4 million to $6.5 million. Schools would lose an estimated $11.2 million to $21.3 million, Statewide.

According to the LAO, the Alternate Clean Energy Initiative could put pressure on the petroleum industry to reduce production and/or investment in new technology to expand production. This could reduce employment and capital purchases in the oil industry. However, this could be offset by prudent investment in alternate fuel technologies that could reduce the demand for petroleum, thus reducing its cost. In addition to the fiscal impact, quality of life in the State could be improved through a reduction in greenhouse gasses and other pollutants resulting from the consumption of oil products. Further, to the extent that alternate fuel technology is developed and manufactured in the State, the economic benefits may offset to an unknown extent, any negative impact on the petroleum industry.

There is no County position on oil severance taxes or on their use as a way to reduce petroleum consumption. **Therefore, a position on the Alternate Clean Energy Initiative is a matter for Board policy determination.**

DEJ:GK
MAL:SK:cc

c: Executive Officer, Board of Supervisors
County Counsel
Auditor-Controller