TAXING OIL
Tapping into Santa Barbara County's Natural Wealth

SUMMARY

One of the responsibilities of each County Grand Jury in the State of California is to inquire into the fiscal health of its county. Most residents of the County of Santa Barbara (County) are aware that the County faces serious financial challenges. Since Fiscal Year (FY) 2007-2008 the County has had a budget gap ranging from $72 million to approximately $5 million. The economic climate that has followed the Great Recession of 2008, combined with other long-term funding challenges, has created a new paradigm under which many citizens expect their elected officials to look at new sources of revenue other than property or other taxes and/or fees obtained from the general populace. As one way of carrying out its fiscal responsibility, and of identifying a new and ongoing source of revenue, the 2012-2013 Santa Barbara County Grand Jury inquired into the types of taxes various states, counties, and municipalities levy on oil extraction.

Although California does not have a tax on the production of oil, the Jury found that the vast majority of states do have such a tax and that several states have more than one type of tax on oil. The Jury also found that five counties in Virginia and several cities in California receive revenue from an oil tax. Members of the Jury, like citizens throughout the county, state, and nation, are aware of the changing economic times and the need to consider alternate revenue sources. For example, funding pensions, healthcare and other employee benefits have become an increasing liability. In addition, the County of Santa Barbara is facing the new expense of building and operating the proposed North County Jail. The Jury recommends that the Board of Supervisors of the County of Santa Barbara follow the recommendation of its Chief Executive Officer and put the question of an oil production tax before the voters as an option for raising critical new and ongoing revenue.

BACKGROUND

The County of Santa Barbara (County) had a projected budget gap of $17 million in Fiscal Year (FY) 2012-2013. The projected gap was closed by using one-time funds, furloughs, and concessions from unions. In other years, there have been hiring freezes and the County's Reserve Fund has been tapped. The proposed budget for FY 2013-2014 recommends Operating Expenditures of $844.5 million with Operating Revenues of $839.5 million; the $5.0 million gap to be funded by Other Financing Sources and/or use of Fund Balance. This gap is expected to widen to $13.7 million in the FY 2014-2015 Proposed Budget.[1] To close this gap, it is projected the County will implement cuts that will include reductions in services, cost reductions, and reductions in staff.

[1] Santa Barbara County Recommended Operational Plan, Fiscal Years 2013-2014 & 2014-2015, May 2013

Oil Taxes in the United States

Over 30 states impose taxes on oil production; some states have more than one tier. The name of the tax varies by state, but they are all levied on oil taken out of the ground. One of three methods is usually used: a percentage of the value of the oil, a wellhead tax, or a price per barrel tax. The wellhead tax is based on the number of wells, but the calculation is complicated and requires extensive reporting that can be burdensome to oil producers and the county assessor. The percentage and price per barrel taxes are more straightforward.

Oklahoma imposes a variable tax of 1% to 7% depending on the current price per barrel of oil. Kentucky's tax is 4.5% of the market value of the oil extracted. Nine states impose two separate oil taxes. In North Dakota, the Gross Oil and Gas Production Tax (GPT) of 5% and the Oil Extraction Tax (OET) of 6.5% combine for a tax of 11.5%. North Dakota officials estimate that an average oil well, over 37 years, produces 838,000 barrels of oil upon which $5,478,000 in GPT and OET taxes will be paid to the state.[2] Alaska imposes a "Petroleum Profit Tax" of 25% to 75%, a conservation tax, and a property tax of 2%.[3] Alaska's Petroleum Profit Tax will be replaced in 2014 with a flat 35% rate on the oil companies' net profits. New Mexico imposes two oil taxes totaling 6.9% plus a conservation tax and a property tax. In Virginia, five counties impose a "Local License Tax" on oil at the rate of 0.5% of the gross receipts.

California is one of the few oil producing states that does not impose an oil production tax.

History of Oil Production in California

The oil industry has been active in the State of California (State) since 1865 when the first productive well was drilled in the Central Valley, east of San Francisco. While the strikes in the valley were not as big as the huge strikes in Pennsylvania at the time, they provided enough oil for the needs of the entire City of San Francisco, then the largest population center in the State. In 1923, California was the number one oil producing state in the country. That year, California also had the distinction of being the source of one quarter of the entire world's output of oil.

History of Oil Production in Santa Barbara County

County onshore oil exploration began in Summerland in 1888 and soon moved offshore into coastal waters via piers. In fact, the world's first offshore oil well was drilled off Summerland. During the same period, oil exploration began in the Santa Maria Valley and soon after expanded to large scale production in Orcutt. The Mesa, Goleta, and El Capitan-Ellwood oil and gas fields were discovered in the late 1920s. Beginning in the late 1950s, oil companies began to explore in state tidelands off Carpinteria. Eight platforms were installed in tidelands between 1956 and 1966. In 1969, an uncontrolled blowout occurred in these tidelands. It lasted eight days and spilled 80,000 to 100,000 barrels of crude oil over 40 miles of coastline. This event resulted in the enactment of environmental laws and the creation of the State's environmental review process. In 1986, the price of crude oil dropped to $6 per barrel and many onshore wells were capped.

[2] nd.gov

[3] alaska.gov

Oil Taxes in California

Historically, the principal vehicle for taxing oil production in the State was through property taxes, levied on reserves of oil and gas. This yielded a significant revenue stream until the passage of Proposition 13 in 1978. According to *A Severance Tax on California Oil:*[4]

> Proposition 13 changed all that, lowering our property tax rate to 1/3 or so of its previous level, while also rolling back and freezing assessed valuations of property. (The property tax levy is the product of the rate times the base. Proposition 13 lowered ***both*** the rate and the base. 1/3 the original rate times 1/2 the original base equals 1/6 the original tax revenue).

Losing 83.3% of the taxes once garnered from oil production was a significant decline in revenue for California counties.

Although California has no statewide oil production tax, there is a conservation tax on oil, described on the State's website: "There is a small statewide assessment on oil and gas produced in California. This assessment goes to support the Department of Conservation's Division of Oil, Gas, and Geothermal Resources (DOGGR) and is levied pursuant to Article 7, Division 3, of the Public Resources Code".[5] The assessment rate for FY 2012-2013 is $0.1406207 per barrel of oil.

Oil producers, like all companies in the State, are also subject to state and federal income taxes and are assessed property taxes that are based, in part, on their proven oil reserves. In California the only taxes unique to oil and gas producers, as opposed to other industries, are the DOGGR assessment and property taxes on proven oil reserves. The Jury acknowledges that imposing a new severance tax on oil producers could reduce their economic incentive for operating in the County.

Oil Taxes in Santa Barbara County

The Jury found that no county governments impose an onshore oil production tax. Although this report does not cover offshore oil production, it is interesting to note that the County does receive funds from the Coastal Resource Enhancement Fund (CREF)[6], applicable to offshore oil production. The Santa Barbara County Board of Supervisors (BOS) established CREF to mitigate possible environmental impacts of offshore oil production. From 1988 to 2012, the County collected a total of $20,379,573 from CREF. CREF fees now provide approximately $600,000 in annual revenue to the County. The Jury found no comparable onshore fund.

Oil Taxes in California Cities

The Jury found that at least five cities in California impose taxes on oil production. The City of Signal Hill covers only 2.2 square miles and is surrounded by the City of Long Beach. In 1924 Signal Hill separated from Long Beach to keep the oil tax for itself. Between 1923 and 1980, the Signal Hill oil fields produced over 900 million barrels and are considered the most productive fields per acre in the world. Its oil tax is $0.60 per barrel.

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[4] Mason Gaffney, Economist, University of California, Riverside, July 2006

[5] conservation.ca.gov

[6] sbcountyplanning.org/energy/CREF/CREF.asp

In 2011, Signal Hill collected $804,000 in oil production taxes. The oil production tax in Long Beach is $0.40 per barrel. In Seal Beach, it is $0.58 per barrel. Torrance has a $0.30 per barrel tax. In Beverly Hills, the tax is $0.388 per barrel on the first 10,000 barrels and $0.36 on each additional barrel.[7]

METHODOLOGY

The Jury interviewed County officials who assess and collect property taxes, set and collect various permit fees from County oil producers, and project budget gaps. The Jury also reviewed documents provided by County officials. In addition, the Jury interviewed executives of oil companies active in the County and elsewhere. The Jury researched severance and other types of oil production taxes collected in other states, counties, and cities.

OBSERVATIONS AND ANALYSIS

County Budget Gaps

According to the *Executive Summary of the Recommended 2012-2013 County Budget* (Executive Summary)[8], "Santa Barbara County continues to face significant internal challenges such as increases in employee retirement and healthcare costs, reliance on one-time funding solutions, deferred maintenance of critical infrastructure, funding of a new North County Jail, increasing cost of Fire Department operations, and lack of new revenues". The current estimate for operating the proposed North County Jail is $17.3 million per year.

To solve the budget gap, the Executive Summary reported the Chief Executive Officer's (CEO) office had "explored strategies for revenue enhancement including an oil production tax, economic development, fee adjustments and increasing the Transient Occupancy Tax (TOT)". On February 14, 2012, the CEO recommended to the BOS that they allow the voters of the County to decide if they agreed with an oil production tax by having staff 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". However, the BOS chose not to implement the recommendation at that time and no ballot proposal on an oil production tax was presented.

During the past four years, significant staffing and service level reductions have been required to balance the budget. In addition to furloughs initiated in FY 2008-2009, the County lost over 450 full-time-equivalent employees. Up to 32.5 additional positions may be lost in the FY 2013-2014 budget cycle. As a result of available revenues and the expected increases to expenditures, it will be necessary to reduce service levels by $8.3 million in FY 2013-2014. Service reductions include, among other things, many losses in the Public Health Department and the elimination of the targeted gang intervention program

[7] Rates as of this writing; many locales have inflation-adjusted rates, exemptions, incentives and other modifications that, where applicable, will change the per barrel rates found in municipal and other codes

[8] Presentation by County CEO to the Santa Barbara County Board of Supervisors on May 15, 2012

in the Probation Department and the Juvenile Justice Program in the Alcohol, Drug and Mental Health Services Department. Also included in the effort to balance the budget are the loss of three firefighter positions and seven Sheriff Deputy positions.

The projected service reductions will help fund expected increases in several areas including employee salaries and pay increases (estimated at $3.6 million), the annual "set aside" for the proposed North County Jail ($3.3 million), and an increase in the contribution to the Santa Barbara County Employee Retirement System (SBCERS) of $8.1 million over FY 2012-2013. It should be noted that the County's Deferred Maintenance Backlog, which is unfunded, is estimated at $292 million and it continues to grow. According to the *Santa Barbara County Recommended Operational Plan, Fiscal Years 2013-14 and 2014-2015:*[9]

> However, it is critical to note that the ongoing cycle of service reductions is not sustainable and therefore the County must consider revenue enhancement strategies resulting from increased economic activity and resident supported tax increases.

County Oil Production

Onshore oil production in the County is experiencing a resurgence. From an all-time high in 1964 of 8,950,404 barrels, oil production fell to a low of 1,913,093 barrels in 2005. This number has risen steadily to 3,388,668 barrels extracted in 2012, as reported by DOGGR. The Jury learned that this resurgence is influenced by three major factors. First, the production of oil is currently economically feasible. Unlike the 1980s, when the price of a barrel of oil dropped to single digits, the price of oil has hovered between $90 and $100 for some time. Using the Midway-Sunset Price per barrel of $95.50[10], the 3,388,668 barrels extracted last year in the County were worth $334,250,000. With the world's energy needs increasing, the price is expected to stay in this range in the near future. Secondly, a part of the Monterey Shale Formation is in the County. (See map in Appendix A.) Although oil companies have drilled in the formation for over 100 years, it is only fairly recently that the reserves residing there have been estimated to contain 15.4 billion barrels of oil.[11] Lastly, today's oil companies are using technology not available years ago such as hydraulic fracturing, or "fracking". Fracking utilizes steam and chemicals under extreme pressure to crack the rock and allow natural gas and oil to flow to the surface. Based on the current economics of oil production, the vast availability of the resource, and the use of ever newer and more efficient technologies, oil exploration and production in Santa Barbara County are here to stay.

Currently, the onshore oil in the County comes from approximately 13 active oil fields with over 4,050 active wells, operated by approximately 20 companies. (See Appendix B.) According to the presentation to the BOS referenced above, there were over 40 proposed

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[9] Executive Summary, Page B-20, May 2013

[10] Presentation by County Assessor and County Counsel to the Santa Barbara County Board of Supervisors on August 14, 2012

[11] eia.gov *Review of Emerging Resources: U.S. Shale Gas and Shale Oil Plays,* U.S. Energy Information Administration, July 8, 2011

projects in the prior three years.

Each proposed project is subject to a lengthy and extensive permitting process. Primary permitting jurisdictions include the County's Planning and Development Department for land use, building, grading, and petroleum permits; the Santa Barbara County Air Pollution Control District for air permits; and DOGGR for well permitting. The BOS also passed new regulations for companies working in the County that require them to obtain an oil drilling and production plan permit for fracking in new or existing wells. In addition, the State's Senate Committee on Natural Resources and Water and Environmental Quality is studying legislation meant to regulate and control the practice of fracking. An important part of the permitting process for many projects is the Environmental Impact Report (EIR). These are voluminous, extensive documents that can cost the oil company upwards of $1,000,000. The review process for the reports attempts to cover every aspect of the potential impacts of a project and allows for public comment at each stage. One element of many EIRs is addressing potential adverse impacts to federally-listed and/or state-listed endangered or threatened species, such as the California Tiger Salamander and the California Red Legged Frog. Projects will commence only after all potential environmental impacts have been addressed and permits have been obtained. Relying on the aforementioned regulatory agencies to thoroughly evaluate all projects for safety and environmental issues before issuing permits, the Jury takes no position on future onshore oil production.

Two concerns raised about an oil production tax are job losses in the County and a possible rise in the price of gasoline at the pump. In its *Oil Production Tax Proposal*, County staff concluded that neither of these would be meaningful.[12]

Current Santa Barbara County Tax Assessments on Oil Producing Properties

The primary tax imposed on oil producers, pursuant to California state law, is the property tax. The process of assessing property used for oil production is complicated. Counties assess property taxes on oil producers pursuant to the State's Revenue and Taxation Code.[13] Subject to various limits including those enacted as part of Proposition 13, the property tax is calculated annually, starting with the "base year value of the property" and continuing according to the "discounted cash flow" estimated from future production of proven reserves.[14] If a production tax applies in a city or county, an oil company can deduct the tax, as it can also deduct permit fees.[15]

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[12] Presentation by County CEO to the Santa Barbara County Board of Supervisors on February 14, 2012; *Oil Production Tax Proposal*, pages 5-6

[13] http://www.boe.ca.gov/proptaxes/pdf/ah566.pdf As specialized appraisal techniques are required according to Property Tax Rule 468(c), county assessors may also consult the "Assessment of Petroleum Properties" portion of the State Board Equalization's(SBE) handbook. It was developed in 1966 with input by industry representatives, county assessors, and petroleum experts.

[14] More information can be obtained from Title 18, Sec 468 (SBE Rule 468) at ca.gov and from the Assessors' Handbook, Section 566, titled "Assessment of Petroleum Properties", ibid

[15] Assessors' Handbook, Section 566, page 5-10, ibid

Oil producers are currently assessed approximately $12,250,000 in property taxes by the County both on proven oil or gas reserves and other taxable property. Often, these assessments are appealed. Resolution of a dispute can take years before the money is released to the County's General Fund. If an oil production tax, similar to those in at least five California cities, were to be enacted in the County, staff stated any reduction to property taxes on oil producing properties likely would be minimal. The cost and complexity of assessing oil producing properties has not deterred those interested in the production of minerals. The Jury learned that over 200 documents were recorded in the County in 2011 transferring leasehold mineral rights interests in over 20,000 acres.

New Revenue Source

Keeping in mind the County's ongoing budget gap, the Jury urges elected officials to identify new sources of revenue. The majority of oil producing states engaged in oil extraction has a production or severance tax. The chart below, the information in the "Background" section of this report and the chart in Appendix C include examples from the Jury's research of these taxes.

Calculated Oil Tax Revenue Using Sample Rates

Rate/Barrel	2012 Santa Barbara Production/Barrels	Calculated Revenue
$1.00 Proposed by County Staff	3,388,668	$3,388,668
$1.44 Measure O Ballot in Los Angeles	3,388,668	$4,879,682

It is evident that a new source of revenue could be raised. It is important to note that the charts illustrate the revenue that would have been raised if the production taxes used in other locations were applied to the number of barrels extracted in the County in 2012. The Jury notes that oil taxation is constantly changing across the country. At this writing, there were over 40 pieces of legislation under consideration, including SB241 in the California State Senate,[16] to implement new oil taxes and/or to change elements of existing taxes in various states. For the County, implementing the tax per barrel would be the simplest way to tax oil production as there is already a requirement to report to the State of California the number of barrels extracted. An oil production tax would represent a new source of revenue, not imposed on the general populace, such as a sales tax would be. An oil production tax could garner additional ongoing revenues for the County.

CONCLUSION

[16] *SB241, The California Education and Resources Reinvestment Act (CERRA)*, if passed, would impose a 9.9% severance tax on the extraction of oil from the earth or water within California's jurisdiction. Ninety-three percent of the proceeds would go to the University of California, California State University, and Community College systems. Seven percent of the proceeds would go to the California Department of Parks and Recreation.

The County of Santa Barbara, like many government entities, found its financial wellbeing severely compromised by the Great Recession of 2008. This exacerbated the County's existing financial challenges. It is critical for elected officials to identify new sources of revenue. The Jury is fully aware of the debates concerning the environmental ramifications of drilling for oil. These include, but are not limited to, the effects on endangered species and the safety of technologies like hydraulic fracturing. The Jury is also aware, given the experience of the 1969 Santa Barbara oil spill and the history of environmentalism in the area, that some residents would prefer that **no** oil be extracted from land in the county or offshore waters. These are complicated issues with devoted advocates on both sides. **The Jury takes no stand on these environmental issues in this report.** However, as this nonrenewable energy resource continues to be extracted from the ground in the county, the 2012-2013 Santa Barbara County Grand Jury recommends that the Santa Barbara County Board of Supervisors follow the recommendation of the Chief Executive Officer of the County of Santa Barbara and allow the voters to decide if an oil production tax will be implemented.

FINDINGS AND RECOMMENDATIONS

Finding 1

The principal vehicle for taxing oil production in California, the property tax, was lowered substantially with the passage of Proposition 13 in 1978.

Finding 2

The County of Santa Barbara is facing estimated budget gaps of $5 million in Fiscal Year 2013-2014 and $13.7 million in Fiscal Year 2014-2015.

Finding 3

Once the proposed North County Jail opens, its operating cost is projected to deplete the Santa Barbara County General Fund by $17.3 million annually.

Finding 4

An oil production tax could generate essential new and ongoing revenue for the County.

Recommendation 1

That the members of the Santa Barbara County Board of Supervisors follow the recommendation of the Chief Executive Officer of the County of Santa Barbara and allow the voters to decide if an oil production tax will be implemented by putting this issue on the next county-wide ballot.

REQUEST FOR RESPONSE

In accordance with *California Penal Code Section 933 (c)*, each agency and government body affected by or named in this report is requested to respond in writing to the findings and recommendations in a timely manner. The following are the affected agencies for this report, with the mandated response period for each.

Santa Barbara County Supervisor, 1st District, Salud Carbajal – 90 days

Finding 1, 2, 3, 4
Recommendation 1

Santa Barbara County Supervisor, 2nd District, Janet Wolf – 90 days

Finding 1, 2, 3, 4
Recommendation 1

Santa Barbara County Supervisor, 3rd District, Doreen Farr – 90 days

Finding 1, 2, 3, 4
Recommendation 1

Santa Barbara County Supervisor, 4th District, Peter Adam – 90 days

Finding 1, 2, 3, 4
Recommendation 1

Santa Barbara County Supervisor, 5th District, Steve Lavagnino – 90 days

Finding 1, 2, 3, 4
Recommendation 1

Appendix A

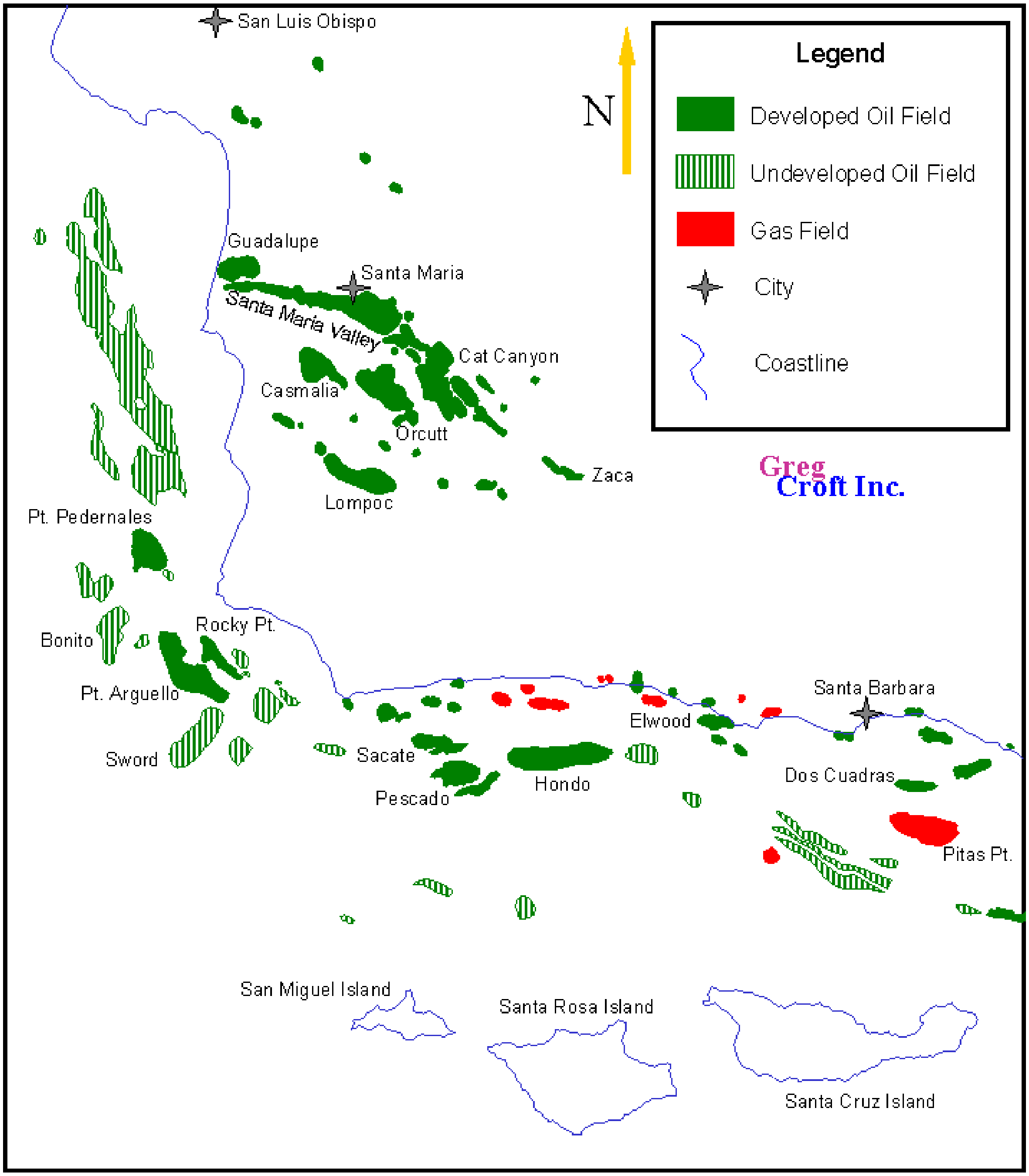
The Monterey Shale Formation Outlined   Source: N Y Times February 3, 2013

Monterey Shale

Appendix B

Source: gregcroft.com/santamaria.ivnu

Oil Fields of The Santa Maria Basin and Adjacent Offshore Areas, California



Appendix C

Calculated Oil Tax Revenue Using Rates from Other Locales

Locale	Rate**		Law	2012 Santa Barbara County Production		Midway-Sunset $/Barrel*	Calculated Revenue **
Kentucky	4.5%		Ky.Rev.Stat§ 143A.020	3,388,668	BBL		$ 14,562,801
North Dakota	11.5%		N.D. Code § 57-51.1-01	3,388,668	BBL		$ 37,216,046
Oklahoma	7.0%		Okla.Stats.§ 68-1001	3,388,668	BBL		$ 22,653,246
5 Virginia Counties	0.5%		(various)	3,388,668	BBL		$ 1,618,089
			Municipal Codes				
Beverly Hills, CA	$ 0.36	BBL	§ 3-1-219	3,388,668	BBL	n/a	$ 1,219,920
Long Beach, CA	$ 0.40	BBL	§ 3.80.221	3,388,668	BBL	n/a	$ 1,355,467
Seal Beach, CA	$ 0.58	BBL	§ 5.55.015	3,388,668	BBL	n/a	$ 1,965,427
Signal Hill, CA	$ 0.60	BBL	§ 5.12.010	3,388,668	BBL	n/a	$ 2,033,201
Torrance, CA	$ 0.30	BBL	§ 228.2.1	3,388,668	BBL	n/a	$ 1,016,600

Calculated Oil Tax Revenue Using Sample Rates

Santa Barbara	@	$1.00/ BBL ***	3,388,668	BBL	n/a	$ 3,388,668
Santa Barbara	@	$1.44 / BBL ****	3,388,668	BBL	n/a	$ 4,879,682

NOTE:

* **To simplify the presentation, the base is assumed to be market value, although some locales use a different base for calculating the tax. Midway-Sunset price is from the Presentation by County Assessor and County Counsel to the Board of Supervisors on August 12, 2012**

** **Most locales have inflation-adjusted rates, exemptions, incentives and other modifications that, where applicable, will change the calculated revenue amount.**

*** **Rate proposed by Santa Barbara County Staff in 2012**

**** **Rate proposed in Measure O for Los Angeles in 2011**