Commission on the 21ST Century Economy

Recommendations

Below are two proposals from the Commission: The Rainy Day Reserve Fund and Revenues from Development of California Oil Resources.

I. "Rainy Day" Reserve Fund

Proposal

The state should fundamentally change how it sets aside and uses money in a "rainy day" fund in three key ways:

- **Rainy Day Fund Target Level.** The state should increase the target for the rainy day fund from the current 5 percent up to 12.5 percent of state revenues.
- **Transfers Into the Rainy Day Fund.** The current transfer of 3 percent of annual General Fund revenues into the Rainy Day Fund should be continued. In addition, revenues over a long term average should be transferred into the Rainy Day Fund. Also, the circumstances under which revenue transfers can be suspended should be severely restricted.
- **Transfers Out of the Rainy Day Fund.** The state should create more stringent controls on the circumstances for the withdrawals of moneys from the reserve fund as well as the purposes the money can be used for.

Rationale

It is critical for the state to maintain an adequate reserve in order to support government services through economic downturns. While the Commission has made proposals that would change the tax system in a way to reduce volatility in the state's income stream, normal economic cycles will continue to produce swings in revenue. As California's economy and fiscal structure have evolved, revenue volatility has emerged as a major budgeting problem. As a result, the need for a robust and well-protected reserve fund has increased.

The California Constitution already requires the establishment of a prudent state reserve fund, and the state has long contributed to a reserve. But the reserves and the restrictions that apply to them have proven to be inadequate to the task. The amounts in the reserves have been insufficient to compensate for the increasing volatility in California's revenues. Restrictions on withdrawals have not been stringent enough to maintain the reserve for the times when it is most needed. Finally, contribution requirements to the funds have been too easily skirted.

Background

Each year, the state sets aside a portion of revenues it estimates it will receive in the upcoming year in one of two reserve funds. The money can be used to pay for unexpected expenses, cover shortfalls in tax revenue and save for future years. The two funds are:

- **Special Fund for Economic Uncertainties (SFEU).** The SFEU is the state's traditional reserve fund, from which funds may be withdrawn and spent for any purpose with approval by the Legislature. Any unexpected funds received during a year are automatically deposited into the SFEU. Generally, the SFEU has not acted as a reserve that helps offset the effects of economic downturns and uncertainties; instead, it has been a source of cash to help with one-time emergencies.
- **Budget Stabilization Account (BSA).** In 2004, California voters passed Proposition 58 establishing the Budget Stabilization Account as part of the state's General Fund. Among its budget-related requirements, the ballot initiative set a reserve fund target size at 5 percent of revenues. It also required that half of the money transferred to the fund pay off debt and the other half go into a rainy day reserve. Prop. 58 also set rules for transferring money into and out of the fund. The Governor can stop transfers into the BSA with an Executive Order. Once the reserve reaches its target, no more transfers are required. By passing a law, the state can use the reserve funds for any purpose.

Recent history suggests the inadequacy of the state reserve fund approach. Transfers into the BSA occurred for two fiscal years, 2006-2007 and again in 2007-2008. But as the economy began to deteriorate, the entire reserve balance of $1.4 billion was transferred back to the General Fund and used on spending programs. The Governor suspended transfers in 2008-2009 and it is expected that the state will continue to suspend transfers for the next few years. The existing target amount is the higher of $8 billion or 5 percent of revenues.

Recommendation

Establish a new "rainy day" reserve fund policy with increased funding levels, stringent contribution requirements, and limitations on withdrawals.

Rainy Day Fund Target Level. The cap on the amount held in the Reserve Fund should be dramatically increased from the Budget Stabilization Account cap. Specifically, the amount to be maintained in the fund would be equal to 12.5 percent of General Fund revenues. This percentage is currently equal to about $10 billion, but would grow over time.

Revenues to the Rainy Day Fund. **Transfers to the reserve fund should be based on a more aggressive schedule than is currently in place**.

- The annual transfer of three percent would continue until the balance in the Rainy Day Fund reaches the target of 12.5 percent of General Fund revenues. The three-percent annual transfers would resume in any year in which the balance in the Rainy Day Fund falls below the target.
- Additionally, in periods of higher than normal rates of revenue growth, the excess revenue would be transferred into the Rainy Day Fund. Specifically, a ten-year revenue trend would be established each year, based on a simple regression analysis of growth in the previous ten years. Whenever the growth in a given year exceeds the ten-year average rate of growth, the revenue above the trend would be deposited into the Rainy Day Fund. In years in which revenue grows less than the trend, there would be no transfer beyond the 3-percent annual transfer.
- The Governor would be able to stop or reduce the transfers into the reserve fund only in years when the state does not have enough revenues to pay for state spending equal to the prior year's level of spending, adjusted for changes in the state's population (as estimated annually by the Department of Finance) and the California Consumer Prices Index.

Spending From the Rainy Day. The ability to withdraw funds from the reserve should be restricted to specific situations.

- Rainy Day Funds could be used to cover any costs associated with an emergency, such as fire, earthquake or flood.
- The state could use the reserve funds if it did not have revenues sufficient to cover state spending equal to the prior year's level of expenses, after adjusting for changes in population and inflation. Through this mechanism, the Rainy Day Fund would substantially stabilize spending over time, keeping it on average in line with revenues.
- Once the Rainy Day Fund reaches the targeted balance of 12.5 percent of General Fund revenues, any excess amounts in the fund could be used only for one-time expenses. Examples of allowable one-time expenses include capital spending for infrastructure projects, temporary tax cuts or rebates and defeasance of bonds.

The Commission recognizes that the creation of the Rainy Day Fund would raise budgetary questions, such as whether transfers into the fund would be excluded from the constitutional formula that establishes a minimum funding guarantee for K-14 education (Proposition 98). However, the Commission makes no recommendation on such budget issues since they are outside its scope.

II. Revenues from Development of California Oil Resources

Proposal: The state should permit additional offshore oil leases, under strict environmental safeguards, with royalty revenues going to a reserve fund to be used for specific limited purposes.

Rationale: The development of additional oil resources would expand the domestic oil supply, while providing tens of billion of dollars of revenue to the state over a number of years.

Background: California is the nation's third largest oil-producing state. Most of California's state-owned proven oil reserves are off-shore. California has a resource claim to submerged lands that are three miles from the coastline. The federal government controls resources off the coast of the United States and shares oil revenue in large offshore areas, such as the off-shore areas of the Gulf States.

There has been a ban on new leases for off-shore drilling in California waters since the after-math of the 1969 Santa Barbara oil spill, which sparked environmental legislation to protect the land and waters.

There are currently 26 leases on state offshore lands producing about 11,047 barrels of oil per day.[1] The State Lands Commission, which manages the state's submerged lands, estimates that there are 1.635 billion barrels of recoverable oil on state lands that are not currently under lease[2]. The U.S. Minerals Management Services, which controls leasing and drilling on federal lands, estimates that another 10.1 billion barrels remains undiscovered but is technically recoverable oil resources
off the California coast[3]. Such estimates have historically risen over time as new technology and rising prices make finding and recovering more resource economic.

Royalty rates on current state leases vary from 16.7 percent to 55 percent of revenues. (Typical royalties are in the 30 to 35 percent range). Last year, 240 million barrels of crude were extracted from California lands and waters, including federal waters off-shore. State revenue from these leases is roughly $400 million annually. If the ban were lifted, it could make available the 1.63 billion barrels of recoverable oil. In addition, California would receive a share of revenue from new leases on federal lands off of the state's coast.

Recommendation: Permit new oil leases with royalty revenues going to a reserve fund.

There are several economic reasons for permitting new oil leases. Unlike all other revenue sources, the oil companies, which would make these new royalty payments, have requested the ability to do so. Revenues from this source would create no economic distortions, and the economic activity being taxed could not migrate elsewhere.

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[1] Offshore Oil and Gas Lease Status Report, State Lands Commission, April 2009.
[2] Paul Thayer, Executive Officer of State Lands Commission, June 2009.
[3] "2006 Resource Evaluation," U.S. Department of the Interior, Minerals Management Service, http://www.mms.gov/revaldiv/ResourceAssessment.htm.

Environmental concerns are paramount, and technological advancements have lessened the environmental impact of the oil industry. The use of 3-D and 4-D seismic work has improved oil exploration and reduced the number of exploratory wells that are needed. Wells tend to have smaller holes and use fewer chemicals. The use of horizontal and slant drilling has reduced the environmental disturbance of oil extraction by requiring fewer drilling sites or platforms[4]. Shore-based facilities can now recover oil from as far as seven miles off-shore[5].

Strict environmental safeguards would need to be imposed. Britain provides an example of a country that has successfully exploited its energy resources while maintaining effective environmental controls[6].

Revenue from New Oil Leases would go into Reserve

The amount of revenue that could be generated is likely to vary from year to year because it depends upon the volatile price of oil. Therefore, revenues should be deposited in a reserve fund which would be restricted to such things as paying off debt, lowering other taxes, one-time infrastructure spending and building the state's Rainy Day reserve.

Over time, the state could receive as much as $34 billion in royalty revenues from new leases in California waters, assuming oil trades on average $70 per barrel and the average royalty rate is 30 percent.

Making predictions about the revenue California could receive on new leases on oil drilling on federal lands is difficult. It is unclear what percentage of undiscovered oil would be eligible for federal state revenue sharing and the federal government has various royalty rates with different states. Given these variables, California could stand to gain $3.19 billion[7] and as much as $80 billion by some estimates.
Assume a 1/6 royalty rate for the federal government ($70.91 billion/6 = $11.81 billion in federal revenue). Under section 8(g) from the Outer Continental Shelf Lands Act, California would be eligible for 27 percent of the total federal revenue. ($11.81 x 0.27 = $3.19 billion).

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[4] The oil and gas industry from Rio to Johannesburg and beyond Contributing to sustainable development, International Petroleum Industry Environmental Conservation Association (IPIECA) and the International Association of Oil & Gas Producers (OGP), pp. 6-7.

[5] The Chayvo field in the Sea of Okhotsk has two extended-reach drilling wells that are over 7 miles.

[6]" BP Wytch Farm Field Wins Queen's Environmental Award," http://www.bp.com/genericarticle.do?categoryId=2012968&contentId=2001682

[7] Assume 10 percent of the estimated 10 billion barrels would be eligible for revenue sharing. (10 percent of 10.13 billion = 1.013 billion barrels)
Assume price of oil at $70/barrel. (1.013 X $70 =$70.91 billion)