MINUTES
of the
FOURTH MEETING
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

September 13, 2004
Western New Mexico University, Global Resource Center
Silver City

September 14-15, 2004
Western New Mexico University, Deming Mimbres Learning Center, Room 152 A
Deming

The fourth meeting of the Revenue Stabilization and Tax Policy Committee (RSTPC) for the 2004 interim was called to order by Representative Donald L. Whitaker, chair, on Monday, September 13, 2004, at 9:20 a.m. at the Western New Mexico University Global Resource Center in Silver City.

PRESENT

Rep. Donald L. Whitaker, Chair
Sen. John Arthur Smith, Vice Chair
Rep. Janice E. Arnold-Jones
Sen. Sue Wilson Beffort
Rep. Anna M. Crook
Sen. John Grubesic
Rep. George J. Hanosh
Sen. Timothy Z. Jennings
Rep. Ben Lujan
Rep. Daniel P. Silva
Rep. Thomas C. Taylor
Rep. Luciano "Lucky" Varela

ABSENT

Sen. Mark Boitano
Sen. Carlos R. Cisneros
Sen. Joseph A. Fidel
Rep. Roberto "Bobby" J. Gonzales
Sen. William E. Sharer
Sen. H. Diane Snyder

Designees
Rep. Manuel G. Herrera (*designee for Sen. Carlos R. Cisneros*)
Rep. Henry Kiki Saavedra (*designee for Rep. Roberto "Bobby" J. Gonzales*)
Sen. Leonard Lee Rawson (*designee for Sen. H. Diane Snyder on 9/14 and 9/15*)

Staff
Amy Chavez, Pam Ray and Tim Crawford

Guests
The guest list is in the meeting file.

Copies of all written testimony are in the meeting file.

Monday, September 13

APPROVAL OF MINUTES

The committee unanimously approved the minutes of its third meeting held on August 23-25, 2004 in Ruidoso.

INTRODUCTORY REMARKS

Faye Vowell, provost of Western New Mexico University (WNMU), welcomed the RSTPC members to Silver City and to WNMU. She indicated that branches of WNMU exist in Silver City, Truth or Consequences, Deming and Gallup. Last year, over 400 students graduated from WNMU. Hispanics comprise over 50 percent of the student body, largely due to support from a federal Title V grant that requires at least 26 percent of the student body to be comprised of Hispanic students. She also indicated that a majority of the student population is comprised of students that graduated from small high schools. Ms. Vowell discussed recent training initiatives at WNMU for faculty and staff. One initiative involves a national study of student engagement to improve communication between faculty and staff through improved technology. WNMU also participates in the American Democracy Project, which promotes student-driven discussions regarding civic engagement and voter responsibility.

SILVER CITY COPPER MINING INDUSTRY

Richard Peterson, regional communications manager of Phelps Dodge, and Nancy M. King, attorney from the Montgomery and Andrews law firm, discussed the status of copper mining by Phelps Dodge in the Silver City area. Mr. Peterson provided the committee members with a background of copper mining in New Mexico. He indicated that Phelps Dodge purchased property in Tyrone, New Mexico, for the purpose of producing copper in 1909. Although the company closed the mine in 1921, it reopened the mine as a modern open-pit mine in 1968. Beginning in 1996, the company purchased several other New Mexico mining companies, including Chino Mines Company, Cobre Mining Company and Cyprus-Amax Mining Company.

Mr. Peterson discussed the financial outlook for Phelps Dodge in recent years. In 2002, the company lost $341.6 million, but earned $95 million in 2003. During the first quarter of 2004, the company earned $185 million and in the second quarter, the company earned $225 million. Mr. Peterson stated that the financial outlook for the copper mining industry worldwide is favorable because worldwide economic conditions, particularly in the manufacturing and capital goods sectors, are improving. After several years of slow sales and rising inventories, demand for copper exceeds worldwide production.

The financial outlook is also improving for the Chino Mines Company in New Mexico. For instance, although the production of copper by the Chino Mines Company was less than one-third of capacity in 2003, operations are expected to improve. Employment has risen from 380 employees in 2003 to over 600 employees this year.

Unlike the Chino Mine, the Tyrone Mine has reduced copper production. New material is not currently mined in Tyrone. Phelps Dodge is in the process of reclaiming the mining site. The mine currently employs 380 workers, which has increased from 260 at the end of 2003.

Mr. Peterson discussed challenges to the success of copper mining by Phelps Dodge in New Mexico. Those challenges include regulatory uncertainties, complex permitting processes, understaffed agencies, inconsistencies in regulatory interpretation, the complexity of mining sites and aging copper ore bodies. However, Mr. Peterson also indicated that several technological opportunities will soon be available to reduce reclamation and other costs to the industry.

TAXATION AND REVENUE DEPARTMENT ENHANCED AUDIT INITIATIVE

Manu Patel, deputy director of the Legislative Finance Committee (LFC), discussed the LFC's recent review of the enhanced tax collection initiative efforts of the Taxation and Revenue Department (TRD). During the 2003 legislative session, the TRD received a $5 million special appropriation. The TRD allocated $4 million to the Audit and Compliance Division and $1 million to the Tax Fraud Investigations Division of the department. The TRD's goal was to enhance the general fund by $50 million through an initiative to collect $68 million in additional tax revenue from February 1, 2003 to June 30, 2004. The TRD reported that it increased collections by $66.5 million and that $55.1 million of that amount was distributed to the general fund.

The TRD received a $2.3 million special appropriation to continue the enhanced collection initiatives during the 2004 legislative session. The TRD has been required to collect an additional $31 million of delinquent taxes, with $25 million distributed to the general fund, during fiscal year 2005.

The LFC additionally reviewed the operations of the Tax Fraud Investigations Division of the TRD. The director of the division was hired in February 2003, and the division is almost fully staffed. However, a division policy has not been developed. Although the division is not directly involved in the enhanced collection initiatives, the division is viewed as a deterrent against noncompliance. Legislation has been proposed for the 2005 legislative session to formally establish the Tax Fraud Investigations Division as a statutory division. The TRD and the LFC will discuss performance measures for the division to be addressed during the 2005 legislative session.

The Managed Audit Program of the TRD was also reviewed. Legislation passed during the 2003 session expanded the program to include all tax programs as part of the initiative to enhance tax collections. The program allows taxpayers to conduct a self-audit and to avoid penalties and interest. Money owed must be paid within 30 days of assessment. One full-time employee and one part-time employee operate the program. Managed Audit Program collections comprised $3.8 million, or 2.6 percent, of total collections during the initiative's period. The TRD does not have procedures to monitor and enforce compliance with Managed Audit Program time limits for submitting self-audit documents within 180 days and paying assessments within 30 days.

The LFC formulated several recommendations for improvement of the TRD's enhanced audit initiative. First, it suggested avoidance of manual collections and tabulation procedures. Second, it recommended maintenance of audit trails and internal reviews of manual collections tabulation procedures. It also suggested that the department devise procedures to evaluate the effectiveness of the Tax Fraud Investigations Division and to monitor and enforce Managed Audit Program time limits for submitting self-audit documents and paying assessments. The LFC finally suggested that the TRD ensure staffing depth for the Managed Audit Program. Since one employee currently operates the entire program, the LFC suggested that additional staff might buffer against a work stoppage that might occur if that employee is unavailable to work.

LAND GRANT PERMANENT FUND AND PIPELINE INVESTMENT PROPOSAL UPDATE

Gary Bland, state investment officer, provided the committee with an update of the status of the Permanent School Fund and other permanent funds derived from lands granted to the state by the federal government. State Investment Officer Bland explained that although the state investment officer is charged with the duty of investing the funds, the types of investments that can be made are restricted by the New Mexico Constitution. Article XII, Section 7 of the New Mexico Constitution also requires distribution of five percent of the average year-end market values of the fund for the immediately preceding five calendar years. If the average of the year-end market values of the funds for the immediately preceding five calendar years is greater than $5.8 billion, the state investment officer must make additional distributions from the funds pursuant to a schedule set by Article XII, Section 7.

State Investment Council (SIC) estimates show that approximately $240 million will be earned on investment of the Land Grant Permanent Fund in 2004. The average of the year-end market values of the fund for the previous five years will be approximately $7.3 billion. Distributions from the fund in 2005 will be approximately $421 million. The market value of the Severance Tax Permanent Fund in 2004 is expected to be $3.6 billion in fiscal year 2004 and distributions for fiscal year 2004 are expected to be $172 million.

State Investment Officer Bland also updated the committee members on the reasons for the SIC's decision not to invest $50 million on a natural gas pipeline expansion project in the San Juan Basin near Farmington. Mr. Bland indicated that the SIC did not proceed with the investment because the investment might violate state law and would not necessarily provide additional benefits to the state's natural gas industry. Attorneys hired to review the proposal advised the SIC that the proposed investment did not meet state requirements to invest only in companies whose stocks are registered on a national exchange. The attorneys also advised the SIC that there was not independent proof that natural gas production in the San Juan Basin would benefit from increased pipeline capacity.

The committee recessed for the day at approximately 2:30 p.m.

Tuesday, September 14

WELCOMING REMARKS BY DEMING OFFICIALS

Sam Baca, mayor of the city of Deming, welcomed the committee members to the city of Deming and discussed the various benefits of legislative committees meeting in cities throughout the state. Representative Dona G. Irwin from Deming also welcomed the members. Senator John Arthur Smith, also from Deming, welcomed the committee members. Representative Whitaker handed over the title of chair to Senator Smith for the remainder of the meeting.

EDUCATIONAL RETIREMENT FUND UNFUNDED LIABILITY AND PENSION OBLIGATION BOND INVESTMENT

David Paul, financial advisor to the State Board of Finance, discussed the unfunded actuarial accrued liability (UAAL), the difference between the assets and liabilities, of the Educational Retirement Fund. The Educational Retirement Board (ERB) has reported that the pension fund's UAAL is expected to rise from $1.7 billion in 2003 to $2.4 billion in 2004. The issuance of pension obligation bonds (POBs) has been addressed as an option to address the growing UAAL. POBs are taxable, long-term bonds issued by the state to pay all or part of a pension system's UAAL. Proceeds from the bonds would be distributed to the ERB to invest in the same manner as other assets of the ERB are invested. The POBs would be considered a state liability because the state has the ultimate obligation to pay annuitant benefits. Since the POBs would take the form of revenue bonds, the state would need to identify a revenue stream dedicated to make annual debt service payments. A revenue source to pay the bond debt service would need to be determined. Mr. Paul suggested that pledging a portion of the gross receipts tax might be appropriate.

Mr. Paul indicated that the objective of POB issuance is to refinance long-term UAAL costs at low-interest costs. Under current market conditions, POBs might provide substantial budget savings. Savings in the range of 20 percent might occur on a present value basis. The interest cost of POBs is six percent, which is below the actuarial rate of eight percent. POBs are also viewed favorably because a portfolio of equities and bonds might outperform bond interest rates over time. In the long term, the actual pension fund portfolio return should exceed the pension obligation bond interest cost. Mr. Paul indicated that Internal Revenue Service rules permit such arbitrage so long as the bonds are subject to federal income tax. Mr. Paul indicated that issuance of the bonds should approach $150 million and once the bonds are issued, the state should retire the UAAL over 20 years.

Mr. Paul stated that POBs are an ultimately reasonable strategy for reducing the UAAL and providing a financial benefit to the state. Savings structured up front over a three-year timeframe can help offset the budget impact of income tax rate reductions. POBs replace one long-term liability with another long-term liability that carries a lower cost of funding. Success of the POB strategy depends upon effective portfolio management in achieving competitive returns over time. Issuance should provide for partial funding of the deficit and provide for a clear proceeds investment plan. Credit rating agencies view a well-structured transaction positively with respect to UAAL impact, balance sheet risk and commitment to pension funding. The use of gross receipts tax bonds to fund bond debt might provide an effective proxy for general fund credit and would likely be positively received by credit rating agencies.

Mr. Paul also cautioned that other strategies for funding the UAAL might need some consideration. Those strategies might include increased employer contributions to the Educational Retirement Fund, reduced educational retirement benefits to future retirees and conversion of the defined benefit structure of the educational retirement system to a defined contribution system.

<u>EDUCATIONAL RETIREMENT STATUS</u>

Evalynne Hunemuller, director of the ERB, discussed the status of the state educational retirement system. She stated that the ERB administers the largest retirement system in the state. The system is composed of 65,000 active members. The educational retirement system is a defined benefit plan, so the monthly pension of its members is assured.

Ms. Hunemuller provided a comparison between state educational retirement and Public Employees Retirement Association (PERA) benefits. Educational employers provide 8.65 percent of the contribution to the educational retirement plan, while employers provide 16.59 percent of the contribution for the PERA retirement plan. Educational retirement plan members contribute 7.6 percent to their plan while PERA members contribute 7.42 percent. The cost-of-living adjustment for educational retirement beneficiaries starts at age 65 and is one-half of the previous year's consumer price index. The cost-of-living adjustment for PERA members begins to take effect after three years of retirement.

In response to concerns regarding the soundness of the Educational Retirement Fund, Ms. Hunemuller stated that the fund remains strong. However, she indicated that several issues that need to be addressed include increased fund liabilities, investment losses and inadequate contribution levels. She stated that increased liabilities have resulted from increased membership due to an increasing number of retirements. The fund is also obligated to pay more in pensions because of increased life expectancies of members and higher average salaries upon retirement.

The low earning performance of the fund's investments has not assisted in offsetting increased liabilities. In 2001, the return on market investments was -11.1 percent; in 2002 it was

-8.8 percent; and it was 2.7 percent in 2003. To offset the poor performance of recent years, the fund would need to earn a 24.8 percent return on its investments during the next year. As a result of the combination of increased liabilities and unfavorable investment performance, the UAAL of the Educational Retirement Fund has increased from $1.1 billion to $1.7 billion. The UAAL funding period for the Educational Retirement Fund has increased from 27.2 years to 78 years.

Ms. Hunemuller discussed various methods to reduce the UAAL of the Educational Retirement Fund. Options include increased contributions from employers and employees; required retirement periods for members; increased funding from the legislature; and the issuance of POBs.

PUBLIC EMPLOYEES RETIREMENT STATUS

Terry Slattery, executive director of the PERA, discussed the financial status of the public employees retirement system in New Mexico. He explained that the PERA is charged with the responsibility of making pension payments to current and future retired PERA members, vested former members and to survivor pension beneficiaries. PERA funding is provided by member contributions, affiliated public employer contributions and investment earnings of PERA assets. Seventy-three percent of the funding for the public employees retirement system comes from investment of present PERA assets. Fifteen percent of the funding is comprised of employer contributions and the remainder is comprised of future member contributions.

Mr. Slattery indicated that the basic funding objective of the PERA is to avoid transfers of the cost of statutory obligations between generations of taxpayers. He stated that the objective will be realized if PERA funding resources are sufficient to finance normal costs, which are costs allocated to the current year attributable to services rendered by PERA members for the current year. UAAL, including costs allocated to prior years attributable to services rendered by PERA members in prior years, must also be funded over a period not to exceed 30 years. As of June 30, 2003, actuarial valuation indicated that PERA funding resources are sufficient to fund the normal cost and finance the UAAL over an aggregate period of 17 years.

Mr. Slattery also discussed the status of the Judicial Retirement Fund, which provides pension payments to current and future retired judges, vested former judges and survivor pension beneficiaries. Five percent of the fund is comprised of member contributions and nine percent is comprised of employer contributions. The remainder of the fund is comprised of investment earnings of Judicial Retirement Fund assets and of a portion of district court civil case docket fees. The UAAL of the Judicial Retirement Fund is currently $20,728,330 and the judicial retirement system is 76 percent funded. Reduced contributions have contributed to the UAAL amount. Contributions are not based upon a percentage of salaries and thus do not rise with increased salaries. As a result, while a demand is placed upon retirement benefits, the amount contributed to the retirement fund has not increased at the same rate. The formulation of a salary-based contribution rate into the Judicial Retirement Fund is a proposed solution to the disparity between contributions to and payments from the fund.

TAXATION OF STATE PARK RECEIPTS

Doug Williams, Legislative Council Service economist, discussed various options for the taxation of state park receipts. He discussed the advantages and disadvantages of creating a new local governmental gross receipts tax applicable to state park fees, creating a new local sales tax applicable to state park fees, increasing state park fees and earmarking an increase for localities and altering the distribution of the governmental gross receipts tax related to state park fees. The revenue raised by such options statewide would approximate $35,000 for each one percent of tax allocated to local governments.

Adam Polley, Sierra County manager, discussed a proposal to subject state and federal agencies to a five percent local option lodger's tax. He stated that many state and federal parks use county resources, including roads and police, rescue, fire and hospital services. Mr. Polley suggested that counties should not have to bear the entire burden of paying for such resources and that the state and federal government could pay for their use of the resources by paying the local option lodger's tax.

GOVERNMENTAL GROSS RECEIPTS TAX OVERVIEW

Mark Valenzuela, director of intergovernmental relations with the New Mexico Finance Authority (NMFA), explained that the governmental gross receipts tax (GGRT) is a five percent tax on the receipts of agencies, institutions, instrumentalities and political subdivisions of the state for the privilege of engaging in activities, such as the sale of tangible personal property from facilities open to the general public; the performance of or admissions to recreational and athletic events; and refuse collection and disposal. The governmental gross receipts tax is also imposed upon the receipts of local water utilities for providing sewage services and solid waste management. One percent of the GGRT is distributed to the Cultural Affairs Department, 24 percent is distributed to the Energy, Minerals and Natural Resources Department and 75 percent is distributed to the NMFA. The amount distributed to the NMFA is further distributed to funds such as the Water Facility Construction Loan Fund and the Solid Waste Facility Grant Fund. GGRT collections have risen steadily during the last decade. Collections for fiscal year 2004 are expected to approximate $24.49 million.

The committee recessed for the day at 3:00 p.m.

Wednesday, September 15

INFRASTRUCTURE INVESTMENT AND CAPITAL OUTLAY MONITORING

James Jimenez, director of the Department of Finance and Administration (DFA), made a presentation on the governor's proposal to reform the capital outlay appropriation process. The DFA has created the Capital Projects Unit, which will be responsible for developing a long-range approach to infrastructure and linking projects to statewide priorities; recommending projects that provide adequate funding to ensure timely project completion; and recommending capital projects that can be completed within four years. The Capital Projects Unit is soliciting requests from local governments, special districts, tribes, pueblos and chapters to identify capital priorities for inclusion in the governor's 2005 executive recommendation for capital outlay.

Robert Apodaca, director of the Capital Projects Unit, DFA, reviewed the strategic plan for the unit for the 2005 legislative session. Goals include cooperation with agencies to improve accountability and reporting; identification of stagnant projects and fund balances available for reauthorization or reversion; and providing training and assistance to agencies on planning, budgeting and administration on capital projects. The unit will also work with the governor, legislature and local and tribal governments to develop joint priorities to be funded through the capital outlay process. The unit will make recommendations to the governor for capital projects to be funded during the legislative session.

The meeting adjourned at 11:45 a.m.