MINUTES
of the
SECOND MEETING IN 2009
of the
REVENUE STABILIZATION AND TAX POLICY COMMITTEE

July 14-15, 2009
Henderson Fine Arts Center
San Juan College
Farmington, New Mexico

The second meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) for 2009 was called to order on July 14, 2009 by Senator John Arthur Smith, chair, at 9:10 a.m. in the Henderson Fine Arts Center of San Juan College in Farmington, New Mexico.

Present	**Absent**
Sen. John Arthur Smith, Chair	Sen. William E. Sharer
Rep. Edward C. Sandoval, Vice Chair	
Sen. Carlos R. Cisneros	
Rep. Nathan P. Cote	
Rep. Anna M. Crook	
Sen. Dianna J. Duran	
Sen. Tim Eichenberg	
Rep. Keith J. Gardner	
Sen. Timothy Z. Jennings	
Sen. Timothy M. Keller	
Sen. Gay G. Kernan	
Rep. Ben Lujan, Speaker of the House	
Rep. Rodolpho "Rudy" S. Martinez	
Sen. Howie C. Morales	
Rep. Henry Kiki Saavedra	
Rep. Thomas C. Taylor	
Rep. Jim R. Trujillo	
Designees	
Sen. Steven P. Neville	Rep. Ray Begaye
	Sen. Mark Boitano
	Rep. Donald E. Bratton
	Sen. Kent L. Cravens
	Rep. Miguel P. Garcia
	Rep. Sandra D. Jeff
	Sen. Carroll H. Leavell
	Rep. Antonio "Moe" Maestas
	Rep. Debbie A. Rodella
	Sen. Nancy Rodriguez
	Sen. Bernadette M. Sanchez

Sen. John M. Sapien
Rep. Don L. Tripp
Rep. Luciano "Lucky" Varela
Sen. Peter Wirth

Other Legislators Attending
Rep. James R.J. Strickler (July 15)

(Attendance dates are noted for those members not present for the entire meeting.)

Staff
Pam Ray, Staff Attorney, Legislative Council Service (LCS)
Doris Faust, Staff Attorney, LCS
Ric Gaudet, LCS

Guests

The guest list is in the meeting file.

Handouts

Copies of all handouts and written testimony are in the meeting file.

<u>Tuesday, July 14</u>

Welcome and Update

Carol Spencer, president, San Juan College, welcomed committee members to the college. She said that the college's budget has been affected by recent oil and gas price volatility and the current budget has already been cut by three percent. So far, the college has not had to layoff any employees, but if revenues continue to decline, furloughs may become necessary. Enrollment at the college is increasing tremendously, with 14,000 students expected to enroll for the fall 2009 semester.

Bill Standley, mayor of Farmington, briefed the committee on the city's fiscal state. He said that the Farmington metropolitan area ranks among the lowest in the nation for unemployment, demonstrating the long-term commitment of the extraction industry to the area. Although the city has received 10 percent less in gross receipts tax (GRT) revenues from natural-gas-related activities, there has been a two percent increase in retail GRT collections this year. He said that property tax valuations for the area are down a bit from last year. Finally, Mayor Standley told the committee that the Public Service Company of New Mexico (PNM) recently completed a $300 million upgrade to its power plant, which has improved the air quality. The area ranks seventh in the nation for short-term air particulates, he said.

James Henderson, chair, San Juan County Commission, described recent developments in San Juan County. The county is moving toward establishing zoning ordinances, since much of the recent growth in the county has been in unincorporated areas. The county is also trying to develop alternatives to septic systems, which have been causing problems in some areas. The regional medical center was completed in November 2008, and a substance abuse and DWI facility will be completed soon. Finally, Dr. Henderson said that the county is attempting to find funds to chip seal the Chaco Canyon road.

Tony Atkinson, the new president of the New Mexico Association of Counties (NMAC), introduced himself to the committee and said that the NMAC would present its concerns to the committee in September. He said that the NMAC will reappoint a property tax education committee this year. A committee member asked if county assessors will be able to comply with the newly enacted real estate property tax disclosure law, which requires county assessors to disclose estimated property taxes on properties to potential buyers. Mr. Atkinson said that he did not think that compliance would be very difficult.

The committee asked about GRT trends in Farmington. Mayor Standley said that although GRT collections from last year are up slightly, there has been a 12 percent drop in the past two months. He said that Farmington has the highest occupancy rate in the state and that a new Marriott hotel is being constructed. The price of natural gas determines whether operators keep wells operating, which affects GRT collections. With the average price of natural gas down significantly from last year, many operators are instead recapitalizing and waiting for the price to go back up before pumping again. In addition, the new pit rules promulgated by the Energy, Minerals and Natural Resources Department (EMNRD) had an initial large negative impact on well drilling and operation. Some companies have moved operations across the border into Colorado, he said.

A committee member said that the Four Corners economy has a huge impact on the state. The state's budget had been set based on natural gas prices of $4.70 per million British thermal units (MMBTU), but the average price that day was only $2.98 per MMBTU. The member said he expects a special session in the fall because revenues are seriously declining.

A committee member asked if nonprofit entities in the Farmington area have suffered from the economic downturn. He expressed concern that people in need of services will not be cared for if nonprofits close. Mayor Standley said that the extraction industries have been huge contributors to nonprofits in the past. He said that the key to helping people thrive is in creating jobs. He also said that fundraising by the United Way in Farmington exceeds the level raised in Albuquerque.

A committee member asked about the San Juan College budget. Ms. Spencer said that the college's budget was cut by the legislature by $800,000 and that the current revenue projections for the year are down 2.5 percent. She said that although enrollment is increasing at the college, the state higher education funding formula does not increase funding correspondingly for a couple of years. She said that the community college board has made a commitment to keeping tuition low, but that it did raise rates this year.

A committee member commented that downturns in the oil and gas industry seem to show up in the Farmington economy six to 12 months later. He cautioned that the area may have not seen the full impacts of the downturn. Another committee member said that Farmington has the highest per capita gross receipts in the state. He also said that he did not understand why Santa Fe County is so resistant to energy development.

Energy Tax Comparison Across States

Beatrice Lucero, senior economist, Taxation and Revenue Department (TRD), briefed the committee about how different states tax coal and other energy resources. There are four basic types of coal, with increasing carbon content and corresponding heat values: lignite, subbituminous, bituminous and anthracite. New Mexico deposits are subbituminous and bituminous. Energy production is the primary use for coal and accounts for approximately 50 percent of all electricity produced in the United States. In 2008, total coal production in the U.S. was nearly 1,200 million short tons (MST), with New Mexico accounting for 25.6 MST that year. Although producing a relatively small quantity of coal, New Mexico is the third-largest subbituminous producing state. Average coal prices vary by state, often due to the type of coal being produced and whether the mines are surface or underground. The average price per ton of coal in the U.S. in 2007 was $26.20, and the New Mexico average was $29.91. Ms. Lucero noted that the extremely low average price for Wyoming coal skewed the national average downward.

All of New Mexico's coal is currently produced in the San Juan Basin, said Ms. Lucero. Sulfur content of New Mexico coal is generally lower than the national average, which means that coal from New Mexico burns cleaner. About 69 percent of New Mexico coal is sent to electric generating stations in New Mexico, with the remainder being shipped by rail to Arizona. Coal is used to produce 77 percent of the electricity produced in New Mexico. Ten years ago, the coal-based percent was 86 percent. Increased electricity generation from natural gas and renewable sources account for the shift, said Ms. Lucero.

Severed coal in New Mexico is taxed at $.57 per short ton for surface coal and $.55 per short ton for underground coal, with the revenues being distributed to the Severance Tax Bonding Fund. In addition to the severance tax on coal, a coal surtax is imposed on some of the coal produced in New Mexico. The tax has varied over the years and is currently set at $1.02 per short ton of surface coal and $.99 per short ton for underground coal. A complicated set of exemptions from the coal surtax has been enacted, with the result today that less than one-half of coal severed in New Mexico is subject to the surtax. New Mexico coal is also subject to the resources excise tax, which is actually composed of the resources tax, the processors tax and the service tax. Currently, only the resources tax is in effect. After deductions, including deductions made for royalties paid, the resources tax is imposed at .75 percent of the value of the coal. The final tax imposed on coal is the conservation tax, which is imposed on the value of the coal, after deductions, at the rate of .19 percent. Nearly all of the collections made pursuant to the resources tax and the conservation tax are distributed to the general fund.

Comparing underground and surface coal and surtax-exempt and nonexempt operations, Ms. Lucero concluded that the per unit tax and higher prices received for underground coal result in much lower effective tax rates for underground coal than for surface coal. Ms. Lucero also calculated revenue losses to the state from the exemption from the coal surtax, which in 2008 totaled $9.2 million.

In order to calculate the total taxes imposed on coal and its effective tax rates, Ms. Lucero also factored in property taxes on coal properties and the GRT, which is imposed on the sale of nearly all coal in New Mexico. The total average production taxes on coal (severance taxes, etc.) are imposed at the rate of 4.11 percent of the total value of the coal. Nonproduction taxes (GRT, property tax) added 6.23 percent to the tax rate. In total, New Mexico has an effective tax rate on coal of 10.34 percent.

Ms. Lucero briefly discussed some of the rationale for taxing natural resource production, including offsetting the negative environmental consequences of exploration, production, transportation, refining and combustion of the resource.

Ms. Lucero then compared production and nonproduction taxes of coal to oil and natural gas in New Mexico. While coal in New Mexico on average is taxed at a total effective rate nearly three percent higher than oil or natural gas, comparing different types of coal production shows that underground coal has production taxes much lower than all other resources. In addition, by comparing total effective taxes when measured per MMBTU, per short ton of carbon content or per short ton of carbon dioxide emissions, coal is shown to be taxed at much lower rates than oil or natural gas.

Ms. Lucero compared New Mexico's effective tax rates on coal with other western states. Although this type of analysis is difficult to perform because of the many different types of tax systems in place, taxes were categorized into production taxes, property taxes and sales taxes. New Mexico's total effective tax rate of 10.34 percent was lower than Montana's 14.51 percent, but was higher than the four other states that were studied. Although New Mexico taxes are high compared to most other western states, Wyoming, which produces the most coal in the nation, has an effective tax rate of 9.75 percent, very close to New Mexico's tax rate.

Ms. Lucero next described the structure of taxes on oil and gas in New Mexico and compared tax rates with other states. Both oil and gas are taxed at slightly different rates using the same taxation structure. The oil and gas severance tax, the oil and gas emergency school tax and the oil and gas conservation tax are based on the value of the severed product, and the production ad valorem tax and the production equipment ad valorem tax are imposed essentially in lieu of property taxes, said Ms. Lucero. The total current production taxes on oil amount to 8.27 percent; and on natural gas, 8.97 percent. Compared to eight other oil- and gas-producing states, New Mexico ranks in the middle for taxation of oil and below the middle for taxation of gas.

Finally, Ms. Lucero compared oil and gas combined tax and royalty rates with the same other states, which would apply only to production on state lands. Under this comparison, total royalties and taxes paid to New Mexico are the second lowest, only above Colorado. However, Ms. Lucero noted that a recent Colorado attorney general ruling allowed that state to increase its severance taxes without regard to a provision in its constitution limiting revenues collected by the state. Immediately after that ruling, severance taxes on coal were increased, and those taxes on oil and gas are expected to increase soon.

A committee member asked how many people in New Mexico are employed by energy companies. Ms. Lucero said she will provide that number to the committee. Another committee member said that the TRD research did not reflect income taxes imposed on energy production, which unfairly skewed the results. Ms. Lucero responded that states tax income very differently and that her research focused on the production of resources.

A committee member asked why some coal production is exempt from the coal surtax. Ms. Lucero said that she did not know why the exemptions were enacted, but she said that the two underground mines that currently benefit from the exemption, BHP Navajo and BHP San Juan, both have no transportation costs, are vertically integrated and have long-term contracts in place.

A committee member asked whether the royalty comparisons factored in federal royalties. Ms. Lucero said that this study did not study federal royalties. She said that although New Mexico generally receives one-half of federal royalties, it would not be accurate to factor those royalties into a state-by-state comparison of effective taxes and royalties.

A member of the committee said that many oil and gas companies moved to Colorado following the EMNRD's onerous pit rules. He also suggested that the Oil Conservation Division of the EMNRD change a rule to allow wells every 80 acres rather than the current 160 acres. That rule change would reduce operating costs and reduce the need to maintain so many roads. He said that New Mexico should give tax breaks to companies operating oil rigs, which provide decades of employment, rather than film companies, which come and go with short-term productions.

A committee member commented that although New Mexico has about-average tax rates for resource extraction, it has high regulatory costs. Another committee member said that the EMNRD pit rule has actually increased air particulate hazards because residue from well sites must now be hauled away, rather than allowing for remediation on-site.

Production Update; Regional Market Differentials; Oil and Gas Forecasting Process

Ms. Lucero, Laird Graeser, chief economist, Department of Finance and Administration (DFA), and Becky Gutierrez, economist, Legislative Finance Committee (LFC), briefed the committee on how state agencies forecast oil and gas revenues for the state.

Mr. Graeser described the basic model for estimating oil- and gas-related revenues to the general fund. That model entails calculating the gross production value from actual volumes produced and the Oil and Natural Gas Administration and Revenue Database (ONGARD) reported price; deducting royalties and processing and transportation costs to calculate the net taxable value; calculating taxable obligations; and multiplying that amount by an estimate of the percent of obligations that actually will be paid to the state. That model gives state economists an ability to predict what the revenues to the general fund will be.

Ms. Lucero expanded on the methodology presented by Mr. Graeser to describe the TRD's oil and gas revenue forecasting process. The department uses many data sources for revenue forecasting, including the ONGARD system, the PIRA Energy Group, Global Insight, the Energy Information Administration (EIA), NYMEX, the New Mexico Institute of Mining and Technology, Platts and the Conoco-Phillips Morning Report. Volumes are predicted using actual historical trends reported in the ONGARD system. Both oil and natural gas volumes have been declining at a one to two percent rate per year. For oil, the consensus revenue group, composed of career economists from the DFA, TRD and LFC, in February 2009 predicted an annual one percent decline in production for fiscal years 2010 through 2012 and a .7 percent decline for fiscal year 2013. Natural gas volumes are predicted to decline over the next four years, but with steeper decline rates, ranging from 1.5 percent to 3.7 percent annually.

Forecasting oil and gas prices has been a more difficult process than forecasting volumes. The TRD uses NYMEX futures contracts, Global Insight's long-term forecasts for West Texas intermediate crude oil and the EIA's long-term forecast for that oil. However, since the prices received by New Mexico producers differ significantly from those forecasts, the TRD maintains a database that reflects historical differentials of average monthly prices by basin. In preparing the February 2009 forecast, the economists used short-term price ratio differentials, due to the extreme volatility of oil prices since August 2008. The consensus revenue group forecast a rate of decline of oil prices for fiscal year 2010 of 24 percent, but prices were expected to increase between nine and 13 percent annually for the subsequent three years. Natural gas prices have seen a similar variation in expected prices in the last year. The TRD uses four sources to forecast gas prices and also uses historical databases to calculate price differentials. The February 2009 consensus forecast expected the average price of gas to decline in fiscal year 2010 by 14 percent but rebound by nearly 30 percent the following year. To finish the oil and gas revenue forecasting model, Ms. Lucero described how deductions and tax credits are factored into the predictions, and finally, an estimate of revenues collected by the state from the various taxes imposed on oil and gas production is produced. While total oil and gas tax revenues are predicted to drop in fiscal year 2010 by more than $300 million from the previous year, revenues are expected to increase in fiscal year 2011 and approach fiscal year 2009 levels by fiscal year 2013.

Mr. Graeser presented to the committee some modeling techniques he is experimenting with in order to better predict oil and gas revenues. In particular, he has begun to track how changes in oil and gas prices affect production levels. As prices rise, companies are encouraged to drill more wells, offsetting the natural decline in volumes somewhat. However, it appears that if production is sensitive to price, there is a lag of about 10 calendar quarters for response time. In addition, Mr. Graeser said that his data show that natural gas production volumes in the San Juan Basin seem to be more a function of technology and geology, but volumes in the Permian Basin seem to be more price sensitive. Mr. Graeser presented data that imply that oil production in the Permian Basin on state and federal leases will increase in the next few years, which will lead to an increase in royalty payments to the state.

Mr. Graeser discussed other complications in predicting oil and gas revenue, including the delay in reporting deductions. While royalties are reported at 98 percent of final value within three months of the due date, transportation and processing deductions are generally not known to that level of accuracy for 17 months. Understanding the delay in reporting helps economists predict quarterly revenues the state will collect. Finally, Mr. Graeser discussed how tracking drilling rigs in the state can lead to better predictions of future revenue.

Ms. Gutierrez described to the committee the oil and gas revenue forecasting process as it relates to federal and state leases. She began with federal lease revenue, which mainly involves knowing the production volumes and the prices of the products. Oil production on federal lands accounts for 42 percent of all oil production in the state, and natural gas production on federal lands accounts for 63 percent. Ms. Gutierrez said that there is typically a three-month lag between the reporting of ONGARD data and federal mineral revenues to the general fund.

The State Land Office manages leases on state land and collects royalties and revenue from rents, leases and bonuses. Royalties from gas production are remitted at 16 percent of value and for oil at 38 percent of value. Revenue is distributed according to the type of collection. Most of the revenue from rents, leases and bonuses is dedicated to the Common School Fund but in effect is deposited into the general fund. Distributions in fiscal year 2008 were $46 million and are expected to be $36 million for fiscal year 2009, said Ms. Gutierrez. Royalties collected are deposited into the Land Grant Permanent Fund, which is invested on behalf of 21 trust land beneficiaries. Three hundred ninety million dollars was distributed to the general fund in fiscal year 2008.

A committee member asked why the TRD projected a 2.4 percent increase in gas production for fiscal year 2011. Ms. Lucero said that this is based on economic recession-related declines and that production would return to expected production levels when the recession ends. The committee member commented that New Mexico's budget will be based on the assumption that the recession will be over by the end of 2009. He also said that the TRD projection of an increase in production skews the rest of the consensus projection, since the other entities involved predict a decline in production during that same period. In addition, the EMNRD's pit rule will probably negatively affect production. The committee member asked for a comparison of several consensus forecasts to actual reported levels.

A committee member questioned the validity of assuming a gas price of $4.80 per MMBTU, when the current price is $2.95. He said that for every $1.00 increase in the price of gas, the state receives about $100 million in revenue.

A committee member asked about the relationship between drilling rigs and production. Mr. Graeser said that oil production of existing wells typically drops 12 to 13 percent per year, but that new wells replace about 10 percent of that loss.

A committee member asked how leases on Indian lands were accounted for in the presentations. Ms. Lucero said she will provide that information. The committee member commented that since royalties are not deductible against ad valorem taxes on private land, it would be beneficial for companies to have leases on state land, which, in turn, would bring more revenue to the state. Finally, he asked whether the February 2009 consensus projection of oil selling at $44.00 per barrel is valid. Mr. Graeser said that the August estimate will probably have a much higher price for oil.

Valuing Oil and Gas Property

Rick Homans, secretary of taxation and revenue, Rick Silva, director, Property Tax Division (PTD), TRD, Michael O'Melia, deputy director, PTD, and Mitch Bonney, bureau chief, State Assessed Property Bureau, PTD, gave a presentation to the committee on how oil and gas property is valued for taxation purposes. Mr. Silva began by discussing the three main property taxes imposed on the industry, including the oil and gas ad valorem production tax, the oil and gas production equipment ad valorem tax and the general property tax. These taxes are all distributed to the regular property tax recipients, including counties, municipalities, school districts and universities, and the actual millage rates are determined in accordance with the system of determining other regular property tax rates. What this means in practice is that the valuation of oil and gas property has an effect on the millage rate of other property taxes, including residential property taxes.

The oil and gas ad valorem production tax is the largest property tax generated by the oil and gas industry, which brought in $184 million in 2008. The tax base is calculated as 150 percent of the value of the oil or gas product after deducting royalties paid to governmental entities and transportation costs. That value is then divided by the uniform assessment ratio of three and multiplied by the applicable millage rate for the location at which the production occurs.

The similarly monikered oil and gas production equipment ad valorem tax is a tax on equipment used in the severing of oil and gas, but the taxable value of equipment is valued based on the value of the severed product, and not the net book value of the equipment, which is how business property for other industries is valued. The tax is calculated by taking 27 percent of the production value, multiplying that by the uniform assessment ratio of one-third and applying the millage rate for that location.

The last property tax assessed on oil and gas industry property is the property tax that is assessed on all property in the state. Certain types of oil and gas property, including pipelines, tanks, meters and plants used in processing, are valued using a statutory special method of valuation. The State Assessed Property Bureau performs assessments on these properties and uses net book value as the basis for valuations.

Mr. Silva then compared property taxation figures of oil and gas property to other types of property. While the weighted average millage rate for all classes of property in New Mexico is 2.8 percent of net taxable value, the average millage rate for oil and gas assets is slightly lower at 2.4 percent. Most taxable property in New Mexico is real property and thus not subject to depreciation. Most oil and gas property, however, is able to be depreciated. Currently, oil and gas assets in the state are depreciated at 44 percent.

An average 2.2 percent of the taxable value of property in New Mexico is protested each year. However, this year, 16 percent of the oil and gas valuation was protested, compared to three percent for other business sectors. One of the key reasons for such high valuation protests, said Mr. Silva, is that current rules for allowing obsolescence claims for depreciated or unused equipment are confusing and new language was recently adopted by the legislature. The division has proposed new rules to govern obsolescence claims, under which companies will need to document an obsolescence claim. That proposed rule has encountered opposition from the oil and gas industry, said Mr. Silva.

A committee member said that he has heard from industry people that the proposed rule seems overly complex and unnecessarily burdensome. Mr. Bonney responded by saying that the rule is merely requiring industry to provide documentation of expectations of its equipment. For example, a pipeline that is designed to operate at 80 percent of capacity is fully functional at that rate of flow. An obsolescence claim would not be valid under those circumstances. He said that the oil and gas industry has requested guidelines on obsolescence claims for 10 years.

A committee member said that it is bad policy for the state to tax certain classes of property based on capacity. Mr. O'Melia said that property tax values are based on actual costs. Obsolescence refers to a mechanism for the industry to reduce valuations based on actual circumstances.

Secretary Homans said that the TRD held a public hearing on the proposed rule and has received feedback from the oil and gas industry. Industry concerns will be taken into account, and if the department makes any substantive changes to the rule, new hearings will be held.

A committee member asked if property valuation litigation involving two oil companies had been resolved. Mr. O'Melia said that the issues have been resolved after seven years of litigation. The PTD ended up negotiating property values with the companies.

A committee member said that industrial property valuations are problematic. Taxes that are paid under protest go to a suspense fund and not directly to the county, which can cause significant budget problems in small counties. Mr. O'Melia agreed, and said that the desire to reduce the amount of valuation protests is the main reason the new rule has been drafted. He said that companies under the new rule will need to document obsolescence. Secretary Homans said that the final rule will be as simple and fair as possible to the oil and gas industry.

The minutes from the June 11-12, 2009 meeting of the committee were adopted without changes.

Managing Volatility of Oil and Gas Revenue

Tom Clifford, chief economist, LFC, gave a presentation to the committee on how the state can better manage oil and gas revenue. Direct and indirect revenues from oil and gas production make a major contribution to financing government in New Mexico. Although those revenues play a major role in government budgets, volatility in prices and production levels as well as long-term sustainability of those revenues create challenges for policymakers. Volatility has increased dramatically since 2000, both from speculation and fundamental factors, said Mr. Clifford.

Mr. Clifford used fiscal year 2008 figures to illustrate the sensitivity of state and local government budgets to price changes in oil and gas. When the price of oil changes $1.00 per barrel, total revenues to state and local governments change a corresponding $8.9 million. A $.10 change in the price of natural gas has a resulting impact of $18.8 million. The huge changes in the prices of both commodities in recent years demonstrate how difficult government budgeting has become, said Mr. Clifford. The negative impacts of overestimating revenues from oil and gas far exceed the positive impacts of underestimating those revenues.

Mr. Clifford discussed four strategies that policymakers could use to manage oil and gas revenue volatility, which include hedging, risk-adjusting revenue forecasts, increasing reserves and making sharper distinctions between recurring and nonrecurring revenue.

Hedging against oil and gas revenue volatility could be used, but hedging contracts would probably cost the state significant premiums. The DFA estimated that insuring the balances of one-fourth of the Severance Tax Permanent Fund for one year would cost $20 million. In addition, after a hedging contract ends, revenues would again become subject to volatility. Mr. Clifford remarked that the state would need to determine the balance between risk and return to the state. Currently, the state accepts the high risk of revenue volatility in order to benefit from the possible gain in return from high prices.

The methodology for generating consensus revenue estimates could also be modified, said Mr. Clifford, including using range estimates that would highlight the level of uncertainty in a given forecast and consulting with industry and economic experts to help assess the risk associated with a forecast. Mr. Clifford also suggested that New Mexico investigate the use of outside experts in helping to determine oil and gas revenue forecasts and volume forecasts.

The third approach the state could take would be using reserves as a risk management tool. However, Mr. Clifford said that because errors in forecasts tend to be compounded in the current year and the budget year, reserves need to be set to cover one and one-half years, rather than the current practice of one year. That would require a 15 percent reserve, up from the current 10 percent.

Finally, the state could classify some revenue as nonrecurring, which could avoid the need to cut services and payrolls in the future while making funds available immediately for short-term uses. However, if the recurring level is set too low, large amounts of revenue would be treated as nonrecurring, and if set too high, projected revenue could easily be higher than actual revenue, requiring that reserves be drawn down.

Mr. Clifford then discussed other issues that may affect the production and revenue generation of the oil and gas industry. He said that severance taxes are generally paid by New Mexico investors, workers and property owners, rather than those entities that use the products. The corporate income tax (CIT) also adds significant tax burdens to the industry, compared to other oil- and gas-producing states. In addition, New Mexico's oil and gas output is in a long-term decline, and without additional investment, the decline will accelerate. That trend requires the state to consider its own policies in relation to the long-term impacts on production.

In conclusion, Mr. Clifford recommended that the state increase general fund reserve targets, use more conservative price assumptions and earmark some revenue for budget stabilization. Finally, Mr. Clifford suggested that the state undertake a comprehensive study of all taxes imposed on the oil and gas industry compared to other states, including different designs for how severance taxes are imposed. Finally, the state should commission an engineering study of the long-term production outlook for oil and gas.

A committee member questioned whether Mr. Clifford was correct in asserting that New Mexico highly taxes the oil and gas industry in relation to other states. He also said that most analyses of tax burdens he has heard have come to very different conclusions, depending on the biases of the presenters.

A committee member said that New Mexico's current reserve includes two funds that actually cannot be used without legislative approval, which amounts to not being reserves at all. In fact, the general fund reserves are actually only two percent, rather than the claimed 10 percent. He agreed that actual general fund reserves need to increase significantly.

A committee member said that although reserves are important, setting a reserve level too high also causes problems. Another committee member agreed and said that reserve levels were increased at the behest of the LFC because oil and gas revenue volatility recently became a major issue.

A committee member wondered whether the oil and gas industry would be interested in having CITs abolished in exchange for an increase in royalties paid. Mr. Clifford said that the CIT structure is very complicated and is volatile as well.

Motor Vehicle Code Recompilation

Secretary Homans and Michael Sandoval, director, Motor Vehicle Division (MVD), TRD, discussed with the committee the need for and proposed process to rewrite and recompile the Motor Vehicle Code. Secretary Homans began by describing the results of a needs assessment completed in 2006, which provided a road map to "fix" the MVD in three key areas: technology, operations and customer service. The assessment made recommendations, many of which are being implemented, including development of a user-friendly web site, a new driver and vehicle registration system, an improved automated call center, the simplification of MVD fees and a rewrite of the Motor Vehicle Code to provide consistent policies and clear direction to MVD staff and customers. Secretary Homans said that sometimes different offices of the MVD provide slightly different interpretations of statute, leading to inconsistencies and problems.

The Motor Vehicle Code is quite extensive and provides the MVD with the authority to administer business functions. Over time, the code has become complex and disjointed and currently contains many conflicts, inconsistencies and areas in need of clarification. These inconsistencies cause confusion and frustration for MVD staff and customers of the agency, said Secretary Homans. Citing just one example, he explained how current statutes relating to vehicle title transfers on death do not specify either how long after death can a vehicle be titled to heirs, nor do they state the standard of proof to be provided. The TRD, partnering with the University of New Mexico Institute of Public Law, worked with affected MVD user groups to identify conflicts, inconsistencies and unclear statutes. Over 60 areas in the code were identified that need improvement, said Secretary Homans.

Mr. Sandoval led the committee through the MVD's proposed time line and revision process of the Motor Vehicle Code. The first stage would be to recompile existing sections into more useful arrangements, including creating new articles in law relating to driver's licenses and identification cards; titles, registrations, plates and permits; and fees and distributions. The MVD is proposing to the New Mexico Compilation Commission that it recompile those sections prior to the 2010 legislative session if possible. Stage 2 of the code rewrite involves making technical and nonsubstantive changes to the code. The following year, the legislature would tackle stage 3, addressing the various substantive issues that need resolving, some of which could be controversial. An example of a minor substantive change includes addressing the inconsistent vision test requirements for renewal of driver's licenses, as licenses can be renewed for either four or eight years. A slightly more problematic substantive issue that needs to be resolved is development of testing, age and motor size requirements for motorcycle endorsements. Finally, DWI statutes have some inconsistencies, but any changes to them will involve major efforts due to the high public interest in that area of law.

The TRD has sent a letter to the New Mexico Compilation Commission requesting that it recompile Motor Vehicle Code statutes. If that recompilation is determined to need legislative action, the TRD will submit recompilation legislation to the 2010 legislature. If the commission recompiles the statutes without legislative action, the TRD will submit stage 2 legislation in the upcoming session.

A committee member said that many rural MVD offices need to call the main MVD office to clarify the interpretation of statutes. She related a story about a young constituent who spent more than one month attempting to fulfill the requirements in obtaining a first-time driver's license. She also suggested having the MVD administer the young driver education course, rather than the Department of Transportation (DOT).

A committee member said that it should not take longer than one day for a person to get a driver's license. He also said that he is opposed to the TRD selling driver information. Finally, he said that tow truck operators have a very difficult time obtaining titles for abandoned vehicles. Secretary Homans said that people already have the right to access driver information via the Inspection of Public Records Act, which is a very cumbersome process. A database to provide that information allows many industries quick access to driver information.

Responding to a question about the cost of the new driver's license and vehicle registration system, Secretary Homans said that the TRD is in the middle of a request for proposals (RFP) process, but that the cost will be in the millions of dollars.

Representative Taylor said that he was very concerned that Secretary Homans provided justification for a sole-source contract the TRD entered into for the driver information database by referring to House Bill 12 of the 2009 session, sponsored by Representative Taylor. Representative Taylor said that the bill mostly provided for a five percent reduction in fees for online vehicle registrations and made certain fees available for the operation of the MVD. The bill had nothing to do with the driver information database, said Representative Taylor, and a letter that Secretary Homans wrote to Senator Smith suggesting that it did was untrue.

Secretary Homans said that he was sorry if Representative Taylor read his letter in the wrong way. He also said that he was bothered by the suggestion that he had been dishonest in discussing the driver information database. He said the project has always been very open, that the contract was not a sole-source procurement and that the TRD has had the ability to provide such a database for several years. What House Bill 12 did, however, was to allow the MVD to keep the royalties and certain fees. That provision was the final step that allowed the MVD to proceed with the RFP. He also said that an audit of one of the previous database contractors, Oso Grande, showed that the company had no control over the security of driver information, which violated both its contract and state law. Finally, Secretary Homans said that the cost of access to the database will be lower than the national average for such information.

The committee requested that Secretary Homans review the letter sent to Senator Smith and provide any clarification or corrections.

A committee member suggested that the TRD include motor vehicle hobbyist groups in pertinent discussions about the Motor Vehicle Code rewrite. He also asked whether tickets issued to motorists by a red-light camera system are reported to the state. Mr. Sandoval said that records of those tickets are not reported.

Committee members suggested that the MVD allow for 24-hour MVD customer services at kiosk stations; that driver's license applicants be allowed to take the driving test the same day as the written test; and that more training be provided to MVD employees.

The committee recessed at 5:25 p.m.

<u>Wednesday, July 15</u>

Senator Smith reconvened the committee at 9:12 a.m.

Capital Gains Taxes

Richard Anklam, executive director, New Mexico Tax Research Institute, presented to the committee issues raised by income tax treatment of capital gains. Capital gains are defined as increases in the value of capital assets. Gains on corporate stocks account for the largest component of U.S. capital gains, with pass-through entity gains and mutual fund distributions making up large shares as well. According to the federal Internal Revenue Service, over 90 percent of net capital gains are classified as long-term gains, or those assets that had been held for more than one year. Since it is difficult to tax capital gains as they accrue value, federal tax law has traditionally taxed gains only upon realization. Long-term capital gains are given preferential tax treatment; they are taxed by the federal government at a lower rate than ordinary income, set at a maximum of 15 percent, compared to an ordinary top income tax rate of 35 percent. Mr. Anklam said that the Obama administration has indicated it wants to maintain a preferential rate for capital gains, but taxed at a higher rate of 20 percent.

For states that "piggyback" on federal tax law, like New Mexico, capital gains are fully included in adjusted gross income and thus are subject to full state taxation. In 2003, in an attempt to attract high-income residents to the state, New Mexico enacted a phased-in deduction from capital gains up to 50 percent. The fiscal impact from those increased deductions in 2006 was about $60 million and about $80 million in 2007.

It has been argued that New Mexico's generous preferential treatment of the taxation of capital gains reduces the progressivity of the state's income tax structure. Some economists suggest that the 2003 reduction to the capital gains tax base should be modified to restore progressivity to the income tax system. However, other economists counter that argument by claiming that if New Mexico aggressively redistributes wealth, wealthy taxpayers will leave the state, leaving the remainder of its residents in a "race to the bottom". If a business owner sells a business, the person may choose to relocate to another state to avoid paying high capital gains taxes. However, Mr. Anklam suggested that if that is perceived as a problem, the state could specifically target for exemption the sale of closely held businesses. Another argument for maintaining capital gains deductions is that the allowance of a large deduction reduces to some degree the volatility of the state's income tax collections.

Compared to neighboring states, New Mexico has the most generous treatment of the taxation of capital gains. Some states do not have any preferential treatment, while others provide some but limit that preference to investments made in the state.

In conclusion, said Mr. Anklam, if policymakers are considering changes to the structure of capital gains taxation, they might consider limiting preferential tax treatment to New Mexico investments, which would achieve some of the stated policy goals of the 2003 tax law changes but would not cost the state so much in lost revenue. He cautioned that any reductions to the preferential tax treatment in the short term will not bring in much revenue to the state due to the current state of the economy. After the economy recovers, however, the state would realize more revenue from a less preferential treatment, he said. Another possibility, although seemingly impossible given today's economic realities, would be to expand the capital gains deduction for economic development purposes. This expansion could encourage new business in the state and in the short term would not cost the state very much in lost revenue.

Committee members asked about the reported problem of people who sell businesses and then move to another state to avoid paying New Mexico capital gains taxes. Mr. Anklam said that it is very difficult to gather that sort of data, except anecdotally. The reduction of personal income tax, coupled with deductions from capital gains, most likely have reduced that problem, he said.

A committee member said that tax burdens need to be examined in their entirety and not just individually.

Blue Ribbon Tax Reform Commission Review and Recommendations

Jim O'Neill, former tax policy advisor for the TRD and staff to the 2003 Blue Ribbon Tax Reform Commission, reviewed for the committee the work and recommendations of that commission, much of which is still relevant today. The commission consisted of 23 members appointed by the governor and legislature. The commission met seven times during the 2003 interim, with additional committees meeting to focus on specific tax law areas. The commission considered 196 proposals and adopted 71. About one-third of the commission's recommendations have been adopted in some form since 2003.

Although the commission was created to reform New Mexico's tax system, its ability to make significant reform was hampered by drastic personal income tax (PIT) cuts enacted earlier that year. With much of the state's surplus suddenly taken away, reform proposals that cost money were unable to garner support. Additionally, said Mr. O'Neill, many of the final recommendations from the commission were not favorably received by the governor, who had his own ideas about tax reform. Mr. O'Neill said that the PIT reductions gave assistance to wealthy New Mexicans and did little for low-income people. The governor had proposed removing the GRT on food as a means of giving relief to poor residents, but the commission instead recommended reworking the low income comprehensive tax rebate and increasing the income threshold for the rebate to $48,000.

Other major issues facing the commission included how to raise money for the State Road Fund, which in 2003 already was showing signs of financial unsustainability; inconsistent and possibly unfair tax treatment of certain medical and hospital receipts; lack of accountability of economic development incentives; and how to better structure the CIT to encourage businesses to locate in New Mexico while maintaining the tax as an important revenue source for the state. Many other states have changed the apportionment factors of the CIT to encourage business relocation, but New Mexico has stayed with the traditional equal apportionment of sales, labor and property. Mr. O'Neill said that although New Mexico probably will benefit from changing the apportionment factors, there will be definite winners and losers from such a change.

Two other outstanding tax issues that still need work are property tax reform, which could benefit from a complete overhaul, and addressing the significant pyramiding issues associated with the GRT.

A committee member commented that other states are now looking at New Mexico's system of taxing services, since much of the country's manufacturing base has left. He also said that although raising taxes always affects somebody, New Mexico needs a balanced budget. Another committee member said that some of the commission's recommendations should be reexamined for possible enactment. He also said that transportation funding in 2003 was becoming a problem, and since nothing was done, it is now a big problem.

A committee member asked about the Streamlined Sales and Use Tax Agreement (SSUTA). Mr. O'Neill said that the SSUTA is an attempt by states to get around a U.S. Supreme Court decision that forbids states from taxing out-of-state mail order sales. Member states agree to tax products uniformly, thus avoiding constitutional issues involved in out-of-state taxation. The problem with New Mexico joining the agreement is that New Mexico has a seller-based GRT, and most other states have a buyer-based sales tax. New Mexico still needs to align its GRT base with the SSUTA base, which will involve some potentially controversial tax law changes.

A committee member asked how much the "hold harmless" food tax deduction provisions enacted for cities and counties cost the state. Mr. O'Neill said that those provisions cost about $200 million annually. The committee member said that removing the GRT on food reduced the GRT base too much and has caused significant revenue issues for the state. Mr. O'Neill said that medical services deductions have also added to the narrowing of the

GRT base.

A committee member asked how the State Road Fund issues could be resolved. Mr. O'Neill said that although some earmarked fees have been raised, the primary funding source from the state is the gasoline tax, which has not been raised in many years.

Cable Industry Property Valuation and Tax Update

Pat Dolahanty, vice president and treasurer, Cable One, and Scott Scanland, lobbyist for the Arizona-New Mexico Cable Association, briefed the committee on the cable industry's attempt to keep property valuations of that industry at the county level rather than the state level. Mr. Scanland began by discussing a bill introduced in 2008 by Representative Varela that would require a central assessment for the cable industry. At that time, the industry opposed the bill because it would essentially be another tax. Since then, discussions with the TRD have taken place to come up with a compromise. The main issue now is the interpretation of an antiquated statute dealing with the telecommunications industry, which the department contends applies to the cable industry, and thus, cable industry properties should be assessed by the PTD, rather than county assessors.

Mr. Dolahanty introduced himself to the committee and described Cable One's operations in New Mexico, which consist of 20,000 customers in the state. He said that his company has discussed the state assessment issue with Comcast, and that company has a similar view. If the state assesses the cable industry, valuations will probably be much higher than county valuations. Mr. Scanland said that there should be a level playing field between cable and phone companies.

Mr. O'Melia, responding to a question from a committee member, said that the TRD does not regard the statute in question as antiquated and that cable properties clearly are supposed to be assessed at the state level. He said that one reason why the state valuations will be higher than county valuations is that while the state sets a floor level for fully depreciated assets at 20 percent of original value, counties have a 12.5 percent floor. He said the PTD is willing to work with the industry in resolving that discrepancy.

A committee member suggested that an interim committee that deals with the telecommunications industry should study this issue.

There being no further business, the committee adjourned at 11:45 a.m.