

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

September 11-12, 2008
San Juan College, Zia Room
Farmington, New Mexico

September 10, 2008**
Tour of BHP Underground Mine and PNM Coal-Fired Electric Generating Plant

The fourth meeting of the Revenue Stabilization and Tax Policy Committee (RSTP) was called to order by Representative Edward C. Sandoval, chair, at 10:23 a.m. in the Zia Room of San Juan College in Farmington, New Mexico.

Present

Rep. Edward C. Sandoval, Chair
Sen. Carlos R. Cisneros, Vice Chair
Rep. Anna M. Crook
Rep. Keith J. Gardner
Rep. Roberto "Bobby" J. Gonzales
Rep. William J. Gray
Rep. Ben Lujan, Speaker
Rep. Daniel P. Silva
Sen. H. Diane Snyder
Sen. James G. Taylor
Rep. Thomas C. Taylor

Absent

Sen. Mark Boitano
Sen. Kent L. Cravens
Sen. Dianna J. Duran
Rep. George J. Hanosh
Sen. Timothy Z. Jennings
Sen. Bernadette M. Sanchez

Designees

Rep. Janice E. Arnold-Jones
Sen. Sue Wilson Beffort
Sen. Cisco McSorley (9-11)
Sen. Steven P. Neville
San. Nancy Rodriguez (9-11)
Rep. Henry Kiki Saavedra
Sen. William E. Sharer

Rep. Donald E. Bratton
Rep. Nathan P. Cote
Sen. Phil A. Griego
Sen. John T.L. Grubestic
Sen. Stuart Ingle
Sen. Gay G. Kernan
Rep. Andy Nuñez
Rep. John Pena
Sen. John C. Ryan
Rep. Don L. Tripp

Guests

Rep. Debbie A. Rodella

(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

Cleo Griffith, Drafter, LCS

Tim Crawford, LCS

Guests

The guest list is in the meeting file.

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

****Wednesday, September 10**

Tour of PNM Coal Generating Power Plant and BHP Underground Coal Mine (see notes at end of minutes).

Thursday, September 11

Welcome and Brief Statements

Dr. Carol Spencer, president, San Juan College, spoke first. She welcomed the committee to San Juan College and discussed the vocational programs that San Juan College provides in conjunction with BHP-Billiton, the owner of the coal mines feeding the Arizona Public Service and Public Service of New Mexico (PNM) power plants.

Tony Atkinson, chair, San Juan County Commission, welcomed the committee on behalf of San Juan County and discussed the partnerships the county has entered into with local organizations, local legislators and other communities in San Juan County to promote economic development.

In addition, the county has won several achievement awards in the last four years, and the state health complex office is near completion. The county encourages growth, but is aware of the stress effects of that growth on the local infrastructure.

Bill Standley, mayor of Farmington, welcomed the committee to Farmington and noted that his town was designated as a metropolitan statistical area (MSA) because of the growth of the community. New investment in the community has been notable. Extractive industry has invested \$900 million in Farmington, and there is \$850 million in retail and support services investment. The lifestyle and livability of Farmington is clearly attractive to new residents. He also noted that when the Desert Rock electric generating facility is operational, it will bring an additional 2,500 jobs to the area, which will require housing and other supporting businesses.

Part of the attractiveness of the community is also the five-star golf course that is rated fourth in the country. He reminded the committee members that there will be a luncheon at the civic center at noon in remembrance of the events of 9-11.

Mayor Standley also noted that of the golf course's annual 60,000 tee times, about 50 percent were taken by local residents and 50 percent by visitors from out of town. The community also offers fly fishing. Representative Taylor commented on golfing barefoot.

The ethnic composition of enrollment at the San Juan College campus, according to Dr. Spencer, is 24 percent Native American and 11 percent Hispanic. The remainder are predominantly Anglo. The school is receiving \$1.5 million from the federal government for Native American enrichment programs. The nursing program is growing. She noted that a bridge on the Bloomfield highway is being replaced to accommodate school vehicles. It is an old trestle bridge that crosses Largo Canyon, which is a very wide arroyo. Heavy equipment and other large trucks will be banned from the bridge. The construction project could cost up to \$20 million. Main Street traffic is also getting very heavy, and more funds are expected to help relieve congestion on that road.

Chairman Atkinson discussed the need to change terms of county commissioners to three years rather than two. He then noted that the county had issued \$17.4 million in revenue bonds to develop a new district court complex, including two new court buildings, the district attorney's office and a centralized crime unit building. No tax increase was needed to repay the bonds. The Desert Rock electric generating facility will be built using industrial revenue bonds.

Mayor Standley noted that there will be a review of the bridge and animal shelter in about one week. Both the county and Farmington are in support of opening Desert Rock.

Local Tax Base

Rob Mayes, city manager, Farmington, and Andy Mason, financial officer, Farmington, spoke about the dependence of Farmington on gross receipts taxes. They discussed their desire to maintain current tax policy to preserve the revenue of the city.

Kathy Lamb, assistant financial director, Aztec, noted that the population of Aztec is 7,000. There are 18,000 people in the service area of Aztec. Its gross receipts tax is the highest in the county. Aztec's general fund is 100 percent dependent on gross receipts taxes. The city is currently tapping into reserves to cover expenses. Ms. Lamb said that transportation is one of the greatest expenses of the city. Maintenance, gas tax and infrastructure costs are high, and there is insufficient money to meet those needs. Many of the energy industry offices are located east of Aztec and travel through Aztec to get to their field locations, causing great wear and tear on the infrastructure used. There is an arterial route planned to divert this traffic, but the money was not in GRIP II. The heavy volume of large trucks traveling through the city causes structural damage to buildings from the constant vibration. The arterial road would eliminate this problem.

The capital outlay tax has provided funds to complete a new domestic water reservoir. Additional funding is needed for water and wastewater delivery and treatment.

Keith Johnson, city manager, Bloomfield, and Kevin Rodolph, financial manager, Bloomfield, stated that Bloomfield, unlike Aztec, is in great financial condition because of the energy boom. Oil and gas production is up, and people are employed by those companies. Bloomfield's wastewater plant is entering into its phase 2 of construction. The police department is expanding to add a court and police department complex. The fire department is building a new station. Bloomfield is keeping up with infrastructure replacement. The town is helping developers to develop acreage from the Bureau of Land Management for an industrial park. The gross receipts tax is 7.5625 percent, the second highest in the county. All five increments of local gross receipts taxes allowed have been enacted.

Property tax rates in Bloomfield provide only \$450,000 of a total general fund budget for the town of \$8.575 million. Most of the gross receipts are from one business, which is a wholesaler of oil and gas equipment. An increase of 125 percent in gross receipts revenue has occurred over the last few years. Mr. Johnson is concerned that the new pit rules will have a major negative effect on the gross receipts of Bloomfield's greatest gross receipts tax contributor. Right now, Bloomfield is at maximum capacity for general obligation bonds. Eight to 12 million dollars are needed to keep up with the infrastructure needs of the community.

Keith Johns, county executive officer, San Juan County, and Tasia Young spoke next. They stated that San Juan County has been identified as the number two "up and coming" community in the nation. Right now, 22 bridges and roads are really stressed because of the heavy use by large vehicles. They noted that damage to a road made by one 18 wheeler is equal to that done by 32 cars. Nitrates are being found in the rivers, most likely from septic systems. The county is trying to convert septic systems to sewer systems. So far, three increments of one-eighth percent county gross receipts tax have been imposed. Also, the one-eighth percent environmental gross receipts tax has been imposed. This does not come close to covering the solid waste budget. A subsidy of \$600,000 is needed to cover the revenue deficit for the solid waste facilities in the county. A suggestion was made by a committee member that the county should look into using the county fire protection funds for salaries and benefits and free up other county resources for operations and capital costs. Changes to the local gross receipts taxes are needed, and one change might be to allow the hospital gross receipts tax for operations and maintenance. Also, the county would like to see the emergency services gross receipts tax amended to allow the revenue to be used for capital in addition to operations.

Tasia Young, legislative liaison, New Mexico Association of Counties, explained that property taxes comprise more than 55 percent of San Juan County revenue. Gross receipts taxes provide 43 percent of the county's revenue. There are two taxes that no county has imposed: the quality-of-life gross receipts tax and the spaceport tax. The county correctional gross receipts tax will be introduced to increase from an authorized

one-eighth percent increment to a one-half percent total tax. But in smaller counties, even if the authorized gross receipts increments are adopted, these would not provide adequate revenue to operate the county. An ongoing problem that counties face is the requirement that they house, at their own expense, offenders awaiting trial on state charges. This is a \$30 million problem. Also, it is necessary that the requirement that all increments of local gross receipts tax that are authorized be imposed before a county can impose the county capital outlay gross receipts tax be changed to allow imposition of the capital outlay gross receipts tax. Other issues mentioned were the use and distribution of payment in lieu of taxes funding from the federal government and sole community provider provisions regarding hospitals.

Bill Fulginiti, executive director, New Mexico Municipal League, provided the last comments of this panel. He noted that the "Big Mac" tax reduction made in the early 1980s helped cities by authorizing imposition of the occupancy tax (lodger's tax) and providing for a distribution of state gross receipts tax back to the local governments. The state gross receipts tax distribution was decreased in some lean budget years to 1.225 percent, but will be increased back to the 1.35 percent originally intended. There used to be a local option gasoline tax, but that was included in the state tax and is now distributed back to municipalities. In addition, cigarette taxes used to be local taxes, but are now imposed only at the state level, and a percent is distributed back to the municipality. He seconded the comments that Ms. Young made about the requirement to impose the general purpose gross receipts increments before a municipality can impose a capital outlay gross receipts tax. He requested that the legislature consider changing that provision. The quality-of-life increment should be converted to something more useful. The largest three cities in the state collect 95 percent of the state's gross receipts tax revenue.

It is fairly clear that San Juan County has not yet seen drastic changes in its economy due to its reliance on oil and gas production.

Coal in San Juan County — BHP Billiton

Glenn Kellow, president and chief operating officer, BHP-Billiton New Mexico (BHP), gave some background on the operations of the company in San Juan County. There are three mines operated by the company in San Juan County: the Navajo Mine, a mine-mouth operation with Arizona Public Service Company's Four Corners Power Plant; La Plata Mine, which is scheduled to close soon; and the San Juan Mine, which feeds PNM's San Juan Generating Station. Programs are in place to develop the skills of Native American and other San Juan County residents so that they are able to be placed in jobs at the mines. The courses are offered through San Juan College. The skills development courses offer training in mechanical, electrical and welding trades. Mine safety is taught.

The underground mine visited by the committee members and staff on Wednesday, September 10, has introduced technology that has never been used

previously in the United States. When La Plata Mine closes, the facilities will be donated to San Juan College to be renovated into an industrial park.

Over 50 percent of United States energy production is from coal. Much coal is exported to India and other countries. The United States military is working on technology to convert coal into gasoline, diesel or jet fuel. It takes two years to obtain a permit to mine coal. BHP will seek to remove the surtax from coal and is undertaking a comparative review of relative tax burdens placed on extraction and sales of coal by states where coal is mined. There is a need to update the study made 10 years ago.

Tax Issue Review

Secretary of Taxation and Revenue Rick Homans described the outreach program that is being used to reach residents of New Mexico that were not required to file tax returns. A broad media campaign is planned, filing assistance will be provided and special efforts will be made to find those residents who are difficult to identify. The handout can be reviewed for more detail of this discussion.

The legislative proposals prepared for the Taxation and Revenue Department (TRD) were discussed. One provides cleanup of some issues that need to be addressed in the Tax Increment for Development Act. The second bill discussed was the personal income tax simplification proposal. These both have been presented to the committee previously this year. The next bill reorganizes the provisions that allow the TRD to disclose taxpayer information to another agency and that allow disclosure of information regarding taxes paid by businesses and residents of tax increment development districts. Penalties for unauthorized disclosures are tied to Section 7-1-76 NMSA 1978. Another proposal deals with electronic filing of corporate tax returns, among other administrative changes, regarding rates of penalties and interest. This proposal provides for a waiver of penalties and interest in the event of a public emergency declared due to terrorist activity. The time in which to file tax protests would be increased from 30 to 90 days, and other changes supporting that change in the time allowed to file a protest are included in another proposal under consideration by the TRD. Another proposal would modify corporate income tax withholding provisions to require withholding to be submitted on four dates throughout the year rather than three. Filing requirements of film entities and other pass-through entities are also clarified in the proposal that includes the withholding changes. Finally, the cigarette and tobacco taxes would be modified to enable enforcement of contraband cigarette laws.

Master Settlement Agreement

Dave Thomson, assistant attorney general, discussed the impediments to enforcement of some of the provisions of the Master Settlement Agreement (MSA) entered into by New Mexico and other states with tobacco manufacturers selling tobacco products in the country. There is a concern among participating manufacturers that have signed on to the MSA that contraband cigarettes are an increasing problem and that all cigarettes in New Mexico should carry a stamp on the pack to be sold. He also discussed the increase in internet sales of cigarettes. Little cigars have caused an evasion of

appropriate taxes due to a dispute over the definition of what a little cigar is versus the definition of a cigarette. The committee was not requested to take any action on the information presented by Mr. Thomson. The handout given by Mr. Thomson did note that increased resources will be needed to prosecute, investigate and audit suspects.

Sithe Global — Desert Rock Power Plant Update

Nathan Plagens, vice president, Desert Rock Power Plant, described how the plant, which is being developed by Sithe Global, will be a pulverized coal-powered electric generating plant (see Mr. Plagens' handout). Sithe Global is a privately held, independent power company with interests in solar, hydropower and palm oil plantations, which is a fuel that may replace crude oil in power or heat generation.

The Desert Rock Power Plant will consist of two 750 milliwatt ultrasuper critical coal-fired units that will be constructed at a cost of \$2.8 billion. Sithe Global will not construct the twin coal-fired plant, but will act as "owner-engineers" on the project. The final environmental impact statement is expected to be complete by November 2008. Plans now are to break ground for the coal-fired generating plant by September 2009. The expected output of sulfur dioxide emissions are 0.06 pounds per million British thermal units. It will be an integrated gasification combined cycle plant, which is the best technology in common use today. There will be no burden on the San Juan River, according to Mr. Plagens, and the company will provide training for workers. There will be 1,000 workers for the four years of construction; then, the power plant will employ 200 people annually. In addition, there will be 200 additional mining jobs at the BHP Navajo Mine when it expands its open pit to accommodate the needs of the Desert Rock Power Plant. San Juan County will receive payment in lieu of taxes from Desert Rock's construction, paid for by industrial revenue bonds issued by the county and purchased by Sithe Global. There is no plant of this type of technology in operation in the United States yet. It is a German design, and it is in use in Europe. An air permit was issued on July 31, 2008. Sithe Global is anticipating that all appeals of permit applications will be complete by July 1, 2009. The plant's investment for environmental controls is estimated to require a \$400 million to \$500 million expenditure. The emissions tower will be 900 feet in height.

Recess

The committee recessed at 4:49 p.m.

Friday, September 12

The committee was reconvened by Representative Sandoval at 9:10 a.m. Representative Strickler greeted the committee. Jason Sandel brought greetings from his father and the community as a Farmington city councilman.

Oil and Natural Gas Pricing and Price Fluctuations

Tom Clifford, research director, New Mexico Tax Research Institute, presented background on pricing and price fluctuations of oil and gas. Mr. Clifford noted that there

is inelastic demand for oil and gas. This means that it is hard to adjust the volume used, and demand follows use. However, supplies of oil and gas can be interrupted by things like political instability and natural disasters. He recapped that demand is fixed, whereas supply is volatile. To change the behavior of consumers, a drastic change in price must occur; that is, the price must rise considerably to decrease use. This is why stockpiles are needed to help maintain supply at a constant, reliable level (see Mr. Clifford's handout). In the long term, the outlook for demand for oil and gas is predicted to increase. The growth rate of four percent is a robust growth for the oil industry. Because surplus capacity is limited, the price must control the demand. Only "market destruction", or a price that is so high that it will destroy demand, will decrease demand. Speculators who buy and sell futures of oil can insert a great deal of risk into the market.

Mr. Clifford tried to distinguish between speculators and hedgers, but noted that the difference is not clear. This is because the terms include the motive of the investor, and this is not an objective status that can be objectively evaluated such as terms like "commercial" or "noncommercial" trader. Mr. Clifford said that the market has recently seen large numbers of traders, the number of whom doubled from 2004 to 2008, who have caused a price bubble to occur. Eventually, the market will correct itself, and the "bubble" will "burst", and the prices will fall.

Speculators follow a market increase; they do not predict or precede an increase. Speculators have grown in number most quickly in the last four years. If the price is too high, inventories will deplete and will no longer be built. No one wants to hold high-priced oil in inventory for use during times when prices are more modest. Inventories will not be rebuilt until the demand decreases. Mr. Clifford does not believe that speculation contributed to price increases that have occurred over the last few years. He believes that prices will settle at between \$25.00 and \$100 per barrel.

Ongard System has shown that when there is a downward trend in production, there is an upward trend in prices. Production has stabilized at about 60 million barrels per year.

Natural gas is declining in production in the state at one to two percent per year. This is as expected. When the federal tax credit for producing natural gas from coal seam formations stopped, there was not an equal decrease in natural gas production. In the last few years, there have been three spikes in natural gas production. One was during the California energy crisis. Gas prices are more volatile than oil. Gas pricing at the Henry Hub is usually higher than San Juan pricing. However, since January 2008, the price is less reliably below San Juan crude prices. Since July, New Mexico spot prices have decreased with the Henry Hub prices. He noted that the Ongard price currently is outperforming the spot price of natural gas. Revenue from natural gas can easily fall more than three percent in one year. He reminded the committee that each \$.10 change in the price of natural gas equates to a \$1.00 change in the revenue of the general fund. Oil and gas revenue constitutes 20 percent of the general fund revenue. State revenue tends to move together with fluctuations in oil and gas revenue. It is of

concern to the economists who forecast state revenues that oil and gas prices can fluctuate so radically in such a short time. It is very hard to forecast prices and rely on those numbers for revenue projections. Higher oil and gas prices tend to generate high nonrecurring revenue and, after a few cycles of having high nonrecurring revenue, people mistake it for recurring revenue.

Hedging is not recommended for state use. The state could lose revenue if prices rise and the state buys futures at that higher price and then the price falls. Hedging normally is used to manage revenue forecasts, manage reserves and manage recurring and nonrecurring revenue. Adjustments to forecasts were conservative and appeared too small or low in the rising price market. It might be more helpful for forecasting if a range of oil and gas revenue projections could be used. The revenue forecast now is above the NYMEX level of \$8.45 per 1,000 cubic feet (mcf) and is projected at \$9.60 per mcf. Oil on the NYMEX is predicted at \$111.21 per barrel, but the consensus estimate is \$122 per barrel.

Reserves must be maintained at a fairly high level to manage the risk found in such a volatile market environment. Ten percent of the appropriated operational budget is the minimum level of reserves that must be maintained. If other methods of managing the state's revenue response to volatility are not used, then reserves must be maintained at an even higher level. The level of recurring expenditures that are optimally to be maintained into the future should be identified and adhered to when setting the operating budget of the state. The state needs to adopt a plan explicitly setting aside five percent or some higher level of budget reserves and identifying reserves that will cover a three percent or greater error in the forecast so that falling revenue can still support the budget approved.

Field Trip to Gas Well

The committee was taken to a gas well situated on San Juan College's property.

Building Code Adopted by Reference

Lisa Martinez, director, Construction Industries Division (CID), Regulation and Licensing Department (RLD), requested the committee to consider the need to alter the authorization set forth in House Bill 219 adopted in 2007. Section 3-17-6 NMSA 1978 authorizes municipalities to adopt by reference to its title an administrative code; air pollution code; building code that includes provisions for plan review, permitting and inspections for general, electrical, mechanical and plumbing construction; and various other codes. Ms. Martinez and Michael Arellano and Chris Williams (both of whom are building inspectors) noted that though there are inefficiencies in the current inspection system, these problems cannot be corrected by adopting codes that do not address the needs of the inspectors. New Mexico has limited inspection resources and should be looking at a statewide system that allows inspectors to be sent to any county or municipality in the state to conduct inspections. They asked the committee to consider repealing the authorization for municipalities to adopt building codes by reference to

their titles and to assure that inspectors are permitted to cross jurisdictional lines to make inspections and to ensure that they are completed in a timely and uniform manner.

Adjournment

The committee adjourned at 12:13 p.m.

September 10, 2008 Field Trips

San Juan Generating Station Tour

The committee members were picked up at 8:30 a.m. by BHP and PNM. The first stop was the PNM San Juan Generating Station.

PNM gathered the group together at 9:15 a.m. to discuss the power plant. The presentation was made by John Myers, PNM vice president for power generation, Jim Ferland, senior vice president for utility operations, and Russel Hoffman, San Juan Generating Station plant manager. Environmental improvements that have been made to the plant over the last several years were described. The state regulations have required that the plant retrofit equipment for removal of sulfur dioxide, nitrogen oxides, mercury and particulates. Carbon dioxide is not being removed because there is no current technology that can be used to retrofit the plant to remove this compound. The upgrades will cost approximately \$35 million. Mercury is being removed by use of activated carbon injection. This process is expected to remove up to 95 percent of the mercury.

There are four generating units, and upgrades to units 3 and 4 are now complete. Each unit generates 1,800 megawatts of electricity. It costs \$1 million per day to run each unit to produce 1,800 megawatts of power. Coal is one-third the cost of natural gas, which is one method of replacing coal if for some reason the coal burners are malfunctioning or if coal is unavailable. Each unit is down at least three weeks per year for maintenance. Sixty-five percent of the power is sold in New Mexico, with the remaining 35 percent sold in Arizona, Utah or other states. Today, it would cost \$4.5 billion to build a similar facility. The price of the needed inputs has doubled or tripled over the last 10 years. There was a discussion of the costs of purchasing power to replace generation capacity when part of the plant shuts down, either because of scheduling or unexpected events.

San Juan Generating Station has a payroll of \$25 million annually and pays \$9 million in payroll taxes and benefits. In addition, PNM pays \$6.3 million in property tax on the plant. Thirty-one million dollars is paid by PNM in royalties, and \$3.7 million is paid to the Navajo Nation in royalties and taxes. Thirty-five to 45 percent of the work force of the San Juan Generating Station are members of the Navajo Nation. The environmental upgrades added \$33 million to the San Juan County economy in wages and had a total impact on state and local taxes of \$32.8 million. A large multiplier effect was experienced by the City of Farmington, the county and the state from the wages paid for installing the improvements.

Seven tons of coal are required to produce 1,800 megawatts per year. This produces 1.4 tons of ash from the coal used for the plant. Some of the ash can be sold for road base stabilization; however, the amount sold is about 200,000 tons per year. About 60 percent of PNM's needed power for New Mexico is produced by the San Juan Generating Station. This is about 765 megawatts per year. Right now, about 23,000 acre-feet of water is purchased from the Jicarilla Apache Nation for plant use annually. The plant is planning to reduce this water consumption by about 15 percent over the next five years. Water now is used for cooling and producing steam for turbine operations. The plant is considering using about 5,000 acre-feet of gray water from Farmington annually to replace fresh water.

The committee members were then taken on a tour of the plant to see the generators, turbines and other equipment in the plant. It was warm, wet and noisy. Hard hats were issued. After the tour, the committee moved on to the mine.

BHP Long Wall Mine Tour

The committee gathered at about 1:00 p.m. for a safety briefing and to be fitted for overalls and other clothing and shoes for the trip into the BHP underground San Juan Coal Company. Chad Pfeiffer, Nick Chavez and Loni Mascarenas provided the committee with all that was needed to tour the mine. The group was divided into smaller groups, and each was assigned to a driver. The drivers took members several miles into the mine, at which point the groups got out of the trucks and walked to the area where mining was active. The mining is predominantly done by a machine that cuts about one to three feet into the wall of the mine for a mile. Then the miners load the cut material onto a conveyor belt, and it is transferred out of the mine. The mine is dark and wet and, when the coal is being cut, noisy. The equipment was not cutting the wall of the mine when the group was touring. Everyone got wet, very black and tired. This underground mine seemed safe and fairly well ventilated. There were not very many people working in the mine. It was difficult and uncomfortable work around large, dangerous machinery. The safety record of the mine is very good, although one worker died in the mine recently. Structurally, the mine seems safe from cave-ins and, hopefully, the ventilation is more than what is needed to keep methane or other explosive gases from settling in the deeper or dead-end areas of the mine. It appears that underground mines are not clean, dry and light.