NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

TAXATION COMMITTEE

Friday, July 30, 1999
Roughrider Room, State Capitol
Bismarck, North Dakota

Senator Randel Christmann, Chairman, called the meeting to order at 9:00 a.m.

Members present: Senators Randel Christmann, Meyer Kinnoin, Kenneth Kroeplin, Randy A. Schobinger, Bob Stenehjem, Vern Thompson, Steve Tomac, Herb Urlacher; Representatives Wesley R. Belter, Mick Grosz, Pam Gulleson, C. B. Haas, Gil Herbel, Stacey L. Mickelson, Ronald Nichols, Dennis J. Renner, Earl Rennerfeldt, Arlo E. Schmidt, Ben Tollefson, John M. Warner, Ray H. Wikenheiser

Others present: See Appendix A

Chairman Christmann called on committee counsel for review of the Legislative Council supplementary rules of operation and procedure.

Chairman Christmann welcomed committee members and described the four studies assigned to the committee for this interim. He said committee members have a strong background in taxation issues, and he expects a productive interim study process.

LIGNITE INDUSTRY TAX STUDY

Chairman Christmann called on committee counsel for presentation of a memorandum entitled *Taxation and Regulatory Environment for North Dakota's Lignite Industry*. Committee counsel said this study is a continuation of a study conducted by the Taxation Committee during the 1997-98 interim. He reviewed the coal severance tax and coal conversion tax history, rates, allocation, and estimated revenues for the 1999-2001 biennium. He said during the 1997-98 interim study, the Lignite Energy Council and the Legislative Council jointly funded a consultant study of competitive aspects of the lignite industry which was conducted by Dr. David Ramsett, Director, Division of Economics and Public Affairs, University of North Dakota. Committee counsel said each committee member was provided a copy of Dr. Ramsett's report for background information. He said the report states that states in this region are exporters of electric power and are in competition with each other for markets. He said the report points out that competitive factors must be examined closely because very small price margins make the difference between success and failure in the marketplace. He said the report points out that North Dakota tax and regulatory policy for the coal industry is not what has created the current economic problems faced by the lignite industry but that price reductions in subbituminous coal and coal transportation costs have been so significant that they have placed enormous competitive pressure on the lignite industry. He said the report points out that Wyoming coal can be used in North Dakota generating plants at a lower cost per megawatt hour of power than lignite coal.

Chairman Christmann called on Mr. John Dwyer, President, North Dakota Lignite Energy Council, for comments on the lignite industry tax study. Mr. Dwyer said the lignite industry is a major contributor to North Dakota's economy. He said the industry serves more than two million people with electricity and approximately 225,000 homes with synthetic natural gas. He said the lignite industry creates more than 18,000 direct and indirect jobs in the state, generates personal income of more than $430 million, generates over $1.3 billion of business volume, and generates over $60 million of state tax revenue.

Mr. Dwyer said the North Dakota lignite industry operates in a very competitive environment with competition from Canadian hydropower, subbituminous coal from Montana and Wyoming, and other fuel sources used to generate electricity in the midwest area power pool (MAPP). He said power sold in the MAPP region operates on a margin of one-half of one mill. He said because of this very small operating margin, taxation and regulatory costs for lignite are very important. He said taxation and regulatory costs comprise 20 to 30 percent of the cost of lignite.

Mr. Dwyer reviewed the results of test burns of Powder River Basin coal from Wyoming at the Stanton and Leland Olds Stations in North Dakota. He said the results of these tests showed that Powder River Basin coal is actually cheaper to burn in North Dakota generating plants than North Dakota lignite, on the basis of energy produced. He said test results show that the cost of Powder River Basin coal per million BTU is 72 cents as compared to 78 cents for North Dakota lignite. He said it is clear that North Dakota lignite is in a competitive war with Wyoming coal, and state tax and regulatory costs impact the competitive position of the lignite industry. He said this is the reason the committee study is so important to the lignite industry. He said the state of North Dakota has traditionally been very supportive of the lignite industry, but the federal government has been a problem to the industry. He said coal in general, and lignite coal in particular, have been targets of federal efforts to limit use and emissions. He said the Kyoto Protocol was negotiated by industrial countries in 1997 as a result of concerns about global warming. He said the treaty calls for substantial reductions in carbon dioxide gas emissions and, if implemented, these changes would cause substantial impact to North Dakota consumers. He said if the treaty is implemented, North Dakota lignite production would decline from 30 million tons to 25 million tons per year. He said it has been estimated that the cost of this treaty to the United States economy would be approximately $300 billion per year, and there would be a cost to each United States family of $2,700 per year by the year 2010.

Mr. Dwyer said it appears very unlikely that Congress will adopt the Kyoto Protocol. He said it appears the current administration has adopted a strategy of implementation without ratification of the treaty, by use of federal rulemaking. He said it appears the strategy calls for using the Environmental Protection Agency to gradually make the Kyoto Protocol the law of the land.

Mr. Dwyer said another lignite industry concern is with regional haze rules of the Environmental Protection Agency adopted in 1999. He said these rules require a 10 percent improvement in visibility every 10 years. He said the rules do not give consideration to existing visibility. He said these rules apply to all older lignite facilities that would include the Stanton, Leland Olds, and Milton R. Young Stations in North Dakota. He said options for compliance are limited to switching to other fuel types, installing emissions control devices that may cost more than the plant, or shutting down older plants.

Mr. Dwyer said Environmental Protection Agency rules on mercury and nitric oxide emissions are likely to adversely impact the lignite industry.

Mr. Dwyer said there are many challenges for the future for the lignite industry. He said it is necessary to focus on the strengths of lignite. He said lignite is an abundant resource, has among the lowest cost plants in the country, is closer to electrical markets than Montana and Wyoming coal, and enjoys a healthy business climate in North Dakota. He said the industry has established the Lignite Vision 21 Project in an effort to revitalize growth in lignite and increase lignite use and production. He said the vision of the project is one new baseload power plant using state-of-the-art mining technology, innovative generation technology, and the latest environmental technologies to improve efficiency and reduce emissions all in an effort to allow the lignite industry an opportunity to meet energy growth demands in the region. He said the strategy is to focus on the strength of lignite which is baseload generation. He said one new power plant could mean three million more tons of coal mined in the state annually, 1,300 more jobs, $140 million more business volume, and $6 million more tax revenue. He described the strategy and initial areas of focus of the project.

Senator Christmann asked how much coal is being imported by North Dakota generation facilities for burning or blending. Mr. Dwyer said approximately one-half million tons of Wyoming coal is stockpiled at the Leland Olds Station, but there is no ongoing contract to import coal.

Senator Thompson asked what areas of tax and regulatory policy at the state level should be considered. Mr. Dwyer said on the regulatory side the industry has had fairly good support from regulatory agencies. He said the industry hopes to reduce regulatory costs, but there are no specific suggestions at this time. He said it will be necessary to examine the level of coal taxes, but there is no proposal at this point on changing tax policies.

Representative Nichols asked how the 1999 legislation on taxing imported coal differs from the 1997 legislation that was declared unconstitutional. Mr. Dwyer said the tax imposition in the 1997 legislation was on a BTU basis, which was discriminatory to imported coal. He said the 1999 legislation imposes a flat rate of tax per ton and is not discriminatory.

Senator Tomac asked for a description of economics on the demand side and asked whether consumers are oversupplied with electric energy choices. Mr. Dwyer said utilities are looking at baseload generation versus peaking plants. He said baseload generation produces a steady supply of electric energy while peaking plants are used to increase generation in times of high demand. He said the strength of the lignite industry is baseload generation, but natural gas peaking plants have become popular in the current market for a variety of reasons. He said consumers are not oversupplied with electric energy, but there is a range of production source choices with which lignite must compete.

In response to a question from Representative Gulleson, Mr. Dwyer said the lignite industry is able to export its product by transmission line while Wyoming and Montana export coal by rail. He said this has been a traditional advantage of the lignite industry, but that advantage has diminished with recent decreases in rail transportation costs. In response to another question from Representative Gulleson, Mr. Dwyer said the Montana coal tax structure differs from North Dakota's. He said the Montana tax per ton of coal is higher, but on a BTU basis it is less than North Dakota's tax because Montana coal is a higher grade coal. He said the North Dakota Tax Department publication has a good comparison on these tax rates.

Representative Rennerfeldt said wind energy studies have been conducted and asked whether wind energy is competition for the lignite industry. Mr. Dwyer said Minnesota wind energy farms were mandated in consideration of an extension of time to store nuclear waste. He said wind energy represents competition, but during the recent heat wave wind energy produced zero electricity and coal is a much more dependable source. He said wind energy has a role in the future of the energy industry but will not drive coal out of business.

Senator Christmann asked whether there are any administrative rules at the state level that stand out as concerns of the industry. Mr. Dwyer said the industry has enjoyed good cooperation with state agencies and has recently gone through the reclamation rules with the Public Service Commission and believes they are current. He said a bigger concern of the industry is federal rules, particularly the Environmental Protection Agency rules and those mandates on the State Department of Health. Chairman Christmann said he would welcome information on these topics from the Lignite Energy Council.

Senator Christmann said he shares the concern about the Environmental Protection Agency regional haze rules. He said he believes the source of some of the haze in North Dakota is from Canadian generation plants. He asked whether this is a problem. Mr. Dwyer said in Canada there are practically no regulations on emissions, and he found it ironic that the greatest number of lobbyists on the United States Clean Air Act were from Canada.

Representative Gulleson said it would be worthwhile for the committee to receive a briefing from the Attorney General on the constitutionality of the current provisions for taxing imported coal.

Senator Thompson said a request should be made to state agencies to review rules on the lignite industry to determine which rules are stricter than applicable federal requirements.

Senator Thompson said fiscal estimates should be obtained on the impact of removing increments of the coal severance tax of 25 percent, 50 percent, 75 percent, and 100 percent.

FUELS TAX STUDY

Chairman Christmann called on committee counsel for presentation of a background memorandum entitled *Fuels Taxes - Background Memorandum*. Committee counsel reviewed motor vehicle, special fuels, and aviation fuel tax rates, history, and allocation. He said 1999 legislation eliminated the sunset provision that would have reverted fuels tax rates from 20 cents per gallon to 17 cents per gallon and increased those rates by an additional one cent per gallon, to a rate of 21 cents per gallon. He said the 21-cent rate does not have an expiration date. He said 1999 Senate Bill No. 2177 was a lengthy bill revising administrative provisions of fuels tax laws. He said the bill was the product of a three-year study by the office of the State Tax Commissioner and a Petroleum Marketers Association study group. He said 1999 House Bill No. 1462 was commonly referred to during the legislative session as the "rack tax" bill, although the bill as passed did not change the point of taxation to the rack. He said the bill as passed reduced the shrinkage allowance for fuels suppliers, distributors, and retailers from a maximum of one percent to a maximum of .5 percent. He said the bill created a "buy right" provision, which eliminates refunds of special fuels taxes for nonhighway purposes and requires users of those fuels to buy and use dyed special fuels which are subject to the reduced rate of two percent of purchase price. He said the most controversial provision of House Bill No. 1462 would have moved the point of taxation for fuels to the "rack", meaning a fuels storage and distribution terminal supplied by a refinery or pipeline. He said 16 states have moved the point of collection for diesel fuel to the rack since federal fuel tax imposition for diesel fuel was moved to the rack effective January 1, 1994. He said many groups were aligned in support of or opposition to the change in the point of taxation to the rack.

Chairman Christmann called on Ms. Joan Galster, Director, Fuels Tax Division, Tax Department, for comments on the implementation of 1999 legislative changes. Ms. Galster said with regard to the tax rate increase to 21 cents per gallon that was effective July 1, 1999, there has not been much feedback, so it appears it has been a smooth transition. She said with regard to the shrinkage allowance reduction for fuel dealers and suppliers, there have been calls on administrative questions but not much complaint. She said the shrinkage allowance change has just taken effect so suppliers and dealers have not prepared returns under the reduced allowance and it is too early to gauge reactions.

Ms. Galster said the department has been active in implementing the "buy right" provisions for dyed fuel use enforcement. She said the department has met with the regional Internal Revenue Service (IRS) supervisor for fuel tax enforcement and the department will be entering a joint agreement with the IRS. She said the enforcement will be handled by the Highway Patrol sampling of fuel tanks, and samples will be turned over to the IRS. She said reports of results will be made to the Tax Department for enforcement. She said IRS testing will be done at no cost to the state, which has the advantage of providing this testing service instead of requiring the state to establish a testing mechanism that would be an expense to the state. She said the joint agreement is on hold until the IRS has authority to enter the agreement. She said the department is also working with the Highway Patrol and the Department of Transportation and with other states on issues involved with administering the dyed fuel enforcement provisions of the new law.

Senator Christmann asked why testing of dyed fuel is necessary and said he believed the presence of dyed fuel could be detected by a simple visual inspection. Ms. Galster said if the fuel looks red, it probably contains dye, but laboratory results are needed for evidence in court before a fee may be assessed.

Senator Stenehjem questioned why the state should use the IRS for testing of fuel samples. Ms. Galster said a majority of states having dyed fuel enforcement provisions use IRS testing. She said another reason for using IRS laboratory facilities is that our State Laboratory is not equipped for testing these fuels. She said transportation and testing of samples would cost about $30 per sample, which is avoided by using IRS testing. Senator Stenehjem asked Ms. Galster to find out from the State Laboratory what it would cost for them to do this testing.

Ms. Galster said the Tax Department sent newsletters on the dyed fuel enforcement changes to all consumers who claimed refunds of special fuels taxes last year. She said very few calls have been received on this issue as a result of the mailing, as compared to the volume of calls the Tax Department had expected to receive.

Chairman Christmann asked Ms. Galster for information on alternatives for enforcement of the fuels tax laws. Ms. Galster said she will contact surrounding states in this research.

Chairman Christmann called on Mr. Ron Ness, President, Petroleum Marketers Association, for comments on 1999 fuels tax law changes. Mr. Ness said the fuels tax is much more difficult to collect and administer than the sales tax. He said there are several different types of fuel which are sold in varying quantities by each marketer and which are subject to different rates of taxes and provisions for refunds. He said Senate Bill No. 2177 made significant changes to reporting and administration under the fuels tax laws.

Mr. Ness said the rack tax issue that was considered in 1999 is important to the Petroleum Marketers Association, which opposes taxing fuel at the rack. He said 16 states have moved the point of taxation to the rack. He said rack tax bills in Maine and Texas failed. He said Maine and Texas came to the same conclusion that North Dakota did, which is that taxing diesel fuel at the rack is unfair to midlevel distributors. He said there are concerns about consolidation of oil suppliers.

In response to a question from Senator Christmann, Mr. Ness said the Petroleum Marketers Association is not comfortable with the 1999 reduction in the shrinkage allowance for suppliers, distributors, and retailers.

AGRICULTURAL BUSINESS INVESTMENT STUDY

Chairman Christmann called on committee counsel for presentation of a memorandum entitled *Encouraging Investment in Agricultural Business - Background Memorandum*. Committee counsel reviewed tax exemptions for new and expanded business under North Dakota Century Code Chapter 40-57.1, seed capital investment credits under Chapter 57-38.5, and the low-risk incentive fund under Chapter 26.1-50. He said the Bank of North Dakota and the Department of Economic Development and Finance have programs to foster development of agricultural businesses and representatives of the Bank and department would review those programs. He said it will be necessary to identify methods to encourage investments after examining existing programs. Existing programs then may be reviewed to determine whether they address identified needs and whether to augment or improve existing programs or create new programs.

Chairman Christmann called on Mr. Russ Hanson, Executive Director, Agricultural Products Utilization Commission, to review programs of the commission to encourage agricultural business. Mr. Hanson distributed copies of the *Agricultural Products Utilization Commission Biennial Review 1997-1999*. He said the mission of the Agricultural Products Utilization Commission is to create new wealth and jobs through development of new and expanded uses for North Dakota agricultural products. He said the commission administers five grant programs, including basic and applied research, marketing and utilization, cooperative marketing, farm diversification, and agricultural prototypes. Mr. Hanson reviewed the grant programs and projects.

Mr. Hanson said other states have looked to North Dakota as a leader in the area of fostering agricultural diversification and development of new and expanded uses for agricultural products. He said South Dakota and Oklahoma recently enacted legislation modeled after the program in North Dakota. He said Kentucky is preparing legislation for consideration in the year 2000.

Senator Christmann said it will be necessary to identify statutory stumbling blocks that must be eliminated or overcome to encourage private investment in agricultural businesses. Mr. Hanson said he is not sure at this time what those obstacles might be. He said with the current economy in the agricultural industry, many operators cannot afford to invest in agricultural processing businesses.

Senator Urlacher asked how appropriations are provided for programs in other states patterned after the Agricultural Products Utilization Commission programs. Mr. Hanson said South Dakota made money available through an economic development fund, and Kentucky will consider a proposal to spend tobacco settlement moneys for these programs.

Chairman Christmann called on Mr. Eric Hardmeyer, Senior Vice President for Lending, Bank of North Dakota, for comments on the study of encouraging investments in agriculture. Mr. Hardmeyer said the Bank has developed a two-part strategy to assist agriculture. He said one aspect of the strategy is to provide immediate assistance to deal with the agricultural crisis and the second part of the strategy is to review and revise programs with an eye on the future of agriculture.

Mr. Hardmeyer said the farm initiative is geared toward dealing with the agricultural crisis and consists of a financial assistance loan program, farm operating and family farm programs, and encouragement of young farmers to enter farming through a beginning farmer program and a first-time farmer program.

Mr. Hardmeyer said the second phase of the strategy is to move agriculture into the future, which the Bank believes requires increasing value-added agricultural processing and diversifying and increasing the value of agricultural production. He said the Bank encourages investment in agricultural businesses through the Ag PACE program, which provides an interest subsidy for farmers diversifying their operations. He said this program can also be used by farmers and ranchers to buy equity shares in a value-added processing facility or first-time purchase of irrigation equipment. He said the Bank has developed an Envest program to make available to all North Dakota residents the ability to purchase stock in a value-added agricultural processing facility by financing the stock purchase at a below market interest rate.

Chairman Christmann called on Mr. James Moench, Coordinator, Commission on the Future of Agriculture (COFA). A copy of Mr. Moench's prepared testimony is attached as Appendix B.

In response to a question from Representative Belter, Mr. Moench said COFA recently considered a proposal to raise the state income tax on the short-form from 14 percent to 17 percent and devote the revenue increase to property tax relief.

In response to a question from Senator Tomac, Mr. Moench said COFA recently considered a change in the law on cooperatives to allow nonparticipating farmers to invest, which would have the effect of increasing available capital.

Senator Urlacher said the Agriculture Committee is also studying the issue of farm cooperatives and recommendations of this committee and the Agriculture Committee should be consistent.

Chairman Christmann called on Ms. Clarice Liechty for comments on the study. Ms. Liechty said the solution to the farm crisis is exporting agricultural products. She said value-added agricultural processing is a key to the solution and good management practices are necessary. She said rising property taxes are an additional problem of farmers.

Senator Thompson said two things that will improve the agricultural economy are improved prices and better marketing. He said these are two things the committee cannot control. He said it would be within the committee's study authority to investigate tax incentives and regulatory relief. He said COFA should be asked to present information to the committee at its next meeting on proposals for tax incentives and regulatory relief to assist agriculture.

FARM AND RANCH RETIREMENT FUND STUDY

Chairman Christmann called on committee counsel for presentation of a memorandum entitled *Farm and Ranch Retirement Fund Tax Study*. Committee counsel said savings plans are available to employees, employers, and self-employed persons to allow tax benefits of retirement investments. He said funding retirement and investment plans requires cash and the reality of family farming and ranching is that profits, if available, are often devoted to retiring debt, repairing or replacing equipment, expanding or upgrading operations, or saving for lean years that might be ahead. As a result, farmers and ranchers develop wealth in their operations, rather than investment opportunities that qualify for tax breaks under federal law.

Senator Tomac said the problem as he sees it is that farmers may be asset rich and cash poor. He said one solution might be to allow land principal payments to be treated as an IRA contribution. He said this would require a change in federal law. He said exploration of federal law in this area is required. He said another area that might be considered would be a statewide retirement plan for farmers.

Senator Thompson said he questions how federal income tax changes being considered by Congress will affect North Dakota. He said this would likely decrease North Dakota revenues and decoupling from the federal system might be considered.

Chairman Christmann called on Mr. Moench for comments on the agricultural retirement fund study. A copy of Mr. Moench's testimony is attached as Appendix C.

Committee counsel said experts in retirement planning have been contacted with regard to this study topic and have expressed willingness to assist the committee to understand existing opportunities for retirement planning.

The meeting was adjourned at 3:00 p.m. subject to the call of the chairman.

John Walstad
Committee Counsel

ATTACH:3