



Revenue and Transportation Interim Committee

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58th Montana Legislature

SENATE MEMBERS

GREGORY BARKUS
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HOUSE MEMBERS

JOE BALYEAT
EILEEN CARNEY
RONALD DEVLIN
CHRISTINE KAUFMANN
KARL WAITSCHIES
BILL WILSON

COMMITTEE STAFF

LEANNE KURTZ, Research Analyst
JEFF MARTIN, Research Analyst
LEE HEIMAN, Staff Attorney

MINUTES

Please Note: These are summary minutes. Testimony and discussion are paraphrased and condensed. Committee tapes are on file in the offices of the Legislative Services Division. **Exhibits for this meeting are available upon request. Legislative Council policy requires a charge of 15 cents a page for copies of the document.**

Room 102, State Capitol
February 13, 2004

COMMITTEE MEMBERS PRESENT

SEN. VICKI COCCHIARELLA
SEN. JON ELLINGSON
SEN. ROBERT STORY
SEN. KEN TOOLE
REP. JOE BALYEAT
REP. EILEEN CARNEY
REP. CHRISTINE KAUFMANN

COMMITTEE MEMBERS EXCUSED

SEN. GREGORY BARKUS
SEN. JERRY BLACK
REP. RONALD DEVLIN
REP. KARL WAITSCHIES
REP. BILL WILSON

STAFF PRESENT

LEANNE KURTZ, Research Analyst
JEFF MARTIN, Research Analyst
LEE HEIMAN, Staff Attorney

Visitors

Agenda, Attachment 1
Visitors' list, Attachment 2.

COMMITTEE ACTION

None.

CALL TO ORDER AND ROLL CALL

The February 13, 2004, meeting convened at 9:00 a.m. and was called to order by Revenue and Transportation Committee Chairman Sen. Bob Story. The secretary noted the roll (Attachment 3).

SJR 29 STUDY ON THE TAXATION AND VALUATION OF ELECTRICAL GENERATION PROPERTY

- **Gene Walborn, Montana Department of Revenue**

Gene Walborn, Montana Department of Revenue (DOR) followed up with information requested by the Committee at the last meeting. Mr. Walborn discussed the report "Valuation of Electrical Generation Property" (EXHIBIT 1) on the valuation of centrally assessed property.

Mr. Walborn reviewed the cost approach, which is the original cost less depreciation. Sen. Ellingson asked whether the depreciation is the same as that allowed for tax purposes or whether it is based upon actual wear and tear and a judgment on how much the market value of the plant has deteriorated over time. Mr. Walborn said that it is "book depreciation," and it could be tax depreciation, or it could be regulatory depreciation, depending on what financial they were using, and it is not observed depreciation, adding they do not go out and look at generators for physical deterioration.

Rep. Balyeat asked how DOR derived 9% as the capitalization rate under the income approach. Rep. Balyeat said the difference in the capitalization rate can make huge differences in the valuation and asked Mr. Walborn to comment. Mr. Walborn said there are different types of capitalization and DOR uses direct capitalization. It is a weighted cost of capital that includes an equity component and a debt component. Adding those together gets to 9%. For example, equity owners of comparable companies earn 10% and bonds are earning 5%. Those two figures are weighted together. Yield capitalization discounts future income to present value. This requires doing a growth rate forecast and a risk-free grade for the assets you are valuing, and a rate of return. Mr. Walborn said the yield capitalization model is more speculative. In response to Rep. Balyeat's second point, Mr. Walborn said adjusting the capitalization rate by 1% up or down can have a large impact on the valuation. The higher the rate, the lower the value; the lower the rate, the higher the value. As an example, Mr. Walborn said that if the capitalization rate were 10% instead of 9%, the valuation would be \$625 million instead of \$694 million.

Rep. Balyeat said, in a certain respect, the income approach is redundant with the market approach because the value of stock in the open market is largely dependent on earnings and price/earnings ratios. Mr. Walborn said that Rep. Balyeat's observations were correct and there is some tie between the two approaches. The capitalization rate is derived from a blend of companies in the industry; the market approach, however, is very specific to a company.

Rep. Balyeat was trying to relate this to differences in valuation between two portions of a power generation plant that are owned by two different entities. Rep. Balyeat's understanding is that part of the reason for the different valuations is that one was selling into unregulated markets, whereas the other one was not. If they are selling into unregulated markets, their income earning potential is higher and, therefore, the equipment should be worth more. Rep. Balyeat said an accountant's perspective would argue equipment is equipment, and the tangible value of that equipment should be the same regardless of market differences. If there is a difference in income-earning potential, that would be attributable to intangible assets and the ability to sell in a different market and not attributable to tangible assets.

Mr. Walborn said they are the same assets and operate in different markets, and have the ability to earn more or earn less. Mr. Walborn said there may be a situation where an exempt wholesale generator may earn less than a rate-regulated utility. When assets are placed on a balance sheet, the balance sheet needs to show the value of the assets. Mr. Walborn recognized there may be some intangibles associated with those assets that affect the earnings of those assets. It could be that a business owns some technology that no one else owns and the assets cost \$1 million, but they earn \$10 million. It could be those assets operating together have more value than a stand-alone operation. If the balance sheet does not reflect the value of the assets, those assets have to be written up or written down as required by FAS (Financial Accounting Standards) Order 144. Mr. Walborn said that investors invest in a publically traded company based on the value and earning power of the assets. At some point, the balance sheet needs to recognize whether there is some intangible value. Mr. Walborn clarified that intangible value is not exempt in Montana, but intangible personal property is exempt. Mr. Walborn described it as being the difference between buying an acre of land in Helena and an acre of land on Flathead Lake, having a view of Flathead Lake would be worth more.

Rep. Balyeat agreed the assets must be written up or down on the balance sheet based on income-earning potential, but he believed the write up or write down is intangible. Rep. Balyeat stated they are talking about taxing tangible property under the equipment tax. Rep. Balyeat asked Mr. Walborn if he thought even if it is intangible, it is still subject to equipment tax, unless it's intangible personal property. Mr. Walborn said there is intangible value associated with all property, including right to ownership and right to income. Section 15-6-218, MCA, exempts intangible personal property, but the list does not say intangible value is exempt. But if goodwill is not on the balance sheet, it is not exempt.

Mr. Walborn said that the correlated unit value is determined by weighting the cost approach, income approach, and market approach to obtain a system market value.

Sen. Story said nine other states go through the same process, and he asked if those states used different methods. Mr. Walborn said there are 38 states that centrally assess property and there are some differences in exemptions and calculations. Ideally, each state should come up with the same answer, but that is not always the case.

Sen. Toole asked whether it was unusual that a similar asset's valuation would be based on its use. Mr. Walborn replied they value the use of the property. Sen. Toole said it is not an unusual concept that valuation is going to look at the income and the end result of the use of

that property. Mr. Walborn said that was correct, and it was a decision of the Montana Supreme Court to value the use of the property.

Mr. Walborn discussed the hypothetical sale of Western Electric to Southern Electric for \$1 billion on January 1, 2004. Mr. Walborn provided the correlated unit value after the sale to Southern. Mr. Walborn said Southern allocated the purchase price to the existing assets on an original-cost basis and may even have an appraisal done and allocate the purchase price to those assets. Mr. Walborn said this is common in all sales such as Pennsylvania Power and Light (PPL) and Touch America.

Sen. Story asked whether debt would have reduced the market value. Mr. Walborn said it would have.

Mr. Walborn provided a copy of Table 1: Market Value of Coal-Fired Electrical Generation Property—1999-2003 (EXHIBIT 2). The question at the last meeting had to do with PPL Montana Unit 3 and the change in value from \$181.3 million in 1999 to \$130.9 million in 2000. Mr. Walborn said this is due to the purchase price allocation and the appraisal that was performed. Another factor was that Colstrip 1 and 2 were built in 1975 and the costs would have been on the Montana Power Company's books at that value. Unit 3 was built in 1985, so its original cost would have been higher. In 2000 when the assets were appraised, the purchase price was allocated based on that appraisal, and it was determined at that time that Colstrip Unit 3 was worth something less than what MPC thought, but Units 1 and 2 on their original cost were assigned more to purchase price, causing a flip in the value of assets.

Sen. Toole asked whether the allocation included the dams. Mr. Walborn said page 4, Exhibit 2, shows the figures for the dams. Mr. Walborn explained they had determined the dams' original costs were not correct. Under MPC, the total was \$154 million, and it went to \$321 million.

Sen. Ellingson asked if the variations in market value were based upon PPL's assessment, and if PPL said the value of Hauser Dam really is not worth \$7.1 million but \$3.9 million, whether DOR would accept that as accurate. Mr. Walborn replied that was the case, and what PPL reported on their balance sheet was the original cost now of Hauser Dam, and they go through the steps of apportionment of value and arrive at this market value. Sen. Ellingson asked if DOR looked at this with some degree of skepticism or if they simply took it at face value. Mr. Walborn replied they took it at face value.

Sen. Story said that in looking at the hydro plants and the growth of the system over a period of time, the hydro facilities carried their value with them. The book value of those facilities under regulated ownership is a result of what has happened over time. Mr. Walborn agreed and cited the Hauser Dam as a good example since it was built in 1907, so the cost of the plant on MPC's books are all costs from 1907 until 1999, and then when there was a purchase price allocation, it was determined the purchase price should have been something less than that. Sen. Story added that under new ownership, creating new values is an apples and oranges comparison because they have to redetermine what everything is worth. Consideration must now be given to what they are doing, how much electricity will be generated, how dependable they are, and how they decide to operate as opposed to using historical costs and depreciation to determine the value.

Sen. Toole said MPC valued the dam higher than someone who would value it at the purchase. Therefore, it is not just cost less depreciation, but also must include addition of improvements. Hauser Dam was held by MPC for a long period of time, and MPC would have the value of the dam set higher than a new purchaser, so MPC must have considered something beyond cost less depreciation. Mr. Walborn said that the apportionment process uses "original cost" rather than "cost less depreciation." Therefore, the process starts over again when there is a purchase and begins with an appraisal. MPC's cost is more historical costs and included assets new to them and the value MPC had to pay to put those into place. PPL is original costs and what they had to pay for the assets.

Sen. Toole said MPC had the dams valued for much less than what PPL had the dams valued at for tax purposes. Mr. Walborn said DOR allocated less market value to the dams under MPC than it did to PPL.

Mr. Walborn said DOR's determination of central assessment is a two-part test. The first part is the property has to be specifically listed in statute, and the second part is the property has to be physically connected or the property has to be operated on a unitary basis. Mr. Walborn said the valuation would be the same whether it was local versus central assessment.

Sen. Ellingson asked if to get to the Montana market value approach you go to the stock value of Avista as it is traded. Mr. Walborn explained DOR calculates all three approaches and correlates them together. Sen. Ellingson commented that when they say "market value" it really is "assessed value." Mr. Walborn replied it is "market value." Sen. Ellingson responded the market approach defined on page 7 is different from the market value on page 15. Sen. Ellingson felt this was confusing. Mr. Walborn replied in determining market value, three approaches to value are used, and one of those approaches is the market approach. Mr. Walborn added it should be a representation of market value.

- **Neil Colwell and Bob Hanson, Avista Corp.**

Bob Hanson discussed the central assessment procedure for investor-owned utilities (EXHIBIT 3). Mr. Hanson said fair-market value is the first step in determining value, and that everybody has an idea of what fair-market value is. In the utility business people recognized many of the methods used to determine fair-market value did not always work well and needed to be modified. Mr. Hanson submitted written testimony to the Committee (EXHIBIT 4) and statistical information for Avista Corporation (EXHIBIT 5).

(Tape 2; Side A)

Sen. Toole asked about Avista's load and capacity since 1999 and about off-system sales. Sen. Toole was specifically interested in how profits from off-system sales are treated. Mr. Hanson replied that because they are mostly a hydro-based company which is subject to fluctuations in stream flows, they have had opportunities to make surplus off-system sales. Before 1999 and 2000, they had as much as 10% of total generation available for sale off-system. However, the market price for those off-system sales was not much more than what they could sell under regulation. Therefore, there was not much of an opportunity to make extra profit. Mr. Hanson said it was prudent for a utility to have some excess capacity to help

off-set bad water years. Mr. Hanson did not have exact numbers on what Avista sold surplus. If Avista is in the position to make profits, those profits would go into the regulated return and the customers would get the benefit of the profits and not the shareholders.

Neil Colwell said that 1997 was the biggest water year they ever experienced and 2000 and 2001 were the lowest water years. In 2000, Avista sustained huge losses because of the market and low stream flows. Those losses or profits go back to the customers. Mr. Colwell explained to a certain extent, Avista has mechanisms in place for power cost adjustments which are made on an annual basis. Mr. Colwell said Washington and Idaho are still experiencing power cost adjustments attributable to the energy crisis of 2000 and 2001.

Sen. Toole asked if fuel-cost contract costs could be legitimately passed through to ratepayers. Mr. Colwell said that the costs are shared by customers and investors since the regulating authority does not usually grant all the requested purchase power costs. Sen. Toole asked if the same was true for profits and, if there was an allocation with stockholders and ratepayers, whether it was symmetrical. Mr. Colwell said they have a band of costs established with the PSC, and once they get outside of that band, they need to either start refunding or adding a surcharge.

Rep. Balyeat said there are many variables, and they may even vary among companies, and noted the goals are not even consistent. He said that any value could be justified by slight changes in the formula or in the rates. He said the problem now was caused by the sale of a utility, and now there is no baseline, and the parties cannot agree on an amount. Mr. Hanson agreed with Rep. Balyeat, except for the sale of the utility. Mr. Hanson said the unitary theory developed over the years did not contemplate sales of utility property outside of the regulatory environment. Mr. Hanson said no regulated company would pay the \$1 billion replacement cost of a dam. Mr. Hanson added that the use of multiple indicators serves as a check, and they do not see wide swings in value from year-to-year, although there may be swings from one indicator to another. Mr. Hanson has seen the income indicator at 25% below the cost indicator, and then two years later, it is 25% above. Mr. Hanson felt there has to be some appraiser judgment. As an example, Mr. Hanson cited the state's formula of averaging five-years' worth of income to determine the income to capitalize. In the last five years, Avista had one year it lost money and then three years where the income was in the \$80-\$100 million range. The appraiser had the discretion not to include the year Avista lost money and determined the average on the more normal years. Therefore, Mr. Hanson did not feel this was a negotiated rate, and stated the ranges between the numbers are closer than a person might think.

Mr. Colwell said there is no baseline when there is a sale and in the unitary theory of how you get to the value of a utility company, one of the big drivers is the ability to earn and this ability is limited by regulation. When you bring a utility into your rate base, the regulators will not allow you to raise prices. Mr. Colwell explained that if you change the regulatory scheme, the purchaser of the property will determine what kind of income can be made in an unregulated market and base the transaction on that estimate, much more like a normal business transaction.

Sen. Vicki Cocchiarella asked how the appraisal process affects rates. Mr. Hanson said property taxes are a cost of doing business but could not give an estimate on how it will impact

rates. Utilities are very high-taxed businesses, and costs have to be passed on to customers, and this is accepted by regulators.

Mr. Colwell said there are two issues in play: The changes in the energy prices were the result of short-term power cost adjustments because all the utilities in the Northwest were purchasing energy and did not have the capacity to produce enough. Power was purchased at a higher rate than what it was sold for, which created a deficit. This deficit was addressed by short-term rate increases. In the longer term, as rates increase, the supplier went to the regulator and asked for rate increases. Utility taxes are a significant portion of the overall costs to customers. Avista has filed proposed rate increases with the Idaho Commission for both electricity and gas to recover costs for increased operation costs. The question is how do you get to the value of a utility company for tax purposes, and what are the utility companies really worth. Mr. Colwell said regulated monopoly utility companies are different from all other businesses because their ability to earn on their assets is limited.

(Tape 2; Side B)

Sen. Story said most states do not put much emphasis on the market approach, and wanted to know if this was because there were not many sales. Mr. Hanson said that was correct, but added that is not the real flaw with the market indicator. The market indicator measures the value of stock and debt that is freely traded and probably comes the closest to true value in the sense that there are always willing buyers and sellers in the stock market. The problem with the indicator is that the stock price itself is not deemed to be indicative of the underlying value of the utility property for the simple reason that there is so much other property being supported by that stock. Mr. Hanson gave an example of Avista's energy trading company, which was unregulated, making a profit while Avista was doing poorly. The energy trading company propped up Avista's earnings enough so the stock price did not drop nearly as much as it would have without the unregulated business. Mr. Hanson said you do not really want to capture the value of an unregulated business if it is helping your stock price.

Sen. Story said that in Montana regulated utilities can track their property tax and if the taxes go up, rates can be adjusted. Sen. Story wanted to know if that is the case in other states or if companies have to conduct a rate hearing every time they want to recover an increase in property tax. Mr. Hanson replied Avista has power cost mechanisms and Washington relies heavily on distribution-level excise taxes, and they have no other costs, including property taxes, that can be simply tracked to the customers; therefore, they would have to conduct a full-blown rate case.

Sen. Story asked if Avista experienced a savings in property taxes after Montana reduced the tax rate on electric generation property and was able to pass that savings on to ratepayers. Mr. Hanson replied the reduction in property taxes was beneficial to Avista's overall earning situation, but pointed out they were already trying to do everything they could to trim costs, so they would not have to adjust rates. The reduction did not put them into an over-earning situation.

In response to a question from Sen. Toole, Mr. Colwell said that Avista does not provide retail service in Montana, with the exception of a few employees at Noxon, and their rates are

established by agreement with the Montana PSC and the Idaho Public Utilities Commission, and that is at Idaho's rates.

Sen. Toole asked if cutting property taxes in Montana was beneficial to ratepayers, does the benefit flow out-of-state. Mr. Colwell replied it would, but the effective tax rates in Montana are significantly higher. Mr. Colwell asked if taxes on generation property were cut from 12% to 6%, whether the transmission facilities would still be taxed at the 12% rate. Sen. Toole asked again if the benefits of the tax cut would go to out-of-state ratepayers. Mr. Colwell said that to the extent they were already under earning, the value went to the shareholders.

- **Jeff Martin, Legislative Services Division**

Jeff Martin, Legislative Services Division, discussed the report entitled "The Valuation of Electrical Generation Property in Selected States" (EXHIBIT 6). Mr. Martin said the states in the report included states that are restructuring, states that have delayed restructuring, and states that have not restructured; and the valuation method used in each state. Exhibit 6 contains a summary of how restructuring is proceeding in each state, and Mr. Martin highlighted those summaries for the Committee.

(Tape 3; Side A)

DEPARTMENT OF REVENUE USE OF A COLLECTION AGENCY FOR COLLECTION OF DELINQUENT TAXES

- **Neil Peterson, Montana Department of Revenue**

Neil Peterson, Montana Department of Revenue, submitted a handout entitled "Debt Collection, Use of a Collection Agency to Collect on Delinquent Taxes" (EXHIBIT 7), and reviewed the information with the Committee.

Rep. Carney asked what the cost difference was between the Montana company that submitted a proposal and GC Services, the company that was awarded the contract. Mr. Peterson said that GC Services bid 18.9% of the amount collected and the Montana company bid 14%. DOR evaluated the proposals on the scope of the project and the services a bidder would provide as well as the bidder's qualifications and its collection process. While the percentage was important, what DOR was really looking for was what the company would do to collect the debt and how actively the company would be in working for the contingency fee.

Rep. Balyeat asked if DOR considered splitting the contract to see what the difference would be between the two companies. Mr. Peterson said they did consider that option, but since this was their first time dealing with a collection agency, they wanted to use just one agency to start with. Mr. Peterson said it could get complicated when there is more than one collection agency.

Rep. Balyeat asked about collections handled in-house. Mr. Peterson said DOR's cost of collection is about 10-12%. DOR collectors work on newer debt, which means there is an increased likelihood of collection. A principle of debt collection is that you need to get to the

debtor as quickly as possible. GC Services collects on debt that is at least two years old, and there would be a range of 10-15% recovery on that debt.

Rep. Balyeat wanted to know if there was a way to compare DOR's success ratio in collecting older debt with GC Services' success rate. Mr. Peterson said older debt was sent to the Department of Administration's Bad Debt Unit, and their recovery was in the 4%-5% range.

Rep. Balyeat said there should be legislation that says when there is a situation where you can collect more money than what it costs for these different collectors, DOR should be given the authority to do that. Mr. Peterson agreed and said he is working with GC Services and has supplied them with some of DOR's costs to collect and will do a comparison to determine what their rate of return is versus DOR's rate of return. Mr. Peterson's initial impression of the data is that it is a good bargain given the type of debt assigned to GC Services. Mr. Peterson will attempt to complete his analysis and report back to the Committee.

Rep. Balyeat wanted to know what would happen if someone received a notice from GC Services and sent a check directly to DOR. Mr. Peterson said there are some people who refuse to send a check to GC Services and will only send the check to DOR. If that particular account has been assigned, GC Services will receive their percentage.

Sen. Cocchiarella said using GC Services was efficient since DOR is not adding staff to do the collections. Mr. Peterson was confident when he completes his comparison analysis, it will show a very good return on investment. Sen. Cocchiarella stated she disagrees with Rep. Balyeat's analysis because no one is collecting these debts right now, and the only time GC Services gets paid, is if the debt is collected.

Mr. Peterson said that other states, as well as the Internal Revenue Service, are attempting to manage debt as best they can. He said counties are also considering outsourcing debt and that the outsourcing trend is here to stay.

Sen. Toole wondered if the cost of the GC Services' contract is in the budget. Mr. Peterson replied it is not. Sen. Toole asked if any of the employees of GC Services were in Montana. Mr. Peterson believed most of the people working on these accounts were in the Oklahoma City office.

Sen. Story asked if DOR considered selling the debt. Mr. Peterson replied they did consider that option, and while none of the other states have done that as of yet, it is an option. One problem might be if it has been determined the debt was not actually owed. In addition, when tax debt is outsourced, some people are concerned about a private organization having access to tax information.

Sen. Story wanted to know if there was a policy requiring that when a debt becomes two years old, it automatically gets turned over to GC Services. Mr. Peterson said that is what would happen, but if GC Services is not successful in collecting the debt within 180 days, the debt comes back to DOR, and it will then decide whether to write it off.

Sen. Story asked if this is just debt owed to the DOR, or if other agency debt was included. Mr. Peterson said it is limited to individual income tax receivables. Sen. Story wanted

to know if DOR's collection group is now collecting for other agencies. Mr. Peterson said they are running an offset program, so any state warrant that is issued offsets against debt to state agencies. Agencies are charged a 10% rate for that debt collection.

REPORT REQUIRED BY 15-1-230, MCA, ON CREDIT FOR CONTRIBUTION TO QUALIFIED ENDOWMENT

- **Larry Finch, Montana Department of Revenue**

Larry Finch, Montana Department of Revenue, discussed the report "Charitable Endowment Credit Legislative History and Use" (EXHIBIT 8). Exhibit 8 also provided a history of usage of the credit.

Mr. Finch said most people who utilize the credit wait until the end of the tax year for planning purposes. Therefore, the lower credit under SB 15 (2002 special session) influenced what taxpayers did in November and December.

Rep. Kaufmann asked if that was the intention of SB 15 and if what happened was exactly what was expected. Mr. Finch agreed and stated those were tight budgetary times, and one of the things that was looked at to provide revenues was to change the parameters of the tax credit, and that was exactly what happened.

Sen. Story suggested reviewing the fiscal note and that this drop was considerably higher than the drop anticipated, and if the other half of the bill had stayed in effect and gone to 50%, the rebound in the second year would have been considerably higher.

Sen. Balyeat's recalled that the fiscal note was approximately \$2 million, and observed there appears to be approximately a \$6 million drop just on the individual income tax side. Therefore, it was considerably more than anticipated.

Rep. Kaufman asked Mr. Finch about the recipients of the contributions. Mr. Finch replied the recipients are all over the board as to the type of organizations, but there is an organization that tracks and monitors this type of information.

(Tape 3; Side B)

RULE REVIEW RELATED TO THE IMPOSITION OF INCOME TAXES ON SALES BASED ON SOLICITATION OF ORDERS FROM OUT-OF-STATE BUSINESSES

- **Lee Heiman, Legislative Services Division**

Lee Heiman, Legislative Services Division, discussed a memorandum on DOR proposed rules (EXHIBIT 9). Mr. Heiman said the new rules basically codify what court cases have done. Mr. Heiman explained this is a nexus question of how much contact a company needs to have within a state before it can be taxed. Mr. Heiman was not aware of any controversy over the proposed rules.

PROGRESS REPORTS FROM TAX STUDY COMMITTEES

- **Tax Reform Study Committee (SB 461)–Rep. Eileen Carney and Sen. Jon Ellingson**

Rep. Eileen Carney reported on the last meeting of the Tax Reform Study Committee. She said that Larry Finch, DOR, presented a report on the exportability of the sales tax. One argument for the sales tax is tourists will pay it. The report said nonresidents pay 6.5% of our income tax and 8% of our property tax. If a sales tax bill reduced or eliminated one of those taxes, non-residents would pay less because they would also receive a reduction in either income or property taxes. The estimate is that if Montana's income tax is eliminated, Montanans would pay \$21 million less in state taxes, but pay \$117 more in federal taxes. The same thing is true if the state portion of property taxes is eliminated. Montanans would pay \$38 million more to the federal government, for a total net increase in taxes of \$26 million. The third point the report made was that tourists already pay accommodations, alcohol, gambling, gasoline, and rental car taxes, so there would not be much of a gain by taxing tourists with a sales tax.

Rep. Carney said while many states are working on tax reform, comparison is difficult because they are all doing something different. For example, Washington had a study commission in 2002. Washington does not have an income tax, but does have a very high sales tax. If you make less than \$20,000 a year in Washington, you pay between 15% and 17% of your total income in state taxes. If you make \$1 million, you pay 4% of your total income in taxes. The study commission recommended an income tax in lieu of a sales tax. The Washington sales tax may be bad for business because Oregon does not have a sales tax, and Idaho's sales tax is less. The report suggested businesses in the counties bordering Oregon and Idaho lose about 22% of their sales. Internet sales are not subject to sales tax. Because Washington residents cannot deduct income taxes, they are paying approximately \$500 million more to the federal government than they would if they were paying state income tax instead of a sales tax.

Sen. Ellingson said that one of the arguments for a sales tax is that there are a lot of tourists who would contribute to the tax revenue. What was fascinating with the analysis of exportability was just the opposite, and if a sales tax is coupled with a reduction of income tax or a reduction or elimination of property tax, Montana residents end up paying more money, and more money goes to the federal government. Basic economics will show that if you are sending money out of the state instead of spending it here, it will hurt Montana's economy.

Mr. Martin said he would check into whether there is federal legislation to restore the deduction for sales taxes.

Property Reappraisal Study Committee (SB 461)–Sen. Bob Story

Sen. Story said that the Reappraisal Study Committee is looking at a targeted land cap for Montanans. The land cap would say your property could not be assessed at any more than a percentage of the value of the structure located on the property. The problem experienced in Lake and Flathead counties was that there were a lot of out-of-staters with high-value properties. Sen. Story said the Study Committee's intention is to continue to work on this problem because it is an issue with those people who have owned the property for a long period

of time and the land values are the problem. This problem has spread to other parts of the state.

REPORT REQUIRED BY 90-8-311, MCA, ON CAPITAL COMPANIES

- **Gary Morehouse, Department of Commerce**

Gary Morehouse, Business Resources Division, Montana Department of Commerce, said there are no active capital companies, and there are no tax credits available. Mr. Morehouse submitted a written report to the Committee (EXHIBIT 10).

Sen. Toole asked Mr. Morehouse to explain what caused decertification. Mr. Morehouse replied the Montana Capital Company Act required that after 70% of the funds were invested and five years expired, the Department of Commerce (DOC) was required to decertify, which essentially means the contract was completed. In certain cases, decertification could also occur for cause.

Sen. Story inquired whether the \$1 million loan the state made to the Glacier Venture Fund (GVF) was repaid. Mr. Morehouse said the loan was made by the Montana Science and Technology Alliance, and the management of that loan has been transferred to the Board of Investments. It has been about seven years since the loan was originally made. Mr. Morehouse said this \$1 million loan would have doubled by now based on interest accrual.

Rep. Balyeat asked if GVF only invested in the four businesses listed. Mr. Morehouse said they only track the tax credit portion, so half of their fund is a tax credit base that GVF had to report to DOC. GVF has made other investments, and Mr. Morehouse said GVF's reporting requirements are only applicable to the tax credits.

Rep. Balyeat asked how they decided which businesses to include for the tax credit versus other funding. Mr. Morehouse said they invested in the tax credit first because there were time restrictions in the statute. Therefore, the first four investments are the ones listed in Exhibit 10. Rep. Balyeat asked if Implemax Equipment Company is still in business. Mr. Morehouse said the business is not doing very well and believed \$350,000 was advanced to that company. Mr. Morehouse said that investors in GVF had to put in \$1.5 million of private funds to receive \$750,000 in tax credits.

BACKGROUND INFORMATION ON ISSUES IDENTIFIED AT THE DECEMBER MEETING

- **Class Eight Business Equipment, Jeff Martin, Legislative Services Division**

Jeff Martin, Legislative Services Division, discussed a memorandum he prepared on the taxation of class eight business equipment (EXHIBIT 11).

(Tape 4; Side A)

Mr. Martin said North Dakota exempts personal property from taxation, but taxes utility personal property except for railroad property. South Dakota also exempts personal property but taxes centrally assessed personal property including railroads. Mr. Martin also summarized

a U.S. Supreme Court decision that held a state could tax personal property of railroads even if other commercial and industrial personal property were exempt.

Mr. Martin reviewed the options and actions the Committee may want to take as listed in Exhibit 11.

Sen. Ellingson asked Mr. Martin what the impact would be on class 12 railroad and airline property if they got rid of the tax. Mr. Martin said that DOR has a method of calculating the change. Sen. Ellingson was interested in seeing those estimates.

Sen. Cocchiarella suggested the Committee work on combining, or at least applying the same tax rate, to class eight that is applied to class four and eliminate the trigger. Sen. Cocchiarella said combining the two classes, at least for the purposes of a tax rate, would address issues that businesses have always had with their taxes. Sen. Cocchiarella hoped the Committee could develop a bipartisan approach to the taxation of personal and real property.

Rep. Balyeat said the class four rate is 3.4%, but only on two-thirds of the value, so really the effective rate is around 2.3%. If homeowners were thrown into the same category as business equipment, it would result in a significant tax increase on homeowners. Sen. Story thought Sen. Cocchiarella's idea was to go the other way and not to increase taxes on homeowners. Mr. Martin said that effective tax rates are not the statutory tax rate. The effective tax rate is the market value of property divided into the taxes paid. Mr. Martin noted that in DOR's biennial report for fiscal year 2002, the effective tax rate on residential land and improvements was 1.3%, the effective tax rate on commercial land and improvements was 1.6 %, and the effective tax rate on business equipment was 1.3%. These rates were on a state-wide level.

Sen. Cocchiarella said the Committee should deal with this issue together and put businesses and homeowners on a level playing field. Sen. Cocchiarella said the Committee was the perfect place to deal with the trigger topic. Sen. Story would like to see the numbers on distribution of class eight property for the various counties. It was suggested that if any legislation was going to be drafted, it should be ready for the Committee to review in July.

- **Trends in State Corporation Business Taxes—Jeff Martin, Legislative Services Division**

Mr. Martin summarized *corporation tax trends based on State Corporate Revenue Trends, Causes and Possible Solutions* by William Fox and LeAnn Luna; *The Future of State Corporation Income Tax, Reflections and Confessions of the Tax Lawyer*, by Richard Pomp, and *State Tax Policy, a Political Perspective*, by David Brunori.

Mr. Martin reviewed conditions which may affect the level of corporate taxes. The first were cyclical fluctuations in corporate income tax. There could be deterioration because of the changes in the federal corporate tax base. The 1981 Economic Recovery Tax Act provided for an accelerated cost-recovery system. This did have a significant effect on state tax collections in the early 1980s, and several states decoupled from federal law. The Tax Reform Act of 1986 broadened the base, but lowered the rate, which had the effect of increasing the after-tax cost of deductible state taxes. This led to increased focus on state tax planning by corporations.

Mr. Martin said state tax policy may lead to declining collections because states may provide incentives for the “foot-loose corporations.” One of the most well known are the tax incentives Alabama gave to Mercedes Benz and Hyundai.

Changes in the apportionment formula can also have an effect. In Montana, corporation taxes for multi-state corporations are allocated based on payroll, sales, and property factors. Many states weight the sales factor higher, so out-of-state sales would affect their tax liability in state. Mr. Martin said that aggressive state tax planning is important because state taxes are becoming more significant, especially for multi-state corporations.

Mr. Martin said that he asked Terry Johnson to look at the corporation tax database to see if he could identify any significant trends with the Montana corporation tax.

Terry Johnson, Legislative Fiscal Division, said that based on what he has looked at so far, there are two issues: The good news is that as the result of an audit DOR collected approximately \$7 million. If that is included in the collection activity to date, it looks like corporate tax is doing much better than expected. If you subtract out the \$7 million, collections are just barely above last year’s level. Overall, not much growth from last year’s level is expected. Next year, corporate tax revenues may increase above this year’s level, but Mr. Johnson cautioned he is basing this on a very preliminary analysis.

Sen. Story said two issues that might affect Montana are the weighting between Montana’s share of multi-state corporations and the unitary system of taxation of a corporation with a lot of different entities. Sen. Story said the MPC distribution company, which mainly was an in-state company, is now owned by NorthWestern, an interstate company. It could have the same property, same employees, and be doing the same amount of business, but because now it is distributing in other states, Montana may not realize the same revenue from that company. Mr. Martin responded the allocation would be weighted based on NorthWestern’s share of payroll, sales, and property in Montana, but he did not know what effect its business out-of-state would have.

(Tape 4; Side B)

- **Federal Policy on the Taxation of Internet Access, Leanne Kurtz, Legislative Services Division**

Leanne Kurtz, Legislative Services Division, discussed a memorandum (EXHIBIT 12) on federal legislation regarding taxation of Internet access. Sen. Story had brought this issue to the Committee’s attention in December.

HIGHWAY ECONOMIC ANALYSIS TOOL FOR HIGHWAY PROJECT SELECTION

- **Jim Currie, Montana Department of Transportation**

Jim Currie, Deputy Director, Montana Department of Transportation (MDT), spoke about the Highway Economic Analysis Tool (HEAT), which was developed as a result of HJR 30 in the 2001 Session. HJR 30 asked MDT to address economic development in its long-range transportation plan and to include economic development criteria in MDT’s funding allocations

and project selection process. In addition, in 2001 Governor Martz held an economic summit and directed MDT to analyze the economic development potential and the cost-benefit of widening Montana's highways. Mr. Currie introduced Sandy Straehl and Chris Wornum to explain HEAT.

- **Sandy Straehl, Montana Department of Transportation, and Chris Wornum, Cambridge Systematics**

Ms. Straehl and Mr. Wornum gave a presentation on the Highway Economic Analysis Tool (HEAT) (EXHIBIT 13) and described its importance to MDT's planning, programming, and project selection processes. Ms. Straehl pointed out that economic development is not the only consideration within its planning and prioritization process. Ms. Straehl submitted a copy of *TranPlan 21/2002 Update* (EXHIBIT 14), and a copy of Performance Programming Process (EXHIBIT 15). Ms. Straehl said MDT's first policy goal is to preserve Montana's existing highway system, the second goal is to provide capacity expansion and mobility improvements where necessary. The third goal is to make other improvements such as in rest areas.

Mr. Wornum said HEAT was a way to look at the benefit and costs of highway investments. The analysis helps to assess whether the expectations of economic development of a project are reasonable or not. They looked at every project equally and evaluated the merits based on a common method.

Sen. Toole asked if the models look at externalities such as noise, changes in neighborhoods, encouraging sprawl, and other negative effects. Mr. Wornum replied those are not built into the model, but they are often asked to look at those externalities in relation to the economic benefits. Mr. Wornum has done work to try to quantify the economic consequences. Ms. Straehl said every project has an environmental review process, and HEAT is not designed to supplant any part of the environmental review process.

(Tape 5: Side A)

Ms. Straehl said that they are confident about the results of HEAT analysis on the corridors they have tested. Ms. Straehl and Mr. Wornum discussed the results of the tests on U.S. Hwy. 2 and U.S. Hwy. 93. Ms. Straehl added MDT has long wanted to improve U.S. Hwy. 2 because it is substandard and not necessarily because the improvement will generate a huge amount of economic development potential. If there is any national highway system road in the state that is important to the state's network the way U.S. Hwy. 2 is, it must be brought up to a modern condition. The economic development component needs to be looked at, but it is not the only driver behind how decisions are made.

Rep. Eileen Carney said she has heard that the Swamp Creek project outside of Libby will not receive any money until 2009. Rep. Carney believes by 2009, the road would be reduced to gravel. Rep. Carney asked why that road was not being looked at for repair. Mr. Currie said the road is built over a peat bog, and it is a difficult project. They are in the process of designing the project and have it on a fast track for the design to be completed in 2006. MDT is meeting with the Transportation Commission to discuss strategies and project mix and how funds will be allocated across the state. The Missoula district has a large number of proposed projects, and they do not have near the funding they need to meet all the needs. The

Commission had to decide where the greatest need is, and because of the problem with the design in Swamp Creek, the project was not ready to go. Also, the Commission felt there were greater needs on Hwy. 93. Therefore, the project was moved to 2009. They are moving forward to get the project designed as quickly as they can. Mr. Currie reiterated MDT recognizes the need for that project, and it is working hard to get the Swamp Creek project designed and ready to go. Rep. Carney asked if there are plans to patch the road in the meantime. Mr. Currie responded MDT will keep the surface driveable.

Sen. Toole asked if the jobs data in HEAT referred to the direct jobs from construction, operation, and maintenance. Mr. Wornum said they did not include construction, because they are short-term jobs, and the jobs they included were long-term because of structural changes in the economy. Mr. Wornum said it includes indirect and induced employment. Mr. Wornum added there is a type of multiplier effect imbedded in the model, and it is a little more sophisticated than the multiplier in that it uses a dynamic programming situation. Mr. Wornum did not know what the multiplier effect was because it is a composite of all the industries affected.

Ms. Straehl said that the United States Department of Transportation reports that 47.1 jobs are created per \$1 million invested in highway programs. The problem is that these numbers are not regionally specific. In some areas, Montana's numbers are higher, and in some areas, they are lower. The model looks at the reality of the particular corridor, and the particular industry in that region of the state and, therefore, is much more specific.

Ms. Straehl and Mr. Wornum submitted a technical memorandum on U.S. Hwy. 2 (EXHIBIT 16).

In addressing U.S. Hwy. 93, Mr. Wornum explained they looked at an annual economic benefit in terms of gross state product of approximately \$9 million a year, and \$6 million in real personal income. The total economic benefits are approximately \$145 million discounted to the present, and \$125 million estimated total construction cost. This \$125 million is all federal money.

Sen. Toole asked if a similar analysis was performed on U.S. Hwy. 93 as a four-lane. Mr. Wornum replied it was not. Sen. Toole wanted to know if the analysis was performed as a four-lane, would the cost-benefit ratio come out higher. Mr. Wornum replied the primary drivers of benefit are improving speed in Montana because, in most cases, there is a significant distance between markets. Where benefits are really generated is that it creates a faster trip in bringing businesses together. Ms. Straehl added that MDT has an agreement with the Confederated Salish and Kootenai Tribe regarding the design standards for U.S. Hwy 93. Therefore, to suggest an alternative at this point would not be possible since they have agreed to a narrowly-defined set of improvements.

Mr. Wornum said one of the most compelling parts of HEAT is the ability to determine what industries are affected. If somebody believes an improvement in their area will make a difference, HEAT will be able to focus on which industry and which businesses will respond. Mr. Wornum explained HEAT cannot predict shocks to the system, and if there's a big change in international trade, the basic assumptions that go into the forecast will change, and the results would also change.

Ms. Straehl pointed out they want to be careful how HEAT is used and that it is not misused or misunderstood, and that it is an important tool and a powerful tool. Ms. Straehl said it would be beneficial to use HEAT as a screening tool to determine which projects are going to be most beneficial to Montana in terms of economic development.

Sen. Toole was still concerned about externalities being excluded from the analysis. He said the U.S. Hwy. 93 project could make sense using HEAT, but in reality it is not wanted by the community. Ms. Straehl replied work at the national level is trying to find a way to include externalities. Sen. Toole emphasized he was not only speaking about environmental externalities and reminded the Committee that people are very concerned about these projects and ultimately they become political problems.

Mr. Currie responded safeguards are in place or are being worked out, and include a massive amount of public input, as well as an Environmental Impact Statement. Mr. Currie suggested land use planning has an important role to play as well.

Ms. Straehl explained MDT's Systems Impact Analysis Process and how local governments can often put mitigations into their planning requirements that MDT does not have authority to impose. In the same way, MDT can attach conditions to their permits that are important to local government. Ms. Straehl felt MDT has a very successful working relationship with local governments to make sure their land use planning goals are incorporated into any MDT access permits. The goal of the process overall is to make sure that the mitigations are paid for by those who are going to economically benefit from the development.

(Tape 5; Side B)

HIGHWAY SAFETY

- **Jim Currie, Montana Department of Transportation**

Jim Currie submitted a list of highway fatalities in Montana for November and December 2003 (EXHIBIT 17). Mr. Currie clarified what "unknown" means in relation to the alcohol factor. He said sometimes the officer cannot determine directly that alcohol was involved and they will not report that alcohol was a factor until the results of the blood-alcohol content (BAC) are determined. He said that Director Galt would like to establish a high-level safety committee in the state which would consist of representatives from the Department of Justice, as well as representatives from local law enforcement. The safety committee is close to being established. Also, the comprehensive safety plan is underway, and MDT is in the process of hiring a consultant.

Mr. Currie discussed the status of the Alcohol Tax Incentive Program (EXHIBIT 18). MDT can pay out a maximum of \$6 million of tax incentives for operating ethanol plants. There are three business plans on file, including the Rocky Mountain Ethanol plant in Hardin, which is on schedule to begin operating, and Agri-Technology in Great Falls. The projected output of these two plants is high enough that it would take the entire \$6 million. The incentive is paid on a first-come, first-served basis. The third application is from Yellowstone Power, a shell corporation for Rocky Mountain ethanol in Hardin.

Bob Turner, Montana Department of Transportation, said that Yellowstone Power does not have any assets, but is in the application process and is current with its reports.

Sen. Story commented this was not the way the law was intended to work, and asked if MDT had any suggestions as to how the statute could be modified. Mr. Currie replied that they are looking at designing their legislative package, and this issue has just recently surfaced. In addition the EQC subcommittee is working on the ethanol issue and also had questions. Mr. Currie said he will be making a presentation to EQC next month and felt guidance is needed and maybe first-come, first-served, which is now required by law, is not the best way.

AUTHORITY TO CLOSE ROADS

- **Jim Currie, Montana Department of Transportation**

Sen. Story decried the situation in which emergency personnel wanted to close I-90 from Springdale to Reedpoint during a severe storm in December 2003, but could not locate anyone with authority to close the road. Sen. Story received a letter from Mark Stephens, Fire Chief, Big Timber Volunteer Fire Department (EXHIBIT 19).

Mr. Currie said that ten years ago, MDT worked with the same group of people to develop a protocol for closing highways. The group will meet to work out protocol and enforcement. He said that if an interstate highway is going to be closed, law enforcement will need to be posted at every interchange. He said that the maintenance chief and the maintenance superintendent have the authority to close the road. In addition, the section manager has the authority to recommend when the road should be closed, but they do not have the authority to put barricades in place. Mr. Currie said they would have this authority clarified.

Sen. Story felt there are statewide ramifications and wondered if the sheriff and other emergency personnel get together and discuss what would happen in a blizzard. Mr. Currie did not know the answer and explained they participate in statewide drills, but was uncertain as to the extent that gets down to the local level.

WHITE PAPER ON REAUTHORIZATION

- **Jim Currie, Montana Department of Transportation**

Mr. Currie reported that the U.S. Senate passed a reauthorization bill which will be very good for Montana. He submitted a white paper on reauthorization dated February 13, 2004 (EXHIBIT 20). This bill provides a 25% increase for the highway program and a large increase for transit in Montana. Right now, Montana is operating under temporary extensions at \$295 million. If the bill is passed, this amount will be increased to about \$321 million and \$437 million by 2009. Mr. Currie added the House of Representatives is also working on a bill.

Sen. Story asked whether the elimination of the alcohol incentive would affect match money. Mr. Currie said the \$6 million is set-aside. Sen. Story clarified if they have to use the \$6 million, the Highway Special Revenue Fund is solvent until 2007. Mr. Currie said MDT has to assume every dime appropriated by the legislature will be spent.

Sen. Story said that one of the big issues in federal funding is the proposal to raise the federal gas tax five cents per gallon and wondered if there was much chance of that happening. Mr. Currie did not believe anybody thinks they can get a federal gas tax increase passed.

- **Public Comment**

Spook Stang, representing the Montana Motor Carriers' Association, commented that from an interstate commerce point of view, they would like to see the road closure authority left with the state of Montana. Mr. Stang also said that the reauthorization bill may include expanding the authority for states to establish toll roads.

OTHER BUSINESS—INSTRUCTIONS TO STAFF

Jeff Martin said he had asked the committee for guidance on the valuation study. Sen. Toole would be interested in getting some information at least as close to the crux of the controversy about different valuation, and how profitable the companies are based on whether they are selling into a regulated market or into an unregulated market. Sen. Toole was interested in getting information from 1997 or 1999 until the present, so they can look at what their profits are. Sen. Toole said it would be similarly valuable to have a comparison while recognizing there was a market anomaly which occurred with California. Sen. Toole felt it would be worth looking at whether they are making more money in deregulated markets.

Mr. Martin stated he was not sure whether the Committee had any interest in giving legislative direction to the valuation of generation property, and PPL would probably still dispute the way DOR values their property. Sen. Story said the results of the court case would be needed before they attempt to change the law. Mr. Martin added DOR's attorney had indicated a portion of the appeal will be before the State Tax Appeal Board in April, and if there is anything to report from that hearing, he will bring it before the Committee.

The next meeting of the Revenue and Transportation Committee will be April 30, 2004.

ADJOURNMENT

There being no further business to come before the Committee, the meeting was adjourned at 4:30 p.m.

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