MINUTES OF THE
TAX REVIEW COMMISSION

Friday, July 12, 2002 – 1:00 p.m. – Room 405 State Capitol

Members Present:
Mr. Gary Cornia, Chair
Mr. Keith Prescott, Co-Chair
Sen. Lyle W. Hillyard
Sen. Millie M. Peterson
Rep. Judy Ann Buffmire
Mr. Larry Barusch
Mr. Mark K. Buchi
Mr. David Crapo
Ms. Kathleen Howell
Ms. Dorothy P. Owen

Members Absent:
Rep. Greg J. Curtis
Ms. Anne Clark
Commissioner Bruce Johnson
Mr. Bruce Jones

Staff Present:
Mr. Bryant Howe, Research Analyst
Mr. O. William Asplund, Assistant Director
Ms. Rebecca L. Rockwell, Associate General Counsel
Ms. Sandra Wissa, Legislative Secretary

Note: A list of others present and a copy of materials can be found at http://www.image.le.state.ut.us/imaging/history.asp or by contacting the committee secretary at 538-1032.

1. TRC (Tax Review Commission) Business

Chair Cornia called the meeting to order at 1:10 p.m. He excused Mr. Jones, Commissioner Johnson, and Ms. Clark from the meeting.

2. Oil and Gas Severance Taxes

Mr. Howe distributed and provided a brief overview of the "Background Information: Oil and Gas Severance Tax: July 12, 2002." He reviewed the TRC Severance Tax Policy which was adopted May 1, 1992. Mr. Howe also explained the severance tax on oil and gas statute which indicates that the TRC is required to review certain aspects of the tax before October 2002 and report its findings to the Revenue and Taxation Interim Committee on or before the November 2002 interim meeting.

Mr. Mike Murff, Research Assistant, Office of Legislative Research and General Counsel, distributed and reviewed "Utah Oil and Gas Recovery Incentives" from the "Background Information" packet. He explained the various recovery and production incentives in the oil and gas severance tax and provided information on industry trends and state comparisons.

Professor Shelby Gerking, University of Florida, distributed the handouts "Presentation to Utah Tax Review Commission: July 12, 2002" and "Sensitivity of Production and Drilling in the Utah Oil and Gas Industry to Changes in the Severance Tax." He explained that he was asked to examine the effects that the recompletion and work over credit, various exemptions, and the tiered rate structure in the Utah oil and gas severance tax have on oil and gas exploration and production. He said that he has developed an econometric model to help provide an answer to this question. He explained that the model has the following characteristics: (1) it is a dynamic, rather than static model; (2) it is based on work done by natural resource economists in the 1930s and first published in 1978; and (3) it considers the entire state, local and federal tax structure. He noted that the state severance taxes are deductible under federal corporate income tax laws.

Professor Gerking explained that the model looks at the effects on exploration, drilling, production, and severance tax revenues over a 50 year horizon. First, a price per barrel equivalent is set at $20. This assumes that the price of oil remains constant at $25 per barrel and that the price for natural gas remains constant at $2.20 per metric cubic foot. He said that to show the effects of eliminating the various exemptions, recompletion credit, and tiered rate structure is to raise the effective rate from its current 2.7 percent to 5 percent. He said that raising the effective rate to 5 percent over a 50 year period results in the following: (1) 524 fewer wells would be drilled; (2) production would be lowered by about 2 percent; and (3) oil and gas tax severance revenues would increase by 82 percent. Professor Gerking concluded that production is generally insensitive to changes in the state severance tax on oil and gas.

Mr. Crapo asked whether Professor Gerking was recommending that the effective state severance tax rate on oil and gas production should be increased from its current 2.7 percent to 5 percent. Professor Gerking said that he was not making that recommendation, the purpose of setting a 5 percent effective rate is to show that the various exemptions and credit have a small effect on production.

Mr. Buchi noted that when deciding where to invest capital, companies will have control hurdle rates on where to invest money. He said that firms tend to prioritize investment decisions based on each project's rate of return. A firm will fund projects until it runs out of capital or if the return on the project is below the hurdle rate. He asked if Utah's high production costs and low quality of oil make it more difficult to invest capital in Utah oil and gas production, given the likelihood of a lower rate of return. Professor Gerking said that the model assumes that producers are profit maximizers and that they will attempt to maximize profits wherever they are producing. He said that the model assumes that oil producers are already realizing maximum profits in other locations where they produce. He also said that there are both near term and long term investment decisions. While it is true that in the near term a firm will only invest the capital currently available, if it sees a particularly worthwhile long term investment it will seek to raise additional capital to fund that investment.

Chair Cornia noted that what Professor Gerking is saying is a common way that most economists think about capital investment. If the return on capital drops too low in one state, a firm is unlikely to move that capital to other states because it is assumed that the firm is already realizing maximum profits in all states where it invests.

Rep. Buffmire noted that as an oil field ages, it becomes more and more difficult to extract oil and becomes less profitable. Professor Gerking replied that this is true and since an oil company has already made the investment in drilling the well, it will produce as much oil from the well as possible. That is why production is driven more by reserves than by price. As long as price is higher than marginal cost, it pays to have the well producing. Also, because of the time value of money, it is advantageous for firms to get as much out of the ground now as opposed to the future, given a constant price.

Mr. Cornia asked whether the model was sensitive to differences in the cost of production between states. Professor Gerking replied that the differences in drilling costs between states is really a "red herring." What is critical to examine is the marginal cost of adding a unit of reserve. He said that in high cost states any time you drill you have to anticipate a much bigger payoff from drilling than you would in a state where drilling costs are very low, this all just equals out. He said that if you examine marginal or the extra costs of adding a unit of reserves by state there is very little difference. He said that theoretically you would say that the extra costs of adding a unit of reserves should be the same everywhere. Of course it is not because information is not perfect.

Chair Cornia thanked Professor Gerking for his presentation.

Mr. Palmer DePaulis, Commissioner, Tax Commission (Utah State Tax Commission), reviewed with the TRC the Tax Commission's recommendations for changes to the state oil and gas severance tax. He reviewed Subsection 59-5-102(1)(a), Utah Code Annotated, which still has a 4 percent oil and gas severance tax rate listed. He said that this rate is no longer effective and should be repealed. He also asked the TRC to consider combining the conservation fee with the severance tax. This would simplify the administration of the tax. Mr. DePaulis asked whether there could be a better definition of "value at the well" as the current definition has a potential for misinterpretation. He also had other changes to Subsection 59-5-107 (3), Utah Code Annotated. (See handout "Severance Tax Review Utah State Tax Commission Recommendations.") Mr. DePaulis asked that the Tax Commission would work with staff to provide further input on this issue.

Mr. Lee Peacock, Executive Director, Utah Petroleum Industry, distributed and reviewed the handout "Utah's Oil and Gas Industry: A Thumbnail Sketch." He explained how the severance tax affects the oil and gas producing industry and how that producing industry falls into the bigger scheme of where these products come from, where they go, and how they are used. Mr. Peacock stated that Utah must maintain a stable, predictable, competitive tax policy to compete with other producing areas.

Mr. Tom Bechtell, an independent petroleum producer, stated that Dr. Gerking's report is very important for making a decision on the severance tax but that it is not the only information necessary. He explained that the industry would like the opportunity to provide information an analysis of the other impacts that an increase in severance tax and a deletion of the tax exemptions would cause. Mr. Bechtell noted how important the workover and recompletion credit is for oil companies that operate in the Uintah Basin.

3. Financing Water Development and Delivery

Mr. Howe distributed and reviewed the handout "Property Tax and State Sales and Use Tax Earmarked for Water Development and Delivery." He noted that water conservancy districts annually collect about $58 million property tax revenues, about 4 percent of total property tax revenues.

Mr. B. Dell Gardner, Professor Emeritus, Brigham Young University, said that he would like to discuss the efficient allocation of water. He said that he is concerned about the efficient development and allocation of water, since water is probably our most limited resource. He said that his comments would center on how to price water to promote an efficient development and allocation system. He distributed a graph showing possible supply and demand curves for water.

Professor Gardner said that in a free enterprise system, price is a signal both as to how to allocate resources and as a reflection of scarcity. He said that for consumers of water, price represents the unit cost to them that determines how much of a commodity that will be demanded. For suppliers of water, price represents the per unit of revenues to the water seller or the amount of the resource that will be supplied by the sellers at different prices. He noted that sometimes in the political arena there will be pressure to satisfy excess demand by increasing the water supply through a subsidy. He said that too often in our society, political leaders seek to satisfy the excess demand caused by underpricing water.

Professor Gardner said that subsidizing water with a sales tax or a property tax hides the true costs of providing water. Because consumers of water don't have to pay, they don't have to face those prices as represented on the supply curve with that kind of subsidy. Therefore, Professor Gardner believes the point is clear and indisputable that if you hide those social costs on the supply curve by any kind of subsidies to consumers as represented by these taxes which are unrelated to water use, they're related to the value of the property or to the sales, whichever tax we are talking about, they you are going to have this kind of result. He argued that the best way to prevent infeasible water projects is to insist that the beneficiaries, the users, pay the full cost.

Professor Gardner said that one example of the detrimental effect of subsidizing the true cost of water are the federal projects that involve subsidies to agricultural users. He said that his research for over 40 years on this subject indicate that the social cost (the total development, O&M cost, separable costs of irrigation development) is between $300 and $400 an acre foot on the recent federal projects, including the Central Utah Project. He said that while this is the cost of the water, it is probably only worth about $50 to $100 per acre foot. He said that the difference between the cost to produce the water and what farmers are willing to pay (about $300 an acre foot) is "deadweight loss." It results from excessive resources that are used to develop very expensive water.

Professor Gardner said that under Bureau of Reclamation rules, "ability to pay" principles govern what agricultural users are actually charged for water. This results in a price of about $10 to $20 an acre foot. He said that the additional $80 of value that the farmers receive is capitalized into land values thereby increasing the wealth of the agricultural producer. He said that the state should eliminate subsidies to the water users, especially on new water and that users should pay the true costs. He said that if they are not willing to pay the costs, then this is very good evidence that probably the water isn't worth what its costing. He cautioned, however, that there are both long term and near term transition issues in adopting a cost based pricing system. He said that if the price of water were to increase suddenly to reflect actual costs, that this would result in excess supply. However, in the long term, as populations and incomes rise, that demand will eventually catch up with excess supply. He also said that because water supply is stochastic, in that it can randomly vary from year to year, that perhaps price should also vary from year to year and perhaps according to the season.

Professor Gardner concluded by stating that some water planners incorrectly assume that demand for water is price insensitive. He said that based on his research that the elasticity of demand is somewhere between a -.5 and -.77. This means if you increase the price of water by 10 percent the water demanded would fall by 7.7 percent. He said that consumers respond to these prices and they will consume less.

Mr. Prescott asked how the state should price water to ensure that there is an adequate supply to meet demands of future growth. Professor Gardner said that there would be two way to accomplish this. The first method would be through average cost pricing where the cost of developing new water sources is included in the price that everyone pays–both old and new consumers. The second method is more efficient, but is politically difficult. This would be to require that new connections pay the full cost of developing new water supplies. He said that as income and population grows that perhaps consumers would be willing to spend more on water.

Mr. Barusch asked what would be the effect if the state were to impose the same water tax on everyone? Would this improve efficiency? Professor Gardner replied that while it is more efficient for everyone to pay the same taxes or receive the same subsidy, it still interferes with the price system as being the most efficient way to allocate resources.

Sen. Hillyard noted that most farmers would find it difficult to pay increased water prices. Professor Gardner said that under the current system the subsidized water price is capitalized in the value of the land. He suggested that you compare the value of unirrigated vs. irrigated land. He said that without the irrigaton that the land would have fewer uses and therefore be less valuable. This results in a net transfer of wealth to the owners of these agricultural lands.

Chair Cornia thanked Professor Gardner for his testimoy.

4. S.J.R. 6: Hospitals or Nursing Homes Owned by a Nonprofit Entity

Mr. Howe distributed and reviewed "S.J.R. 6 Study: Nonprofit Hospitals, IHC Hospitals" and "Selected Characteristics of Utah Hospitals 2002." He noted that in 2000, IHC Hospitals, Inc. held a 56 percent market share of the hospital industry while investor owned hospitals held about a 30 percent market share.

Mr. John Nielson, Senior Counsel and Director of Governmental Relations, IHC (Intermountain Health Care), introduced Mr. Douglas Hammer, Vice President and General Counsel, and Mr. Wes Thompson, Vice President of Mission Services which includes all charitable services. Mr. Nielson distributed and reviewed information on IHC's history as an organization, tax exemption history, charity care policy, and other issues.

Mr. Doug Hammer reviewed the questions asked by the TRC and explained how IHC is organized. He also reviewed the charity care services explaining what is considered charity care and what does not fall under charity care services.

Mr. Prescott asked whether IHC was discontinuing its participation in the state's Medicaid program. Mr. Hammer explained that was not true IHC discontinued its medicaid HMO but will still accept medicaid patients on a fee per services basis.

Mr. Wes Thompson reviewed the IHC clinics and how they contribute to overall charity care and lower cost services. He explained that these clinics keep patients from seeking routine and urgent care from emergency rooms. He said that by recruiting voluntary physicians to take patients without means to pay they are reducing the amount of charity cases using emergency rooms.

5. Other Items/Ajourn

MOTION: Mr. Prescott moved to adjourn the meeting. The motion passed unanimously. Chair Cornia adjourned the meeting at 4:45 p.m.