S. HRG. 108–457

RURAL ECONOMY, RENEWABLE ENERGY, AND THE ROLE OF OUR COOPERATIVES

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

(DALLAS CENTER, IA)

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RURAL ECONOMY, RENEWABLE ENERGY, FARMER COOPERATIVES

TUESDAY, AUGUST 26, 2003

U.S. SENATE,
COMMITTEE ON FINANCE,
Dallas Center, IA.

The hearing was convened, pursuant to notice, at 9:30 a.m, at the Heartland Cooperatives, 1107 Sycamore, Dallas Center, Iowa.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTTE ON FINANCE

The CHAIRMAN. It's my privilege to welcome you all to this hearing of the Senate Finance Committee, and I hope you folks that are sitting right in front of the fans can hear this. If you can't, there's room up here in the front row. Can everybody hear in the back okay?

First of all, I think I need to thank some people who have helped make the arrangements. First of all, this entire hearing is going to be recorded, so we have a court reporter, Amy Rose, from Cassady Court Reporting that I wanted to thank, and after some period of time—and I don't know whether it's weeks or months—but any of you who are present that would want to contact them for a printed copy of the testimony, the hearing record, and all the changes in regard to questions, you could get that from my office—or I should say more specifically the Senate Committee on Finance.

I also obviously want to thank Heartland Cooperative for their hosting this event, giving us this facility, and particularly the hard work of Dennis Meyer working with my staff to put it together.

The way a hearing normally works is I have an opening statement, then usually when there is a reason for an administration witness to testify, they testify. We have an exchange of questions, and then we have other panelists testify, and—and then we have questions of the—of the panelists.

So I have an opening statement, and then I also have a statement that my democratic colleague, the ranking democrat on this committee, Senator Baucus, asked if I would read, so I want to do both of those before I introduce our special panelists.

This is an exciting thing to have this hearing on the role of our cooperatives in the pursuit of renewable energy and the ongoing support that cooperatives need for rural economy. I thank everyone who's here today, most importantly witnesses who have had to put in a lot of extra time and work to make a meaningful presentation to our committee.

There are many provisions in the bill that are before the Senate that will help our cooperatives succeed in the versification of our energy supply. For years I have worked to decrease our reliance on foreign sources of energy and accelerate and diversify domestic energy production. I believe the public policy ought to promote domestic production of renewable energies.

Specifically, the development of alternative energy sources should insulate the United States from Middle East dominated oil supply in addition to developments of renewable energy resources, concerns, existing natural resources, and protects the environment.

Alternatively, alternative energy development also provides economic benefits to farmers wherever in the United States especially in the green growing areas of the midwest; Iowa being the most—best example. And these states at the same time warrant efforts to diversify the State's economy and define creative ways to extract a greater return from our National resources, and renewable fuels is one way of doing that.

Section 45 in the Internal Revenue Code currently provides a production tax credit for electricity produced from renewable sources including wind biomass upolstry (inaudible) waste. The energy tax incentive act that is now in conference between the House and Senate extends Section 45 credit and expands the sources of electricity to include biomass of all agricultural waste, geothermal and solar.

Since the inception almost 10 years ago of wind energy credit, nearly 4,300 megawatts of generating capacity have been installed. 40 percent of that capacity was added to this during the year 2001, the year in which the wind energy installation increased by 3,000 percent over the previous year, demonstrating, I think, significant capacity of wind to produce energy and the utilization of that. In addition, wind represents an affordable and inexhaustible source of energy. Extending the wind energy tax credit until the year 2007 would support the tremendous continued development of this renewable energy. Experts have established wind energy's valuable contributions to maintain cleaner air, a cleaner environment. Every 10,000 megawatts of wind energy produced in the United States can reduce carbon monoxide emissions by 33 million metric tons as opposed to using fossil fuels. This proposal in regard to wind also helps empower our rural communities to recontinue economic benefits. Because the installation of wind turbines has a cinative (phonetic) economic effect because it requires significant capital investment, that results in the creation of many jobs. We also have some extension of Section 45, the biomass. I'm not going to go into details on that, but all of you heard about the switch grass projects in Iowa, but that's just one of many sources of energy that we have in Iowa, sources of production. You could use saw dust, tree trimmings, agricultural by-products on treated construction costs to help make use of that energy tax credit as well, and that also produces good economic benefits. I think that for the most part I'm going to put the rest of my statement in the record rather than go through it. I think one thing that I want to emphasize though, and that is that in the energy tax bill we also have an ethanol-like incentive for biodiesel, and also don't forget in another part of the energy policy bill not coming out of my committee but coming out of another committee of the Senate, because it deals with the clean energy act, and that is the 5 billion gallon—the 5 billion gallon mandate for biodiesel. Now, I want to go through the statement that I have from the ranking Democrat, Senator Max Baucus, who I invited to be here but could not come. So this is a direct quote:

Thank you, Chairman Grassley, for holding this important hearing. I regret my schedule does not permit me to attend. However, our witnesses' testimony will be a valuable resource as we move forward with relevant legislation this fall.

America's cooperatives, in their sundry forms, are an essential element of rural economies. As these economies change, and as technology creates new products and greater efficiency, cooperatives must be prepared to adapt. Congress must also make sure that the laws governing cooperatives allow them that ability to adapt.

Rural economies and the cooperative system grew up around the traditional family farm. The average American farmer today is in the mid-fifties. As these farmers retire, fewer new farmers are lining up to take their place. These demographic changes will require cooperatives to pursue a more diverse membership and provide new services.

Greater international competition will create new opportunities but also new demands for America's farmer cooperatives. U.S. demand cannot keep up with the ability of American farmers to produce more efficiently. As a result, cooperatives must position themselves to help their producers compete globally. Value added processing and product diversity can help cooperative marketers compete with commodity suppliers that have more opportunities to source products from various markets.

Changes in energy markets and environmental regulation also pose new hurdles to rural electric cooperatives, refiner cooperatives and agriculture. The recent electricity blackout that idled much of the country has renewed attention on electricity deregulation and the security of our transmission system. Efforts to improve our electric grid must not ignore the needs for special rules for rural electric cooperatives. That's why Chairman Grassley and I have worked in the last two Congresses to establish appropriate changes to the tax code that will enable electric cooperatives to participate in updated transmission markets.

Today's hearing will focus on several areas where we can improve the tax law to address these developments and other issues facing cooperatives. The Tax Empowerment and Relief for Farmers and Fishermen Act has long been a priority for Chairman Grassley and me. Specifically, modifying the dividend allocation rule which is key to enhancing the ability of cooperatives to attract equity capital. Increased access to capital is the tool cooperatives need to make investments on a shorter planning horizon demanded by competitive markets.

The imminent repeal of the extraterritorial income exclusion provides an opportunity to focus on the challenges faced by America's producers. As we consider a replacement for ETI, I am committed to supporting tax relief for domestic manufacturers and producers. This relief should be available to cooperatives or directly to cooperative members.

New energy alternatives offer greater energy independence and new value added processing opportunities for cooperatives. That is why Chairman Grassley and I are working to improve the tax incentives for the production of electricity from renewable resources like wind and biomass, and the tax incentives for ethanol, biodiesel, and clean coal technologies. Cooperatives are key players in each of these new markets. The tax code must recognize this fact, and I will work to make sure it happens.

Finally, this hearing will also address developments in the state organizational law of cooperatives and the interplay with Federal law. These developments can have significant implications for the Federal tax law treatment of the cooperative form.

Mr. Chairman, thank you again for holding this important hearing. I look forward to our continued cooperation on these issues.

It's my privilege now to call the first witness who is already at the table: The Honorable Thomas Dorr, a native of Iowa, Under Secretary for Rural Development, U.S. Department of Agriculture. He is from Marcus, Iowa. I've known Tom for many years and am very happy that he was able to join us today, but rumor has it that he has a brand-new grandchild. I didn't know this, and he really wanted to spend the weekend playing Grandpa, so I don't blame him for that. I have several of those myself, and—and I want you to know that we appreciate you taking time out from your busy schedule to be here with us, so would you proceed.

STATEMENT OF HON. THOMAS C. DORR, UNDER SECRETARY FOR RURAL DEVELOPMENT, U.S. DEPARTMENT OF AGRICULTURE, WASHINGTON, DC

Mr. DORR. Thank you, Mr. Chairman. In fact, I do have a new grandchild, my first one, and I did have a fun weekend with her.

I'd like to thank the Chairman, Members of the Committee, on behalf of the President and Secretary Veneman. I do appreciate the opportunity to come before this committee to discuss with you ways in which the Federal Government can help farmers and ranchers and other rural residents increase their incomes and improve their quality of life through effective cooperative organizations.

I am honored at the opportunity President Bush has given me to be at the helm of a consortium of dynamic and progressive investment programs within the USDA. Rural development is really a Venture Capital Bank for rural America, and we have two primary goals: The first is to increase economic opportunity and the second to improve the quality of life for all rural Americans.

As an $86 billion bank, USDA Rural Development is by today's standards a very large bank. This year alone, we will invest nearly $16 billion in rural venture capital investments to build housing, support business development, and strengthen our rural infrastructure of community water, wastewater, electric, telecommunications, and community facilities.

Since arriving at rural development, I have quickly learned to understand the critical need to look at the effectiveness of the current cooperative model for assisting farmers and ranchers.

I believe we should move away from the decades old cooperative concepts toward a new concept of a cooperative, one that is attractive to investors. Existing tax rules applicable to investment in cooperatives need to be more flexible and favorable. As a former farmer, I realize the interpretations place and undue share of the tax burden on funds distributed as dividends to patrons. This tax treatment reduces the benefits of patronizing the cooperative and discourages patrons from seeking investments that could fund more and better services.

The traditional model and tax structure was developed with good intentions.

However, cooperatives are now struggling to convert the equity and dreams of many rural Americans into the kinds of economic opportunity they both need and desire.

We must approach economic development in rural America with the same foresight as you did when you authored the Value-Added Agricultural Product Development Grant Program.

A good vehicle to diversify farmer investment is a cooperative that adds value to the products that farmers produce through processing, distribution, and perhaps even branding. This allows the farmer to capture some of the dollars now going to the middlemen between producers and consumers. At the end of this calendar year, nearly $100 million of these value-added grants will have been invested in these value-added ventures, including nearly $10 million for Iowa ventures alone.

To build upon your efforts, USDA Rural Development announced yesterday over $21 million in renewable energy and energy efficiency systems improvement grants, which were authored by your Iowa colleague on the Senate Ag Committee, Mr. Harkin, to help improve energy efficiency and create new renewable energy ventures.

As Under Secretary, I will be looking at ways to increase profitability for producers who use cooperatives as an investment vehicle. If we begin to look at cooperatives with the idea that they can serve not only as a form of security, but also as an investment vehicle that pays dividends to its members—one that is focused on creating an acceptable return on investment—we will have gone a long way to strengthening rural America.

Let me add that as a farmer, I understand that we probably can't get much better at farming. However, perhaps we could do better at investing.

Most farmers have not used their asset base—their land—to its maximum return. Instead of just rolling that capital into the relatively low returns from farming, perhaps we could figure out ways to move some of their capital into other areas. This would simultaneously raise farm incomes and enable more farmers to stay on the farm.

Today's cooperatives, like much of rural America, are facing serious challenges. They have equity needs and the companies they buy from and sell to are becoming larger, fewer in number, and more sophisticated at reducing costs and improving returns within their industry sector which can impact other participants in these industries.

Sweeping innovations in areas such as biotechnology, information services, and transportation have made many cooperative facilities and equipment obsolete. Foreign countries are using our technology to become lower-cost producers of the same products we produce in rural areas. They are being—They are becoming competitors rather than customers.

Mr. Chairman, I believe we should move away from the decades old cooperative concepts toward a new concept of a cooperative, one that is attractive to investors. Existing tax rules applicable to investment in cooperatives could be more flexible and favorable. Current Tax Code interpretations appear to place an undue share of the tax burden on funds distributed as dividends to patrons. This tax treatment reduces the benefits of patronizing the cooperative and discourages patrons from seeking investments that could fund more and better services.

My written testimony which I have submitted for the record provides a more in-depth assessment of my views related to improving the ability of our farmers and ranchers to utilize a cooperative structure, that with the right tax incentives, can improve their profitability and the quality of life for their rural family members.

Mr. Chairman, I want to offer my personal appreciation to you and to the Committee's Ranking Minority Member, Senator Baucus, for having spearheaded a bi-partisan effort to secure enactment of legislation covering these and other issues of importance to cooperatives. Rural Development stands ready to offer whatever we—whatever support we can to proposals that improve the business environment for cooperatives and rural America.

I would be happy to answer any questions you may have at this time. Thank you.

The CHAIRMAN. Let me suggest—and generally this doesn't happen at a field hearing like we're having a hearing outside of Washington, but each of you who have testified, including you, Mr. Dorr, might expect questions in writing from other members of the committee who can't be here, and if you do, we generally would like to have those back in a couple of weeks so we can complete the record. So you could get some questions in writing, I suppose even from me, but hopefully we have time to go through all the questions that I wanted to ask.

A challenge that faces cooperatives is developing programs to stimulate exports. Past efforts have sometimes placed cooperatives at a disadvantage by not taking into account unique tax rules that apply to cooperatives. Whatever we do next in this area, Mr. Dorr, do you think that it's important to make sure that the same treatment be available to cooperatives that are provided to other tax payers?

Mr. DORR. I certainly do, Senator Grassley. I think it's commonly understood that nearly one-third of all agricultural crop production in rural America is dependent upon going into the export market, or a good share of it is, and nearly one-third of all rural American jobs are dependent upon exports. I believe we now determined that about one billion dollars of exports are equivalent to 15,000 jobs or the development of 15,000—or sustained 15,000 jobs, so it would appear to me that any treatment that is provided for foreign sales to anyone should be made available to the cooperative sector as well.

The CHAIRMAN. Your statement describes very constructive new initiatives that Congress authorized and that the rural development mission area is implementing to stimulate production of energy for renewable sources. What else can we do, particularly this Committee do, to expand the production and use of renewable energy?

Mr. DORR. Well, an interesting component of the 2002 farm bill was the new energy title in Section 9, and one of the components that we were responsible, Section 9006, which was the renewable energy grants that I just mentioned, has a direct implication in this area. What we did when we looked at that, given the fact that there were a number of other initiatives going on in the Federal government, the first thing we did was to attempt to get all the agencies involved to collaborate and to work together to develop the rules so that these new energy opportunities might be leveraged more effectively across all programs. And in that vein when I got the group together that was to develop the rules, I made the observation that we needed to take into consideration two things as we looked at developing the programs that were responsible for stimulating renewable energy. One was I hoped that we would look at it from the perspective of how to develop the kinds of tax credits and incentives or to allow our rules to attach themselves the appropriate tax credits and incentives that would allow these industries to grow. Typically farmers are tied to traditional production subsidies. This is not a traditional way in which we think outside of the tax credits that we've been given in the ethanol production area.

And the second area that I asked them to do, and I think is critically important and is reflected in—in a number of the power outage issues that have impacted this country in the last ten days, is that we need to look at ways to make sure that our programs accommodate and adapt to the regulatory schemes so that we can attach these renewable energy initiatives and particularly those that lend themselves to short grid distributive systems like wind power or like anaerobic digestion that may work into a short grid distributive system. So we designed these programs so that they accommodate those kinds of rules and regulations in these states as well, and if we're cognizant of that, I think we can go a long way toward that effort.

The CHAIRMAN. I would like to ask what you're doing, or through your agency, and also what else can we do through your agency to help increase the use of renewable sources for electric power generation, that would be in addition to some tax credits that obviously are out there?

Mr. DORR. Well, I would just simply reiterate what I—what I just laid out, is the need for us to make sure that the programs that we are given the ability to implement from Congress by—by acts of Congress are able—that we have the statutory language to accommodate these start-up enterprises in ways that recognize that they're going to have some developmental time frames that will enable them to—to essentially get imbedded into the system.

I think we need to recognize that the ethanol industry, although it is truly recognized as a commercialized industry today, it really took us about 20 years to get over the research and development curve. And given those lists of experiences, I would hope that as we develop these new renewable energy opportunities, we can circumvent that 20-year time frame, hopefully shorten it up.

The CHAIRMAN. Okay. You've also commented favorably on some tax changes I've proposed to mitigate the impact of EPA sulfur reduction mandates and gasoline and diesel fuels on rural refineries. The importance of that to the rural economy as you see it from your agency?

Mr. DORR. As you know, Senator, rural development is involved as—as one of our mission areas incorporates the rural business cooperative service, and we do a lot of analysis and evaluation of what is going on in the cooperative sectors. One of the things that we do know, there used to be, I believe, as many as perhaps 20 cooperative-owned refineries. We're now down to four in this country. The cost to retrofit them to lower the sulfur emissions and diesel fuel has put a great deal of financial pressure on them. I believe we now have four refineries that produce somewhere in the realm of 2 to 3 percent of the total refined petroleum products nationally, but they provide nearly 50 percent of the all the petroleum products made available to production agriculture.

So we have to be very careful as to how we approach these issues in order that we don't preclude that supply and—and recognize the implications that may occur if we don't have some—some accommodation in this area.

The CHAIRMAN. I've heard you talk about one of your priorities there at the agency is to look at effectiveness of the current cooperative model in meeting the needs of farmers and ranchers. I would like to have you give our Committee more details about how that perception of cooperatives might change. And in regard to that, I know that a couple states like Wyoming and Minnesota have—have allowed limited-liability companies to be like cooperatives and things of that nature.

Mr. DORR. You have an esteem panel over here I think who are—is going to be able to give you, I think, probably as much or more insight than I later on this morning, but the evolution of new generation co-ops is kind—is what they're known as in a generic term.

Frankly, as a result of the—the inability of the traditional Capper-Volstead Act Beneficial Interest Co-op to put itself in a position to build the kind of equity or asset base it needs on anything other than a debt mechanism, and consequently I think that we need to recognize that on the one hand we have an incredible asset base in rural America. I believe the commonly understood number today is that we have about a percent debt-to-equity ratio in rural America, so we have an extensively under-leveraged land base, and realizing when I say that that there's some risk when people reflect back on the ag crisis of the '80's when we were excessively leveraged.

But the other aspect of this is the co-ops are the only really recognized traditional institution in rural America in which producers and rural families feel comfortable investing through. What we need to focus on, in my view, is to consider ways to both allow the institution of co-ops as is being done in Wyoming and Minnesota, as was done in some 1996 legislation in Iowa, the ability to—to aggregate equity in manners in which these benefits flow back to the patrons in a more effective basis without requiring the cooperative structure institution itself to build all of this on a debt base, and I think if we can focus on those efforts—and I know a number of you other panel members will talk about that this morning—we can go along way toward resolving some of these issues.

The CHAIRMAN. You may have just touched on this a little bit now, but let me ask you to elaborate a bit more on what changes in the overall system would be beneficial to cooperatives?

Mr. DORR. Well, I think I touched on it generally speaking, and the real issue is to take a look at a number of these tax issues and other flow-through issues and mechanisms that impact the ability of cooperatives to actually aggregate equity, investment equity, through not only patron members but perhaps even non-patron members were required. I think that would help a great deal.

The CHAIRMAN. And then lastly, would you have any comment on what the Senate has already passed and hopefully survives Congress, which is energy bill concerning renewable fuel sources, in other words, changes in tax law that would influence renewable fuel sources?

Mr. DORR. I don't know that—at this point what the administration's position is on it, so I can't speak for the administration, but my view is I think—personal view is I think that what you're doing there makes a lot of sense, but I'm—I'm not exactly—I haven't got the final read on the administration's view, and—and that's probably as far as I should go at this point.

The CHAIRMAN. Well, let me help you out. One of the things that the President—I can tell you what the President's told me, but it's kind of a funny way of putting it, but he said that he learned from campaigning in Iowa two words. Well, I came into the White House one time, and he says "Can I get you something to drink? You want some pop, don't you?" He says, "I learned two words in Iowa, 'pop' and 'ethanol.' " So at least that's one source of renewable I don't think you have to worry about speaking out for the administration before you get clearance.

Mr. DORR. Well, I—I will assure you that I did have a little—little impact on helping him learn the word ethanol so——

The CHAIRMAN. Okay. You sure did. Well, listen, I thank you very much, and traditionally people like you are so busy you have to go. I don't know what your schedule is now, but I want you to know——

Mr. DORR. I'll stay right here.

The CHAIRMAN. Thank you for staying. I appreciate that. I wasn't going to ask you to stay, but I was hoping you could stay, because there might be some comments that we could ask you to make after our next panelist. And I think for the benefit of my audience, I need to give a fine introduction to each one of our panelists, and I'm going to go through the entire panel, and I think you're seated in the way that I'd like to have you testify.

So I understand your name is Geu?

Mr. GEU. That's correct.

The CHAIRMAN. Or Geu?

Mr. GEU. Geu is really the American derivation.

The CHAIRMAN. Okay.

Mr. GEU. That's what we go by here.

The CHAIRMAN. Okay. Professor Tom Geu is Professor of Law, University of South Dakota, but most importantly he is also the reporter for the National Conference of Commissioners on Uniform State Law. He will be reporting on their new uniform law project for cooperatives.

Then we have Regi Goodale. He graduated from the University of Northern Iowa, my alma mater, and currently serves as Director of Regulatory Affairs, the Iowa Association of Electric Cooperatives.

And another person I've dealt with frequently, John Campbell, Vice President of Governmental Relations and Industrial Products for Ag Processing, Inc. Prior to joining AGP, John served as deputy under secretary international affairs and commodity programs of the Department of Agriculture. He'll be discussing international exports and cooperatives.

And then we have Josh Blaisdell of CHS, Inc. formally known as Cenex Harvest States. Josh is Director of Tax at CHS and will be discussing the refiner cooperative legislation and the dividend allocation rule.

The last witness will be Bob Dinneen, another person in an organization representing that I've had much to do with, because he is now the president and CEO of Renewable Fuels Association and the National Trade Association for the ethanol industry. Bob and his organization have been invaluable in helping coordinate all of the many changes needed to simplify ethanol excised tax proposals. I know after the hearing that he would be happy to talk to any of you, if you want to stay around, about some exciting new changes.

So in that order, Professor, would you please go ahead.

STATEMENT OF THOMAS EARL GEU, PROFESSOR, USD SCHOOL OF LAW, SERVING AS REPORTER FOR NATIONAL CONFERENCE ON COMMISSIONERS ON UNIFORM STATE LAWS, VERMILLION, SD

Mr. GEU. It would be my pleasure. Mr. Chairman, Under Secretary, other participants, my name is Tom Geu, and I'm professor of law at the University of South Dakota. It is indeed a privilege to testify as reporter for the Drafting Committee on Uniform Business Cooperatives of the National Conference Commissioners on the Uniform State Laws, the acronym known as NCCUSL. The drafting committee was approved just this month by the conference based on the recommendation of a study committee for which I also served as Reporter. The scope of the drafting committee is currently limited to new generation agriculture cooperatives whose structure is more conducive to value-added processing. Its goal is to draft Uniform Cooperative Act for promulgation to the individual states for adoption as state law. The promulgation of a uniform act will take at least 2, and likely 3, years. The NCCUSL procedure is more comprehensively introduced in appendices A and B submitted with this testimony.

The state organizational law of cooperatives is influx. The Wyoming Processing Cooperative Law went effective in 2001; the Minnesota Cooperative Associations Act was passed just this past legislative session; and an act similar to the Minnesota Act was introduced in the Wisconsin Legislature. An industry group has also been studying this issue in Iowa. The NCCUSL study report highlighted the economic development success of the several new generation cooperatives, one of which was Dakota Growers Pasta Company, a cooperative from Carrington, North Dakota. The Dakota Growers provides a case study for the positive development possible through the use of cooperatives and was used solely for that purpose in that NCCUSL Report. It might be an example too of the restrictions of the current cooperate structure, because in July 2002 it converted from a cooperative to a business corporation.

According to a story in the *Grand Forks Herald* on April 7, 2002, which purports to quote SEC filings: The change would enhance the possibility of relationships with strategic partners, would improve the liquidity of the corporation's capital stock. Conversion will afford greater access to capital markets, which may allow it to expand its business over time.

The document says the company is unlikely to obtain significant additional capital from its current members or other durum wheat producers and has been having difficulty getting durum, a consequence of—in a short-term of widespread disease problems in the North Dakota crops.

In the last 3 years, the company has relied on non-members for durum but doesn't say how much. The co-op maintains it hasn't run afoul of Federal income tax rules but acknowledges concerns.

In addition to the new Wyoming and Minnesota Cooperative Acts, several states, including Colorado and Iowa, have reportedly consolidated some of the various special purpose cooperative statutes into a more coherent and centralized legislative scheme in the past decade. In the '80's and '90's, Minnesota, Colorado, Ohio, Iowa redrafted their cooperative statutes. The recodification of Minnesota's cooperative statutes in 1989 was constructed: In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute.

The organizational law of cooperatives is traditionally state law as is, of course, the law of business entities generally. Just as obviously, however, Federal law is undeniably important in the law of cooperatives just as it is in the larger scope of business entities. Particularly in the area of cooperatives, state law is developed in the context of Federal law and policy concerning taxation, security regulation, antitrust, finance, and provision of both direct and indirect government services.

The law of cooperatives, therefore, develops in a coevolutionary environment. That is, the environment in which individual coops are built and operate on a legal infrastructure that results from the interplay of both state and Federal law.

Wyoming enacted a "Wyoming Processing Cooperative Law," as I stated in 2001. The impetus of the Wyoming law was from lamb producers in Wyoming and adjoining states. Its purpose was to allow the producers to "acquire lamb meat, wool and pelt processing and marketing businesses to make lamb production more marketable on a cooperative basis." It was drafted to allow for partnership taxation or, at the discretion of the particular entity, to elect corporate taxation and thereby be eligible for Subchapter T and, perhaps, Section 521 tax treatment as cooperatives.

As a result, the Wyoming Act is more flexible than traditional cooperative acts and gives far more freedom to the organizers in their entity documents than typically afforded under traditional cooperative statutes.

The "New Generation Cooperative" is the favored form of new cooperatives. NGCs include some combination of features not typical of traditional cooperatives. A list of nontraditional features include appreciable equity shares which may or may not be transferable; limited but real opportunity for outside equity investment; legally binding delivery contracts or uniform grower agreements which may or may not be transferable; minimum up-front equity investment by members, closed memberships, and a way for members to redeem, transfer, or otherwise recognize the appreciation of their equitable shares. All these features reflect theoretically identified economic inefficiencies in the operation of traditionally organized cooperatives.

Indeed one of the primary driving forces for NGCs is the need for equity capital to build capital intensive processing and manufacturing facilities like ethanol plants. The adoption and use of nontraditional features by cooperatives often requires organizing under state LLC laws currently rather than under state cooperative laws and being taxed as a partnership rather than as a cooperative under Subchapter T of the Internal Revenue Code. Research published in the American Journal of Agricultural Economics gives empirical credibility to these theoretical but obviously observable demands on cooperatives.

These features, however, are not necessarily consistent with cooperative values as described by the Rochdale Principles in the 1800's, and organizing cooperatives under state LLC laws comes with some transactional costs and risk born of uncertainty caused by differing definitions of cooperatives between and among laws at the state and at the Federal levels. It also raises issues about registration of nontraditionally organized co-ops doing business in states other than their state of organization.

And I think there is evidence too of a worldwide recognition of the growing importance of cooperatives, their potential, and the challenges confronting them today. The appointment of a drafting committee by NCCUSL evidences this importance, and it is hoped the resulting uniform law will help cooperatives respond to these challenges and continue to be a source of economic development through a modernization and unification of state law. Many of the challenges faced by co-ops today, however, are matters of Federal law and policy as well.

Thank you for the opportunity to testify. I welcome any questions you may have now or later.

The CHAIRMAN. It will be later when we get done with all the panelists.

STATEMENT OF REGINALD V. GOODALE, DIRECTOR, REGULATORY AFFAIRS, IOWA ASSOCIATION OF ELECTRIC COOPERATIVES, DES MOINES, IA

Mr. GOODALE. Good morning and thank you, Chairman Grassley and Members of the Committee. I am honored and privileged to be able to address the United States Senate Finance Committee. My name is Regi Goodale, and I am here today representing the Iowa Association of Electric Cooperatives. The IAEC is a trade association representing electric cooperatives in Iowa. On behalf of the member electric cooperatives and the approximately 200,000 homes, farms and industries served by Iowa's electric cooperatives, I would like to express our appreciation for the opportunity to present information on this very important topic. I am employed by the IAEC as the Director of Regulatory Affairs.

Iowa's locally based, not-for-profit RECs provide electric service to their member-consumer owners in 99 counties within the state of Iowa. Based on kilowatt hours or revenues, Iowa's RECs serve about 15 percent of the $2.7 billion dollar electric market in Iowa.

Iowa's RECs are working hard to provide safe and reliable electricity in a very environmentally responsible manner while at the same time keeping the electricity affordable for member-consumers. Providing environmentally responsible power comes in many forms.

Electric cooperatives are involved in a multitude of activities relative to renewable energy in providing electric service to their member-consumers.

Some of the renewable technologies that have been deployed or are being researched include: Geothermal, wind, hydro, biomass including methane, corn, and biodiesel.

Electric cooperatives in the northeast part of the state led the state in first offering customers the option to purchase green energy through green pricing programs. This is merely one example that demonstrates how Iowa's electric cooperatives are member-consumer controlled and service-driven organizations. In 2004 all of Iowa's electric cooperatives are expected to be offering green pricing programs to their member-consumers.

Some cooperatives are investing directly into renewable projects by owning the generators, while others are investing in renewable projects through partnerships with other entities. Yet, others are establishing funds to allow for the promotion of renewable technologies owned by consumer-members. Another is investigating the purchase of renewable fuel products to be used in generators owned by the cooperative.

Flexibility with partnerships as well as approaches in finding cooperative solutions is paramount to moving forward as we see the electric industry change. Providing for tradable tax credits is certainly something that would add to this flexibility in partnerships as well as approaches.

The Energy Tax Incentives Act makes tradable tax credits available to electric cooperatives enabling us to also utilize the financial benefits.

Many rural electric cooperatives do not have sufficient Federal income tax liability against which to apply a tax credit. Therefore, in order for Congress to provide rural electric cooperatives with useful incentives, we will need the ability to trade or sell our tax credits to private entities that can utilize them.

Because renewable energy sources and environmentally clean, advanced fossil fuel technologies usually are more expensive to operate than traditional sources, the Federal Government has made it a policy to provide investment incentives to encourage investor-owned utilities to build these facilities. The rewards are cleaner, more secure, independent, and diverse energy sources. Without comparable incentives, rural electric cooperatives are not afforded the same opportunities to make these investments.

Additionally, electric cooperatives have in place a streamlined process for the interconnection of member-owned renewable facilities.

Electric cooperatives have a strong commitment to education, and the IAEC has also been working with our member cooperatives and the member-consumers with regard to renewable energy. We've also partnered with the Iowa Farm Bureau in educating our members about opportunities under the Federal farm bill related to renewable energy as well as energy efficiency.

While renewable resources certainly have economic impacts on the rural economy, other aspects of the electric cooperatives' business also have impacts. One critical area is the efficient use of energy. Iowa's electric cooperatives are investing about six-and-a-half million dollars per year in energy efficiency in some 27 different programs. This annual investment has a significant environmental as well as economic impact on the local communities that we provide service in. Iowa RECs are also involved in a multitude of other rural economic development activities through alliances such as the Iowa Area Development Group and participation in the rural economic development loan and grant program.

This overview should give you an idea of some of the activities related to renewable energy and the rural economy that RECs in Iowa have been deploying to deliver electric service. Iowa's locally based, not-for-profit RECs are committed to providing safe, reliable, environmentally responsible and affordable service to member-consumers.

We do appreciate the efforts of Chairman Grassley and others in working to make the tax credits tradable as this will provide another potential option.

Thank you for the opportunity to appear before you today. I would be pleased to answer any questions.

[Short break.]

[The following portion of the hearing was tape-recorded and transcribed at a later time.]

The CHAIRMAN. I think we'll go ahead, and so I'll ask Mr. Campbell to proceed.

STATEMENT OF JOHN CAMPBELL, VICE PRESIDENT OF GOVERNMENT RELATIONS AND INDUSTRIAL PRODUCTS, AG PROCESSING, INC., OMAHA, NB

Mr. CAMPBELL. Thank you, Mr. Chairman, and good morning. We very much appreciate the opportunity to testify before the Finance Committee here in Iowa. It's kind of ironic, it took me about as much time to get over here from Omaha as it does to get to Washington from Omaha Midwest Express. I guess I just don't drive fast enough, even though I had soy diesel in my truck this morning.

AGP, as you know, is a regionally federated co-op. We have about 260 members heavily concentrated in Northwest Iowa. Heartland Co-op is an important member of ours. Our primary business is soybean processing and vegetable oil refining, but we are in the ethanol and the biodiesel business. We constructed the first biodiesel plant in the country really, in Sergeant Bluff, Iowa.

My mission today is to talk about the FSC/ETI issues and the importance of those fixes to the agricultural community and to co-ops in particular. Farmers manufacture and market their products through cooperatives. Cooperatives are member-owned corporations formed under Subchapter T.

Cooperatives determine their taxable income at the entity level like any other corporate taxpayer. They're treated much like L.L.C.'s and partnerships for purposes of taxes, but they're eligible to claim deductions from taxable income for certain distributions to their members in the form of qualified patronage dividends, per-unit retain allocations and certain other items.

The FSC Replacement and Extraterritorial Income Exclusion Act provides that gross income for U.S. tax purposes does not include extraterritorial income. The ETI act allows a cooperative to exclude percent of its qualifying foreign trade income from gross income and to pass the ETI exclusion through to its members.

The World Trade Organization, in response to a request by the European Union, held in a decision on January 2002 that the ETI Act and the remainder of FSC violated the terms of various trade agreements.

Legislation has been introduced, and I know you're considering fixes to this situation, despite the U.S.'s strong objections that our regime was legal. But we do have to fix it. The purpose of the fix has been to offset the tax advantages enjoyed by the EU and other foreign producers who compete directly with U.S. producers. Those EU tax advantages consist of lower corporate tax rates, rebates on the value-added tax, territorial tax systems, and other subsidies. The effect of these foreign tax regimes is to provide a significant competitive advantage to foreign producers. It's therefore imperative that any measure to repeal FSC/ETI offset the resulting tax increase on domestic producers by an equal or greater reduction. Otherwise the repeal will reduce the earnings of the U.S. producers.

Cooperatives are essentially passthrough entities, and as such they generally have no taxable income except for our nonmember business. They are permitted a deduct from taxable income in the amount of their distribution to members.

Consequently, something known as the Crane-Rangel Bill or any similar legislation that creates a deduction or credit based on taxable income must provide special rules regarding the treatment of co-ops.

For example, the Crane-Rangel Bill or any similar legislation should provide that, for purpose of calculating deduction with respect to domestic production, taxable income is not reduced by the amount of any patronage dividends or per-unit retain allocations of a co-op.

In addition—and this is very important—the definition of "manufacturing" should look through to the patron producer. For cooperatives involved in grain operations, like Heartland and AGP, it would be necessary for elevation, storage, handling, drawing, cleaning or other typical grain activities to be considered eligible "manufacturing of production activities" as was the case for the investment tax credits.

Furthermore, in order to provide a patron-level benefit similar to that provided under ETI, it is necessary that legislation provide distributions received by a patron or member of a co-op which is allocable to the cooperative's deduction for qualified U.S. activities may also be treated as a deduction of the patron or member, and, thus, deductible against the gross income of the patron or member.

Finally, in conclusion, the transition provisions of the Crane-Rangel Bill or any other fix should be amended to clarify that the amount of any patronage dividends or per-unit retain allocation received by a patron or a member of an ag co-op which is allocable to the cooperative's transition amount is treated as the transition amount of the patron or member and thus is excludable from the gross income of the patron or member during the transition period.

We appreciate all the work that you and your staff have done on this issue. We know it's complicated, and we're just pleased someone is looking out for the co-ops and for agriculture in this transition. Thank you.

The CHAIRMAN. Thank you very much, Jeff.

Proceed, Mr. Blaisdell.

STATEMENT OF JOSH BLAISDELL, DIRECTOR OF TAX, CHS, INC., ST. PAUL, MN

Mr. BLAISDELL. Thank you, Mr. Chairman. We appreciate the opportunity to speak today on tax issues affecting refiner co-ops. We know firsthand based on many years of working with the Congress, in particular with the Senate Finance Committee and you, Mr. Chairman, that you do listen to co-ops, you appreciate co-op input, and do actually incorporate co-op input into many tax bills.

My name is Josh Blaisdell, Director of Tax at CHS. CHS is a regional cooperative owned by 325,000 members. We have over 3,800 member cooperatives and affiliated facilities primarily in 28 states from the Great Lakes to the Pacific and from the Canadian border to Texas. Iowa is our third largest state with 339 system locations, and we are the second largest employer in Montana.

Today there are four refiner co-ops in the United States that collectively sell over 90 percent of the petroleum products that they make to farmers and local cooperatives. These products touch over 1.1 million farmers annually. The value of refiner co-ops to agriculture is well understood at USDA, especially by the office of rural development led by Under Secretary Tom Dorr.

The value of refiner co-ops is also well understood in Congress, especially in the Senate Finance Committee. For the past several years the Committee leaders have been promoting major tax assistance to all cooperatives.

I would like to touch on three pending bills and their role in helping co-ops. The Tax Empowerment and Relief for Farmers and Fisherman Act, or TERFF, has 13 items keyed on reducing the burdens of our tax system on farmers and cooperatives. Among those items are provisions that permit risk management accounts, exclude rental income from self-employment tax, and coordinate income averaging with the alternative minimum tax. We see the bill as an important vehicle to address farmer issues and some cooperative issues. 785 includes a provision that would repeal the dividend allocation rule or DAR. The DAR is a tax rule that creates an additional tax for cooperatives that pay a dividend on their capital stock. When a cooperative pays a dividend on its stock, the amount of the dividend is allocated between the cooperatives patronage and nonpatronage operations. The portion allocated to the patronage operation reduces the amount of the patronage dividend tax deduction. This allocation generates an additional tax on the cooperative's patronage earnings. Similar to seed corporations, the cooperative and its shareholders are already subject to a double tax on nonpatronage earnings. This additional tax created by the DAR is in essence a third tax on co-ops.

The elimination of the DAR would have a significant impact on CHS and other co-ops that currently offer preferred stock to the public. We recently offered $88 million in 8 percent preferred stock to the public, and the dividends that we will allocate to our patronage pools on this stock this year are going to be almost $5 million. This produces an additional tax on CHS of almost $2 million per year and will significantly reduce the amount we will pay our members in patronage.

Passage of the bill will increase our patronage distribution by the amount of dividends we currently allocate to our patronage pools and reduce our tax burden at the cooperative level. This means that real money will be kept in the cooperative system for our members.

A third example of tax help for refiner co-ops is found in both the senate and house versions of the 2003 Energy Bill. We are particularly interested in the tax help for all small refiners since we must incur cost to remove over 95 percent of the sulfur from diesel fuel to make the new ultralow sulfur diesel. The small refiner tax provisions include an expensing option that allows us to accelerate the write-off of those costs. They also provide a 5-cent per gallon tax credit for producing the ultralow sulfur diesel.

Passage of the provisions will ease the burden CHS and the National Cooperative Refinery Association face when they incur over 450 million dollars in gas and diesel desulfurization compliance costs in the next few years.

In summary, repeal of the DAR will provide cooperatives access to new untapped sources of capital as well as provide an opportunity for farmers and local cooperatives to reinvest in their systems. Repeal of the DAR provides refiner co-ops a new arena to find funding for their low sulfur diesel capital improvements. The credit and expense provisions of the energy bill allow refiner co-ops the ability to recover the costs of those improvements. These provisions significantly reduce the costs of funding these improvements allowing refiner co-ops to return more cash to local cooperatives and farmers through increased patronage distributions. Together they provide much-needed help to a diminishing pool of refining co-ops.

Thank you for your time today, and most importantly thank you for helping the cooperatives.

The CHAIRMAN. Thank you very much. Now we'll hear from Bob Dinneen. Then I'll have some questions to ask.

STATEMENT OF BOB DINNEEN, PRESIDENT, RENEWABLE FUELS ASSOCIATION, WASHINGTON, DC

Mr. DINNEEN. Good morning, Mr. Chairman.

The CHAIRMAN. Good morning. How are you doing?

Mr. DINNEEN. I'm doing great. I thought there was only hot air in Washington, DC.

Mr. Chairman, thank you for the opportunity to testify this morning at this important hearing.

Clearly tax policy is critically important to rural economic development and growth. Thank you as well, however, for your leadership and continued commitment to increasing the production and use of renewable fuels like ethanol and biodiesel, for your efforts to encourage farmer ownership in ethanol production facilities, and all that you do to promote value-added agricultural.

I can assure you that your vision of a more sustainable energy future will benefit not just Iowa but every American as we become less dependent on imported energy, as we become more environmentally secure, and as we become more economically sound. I can assure you that your efforts to restructure and streamline the tax code for renewable fuels that you have worked on so hard with Senator Baucus is perhaps the most important legislation affecting renewable fuels since the Energy Tax Act of 1978, but I get ahead of myself.

Mr. Chairman, first I want to tell you that the U.S. ethanol industry, as you know, is growing at an incredible pace. Since the last time that I was privileged to testify before the Senate Finance Committee, the ethanol industry has opened 20 plants. Indeed, since President Bush denied California's request for a waiver of the oxygen requirement in federally-formulated gasoline, the industry has added more than a billion gallons of production capacity because that denial sent such a strong signal to our industry that the demand for ethanol was going to grow as MTBE came out of gasoline. It was a seminal moment in the industry's history.

We now have 73 plants across the country, 12 of them in Iowa. There are 13 plants under construction, four of those are in Iowa. We anticipate producing almost three billion gallons of renewable ethanol this year, processing more than a billion bushels of grain. The industry has grown at an unbelievable pace. We want to see that growth continue, and we believe that it can.

The fastest growth, the most significant growth, has been in farmer-owned ethanol plants. Indeed, the single largest ethanol producer in the country today as a whole as an entity is the farmer-owned ethanol facility, and most of the growth in the industry continues to be in farmer-owned plants, farmer cooperatives. We want to see that continue, because the economic benefits of farmer-owned facilities are just tremendous.

Last year we did a study of what the economic impact of a 40-million-gallon, farmer-owned facility would be to local economies, because that's the way most of the industry is growing, and what we found was nothing short of extraordinary. One single 40-million-gallon ethanol facility generates $4 just during the construction period in a local area that's between twelve and eighteen months. Once that plant is up and in operation, it's generating $59 in economic activity—I'm sorry—$59 just in outlays for its daily operations which generates $110 in economic activity in that local community. Farmers will realize a 5- to 10-cent increase in the price of grain in the radius around the facility, and that's on top of the 30 to 50 cents USDA estimates is the increase in corn price attributable to one billion bushels of corn used in the production of ethanol today.

Ethanol is not a terribly labor-intensive industry, probably 40 jobs associated with a 40-million-gallon facility, but because of the economic activity associated with that plant, it's generating 694 jobs nationwide as a result of that one facility. That one plant is generating $19 in household income to a local community whether it's Galvo or Marcus, Iowa or any of the other places these facilities are being built, and that, in turn, is generating increased local income taxes.

The study indicated that $1.2 million in increased local taxes is attributable to an ethanol facility. Well, Mr. Chairman, that's teachers, that's fire and safety, that's infrastructure, that's improving the quality of life in these rural communities.

We believe this kind of growth can be sustained, and we want to work with you to assure that it is. We've got a couple of proposals that you're working on, and we want to encourage you and

Senator Baucus and the Committee and the Senate to make sure they become laws this year.

The first is, as mentioned, S. 48, the Volumetric Ethanol Excise Tax Credit that you have introduced with Senator Baucus. It's seminal legislation. It eliminates any impact whatsoever of the renewable fuels tax credits on the Highway Trust Fund which is a very important issue for states and localities that want to build infrastructure.

We believe that sound energy policy, sound economic policy, sound environmental policy ought not be mutually exclusive of this country's interest in roads and infrastructure. Your legislation accomplishes that. It makes sure that the Highway Trust Fund is not impacted whatsoever by our efforts to encourage the increased production and use of fuel ethanol. It also provides a great deal more flexibility to refiners to utilize ethanol in any blend levels that they want so they are not constrained by now antiquated Clean Air Act requirements. If they want to blend ethanol at 4 percent or 6 percent or 8 percent, they can do so as a result of the flexibility that your legislation has provided.

It eliminates any potential for waste fraud and abuse because it tracks so closely with the way gasoline taxes are collected in the gasoline distribution system. It accelerates the refund mechanism for gasoline marketers so it makes it much easier for them to gain access to the incentive, and it eliminates the need for the alcohol fuels credit and the limitations that are attended with that in terms of alternative minimum tax and others such that E 85 which right now has to utilize the alternative fuels credit can now gain better access, and the economics of the E 85 are going to be greatly enhanced by this legislation.

It's a tremendous piece of legislation. I certainly commend your staff, Senator Baucus, but most certainly yourself in introducing it, and I hope that we're able to get this done as part of the energy bill.

Secondly, the small producers tax credit clarification that you've been working on for some time is a critical component to assure the continued growth in small ethanol-producing, farmer-owned facilities.

As you know, when the small producer tax credit was created in 1990, as you worked on it, I don't think we anticipated the growth in farmer-owned facilities that we have seen, and unfortunately the act didn't accommodate that, and so the farmer-owned facilities now are discouraged by the act such that they cannot pass along the benefits of the small producer tax credit to their members.

Legislation that you have worked on and that has passed the United States Senate now three times addresses that situation such that the tax credit can be allocated amongst the farmer members. It also recognizes that the industry is continuing to grow, and the facilities, even small facilities, are getting larger, and it increases the definition of a small producer from 30 million to 60 million gallons.

It's critically important legislation, and I certainly hope that we are able to get that on the President's desk and signed into law this year, and I know that with your leadership it will be.

Finally, we continue to support the dividend allocation rules that you have proposed. Our industry is growing. It's very capital intensive, and the access to capital that those revisions will allow are indeed very critically important also.

Mr. Chairman, you need not look any further than today's headlines to see the efficacy of your efforts to promote the increased production and use of renewable fuels like ethanol and biodiesel. We have 200,000 troops in the Persian Gulf today. Rural economies continue to suffer, and in today's headline gas costs now are a record $1.74 a gallon.

We don't need to be as dependent as we are on imported energy. We can add to domestic supplies of energy through the increased production and use of renewable fuels like ethanol and biodiesel, but we need to start now to accelerate that growth.

And I know again with your continued leadership, with your continued commitment, we are going to do that.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you, and I appreciate your recognizing my commitment, and obviously, I intend to keep working in that direction.

Now I have questions of each one of you, and I want to encourage other people that I may not direct the question at, if you have something to add, I'll be glad to entertain your supplementing the person I direct the question to. I think I have enough time to get the question through here.

[Off-the-record discussion.]

The CHAIRMAN. I'm going to ask my first question of Mr. Blaisdell. Does CHS benefit from the current ETI exclusion that Mr. Campbell discussed? Do you agree with Mr. Campbell that a manufacturer exclusion could operate as an appropriate replacement for co-ops?

Mr. BLAISDELL. Yes, Mr. Chairman. CHS does currently benefit from the ETI exclusion. We generate about a two and three quarter million dollar benefit annually from this exclusion. The manufacturer's—The manufacturer's exclusion that Mr. Campbell laid out, that would also work for us, provided some things happened to that to enhance things for cooperatives. That would be—co-ops would have to be able to pass through what they can't use as far as that exclusion to their patrons. I think you would have to expand the definition of "production," and I think the way the bill is currently worded, it doesn't really specifically address a cooperative like CHS; it really addresses producers, which is very good, but we have to recognize that there are downstream processing activities such as elevators and transportation facilities and other people that manufacture this type of—or manufacture the agricultural output that has to be involved in that chain, and so there has to be some type of a look-through mechanism to aggregate the fact that the producers and the companies like CHS are all working in concert to make this product.

The CHAIRMAN. Would you also tell us what CHS is doing to comply with the regulation on the reduction of sulfur. The date, I think, is July 2006.

Mr. BLAISDELL. CHS is—Well, CHS has already complied with the gasoline portion of that requirement. We have an investment in a 75-percent-owned subsidiary called National Cooperative Refinery Association that has not complied with either the gas or the diesel requirements. CHS has not complied with the diesel requirements.

Currently we are going through designs and incurring costs relative to designing structures to get us through those requirements.

The CHAIRMAN. Are you by any chance reserving some expenditure of money, holding back, postponing for the low sulfur upgrades pending passage of the energy bill?

Mr. BLAISDELL. Mr. Chairman, I don't think—Right now we are doing some holding back, and that's purely because we have these expenditures out in front of us, and the holding back started at NCRA where they are no longer redeeming patronage certificates. CHS has reduced the amount of cash that they put out to their patrons now because of this NCRA cash shortfall.

The CHAIRMAN. But the energy bill—I thought maybe I could find out from you if the energy bill and the passage of it would help in any way with the sulfur problem?

Mr. BLAISDELL. There is no question, Mr. Chairman, that the passage of the energy bill will very much help CHS, NCRA, all small refiner co-ops deal with these significant expenditures that we're facing.

The CHAIRMAN. Mr. Dinneen, I know you mentioned that there are twelve Iowa ethanol plants, and I think you said we had four or five more under construction. How many gallons of ethanol will be produced right here in Iowa?

Mr. DINNEEN. Currently Iowa produces a little bit more than 600 million gallons. 135 million gallons of that today is produced at farmer-owned facilities. The four production facilities that are currently under construction would bring that total to about 295 million gallons. With other farmer-owned facilities that are seeking financing, that would bring the total of farmer-owned ethanol facilities in Iowa to more than 350 million gallons, and when all of that occurs, Mr. Chairman, I know that you would never gloat, but you could tell Senator Durban from Illinois that Iowa would now be the single largest ethanol producing state in the country.

The CHAIRMAN. I'll be glad to do that. Do you have a number on either the existing jobs or potential jobs from the ethanol industry unrelated to itself to agricultural?

Mr. DINNEEN. I don't have an employment number, but I can get that to you.

The CHAIRMAN. Okay. Something I—Again, as we anticipate the 5 billion gallon mandate is whether or not the ethanol industry can reach that mandate—produce to meet that mandate.

Mr. DINNEEN. Mr. Chairman, we can absolutely produce the volumes that are going to be required under a renewable fuel standard as currently contemplated in the senate energy bill. I would suggest to you as well that the schedule that is currently contemplated does not at all reflect the growth in the industry that has occurred. Under the current schedule, the RFS would require 2.6 billion gallons of ethanol to be sold in 2005. While, Mr. Chairman, we're going to be producing close to three billion gallons this year alone.

We have had to undergo that kind of growth in order to have enough volume just for current law, because states are passing MTBE ban legislation all across the country, and we have had to grow in order to accommodate the demand that will be necessary as MTBE comes out of gasoline.

So I would hope that in conference we're able to take a look at that schedule, recognize the growth that has occurred within the industry over the past couple of years and perhaps accelerate the early years of that schedule even more.

I would also suggest, Mr. Chairman, I am very pleased, and I know that Iowans should be very happy and much of the country should be proud that you are a member of the conference committee for the energy bill. I look forward to seeing a conference report resolved and sent to the Senate and a bill sent to the President.

Mr. Chairman, I believe that an energy bill is critically important to this country. We didn't get a bill done last year. We need one.

If you'll indulge me for just a moment, I carry along with me a letter that was published in the "Washington Post" a few months ago. It's from a marine, Private First Class Christian Guertner, who wrote to his family, "Hello. How are you guys doing? I am good. We are sittingmiles from Iraq. We look to be leaving in 48 hours. I really miss you guys. Hey, if someone says anything bad, just tell them your one and only son is fighting so that they can pay less for gas and sleep better at night because there is less terrorism in the world. Hoorah."

Mr. Chairman, Private First Class Christian Guertner didn't get back to this country to purchase some of that cheaper gas. He was killed outside of Bagdad on April 2, Ironically the same day that the little Sioux ethanol plant in Marcus, Iowa opened.

I am offended by the fact that American lives would be lost in order so that we might pay less for gasoline. I don't ever want to see another American have to sacrifice his or her life so that we can pay less for gasoline.

We need an energy bill, a comprehensive energy bill that makes us less dependent on imported oil, less dependent on Mideast oil sheiks, makes us more dependent on Midwest farmers for our energy.

With your leadership the current bill does that. With the RFS, with the tax changes that you have written, our country will absolutely be less dependent on imported oil and perhaps less Marines will have to suffer and pay the ultimate price as a result, but we need that bill done.

The CHAIRMAN. I appreciate very much your comment and your understanding.

I now go to Professor Geu. You mentioned that you believe that the law of cooperatives develops in a legal environment that involves the interplay of Federal and state law. I'd like you to do either one of two things: Either explain what you mean in more detail or maybe give me an example of that.

Mr. GEU. There's a real easy example that you're probably familiar with already, and that was the interplay or revolution between the limited liability company acts across the United States and treasury regulation 301.7701 which changed how partnerships are classified for Federal tax purposes.

Just very briefly, a bit of history: In the '80's Wyoming—maybe in the late '70's now that I think about it, Wyoming passed an L.L.C. Act that provided certain features that were conducive to economic development, however there was strong doubt about whether that particular vehicle would be taxed as a partnership with close to true flow-through taxation. Therefore it was not utilized very much.

The service undertook a study committee and then administratively issued a revenue ruling in 1985 that said under certain circumstances a Wyoming L.L.C. could qualify for partnership flow-through taxation.

As of 1996 I believe 49 states had limited liability company acts. I think that shows the relationship between Federal definitions and state definitions and how the flexibility provided by state law in conjunction with Federal programs, whether they be expenditure or tax programs, revenue programs, can unleash the genius that is out in the country, the potential for making money and providing a better place for us all.

The CHAIRMAN. I continue the question: Your testimony indicated that new state laws allow more flexibility under state law than under traditional state law cooperative acts. Did the uniform laws commission study report identify any new issues raised by this flexibility?

Mr. GEU. Well, yeah, there are some issues relating to flexibility, and I've been trying to think of an analogy perhaps to explain at least the naccusal (phonetic) view to others—now this wasn't in an naccusal report, but I guess to borrow some—an example from Russian literature, you know, there are lots of successful marriages out there, but every successful marriage is different, and the flexibility provides in—on the state side—particularly the flexibility provides the ability for the spouses to adjust to one another and make a successful relationship. There is no one single recipe that is necessarily going to be successful for every partner.

And state law flexibility—and I think this extends to the Federal level as well—needs, I think, to recognize the flexibility. That kind of flexibility is important just as it is in a marriage.

Now, having said that, there has to be structure, because without structure there's chaos. When I say "marriage," most of us have at least some prototypical idea of what a marriage is. The features and the relationships within that marriage may be quite different between marriages, but there is a shifting pattern of relationship between husband and wife, so that's one of the issues that was identified in the study committee report, that is, how can you provide flexibility on every feature of an organizational entity act, be it cooperative or otherwise, while at the same time providing some gravamen of the tradition that has worked so well at least for historical purposes.

The CHAIRMAN. Thank you.

Mr. Goodale, you mentioned several partnerships included between rural electric cooperatives and farm cooperatives to develop renewable electricity, and could you—I'd like to have you tell us more about those projects.

Mr. GOODALE. A few of the products, Mr. Chairman, that I was referring to there include the—The generation and transmission cooperatives are the entities that procure the power supply for the distribution cooperatives, and in that process they look for different relationships in assessing the affordability and looking at environmentally responsibly providing that power.

Some of those GNT cooperatives have looked to invest directly into wind—wind farms themselves and the roll that wind power into the base rates that they charge customers. Others have looked for programs beyond that where they're investing in wind turbines and then allowing customers to contribute into the green pricing programs that allow for the financial support of those.

Another example is a cooperative looking on a contractual basis to partner with Florida Light and Power to take advantage of some of the tax credits that otherwise would not be available. So those are some of the programs specifically that have been out there.

The CHAIRMAN. Regi, in your opinion, which is a better way to encourage more renewable electricity development, incentives like those in the Energy Tax Incentive Act or perhaps additional production requirement?

Mr. GOODALE. I think as we look to the future on energy policy and as the industry changes, I think if we get creative on incentive-based approaches, that's by far a preferable method as opposed to mandates. The incentive-based approach would allow for locally-based solutions as opposed to those solutions being based either in Des Moines or in Washington allowing a lot more flexibility to deal with some of the transmission constraints that might be out there and some of the renewable technologies and things like that.

The CHAIRMAN. Mr. Campbell, I obviously appreciate your testimony. As you know, upon my return to Washington this weekend we're going to immediately focus on the FSC/ETI reform. Would you explain what agriculture has at risk if we do not change the law.

Mr. CAMPBELL. We had a special provision that allowed foreign sales corporations with extraterritorial income, meaning income from export sales, to receive special tax treatment that we thought put us on a level playing field with some of our foreign competitors. Well, the WTO has determined that that regime is inconsistent with trade rules, and so there's been a struggle the last few years in Washington to figure out how to replace it with something that is WTO legal. And we realize that in this environment we're probably not going to get the advantages for export activities that we did before because we're going to probably end up with a general manufacturing credit, so we've come basically to terms with that, and so then the question becomes of, well, what kind of general manufacturing credit?

We know, for example, I think in the Midwest at least, that we're not going to have a full economic recovery until the manufacturing sector recovers, and agriculture being a base industry has to recover for manufacturing to significantly recover, so in this regime of a general manufacturing credit, it is critically important that what we do count as deductible or creditable activities.

In the case of the investment tax credit in the 1960's, the Internal Revenue Service ruled that things like elevation, handling, drawing, storage, all the things that grain co-ops do, were not eligible for the taxed—income tax credit, and it took a court case for that issue to be resolved. And so in whatever the FSC/ETI fix is, we've got to make sure that what we do here in the Heartland is eligible for that—those benefits, whatever they may be, and then in particular that co-ops are able to take full advantage of it.

We at AGP and Harvest States and others, we compete against the largest corporations in the world. We compete against multi-national companies. We have nothing against those companies—ADM, Cargill, Bungee—you know, the list goes on, but they have assets that they shift all over the world. And if the tax regime is better in one country, that's where the assets go, and that's where the value added goes, and so we have to be cognizant in our structuring of our tax regime that we keep U.S. domestic agricultural producers, and that particularly co-ops that are not multi-national, we're keeping our assets right here in Iowa. We're not going to South America, we're not going to India, we're not going to China, we're keeping them here.

So we've got to have a tax situation that at least puts us on an even keel with the rest of those countries as much as possible.

The CHAIRMAN. Have you mentioned the definition of "manufacture" and how it impacts agriculture. You almost said we can't do much about that definition. Is that a conclusion you had working with other people?

Mr. CAMPBELL. Well, what I mean is we—what I meant to say, and I'm sorry, is we can't do much about whether or not our ETI/FSC regime is WTO legal. In order words, I think we're beyond that, so now since we can't have that, what can we have? And whatever we do have has got to include what we do here as eligible for that general manufacturing credit.

The CHAIRMAN. When it comes to a definition of "manufacturing credit," is it your view that we can get over that hurdle and not create problems for agriculture manufacturers like we have here as opposed to other manufacturers?

Mr. CAMPBELL. I think we can. We had to fight the issue in the '60's, but I think if we follow the general definition that's used for investment tax credit purposes, we'll be okay, but it has to be—it has to be specifically spelled out in the legislation and not left up to the Internal Revenue Service or the courts.

The CHAIRMAN. Yesterday I was asked at a news conference a question that I thought was, you know, quite obvious, and so why ask the question? What does agricultural policy have to do with tax policy?

The statement was made to me that I sit on both the agricultural committee as well as the finance committee as chairman, and I obviously—from that position I know that agriculture policy and tax policy have to work together, but I would like to have you comment on the interplay between good ag policy and in effect compare tax policy.

Mr. CAMPBELL. I'd take a shot at that, because Bob's already got too much time to talk already anyway. I tell farmers and I tell our co-ops that we tend to focus on the farm bill too much, that the energy bill, for example, is as important, if not more important, to the future of rural America and to agriculture as the farm bill.

When you look around the world and you see what's happening with competition and whether we're exporting low value products or high value products, I've come to the conclusion that if we can add value here at home, we're going to be better off than paying the freight for somebody else to add value somewhere else. And what that means is things like ethanol, biodiesel, renewable energy, and other livestocks and other value-added products have got to come higher on our list than just subsidies for subsidies' sake, and so we've got to look outside the agriculture committee for the future in my opinion, and the finance committee is, in my opinion, where it's at right now.

The CHAIRMAN. It seems to me oftentimes that there's more opportunity for me on the finance committee to do things for agriculture than even on the surface on the agriculture committee.

Mr. CAMPBELL. I think that's true, because we're locked into a 1930's era mentality in our agricultural subsidy regime, and that time is gone. Now we have to look out to the future, and our farms are factories that need to be viewed as having more options than just giving grain to the government or putting grain on the market to the lowest bidder and what you're doing in the finance committee and what we're doing in renewable fuels and other products.

We, for example, have a line of cleaning solvents that's made from soybean oil. We have agricultural spray adjuvants made from soybean oil. We can do about anything with soybean oil that we can with petroleum oil. We just need the research, the development and the incentives to make that happen.

The CHAIRMAN. I've asked my last question. Mr. Secretary, you were listening to this. Do you have any information that you would like to make at this point after hearing the testimony?

Mr. DORR. I suspect everybody is getting plenty warmed up and ready to go so they don't really desire to hear me anymore, but I think the points that have made by the panel are quite frankly enlightening. I think they're in many respects provocative, and I think they're the kinds of things that I would encourage all policymakers to take into consideration as they evaluate the options and the opportunities for the future.

The very short time that I've been the under secretary I am frankly more encouraged about the opportunity in rural America via rural policy utilizing the kinds of opportunities and initiatives that were discussed by these other panel members than I have been in a long time. I think we're all on the right track. It's going to take some time, but these sorts of sessions are very encouraging. Thank you.

The CHAIRMAN. I thank all of the witnesses. I particularly thank all of the people from this area or around Iowa and some of you came from outside Iowa to be with us today. I want to thank you very much. I want to thank Senator Baucus for his statement, and I regret he could not be with us, but he is a person who works very closely with me on almost every issue but particularly on the issues that have been discussed here today. There isn't much light between Senator Baucus and me when it comes to the issues presented here, and so it's a privilege for me to have that working relationship. That helps us to get more things done, because in the Senate ununlike the House of Representatives nothing gets done if it isn't somewhat bipartisan, and the more bipartisan the better, so that's appreciated then as I try to do my work as chairman of the committee.

As a senator for Iowa, I intend to pursue these issues whether they're in the finance committee or some other committees I serve on, but I can say in conclusion as far as the issues discussed that were here most but maybe not all of them will be issues that will be taken up this fall. A lot of the energy issues and tax related energy issues, obviously, I expect even without the blackout or the $1.75 gasoline to be on the president's desk sometime this fall.

There were a lot of people dragging their feet in the U.S. Senate that really don't want an energy bill. Where they're coming from, I don't understand, and maybe its because they want to cut down on the use of energy and change our lifestyle to some extent. They never say that. That's a perception I have about them, but regardless, I don't think they would have been able to slow it, but with the high price of gasoline and considering nothing more consumer sensitive than the price of gasoline, I expect that to give it some further impetus to get a bill passed and also on the issue of the blackout 2 weeks ago in the Northeast additional incentive.

I don't think I'm different than other Iowans or Americans. When we go to the gas pump, we expect to get gas out of the hose, and I don't want any excuses why we can't, and when we turn on the light switch, we expect the lights to go on and stay on, and I don't want any excuse when they don't.

Now, what's the difference between turning the light switch on and lights not going on or going to the gas pump and the gas not going on? It's not as much the total supply out there, it's what's at the margin, an additional 2 or 3 or 4 percent. Maybe in the case of electricity it might be 10 percent.

It's a surplus capacity at the margins that's going to make the difference of whether or not we've got a predictable supply and a predictable price that comes with a predictable supply, and then the bottom line, not just for today, but there's a lot of businesses in America, including agriculture, that are depending upon knowing that there's going to be energy available as we expand our economy for an increase in population and increasing our standard of living. And you're not going to get the investment that it takes to do that if you don't have a certain supply of energy, so we're not talking about just today. In fact, most of the legislation we're talking about is getting set for down the road a considerable amount and to plan for the future, but obviously there's some things that need to be done for right now or we wouldn't have gas for a $1.75.

So saying that and expressing my appreciation to all of you who have come to talk about a very important subject, I want to thank you for that, and the committee meeting is adjourned.

I would suggest perhaps that most of the people who are panelists might be willing to stay around and visit with you one-on-one and maybe answer questions for you or maybe they can help you solve some problems. If the panelists can do that, I would encourage that, and I suppose in about five or seven minutes I'm going to have to go to Rockwell City.

But I thank all of you who visited with me the half hour I got here before the meeting started. I'm sorry that there weren't more of you here that I could visit with privately, but I was very happy to greet old friends and meet a lot of new people. Thank you very much.

[Whereupon at 11:30 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF JOSH BLAISDELL

CHS appreciates the opportunity to speak today on tax issues affecting refiner co-ops. We know first hand based on many years of working with the Congress, in particular with the Senate Finance Committee and you, Mr. Chairman, that you do listen to co-ops, do appreciate co-op input, and do actually incorporate co-op input into many tax bills.

My name is Josh Blaisdell, Director of Tax at CHS. CHS is a regional cooperative owned by 325,000 members. We have over 3,800 local cooperatives and facilities primarily in 28 states from the Great Lakes to the Pacific and from the Canadian border to Texas. Iowa is our third largest state with 339 facilities. We are the second largest employer in Montana.

Overview of refiner co-ops

Few people outside rural America know the importance farmer owned petroleum refineries—called refiner co-ops—have in local communities.

Since the 1950's when the number of refiner co-ops reached their height of 20, the number of refiner co-ops has been decreasing and stands at 4 today.[1] They are Farmland in Kansas, CHS in Montana, National Cooperative Refinery Association in Kansas and Countrymark in Indiana.

Together these 4 refiner co-ops sell over 90% of the petroleum products they make to farmers, and local cooperatives. Cumulatively, refiner co-ops sell through the cooperative system to over 1.1 million farmers.[2] That is over 60% of the farmers in the United States.[3]

Petroleum operations at the local cooperative level are an important source of income, sometimes making up to 40% of a local cooperative's revenue.[4]

Refiner Co-ops work with USDA and Congress

The value of refiner co-ops to rural America and agriculture is well understood at USDA especially by the office of Rural Development, lead by Undersecretary Tom Dorr and the Energy Office, lead by Roger Conway. These are the two offices with which CHS does much of its federal coordination on co-op issues.

The value of refiner co-ops is also well understood in the Congress especially in the Senate Finance Committee. For the past several years the Committee leaders have been promoting major tax assistance to all cooperatives. Today they continue to fight for needed help for cooperatives—we very much appreciate that.

Senate Tax help for Co-ops

Take for example three of the Committee's recent major efforts: (1) to advance the "Tax Empowerment and Relief for Farmers and Fishermen Act"—called "TERFF"; (2) the elimination of the Dividend Allocation Rule (known as the DAR) and (3) tax

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[1] The closure rate of refiner co-ops has been much faster than the petroleum industry in general. It has decreased from a high of about 350 down now to 152 refineries. USDA Rural and Cooperative Development Service report #143, "Petroleum Cooperatives, 1995".

[2] Although refiner co-ops sell most of what they produce to co-ops (88% of their gasoline, 94% of their diesel and other distillates fuels, and 95% propane), their production only meets about 40% of the demand from co-ops. Therefore they have to buy from other refiners, predominantly small refiners, the balance of their needs—about 60%. USDA Rural Business Cooperative Service report #149, "Local Petroleum Operations".

[3] According to USDA Economic Research Service report #768, "Structural and Financial Characteristics of US Farms, 2001 Family Farm Report".

[4] USDA Rural Business Cooperative Service report #149, "Local Petroleum Operations".

provisions in the energy bill for agriculture and small petroleum refiners including refiner co-ops.

I would like to touch on these three bills and their role in helping co-ops.

What is TERM The TERFF Bill (Senate Bill number 665 or as we call it “S665”) is a bill of 13 items keyed on reducing the burdens of our tax system on farmers and cooperatives. It would, for example, permit risk management accounts, include value added animal processing cooperatives as marketing cooperatives, exclude rental income from self employment tax, coordinate income averaging and the alternative minimum tax, to name a few. We see the bill as an important vehicle to address farmer issues and some cooperative issues.

What is the dividend allocation rule or DAR? The DAR is a tax rule that creates an additional tax for cooperatives that pay a dividend on their capital stock—like nonvoting preferred stock that some cooperatives issue to raise much needed equity for their operations. No other type of corporation pays this additional tax. Today, regular corporations pay a double tax on corporate earnings—once at the corporate level and again at the shareholder level when a dividend is paid on stock. Cooperatives pay this double tax on their nonpatronage business, but they also pay an additional tax under the DAR.

How does this work? Under the DAR, when a cooperative pays a dividend on its stock, the amount of the dividend is allocated between the cooperative’s patronage and nonpatronage operations, and the portion allocated to the patronage operation reduces the amount of the patronage dividend tax deduction. By reducing the patronage dividend deduction in this way, an additional tax is generated on the cooperative’s patronage earnings. The cooperative and its shareholders are already subject to a double tax on nonpatronage earnings; this additional tax created by the DAR is in essence a third tax on co-ops.

Senators Grassley and other Finance Committee members have argued for years that this rule is unfair and have tried repeatedly to get it repealed.[5] Their current bill, S. 785, is focused on helping large and small cooperatives. It would amend the DAR and eliminate the third level of tax. Cooperatives have historically had great difficulty raising equity capital, and the DAR has contributed to the current situation we see in agriculture where many of our cooperatives are debt heavy.

This past year, two of the largest agricultural cooperatives have gone into bankruptcy—Farmland Industries, Inc. (a large agricultural marketing and supply cooperative, headquartered in Kansas City) and Agway, Inc. (one of the nation’s largest supply cooperatives, headquartered in Syracuse, NY). Several other regional cooperatives are heading toward similarly difficult times.

We need to help cooperatives strengthen themselves financially by giving them greater access to equity capital and removing this unfair third tax that cooperatives pay under the DAR for having dividend bearing stock. We believe S. 785 could be very useful in strengthening the financial situation of agricultural and other cooperatives across the country.

I will give you an example how elimination of the DAR would impact CHS. Recently, CHS offered $88 million in preferred stock. When we pay dividends on this stock, the DAR requires us to allocate a large portion of that dividend to our patronage operation and then reduce the amount of our patronage dividend deduction by the amount so allocated. This produces an additional tax for CHS of almost $2 million per year. That reduces our patronage equity, affecting our ability to secure better loans. It also significantly reduces the amount we pay our farmer members as a patronage dividend each year.

Elimination of the DAR by passage of S. 785 would allow us to increase our patronage distribution by the amount of dividends we currently allocate to our patronage pools and reduce our tax burden at the cooperative level. That is real money kept in the co-op system for our members.

Finally, a third example of tax help for cooperatives is found in both the Senate and House versions of the 2003 Energy Bill, now called “The Energy Policy Act of 2003” and HR 6. The bill is awaiting a conference between selected House and Senate members to work out compromises. Few people know that the Senate version of an energy bill has 10 tax items for agriculture and co-ops, three very specific for refiner co-ops. These tax provisions include for example, tax credits for (1) producing electricity from poultry, bovine and swine waste, (2) small ethanol producers, (3) biodiesel, (4) installation of alternative fueling stations, and (5) retail sale of alternative fuels for motor vehicles.

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[5] Elimination of the DAR has broad and deep Congressional support. In fact it passed both Houses of Congress in 1999 as part of an overall budget bill only, to be vetoed by the President. It has since been introduced several times with broad bipartisan support but has never passed the Congress. Today, it is found both in S. 785 and S. 665 as well in the House HR 1671.

We are particularly interested in the tax help for all small refiners since this group includes refiner coops. The refining industry must remove over 95% of the sulfur from diesel fuel to make the new ultralow diesel fuel. The Energy Bill's small refiner tax provisions include an expensing provision that allows us to accelerate the writeoff of most costs we incur to comply with the new diesel desulfurization rule. It also provides a 5-cent per gallon tax credit for producing the ultralow sulfur diesel.

Passage of these tax provisions is critical to refiner co-ops. Collectively, two refiner co-ops, CHS and the National Cooperative Refinery Association, face over $450 million in compliance costs between 2002 and 2005. The two tax provisions really help us ease the burden of complying with the new rules by reducing the costs to our member owners and permitting us to maintain our role as the dependable provider of petroleum products to keep agriculture strong.

Repeal of the dividend allocation rule and the credit and expensing provisions have significant impact on refiner co-ops. Repeal of the DAR will provide cooperatives access to new, untapped sources of capital as well as provide an opportunity for farmers and local cooperatives to reinvest in their systems. In order for refiner coops to maintain their production capacity under the ultra-low sulfur diesel rules and take advantage of growth opportunities as they become available, access to new capital markets is necessary.

While repeal of the DAR rule provides refiner co-ops a new arena in which to find funding for the low sulfur diesel capital improvements, the credit and expensing provisions of the Energy Bill allow refiner co-ops the ability to recover the costs of those improvements. These provisions significantly reduce the cost of funding these improvements allowing refiner co-ops to return more cash to local cooperatives and farmers through increased patronage distributions. Together they provide muchneeded help to a diminishing pool of refiner coops.

In summary, each of these tax bills—TERFF (S 665), DAR (S 785) and the energy bill (HR 6) with its tax provisions—has some very good provisions to help cooperatives, in turn either reducing costs or returning money back to local cooperatives, their members and the communities we live in. We just need them to be passed by the Congress.

Thank you for your time today and most importantly thank you for helping cooperatives.

Prepared Statement of John B. Campbell

FSC/ETI REPEAL AND COOPERATIVES

Good morning. Thank you Chairman Grassley for holding this important hearing in Iowa. We in the cooperative world appreciate your continuing concern and effort on behalf of agriculture and agricultural cooperatives.

Ag Processing Inc (AGP) is a regionally federated cooperative. We are owned by approximately 260 local and regional cooperatives who are in turn owned by an estimated 260,000 individual farmers and ranchers. Our primary business is soybean processing and vegetable oil refining. We are proud to process more soybeans in the state of Iowa than any other entity—and—of course—soybeans are the number one value crop in Iowa.

We are also involved in renewable fuels production with a 50 million-gallon ethanol plant in Nebraska and Iowa's first soydiesel plant at Sergeant Bluff, Iowa.

BACKGROUND

Cooperatives

Farmers manufacture and market their products through cooperatives. Cooperatives are member-owned corporations formed under Subchapter T of the Code (sections 13811388). Cooperatives determine their taxable income at the entity level like any other corporate taxpayer,[1] but they are eligible to claim deductions from taxable income for certain distributions to their members in the form of qualified "patronage dividends," "per-unit retain allocations" and certain other items.[2] These deductions effectively make cooperatives passthrough entities for tax purposes.

[1] Code § 1381(b).
[2] Code § 1382(b)(1), (3).

A "patronage dividend" is an amount a cooperative distributes to a patron on the basis of quantity or value of business done with or for that patron.[3] A "per-unit retain allocation" represents part of the equity of members or patrons in the cooperative.[4]

A patron must include in income distributions received during the taxable year that constitute patronage dividends and per-unit retain allocations.[5]

FSC/ETI

The FSC Replacement and Extraterritorial Income Exclusion Act of 2000 (ETI Act), Pub. L. 106–519, provides that gross income for U.S. tax purposes does not include extraterritorial income (ETI). The exclusion is available for both corporate and individual taxpayers. ETI is eligible for the exclusion to the extent that it is "qualifying foreign trade income."

The ETI Act allows a cooperative to exclude 15% of its qualifying foreign trade income from gross income and to pass the ETI exclusion through to its members. This allows members of cooperatives to benefit directly, when portions of their crops are sold abroad by providing an individual-level exclusion from gross income. The ETI Act provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative that is allocable to qualifying foreign trade income of the cooperative is treated as qualifying foreign trade income of the member. In general, 15% of that amount is therefore excludable from a member's gross income under the ETI Act.

The World Trade Organization, in response to a request by the European Union, held in a decision in January 2002 that the ETI Act and the remainder of FSC violated the terms of various trade agreements. The WTO therefore directed the United States to eliminate FSC/ETI. A WTO arbitration panel in August 2002 approved a EU proposal for $4.043 billion in countermeasures, in the form of duties on U.S. goods imported into the EU, which might be applied if the U.S. fails to comply with the WTO directive.

FSC/ETI Replacement

Legislation has been introduced that would repeal FSC/ETI, despite the strong case made by the USTR that the WTO erred in its rulings. The purpose of FSC/ETI has always been to offset tax advantages enjoyed by EU and other foreign producers, who compete directly with U.S. producers. Those EU tax advantages consist of lower corporate tax rates, rebates of VAT, territorial tax systems, and other subsidies. The effect of these foreign tax regimes is to provide a significant competitive advantage to foreign producers.

The tax advantages enjoyed by foreign producers would, of course, be increased by repeal of FSC/ETI. The effect of the increase in this imbalance would be further to place U.S. producers at a disadvantage in both domestic and international markets.

It is therefore imperative that any measure to repeal FSC/ETI offset the resulting tax increase on domestic producers by an equal or greater reduction in the tax on domestic producers. Otherwise, the effect of FSC/ETI repeal will be to further reduce the earnings of U.S. producers both absolutely and relative to their foreign competitors. That can only result in the further loss of business and jobs in the United States, for members of cooperatives, no less than for any other U.S. business.

The Job Protection Act of 2003 (H.R. 1769) (the "Crane-Rangel Bill"), introduced on April 11, 2003 by Representatives Philip Crane and Charles Rangel, would satisfy the necessary elements of a FSC/ETI replacement if—and only if—it is amended to apply to cooperatives and their members.

The Crane-Rangel Bill would repeal FSC/ETI and provide transition relief over a 5-year period for current FSC/ETI beneficiaries. It would also replace FSC/ETI with a new deduction for U.S. corporations engaged in U.S. production activities.

The legislation provides that the determination of the amount of transition relief available to agricultural and horticultural cooperatives is to be made at the coopera-

[3] Code § 1388(a). A patronage dividend is defined as an amount distributed to patrons: (i) on the basis of quantity or value of business done with or for that patron, (ii) under an obligation of such organization to pay such amount which obligation existed before the organization received the amount so paid), and (iii) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

[4] 744 T.M., *Taxation of Cooperatives*, A–32. "Per-unit retains" generally take the form of withholding of cash from proceeds of sales. The "per-unit" designation refers to cents or dollars per bushel of grain, per hundred-weight of milk, or some other unit of production.

[5] Code § 1385(a)(1), (3). These amounts are includible in income regardless of whether such distributions are paid in money, property, "qualified written notices of allocation," or "qualified per-unit retain certificates."

tive level, and that such amounts should be excluded from the gross income of patrons when distributed.[6]

PROPOSAL

Cooperatives are essentially passthrough entities, and as such they generally have no taxable income. They are permitted a deduction from taxable income the amount of their distributions to members in the form of patronage dividends and per-unit retain allocations.

Consequently, the Crane-Rangel Bill or any similar legislation that creates a deduction or credit based on taxable income must provide special rules regarding the treatment of cooperatives.

For example, the Crane-Rangel Bill or any similar legislation should provide that, for purposes of calculating deduction with respect to domestic production, taxable income is not reduced by the amount of any patronage dividends or per-unit retain allocations of a cooperative.

In addition, the definition of manufacturing should look through to the patron producer. For cooperatives involved in grain operations it would be necessary for elevation, storage, handling, drying, cleaning or other typical grain activities be considered eligible manufacturing or production activities as was the case for investment tax credits.

Furthermore, in order to provide a patron-level benefit similar to that provided under ETI, it is necessary that legislation like the Crane-Rangel Bill provide distributions received by a patron or member of a cooperative which is allocable to the cooperative's deduction for qualified U.S. production activities may also be treated as a deduction of the patron or member, and, thus, deductible against the gross income of the patron or member.

Finally, the transition provisions of the Crane-Rangel Bill should be amended to clarify that the amount of any patronage dividends or per-unit retain allocation received by a patron or member of an agricultural or horticultural cooperative and which is allocable to the cooperative's "transition amount," is treated as the "transition amount" of the patron or member, and, thus, is excludable from the gross income of the patron or member during the transition period.

Mr. Chairman, I would like to note that there is a coalition of cooperatives working on this issue. We have been ably assisted by Thomas A. Stout, Jr., Teree Castanias and Katherine Breaks of KPMG LLP. I am in debt to them for their assistance with this testimony.

PREPARED STATEMENT OF BOB DINNEEN

Mr. Chairman and Members of the Committee, thank you for the opportunity to provide comments on the important role that tax policy has in determining the nation's energy policies and priorities. Tax policy is critically important to the continuing development of rural America. With your strong leadership, Chairman Grassley, we have an opportunity to realize very important tax policy changes that will provide much-needed rural economic stimulus. I will comment on a number of provisions that will assist in the ongoing development of farmer-owned businesses in rural America and specifically enhance the opportunity for the ongoing development of ethanol facilities.

The Renewable Fuels Association (RFA) is the national trade association for the domestic ethanol industry. RFA membership includes ethanol producers and suppliers, gasoline marketers, agricultural organizations and state agencies dedicated to the continued expansion and promotion of fuel ethanol. Today's domestic ethanol industry consists of 73 production facilities located in 20 states with an annual production capacity of 2.9 billion gallons. Production capacity continues to expand, particularly among farmer owned cooperatives, the fastest growing segment of the industry. Indeed, since 1999, the U.S. ethanol industry has expanded by 45%. So far this year, we have opened five new ethanol plants, expanded half a dozen, and are building 13 new facilities. The industry is on pace to produce almost 3.0 billion gallons of ethanol in 2003, processing more than 1 billion bushels of corn. In Iowa, there are 12 ethanol plants in operation and 4 more under construction, most of which are farmerowned.

[6] H.R. 1769, Section 2(e)(6) ("Under regulations prescribed by the Secretary, determinations under this subsection with respect to an organization described in section 943(g)(1) of such Code, as in effect on the day before the date of the enactment of this Act, shall be made at the cooperative level and the purposes of this subsection shall be carried out by excluding amounts from the gross income of its patrons.").

Background

Ethanol is a clean, energy efficient, environmentally friendly fuel produced at production facilities that create jobs and economic opportunity in the rural communities in which they are located. Ethanol is an alcohol produced primarily from grain using a process almost as old as civilization itself. Today, however, ethanol production has come a long way from the wineries of ancient Greece or the stills of Prohibition. Fuel ethanol is produced on an industrial scale utilizing millions of bushels of grain annually in a fermentation/distillation process. While the fundamentals of ethanol production have remained constant, the process technology has become quite sophisticated.

The processing of grains for ethanol production provides an important value added market for farmers; helping to raise the value of commodities they produce. As the third largest use of corn, behind only feed and export uses, ethanol production utilizes approximately ten percent of the U.S. corn crop, or over 1 billion bushels of corn.

The production of ethanol has sparked new capital investment and economic development in rural communities across America. There has not been an oil refinery built in this country in 25 years. However, during that same time frame the U.S. ethanol industry has constructed 73 ethanol refineries, stimulating rural economies and creating jobs. USDA estimates that each 100 million bushels of grain used in the production of ethanol increases the national corn price between $0.03 and $0.05. Thus, today the production of ethanol is adding at least 30θ to each bushel of corn grown in the United States.

Industry growth offers enormous potential for overall economic growth and additional employment in local communities throughout the country. According to a Midwestern Governors' Conference report, the economic impact of the demand for ethanol:

- Adds $4.5 billion to farm revenue annually
- Boosts total employment by 195,200 jobs
- Increases state tax receipts by $450 million
- Improves the U.S. balance of trade by $2 billion, and
- Results in $3.6 billion in net savings to the federal Treasury.

The majority of growth in the industry in the last several years has been the result of farmer ownership of ethanol production facilities. These highly efficient dry mill plants typically go from the drawing board to production in less than two years. Today, farmer-owned facilities account for approximately one-third of all U.S. fuel ethanol production. Farmer-owned ethanol facilities help to ensure farmer members a value-added market for their crops and offer profit sharing dividends as the industry prospers.

The Renewable Fuels Association recently completed a study [1] on the economic impacts of a 40 million gallon ethanol facility on local communities. The results are extraordinary. The study concluded:

- During construction, capital spending generates $142.2 million in gross output to a local economy and $46 million in new household income (one-time impact);
- More than $56 million is spent locally on its daily operations each year;
- The local economy is expanded by $110.2 million each year;
- Local farmers receive an additional 5–10 cents per bushel in increased revenue at the farm gate (whether delivered to the ethanol facility or not);
- The plant creates 41 permanent direct jobs and 694 permanent jobs throughout the entire economy; and,
- The ethanol plant will generate $19.6 million in annual household income for the community.

Tax Policy and Rural Economic Development

The focus of this hearing is the economic health of rural America. Over the last 20 years, the single most significant contributor to the development of rural America has been ethanol. Today, the ethanol industry is positioned to expand further and to enhance its contribution to the development of rural economies. Congress can help by passing a few minor tax provisions that will unlock the full value of ethanol facilities to their farmer owners, including:

1. "The Volumetric Ethanol Excise Tax Credit Act of 2003" (S. 1548), which would streamline the tax collection process for renewable fuels such as ethanol and biodiesel.

[1] **Ethanol and the Local Community,** John M. Urbanchuk, Executive Vice President, AUS Consultants and Jeff Kapell, Associate Principal, SJH & Company (June, 2002).

2. Modifications to the Small Ethanol Producer Tax Credit, which would enhance the provision so the entire $1.5 million tax credit can be used by the ethanol facility or passed to the farmer owners of a cooperative.

3. Modifications to the farmer cooperative "dividend allocation rule," which would allow farmer cooperatives to more easily access equity capital.

The Volumetric Ethanol Excise Tax Credit (S. 1548)

The tax incentive program created by Congress to encourage refiners and gasoline marketers to utilize renewable fuels has been a tremendous success. It has created a growing value-added market for farmers that, as stated, will process more than a billion bushels of grain and add more than $4.5 billion to farm income every year.

But the current structure of the tax incentive has an unintended consequence—it reduces federal funds available to states for highway construction. Sound energy, economic and environmental policy need not be mutually exclusive of America's investment in transportation infrastructure.

Today, we urge Congress to reform the alcohol fuels tax credit and create a new "Volumetric Ethanol Excise Tax Credit" (VEETC), as introduced by Senators Grassley and Baucus on July 31, 2003 in S. 1548. Under the VEETC three objectives are accomplished:

1. The tax collection system for renewable fuels is improved;

2. The revenue source for the Highway Trust Fund is increased, because the full amount of user excise taxes levied will be collected and remitted to the Highway Trust Fund (HTF). On average, the proposal would generate more than $2 billion per year in additional HTF revenue, which would improve the ability of the federal government to address the nation's transportation infrastructure needs; and

3. The delivery of renewable fuels in the marketplace will be enhanced because the federal government's tax collection system will work in concert with the petroleum industry's and independent terminal's fuel delivery system.

Specifically, the VEETC will:

- Eliminate any impact of renewable fuels tax incentives on the Highway Trust Fund by assuring the full 18.4¢ per gallon of each gallon of ethanol-blend fuel and 24.4¢ per gallon for diesel and biodiesel blends will be remitted to the U.S. Treasury;
- Eliminate waste, fraud and abuse within the excise tax collection system;
- Provide flexibility to petroleum blenders at the terminal rack because fuel mixtures will not be based on the soon-to-be outdated Clean Air Act blending levels;
- Accelerate the tax refund system for below the rack blenders by requiring IRS to complete refunds *within 20 days* of filing; and
- Eliminate the need of the alcohol fuels income tax credit that is subject to the alternative minimum tax.

S. 1548 also provides a new tax incentive for biodiesel that is extremely important and will stimulate tremendous new production of biodiesel from both soybeans and other agricultural products, as well as biodiesel from animal fats. The biodiesel provisions mirror the VEETC by providing extraordinary flexibility for gasoline marketers to claim the credit for both on-road and off-road diesel uses, and similarly protects the Highway Trust Fund. The provision also encourages petroleum marketers to blend biodiesel as far upstream as possible, which under a Renewable Fuel Requirement contemplated by the Senate energy bill or Minnesota's 2% biodiesel requirement is critically important.

The Renewable Fuels Association strongly encourages Congress to enact S. 1548 during this Congress, because it eliminates the tax, infrastructure, and fuel delivery impediments that have been problematic throughout the history of the renewable fuels industry.

Modifications to the Small Ethanol Producer Tax Credit:

Under present law, a small ethanol producer (annual production capacity of 30 million gallons or less) is eligible for an income tax credit of 10 cents per gallon on up to 15 million gallons of alcohol production. While intended to stimulate expanded production, particularly by small farmer-owned facilities, the credit is not readily available to cooperatives or their patrons. Furthermore, for all small producers, the credit is subject to a number of limitations that reduce its benefit or limit its availability.

In the current marketplace, ethanol production costs are rising because of unprecedented natural gas and energy prices at the same time several state ethanol programs are being cut or eliminated. The small ethanol producer tax credit is the only program that helps established small ethanol companies compete in the marketplace. It is doubly important to small farmer cooperatives that are not currently eligible for the incentive. Over the past several years, a number of bills have been introduced to address these concerns[2] and, indeed, the Senate has approved modifications to the small producer tax credit on a number of occasions. Legislation has also been introduced this year,[3] and the provision is included in the Senate's tax title of the current "Energy Policy Act of 2003" (H.R. 6). But these much needed changes have never been included in a bill that was signed into law. Now is the time to assure these much needed changes become law.

The legislation would do the following:

- Allocate the ten-cents-per-gallon production income alcohol fuels credit to the members of a farmer cooperative;
- Change the definition of a "small ethanol producer" from 30 million gallons per year to 60 million gallons per year;
- Allow the credit to be claimed against the alternative minimum tax; and
- Repeal the rule that the amount of the credit is included in the income of the small ethanol producer.

If these modifications were made, each farmer member of a small ethanol-producing cooperative would receive up to a ten-cent per gallon tax credit on his or her share of the company's production in any given year. The effect of the legislation will directly send the benefit of a tax credit to the farmer owners of ethanol processing cooperatives, providing a much needed economic boost to this nation's troubled rural economy.

A letter of support for the Small Ethanol Producer Tax Credit signed by more than 50 companies is attached.

The Renewable Fuels Association enthusiastically supports the effort to address the small ethanol producer tax credit, and encourages Congress to include it in the final energy bill to be enacted this year.

The Farmer Cooperative Dividend Allocation Rule:

Farmer cooperatives are unique in that they are limited in their corporate structure to be owned, used and controlled by their farmer members. A number of the farmer-owned ethanol facilities are either organized as farmer cooperatives or as a Limited Liability Company (LLC) that is owned in part by a farmer cooperative. As such, issues important to farmer cooperatives are important to the ethanol industry. One of the major impediments to the ongoing development of farmer cooperatives is access to equity capital. As a class, cooperatives debt levels are high and due to antiquated rules, they have a difficult time raising capital.

Senator Grassley, you have been working on legislation that will make it easier for cooperatives to raise equity capital by removing the dividend allocation rule from the regulatory regime created by the Department of Treasury.

The Renewable Fuels Association strongly supports your legislation because we are a capital-intensive industry and every new facility constructed requires substantial investment.

Conclusion

The importance of ethanol as an alternative fuel to the nation's economy has never been greater, and its value promises to grow even larger. Oil prices are again playing havoc with the American economy. The U.S. economy is facing the most significant period of sluggish growth in more than a decade and high oil prices are a major contributor to the current economic slowdown.

With 45 percent growth in the last three years, one of the only economic sectors that is currently posting gains in the economy is the ethanol sector. If Congress adopts the proposals discussed today, the growth in the ethanol industry and the benefits to rural America will continue.

Therefore, we urge Congress to work with you, Chairman Grassley, and Finance Committee Ranking Member Max Baucus (D–MT) to pass "the Volumetric Ethanol Excise Tax Credit Act of 2003" (S. 1548); together with modifications to improve "the Small Ethanol Producer Tax Credit," as contained in H.R. 6 "the Senate's Energy Policy Act of 2003;" and finally, we urge adoption of the modifications to the farmer cooperative "dividend allocation rule," as proposed by Senator Grassley, which would allow farmer cooperatives to more easily access equity capital.

Thank you.

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[2] See H.R. 1999 by Rep. Jim Nussle (R–IA); H.R. 1636 by Rep. John Thune (R–SD); S. 907 by Senator Jean Carnahan (DMO) and S. 613 by Sen. Peter Fitzgerald (R–IL).

[3] See H.R. 465 by Rep. Steve King (R–IA) and S. 240 by Sen. Peter Fitzgerald (R–IL).

RFA

Renewable Fuels Association

July 25, 2003

The Honorable Charles Grassley
Chairman
Committee on Finance
SD219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable William M. Thomas
Chairman
Committee on Ways & Means
1100 Longworth House Office Building
Washington, DC 20515

Dear Chairmen Grassley & Thomas:

At this critical time for America and its need for energy independence, we urge you to include in tax legislation this year, a provision to modify the "small ethanol producer credit." Ethanol is one of the few viable sources of renewable fuels that will assist in meeting the domestic energy needs of this country.

Under current law, small ethanol producers are allowed a 10-cent per gallon production income tax credit on up to 15 million gallons of production annually. The provision is generally available to all small ethanol producers except those organized as farmer cooperatives. Due to their structure, farmer cooperatives are not able to take the credit. . Originally, the credit was created to incentivize farmers' involvement as small ethanol producers. Unfortunately, the current credit serves as a disincentive to farmers organized as a cooperative. Farmer cooperatives are pass-through entities that are owned and controlled by farmers. The provision would effectively allow farmer cooperatives to be treated like other small ethanol producers, in that it would allow cooperatives to elect to pass-through the "small ethanol producer credits" to its patrons.

We urge you to include this modification to the "small ethanol producer credit" in final tax legislation during this Congress.

Sincerely,

Bob Dinneen
President & CEO
Renewable Fuels Association
Washington, DC

Todd Block
General Manager
Adkins Energy LLC
Lena, IL

John Campbell
Vice President
Ag Processing, Inc.
Ohama, NE

Rick Mummert
General Manager
Agra Resources Coop d.b.a. Exol
Albert Lea, MN

Rick Serie
General Manager
Agri-Energy, LLC
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Randy Doyal
General Manager
Al Corn Clean Fuel
Claremont, MN

Gary Kramer
President
Badger State Ethanol
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John Doyle
BC International
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Ray Defenbaugh
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Kerry Nixon
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Bill Lee
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David Kolsrud
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CORN-er Stone Farmers Cooperative
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Tydd Rohrbaugh
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Greenwood, NE
Keith Kor
General Manager
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Dakota Ethanol LLC
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Tom Branham
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Glacial Lakes Energy, LLC
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Darrin Ihnen
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O. Kelly Hodson
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Ben Brown
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Bob Clark
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Don Endres
President & CEO
VeraSun Energy
Brookings, SD

Kevin Roche
United Wisconsin Grain Producers
Columbus, WI

Jeff Torluemke
Western Plains Energy
Hoxie, KS

PREPARED STATEMENT OF THOMAS DORR

Thank you Mr. Chairman.

Mr. Chairman, Members of the Committee, on behalf of the President and Secretary Veneman, I appreciate the opportunity to come before this committee to discuss with you ways in which the Federal government can help farmers and other rural residents increase their incomes and improve their quality of life through effective cooperative organizations.

For those who may not be familiar with USDA Rural Development, our vision is to serve as rural America's venture capitalist. Rural Development provides financial and technical assistance to finance and foster growth in existing and new opportunities for homeownership, business development, and critical community and technology infrastructure. The return on this assistance is the economic growth realized through direct assistance and by incentivizing private market forces.

Mission

It is with this vision in mind that Rural Development's mission has been designed to deliver programs in a way that will support: (1) increasing economic opportunity; and (2) improving the quality of life of rural residents.

Historically, Rural Development has been associated with the old Farmers Home Administration—the lender of last resort. However, in order to properly address these mission goals, it was important to recognize the changes that have occurred throughout rural America.

With a renewed sense of understanding and purpose, Rural Development must, as rural America's venture capitalist, utilize the tools and resources at hand to support new economic growth in rural America.

For over 100 years, cooperatives have organized and operated according to a relatively static model. Equity financing and control were the responsibility of the member-patrons. Earnings were allocated to patrons on the basis of use.

This model has served rural America well, and has provided several important benefits to farmers and other rural residents, such as:

(1) Access to quality farm supplies, power and communications services, and debt financing at a reasonable cost.

(2) Increased clout in the marketplace through cooperative processing, handling, and marketing of farm products.

(3) The return of earnings to local producers on the basis of their use of their cooperative, rather than to outside investors based on their investment.

(4) A local economy enhanced by the jobs created and taxes paid by the cooperative.

(5) A diverse local ownership unlikely to sell out or close down unless forced to do so, thereby protecting the local economy from the loss of a valuable asset.

Today, cooperatives, like much of rural America, are facing serious challenges. The companies they buy from and sell to are becoming larger, fewer in number, and more sophisticated at reducing costs and improving returns within their industry sector which can impact other participants in these industries. Sweeping innovations in areas such as biotechnology, information services, and transportation have made many cooperative facilities and equipment obsolete. Foreign countries are using our technology to become lower cost producers of the same products we produce in rural areas. They are becoming competitors rather than customers. One of our top initiatives at Rural Development is to look at the effectiveness of the current cooperative model for assisting farmers and ranchers.

The traditional model has been effective for a long time. However, cooperatives are now struggling to convert the equity and dreams of many rural Americans into the kinds of economic opportunity they need and desire. As Under Secretary, I am looking at ways to increase the profitability of producers who use cooperatives.

If we begin to look at cooperatives with the idea that they can serve not only as a form of security, a "home" for farm production, but also as an investment vehicle that pays dividends to its members—one that is focused on creating an acceptable return on investment—we will have gone a long way to strengthening rural America.

It is incumbent upon all of us who believe in a strong rural America, whether we are active producers, working at USDA, or serving in Congress, to do what we can to develop and implement new strategies so cooperatives can realize their potential as a tool for providing a better life for rural residents in the years ahead. Rural Development should be at the focal point of this process, and we intend to be.

A good vehicle to diversify farmer investment is a cooperative that adds value to the products that farmers produce through processing, distribution, and perhaps even branding. This allows the farmer to capture some of the dollars now going to the middlemen between producers and consumers.

In order to help producers, we need to help improve business knowledge and skills in rural America. Serious education on business strategies, finance, marketing, and decision making will enable farmers, and business and community leaders to lead dynamic, creative cooperative businesses that can succeed.

Don't get me wrong. There is nothing magical about organizing a business on a cooperative basis. But if the business plan is strong and the implementation of that plan is focused and visionary, farmers can expect a strong return on their investment. The money is there. Farmers just have to understand the untapped potential of their capital, and then invest it.

The public sector, and those of us in Rural Development at USDA in particular, must adapt new approaches in providing our services to rural America. We no longer think of ourselves as the lender of last resort to rural America. Today, Rural Development is rural America's venture capital firm. Recent legislation has recognized our new role by making it possible for us to provide start-up funding for new rural businesses.

The Value-Added Producer Grant Program provides planning money and working capital for independent producers and producer groups to develop new value-added agricultural products. In 2001, and 2002, grants totaling $57.5 million were awarded to 291 recipients in 43 states. In 2003, an additional $40 million is anticipated to be awarded.

The Agriculture Innovation Center Demonstration Project is authorized to provide grants of up to $1 million to each of 10 centers that will provide technical assistance to producers who want to develop and market value-added agricultural products.

The Agricultural Marketing Resource Center is designed to be the national focus on research and information about value-added products. It is being developed through a collaborative effort of Iowa State University, Kansas State University, and the University of California.

An area of value-added activity that offers great promise is the production of energy from renewable energy sources. Renewable energy involves everything from ethanol produced from many sources of biomass to wind, geothermal, and even anaerobic digestion of animal waste. During the last two years, Rural Development has financed 73 loans and grants in 25 states totaling $45 million to fund biobased and bioenergy related businesses. This is a significant step toward diversifying our Nation's energy sources, which is an objective of the President's national energy policy.

Section 9006 of the 2002 Farm Bill authorized the Renewable Energy Systems and Energy Efficiency Improvements program. Funds will be used for projects that derive energy from a wind, solar, biomass, or geothermal source, or hydrogen derived from biomass or water using wind, solar, or geothermal energy sources. Yesterday, I announced the selection of 113 applications for renewable energy systems and energy efficiency improvement grants in 23 states totaling $21,207,233.

Rural Development is more than a source of funding, especially where cooperatives are involved. Our technical assistance and research efforts are used throughout the country by producers interested in developing new cooperatives and making existing cooperatives better able to serve the needs of their members.

To make sure our efforts are focused on recognizing challenges and using techniques that look to the future and not the past, we are creating an Outside Program Review for Cooperative Services. The review team will be co-chaired by Dr. John Miranowski, a professor in the Department of Economics at Iowa State University. Its purpose will be to identify steps we can take to make sure all of our cooperative support is provided as efficiently and effectively as possible.

All of these initiatives are positive developments that are proving valuable to rural Americans. But the challenges are great and more can be done. Some of the more constructive changes in existing policy concerning cooperatives could involve modification of Federal tax rules.

Mr. Chairman, I believe we should move away from the 100 year-old cooperative concept toward a new concept of a cooperative, one that is attractive to investors and one that would make it possible for cooperatives and other rural businesses to play a leading role in increasing the supply of affordable, environmentally friendly renewable energy.

I look forward to continuing to work with you on these important issues within the overall revenue proposals of the President's budget request for 2004.

Congress has recognized the value of renewable environmentally friendly products as a source of electrical energy through enactment of the Section 45 Electricity Production Credit of the Tax Code. However, the credit is due to expire on January 1, 2004, and is only available for the use of a selective list of sources. This credit has stimulated low-pollution electrical production.

Mr. Chairman, I also want to commend you on your foresight in the original creation of the production tax credit, as it has been very successful. In addition, we support your position that Section 45 should be amended to increase its role in supporting the development of environmentally friendly power production in rural areas. These changes include:

(1) Extending the life of the credit.

(2) Expanding the list of qualifying energy resources. The addition of appropriate livestock and municipal waste would provide even greater environmental benefits by opening an economic incentive for the proper disposition of these materials.

Mr. Chairman, we at USDA recognize how hard you have worked to address these issues, and I want to offer my appreciation to you and to the Committee's Ranking Member, Senator Baucus, for having spearheaded a bi-partisan effort to secure enactment of legislation covering this and other issues of importance to cooperatives. Rural Development stands ready to offer whatever support we can to proposals that improve the business environment for cooperatives and rural America.

In conclusion, let me offer a few thoughts on where I think, and hope, we are headed with regard to cooperatives in rural America. I'm concerned about the long term health of an agriculture that focuses only on production, especially the production of basic commodities that are being grown at less cost in an increasing number of countries around the world. Cooperatives offer a vehicle to allow producers to turn their production into food, clothing, energy, pharmaceuticals, and, in the future, other value-added products that may not have even been imagined as yet.

To take advantage of these opportunities will require substantial new investments of equity capital. Farmers can, and should be expected to, invest in their own future. But steps should also be taken to facilitate and encourage outside investors to be part of the farmer-based cooperative businesses.

Creating new ways to invest equity capital in cooperatives may well require both State and Federal levels to examine laws that offer more flexibility in the organization and operation of cooperatives. However, new laws should not subvert the basic cooperative characteristic that they exist for the benefit of their member-patrons and not outside investors.

Rural Development continues to work to ensure that both funding programs and research and technical assistance efforts focus on cooperative approaches that meet the challenges and seizes the opportunities that lie ahead.

In addition, we look forward to your leadership in Congress to provide reasonable tax incentives to encourage the changes and new initiatives that are needed for cooperatives and other rural entities to meet the challenges of the 21 st Century.

Thank you for inviting me to be here today and I look forward to answering any questions you may have.

PREPARED STATEMENT OF THOMAS EARL GEU

Mr. Chairman, Members of the Committee:

My name is Tom Geu and I am a Professor of Law at the University of South Dakota. It is indeed a privilege to testify as Reporter for the Drafting Committee on Uniform Business Cooperatives of the National Conference of Commissioners on Uniform State Laws (NCCUSL).

The Drafting Committee was approved just this month by the Conference based on the recommendation of a Study Committee for which I also served as Reporter. The scope of the Drafting Committee is currently limited to "new generation" agricultural cooperatives whose structure is more conducive to value-added processing. Its goal is to draft a Uniform Cooperative Act for promulgation to the individual states for adoption as state law. The promulgation of a uniform act will take at least two, and likely three, years. The NCCUSL procedure is more comprehensively introduced in Appendices A and B submitted with this testimony.

The state organizational law of cooperatives is in flux. The Wyoming Processing Cooperative Law went effective in 2001; the Minnesota Cooperative Associations Act was passed this past legislative session; and an Act similar to the Minnesota Act was introduced in the Wisconsin legislature. An industry study group has been formed in Iowa. I do not know whether legislative study activity in other states has been undertaken at this time. I do know, however, that inflammatory leadins like one in a recent article appearing in *The McKinsey Quarterly* should continue to stoke interest in forming groups and studying possible legislative change. It states:

> Despite the $1.5 trillion a year that agriculture and the activities associated with it bring to the US economy—fully 16 percent of GDP—much of the industry is destroying value. The problem is not only the agricultural boom-and-bust cycle and the vagaries of the weather but also the performance of one of the industry's traditional business models: agricultural cooperatives. Co-ops, a substantial part of the industry, handle $121 billion annually out of a total of $675 billion (exhibit omitted).

Jack J. Dempsey, Ashish A. Kumar, Bernard Loyd, and Loula S. Merkel, "A value culture for agriculture," *The McKinsey Quarterly*, Issue 3, 2002, p.64 at 64–5.

To be fairer, the article also states, "most coops have changed" but "the world around them has changed even more." It also states that cooperatives organized using hybrid structures outside traditional lines have had success. Although the NCCUSL Study Report did not cite or use the article from *The McKinsey Quarterly*, it did highlight the economic development success of a "new generation cooperative," the Dakota Growers Pasta Company, a cooperative from Carrington, North Dakota. Dakota Growers provides a case study for the positive development possible through the use of cooperatives and was used solely for that purpose in the NCCUSL Report. It might be an example, too, of the restrictions of the current cooperative structure because in July 2002 it converted from a cooperative to a corporation. According to a story in the *Grand Forks Herald* (Ap. 7, 2002) which quoted SEC filings:

> The filing says the change would enhance the possibility of relationships with strategic partners and improve the liquidity of the corporation's capital stock. Conversion will afford greater access to capital markets, which may allow it to expand its business over time, the company says in the filing.

The document says the company is unlikely to obtain significant additional capital from its current members or other durum wheat producers and has been having difficulty getting durum—a consequence of widespread disease problems in recent North Dakota crops.

In the last three years, the company has relied on non-members for durum but doesn't say how much. The co-op maintains it hasn't run afoul of federal income tax rules but acknowledges concerns.

(T)here is legal authority suggesting that, if a cooperative's inputs are obtained predominantly from nonpatron sources, its tax status as a cooperative might be jeopardized, the filing says.

The Dakota Growers Pasta Company is a story of rural economic success. As a so-called "new generation cooperative" it was owned by between 1000–1100 farmers in North Dakota and expanded by acquisition of plants near Minneapolis. It invested over $45 million in plant property and equipment between 1993 and 1997. According to a case study by the Illinois Institute for Rural Affairs the coop provided premium prices to farmers, created almost 200 jobs in Carrington, and earned farmermembers a twenty percent annual return through 1995. In 1999 the shares, which were originally issued at $3.85, were worth approximately $10. Its story seems to be an example of both the advantages and disadvantages of the cooperative form cited by proponents of structural change.

In addition to the new Wyoming and Minnesota Cooperative Acts, several states, including Colorado, have reportedly consolidated some of their various special purpose cooperative statutes into a more coherent and centralized legislative scheme in the past decade. In the late 1980s and 1990s, Minnesota, Colorado and Ohio redrafted their cooperative statutes. The recodification of Minnesota's cooperative statutes is instructive: "In Minnesota, five different stock and nonstock cooperative statutes were recodified and revised into one corporate cooperative statute" in 1989. Moreover, coop lawyer Mark Hanson states that "many" states loosened the statutory restrictions in their commodity marketing acts to allow nonagricultural producers to form cooperatives. Again according to Hanson, "[t]he modern corporate cooperative statutes are general cooperative statutes with certain provisions to accommodate agricultural producer cooperatives." Nonetheless, there is a marked lack of uniformity in state cooperative statutes that reflect the needs underlying what appears to be a state law trend toward more flexible cooperative statutes.

This renewed interest in cooperatives appears to be a result of business globalization which may require larger entities; a change to farm subsidy programs putting pressure on farmers to seek value-added processing; and, reflect that cooperatives may still represent one of the best forms of economic development in rural (and other) areas.

I want to highlight a few of the criteria NCCUSL uses for designating and considering uniform acts because I believe they bear, on the issues before this Committee. A complete statement of criteria that NCCUSL uses for designating and considering acts has been submitted as Appendix B.

First, of course, "[t]he subject matter must be appropriate for state legislation in view of the powers granted by the Constitution of the United States to the Congress." (Stat. of Policy Est. Criteria 1/13/01). *Second*, the subject matter of the act must further the objective of the Conference which is "to promote uniformity in the law among the several states on subjects where uniformity is desirable and practicable" (id., quoting NCCUSL Const.). *Third*, according to the NCCUSL Statement of Policy, consideration should be given to whether the act "facilitate(s) the flow of commercial transactions across State lines"; and whether the act is "*conceived to fill emergent needs to modernize antiquated concepts*, or to codify common law" (*id.*, emphasis added). *Finally*, the criteria for selecting uniform acts specifically states that they "may promote uniformity indirectly as well as by substantially verbatim adoptions as, for example, by: . . . extensive adoptions in principle [or] . . . impact on case law and teaching practices. . ." (*id.*).

I mention each of the previous criteria because they frame NCCUSL's recognition that the law of cooperatives needs careful re-examination and possible modernization at the state level. These same criteria seem to evidence the possible need for changes in federal law and policy as well.

First, the organizational law of cooperatives is traditionally state law as is, of course, the law of business entities generally. Just as obviously, federal law is undeniably important in the law of cooperatives just as it is in the larger scope of business entities. Particularly in the area of cooperatives, state law is developed in the context of federal law and policy concerning taxation, securities regulation, antitrust, finance and the provision of both direct and indirect government services. The Legal, Tax & Accounting Committee of the National Council of Farmer Cooperatives (NCFC) has been following the legal and economic developments concerning cooperatives closely. At a committee conference, J. Gary McDavid attributed the success of cooperatives to several factors including: "1. Tax, SEC, antitrust, and other benefits provided to co-ops, 2. Special banks that provided financing for co-ops, 3. Encouragement and assistance from USDA and NCFC, and 4. the fact the concept worked." The law of cooperatives, therefore, develops in a coevolutionary environment. That is, the environment in which individual coops are built and operate is the legal infrastructure that results from the interplay of state and federal law.

A good example of the coevolution of this environment occurred with the promulgation of the "check-the-box" treasury regulations. State law and federal tax law provided a virtuous circle (self-reinforcing feedback loop) that resulted in a number of innovative and efficient entities in the states. These entities include, for example, entities formed under state versions of the following NCCUSL Acts: the Uniform Limited Liability Company Act, the Limited Liability Partnership Amendments to the Uniform Partnership Act and the new Uniform Limited Partnership Act (2001). ULPA (2001) was recently adopted by Hawaii, the first state to do so. The legal infrastructure of federal and state law which evolved to meet the need for economic efficiency and flexibility by individual businesses, when aggregated, encourages economic development. In approving the drafting committee on cooperatives NCCUSL tacitly recognized the role of state legislation in the legal infrastructure of economic development.

The same federal tax—state law interplay seems it seems to be extending to cooperatives. For example, in 1996 Iowa enacted a cooperative statute specifically designed for agricultural value-added purposes. It was a corporation-based statute and it required, among other things, that "farming entities" have at least 60 percent of the voting and financial rights. Further, it provided "authorized persons" to have 75 percent of the voting and financial rights. Some organizations incorporated under the 1996 Iowa Act sought "Exempt Farmer Cooperative" Certification from the IRS under § 521 and, according to coop lawyer Mark Hanson, questions were raised whether they qualified for § 521 status as operating on a cooperative basis. As a result of these questions the Iowa statute was amended to replace corporate terms like "incorporation," "stock" and "shareholders" with unincorporated entity terms like "organizers", "members" and "interests" so that the organization might qualify for partnership income tax status (like a limited liability company under state law) and, therefore, be taxed on a purer flow-through basis under Subchapter K.

This *different* statutory design that attempts to take advantage of partnership tax classification should not be underestimated because it evidences that the organizers were willing to leave the traditional protective confines of the corporate tax structure as modified by Subchapter T in order to make value-added processing financially viable based on a different capital structure. In other words, the approach evolved from perceived real-world need.

Wyoming enacted a "Wyoming Processing Cooperative Law", effective in 2001, for purposes similar to Iowa's law. The impetus for the Wyoming law was from lamb producers in Wyoming and adjoining states. Its purpose was to allow the producers to "acquire lamb, meat, wool and pelt processing and marketing businesses to make lamb production more marketable on a cooperative basis." It was drafted to allow for partnership taxation or, at the discretion of the particular entity, to elect corporate taxation and thereby be eligible for Subchapter T and, perhaps, § 521 tax treatment. As a result, the Wyoming Act is more flexible than traditional cooperative acts and gives far more freedom to the organizers in their entity documents than typically afforded under traditional cooperative statutes.

Neither the Wyoming nor the Iowa cooperative statutes, to my knowledge, have received revenue rulings, however, an entity organized under the Wyoming Act apparently received a private letter ruling (PLR) from the Internal Revenue Service in 2001 indicating that it is eligible for partnership income tax classification. Identifying facts are excised from published letter rulings. Nonetheless PLR 2001–125369 included the following statement of relevant fact:

> Company A is a new entity that will be organized on Date 1, under the State Cooperative LLC Act (Act). The Act was enacted on Date 2, with an effective date of Date 1. The Act defines "Cooperative" as association organized under this article conducting business on a cooperative plan as provided under this Article.

It concluded:

> In the present case, Company A is organized as an unincorporated association under the Act, which does not refer to an association as incorporated or as a corporation, body corporate, or body politic. . . . Therefore, it is an "eligible entity" and not a per se corporation under section 301.7701–2(b)(1).

I want to particularly emphasize the NCCUSL selection criteria concerning the third consideration I mentioned. It is, in part, whether the act in question is "conceived to fill emergent needs, to modernize antiquated concepts, or to codify common law." Most of the Report of the NCCUSL Study Committee on a Uniform Business Cooperative Act was directly related to this consideration. A major factor in this renewed interest in cooperative business organizations and statutes by NCCUSL is the advent of the value-added agricultural cooperative, including those for ethanol production. A book published by the Illinois Institute for Rural Affairs delineates this evolution as follows:

> The development of cooperatives in the Upper Midwest from the 1970s through the 1990s provides vivid examples of several new phenomena and trends. Among the most important are the New Generation Cooperatives (NGCs). The term, used since the mid-1990s, was proposed by the Centre for the Study of Cooperatives, University of Saskatchewan, Canada [citation omitted]. These NGCs represent the newest wave of U.S. co-ops. While earlier generations had emerged in the 1900s, the 1920s, and again in the 1940s, NGCs have several features that distinguish them from traditional farmers co-ops.

The "New Generation Cooperative" is the favored form for new cooperatives. New Generation Cooperatives (NGCs) include some combination of features, not typical of traditional cooperatives. A list of nontraditional features include appreciable equity shares which may or may not be transferable; limited but real opportunity for outside equity investment; legally binding delivery contracts or uniform grower agreements which may or may not be transferable; minimum up-front equity investment by members, closed membership, and a way for members to redeem, transfer, or otherwise recognize the appreciation of their equitable shares. All these features reflect theoretically identified economic inefficiencies in the operation of traditionally organized cooperatives. Indeed one of the primary driving forces for NGCs is the need for equity capital to build capital intensive processing and manufacturing facilities like ethanol plants. The adoption and use of nontraditional features by cooperatives often requires organizing under state LLC laws rather than under state cooperative laws and being taxed as a partnership rather than as a cooperative under Supchapter T of the Internal Revenue Code.

J. Gary McDavid identified the same general structural challenges for cooperatives as those previously identified. Given the advent of other entity choices, structural challenges he mentioned included "lack of outside equity" and the "inability to access going concern value." Other challenges included "competition from LLCs" and the desire of investment return on the part of member-investors and stock options in order to retain qualified management. Specifically the speech stated, "some cooperatives have converted to LLCs and many new ventures are structured as LLCs. . . [because] LLCs are flexible vehicles and allow patronage and non-patronage income to pass through to the members." Indeed, the article from *The McKinsey Quarterly* observes:

> In general, a co-op that has a strong plan and uses alternative governance structures such as the LLC will find it easier to raise capital from both farmers (who are willing to invest in strong plans) and outside sources (which are now put off by the convoluted governance of most large co-ops).

Jack J. Dempsey, Ashish A. Kumar, Bernard Loyd, and Loula S. Merkel, "A value culture for agriculture," *The McKinsey Quarterly*, Issue 3, 2002, p.64 at 72.

McDavid's comments seem to be supported generally by agricultural economists. For example, a 1995 article in the *American Journal of Agricultural Economics* lists five problems inherent in operating within the traditional cooperative structure. All five relate to "vaguely defined property rights." According to the article, a free-rider problem exists for open-membership cooperatives because new members receive the same patronage dividends as do members who originally invested in the cooperative; portfolio and horizon problems arise due to lack of share transferability; that is, members cannot adjust their investment over time to match their investment profiles; and, there is a disincentive for members to invest more capital because of lack of liquidity of the investment and lack of the ability for the investor to time sales (e.g. redemption fixed upon death or retirement). Finally, the control and influence cost problems (e.g. agency cost and monitoring costs) inherent in any nonpublicly traded business are present in cooperatives. According to follow-up research conducted in 1996 and 1997, "[e]mpirical work confirmed the connection between theory and practice."

The research analyzed,

> [A]ll rural or agricultural-related cooperative formations in the Upper Midwest between 1988 and 1996. . . . and made the following observations:
>
> 1. More than 80 percent of cooperative formations in the Upper Midwest adopted non-traditional cooperative organization characteristics.
>
> 2. Why? According to the results of the survey—to solve for a set of problems cause by vaguely defined property rights.

3. A coordinated set of simple organizational policies to solve for vaguely defined property rights; transferable and appreciable equity shares, defined membership, uniform grower agreements, and a minimum up-front equity investment requirement were identified.

4. Ninety-six percent of the cooperatives in the survey reduced the free-rider problem by linking member investment to use.

5. Ninety-four percent allowed members the ability to adjust their asset portfolio to meet the risk preferences by allowing the transfer of equity shares.

6. In addition, 93.6 percent of the cooperatives allowed producers to realize changes in the cooperative's value upon divestment of their equity shares.

7. Defined (closed) membership policies were popular among newly organized agricultural cooperatives with 98 percent of the survey cooperatives implementing a defined membership structure.

8. Direct investment through the sale of nonvoting equity stock was the primary method employed to raise producer equity in these cooperatives. Nearly 98.7 percent of equity raised from producers took this form.

Michael L. Cook, Constantine Iliopoulis, *Beginning to Inform the Theory of the Cooperative Firm: Emergence of the New Generation Cooperation* 1999 THE FINNISH JOURNAL OF BUSINESS ECONOMICS 525 at 530 (Issue 4).

These findings are consistent with the more theoretical suggestions to amend the cooperative form to include some combination of features like transferability of equity shares, appreciable equity shares, defined membership, legally binding delivery contract or uniform grower agreement, and minimum up-front equity investment. These features, however, are not necessarily consistent with cooperative values as described by the Rochdale Principles, and organizing cooperatives under state LLC laws, however, comes with transactional costs and risk born of uncertainty caused by differing definitions of cooperatives between and among laws at the state and federal levels. It also raises issues about registration of nontraditionally organized coops doing business in states other than their state of organization. There is some fear, too, that some embedded efficiencies under current statutes for selected industries may be inadvertently lost. Finally, some of the defining principles of cooperatives, for example those referred to as the "Rochdale Principles," are not reflected by the law of other entities like LLCs though the principles may be added to the governing documents of the LLC or other organization.

The Rochdale principles have been stated a number of ways. The original principles contained a list of twelve. Some sources now have consolidated that list to eight or even four. I think they can be summarized by five principles. These principles are: (1) business at cost with returns paid to members based on patronage; (2) democratic control, one person, one vote; (3) limited dividends on invested equity capital; (4) ownership (or beneficial membership) limited to patrons; and (5) open membership.

Finally, the NCCUSL Study Committee Report briefly referred to cooperatives in the transnational and international context. There seems to be a resurgent interest in cooperatives in other countries as well as in the United States as capital markets have become increasingly important worldwide. The role of capital markets is a change in emphasis and infrastructure for European businesses, generally, and presents challenges to its cooperatives, too. The Pellervo Confederation of Finnish Cooperatives organized a Working Group to consider issues related to the new business environment of cooperatives in 1999. According to the Foreword of its initial Report issued in 2000:

> The proliferation of share ownership and the development of the capital markets have led to the effective supervision of management by the capital markets. The decisions of major corporations are assessed daily by the owners, as well as by the hundreds if not thousands of analysts and investors.

Ownership in a cooperative is different from that in a listed company because cooperative shares are not normally freely transferable and so there is no market for them. In practice, the benefit and added value produced by a cooperative accrues to the owners, that is the members of the society, via the business relations between them and the cooperative .

. . . The role of cooperative member-owners and their responsibility for the success of the enterprise is in actual fact greater than in publicly quoted companies as the market continuously monitors the company and distributes information via the media.

> The management of cooperatives, both professional and lay, has certainly improved during the last decade. Likewise transparency has increased. The requirements, however, are growing continuously and *cooperatives are subject to the same pressures for greater efficiency and change in corporate governance as other enterprises*. For this reason, it is important for cooperatives to consider

corporate governance within the framework of their cooperative origins. It is useful to think about building up an effective system of internal control simly because even the largest cooperatives lack the kind of control that comes from the stock market. The general discussion concerning joint stock companies will provide many suggestions, but the cooperatives themselves must find solutions suitable to their form of enterprise, field of operation and operating environment. This discussion should concern itself with good governance practice, that is how internal control is organised, as well as broader issues as how to run cooperatives so that their resources produce the best possible benefits to their members. . . . The report aims at stimulating discussion of this vital subject within the cooperative movement rather than offering readymade models.

The European Commission D.G. Agriculture generously contributed towards the cost of translating the report into English. The translation was made by Michael Wynne-Ellis. This paper has been provided also for the Corporate Governance seminar organised by the General Committee of Agricultural Cooperatives in the EU (COGECA) in Brussels in November, 2000.

Corporate Governance and Control in Cooperatives, Pellervo Confederation of Finnish Cooperatives (Nov. 2000).

I think this evidences, too, a worldwide recognition of the growing importance of cooperatives, their potential, and the challenges confronting them today. The appointment of a drafting committee by NCCUSL, too, evidences this importance and it is hoped the resulting uniform law will help cooperatives respond to these challenges and continue to be a source of economic development through a modernization and unification of state law. Many of the challenges faced by coops today, however, are also matters of federal law and policy.

Thank you for the opportunity to testify, and I welcome any questions you may have.

APPENDIX A

NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS

Purpose

The purpose of the National Conference of Commissioners on Uniform State Laws is to promote uniformity in state law on all subjects where uniformity is desirable and practicable. To accomplish this, the Commissioners participate in drafting Acts on various subjects and endeavor to secure enactment of the approved Acts in the various States.

Organization

The National Conference is composed of the Commissioners on Uniform State Laws from each State, the District of Columbia, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands. In addition, the principal officer of the state agency, such as the legislative reference bureau, charged with responsibility of drafting legislation for the State is generally an Associate Member of the Conference.

The Governors of the States and other appointing authorities have appointed lawyers, judges, legislators, and law school professors as Commissioners. While a common term is three or four years, it is common practice for Commissioners to be reappointed, without regard to their political affiliation, if they have actively participated in the work of the Conference. Commissioners who have served by official appointment for twenty or more years are eligible for Life Membership. All Commissioners are members of the bar.

The organizational plan of the Conference makes its nonpartisan nature self-evident. Moreover, while Commissioners are obligated to endeavor to procure enactment of Uniform Acts, they represent no special interest.

A small staff is maintained at the Conference headquarters in Chicago to serve the organization's administrative needs.

History

The Conference, one of the oldest of state organizations designed to encourage interstate cooperation, was organized in 1892 to promote uniformity by voluntary action of each state government. Since its organization, the Conference has drafted hundreds of uniform laws on numerous subjects and in various fields of law. Many of these, like the Uniform Commercial Code, have been universally enacted, or nearly so.

With the development of interstate transportation and electronic transactions, the States have become increasingly interdependent socially and economically so that a single transaction may cross many state lines and involve citizens in many States.

Citizens of one state constantly travel to other states or move their residence. A confusion or difference of laws among the several states may present, in some fields, a deterrent to the free flow of goods, credit, services, and persons among the States; restrain full economic and social development; disrupt personal planning; and generate pressures for federal intervention to compel uniformity. The Conference seeks to alleviate these problems in areas of law traditionally left to the states, thus preserving the federal system.

The Conference occasionally drafts Model Acts on subjects which do not directly affect relationships among the States, but which involve problems common to many if not all the States. On other occasions, it drafts model legislation on subjects where state legislation could help implement international treaties of the United States or where uniformity would be desirable.

Financial Support

The Conference is considered a state organization. The major portion of its financial support comes from state appropriations. The expenses are apportioned among the States primarily based upon their population. Individual Commissioners receive no salary or compensation, and in some cases they pay their own expenses to attend the annual meeting of the Conference.

The American Bar Association and, in connection with the Uniform Commercial Code, The American Law Institute, make a yearly contribution to the conduct of Conference business. Moreover, as some projects have involved extraordinary expenditures for extensive research, drafting experts working on a sustained basis, and numerous meetings of advisors, the Conference and the Uniform Law Foundation have sought financial help from foundations and other public-spirited persons and groups. Because the Conference is composed of Commissioners designated by the States and prepares Uniform Acts for States and is supported by States, the Internal Revenue Service has recognized the Uniform Law Foundation as qualified to receive tax-deductible contributions under federal law as contributions to state government or organizations of state government for public purposes.

Procedures

The Conference meets annually to consider drafts of proposed uniform legislation. Proposals that Uniform Acts be drafted, received from many sources, are referred to a Committee on Scope and Program that makes an investigation, sometimes hears interested parties or recommends a further study, and reports to the Conference whether the subject is one on which it is desirable and feasible to draft a uniform law.

If the Conference decides to accept a subject, a special committee of Commissioners is appointed to prepare a draft of an Act. In the case of the Uniform Commercial Code, representatives of The American Law Institute are appointed to the committee. The American Bar Association is invited to appoint an advisor to each drafting committee. Drafts are not submitted to the Conference until they have received extensive committee consideration.

A draft Act must be discussed and considered section by section by the entire Conference at normally no fewer than two Annual Meetings before the Conference may decide by a vote of States whether to promulgate the draft as a Uniform Act. Each State is entitled to one vote, and an Act is not promulgated unless a majority of the States represented at an Annual Meeting and at least twenty jurisdictions have approved the draft.

In addition, each Uniform Act may be submitted for consideration to the American Bar Association. The Drafting Committees of the Conference establish liaison with the American Bar Association and other interested groups throughout the drafting process.

Publications

The text of each approved Uniform and Model Act, with notes and comments, is published in pamphlet and other forms by the Conference. Working drafts, as well as current Acts of the Conference with the exception of the Uniform Commercial Code, are also available on the Internet at www.nccusl.org.

In addition, it publishes a Handbook of the National Conference of Commissioners on Uniform State Laws that contains the proceedings of the annual meeting of the Conference and basic statistical data about the various Uniform and Model Acts promulgated by the Commissioners, including a list of the Acts adopted and the States which have adopted them.

Copies of the Acts and the Handbook are available from the Conference headquarters in Chicago.

Web Site

The address of the Conference Web site is www.nccusl.org, where you'll find:

- Uniform Acts, factsheets, and summaries
- Information on drafting projects
- Current drafting committee meeting information
- Bill tracking features
- Press releases
- Archives of drafts and final acts
- Links to state legislatures and other organizations

Other Selected NCCUSL Committees and Acts

Uniform Commercial Code
Uniform partnership Act (1997)
Uniform Probate Code
Drafting Committee on Electronic Payment Systems
Standby Committee on Uniform Rules of Evidence
Drafting Committee on Nonjudicial Foreclosure Act
Drafting Committee to Revise Uniform Management of Institutional Funds Act
Drafting Committee to Revise Uniform Securities Act
Drafting Committee on Uniform Wage withholding Procedure Act

APPENDIX B

STATEMENT OF POLICY ESTABLISHING

CRITERIA AND PROCEDURES FOR DESIGNATION

AND CONSIDERATION OF ACTS

JANUARY 13, 2001

The Conference and its committees shall conform to the following criteria and procedures in proposing or considering Acts:

1. Criteria.

(a) The subject matter must be appropriate for state legislation in view of the powers granted by the Constitution of the United States to the Congress. If it properly falls within the exclusive jurisdiction of the Congress, it is obviously not appropriate for legislation by the several States. However, if the subject matter is within the concurrent jurisdiction of the federal and state governments and the Congress has not pre-empted the field, it may be appropriate for action by the States and hence by the Conference.

(b) The subject matter must be such that approval of the Act by the Conference would be consistent with the objectives of the Conference, as stated in Article 1.2 of its Constitution: "to promote uniformity in the law among the several States on subjects where uniformity is desirable and practicable."

(c) Every Act drafted by the Conference shall conform to the following requirements:

(i) there shall be an obvious reason for an Act on the subject such that its preparation will be a practical step toward uniformity of state law or at least toward minimizing its diversity;

(ii) there must be a reasonable probability that an Act, when approved, either will be accepted and enacted into law by a substantial number of jurisdictions or, if not, will promote uniformity indirectly;

(iii) the subject of the Act shall be such that uniformity of law among States will produce significant benefits to the public through improvements in the law (for example, facilitating interstate economic, social or political relations, or responding to a need common to many States as to which uniform legislation may be more effective, more efficient, and more widely and easily understood) or will avoid significant disadvantages likely to arise from diversity of state law (for example, the tendency of diverse laws to mislead, prejudice, inconvenience or otherwise adversely affect the citizens of the States in their activities or dealings in other States or with citizens of other States or in moving from State to State).

(d) Experience demonstrates that Acts to accomplish the following purposes have met with the widest acceptance by state legislatures;

(i) Acts to facilitate the flow of commercial transactions across state lines, such as the Uniform Commercial Code;

(ii) Acts to avoid conflict of laws when the laws of more than one State may apply to a transaction or series of transactions, such as the Uniform Act on

Transfers to Minors, the Uniform Certification of Questions of Law Act, the Uniform Child Custody Jurisdiction and Enforcement Act, the Uniform Interstate Family Support Act, and the Uniform Attendance of Out of State Witnesses Act;

(iii) Acts without substantial interstate implications but conceived and drafted to fill emergent needs, to modernize antiquated concepts, or to codify the common law, such as the Uniform Acts on Simultaneous Death, Limited Partnership, Partnership, Limited Liability Company, Rules of Evidence, Common Trust Fund, Principal and Income, and Fraudulent Transfers.

(e) Acts may promote uniformity indirectly as well as by substantially verbatim adoptions, as, for example, by:

(i) extensive adoptions in principle, such as the Uniform Alcoholism and Intoxication Treatment Act;

(ii) impact on case law and teaching practices, such as the Uniform Rules of Evidence;

(iii) gradually increasing adoptions, either in statutes or in case law, of particular sections or parts of a Uniform or Model Act addressing specific problems within the larger area to which the Act is directed, as for example, the Uniform Acts on Intestacy, Wills and Donative Transfers, Testamentary Additions to Trusts, Disclaimer of Property Interests, Statutory Rule Against Perpetuities, International Wills, Succession without Administration, Trustee Powers, Estate Tax Apportionment, Guardianship and Protective Proceedings, Durable Powers of Attorney, and Nonprobate Transfers on Death, which address specific and discrete problems within the larger area to which the Uniform Probate Code is directed.

(f) As a general rule, the Conference should consider past experience in determining future projects and should avoid consideration of subjects that are:

(i) entirely novel and with regard to which neither legislative nor administrative experience is available;

(ii) controversial because of disparities in social, economic or political policies or philosophies among the various States; and

(iii) of purely local or state concern and without substantial interstate implications unless conceived and drafted to fill emergent needs or to modernize antiquated concepts.

Prepared Statement of Reginald V. Goodale

Introduction

Good Morning, I am honored and privileged to be able to address the United States Senate Finance Committee. My name is Regi Goodale and I am here today representing the Iowa Association of Electric Cooperatives (IAEC). The IAEC is a trade association representing electric cooperatives in Iowa. On behalf of the member electric cooperatives and the approximately 200,000 homes, farms and industries served by Iowa's electric cooperatives I would like to express our appreciation for the opportunity to present information on this very important topic. I am employed by the IAEC as the Director of Regulatory Affairs.

On Friday August 22, 2003, I submitted 150 hard copies of the written testimony as well as an electronic copy to 721 Federal Building, 210 Walnut Street, Des Moines, Iowa 50309. I ask that my entire testimony be included in the record.

Iowa's locally based, not-for-profit REC's provide electric service to their memberconsumer owners in 99 counties within the state of Iowa. Based on kWhs or revenues Iowa's RECs serve about 15% of the $2.7 billion dollar electric market in Iowa.

The topic of today's hearing is "Rural Economy, Renewable Energy, and the Role of Our Cooperatives".

Renewable Energy

Iowa's RECs are working hard to provide safe and reliable electricity in a very environmentally responsible manner while at the same time keeping the electricity affordable for member-consumers. Providing environmentally responsible power comes in many forms.

Let us start with a common understanding of the concept "renewable energy". What is renewable energy? The Iowa Department of Natural Resources defines "renewable energy" as "resources that can be naturally replenished, such as wind, solar, biomass and water. The energy from these resources can be converted into electricity, heat or transportation fuel."[1]

Electric cooperatives are involved in a multitude of activities relative to renewable energy in providing electric service to their member-consumers.

Some of the renewable technologies that have been deployed or are being researched include: geothermal, wind, hydro, biomass including methane, corn, biodiesel and walnuts.

Electric cooperatives in the northeast part of the state led the state in first offering customers the option to purchase green energy through green pricing programs. This is merely one example that demonstrates how Iowa's electric cooperatives are member-consumer and service driven organizations. In 2004 all of Iowa's electric cooperatives are expected to be offering green pricing programs to their member-consumers.

Some cooperatives are investing directly into renewable projects by owning the generators, while others are investing in renewable projects through partnerships with other entities. Yet, others are establishing funds to allow for the promotion of renewable technologies owned by local consumer-members. Another is investigating the purchase of renewable fuel products to be used in generators owned by the cooperative. Flexibility with partnerships as well as approaches in finding cooperative solutions is paramount to moving forward as we see the electric industry change. Providing for tradable tax credits is certainly something that would add to this flexibility in partnerships as well as approaches.

Tradable Tax Credits for Rural Electric Cooperatives

The Energy Tax Incentives Act makes tradable tax credits available to electric cooperatives and publicly owned utilities enabling us to also utilize the financial benefits.

Many rural consumer-owned electric cooperatives and publicly-owned utilities do not have sufficient federal income tax liability against which to apply a tax credit. Therefore, in order for Congress to provide rural electric cooperatives and publiclyowned utilities with useful incentives, we will need the ability to trade or sell our tax credits to private entities that can utilize them.

Because renewable energy sources and environmentally clean, advanced fossil fuel technologies usually are more expensive to operate than traditional sources, the federal government has made it a policy to provide investment incentives to encourage IOUs to build these facilities. The rewards are cleaner, more secure, independent, and diverse energy sources. Without comparable incentives, rural electric cooperatives and publicly owned electric utilities are not afforded the same opportunities to make these investments.

We hope you agree that cost-based power production, such as offered by cooperatives, should also be entitled to incentives associated with the development and implementation of clean coal technology and renewable energy production. Offering incentives that are not usable by this significant segment of the market removes the opportunity to employ the existing capacity of cooperative and publicly owned utilities to deploy their expertise and resources in seeking solutions to the nation's energy challenges. To offer incentives to investor-owned companies and not to consumer-owned cooperatives would place us at a great competitive disadvantage in addressing the energy needs of Iowa and our country.

Parallels in Law Supporting Tradable Tax Credits

There are several provisions in the Tax Code similar to the tradable tax proposal. Exempt organizations can qualify for tax credits by engaging in an unrelated trade or business; however their ability to benefit from the general business credit (the term used to include virtually all credits) is extremely limited. However, some of the credits are directed toward the economic event targeted in the law as opposed to taxpayer's investing in the property or activity generating the credit. For example,

- Section 41 Research credits are allowed for qualified research expenses paid to tax exempt universities;
- Section 38(b)(3) Alcohol fuel credits apply to the alcohol sold or used as fuel, regardless of the tax status of the producer or user;
- Section 47(a) credit addressing, in part, certified historic structures, allows the credit even though the structure may be used by a tax exempt entity; and
- Sections 613A and 619 provide for the depletion allowance for oil and gas and timber, regardless of the tax status of the owner of the property.

[1] See page 7 of the Iowa Department of Natural Resources 2002 Renewable Energy Resource Guide *http://www.state.ia.us/dnr/eneray/pubs/irerg/index.htm.*

Each of these examples advance the public policy without penalizing any member of the economy that implements the public policy objective. In addition, while not a tax provision, an excellent and parallel example of the Tradable Tax Credit proposal is found in the tradable credits of 1990, 42 U.S.C. section 7651 et seq. The Clean Air Act Amendments of 1990 established a system to issue emission allowances for airborne pollutants, implemented by the Environmental Protection Agency. Electric utilities were issued emission allowances authorizing the emission of a specified amount of airborne pollutants by the utility during a specified calendar year or later period. Starting in 1993, unused allowances may be sold, traded or held in inventory for use against emissions in future years.

Rural Economics

While renewable resources can certainly have economic impacts on the rural economy, other aspects of the electric cooperative's business also have impacts. One critical area is the efficient use of energy. Efficient use of energy is positive from virtually any angle, particularly from a rural economic point of view. Iowa's electric cooperatives have initiated and implemented programs that encourage the efficient use of the member's resources, the cooperative's resources and our nation's natural resources. Iowa's electric cooperatives are investing about $6.5 million per year in energy efficiency in some 27 programs. This annual investment has significant environmental and economic benefits in the local communities where we provide service.

Electric cooperatives have in place a streamlined process for the interconnection of member-owned renewable facilities. This is an option available for those memberconsumers who want to invest directly in renewable technologies and sell any of their excess output to the cooperative.

Electric cooperatives have a strong commitment to education, and the IAEC has also been working with our member cooperatives and the member consumers with regard to renewable energy. The IAEC has conducted several training sessions for cooperative employees with regard to renewable energy. We have developed a brochure for use with member-consumers and we have run a series of stories in our statewide magazine, the Iowa REC News, addressing renewable energy. We have also partnered with the Iowa Farm Bureau in educating the electric cooperatives and member-consumers about opportunities under the federal farm bill related to renewable energy and energy efficiency.

Leveraging technologies that can impact energy savings is another important approach to this issue. For example, several Iowa RECs are investing in or investigating automated meter reading technologies. While transportation fuel savings are not the primary driver of such investments, this technology certainly impacts energy savings related to transportation fuels that would be used in vehicles that would otherwise travel the roads each month to read the meters. Having meetings via the internet and other technologies can also save transportation fuel. This becomes particularly relevant when one looks at how spread out the REC customer base is relative to investor-owned utilities or municipal utilities. In Iowa, the RECs average about 3 consumers per mile of line whereas the investor-owned utilities average about 22 and municipal utilities average about 42.

Iowa's RECs are also involved in a multitude of other rural economic development activities through alliances such as the Iowa Area Development Group and participation in the rural economic development loan and grant program.

Conclusion

This overview should give you an idea of some of the activities related to renewable energy and the rural economy that RECs in Iowa have been deploying to deliver electric service. Iowa's locally based, not-for-profit RECs are committed to providing safe, reliable, environmentally responsible and affordable electric service to memberowners. We do appreciate the efforts of Chairman Grassley and others in working to make the tax credits tradable as this will provide another potential option.

Thank you for the opportunity to appear before you today. I would be pleased to answer any questions that you may have.

U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

http://finance.senate.gov

For Immediate Release
Thurs., August 21, 2003

Grassley Plans Iowa Hearing on Rural Economy, Renewable Energy, Farmer Cooperatives

Event:	Field Hearing of the Senate Committee on Finance "Rural Economy, Renewable Energy & the Role of Our Cooperatives" Chairman, U.S. Sen. Chuck Grassley, of Iowa
Date: Time:	Tues., August 26, 2003 9:30 a.m. (CDT)
Location:	Heartland Cooperatives 1107 Sycamore, Dallas Center, Iowa
Description:	The Senate Committee on Finance has jurisdiction over all tax policy considered by the U.S. Senate. As chairman of the committee, Sen. Chuck Grassley has promoted a wide range of tax initiatives designed to enhance the rural economy.

His initiatives include legislation to repeal the dividend allocation rule for farmer cooperatives. This bill would eliminate a triple tax now imposed on dividends of capital stock for farmer cooperatives. The tax penalizes farmer cooperatives relative to other types of cooperatives and limits the ability of farmer cooperatives to raise the equity capital needed to modernize, expand, seek value-added market opportunities and compete.

Sen. Grassley also has advanced a renewable energy tax package through the Senate. The package reflects Sen. Grassley's longtime effort to foster domestic production of environmentally friendly electricity and fuel. It includes tax incentives for wind energy, biomass, biodiesel, ethanol, energy-efficient appliances, and swine and bovine waste. In 1992, Sen. Grassley authored the first-ever wind-energy tax credit. The new proposal would allow non-taxpaying electric utilities, like electric cooperatives, to trade or sell the tax credits. It would also change current law so that ethanol cooperatives could benefit from the small producers ethanol credit. In 1997, he won a 10-year extension of the ethanol excise tax exemption. The original wind-energy tax credit and ethanol tax incentive helped create a launching pad for investors and farmers to build wind farms and ethanol processing facilities in Iowa.

In addition, Sen. Grassley has worked to reshape the ethanol excise tax exemption so that ethanol-blended fuels make the same contribution to the highway trust fund as regular gasoline, while extending the ethanol tax incentive to 2010 and making biodiesel eligible for the excise tax credit. His proposal has 22 Senate cosponsors, reflecting broad, bipartisan support.

Finally, Sen. Grassley has sponsored legislation to override an IRS position that now prevents tax-exempt cooperatives from including processes that add value through animals in their marketing activities. Sen. Grassley's legislation, for example, would allow cooperatives to market eggs laid by chickens who are fed corn received by the cooperative from member farmers. Sen. Grassley has also sponsored legislation that would expand access to judicial review for farmer cooperatives in disputes over their tax-exempt status.

Sen. Grassley has planned a field hearing of the Committee on Finance to promote these policies and collect testimony from rural leaders. The following witnesses are scheduled to appear at the August 26 hearing in Dallas City, Iowa.

Thomas C. Dorr, Undersecretary for Rural Development
U.S. Department of Agriculture, Washington, D.C.

Thomas Earl Geu, Professor of Law
University of South Dakota, Vermillion, South Dakota
Mr. Geu will testify as a representative of the National Conference on Commissioners of Uniform State Laws

Regi Goodale, Director of Regulatory Affairs
Iowa Association of Electric Cooperatives, Des Moines, Iowa

John Campbell, Vice President of Gov't Relations and Industrial Products
Ag Processing Inc., Omaha, Nebraska

Bob Dinneen, President
Renewable Fuels Association, Washington, D.C.

Senator Grassley's statement introducing the Volumetric Ethanol Excise Tax Credit (VEETC)

Mr. President, As Members of this Senate are well aware, I have worked for many years on the development of renewable fuels in the marketplace. Twenty-five years ago we created an alcohol fuels tax incentive to promote the use of ethanol. Today, I am introducing legislation that will simplify the excise tax collection system for all transportation and renewable fuels.

This legislation reforms the alcohol fuels tax credit and creates a new "Volumetric Ethanol Excise Tax Credit" (VEETC).

In addition to streamlining the alcohol fuels tax credit, this legislation creates a new tax credit for biodiesel.

Under the VEETC we accomplish three objectives:

1. Improve the tax collection system for renewable fuels;

2. Increase the revenue source for the Highway Trust Fund.

This is because the full amount of user excise taxes levied will be collected and remitted to the Highway Trust Fund (HTF). In simplifying the tax collection system, all user excise taxes levied on both gasoline and ethanol blended fuels would be collected at 18.4 cents per gallon; and all excise taxes levied on diesel and biodiesel blended fuels would be collected at 24.4 cents per gallon. On average, the proposal would generate more than $2 billion per year in additional HTF revenue, which would improve the ability of the federal government to address the nation's transportation infrastructure needs; and

3. We will enhance the delivery of renewable fuels in the marketplace, because the federal government's tax collection system will work in concert with the petroleum industry's and independent terminal's fuel delivery system.

The Grassley/Baucus amendment provides tremendous new flexibility to gasoline refiners, marketers, and ethanol producers. It eliminates the restrictive blend levels (5.7%, 7.7% and 10%) dictated by the tax code to reflect obsolete Clean Air Act requirements, providing significant flexibility to oil companies to blend as much or as little ethanol or biodiesel to meet their octane or volume needs. It streamlines the tax collection system to avoid the potential for fraud while accelerating the refund mechanism. It provides new market opportunities for ethanol and biodiesel in off-road uses, E-85 and ETBE. and, of course, it resolves a longstanding issue with regard to the Highway Trust Fund.

The "Volumetric Ethanol Excise Tax Credit Act of 2003" is a forward-looking piece of legislation that deserves universal support and it will address a number of tax issues that have created roadblocks for the renewable industry for a number of years. Specifically, the tax amendment will do the following:

Ethanol

- Eliminate the negative impact of the ethanol tax incentive on the Highway Trust Fund;

- Eliminate the waste, fraud and abuse of the excise tax collection system, which means that 18.4¢ per gallon of each gallon of ethanol-blend fuel will be remitted to the U.S. Treasury;

- Streamline the delivery of renewable fuels to petroleum blenders at the terminal rack because fuel mixtures will not be based on the Clean Air Act requirements of 5.7, 7.7 or 10% blends

  Streamline the tax refund system for below the rack blenders to allow a tax refund of 52 cents per gallon on each gallon of ethanol blended with gasoline <u>to be paid within 20 days</u> of blending gasoline with ethanol;

- Eliminate the need of the alcohol fuels income tax credit that is subject to the alternative minimum tax;

- any taxpayer eligible for the alcohol fuels tax credit will be able use the volume ethanol excise tax credit system, which means they will be able to file for a refund for every gallon of ethanol used in the marketplace without regard to the income of the taxpayer or whether the ethanol is used in a taxed fuel or tax exempt fuel.

Biodiesel

- Create a new tax credit for biodiesel
  - $1.00 per gallon for biodiesel made from virgin oils derived from agricultural products and animal fats; and
  - $.50 per gallon for biodiesel made from agricultural products and animal fats;

- Allow the credit to be claimed in both taxable and nontaxable markets;
  - Tax exempt fleet fuel programs
  - Off road diesel markets (died diesel)

- Streamline the use of biodiesel at the terminal rack
  - The tax structure and credit will encourage petroleum blenders to blend biodiesel as far upstream as possible, which under the RFS or Minnesota's 2% volume requirement will allow more biodiesel to be used in the marketplace

- Streamline the tax refund system for below the rack blenders to allow a tax refund of the biodiesel tax credit on each gallon of biodiesel blended with diesel (dyed or undyed) to be paid within 20 days of blending;

- The alternative minimum tax (AMT) will not be an issue for biodiesel;
  - any taxpayer eligible for the biodiesel tax credit will be able use the volume biodiesel excise tax credit system, which means they will be able to file for a refund for every gallon of biodiesel used in the marketplace without regard to the income of the taxpayer or whether the ethanol is used in a taxed fuel or tax exempt fuel;

- No affect on the Highway Trust Fund – the biodiesel tax credit will be paid for out of the "General Fund" not the "Highway Trust Fund."

E85

- Eliminate the E85 AMT issue
  - any taxpayer eligible for the alcohol fuels tax credit will be able use the volume ethanol excise tax credit system, which means they will be able to file for a refund for every gallon of ethanol used in the marketplace without regard to the income of the taxpayer or whether the ethanol is used in a taxed fuel or tax exempt fuel.

- Allow the alcohol fuels tax credit to be claimed in both taxable and nontaxable markets;
  - Tax exempt fleet fuel programs

- Streamline the tax refund system for below the rack blenders to allow a tax refund of the alcohol fuels credit on each gallon of ethanol blended with gasoline to be paid within 20 days of blending.

I feel strongly about the legislation because it simplifies the tax, infrastructure, and fuel delivery impediments that have been problematic throughout the history of the renewable fuels industry and encourage you to join us in working to enact this legislation during this Congress.

Floor Statement of Senator Charles Grassley regarding the Introduction of the Dividend Allocation Rule Remedy

The Dividend Allocation Rule (DAR) is the result of several old court cases and subsequent IRS interpretation that applies only to cooperatives which are corporations. When a non-cooperative corporation pays a dividend to its shareholder the corporation pays tax on the dividend issued and the shareholder pays a tax on the dividend received, so they pay two levels of taxation. In fact, under the President's dividend exclusion proposal as presented to the US Congress, the President of the United States makes a compelling argument that being taxed twice is inherently unfair and it would be good for the Nation's economy that only one level of tax should be paid by the corporation and that the shareholder would receive the dividend tax free.

Well - if two levels of taxation on corporations and their shareholders is unfair and adverse to the creation of capital and the economy - how would you like to try to operate as a fiscally sound business entity if you had to figure out every day how you were going to generate enough cash flow to pay THREE levels of taxation.

Current law requires corporate cooperatives to treat income from their member-owners (patrons) separate from income of their non-members money. Contributions and earnings used by the cooperative to operate is typically called retained patronage. The member (unlike a shareholder) has to pay income tax on that amount even if the Cooperative retains the money for operation expenses. Then, because of the IRS' rules, when the Cooperative returns money to its non-members it loses its corporate deduction which in turn reduces the return of earnings that the patron has already paid taxes on - the result is a triple layer of tax. This rule is inherently unfair to our corporate cooperatives.

Now is the time to finally correct this injustice. The Congress passed this bill in 106th Congress, but it was subsequently vetoed by President Clinton. It was a part of a bill I sponsored the "Tax Empowerment and Relief for Farmers and Fisherman (TERFF) Act" in the 107th, and now it is time for the Senate to pass it again in the 108th. As Chairman of the Finance Committee, I am proud to join with my Ranking Member Max Baucus to introduce the bill to repeal the Dividend Allocation Rule. We have been joined by many of our farm states' Senators in a truly bipartisan effort to correct this financial injustice.

The time to act is now and this bi-partisan legislation will eliminate the adverse tax problem and will help rejuvenate over 100 our farmer cooperative networks in Iowa and nearly 3000 of our cooperatives across the America.

Calendar No. 113

108TH CONGRESS } SENATE { REPORT
1st Session } { 108–54

ENERGY TAX INCENTIVES ACT OF 2003

MAY 23, 2003.—Ordered to be printed

Mr. GRASSLEY, from the Committee on Finance, submitted the following

REPORT

[To accompany S. 1149]

[Including cost estimate of the Congressional Budget Office]

The Committee on Finance reported an original bill (S. 1149) to amend the Internal Revenue Code of 1986 to provide energy tax incentives, and for other purposes, having considered the same, reports favorably thereon and recommends that the bill do pass.

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TITLE I—RENEWABLE ELECTRICITY PRODUCTION TAX CREDIT

A. EXTENSION AND MODIFICATION OF THE SECTION 45 ELECTRICITY PRODUCTION CREDIT

(Sec. 101 of the bill and sec. 45 of the Code)

PRESENT LAW

An income tax credit is allowed for the production of electricity from either qualified wind energy, qualified "closed-loop" biomass, or qualified poultry waste facilities (sec. 45). The amount of the credit is 1.5 cents per kilowatt hour (indexed for inflation) of electricity produced. The amount of the credit was 1.8 cents per kilowatt hour for 2002. The credit is reduced for grants, tax-exempt bonds, subsidized energy financing, and other credits.

The credit applies to electricity produced by a wind energy facility placed in service after December 31, 1993, and before January 1, 2004, to electricity produced by a closed-loop biomass facility placed in service after December 31, 1992, and before January 1, 2004, and to a poultry waste facility placed in service after December 31, 1999, and before January 1, 2004. The credit is allowable for production during the 10-year period after a facility is originally placed in service. In order to claim the credit, a taxpayer must own the facility and sell the electricity produced by the facility to an unrelated party. In the case of a poultry waste facility, the taxpayer may claim the credit as a lessee/operator of a facility owned by a governmental unit.

Closed-loop biomass is plant matter, where the plants are grown for the sole purpose of being used to generate electricity. It does not include waste materials (including, but not limited to, scrap wood, manure, and municipal or agricultural waste). The credit also is not available to taxpayers who use standing timber to produce electricity. Poultry waste means poultry manure and litter, including wood shavings, straw, rice hulls, and other bedding material for the disposition of manure.

The credit for electricity produced from wind, closed-loop biomass, or poultry waste is a component of the general business credit (sec. 38(b)(8)). The credit, when combined with all other components of the general business credit, generally may not exceed for any taxable year the excess of the taxpayer's net income tax over the greater of (1) 25 percent of net regular tax liability above $25,000, or (2) the tentative minimum tax. For credits arising in taxable years beginning after December 31, 1997, an unused general business credit generally may be carried back one year and carried forward 20 years (sec. 39). To coordinate the carryback with the period of application for this credit, the credit for electricity produced from closed-loop biomass facilities may not be carried back to a tax year ending before 1993 and the credit for electricity produced from wind energy may not be carried back to a tax year ending before 1994 (sec. 39).

REASONS FOR CHANGE

The Committee recognizes that the section 45 production credit has fostered additional electricity generation capacity in the form of non-polluting wind power. The Committee believes it is important to continue this tax credit by extending the placed in service date for such facilities to bring more wind energy to the United States electric grid. The Committee also believes it is important to extend the placed in service date for closed-loop biomass facilities to give those potential fuel sources an opportunity in the market place. The Committee also believes it is appropriate to include in qualifying facilities those facilities that co-fire closed-loop biomass fuels with coal, with other biomass, or with coal and other biomass.

Based on the success of the section 45 credit in the development of wind power as an alternative source of electricity generation, the committee further believes the country will benefit from the expansion of the production credit to certain other "environmentally friendly" sources of electricity generation such as open-loop biomass and agricultural waste nutrients, geothermal power, solar power, biosolids and sludge, small irrigation systems, and trash combustion. While not all of these additional facilities are pollution free, they do address environmental concerns related to waste disposal. In addition, these potential power sources further diversify the nation's energy supply.

In the current electricity market, the Committee believes that a subsidy via a tax credit of 1.8 cents per kilowatt-hour should provide sufficient incentive to investors to enter the market with alternative sources of electricity. Therefore the Committee believes indexing of the credit amounts for years after 2003 is unwarranted.

Because tax-exempt persons such as public power systems and cooperatives provide a significant percentage of electricity in the United States, the Committee believes it is important to provide the incentive for production from renewable resources to these persons in addition to taxable persons.

Lastly, the Committee believes that certain pre-existing facilities should qualify for the section 45 production credit, albeit at a reduced rate. These facilities previously received explicit subsidies, or implicit subsidies provided through rate regulation. In a deregulated electricity market, these facilities, and the environmental benefits they yield, may be uneconomic without additional economic incentive. The Committee believes the benefits provided by such existing facilities warrant their inclusion in the section 45 production credit.

EXPLANATION OF PROVISION

The provision extends the placed in service date for wind facilities, and closed-loop biomass facilities to facilities placed in service after December 31, 1993 (December 31, 1992 in the case of closed-loop biomass) and before January 1, 2007.

The provision provides that, for facilities placed in service after the date of enactment, the amount of the credit will be 1.8 cents per kilowatt hour with no adjustment for inflation for production in years after 2003.

The provision also defines six new qualifying energy resources: biomass (including agricultural livestock waste nutrients), geothermal energy, solar energy, small irrigation power, biosolids and sludge, and municipal solid waste.

Qualifying biomass facilities are facilities using biomass to produce electricity that are placed in service prior to January 1, 2005. Qualifying agricultural livestock waste nutrient facilities are facilities using agricultural livestock waste nutrients to produce electricity that are placed in service after the date of enactment and before January 1, 2007.

For a facility placed in service after the date of enactment, the ten-year credit period commences when the facility is placed in service. In the case of biomass facility originally placed in service before the date of enactment, the ten-year credit period is reduced to a five-year period and commences after December 31, 2003 and the otherwise allowable 1.8 cent-per-kilowatt-hour credit is reduced to a 1.2 cent-per-kilowatt-hour credit.[1]

[1] As is the case for the 1.8 cents-per-kilowatt-hour credit, the 1.2 cents-per-kiowatt-hour credit is not indexed for future inflation.

The provision modifies present law to provide that qualifying closed-loop biomass facilities include any facility originally placed in service before December 31, 1992 and modified to use closed-loop biomass to co-fire with coal, to co-fire with other biomass, or to co-fire with coal and other biomass, before January 1, 2007. The taxpayer may claim credit for electricity produced at such qualifying facilities with the credit amount equal to the otherwise allowable credit multiplied by the ratio of the thermal content of the closed loop biomass fuel burned in the facility to the thermal content of all fuels burned in the facility.

Qualifying geothermal energy facilities are facilities using geothermal deposits to produce electricity that are placed in service after the date of enactment and before January 1, 2007. Qualifying solar energy facilities are facilities using solar energy to generate electricity that are placed in service after the date of enactment and before January 1, 2007. In the case of qualifying geothermal energy facilities and qualifying solar energy facilities, taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility is placed in service.

A qualified small irrigation power facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A small irrigation power facility is a facility that generates electric power through an irrigation system canal or ditch without any dam or impoundment of water. The installed capacity of a qualified facility is less than five megawatts.

A qualified biosolids and sludge facility is a facility originally placed in service after the date of enactment and before January 1, 2007. A biosolids and sludge facility is a facility that uses the waste heat from the incineration of biosolids and sludge to produce electricity. For example, if the taxpayer conveys biosolids and sludge into a glass furnace for the purpose of stabilizing the inorganic contents of the biosolids and sludge in an amorphous glass matrix (and potentially selling the resulting glass aggregates), and the taxpayer uses the waste heat from the glass furnace to generate steam to power a turbine and produce electricity, the electricity produced would be from a qualified biosolids and sludge facility. In addition, a qualifying biosolids and sludge facility is a facility for which the taxpayer has not claimed credit as a combined heat and power system property as defined elsewhere in this bill.

Municipal solid waste facilities (or units) are facilities (or units) that burn municipal solid waste (garbage) to produce steam to drive a turbine for the production of electricity. Qualifying municipal solid waste facilities (or units) include facilities (or units[2]) placed in service after the date of enactment and before January 1, 2007. In the case of qualifying municipal solid waste facilities (or units), taxpayers may claim the otherwise allowable credit for the five-year period commencing when the facility (or unit) is placed in service.[3]

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[2] For this purpose a unit eligible under the bill would comprise a new burner, boiler and turbine system installed on the site of an existing municipal solid waste facility.

[3] No credit is permitted during the taxable year if, during any portion of the taxable year, there is a certification in effect by the Administrator of the Environmental Protection Agency that the facility was permitted to operate in a manner inconsistent with section 4003(d) of the Solid Waste Disposal Act.

Biomass is defined as any solid, nonhazardous, cellulosic waste material which is segregated from other waste materials and which is derived from any of forest-related resources, solid wood waste materials, or agricultural sources. Eligible forest-related resources are mill and harvesting residues, precommercial thinnings, slash, and brush. Solid wood waste materials include waste pallets, crates, dunnage, manufacturing and construction wood wastes (other than pressure-treated, chemically-treated, or painted wood wastes), and landscape or right-of-way tree trimmings. Agricultural sources include orchard tree crops, vineyard, grain, legumes, sugar, and other crop by-products or residues. However, qualifying biomass for purposes of this provision does not include municipal solid waste (garbage), gas derived from biodegradation of solid waste, or paper that is commonly recycled. Agricultural waste nutrients are defined as livestock manure and litter, including bedding material for the disposition of manure. Agricultural livestock comprise bovine, swine, poultry,[4] and sheep among others.

Geothermal energy is energy derived from a geothermal deposit which is a geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure).

Biosolids and sludge are the residue or solids removed during the treatment of commercial, industrial, or municipal wastewater.

Municipal solid waste is "solid waste" as defined in section 2(27) of the Solid Waste Disposal Act.

The provision provides that certain persons (public power systems, electric cooperatives, rural electric cooperatives, and Indian tribes) may sell, trade, or assign to any taxpayer any credits that would otherwise be allowable to that person, if that person were a taxpayer, for production of electricity from a qualified facility owned by such person. However, any credit sold, traded, or assigned may only be sold, traded, or assigned once. Subsequent transfers are not permitted. In addition, any credits that would otherwise be allowable to such person, to the extent provided by the Administrator of the Rural Electrification Administration, may be applied as a prepayment to certain loans or obligations undertaken by such person under the Rural Electrification Act of 1936.

In the case of qualifying open-loop biomass facilities, qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, and qualifying municipal solid waste facilities, the provision permits a lessee or operator to claim the credit in lieu of the owner of the facilities.

Lastly, the provision repeals the present-law reduction in allowable credit for facilities financed with tax-exempt bonds or with certain loans received under the Rural Electrification Act of 1936. In the case of qualifying closed-loop biomass facilities modified to use closed-loop biomass to co-fire with coal, with other biomass, or with coal and other biomass, the provision repeals the present-law reduction in allowable credit for facilities that receive any subsidy.

EFFECTIVE DATE

The provision generally is effective for electricity produced and sold from qualifying facilities after the date of enactment. For electricity produced from qualifying open-loop biomass facilities originally placed in service prior to the date of enactment, the provision is effective January 1, 2004.

[4] The provision deletes poultry litter as a separate qualifying facility for facilities placed in service after the effective date. Poultry litter facilities remain qualifying facilities as agricultural waste nutrient facilities. Any poultry litter facility placed in service on or prior to the date of enactment is unaffected by the modifications made by this provision. For example, the value of the credit that may be claimed for production from such a facility would continue to be indexed for inflation.

B. Modifications to Small Producer Ethanol Credit

(Sec. 205 of the bill and secs. 38, 40, 87, and 469 of the Code)

PRESENT LAW

Small producer credit

Present law provides several tax benefits for ethanol and methanol produced from renewable sources (e.g., biomass) that are used as a motor fuel or that are blended with other fuels (e.g., gasoline) for such a use. In the case of ethanol, a separate 10-cents-per-gallon credit for small producers, defined generally as persons whose production does not exceed 15 million gallons per year and whose production capacity does not exceed 30 million gallons per year. The alcohol fuels tax credits are includible in income. This credit, like tax credits generally, may not be used to offset alternative minimum tax liability. The credit is treated as a general business credit, subject to the ordering rules and carryforward/carryback rules that apply to business credits generally. The alcohol fuels tax credit is scheduled to expire after December 31, 2007.

Taxation of cooperatives and their patrons

Under present law, cooperatives in essence are treated as pass-through entities in that the cooperative is not subject to corporate income tax to the extent the cooperative timely pays patronage dividends. Under present law, the only excess credits that may be flowed-through to cooperative patrons are the rehabilitation credit (sec. 47), the energy property credit (sec. 48(a)), and the reforestation credit (sec. 48(b)).

REASONS FOR CHANGE

The Committee believes provisions allowing greater flexibility in utilizing the benefits of the small ethanol producer credit are consistent with the objective of the bill to increase availability of alternative fuels.

EXPLANATION OF PROVISION

The provision makes several modifications to the rules governing the small producer ethanol credit. First, the provision liberalizes the definition of an eligible small producer to include persons whose production capacity does not exceed 60 million gallons. Second, the provision allows cooperatives to elect to pass-through the small ethanol producer credits to its patrons. The credit allowed to a particular patron is that proportion of the credit that the cooperative elects to pass-through for that year as the amount of patronage of that patron for that year bears to total patronage of all patrons for that year.

Third, the provision repeals the rule that includes the small producer credit in income of taxpayers claiming it and liberalizes the ordering and carryforward/carryback rules for the small producer ethanol credit. Fourth, the provision allows the small producer credit to be claimed against the alternative minimum tax. Finally, the provision provides that the small producer ethanol credit is not treated as derived from a passive activity under the Code rules restricting credits and deductions attributable to such activities.

EFFECTIVE DATE

The provision is effective for taxable years beginning after date of enactment.

C. Expensing of Capital Costs Incurred and Credit for Production in Complying With Environmental Protection Agency Sulfur Regulations

(Secs. 503 and 504 of the bill and new secs. 179C and 45L of the Code)

PRESENT LAW

Taxpayers generally may recover the costs of investments in refinery property through annual depreciation deductions. Present law does not provide a credit for the production of low-sulfur diesel fuel.

REASONS FOR CHANGE

The Committee believes it is important for all refiners to meet applicable pollution control standards. However, the Committee is concerned that the cost of complying with the Highway Diesel Fuel Sulfur Control Requirement of the Environmental Protection Agency may force some small refiners out of business. To maintain this refining capacity and to foster compliance with pollution control standards the Committee believes it is appropriate to modify cost recovery provisions for small refiners to reduce their capital costs of complying with the Highway Diesel Fuel Sulfur Control Requirement of the Environmental Protection Agency.

EXPLANATION OF PROVISION

The provision generally permits small business refiners to claim an immediate deduction (i.e., expensing) for up to 75 percent of the qualified capital costs paid or incurred for the purpose of complying with the Highway Diesel Fuel Sulfur Control Requirements of the Environmental Protection Agency. Qualified capital costs are those costs paid or incurred and otherwise chargeable to the taxpayer's capital account that are necessary for the refinery to come into compliance with the EPA diesel fuel requirements.

In addition, the provision provides that a small business refiner may claim a credit equal to five cents per gallon for each gallon of low sulfur diesel fuel produced at a facility of a small business refiner. The total production credit claimed by the taxpayer generally is limited to 25 percent of the qualified capital costs incurred with respect to expenditures at the refinery during the period beginning after the date of enactment and ending with the date that is one year after the date on which the taxpayer must comply with applicable EPA regulations. No deduction is allowed to the taxpayer for expenses otherwise allowable as a deduction in an amount equal to the amount of production credit claimed during the taxable year.

For these purposes a small business refiner is a taxpayer who within the business of refining petroleum products employs not more than 1,500 employees directly in refining on business days during a taxable year in which the deduction or production credit is claimed and had an average daily refinery run (or retained production) not exceeding 205,000 barrels per day[34] for the year prior to enactment.

[34] The refining capacities of all persons that are part of a related group are aggregated for purposes of this definition. In addition, in any case where refinery through-put or retained production of the refinery differs substantially from its average daily output of refined product, the Committee intends that capacity be measured by reference to the average daily output of refined product.