Memo file

Prepared by the North Dakota Legislative Council
staff for the Taxation Committee
July 1997

TAXATION AND REGULATORY ENVIRONMENT FOR NORTH DAKOTA'S LIGNITE INDUSTRY

Senate Concurrent Resolution No. 4050 (attached as an appendix) directs the Legislative Council to study the feasibility and desirability of providing taxation incentives and eliminating unnecessary regulatory burdens to improve the competitive position of the North Dakota lignite industry. The resolution states that the objective of enhancing the competitive position of the lignite industry is to protect and enhance the jobs and economic activity associated with the development of the state's abundant lignite resource, while at the same time maintaining a clean and healthy environment for all of our state's citizens. Supporters of the resolution testified before the standing committees considering the resolution that the intent is to explore methods to allow the state to maintain assurance that the lignite industry remains competitive with production from other coal-producing states. Supporters of the resolution and the text of the resolution indicate that taxation and regulatory compliance costs constitute up to 30 percent of the production costs for North Dakota lignite and reduction of these costs could improve the competitive position of North Dakota's lignite industry.

The purpose of this memorandum is to review the taxation and regulatory structure provided under state law. North Dakota has two taxes that are imposed on the coal industry--the coal severance tax and the coal conversion facilities privilege tax, both enacted in 1975. The coal severance tax is imposed on coal mined in North Dakota while the coal conversion facilities privilege tax is imposed on the privilege of producing electricity, synthetic natural gas, or other products from coal. The general state sales tax is significant because it applies to sales of coal that are not subject to the severance tax. The supporters of the study resolution testified that up to 40 state and local permits must be obtained before operation of a coal mine or a coal conversion facility.

COAL SEVERANCE TAX

A 1973-74 interim Legislative Council study of coal severance taxes, property tax imposition on coal gasification plants, distribution of revenues, and aid for impact of coal development led to enactment of 1975 Senate Bill No. 2031, which created a coal severance tax and a coal impact aid program. The 1975 Legislative Assembly also passed House Bill No. 1221, which created a privilege tax on coal conversion facilities.

Senate Bill No. 2031 (1975) was a temporary law and was essentially reenacted in 1977, again as a temporary law. In 1979 the coal severance tax became permanent law. Under the 1975 law, the coal severance tax rate was set at 50 cents per ton plus an amount determined by an escalator clause that provided for an increase in the tax of one cent per ton for every three-point increase in the index of wholesale prices for all commodities as prepared by the United States Department of Labor, Bureau of Labor Statistics. The 1977 Legislative Assembly increased the base rate of the tax to 65 cents per ton plus an amount determined by application of an escalator equal to one cent per ton for each one-point increase in the index of wholesale prices for all commodities. In 1979 the coal severance tax rate was set at a base rate of 85 cents per ton with an escalator that would increase the rate of tax by one cent per ton for every four-point increase in the index of wholesale prices for all commodities. It was provided that, even though the wholesale price index may decline, the rate of severance tax would not be reduced. The formula for determining the coal severance tax rate remained as passed in 1979, and the rate imposed reached a high of $1.04 per ton, which remained in place until passage of 1987 House Bill No. 1065. The 1987 legislation reduced the general coal severance tax rate to 75 cents per ton, eliminated the escalator provision, and imposed an additional separate tax of two cents per ton, with the proceeds of the separate tax allocated to the lignite research fund. The rate of tax has been unchanged since 1987.

The coal severance tax is in lieu of sales or use taxes. Any coal that is exempt from the severance tax is subject to sales and use taxes unless a sales or use tax exemption exists. Severance tax exemptions are provided for coal used primarily for heating buildings and coal used by the state or any political subdivision. Purchases by the state or a political subdivision are exempt from the sales tax, but coal used for heating privately owned buildings is not exempt from the sales tax. An additional severance tax exemption was created in 1985 by enactment of North Dakota Century Code (NDCC) Section 57-61-01.4, which provides an exemption for coal used in agricultural processing or sugar beet refining plants located in North Dakota or adjacent states. Coal exempted for these purposes is not subject to sales and use taxes under subsection 44 of Section 57-39.2-04. Section 57-61-01.3, also created in 1985, provides

that the severance tax rate is reduced by 50 percent if the coal is to be burned in a cogeneration facility. Coal mined for out-of-state shipment is subject to a reduced tax rate from July 1, 1995, through June 30, 2000.

Coal shipped into North Dakota for use in a coal conversion facility would not have been subject to North Dakota's severance tax under the law as it existed until this year. Passage of 1997 House Bill No. 1467 provided that such coal would be subject to a special sales tax of six cents per million Btus and that revenue from the special sales tax would be allocated in the same manner as coal severance tax revenues.

An exemption from the state's share of coal severance or sales taxes was created for coal burned in smaller generating stations in this state or an adjacent state by passage of 1997 House Bill No. 1467. This exemption does not apply to the coal development trust fund share of revenue but the bill allows political subdivisions to individually give up their share of tax revenues on such coal.

Coal is considered to be severed and subject to the severance tax when it is first removed from the earth unless within 30 days of removal it is placed into a long-term storage deposit. If placed in storage, it is considered severed when removed from storage or pledged as collateral on a loan, as provided in NDCC Section 57-61-01.2.

All severance taxes, penalties, and interest collected by the State Tax Commissioner are transferred to the State Treasurer within 15 days of receipt and are credited to a special fund in the state treasury called the coal development fund. The revenue in the coal development fund is allocated under a detailed formula contained in NDCC Section 57-62-02. Fifteen percent of the revenue in the coal development fund is to be deposited in a permanent trust fund in the state treasury known as the coal development trust fund. This fund is held in trust and administered by the Board of University and School Lands for loans to coal-impacted counties, cities, and school districts. Under NDCC Section 57-61-01.5(2), 70 percent of deposits in the trust fund are to be transferred to the lignite research fund. Thirty-five percent of the revenue in the coal development fund is allocated to coal-producing counties in the proportion that the number of tons of coal severed in each county bears to the total number of tons of coal severed in the state. The remaining 50 percent of the revenue in the coal development fund is to be deposited in the state general fund, but after June 30, 1997, the general fund share of revenue from new production from clean coal demonstration projects is to be deposited in the lignite research fund.

Of the 35 percent portion of coal development fund moneys which is distributed to coal-producing counties, 30 percent is paid by the county treasurer to incorporated cities of the county based upon population, 40 percent is deposited in the county general fund, and 30 percent is apportioned to school districts within the county based on average daily membership of each school district. The distribution formula within counties also provides for recognition of impact on surrounding areas not within the county. If the tipple of a currently active coal mining operation in a county is within 15 miles of another county in which no coal is mined, revenue apportioned from that coal mining operation is apportioned according to the same formula as county revenues with inclusion of cities, school districts, and the general fund of the non-coal-producing county within certain geographical limits.

Coal severance tax revenues for the 1997-99 biennium are estimated to be $45,846,000. Of this amount, the state general fund would receive $22,310,000, allocations to political subdivisions would be $15,640,000, and the coal development trust fund would receive $6,703,000. The remaining $1,192,000 would go to the lignite research fund.

PRIVILEGE TAX ON COAL CONVERSION FACILITIES

The privilege tax on coal conversion facilities is imposed by NDCC Section 57-60-02. A coal conversion facility is defined as an electrical generating plant that converts coal into electrical power and has a capacity of 120,000 kilowatts or more or a facility that uses over 500,000 tons of coal per year to be converted into other products. Differing tax rates are imposed on different types of coal conversion facilities.

As enacted in 1975, the coal conversion facilities privilege tax on electrical generating plants was at a rate of one-fourth of one mill per kilowatt hour of electricity produced, and the tax on coal gasification plants was the greater of 2.5 percent of gross receipts or 10 cents per 1,000 cubic feet of synthetic natural gas. In 1983 an additional one-fourth of one mill per kilowatt hour tax was imposed on electrical generating plants. In 1985 the floor on the tax for coal gasification plants was increased from 10 cents to 15 cents per 1,000 cubic feet of synthetic natural gas. In 1987 the basis of the tax for electrical generating plants was changed from kilowatt hours of electricity produced to 60 percent of the installed capacity of each generating unit times the number of hours in the taxable period, and for damaged units a reduced tax rate based on cost of repairs was established to be in effect until the unit is capable of generating electricity. Other 1987 legislation reduced the alternative tax for coal gasification plants from 15 cents to seven cents for each 1,000 cubic feet of synthetic natural gas and provided an exemption for any

synthetic natural gas production in excess of 110 million cubic feet per day. In 1989 separate tax treatment was provided for coal beneficiation plants, providing an alternative tax of 20 cents per ton of beneficiated coal or one and one-quarter percent of gross receipts, whichever is greater. In 1991 legislation was enacted to provide a five-year exemption for new electrical generating plants from all but 35 percent of the one-fourth of one mill tax based upon production capacity of the generating unit, and the 35 percent remaining tax is allocated entirely to the county and may be eliminated by the approval of the board of county commissioners.

For electrical generating plants, the present conversion tax is at a rate of one-half of one mill on each kilowatt hour of electricity produced for the purpose of sale. This tax is divided into two separate one-fourth of one mill taxes, revenues from each of which are subject to different allocations. For coal gasification plants, the rate of tax is either 2.5 percent of gross receipts or seven cents per 1,000 cubic feet of synthetic natural gas, whichever is greater. A provision enacted in 1985 provides that gross receipts from the sale of a capital asset are not included in gross receipts for purposes of the coal conversion tax. Provisions added in 1985 exempted from gross receipts any financial assistance provided by the federal government. A 1987 amendment exempted byproducts of the gasification process to a maximum of 20 percent of all gross receipts of the facility. Passage of 1997 Senate Bill No. 2196 increased the maximum gross receipts from 20 to 35 percent to be eligible for the exemption until December 31, 2000, when the limit will revert to 20 percent. Senate Bill No. 2196 also exempted sales of carbon dioxide for oil and gas recovery from the gross receipts tax. Passage of 1997 Senate Bill No. 2339 extended the property tax exemption for a pipeline to transport carbon dioxide to 10 years after initial operation, rather than commencement of construction, and allowed the exemption to apply to a pipeline carrying carbon dioxide outside the state.

Under the coal conversion tax, each coal conversion facility is classified as personal property and is exempt from property taxes except taxes on the land upon which the facility is located. The coal conversion tax is in lieu of property taxes on the facility. The coal conversion tax is also in lieu of taxes on rural electric cooperatives and cooperative electrical generating plants that qualify as coal conversion facilities.

Allocation of coal conversion tax revenues is made annually on or before July 15 of each year. Revenue from one-fourth of one mill of the tax on electrical generating plants is deposited entirely in the state general fund. Revenue from all remaining coal conversion taxes is allocated 35 percent to the producing county and 65 percent to the state general fund.

Revenue allocated to counties from the coal conversion tax is allocated within the county 40 percent to the county general fund, 30 percent to cities in the county according to population, and 30 percent to school districts in the county on an average daily membership basis.

Total revenue from coal conversion taxes for the 1997-99 biennium is estimated to be about $30,847,000. Of that amount, political subdivisions are expected to receive about $6,133,000, and the state general fund is expected to receive about $24,714,000.

ENERGY DEVELOPMENT IMPACT PROGRAM

North Dakota Century Code Section 57-62-04 establishes an energy development impact office as a division within the office of the Commissioner of the Board of University and School Lands. The director of the energy development impact office is required to develop a plan for the assistance of counties, cities, school districts, and other political subdivisions in coal development and oil and gas development impacted areas and to make grants to counties, cities, school districts, and other taxing districts within the limitations of legislative appropriations for this purpose.

Section 57-62-06 provides that it is the intent of the Legislative Assembly that the moneys appropriated to, and distributed by, the energy development impact office for grants are to be used by grantees to meet initial impacts affecting basic governmental services, and directly necessitated by coal development or oil and gas development impact.

LIGNITE RESEARCH, DEVELOPMENT, AND MARKETING

North Dakota Century Code Section 54-17.5-02 requires the Industrial Commission to consult with the Lignite Research Council established by executive order in matters of policy affecting the administration of the lignite research fund. In evaluating applications for funding from the lignite research fund for North Dakota's lignite research, development, and marketing program, the Industrial Commission and the Lignite Research Council are required to give priority to those projects, processes, or activities that will preserve existing jobs and production, that will create the greatest number of new jobs and most additional lignite production and economic growth potential in coal-producing counties or those counties with recoverable coal reserves, that will attract matching private industry investment equal to at least 50 percent or more of the total cost, and that will result in development and demonstration of a

marketable lignite product or products with a high level of probability of rapid commercialization. For marketing applications, priority must be given to those projects, processes, or activities that develop baseline information, implement specific marketing strategies, and otherwise contribute to the effective marketing of lignite and its products. For reclamation applications, priority must be given to those projects, processes, or activities that will reduce unnecessary regulatory costs and assist in effectively reclaiming surface mined land to its original or better productivity as soon as possible.

Under Section 54-17.5-05, the Industrial Commission is authorized to issue evidences of indebtedness payable solely from appropriations by the Legislative Assembly from moneys in the lignite research fund, revenues or income that may be received by the commission from lignite projects, processes, or activities funded with the proceeds of the commission's evidences of indebtedness, and revenues or income received by the commission from any other source under Chapter 54-17.5. The evidences of indebtedness may be issued for the purpose of funding research, development, and marketing projects, processes, or activities directly related to lignite and products derived from lignite. The Industrial Commission must maintain a reserve fund for evidences of indebtedness issued by the Industrial Commission relating to lignite resources. The Industrial Commission must submit to the Office of the Budget, not later than July 15 of each year preceding the biennial session of the Legislative Assembly, a request for the amount required to be appropriated from the lignite research fund to pay debt service on outstanding evidences of indebtedness during the following biennium.

Section 54-17.5-06 provides a procedure through which a person or entity may file a request with the Industrial Commission to have materials submitted to, or made or received by, the Industrial Commission and the Lignite Research Council relating to trade secrets or commercial, financial, or proprietary information confidential. In addition, a request to have material designated as confidential is considered to be confidential.

For the 1997-99 biennium, the estimated receipts for the lignite research fund are approximately $6,245,000. That amount includes about $1,192,000 from the separate and additional two-cent coal severance tax, about $4,693,000 from the coal severance tax deposited in the permanent coal development trust fund, and about $360,000 from interest income. The estimated balance at the beginning of the 1997-99 biennium is approximately $7,877,000.

Estimated expenditures from the lignite research fund for the 1997-99 biennium are about $13,430,000. Estimated expenditures included about $400,000 for a lignite marketing feasibility study and $13,030,000 for administration and development of the lignite research, development, and marketing program. The Industrial Commission has authorized an investment of $4,200,000 from the fund in the Dakota Gasification Company lignite to the anhydrous ammonia project and issuance of tax-exempt bonds to provide $8,100,000 to the Dakota Gasification Company. The bonds are for 10-year financing with annual principal and interest payments of approximately $1,085,000 from lignite research fund revenues. The total bond cost to the fund is estimated to be $11 million.

REGULATION OF COAL MINING

Coal Exploration

North Dakota Century Code Section 38-12.1-04 provides that the Industrial Commission has jurisdiction over all persons and property necessary to regulate the exploration for coal on state and private lands within the state. The State Geologist is required to act as a supervisor responsible for enforcing the regulations and orders of the commission. The commission may require the furnishing of a reasonable bond conditioned upon the full compliance with state law and rules of the commission prescribed to govern the exploration for coal. In addition, the commission may require the delivery to the State Geologist of basic data collected during the exploration for coal; may require the plugging, covering, or reburial to protect environmental quality, general health, and safety and economic values, of all holes, pits, or trenches excavated during the course of coal exploration; and may inspect all drilling or exploration sites. The commission is directed to require that any lands substantially disturbed in coal exploration, including excavations, roads, drill holes, and the removal of necessary facilities and equipment be reclaimed.

Section 38-12.1-05 prohibits the commencement of operations for drilling for the exploration for coal without first obtaining a permit from the State Geologist. In addition, that section prohibits the removal of more than 250 tons of coal pursuant to an exploration permit without first obtaining a permit from the Public Service Commission.

Surface Mining and Reclamation Operations

North Dakota Century Code Chapter 38-14.1 addresses surface mining and reclamation operations. Under that chapter, the Public Service Commission is designated the state regulatory authority for all purposes relating to the federal Surface Mining Control and Reclamation Act of 1977. The commission is authorized to issue permits for surface coal mining operations and to adopt regulations necessary to carry out Chapter 38-14.1 and the federal Surface Mining Control and Reclamation Act of 1977.

Section 38-14.1-04 authorizes the commission to

develop a data base and an inventory system that will permit proper evaluation of the capacity of different land areas of the state to support and permit reclamation of surface coal mining operations and to develop methods of implementing land use planning decisions concerning surface coal mining operations. The commission is also authorized to develop procedures through which determinations of the unsuitability of land for surface coal mining are integrated as closely as possible with land use planning and regulation processes at the state and local levels. Section 38-14.1-04.1 required the Governor to appoint a three-member Reclamation Research Advisory Committee consisting of a representative from the coal-producing counties, a representative from the North Dakota Lignite Council, and one representative from the reclamation staff of the Public Service Commission. The provisions relating to the Advisory Committee were repealed by 1997 Senate Bill No. 2035. Responsibilities of the committee included inventorying and briefly describing and analyzing the conclusions from all reclamation research projects in the state that have been conducted, as well as an inventory and brief description of all ongoing projects; reviewing all past and current reclamation research projects to identify all existing or future research needs and objectives and establishing priorities for which future reclamation research projects should be funded; and recommending to the Public Service Commission future reclamation research budgets to be administered by the commission.

Section 38-14.1-06 allows any person having an interest that is or may be adversely affected, including state agencies other than the Public Service Commission, to petition the commission to hold a hearing for the purpose of having an area designated as unsuitable for surface coal mining operations or to have such designation terminated. The section requires the Public Service Commission to hold public hearings in the locality of the affected area for each petition filed. The commission may designate an area as unsuitable for surface coal mining operations after a hearing if the commission determines that the operations will be incompatible with existing state or local land use plans or programs; affect fragile or historic lands in which the operations could result in significant damage to important historic, cultural, scientific, and aesthetic values and natural systems; affect renewable resource lands in which the operations could result in a substantial loss or reduction of productivity of long-range water supply or food or fiber products, and the lands include aquifers and aquifer recharge areas; or affect natural hazard lands in which the operations could substantially endanger life and property and the lands include areas subject to frequent flooding and areas of unstable geology.

Section 38-14.1-14 provides the requirements for permit applications for surface coal mining and reclamation operations. Among other things, the permit application requires the applicant to provide cultural resource information and submit a reclamation plan for the land. In addition, the permit applicant is required to file a performance bond in an amount sufficient to complete the reclamation plan.

Chapter 38-14.1 establishes procedures for ruling on permit applications, permit renewals, and permit revisions. Section 38-14.1-24 establishes general performance standards applicable to all surface coal mining and reclamation operations.

Section 38-14.1-27 establishes requirements for the maintenance of records for surface coal mining and reclamation operations and provides for the monitoring and inspections of the operations.

Section 38-14.1-28 authorizes the commission to initiate enforcement procedures when an alleged violation is discovered.

Section 38-14.1-29 allows the commission to assess a civil penalty after opportunity for a public hearing for a violation of Chapter 38-14.1 or any rule adopted pursuant to that chapter.

Section 38-14.1-40 authorizes any person having an interest that is or may be adversely affected to commence a civil action on that person's own behalf to compel compliance with Chapter 38-14.1 or any rule, order, or permit issued under the chapter. The action may be commenced against any person or governmental instrumentality or agency who is alleged to be in violation of any rule, order, or permit issued pursuant to Chapter 38-14.1 or against the commission where there is alleged a failure of the commission to perform any act or duty under Chapter 38-14.1 which is not discretionary with the commission. In addition, any person who is injured or sustains property damage through the violation by any operator or permittee of any rule, order, or permit issued pursuant to Chapter 38-14.1 may bring an action for damages or permanent equitable relief.

Chapter 38-14.3 establishes a surface mining and reclamation bond fund to be maintained at the Bank of North Dakota to provide bonds for the faithful performance of all surface coal mining laws, rules, and permit conditions and terms. The bond fund is to be administered by the Industrial Commission.

Surface Owner Protection

North Dakota Century Code Chapter 38-18 was enacted in 1975 to provide the maximum amount of constitutionally permissible protection to surface owners from the undesirable effects of development of minerals underlying the surface of their property. A mineral developer is required to give the surface owner written notice of the type of land disturbance or mining operation contemplated by the mineral owner before the Public Service Commission may issue a

permit to surface mine the land. The Public Service Commission may not issue a permit to surface mine land unless the permit application is accompanied by statements of consent executed by each surface owner whose land is included within the permit area. The Surface Owner Protection Act (Chapter 38-18) also provides for the payment of surface damage and disruption payments to surface owners and requires a mineral developer to pay the entire cost of the surface reclamation necessitated by that developer's mining operation.

ADMINISTRATIVE RULES

More than 300 sections of the North Dakota Administrative Code have been adopted by the Industrial Commission and Public Service Commission regarding coal exploration and surface mining and reclamation. Administrative rules of the State Department of Health and State Tax Commissioner also affect coal mining operators. Passage of 1997 House Bill No. 1410 prohibits the State Department of Health from adoption of administrative rules on air quality affecting coal conversion facilities which are more strict than federal rules or standards under the Clean Air Act (42 U.S.C. 7401 et seq.). Passage of 1997 Senate Bill No. 2356 prohibits the State Department of Health from adoption of administrative rules on sulfur dioxide air quality which are more strict than federal rules or standards under the Clean Air Act.

SUGGESTIONS ON STUDY APPROACH

Given the extensive regulatory framework within which the coal industry operates, it may not be feasible to review all aspects of regulation. The committee may choose to seek advice from coal industry representatives regarding those aspects of regulation they believe could be eliminated or simplified. Opinions of affected agencies and other interested parties could then be sought in response to industry suggestions.

Study of taxation of the coal industry involves obtaining information on taxes paid and where revenues go and analysis of how tax policy affects the competitive position of the North Dakota coal industry. Ample information is available on taxes paid and where revenues go. However, questions on the competitive aspects of tax and regulatory policy require economic analysis in addition to gathering data. Resources available to the committee include agency and industry representatives, representatives of political subdivisions in coal development areas, and groups and individuals affected by coal development.

ATTACH:1

Fifty-fifth Legislative Assembly, State of North Dakota, begun in the Capitol in the City of Bismarck, on Monday, the sixth day of January, one thousand nine hundred and ninety-seven

SENATE CONCURRENT RESOLUTION NO. 4050
(Senators G. Nelson, Mathern)
(Representatives Dorso, Boucher)

A concurrent resolution directing the Legislative Council to study taxation and regulatory incentives for the lignite industry in order to improve its competitive position in the energy marketplace.

WHEREAS, North Dakota's lignite industry produces approximately thirty million tons of lignite annually, contributing to our state's and nation's energy independence by generating electricity for more than two million people in the northern great plains region and by producing synthetic natural gas from coal that heats 300,000 homes and businesses in eastern states, which is equivalent to over 20,000 barrels of oil per day; and

WHEREAS, North Dakota's lignite industry generates over 20,000 direct and indirect jobs for North Dakota, over one billion dollars in annual business volume, and over sixty-five million dollars in annual tax revenue; and

WHEREAS, the Legislative Assembly has previously determined that it is an essential governmental function and public purpose to assist with the development and wise use of North Dakota's vast lignite resources by supporting a lignite research, development, and marketing program; and

WHEREAS, the Gascoyne Mine recently closed due to the loss of its contract due to out-of-state coal competition; and

WHEREAS, subbituminous coal is presently being test burned in two North Dakota coal generating facilities; and

WHEREAS, with deregulation and restructuring within the electrical industry, there are increasing competitive pressures on the lignite industry; and

WHEREAS, government taxation and regulatory costs constitute up to thirty percent of the cost of North Dakota lignite; and

WHEREAS, North Dakotans desire to maintain their state's status as one of only a few clean air states and as a state with an equitable tax structure;

NOW, THEREFORE, BE IT RESOLVED BY THE SENATE OF NORTH DAKOTA, THE HOUSE OF REPRESENTATIVES CONCURRING THEREIN:

That the Legislative Council study the feasibility and desirability of providing taxation incentives and eliminating unnecessary regulatory burdens in order to make the lignite industry more competitive in order to protect and enhance the jobs and economic activity associated with the development of the state's abundant state lignite resource, while at the same time maintaining a clean and healthy environment for all of our state's citizens; and

BE IT FURTHER RESOLVED, that the Legislative Council report its findings and recommendations, together with any legislation required to implement the recommendations, to the Fifty-sixth Legislative Assembly.

Filed March 25, 1997