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ELECTRIC INDUSTRY TAXATION - BACKGROUND MEMORANDUM

Under North Dakota Century Code (NDCC) Sections 54-35-18, 54-35-18.1, and 54-35-18.2, the Electric Industry Competition Committee has studied this state's electric industry since 1997. The statutory provisions were scheduled to expire August 1, 2003, but 2003 Senate Bill No. 2015 amended these sections to extend the existence of the committee until August 1, 2007. The committee was established in 1997 to study the impact of competition on the generation, transmission, and distribution of electric energy in this state in light of anticipated deregulation of the electric industry.

As a large part of its activities during three interims of study, the Electric Industry Competition Committee has received an enormous amount of data and opinions on taxation of the industry. The committee has not made any recommendations for legislation relating to taxation of electric utilities. However, committee deliberations have been part of the background of legislation since 1999, which does affect electric industry taxation.

ELECTRIC INDUSTRY ENTITIES

The participants in the electric utility industry in North Dakota may be grouped in four categories:

1. Rural electric cooperatives (RECs) - Rural electric cooperatives are nonprofit, member-owned corporations engaged in the electric utility business. Rural electric cooperatives may be further divided into distribution cooperatives, of which there are 19 operating in North Dakota, and generation and transmission cooperatives, of which there are seven operating in North Dakota.
2. Investor-owned utilities - These are for-profit corporations owned by their shareholders. Three investor-owned utilities do business in North Dakota.
3. Municipal utilities and municipal power agencies - These are political subdivisions engaged in distribution of electricity to residents of a city or group of cities. A municipal utility provides services to one city. In North Dakota there are 12 municipal utilities. A municipal power agency is comprised of two or more municipal utilities functioning jointly to take advantage of economies of scale. In North Dakota there is one municipal power agency functioning on behalf of six member municipal utilities.
4. Power marketers - These entities engage in purchase and resale of electricity through transmission and distribution infrastructure owned by electric utilities. In North Dakota one power marketer is doing business.

TAX TYPES IMPOSED ON THE

ELECTRIC INDUSTRY

In addition to differences in types of taxes that apply to electric utilities depending upon how they conduct business, different forms of taxation apply to each part of the process of generating and delivering electricity. Separate forms of taxation apply to severance of coal from the earth, generation of electricity or production of other products from coal, generation of electricity from wind, transmission of electricity through large-capacity transmission lines, and distribution of electricity to consumers.

Coal Severance Tax

The coal severance tax was initially imposed in North Dakota in 1975 and has been the subject of numerous rate changes and other adjustments. A substantial change in severance and conversion tax policy was made by passage of 2001 Senate Bill No. 2299. The legislation was intended to assist the North Dakota lignite industry to maintain its competitive position in the market by shifting some tax burden from severance to generation of electricity. The legislation reduced the general coal severance tax rate from 75 cents per ton to 37.5 cents per ton and increased the rate of coal conversion taxes to offset revenue losses to the state and affected political subdivisions.

In addition to the general severance tax rate, a separate two cents per ton tax is imposed upon severance of coal. The entire revenue from the two cents per ton tax is deposited in the lignite research fund. The tax of 37.5 cents per ton imposed upon severance of coal is allocated 30 percent to a constitutionally established coal development trust fund and 70 percent to the coal-producing counties based upon coal production in each county. Severance tax revenues received by a county are further allocated 30 percent among cities, 30 percent among school districts, and 40 percent to the county.

Coal Conversion Tax

The coal conversion tax is imposed on the operator of a coal conversion facility, defined to include any coal-fired electric generating unit with a capacity of 10,000 kilowatts or more and any coal gasification facility. The tax is in lieu of property taxes on the facility, but the land on which the facility is located remains subject to local property taxes. The coal conversion tax for an electric generating facility is imposed at a rate of .65 mill times 60 percent of the installed capacity of the facility times the number of hours in the taxable period and an additional tax of .25 mill per kilowatt-hour of electricity produced for sale. For coal gasification plants, the tax is imposed at the greater of 4.1 percent of gross receipts or 13.5 cents per 1,000 cubic feet of synthetic natural gas produced for sale.

Coal conversion tax revenues are allocated 15 percent to the producing county and 85 percent to the state general fund, except the separate tax of .25 mill per kilowatt-hour produced for sale and (through 2009) the first \$41,666.67 each month from coal gasification plant tax revenues must be deposited in the state general fund. Coal conversion tax revenues received by a county are allocated 30 percent among cities, 30 percent among school districts, and 40 percent to the county general fund.

Among the changes in 2001 Senate Bill No. 2299 was a change in the tax status of the Heskett generating station in Morton County, which was an issue that arose in earlier discussions of the Electric Industry Competition Committee. Under previous law the Heskett station was excluded from the definition of a coal conversion facility because the production capacity of its two generating units was less than the threshold for application of the coal conversion tax. The 2001 legislation reduced the threshold for inclusion as a coal conversion facility, changing the status of the Heskett station from payment of property taxes to payment of coal conversion taxes. A special provision was added to the coal conversion tax law to incorporate a "hold harmless" provision for Morton County and taxing districts in Morton County to ensure that the county and taxing districts will continue to receive at least as much coal conversion tax revenue as was received from the property taxes for the facility for taxable year 2001.

Property Taxes

Under Article X, Section 4, of the Constitution of North Dakota, property used to furnish or distribute electricity is subject to central assessment by the State Board of Equalization as prescribed by law. Under Article X, Section 5, of the Constitution of North Dakota, the Legislative Assembly is allowed to exempt any personal property from taxation and has authority to classify any property other than land as personal property.

Property of investor-owned utilities is subject to property taxes. All operative property is subject to assessment by the State Board of Equalization under NDCC Chapter 57-06. Operative property is defined to include all property reasonably necessary for use by a public utility in operation and conduct of the business engaged in by the company. Property subject to assessment by the State Board of Equalization has its valuation assigned to the taxing district in which the property is located. Assessments of continuous lines of property, such as transmission and distribution lines, are allocated among counties based on the prorated portion of mileage of such lines in each county. The Tax Commissioner certifies to the county auditor of each county the total assessed valuation of centrally assessed property and the amount in each assessment district within the county. Local tax levies are then applied against the valuation in the same manner used for other property subject to local property taxes.

Property of a municipal utility or municipal power agency is exempt from property taxes under Article X, Section 5, of the Constitution of North Dakota.

Property, other than land, owned by a rural electric cooperative and used as operative property or part of a generating facility is exempt from property taxes and is instead subject to gross receipts taxes under NDCC Chapter 57-33, which applies to operative property of rural electric cooperatives, or Chapter 57-33.1, which applies to cooperative electrical generating plants. Taxes imposed under each of these chapters is in lieu of property taxes, except taxes on land (which may not be exempted under Article X, Section 5, of the Constitution of North Dakota). Land owned by a rural electric cooperative is subject to local assessment and payment of property taxes. In addition, Basin Electric Power Cooperative pays locally assessed property taxes on its headquarters land and buildings because the building is not a part of the cooperative's operative property or part of a generating facility.

Wind generation facilities are subject to differing taxes depending on ownership. A wind generation unit owned by a rural electric cooperative is exempted from property taxes but subject to the 2 percent gross receipts tax. A wind generation unit with a nameplate generation capacity of at least 100 kilowatts owned by an investor-owned utility is subject to property taxes but if completed before 2011 receives a reduced taxable valuation under NDCC Section 57-02-27.3 of 3 percent of assessed value (only 30 percent of the usual taxable valuation for centrally assessed property).

Gross Receipts Taxes and Transmission Line Taxes

A 2 percent tax on gross receipts is imposed on rural electric cooperative transmission and distribution cooperatives. A 2 percent gross receipts tax also applies to rural electric cooperative generation cooperatives, but only if a generation facility is not subject to coal conversion taxes under NDCC Chapter 57-60. An additional tax of \$225 per mile applies to rural electric cooperative-owned transmission lines of 230 kilovolts or larger under Section 57-33.1-02.

Gross receipts taxes from transmission and distribution cooperatives are allocated among counties in proportion to the miles of line in each county. Tax revenues received by a county are allocated among taxing districts in proportion to the miles of line in each taxing district. Gross receipts taxes from a cooperative electrical generating plant during the first two years of operation go entirely to the county in which the facility is located. After the first two years of operation, taxes from an electrical generating plant are allocated so that the first \$50,000 goes to the county, the second \$50,000 is split evenly between the county and the state general fund, and all additional revenue is divided 25 percent to the county and 75 percent to the state general fund. Cooperative electrical generating plant gross receipts taxes received by the county are allocated 15 percent to cities based on population, 40 percent to the county general fund, and 45 percent to school districts based on average daily attendance. Transmission line taxes under NDCC Section 57-33.1-02 are allocated among

counties in proportion to the miles of line in each county and are allocated entirely to the county general fund.

Passage of 2001 House Bill No. 1348 increased the rate of the transmission line tax to \$300 per mile for a transmission line of 230 kilovolts or larger initially placed in service on or after October 1, 2002. However, House Bill No. 1348 also created an exemption from this tax for the first year after a new transmission line is placed in service and provided a 75 percent reduction for the second year, 50 percent reduction for the third year, and 25 percent reduction for the fourth year of operation of the transmission line. House Bill No. 1348 also established a distinction between a transmission line and a distribution line. The bill provides that a transmission line is one which operates at a voltage of 41.6 kilovolts or more, and a line operating at lower voltage would be a distribution line.

Another significant change made by 2001 House Bill No. 1348 is that a new transmission line owned by an investor-owned utility will be exempt from property taxes and subject to taxation in the same manner as taxes apply to transmission lines of rural electric cooperatives for lines placed in service on or after October 1, 2002. Such lines of investor-owned utilities will be subject to a tax of \$300 per mile and will be entitled to exemption for the first year of operation and a reduction of 75 percent for the second year, 50 percent for the third year, and 25 percent for the fourth year of operation of the transmission line.

A problem with "pancaking" of gross receipts taxes for certain rural electric cooperatives was described to the Electric Industry Competition Committee in 1997. The compounding of taxes arose because generation and transmission cooperatives pay a 2 percent gross receipts tax on generated electricity and that electricity is again subjected to a 2 percent gross receipts tax at the distribution level. The problem applied to rural electric cooperatives that purchased power through intermediate transmission cooperatives in North Dakota. Transmission cooperatives purchasing power from Basin Electric

Power Cooperative and blending it with hydroelectric power purchased from the Western Area Power Administration were subjected to a 2 percent gross receipts tax on revenue from member cooperatives purchasing power. The member cooperatives were subjected to a 2 percent gross receipts tax on resale of power to consumers. In 1999 the Association of Rural Electric Cooperatives announced to the Electric Industry Competition Committee that a change in contractual arrangements had been made to provide that 95 percent of power previously purchased by an intermediate cooperative from Basin Electric would instead be purchased directly from Basin Electric by individual cooperatives. This arrangement would allow 95 percent of power purchased by individual cooperatives to be subjected to only one 2 percent gross receipts tax, thus avoiding most of the impact of the pancaking effect.

Gross receipts taxes do not apply directly to investor-owned utilities, municipal utilities, municipal power agencies, or power marketers but may be embedded in the cost of electricity purchased from a rural electric cooperative.

City Privilege Tax

Under NDCC Section 57-33-04 a city is allowed to impose a privilege tax on the value of electric distribution facilities of a rural electric cooperative furnishing power to city consumers. The tax must be reduced by the amount of gross receipts tax allocated to the city. The tax is imposed only in Minot and New Town.

Municipal Utility Revenues

A municipal utility is limited by NDCC Section 40-33-12 to a maximum of 20 percent of its annual gross revenues which may be transferred by the municipal utility to the general fund of the city. It appears that Section 40-33-12 would allow a greater amount of gross revenues to be transferred if approved by electors of the city at a regular city election.