BEFORE THE DEPARTMENT OF REVENUE
OF THE STATE OF MONTANA

In the matter of the adoption of New Rule I, amendment of ARM 42.25.501, 42.25.502, 42.25.511, 42.25.512, 42.25.514, 42.25.1701, 42.25.1707, and 42.25.1708, and repeal of ARM 42.25.515 and 42.25.1706 pertaining to coal valuation for coal gross proceeds and coal severance tax on coal production	)	NOTICE OF ADOPTION, AMENDMENT, AND REPEAL

TO: All Concerned Persons

1. On September 22, 2017, the Department of Revenue published MAR Notice No. 42-2-982 pertaining to the public hearing on the proposed adoption, amendment, and repeal of the above-stated rules at page 1637 of the 2017 Montana Administrative Register, Issue Number 18.

2. On October 12, 2017, a public hearing was held to consider the proposed adoption, amendment, and repeal. Tim Brown, Decker Coal Company, and Jason St. John, Cloud Peak Energy, appeared and testified at the hearing. Other members of the public attended the hearing, but did not testify. Written comments were received from Matthew Adams, Cloud Peak Energy, and Joe Evers and Emma Kucharski, Westmoreland Coal Company.

3. The department adopts New Rule I (42.25.1709), amends ARM 42.25.502, 42.25.511, 42.25.514, and 42.25.1707, and repeals ARM 42.25.515 and 42.25.1706, as proposed.

4. Based upon the comments received, the department amends the following rules as proposed, but with the following changes from the original proposal, new matter underlined, deleted matter interlined:

<u>42.25.501 DEFINITIONS</u> The following definitions apply to this subchapter:
(1) through (4) remain as proposed.
(5) "Market value" means the value at which coal would change hands between a willing buyer and a willing seller under market and economic conditions at the time of sale, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Agreements that are not arm's-length transactions ~~do not reflect the~~ <u>will not be considered</u> market value ~~of~~ <u>for purposes of filing the Montana</u> coal <u>production taxes</u>.
(6) and (7) remain as proposed.

<u>42.25.512 IMPUTED VALUATION</u> (1) When imputing value pursuant to 15-35-107, MCA, the department may use valuation methods which approximate the

value of the coal ~~at its intended market use~~, including but not limited to comparable actual arm's-length sales, comparable actual arm's-length sales adjusted to FOB mine price, or published coal sales indexes. Contract term, tonnage, quality, Btu rating, and any other appropriate comparability criteria will be considered.

(2) remains as proposed.

42.25.1701 DEFINITIONS The following definitions apply to this subchapter:

(1) through (4) remain as proposed.

(5) "Market value" means the value at which coal would change hands between a willing buyer and a willing seller under market and economic conditions at the time of sale, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Agreements that are not arm's-length transactions ~~do not reflect the~~ will not be considered market value ~~of~~ for purposes of filing the Montana coal production taxes.

(6) and (7) remain as proposed.

42.25.1708 IMPUTED VALUATION (1) When imputing value pursuant to 15-35-107, MCA, the department may use valuation methods which approximate the value of coal ~~at its intended market use~~, including but not limited to comparable actual arm's-length sales, comparable actual arm's-length sales adjusted for FOB mine price, or published coal sales indexes. Contract term, tonnage, quality, Btu rating, and any of the appropriate comparability criteria will be considered.

(2) remains as proposed.

5. The department has thoroughly considered the comments and testimony received. A summary of the comments received and the department's responses are as follows:

COMMENT 1: Cloud Peak Energy commented that they are generally in favor of new regulations to provide consistency and clarity, but they would like to see some changes in the rules as proposed. The rules contemplate two methodologies for imputing value to govern non-arm's-length sales, including a comparable sales approach, and a netback methodology. Both methods are reasonable, but the rules lack guidance on which should be used. The method used should be applied consistently. It should not be the greater or lesser of the two taxes for the producer.

They further commented that following the public hearing their understanding is that the department's preferred method is the netback approach, at least for coal exported abroad. However, they believe a comparable sales approach should be used, because it is the well-accepted and preferred methodology for determining value. They asked the department to clarify in the language when it is appropriate to use each method and also indicate that the method is to be used consistently for groups.

The Decker Coal Company expressed similar concerns with calculating the imputed rate. The department has the information to compute this, but the companies do not. The rules will be very difficult to follow.

Westmoreland Coal Company also commented on the department's preferred methodology of employing a netback approach. Under this approach, the department would start with the price received under the first arm's-length sale, less transportation, to reach a value at the mine. Such an approach fails to account for the value-added to the coal for logistic services or risk involved in transporting to distant sales points. The netback approach has been recognized by the federal government as a methodology to be used "only when other methods of determining value . . . are inapplicable," and provided the department with court case examples. They further commented that a comparable sales approach is the best method for determining value of coal at the mine and stated that the department should adopt it as its preferred method.

They further commented that the department's proposed revisions to the imputed value regulation rules are vague and unclear. First, the rules do not provide any guidance as to which valuation method the department prefers, or in what circumstances the department will use each valuation method. This leaves open the opportunity for the department to select the method that produces the highest value on each contract. The rules should specify the preferred method of valuation, and the preferred method should be the comparable sales approach.

RESPONSE 1: The department understands the industry's recommendation to first use the comparable sales approach; however, the department's preference is to go to the first arm's-length agreement, on a contract-by-contract basis, and adjust the value to a FOB mine price. Then, if a net back approach to determine contract sales price is not feasible, the department will consider other available methods to reach an FOB mine price. The other available methods, however, are determined on a case-by-case basis related to the unique facts of each coal producer and each contract or transaction.

The department has further amended ARM 42.25.512(1) and 42.25.1707(1) to add the phrase "actual arm's-length" in the references to comparable sales in those sections.

COMMENT 2: Cloud Peak Energy commented that the rules should allow a process for the department and the producer to enter into a prospective valuation agreement to provide certainty to both parties, similar to the process used by the federal government for royalty valuation. Owners have that ability through their regulations. Coming to the table early can head off disputes before they happen and give all parties some certainty going forward. Agreements can be canceled at any time by either party, so nobody would be locked into a long-term agreement, but this approach would provide clarity for sales up to a point.

RESPONSE 2: The department always welcomes and encourages taxpayers to come in and discuss valuation issues, at any time, as has always been the case. Adding language to that effect is unnecessary.

COMMENT 3: Cloud Peak Energy stated concern that the draft rules add terms that aren't clearly defined, such as "transportation costs." The department should consider providing detailed guidance, whether in the rules or a policy document, as to what is or is not an allowable transportation cost. Producers could help by providing the department with a list of the kinds of costs they encounter.

They further commented that instead of determining value on a contract-by-contract basis, the department should allow calculation of a weighted-average sales price for all of a mine's comparable contracts in a given month. If using a netback approach, there should be no limit on the amount of transportation costs that can be deducted.

Westmoreland Coal Company also commented that the department's use of the term "transportation costs" is vague and unclear. The proposed rules amend "FOB mine price" to provide the point at which reasonable transportation costs can be reduced from the purchase price of the coal, and reduces the contract sales price by transportation costs to determine the contract sales price. However, the proposed rules fail to clearly define transportation costs. To provide clarity to the taxpayer and avoid future disputes, the department should offer guidance as to what costs make up "transportation costs."

RESPONSE 3: The department did not define "transportation costs" or include an itemized list of allowed or disallowed expenses, because expenses that may be allowed for one contract may not be allowed for another, depending on the contract and the location of the first third-party sales point. However, the department is always available to answer questions and offer guidance and welcomes taxpayers to call or come into the office to discuss any expenses they wish to deduct. Reasonable and actual costs will be determined on a case-by-case basis.

COMMENT 4: Cloud Peak Energy commented that the department's consideration of the value of the coal at its intended "market use" is undefined, vague, and confusing. Defining the term would be helpful. The industry tends to consider their three biggest markets to be steam or electrical, metallurgical, and industrial. Is that what "market use" is referring to, or is it referring to geographies? And, if so, what kind of a geography would constitute a market? Is it Powder River Basin or coal sold to Michigan versus Texas? Are those the same or different markets?

Westmoreland Coal Company commented that the term "intended market use" offers no guidance as to how the coal's intended market use relates to its value. It is unclear whether the department intends the phrase to refer to the type of end-use consumption, the geographic location of end-use of the coal, or something else. Furthermore, the term "intended" implies that the intended market use may differ from the actual market use. It is unclear why the intended market use of the coal is relevant to its value. If the phrase refers to the ultimate destination of the coal, or the intended destination of the coal, such an approach has no bearing on the value of the coal and should not be utilized by the department. Applying that meaning to the phrase further muddies the proposed rule, because one of the acceptable valuation methods is "comparable sales adjusted to FOB mine price." The department should replace the phrase "at its intended market use" with "FOB mine."

RESPONSE 4: The department agrees that "intended market use" is vague and has further amended ARM 42.25.512 and 42.25.1708, the imputed valuation rules, to eliminate the phrase "at its intended market use" from both rules.

COMMENT 5: Westmoreland Coal Company commented that non-arm's-length transactions can reflect the market value of coal. The proposed revision of the "market value" definition provides that "agreements that are not arm's-length transactions do not reflect the market value of coal." That provision is not true and is inconsistent with the Montana Supreme Court's interpretation and application of 15-35-107(1)(c), MCA, which provides the department the power to impute a value to the coal which approximates market value FOB mine where the coal was sold under a non-arm's-length contract. Before imputing a value to the coal, the department must first find that the contract price does not represent market value and the transaction was less than market value, as shown by comparable arm's-length sales. When a contract price from a non-arm's-length contract was comparable to the contract price of an arm's-length contract, and thus representative of the market value of coal, the department could not impute a value to the coal. The Montana Supreme Court has recognized that non-arm's-length transactions are capable of reflecting the market value of coal. The proposed definition disregards the non-arm's-length transactions and imputes a value for coal without requiring a threshold determination that the non-arm's-length contract price does not represent market value. Such a method ignores the fact that many non-arm's-length contracts reflect market value for a multitude of reasons. Categorically ignoring these contracts serves no legitimate purpose. The assumption that all non-arm's-length contracts do not represent market value discriminates against coal producers who sell coal to affiliates or related parties. The last sentence of the proposed definition for "market value" should be deleted. The department should still be required to determine whether a non-arm's-length contract represents market value and whether the transaction was less than market value, as shown by a comparable arm's-length transaction before imputing a value to the coal.

RESPONSE 5: The section of statute referenced as interpreted by the Montana Supreme Court, 15-35-107(1)(c), MCA, has since been amended. Section 15-35-107(1)(b), MCA, currently states that the department may impute a value when a person sells coal under a contract that is not an arm's-length agreement. When the department imputes value according to 15-35-107(1)(b), MCA, the department will determine the contract sales price which may or may not be the same contract sales price as stated in the non-arm's-length agreement.

COMMENT 6: Westmoreland Coal Company stated that the contract sales price of coal should not be determined on an individual contract basis. The proposed rules provide that contract sales price for coal is calculated by taking the first arm's-length purchaser of the coal, and subtracting the transportation costs to reduce the contract sales price of the coal. As proposed, ARM 42.25.511 applies the formula to each contract individually. Such a method ensures that the contract price of coal, on each individual contract, will not be reduced below zero. They stated they do not support the netback approach proposed by this rule. However, if a netback calculation is used, the department should consider all of the contracts together. Employing the netback method without accounting for negative values is not a representative or fair calculation. When the sales price is lower than the transportation costs, the taxpayer coal producer receives no benefit, but is still responsible for taxes owed on the positive value when the sales price exceeds the transportation costs. To produce a fair and representative netback calculation, it must be performed in the aggregate.

RESPONSE 6: Determining the cost of coal on an individual contract basis is not a new provision in the rule. ARM 42.25.511(3) originally stated that the "contract sales price should be computed for each contract individually . . ." The language in that section of the rule was proposed to be removed as unnecessary verbiage. The provision is already in statute, in the definition of "agreement" in 15-35-102(1), MCA, which contemplates that the contract sales price be considered on a contract-by-contract or agreement-by-agreement basis.

COMMENT 7: Decker Coal Company commented that their mine has a lot of sales at arm's-length to arm's-length parties that tell them exactly what the value of coal is on any given day. They have a lot of current sales data to determine what the coal is worth. They view coal as a commodity and don't think that its ultimate destination or use changes its value. The intent is to assess value when it comes out of the ground. The best way to do this is to look at comparable sales at the same mine. It is much simpler than going to some point of delivery thousands of miles away and working backwards. Doing so makes it tough to tell if you are really valuing coal or if you are valuing some of the value-added activities such as transportation and all of the risk that goes into that. This really starts pulling into the tax base things that aren't related to the value of the coal as it comes out of the ground. They prefer the first method of evaluation be a look at comparable arm's-length sales from the mine, if available, and use of the first arm's-length sale only in instances where that is not available.

RESPONSE 7: The department appreciates these comments and recognizes that while there may be situations where an FOB mine price comparison is used, there may also be a sale that occurs away from the mine which requires the department to netback to reach an FOB mine price. Section 15-35-107, MCA, provides that if the agreement is non-arms-length, the department will impute value. Therefore, in the instance that a contract is a non-arm's-length transaction, the department will follow the provisions provided for in this statute and administrative rules to determine the contract sales price.

/s/ Laurie Logan	/s/ Mike Kadas
Laurie Logan	Mike Kadas
Rule Reviewer	Director of Revenue

Certified to the Secretary of State November 13, 2017.