

Stranded Gas Hearings

(0406170930 Minutes)

Alaska Property and Net Income Taxes: How Do They Impact Tariffs?

Roger Marks, Petroleum Economist, Tax Division, Dept. of Revenue, June 17, 2004.

MR. ROGER MARKS, Department of Revenue, told members his presentation would focus on the impact of property and corporate income taxes on tariffs. [A paper copy of Mr. Marks's PowerPoint presentation is located in the committee file.] He began:

Just to review on what the elements of a tariff are, a tariff is simply a way of passing through all of the costs and so the pipeline owner can be reimbursed for all of his costs and also make a profit. There are different ways to characterize the costs. I've put them into seven different categories here: capital costs, which are recovered through depreciation over time and include interest during construction and, on the equity part, funds used during construction; operating costs; debt or interest costs; property taxes; state and federal corporate income taxes; and the return on equity, which is the profit element, which we'll discuss in some detail.

So starting out with the property tax on page 3, the property tax administered under AS 43.56 is based on 20 mills, or 2 percent of the remaining value of the pipeline at any point in time. Value is determined based on both a cost or income approach by our assessors. Since it's based on remaining value at any point in time, it starts high and declines. Any piece of property that's within a municipality, they retain their share of the property tax up to their mill rate and the state gets the remainder. In other words if, I believe, the Fairbanks North Star Borough, their mill rate is I think about 15 mills now, so they would get 15 mills, the remaining 5 mills would go to the state.

On the producers' proposed project, the \$19 billion project to Chicago, the portion of that in Alaska is about \$7 billion, which includes the conditioning plant and the pipeline part. My estimate of the property tax part of that would be about 8 cents on the tariff.

Page 4 – in thinking about the economics of the project and the viability, there are a couple of issues that the property tax presents that are problematic to some extent for the pipeline. The first is that the property tax is what we call front-end loaded. The way we administer the tax through the law, the tax starts accruing as soon as property enters the state, which could be years before it goes into service and starts producing revenue. On the time value of money, paying those taxes reduces the rate of return. And again, the interest and funds used during construction accumulate and are put in part of the tariff base.

The second problem with the property tax is what's called regressive and regressive, in terms of tax terms means that when profits are low, the taxes are a high percentage of the profits and when profits are high, taxes are a low percentage of the profits. The regressivity part creates an economic problem again when profits are low.

In the case of the property tax, one of the big risks of this project is a cost overrun. If there is a cost overrun, not only do you have a cost overrun, but since the property tax is based on value, not only are your costs higher but your property taxes are higher too, which kind of presents a double whammy.

In the Stranded Gas Development Act, a couple of these problems have been presented as issues that could be addressed in negotiations with project sponsors, the idea being there may be a way to modify the property tax. This has naturally created a lot of concern for the local municipalities in terms of their tax base being modified. With the highway project, it would be the Fairbanks North Star Borough and the North Slope Borough who would be affected if the property tax is modified. Per the Stranded Gas Act, it says that if we do develop a contract with the project sponsors, that a fair and reasonable share of the amount of money we take in as a state should be given to both revenue-affected communities, which are ones whose tax base is being affected,

and economically-affected communities, ones who are bearing social burdens because of a project, that a fair and reasonable share of the taxes should be given to them with due regard to the amount of the tax base, the amount of the social burdens.

A municipal advisory group has been established for the Stranded Gas Act to address concerns that the local jurisdictions have over modifying the property tax and that group is up and running.

That's really all I have to say about the property tax. I was going to go on to the corporate income tax now on page 5. In understanding the corporate income tax, it's important to sort of understand just what the source of income is that's being subject to the tax and, as we saw back on slide 2, the tariff is made up of several elements and all those elements are costs that are recovered through the tariff. The return equity is not a cash flow cost. What the return on equity represents is an allowance for an opportunity cost for the cost of equity and, again, that represents the income that's subject to the tax.

On page 6, there's an example showing a simple derivation of the return on equity. Just in this example we assume a \$500 asset that's 80 percent debt and 20 percent equity so the equity part of it would be \$100. And let's just assume it has a 5-year life and it's depreciated, I just assumed for this example, a straight-line depreciation where there's just \$20 depreciated each year for 5 years. There are other methods of depreciation that are allowable under FERC methods, depending on whether you want to get a declining tariff or an increasing tariff or a leveled tariff, but just a real simple method for the example here, it's just a straight line depreciation. And so, you can see if you start out with \$100 and depreciate \$20 each year, the third column shows the undepreciated amount each year and then assuming a return on equity of 10 percent, the return on equity in each year would be 10 the first year, then 8-6-4 and 2. Under long-term capital markets, return on equity would probably be something around 12 percent. It would really depend on just exactly when the pipeline comes into service and what the capital markets are at the time. I just used 10 percent here because it's easier to multiply by 10 percent in looking at these figures.

But this return on equity represents the income that's subject to taxation and I'll just note here with this straight-line depreciation, you get a return on equity that declines each year and this would produce a declining tariff. Again, there are different depreciation methods you can do to have either a leveled tariff or an increasing tariff.

On the debt side there's a mirror image in terms of the tariff also. A similar way to calculate the return on debt, in this case it would be with 80 percent debt it would be a \$400 debt that there would be return on debt. The debt would have a lower rate of interest. Again, the long-term capital markets - that would probably be about 8 percent. Again, that depends on just when the pipeline is built and the capital markets at that time. On the debt side of this, what we call the return on equity here, the return on debt would actually be interest payments and those - again, it would be an element in the tariff as well. But this return on equity is not a cash flow cost but represents again the income subject to taxation.

When talking about the state corporate income tax, it's useful to know how it works on page 7. The state corporate income tax - and income taxation in most states is administered by a method that's called apportionment where either U.S. income or worldwide income is apportioned to the state and that becomes the income subject to taxation. The reason states use apportionment rather than an actual sort of cash flow method of measuring income - an example that's used is sort of if you have General Motors producing cars in Michigan and selling them all over the country, it would be very difficult to determine how much the income is determined in each state. So what states do in general is use this method of apportionment where, based on economic factors in the state relative to worldwide, you apportion the worldwide or U.S. income back to the state. With oil and gas in Alaska, the apportionment factors are property sales within the state or for a pipeline it would be gross tariff income, and extraction or production if the company also

produces oil or gas. If it's just a plain pipeline company it would be two factors, property and sales.

Moving over to page 8, this is how the apportionment factor in Alaska for oil and gas is determined. It looks at the relative amount of property sales and extraction in Alaska to the world.... There is an error on this. The last fraction should be Alaska Extraction/Worldwide Extraction – not worldwide sales.

But the three factors - Alaska Property, as opposed to the property tax, where the property kicks in when it enters the state with the income tax as property when the asset goes into service. So what we have here is the three fractions, the Alaska part divided by the worldwide part and the average of those divided by three and that gives you a factor. That's sort of the percent of your worldwide activity that's deemed to be in Alaska.

On the extraction part, if there's both oil and gas, the gas is put on the BTU equivalent with oil so it's an apples-apples approach. They just take the thousands of cubic feet and divide by six. That's the mcf of gas and the barrels of oil on an apples-apples basis. Now this is what is called a modified apportionment. Most states, and with non-oil and gas activity in the state instead of extraction, payroll is used but starting in 1981, this modified apportionment has been used. And the other difference again between oil and gas and other activities in the state, the way our corporate income tax works, is with non-oil and gas it's Alaska property divided by U.S. property and Alaska sales divided by U.S. sales. That's called a water's edge approach, just putting a ring fence around U.S. activity and bringing in U.S. income rather than worldwide. With oil and gas, it's a worldwide approach.

Page 9 – so once you know the apportionment factor, the Alaska income is the apportionment factor multiplied by the worldwide income and our corporate income tax rate, I believe once your income is over \$100,000 a year, is 9.4 percent so the corporate income tax is 9.4 percent times the Alaska income.

So what does all this mean? Well if this gas project happens, there are seven things that will happen. One, worldwide income will increase. Alaska property will increase. Alaska's extraction will increase. Alaska sales will increase. Worldwide sales will increase. Worldwide extraction will increase and worldwide property will increase. That's a sure thing.

What does this mean? On the income side, again, worldwide income would increase but the way apportionment works, this income is never distinguished between Alaska income and non-Alaska income. That's the whole point of apportionment is that that's difficult to do so it just goes in one big pot called worldwide income and the apportionment factor allocates worldwide income into the Alaska tax base. So, for example, if the Alaska apportionment factor is 10 percent and worldwide income is \$100, \$10 gets apportioned into the worldwide tax base and that's subject to the 9.4 percent tax rate.

And income generated by the Alaska project is apportioned only to the same extent any other income is so if there's \$20 generated by an Alaska project and there's a 10 percent apportionment factor, \$2 comes into the Alaska tax base. But if there's \$20 generated in Peru, same thing, with the 10 percent apportionment factor, \$2 would be apportioned into Alaska. So, again, income is never distinguished between Alaska and non-Alaska in origin.

On the apportionment side, again, the apportionment factor would increase as the result of this project and the [indisc.] apportionment factor would apportion more worldwide income into the state. For example, if we were 10 percent before, the project might make it go to 11 percent. That might not sound [like] much, but you're getting an extra 1 percent of worldwide income. That's quite a bit of money coming into the Alaska tax base.

So for the derivation of the tax rate for the tariff, what does this mean for the tariff? Again, income generated in Alaska is apportioned for taxes everywhere, not just Alaska, but in the tariff, the tariff is designed to recover all of the costs to the company, including the taxes they pay everywhere as a result of tariff income, not just in Alaska.

Now taxes rates are not uniform everywhere. Income could be apportioned to all the other 49 states but they all have their own individual tax rates. They're not 9.4 percent. However, since each state has its own apportionment factor and its own tax rate, it's impossible to determine the exact tax burden that's going to be borne by the pipeline owner. And what regulators generally do is assume, for the piece of property within a jurisdiction, they assume the tax rate in that jurisdiction. So for the piece of pipe that's in Alaska, they would assume a 9.4 percent tax rate.

This just shows sort of the derivation of the corporate income tax allowance in the tariff. The allowance is an after tax allowance and in the example we had back on slide number 6 where we had a 10 percent return on equity, that 10 percent is an after tax return. To get an after tax – you need to recover more before tax to get a 10 percent return after tax. And in that example, with a 10 percent return on equity – let me just go back to slide 6 for a second here, just looking at that first year with a 10 percent return on equity, that \$10 is an after tax return. For taxes, the way a pipeline company will pay its taxes, it will receive tariff income for shipping the gas and the tariff times the amount of gas will be its gross income. Then it will subtract its cost and that will be its taxable income and then they'll pay tax on that. Now the tariff gives the pipeline company an allowance to cover the taxes and, in this case, so that they're left with \$10 after they pay the tax. So they need to recover more than \$10 before tax to be left with \$10 after tax and that's done with something called a tax gross-up factor and that's simply the tax rate divided by 1 minus the tax rate and again, with our state, with a 9.4 percent income tax rate, 9.4 divided by 1.94 is 10.38 percent as sort of the effective amount of tax you need to collect before so that you're left with return on equity afterwards. So, if your return on equity target is \$10, the state corporate income tax allowance needs to be, in this example, you know, .1038 times 10 or \$1.038.

And just in the box here, to see how it works, if your return on equity allowance is \$10 and your tax allowance is \$1.038, you have \$11.038 and when you're computing your taxes if you take 9.4 percent for your tax times the \$11.038, that gives you 1.038 and so your return after tax is your total allowance minus a tax allowance, 11.038 minus 1.038, which leaves you with \$10. Again, that's what your return on equity was.

Again, this is for tariff making purposes. This is again pro forma, the calculation for the tax allowance. It's different than the actual taxes that will be paid. They'll be paid again subject to apportionment and worldwide income. If this project goes forward there will also be state income taxes on upstream profits that are made from the producers selling the gas. In addition to state corporate taxation, there's also federal income taxation - which there's an allowance for that in a tariff as well. That's computed similarly. The only difference is, again, the feds have a different tax rate. It's at 35 percent and the state income tax is deductible for the federal tax. My estimate of the Alaska corporate income tax adds about 2 cents to the tariff and the federal side, again, on a \$19 billion project, is about 20 cents.

That concludes my remarks and I'd be happy to answer questions if I can. Thank you.

CO-CHAIR SAMUELS said the committee heard yesterday that the amount of risk a pipeline owner has in a project would also be factored into the tariff by FERC. He asked Mr. Marks where he would incorporate that risk on page 2 of his PowerPoint presentation.

MR. MARKS said risk would be explicitly addressed as the return on equity. Generally, pipeline companies need a throughput commitment and a shipper pay commitment to get financing. In a shipper pay commitment, the shipper will commit to put gas in the line and pay to ship it, whether the shipper has the gas or not. That reduces the risk of the project. The 12 percent return on equity is commensurate with that amount of business risk.

