Stranded Gas Hearings

(0409021045 Minutes)

Negotiation of State and Municipal Property Taxes Under the Stranded Gas Act
Larry Persily, Special Assistant to the Commissioner, Dept. of Revenue
Steven Thompson, Mayor, City of Fairbanks, and presenter for the Municipal Advisory Group (MAG), September 2, 2004.

MR. STEVEN THOMPSON, Mayor, City of Fairbanks, said he is chair of the Municipal Advisory Group (MAG), and that he would give them an overview of MAG and what it has agreed upon so far in resolutions regarding taxes and gas pipeline impacts. MAG was formed to advise and make recommendations to the administration on the anticipated social, economic and revenue impacts of a gas pipeline project as well as on the affect of any municipal tax relief the administration may negotiate in an effort to enhance the economics of a project.

> The group is made up of representatives from communities that will likely be impacted by construction of the natural gas pipeline, including Anchorage, the City of Delta Junction, the City of Fairbanks, the Fairbanks North Star Borough, the City of Kenai, the Kenai Peninsula Borough, Skagway, the Haines Borough, the City of North Pole, the North Slope Borough, the City of Seward, the City of Valdez and representing the unorganized regions, the Tanana Chief's Conference....
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> Today I'm here to talk to you about what's important mostly to our communities. Even though we are a very geographically and culturally diverse group, we have been able to identify many issues that we share similar perspectives on and those are reflected in our first resolution. I believe you have copies of those. We all agreed that no reduction or deferral in municipal taxes is acceptable without appropriate justification from the State of Alaska and the project sponsors. We are willing to help make the project happen, but if it means a reduction in revenue opportunities for us, there needs to be a clear, verifiable justification for it. We have also agreed that the State of Alaska should weigh the cost of benefit of a tax exemption with the difficulty of administering an exemption from specific taxes.
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> We've agreed that the State of Alaska should devise a payment in lieu of taxes structure that provides certainty for municipalities at least through the end of the stated contract period - that the State of Alaska should insure the payment in lieu of taxes structure recognizes the loss to present and future forms of local government of opportunity to respond to changing conditions through changing tax rates, and that the State of Alaska should provide incentives to the successful applicant under the Stranded Gas Act to insure the training and hiring of Alaskans for the construction, operation, and maintenance of the gas line.
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> One critical point we all agreed on is that the State of Alaska should require that the successful applicant will include takeoff points at strategic locations along the pipeline to make gas available to meet the reasonably foreseeable demand for in-state natural gas use – that the State of Alaska should insure there will be a fair tariff to the points of in-state takeoff of gas.
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> Finally, we agree that the State of Alaska should insure that affected municipalities' combined share of the economic rent of [an] approved project should correlate with the revenue stream of the project by negotiating that the present value of the aggregate amount of payment in lieu of taxes is not less than the amount that would have been collected under current Alaska law.
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> The points of our second resolution are that no property currently taxed under Titles 29.45 and 43.56 should become exempt under this contract. The contract should clarify how dual-use facilities will be taxed in order to protect municipalities' current tax base. No exemption should apply to existing gas infrastructure. Due to the relatively small amount and incredible complexity in administering a sales and use tax exemption, those taxes should not be on the table for negotiations.

> Finally, at our last meeting last week, we approved a third resolution that mainly focuses on issues surrounding the need for natural gas in communities all around the state and we requested the administration specifically to include the placement of municipal takeoff points in the rural and urban areas of Interior, Southcentral and Southeast Alaska [and] amend statutes to provide greater assurance that Alaska communities will have access to gas from any trans-Alaska gas pipeline – and that the State of Alaska should retain its right to take the state's royalty gas in kind to meet those needs. This third resolution has been approved by the group. However, there still needs to be ratification by community councils before it is final.
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> We have also had some great discussions on what shape of payment in lieu of taxes [PILT] might work best for us. Although we all have different tax structures, the municipal advisory group is working together to identify what our similarities are and make as many unified recommendations to the governor as possible. Again, the point I want to make very clear to you right now is that our communities need access to the gas. It is unthinkable that there may even be a possibility of a gas pipeline through Alaska that doesn't allow us to use some of that gas right here in the state. And yet, for some reason, it's apparently a point of negotiation in this proposed project application.
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> The MAG, in our first and third resolutions, made very clear that we expect any gas pipeline project be required by law to provide for adequate takeoff points and spur lines to meet the reasonably foreseeable demand for in-state use. We recommend in our third resolution that you change Alaska statutes to do just that. We also want to make it clear that we want the State of Alaska to insure a fair tariff to the points of in-state takeoff of gas and that the state retain its right to choose to take its royalty gas in kind or in value – as determined to be in the best interests of the state and to change that determination when conditions warrant.
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> We need to be able to share in the revenue benefits of a gas pipeline. Having said all that, if you have any questions before the Information Insights presentation, I would be very happy to answer them.

SENATOR FRED DYSON agreed with the spirit of what Mayor Thompson said but had a few questions. He referred to language on the last page that reads – be able to share in the revenue benefits of the gas pipeline. He asked if Mayor Thompson thought there should be a formula for the revenue that the state gets from the gas pipeline, similar to the revenue sharing program.

MR. THOMPSON said that is the point that MAG was trying to make.

SENATOR DYSON asked if he was implying that there must be a pipeline to Southeast or that there be a supply system for Southeast.

MR. THOMPSON answered that it means that there should be points from which take-off spur lines could advance. Ports and valves could be put into the line for a future time when a compression plant is built to service Southeast.

SENATOR DYSON asked if he thought there should be a pipeline to Southeast or whether a supply could be barged – not necessarily a pipeline everywhere.

MR. THOMPSON said that is correct.

SENATOR LYMAN HOFFMAN asked why Western Alaska was left out.

MR. THOMPSON said it wasn't left out. One of the take-off points would be the Yukon and areas in the upstream side.

SENATOR ELTON asked if he had identified what the statutory changes should be and communicated them to the governor's office.

MR. THOMPSON replied that MAG got to the point of adopting the resolutions, but not beyond that point.

SENATOR ELTON asked who the governor's office or a legislator would get in touch with to discuss the statutory changes MAG envisions.

MR. THOMPSON said he could get more information on that and that MAG would be adopting more resolutions.

SENATOR SEEKINS asked if he is suggesting that municipalities be able to tax construction of a pipeline on a property tax basis.

MR. THOMPSON replied that under the Stranded Gas Act, the state can exempt properties having to do with the gas line - an office building, for instance, from property tax through the contract period. The municipalities would receive payment in lieu of taxes from the state for that. How municipalities receive that payment is a problem that needs to be resolved. They need to figure out how to deal with a dual use facility as far as property tax goes.

SENATOR SEEKINS asked if the tax bill would be due after completion of the building or during the process. Discussions indicate that the impact would occur now and there is no way to meet the need for additional schools and services, etc.

MR. THOMPSON said MAG is addressing those questions.

> We're looking at the economic impact, which would be during the construction and then the revenue impact of not having property tax for the length of the contract.... That will be in our reports. I think Information Insights will give you some of the economic impact during construction when he makes his presentation.... The ramp up period of construction is going to have an effect on communities along the construction route clear to Seward. If that's where a pipe comes in, there'll be an economic impact of upgrading their ports to be able to receive the pipe. Kenai could be building compression modules. There could be a big impact there. Influx of pipeline workers is going to definitely increase the need for police and emergency services. The schools part of it is going to be addressed.

CHAIR SAMUELS agreed with what he said, particularly about Alaskans using their own resource and being able to choose between royalty in kind and royalty in value.

> I want to just make sure that it has a down side also, that internally your discussion – if you cannot adjust the compression from the North Slope to the distribution center in Fairbanks or Delta or wherever, and you have empty capacity going south, somebody has to pay – it either gets spread over the cost of the remaining gas, in which case at the end point our gas is now the transportation costs are higher and they are already very high or we have to charge more on the front end on the Slope to Delta portion. Internally, I'm assuming that your discussions have been taking place that there's not a line in the sand going - we're not going to pay a tariff one penny more than what it costs to go from A to B if it puts the whole project at risk to pay on the capacity in the pipeline headed south from Fairbanks or Delta.

MR. THOMPSON responded that those conversations continue to take place within the group. They want to make sure the State of Alaska benefits from the gas and not just see it all disappear.

CHAIR SAMUELS said the trade-off would be that you get the gas here, but you lose the cash at the end of the line.

MR. LARRY PERSILY, Department of Revenue, testified:

> The state's ad valorem property taxes, which are AS 43.56, apply to oil and gas production exploration property. Just to run through some of the basics for people who may not be familiar with it – it's generally based on the remaining value of the asset. That would be your value after depreciation. Under state law, it's limited to 20 mils. The municipalities assess their tax first; the

state gets the balance. So, if a municipality has an 18 mil rate, they would get 18 mils; the state would get 2 mils. If the muni is at 15, they would get 15; the state would get 5.

Property tax statute regulations treat pipelines different during construction than during operation. This gets to Senator Seekins' question. First of all, under construction, the property tax is due from the commencement date of construction. When that pipe hits the dock and the front end loaders are there, the property tax is due – not at the completion of the project. That has been one of the issues certainly in the past and certainly of concern to any project sponsor – that they have to start paying property tax during the years of construction before there is any cash flow from the project. During the construction, it's the full and true value of the actual cost. Then when it goes into operation, it becomes the economic value, which is based on the estimated life of the proven reserves. So, if you believe you've got 30 years of proven reserves, we're going to use a depreciation schedule for that 30-year life-span of the project and in trying to appraise it – just to back up a minute – even though the municipalities collect oil and gas exploration production property tax, the state does the assessing, which has also in the past been an issue of contention between the state and municipalities. Because, of course, if you're a municipality and the state is doing the assessing and you're looking at your revenue drop as the assessments drop, you may think the state is doing a bad job of assessing. There is a state assessment review board that will deal with those cases. Of course, property owners would think the state is doing a bad job of assessing, because it might be too high. So, the state often gets caught in the middle between municipalities who want the assessments higher and the property owners who want the assessments lower.

In assessing pipeline property that's in operation, we look at the life of the proven reserves; you look at sales comparison, which is difficult because this isn't a home. You don't have comps out there as you think of your home assessment. It's not that someone has sold pipelines in Alaska or sold gas treatment plants on the North Slope. So, doing comps or sales comparison is difficult. Costs – you can get into a debate – what is the replacement cost, which is what state law talks about, not explicitly what did it just cost to build that facility, but what would it cost you today to replace it. And certainly, on older facilities, the replacement costs could be significantly less than what it cost you to build it with new technologies. You can look at the income approach and from all those hopefully come up with the right answer.

As you think of the importance of property taxes to municipalities on this gas line project, certainly there is the impact funding in the construction years as the mayor talked about, as Brian Rogers will discuss. Under property tax law, status quo tax payments are due the minute you start construction and during those years, in many of the communities, you're going to have the most impact – schools, roads, ambulances, police protection and such. After construction, funding of ongoing general government – that's what property taxes are for – and that's going to be an important issue to municipalities who, when they look at this, are looking for certainty as they try working on their budget planning – as they are deciding whether to issue bonds. Are they going to have revenue to pay it off? They need to know with some certainty what kind of revenue stream they are going to have.

This is perhaps just the way the grid was set up – an exaggerated look, but it points out the problem. This is a very conservative scenario. This is based on pure cost of a gas pipeline – no new reserves that would extend the life. So, if you find new reserves that line that declines would hit a new plateau. If you think you've got 20 more years, it's going to level it out and then it's going to start declining again. It assumes no new investments, which would add to the basis value of that property. But what this points out, and this is an example if you had a $5 billion pipeline, during construction, you're property tax payments increase very quickly and very steeply as all that money is being spent during the five years. At that point then, you now have the basis in your line, you're draining your reserves. Every year the value of that operating pipeline decreases. So, the property tax revenue decreases. As I said, this is a conservative scenario that shows no new investment and no new reserves. So, it really wouldn't be that steep, but it points

> out the problems for municipalities – you're getting a percentage of an asset that's declining in value, which, if it's your municipality, is maybe not where you'd want to be long-term.

SENATOR DYSON said he suspected the gas pipeline, like the oil pipeline, would have a much longer life than was originally anticipated. "When that turns out to be true, is there a mechanism for recapture and how does that work for the local folks?"

MR. PERSILY replied:

> As the Department of Revenue's assessors looked at the oil pipeline and we looked at extending the life of the line, adjustments are made and the assessed value of that pipeline is taken into account. If it's going to be producing income for a longer period of time, it should have a higher value as you extend it out. So, under law we do make adjustments and change the assessments. It's just like your home – every year a new assessment notice goes out.

SENATOR DYSON said a 15-year longer life than is expected would change the slope of the line considerably. He asked:

> Is there a mechanism to go back and recapture the property taxes that should have been paid based on now a more accurate assumption of the useful life of the line?

MR. PERSILY replied:

> The number doesn't go back up if you can visualize.... You still only had $X billion into the line. The cost basis didn't change. What you're doing now is not so much stopping the depreciation, but extending out. So, instead of going down steep, it might reach a plateau and go close to level and then start to climb again, but at a much more gradual pace because you're not going to retroactively change your collections, but you're going to extend your collections for many more years than you had expected collecting more money over the life of the project. But the total basis into it that you're depreciating hasn't gone up, so the value is still, say, a $10 billion line. Instead of collecting taxes for 30 years, now maybe you're going to collect tax for 50 or 60 years.

SENATOR SEEKINS inserted, "But at a low rate."

MR. PERSILY replied, "Right, but cumulatively it's going to be much more than you would expect at the beginning of the project."

SENATOR DYSON added, "And similarly, if the replacement costs go up, that would also change the basis?"

MR. PERSILY answered:

> Sure, you could argue if the replacement costs go up that could be a factor the state would take into account. I can certainly tell you that the owners of the TransAlaska Pipeline, well not so much the pipeline, but the Prudhoe Bay facilities, always argue that the replacement costs go down, because they would argue you could build those facilities today much cheaper than you built them then, because of what they know now as opposed to what they knew 30 years ago. So, I welcome your input, but I think they might disagree. Not surprising.

SENATOR SEEKINS asked what the statute says regarding the administrative codes he's quoting on page 3.

MR. PERSILY read from AS 43.56.060 (d), "'The department shall assess property for the taxes levied at the full and true value January 1' - and this deals with pipelines – 'The first assessment date shall be the construction commencement date.'"

SENATOR SEEKINS said if the legislature wants to change any of that, it has to be done in statute.

MR. PERSILY replied that is correct. Section (b) of that statute deals with construction; section (e) talks about once it's in operation. It says, "the full and true value of taxable property used in pipeline transportation" and then it goes on to say, "economic values based on estimated life of the proven reserves." Technically, economically recoverable talks about, "straight line basis for depreciation over the economic life of the project."

MR. PERSILY moved on to slide 7 and said:

The commercial problems presented by the property tax in the current form – and I guess these would be commercial problems from the perspective of the project sponsors – front end loaded. As I explained, you start paying property taxes the minute the equipment hits state territory. If you're a project sponsor, you might say, 'Gee, that's a lot of money to pay before I start having cash flow," but certainly from a municipal perspective, that's when you start seeing the impact when the construction begins. You could say it's regressive in that it exacerbates the impact of cost overruns because your property tax is based on the value of what you're putting in there during construction or the basis when you go to operation. If project sponsors are worried about a 20 percent cost overrun on the project, that would mean not only do they have that problem to deal with, which leads to a higher tariff, but if you have a cost overrun, the property tax bill is going to go up.

Fiscal uncertainty is an issue certainly for the sponsors. They are not going to know what the property tax rate is going to be – not just the assessment, but the mil rate itself in the future. For the municipalities it's a problem too, as you think about municipal budgeting and wanting some certainty.

The uncertainty in the asset valuation is an issue just about every year. There's a lot of money at stake. This isn't whether your home is worth $240,000 or $220,000; this is whether the property might be worth $3 billion or $3.5 billion – disputes whether to use cost income market approach, asset life, capitalization rate. So, these are a lot of the problems that are faced under the status quo that we would hope to deal with in the Stranded Gas Act to help encourage construction of a project and setting up a fiscal system that would be best for the municipalities, too.

Under the Stranded Gas Act in terms of property taxes, first is that obligation that the payments are shared with the municipalities, that the state sets up in the Stranded Gas Act and it's approved by the legislature some system in lieu of the status quo for property taxes. The state is obligated under statute to share that with municipalities who would be losing that property tax ability on their own. It's to be shared with not just the economically affected communities, certainly, but the revenue affected communities. There are two different ones – a revenue-affected community might be someone who is losing the ability to assess property tax revenue on that pipeline. Someone who is economically affected might be someone who is not going to have any of the pipe in their community, but would have an economic impact, for example – if construction equipment is brought in at Haines, barged to Haines and trucked through the highway system to construction sites. Ultimately, when the line goes into operation, Haines will not have pipeline property, but during those years of construction, they're going to have an impact if you're talking of thousands of truckloads of equipment moving across the dock and moving through their community. So, you've got two different kinds of communities, both of which need to be accommodated in the Stranded Gas Act.

You certainly want something that's fair and reasonable with due regard to the size of the tax base that would be exempted under the Stranded Gas Act. You've got to deal with the economic and social burdens imposed by construction and operation in the communities. The Stranded Gas Act also calls on the Department of Revenue to consult with the Municipal Advisory Group in crafting contract language.

MR. PERSILY said the last slide looks at negotiation issues.

Certainly, one key is to improve the project economics. We want a project; you want a pipeline built; that's the whole goal of the Stranded Gas Act. One way you can deal with it, certainly, is the issue of the front end loading, the [indisc.] at the beginning during construction as long as you take into account certainly the strong needs for municipalities during those years, but you want to come up with something that improves project economics, recognizes the municipal issues, deals not just with the certainty for the sponsors, certainty for the municipalities as they budget and the issue of the declining tax base. The fact that under status quo every year in theory, that pipeline is going to be worth less as you get closer to the end of the economic life, impact aid during

> construction – that's when a lot of municipalities are going to see their highest costs – is during the construction boom. We don't believe it would be as much as during the oil pipeline, but it's going to be significant and as we heard at the last committee meeting from the Department of Natural Resources and the federal geologists, there could be a lot more gas there.
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> This project could have a much longer life than we're looking at now with just 35 TCF. You want to make sure that what's in that contract protects the municipalities so that if this project runs 50 or 60 years, they're still getting substantial revenue during all that time. And, at the end of the contract, because under the Stranded Gas Act, it's limited to a 35-year contract, you've got to look at what happens that next day. If you've got a 35-year contract, and you've got some payment in lieu of taxes, some mechanism set up and then the next day when you revert back, that needs to be dealt with in the contract rather than just saying you'll worry about it in 35 years.
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> One other thing to keep in mind is restructuring taxes is not necessarily lowering taxes. Improving the project economics doesn't mean giving away money or taking something away from the municipalities. Restructuring tax in the Stranded Gas Act, hopefully, would improve the economics and also enhance the revenue stream for the municipalities at the same time.

MR. PERSILY, in response to a question from Senator Seekins, related that the Stranded Gas Act negotiators are looking at what is the best way to insure the municipalities' revenue most accurately reflects the economics of the project and the length of the project's life rather than the current status quo, which is tied to a declining number.

REPRESENTATIVE LES GARA asked, "If I'm correct, we've taken roughly $75 million per year in property taxes now, then distribute it to the municipalities from North Slope operations?"

MR. PERSILY responded:

> The last time I looked, I believe the total take of oil and gas production and exploration property tax was around $250 million, of which I think the municipalities get a couple hundred million and the state about $50 million – about 20 percent.

REPRESENTATIVE GARA asked if he could assume the ratio would be similar for pipeline operations and if he could guess at the amount property taxes would bring in during the construction phase.

MR. PERSILY said the state would be involved in receiving payments if there is a new structure in lieu of property taxes, because more of the gas line is going to be on state lands than with the oil line. He guessed that a property tax rate of 20 mils on a $10 billion project would bring $200 million. He reminded them that property taxes are not linked to the economics of a project.