

**PROPOSED STUDY PLAN FOR AN INTERIM STUDY
OF THE PROPERTY TAXATION OF OIL
AND NATURAL GAS PROPERTY**

Prepared for the Revenue and Transportation Interim Committee
by
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INTRODUCTION

During the 2005 legislative session, Rep. Walter McNutt introduced House Bill No. 569 to clarify the taxation of oil and natural gas flow lines and gathering lines. These types of pipelines transport oil or gas from a production area to a transmission line. The legislation would have taxed all oil and natural gas flow lines and gathering lines, regardless of ownership, as class eight personal property under 15-6-138, MCA, and would have eliminated the central assessment of this type of property. The purpose of the legislation was to deal with property tax disputes between certain taxpayers and the Montana Department of Revenue on the assessment, classification, and taxation of certain oil and natural gas production property. The bill passed the House of Representatives but was tabled in the Senate Taxation Committee

To deal with the issues raised by House Bill No. 569, Rep. Alan Olson introduced House Joint Resolution No. 44. The resolution, passed by the 59th Legislature, requests that an appropriate interim committee study the property taxation of oil and natural gas property. The preamble of the resolution describes the rationale for the study:

- Oil and natural gas production machinery and equipment, gathering lines, and transmission lines make up a significant portion of the property tax base of many taxing units across the state.
- Oil and natural gas property that is located in more than one county [or that crosses state lines] is centrally assessed and is taxed at a higher rate than other property.
- Ownership patterns of oil and natural gas property have changed over the last several years.
- Many different entities own oil and natural gas property that is centrally assessed.
- Higher property taxes on this property may impede the competitive position of small producers.
- Several owners of oil and natural gas property have challenged the Department of Revenue's authority to centrally assess certain oil and natural gas property.
- It is in the public interest to establish a balance between the financial needs of local governments and the equitable taxation of oil and natural gas property.

The body of the resolution directs that the study should include but not be limited to:

- an evaluation of the types of oil and natural gas property subject to taxation;
- the ownership patterns of oil and natural gas property subject to central assessment;
- an analysis of the importance of oil and natural gas property to the property tax structure of taxing jurisdictions, including the state;
- a review of the Department of Revenue's assessment procedures and practices with respect to oil and natural gas property, especially property that is centrally assessed by the Department;
- an analysis of the state's policy regarding the taxation of oil and natural gas property.

ASSESSMENT OF PROPERTY FOR PROPERTY TAX PURPOSES

Article VIII, section 3, of the Montana Constitution requires that the Department of Revenue "appraise, assess, and equalize the valuation of all property which is to be taxed in the manner provided by law". Property is either locally assessed or centrally assessed by the Department of Revenue. Local assessment means that a taxpayer's property is valued separately in each county or taxing jurisdiction in which the property is located. Examples of locally assessed property that is taxed on the basis of market value include:

- residential and commercial land and improvements (class four, taxed at 3.22% of market value in tax year 2005);
- qualifying new industrial property; real and personal property used for the production of gasohol; all property that is devoted to research and development; machinery and equipment used in electrolytic reduction facilities (Columbia Falls aluminum plant) (class five, taxed at 3% of market value);
- rural electrical associations that serve less than 95% of the electricity consumers within the incorporated limits of a city or town (class seven, taxed at 8% of market value);
- business equipment, including (noncentrally assessed) oil and gas production equipment (class eight, taxed at 3% of market value).

The Department of Revenue is required to centrally assess the property of a taxpayer that is operated in more than one county or state. Central assessment means that an entity's property statewide is valued as one unit. Section 15-23-101, MCA, directs the Department of Revenue to centrally assess each year:

- (1) the railroad transportation property of railroads and railroad car companies operating in more than one county in the state or more than one state;

(2) property owned by a corporation or other person operating a single and continuous property operated in more than one county or more than one state, including but not limited to telegraph, telephone, microwave, and electric power or transmission lines; natural gas or oil pipelines; canals, ditches, flumes, or like properties and including, if congress passes legislation that allows the state to tax property owned by an agency created by congress to transmit or distribute electrical energy, property constructed, owned, or operated by a public agency created by congress to transmit or distribute electrical energy produced at privately owned generating facilities, not including rural electric cooperatives;

(3) all property of scheduled airlines;

(4) the net proceeds of mines;

(5) the gross proceeds of coal mines; and

(6) property described in subsections (1) and (2) that is subject to the provisions of Title 15, chapter 24, part 12.

The unit value approach uses companywide information regardless of location of the property to determine the market value of the business entity and allocates a proportionate share of the total value to the state and to political subdivisions within the state. There are three indicators to determine the market value of the entity: cost, market, and income. In Montana, the cost indicator is original cost, less depreciation. The income indicator uses the business entity's present value net income stream. Changing market conditions (e.g., risk, price, and market share) will affect valuation under this approach. The market indicators include such factors as sales of comparable assets or the business entity's stock and debt value. Ideally, each of these methods should yield about the same value of the entity being assessed. In practice, however, these methods may produce widely disparate results. To resolve the differences, the appraiser will weight each approach in order to produce a final unit value.¹

Centrally assessed property is classified in several different property classes:

- Class five property (15-6-135, MCA): rural electric cooperatives and rural telephone cooperatives and pollution control equipment of centrally assessed property. As noted above, class five property also includes property that is not centrally assessed. Class five property is taxed at 3% of market value.
- Class nine property (15-6-141, MCA): centrally assessed electric power companies; centrally assessed natural gas companies; rural electric cooperative property used for the sole purpose of serving customers representing less than 95% of the electricity consumers in a city or town of more than 3,500 people in which a centrally assessed electric power company also owns property; and other centrally assessed companies. Class nine property is taxed at 12% of market value.
- Class twelve property (15-6-145, MCA): railroad and airline property. Class twelve property is taxed at the average taxable percentage of other commercial and industrial property.

¹Lawrence C. Walters and Gary C. Cornia, "Electric Utility Deregulation and the Property Tax in the United States", in Impacts of Electric Utility Deregulation on Property Taxation, edited by Philip Burling (Lincoln Land Institute of Land Policy: 2000), p. 49.

- Class thirteen property (15-6-156, MCA): electrical generation facilities of a centrally assessed electric power company; electrical generation facilities owned or operated by an exempt wholesale generator or an entity certified as an exempt wholesale generator (e.g., PPL Montana); noncentrally assessed electrical generation facilities (except qualifying facilities); and centrally assessed telecommunications services companies. Class thirteen property is taxed at 6% of market value.

Centrally assessed class nine property has included regulated electrical and natural gas utilities, telephone companies, oil and gas transmission lines, railroads, and airlines. The tax rate applied to property in this class has typically been higher than other types of property. Changes in federal law and the restructuring of electric and telecommunications services markets have led to the reclassification of certain property previously included in this class. For example, the federal Railroad Revitalization and Regulatory Reform Act of 1976 and the Tax Equity and Fiscal Responsibility Act of 1982 prohibit states from imposing discriminatory taxes on the railroad and airline industries, respectively. The property tax rate on railroad and airline property may not be higher than the tax rate generally applicable to commercial and industrial property. In 1985, the Montana Legislature reclassified railroad and airline property. In 1999, the Montana Legislature reclassified electrical generation facilities and telecommunications property to help make these industries more competitive with other states. The Legislature also imposed a wholesale energy transaction tax and a retail telecommunications excise tax to help offset the revenue loss from the lower property tax rates on these properties.

The Department of Revenue is guided by administrative rule 42.22.102 in valuing centrally assessed property:

42.22.102 CENTRALLY ASSESSED PROPERTY (1) The department shall centrally assess the interstate and inter-county continuous properties of the following types of companies:

- (a) railroad;
- (b) railroad car;
- (c) microwave;
- (d) telecommunications;
- (e) telephone cooperatives;
- (f) gas;
- (g) electric;
- (h) electric cooperatives;
- (i) ditch;
- (j) canal;
- (k) flume;
- (l) natural gas pipeline;
- (m) oil pipeline; and

(n) airline.

(2) The property of a centrally assessed company is separated into two categories: operating and non-operating. All operating property will be apportioned to the taxing units as provided in ARM 42.22.121 and 42.22.122.

(3) The department will determine centrally assessed property based on the property's operating characteristics such as but not limited to property use, integration of operations, management, and corporate structure.

In 1999, the Department, through the administrative rule process, added ARM 42.22.102 (3) to clarify its current practice of valuing centrally assessing property under existing law.¹ According to the Department, the rule "effectuates the legislature's intent to centrally assess those unique properties whose true value can only be determined by examining their operating characteristics".²

Recently, two taxpayers have disputed the Department of Revenue's central assessment of natural gas gathering lines and related property located in various counties. In tax year 2004, Omimex Canada, LTD reported its personal property for local assessment to the various counties.³ The Department determined that the property should be centrally assessed and taxed at 12% rather than at the class eight personal property tax rate of 3%. In April 2004, Omimex filed a complaint for declaratory judgment in the District Court in Helena, asking the court to find, among other things, that its personal property be locally assessed and that ARM 42.22.102(3) is invalid.⁴ The complaint contends that the subject property consists of unregulated gathering lines and related property that transmits natural gas from various wellhead connections to various interconnections with transmission lines in which Omimex has no ownership interest. The complaint states that similarly situated taxpayers with comparable property operating in more than one county are locally assessed and are taxed at 3% of market value. A trial in District Court on the complaint is scheduled to begin on December 12, 2005.

Montana-Dakota Utilities has appealed the valuation of its property as well as the classification of "indirect subsidiaries" as centrally assessed property to the State Tax Appeal Board. The appeal claims that the Department of Revenue improperly included in the appraisal of the Williston Basin Pipeline Company the value of gathering lines owned by Bitter Creek Pipeline,

¹See Department of Revenue's Response No. 8, Montana Administrative Register, 1999 Issue No. 24, p. 2918, December 16, 1999.

²DOR's Brief in Support of Cross-Motion for Partial Summary Judgment, in *PanCanadian Energy Resources, Inc. v. Montana Department of Revenue*, Cause No. DV-02-3223, February 28, 2003.

³The Montana Power Company sold its natural gas exploration, production, and marketing assets to PanCanadian Petroleum. In 2003, Omimex purchased certain gathering facilities in Montana from EnCana Oil and Gas, a successor company to PanCanadian Petroleum.

⁴*Omimex Canada, LTD v. State of Montana, Department of Revenue, Montana First Judicial District, Cause No. DV-2004-2288*, April 14, 2004.

LLC, and gas production property owned by Fidelity Exploration and Production Company. The appeal states that these two companies are not subject to central assessment and that their property should be taxed at 3% of market value rather than 12%.⁵ ⁶ The State Tax Appeal Board is scheduled to hear the complaint on February 20, 2006.

STUDY QUESTIONS

Regardless of the merits of the property tax protests, the disputes raise the issue of whether the procedures for the classification and taxation of certain types of property for property tax purposes under a partially restructured environment should be reexamined. The following questions may be considered regarding the classification and taxation of certain oil and natural gas property in Montana:

- How has federal and state restructuring of the natural gas industry affected markets in Montana and the delivery of natural gas from the wellhead to the final consumer?
- How have the ownership and organizational structure of oil and natural gas production property changed over the last several years?
- To what extent does central assessment and higher tax rates of gathering lines of certain owners affect them in the markets in which they operate?
- Would the local assessment of certain gathering lines and flow lines have any implications for the Department of Revenue centrally assessing other property and for the state?
- What would be the change in market value if property that was previously centrally assessed were locally assessed?
- If the assessment, classification, and taxation of certain oil and natural property are revised, what are the fiscal impacts on taxing jurisdictions and how can the fiscal impacts be mitigated?
- Are there dissimilarities in oil and natural gas property that justify differences in the assessment or classification, or both, of these types of property?

⁵Montana-Dakota Utilities Co., Williston Basin Interstate Pipeline Co., and Fidelity Exploration and Production Co. v. Department of Revenue of the State Of Montana, Before the State Tax Appeal Board of the State of Montana, No. SPT-2004-2, June 24, 2004.

⁶The appeal also contends that the Department of Revenue used capitalization rates in its appraisal that are unreasonably low, improperly included contributions in aid of construction, and failed to account for plant decommissioning costs.

- What are the policy options available to the state under a variety of conditions?

MAJOR STUDY AREAS

The primary focus of the study may include the following:

1. Provide an overview of how oil and natural gas delivery systems work.
2. Briefly review federal and state restructuring of the natural gas industry.
3. Evaluate the extent to which natural gas markets have changed as a result of restructuring. This element would include looking at participants in the market and structural changes in the market.
4. Compare the property assessment, classification, and taxation of oil and natural gas flow lines and gathering lines and transmission lines in Montana with surrounding states.
5. Develop criteria for determining whether property is part of a flow line/gathering line system or a transmission system. Evaluate whether revisions are needed to clarify, refine, or improve statutes related to the assessment, classification, and taxation of oil and natural gas property.
6. Develop a database to evaluate proposed changes to the taxation of oil and natural gas property.
7. Identify legal, policy, and fiscal implications related to the assessment, classification, and taxation of oil and natural gas property.
8. Develop options, if options are considered necessary, to revise the assessment, classification, and taxation of oil and natural gas property in Montana, with attention focused on direct and secondary effects that any option might entail. The options should be evaluated using established criteria of good tax policy, including equity and fairness, economic efficiency, and simplicity.

PROPOSED SCHEDULE

The following schedule is proposed for conducting the study:

- September 2005 meeting -- Review, refine, and adopt study plan. Overview of how oil and natural gas delivery systems work.

- December 2005 meeting -- Report on natural gas restructuring and changes in market structure in Montana. Comparison with Montana of valuation procedures used in other states.
- February 2006 meeting -- Review oil and natural gas database and analyze legal, policy, and fiscal issues related to valuation methods of oil and natural gas property.
- April 2006 meeting -- Evaluate the implications of policy changes on taxpayers and state and local taxing jurisdictions; develop options and initial recommendations for consideration; request draft legislation if considered appropriate.
- June 2006 meeting -- Act on draft legislation, if any; finalize recommendations; approve outline for the final report.
- September 2006 meeting -- Review final report of committee actions.

Although decisions made outside the arena of this study may ultimately determine how oil and natural gas property is taxed, the information developed by this study should assist the Legislature in responding to those decisions.

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