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CHAPTER ONE
HOUSE JOINT RESOLUTION NO. 44

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 (HJR 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

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assessed by the Department;

- an analysis of the state's policy regarding the taxation of oil and natural gas property.

The HJR 44 study was assigned to the Revenue and Transportation Interim Committee (Committee) by the Montana Legislative Council. On September 30, the Committee tentatively adopted the study plan. During the course of the interim, the HJR 44 study focused primarily on the classification, assessment, and taxation of three natural gas producing entities in Montana--EnCana Energy Resources, Inc., Fidelity Exploration and Production Company, and Omimex Canada, Ltd. EnCana, Fidelity, and Omimex are centrally assessed by the Montana Department of Revenue and are taxed at 12% of market value under 15-6-141, MCA. Each of these companies has protested the assessment, classification, and taxation of its property. The protests have gone through various stages of review, appeals, and settlements.

To a lesser extent, the study also dealt with the taxation of oil production property. This report presents the information, analysis, and discussion that the Committee considered during the course of the study.

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CHAPTER TWO
ASSESSMENT OF PROPERTY FOR PROPERTY TAX PURPOSES

This chapter provides a brief overview of the assessment of property for tax purposes in Montana and some significant legislative changes to the taxation of business property. It also highlights the disputes between certain natural gas producers and the Department of Revenue.

Most oil and natural gas production property, including flow lines and gathering lines, are locally assessed and are classified as class eight personal property and taxed at 3% of market value. However, if an entity that is centrally assessed has oil or natural production property, that property is also centrally assessed and taxed at 12% of market value.

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.

Locally Assessed Property

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:

- Class four property (15-6-134, MCA): residential and commercial land and improvements. The general tax rates for class four property are: 3.22% of market value in tax year 2005, 3.14% in 2006, 3.07% in tax year 2007, and 3.01% after 2007.

- Class five property (15-6-135, MCA): 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 property is taxed at 3% of market value.

- Class seven property (15-6-137, MCA): rural electrical associations that serve less than 95% of the electricity consumers within the incorporated limits of a city or town. Class seven property is taxed at 8% of market value.

- Class eight property (15-6-138, MCA): business equipment, including (noncentrally assessed) oil and gas production equipment. Class eight property is taxed at 3% of market value.

Locally assessed property also includes class three agricultural land (15-6-133, MCA) and class ten forest land (15-6-143, MCA) that are valued on the basis of productivity. The productivity value of class three agricultural land is taxed at the same rate as class four property, and the productivity value of class ten property is taxed at 0.79%.

Centrally Assessed Property[1]

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, or by the unitary valuation method. 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 unitary valuation method 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 entity's 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.[2]

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;

[1] See also Appendix A in this report, memo from Lee Heiman to the Revenue and Transportation Committee on the central assessment and classification of property.

[2] Lawrence 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.

(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.[3] 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".[4]

In Montana, 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

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

[4] DOR'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.

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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. A change in the tax rate applied to any class of business property will affect the tax rate applied to railroad and airline property.

- 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, which are taxed as class four property and class eight property); and centrally assessed telecommunications services companies. Class thirteen property is taxed at 6% of market value.

Trends in Property Classification and Taxation

In 1987, most business personal property was taxed between 11% and 16% of market value and class four land and improvements were taxed at 3.86% of market value. Most centrally assessed property (except for railroad and airline property, rural cooperatives, and mines) was taxed at 12% of market value. In 1989, the Legislature consolidated the taxation of most business personal property and reduced the tax rate to 9%. Since then the Legislature has gradually reduced the tax rate on business personal property. In 1999, the Legislature reduced the tax rate on business personal property to 3% and phased-out over a four-year period the taxation of class six property, which included livestock, certain rental personal property, canola facilities, and malting barley facilities. Before the consolidation and reduction of taxation on business personal property, the disparity between the tax rates of regulated utilities and other business was related to the lower tax rate on commercial land and improvements. Typically taxes paid by regulated utilities are included in the rate base.

Centrally assessed class nine property has included regulated electrical and natural gas utilities, telephone companies, oil and gas transmission lines, railroads, and airlines. 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.

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The Dispute

Two taxpayers[5] 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.[6] 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.[7] 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.[8] A trial in District Court on the complaint, originally scheduled to begin on December 12, 2005, has been rescheduled to September 2006.

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, LLC, and gas production property owned by Fidelity Exploration and Production Company. The appeal further states that by including the gathering lines of Bitter Creek and the production property of Fidelity in the Williston Basin assessment subjected property of Fidelity to the class nine 12% tax rate rather than the class eight 3% tax rate.[9] [10] Williston Basin Pipeline and the

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[5]EnCana Energy Resources has also disputed the central assessment of its property, but this company was not a significant part of the House Joint Resolution No. 44 study.

[6]The 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.

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

[8]On August 9, 2005, in a partial summary judgment, District Court Judge Jeffrey M. Sherlock ruled in Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County) that ARM 42.22.102(3) was invalid. Conversely, on October 27, 2003, District Court Judge Marc G. Buyske ruled in partial summary judgment in PanCanadian Energy Resources v. Department of Revenue (No. DV 02-3223, Twelfth Judicial District, Liberty County) that ARM 42.22.102(3) is a valid rule. For more information about the two district court rulings, see Appendix A in this report, memo from Lee Heiman, Committee staff attorney, to the Revenue and Transportation Committee.

[9]Montana-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.

[10]The 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

Department of Revenue have settled the property tax disputes for property tax years 2002 through 2006.

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costs.

CHAPTER THREE
PROFILES OF OIL AND NATURAL GAS PRODUCTION COMPANIES

At the time of the this report, Encana, Fidelity, and Omimex are the only natural gas production companies that are centrally assessed. This chapter provides a brief overview of EnCana Energy Resources, Omimex Canada, Ltd., MDU Resources Group companies including Fidelity Exploration and Production Company, Bitter Creek Pipelines, LLC, and Williston Basin Interstate Pipeline Company. It also includes an overview of Encore Operating Company. Although primarily an oil production company in Montana, Encore also produces a small amount of natural gas in the state, and, as noted, below could be subject to central assessment.

Omimex Canada, Ltd.

Omimex is an independent oil and natural gas production company. Its corporate headquarters are located in Fort Worth, Texas, and has Montana offices in Butte and Cut Bank. Omimex acquired most of its Montana property from EnCana in 2003.[1] Omimex owns property in Blaine, Chouteau, Glacier, Hill, Liberty, Phillips, Pondera, Toole, and Valley Counties. Omimex's properties generally consist of:

Cut Bank Area Glacier and Toole Counties	**Reagan Glacier and Toole Counties**	**Battle Creek Blaine and Phillips Counties**	**Shelby Area Liberty and Toole Counties**	**Bowdoin Phillips and Valley Counties**
Cut Bank gathering Cut Bank gas plant Cut Bank pipeline Big Rock gathering	Reagan field gathering	Battle Creek gathering Chinook pipeline	Kevin Sunburst gathering, Toole County East Keith gathering Utopia gathering East Keith pipeline	Bowdoin field gather-ing Whitewater pipeline

Source: Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County), January, 17, 2006.

In an order on motions for summary judgment, District Court Judge Jeffrey M. Sherlock provided some detail on the location and nature of Omimex's property in Montana.[2] He described the properties as consisting of hundreds of miles of natural gas pipelines and about 1,400 wells. The Cut Bank pipeline crosses the county line between Glacier and Toole Counties, and another natural gas pipeline crosses the border between Montana and Alberta, Canada. The East Keith Pipeline runs from Hill County through Liberty County into Toole County.

Omimex transports in its pipelines its own natural gas, third-party gas, and gas of which it owns

[1] In 2002, PanCanadian Energy Resources merged with Alberta Energy Company to form EnCana. PanCanadian Energy had previously acquired the Montana Power Company's exploration, production, midstream, and marketing property, including the gathering and processing facilities held by North American Resources Company, a Montana Power Company wholly-owned subsidiary.

[2] Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County), January, 17, 2006.

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a working interest. For example, the Whitewater pipeline transports third-party gas to the U.S.-Canadian border crossing. The Chinook pipeline also delivers gas to the border crossing. The court noted that it appears that none of the properties are physically connected with each other.

Omimex has a single gas marketing agreement with Wisconsin Public Services. One hundred percent of the gas owned by Omimex and transported to market on its pipelines is sold off the TransCanadian pipeline, the Northern Border pipeline, and NorthWestern Energy pipelines.

Fidelity Exploration and Production Company, Bitter Creek, and Williston Basin Interstate Pipeline

Fidelity Exploration and Production is a direct wholly owned subsidiary of WBI Holdings, Inc; it is a MDU Resources Group, Inc., company. In the Rocky Mountain Region, Fidelity operates primarily in Colorado, Montana, North Dakota, and Wyoming. Fidelity operates oil and natural gas leases in the Baker area (Cedar Creek Anticline) in southeastern Montana (Fallon County) and southwestern North Dakota, the Bowdoin area located in northcentral Montana (Phillips and Valley Counties), and the Powder River Basin of Montana (Big Horn County) and Wyoming (coal bed methane). It also operates in Alabama, Arkansas, Louisiana, New Mexico, Oklahoma, Texas, and the Gulf of Mexico.[3] Several years ago, Fidelity acquired Red Stone Partners production company, including coal bed methane property.

Bitter Creek owns gathering lines in gas fields located in Montana, Wyoming, Colorado, and Kansas. It is an unregulated company and transports gas, including gas produced by Fidelity, from the wellhead to a central location in the gas field for treatment and injection into a natural gas transmission pipeline. Its pipelines are interconnected with the Williston Basin Interstate Pipeline as well as with other pipelines.

Williston Basin Interstate Pipeline, regulated by the Federal Energy Regulatory Commission, transports and stores natural gas in the four states in which Montana-Dakota Utilities operates (Montana, North Dakota, South Dakota, and Wyoming).[4]

EnCana Energy Resources

EnCana Energy Resources operates in Carbon, Golden Valley, and Stillwater Counties. Its property is centrally assessed by the Department of Revenue. EnCana also operates in the Rocky Mountain Region and in the Gulf of Mexico.

Natural Gas Production Data

The table below shows recent natural gas production history of several production companies operating in Montana. Consolidations, acquisitions, and mergers have changed the relative

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[3] U.S. Securities and Exchange Commission, Form 10-K, MDU Resources Group, Inc. For the fiscal year ended December, 31, 2005. Available from http://www.sec.gov/Archives/edgar/data/67716/000006771606000058/mdu200510k.htm.

[4] Presentation by John Alke, in Minutes, Revenue and Transportation Interim Committee, December 2, 2005, Exhibit #2. The Minutes and links to the exhibits are available on the Committee's webpage at http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp.

Production (in Thousands of Cubic Feet, MCF) of Selected Natural Gas Producers in Montana, 2000-2004					
Company	2000	2001	2002	2003	2004
WBI Production	12,591,781	3,631,400	Consolidated with Fidelity Oil Group in 1999		
Ocean Energy Resources	10,538,520	14,814,672	NA	NA	NA
Ocean Energy	9,125,763	2,960,931	16,778,669	11,063,572	Merged with Devon in 2003
Devon Louisiana	NA	NA	NA	6,083,660	18,183,453
Klabzuba Oil and Gas	6,192,395	9,841,274	9,413,276	7,815,151	6,934,708
Redstone Gas Partners	3,494,723	1,792,636	Acquired by Fidelity Exploration and Production in 2000		
Montana Power Gas	3,066,480	3,038,384	NA	NA	NA
EnCana Energy Resources, Inc.	996,771	973,858	8,909,103	6,700,639	554,985
Montana Power	138,011	205,867	59,372	NA	NA
Fidelity Exploration & Production	109,346	17,461,270	28,703,166	30,582,744	40,694,269
Omimex Canada	NA	NA	NA	348,935	3,848,751
NorthWestern Energy	NA	NA	136,410	170,680	160,312

Source: Montana Board of Oil and Gas Conservation, *Annual Report*, various years.

importance of certain producers since 2000. For example, EnCana was the fourth largest producer in the state in 2002 and 2003. In 2004, it was the ninth largest producer. Fidelity has been the largest producer of natural gas since 2001.

Encore Operating Company

Encore Operating Company is the largest oil producer in Montana. It produces oil from the Cedar Creek Anticline that stretches almost interrupted from Bowman County in southeastern North Dakota through Fallon, Wibaux, Prairie, and Dawson counties in Montana. Flow lines transport oil to separation and processing facilities owned by Encore. From the processing facilities, oil is transported on third party lines to the Baker gathering station for transfer to larger transmission lines. It appears from a map included in the presentation to the Committee at its February 17, 2006, meeting that a small portion of Encore's flow lines cross the state border from North Dakota. Likewise, a small portion of the company's flow lines appears to cross the county line between Dawson and Prairie counties to a third-party pipeline.[5]

Encore produces a small amount of natural gas in Montana (based on the Board of Oil and Natural Gas annual reports, the amount is less than 10,000 MCF). An Encore pipeline moves gas

[5] Bob Jacobs, "Encore Operating, LP", in Minutes, Revenue and Transportation Committee, February 16 and 17, 2006, Exhibit #33.

from Wibaux County to a compressor station in Fallon County. From there, the gas is transported by a third-party pipeline to a gas plant, also in Fallon County.

The property of oil production companies is locally assessed and taxed at 3% of market value. However, if the property of an oil production company were to cross county lines, that property would be subject to centrally assessed and taxed at 12% under current law.

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CHAPTER FOUR
A VERY BRIEF HISTORY OF THE REGULATION OF NATURAL GAS[1]

In Montana, as well as other states, the assessment and taxation of certain natural gas property has been linked to regulatory policy. This chapter presents a brief history of the regulation of the supply of natural gas, focusing primarily on federal regulatory policy.

The first regulation of natural gas was initiated by municipalities in the mid-1800s. Natural gas was produced from coal for delivery to the municipality. Municipalities determined that a single provider could deliver natural gas more efficiently than several providers. However, because of the monopolistic characteristics of a single provider of natural gas, municipal authorities regulated rates and other aspects of the market in the public interest. As natural gas distribution expanded within a state, the state took over the regulatory responsibilities with the establishment of public utility commissions or public service commissions.

In the early 1900s, as technology improved for transporting natural gas, pipeline companies began the interstate shipment of natural gas. Between 1911 and 1928, some states attempted to assert regulatory oversight of interstate natural gas pipelines. However, the U.S. Supreme Court ruled that state regulation of interstate pipelines violated the Commerce Clause of the U.S. Constitution. It was not until 1938, with the enactment of the Natural Gas Act, that the federal government asserted regulatory control of interstate pipelines. The act gave the Federal Power Commission[2] the authority to regulate rates that interstate pipelines (natural gas companies) could charge for interstate delivery of natural gas and, under amendments adopted in 1942, to certify the construction of new pipelines. The purpose of the act was to protect consumers by ensuring "just and reasonable" prices for natural gas and a "fair profit" for natural gas companies.[3]

The Natural Gas Act specifically exempted the production and gathering of natural gas from regulation because the states had the authority to regulate local production and gathering and because, unlike the interstate transportation of natural gas, production and gathering were generally competitive.[4] In a series of cases decided in the 1940s, the U.S. Supreme Court ruled that natural gas producers that were affiliated with purchasing pipelines were subject to federal regulation. Based on those decisions, the Federal Power Commission determined that producers

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[1]The discussion on the regulation of natural gas draws heavily from "The History of Regulation" (NaturalGas.org, 2004, available from http://naturalgas.org/regulation/history.asp; Internet; accessed November 22, 2005).

[2]Congress created the Federal Power Commission in 1920 to coordinate hydroelectric projects under federal control.

[3]Castaneda, Chrisopher, review of *The Natural Gas Market: Sixty Years of Regulation and Deregulation*, by Paul MacAvoy. Economic History Services (http://www.eh.net/bookreviews/library/0385.shtml; Internet, accessed August 8, 2005) pp. 1-4.

[4]Bryce, David V., "Pipeline Gathering in an Unbundled World: How FERC's Response to 'Spin Down' Threatens Competition in the Natural Gas Industry", *Minnesota Law Review*, Vol. 89, No. 2 , obtained from Thomson/West (Minneapolis, MN: Minnesota Law Review Foundation, December, 2004) p. 4.

that were not affiliated with a pipeline were not subject to regulation. In particular, the commission conducted an investigation of whether Phillips Petroleum Co. was a natural gas company under the Natural Gas Act. The company was engaged in the production, gathering, processing, and sale of natural gas. It sold its gas to five interstate pipelines. The commission concluded that its jurisdiction did not extend to Phillips Petroleum. However, the U.S. Supreme Court came to the opposite conclusion by ruling that the company "is a 'natural-gas company' within the meaning of the Natural Gas Act, and its sales in interstate commerce of natural gas for resale are subject to the jurisdiction of, and rate regulation by, the Federal Power Commission."[5] The Court determined that the "sales by this Company are not part of the 'production or gathering of natural gas,' which are excluded from the Commission's jurisdiction. . ., since the production and gathering end before the sales occur."[6]

As a result of this decision, the Federal Power Commission gained additional regulatory authority of natural gas markets. Over the years, it adopted a number of pricing schemes for natural gas producers that sold gas to interstate pipelines. These included treating each producer as a public utility and setting prices based on cost of service; setting rates based on geographic area; and establishing national price ceilings. Each of these approaches inhibited natural gas production by maintaining artificially low prices. As a result, the interstate demand for natural gas exceeded the supply, which over time led to shortages.

In 1978, Congress enacted the Natural Gas Policy Act to deal with natural gas shortages in interstate markets by providing for the gradual deregulation of wellhead prices of natural gas. More competitive prices and long-term "take-or-pay" contracts with producers led to an oversupply of natural gas.

Deregulation took another step forward in the early 1980s when large customers of natural gas who had the capability of switching their source of energy were allowed to purchase natural gas directly from the producer. These arrangements were ruled discriminatory because other customers (e.g., local distribution companies) were not allowed to purchase natural gas from the producer. However, the Federal Energy Regulatory Commission[7] decided that there would be advantages to allowing customers to purchase directly from producers. In 1985, it issued Order No. 436 to permit interstate pipelines to voluntarily offer transportation services to customers on a "first come, first served basis." FERC established a range of prices that pipelines could charge for transportation services, but otherwise pipelines were allowed to transport gas for others at competitive rates. The new rule (referred to as the Open Access Order) began the process of changing the function of interstate pipelines from providing bundled services (an integrated supply system that was capable of delivering natural gas from the wellhead to the ultimate retail

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[5] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

[6] *Ibid*.

[7] The Federal Energy Regulatory Commission replaced the Federal Power Commission under the Department of Energy Organization Act of 1977.

gas consumer[8]) to providing transportation services.

In 1987, FERC issued Order No. 500 to encourage interstate pipelines to buy out take-or-pay contracts. Pipelines were allowed to pass on a portion of those costs to local distribution companies who in turn were allowed to pass on these costs to retail customers.

The move to deregulate most natural gas prices at the wellhead occurred in 1989 with the enactment of the Natural Gas Wellhead Decontrol Act. Under the act, all federal regulation of prices at the wellhead for the first sale of natural gas were eliminated on January 1, 1993. The term "first sale" means the sale of natural gas:

- to an interstate or intrastate pipeline;
- to a local distribution company;
- to a person for use by the person;
- that precedes the sale to any of the above businesses;
- as determined by the Federal Energy Regulatory Commission.

The first sale of natural gas does not include the sale by an interstate or intrastate pipeline, local distribution company, or any affiliates of these businesses unless produced by the business.[9]

In 1992, FERC issued Order No. 636 to require interstate natural gas pipelines to separate, by November 1, 1993, their transportation and sales services and to transport natural gas for all qualified shippers on a nondiscriminatory basis. The order meant that all pipeline customers "have a choice in selecting their gas sales, transportation, and storage services from any provider, in any quantity."[10] Although pipelines were not permitted to sell any product as a bundled service, they could still provide a variety of services, such as gathering and storage. However, the trend has been to establish separate production and marketing affiliates, many pipeline companies having transferred their unbundled services to another corporate entity.[11] While FERC still has regulatory authority over pipelines and storage, natural gas purchases are essentially free from regulation.[12]

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[8]"FERC Policy on Natural Gas Gathering System Ownership Since 1992", Energy Information Administration, U.S. Department of Energy (Energy Information Administration: Washington, D.C., modified on January 7, 2005, available from http://www.eia.doe.gov/oil_gas/natural_gas/analysis_publications/ngmajorleg/fercpolicy.html; Internet; accessed November 11, 2005) p. 1.

[9]See 15 U.S.C. 3301(21).

[10]NaturalGas.org, *op. cit.*, p. 10.

[11]"Natural Gas 1994: Issues and Trends", Energy Information Administration, U.S. Department of Energy (Energy Information Administration, Office of Oil and Gas: Washington, D.C., July 1994 http://www.eia.doe.gov/pub/oil_gas/natural_gas/analysis_publications/natural_gas_1994_issues_trends/pdf/056094.pdf; Internet, accessed November 11, 2005) p. 39.

[12]*Ibid.*, p. 1.

Gathering systems accumulate and transport natural gas from a well to an acceptance point of a transportation pipeline. In the past, FERC used two tests to distinguish jurisdictional transportation of natural gas from nonjurisdictional gathering systems. Under the "behind-the-plant" test, pipelines upstream of compressors and processing plants (toward the wellhead) were considered gathering lines, while pipelines below the plants were considered transportation systems. Under the "central-point-in-the-field" test, lateral lines that collected and transported natural gas that required no processing from separate wells that then converged into a single large line were considered gathering lines, while pipelines downstream of the collection were considered transmission lines. In 1983, FERC adopted a "primary function" test that takes into account several physical and nonphysical factors.[13] The physical factors include:

- the length and diameter of the pipeline (longer and wider pipelines indicate a transportation system);
- the extension of pipeline beyond the central point in the field;
- the pipeline's geographic configuration (a weblike pattern indicates a gathering system);
- the location of compressors and processing plants ("behind-the-plant" test);
- the location of wells along all or a part of the facilities (indicates a gathering system); and
- the operating pressure of the pipeline (higher pressure needed to propel gas indicates a transportation system).[14]

The nonphysical factors include:

- the purpose, location, and operation of the pipelines;
- the general business activity of the owner of the pipeline;
- whether a jurisdictional determination (i.e., gathering versus transmission) is consistent with the objectives of the Natural Gas Act and other legislation; and
- the changing technical and geographic nature of exploration and production activities.[15]

Under the primary function test, no one factor is determinative, nor do all factors apply in every situation.[16] Despite these physical and nonphysical factors, it may not always be clear whether a particular portion of pipeline should be treated as gathering lines or transmission lines.

Changes in federal and state regulatory policy have significantly changed the structure of natural gas markets. The dynamics of natural gas markets have changed significantly over the last few decades beginning with the gradual deregulation of wellhead prices at the federal level in 1978. In 1992, the Federal Energy Regulatory Commission issued Order 636 to require natural gas

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[13] These factors were instituted primarily to deal with production and gathering of natural gas occurring on the Outer Continental Shelf. Apparently, these factors work fairly well for on-shore gathering and production, but several off-shore companies have challenged FERC's determinations.

[14] ExxonMobil Gas Mktg. Co. v. FERC, 297 F.3d 1071, 1076-77 (D.C. Cir. 2002).

[15] *Ibid.*

[16] Energy Information Administration, "FERC Policy on Natural Gas Gathering System Ownership Since 1992", *op. cit.*, p. 2.

pipeline companies to provide open access for transmission services and to separate its production and gathering operations.

In 1997, the Montana Legislature enacted Senate Bill No. 396 (Ch. 506, L. 1997) to require a natural gas utility that provides customer choice and open access to "functionally separate its natural gas production and gathering from its natural gas transmission, storage, and distribution services and remove natural gas production from the rate base."

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CHAPTER FIVE
THE VALUATION OF OIL AND GAS PROPERTY IN SELECTED STATES

This chapter summarizes how several states value oil and natural gas pipelines (flow lines, gathering lines, transmission lines, and natural gas distribution lines) for property tax purposes. The states selected for this review have significant gas production, and the state agency responsible for centrally assessing certain types of property uses the unitary valuation method, as does Montana, to determine the market value of that property. The table below lists gas producing states, indicates the method of assessment for public utility property, and highlights the states selected for review. A significant amount of information about state assessment procedures was obtained from "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" prepared by the New York Office of Real Property Services (ORPS study).[1] Additional information was obtained from telephone conversations with state property assessment officials.

WYOMING[2]

The Wyoming Department of Revenue uses the unitary method of valuation[3] for determining the fair market value of the following types of property (39-13-102, WS):

- the gross product of all mines and mining claims;
- pipeline companies;
- electric utilities;
- railroad companies;
- rail car companies;
- telecommunications companies;
- other public utilities.

The department uses income, market, and cost approaches to value this type of property. The lack of good information (e.g., negative income or privately held entity) may preclude the application of one or more of the approaches (ORPS study).

According to a Wyoming Department of Revenue memorandum,[4] there are two types of pipelines: (1) gathering systems; and (2) common carrier pipelines. Gathering systems carry natural gas to processing centers to be treated to meet quality standards for introduction into a

[1] The report is available on the Internet at http://www.orps.state.ny.us/ref/pubs/railroadutility/section1.htm.

[2] Kenneth Ulrich, Wyoming Department of Revenue, telephone conversation January 15, 2006.

[3] The Wyoming Department of Revenue defines "unitary valuation" as "the process of determining the value of a company as a whole without reference to individual parts. The unitary approach is used in the valuation of properties which derive their value from interdependent assets working together. The market value is not a summation of fractional appraisals, but the value of a company as an operating unit."

[4] Chubb, Ronald J., "Pipeline Assessment Clarification", Memorandum (00-030), Wyoming Department of Revenue, March 25, 2002.

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Natural Gas Producing States and Method of Valuation of Utility Property				
State*	Number of Gas and Gas Condensate Wells**	Marketed Natural Gas Production in MMCF***	Unitary valuation	Property classification system
Alabama	5,157	316,943	Yes	4 classes
Alaska (1)(2)	195	471,213	No	No
Arizona	9	331	Yes	9 classes
Arkansas	7,606	169,279	Yes	No
California (3)	1,249	319,665	Yes	Real and personal
Colorado (4)	18,774	1,037,121	Yes	2 classes
Illinois	240	126	No (RR real, yes)	Personal prop. exempt
Indiana	2,291	1,464	Yes	No
Kansas	17,387	394,173	Yes	7 classes of real, 6 classes of pers.
Kentucky	12,900	87,609	Yes	Residential & comm
Louisiana	16,939	1,382,253	Yes	4 classes
Maryland	7	22	Yes	No
Michigan	8,600	260,820	Yes	No, 50% of value
Mississippi	427	145,374	Yes	5 classes
Montana	4,539	96,199	Yes	13 classes
Nebraska	109	1,168	Yes	4 classes
New Mexico	37,100	1,632,536	Yes	No 33.3% of value
New York	5,878	35,044	No	No
North Dakota (5)	117	55,645	Yes	2 classes
Ohio (6)	33,828	120,080	Yes	Yes
Oklahoma	34,334	1,690,818	Yes	No
Oregon	15	467	Yes	No
Pennsylvania	42,437	157,800	No	No
South Dakota (7)	61	1,025	Yes	Yes
Tennessee	430	1,803	Yes	Yes
Texas	68,572	5,189,998	No	No
Utah (8)	3,220	276,969	Yes	2 classes
Virginia (9)	3,506	NA	No	No
West Virginia (10)	46,203	187,723	Yes	4 classes
Wyoming	18,154	1,590,746	Yes	3

Notes:
*States marked in bold are included in report
**Wells for calendar year 2004
***Production from different years
(1) Property used for oil or gas exploration, production, or pipeline transportation is exempt from local assessment but subject to state tax of 20 mills.
(2) The only property that is centrally assessed and apportioned is the Trans-Alaska Pipeline System.
(3) Classification system between real and personal property for utility property under unit valuation method.
(4) Residential property is taxed at 9.15% (annually adjusted) and all other property taxed at 29%.
(5) Personal property is exempt from taxation in North Dakota, however utility property is subject to taxation as personal property. Residential property is taxed at 9%, all other property is taxed at 10%.
(6) In 2005 property was assessed at 25% to 88% of true value; all real property is assessed at 35%. The personal property tax will be phased out by 2009. Assessment rates for certain other property is reduced.
(7) Real property is assessed at 85% of true value (personal property is exempt). There are three separate property tax rates: agricultural, owner-occupied housing, commercial and all other property.
(8) Primary residential property is assessed at 25% of market value; all other property is assessed at 100% of market value.
(9) Unitary valuation has been banned by state courts.
(10) Property is assessed at 60% of market value. Four classes of property are taxed at the following rates: intangible property ($0.50/$100 of value), owner-occupied residential property ($1.00/$100 of value), other real and personal property located outside a municipality ($2.00/$100 of value), and other real and personal property located within a municipality ($2.50/ $100 of value).

Sources: Energy Information Administration for wells and production and New York Office of Real Property Services, "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" for property tax information.

transmission pipeline. After treatment, the gas passes through a metering device, which marks the point of sale by the producer. Transmission pipelines (or common carrier pipelines) are subject to regulation by FERC or the Wyoming Public Service Commission. Regulatory changes at the federal and state level during the late 1980s and early 1990s created the distinction between nonregulated gathering lines and transmission system. In particular, after FERC issued Order 636 in 1992, production, gathering, and processing services were "spun-off" from regulated pipeline companies into nonregulated companies.[5]

For Wyoming severance tax purposes, "gathering lines" means the transportation of crude oil, lease condensate, or natural gas from multiple wells by separate and individual pipelines to a central point of accumulation, dehydration, compression, separation, heating and treating or storage (39-14-201, WS). For property tax purposes, gathering lines, even if they cross county lines, are typically locally assessed and transmission pipelines are assessed by the state. In determining whether a particular pipeline is part of a gathering system or a transmission system, the Wyoming Department of Revenue reviews the business activity of the company that owns the pipeline and the regulatory environment in which the company operates.[6]

The Wyoming Department of Revenue considers two factors to distinguish between gathering systems subject to local assessment and transmission lines subject to state assessment. First, if the producer owns the gas (or oil) in the pipeline, the pipeline is part of the gathering system. Second, if the pipeline is downstream from the meter, the pipeline is part of the transmission system.[7]

Wyoming has three categories of taxable property (39-13-103, WS):

- mineral property is taxed at 100% of market value;
- industrial property (including oil and gas property and the property of public utilities) is taxed at 11.5% of market value; and
- all other real and personal property (commercial and residential) is taxed at 9.5% of market value.

KANSAS[8]

The Kansas Department of Revenue uses the unitary valuation method to assess the property of public utilities. All other property is locally assessed. The Department uses the income, market, and cost methods to value public utility property. The weighting of each approach depends on the availability and reliability of information. Generally, the Department considers the capitalized income approach the most reliable (ORPS study).

Kansas defines public utility property (79-5a01, KSA) as an entity that owns, controls, and holds

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[5] *Ibid.*

[6] *Ibid.*

[7] *Ibid.*

[8] Roger Dallam, Property Assessment Division, Kansas Department of Revenue, telephone conversation, January 15, 2006.

for resale stored natural gas in an underground formation in the state or that operates a business of:

- a railroad;
- transmitting telegraphic messages;
- transmitting telephonic messages;
- transporting or distributing to, from, through or in this state natural gas, oil or other commodities in pipes or pipelines, or engaging primarily in the business of storing natural gas in an underground formation;
- generating or distributing electric power;
- transmitting water if for profit or subject to regulation of the state corporation commission; and
- transporting cargo or passengers by means of any vessel used in navigating any of the navigable watercourses within or bordering upon this state.

The definition of a public utility specifically excludes intracounty oil or natural gas gathering systems; this type of property is considered commercial and industrial property. Wells and flow lines are not considered part of the centrally assessed unit.[9] Intracounty gathering systems are depreciated on a 7-year, straight-line basis to a minimum of 20% of original cost and are taxed at 25% of the depreciated value.[10]

Kansas has seven classes of real property and six classes of personal property, and property is assessed at various percentages (79-1439, KSA). Real property is assessed at the following percentages of market value:

- real property used for residential purposes, 11.5%;
- land devoted to agricultural use (valued on productivity), 30%;
- vacant lots, 12%;
- real property which is owned and operated by a not-for-profit organization not subject to federal income taxation, 12%;
- public utility real property, 33% (except railroad property, which is taxed at the average rate of all other commercial and industrial property);
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- real property used for commercial and industrial purposes and buildings and other improvements located upon land devoted to agricultural use, 25%; and
- all other urban and rural real property, 30%.

Personal property is assessed at the following percentages of market value:

- mobile homes used for residential purposes, 11.5%;
- mineral leasehold interests, except oil leasehold interests the average daily production from which is five barrels or less, and natural gas leasehold interests, the average daily production from which is 100 mcf or less, which is assessed at 25%, 30%;
- public utility tangible personal property, 33% (except railroad personal property which is assessed at the average rate of all other commercial and industrial property);

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[9]Roger Dallam, *Ibid.*

[10]In re CIG Field Services Co., _Kan. _, 112 P3d 138, 149 (2005).

- motor vehicles, 30%;
- commercial and industrial machinery and equipment, 25%; and
- all other tangible personal property not otherwise specifically classified, 30%.

CIG Field Services Company appealed the Kansas Department of Revenue's valuation and assessment of its gathering lines as public utility property to the Kansas Board of Tax Appeals for tax years 1997 to 2003. The company contended that the different tax treatment of interstate and intercounty gathering systems from intracounty systems violated the federal Interstate Commerce Clause and federal and state Equal Protection Clauses. The majority of the Board of Tax Appeals found that CIG and intracounty natural gas systems were competitive and thus similarly situated. However, the Board does not have the authority to rule on constitutional issues and therefore upheld the Department of Revenue's valuation and assessment for the years in dispute.[11]

CIG appealed the Board's decision to the Kansas Supreme Court. The Court ruled that the statute violated the federal Interstate Commerce Clause because it "discriminates against and has the effect of unduly burdening interstate commerce by defining interstate and intercounty natural gas gathering systems as public utilities taxable at a higher assessed value and higher rate than intracounty systems. . .".[12]

MISSISSIPPI[13]

The Mississippi State Tax Commission uses the unitary valuation method to assess the value of the operating property of railroads, oil or gas pipeline companies, electric companies, and other public service companies with property in more than one county and the property of telephone companies operating in more than six counties.

Oil and natural gas production personal property, including drilling rigs (on which a permit fee has been paid), wellheads, and downhole equipment, is exempt from property taxation if the severance tax has been paid on production from the property.[14]

All gathering lines are locally assessed even if they cross county lines. Previously, gathering lines were centrally assessed, but in the 1980s, the Mississippi Supreme Court ruled that gathering lines were not a public service company.[15] Mississippi State Tax Commission centrally assesses pipelines that are regulated by the Federal Energy Regulatory Commission or the state. Gathering lines would be centrally assessed if gathering lines are reported to the Federal Energy

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[11] *Ibid.*

[12] *Ibid.*

[13] Bill Dampeer, Mississippi State Tax Commission, telephone conversation, January 25, 2006.

[14] The exemption for oil production property is under 27-25-523, Mississippi Code, and the exemption for natural gas production property is under 27-25-721, Mississippi Code.

[15] Bill Dampeer

Regulatory Commission.[16]

Following the Supreme Court decision, the State Tax Commission and representatives of the oil and natural gas industry negotiated the point of assessment for tax purposes for gathering lines. For natural gas lines, property located downstream of the pin recording meter (for measuring the severance tax) is taxable. For oil lines, property located downstream of the holding tank is taxable.[17]

Section 112 of the Mississippi Constitution provides for the classification and taxation of property:

- Class I: single family residences are assessed at 10% of true value;
- Class II: all other real property [including railroads and airlines] not included in Class I or Class IV is assessed at 15% of true value;
- Class III: personal property [including railroads and airlines], except for motor vehicles and for personal property included in Class IV, is assessed at 15% of true value;
- Class IV: public utility property, which is property owned or used by public service corporations required by general laws to be appraised and assessed by the state or the county, is assessed at 30% of true value; and
- Class V: motor vehicles are assessed at 30% of true value.

MICHIGAN[18]

The State Tax Commission centrally assesses the property of railroad, telegraph, and telephone companies. The cost, income, and market approaches may be used to value property. However, the market approach is seldom used, and the income approach is used if income is stable over time (ORPS study). Centrally assessed property is subject to a statewide levy in lieu of all other property taxes. The statewide levy is based on the average rate of taxation applied to commercial, industrial, and public utility property. Proceeds from the tax are deposited in the state general fund.

All other property is locally assessed. For the valuation of public utility property, local assessors use multiplier tables developed by the State Tax Commission. The multiplier tables are used to value electric transmission and distribution property and natural gas transmission and distribution lines for property tax purposes. The multipliers convert the original cost or historical cost of transmission property for the year in which the property was installed to the current year value. The multiplier varies depending on the age of the property. The multipliers take into

[16] Bill Dampeer.

[17] Bill Dampeer.

[18] Timothy Schnelle, Michigan Department of Treasury, Commercial/Industrial Unit, Telephone Conversation, January 29, 2006.

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account the income and cost approaches to valuation.[19]

Oil and natural gas gathering lines that serve one project are valued as business machinery and equipment and are subject to lower multipliers (based on shorter economic life). If, however, the gathering lines serve more than one project, that is, if the gathering lines are used to transport third-party oil or natural gas, they are considered public utility property and are valued using the multiplier tables applicable to public utilities.[20]

All property in Michigan is assessed at 50% of market value (211.27a, MCL).

OHIO[21]

In Ohio, public utilities include telephone companies, telegraph companies, electric companies, natural gas companies (distribution companies), pipeline companies, waterworks companies, water transportation companies, natural gas distribution companies, rural electric companies, and railroad companies. The Ohio Department of Taxation uses the unit value method to value public utility property and railroad property. Railroad personal property is valued using the cost and income approach, while public utility personal property is valued using capitalized costs less allowances (ORPS study). Subsidiaries of parent companies cannot file combined reports and are valued separately from the parent company. The method of valuation the subsidiary would be based on its primary business function.[22]

Most oil and gas production equipment is assessed locally. However, the Department of Taxation centrally assesses the property of a general business, including gathering lines, located in more than one county, regardless of whether the property is continuous. The property is valued at its location and is not apportioned. In tax year 2005, personal property was taxed at 25% of true value. The taxation of general business personal property is being phased out. Beginning in tax year 2009, general business personal property will be exempt from taxation. A portion of the revenue from the newly enacted commercial activities tax will be used to offset the revenue loss to taxing jurisdictions.

Real property, regardless of ownership or use (e.g., residential, commercial, or public utility) is valued locally and is assessed at 35% of true value. The assessment level for utility personal property, on the other hand, is taxed at various assessment levels, ranging from 25% to 88% of true value. For example, the transmission and distribution property of an electrical utility is taxed at 88% of true value and all other property of the utility is taxed at 25% of true value. The transmission and distribution property of a rural electric cooperative is taxed at 50% of true value. The property of natural gas distribution companies and railroad companies is taxed at 25% of true value, while the property of pipeline companies is taxed at 88% of true value.

[19]Timothy Schnelle.

[20]Timothy Schnelle.

[21]Bill Peters, Public Utility Tax Division, Ohio Department of Taxation, telephone conversation, February 7, 2006.

[22]Bill Peters.

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CALIFORNIA[23]
Article 13, section 19, of the California Constitution requires the California Board of Equalization to annually assess:

- pipelines, flumes, canals, ditches, and aqueducts lying within 2 or more counties; and
- property, except franchises, owned or used by regulated railway, telegraph, or telephone companies, car companies operating on railways in the state, and companies transmitting or selling gas or electricity.

The constitutional provisions for the assessment of pipelines limits how the Board of Equalization assesses this type of property. In 1993, the California Supreme Court determined that the Board could assess only pipeline property and not other property owned by the company. As a result, land, improvements, and personal property are locally assessed.

The Board uses the unitary valuation method to value centrally assessed property, using the cost, income, and market approaches. The income approach is given more weight in valuing regulated pipeline property. Unregulated pipelines (including gathering lines) that cross county lines are valued locally by using the replacement cost new, less depreciation method.

Property in California is assessed at 100% of fair market value and taxed at 1% of value. Pipeline property that is annually assessed is not subject to Proposition 13 base year limitations.

LOUISIANA
The Louisiana Tax Commission is required to appraise the property of all public service companies. Public service companies include investor-owned electric, gas, water, barge, and telephone companies, pipelines, railroads, airlines, and electric cooperatives. Louisiana statute requires the Tax Commission to use the market approach, income approach, and cost approach, giving the appropriate weight to each approach, to determine fair market value of these properties (RS 47:1853).

Pipeline companies that are regulated by FERC, the Interstate Commerce Commission, or the Louisiana Public Service Commission are centrally assessed by the Tax Commission. Regulated and other subsidiaries of parent companies are valued separately from the parent company.

Oil and natural gas production property, including flow lines and gathering lines (even if they cross parish lines), are valued locally. Local assessors use replacement cost schedules to value intrastate pipelines. Lower quality "lease lines" are valued on a different schedule than higher quality "other pipelines", which include larger gathering lines and transmission lines.[24]

Article VII, section 18(B), of the Louisiana Constitution provides for the classification of property subject to taxation and the percentage of fair market value for determining the assessed valuation of the property:

- land is assessed at 10% of fair market value;

[23] Ken Thompson, Valuation Division, California Board of Equalization, telephone conversation, February 2, 2006.

[24] Louisiana Administrative Code, Revenue and Taxation, Title 61, section 1301.

- residential improvements are assessed at 10% of fair market value;
- electric cooperatives, excluding land, are assessed at 15% of fair market value;
- public service properties, excluding land, are assessed at 25% of fair market value;
- other property is assessed at 15% of fair market value.[25]

For tax years 1994 through 2003, several interstate pipeline companies in Louisiana paid property taxes under protest because some intrastate pipelines regulated by the Louisiana Public Service Commission that should have been assessed by the Tax Commission were locally assessed and taxed at 15% of fair market value rather than at 25%. In a consolidated case, a District Court judge ruled that the actions of the Louisiana Tax Commission, as it relates to the plaintiffs, "violated the equal protection clauses and due process clauses of the Louisiana and U.S. Constitutions because of the Commission's disregard of the requirement for uniformity."[26] The Court directed the Tax Commission to require parish assessors to appraise the plaintiffs' property for the tax years in dispute and assess the property at 15% of value. It also directed the Tax Commission to provide refunds on the difference between the amount of property taxes paid and the reassessed amount.[27]

The plaintiffs appealed the District Court decision to the Court of Appeal, arguing, among other things, that using replacement cost less depreciation would lead to a higher valuation of property than valuing the property on its ability to earn an acceptable (regulated) rate of return. The Tax Commission testified at trial that the unit method of valuation used to value public service property gives different values than locally determined replacement cost.[28] The Appeal Court concluded, based on prior case law, that the appropriate remedy in this case was to use the same valuation and assessment method for the plaintiffs' property as was used for the "preferred properties" (i.e., intrastate pipeline companies), even though that method was contrary to law.[29]

ALABAMA[30]

The Alabama Department of Revenue uses the unit value method to value the property of public utilities. Public utilities include, among other entities, the property of railroads, telecommunication and telegraph companies, electric power companies, and water, gas, and pipeline companies. Alabama statute (40-21-6, COA) requires that the Department use the market, income, and cost approaches. The Department gives more weight to the income and cost approaches (ORPS study). Regulated subsidiaries of parent companies are valued as separate units. All other taxable property, including nonoperating property of utilities, is locally assessed even if it crosses county lines.

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[25] The Louisiana Constitution also provides for the specific exemption of property from taxation and for sale of property for delinquent taxes.

[26] ANR Pipeline Company v. Louisiana Tax Commission, 19th Judicial District Court, District Court Parish of East Baton Rouge, State of Louisiana, NO: 468,417, Sec: 22, March 30, 2005.

[27] *Ibid.*

[28] ANR v. Louisiana Tax Commission No. 2005 CA 1142, pp. 22-23.

[29] *Ibid.*

[30] Kelly Eggers, Property Tax Division, Alabama Department of Revenue, telephone conversation, February 7, 2006.

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Taxable property in Alabama is divided into the following classes of property and is assessed at the following ratios of assessed value to the fair and reasonable market value of property:

- Class I: property of utilities used in the utility business, 30%;
- Class II: real and personal property not otherwise classified (includes railroad, airline, and wholesale electrical generation property for tax purposes), 20%;
- Class III: agricultural, forest, and residential property, and historic buildings and sites, 10%; and
- Class IV: private autos and pickup trucks not used for hire, rent, or compensation, 15%.

The Alabama Department of Revenue rules provide guidelines for assessing equipment used in the oil and gas industry. Common carrier pipelines transport oil or natural gas from a producer to a user, refiner, or other entity for a fee or tariff. Common carrier pipelines are assessed by the Department as Class I property. Flow lines and gathering lines owned and controlled by the owner or owners of the wells are locally assessed as Class II property. Gathering lines that transport oil or natural gas of persons other that the owners of the wells for a fee or tariff are assessed as common carrier pipelines.[31]

CONCLUDING COMMENTS

The states included in this survey use a variety of approaches to value public utility property, including oil and natural gas pipelines, as well as oil and natural gas gathering lines. Several states use the unitary valuation method to centrally assess all operating property of public utilities, while some states have variations to that method. For example, Michigan centrally assesses statutorily specified property, which is taxed at the state level only. All other public utility property is locally assessed. Ohio centrally assesses personal property, while all real property is subject to local assessment. A fluke in the California Constitution limits the assessment of pipeline property to personal property. Several states value separately regulated subsidiaries of a parent company.

The states in this survey also use different approaches to value oil and natural gas gathering lines. Wyoming, Mississippi, California, Louisiana, Michigan, and Alabama provide for the local assessment of gathering lines, even if they cross taxing jurisdiction boundaries. Wyoming and Alabama provide for the central assessment of gathering lines under certain conditions, while Michigan values gathering lines that serve more than one project as (locally assessed) utility property. In Ohio, gathering lines that cross county lines are centrally assessed based on location. Kansas, because of the CIG Field Services court decision, is going to have reexamine how it taxes gathering lines.

Kansas, Mississippi, Louisiana, and Alabama tax public utility property at higher rates than other types of property. Ohio has an array of tax rates that apply to public utility property. Wyoming taxes public utility property at the same rate as industrial property. Michigan and California tax all property at the same rate.

[31] Alabama Administrative Code, 810-4-1-.15, Distinction Between Flow lines, Gathering Lines, and Pipelines for Assessment of Business Personal Property of the Oil and Gas Industry.

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CHAPTER SIX
OPTIONS FOR REVISING THE ASSESSMENT AND TAXATION OF OIL AND NATURAL GAS PRODUCTION PROPERTY

At its May 2, 2006, meeting, the Revenue and Transportation Committee reviewed information on the HJR 44 study at previous meetings and considered several discussion points on how to deal with the classification, assessment, and taxation of certain oil and natural gas property. The Committee also considered a proposed bill draft from industry that would require the local assessment of certain oil and natural gas production companies. This chapter highlights the discussion points and summarizes the provisions of the industry proposal. Chapter seven analyzes the property tax revenue implications of the industry proposal.

Discussion Point 1...The trial on the Omimex case is scheduled for September 2006. The Committee could suspend any action until the District Court has made a determination. It is possible that a decision could result in a bifurcated valuation scheme in which a portion of Omimex's property could be locally assessed and a portion centrally assessed. Although Judge Sherlock's decision may provide guidance, it is likely that the losing party will appeal to the Montana Supreme Court. In addition, the ruling may not apply to Fidelity or to other companies because of factual differences.

Discussion Point 2...The Committee could consider an approach similar to the introduced version of House Bill No. 569. That is, provide for the local assessment of oil and gas production equipment, including gathering lines. Under this approach, producer gathering lines, if any, "independent" gathering lines, and gathering lines associated with regulated oil or natural gas transmission lines would be locally assessed. This approach would require a clear distinction between gathering lines and transmission lines.

Apparently, there have been no property tax protests on the classification and assessment of gathering lines associated with regulated oil or natural gas transmission lines. This approach could lead, depending on the ownership structure of the affected property, to part of a company's property being centrally assessed and part of its property being locally assessed. The number of counties affected and the fiscal impact under this approach would be greater than under a more narrowly constructed approach.

Discussion Point 3...The Committee could consider an approach similar to the amended version of House Bill No. 569. That is, provide for the local assessment of oil and gas production facilities, including the producer's flow lines, gathering lines, compressors, and meters, regardless of whether the property is located in more than one county or state. Under the amended version of House Bill No. 569, the producer is the legal entity liable for the oil and gas production taxes under Title 15, chapter 36, MCA.

At least two unintended consequences could arise from this option. First, a transmission company or its affiliated gathering company could acquire oil or natural gas wells resulting in the local assessment of the entity's gathering lines. Second, a locally assessed small, independent gathering company that installs gathering lines that cross county lines would be subject to central assessment and to a higher tax rate. If pursued, this approach should preclude allowing an entity to put in a well in order to qualify the property for locally assessment when it should be centrally

assessed. In addition, this approach should ensure that certain gathering lines (e.g., those of small, independent gathering companies) that cross county or state lines are not subject to a higher tax rate.

Discussion Point 4...The Department of Revenue presented a suggested test to the Senate Taxation Committee during the 2005 legislative session and to the Revenue and Transportation Committee at its December 2, 2005, meeting for determining whether certain oil and natural gas property would be locally assessed or centrally assessed.[1] Under the Department's formulation, the following scenarios would apply for determining whether the property is locally assessed or centrally assessed if the property crosses county lines or state lines:

Scenario 1: If the owner (oil or natural gas producer) of the natural gas or oil pipeline owns 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition,[2] then all property, including but not limited to the pipeline property, is locally assessed.

Scenario 2: If the owner (oil or natural gas producer) of the natural gas or oil pipeline does not own 100% of the oil or gas in the pipeline upstream from the point where the oil or gas is in marketable condition, then all property, including but not limited to the pipeline property, is centrally assessed.

Scenario 3: If the owner (oil or natural gas producer) of the natural gas or oil pipeline owns any portion of property downstream from the point where the oil or natural gas is in marketable condition, then all of the property is subject to central assessment.

Scenario 1 would likely apply to Encore because its pipeline property apparently is used only for its own production. It would be subject to local assessment even if its pipeline property crossed state or county lines. EnCana, Fidelity, and Omimex would likely continue to be centrally assessed under scenario 2 or 3. The Committee could provide that property upstream of the point of marketable condition that is centrally assessed be reclassified as class eight personal property under 15-6-138, MCA. The Committee would have to take into account the tax treatment of small, independent gathering lines that cross county lines as well as the tax treatment of Bitter Creek's gathering lines. It is possible that the differential tax treatment of small, independent gathering companies and a gathering company such as Bitter Creek could raise problems under the Commerce Clause of the U.S. Constitution.

Discussion Point 5...The Committee could consider codifying ARM 42.22.102(3) related to the central assessment of property. Under that rule, the central assessment of property is "based on the property's operating characteristics such as but not limited to property use, integration of operations, management, and corporate structure".

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[1] Gene Walborn, "Valuation of Centrally Assessed Properties", in Minutes, Revenue and Transportation Interim Committee, December 2, 2005, EXHIBIT #2, slides 20-24. The Minutes and links to the exhibits are available on the Committee's webpage at http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp.

[2] Under the Department of Revenue's proposal, "marketable condition" means oil or natural gas that is (sufficiently) free from impurities and otherwise in a condition a purchaser will accept under a sales contract typical for the field or area.

The second part of this approach would be to reclassify centrally assessed production and gathering property as class eight property, taxed at 3% of market value. Under this option, any gathering lines that cross a county line would be centrally assessed but taxed at 3% of market value. Again, a distinction should be made between gathering lines owned by a centrally assessed production company and other types of gathering lines (e.g., Bitter Creek).

Industry Proposal: Following a review of the discussion points, John Alke, representing Montana-Dakota Utilities, presented a bill draft (LC8000)[3] that would require the local assessment of "legal entities that are primarily oil or gas producers even if their production facilities include flow lines, gathering lines, or injection lines that cross a county or state line.". Under the proposal, these companies would be locally assessed and taxed at 3% of market value. At the time of this report, the proposal would apply to EnCana Energy Resources, Inc.; Fidelity Exploration and Production Company; and Omimex Canada, Ltd. The bill draft would also provide for a phased-out reimbursement to local taxing jurisdictions over a 3-year period for the reduction in the tax rate from 12% to 3%.

Jerome Anderson, representing Encore Acquisition, spoke in favor of the bill draft. He told the Committee that increased oil production in eastern Montana and Canada has strained the capacity of interstate oil pipelines operating in that part of the state. If pipeline companies are to expand capacity, they are likely to need help in investing from producers. However, if a producer obtains an ownership interest in an interstate pipeline, the producer may be subject to central assessment and the higher tax rate.[4]

Willie Duffield, representing coal, oil, and natural gas producing counties, said that counties were unsure of what effect the legislation might have on counties and other taxing jurisdiction within the counties.[5]

Dan Bucks, director, Montana Department of Revenue, said that the proposal could jeopardize the unit valuation approach for valuing integrated operations that cross county or state boundaries. He said that companies could reassign property to closely held businesses organized on county lines to change their property classification and valuation method, resulting in a tax shift to other taxpayers.[6]

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[3]See Appendix C.

[4]Jerome Anderson, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, p. 4.

[5]Willy Duffield, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, p. 5.

[6]Dan Bucks, in Minutes, Revenue and Transportation Interim Committee, May 2, 2006, pp. 5-6.

CHAPTER SEVEN
PROPERTY TAX IMPLICATIONS OF INDUSTRY PROPOSAL

This chapter quantifies the property tax revenue implications on counties, school districts, and the state if LC8000 were adopted. The tables that follow show for each of the three natural gas producing companies the 2005 estimated taxes for county government levies, state levies (including the university system levy and the 95-mill school equalization levies), public school levies (school district levies and countywide school levies for transportation and retirement) in each county in which the company operates, and the relative importance of the company's taxable value in each taxing jurisdiction. The tables also show the amount of taxes each company would have paid had the proposal been in effect in tax year 2005 and the amount by which mill levies in the local taxing jurisdiction would have to increase to offset the lower property taxes on the company.[7]

The information compiled in the tables was derived from a spreadsheet provided by the Montana Department of Revenue and from mill levies compiled by the Montana Tax Foundation for each taxing jurisdiction. The total amount of estimated taxes shown in the tables are slightly lower than those calculated by the Department of Revenue in its spreadsheet because the tables may not include miscellaneous taxing jurisdictions. However, the amount of unaccounted revenue is insignificant.

ENCANA ENERGY RESOURCES, INC.

Encana operates in Carbon, Golden Valley, and Stillwater counties. In tax year 2005, its total estimated taxes were $111,954 based on a total taxable value of $285,682.

Carbon County

Most of Encana's property is located in Carbon County. According to Department of Revenue figures, EnCana's total estimated taxes in Carbon County for tax year 2005 were $72,794 based on a taxable value of $176,778. EnCana accounted for less than 1% of the property tax base in the county and for other county school levies, but accounted for 3.57% of the tax base in the Bridger K-12 school district. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

Carbon County	Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Tax Value As % of Total	Proposal Tax Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	110.13	$19,469	$4,867	($14,601)	0.69%	0.17%	110.70	0.5%
University levy	6	1,061	265	(796)	NA	NA	NA	NA
School Equalization	95	16,794	4,198	(12,595)	NA	NA	NA	NA
Other county school levies	47.88	8,464	2,116	(6,348)	0.69%	0.17%	48.13	0.5%
Bridger K-12	140.31	24,804	6,201	(18,603)	3.57%	0.92%	144.16	2.7%
Total	399.32	$ 70,591	$ 17,648	($52,943)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

[7] Statewide levies are not included in this analysis because they cannot be increased to raise the same amount of revenue.

Golden Valley County

According to Department of Revenue figures, EnCana's total estimated taxes in Golden Valley County for tax year 2005 were $10,210 based on a taxable value of $29,124. EnCana accounted for less than 1% of the property tax base in each of the taxing jurisdictions in the county. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

Golden Valley County	Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Tax Value As % of Total	Proposal Tax Value as % of Total	Mill Levy to Raise Same Amount	Percent Increase
County	83.76	$ 2,439	$ 610	($1,830)	0.58%	0.15%	84.13	0.4%
University levy	6	175	44	(131)	NA	NA	NA	NA
School Equalization	95	2,767	692	(2,075)	NA	NA	NA	NA
Other county school levies	37.87	1,103	276	(827)	0.58%	0.15%	38.04	0.4%
Ryegate K-12	125.71	3,661	915	(2,746)	0.88%	0.22%	126.55	0.7%
Total	348.34	$ 10,145	$2,536	($7,609)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Stillwater County

According to Department of Revenue figures, EnCana's total estimated taxes in Stillwater County for tax year 2005 were $28,951 based on a taxable value of $79,780. EnCana accounted for less than 1% of the property tax base in the county and for other county school levies, but accounted for a little over 2% of the property tax base in the Rapelje elementary school district and a little under 2% in the Rapelje high school district. Mill levy increases would have been minimal had the proposal been in effect in tax year 2005.

Stillwater County	Mill Levy	2005 Estimated Taxes	Proposal Taxes	Difference	2005 Taxable Value As % of Total	Proposal Taxable Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	115.18	9,189	2,297	(6,892)	0.27%	0.07%	115.42	0.2%
University levy	6	479	120	(359)	NA	NA	NA	NA
School Equalization	95	7,579	1,895	(5,684)	NA	NA	NA	NA
Other county school levies	33.74	2,692	673	(2,019)	0.27%	0.07%	33.81	0.2%
Rapelje Elementary	55.51	4,429	1,107	(3,321)	2.12%	0.54%	56.41	1.6%
Rapelje High School	57.46	4,584	1,146	(3,438)	1.86%	0.47%	58.27	1.4%
Total	362.89	28,951	6,092	(22,860)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

FIDELITY EXPLORATION AND PRODUCTION COMPANY

Fidelity owns property in Big Horn, Fallon, Phillips, and Valley counties. The property valuation of Fidelity is included in the valuation of Williston Basin Interstate Pipeline. In tax year 2005, Fidelity's total estimated taxes were $275,145 based on a total taxable value of $1.1 million. The company has minimal presence in Valley County ($4,524 total estimated taxes); Valley County is not included in the discussion below. County allocations of property attributable to Fidelity were provided by the Department of Revenue.

Big Horn County

Fidelity's total estimated taxes in Big Horn County for tax year 2005 were $198,991. Fidelity accounted for 13.64% of the tax base in the Spring Creek elementary school district but a much smaller amount in the other taxing jurisdictions. Under the proposal, total property taxes would

be $149,243 less. In order to offset the property tax reduction, mill levies would increase a little over 3% in most taxing jurisdictions. However, the mill levy in the Spring Creek elementary school district would increase by 11.4%, going from 2.9 mills to 3.23 mills.

Big Horn County	Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Taxable Value As % of total	Proposal Taxable Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	80.14	$61,224	$ 15,306	(45,918)	3.97%	1.02%	82.60	3.1%
University levy	6	4,584	1,146	(3,438)	NA	NA	NA	NA
School Equalization	95	72,577	18,144	(54,433)	NA	NA	NA	NA
Other county school levies	27.16	20,749	5,187	(15,562)	3.97%	1.02%	27.99	3.1%
Spring Creek Elementary	2.9	2,216	554	(1,662)	13.64%	3.80%	3.23	11.4%
Hardin High School	49.27	37,641	9,410	(28,231)	4.65%	1.20%	51.05	3.6%
Total	260.47	$198,991	$ 49,748	($149,243)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Fallon County

Fidelity's total estimated taxes in Fallon County for tax year 2005 were $50,294 based on a taxable value of $217,140. Fidelity is relatively insignificant to the property tax base in the county. In addition, neither of the K-12 school districts imposed any mill levies in tax year 2005. Under the proposal, total property taxes would be $37,720 less.

Fallon County	Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Taxable Value As % of total	Proposal Taxable Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	130.62	28,363	7,091	(21,272)	1.70%	0.43%	132.31	1.3%
University levy	6	1,303	326	(977)	NA	NA	NA	NA
School Equalization	95	20,628	5,157	(15,471)	NA	NA	NA	NA
Other county school levies	0	-	-	-	NA	NA	NA	NA
Baker K-12	0	-	-	-	2.24%	0.57%	0.00	NA
Plevna K-12	0	-	-	-	0.19%	0.05%	0.00	NA
Total	231.62	50,294	12,573	(37,720)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Phillips County

Fidelity's total estimated taxes in Fallon County for tax year 2005 were $21,554 based on a taxable value of $84,320. Fidelity is relatively insignificant to the property tax bases in the county. Under the proposal, total property taxes would be $16,166 less.

Phillips County	Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Taxable Value As % of total	Proposal Taxable Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	77.52	6,536	1,634	(4,902)	0.61%	0.15%	77.88	0.5%
University levy	6	506	126	(379)	NA	NA	NA	NA
School Equalization	95	8,010	2,003	(6,008)	NA	NA	NA	NA
Other county school levies	41	3,457	864	(2,593)	0.61%	0.15%	41.19	0.5%
Saco Elementary	18.18	1,638	409	(1,228)	2.59%	0.66%	18.54	2.0%
Saco High School	16.68	1,406	352	(1,055)	2.39%	0.61%	16.98	1.8%
Total	254.38	21,554	5,389	(16,166)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

OMIMEX CANADA, LTD

Omimex owns property in Blaine, Glacier, Hill, Liberty, Phillips, Silverbow, Toole, and Valley counties. In tax year 2005, its total estimated taxes were $1.08 million based on a total taxable value of $2.2 million. The company has minimal presence in Hill County ($566 total estimated taxes), Silver Bow County ($14,927 total estimated taxes), and Valley County ($743 total estimated taxes); these counties are not included in the discussion below.

Blaine County

According to Department of Revenue figures, Omimex's total estimated taxes in Blaine County for tax year 2005 were $136,282 based on a taxable value of $286,828. The property of Omimex accounted for less than 2.4% of the property tax base in the county and in the Zurich elementary school district and for other county school levies, but accounted for 7.48% of the tax base in the Chinook elementary school district and a little over 3.95% in the Chinook high school district. Mill levy increases for the county, other county school levies, and Zurich elementary school would have been minimal had the proposal been in effect in tax year 2005. The mill levy for Chinook elementary school would have increased by 5.9% and the mill levy for the Chinook high school district by 3%.

Blaine County	2005 Mill Levy	2005 Est. Taxes	Proposal Taxes	Difference	2005 Tax Value As % of Total	Proposal Tax Value as % of Total	Mill Levy to Raise Same Amount	Percent Increase
County	168.77	$ 48,408	$ 12,102	($36,306)	2.41%	0.61%	171.88	1.8%
University levy	6	1,721	430	(1,291)	NA	NA	NA	NA
School Equalization	95	27,249	6,812	(20,436)	NA	NA	NA	NA
Other county school levies	42.66	12,236	3,059	(9,177)	2.41%	0.61%	43.45	1.8%
Chinook Elementary	141.11	38,539	9,635	(28,904)	7.48%	1.98%	149.50	5.9%
Zurich Elementary	21.03	288	72	(216)	0.84%	0.21%	21.16	0.6%
Chinook High School	34.43	9,875	2,469	(7,407)	3.95%	1.02%	35.48	3.0%
Total	NA	$138,317	$34,579	($103,737)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Glacier County

According to Department of Revenue figures, Omimex's total estimated taxes paid in Glacier County for tax year 2005 were $596,561 based on a taxable value of $1,045,485. The relative importance of property owned by Omimex in the taxing jurisdictions ranges from 5.6% in the

Cut Bank high school district to 8.3% in the Browning elementary school district. Under the proposal, total property taxes would be $444,237 less. Mill levies would have increased for most taxing jurisdictions by 4.4% to 4.9% had the proposal been in effect in tax year 2005. The mill levy in the Browning elementary school district would increase by 6.6%.

Glacier County	2005 Mill Levy	2005 Estimated Taxes	Proposal Taxes	Difference	2005 Tax Value As Percent of total	Proposal Tax Value as % ot Total	Mill levy to raise Same Amount	Percent Increase
County	172.01	$179,834	$ 44,958	($134,875)	5.87%	1.53%	179.93	4.6%
University levy	6	6,273	1,568	(4,705)	NA	NA	NA	NA
School Equalization	95	99,321	24,830	(74,491)	NA	NA	NA	NA
Other county school levies	59.67	62,384	15,596	(46,788)	5.87%	1.53%	62.42	4.6%
Browning Elementary	209.46	92,406	23,101	(69,304)	8.27%	2.20%	223.31	6.6%
Browning High School	85.06	37,525	9,381	(28,144)	6.28%	1.65%	89.27	4.9%
Cut Bank Elementary	109.1	65,932	16,483	(49,449)	5.65%	1.47%	113.92	4.4%
Cut Bank High School	80.49	48,642	12,160	(36,481)	5.6%	1.5%	84.02	4.4%
Total		$ 592,317	$148,079	$(444,237)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Liberty County

According to Department of Revenue figures, Omimex's total estimated taxes in Liberty County for tax year 2005 were $146,283. The relative importance of property owned by Omimex in the taxing jurisdictions ranges from 3.79% in the Chester joint-high school district to 4.54% in the county. The tax base for the Chester school districts includes property in Hill County. Under the proposal, total property taxes would be $109,639 less. Mill levies would have increased by 2.9% to 3.5% had the proposal been in effect in tax year .

Liberty County	2005 Mill Levy	2005 Estimated Taxes	Proposal Taxes	Difference	2005 Taxable Value As Percent of total	Proposal Tax Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	211.8	$65,935	$ 16,484	($49,452)	4.54%	1.18%	219.27	3.5%
University levy	6	1,868	467	(1,401)	NA	NA	NA	NA
School Equalization	95	29,574	7,394	(22,181)	NA	NA	NA	NA
Other county school levies	28.37	8,832	2,208	(6,624)	4.54%	1.18%	29.37	3.5%
Chester-Joplin-Inverness Elem	78.93	24,572	6,143	(18,429)	3.97%	1.02%	81.35	3.1%
Chester-Joplin-Inverness HS	49.48	15,404	3,851	(11,553)	3.79%	0.98%	50.93	2.9%
Total	469.58	$146,185	$36,546	($109,639)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Phillips County

According to Department of Revenue figures, Omimex's total estimated taxes in Phillips County for tax year 2005 were $141,809 based on a taxable value of $416,190. Omimex accounted for less than 1% of the tax base in the Saco school district, 3.03% in the county, and 10.87 % in the Whitewater K-12 school district. Under the proposal, total property taxes would be $103,555 less. Mill levies would have increased by 0.7% to 8.9% had the proposal been in effect in tax year 2005.

Phillips County	Mill Levy	2005 Estimated Taxes	Proposal Taxes	Difference	2005 Taxable Value As Percent of total	Proposal Tax Value as % of Total	Mill levy to raise Same Amount	Percent Increase
County	77.52	$32,263	$ 8,066	($24,197)	3.03%	0.77%	79.32	2.3%
University levy	6	2,497	624	(1,873)	NA	NA	NA	NA
School Equalization	95	39,538	9,885	(29,654)	NA	NA	NA	NA
Other county school levies	41	17,064	4,266	(12,798)	3.03%	0.77%	41.95	2.3%
Whitewater K-12	118.69	45,594	11,399	(34,196)	10.87%	2.96%	129.23	8.9%
Saco Elementary	18.18	583	146	(437)	0.92%	0.23%	18.31	0.7%
Saco High School	16.68	535	134	(401)	0.91%	0.23%	16.79	0.7%
Total	NA	$138,073	$ 34,518	($103,555)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

Toole County

According to Department of Revenue figures, Omimex's total estimated taxes in Toole County for tax year 2005 were $46,440. Property owned by Omimex is relatively unimportant in the taxing jurisdictions in the county. Omimex accounts for 2.34% of the tax base in the Galata elementary school district. Under the proposal, total property taxes would be $33,013 less. Mill levy increases to offset the loss would be insignificant.

Toole County	Mill Levy	2005 Estimated Taxes	Proposal Taxes	Difference	2005 Taxable Value As Percent of total	Proposal Tax Value as % ot Total	Mill levy to raise Same Amount	Percent Increase
County	145.38	$18,161	$4,540	($13,621)	0.94%	0.24%	146.41	0.7%
University levy	6	750	187	(562)	NA	NA	NA	NA
School Equalization	95	11,868	2,967	(8,901)	NA	NA	NA	NA
Other county school levies	13.13	1,640	410	(1,230)	0.94%	0.24%	13.22	0.7%
Sunburst K-12	97.55	5,591	1,398	(4,193)	1.16%	0.29%	98.41	0.9%
Shelby Elementary	168.58	1,308	327	(981)	0.13%	0.03%	168.75	0.1%
Galata Elementary	3.97	238	59	(178)	2.34%	0.59%	4.04	1.8%
Shelby High School	66	4,462	1,116	(3,347)	0.8%	0.2%	6640.0%	0.6%
Total	NA	$44,017	$11,004	($33,013)	NA	NA	NA	NA

Source: Montana Department of Revenue spreadsheet, unpublished; Montana Tax Foundation, Montana Property Tax Mill Levies, 2005-2006, unpublished

The table below summarizes the property tax revenue implications of the proposal. The revenue effect on county governments and on school districts is about the same at around $353,800. The effect on state and county school equalization is about $252,000, while the effect on other school levies (countywide transportation and retirement) is about $104,000. The effect on the university system is about $16,000.

Summary of the Effects of Reducing the Tax Rate on Natural Gas Production Property				
Taxing Entity	Encana	Fidelity	Omimex	Total

County	23,323	72,093	258,451	353,867
University system	1,286	4,794	9,831	15,911
School equalization (state general fund)	20,355	75,912	155,622	251,929
Other school levies	9,194	18,155	76,617	103,966
School districts	28,108	32,175	293,473	353,757
Total	82,266	203,129	794,035	1,079,430

The total effect on local taxing jurisdictions is about $811,590. This amount is slightly understated because of the counties that were not included in the analysis. Section 15-10-420, MCA, allows local taxing jurisdictions to impose mill levies to raise the same amount of property taxes actually assessed in the previous year. This provision does not apply to statewide mill levies. Each year, the Department of Revenue calculates, on a statewide basis, the number of mills to be imposed for statewide levies. However, levies may not exceed the statutory maximum. As such, revenue losses typically could not be offset by raising these levies.

If the proposal were adopted, the effect on local taxing jurisdictions would vary depending on the relative importance of the property in the taxing jurisdiction. The relative importance of the affected property to a particular jurisdiction does not correspond to the relative proportion of the property to the total financial resources of the taxing jurisdiction. Taxing jurisdictions receive oil and natural gas production revenue, other nonlevy revenue, and entitlement share payments under 15-1-121, MCA.

The proposal would have other revenue implications. Railroad and airline property classified under 15-6-145, MCA (class twelve property), is taxed at the average statewide commercial tax rate. Reducing the tax rate on natural gas property would reduce the tax rate applied to class twelve property. The fiscal note on House Bill 569 from the 2005 session estimated a state general fund reduction of between $22,000 and $23,000. The effect on local taxing jurisdictions would be minimal.

According to the fiscal note for the amended version of House Bill No. 569, the reduction in the taxable value of the affected property would have caused a one-time increase in guaranteed tax base aid for school districts and countywide school retirement of $102,622.

draft

CHAPTER EIGHT
CONCLUSION

Following the discussion of property tax implications of the industry proposal, the Committee decided not to take action on the industry proposal. Senator Jim Elliott, Committee chair, suggested that it would be appropriate for the court system to settle the issue. The Committee was concerned both about tax fairness and ensuring that property tax burdens are not shifted to other taxpayers.

As noted earlier, the industry proposal, notwithstanding any unintended consequences, would only affect, at this time, three natural gas production companies. Because of the different factual circumstances involving each company, it is difficult to assess whether a court decision in the Omimex case would apply to the property of Fidelity or EnCana, or both. However, in the instance of an appeal of the Omimex case in which the Montana Supreme Court upheld Judge Jeffrey Sherlock's determination that administrative rule 42.22.102(3)[8] is an invalid rule (see footnote 8, chapter 2) could lead to the local assessment of Fidelity.

At some point, the Legislature may have to deal with the complex issues raised by this study. In large part, the central assessment of property has been associated with regulated utilities and other industries. Typically, property taxes paid by utilities are passed on to customers in the rate base. However, the dynamics of natural gas markets have changed significantly over the last few decades beginning with the gradual deregulation of wellhead prices at the federal level in 1978. In 1992, the Federal Energy Regulatory Commission issued Order 636 to require natural gas pipeline companies to provide open access for transmission services and to separate its production and gathering operations. In 1997, the Montana Legislature enacted Senate Bill No. 396 (Ch. 506, L. 1997) to require a natural gas utility that provides customer choice and open access to "functionally separate its natural gas production and gathering from its natural gas transmission, storage, and distribution services and remove natural gas production from the rate base."

The initial buyer of a large portion of the former Montana Power Company's property has in turn sold it to Omimex. In addition, small natural gas producers have acquired other parts of MPC's property. Other acquisitions and the merger of companies, including oil production and pipeline property, has also occurred over the last several years and will likely continue in the future.

The Legislature should discuss the appropriate method of assessment and tax rates in a changing market structure, taking into account the equitable treatment of taxpayers, avoiding unintended consequences, and maintaining the integrity of the central assessment process.

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[8]Administrative rule 42.22.102(3) provides that 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.