BRENA, BELL & CLARKSON, P.C.

ROBIN O. BRENA, MANAGING ATTORNEY
JESSE C. BELL
KEVIN G. CLARKSON
DAVID W. WENSEL
ANTHONY S. GUERRIERO
LAURA S. GOULD
FREDERICK H. HAHN V
MATTHEW C. CLARKSON
KELLY M. MOGHADAM
JON S. WAKELAND
JAKE W. STASER

ATTORNEYS AT LAW

810 N STREET, SUITE 100
ANCHORAGE, ALASKA 99501
TELEPHONE: 907.258.2000
FACSIMILE: 907.258.2001
WEB SITE: BRENALAW.COM

Robin O. Brena, Esq.
rbrena@brenalaw.com

M E M O R A N D U M

TO: Commissioner Randy Hoffbeck

C: Governor Bill Walker
Attorney General Craig Richards
MAGPR Board Members:
Mark Myers
Fred Parady
Clay Walker
Vern Halter
Mike Navarre
Robert Venables
Karl Kassel
Robert Bartholomew
Ona Brause
Jacob Adams

FROM: Robin O. Brena

DATE: December 15, 2015

RE: Payment in Lieu of Taxes (PILT) Tentative Agreement
Our File No. 1197-020

I. PILT Tax Payments Should Reflect Full and True Value

A payment in lieu of taxes ("PILT") should be based upon the full and true value of the gas line.[1] This is the standard for ad valorem taxation under existing law in Alaska and throughout the country. The Municipal Advisory Gas Project Review ("MAGPR")

[1] The phrase "gas line" is intended to mean the gas line and related facilities.

Board was originally told the purpose for the PILT was to increase the certainty and decrease the conflict associated with property tax payments and *not* to reduce the amount of tax payments that would otherwise be due under the full and true value standard. The MAGPR Board accepted this standard and recommended a PILT be based upon the full and true value of the gas line.[2] Reducing the PILT to any level below what would otherwise be due under the full and true value standard would be simply reducing tax payments without proper analysis or clear purpose.[3]

II. Determining Full and True Value

Perhaps the best and least controversial estimate of the full and true value of the gas line would be based upon the *actual* cost of building and expanding it. Generally, a pipeline cannot be worth less than the cost to build and expand it, or it would not be built and expanded.

Unfortunately, the proposed PILT is based upon preliminary cost estimates and not the actual costs of building and expanding the gas line.[4] These preliminary cost estimates are currently $45 billion to $65 billion.[5] Such preliminary cost estimates do not take into consideration the (1) additional work revealed by either the preliminary or the more-detailed final engineering, (2) unanticipated project delays and construction events, (3) scope changes (42-inch pipeline upsized to 48-inch pipeline), and (4) capacity expansion after initial construction (adding additional compression or looping portions).

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[2] Importantly, there has been no economic analysis suggesting a subsidy of the gas line is necessary to support its construction or suggesting an economic subsidy in the form of a reduced PILT is necessary. Moreover, it is not apparent that a reduced PILT would be the most appropriate method for providing a subsidy for the gas line were such a subsidy to become necessary. In all likelihood, an economic subsidy by the State rather than by the Municipalities would be a more appropriate form of subsidy. In short, there is a complete absence of any analysis suggesting a reduced PILT is needed or appropriate to achieve the construction of a gas line.

[3] As a matter of sound policy, ad valorem taxes should generally be assessed on the same basis among all taxpayers unless there is a clear policy and legal basis to provide cross-subsidization among taxpayers. While detailed consideration of such policy and legal concerns is beyond the scope of this memorandum, it should be recognized that such policy and legal considerations should be carefully considered before PILT tax payments are based on any other basis than the full and true value of the taxable property.

[4] Earlier in the process, the use of the actual costs was suggested but apparently was not adopted.

[5] It appears the negotiations concerning the PILT were based on the average in this range of preliminary estimates, or $55 billion. These preliminary estimates are currently slated to be updated as the engineering becomes more defined.

As a result, such preliminary cost estimates have proven notoriously unreliable for major cross-country pipeline projects. In fact, even the final cost estimates for major pipeline projects after final engineering is complete have tended to understate the actual costs for such projects by an average of 46 percent.[6] Cost overruns for similar major pipeline projects in Alaska have far exceeded this average of 46 percent.[7] For these reasons, the current preliminary cost estimates of $45 billion to $65 billion are likely to substantially understate the actual cost of building the gas line.

Any reliance upon such preliminary cost estimates for establishing the PILT transfers a substantial project risk to the Municipalities. Generally, project risk should not be borne by the Municipalities because they are completely unfamiliar with the basis for the preliminary cost estimates and have no ability to manage such risk. For these reasons, the Municipalites should not take the significant project risk associated with establishing a PILT based upon preliminary cost estimates. Instead, the Municipalities should base a PILT upon the *actual* costs of building and expanding the gas line. Accordingly, any proposed PILT should provide for initial tax payments equal to 20 mills of the actual costs of building and expanding the gas line.

While using the actual cost of constructing the gas line is the best initial reference for the full and true value of the gas line, the best evidence suggests that the full and true value of the gas line over its economic life would be upwardly influenced by the rising costs of building such pipelines and downwardly influenced by depreciation. Generally, the result of these two offsetting influences is that the value of a pipeline rises slightly in nominal terms while it depreciates in real terms.[8] Accordingly, the full and true value of the gas line may be conservatively based on the actual costs of building and expanding the pipeline increased slightly over its economic life.

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[6] Average cost overrun from the final cost estimate with a contingency included for large pipeline and oil field projects is 46 percent. Edward W. Merrow, *Mega-field developments require special tactics, risk management*, www.offshore-mag.com (June 1, 2003).

[7] The largest two pipeline projects in Alaska are illustrative. These two pipeline projects are the original construction of TAPS and the strategic reconfiguration project electrifying the pump stations and control systems of TAPS. The preliminary cost estimates for original construction of TAPS were less than $1 billion, and the actual costs were over $8 billion. The preliminary cost estimates for the strategic reconfiguration project were roughly $200 million and the actual costs were roughly $1 billion.

[8] To use TAPS as an example, TAPS cost $8 billion (1977 dollars) or $24 billion (2015 dollars) to build but is currently valued for ad valorem purposes at $10 billion. This represents an increase in nominal dollars of roughly 25% ($8 billion to $10 billion) from 1977 to 2015. The gas line may reasonably be expected to experience a similar slight increase in nominal terms over its economic life.

For the purposes of the following analysis concerning the PILT, it has been assumed that the full and true value of the gas line would ramp up to $65 billion during the construction phase and would remain at $65 billion during the economic life of the gas line. It has also been assumed that the appropriate tax rate is 20 mills.[9]

III. Full and True Value During Construction Period

The proposed PILT reflects no tax payments during the construction period of the gas line. Under existing law, the full and true value during the construction period would otherwise be based on "the actual cost incurred or accrued . . . as of the date of assessment." AS 43.56.060(e)(1). Since the construction period for the gas line may be several years in duration, the proposed PILT substantially understates tax payments that would otherwise be due under existing law. Assuming an average construction balance of $32.5 billion over five years,[10] the proposed PILT would under collect tax payments during the construction period by roughly $3.25 billion.[11]

IV. Full and True Value During Initial Project Period

The proposed PILT reflects substantially lower tax payments during the initial twenty-five year project period than would otherwise be due under the full and true value standard. Conservatively, the tax payments under the full and true value for this initial twenty-five year project period would be $32.5 billion,[12] but the proposed PILT only provides tax payments of $15.7 billion or less than half of the amount that would otherwise be due. Moreover, the proposed PILT payments are weighted toward the outer years which further reduces the net present value of the total tax payments.

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[9] The author is aware that the Kenai Peninsula Borough currently has a mill rate less than 20 mills and a significant portion of the gas line facilities may be built within the borough. Nevertheless, the author has chosen to use 20 mills because there have been no assurances that the current and lower mill rate would remain in effect should the gas line be built. Moreover, assuming the Kenai Peninsula Borough residents seek to maximize taxes from the gas line facilities under Title 29, the mill rate may be expected to rise to 20 mills.

[10] The major spend in a major pipeline project is generally in the last three years, so this simplifying assumption would slightly overstate the impact. Given the likelihood that $65 billion is substantially understated, this simplifying assumption was considered reasonable.

[11] The calculation would be $32.5 billion * 20 mills * 5 years.

[12] The calculation would be $65 billion * 20 mills * 15 years. This is considered conservative because of the likelihood that the preliminary cost estimate of $65 billion substantially understates the actual costs of building the gas line.

V. Full and True Value During Remaining Economic Life

The proposed PILT only reflects tax payments during the initial twenty-five year project period and does not reflect tax payments for the remaining economic life of the gas line. We understand, based on Commissioner Hoffbeck's comments to the MAGPR Board, that the intention would be that after the initial twenty-five year project period, the ad valorem taxes would be based upon the full and true value as currently determined under AS 43.56.

Since the proposed PILT payments were intended to reflect the tax payments that would otherwise be due based on the full and true value of the gas line, any enabling statute must be clear that the tax payments would continue to be based on the full and true value of the gas line during its remaining economic life. This is a critical issue because the economic life of the gas line may well extend 50 to 75 years beyond the initial twenty-five year project period.[13] The tax payments otherwise due during this potentially 75-year remaining economic life would approach $100 billion.[14]

VI. Recommendations Summarized

A. The PILT should be based upon the full and true value of the gas line.

B. The full and true value of the gas line should be based upon the actual costs of building and expanding the gas line and not upon preliminary cost estimates.

C. During the construction period, PILT payments should be based upon the actual cost incurred as of the lien date.

D. During the initial 25-year project period, the PILT should be based on the actual costs of building and expanding the gas line.

E. After the initial 25-year project period and through the remaining economic life of the gas line, ad valorem tax payments should be based upon existing law as set forth under AS 43.56.

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[13] There is massive potential gas resource on the Alaska North Slope, and considerable likelihood of resource growth over time. With proper maintenance, the physical life of the gas line would be indefinite. The economic life of the gas line would likely be the same as the economic life of the gas resources on the Alaska North Slope. Large-diameter gas or liquids pipelines are rarely abandoned.

[14] The calculation would be $65 billion * 20 mills * 75 years or $97.5 billion.