THE STATE of ALASKA
GOVERNOR BILL WALKER

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April 12, 2018

The Honorable Anna MacKinnon and Lyman Hoffman
Alaska State Senators
Senate Finance Committee
State Capitol
Juneau, AK 99801

Dear Co-Chairs MacKinnon and Hoffman:

The purpose of this letter is to provide you with responses to the questions asked of the Department of Revenue during our presentation to the Senate Finance Committee on March 22, 2018 regarding the Department of Revenue's role in AK LNG project. Please see the request in italics and our response immediately below the request.

1. *How typical is the collection of PILT during construction elsewhere?*

Please see the two examples below of North Dakota and Kansas regarding PILT collection during construction:

North Dakota

Background: Like Alaska, major pipelines that cross intrastate jurisdictions or taxing areas are centrally assessed by the state, but most of the property tax revenue goes to the local governments

Major pipelines: Keystone Oil Pipeline, Dakota Access Pipeline, Others

Answer: No special property tax treatment, no PILT to local or state governments, and no impact payments to state or local governments during major pipeline construction. Standard property tax treatment is administered during major pipeline construction, which for pipelines under construction is based on 75% of actual cost. Once a pipeline goes into operation, it is assessed using DCF and the replacement cost new less depreciation method, with primary weight going to DCF over time. Further, the North Dakota staff person stated that all major pipeline development in North Dakota has been the result of demand for the infrastructure and no special property tax treatment has been needed to incentivize or enable major pipeline construction.

Kansas

Background: Like Alaska, major pipelines that cross intrastate jurisdictions or taxing areas are centrally assessed by the state, but most of the property tax revenue goes to the local governments

Major pipelines: Keystone Oil Pipeline, Overland Pass LNG Pipeline, Others

Answer: By Kansas statute, major pipelines under construction are exempt from paying property taxes for a 2-year construction period and a 10-year operating period. After the exemption periods expire the pipeline owners begin to pay property taxes. Pipeline assessments are assessed using DCF and the replacement cost new less depreciation method, with primary weight going to DCF over time. To qualify as a major pipeline the pipeline must be at least 190 miles long and have access to in-state refineries. Kansas has seven pipelines that qualify for the major pipeline property tax exemption. It was the possible belief of the Kansas staff person that the statutory property tax exemption for major pipelines may have been created specifically for the Keystone pipeline but that other pipelines also ended up qualifying for it as well. No PILT to local or state governments and no impact payments to state or local governments during major pipeline construction.

**Correction from DOR testimony regarding MAGPRB on 3/22/2018 in Senate Finance Hearing*

During testimony Deputy Commissioner Barnhill stated that the calculation of $800 C-PILT and $15.7B O-PILT was computed by the Municipal Advisory Gas Project Review Board ("MAGPRB"). Instead, we have learned that these numbers were in fact the product of the discussions in 2015 between a State of Alaska negotiating team and the producers and then was provided to the MAGPRB. Attached is a draft letter from the MAGPRB to Governor Walker reflecting and approving of the process.

I hope you find this information to be useful. Please do not hesitate to contact me if you have further questions.

Sincerely,

Mike Barnhill

Mike Barnhill
Deputy Commissioner
Department of Revenue

Oct. 30, 2015

Governor Bill Walker
Senate President Kevin Meyer
House Speaker Mike Chenault

The Municipal Advisory Gas Project Review Board commends the administration and legislature for their efforts to advance the Alaska LNG project. The decisions are not easy, the numbers are huge and the risks significant — as are the potential rewards for the state and its residents. Thank you.

The municipal review board would like to address two important issues currently being worked by state negotiators that we expect could come before the legislature next year. They are the issues of impact payments to municipalities during project construction (in lieu of property taxes), and the negotiated payment in lieu of property taxes (PILT) during project operations.

The state negotiating team and Alaska LNG project sponsors ExxonMobil, BP and ConocoPhillips have settled on impact aid payments during construction totaling $800 million, with the expense shared by the producers and the state. The negotiations also settled on a formula for calculating PILT during project operations, targeting $15.7 billion in revenues over a 25-year period.

The municipal advisory group has no significant problem with either of the raw numbers or the calculation methodology for the PILT. Although only one part of a bigger equation, the numbers look reasonable. It's the allocation of those amounts that concerns us. We realize the need for the state and its partners to move ahead with negotiating and setting fiscal terms in order to stay on schedule for a project decision in the third quarter of 2016 for front-end engineering and design. As such, the advisory group is willing to endorse the gross numbers agreed to in the negotiatons, as long as everyone accepts that detailed discussions still need to occur for the net distribution to the municipalities — recognizing those discussions are entirely between the state and municipalities and do not involve the producer partners.

While the municipalities understand the need for a negotiated structure for impact aid and PILT, understand the risk of too high a tax burden on the project's competitive economics, and understand that the municipalities should share in the effort to achieve a successful project, we have identified a number of concerns.

First, we recognize that if the entire Alaska LNG project were assessed at the status quo under AS 43.56 for the pipeline and gas treatment plant, and AS 29.45 for the liquefaction plant, the combined annual property tax levy could come close to $900 million to $1 billion in the first year of operations. That works out to almost $1 per million Btu, which is the equivalent of 15 percent of current spot-market prices for LNG in Asia. Though prices are expected to rise before

Alaska LNG ever loads it first cargo at Nikiski, $1 per million Btu is almost certainly too heavy of a burden for the project to carry in the highly competitive marketplace. As such, the municipalities are willing to do their part to help the project succeed. If the project goes forward, we all win.

But, as municipal officials, we also understand that changing the existing tax structure to allow for impact aid payments and a PILT formula means we relinquish local control over our respective tax revenues. It's a trade-off we are willing to accept and endorse, pending more details on the administration and allocation of the payments.

For example, the $800 million in impact aid, to be paid out over the anticipated five years of construction, probably is adequate to cover community impacts on schools, roads, police and other public services, but it could quickly become inadequate if the state decided not to contribute its share as a project partner and, in addition, if the state intends to withdraw from the fund to cover its own impacts. Under that set of "what ifs," the $800 million could easily be reduced to an amount inadequate to address impacts to municipalities.

Also regarding the impact aid, the municipalities are rightfully concerned about how the money would be distributed by the state (which would receive the funds from the project sponsors). Though the advisory group has lightly discussed the need for a new grant program of some kind (which would require legislation), we have not settled on any specific details. To help move that discussion along, the Kenai Peninsula Borough drafted a discussion paper, outlining and suggesting a mechanism for such a grant program (attached). The municipalities will need to know how distributions from the impact aid fund will be administered, for what purposes and the rules associated with the operation of the fund.

As to the PILT, the biggest question is allocation — sharing <u>between</u> the municipalities and, we assume, with the state.

The $15.7 billion "target" for PILT revenues negotiated by the state team and Alaska LNG partners assumes more than just Prudhoe Bay and Point Thomson gas to keep the pipeline full for 25 years. Additionally, there is some uncertainty about PILT revenues during the initial "ramp up" in the throughput volumes. Again, as with the impact aid funds, the total PILT revenues are dependent on the state paying its share as a project partner. If the state's portion is determined to be tax exempt or the state decides against paying its share, the available funds would be significantly reduced. The actual total makes a big different to the municipalities and directly affects the allocation of the PILT funds.

Just as with the impact aid money, the portion of the PILT funds the state intends to lay claim to has a direct impact on the PILT funds available for allocation among the municipalities. There are also questions whether the allocation of PILT funds among municipalities will be based on the proportional allocation of property assets in their respective jurisdictions or some other, as yet undefined, structure for allocating the PILT funds. Unlike AS 43.56, which sets out clear directions for how the state and municipalities will share tax proceeds on oil and gas exploration, production and transportation property, the PILT calculation, as it now stands, is silent on such sharing.

We are not attempting to criticize the work of the state negotiators or project sponsors, merely pointing out that there are significant unresolved issues and lack of specific detail . The MAG has drafted a proposal for allocating PILT revenues between the state, affected municipalities along the project route and all municipalities statewide (attached). The proposal is offered to help begin discussions, knowing full well it is only a starting point. Legislation will be required to establish the allocation formula, and we look forward to working with the administration and lawmakers to achieve that goal.

Much of the discussion about the state share of PILT revenues comes down to what the state sees as its take from the Alaska LNG project. That state take includes the revenues from the sale of the state's 25 percent share of the gas stream, plus corporate income taxes, plus a possible share of PILT. We believe any discussion of dividing PILT dollars between the state and municipalities has to occur within the context of the overall state take. The municipalities have essentially one option — PILT, as a substitute for property taxes — whereas the state has at least two other options for its share of revenues from the project.

As you would expect, each affected municipality has different issues. The North Slope Borough and Kenai Peninsula Borough would have the two largest components — and taxable property — of the project, the gas treatment plant and the LNG plant and marine terminal. As such, they will have the single largest concentration of workers and property during construction and operations — and localized community impacts — and the PILT allocation structure should not unduly shortchange those communities.

The Denali Borough and Matanuska-Susitna Borough will see more miles of pipeline than anyone else, which creates its own impacts and PILT allocation issues. And although the Fairbanks North Star Borough will have the fewest pipeline miles of any of the affected municipalities along the route, Fairbanks no doubt will see significant impact as a supply and worker hub during construction.

There are a lot of questions to answer and policies to decide. The state and project sponsor negotiations have made progress and the municipal advisory group is involved. Now we need to work through the list above to get to a point where everyone understands the numbers, the sharing and the process for distributing the impact aid and PILT funds. We look forward to working with you in support of a successful project.

Thank you.

Municipal Advisory Gas Project Review Board members

Attachments: Proposed municipal grant program for impact aid
Proposed allocation of PILT funds