



# Revenue and Transportation Interim Committee

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## 59th Montana Legislature

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May 2, 2006

TO: Revenue and Transportation Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: Summary of House Joint Resolution No. 44 Study

### INTRODUCTION

During the 2005 legislative session, Representative Walter McNutt introduced House Bill No. 569 to clarify the taxation of oil and natural gas gathering lines. These types of pipelines transport oil or gas from a production area to a transmission line. As amended, the legislation would have taxed oil and gas production facilities, including the producer's flow lines, gathering lines, compressors, and meters (even if they are located in more than one county or state) as class eight personal property under 15-6-138, MCA, and would have eliminated the central assessment of this type of 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, Representative Alan Olson introduced House Joint Resolution No. 44. The resolution, passed by the 59th Legislature, requested that an interim committee study the taxation of oil and natural gas property.

The focus of the House Joint Resolution No. 44 study has been 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. To a lesser extent, the study has also dealt with the taxation of oil production property.

The purpose of this memorandum is to review information that the Revenue and Transportation Committee has considered related to the House Joint Resolution No. 44 study and to present some ideas for Committee discussion.

### COMPANY PROFILES

EnCana, Fidelity, and Omimex are centrally assessed by the Montana Department of Revenue and are taxed at 12% of market value. Each of these companies has protested the assessment, classification, and taxation of its property; the protests are in various stages of the review and appeals process. In the central assessment of these properties, the Department relies in part on ARM 42.22.102(3), which provides that central assessment is "based on the property's operating characteristics such as but not limited to property use, integration of operations, management,

and corporate structure". One effect of the rule is that the Department of Revenue includes the value of gathering lines owned by Bitter Creek Pipeline, LLC, and gas production property owned by Fidelity Exploration and Production Company in the unitary valuation of the Williston Basin Interstate Pipeline Company. Omimex and previously PanCanadian Energy Resources had challenged this rule in court.<sup>1</sup>

**Omimex Canada, Ltd.**

Omimex acquired most of its Montana property from EnCana in 2003.<sup>2</sup> Omimex owns property in Blaine, Chouteau, Glacier, Hill, Liberty, Phillips, Pondera, Toole, and Valley Counties. Omimex's properties generally consist of:

<b>Cut Bank Area Glacier and Toole Counties</b>	<b>Reagan Glacier and Toole Counties</b>	<b>Battle Creek Blaine and Phillips Counties</b>	<b>Shelby Area Liberty and Toole Counties</b>	<b>Bowdoin Phillips and Valley Counties</b>
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.<sup>3</sup> 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 a working interest. For example, the Whitewater pipeline transports third-party gas to the U.S.-

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<sup>1</sup>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

<sup>2</sup>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 subsidiary.

<sup>3</sup>Omimex Canada, Ltd. v. Department of Revenue (No. BDV-2004-288, First Judicial District, Lewis and Clark County), January, 17, 2006.

Canadian border crossing. The Chinook pipeline also delivers gas to the border crossing. The court noted that most of the property is not 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**

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.<sup>4</sup>

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 pipeline as well as with other pipelines. Bitter Creek has not protested the central assessment of its property. 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).<sup>5</sup>

### **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.

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<sup>4</sup>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>.

<sup>5</sup>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](http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp).

## Production Data

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

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 uninterrupted 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.<sup>6</sup>

Encore produces a small amount of natural gas in Montana (based on the Board of Oil and Gas Conservation annual reports, the amount is less than 10,000 MCF). An Encore pipeline moves gas 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, which is also located 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 centrally assessed and taxed at 12% under current law.

### **CENTRAL ASSESSMENT OF PROPERTY**

Section 15-23-101, MCA, provides for the central assessment (unit valuation of property)<sup>7</sup> of railroad transportation property (including rail car companies), scheduled airlines, telecommunications companies, electric power and transmission lines, oil and natural gas pipelines, canals, ditches, and flumes. These properties are single and continuous property operated in more than one county or state. The net proceeds of mines and the gross proceeds of coal mines are also centrally assessed.

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. Since then, the Legislature has consolidated the taxation of most business personal property and created a separate class of property, taxed at 6% of market value, for centrally assessed telecommunications services and electrical generation 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.

### **DISCUSSION POINTS**

The following presents discussion points that may give the Committee some ideas on how to deal with the classification, assessment, and taxation of certain oil and natural gas property.

**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

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<sup>6</sup>Bob Jacobs, "Encore Operating, LP", in Minutes, Revenue and Transportation Committee, February 16 and 17, 2006, Exhibit #33.

<sup>7</sup>Unit valuation involves appraising as a going concern and single entity the entire operating property of a company wherever the company is located in the U.S., and allocating a portion of the value to the state. See footnote #8, slide 2.

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. One, 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<sup>8</sup> for determining whether certain oil and natural gas property would be locally assessed or centrally assessed. Under the Department's formulation,

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<sup>8</sup>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](http://leg.state.mt.us/css/committees/interim/2005_2006/rev_trans/default.asp).

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,<sup>9</sup> 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 4**...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".

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).

## **REIMBURSEMENT OF REVENUE TO TAXING JURISDICTION REIMBURSEMENT**

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<sup>9</sup>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.

Because the types of property under consideration account for a large portion of the tax base in taxing jurisdictions in several countries, it may be appropriate for the Committee to consider creating a way to reimburse taxing jurisdictions for lost revenue.

The revised fiscal note for the introduced version of House Bill No. 569 estimated a total reduction of property tax collections in fiscal year 2006 of \$3.4 million, of which \$2.6 million would have been lost by local taxing jurisdictions, and a total reduction of property tax collections in fiscal year 2007 of \$3.5 million, of which \$2.7 would have been lost by local taxing jurisdictions. The estimates included gathering line property of transmission pipeline companies, including Conoco Pipeline Company, Williston Basin Interstate Pipeline (Bitter Creek), Belle Fourche Pipeline Company, Bridger Pipeline, Havre Pipeline Company, and Rocky Mountain Pipeline. Forty-one counties would have been affected if the introduced version had passed.

Under the amended version of House Bill No. 569, the local assessment of production equipment, including flow lines and gathering lines, and reduction in the tax rate ostensibly would have affected only property owned by EnCana, Fidelity (notwithstanding the possible effect on small, independent gathering lines that cross county lines), and Omimex. The reduction in property tax collections allocated to local taxing jurisdictions was estimated to be \$1 million in fiscal year 2006 and \$1.1 million in fiscal year 2007. Only 11 counties would have been affected:

<u>Omimex</u>	<u>Fidelity</u>	<u>EnCana</u>
Blaine	Big Horn	Carbon
Glacier	Fallon	Golden Valley
Liberty	Phillips	Stillwater
Phillips	Valley	
Toole		
Valley		

If a change in taxation of oil and gas property is limited in scope, it may be appropriate to create a separate reimbursement scheme rather than trying to incorporate the reimbursement under the entitlement share payment provisions contained in 15-1-121, MCA.

## **CONCLUSION**

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 69-3-1404, MCA, as part of 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 odyssey in the ownership of the former Montana Power Company's natural gas property is an example of the changing natural gas markets. The initial buyer of a large portion of MPC'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 has also occurred over the last several years.

This memorandum has highlighted several ways in which the Committee could revise the assessment, classification, and taxation of certain oil and natural gas property. The Committee would have to consider a variety of factors under each approach to ensure the equitable treatment of taxpayers, to avoid unintended consequences, and to maintain the integrity of the central assessment process.

Although there are just a few companies that have challenged the classification, assessment, and taxation related to this study, any changes could affect a multitude of taxpayers because of the different types of property involved and because of the ownership patterns of those properties. Finally, it would be a strange result if a taxpayer ended up owing more taxes because of the accident of geography.

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