

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

Prepared for the Revenue and Transportation Interim Committee

by

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July 2009

## **INTRODUCTION**

Senate Bill No. 489 was enacted during the 2009 legislative session to deal with a state Supreme Court decision that certain natural gas property must be classified under class eight property (business equipment) and taxed at 3% of market value rather than under class nine property (centrally assessed allocations) and taxed at 12% of market value.

The amended version of the bill revised the description of centrally assessed allocations under 15-6-141, MCA, to include: "natural gas distribution utilities, rate-regulated natural gas transmission or oil transmission pipelines regulated by either the public service commission or the federal energy regulatory commission, a common carrier pipeline as defined in 69-13-101, a pipeline carrier as defined in 49 U.S.C. 15102(2), or the gas gathering facilities specified in 15-6-138(6)".

The legislation also revised the description of class eight property under 15-6-138, MCA, to specifically include locally assessed oil and natural gas flow lines and gathering lines, except for gas gathering facilities of stand-alone gas gathering companies providing gathering services to third parties on a contractual basis, owning more than 500 miles of gas gathering lines in the state, and centrally assessed in tax years prior to 2009. This type of property is classified under 15-6-141, MCA.

## **BACKGROUND**

The Supreme Court decision culminated a dispute between Omimex Canada, Ltd., and the Montana Department of Revenue. Omimex is primarily a natural gas production company that operates in several counties in Montana. Omimex produces natural gas (and some oil) and transports in its pipelines its own natural gas, third-party gas, and gas in which it owns a working interest. In tax year 2004, Omimex reported its personal property for local assessment to the counties in which it operates.<sup>1</sup> The Department of Revenue determined that the property should be centrally assessed, classified as class nine property, and taxed at 12% of its market value rather than as class eight personal property at 3% of market value.

District Court Order: For tax year 2004, Omimex filed a complaint in the First Judicial District Court, Lewis and Clark County, for declaratory judgment that asked the Court to find, among other things, that the Department had failed to equalize Omimex's property with similarly

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<sup>1</sup>Omimex did not dispute the valuation of its property for tax year 2004. It has disputed the valuation and taxation of its property for subsequent tax years. Those tax disputes are still under review.

situated property, violating Article VIII, section 3, of the Montana Constitution, and that its personal property be locally assessed and classified as class eight personal property. The District Court determined that the Department had properly centrally assessed Omimex's property under 15-23-101, MCA, and had properly classified the property as class nine property under 15-6-141(1)(c), MCA, which includes "centrally assessed companies' allocations". The Court noted that "[c]learly, the intent of the legislature was to centrally assess all of the company's operating property."<sup>2</sup>

Montana Supreme Court Ruling: Omimex appealed the matter to the Montana Supreme Court. On December 2, 2008, the Supreme Court reversed the District Court decision. The Supreme Court concluded that "centrally assessed companies' allocations" did not apply to Omimex's property because the "specific description of 'centrally assessed natural gas companies having a major distribution system in this state' in 15-6-141(1)(b), MCA, prevails over the general catch-all provision". The Supreme Court pointed out that the Legislature could have included other natural gas companies in the description of class nine property if it had intended to do so. The Supreme Court determined that Omimex's property must be classified under 15-6-138, MCA. Because Omimex's property had been improperly classified, the Supreme Court did not find it necessary to deal with the central assessment of the property because "where the property is assessed does not make any difference for its classification." Likewise the court did not deal with Omimex's due process and equal protection arguments.<sup>3</sup>

Legislative action: The Montana Department of Revenue concluded that the Supreme Court ruling would affect the assessment and taxation of several oil and natural gas pipelines operating within the state and would significantly reduce the property taxes paid by these companies.

Two bills were introduced during the 2009 regular session to deal with the taxation of oil and natural gas pipeline property. House Bill No. 642, introduced by Rep. Julie French, would have amended 15-6-141, MCA, to specifically include oil and natural gas pipeline property that had been classified as class nine property before the Supreme Court decision. The bill died in the House Taxation Committee on a 10-10 vote.

Senate Bill No. 489, introduced by Sen. Jeff Essmann, provided, as amended, that regulated natural gas and oil pipelines and common carrier pipelines are taxed as class nine property and that oil and natural gas production equipment, including flow lines and gathering lines, is taxed as class eight property, except for stand-alone gas gathering facilities described above.

The fiscal note to the bill as amended by the Senate contains a list of pipeline companies,

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<sup>2</sup>Omimex Canada, LTD v. State of Montana, Department of Revenue, Montana First Judicial District, Cause No. BDV-2004-288 (Findings of Fact, Conclusions of Law and Order), February 2, 2007.

<sup>3</sup>Omimex Canada, LTD v. State of Montana, Department of Revenue, Montana Supreme Court, 2008 MT 403, December 2, 2008.

including Omimex, that would be centrally assessed and taxed as class nine property. It also categorized the tax status of property owned by Devon Energy Production Company and by Fidelity Exploration as uncertain. For the purposes of the fiscal note, however, it was assumed that these companies would be taxed as class eight property.

Bill Becomes Law Without Governor's Signature: Senate Bill No. 489 became law without the governor's signature. In a letter to the secretary of state, the governor noted his objections to the legislation, including the delay in sending the legislation to his office. He said that although the bill restores much of the tax base to local governments and school districts before the Omimex decision, it would "allow companies to manipulate their ownership interest in gas lines to avoid payment of taxes." He said that, based on public testimony on the bill, there was uncertainty as to whether a particular company would or would not be centrally assessed. He also said that the "litigation risks by Senate Bill 489, at best, will limit and, at worst, prevent, the successful completion of the [House Bill No. 687] study, as occurred during the 2005-2006 interim when the *Omimex* case was in court."

Department of Revenue's Request for Information: In early May, the Department of Revenue sent a letter to each owner of oil and natural gas pipeline property requesting information on the definition of the company's pipeline as it relates to the provisions of Senate Bill No. 489; miles of gathering lines owned by the company and its affiliates; maps identifying the location of oil or natural gas pipelines, or both; the company's organizational chart; and information on whether the owner of the pipeline property believes its property qualifies as class eight property or class nine property.

### **LEGISLATION TO CONDUCT STUDY**

House Bill No. 657, introduced by Rep. Wayne Stahl, directs the Revenue and Transportation Interim Committee to conduct an interim study on the classification, valuation, and taxation of oil and natural gas property. The study must include:

- an overview of how oil and natural gas markets function, including the effects of state and federal regulatory policy on the operation of these markets;
- an inventory of the ownership of oil and natural gas property subject to central assessment or local assessment;
- a review of the Department of Revenue's policies, procedures, and practices for the valuation of locally assessed and centrally assessed oil and natural gas property;
- an analysis of the importance of oil and natural gas property to the property tax base of taxing jurisdictions, including the state;
- an analysis of state tax appeal board and court decisions affecting the classification, valuation, and taxation of oil and natural gas property; and

- the development of an appropriate policy of taxing oil and natural gas property that takes into account the balance of the financial needs of taxing jurisdictions within the state and the equitable taxation of oil and natural gas property.

The legislation calls for a subcommittee to conduct the study, but the Committee may want to consider whether involving the full Committee in the study would be appropriate.

### **OUTLINE OF STUDY ACTIVITIES**

The primary elements of the study may include the following:

- Overview of how the oil and natural gas production and delivery systems work.
- Brief review of federal and state restructuring of the natural gas industry.
- Review the provisions contained in Senate Bill No. 489 and the implications of the changes on the valuation, classification, and taxation of oil and natural gas property.
- Inventory the classification of oil and natural gas property in the state, including the reclassification of property under Senate Bill No. 489, and assess the fiscal impact on local governments and school districts.
- Assess whether the provisions of Senate Bill No. 489 are working as intended and determine whether refinements, including any "bright line" tests of determining the assessment and classification, are needed.
- Develop a database to evaluate the effects of proposed changes, if any, on the taxation of oil and natural gas property.
- Identify legal, policy, and fiscal implications related to the assessment, classification, and taxation of oil and natural gas property.
- Develop options, if options are considered necessary, related to the valuation, classification, and taxation of oil and natural gas property in Montana, with attention focused on direct and secondary effects that any option might entail. The options should be evaluated using established criteria of good tax policy, including equity and fairness, economic efficiency, and simplicity.

### **PROPOSED SCHEDULE**

The following schedule is proposed for conducting the study:

1. July 2009 meeting -- discuss, refine, and adopt study plan.
2. September 2009 meeting:
  - a. review provisions and implications of Senate Bill No. 489;

- b. discuss primer on central assessment of property, unitary valuation, and classification of property;
  - c. inventory the classification of oil and natural gas property by owner (using the list of companies contained in the revised fiscal note as a guideline) and changes in classification of property as a result of Senate Bill No. 489; and
  - d. review of market structure of oil and natural gas production and transportation.
3. December 2009 meeting:
- a. assess the fiscal impact of Senate Bill No. 489 on the state, local governments, and school districts;
  - b. review how oil and natural gas production and transportation systems work and the distribution of oil and natural gas pipeline property (flow lines, gathering lines and transmission lines within the state; utilize industry or other maps if available; and
  - c. evaluate whether Senate Bill No. 489 is working as intended and identify changes, if any, that would improve the operation of the law.
4. February 2010 meeting:
- a. if the Committee determines at the December meeting that changes may needed, evaluate the implications of policy changes on taxpayers, state and local taxing jurisdictions; and
  - b. develop options and initial recommendations and request draft legislation if considered appropriate.
5. April 2010 meeting:
- a. act on draft legislation, if any; and
  - b. finalize recommendation and review outline for final report.
6. July 2010 meeting -- review final report of committee actions.

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