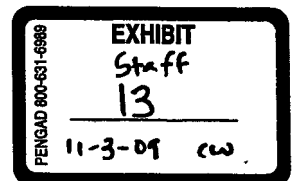


BEFORE THE  
PUBLIC UTILITIES COMMISSION  
STATE OF SOUTH DAKOTA

KEYSTONE XL PROJECT  
DOCKET HP09-001

PREFILED TESTIMONY OF MICHAEL KENYON  
ON BEHALF OF THE COMMISSION STAFF  
SEPTEMBER 2009



BEFORE THE PUBLIC UTILITIES COMMISSION STATE OF SOUTH DAKOTA

PREFILED TESTIMONY OF MICHAEL KENYON

**Q. Please state your name, occupation and business address.**

A. My name is Michael Kenyon. I am the Director of the Division of Property and Special Taxes for the South Dakota Department of Revenue & Regulation, located at 445 East Capitol Avenue, Pierre, South Dakota 57501 (the "Department").

**Q. On whose behalf was the testimony provided?**

A. This testimony was provided on behalf of the staff of the South Dakota Public Utilities Commission.

**Q. What is the purpose of the testimony in this proceeding?**

A. The purpose of the Department in providing this testimony is to explain the property tax impacts of the TransCanada Keystone XL Pipeline (Keystone XL).

**Q. Can you please describe the real property taxation system in South Dakota?**

A. South Dakota has an ad valorem system of real property taxation, which means that the tax is imposed on the value of the real property, rather than on its quantity or some other measure.

**Q. Can you please describe the central assessment of pipeline property?**

A. Yes. Central assessment means that the property is valued by the Department rather than by the local assessor. Certain industries and public utilities in South Dakota are centrally assessed. In general, these are companies that have property in multiple counties or states.

**Q. Does South Dakota have specific laws for the taxation of pipelines?**

A. Yes. Chapter 10-37 of the South Dakota Codified Laws ("SDCL") contains laws specific to the taxation of pipeline companies. As used in that chapter, the phrase "pipeline companies" includes business entities that transport gasoline, oils or motor fuels by pipeline as a common carrier.

**Q. Does SDCL Chapter 10-37 govern the taxation of Keystone XL?**

A. Yes. TransCanada Keystone Pipeline, LP fits within the definition of a pipeline company, so SDCL Chapter 10-37 governs the real property taxation of Keystone XL.

**Q. What does SDCL Chapter 10-37 require of pipeline companies?**

A. Pursuant to SDCL § 10-37-3, a pipeline company must submit an annual statement detailing all of the South Dakota property it owns or uses to the Department. The statement must include pipeline mileage in the state, a description of the pipeline county by county, the cost and present value of buildings owned by the company, and the location of and a description of all pump stations. SDCL § 10-37-4 requires the annual statement to include "the rights-of-way, pumping or station grounds, buildings, storage or tank yards, equipment grounds for any and all purposes, with the estimated actual value thereof."

**Q. Can you please give a general overview of how pipeline property is assessed?**

A. Yes. The Department's assessment includes the rights-of-way, easements, pipelines, stations, grounds, shops, buildings, pumps and all other property, real and personal, used in the operation of the pipeline.

The Department uses the "unit value" method to assess pipelines and most other centrally assessed companies. Generally speaking, there are three steps to this approach. First, the Department determines the fair market value for the whole company as a unit. Second, the Department apportions some of the total value of the company to South Dakota. Finally, the Department distributes the company's value within South Dakota amongst all of the taxing districts where the company owns property.

**Q. How does the Department of Revenue & Regulation determine the "unit value" or the value of the pipeline company as a whole?**

A. SDCL § 10-37-9.1 directs the Department to consider the cost approach, the market approach, and the income approach to valuing the pipeline property. When using these

approaches, SDCL § 10-37-8 allows the Department to take into account everything which will enable the Department to make a just and equitable assessment of pipeline property.

**Q. Can you please describe the cost approach, the market approach and the income approach?**

A. Generally speaking, the cost approach looks at the estimated cost of replacing the property, taking into account the age and condition of the property, and obsolescence. The market approach considers the price the property would bring in a competitive and open market between a willing buyer and willing seller. In the case of a pipeline company, SDCL § 10-37-9.1 allows the Department to consider the company stock value and indebtedness when using the market approach. The income approach capitalizes the income earned from the property to arrive at a value.

**Q. Does the central assessment process typically give equal weight to the cost, market and income approaches?**

A. No. The assessment process requires you to evaluate the data or information used to establish a value using each of the approaches. For example, the market approach requires you to look at sales of comparable property. Because these companies do not sell often enough to establish a market, this approach is typically not very useful in valuing centrally assessed companies.

**Q. Can you please describe application of the market approach to Keystone XL?**

A. As is typical, there are no comparable sales of similar crude oil pipelines that could be used for the valuation of Keystone XL. SDCL § 10-37-9.1 allows the Department to consider the company's stock value and indebtedness as part of the market approach. However, both Keystone XL and the original Keystone pipeline being constructed in South Dakota belong to TransCanada Keystone Pipeline, LP. TransCanada Keystone Pipeline, LP is a wholly owned subsidiary of TransCanada Corporation, a publicly held

Canadian corporation. Since the stock of the subsidiary company is not publicly traded, the alternative provided in SDCL § 10-37-9.1, which allows the Department to consider the company's stock value and indebtedness, is not particularly useful.

**Q. Can you please describe application of the income approach to Keystone XL?**

A. Neither Keystone XL nor the original Keystone pipeline is currently operational. Keystone XL is in the permitting stage and the original Keystone pipeline is under construction. TransCanada Keystone Pipeline, LP has no revenue stream. Based on information available to the Department, application of the income approach to Keystone XL would be little better than guesswork, pending commencement of operations.

**Q. Can you please describe application of the cost approach to Keystone XL?**

A. Estimated construction costs can be used to determine a value for Keystone XL's property. However, the cost approach requires the Department to calculate an "external obsolescence" factor. Basically, an external obsolescence factor is calculated by comparing the rate of return of the company with the company's cost of doing business. If the comparison is favorable, this will increase the value of the company. If the comparison is not favorable, this will decrease the value of the company. Because income information is required, but not available, to calculate the company's rate of return, the cost approach cannot be fully calculated.

**Q. Once the unit value of the company is determined, what is the second step to establishing a value for the company using the unit value method?**

A. Once we have a value for the whole company, we have to allocate a portion of that value to South Dakota. It would not be fair for South Dakota to tax 100% of the value of a company that operates and owns property in multiple states. We allocate the value of the company based upon the percentage of the company's operating assets that are within South Dakota. So, if 40% of a company's operating assets are in SD, we allocate 40% of their total value to South Dakota.

**Q. Once a portion of the company's value is allocated to South Dakota, how do we distribute the company's value within South Dakota?**

A. The company reports the total original cost in each of the individual taxing districts where the company has property. The company also reports the total original cost in the state. The total original cost in the taxing district is divided by the total cost, and that percentage is taken times the state value to determine the value in the individual taxing district. For example if a taxing district has 5% of the total original state cost in that taxing district, then it receives 5% of the state value. The Department informs the county auditor of the company's value in each of the taxing districts.

**Q. Besides this 3-step unit value approach, are there other differences in how these companies are valued or taxed?**

A. There is one other difference. Because the Department provides the assessment, state law gives both the company, and the taxing districts where the property is located, the opportunity to appeal the Department's value. Other than that, once a value is determined the county auditor levies taxes upon that value just like any other commercial property. Like other property, no portion of the property taxes paid by the company goes to the state.

**Q. Is it possible to estimate the property taxes that will be paid by Keystone XL, and how those taxes will effect local governments and other taxpayers?**

A. It is certainly possible to make some broad generalities about how the taxes paid by Keystone XL will impact the local governments and other taxpayers. In general, there is no downside to adding value to a taxing district. Often, when you add significant new value to a taxing district, the local governments will receive more revenue and the other taxpayers within the taxing district will pay lower taxes.

However, estimating the property taxes that Keystone XL will pay, and how that will effect the local governments and other taxpayers requires some assumptions to be made.

**Q. What assumptions would have to be made to estimate the taxes Keystone XL will pay, and how those additional taxes will effect local governments and other taxpayers?**

A. As I discussed earlier, without income information it is not possible to determine a value for Keystone XL using the normal methods. The market approach is not useful because Keystone XL is a subsidiary of TransCanada that is not publicly traded. The income approach is not useful because we do not have income information. Similarly, we cannot calculate the "external obsolescence" in the cost approach, without income information. Therefore, the first thing you would have to do is make an assumption of what the assessed value of Keystone XL will be.

In addition, South Dakota law gives some discretion to local governments and school districts on the amount of property taxes they collect. That discretion is limited in several ways, but it still requires you to make some assumptions about what the taxing districts will do.

These assumptions will also control the effect the new value will have on other taxpayers within the taxing jurisdiction.

**Q. Can you please give an overview of the process to estimate the property taxes that will be paid by Keystone XL?**

A. Yes. To make a good estimate you have to look at three different portions of the property tax system: (1) the county taxes, (2) the school general fund taxes, and (3) the school capital outlay, pension, and special education levies. The taxes for each of these portions of the tax system work a bit differently.

The total county taxes are capped at the amount collected last year, plus increases for inflation and growth. The school general fund taxes are based upon the school funding formula and tax levies set by the Legislature each year. The last three levies, the school capital outlay, pension, and special education levies, are limited by maximum levy rates

and how the money generated can be spent.

**Q. Have you looked at any example taxing districts to illustrate the property taxes Keystone XL will pay, what that will do to the amount of taxes collected in the district, and how the taxes of other property owners will change?**

A. Yes. We looked at Harding County. Harding County makes for an easy example because the school district boundaries and the county boundaries are the same. As I talk about how the property taxes will change for the counties and the school districts, I will use Harding County as an example.

In my examples, I will assume that Keystone XL will add \$60 million of value to the tax base of Harding County. The most recent year we have full information on is for the taxes payable in 2009. The 2009 tax base, for both the county and the school district, is about \$152 million. Therefore, Keystone XL's value of \$60 million would increase the tax base in Harding County to \$212 million.

Harding County's total tax levy is \$6.69/\$1,000. The school general fund levy for commercial property is \$8.78/\$1,000. The school capital outlay, pension, and special ed levy rates are \$2.72/\$1,000, \$.30/\$1,000, and \$.84/\$1,000 of value, respectively.

**Q. Can you explain how the levy rates are expressed?**

A. The levy rates or tax rates are expressed as an amount of tax per \$1,000 of taxable value. So, a levy rate of \$2.72/\$1,000 means that for every \$1,000 of taxable value, you will pay \$2.72 in property taxes. In some of the older statutes, \$1/\$1,000 is expressed as one "mill." As a percentage, \$1/\$1,000 is expressed as .001.

**Q. How would you estimate the county taxes that will be paid by Keystone XL?**

A. Property taxes for the county (and all other units of local governments, except schools) are capped in South Dakota. This cap limits the counties to what they collected last year in property taxes, plus increases for inflation and for growth. The increase for inflation is set by the Consumer Price Index, but limited to 3% a year.



The increase for growth is based upon the percentage change of value in the tax base because of new construction. For example, if the total value of a county increases by 1%, because of new construction, then the county can increase the amount of property taxes it collects by 1%. This 1% increase is in addition to any increase allowed by inflation.

Using Harding County as an example, they collected about \$1,000,000 in property taxes by applying a levy of \$6.69/\$1,000 on a tax base of \$152 million ( $.00669 \times \$152,000,000 = \$1$  million). If we assume the Keystone XL pipeline adds \$60 million of value to the county, then Harding County could increase the amount of property taxes they collect by about 40% for growth. The 40% growth is calculated by dividing the new tax base of \$212 million by the old tax base of \$152 million ( $\$212$  million divided by  $\$152$  million = 1.4).

Harding County has three options for handling the new value: (1) they could collect the same amount of property taxes they collected last year; (2) they could increase the \$1,000,000 in property taxes they collected last year by 40% to \$1.4 million; or (3) they could collect an amount between the other two options.

**Q. Could you explain the impact of each of these options on Keystone XL and the other taxpayers within Harding County?**

A. If Harding County decided to collect the same amount of taxes they collected in 2009, the tax levy would drop from \$6.69/\$1,000 to \$4.72/\$1,000 ( $.00472 \times \$212$  million = \$1 million of property taxes). This would amount to a 30% decrease in the county property taxes paid by the other property owners in the county ( $.00472$  divided by  $.00669 = .70$ ). Under this scenario, Keystone XL would pay \$283,200 in county property taxes ( $\$60$  million  $\times .00472$ ).

If Harding County decided to collect the maximum amount possible, they would increase the amount of property taxes they collect to \$1.4 million ( $\$1$  million  $\times 1.4$  for the 40%

growth). Even with that 40% increase in taxes collected, the property taxes paid by everyone else in the county would actually decrease slightly. The old tax rate of \$6.69/\$1,000 would drop to \$6.60/\$1,000 (the new tax call of \$1.4 million divided by the new tax base of \$212 million). Under this scenario, Keystone XL would pay \$396,000 (\$60 million x .0066).

The above estimates, not accounting for inflation, represent the likely extremes of the county taxes on Keystone XL. A reasonable estimate somewhere between the extremes would be to assume the county uses the potential growth to increase the property taxes they collect by 10%, to \$1.1 million in property taxes. The new tax levy would be \$5.19/\$1,000 (\$1.1 million divided by the new tax base of \$212 million). This would be a significant increase in tax revenue for the county and a significant decrease in property taxes paid by other property owners in the county. Under this scenario, Keystone XL would pay \$311,400 in county property taxes (\$60 million x .00519).

**Q. How would you estimate the school general fund taxes that will be paid by Keystone XL?**

A. South Dakota's school funding formula is complex. The formula consists of three elements, local need, local effort, and state aid. The "local need" represents an estimated cost to educate the children in the school district. The "local effort" represents the amount of property taxes that can be generated locally to meet the "local need." State aid makes up the difference between the local effort and the local need. "Local need" is based upon a statutory estimated cost per child multiplied by the number of children in the school district. The cost per child used in the formula typically increases every year. Certain multipliers are used for small and sparse school districts, because of the extra cost to educate children in these districts. "Local effort" is how much property taxes can be raised locally to meet the "local need." Every year, the Legislature establishes maximum levies for three classes of property:

agricultural, owner-occupied and commercial (or "other") property. The value in the school district for each class of property multiplied by the maximum levy rate establishes the "local effort." For taxes payable in 2009, the maximum levy rates are: ag - \$2.61/\$1,000; owner-occupied - \$4.10/\$1,000; and commercial - \$8.78/\$1,000.

"State aid" is the difference between the "local effort" and the "local need" (State aid = "local need" – "local effort"). Some school districts can generate all of their "local need" with their "local effort." These school districts receive no state aid.

Looking at Harding County as an example, for the 2008-2009 school year, they had a local need of \$1,282,000, local effort of \$752,000, and state aid of \$530,000. Adding \$60 million of value paying the commercial tax levy would generate about \$527,000 in additional "local effort" (\$60 million x .00878).

From the school district's perspective, they will get the same amount of "local need" they received without the new \$60 million of value from Keystone XL. They will now be able to generate \$1,279,000 of local effort and will receive about \$3,000 of state aid.

Keystone XL will pay \$527,000 in school general fund property taxes in Harding County (.00878 x \$60 million). Since the school general fund levy rates are set based upon statewide values of \$55 billion, it takes a lot of new value to change the levy rate even slightly.

**Q. How would you estimate the school capital outlay, pension, and special education taxes that will be paid by Keystone XL?**

A. This is probably the toughest area to make an assumption. The capital outlay, pension, and special ed levies are "uncapped" levies. School districts are limited only by the statutory maximum for the levy rates. However, state law limits the use of taxes generated by these levies to certain categories of expenses. For example, revenue generated by the capital outlay levy can only be used for capital expenses, like textbooks or buildings; it could not be used to pay the salary of a teacher.

The maximum levies are \$3.00/\$1,000 for capital outlay, \$.30/\$1,000 for pension, and \$1.40/\$1,000 for special education.

The Harding County School District is currently at \$2.72/\$1,000 for their capital outlay levy. They generate \$413,000 of capital outlay revenue (\$152 million x .00272). Adding \$60 million of value and keeping the same levy rate would allow them to generate \$577,000, or an extra \$164,000 of capital outlay revenue. Because the school district is not at the statutory maximum levy rate, it is not likely they need an extra \$164,000 of capital outlay revenue. A reasonable assumption may be to increase their capital outlay revenue by 10%, or \$41,000. With the additional \$60 million of Keystone XL value and the 10% increase in revenue, the levy would drop from \$2.72/\$1,000 to \$2.14/\$1,000 (\$212 million x .00214 = \$454,000). Keystone XL would pay \$128,000 in Harding County School District capital outlay taxes (\$60 million x .00214).

Harding County School District is currently at the maximum pension levy of \$.30/\$1,000. They are currently collecting \$45,600 of pension revenue (\$152 million x .0003). Because the school district is at the statutory maximum levy rate, they may want the additional pension revenue. A reasonable assumption may be to apply the current maximum levy rate of .30/\$1,000 to the new higher value. With the additional \$60 million of value from Keystone XL, the school district would collect \$63,600 in pension levy revenue (\$212 million x .0003). Keystone XL would pay \$18,000 in pension levy taxes to the Harding County school district.

Harding County school district is currently at \$.84/\$1,000 for their special education levy. They are currently collecting \$127,000 of special ed revenue (\$152 million x .00084). Adding \$60 million of value and keeping the same levy rate would allow them to generate \$178,000, or an extra \$61,000 of special education revenue. Because the school district is not at the statutory maximum levy rate, it is not likely they need an extra \$61,000 of special education revenue. A reasonable assumption may be to increase their special

education revenue by about 10%, to \$140,000. With the additional \$60 million of Keystone XL value and the 10% increase in revenue, the levy would drop from \$.84/\$1,000 to \$.66/\$1,000 ( $\$212 \text{ million} \times .00066 = \$140,000$ ). Keystone XL would pay \$40,000 in special education taxes to the Harding County School District ( $\$60 \text{ million} \times .00066$ ).

**Q. Could you summarize the assumptions you made and the impact on the various taxing entities and Keystone XL?**

A. Yes. Based upon an estimate of Keystone XL having a taxable value of \$60 million, I estimated they would pay \$713,000 in taxes to the Harding County School District. Keystone XL's tax liability would consist of \$527,000 of school general fund tax, \$128,000 of capital outlay tax, \$18,000 of pension tax, and \$40,000 of special education taxes.

For the school district, those taxes would represent additional revenue of \$41,000 of capital outlay revenue, \$18,000 of pension revenue, and \$13,000 of special education revenue. The \$527,000 of school general fund taxes paid by Keystone XL would not be additional revenue for the school. Instead, that money would replace state aid dollars. Based upon these assumptions, the other taxpayers in the school district would pay \$.76/\$1,000 less in school property taxes.

For the county taxes, I made a range of estimates. The minimum amount I estimated was no increase in the amount of property taxes collected by the county. Keystone XL would pay \$283,200 in county property taxes. The levy paid by all of the other taxpayers in the county would drop from \$6.69/\$1,000 to \$4.72/\$1,000 (a 30% decrease).

The maximum amount I estimated was the county increasing their property taxes by 40%, or \$400,000, the maximum allowed by the property tax caps. Keystone XL would pay \$396,000 in county property taxes. The levy paid by all of the other taxpayers in the county would drop from \$6.69/\$1,000 to \$6.60/\$1,000 (a 2% decrease).

For a reasonable estimate between the two extremes, I assumed the county would increase their property taxes by 10%, or \$100,000. Keystone XL would pay \$311,400 in county property taxes. The levy paid by all of the other taxpayers in the county would drop from \$6.69/\$1,000 to \$5.19/\$1,000 (a 22% decrease).

**Q. Do you have anything else to say about this estimate?**

**A. Yes.** Making these estimates required assumptions about what the taxable value of Keystone XL will be, as well as assumptions about what the school and counties will do. The assumptions I made were stated in my testimony. If anyone wants me to calculate what the tax liability would be making different assumptions, I could do that if I was provided the list of assumptions before my live testimony.

In addition, the estimate is also based upon what the values and tax levies are in 2009. If the Keystone XL pipeline is built by November 1 of 2011, it will pay taxes on that value in 2013. Many things could happen between now and 2013 that would change the assumptions and the calculations made in this estimate. The amount of other taxable value in the counties will change, the school general fund tax levies set by the Legislature will change, and it is possible the county or school district could opt out. All of those potential changes could significantly modify the estimates I have made.