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October 18, 2005

Mayor Roy Gilbertson  
City of Delta Junction  
PO Box 229  
Delta Junction, Alaska 99737

Re: Amended PILT Agreement  
Report to City Council  
Background, Analysis and Recommendations  
Our File No. 11025.018

Dear Mayor:

The Finance Committee of the Deltana Charter Commission/City of Delta Junction Finance Committee has successfully concluded negotiations with Teck-Pogo over the terms and conditions of an agreement for payment in lieu of taxes ("the PILT Agreement"). I have asked the City Clerk to place introduction of the amended PILT Agreement on the agenda for the October 19, 2005 meeting, and a public hearing on approval of that PILT Agreement on the agenda for the November 1, 2005 meeting.<sup>1</sup>

In this letter, I will first try to set out the background on which this PILT Agreement was negotiated. I will then provide a brief analysis of the PILT Agreement, and what the agreement means for the City and for the Borough, if the voters incorporate the Borough. Lastly, I will recommend enactment of the PILT Agreement.

Please note that nothing in this letter, and nothing in the PILT Agreement, is a decision as to whether or not the Borough should be created. The proposed action of the City Council will **not** address the fundamental question of whether the Borough should be created; only the Deltana voters can decide that. Rather, the PILT sets out an agreement that will bind the Borough if it is created, and provide a revenue stream for that new Borough if it is created. The PILT Agreement also provides a revenue stream to the City.

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<sup>1</sup> For the benefit of new city council members, I am the City Attorney. I was "loaned" to the Finance Committee of the Charter Commission to assist in negotiating the PILT Agreement with Teck-Pogo, in part because the proposed agreement would pay money to the City and not just to a borough that might be created.

## **1. The Background to the PILT Agreement.**

Several factors have led to the Deltana area exploring creation of a Borough. I will review some of them.

### **(a) Pressure to Create a Borough.**

First, there has been some pressure from the Alaska Legislature to create a Borough. Those of us who live in the Fairbanks North Star Borough remember very clearly that the Legislature, if it wants, can impose a borough form of government on a community, even against the wishes of the community. The Fairbanks North Star Borough was created in 1964 by Legislative act, not by vote of the borough residents. By creating a Borough Charter Commission, and voting on a Borough, the community can at least have a chance of designing the form of borough government it wants, rather than having a less desirable government imposed upon it.<sup>2</sup> If the Legislature created the Borough, not only would its powers be defined by the Legislature, its boundaries would be defined by the Legislature. Under present State of Alaska plans, the boundaries of a Deltana Borough would extend to the Alaska border.

The construction of the Teck-Pogo Mine is another important factor. The mine, with a value between \$250 and \$350 million, represents quite a large taxable asset, and it is attracting taxing authorities who would like to be able to levy taxes on its value. The Fairbanks North Star Borough has expressed an interest, and the Alaska Legislature has bills before it which would allow it to tax mining properties in the unorganized borough. Because the Teck-Pogo Mine is within the nominal boundaries of the Deltana Borough, the proposed Borough has a kind of "first shot" at being the government that gets to impose that tax. If the Deltana Borough does not act, there are others waiting in the wings.

The Fairbanks North Star Borough, in particular, has looked at annexing the Delta area in order to include the Teck-Pogo Mine in its tax base. From the Fairbanks Borough's point of view, it gets about \$10 to \$15 million in additional property tax and oil pipeline revenues, in return for additional expenses of about half that amount. From Deltana's point of view, its population base is so small that it cannot be assured of even

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<sup>2</sup> A borough created by the Alaska Legislature would be a general law borough. Its powers and authority are defined by statute. By contrast, a home rule borough can be created by voters and the powers and authorities are defined by the charter.

one Borough Assembly seat or School District Board of Education seat in an expanded Fairbanks North Star Borough. Deltana residents would pay 14-15 mills property tax but could not be certain they would be directly represented in the elected government.

The Delta-Greely School District is presently funded by the State of Alaska. It receives all of its revenue from the State's education funding. There is no mechanism by which the Delta-Greely School District can invest more money than the State's basic education funding in its students. Creation of a Borough would allow, but not require, the community to invest more than the minimum amounts provided by the State in the education of its youth.

Finally, as suggested above, by voluntarily creating its own form of borough government, the Deltana area can avoid the mistakes made by other borough governments and design a form of government that addresses the needs and concerns of the Deltana area. For example, by creating a home rule borough, as opposed to a general law borough, Deltana residents can tailor their borough's powers to local concerns. And Deltana can avoid the duplicate and wasteful "layers" of government that exist in other boroughs.

#### **(b) Funding the New Borough.**

In most, but not all boroughs, property taxes are a primary source of revenue. The Deltana Charter Commission has approached the creation of the Deltana Borough with the goal of not requiring a property tax (and in fact making it difficult to ever impose a property tax). The traditional funding sources – a property tax levy at a modest mill rate – is therefore unavailable to levy a tax on Teck-Pogo. So the focus of discussions and negotiations has been a mineral severance tax.

The Alaska Constitution was written to encourage local government. Especially in the case of a "home rule" government, a local government has quite broad powers. Several local governments have interpreted their broad powers to allow them to impose a mineral severance tax on minerals extracted from property within their borough boundaries. The Northwest Arctic Borough imposes a mineral severance tax on Red Dog Mine under a PILT agreement. The Denali Borough imposes a mineral severance tax on Usibelli Coal Mine by ordinance. While it is not completely clear under the Alaska Constitution or Alaska Statutes that such a mineral severance tax is lawful, there have not been any court challenges to date and the practice has become part of the municipal financial landscape.

By contracting for payment of a mineral severance tax, instead of imposing the tax by ordinance, a local government has more flexibility in how the tax will be calculated and imposed, and the risk of litigation is reduced. Red Dog Mine, for example, has a contract for the payment of mineral severance taxes to the Northwest Arctic Borough. Remember that the right of a municipality to levy a mineral severance tax is uncertain. By entering into a contract like a PILT Agreement, the risk that the person most likely to challenge the legality of the mineral severance tax – the mine that is the taxpayer – is greatly reduced.

Mineral severance taxes can be calculated in a number of ways. Classically, the tax is a percentage of the value of mineral extracted, in effect a royalty. If a mineral severance tax were one percent, and a mine sold \$1,000 worth of gold, the severance tax would generate 1% of \$1,000 or \$10.00 in revenue.

But a mineral severance tax can also be calculated as a property tax, a percentage of value of the assets used to produce the valuable minerals. A property tax formula results in much more predictable tax revenues. Both the mine and the Borough have a clearer idea how much will be paid, without having to consider changes in commodity prices.

### **(c) Other Factors in Negotiating the Proposed PILT Agreement.**

In addition to those general considerations, there were other factors that impacted negotiation of the proposed PILT Agreement. One of the most critical was a pending piece of legislation. The proposed state law would very seriously limit the ability of a new borough to levy a mineral severance tax. Some versions of the proposed law would limit a new borough to an effective property tax rate of just four mills on just a portion of the mine's assets. It is by no means certain that such a proposal would become law, or that such a law would be constitutional. But the threat of such a law influenced discussions. The Alaska Miners Association spends hundreds of thousands of dollars lobbying the Alaska Legislature; the Deltana Borough and the City of Delta Junction cannot compete at lobbying. And a legal challenge to such a law would require financial resources the Charter Commission and the City simply do not have.

Another factor involves the value of the mine. The Teck-Pogo mine presently has established publicly-reported reserves for ten years of operation. The mine may have additional reserves not presently publicly disclosed, but we do not know with any certainty. The effect is to create a ten-year depreciation life for the Teck-Pogo property. Put another way, about nine percent of the value of the mine goes away each year. About

nine percent of the value of the mine escapes municipal and state taxation of any form each year. The effect is to make it more important to get a PILT Agreement sooner, rather than later.

A final issue in drafting the PILT Agreement involves preserving as much flexibility as possible for that future Deltana Borough Assembly. The Finance Committee of the Charter Commission took as one of its guideposts to maximize the options for the Borough Assembly. That policy affected everything from the term of the PILT agreement to possible future bond requirements to restrictions on use of funds, and much more.

The PILT Agreement attached to this letter is a product of all of these factors and considerations, as well as other issues, concerns, and tactics.

## **2. Analysis of PILT Agreement.**

Turning to the PILT Agreement itself, the attached version is in markup format, showing changes from the version originally introduced to this final version. Those specific, final changes are discussed below. First, I want to touch on some of the key provisions of the PILT Agreement.

### **(a) Impacts on the City.**

Of course, there is not presently a borough that has taxing authority on Teck-Pogo. There is no one trying to levy a tax with whom Teck-Pogo can contract. But Teck-Pogo wants to avoid the risk of annexation by the Fairbanks North Star Borough with its high mill rate, and wants to have some certainty as to the amount of tax it will have to pay. So until a Borough is created, PILT payments will go to the City. These payments are a measure of the importance Teck-Pogo attaches to having certainty and staying out of the Fairbanks North Star Borough.

In 2005, Teck-Pogo will pay the City \$500,000. In 2006, Teck-Pogo will pay the City \$250,000, with another \$250,000 to be paid to the Borough if it is created by December 31, 2008. In 2007, Teck-Pogo will pay the City \$500,000, with another \$500,000 to be paid to the Borough if it is created by December 31, 2008. The City is free to approach Teck-Pogo for additional, voluntary payments at any time. For example, the City could approach Teck-Pogo for money to help create a heated hockey rink, or indoor rifle range. But the City is assured of receiving \$1.25 million between enactment of the PILT Agreement and July 2007. See generally Paragraph 2 of the proposed PILT Agreement.

The City is not endorsing, supporting or creating the proposed Borough by enacting this agreement. However, it is critical to remember that this PILT Agreement will be enforceable against the Borough if it is incorporated.

**(b) Impacts on the Borough.**

If the Deltana voters vote to incorporate the proposed Deltana Borough, then the PILT Agreement, as a City of Delta Junction contract, is automatically assumed by the Deltana Borough. Depending on the date of incorporation, the Deltana Borough would be bound by the contract for a period of seven to nine years. So assuming the Deltana Borough is incorporated, the major impact of the PILT Agreement will be on the new borough.

The PILT Agreement impacts the new Borough in many ways. First, and easiest, if the Deltana Borough is incorporated by December 31, 2008, then a total of \$750,000 in escrow from the 2006 and 2007 payments from Teck-Pogo to the City become the property of the Borough.

Beginning in the year of incorporation, the Borough will also receive the greater of 10 mills multiplied by the then-current value of the Mine or \$2 million. "Then-current value of the Mine" means

Total cost of the mine, but not less than \$260 million

LESS 10% annual depreciation

PLUS additional capital improvements

Mine depreciation is over a period of ten years and has an agreed residual value of about \$66 million. Teck-Pogo has stated publicly that there have been extra costs incurred, perhaps as much as \$350 million. If Teck-Pogo finds additional reserves and increases the size of its mine, then the formula will impose additional PILT on Teck-Pogo.

The Finance Committee projects that this will generate significant surpluses for the Borough in the first 5-6 years. The amount of those surpluses depends on the assumptions made, but under all reasonable projections there is a surplus through the ten-year term of the PILT Agreement, and on many projections that surplus is substantial.

It is possible that the Borough, during the term of the PILT Agreement, will want to issue general obligation bonds for a specific project. One possible scenario would be the construction of a new school, for example. General obligation bonds are a pledge of the full faith and credit of the Borough for the repayment of the bonds; they differ from revenue bonds, where the bondholder can only look for payment from the things created with the revenue bonds. In the event of a default in general obligation bonds, the bondholder has the power to impose property taxes for collection. Let me hasten to note that no such default has ever occurred, and that most smaller communities issue bonds through the Alaska Municipal Bond Bank, which provides additional assurances that such a default will not occur. But that is the critical difference between general obligation bonds and revenue bonds.

Under the PILT Agreement, Teck-Pogo has agreed to pay additional taxes for the debt service on those general obligation bonds at the rate of 1.35 mills to a maximum of \$350,000 per year. However, there is a requirement that the citizens of Deltana Borough impose a tax levy upon themselves as a condition to Teck-Pogo being required to make these general bond payments. Those additional citizen levies need not be property taxes; the Finance Committee has tried to give the future Borough Assembly a great deal of flexibility as to how it raises the citizens' share of the general obligation bond payments. For example, the levy could be a sales tax, or a user fee, or something else entirely. As always, the Finance Committee has worked to give the Borough assembly as much flexibility as possible. The bond payment obligation extends five years beyond the term of the PILT Agreement.

In return for those payments, the Borough would agree it could not impose taxes on Teck-Pogo for the life of the agreement. Teck-Pogo's liability would be limited to its obligations under the PILT Agreement, subject to some minor exceptions.

**(c) Changes from the Last Draft.**

The enclosed copy of the PILT Agreement is in markup format. Insertions are underlined; deletions are in strike-through face.

The repeated changes make the draft a bit hard to read. The practical effects of the final round of changes are

- (i) Teck-Pogo's attempt to require the Borough to raise any specific minimum level of taxes as a condition to Teck-Pogo paying taxes, with a penalty to the Borough if the Borough failed to meet that minimum level is DELETED. See

former Par. 5.5. The Borough would have to raise some material amount of revenue, See Recitals H and I, but that has been an assumption by the Finance Committee all along.

(ii) As noted above, for general obligation bond payments by Teck-Pogo, the Borough must raise funds to trigger Teck-Pogo's "match." After much discussion as to what sources of funds would be eligible to trigger that "match" requirement, the parties agreed that half of the annual unrestricted federal grant could be used, to a maximum of \$175,000.<sup>3</sup> The Borough's savings accounts accrued prior to incorporation could be used to trigger Teck-Pogo's "match;" payments by Teck-Pogo after Borough incorporation could not be used. See generally Paragraph 6.2.

The change to Paragraph 5.5 was viewed by the Finance Committee as much more important than Paragraph 6.2, since issuance of general obligation bonds in the next ten years is much less certain.

#### **(d) Impacts on Incorporation.**

It's critically important to understand what the PILT Agreement, and the City's action on the PILT Agreement, does and does not do.

What the City's approval of the PILT Agreement **DOES** do is allow the Charter Commission to go to the Local Boundary Commission and demonstrate that the Deltana Borough is financially feasible, satisfying one of the requirements for Local Boundary Commission approval of the petition to incorporate. Only after the Local Boundary Commission has approved the petition can the issue of incorporation be presented to the Deltana voters.

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<sup>3</sup> This annual federal grant, confusingly, is called PILT. It is currently in the amount of \$256,000, and is indexed for inflation. It is paid to compensate municipalities for the loss of the ability to tax federally-owned lands. However, it is not presently a requirement that the municipality tax non-federal land as a condition to receiving these payments. There is also an educational payment by the federal government, sometimes called PILT, but it can only be used to operate schools, not for general obligation bond purposes.

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What the City's approval of the PILT Agreement **DOES NOT** do is somehow create the Borough. Only the Deltana voters can create the Deltana Borough by an election; the City Council can't cause the incorporation.<sup>4</sup>

The City's approval of the PILT Agreement **DOES NOT** operate as an endorsement of incorporation of the Deltana Borough. Nothing in the agreement is an express or implied approval of the idea of a Borough.

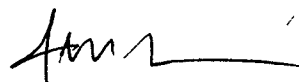
### 3. Recommendations.

As City Attorney, I recommend the City Council approve and enter into the PILT Agreement. There are obvious revenue incentives to the City, and very few identifiable risks or liabilities. The PILT Agreement is beneficial enough to the proposed Borough that the City's approval of it is a responsible decision for the benefit of the City's possible successor municipality. Value is captured from Teck-Pogo that would otherwise be lost to everyone.

If you have questions regarding any of these matters, please let me know.

Sincerely yours,

GUESS & RUDD P.C.



James D. DeWitt

JDD/bkh

Enclosure: PILT Agreement

cc: Pat White, City Clerk

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<sup>4</sup> As noted earlier, the Alaska Legislature can create a Borough, even over the objections of the voters. But that authority is reserved to the Legislature.