PROPERTY TAX ISSUES WITH WEST VIRGINIA STATE TAX DEPARTMENT APPRAISALS OF PRODUCING OIL AND NATURAL GAS WELLS IN THE MARCELLUS SHALE AREA

The Tax Commissioner is responsible for the annual appraisal of producing and reserve oil and natural gas properties. W.Va. Code § 11-1C-10. The Tax Commissioner employs separate mass appraisal methodologies to appraise the working interest and royalty interest in producing oil and natural gas wells. Non-producing oil and natural gas reserves are appraised at nominal values. Legislative Rule – 110 C.S.R. 1J ("Oil and Natural Gas Rule") governs the appraisal of oil and natural gas property.

Producing Oil and Natural Gas Wells. Producing oil and natural gas wells are appraised using an income-based appraisal method in which the gross receipts of the royalty owner and net receipts of the working interest owner are capitalized based on a yield capitalization model to determine the value of each interest. The model is used to produce an income series of production receipts that are proportionately reduced over time by application of appropriate production decline rates. One of the critical variables of the model is the selection of the appropriate production decline rates for use in to determining the estimated annual reduction in production revenue for each producing strata in each oil and natural gas producing region of the state. The resulting income from the well is then apportioned between the working interest and royalty interest based on their applicable percentage of production receipts.

Valuation of the Working Interest. Income apportioned to the working interest is reduced by the annual operating expenses allocable to the well. The net working interest income stream is then discounted to present value to determine the market value of the working interest in the producing oil and/or natural gas well. The value determined by this method for the working interest is deemed to include the value of any machinery and equipment, other personal property and gathering lines used in the production of the oil and/or natural gas from the well.

Valuation of the Royalty Interest. The royalty interest in producing oil and natural gas wells is valued by a method similar to the valuation of the working interest except that no reduction in the royalty interest income stream is allowed for any operating expenses that are the responsibility of the working interest owner.

Problems with the Tax Commissioner's Appraisal of Horizontal Marcellus Wells. We have become aware of several problems that have arisen with the appraisals of producing horizontal wells in the Marcellus Shale region in northern West Virginia. Specifically, these wells generally produce natural gas and liquids at very high volumes and pressures during the period of flush production. However, as the well ages, production falls off rapidly. The Tax Commissioner is currently using production decline tables developed from the study of vertical wells producing in strata other than the Marcellus to determine the decline rate of Marcellus Shale wells. Based on the information we have obtained, the Tax Department's production decline curve may be significantly over-valuing producing wells in the Marcellus Shale region.

The second problem with the valuation of horizontal wells in the Marcellus shale is the Tax Commissioner's limitation of annual operating expenses associated with the working interest in Marcellus horizontal wells to $30,000 of expenses per year. In some cases, this limitation appears to overstate the revenue stream (and appraised value) from such wells by significantly understating reasonable operating expenses.

Property Tax Appeal Procedures. We suggest that taxpayers operating horizontal wells in their Marcellus Shale take a close look at their annual appraisals for the 2013 tax year and be prepared to challenge these appraisals where the mass appraisal methodology used by the Tax Commissioner overvalues the well for property tax purposes. The Tax Commissioner released tentative valuations of producing Marcellus wells around the first of December. When taxpayers receive these valuations, if they appear excessive, there is an opportunity to informally challenge these appraisals by filing a protest with the State Tax Department, Property Tax Division. Taxpayers are not required to informally challenge appraisals that they intend to formally contest, however, in some instances it may be possible to avoid litigation if the State Tax Department is willing to correct an error discovered in the appraisal.

In order to formally challenge the State Tax Department's appraisal of a Marcellus gas well, the taxpayer must file an appeal of the assessment of the well with the County Commission of the county in which the well is located. These appeals must be filed between February 1 and February 20, 2013. County Commissions sit as Board of Equalization and Review to hear challenges to property tax valuations only during the month of February. However, taxpayers who are willing to delay the hearing on their property tax appeals until October of the tax year may request that the County Commission hear their appeals in October when the Commission sits as a Board of Assessment Appeals. Even if a taxpayer elects to go to hearing in October, the appeal of the appraisal must still be filed before February 20, 2013. The disadvantage of delaying the hearing until October is that any relief granted by the Board of Assessment Appeals will be in the form of a credit against the following year's taxes.

Adverse decisions of the Board of Equalization and Review and the Board of Assessment Appeals are appealable to the Circuit Court of the county in which the well is located within 30 days of the date of the decision. Under a law passed last year by the Legislature, it is possible for taxpayers to request their property tax appeals be heard by the newly established Business Court. In order to request that a case be moved to the Business Court, a motion must be filed with the Circuit Judge of the Court in which taxpayer's appeal was filed.

If you have any questions regarding the State Tax Department's valuation of horizontal producing Marcellus Shale wells or about the procedures for appeals such valuations, please feel free to contact John A. Mairs at 304/340-1230 or jmairs@jacksonkelly.com.