Methodology Mishap:

West Virginia Supreme Court Rules Tax Department Misinterpreted Regulation for Assessment of Oil and Gas Wells

INTRODUCTION

The Supreme Court of West Virginia recently overruled the State Tax Department's (the "Department") methodology for calculating the allowed deduction for average annual operating expense for oil and gas wells. In *Steager v. Consol Energy, Inc., et al.*, Consol Energy, Inc., doing business as CNX Gas Company, LLC, and Antero Resources Corporation, as owners of oil and gas wells assessed for *ad valorem* tax purposes, appealed the valuation method used by the Department to formulate the companies' respective assessments for tax years 2016 and 2017. Specifically, the Court held that the Department's methodology for calculating the average annual operating expense deduction was improper under the Department's own regulation and inconsistent with constitutional principles.

BACKGROUND INFORMATION

To determine the value of gas wells for *ad valorem* tax purposes, the Department applies a "production decline rate" to the gross receipts reported by an operator from the operator's well production. The Department then deducts the "average annual industry operating expense" to establish a "net receipts" value, which is then capitalized to determine the taxable value. The Tax Department publishes the average annual operating expense by an administrative notice each tax year – expressed as a percentage of a well's gross receipts with a "not to exceed" cap.

For tax year 2016, the average annual operating expense for conventional wells was estimated to be 30% of an operator's gross receipts, not to exceed $5,000, and the operating expense allowed to be deducted for Marcellus wells was 20% of gross receipts, not to exceed $150,000. For tax year 2017, the average annual operating expense maintained the 20% rate for gross receipts but increased the cap to $175,000.

FACTS

CNX and Antero appealed their assessments to the Board of Assessment Appeals for the county where the companies' wells are located. CNX claimed that its actual operating expenses were 37% of gross receipts for 2016, whereas Antero claimed that its actual operating expenses for 2016 were 23% of gross receipts but increased to 36% of gross receipts for 2017. Each company believed the annual operating expense estimate from the Department was less than the companies' actual operating expenses, and the companies claimed the Department's cap resulted in an artificial reduction in the operating expense deduction. The companies supported their actual expenses with industry-reported data regarding operating expenses. By contrast, the Department's annual operating expense estimate was based on a 2014 survey of various well producers.

Additionally, as to unconventional horizontal wells, the companies claimed that the Department's operating expense estimate did not account for certain production-related costs. As a result, the method used by the Department required operators to report gross receipts based on the field line point of sale. The Department maintained that certain production-related expenses were unrelated to "ordinary expenses" incurred by the companies for the maintenance and production of oil and gas, according to the Department's own administrative rule.

The Assessment Appeal Boards upheld the Department's valuations, and the companies then appealed to the circuit court. After the case was removed to the Business Court Division, the Business Court concluded that the Department failed to assess the companies' wells based on their true and actual value as required by the West Virginia Constitution. In particular, the Business Court ruled that the Department's use of a cap was not supported by state regulations and effectively allowed the Department to limit the deductible operating expenses based on the percentage and cap, which the Business Court found disproportionately affected wells with higher gross receipts and violated the equal and uniform assessment requirement of the West Virginia Constitution.

The Business Court also found that the Department's average operating expense was under-inclusive of operating expenses for unconventional horizontal wells. Specifically, the Business Court noted that the survey utilized by the Department was not updated to include certain production-related expenses incurred for horizontal wells. Ultimately, with respect to conventional wells, the Business Court required the Assessment Appeal Boards to determine a new deductible percentage for conventional wells without a cap, but the Business Court permitted the Department to utilize its percentage to calculate the operating expense estimate for unconventional wells without imposition of a cap.

ANALYSIS

A. Department's Method Utilizing Both a Percentage and Cap

The Court noted that the applicable state regulation for formulating the deductible average operating expense did not include the cap utilized by the Department. In essence, the Court determined that the Department's use of the cap was inconsistent with the requirements of the state regulation. The Court found that the Department was reluctant to revise the cap and percentage consistently, causing wells to be assessed in a dissimilar manner contrary to the West Virginia Constitution's mandate. Further, the Court stated that the Department was unable to offer a reasonable governmental purpose to support its use of both the percentage and cap, and the Court affirmed the Business Court's ruling that the Department's methodology did not satisfy the requirements of applicable state regulations or constitutional protections.

B. Exclusion of Certain Expenses

The Court next addressed whether the Department's methodology for calculating the average annual operating expense was flawed because it failed to take into account certain well-related expenses. As previously mentioned, the applicable state regulation defines operating expenses included within the Department's average to be those that are directly related to the maintenance and production of natural gas and/or oil. The companies argued that the regulation's use of the field line point of sale as the point of calculating gross receipts required the inclusion of certain expenses related to production of gas.

The Court found that the state regulation was ambiguous as to what expenses were directly related to maintenance and production. As a result, the Court applied the *Chevron* standard to determine whether the Department's action was a permissible interpretation of the regulation. The Court ruled that the Department's exclusion of certain production-related expenses from its calculation of the annual operating expense was not an arbitrary action. The Court overruled the Business Court's ruling to the extent it required the Department to include certain production-related expenses in its calculation of the average annual operating expense.

C. Department's Use of Percentage Compared to Average Number

Finally, the Court considered whether the Business Court erred by requiring the Department to use a percentage to calculate the deductible average operating expense. Importantly, the Court found that the state regulation did not provide for a pro rata deduction of operating expenses. The regulation instead requires the average annual industry operating expense be deducted from working interest gross receipts. Based on the language of the regulation, the Court ruled that the Department was required to utilize a fixed number for the allowable average operating expense deduction.

CONCLUSION

The Court distinguished the present case from a recent appeal of the Department's methodology for appraising coal for *ad valorem* tax assessment purpose. In *Murray Energy Corp. v. Steager, et al.*, No. 18-0018, 2019 WL 1982993 (W. Va. Apr. 29, 2019), coal owners claimed that alternative methods of calculation better calculated the value of coal for *ad valorem* assessment. Although the *Murray Energy* court recognized that alternative methods of assessment might exist, the Court ultimately afforded the Department great deference in holding that the Department's methodology satisfied applicable state regulations concerning the assessment of coal for *ad valorem* tax purposes.

By contrast, the oil and gas companies in *Consol Energy, Inc*. specifically challenged the Department's methodology as a misapplication of the applicable state regulation. The *Consol Energy, Inc*. court noted that the oil and gas companies did not directly contest the regulation; rather, the primary issue of the case was the Department's chosen interpretation and implementation of state regulation. The *Consol Energy, Inc*. court correctly determined that the Department's methodology was improper under applicable state regulation and inconsistent with constitutional requirements.

ABOUT THE AUTHOR

***Evan Conard** is a member of the Bowles Rice Energy Team. Contact him at (304) 347-1730 or via email at econard@bowlesrice.com.*