More Changes to West Virginia Oil & Gas Property Tax Valuation

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Authors:

Joseph (Joe) Ward
Craig A. Griffith

The West Virginia Legislature passed H.B. 4336 on March 11. It is the second piece of legislation in as many years aimed at changing the methodology the State Tax Department must use for oil, gas and natural gas liquids (NGL) property tax valuation.

In 2021, the Legislature passed H.B. 2581, requiring the Tax Commissioner to promulgate a legislative rule adopting a valuation methodology that applies a yield capitalization model to net proceeds for a particular well. That legislation was a response to a 2019 decision by the Supreme Court of Appeals of West Virginia striking down part of the Tax Department's methodology for calculating the allowed operating expense deduction, finding it was inconsistent with the department's own legislative rule. See *Steager v. Consol Energy, Inc.*, 242 W. Va. 209, 832 S.E.2d 135 (2019).

The department had been calculating the deduction based on gross receipts of well production and a cap set by the department. The Court ruled that the department's use of a cap for operating expenses was improper and instead required the department to use a singular monetary average for annual industry operating expenses. However, on the important issue of including, gathering, compressing, processing, and transportation expenses in the calculation of operating expenses, the Court held that the department's decision to exclude them from the appraisal methodology was not arbitrary, capricious, or manifestly contrary to the statute. The Court also found that, in addition to inaccurate assessments, the methodology resulted in oil and gas wells being inconsistently assessed from county to county, contrary to the West Virginia Constitution's mandate of uniform taxation.

H.B. 2581 required the Tax Commissioner to propose an emergency rule by July 1, 2021—which he did—setting forth a valuation methodology that applies a yield capitalization model to net proceeds for a particular well. The bill defined "net proceeds" as actual gross receipts on a sales volume basis determined from the actual price received by the taxpayer as reported on the taxpayer's

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return, less royalties and less actual annual operating costs as also reported on the taxpayer's return. In addition, it defined "actual annual operating costs" to include lease operating expenses, lifting costs, gathering, compression, processing, separation, fractionation, and transportation charges, thus preventing the department from excluding these expenses from the appraisal methodology going forward.

When the Tax Commissioner's emergency rule was taken up by the Legislature in January of 2022, it was met with opposition in the legislative rulemaking review process from industry and county governments alike. Ultimately, the Legislature opted not to approve the emergency rule, which would have made it permanent. Instead, it introduced and passed H.B. 4336.

Building on H.B. 2581, H.B. 4336 further specifies how the tax department is to apply the yield capitalization model for all assessments, including that it must consist of a working interest model and a royalty interest model and that, together, they would represent the fair market value of the property. H.B. 4336 also codifies the various types of expenses that the department will be required to include in actual annual operating costs, rather than leaving the determination up to the department through its rulemaking authority. Similarly, "capitalization rate" is now defined in the West Virginia code, a crucial factor in the application of the yield capitulation model used to value-producing wells.

H.B. 4336 also adds a safe harbor provision for marginal well costs under which marginal well producers would have the option of choosing a safe harbor amount to be determined by the tax department rather than calculating an actual annual operating cost and filing a detailed return. The safe harbor amount is to be based on the costs of producing oil, natural gas and/or NGLs typical in the given geographical and geological location. Critically, the bill also includes a sunset date of July 1, 2025, meaning the Legislature will need to extend or replace the valuation methodology in three years.

H.B. 4336 is now under consideration by Governor Jim Justice. If signed into law by the Governor, the legislation would go into effect on June 9, 2022.

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H.B. 4336 was not the only important legislation passed by the West Virginia Legislature this year affecting the oil and natural gas industry. Click here to read what to expect from West Virginia broadening the Cotenancy Statute and adopting the long-sought-after unitization legislation.

For more information on these issues, please contact Joe Ward, Craig Griffith, or any attorney with Frost Brown Todd's Energy Oil & Gas industry team or Tax practice group.

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