West Virginia's Malleable Approach to Taxation of Natural Gas

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Since 2015, various natural gas producers have pursued appeals against the West Virginia Tax Department regarding the method used to value producing natural gas wells. The appeals have been filed primarily by companies that produce natural gas from horizontal wells, predominantly in the Marcellus Shale region. The main focus of the appeals has been the Tax Department's denial of deductions for postproduction expenses in its net-income-based valuation model.

This article discusses the current version of the legislative rule used to value producing natural gas wells in West Virginia, several years' worth of litigation that has resulted from the Tax Department's interpretation of provisions of the legislative rule, and recent efforts by the Tax Department and the natural gas industry to address flaws in the valuation model.

I. Current Legislative Rule

The current version of the legislative rule for the "Valuation of Producing and Reserve Oil and Natural Gas for Ad Valorem Property Tax Purposes"[1] was passed in 2005, when most natural gas wells in West Virginia were conventional vertical wells. As a result, many of the concepts associated with horizontal wells with longer lateral lengths are not addressed in the rule, including the application in the Tax Department's net-income-based model of postproduction expenses like gathering and compression, transportation, and processing.

To appraise producing oil and natural gas wells, the Tax Department requires producers to report gross receipts information based on the "field line point of sale" of the oil or natural gas.[2] While "field line point of sale" is undefined in the legislative rule, the Tax Department has always interpreted it as the point where possession of the oil or natural gas changes hands between the

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producer and buyer, regardless of the proximity of that point to the wellhead. Gross receipts are then adjusted for "production decline to reflect the income available to the property owner beginning with the July 1 assessment date to June 30 next succeeding the assessment date.[3] The adjusted gross receipts figure for a producer's working interest in a producing well is then reduced by average operating expenses to arrive at a net-income-based income series, and a capitalization rate is then applied to the net income series to arrive at the appraised value for the working interest in a producing well for the upcoming property tax year, with the producer's working interest valued as personal property.[4]

Operating expenses are defined as "only those ordinary expenses which are directly related to the maintenance or production of natural gas and/or oil. These expenses do not include extraordinary expenses, depreciation, ad valorem taxes, capital expenditures or expenditures relating to vehicles or other tangible personal property not permanently used in the production of natural gas or oil."[5] In the past, the Tax Department has allowed an operator's actual operating expenses to be applied only in specific instances, and instead generally applies "average annual industry operating expenses per well."[6] The Tax Department calculates this average operating expense figure using a periodic survey that it distributes to producers.

II. Litigation

During tax years 2015-2020, multiple producers protested their well valuations, appearing before various county commissions sitting as either a board of assessment appeals or a board of equalization and review.[7] The primary issue raised by producers in the appeals was the application of operating expenses in valuing producing wells. The Tax Department calculated operating expenses as a function of gross receipts, as noted above, but applied a maximum operating expense dollar amount, along with a percentage working interest expense for a producing well. For example, from 2015 to 2019, the maximum operating expenses for a horizontal

Marcellus or Utica Shale well ranged from $150,000 to $175,000, with operating expenses of 20 percent of gross receipts allowed for

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lower-producing wells.[8] Producers objected to the imposition of a "maximum amount," and argued that the operating expenses allowed by the Tax Department did not include postproduction expenses. To capture postproduction expenses, producers argued that no maximum amount or "cap" should be applied and that average annual industry operating expenses should be a percentage of gross receipts, which would allow for expenses to fluctuate based on the volume of production for individual wells.

The West Virginia Supreme Court of Appeals addressed the producers' arguments in *Consol Energy*.[9] The matter included the consolidated appeals of Consol Energy Inc., d/b/a CNX Gas Co. LLC, and Antero Resources Corp. The court held that it is clear "the Tax Department's use of a percentage deduction limited by use of a 'not to exceed' amount or 'cap' is neither authorized by nor consistent with" W. Va. Code St. R. section 110-1J-1 et seq.[10] According to the court, use of a not-to-exceed limitation "along with a percentage deduction violates the 'equal and uniform' requirement of West Virginia Constitution Article X, Section 1, as well as the equal protection provisions of the West Virginia and United States Constitutions."[11] As noted by the court, the constitutional issues stem from the "use of two differing formulas to calculate operating expenses, which results in some wells receiving the full benefit of the [operating expense] deduction and others being denied it."[12]

However, the supreme court did not agree with the producers' arguments that operating expenses should be calculated using only a percentage of gross receipts, holding that "the provisions contained in West Virginia Code of State Rules [sections] 110-11-4.1 and 110-1J-4.3 for a deduction of the average annual industry operating expense requires the use of a singular monetary average deduction.[13] This overturned the business court's holding that the legislative rule allowed only "average annual industry operating expense" to be calculated based on a percentage of gross receipts.[14]

Also, the court overturned the business court's decision regarding postproduction expenses, noting that "the Legislature has not, in its enabling statute, spoken to the issue of whether a Marcellus well average operating expense calculation must necessarily include

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gathering, compressing, processing, and transporting or 'post-production' expenses."[15] The court further held that "the legislative rules likewise do not specify whether expenses 'directly related to the maintenance and production of natural gas' include expenses which are incurred from the time the gas is extracted from the ground but before the gas reaches the buyer. West Virginia Code of State Rules [section] 110-1J-3.16 provides that such expenses expressly *do not* include 'extraordinary expenses, depreciation, ad valorem taxes, capital expenditures or expenditures relating to vehicles or other tangible personal property not permanently used in the production of natural gas or oil.' However, there is no indication that gathering, compression, processing, or transporting expenses fall within any of these excluded categories."[16]

Given the gap or ambiguity on the issue of postproduction expenses, the court stated that the Tax Department's interpretation of the legislative rule to disallow postproduction expenses would stand "unless it is 'arbitrary, capricious, or manifestly contrary to the statute.'"[17] The court could not "say that the Tax Department's position that gathering, compressing, processing, and transporting expenses are not 'directly related' to the 'maintenance and production' of natural gas is arbitrary, capricious, or manifestly contrary to the enabling taxation statute."[18] The court thus held that "the Tax Department's exclusion of these expenses from its average expense calculation is a reasonable construction of the regulation and not facially inconsistent with the enabling statute," and found that "the business court's conclusion that such expenses must necessarily be included in the Tax Department's average operating expense calculation to be erroneous."[19]

Recent Tax Department Guidance

A. Reversal of Prior Position

On June 30 the tax commissioner issued an "Important Notice to Producers of Natural Gas and Oil for Property Tax Year 2021."[20] While noting that the property tax return for tax year 2021 is essentially identical to returns filed for prior years, the tax

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commissioner indicated that he was amending the policy regarding the reporting of gross receipts from sales of natural gas and oil at the "field line point of sale."[21] He said that "when sale of the natural gas or oil produced from a well is not sold in a field line sales transaction, then the gross proceeds of sales derived from the sales transaction needs to be adjusted to approximate the gross receipts you would have received had the sale been a field line sales transaction."[22] Further, the commissioner conceded that natural gas is often not sold in field line sales transactions, and "to avoid having your well overvalued for property tax purposes, it is important that you appropriately adjust actual gross proceeds of sale to properly reflect gross receipts you would have received had the sales transaction been a field line point of sale."[23] The commissioner's notice essentially embraced many of the arguments made by the producers in *Consol Energy*, namely that the application of postproduction expenses is necessary to arrive at a field line point of sale gross proceeds amount.

The proposed change to the method for reporting of gross receipts represented a complete reversal of the Tax Department's policy. The department has consistently equated the field line point of sale to the producer's point of sale for natural gas or oil - that is, where the natural resource is transferred to the possession of the purchaser. The term "field line point of sale" is referenced twice under the legislative rule that is used for valuation of producing natural gas and oil wells: (1) "'Gross receipts' means total income received from production on any well, at the *field line point of sale*, during a calendar year before subtraction of any royalties and/or expenses";[24] and (2) "'Personal property' used in oil or natural gas production means machinery and equipment in and about the well and all other tangible personal property used in oil and/or natural gas production from the well to the *fieldline point of sale*. It shall not include vehicles or other tangible personal property not permanently used in production."[25]

The problematic omission of a definition of field line point of sale has never been addressed in the Tax Department's Form STC-1235, "West Virginia Oil and Gas Producer/Operator Return" or the return's instructions. The return itself states that "gross receipts are field line receipts."[26] The instructions to the return reference "field

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line receipts" when discussing total oil receipts and total gas receipts, but provide no additional guidance regarding the "field line."[27] Neither do the additional instructions for the return reference points of sale.[28]

During multiple hearings for multiple producers between 2015 and 2020, when the Tax Department's primary witness was asked whether the department provided guidance regarding a point of sale other than where the natural gas or oil changed possession between the producer and the purchaser, she consistently said that no alternative point of sale was included in the property tax returns or instructions. Rather, taxpayers were to base gross receipts on the point where the purchaser took possession.[29] Producers have consistently reported gross receipts based on the gross proceeds received at the actual point of sale of the natural gas or oil, and not based on an adjusted amount to "properly reflect gross receipts [they] would have received had the sales transaction been a field line point of sale."

B. A Reversal of the Reversal

Unquestionably, a large number of producers timely filed their property tax year 2021 Forms STC-1235 by August 1, 2020, with gross receipts adjusted to arrive at a field line point of sale value, based on the guidance provided by the tax commissioner in his June 30 notice. However, *after* the producer/operator returns were filed, the commissioner made the puzzling decision to withdraw his June 30 guidance.[30] The commissioner said that "after further consideration, it is my determination that the 2021 TY Notice was issued without legal authority, was void, and is ineffective. It is also my determination that it must be withdrawn."[31]

The tax commissioner listed several explanations for his withdrawal of the notice. First, he said that it represented a "material and substantive" change to the Tax Department's legislative rule for the property taxation of oil and natural gas wells. Second, he pointed to *Consol Energy* for the proposition that the Tax Department should use a "singular monetary average" to calculate operating expenses and that the department was warranted in excluding postproduction expenses from the operating expense calculation.

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[32] The commissioner posited that he was only permitted to change the Tax Department's long-standing construction of operating expenses by amending the legislative rule or by amending the West Virginia Code.[33]

The tax commissioner ends the withdrawal notice by saying that when valuing oil and natural gas wells for tax year 2021, the Tax Department will review the information included on the producer/operator returns, "along with other sources of data available to the agency. This will include a review of the best information available to determine whether a taxpayer took an impermissible deduction from gross proceeds outside of that allowed for the 'average annual industry operating expense.[34] The commissioner does not clarify what constitutes an impermissible deduction, because any deductions claimed by producers to arrive at a field line point of sale gross proceeds amount were based on explicit guidance circulated by the commissioner that such adjustments were permissible.[35]

Perhaps more frustrating than the release of diametrically opposed guidance in a three-month timespan is the tax commissioner's misreading of the supreme court's decision in *Consol Energy*. In his withdrawal notice, the commissioner says that according to the precedent of that case, "post-production expenses — like 'gathering, compressing, processing and transportation' expenses — are not 'directly related' to the 'maintenance and production' of oil and gas and therefore, are not included in the average annual industry operating expense deduction. [Citation omitted.] Inasmuch as *Consol Energy* affirmed the Tax Department's refusal to allow deductions for post-production expenses, the continued denial of these deductions does not over-value the oil and gas wells in this State."[36] Quite simply, the West Virginia Supreme Court never affirmed the Tax Department's refusal to allow postproduction expenses based on a determination that such expenses are not directly related to the maintenance and production of oil and natural gas, nor was any precedent set regarding the allowance of such expenses. Instead, the court recognized that the legislative rule was silent regarding postproduction expenses and that "the Tax Department's position that gathering, compressing, processing, and transporting expenses are not 'directly related' to the 'maintenance

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and production' of natural gas" was not arbitrary, capricious, or manifestly contrary to the enabling tax statute.[37] The court did not impose upon the parties its own construction of the legislative rule, noting that "such an interpretation is well beyond the reach of this Court under the circumstances" and that the Tax Department's exclusion of postproduction expenses was "reasonable construction of the regulation and not facially inconsistent with the enabling statute."[38]

The tax commissioner undoubtedly was aware of the lack of precedent set by the supreme court when he released the initial notice to producers June 30. If the supreme court had actually held that postproduction expenses are not directly related to the maintenance and production of a producing oil or natural gas well, the commissioner would never have issued the release, as it would have defied precedent established by the court. Most likely, he based his initial reversal regarding postproduction expenses on the court's determination that the commissioner's construction of language "gaps" in a legislative rule will be upheld if reasonable, and not arbitrary, capricious, or manifestly contrary to the enabling statute. While the June 30 guidance regarding postproduction expenses represents a reversal of prior positions taken by the Tax Department, there was nothing inherently unreasonable about the new guidance, and it was within the tax commissioner's authority to change positions because the legislative rule is silent on the issue of postproduction expenses.

IV. Proposed Amendments to Legislative Rule

A. Working Toward an Equitable Model

Between the time the tax commissioner issued the guidance regarding postproduction expenses and then withdrew it, the Tax Department began revising the rule used to value producing and reserve natural gas and oil properties. On August 21 the department submitted a Notice of Public Comment Period with revisions to W. Va. Code R. section 110-1J-1 et seq. to the secretary of state.[39] Within 90 days from the end of the public comment period, a state agency is authorized to modify proposed amended rules to

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incorporate comments. All draft rules are then filed with the Legislative Rule-Making Review Committee, along with received comments and agency responses.[40] The committee may present draft rules as submitted during the 2021 regular legislative session, or it may suggest changes, which would be made by state agencies and filed again with the committee as a modified rule to be presented during the upcoming legislative session.

However, agencies have the option of withdrawing a proposed rule altogether, which the Tax Department did regarding the proposed rule for oil and natural gas properties, as discussed in the next section.

The now-withdrawn draft rule proposed adopting several concepts that would have resulted in a significant improvement over the current method, including use of regional price indices to calculate gross receipts,[41] a deduction for postproduction expenses associated primarily with horizontal wells,[42] and calculation of operating and postproduction expenses based on the volume produced by the well.[43]

Furthermore, the withdrawn draft rule tried to provide far more detail in terms of well categories, which would theoretically allow the Tax Department to apply the appropriate amount of operating and postproduction expenses for each well.[44] Also, the withdrawn draft rule required that the Tax Department include in its annual natural resource property valuation variables report more information regarding the calculation of the variables, including "information about the components of the capitalization rates, the sales price of various natural resource products, the method used to determine the various weighted averages, and the annual average industry operation and post-production operating expenses for each category and subcategory of well."[45]

Despite these positive changes, public comments from entities in the oil and natural gas industry suggested that the draft rule would benefit from some additional amendments and clarification. The now-withdrawn draft rule provided that average annual industry operating and postproduction expenses for various categories and subcategories of producing wells are to be calculated using an annual survey.[46] A better method would be to leverage publicly

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available expense information, because a large percentage of producers in West Virginia are public entities that are required to file annual 10-K reports with the Securities and Exchange Commission. The 10-Ks include detailed expense information pertaining to lease operating expenses; gathering, compression, processing, and transportation expenses; production and ad valorem taxes; net marketing expenses; depletion, depreciation, amortization, and accretion; and general and administrative expenses. Using this publicly available information, rather than confidential surveys, would allow producers to better predict annual operating and postproduction expenses, and it would alleviate many of the tax confidentiality concerns that the Tax Department may have in demonstrating its calculations of expenses. If the department continues its current method of calculating operating and postproduction expenses via a periodic survey, it should provide detailed supporting information on its annual valuation variables document to demonstrate how such expenses are calculated.

Also, the withdrawn draft rule used 1,000 cubic feet as the volume measurement unit for calculating the gross receipts and operating and postproduction expenses for producing natural gas wells.[47] However, the regional published indices that the Tax Department referenced in the draft rule use $/dekatherms (dth) as the price point for natural gas sales. While $/dth can be converted to $/mcf, the Tax Department could avoid the necessity of a conversion calculation by valuing natural gas using $/dth for calculating both gross receipts and operating and postproduction expenses for wells.

The Tax Department has historically subjected natural gas liquids to property taxation under the current version of the legislative rule. However, neither the West Virginia Code nor the current version of the legislative rule[48] use or define the term “natural gas liquids.” A strong argument can be made by producers that the Tax Department does not have the statutory authority to tax natural gas liquids, because the state code specifically defines the types of products that constitute “natural resources.”[49] Also, many natural gas producers transport natural gas liquids out of West Virginia, where the liquids are then processed and sold. Subjecting natural

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gas liquids that are processed in other states to tax could lead to federal due process and commerce clause challenges by producers.

The market for natural gas liquids is highly volatile, with prices fluctuating drastically, and there are no regional natural gas liquid price indexes in West Virginia. In lieu of taxing natural gas and natural gas liquids separately, as contemplated in the draft rule, a dth-based wellhead volume could be used to tax every molecule of natural resource produced by a well. The total wellhead dth volume would include both natural gas and natural gas liquids, and this volume would be multiplied by the appropriate dth-based regional price index. Operating and postproduction expenses, based on $/dth, would then be subtracted from the gross receipts for each well.

While the draft rule provided for the sharing of some information regarding well valuation components,[50] stronger provisions are needed to ensure that aggregate production and expense information is in the annual valuation variables document.

B. Withdrawal of the Proposed Rule

The tax commissioner, after receiving public comments on the proposed rule, sent a letter November 16 to members of the Rule-Making Review Committee and the secretary of state stating that the Tax Department had decided to withdraw the proposal from further consideration. Instead, the Tax Department anticipates that it will submit legislation addressing property taxation of oil and natural gas wells during the 2021 regular session.

The tax commissioner provided no detail regarding the public comments that were received, nor has draft language regarding the proposed bill been made available. It is possible that the bill to be introduced will address issues raised by commentators.

V. Conclusion

The June 30 notice for tax year 2021 and the proposed amendments to the legislative rule tried to address many of the issues that the natural gas industry has had with the Tax Department's method for valuing producing wells for property tax

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purposes. However, the withdrawal of both has left oil and gas producers in limbo, unable to forecast their property taxes pending the possible legislation that the Tax Department anticipates introducing during the 2021 legislative session.

For more information, please contact any member of the Frost Brown Todd Tax practice group.

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[1] W. Va. Code R. section 110-11-1 et seq.

[2] W. Va. Code R. section 110-1J-3.8.

[3] W. Va. Code St. R. section 110-1J-4.6.

[4] W. Va. Code St. R. sections 110-1J- 4.1 and 4.6.1.

[5] W. Va. Code St. R. section 110-1J-3.16.

[6] W. Va. Code St. R. section 110-1J-4.3.

[7] The author served as counsel for various producers who pursued valuation appeals.

[8] *See West Virginia Register*, "Final Natural Resource Property Valuation Variables" for tax years 2015-2019.

[9] *Steager v. Consol Energy Inc.*, 242 W. Va. 209, 220, 832 S.E.2d 135, 146 (2019).

[10] *Id.* at 221, 147.

[11] *Id.* at Syl. Pt. 8 and at 221, 147.

[12] *Id.* at 221, 147.

[13] *Id.* at 225, 151.

[14] *Id.*

[15] *Id.* at 222, 148.

[16] *Id.* at. 223, 149 (emphasis in original).

[17] *Id.* (citing *Appalachian Power Co. v. State Tax Department of West Virginia*, 195 W. Va. 573, 589, 466 S.E.2d 424, 440 (1995) (quoting *Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.*, 467 U.S. 837, 844 (1984)).

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[18] *Id.* at. 223, 149.

[19] *Id.* at. 223-224,149-50.

[20] Dale W. Steager, state tax commissioner, "Important Notice to Producers of Natural Gas and Oil for Property Tax Year 2021" (June 30, 2020).

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] See W. Va. Code IL section 110-1J-3.8 (emphasis added).

[25] See W. Va. Code R. section 110-1J-3.18 (emphasis added).

[26] Form STC-1235, "West Virginia Oil and Gas Producer/Operator Return."

[27] Filing instructions for Form STC-1235.

[28] Additional instructions for Form STC-1235.

[29] *See, e.g.,* transcript of Antero Resources Corp.'s October 30, 2018, hearing before the Tyler County Commission sitting as a Board of Assessment Appeals. "Q: On the [producer/operator] returns, producers are expected to report their revenues based on the fieldline point of sale? A: Correct. Q: Any guidance that provided alternate fieldline point of sale to the producers [?] A: Just gross receipts."

[30] Steager, "Notice of Withdrawal of *Important Notice to Producers of Natural Gas and Oil for Property Tax Year 2021*" (Oct. 9, 2020).

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

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[37] *Consol Energy*, 242 W. Va. at 223, 832 S.E.2d at 149.

[38] *Id.* at 223, 149.

[39] *See* W. Va. secretary of state, Administrative Law, Code of State Rules, Online Data Services, Notice of Public Comment Period to Tax Department Legislative Rule 110-1J.

[40] *See* W. Va. secretary of state, Administrative Law, Code of State Rules, Online Data Services, letter withdrawing the Tax Department's proposed Legislative Rule 110-11.

[41] Draft amended rule, W. Va. Code R. sections 110-1J-5.2, 6.2, and 6.2.1.

[42] *Id.* "'Post-production expense' means an expense or cost subsequent to production, including, but not limited to, an expense or cost related to severance taxes, pipelines, surface facilities, telemetry, gathering, dehydration, transportation, fractionation, compression, manufacturing, processing, treating, or marketing of oil or natural gas and their constituents." Draft amended rule, W. Va. Code R. section 110-1J-3.49.

[43] Draft amended rule, W. Va. Code R. section 110-1J-3.5.

[44] Draft amended rule, W. Va. Code R. section 110-11-10.

[45] Draft amended rule, W. Va. Code R. sections 110-1J-11.2.

[46] The most accurate method for determining the true and actual value of the producing wells would be to use the actual operating and postproduction expenses of each producer. However, the Tax Department notes that the draft rule is intended to apply a "mass appraisal" method, and uses average annual industry operating and postproduction expenses in lieu of actual expenses in furtherance of the mass appraisal method.

[47] *See, e.g.,* draft amended rule, W. Va. Code IL sections 110-1J-35 and 3.67.

[48] *See, e.g.,* W. Va. Code sections 11-6K-2(5) and 11-1C-10(a)(2) or W. Va. Code R. section 110-1J-1 et seq.

[49] Generally, coal mining property, natural gas-producing property, oil-producing property, managed timberland, or "other

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natural resources property" or minerals, including limestone, fireclay, dolomite, sandstone, shale, sand and gravel, salt, lead, zinc, manganese, iron ore, radioactive materials, and oil shale.

[50] Draft amended rule, W. Va. Code R. section 110-11-11.2.

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