

IN THE CIRCUIT COURT OF BARBOUR COUNTY, WEST VIRGINIA

CNX GAS COMPANY LLC,

Petitioner,

v.

Civil Action No. 16-AA-04
The Honorable Alan Moats

THE HONORABLE MARK MATKOVICH,
West Virginia State Tax Commissioner,

THE HONORABLE JOHN M. CUTRIGHT,
Assessor of Barbour County, and

THE COUNTY COMMISSION OF BARBOUR COUNTY,
Sitting as a Board of Assessment Appeals,

Respondents.

COMPLAINT OF PETITIONER CNX GAS COMPANY LLC

I. INTRODUCTION

CNX Gas Company LLC ("CNX") is a producer of natural gas throughout the state of West Virginia, with many wells located in Barbour County.

Those wells are appraised by the West Virginia Department of Revenue, State Tax Department, Property Tax Division (the "Tax Department" or "State") based on a state-wide mass appraisal system. Certain variables are used by the State to value producing oil and natural gas wells, including, notably for this Brief, operating expenses. Specifically, the Tax Department periodically circulates a survey by which it solicits data from oil and natural gas producing taxpayers regarding operating expenses for their wells, and based on that, the Tax Department determines the operating expense variables used in its mass appraisal system. The amount of operating expenses applied to a well using the mass appraisal system is based on a percentage of the well's gross receipts not to exceed a maximum amount, and the percentage and maximum

vary by the type of well (typical or conventional, Marcellus, etc.). The operating expense calculations are included in a natural resources “valuation variables” document that the Tax Department releases annually.

In addition to the valuation variables document, the Tax Department releases an annual administrative notice that lists the percentages and caps for operating expense calculations. In prior years, the Tax Department invited taxpayers to submit actual operating expenses that exceed the percentages and maximum amounts listed in the valuation variables document. In several prior tax years, CNX submitted their actual operating expenses to the Tax Department for consideration. The 2016 administrative notice, unlike administrative notices from 2000 through 2015, however, does not include language that invites taxpayers to submit actual expenses, despite no changes to the West Virginia Code or the Tax Department’s Legislative Rule that governs the valuation of producing natural gas wells. For tax year 2016, CNX had submitted its actual operating expense information to the Tax Department prior to the Tax Department releasing the administrative notice in which it omitted the language inviting taxpayers to submit actual operating expense information.

CNX evaluated its actual operating expenses for calendar year 2014,¹ and determined that for conventional wells and the Marcellus wells in the county, the amount of operating expenses that it was incurring for each of these wells exceeded the maximums set by the state.

The Tax Department’s operating expense allowance fails to consider all the expenses that are necessary to get gas to the point of sale. The Tax Department caps operating expenses at

¹ For property tax purposes, the operating expense data from calendar year 2014 is used to value the wells for tax year 2016.

20% or \$150,000 for Marcellus wells, and 30% or \$5,000 for conventional wells. These caps unduly restrict the amount of operating expenses that should be allowed for each of these wells. By failing to consider CNX's actual operating expenses, the Tax Department overvalued the wells.

On February 17, 2016, CNX protested the Tax Department's valuation (as adopted by the Barbour County Assessor) to the Barbour County Commission sitting as the Barbour County Board of Assessment Appeals (the "Board"). CNX presented clear and convincing evidence that the Tax Department failed to consider CNX's actual operating expenses, or properly apply other valuation variables, as discussed below, in determining the valuation for the wells assessed for Barbour County. CNX also presented an analysis of its actual operating expenses from the state and local tax firm Altus Group US, Inc. ("Altus"), supported by testimony from Kirsten Evans of Altus. The Board, however, made no adjustment to the Tax Department's valuation.

CNX timely petitioned the Court for appeal of the Board's decision. As explained below, the Tax Department has abused its discretion by failing to consider CNX's actual and allowable operating expenses in a manner contrary to the statutes, regulations and official releases from the Tax Department governing valuation of personal property. Moreover, the Tax Department has failed to support its valuation with substantial evidence. CNX, on the other hand, presented clear and convincing evidence for its allowable operating expenses to be used in valuing its wells for tax year 2016, and that the State has overvalued its Barbour County wells.

II. FACTUAL BACKGROUND

A. CNX's Property.

CNX owns gas wells in Barbour County. (Certified Transcript of October 17, 2016 Hearing before the Barbour County Board of Assessment Appeals, See Exhibit A (hereinafter "Hr'g Tr."]²). CNX pays significant taxes to Barbour County for its oil and gas wells.

B. CNX's 2014 Operating Expenses.

CNX's average operating costs for a Marcellus well is 26% of revenue, or \$537,000. (Hr'g Tr. At p. 28:4-28:16). CNX's average operating costs for a conventional well is 37% of revenue, or \$5,898. (*Id.*).

C. The Tax Department's Calculation of CNX's Operating Expenses.

The Tax Department prepares annual natural resource property valuation variables for appraising oil and gas. (Hr'g Tr., Ex. 8). Further, the Tax Department makes determination of those valuation variables pursuant to Series 1J of Title 110, a legislative rule of the Tax Department, promulgated pursuant to W. Va. Code §§ 11-1C-5(b), 11-1C-5a, and 11-1C-10(d). In order to determine the amount of CNX's operating expenses, and, in turn, the value of CNX's oil and gas wells, the Tax Department further is governed by Administrative Notices.

In the past, the Tax Department included a statement in its Administrative Notices indicating that it was willing to consider actual operating expenses if a taxpayer thought that the value of their wells was overstated. (Hr'g Tr. At 69:11-69:17). In 2016, the Tax Department decided that it would no longer consider actual operating expenses. *Id.*

² As fully explained in § II.E, *supra*, the record of CNX's proceedings before the Barbour County Board of Assessment Appeals with Exhibits was timely provided to the Court with CNX's Complaint.

The State caps the allowed operating expenses at 20% of revenue or \$150,000 for Marcellus Wells, and at 30% of revenue or \$5,000 for conventional wells. (Hr'g Tr. At p. 28:4-29:6). Due to the State's failure to take into account CNX's actual operating expenses, the value of CNX's wells is significantly overstated.

CNX timely noticed the Barbour County Commission with its Notice of Protest on February 17, 2016. (*See* Hr'g Tr., Ex. 1). The Barbour County Commission, sitting as the Barbour County Board of Assessment Appeals, held a hearing on October 17, 2016.

At the hearing, the Tax Department offered no credible evidence as the basis for its refusal to accept CNX's calculation of its operating expenses, except to question the apportionment of expenses to individual wells, which are otherwise not individually apportioned in CNX's accounting records. (*See* Hr'g Tr., 62:21 – 63:19). The State further expressed that Series 1J of Title 110 does not require that actual operating expenses be considered. (*See* Hr'g Tr., 66:24 – 71:5). Finally, the Tax Department stated that it was not presented any evidence to show that their model for valuing wells was incorrect. (Hr'g Tr. at 12:18-12:23).

D. CNX's Expert Analysis and Testimony.

CNX's first expert, Altus, a leading independent state and local tax firm, by Kirsten Evans, testified before the Board on October 17, 2016, and showed that a correct application of the allowable operating expenses demonstrated that the Tax Department had erred by failing to allow the operating expenses documented by CNX. (*See* Hr'g Tr., 28:10 – 29:6). A detailed Form 10k that demonstrated CNX's operating expenses was also submitted to the Board. (Hr'g Tr., Ex. 4).

Further, Altus testified regarding an impairment test done by CNX in connection with required Securities and Exchange Commission filings, which provided further evidence that the State had significantly overvalued its wells. (*See* Hr'g Tr. at pp. 32:9-33:6; Hr'g Tr., Ex. 5). This information was provided to the State, but the State did not update the values. (*Id.* at p. 34:2-34:7). Altus further testified that the percentage of operating expenses is increasing as gas prices are going down. (*Id.* at pp. 42:12-43:5).

An expert appraiser from Hein & Associates, Clarence Jim Harden, M.B.A., A.S.A., also testified at the hearing. He testified that he appraised CNX's wells in Barbour County. (*See* Hr'g Tr., 83:15-85:4; *see also* Hr'g Tr., Ex. 7). Mr. Harden explained that the Tax Department's valuation did not properly account for the decline rate or actual operating costs of the wells at issue, and used a different discount rate than his methodology. Mr. Harden valued CNX's Barbour County wells at just over \$40 million, while the State valued them at over \$71 million. (*Id.* at 98:4-98:14).

E. CNX's Protest to the Barbour County Board of Assessment Appeals.

On February 17, 2016, CNX submitted to the Barbour County Assessor and the Barbour County Commission sitting as the Board of Assessment Appeals an Application for Review of Property Assessment with regard to its gas wells (*See* Hr'g Tr., Ex. 1), and CNX appeared on October 17, 2016, by counsel, before the Board. (*See* W. Va. Code § 11-3-24). CNX hired a third party court reporter to produce a certified transcript of the hearing at which it presented the evidence discussed above, a copy of which has been provided to the Barbour County Clerk. Exhibits introduced at the hearing and provided to the Board are appended to the transcript. The

original record of the proceeding was attached to CNX's Petition as Exhibit A. (See W. Va. Code § 58-3-4.)

By October 24, 2016 Order, the Board determined to make no adjustment to the State Tax Department's valuation of CNX's gas wells for the 2016 tax year. (See Ex. B to CNX's Petition). CNX received notice of the Order on October 27, 2016, and CNX timely petitions this Court for relief from the Board's erroneous determination on November 23, 2016. (See W. Va. Code § 11-3-25).

III. ANALYSIS

A. Applicable Legal Standards.

All property in the State of West Virginia is required to "be assessed annually at its true and actual value" W. Va. Code § 11-3-1. The West Virginia State Tax Commissioner³ is charged with determining "the fair market value of all natural resource property in the State" and then providing the values to county assessors to use in assessing the property. W. Va. Code § 11-1C-10(d).

Pursuant to this responsibility to value producing mineral property and reserves, the Tax Commissioner promulgated Title 110, Series 1J of the West Virginia Code of State Rules, which explains the mechanisms to be utilized in valuing taxable property.

To determine the fair market value of producing oil and natural gas property, the Tax Department applies "a yield capitalization model to the net receipts (gross receipts less royalties paid less operating expenses) for the working interest. . . ." W. Va. Code R. § 110-1J-4.1. The

³ Elsewhere in Brief, the Tax Commissioner is variously referred to as the Tax Department or simply the State. All terms refer to the same entity.

methodology set forth in § 110-1J-4.1 is reflected in Tax Department Administrative Notice 2016-02, in which the Tax Commissioner states that the Tax Department primarily relies upon the income approach in valuing producing oil and gas property.

The Tax Department should consider actual operating expenses to offset the presumed valuation of expenses for each well. According to the Tax Department's legislative rule, the Tax Commissioner considers "operating expenses" to be "the "ordinary expenses which are directly related to the maintenance of 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." Section 3.16 of Series 1J, Title 110 State Tax Department Legislative Rule for Valuation of Producing and Reserve Oil & Natural Gas for Ad Valorem Property Tax Purposes. Based on the testimony of CNX's experts, Altus and Mr. Harden, and the documents submitted to the Tax Department and the Board, the operating expenses submitted by CNX are those contemplated in Section 3.14.

CNX's burden before the Board was to show by clear and convincing evidence that the Tax Department's valuation (and, hence, the County's assessment) of its gas well operating expenses was erroneous. Syl. pts. 5-6, *Stone Brooke*, 224 W. Va. 691, 688 S.E.2d 300. On appeal to this Court, the Court relies on the record developed before the Board and determines

whether the challenged property valuation is supported by substantial evidence.⁴ See W. Va. Code § 58-3-4; syl. pts. 1-2, *Stone Brooke*, 224 W. Va. 691, 688 S.E.2d 300.

In this case, the Tax Department failed to apply the demonstrated actual operating expenses supplied by CNX in both informal and formal testimony. Additionally, the Tax Department used an inaccurate decline rate and discount rate. Accordingly, CNX now petitions this Court to find (1) that the Board incorrectly made no changes to the Tax Department's valuation and (2) that CNX's calculation of its allowed actual operating expenses to be used to value its producing natural gas wells is correct and (3) that the decline rate and discount rate used by CNX are correct.

B. The Tax Department Failed to Consider the Actual Operating Expenses of CNX's Gas Wells and, Thus, Failed to Correctly Value that Property; CNX, on the Other Hand, Introduced Clear Evidence of the Allowable Operating Expenses; CNX Also Introduced Clear Evidence Regarding the Proper Decline Rate and Discount Rate for Its Wells.

While the State Tax Department has discretion to select the appraisal method that it determines should provide the most accurate valuation of personal property, once it chooses a method, it must correctly apply the method.

For CNX's conventional wells in Barbour County, the Tax Department has not applied the demonstrated, proven, actual operating expenses, as set forth in CNX's Exhibits and expert testimony at the hearing before the Board on October 17, 2016, and the Tax Department has,

⁴ Furthermore, "[p]ursuant to *In Re Pocahontas Land Co.*, 172 W. Va. 53, 61, 303 S.E.2d 691, 699 (1983), once a taxpayer makes a showing that tax appraisals are erroneous, the Assessor is then bound by law to rebut the taxpayer's evidence." *Mountain Am., LLC v. Huffman*, 224 W. Va. 669, 786 n.23, 687 S.E.2d 768, 785 n.23 (2009). While the Court in *In Re Pocahontas Land Co.* suggested that a county assessor could meet that burden by introducing the State Tax Department's valuation, in this case, CNX showed that the State Tax Department's valuation itself is incorrect, so it was incumbent on the State Tax Department to rebut CNX's evidence.

therefore, failed to apply its own rules in calculating the fair market value of CNX's conventional wells. It is also improper for the Tax Department to place a cap on operating expenses, another factor resulting in an inflated value for CNX's conventional wells.

For CNX's Marcellus wells in Barbour County, the Tax Department has not followed its own rules regarding average industry operating expenses, as set forth in CNX's Exhibits and expert testimony at the hearing before the Board on October 17, 2016, and the Tax Department has, therefore, failed to properly calculate the fair market value of CNX's Marcellus wells. It is also improper for the Tax Department to place a cap on operating expenses, another factor resulting in an inflated value for CNX's Marcellus wells. As demonstrated at the hearing, the survey used by the Tax Department to calculate average industry operating expenses for Marcellus wells was poorly drafted and misleading and resulted in the Tax Department calculating an operating expenses "cap" well below the amount of operating expenses actually required to operate a Marcellus well. CNX avers that not only is a "cap" not supported by law, but that the Tax Department also calculated a wildly inaccurate "cap."

Finally, the Tax Department's valuation of CNX's wells did not properly account for the decline rate or discount rate. As a result, CNX's wells were overvalued.

IV. CONCLUSION

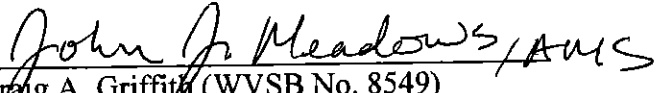
WHEREFORE, CNX Gas Company LLC respectfully requests that the Court:

(i) Find that the Barbour County Board of Assessment Appeals incorrectly upheld the valuation of CNX's Barbour County gas wells by the West Virginia Department of Revenue, State Tax Department, Property Tax Division for the 2016 tax year;

- (ii) Fix the value of CNX's Barbour County gas wells for the 2016 tax year at its true and actual value of \$40.3 million, as calculated by Hein & Associates and based on the actual direct operating expenses incurred by CNX, the amended production decline rate and the different discount rate, for the 2014 calendar year; and
- (iii) Order such other relief as the Court deems appropriate.

CNX GAS COMPANY LLC,

By Counsel


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**EXHIBITS ON FILE
IN THE SUPREME
COURT CLERK'S
OFFICE AND THE
CIRCUIT COURT OF
BARBOUR COUNTY**