

IN THE CIRCUIT COURT OF LEWIS COUNTY, WEST VIRGINIA

CONSOL ENERGY INC.
DBA CNX GAS COMPANY LLC,

Petitioner,

v.

Civil Action No. 17-AA-11
The Honorable **KURT W. HALL**

THE HONORABLE MARK MATKOVICH,
West Virginia State Tax Commissioner,

THE HONORABLE JOHN L. BREEN,
Assessor of Lewis County, and

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

Respondents.

COMPLAINT OF PETITIONER CONSOL ENERGY INC.
DBA CNX GAS COMPANY LLC

I. INTRODUCTION

CONSOL Energy Inc. dba CNX Gas Company LLC ("CNX") is a producer of natural gas throughout the state of West Virginia, with many wells located in Lewis 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

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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, and determined that for conventional wells in the county, the amount of operating expenses that it was incurring for each well exceeded the maximums set by the state. For property tax purposes, the operating expense data from calendar year 2014 is used to value the wells for tax year 2016.

The Tax Department caps operating expenses at the lesser of 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 Lewis County Assessor) to the Lewis County Commission sitting as the Lewis 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 in determining the valuation for the wells assessed for Lewis 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 Nancy Sitton 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 Lewis County wells.

II. FACTUAL BACKGROUND

A. CNX's Property.

CNX owns 864 conventional gas wells in Lewis County. (Certified Transcript of October 24, 2016 Hearing before the Lewis County Board of Assessment Appeals, See Exhibit A [hereinafter "Hr'g Tr."], Ex. 1). CNX pays significant taxes to Lewis County for its oil and gas wells.

B. CNX's 2014 Operating Expenses.

CNX submitted proof of its actual operating expenses from 2014 to the Tax Department for consideration for tax year 2016. CNX's average operating costs for a conventional well is 37% of revenue, or \$5,800. (Hr'g Tr., p. 13:20-14:23, Ex. 4). Ultimately, the Tax Department did not adjust the operating expenses it used to value CNX's wells in Lewis County for tax year 2016.

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 p. 12:9-13:9). In 2016, the Tax Department

decided that it would no longer consider actual operating expenses. (Hr'g Tr. at p. 39:6-39:14; 12:9-13:9). 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. (Hr'g Tr. at p. 13:10-13:13).

The State caps the allowed operating expenses at the lesser of 30% of revenue or \$5,000 for conventional wells. (Hr'g Tr. at pp. 16:22-17:1). Due to the State's failure to take into account CNX's actual operating expenses, the value of CNX's wells is significantly overstated. The State valued CNX's wells at \$26.7 million, whereas CNX, using the State's mass appraisal model and CNX's actual operating expenses, appraised them at \$18.1 million. (Hr's Tr. at p. 18:14-18:23). CNX also hired an expert, Hein & Associates, to appraise the true and actual value of the wells. Hein & Associates appraised the wells at \$14.2 million. (Hr'g Tr. at pp. 30:20-31:4).

CNX timely noticed the Lewis County Commission with its Notice of Protest on February 17, 2016. (*See* Hr'g Tr., Ex. 1). The Lewis County Commission, sitting as the Lewis County Board of Assessment Appeals, held a hearing on October 24, 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 argue that the State's current procedures are in accordance with the legislative rules and the law, and that it would be impractical and an administrative burden to consider actual operating expenses. (Hr'g Tr., at pp. 36:8-41:6).

D. CNX's Expert Analysis and Testimony.

CNX's expert, Altus, a leading independent state and local tax firm, by Nancy Sitton, testified before the Board on October 24, 2016, and showed that a correct application of the allowable operating expenses demonstrated that the Tax Department erred by failing to allow the operating expenses documented by CNX. (*See Hr'g Tr.*, at pp. 8:20-27:24). At the hearing, detailed charts and documentation of actual operating expenses, with numbers specific to Lewis County, were submitted to the Board. (*see Certified Record, Petitioner's Exhibits, 3, 4, 5, 6, and 10*). Among those documents was CNX's Form 10k, which was filed with the Securities and Exchange Commission ("SEC"), and detailed CNX's actual operating expenses.

Further, Ms. Sitton testified regarding an impairment test conducted by CNX in connection with required SEC filings, which provided evidence that the State had significantly overvalued its wells. (*Hr'g Tr. at pp. 15:14-16:8, Ex. 5*). Ms. Sitton also testified that the percentage of operating expenses is increasing as gas prices are going down. She explained that expenses have not changed, but because revenues have decreased, the State's cap places an artificially low ceiling on the operating expenses that CNX is allowed to take. (*Hr'g Tr. at pp. 17:12-18:23*). She testified that, as a result, the values derived from the State's methodology are in excess of the true value of the wells. Finally, Altus valued CNX's wells in Lewis County at \$18.1 million, based on the actual direct operating expenses incurred by CNX. (*Hr's Tr. at p. 18:14-18:23*).

An expert appraiser from Hein & Associates, Clarence James Harden, also testified at the hearing. Hein & Associates appraised the fair market value CNX's wells in Lewis County. (*Hr'g*

Tr. at p. 28:21-28:23). Mr. Harden explained that the Tax Department's valuation did not properly account for actual operating costs of the wells at issue, and used a different decline and discount rate than Hein & Associate's methodology. (Hr'g Tr. at pp. 28:24-30:19). Hein & Associates valued CNX's Lewis County wells at \$14.2 million, while the State valued them at \$26.7 million. (Hr'g Tr. p. 30:20-31:4).

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

On February 17, 2016, CNX submitted to the Lewis County Assessor and the Lewis 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 24, 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. Exhibits introduced at the hearing and provided to the Board will also be transmitted to the Court within thirty (30) days, as provided by West Virginia Code § 11-3-25. The original transcript of the proceeding is attached to CNX's Petition as Exhibit A. (*See* W. Va. Code § 58-3-4.)

By December 27, 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 January 3, 2017, and CNX timely petitions this Court for relief from the Board's erroneous determination on January 25, 2017. (*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 Commissioner¹ 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 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

¹ 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.

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 expert, Altus, 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.² 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. 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.

² 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.

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.

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 Lewis 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 24, 2016. The Tax Department has, 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. Additionally, by capping the allowed operating expenses at the lesser of 30% of revenue or \$5,000, the Tax Department treats similarly situated tax payers differently in violation of United States Constitution and the West Virginia Constitution, as the "cap" of \$5,000 only adversely affects tax payers that have wells that produce revenue over a certain threshold.

IV. CONCLUSION

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


- (i) Find that the Lewis County Board of Assessment Appeals incorrectly upheld the valuation of CNX's Lewis 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 Lewis County gas wells for the 2016 tax year at its true and actual value of \$14.2 million, as calculated by Hein & Associates and based on the actual direct operating expenses incurred by CNX; and

(iii) Order such other relief as the Court deems appropriate.

CNX GAS COMPANY LLC,

By Counsel



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Exhibits are on file in the

WV Supreme Court Clerk's
Office

and the

Lewis County Circuit Clerk's
Office.