

IN THE CIRCUIT COURT OF HARRISON COUNTY, WEST VIRGINIA

CONSOL ENERGY INC.
DBA CNX GAS COMPANY LLC,

Petitioner,

v.

Civil Action No. 17-S-142
The Honorable McCarthy

THE HONORABLE DALE W. STEAGER,
West Virginia State Tax Commissioner,

THE HONORABLE JOSEPH R. ROMANO,
Assessor of Harrison County, and

THE COUNTY COMMISSION OF HARRISON 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 754 conventional wells located in Harrison 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 complaint, operating expenses. Specifically, the Tax

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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 maximum amounts 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, did 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 maximum amounts 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 calculates operating expenses at the lesser of 30% of gross receipts or \$5,000 for conventional wells (the "maximum amount" of \$5,000 of operating expenses per conventional well will be referred to alternatively throughout this complaint as the "maximum amount" or "cap"). The cap unduly restrict the amount of operating expenses that should be allowed for each of these wells, and the imposition of a "cap" is not supported by the Tax Department's legislative rule regarding the valuation of producing oil and natural gas properties. The legislative rule, instead, requires that the Tax Department use "average annual industry operating expenses per well" in valuing producing wells, and does not authorize the Tax Department to "cap" operating expenses at a certain amount. In sum, the Tax Department incorrectly and unfairly ignored the actual operating expenses and instead relied on the maximum calculations found in its valuation variables document and administrative notice. By failing to consider CNX's actual operating expenses, the Tax Department overvalued CNX's wells and did not assess them at their true and actual value.

On October 27, 2016, CNX protested the Tax Department's valuation (as adopted by the Harrison County Assessor) to the Harrison County Commission sitting as the Harrison 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 Harrison County. CNX also presented an analysis of its actual operating expenses from the state and local tax firm Altus Group US, Inc. ("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 CNX's Harrison County wells.

II. FACTUAL BACKGROUND

A. CNX's Property.

CNX owns 754 conventional gas wells in Harrison County. (See Exhibit A, Certified Transcript of October 27, 2016 Hearing before the Harrison County Board of Assessment Appeals [hereinafter "Hr'g Tr."], p. 10:14-18). CNX pays significant taxes to Harrison 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 calculated average operating expenses of 37% of gross receipts per conventional well. (Hr'g Tr. 19:1-6; 23:15-21, 30:7-11, 32:16-17; Hr'g Tr. Exhibit 4). CNX's average operating expense percentage of 37% resulted in \$5,898 of actual operating

expenses per well, slightly in excess of the \$5,000 statewide maximum amount of operating expenses per well calculated by the Tax Department. (Hr'g Tr. 18:23-19:6, 23:15-21, 27:15-23, 30:7-11, 32:16-17; Hr'g Tr. Exhibit 4). Ultimately, the Tax Department did not adjust the operating expenses it used to value CNX's wells in Harrison 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., pp. 28:21-30:2, 61:12-15, 62:2-3). In 2016, the Tax Department decided that it would no longer consider actual operating expenses. *Id.* 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.

The State caps the allowed operating expenses at the lesser of 30% of gross receipts or \$5,000 for conventional wells. (Hr'g Tr. p. 23:2-23:14). Due to the State's failure to take into account CNX's actual operating expenses, the value of CNX's wells is significantly overstated.

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The State valued CNX's wells at \$31.2 million, whereas CNX appraised them at \$21.2 million. (Hr's Tr. at p. 28:4-28:14; Hr'g Tr. Exhibit 1). CNX's expert, Hein & Associates, appraised the wells at \$16.7 million. (Hr'g Tr. at p. 43:8-43:12, Hr'g Tr. Ex. 7).

CNX timely noticed the Harrison County Commission with its Notice of Protest on February 17, 2016. (*See* Hr'g Tr., Ex. 1). The Harrison County Commission, sitting as the Harrison County Board of Assessment Appeals, held a hearing on October 27, 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 not be feasible to consider actual expenses for each well. (Hr'g Tr., at pp. 51-64).

D. CNX's Expert Analysis and Testimony.

CNX's expert, Altus, a leading independent state and local tax firm, by Director Kirsten Evans, testified before the Board on October 27, 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. 12-39). Detailed charts and documentation of actual operating expenses, with numbers specific to Harrison County, were also submitted to the Board. (*see* Certified Record, Petitioner's Exhibits, attached to Hr'g Tr. as "Notebook Entitled 'CNX Notice of Protest Harrison County,'" Exhibits 2, 3, 4, 5, 6, 10). A detailed Form 10k that demonstrated CNX's operating expenses was also submitted to the Board. (Hr'g Tr., Exhibit 4).

Further, Ms. Evans testified regarding an impairment test done by CNX in connection with required Securities and Exchange Commission filings, which provided evidence that the State had significantly overvalued its wells. (Hr'g Tr. at pp. 19:15-21:2, 21:22-22:13; Hr'g Tr. Exhibit 5). Ms. Evans 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. 14:13-14:19, 25:10-28:3). She testified that, as a result, the values derived from the State's methodology are in excess of the true value of the wells. (Hr'g Tr. at pp. 15:11-15:19; 25:10-28:3). Finally, Altus valued CNX's wells in Harrison County at \$21.2 million, based on the actual direct operating expenses incurred by CNX. (Hr'g Tr. at p. 28:4-28:14).

An expert appraiser from Hein & Associates, Jim Harden, also testified at the hearing. Mr. Harden testified that it appraised CNX's wells in Harrison County. (Hr'g Tr. p. 40:21-24). He explained that the Tax Department's valuation did not properly account for actual operating costs of the wells at issue, and that Hein & Associates used a different decline and discount rate than the rate used by the Tax Department. (Hr'g Tr. 41:7-43:12; Hr'g Tr. Exhibit 7). Hein & Associates valued CNX's Harrison County wells at \$16.7 million, while the State valued them at \$31.2 million. (Hr'g Tr. p. 43:4-43:12).

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

On February 17, 2016, CNX submitted to the Harrison County Assessor and the Harrison 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 27, 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 was attached to CNX's Petition as Exhibit A. (*See* W. Va. Code § 58-3-4.)

By March 15, 2017 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). CNX received notice of the Order on March 20, 2017, and CNX timely petitions this Court for relief from the Board's erroneous determination on April 18, 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).

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.

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 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 3.16.

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, (2) that the State's "cap" of \$5,000 in operating expenses for conventional wells be removed, (3) that the value of CNX's Harrison County gas wells for the 2016 tax year be set at their true and actual value of \$16,790,722, as calculated by Hein & Associates and based on the actual direct operating expenses incurred by CNX.

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 Harrison 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 27, 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. By capping the allowed operating expenses at the lesser of 30% of gross receipts 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 with gross receipts over a certain threshold.

IV. CONCLUSION

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

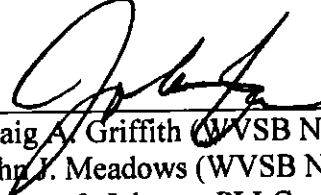
- (i) Find that the Harrison County Board of Assessment Appeals incorrectly upheld the valuation of CNX's Harrison County gas wells by the West Virginia Department of Revenue, State Tax Department, Property Tax Division for the 2016 tax year;

(ii) Fix the value of CNX's Harrison County gas wells for the 2016 tax year at its true and actual value of \$16,790,722, 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
Harrison County Circuit
Clerk's Office.