

**IN THE CIRCUIT COURT OF BARBOUR COUNTY, WEST VIRGINIA
BUSINESS COURT DIVISION**

**DENEX PETROLEUM CORPORATION,
a West Virginia Corporation,**

Petitioner,

v.

**Civil Action No. 16-AA-1
Judge Christopher c. Wilkes**

**THE HONORABLE MARK MATKOVICH,
West Virginia State Tax Commissioner,
THE HONORABLE JOHN CUTRIGHT,
Assessor of Barbour County, and
THE COUNTY COMMISSION OF BARBOUR COUNTY,
Sitting as the Barbour County Board of Review and Equalization,**

Respondents.

**ORDER AFFIRMING THE DECISION OF THE BOARD OF EQUALIZATION AND
REVIEW UPHOLDING THE VALUATION OF DENEX PETROLEUM
CORPORATION'S BARBOUR COUNTY GAS WELLS FOR THE 2016 TAX YEAR**

This matter comes before the Court pursuant to the Petitioner's appeal of its natural gas producing wells in Barbour County, West Virginia, for the 2016 tax year, as appraised by the West Virginia State Tax Commissioner and assessed by the Assessor of Barbour County. The parties have fully briefed the issues before the Court, including clarification memoranda and the record on appeal. The Court dispenses with oral argument because the facts and legal contentions are adequately presented in the materials before the Court, and argument would not aid the decisional process. Therefore, upon full consideration of the issues, the record, and pertinent legal authorities, the Court rules as follows.

I. INTRODUCTION

Every case regarding a challenge to an *ad valorem* tax assessment revolves around the value fixed by the Tax Department and the differing value proffered by the Taxpayers. In this matter, Denex Petroleum Company alleges that the Tax Department improperly valued some of

its natural gas wells despite the calculation of the value pursuant to the controlling Legislative Rule, Title 110, Series 1J. Not only has the Petitioner failed to meet its burden in showing that the valuation is incorrect, the Petitioner has asked this Court to improperly bypass the aforesaid Legislative Rule which has the force of a statute. *See State ex rel. Barker v. Manchin*, 167 W. Va. 155, 169, 279 S.E. 2d 622, 631 (1981); *Appalachian Power Company v. State Tax Dept. of West Virginia*, 195 W. Va. 573, 585, 466 S.E.2d 424, 436 (1995). For the reasons detailed below, the Petition for Appeal must be denied.

II. PROCEDURAL HISTORY

On February 18, 2016, the Petitioner protested the Tax Department's valuation of some of its Barbour County gas wells to the Barbour County Commission sitting as the Board of Equalization and Review (hereinafter "Board"). At the hearing, Denex requested that the Board decrease the value of some of its wells because the Tax Department valuations did not reflect true market value. Following the hearing, the Board made no adjustment to the Tax Department's valuation.

On March 23, 2016, the Taxpayer filed the Complaint currently pending before this Court. Specifically, the Taxpayer requests that this Court conclude that the Board incorrectly upheld the Tax Department's 2016 tax year valuation of its Barbour County natural gas wells.

III. FINDINGS OF FACT

1. Denex Petroleum Corporation is the operator of producing conventional gas wells in Barbour County. Transcript of February 18, 2016 Board of Equalization and Review Hearing at 7 (hereinafter "Tr. at 7").

2. Denex's wells are appraised for *ad valorem* tax purposes by the West Virginia State Tax Department based upon a statewide mass-appraisal system, which is codified at W. Va Code R. § 110-1J-1, *et seq.*

3. The income approach to value is based upon the assumption that a property is worth the future income, discounted to present worth, that it will generate for a perspective buyer. *See* Petitioner's Exhibit 4, Administrative Notice 2016-02.

4. The Tax Department utilized W. Va. Code R. § 110-1J-1, *et seq.* in valuing the active producing wells operated by Denex in Barbour County. Tr. at 104.

5. Denex's President Dennis Xander admitted that the Tax Department appraisal of his wells was conducted pursuant to the Tax Commissioner's "model," which he further admitted was based upon a codified legislative rule. Tr. at 25, 27, 31.

6. Denex made no allegation below that the State failed to properly follow the legislative rule. Tr. at 14. However, in appeal memorandum, Petitioner argues that an exhibit titled the "Industry Operating Expense Survey and Results," demonstrates that the State Tax Department may be calculating the working interest expense for typical producing wells at 30% instead of estimating the industry operating expense from gross receipts before any subtraction of any royalties or expenses.

7. The yield cap model contained in the Legislative Rule is utilized to arrive at a well's value. The Tax Department is required to use a three-year weighted average with the most weight being placed on the most current year.¹ Then, based upon what year the well was in, there are three decline rates for each producing sand. The Tax Department takes 18 months of production before it begins the yield cap model. The Department then utilizes the yield cap model and, based upon

¹ All the wells whose valuation is being contested have been in production for more than three years.

the decline rates and producing sand, calculates that income out into future income. The sum total once the model comes to zero is the appraisal. Stated another way, the Tax Department estimates the future income stream, bringing in current dollars, to come up with what the rule computes to be fair market value. Tr. at 99-100, 102.

8. One variable utilized by the Tax Department to value producing oil and gas wells is operating expenses. Operating expenses are "only those ordinary expenses which are directly related to the maintenance and production of natural gas and/or oil." W. Va. Code R. § 110-1J-3.16.

9. The operating expense variable is based upon a survey in which the Tax Department solicits data from all oil and gas producers regarding operating expenses for their wells. Consistent with the legislative rule, the survey is conducted every five years and requires operators to file the receipts for all of their wells, the expenses for all of their wells, and the number of wells included in that data. The survey is utilized to arrive at the cap for the percentage and the amount used for operating expenses. As a result of the survey, direct ordinary operating expenses were estimated to be 30 percent of the gross receipts derived from production, not to exceed \$5,000. Tr. at 12, 99, 101, and 105.²

10. Denex argues that its actual expenses due to their static nature coupled with dropping gas prices are more than the allowed expense deduction. Tr. at 15. Denex also asserts that its capping liabilities and costs related to a transportation agreement with Dominion Gas should be considered in valuing its wells. Tr. at 57, 58, 77, 81, 103.

² Despite claims that the Tax Department's operating expense variable is inequitable, Denex did not respond to the survey regarding its operating expenses. Tr. at 65, 101-102.

IV. STANDARD OF REVIEW

“[J]udicial review of a decision of a board of equalization and review regarding a challenged tax assessment valuation is limited to roughly the same scope permitted under the West Virginia Administrative Procedures Act, W. Va. Code ch. 29A.” *In re Tax Assessment Against American Bituminous Power Partners, L.P.*, 208 W. Va. 250, 255, 539 S.E.2d 757, 762 (2000).

“In such circumstances, a circuit court is primarily discharging an appellate function little different from that undertaken by [the West Virginia Supreme Court of Appeals. . . .]”; the Circuit Court’s review of the Board’s decision, under W. Va. Code § 11-3-25, is therefore *de novo*.

The taxpayer’s burden before the Board is to show by clear and convincing evidence that its valuation, and assessment, of its property is erroneous. Syl. pts. 5-6, *Stone Brooke Limited Partnership v. Sisnni*, 224 W. Va. 691, 688 S.E.2d 300 (2009). However, “there must be a proper assessment before there can be a presumption that the assessment is correct, and where it appears that there was no proper assessment there can be no presumption in favor of the correctness of the assessment.” *In Re Pocahontas Land Co.*, 172 W. Va. 53, 61, 303 S.E.2d 691, 699 (1983). Furthermore, “[p]ursuant to *In Re Pocahontas Land Co.*, [citation omitted] 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, 687 S.E.2d 768 (2009).

In considering this appeal, the Court relies on the record developed before the Board and determines whether the challenged property valuation is supported by substantial evidence. An assessment made by a board of review and equalization will not be reversed when supported by substantial evidence unless plainly wrong. See W. Va. Code § 58-3-4; syl. pts. 1-2, *Stone Brooke*, 224 W. Va. 691, 688 S.E.2d 300.

V. CONCLUSIONS OF LAW

The Tax Commissioner has the duty to ensure that the laws concerning the assessment and collection of all taxes are faithfully enforced. The West Virginia Legislature mandated that the Tax Commissioner is responsible for appraising certain classes of property, including oil and gas wells. West Virginia Code § 11-6K-1(a) states in pertinent part: “natural resources property shall be assessed annually as of the assessment date at sixty percent of its true and actual value.”

To guide this valuation, the Legislature has created a Rule that requires the assessor to examine three years of income to arrive at the yield capitalization model set out in W. Va. Code R. § 110-1J-4.6 as well as defining the average industry operating expenses allowed under the Rule as set forth in W. Va. Code R. § 110-1J-4.3. With regard to natural resources property, Administrative Notice 2016-02 (Exhibit 4 to the Petitioner’s Complaint) explains why the Legislative Rule utilized an income approach and not a market approach as urged by the Petitioner. Administrative Notice 2016-02 states in pertinent part,

[n]atural resource properties sell infrequently and when they do sell they are quite often only a portion of the property acquisition thus diluting the purity of the market transaction. Therefore, the market approach to value has limited application because of the lack of a sufficient number of sales of natural resource properties to statistically support development of the approach for natural resource properties.

A. The Tax Department Correctly Valued Denex’s Gas Wells Consistent With the Legislative Rule.

The West Virginia Legislature approved a legislative rule which the Tax Commissioner must follow in order to determine the true and actual value of natural resources property. See W. Va. Code R. § 110-1J-1, *et seq.* This Legislative Rule does not provide discretion in the valuation of oil and gas. The Tax Commissioner is not given discretion with regard to whether to use another income approach or the market approach urged by the Petitioner.

While addressing the Board, the Petitioner sought to bypass the Legislative Rule and asked for a reduced valuation for some of its wells based on its own calculation, which is at odds with the Legislative Rule.

To determine the fair market value of producing oil and natural gas property, the Tax Department, consistent with the Rule, applies a yield capitalization model to the net receipts (gross receipts, less royalties paid, less operating expenses) for the well. *See* W. Va. Code R. § 110-1J-4.1. West Virginia Code State Rule § 110-1J-4.6 requires the Tax Commissioner to develop a yield capitalization model for each producing property. The Rule states the following in pertinent part regarding the yield capitalization model,

[t]he model shall use as a beginning point and include for each producing well, the gross receipts (both working interest and royalty interest) and production amounts based on those gross receipts from the most recent consecutive three (3) full production calendar years preceding the July 1 assessment date. These amounts will be weighted average (sum of years digits) and then adjusted for production decline to reflect the income available to the property owner beginning with the July 1st assessment date to June 30 next succeeding the assessment date. Gross receipts and production amounts shall be proportionately reduced by application of the appropriate production decline rate, referenced in Subsection 4.4 of this rule, to yield a declining terminal income series typical of the producing area and strata.

Another element in valuing oil and gas under the income approach is the consideration of allowable expenses. Pursuant to West Virginia Code of State Rules § 110-1J-3.16, the Tax Department considers “operating expenses” to be “those ordinary expenses which are directly related to the maintenance and 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.”

Petitioner also alleges that Tax does not appear to be following the Legislative Rule and does not allow a 30% reduction for ordinary operating expenses; the Tax Department only allows 30% deduction for the working interest.

Petitioner is mistaken. Administrative Notice 2016-08 states: “[d]irect ordinary operating expenses [for a gas well] will be estimated to be 30% of the gross receipts derived from gas production, not to exceed \$5,000.” (Emphasis added.) The Legislative Rule specifically defines “gross receipts” as “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.” W. Va. Code R. § 110-1J-3.8. The standard deduction is calculated from total income and not simply “working interest” as argued by Petitioner.

The Tax Department’s proper application of the Legislative Rule is substantiated by testimony presented before the Board of Equalization of Review. Ms. Cindi Hoover, Tax & Revenue Manager for the State Tax Department, provided specific testimony regarding Account # 010110001530, which had Gross Receipts of \$1,181 and a working interest of \$1,034. (Tr. p. 102-104). Consistent with the Legislative Rule, neither of those figures were the singular basis for the calculation of operating expenses. Rather, as required by the Legislative Rule, the Tax Department utilized a three-year weighted average of the working interest value (\$1,819 for the example well) and then subtracted out 18 months of production, which equated to \$1,382. It is from \$1,382 that the 30 percent operating expense was calculated, which was \$415 for Account # 010110001530.

As a result of the sum of the Legislative Rule, the expense variable utilized to arrive at net receipts is appropriately based upon working interest gross receipts. Operating expenses are not based upon pure gross receipts as the Petitioner incorrectly argues it should be.

Contrary to the Petitioner's assertions, the Tax Department has not abused its discretion in valuing producing gas wells. The legislative rule gives no discretion to the State Tax Department to use an alternative approach to valuation such as market sales of oil and gas. If the Tax Department were to ignore the very clear language of the legislative rule and to value any producing gas well by an alternate methodology which is not found in the applicable legislative rule, then the Tax Department's valuation would be contrary to the law.

C. The Taxpayers Failed to Meet Their Burden of Proof.

It is well settled that taxpayers must prove by clear and convincing evidence that the valuation of the property as determined by the State Tax Commissioner or the county assessors is wrong when challenging *ad valorem* property tax assessments. The West Virginia Supreme Court of Appeals has held that:

An objection to any assessment may be sustained only upon the presentation of competent evidence, such as that equivalent to testimony of qualified appraisers that the property has been under - or over-valued by the tax commissioner and wrongly assessed by the assessor. The objecting party, whether it be the taxpayer, the tax commissioner or another third party, must show by a preponderance of the evidence that the assessment is incorrect.³

Syl. Pt. 8, *Killen v. Logan*, 170 W. Va. 602, 295 S.E.2d 689 (1982).

In this matter, the Petitioner presented testimony from four persons having gas well experience. However, none of the four witnesses provided itemized expenses or testimony to show

³ *Killen v. Logan* stated in Syl. Pt. 8, quoted above, that the burden of proof that taxpayers face is the preponderance of the evidence standard. However, in Syl. Pt. 5, *In re Tax Assessment of Foster Foundation's Woodlands Retirement Community*, 223 W. Va. 14, 672 S.E.2d 150 (2008), the West Virginia Supreme Court resolved any controversy regarding the level of proof that taxpayers must meet in challenging the valuation of property before the county commissions sitting as a board of equalization and review or, in this case, board of assessment appeal. The Supreme Court clearly stated in *Foster Foundation* that taxpayers must prove by "clear and convincing evidence" that the Tax Department's assessment is wrong and expressly overruled *Killen v. Logan* and *Eastern American Energy Corp. v. Thorn*, 189 W. Va. 75, 428 S.E.2d 56 (1993) to the extent that the standard of review is the preponderance of evidence.

with specificity that the assessment was incorrect under the legislatively prescribed valuation scheme.

VI. CONCLUSION

Under West Virginia law, the taxpayer challenging the value of property for *ad valorem* tax purposes must prove by clear and convincing evidence that the value of the property is wrong. The Petitioner has failed to meet this burden. Furthermore, the Petitioner's argument that a valuation scheme inconsistent with the legislative rules should be utilized is unpersuasive. In this matter, the Tax Department applied the legislative rules for producing gas wells and correctly valued the gas well. The Circuit Court must affirm the valuation which was accepted by the Board and dismiss this case with prejudice.

WHEREFORE, it is ORDERED and ADJUDGED that the decision of the Barbour County Board of Equalization and Review upholding the valuation of Denex's gas wells for the 2016 tax year is hereby AFFIRMED. The Petitioner's exceptions are noted for the record. The Court directs the Circuit Clerk to enter the foregoing and forward an attested copy to all counsel of record and the Business Court Division Central Office, Berkeley County Judicial Center, Suite 2100, 380 West South Street, Martinsburg, WV 25401. This being a FINAL ORDER, the Clerk is directed to remove the above captioned case from the active docket and place it amongst those causes ended.

ENTERED: February 7, 2018



CHRISTOPHER C. WILKES, JUDGE
BUSINESS COURT DIVISION

Document(s) served

Order calling for clarification entered January 17, 2018

Person(s) served / Method of Service

Presiding Judge – Business Court Division

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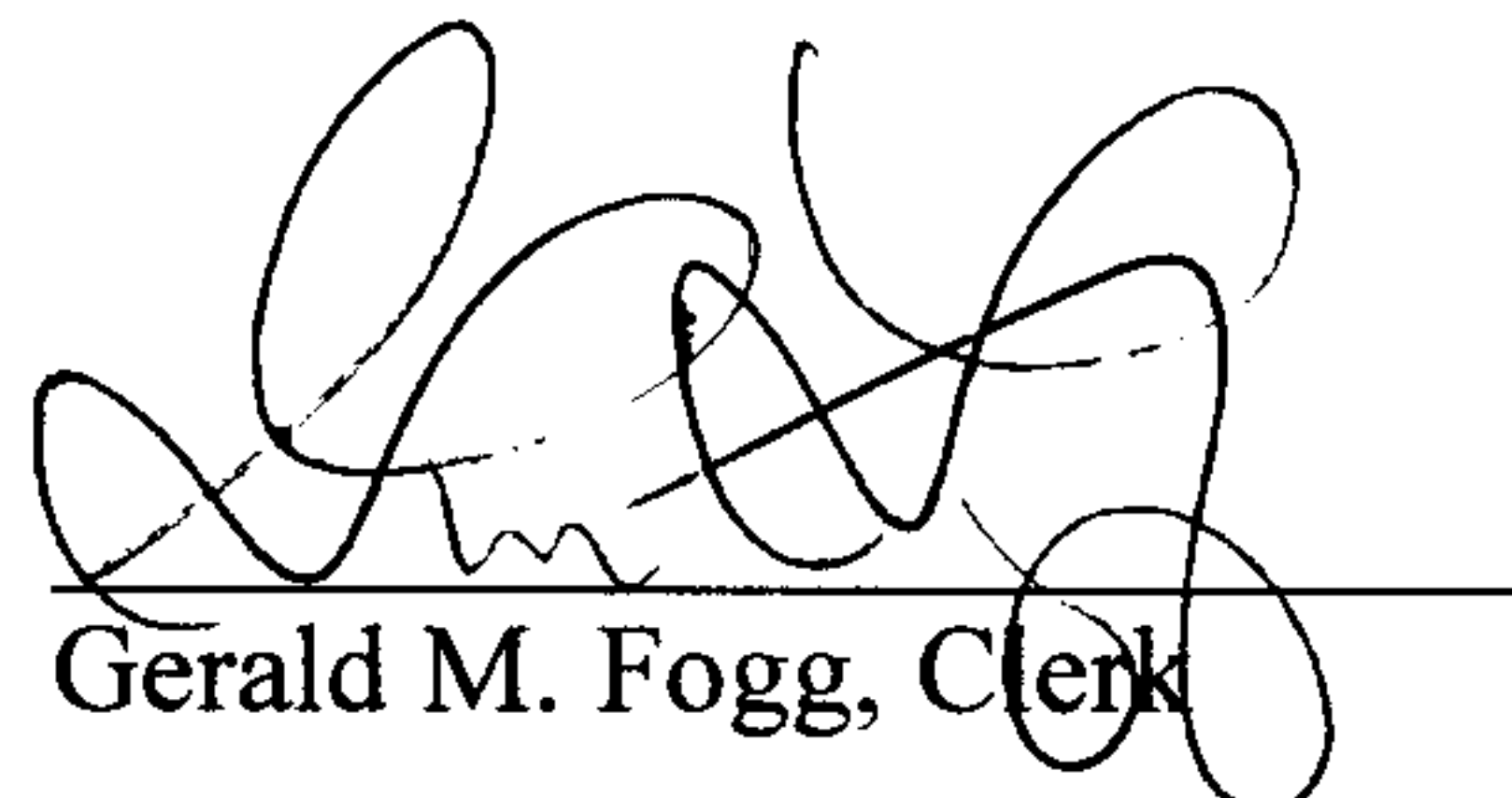
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February 12, 2018



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