

WEST VIRGINIA
SECRETARY OF STATE
KEN HECHLER
ADMINISTRATIVE LAW DIVISION

Form #4

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NOTICE OF RULE MODIFICATION OF A PROPOSED RULE

AGENCY: STATE TAX DIVISION TITLE NUMBER: 110

CITE AUTHORITY W. VA. CODE § 11-1C-1 ET SEQ.

AMENDMENT TO AN EXISTING RULE: YES NO

IF YES, SERIES NUMBER OF RULE BEING AMENDED: _____

TITLE OF RULE BEING AMENDED: _____

IF NO, SERIES NUMBER OF NEW RULE BEING PROPOSED: 1J

TITLE OF RULE BEING PROPOSED: APPRAISAL OF PRODUCING AND RESERVE OIL
AND NATURAL GAS PROPERTY FOR PERIODIC STATEWIDE REAPPRAISAL FOR AD
VALOREM PROPERTY TAX PURPOSES

THE ABOVE PROPOSED LEGISLATIVE RULE, FOLLOWING REVIEW BY THE LEGISLATIVE RULE
MAKING REVIEW COMMITTEE IS HEREBY MODIFIED AS A RESULT OF REVIEW AND COMMENT
BY THE LEGISLATIVE RULE-MAKING REVIEW COMMITTEE. THE ATTACHED MODIFICATIONS ARE
FILED WITH THE SECRETARY OF STATE.



ALAN L. MIERKE
ACTING TAX COMMISSIONER



State of West Virginia
Department of Tax and Revenue

Charleston 25305

GASTON CAPERTON
GOVERNOR

L. FREDERICK WILLIAMS, JR.
SECRETARY

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CONSENT TO FILE RULE

January 9, 1992

To Whom It May Concern:

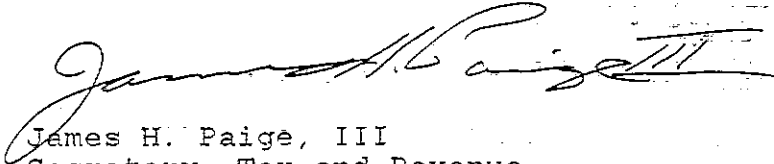
Title of Rule: Appraisal Of Producing And Reserve Oil And
Natural Gas Property For Periodic Statewide
Reappraisals For Ad Valorem Property Tax
Purposes

Title Number: 110

Series Number: 1J

Pursuant to West Virginia Code § 5F-2-2(a), the undersigned hereby consents to the filing of the foregoing rule.

Signed this 9th day of January, 1992.


James H. Paige, III
Secretary, Tax and Revenue

MODIFIED
WEST VIRGINIA LEGISLATIVE REGULATIONS
DEPARTMENT OF TAX AND REVENUE
TITLE 110
SERIES 1J
1991

FILED

1011 JAN 10 PM 3:44

STATE OF WEST VIRGINIA
DEPARTMENT OF TAX AND REVENUE

APPRAISAL OF PRODUCING AND RESERVE OIL AND NATURAL GAS PROPERTY FOR PERIODIC
STATEWIDE REAPPRAISALS FOR AD VALOREM PROPERTY TAX PURPOSES

§ 110-1J-1. General.

1.1 Scope. - These regulations clarify and implement State law as it relates to the appraisal at market value of producing and reserve oil and natural gas properties.

1.2 Authority. - W. Va. Code § 11-1C-1 et seq.

§ 110-1J-2. Introduction. - Oil and/or natural gas is one of the several estates in real property which may be owned either as a separate interest in real property or in conjunction with other interests, usually as fee ownership, oil and/or natural gas ownership or as minerals ownership. If oil and/or natural gas is owned as a separate estate, West Virginia property tax law requires such ownership to be listed, valued and taxed based on its true and actual value. If the interest in oil and/or natural gas is part of a larger interest in a tract of property, the value of the oil and/or natural gas interest shall be included in the value of the larger interest. Oil and/or natural gas may be owned without being produced. Oil and/or natural gas rights may exist where no oil and/or natural gas is actually present, or where the oil and/or natural gas is unproducible or depleted.

2.1 Categories for valuing oil and/or natural gas properties. - Parcels of property thought to bear oil and/or natural gas or having the oil and/or natural gas mineral interest separated from the fee of the property will be classified as producing property; non-producing property; plugged and abandoned property.

§ 110-1J-3. Definitions. - As used in these regulations and unless the context clearly requires a different meaning, the following terms shall have the meaning ascribed herein, and shall apply in the singular or in the plural.

3.1 "Bands of investment discount component" means a discount rate derived by assigning rates to various debt and equity investment financing tiers and summing these rates, weighted by their respective percentages of total financing.

3.2 "Discount component" means a rate reflecting a provision for returning to an investor a sum of money equal to the aggregate of the anticipated return-on-investment over the economic life of an investment.

3.3 "Flush production" means the production of oil and/or natural gas from any well on a producing oil and/or natural gas producing property with an initial production date that is two (2) years or less prior to the date of valuation.

3.4 "Management rate" means a rate reflecting a return to an investor for the management of similar investment portfolios.

3.5 "Market comparison discount" means a discount rate derived by dividing income net of the recapture component and property taxes by the arms-length selling price of the property.

3.6 "Natural gas producing property" means the property from which natural gas has been produced or extracted at any time during the most recent assessment year. Natural gas producing property includes the interest or interests underlying an area of up to one hundred twenty-five (125) acres of surface per well for property with active wells on the parcel. Also to be included on natural gas producing property is the parcel acreage in excess of one hundred twenty-five (125) acres per well, to be valued at the non-producing rate per acre referenced in Section 4.9 of those regulations; such rate however not to exceed the average producing rate per acre of the property.

3.7 "Nonliquidity rate" means a rate reflecting a return to an investor representing the loss of interest on an investment arising from the time required to sell the investment.

3.8 "Oil and/or natural gas, non-producing property" means properties that were not engaged in production during the previous assessment year period of July 1 through June 30. This category shall include any acreage that has been shut-in for the entire year. This category shall also include any acreage owned by a company or individual whose primary business involves the production or leasing of any oil and gas properties.

3.9 "Oil and/or natural gas plugged and abandoned property" means up to one hundred twenty-five (125) acres of surface per well of natural gas or up to forty (40) acres of surface per well of oil producing properties if the well has been plugged and abandoned as required by W. Va. Code § 22B-4-1 et seq.

3.10 "Oil producing property" means property from which oil has been produced or extracted at any time during the most recent assessment year. Oil producing property includes the interest or interests underlying an area of up to forty (40) acres of surface per well with one or more active well(s) on the parcel. Also to be included on oil producing property is the parcel acreage in excess of forty (40) acres per well, to be valued at the non-producing rate per acre referenced in Section 4.9 of these regulations; such rate however not to exceed the producing rate per acre of the property.

3.11 "Overriding royalty" means the fractional interest reserved or purchased by a seller of a lease to another party, thereby participating in the gross proceeds of production from the lease while at the same time not incurring operating expenses.

3.12 "Personal property" used in oil and/or natural gas production means machinery and equipment in and about the well and all other tangible personal property used in producing oil and/or natural gas from the well. It shall not include vehicles or other tangible personal property not permanently used in production.

3.13 "Producer/operator" means any person or persons, corporation, partnership, joint venture or other enterprise which proposes to or does locate, drill, manage or abandon any well.

3.14 "Property tax component" means a rate reflecting a provision for returning to an investor a sum of money equal to property taxes paid over the economic life of an investment.

3.15 "Recapture component" means a rate reflecting a provision for returning to an investor a sum of money equal to his investment.

3.16 "Risk rate" means a rate reflecting a return to an investor necessary to attract capital to an investment containing a possible loss of principal and/or interest.

3.17 "Royalty interest" means the fractional interest in oil and/or natural gas production not subject to operating expenses and retained by the oil and/or natural gas rights owner or lessor.

3.18 "Safe rate" means a rate reflecting a return to an investor on an investment which has little, if any, likelihood of loss of principal or of loss in anticipated return on investment.

3.19 "Settled production" means the production of oil and/or natural gas from all wells on a producing property with an initial production date that is more than two (2) years prior to the date of valuation.

3.20 "Storage wells" means any property used as a reservoir for the storage of natural gas. These properties shall be valued as non-producing natural gas property, such value not inclusive of inventories stored therein. Natural gas inventory stored therein shall be valued separately.

3.21 "Summation discount component" means a discount rate expressed as the aggregate of a safe rate, risk rate, nonliquidity rate, and management rate.

3.22 "Working interest" means the fractional interest in oil and/or natural gas production subject to operating expenses and owned by the leasehold or operator.

§ 110-1J-4. Methods of valuation.

4.1 **General.** -- Oil and/or natural gas producing property value shall be determined through the process of applying a yield capitalization model to the net receipts for the working interest and a yield capitalization model applied to the gross royalty receipts for the royalty interest. Where ownership is split through a lease or royalty arrangement, different values will be

determined for the working interest and the royalty interest. Each term in this valuation is discussed below.

4.2 Percentage interest in oil and/or natural gas. - Where the ownership of oil and/or natural gas in place is divided through a lease or other arrangement, the compensation to the owner of the property is derived by designating a percentage (generally one-eighth) of the production to be the royalty payment to the owner. The remainder (generally seven-eighths) is the working interest. The Tax Commissioner will annually determine a typical working and royalty percentage interest through a review of oil and gas leases from throughout the State.

4.3 Average production rate. - Gas - The Tax Commissioner will annually determine and report the production rate of natural gas wells through review of information filed with other State agencies and data provided by companies and individuals. Oil - The average daily production of an oil well is its production rate, measured in terms of oil field standard forty-two (42) gallon barrels, for the year preceding the annual tax assessment date, divided by the number of full or partial days of well production. Partial days shall include time allowed for oil to collect between pumpings. Full or partial days shall not include time when well non-production results from workover, redrilling, or well maintenance.

4.4 Average industry market price. - Oil - The Tax Commissioner will annually derive the average industry market price by reviewing the price per barrel paid by the major West Virginia crude oil purchasers. The Tax Commissioner's annual report on the average industry market price shall reflect a reduction for average Federal Windfall Profits Tax and West Virginia Severance Taxes deemed to be paid by the working or royalty interests in the production. The average industry market price will be used in the method described in the regulations for determination of the formulas to be used to appraise oil production properties.

Gas - The Tax commissioner will annually derive and report the average industry market price by reviewing the price paid per MCF by the major West Virginia natural gas purchasers, a survey of oil and gas associations, and other statistical data. The Tax Commissioner's annual report on the average industry market price shall reflect a reduction for average Federal Windfall Profits Tax and West Virginia Severance Taxes deemed to be paid by the working or royalty interests in the production.

4.5 Average industry operating expenses. - The Tax Commissioner will annually determine the average industry operating expenses per well. The average industry operating expenses will be deducted from gross receipts in developing an income stream for application of a yield capitalization procedure.

4.6 Average industry production decline rates. - The Tax Commissioner will annually derive and report the average industry production decline rates by a review of well production records of various State agencies and data provided by companies and individuals.

4.7 Capitalization rate. - A capitalization rate will be developed considering the three (3) components set out in Section 4.7.1 of these

regulations. This rate will be used to select the factor(s) from a standard mid-year life present worth of one table using a compound interest premise.

4.7.1 Discussion. - The capitalization rate will be determined annually by the Tax Commissioner through the use of generally accepted methods for estimating such rates. The rate so developed will be applied to a declining-terminal income series which is indicative of oil and/or natural gas producing properties. The capitalization rate used to value oil and/or natural gas properties will be developed considering (1) a discount rate determined primarily by the summation technique, (2) a recapture component, and (3) a property tax component.

4.7.1.1 Discount component.

4.7.1.1.a Summation technique. - The summation technique will be given primary consideration in the valuation of oil and/or natural gas producing property. The summation technique will determine a discount component which will be used to calculate the present value of the future income of the oil and/or natural gas producing property utilizing the following four (4) major subcomponents:

- 4.7.1.1.a.1 Safe rate
- 4.7.1.1.a.2 Risk rate
- 4.7.1.1.a.3 Nonliquidity rate
- 4.7.1.1.a.4 Management rate

The "safe rate" will be developed through review of quarterly interest rates offered on thirteen (13) week United States Treasury Bills for a period of one (1) year prior to the appraisal date. The "risk rate" will be developed through review of data resulting from an annual survey of lending institutions, such survey reflecting interest rates required on loans for acquisition and/or development of natural resource producing properties. This survey will be conducted for a one (1) year period prior to the appraisal date. Results of the survey will be compared to quarterly interest rates offered on thirteen (13) week United States Treasury Bills for the same one (1) year period. An interest differential will then be selected representing the "risk rate" assignable to various financing tiers. The "nonliquidity rate" will be developed through an annual survey to determine a reasonable estimate of time that oil properties remain on the market before being sold. The market time thus determined will be used to identify United States Treasury Bills with similar time differentials in excess of thirteen (13) week Treasury Bills. The interest differential between these securities will be deemed to be representative of the "nonliquidity rate." The "management rate" will be developed through a survey to identify charges for the management of similar investment portfolios.

4.7.1.1.b Bands-of-investment/market comparison. - Data permitting, the bands-of-investment and market comparison techniques will be used to verify the summation discount component.

4.7.1.2. Recapture component. -- Construction of the discount models will be accomplished through access of a standard mid-year life present worth of one table, premised on a compound interest rate. This table has a factor for recapture built into the table coefficients. Inclusion of a recapture component in the capitalization rate is therefore not appropriate.

4.7.1.3 Property tax component. -- This component will be derived by multiplying the assessment rate by the statewide average of tax rates on Class III property.

4.8 Yield capitalization model. - A yield capitalization model will be developed for each producing property. The model will use as a beginning point gross receipts from each producing well. Gross receipt will be proportionately reduced by application of the appropriate production decline rate, referenced in Section 4.6 of these regulations, to yield a declining terminal income series typical of the producing area. The income series will be apportioned to the working interest and to the royalty interest based upon percentage interests referenced in Section 4.2 of these regulations.

4.8.1 Working interest model. - The working interest income series referenced in Section 4.8 of these regulations will be reduced by the annual operating expenses referenced in Section 4.5 of these regulations to yield a net income series. The net income series will be discounted by applying, on an annual basis, a mid-year life Inwood coefficient reflecting the capitalization rate referenced in Section 4.7 of these regulations. The summation of the annual discounted income streams will be the market value estimate for the working interest of the producing oil and/or natural gas well for an area of up to one hundred twenty-five (125) acres for producing natural gas wells and up to forty (40) acres for producing oil wells.

4.8.2 Royalty interest model. - The royalty interest income series referenced in Section 4.8 of these regulations will be discounted by applying, on an annual basis, a mid-year life Inwood coefficient reflecting the capitalization rate referenced in Section 4.7 of these regulations. The summation of the annual discounted income streams will be the market value estimate for the royalty interest of the producing oil and/or natural gas well for an area of up to one hundred twenty-five (125) acres for producing natural gas wells and up to forty (40) acres for producing oil wells.

4.9 Valuation of non-producing acreage. - The value per acre of non-producing acreage shall equal the discounted annual lease payment per acre. A valuation schedule for non-producing properties will be determined annually by the Tax Commissioner on a county basis where data is available. The Tax Commissioner will annually conduct a review of oil and/or natural gas agreements transacted at arms length in all fifty-five (55) counties to determine the average annual lease payment per acre, as well as the lease term, that oil and gas properties in the county typically command. The per-acre value for non-producing property will be the sum of the projected annual income stream during the lease term discounted in each year by a capitalization rate.

4.10 Valuation of plugged and abandoned acreage. - Plugged and abandoned acreage will be valued at the nominal rate of one dollar (\$1.00) per acre. This

category includes any plugged and abandoned acreage of up to one hundred twenty-five (125) acres per gas well and up to forty (40) acres per oil well.

4.11 Valuation of wells that produce both oil and gas. - The valuation of these producing wells shall be determined by use of the methods described herein for oil and natural gas. These values shall then be summed to result in the overall value of the oil and/or natural gas producing acreage.

4.12 Annual reports. - The Tax Commissioner will publish an annual report for the variables to be considered in arriving at the value of the specific oil and/or natural gas related property. This report will be filed with the office of the Secretary of State on or before May 31st of each year, followed by a fifteen (15) day period for written public comment. The Tax Commissioner will review the comments and present final variables and multipliers to be used on or before July 1.

4.13 Active farm properties. - The oil and gas rights, that are part of a "fee" estate where the use of the surface has qualified as an active farm, will be valued in the following manner: (For a definition of an active farm see § 110-1R-1 et seq.)

4.13.1 Where income or royalty is not derived from the oil and gas rights the oil and gas interest shall not be valued.

4.13.2 Where income or royalty is derived from the oil and gas rights the oil and gas interest shall be valued as follows:

4.13.2.1 Fee estates, where the annual wholesale value of farm commodities or products is fifty percent (50%) or more of the usual annual gross income from all uses of the property, shall be subject to farm use valuation. Thus oil and gas interests shall not be valued under this situation.

4.13.2.2 Fee estates, where the annual wholesale value of farm commodities or products is less than fifty percent (50%) of the usual annual gross income from all uses of the property, shall be valued by adding the applicable oil and gas values referenced in this rule to the surface farm use value.

4.14 Property reports. - Prior to September 1 of each year the producer and oil and gas owner will be required to file a report with the Department of Tax and Revenue for each county where the oil and gas property is to be assessed. These reports will be designed by the State Tax Commissioner so that information pertinent to the valuation of such producing property, non-producing property, and plugged and abandoned property will be reported by the oil and gas producer, lessee, and owner.



WEST VIRGINIA LEGISLATURE
 LEGISLATIVE RULE-MAKING REVIEW COMMITTEE
 Room M-152, State Capitol
 Charleston, West Virginia 25305
 (304) 340-3286

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OFFICE OF WEST VIRGINIA
 SECRETARY OF STATE

Senator William R. Wooton, Co-Chair
 Delegate David Grubb, Co-Chair

Debra A. Graham, Counsel
 Michael McThomas, Associate Counsel
 Marie Nickerson, Admr. Assistant

NOTICE OF ACTION TAKEN BY LEGISLATIVE RULE-MAKING REVIEW COMMITTEE

December 10, 1991

TO: Ken Hechler, Secretary of State, State Register

TO: Mr. L. Frederick Williams, Jr.
 Secretary of Tax and Revenue
 State Capitol
 Charleston, WV 25305

FROM: Legislative Rule-Making Review Committee

PROPOSED RULE: Appraisal of Producing and Reserve Oil and Natural
 Gas Property for Periodic Statewide Reappraisals
 for Ad Valorem Property Tax Purposes

The Legislative Rule-Making Review Committee recommends that the West
 Virginia Legislature:

1. Authorize the agency to promulgate the Legislative Rule
 - (a) as originally filed _____
 - (b) as modified by the agency X
2. Authorize the agency to promulgate part of the Legislative
 rule; a statement of reasons for such recommendation is
 attached. _____
3. Authorize the agency to promulgate the Legislative rule
 with certain amendments; amendments and a statement of
 reasons for such recommendation is attached. _____
4. Authorize the agency to promulgate the Legislative rule
 as modified with certain amendments; amendments and a
 statement of reasons for such recommendation is attached. _____
5. Recommends that the rule be withdrawn; a statement of
 reasons for such recommendation is attached. _____

Pursuant to Code 29A-3-11(c), this notice has been filed in the State
 Register and with the agency proposing the rule.

cc: Robert Hoffman, Tax Division
 John Montgomery, Tax Division