

08-1248
CENTRALLY ASSESSED PROPERTY
TAX YEAR: 2008
SIGNED 03-19-09
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, D. DIXON
EXCUSED: M. JOHNSON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>PETITIONER</p> <p>Petitioner,</p> <p>v.</p> <p>PROPERTY TAX DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p>Respondent.</p>	<p>INITIAL HEARING ORDER</p> <p>Appeal No. 08-1248</p> <p>Account No. #####</p> <p>Tax Type: Property Tax / Centrally Assessed</p> <p>Tax Year: 2008</p> <p>Judge: Chapman</p>
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This Order may contain confidential "commercial information" within the meaning of Utah Code Sec. 59-1-404, and is subject to disclosure restrictions as set out in that section and regulation pursuant to Utah Admin. Rule R861-1A-37. The rule prohibits the parties from disclosing commercial information obtained from the opposing party to nonparties, outside of the hearing process. However, pursuant to Utah Admin. Rule R861-1A-37, the Tax Commission may publish this decision, in its entirety, unless the property taxpayer responds in writing to the Commission, within 30 days of this notice, specifying the commercial information that the taxpayer wants protected. The taxpayer must mail the response to the address listed near the end of this decision.

Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REP, President of PETITIONER
For Respondent: RESPONDENT REP 1, Assistant Attorney General
RESPONDENT REP 2, from Property Tax Division
RESPONDENT REP 3, from Property Tax Division

STATEMENT OF THE CASE

This matter came before the Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on March 10, 2009.

At issue is the fair market value of centrally assessed property owned by PETITIONER (“Petitioner” or “property owner”) as of the January 1, 2008 lien date. The subject property consists of one oil and gas well and equipment located in COUNTRY, Utah. For the 2008 tax year, the Property Tax Division (“Division”) valued the subject property at \$\$\$\$\$. The property owner asks the Commission to reduce the subject’s value to approximately \$\$\$\$\$, while the Division asks the Commission to sustain the assessed value of \$\$\$\$\$.

APPLICABLE LAW

1. The Utah State Constitution provides for the taxation of tangible property in the state.

Specifically, Utah Const. art. XIII, §2(1) provides as follows:

. . . all tangible property in the State that is not exempt under the laws of the United States or under this Constitution shall be (a) assessed at a uniform and equal rate in proportion to its value, to be ascertained as provided by law; and (b) taxed at a uniform and equal rate.

2. Utah Code Ann. §59-2-103(1) (2008)¹ provides that “[a]ll tangible taxable property located within the state shall be assessed and taxed at a uniform and equal rate on the basis of its fair market value, as valued on January 1, unless otherwise provided by law.”

3. UCA §59-2-102(12) defines “fair market value” to mean “the amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. . . .”

4. UCA §59-2-201(1)(e) provides that the Tax Commission shall assess at 100% of its fair market value “all mines and mining claims except in cases, as determined by the commission, where the mining claims are used for other than mining purposes. . . .”

1 All cites are to the 2008 version of Utah law.

5. Section 59-12-102(23) defines a “mine” to mean “a natural deposit of either metalliferous or nonmetalliferous valuable mineral.”

6. Section 59-12-102(26) defines “nonmetalliferous minerals” to include “oil, gas, coal, salts, sand, rock, gravel, and all carboniferous materials.”

7. To determine the “fair market value” of a productive mining property, Section 59-2-201(3) provides, as follows:

The method for determining the fair market value of productive mining property is the capitalized net revenue method or any other valuation method the commission believes, or the taxpayer demonstrates to the commission's satisfaction, to be reasonably determinative of the fair market value of the mining property. The rate of capitalization applicable to mines shall be determined by the commission, consistent with a fair rate of return expected by an investor in light of that industry's current market, financial, and economic conditions. . . .

8. Utah Admin. Rule R884-24P-10 (“Rule 10”) provides for the taxation of oil and gas properties, as follows in pertinent part:

A. Definitions.

. . . .

6. "Expected annual production" means the future economic production of an oil and gas property as estimated by the Property Tax Division using decline curve analysis. Expected annual production does not include production used on the same well, lease, or unit for the purpose of repressuring or pressure maintenance.

7. "Product price" means:

a) Oil: The weighted average posted price for the calendar year preceding January 1, specific for the field in which the well is operating as designated by the Division of Oil, Gas, and Mining. The weighted average posted price is determined by weighing each individual posted price based on the number of days it was posted during the year, adjusting for gravity, transportation, escalation, or deescalation.

b) Gas:

(1) If sold under contract, the price shall be the stated price as of January 1, adjusted for escalation and deescalation.

(2) If sold on the spot market or to a direct end-user, the price shall be the average price received for the 12-month period immediately preceding January 1, adjusted for escalation and deescalation.

8. "Future net revenue" means annual revenues less costs of the working interests and royalty interest.

9. "Revenue" means expected annual gross revenue, calculated by multiplying the product price by expected annual production for the remaining economic life of the property.

10. "Costs" means expected annual allowable costs applied against revenue of cost-bearing interests:

a) Examples of allowable costs include management salaries; labor; payroll taxes and benefits; workers' compensation insurance; general insurance; taxes (excluding income and property taxes); supplies and tools; power; maintenance and repairs; office; accounting; engineering; treatment; legal fees; transportation; miscellaneous; capital expenditures; and the imputed cost of self consumed product.

b) Interest, depreciation, or any expense not directly related to the unit will shall not be included as allowable costs.

11. "Production asset" means any asset located at the well site that is used to bring oil or gas products to a point of sale or transfer of ownership.

B. The discount rate shall be determined by the Property Tax Division using methods such as the weighted cost of capital method.

1. The cost of debt shall consider market yields. The cost of equity shall be determined by the capital asset pricing model, risk premium model, discounted cash flow model, a combination thereof, or any other accepted methodology.

2. The discount rate shall reflect the current yield requirements of investors purchasing similar properties, taking into consideration income, income taxes, risk, expenses, inflation, and physical and locational characteristics.

3. The discount rate shall contain the same elements as the expected income stream.

C. Assessment Procedures.

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2. The taxable value of underground oil and gas rights shall be determined by discounting future net revenues to their present value as of the lien date of the assessment year and then subtracting the value of applicable exempt federal, state, and Indian royalty interests.

3. The reasonable taxable value of productive underground oil and gas rights shall be determined by the methods described in C.2. of this rule or such other valuation method that the Tax Commission believes to be reasonably determinative of the property's fair market value.

4. The value of the production assets shall be considered in the value of the oil and gas reserves as determined in C.2. above. Any other tangible property shall be separately valued at fair market value by the Property Tax Division.

5. The minimum value of the property shall be the value of the production assets.

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9. For a party who is requesting a value different from the original assessment to prevail,

that party must: 1) demonstrate that the original value contained error; and 2) provide the Commission with a

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sound evidentiary basis for reducing the original value to the amount proposed by the party. *Nelson v. Bd. Of Equalization of Salt Lake County*, 943 P.2d 1354 (Utah 1997); *Utah Power & Light Co. v. Utah State Tax Commission*, 530 P.2d. 332 (Utah 1979).

DISCUSSION

The subject well produces some oil and natural gas liquids (“NGLs”), but primarily produces natural gas (“gas”). For the 2008 tax year, the County assessed equipment at \$\$\$\$ and the oil and gas reserves at \$\$\$\$\$, for a total assessment of \$\$\$\$\$. The property owner proffers that the subject property would not have sold for the assessed value as of the lien date. The property owner is not contesting the \$\$\$\$ value that the Division derived for the equipment. The property owner is, however, contesting the \$\$\$\$\$ value that the Division derived for the reserves.

The Division estimated the value of the well’s reserves by “discounting future net revenues to their present value as of the lien date of the assessment year and then subtracting the value of applicable exempt federal, state, and Indian royalty interests,” as set forth in Rule 10(C)(2). With this method, the Division estimated the amount of the remaining reserves and projected that the reserves would be produced and sold in years 2008 through 2015. The Division determined future revenue by estimating the prices at which these reserves would be sold each year. After making adjustments and subtracting for expenses, the Division capitalized the resulting cash flow to obtain a “present” value of \$\$\$\$\$ for the reserves. The Commission will address the three concerns that the property owner expressed in regards to factors used in the Division’s methodology.

The property owner contends that the value of the reserves is too high for three reasons: 1) because the Division overestimated the remaining gas reserves as of the lien date; 2) because the Division underestimated the operating expenses of the well; and 3) because the Division overestimated the prices at

which the gas reserves would sell in years 2008 through 2015. The property owner did not contest any portion of the methodology concerning the Division's estimates of cash flow for oil and NGLs.

1. Remaining Gas Reserves. The property owner claims that approximately (X)cubic feet of gas remained in the well as of the lien date. The property owner did not know how many cubic feet of gas the Division used in its formula to assess the subject property, but believes that the Division may have overestimated the reserves by 30% to 50%.

The Division proffered testimony and evidence showing that it estimated the gas reserves remaining as of the lien date at (X) million cubic feet. As a result, the Division's estimate of gas reserves that it used in its discount methodology is the same as the property owner's estimate. Accordingly, the property owner has not shown that this portion of the Division's methodology contains error.

2. Operating Expenses. The property owner states that its annual costs to operate a well average about \$\$\$\$ per well. It also estimates that its annual costs for transportation and other expenses to get its products to market are approximately \$\$\$\$ to \$\$\$\$ per well. As a result, the property owner states that the Division's discount methodology should reflect annual operating expenses that range between \$\$\$\$ and \$\$\$\$. Although the property owner does not know the amount of the operating expenses the Division used in its formula, he believes that it used an amount below \$\$\$\$.

The Division proffered testimony and evidence showing that it used operating expenses of \$\$\$\$ in its formula. The Division stated that the subject's value would increase if it substituted the property owner's estimate of operating expenses into the formula. However, the Division did not ask the Commission to increase the subject's value by finding that a lower amount of operating expenses should be used in the formula. Regardless, the property owner has not shown that this portion of the Division's methodology contained an error that resulted in overvaluation.

3. Estimated Gas Prices. The property owner argues that the prices the Division used in its discount formula are too high. For its formula, the Division estimated gas prices for years 2008 through 2015 as follows:

<u>Year</u>	<u>Price Per Unit</u>	<u>Year</u>	<u>Price Per Unit</u>
2008	\$\$\$\$	2012	\$\$\$\$
2009	\$\$\$\$	2013	\$\$\$\$
2010	\$\$\$\$	2014	\$\$\$\$
2011	\$\$\$\$	2015	\$\$\$\$

Rule 10(A)(7)(b) provides that the gas price to be used in the discount methodology is either:

1) the actual contract price as of the lien date, adjusted for escalation and deescalation; or 2) the average price received by the property owner on the spot market for the 12-month period immediately preceding January 1, adjusted for escalation and deescalation. The Division states that when the property owner provided information to the Division in March 2008 for 2008 assessment purposes, the property owner did not indicate that the subject's gas was subject to sale under a contract. Instead, the property owner disclosed that it sold gas for approximately \$\$\$\$ per unit during 2007.

The Division explains that the \$\$\$\$ per unit price it used in its formula for the 2008 tax year is the average of the 12-month spot prices shown by PIPELINE 1 at CITY 1, STATE 1, the closest location to the subject property for which prices are known. The Division notes that this \$\$\$\$ per unit average price is close to the \$\$\$\$ price that the property owner reported for 2007.

To derive the prices it used in its formula for years subsequent to 2008, the Division explains that it first obtained future estimates of gas prices from four different sources. These four sources estimated that gas prices at PIPELINE 2 in STATE 2 would average around \$\$\$\$ per unit for years 2008 through 2015.

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The Division then determined that prices at the PIPELINE 2 are generally about \$\$\$\$ per unit higher than spot prices at CITY 1, STATE 1. After subtracting the price differential of about \$\$\$\$ per unit, the Division estimated on the lien date that prices for the subject's gas reserves would range between \$\$\$\$ and \$\$\$\$ per unit for the remaining life of the well.

The property owner offers several arguments to show that the prices the Division used are too high. First, the property owner explains that gas prices unexpectedly went down in mid-2008. As a result, the gas produced by the subject well sold for an average of \$\$\$\$ per unit in 2008. The property owner contends that the Division's use of \$\$\$\$ per unit in its formula for the 2008 year overestimates the value of the subject's gas reserves. The property owner states that the actual price of \$\$\$\$ per unit should be used for 2008.

The Division agrees that prices went down significantly in mid-2008. However, it states that the use of actual prices occurring after the lien date would not accurately reflect the value of the subject's reserves as of the lien date. First, it argues that price estimates prepared by experts predicted prices in excess of \$\$\$\$ per unit (adjusted for the PIPELINE 2 – CITY 1 differential in price.) In addition, the actual spot price for gas in December 2007 at CITY 1, STATE 1 was \$\$\$\$ per unit. Because the unexpected drop in prices in 2008 was not forecast, the Division argues that the value of the subject's reserves as of the lien date would not have been affected by the post-lien date occurrence. The Commission agrees with the Division. There is no evidence to suggest that the prices expected on the lien date for gas sold in 2008 would be \$\$\$\$ per unit. In fact, the evidence suggests that the prices expected on the lien date may have been higher than the \$\$\$\$ per unit price that the Division used in its discount formula.

Second, the property owner contends that the Division has underestimated the price differential between gas sold at the PIPELINE 2 in and at the PIPELINE 1 in CITY 1, STATE 1. However,

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the property owner has not provided evidence to show that the Division's differential estimate is incorrect. Nor has the property owner provided evidence to show a better estimate of prices for years subsequent to 2008.

Lastly, the taxpayer proffers that a sales contract exists for the subject's gas reserves and that the contract prices are lower than those used by the Division in its discount formula. The Division states that the property owner has never before disclosed that a sales contract exists or provided it with a copy of the contract. The taxpayer did not proffer a copy of the contract as evidence at the Initial Hearing or proffer what the contract prices are. As a result, the Division's price estimates have not been shown to be incorrect.

The property owner has the burden of proof to show that the Division's assessment is incorrect and to provide a sound evidentiary basis why the subject property's value should be reduced from \$\$\$\$\$ to approximately \$\$\$\$\$. The property owner has not met either of these burdens. As a result, the Commission denies the property owner's appeal and sustains the Division's original assessment.

DECISION AND ORDER

Based upon the foregoing, the Tax Commission denies the property owner's appeal and sustains the current assessed value of \$\$\$\$\$ for the 2008 tax year. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2009.

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Kerry R. Chapman
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION.

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2009.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

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