THE VALUATION OF OIL AND NATURAL GAS PROPERTY IN SELECTED STATES

Prepared for the Revenue and Transportation Committee

by

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INTRODUCTION

This report summarizes how several states value oil and natural gas pipelines (flowlines, gathering lines, transmission lines, and natural gas distribution lines) for property tax purposes. The states selected for this review have significant gas production, and the state agency responsible for centrally assessing certain types of property uses the unitary valuation method, as does Montana, to determine the market value of that property. The table on the following page lists gas producing states, indicates the method of assessment for public utility property, and highlights the states selected for review. A significant amount of information about state assessment procedures was obtained from "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" prepared by the New York Office of Real Property Services (ORPS study).[1] Additional information was obtained from telephone conversations with state property assessment officials.

WYOMING[2]

The Wyoming Department of Revenue uses the unitary method of valuation[3] for determining the fair market value of the following types of property (39-13-102, WS):

- the gross product of all mines and mining claims;
- pipeline companies;
- electric utilities;
- railroad companies;
- rail car companies;
- telecommunications companies;
- other public utilities.

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[1] The report is available on the Internet at http://www.orps.state.ny.us/ref/pubs/railroadutility/section1.htm.

[2] Kenneth Ulrich, Wyoming Department of Revenue, telephone conversation January 15, 2006.

[3] The Wyoming Department of Revenue defines "unitary valuation" as "the process of determining the value of a company as a whole without reference to individual parts. The unitary approach is used in the valuation of properties which derive their value from interdependent assets working together. The market value is not a summation of fractional appraisals, but the value of a company as an operating unit."

Natural Gas Producing States and Method of Valuation of Utility Property				
State*	Number of Gas and Gas Condensate Wells**	Marketed Natural Gas Production in MMCF***	Unitary valuation	Property classification system
Alabama	5,157	316,943	Yes	4 classes
Alaska (1)(2)	195	471,213	No	No
Arizona	9	331	Yes	9 classes
Arkansas	7,606	169,279	Yes	No
California (3)	1,249	319,665	Yes	Real and personal
Colorado (4)	18,774	1,037,121	Yes	2 classes
Illinois	240	126	No (RR real, yes)	Personal prop. exempt
Indiana	2,291	1,464	Yes	No
Kansas	17,387	394,173	Yes	7 classes of real, 6 classes of pers.
Kentucky	12,900	87,609	Yes	Residential & comm
Louisiana	16,939	1,382,253	Yes	4 classes
Maryland	7	22	Yes	No
Michigan	8,600	260,820	Yes	No, 50% of value
Mississippi	427	145,374	Yes	5 classes
Montana	4,539	96,199	Yes	13 classes
Nebraska	109	1,168	Yes	4 classes
New Mexico	37,100	1,632,536	Yes	No 33.3% of value
New York	5,878	35,044	No	No
North Dakota (5)	117	55,645	Yes	2 classes
Ohio (6)	33,828	120,080	Yes	Yes
Oklahoma	34,334	1,690,818	Yes	No
Oregon	15	467	Yes	No
Pennsylvania	42,437	157,800	No	No
South Dakota (7)	61	1,025	Yes	Yes
Tennessee	430	1,803	Yes	Yes
Texas	68,572	5,189,998	No	No
Utah (8)	3,220	276,969	Yes	2 classes
Virginia (9)	3,506	NA	No	No
West Virginia (10)	46,203	187,723	Yes	4 classes
Wyoming	18,154	1,590,746	Yes	3

Notes:
*States marked in bold are included in report
**Wells for calendar year 2004
***Production from different years
(1) Property used for oil or gas exploration, production, or pipeline transportation is exempt from local assessment but subject to state tax of 20 mills.
(2) The only property that is centrally assessed and apportioned is the Trans-Alaska Pipeline System.
(3) Classification system between real and personal property for utility property under unit valuation method.
(4) Residential property is taxed at 9.15% (annually adjusted) and all other property taxed at 29%.
(5) Personal property is exempt from taxation in North Dakota, however utility property is subject to taxation as personal property. Residential property is taxed at 9%, all other property is taxed at 10%.
(6) In 2005 property was assessed at 25% to 88% of true value; all real property is assessed at 35%. The personal property tax will be phased out by 2009. Assessment rates for certain other property is reduced.
(7) Real property is assessed at 85% of true value (personal property is exempt). There are three separate property tax rates: agricultural, owner-occupied housing, commercial and all other property.
(8) Primary residential property is assessed at 25% of market value; all other property is assessed at 100% of market value.
(9) Unitary valuation has been banned by state courts.
(10) Property is assessed at 60% of market value. Four classes of property are taxed at the following rates: intangible property ($0.50/$100 of value), owner-occupied residential property ($1.00/$100 of value), other real and personal property located outside a municipality ($2.00/$100 of value), and other real and personal property located within a municipality ($2.50/ $100 of value).

Sources: Energy Information Administration for wells and production and New York Office of Real Property Services, "Survey of Railroad and Utility Taxation Practices Among the States: 2005 Update" for property tax information.

The department uses income, market, and cost approaches to value this type of property. The lack of good information (e.g., negative income or privately held entity) may preclude the application of one or more of the approaches (ORPS study).

According to a Wyoming Department of Revenue memorandum,[4] there are two types of pipelines: (1) gathering systems; and (2) common carrier pipelines. Gathering systems carry natural gas to processing centers to be treated to meet quality standards for introduction into a transmission pipeline. After treatment, the gas passes through a metering device, which marks the point of sale by the producer. Transmission pipelines (or common carrier pipelines) are subject to regulation by FERC or the Wyoming Public Service Commission. Regulatory changes at the federal and state level during the late 1980s and early 1990s created the distinction between nonregulated gathering lines and transmission system. In particular, after FERC issued Order 636 in 1992, production, gathering, and processing services were "spun-off" from regulated pipeline companies into nonregulated companies.[5]

For Wyoming severance tax purposes, "gathering lines" means the transportation of crude oil, lease condensate, or natural gas from multiple wells by separate and individual pipelines to a central point of accumulation, dehydration, compression, separation, heating and treating or storage (39-14-201, WS). For property tax purposes, gathering lines, even if they cross county lines, are typically locally assessed and transmission pipelines are assessed by the state. In determining whether a particular pipeline is part of a gathering system or a transmission system, the Wyoming Department of Revenue reviews the business activity of the company that owns the pipeline and the regulatory environment in which the company operates.[6]

The Wyoming Department of Revenue considers two factors to distinguish between gathering systems subject to local assessment and transmission lines subject to state assessment. First, if the producer owns the gas (or oil) in the pipeline, the pipeline is part of the gathering system. Second, if the pipeline is downstream from the meter, the pipeline is part of the transmission system.[7]

Wyoming has three categories of taxable property (39-13-103, WS):
- mineral property is taxed at 100% of market value;
- industrial property (including oil and gas property and the property of public utilities) is taxed at 11.5% of market value; and
- all other real and personal property (commercial and residential) is taxed at 9.5% of market value.

[4] Chubb, Ronald J., "Pipeline Assessment Clarification", Memorandum (00-030), Wyoming Department of Revenue, March 25, 2002.

[5] *Ibid.*

[6] *Ibid.*

[7] *Ibid.*

KANSAS[8]

The Kansas Department of Revenue uses the unitary valuation method to assess the property of public utilities. All other property is locally assessed. The Department uses the income, market, and cost methods to value public utility property. The weighting of each approach depends on the availability and reliability of information. Generally, the Department considers the capitalized income approach the most reliable (ORPS study).

Kansas defines public utility property (79-5a01, KSA) as an entity that owns, controls, and holds for resale stored natural gas in an underground formation in the state or that operates a business of:

- a railroad;
- transmitting telegraphic messages;
- transmitting telephonic messages;
- transporting or distributing to, from, through or in this state natural gas, oil or other commodities in pipes or pipelines, or engaging primarily in the business of storing natural gas in an underground formation;
- generating or distributing electric power;
- transmitting water if for profit or subject to regulation of the state corporation commission; and
- transporting cargo or passengers by means of any vessel used in navigating any of the navigable watercourses within or bordering upon this state.

The definition of a public utility specifically excludes intracounty oil or natural gas gathering systems; this type of property is considered commercial and industrial property. Wells and flowlines are not considered part of the centrally assessed unit.[9] Intracounty gathering systems are depreciated on a 7-year, straight-line basis to a minimum of 20% of original cost and are taxed at 25% of the depreciated value.[10]

Kansas has seven classes of real property and six classes of personal property, and property is assessed at various percentages (79-1439, KSA). Real property is assessed at the following percentages of market value:

- real property used for residential purposes, 11.5%;
- land devoted to agricultural use (valued on productivity), 30%;
- vacant lots, 12%;
- real property which is owned and operated by a not-for-profit organization not subject to federal income taxation, 12%;
- public utility real property, 33% (except railroad property, which is taxed at the average rate of all other commercial and industrial property);
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[8]Roger Dallam, Property Assessment Division, Kansas Department of Revenue, telephone conversation, January 15, 2006.

[9]Roger Dallam, *Ibid.*

[10]In re CIG Field Services Co., _Kan. _, 112 P3d 138, 149 (2005).

- real property used for commercial and industrial purposes and buildings and other improvements located upon land devoted to agricultural use, 25%; and
- all other urban and rural real property, 30%.

Personal property is assessed at the following percentages of market value:
- mobile homes used for residential purposes, 11.5%;
- mineral leasehold interests, except oil leasehold interests the average daily production from which is five barrels or less, and natural gas leasehold interests, the average daily production from which is 100 mcf or less, which is assessed at 25%, 30%;
- public utility tangible personal property, 33% (except railroad personal property which is assessed at the average rate of all other commercial and industrial property);
- motor vehicles, 30%;
- commercial and industrial machinery and equipment, 25%; and
- all other tangible personal property not otherwise specifically classified, 30%.

CIG Field Services Company appealed the Kansas Department of Revenue's valuation and assessment of its gathering lines as public utility property to the Kansas Board of Tax Appeals for tax years 1997 to 2003. The company contended that the different tax treatment of interstate and intercounty gathering systems from intracounty systems violated the federal Interstate Commerce Clause and federal and state Equal Protection Clauses. The majority of the Board of Tax Appeals found that CIG and intracounty natural gas systems were competitive and thus similarly situated. However, the Board does not have the authority to rule on constitutional issues and therefore upheld the Department of Revenue's valuation and assessment for the years in dispute.[11]

CIG appealed the Board's decision to the Kansas Supreme Court. The Court ruled that the statute violated the federal Interstate Commerce Clause because it "discriminates against and has the effect of unduly burdening interstate commerce by defining interstate and intercounty natural gas gathering systems as public utilities taxable at a higher assessed value and higher rate than intracounty systems. . .".[12]

MISSISSIPPI[13]

The Mississippi State Tax Commission uses the unitary valuation method to assess the value of the operating property of railroads, oil or gas pipeline companies, electric companies, and other public service companies with property in more than one county and the property of telephone companies operating in more than six counties.

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[11] *Ibid.*

[12] *Ibid.*

[13] Bill Dampeer, Mississippi State Tax Commission, telephone conversation, January 25, 2006.

Oil and natural gas production personal property, including drilling rigs (on which a permit fee has been paid), wellheads, and downhole equipment, is exempt from property taxation if the severance tax has been paid on production from the property.[14]

All gathering lines are locally assessed even if they cross county lines. Previously, gathering lines were centrally assessed, but in the 1980s, the Mississippi Supreme Court ruled that gathering lines were not a public service company.[15] Mississippi State Tax Commission centrally assesses pipelines that are regulated by the Federal Energy Regulatory Commission or the state. Gathering lines would be centrally assessed if gathering lines are reported to the Federal Energy Regulatory Commission.[16]

Following the Supreme Court decision, the State Tax Commission and representatives of the oil and natural gas industry negotiated the point of assessment for tax purposes for gathering lines. For natural gas lines, property located downstream of the pin recording meter (for measuring the severance tax) is taxable. For oil lines, property located downstream of the holding tank is taxable.[17]

Section 112 of the Mississippi Constitution provides for the classification and taxation of property:

- Class I: single family residences are assessed at 10% of true value;

- Class II: all other real property [including railroads and airlines] not included in Class I or Class IV is assessed at 15% of true value;

- Class III: personal property [including railroads and airlines], except for motor vehicles and for personal property included in Class IV, is assessed at 15% of true value;

- Class IV: public utility property, which is property owned or used by public service corporations required by general laws to be appraised and assessed by the state or the county, is assessed at 30% of true value; and

- Class V: motor vehicles are assessed at 30% of true value.

[14]The exemption for oil production property is under 27-25-523, Mississippi Code, and the exemption for natural gas production property is under 27-25-721, Mississippi Code.

[15]Bill Dampeer

[16]Bill Dampeer.

[17]Bill Dampeer.

MICHIGAN[18]

The State Tax Commission centrally assesses the property of railroad, telegraph, and telephone companies. The cost, income, and market approaches may be used to value property. However, the market approach is seldom used, and the income approach is used if income is stable over time (ORPS study). Centrally assessed property is subject to a statewide levy in lieu of all other property taxes. The statewide levy is based on the average rate of taxation applied to commercial, industrial, and public utility property. Proceeds from the tax are deposited in the state general fund.

All other property is locally assessed. For the valuation of public utility property, local assessors use multiplier tables developed by the State Tax Commission. The multiplier tables are used to value electric transmission and distribution property and natural gas transmission and distribution lines for property tax purposes. The multipliers convert the original cost or historical cost of transmission property for the year in which the property was installed to the current year value. The multiplier varies depending on the age of the property. The multipliers take into account the income and cost approaches to valuation.[19]

Oil and natural gas gathering lines that serve one project are valued as business machinery and equipment and are subject to lower multipliers (based on shorter economic life). If, however, the gathering lines serve more than one project, that is, if the gathering lines are used to transport third-party oil or natural gas, they are considered public utility property and are valued using the multiplier tables applicable to public utilities.[20]

All property in Michigan is assessed at 50% of market value (211.27a, MCL).

OHIO[21]

In Ohio, public utilities include telephone companies, telegraph companies, electric companies, natural gas companies (distribution companies), pipeline companies, waterworks companies, water transportation companies, natural gas distribution companies, rural electric companies, and railroad companies. The Ohio Department of Taxation uses the unit value method to value public utility property and railroad property. Railroad personal property is valued using the cost and income approach, while public utility personal property is valued using capitalized costs less allowances (ORPS study). Subsidiaries of parent companies cannot file combined reports and are valued separately from the parent company. The method of valuation the subsidiary would be based on its primary business function.[22]

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[18] Timothy Schnelle, Michigan Department of Treasury, Commercial/Industrial Unit, Telephone Conversation, January 29, 2006.

[19] Timothy Schnelle.

[20] Timothy Schnelle.

[21] Bill Peters, Public Utility Tax Division, Ohio Department of Taxation, telephone conversation, February 7, 2006.

[22] Bill Peters.

Most oil and gas production equipment is assessed locally. However, the Department of Taxation centrally assesses the property of a general business, including gathering lines, located in more than one county, regardless of whether the property is continuous. The property is valued at its location and is not apportioned. In tax year 2005, personal property was taxed at 25% of true value. The taxation of general business personal property is being phased out. Beginning in tax year 2009, general business personal property will be exempt from taxation. A portion of the revenue from the newly enacted commercial activities tax will be used to offset the revenue loss to taxing jurisdictions.

Real property, regardless of ownership or use (e.g., residential, commercial, or public utility) is valued locally and is assessed at 35% of true value. The assessment level for utility personal property, on the other hand, is taxed at various assessment levels, ranging from 25% to 88% of true value. For example, the transmission and distribution property of an electrical utility is taxed at 88% of true value and all other property of the utility is taxed at 25% of true value. The transmission and distribution property of a rural electric cooperative is taxed at 50% of true value. The property of natural gas distribution companies and railroad companies is taxed at 25% of true value, while the property of pipeline companies is taxed at 88% of true value.

CALIFORNIA[23]

Article 13, section 19, of the California Constitution requires the California Board of Equalization to annually assess:

- pipelines, flumes, canals, ditches, and aqueducts lying within 2 or more counties; and
- property, except franchises, owned or used by regulated railway, telegraph, or telephone companies, car companies operating on railways in the state, and companies transmitting or selling gas or electricity.

The constitutional provisions for the assessment of pipelines limits how the Board of Equalization assesses this type of property. In 1993, the California Supreme Court determined that the Board could assess only pipeline property and not other property owned by the company. As a result, land, improvements, and personal property are locally assessed.

The Board uses the unitary valuation method to value centrally assessed property, using the cost, income, and market approaches. The income approach is given more weight in valuing regulated pipeline property. Unregulated pipelines (including gathering lines) that cross county lines are valued locally by using the replacement cost new, less depreciation method.

Property in California is assessed at 100% of fair market value and taxed at 1% of value. Pipeline property that is annually assessed is not subject to Proposition 13 base year limitations.

LOUISIANA

The Louisiana Tax Commission is required to appraise the property of all public service companies. Public service companies include investor-owned electric, gas, water, barge, and telephone companies, pipelines, railroads, airlines, and electric cooperatives. Louisiana statute requires the Tax Commission to use the market approach, income approach, and cost approach,

[23] Ken Thompson, Valuation Division, California Board of Equalization, telephone conversation, February 2, 2006.

giving the appropriate weight to each approach, to determine fair market value of these properties (RS 47:1853).

Pipeline companies that are regulated by FERC, the Interstate Commerce Commission, or the Louisiana Public Service Commission are centrally assessed by the Tax Commission. Regulated and other subsidiaries of parent companies are valued separately from the parent company.

Oil and natural gas production property, including flowlines and gathering lines (even if they cross parish lines), are valued locally. Local assessors use replacement cost schedules to value intrastate pipelines. Lower quality "lease lines" are valued on a different schedule than higher quality "other pipelines", which include larger gathering lines and transmission lines.[24]

Article VII, section 18(B), of the Louisiana Constitution provides for the classification of property subject to taxation and the percentage of fair market value for determining the assessed valuation of the property:

- land is assessed at 10% of fair market value;
- residential improvements are assessed at 10% of fair market value;
- electric cooperatives, excluding land, are assessed at 15% of fair market value;
- public service properties, excluding land, are assessed at 25% of fair market value;
- other property is assessed at 15% of fair market value.[25]

For tax years 1994 through 2003, several interstate pipeline companies in Louisiana paid property taxes under protest because some intrastate pipelines regulated by the Louisiana Public Service Commission that should have been assessed by the Tax Commission were locally assessed and taxed at 15% of fair market value rather than at 25%. In a consolidated case, a District Court judge ruled that the actions of the Louisiana Tax Commission, as it relates to the plaintiffs, "violated the equal protection clauses and due process clauses of the Louisiana and U.S. Constitutions because of the Commission's disregard of the requirement for uniformity."[26] The Court directed the Tax Commission to require parish assessors to appraise the plaintiffs' property for the tax years in dispute and assess the property at 15% of value. It also directed the Tax Commission to provide refunds on the difference between the amount of property taxes paid and the reassessed amount.[27]

The plaintiffs appealed the District Court decision to the Court of Appeal, arguing, among other things, that using replacement cost less depreciation would lead to a higher valuation of property than valuing the property on its ability to earn an acceptable (regulated) rate of return. The Tax Commission testified at trial that the unit method of valuation used to value public service

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[24]Louisiana Administrative Code, Revenue and Taxation, Title 61, section 1301.

[25]The Louisiana Constitution also provides for the specific exemption of property from taxation and for sale of property for delinquent taxes.

[26]ANR Pipeline Company v. Louisiana Tax Commission, 19th Judicial District Court, District Court Parish of East Baton Rouge, State of Louisiana, NO: 468,417, Sec: 22, March 30, 2005.

[27]*Ibid.*

property gives different values than locally determined replacement cost.[28] The Appeal Court concluded, based on prior case law, that the appropriate remedy in this case was to use the same valuation and assessment method for the plaintiffs' property as was used for the "preferred properties" (i.e., intrastate pipeline companies), even though that method was contrary to law.[29]

ALABAMA[30]

The Alabama Department of Revenue uses the unit value method to value the property of public utilities. Public utilities include, among other entities, the property of railroads, telecommunication and telegraph companies, electric power companies, and water, gas, and pipeline companies. Alabama statute (40-21-6, COA) requires that the Department use the market, income, and cost approaches. The Department gives more weight to the income and cost approaches (ORPS study). Regulated subsidiaries of parent companies are valued as separate units. All other taxable property, including nonoperating property of utilities, is locally assessed even if it crosses county lines.

Taxable property in Alabama is divided into the following classes of property and is assessed at the following ratios of assessed value to the fair and reasonable market value of property:

- Class I: property of utilities used in the utility business, 30%;
- Class II: real and personal property not otherwise classified (includes railroad, airline, and wholesale electrical generation property for tax purposes), 20%;
- Class III: agricultural, forest, and residential property, and historic buildings and sites, 10%; and
- Class IV: private autos and pickup trucks not used for hire, rent, or compensation, 15%.

The Alabama Department of Revenue rules provide guidelines for assessing equipment used in the oil and gas industry. Common carrier pipelines transport oil or natural gas from a producer to a user, refiner, or other entity for a fee or tariff. Common carrier pipelines are assessed by the Department as Class I property. Flowlines and gathering lines owned and controlled by the owner or owners of the wells are locally assessed as Class II property. Gathering lines that transport oil or natural gas of persons other that the owners of the wells for a fee or tariff are assessed as common carrier pipelines.[31]

CONCLUDING COMMENTS

The states included in this survey use a variety of approaches to value public utility property, including oil and natural gas pipelines, as well as oil and natural gas gathering lines. Several states use the unitary valuation method to centrally assess all operating property of public utilities, while some states have variations to that method. For example, Michigan centrally

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[28] ANR v. Louisiana Tax Commission No. 2005 CA 1142, pp. 22-23.

[29] *Ibid.*

[30] Kelly Eggers, Property Tax Division, Alabama Department of Revenue, telephone conversation, February 7, 2006.

[31] Alabama Administrative Code, 810-4-1-.15, Distinction Between Flowlines, Gathering Lines, and Pipelines for Assessment of Business Personal Property of the Oil and Gas Industry.

assesses statutorily specified property, which is taxed at the state level only. All other public utility property is locally assessed. Ohio centrally assesses personal property, while all real property is subject to local assessment. A fluke in the California Constitution limits the assessment of pipeline property to personal property. Several states value separately regulated subsidiaries of a parent company.

The states in this survey also use different approaches to value oil and natural gas gathering lines. Wyoming, Mississippi, California, Louisiana, Michigan, and Alabama provide for the local assessment of gathering lines, even if they cross taxing jurisdiction boundaries. Wyoming and Alabama provide for the central assessment of gathering lines under certain conditions, while Michigan values gathering lines that serve more than one project as (locally assessed) utility property. In Ohio, gathering lines that cross county lines are centrally assessed based on location. Kansas, because of the CIG Field Services court decision, is going to have reexamine how it taxes gathering lines.

Kansas, Mississippi, Louisiana, and Alabama tax public utility property at higher rates than other types of property. Ohio has an array of tax rates that apply to public utility property. Wyoming taxes public utility property at the same rate as industrial property. Michigan and California tax all property at the same rate.

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