SUBJECT: Property Tax -- State Tax Commissioner's Statement Concerning Primary
Reliance on the Income Approach for Appraising Reserve Oil and Gas Property
Pursuant to § 110 CSR 1J-4.

On March 10, 1999, the State Legislature approved Legislative Rule § 110 CSR 1J-1 et seq. (for
the appraisal of producing and reserve oil and gas properties). This notice will address this rule’s
primary reliance on the income approach to value when appraising reserve oil and gas properties
for property tax purposes.

DISCUSSION

There are three (3) generally accepted approaches to value that must be considered when
estimating market value of properties for ad valorem tax purposes. These are the cost, market
and income approaches to value. These approaches to value must be considered and should be
developed, if appropriate, to properly estimate market value in compliance with generally
accepted appraisal principals. The following is a brief discussion of these three (3) approaches to
value and their potential use when estimating the market value of reserve oil and gas natural
resource properties for ad valorem tax purposes.

COST APPROACH

The cost approach to value is based upon the assumption that the cost of a property, less
depreciation (loss in value), yields a reasonable estimate of market value. There are three (3)
genernally accepted types of cost approach appraisal methods; these are: original cost less
depreciation, reproduction cost less depreciation, and replacement cost less depreciation.
Depreciation is a loss in value due to physical deterioration through use, functional obsolescence
through design or utility and economic obsolescence due to outside market forces.

Original cost less depreciation is the cost of acquisition of a property less a loss in value due to
physical deterioration, functional obsolescence and economic obsolescence. This approach is
widely employed in the appraisal of "cost-based" regulated utilities, however it has a limited
application when appraising reserve oil and gas properties, as many of these types of properties
were acquired years ago at substantially less than current market value.

Reproduction cost less depreciation is the cost of reproducing an exact replica of a property less
physical deterioration, functional obsolescence, and economic obsolescence. This approach is
employed in appraising one-of-a-kind properties such as works of art or special purpose
properties, an example of which may be the State's Capitol Building. Oil and gas properties are a
nonrenewable natural resource and can therefore not be reproduced. Because of their
nonrenewable nature, reserve oil and gas properties do not lend themselves to development of a
reproduction cost less depreciation appraisal.

Replacement cost less depreciation is the cost of replacing a property with one of like utility less
physical deterioration and economic obsolescence. This approach is the most widely used of the
three (3) cost approaches to value and is widely employed in the appraisal of commercial and
industrial personal property. Replacement cost has limited application, however, in the appraisal
of nonrenewable natural resource properties, as the resource cannot by its nature be replaced.
Because of their nonrenewable nature, reserve oil and gas properties do not lend themselves to
the development of replacement cost new less depreciation appraisals.

MARKET APPROACH
The market approach to value is based upon the assumption that the recent selling price of comparable properties, if properly analyzed and adjusted, will yield a reasonable estimate of current market value. While sales of reserve oil and gas properties do occur within the State, the sales are infrequent and quite often oil and gas interests represent only a portion of the property acquisition thus diluting the purity of the market transaction. Because of these drawbacks the Legislative Rule does not contemplate the development of a market comparable approach to value for reserve oil and gas properties.

**INCOME APPROACH**

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 the prospective buyer. In the oil and gas industry, a common business practice of negotiating advance payments ("delay rentals") for the right to, at some future date, produce oil and gas has developed. By analyzing the amount and duration, typically, of delay rentals and by discounting the resulting income series to present worth an estimate of the probable selling price of reserve oil and gas properties can be developed. This procedure contained in § 110 CSR 1J-4.7 is the method used by the Department to develop, on a county-by-county basis, the per acre market value of reserve (non-producing acreage) oil and gas properties. The resultant county per acre values were developed and published in the State Register on July 1, 1999; and after a public comment period were filed, in finalized form, in the State Register on September 1, 1999.

For more information concerning the appraisal of reserve oil and gas properties consult § 110 CSR 1J-1 et seq. or contact the State Tax Department at telephone number (304) 558-3940.

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