

## **ADMINISTRATIVE NOTICE 2009-12**

**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 June 1, 2005, the State Legislature amended Legislative Rule § 110 CSR 1J-1 et seq. (for the appraisal of producing and reserve oil and gas properties) became effective. 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) generally 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 and district basis, the per acre market value of reserve (non-producing acreage) oil and gas properties. The resultant per acre values were developed and published in the State Register on June 29, 2007; and after a public comment period were filed, in finalized form, in the State Register on September 4, 2007.

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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