Challenging Ad Valorem Tax Appraisals of Oil & Gas Assets: Part I – Lowering Appraised Values

In fiscal year 2019, the oil and gas industry paid $13.3 billion in taxes in Texas. Local property tax accounted for 30%, or almost $4 billion. Thus, about one in three tax dollars paid by oil and gas entities go to local property taxes. It follows that minimizing ad valorem taxes can have a significant impact on the bottom line.

The statutorily-mandated appraisal method for oil and gas interests almost always yields lower appraised values than the less-structured "market value" that appraisal districts prefer.

Texas Property Tax Code Section 23.175 prescribes the calculation of key variables that, taken together, that yield an "appraised" value:

- **Revenue** (which takes into account both price and volume),
- **Expenses necessary to generate that revenue**, and
- a "**discount rate**."

Revenue, less the expenses necessary to generate it, equals income. Income is then "discounted" into the future, valuing dollars received now higher than in the future. Section 23.175 limits the appraisal districts' discretion with respect to price, volume, and perhaps most significantly, discount rate.

<u>Volume</u> is the most straightforward variable. Appraisal districts generally receive production data from the Railroad Commission, allowing volumes to be easily verified. It is important to carefully review the appraiser's assumed decline rate. If the appraiser assumes steady production, but your company expects otherwise, the appraisal will be too high.

<u>Price</u>, the second key variable, must be calculated in accordance with § 23.175, utilizing a defined "average price" and "price adjustment factor." The statute provides detailed instructions for calculating the beginning "average price," the "price adjustment factor," as well as any price escalations in future years. Careful examination to ensure that the district's pricing follows the statutory mandates can result in lower tax values.

<u>Discount Rate.</u> Appraisers must follow the Comptroller's published guidelines to determine the appropriate discount rate, which turn in part on property-specific characteristics. Even the most well-intentioned appraiser cannot know every property well enough to ensure that proper assumptions are made. Your company's in-depth knowledge of its assets can help guide the appraiser's determination of the proper discount rate for each specific property.

The limits on the appraisal district's discretion in valuing oil and gas interests are critical. Left to their own devices, the districts may inflate values, either inadvertently or in an effort to support their tax base. A company armed with knowledge of these limitations can ensure compliance with § 23.0175's constrictions and generally, reduce its ad valorem tax burden.

In Part II of this series, I will address the steps an entity must take to preserve and protect its right to protest excessive appraisals.

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