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OPINION COMMITTEE

Attorney General John Cornyn
P.O. Box 12548
Austin, Texas 78711-2548

FILE # ML-42027-01
I.D. # 42027

Re: Attorney General Opinion

Dear General Cornyn:

I am writing to request an opinion concerning the taxable situs of certain mineral interests, specifically the correct method for allocating the value of minerals interests that underlie two counties. The appraisal districts for Terry County and Hockley County have taken different approaches to the appraisal of these interests, which has resulted in an effective assessment totaling more than 100% of the interests. The appraisal districts would like the help of your office in sorting out this problem.

Multiple oil and gas formations underlie parts of the boundary between Terry County and Hockley County, and numerous leases are split between the two counties. A taxpayer who acquired a working interest through an oil and gas lease holds the mineral interests in question. This lease extends into both counties with approximately eighty-four percent (84%) of the surface acres in Hockley County and approximately sixteen percent (16%) of the surface acres in Terry County. This is a multiple-well lease with two producing wells in Hockley County and five producing wells in Terry County. Production occurs on both sides of the county line with approximately fifty percent (50%) of the present production coming from the wells located in Terry County and approximately fifty percent (50%) of the present production coming from the wells in Hockley County. There is no pooling agreement involved.

The Hockley County Appraisal District ("HCAD") has appraised eighty-four percent (84%) of the value of the subject property for taxation in Hockley County because eighty-four percent (84%) of the surface acres that appertain to the real property are located there. The Terry County Appraisal District ("TCAD") has appraised fifty percent (50%) of the value of the subject property for taxation in Terry County because its analysis of present production rates and geological data indicate that fifty percent (50%) of the remaining recoverable reserves are on Terry County's side of the line. Consequently, the property is being assessed for more than one hundred percent (100%) of its total value. Neither appraisal district wishes the taxpayer to pay more than the law requires, but the appraisal districts have not been able to agree on an approach to use in allocating the value of the property. There is a fundamental difference between the appraisal districts as to what they are appraising. HCAD believes that it is valuing the mineral interests created by interests in real property, while TCAD is apparently appraising the minerals that are under the ground.

We appeal to your office for some guidance in resolving this problem. Should the allocation of mineral interests in question be based: (1) on the ratio of surface acreage covered under the lease

attributable to each county, or (2) on an engineering analysis of the reservoir, the production of minerals and the remaining recoverable reserves present in each county.

Each Appraisal District is submitting a similar request that outlines what it feels is the crux of the matter and I attach a short brief outlining my position on the issues.

County Attorney

Pat Phelan

xc: Nick Williams

BRIEF OF HOCKLEY COUNTY ATTORNEY

Taxable mineral interests should be allocated between the counties based on the acreage covered in the lease(s).

The question presented to the attorney general in DM-490 is almost identical to the current issue: may a taxing entity tax the royalty income generated from a well outside of its jurisdiction? The facts in the instant case are only slightly different in that the allocation will be made between counties and not school districts, but we feel that the differences are minor and not controlling on the result. The currently disputed allocation methodologies in use between the appraisal districts create an aggregate value in excess of 100%. Terry County uses a 50% allocation based on what it considers to be the location of the oil reservoir underneath the two counties and the relative value of the lease's "productive acreage" within its taxing units' area, while Hockley County bases its allocation on the 84% of the surface acres covered under the lease that are located in Hockley County. There is no dispute as to what the value of the entire interest is, only that presently, the taxpayer is assessed at some 134% of that value.

My review of the case law and statutes conforms to the review done by the attorney general's office in DM-490 and I could find no additional cases or new statutory authority that would be determinative of this issue. Using DM-490, it appears that allocating the mineral interests between the counties based on land acres covered under the lease is the only correct method available to the appraisal districts that conforms to the law.

Several mineral leases appertain to surface acreage that splits the common Hockley/Terry County line. The lease that is the subject of this opinion request is producing oil from three separate producing horizons or zones of a field and listed under separate Railroad Commission Numbers ("RRC#") and from several different wells located on both sides of the county line. Hockley County Appraisal District ("Hockley CAD") performed three individual appraisals for each of these RRC#'s and has consolidated these separate appraisals into a single lease value, which is then distributed to the undivided interest owners per their respective net revenue interest. Hockley CAD does not appraise or allocate the oil and gas reserves that are located under the ground, but rather the interests in real property that are created by the lease. This creates an objective, legally defensible, permanent percentage that does not change from year to year.

Terry County Appraisal District ("TCAD")'s approach using "productive acreage" as its basis does not allocate the value of the mineral interest, but instead attempts to define the location of a constantly migrating mineral reserve using current year information to determine where the minerals were on January 1 of the tax year in question. In other words, they are treating the oil reserves, and not the mineral interests, as the property to be appraised and then allocated between the jurisdictions. The use of this method is not easily administered and is very susceptible to protests and challenges due to its hyper-technical and highly subjective attempt to use a snapshot of current production values corresponding to individual well locations to backdate the allocation to January 1 of every year. This method also runs contrary to the allocation of the lease's income to the undivided mineral interest owners; each owner receives income, prorata to their net revenue interest in the lease, from the total lease production and not from individual wells.

Using the reasoning outlined in the most recent attorney general opinion on this subject and its cited cases, it is apparent that the interests in real property, the royalty or working interests, appertain to the land that was leased, and not the oil that may or may not be under that land at any given time. Op. Tex. Att'y Gen. No. DM-490 (1998) at 2. In fact, the derivation of the decimal net revenue interest itself is dependent only on the relative contribution of the interest owner's land to the lease as a whole, and not whether any oil may or may not underlie their land at that time or at any future time.

The conclusion of DM-490 regarding the allocation between school districts depended on the pooling agreement, which is not present in this case. In the absence of such a pooling agreement creating a joint tenancy in all the land covered under the agreement, each school district would only be able to tax the income of royalty interest owners located in that school district. This could only be determined through the examination of the physical boundaries of the lease and school district, not through an examination of where the hypothetical mineral reserve was located on January 1 of the tax year in question.

Therefore, the correct method for allocating mineral interests between taxing entities should be determined based on the location of the lease's boundaries compared to the entities' boundaries. Each entity would be entitled to tax the mineral interests in proportion to the amount of property within its boundaries. We feel that this method is the correct method that should be used for allocating mineral interests throughout the state whenever boundaries of leases overlap entity boundaries. In fact, this is the preferred method around the state and we feel it comports with the law. It yields results that are justifiable, unchanging and fair to all parties.