



# Ohio Legislative Service Commission

## Bill Analysis

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### Sub. H.B. 8\*

131st General Assembly

(As Reported by H. Energy and Natural Resources)

Reps. Hagan and Ginter

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## BILL SUMMARY

### Unit operation procedures under Oil and Gas Law

- Requires the Chief of the Division of Oil and Gas Resources Management to hold a hearing required under current law to consider the need for the operation as a unit of an entire pool or part of a pool not later than 45 days after the Chief's motion or receipt of a complete application by the owners of 65% of the land area overlying the pool.
- Establishes requirements and procedures in accordance with which the Chief or the Chief's designee must review an application for unit operation and determine whether it is complete, including:
  - A requirement that the Chief or the Chief's designee provide the applicants with a notice explaining any deficiency if the application is determined to be incomplete;
  - A provision allowing the applicants to submit additional information to eliminate any deficiency; and
  - A stipulation that if a notice of deficiency is not provided within five business days after receipt of the application, the application is determined to be complete.

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\* This analysis was prepared before the report of the House Energy and Natural Resources Committee appeared in the House Journal. Note that the list of co-sponsors and the legislative history may be incomplete.

- Specifies that an order of the Chief providing for unit operation must be made not later than 30 days after the date of the hearing if the Chief makes certain findings.
- Retains a requirement that the plan prescribed in the Chief's order for unit operation contain a provision for carrying or otherwise financing any person who is unable to meet the person's financial obligations in connection with the unit, allowing a reasonable interest charge for that service, and adds that the interest rate must be not less than 200%.
- Stipulates that a Chief's order providing for unit operation does not authorize an owner to use the surface of unleased land unless that use is consistent with a separate agreement between the surface rights owner of that land and the owner.
- Stipulates that if the Chief adopts rules or establishes guideline for purposes of the statute governing unit operation, both of the following apply:
  - The rules or guidelines cannot establish a prehearing publication notice requirement of more than three publications in a newspaper of daily circulation in the applicable county or counties and cannot require the last date of publication to occur not more than five days prior to the hearing; and
  - Any publication requirement established in the rules or guidelines must allow for publication in the newspaper of daily circulation that is nearest to the proposed area of unit operation if a newspaper of daily circulation is not available in the county in which the proposed area of unit operation is located.

### **Application of unit operation to public land**

- Requires the Chief to issue an order for unit operation of a pool or part of a pool that encompasses a unit area consisting in whole or in part of oil or natural gas resources owned or controlled by the state or a political subdivision, except state nature preserves and state parks in operation as of January 1, 2015.
- Prohibits disruption of the surface of the land in state forests from occurring as a result of an order of the Chief providing for operation as a unit.

### **Property tax valuation of oil and gas reserves**

- Specifies that a discounted cash flow formula used to value certain producing oil and gas reserves for property tax purposes be the only method for valuing all oil and gas reserves.

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## CONTENT AND OPERATION

### Unit operation procedures under Oil and Gas Law

Continuing law requires the Chief of the Division of Oil and Gas Resources Management to hold a hearing, on the Chief's motion or receipt of an application by the owners of 65% of the land area overlying the pool, to consider the need for the operation as a unit of an entire pool or part of a pool. The bill requires the Chief to hold the hearing not later than 45 days after the Chief's motion or receipt of a complete application.

The bill then establishes requirements governing the review of an application for unit operation. Under the bill, when such an application is made, the Chief or the Chief's designee, not later than five business days after receiving the application, must review it to determine if it is complete. If the Chief or the Chief's designee determines the application is incomplete, the Chief or the Chief's designee must provide the applicants a notice explaining the deficiency. The applicants may then submit additional information necessary to eliminate the deficiency. If the Chief or the Chief's designee does not provide notice to the applicants within five business days of receipt of the application, the application must be determined to be complete.

The bill also requires the Chief to make an order providing for the unit operation of a pool or part of a pool not later than 30 days after the date of the hearing if the Chief finds that the operation is reasonably necessary to increase substantially the ultimate recovery of oil and gas, and the value of the estimated additional recovery of oil or gas exceeds the estimated additional cost incident to conducting the operation. Current law requires the Chief to make an order providing for unit operation after making such findings, but does not specify a time by which the Chief must do so.

In addition, current law requires the Chief's order to prescribe a plan for unit operation that includes specified information and provisions, including a provision, if necessary, for carrying or otherwise financing any person who is unable to meet the person's financial obligations in connection with the unit, allowing a reasonable interest charge for that service. The bill requires the interest charge to be not less than 200%.<sup>1</sup>

The bill stipulates that a Chief's order providing for unit operation does not authorize an owner to use the surface of unleased land unless that use is consistent with a separate agreement between the surface rights owner of that land and the owner.<sup>2</sup>

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<sup>1</sup> R.C. 1509.28(A).

<sup>2</sup> R.C. 1509.28(C).



Under the bill, if the Chief adopts rules or establishes guidelines for the purposes of the statute governing unit operation, the rules or guidelines cannot establish a prehearing publication notice requirement of more than three publications in a newspaper of daily general circulation in the applicable county or counties and cannot require the last date of publication to occur not more than five days prior to the hearing. Finally, any publication requirement established in such rules or guidelines must allow for publication in the newspaper of daily circulation that is nearest to the proposed area of unit operation if a newspaper of daily circulation is not available in the county in which the proposed area of unit operation is located.<sup>3</sup>

### **Application of unit operation to public land**

Under existing law, the Oil and Gas Leasing Commission is responsible for administering the leasing of formations for the exploration for and development and production of oil and natural gas within land owned or controlled by state agencies. The governing statutes establish procedures for the nomination of parcels of land and for the leasing of formations within nominated parcels. The Commission is required to adopt rules establishing additional procedures and requirements.<sup>4</sup> As of the date of this analysis, members of the Commission have not been appointed.

The bill requires the Chief, notwithstanding the authority granted to the Commission, to issue an order for unit operation of a pool or part of a pool that encompasses a unit area consisting in whole or in part of oil or natural gas resources owned or controlled by the state or a political subdivision of the state, except nature preserves owned or controlled by a state agency and state parks in operation as of January 1, 2015. It then prohibits disruption of the surface of the land in a state forest from occurring as a result of an order of the Chief providing for unit operation.<sup>5</sup>

### **Property tax valuation of oil and gas reserves**

The bill states that the "only method" for valuing oil and gas reserves is to employ an existing discounted cash flow formula. Under current law, this formula appears to apply only for the purposes of calculating the tax value of oil and gas reserves exploited by an active well that was not the subject of a recent arm's length sale.

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<sup>3</sup> R.C. 1509.28(D).

<sup>4</sup> R.C. 1509.73, not in the bill.

<sup>5</sup> R.C. 1509.28(A).



Under continuing law's discounted cash flow valuation method, producing oil and gas reserves exploited by wells that were not recently sold in an arm's length transaction are valued, for real property tax purposes, under a form of net income capitalization valuation. Generally, the gross value of production is computed on the basis of the five-year average price of oil and gas from Ohio wells, and the gross production value is discounted over a ten-year period to determine the net present value of the oil or gas. Production volume is adjusted for "flush" production and production forced by using various secondary recovery methods (such as pressurized injection), and an annual rate of decline in production is stipulated. Gross value is adjusted by netting out royalty expenses, capital recovery expenses, and operating expenses. The unit of production for oil is a barrel; the unit for gas is MCF. No per-well average of production is employed, and extractions from wells that share the same meter must be apportioned according to each well.<sup>6</sup>

The discounted cash flow formula appears under current law to apply only for the purpose of calculating the taxable value of oil and gas reserves exploited by a "developed and producing well that has not been the subject of a recent arm's length sale."<sup>7</sup> Indeed, the formula accepts production inputs only from wells developed and producing for the tax year.<sup>8</sup> Methods that county auditors are required or allowed to use to value undeveloped oil and gas reserves are not explicitly stated in current law, which requires an auditor to increase the value of land or mineral rights if the auditor determines that their value has increased because of the discovery of oil or gas, construction of production facilities, commencement of drilling, or other factors.<sup>9</sup> Under a rule adopted by the Tax Commissioner, oil and gas rights that have been separated from surface rights must be valued in accordance with the Commissioner's "annual journal entry . . . in the matter of adopting a uniform formula in regard to the valuation of oil and gas deposits in the eighty-eight counties of the state."<sup>10</sup> This annual entry likely refers to the discounted cash flow formula, which sets value based on a reserve's production. Thus, under continuing administrative rules, undeveloped oil and gas reserves that have been separated from adjoining land appear to have a taxable value of zero, even though the statutory formula used to calculate that value purports to apply only to reserves exploited by producing and developed wells not recently sold at an arm's length sale.

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<sup>6</sup> R.C. 5713.051.

<sup>7</sup> R.C. 5713.051(B) and (C).

<sup>8</sup> R.C. 5713.051(A)(6).

<sup>9</sup> R.C. 5713.05, not in the bill.

<sup>10</sup> O.A.C. 5703-25-11(I).



The bill specifies that county auditors may employ no method other than the discounted cash flow formula to determine the tax value of all oil or gas reserves, even in the absence of a developing and producing well.<sup>11</sup> It is not clear how the bill changes the property tax valuation methods of oil and gas reserves that exist under current law, if it changes them at all. The bill may simply confirm the Tax Commissioner's rule that suggests that undeveloped oil and gas reserves may be valued only according to that formula. Conversely, the bill's new language could override continuing law's explicit admonition that the discounted cash value formula applies only to producing oil and gas reserves. It also is not clear whether the bill requires county auditors to apply the discounted cash flow formula to oil and gas reserves exploited by a well and recently sold at arm's length or to undeveloped oil and gas mineral interests recently sold at arm's length. (See **COMMENT.**)

The bill states that it clarifies the General Assembly's intent that the discounted cash flow formula "continues to represent" the only method of valuing oil and gas reserves for property tax purposes.<sup>12</sup> The valuation changes, if any, apply with respect to property added to the tax list, or charged with past-due tax, on or after the bill's effective date.<sup>13</sup>

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## COMMENT

Article XII, Section 2 of the Ohio Constitution requires that, for property tax purposes, "[l]and and improvements thereon shall be taxed by uniform rule according to value." This provision is generally referred to as the "uniform rule." The Ohio Supreme Court has repeatedly held that the best method of determining a property's tax value for purposes of complying with the uniform rule is the actual price paid for property in an arm's-length transaction. Only in the absence of such a sale has the Court held that the uniform rule permits the use of other factors to determine a property's taxable value. See *State ex rel Park Inv. Co. v. Bd. of Tax Appeals*, 170 Ohio St. 410 (1964), *Berea City Sch. Dist. v. Cuyahoga Cty. Bd. of Revision*, 106 Ohio St.3d 269 (2005), and *Cummins Property Services, L.L.C. v. Franklin Cty. Bd. of Revision*, 117 Ohio St.3d 516 (2008).

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<sup>11</sup> R.C. 5713.051(D).

<sup>12</sup> Section 3(A).

<sup>13</sup> Section 3(B) and (C).



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## HISTORY

### ACTION

### DATE

Introduced  
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