STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-4982

December 15, 1987

No. 87/100

TO COUNTY ASSESSORS:

ASSESSMENT OF MINERAL PROPERTIES

As a result of the addition of Chapter 3.5 to the Revenue and Taxation Code (Supplemental Assessments), numerous questions have arisen regarding the impact of this legislation on mineral property assessments. This letter addresses many of those questions, as well as other issues we have become aware of through the appraisal sampling and assessment practices survey programs. A question and answer format is used for the presentation.

Guidance in responding to these questions is derived from the applicable sections of the Revenue and Taxation Code dealing with the definitions of real property, assessments on the supplemental roll, Rules 463 and 468, and the court case involving litigation on the assessment of producing petroleum property (Lynch v. State Board of Equalization 164 Cal.App.3d 94 (1985)).

Discovery Wells

1. Question

Are discovery wells subject to supplemental assessment?

Answer

A discovery well is an exploratory well that encounters a new and previously unknown mineral deposit. The well may open up a new field, or it may locate a new and previously unknown horizon capable of production in an old field. Such wells and their proved reserves are subject to supplemental assessment (Section 75.10(c), Revenue and Taxation Code). If the newly discovered reserves cannot be produced as a result of the lack of approval by a government agency or the physical inability to produce the well (for example, the pipeline cannot be economically installed), then the reserves do not meet the definition of proved reserves (see Section 468, Administrative Code) and should not be assessed until they do.

2. Question

Are added reserves, other than those discovered through discovery wells, subject to supplemental assessment?

Answer

Economic reserves, reserves resulting from enhanced recovery programs, well workovers, recompletions or redrills, or additional reserves resulting from incorrect estimates used for the regular roll are not subject to supplemental assessment unless they meet the discovery well test (Section 75.10(c), Revenue and Taxation Code). Any such new proved reserves are, of course, subject to assessment on the regular roll. Further, in the appraiser's judgment, such reserves may be considered in arriving at any improvement values subject to supplemental assessment as new construction, but such reserves may not be assessed on the supplemental roll.

Development Wells, Reworks, Recompletions and Redrills

3. Question

Is the new improvement value for development wells, reworks, recompletions or redrills subject to supplemental assessment?

Answer

Yes, the additional improvement value, created as a result of completed new construction, is subject to supplemental assessment provided that the improvement is not classified as a fixture (Section 75.10(a) Revenue and Taxation Code). A forthcoming assessors' letter will clarify the meaning of "fixtures" in this regard. For example, if a well is recompleted in an upper zone after abandonment of the lower zone, the added improvement value is subject to supplemental assessment. However, the added value should be offset by the assessed value of the abandoned improvements. In another example, if a well fails mechanically and is replaced, only that improvement value which exceeds the utility of the replaced well, if any, is subject to supplemental assessment. The added reserve value, if any, however, is not subject to supplemental assessment unless it relates to a discovery of previously unknown reserves of oil or gas.

4. Question

A proposed development well is planned to be drilled four months after lien date. The appraiser accounts for this new well's reserves in his lien date appraisal. After the well is actually drilled, it is found that the reserve is either lesser or greater than the appraiser's lien date estimate. May an appraiser pick up the additional reserve on the supplemental roll when the well is completed, or, conversely, may he remove the decreased reserves?

Answer

No. (Section 75.10 of the Revenue and Taxation Code.) The appraiser's valuation estimate on lien date was based on all the engineering and geological information that was available at that time and included the anticipated reserves for the new well. In the event that additional information becomes available later in the assessment year, no positive or negative adjustment to the reserves or the reserves value may be made until the next regular roll.

5. Question

A well is drilled to a depth of 8,000 feet to test a possible productive zone at that depth. However, no productive zone is found, but an oil sand is discovered at 3,500 feet. Should total well cost be used in determining the improvement value?

Answer

Well costs expended below the productive zone yield no economic return to the operator for assessment purposes and are unrelated to the property's current market value (Section 75.10(a), Revenue and Taxation Code). For this reason, the appraiser should value this well as a 3,500 foot well. It would not be proper to prorate the well's total costs because drilling costs increase on a per-foot basis as the well depth increases.

6. Question

If an event, such as a transfer of ownership or new construction, triggers a supplemental assessment, should the last enrolled value be adjusted for depletion to the event date in computing any value change associated with the transfer?

Answer

No, such adjustment is not permitted under current law. (Section 75.11, Revenue and Taxation Code.)

Abandonment

7. Question

If a well has been abandoned (structure removed), is the improvement value of the well the only value change to be recognized for supplemental assessment purposes?

Answer

Yes. (Section 75.10(b), Revenue and Taxation Code.) There should be no adjustment for reserves (mineral right value) until the next regular roll. In addition, no depletion is allowed on the supplemental roll between the event date and the last assessment. Any part of the well or associated equipment classified as a fixture cannot be recognized for supplemental assessment purposes and should therefore remain on the roll until the next lien date.

Completion Date of a Well

8. Question

For assessment purposes, when is a well considered to be completed?

Answer

We have noted that some counties follow a practice of not considering a well to be completed new construction until 30 days after it has been placed on production. For example, a well first begins production on August 15. Using the 30-day rule, it would not be considered to be completed new construction until September 15, and would be subject to supplemental assessment on October 1. The 30-day delay rule is a practice originating in the Public Resources Code (Section 3217) which governs the operations of the California Division of Oil and Gas, a state regulatory agency. (Section 3217 is expressly limited to the purposes of Chapter 1 of Division 3 of the Public Resources Code.) Assessments, however, are governed by the Revenue and Taxation Code, and no such 30-day limitation exists. In the above example, the well is subject to supplemental assessment on September 1, not October 1, assuming that August 15 is the date that the well is first available for use. If, for example, this well was available for use on July 15, even though it was not yet producing, the well should be supplementally assessed on August 1. (Section 75.12(a)(1) and Section 75.12(a)(3), Revenue and Taxation Code.)

Base Year for Mineral Rights with Delayed Production

Situations arise where a well will be drilled and completed but production will be delayed. This most frequently occurs in the case of new discoveries, both oil and gas, and with developing geothermal fields.

Oil Discoveries

9. Question

Suppose an exploratory well discovers a new oil field in a metropolitan area. The new well was "permitted" by the county for exploration purposes only. As a result of the discovery, the operator must devise and submit an environmental impact report and development plan to county authorities. It is estimated that it will take approximately five years to secure all approvals, and two additional years to build production facilities. What is the base year for proved reserves?

Answer

While the well did indeed discover oil in commercial quantities, there is a question concerning the existence of proved reserves. The property value cannot reflect such reserves until they become proved (Rule 468). Reserves do not become proved until all permits are secured and the production facilities are built. At that point in time the base-year value for the proved reserves is determined. Mineral rights or reserves, however, cannot be treated as construction-in-progress, i.e., assessing them at market value every year until production begins (Lynch v. State Board of Equalization 164 Cal.App.3d 94 (1985)).

Gas Discoveries

10. Question

There are frequent situations where an exploratory well "discovers" a new gas field. However, the gas discovery is insufficient in quantity to justify the expense of installing a pipeline to sell the gas. What is assessable?

Answer

Since the gas cannot be sold now and its sale in the foreseeable future is questionable, there are at this time no proved reserves and, therefore, no assessable mineral right value attributable to proved reserves. Further, the reserves cannot be considered to be construction-in-progress. (Lynch v. State Board of Equalization 164 Cal.App.3d 94 (1985).) Such a well would not be considered to be a discovery well. The well, however, is new construction, and it is assessable if it has value. Further, if the well has value, it should be considered to be under construction until it is functionally available for use (Section 75.12(a)(3), Revenue and Taxation Code). Nevertheless, such a well cannot be assessed on the supplemental roll as construction-in-progress, but can only be assessed on the regular roll. The market value of the well, if any, hinges on a number of factors requiring appraisal judgment. (The fact that the operator decides not to abandon the well is an indication of possible future use.)

Geothermal Development

11. Question

Dry steam geothermal development usually requires an operator to drill a sufficient number of wells capable of producing enough quantities of dry steam to support a power plant of commercial size. There is usually a delay of a variable number of years between the development of a minimum steam generation capability, and the completion of the power plant. The operator's wells are capped in the interim. When do the reserves become proved and what is the base year?

Answer

After approvals from the necessary agencies to build the power plant, it may take two or three years to build and put it "on-line." The reserves become proved when the power plant is completed and available for use. Mineral rights are in part quantified by reference to proved reserves and cannot be considered to be construction-in-progress in the interim period. (Lynch v. State Board of Equalization 164 Cal.App.3d 94 (1985).)

Another recent observation involves a case where additional geological information becomes available midyear as a result of development well drilling and testing, thus indicating much higher reserves than appeared on the previous roll. Still, all that is subject to supplemental assessment under existing law in this case is the new improvement, represented by the additional improvement value created by the newly drilled well. If there are any questions relating to this letter, please contact Mr. Ray Rothermel.

Sincerely,

Verne Walton

Verne Walton, Chief
Assessment Standards Division

VW:wpc
AL-19A-0042M