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Commonwealth of Kentucky

Court of Appeals

NO. 2013-CA-001152-MR

COMMONWEALTH OF KENTUCKY,
FINANCE AND ADMINISTRATION
CABINET, DEPARTMENT OF
REVENUE APPELLANT

v.

APPEAL FROM FRANKLIN CIRCUIT COURT
HONORABLE PHILLIP J. SHEPHERD, JUDGE
ACTION NO. 12-CI-00049

PETROTEK, LLC; JWB HOLDINGS, LLC;
ARGYLE IRREVOCABLE TRUST;
CONGOREE IRREVOCABLE TRUST;
GARY MATTINGLY; DANNY AND
DEBBIE BURRIS; JIMMY AND JOYCE
RELIFORD; AND BURRIS OIL, INC. APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: ACREE, CHIEF JUDGE; MAZE AND THOMPSON, JUDGES.

ACREE, CHIEF JUDGE: Appellant, Department of Revenue (Department), appeals from the Franklin Circuit Court's June 4, 2013, order affirming a prior administrative order from the Kentucky Board of Tax Appeals (Board). Finding no error, we affirm the Franklin Circuit Court.

I. Factual and Procedural Background

This appeal concerns taxes levied against four oil wells in Adair County, owned by Petrotek, LLC, and others (Petrotek).[1] These wells are part of the Murfreesborough Formation, a large oil deposit underlying parts of South-Central Kentucky and Tennessee. The peculiar geology of the Murfreesborough Formation renders production from its wells quite volatile. Unlike most oil wells, which pump slow and steady over the course of many years, it is common for Murfreesborough wells to pump furiously at first, only to ebb soon after. These wells become depleted within a year or so of striking oil, and their reserves are unlikely to be replenished. When their oil is pumped out, these wells essentially become dry caverns in the ground with little potential for future oil production.

All parties agree that is what happened here. In 2008, production surged and the four wells generated over 100,000 barrels of oil. But a few months later, production had slowed to a trickle, and by January 1, 2009, one well had completely shut down due to lack of production. While experts cannot predict exactly the amount of production left in these wells, everyone agrees that the halcyon days of the 2008 production boom are unlikely to recur.

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[1] On appeal, we have consolidated several cases in the interest of judicial economy.

During both 2008 and 2009, the Department levied taxes on the four wells based on the estimated fair market value of their unmined reserves. The Department levied these taxes pursuant to its grant of authority under KRS[2] 132.820(1), which reads in relevant part:

> The department shall value and assess unmined coal, oil, and gas reserves, and any other mineral or energy resources which are owned, leased, or otherwise controlled separately from the surface real property at no more than fair market value in place, considering all relevant circumstances.

KRS 132.820(1).

The General Assembly also requires that the Department assess these taxes by January 1 of each calendar year. KRS 132.220(1)(a).

While our General Assembly has charged the Department with assessing taxes based on the fair market value of all unmined resources in light of "all [the] relevant circumstances" by January 1 of each calendar year, its statutes offer no additional guidance. Instead, our legislature has left it to the Department to develop a method to tax these wells in keeping with its general statutory authority.

Consequently, the Department developed a method which allows it to estimate the fair market value of unmined resources, and then levy taxes accordingly. The Department's method is based on a mass appraisal formula that it negotiated with the Kentucky Oil and Gas Association. This formula was first employed in 1996, and the Department now applies this formula to over 4,000 oil leases and 14,000 gas leases across the Commonwealth. The formula reads:

[2] Kentucky Revised Statutes.

Total value of oil produced x percent interest x Revenue Factor[3] x allowance credits.

As with any formula, the result is dependent upon accurate raw data. As a source of data for this formula, the Department relies solely on the wells' production from the previous calendar year. In fact, the Department refuses to consider post-January 1 production data for that year in that year's tax assessment, because under its own interpretation, the Department does not believe post-January 1 production data (or any change after that date from the period before it) constitutes "relevant circumstances" within the meaning of KRS 132.820(1).

The Department's categorical refusal to consider post-January 1 production data means that the data used to calculate the Department's tax bills lag one year behind actual production. Tax bills for the current year are thus based on data from the prior year. In this case, the result is that in 2008 – when production was booming – Petrotek received an inordinately small tax bill based on its (much lesser) production numbers from 2007. But, in 2009 – when actual production had waned – Petrotek received a large tax bill based on the peak production data from 2008.

Petrotek challenged the Department's 2009 assessment, arguing that its 2009 tax bill grossly exceeded its wells' actual production for that year. When the Department refused to amend its bill, Petrotek took its case to the Board.

[3] Department's brief describes the "Revenue Factor" as being based on the "type of interest at issue and the amount of production in dollars (after a deduction for severance tax)." (Appellant's brief at 6).

The Board heard evidence from the parties on July 18, 2011, and issued an order December 15, 2011, in favor of Petrotek. At the hearing, the Board reviewed post-January 1, 2009 production records which demonstrated that the wells' actual production in 2009 was only a fraction of the production numbers used to calculate its annual tax bill. In support of its ruling, the Board cited the significant decline in the wells' production from 2008 to 2009, noting that one well had ceased production entirely by January 1, 2009. Based on that evaluation, the Board determined that post-January 1, 2009 production data constituted a "relevant circumstance" within the meaning of KRS 132.820(1), and thus should have been incorporated in the Department's assessment for the 2009 year.

The Board's reading of the statute directly contradicts that of the Department. The crux of the dispute is the degree of "relevancy" each places upon the post-January 1 assessment data. The Franklin Circuit Court affirmed the Board's order on June 4, 2013.

On appeal, the Department argues that production data after January 1 is not a "relevant circumstance" within the meaning of KRS 132.220(1)(a). It also attacks the character and quality of the evidence below, claiming that the Board's ruling was not based on substantial evidence. We address each argument in turn.

II. <u>Standard of Review</u>

On appeal, we review an agency's interpretation of a statute it is charged with implementing pursuant to the doctrine set forth in *Chevron U.S.A., Inc. v. Natural Resources Defense Council Inc.,* 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d

694 (1984). *Bd. of Trustees of Judicial Form Ret. Sys. v. Att'y Gen. of the Commonwealth,* 132 S.W.3d 770, 786–87 (Ky. 2003) (*citing Christensen v. Harris County,* 529 U.S. 576, 587, 120 S.Ct. 1655, 1662, 146 L.Ed.2d 621 (2000)).

Under *Chevron,* we must defer to the agency's interpretation "if the statute is silent or ambiguous with respect to the specific issue." *Chevron,* 467 U.S. at 843, 104 S.Ct. at 2782 ("[T]he question for the court is whether the agency's [interpretation] is based on a permissible construction of the statute."). However, if "the apparent statutory ambiguity can be resolved using 'traditional tools of statutory construction . . . [a]n agency's interpretation is not entitled to *Chevron* deference." *Id.* at 843 n.9, 104 S.Ct. at 2781 n.9 ("If a court, employing traditional tools of statutory construction, ascertains that [the legislature] had an intention on the precise question at issue, that intention is the law and must be given effect.").

III. Analysis

On its surface, this case turns on the proper interpretation of the directive of KRS 132.820(1) that the Department assess taxes on unmined coal, oil, and gas based on the fair market value of those resources in light of "all relevant circumstances." Drilling deeper, however, we encounter a larger issue: what deference, if any, do Kentucky courts owe an agency's interpretation of an ambiguous statute that the agency is charged with administering? The short answer is this: if an administrative agency is charged with implementing a statute, and the language of that statute is ambiguous, courts must defer to that agency's interpretation so long as it is reasonable.

Because we find the statute ambiguous and the Board's interpretation reasonable, we defer to the Board's interpretation.

Kentucky courts have long adhered to the proposition that an administrative agency's interpretation of a statute within its specific province is "always" entitled to "great deference." *See*, *e.g.*, *Com. ex rel. Beshear v. Kentucky Utilities Co.*, 648 S.W.2d 535, 537 (Ky. App. 1982). Recent binding precedent from the Kentucky Supreme Court has explicitly invoked *Chevron*'s analytical framework in deciding cases. *Metzinger v. Kentucky Ret. Sys*., 299 S.W.3d 541, 545 (Ky. 2009).

However, we will only defer to an agency interpretation in the form of adopted regulations or formal adjudications. *Bd. of Trustees of Judicial Form Ret. Sys.*, 132 S.W.3d at 786-87. Because this case presents conflicting interpretations from two administrative agencies – the Department and the Board – each of which have the authority to administer binding tax decisions and thus interpret KRS 132.820(1), we must consider a threshold issue: whether either agency's interpretation arose via formal rulemaking or a formal adjudication.

We have examined the Kentucky Administrative Regulations, and specifically Title 103, Finance and Administration Cabinet, and find no regulation has been promulgated interpreting KRS 132.820(1). Rather, in a more informal way, the Department simply corresponds with the taxpayer, assessing taxes as it sees fit under the statute. *See* R. 21-22, Oil Ad Valorem Tax Assessments as of January 1, 2009.

On the other hand, the Board has arrived at its interpretation of the statute by administrative adjudication after holding an evidentiary hearing. In that hearing, the Board considered evidence and heard witness testimony from the parties. Such appeals have been deemed sufficiently formal to warrant our deference. *See Louisville/Jefferson County Metro Gov't v. TDC Group,* LLC, 283 S.W.3d 657, 659 (Ky. 2009). Accordingly, we now consider whether we must defer to the Board's interpretation of KRS 132.820(1).

Chevron imposes upon our courts a deferential scope of agency review. When confronted with an agency's interpretation of an ambiguous statute, we apply a two-step test. First, we must determine, using ordinary tools of statutory construction, "whether [our General Assembly] has directly spoken to the precise question at issue. If the intent of [the General Assembly] is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of [the General Assembly]." *Chevron,* 467 U.S. at 842-43, 104 S.Ct. at 2781. However, "if the statute is silent or ambiguous with respect to the specific issue[,]" we move to the second step, and determine "whether the agency's answer is based on a *permissible* construction of the statute." *Id.* at 843, 104 S.Ct. at 2782 (emphasis added).

Under *Chevron*'s second step, our courts must give agency interpretations wide berth when determining whether their interpretations are "permissible," asking only whether such interpretations are "reasonable" in instances where an agency's interpretative authority is implied by an ambiguous statute. *Mayo Found.*

for Med. Educ. & Research v. United States, 131 S.Ct. 704, 714, 178 L.Ed.2d 588 (2011).

At its second step, *Chevron*'s obligatory deference presumes that our legislature "knows to speak in plain terms when it wishes to circumscribe, and in capacious terms when it wishes to enlarge, agency discretion." *City of Arlington, Texas v. F.C.C.,* --- U.S. ----, 133 S.Ct. 1863, 1868 (2013). Accordingly, reviewing courts must assume that "ambiguities in statutes within an agency's jurisdiction to administer are delegations of authority to the agency to fill the statutory gap in reasonable fashion." *Nat'l Cable & Telecomm. Ass'n v. Brand X Internet Servs.,* 545 U.S. 967, 980, 125 S.Ct. 2688, 2699, 162 L.Ed.2d 820 (2005). Under this assumption, our General Assembly purposely enacts ambiguous statutes, with the understanding that ambiguous language will be resolved "first and foremost, by the agency, and desire[s] the agency (rather than the courts) to possess whatever degree of discretion the agency allows." *Smiley v. Citibank (South Dakota), N. A.,* 517 U.S. 735, 740-41, 116 S.Ct. 1730, 1733, 135 L.Ed.2d 25 (1996). Such deference "provides a stable background rule against which [our General Assembly] can legislate: Statutory ambiguities will be resolved, within the bounds of reasonable interpretation, not by the courts but by the administering agency." *City of Arlington*, 133 S.Ct. at 1868.

When we apply the two-step framework to the current case, we conclude that we must defer to the Board's interpretation of KRS 132.820(1)(a). In applying *Chevron's* first step, we are persuaded that our General Assembly did not address

the precise issue at hand: whether post-January 1 assessment data (or deviations from the prior year) constitute a "relevant circumstance" within the meaning of KRS 132.820(1)(a).

To be sure, nothing in the text of KRS 132.820(1)(a) specifies whether such data is relevant or irrelevant. Statutory language is ambiguous when it is susceptible to two mutually exclusive – yet reasonable – constructions. *See, e.g., Young v. Hammond,* 139 S.W.3d 895, 910 (Ky. 2004) (requiring the interpretation of the undefined term "qualified"); *see also* Black's Law Dictionary 73 (5th ed. 1979) (a term is "ambiguous" when "it is reasonably capable of being understood in more than one sense").

Here, while KRS 132.820(1)(a) requires that the Department levy taxes on unmined oil in light of "all relevant circumstances," it fails to offer any guidance as to what "all relevant circumstances" means. *See* KRS 132.010 (listing definitions for terms within KRS Chapter 132). And so, in the absence of any additional guidance, the phrase "all relevant circumstances" is inherently susceptible to several reasonable – yet mutually exclusive – interpretations. We may reasonably conclude that the legislature intended the administering agency to bear the responsibility of developing its own interpretation of the meaning of "all relevant circumstances." Therefore, we must proceed to *Chevron*'s second step.

Chevron's second step requires that we determine whether the Board's interpretation is permissible, that is, whether the Board's interpretation is

reasonable. We conclude that Board's interpretation is reasonable and thus permissible.

In arriving at its interpretation, the Board considered evidence of the wells' rapid decline, finding specifically, even by the assessment date of January 1 that one of the wells had shut down. The Board determined that the wells' decline reduced their fair market value. Its determination considered well-settled Kentucky case law that defines "fair cash value," *see Evans v. Allen*, 305 Ky. 728, 730, 205 S.W.2d 514, 515 (1947), and generally approves mass appraisal techniques. *See Revenue Cabinet v. Gillig*, 975 S.W.2d 206, 209 (Ky. 1997). The Board considered those cases in light of the mandate of KRS 132.820(1)(a) that the Department must assess taxes at "no more than fair cash value." Noting that year-old production data overvalued the wells, the Board rejected the Department's position because it would be inconsistent with the Board's interpretation of the statutory language.

Moreover, the Board relied on persuasive authority (from another jurisdiction) that supports its interpretation. In *Board of County Commissioners of Ness County v. Bankoff Oil Co.,* 265 Kan. 525, 960 P.2d 1279 (1998), the Kansas Supreme Court considered whether post-January 1 production data should be considered in instances where an oil or gas well suffers from significant decline. There, the Kansas Supreme Court noted that such data is relevant, because

> [r]efusing to allow consideration of post-January 1 production data when assessing an oil or gas lease that has suffered a decline in production would be to ignore

> relevant and available factual information pertaining to the lease's future productivity and income.

Bankoff Oil Co., 960 P.2d at 1292.

The Department points out that the Kansas Supreme Court's decision is based on Kansas law. However, its importance to this Court is not as precedent. The case's factual similarity is supportive of the general proposition that an administrative agency must consider sufficient data to arrive at a fair estimation of an oil well's future productivity and therein lies its persuasive value.

In light of the Board's thorough opinion – which resulted from a full evidentiary hearing and a careful consideration of relevant precedent – we cannot say that its interpretation is unreasonable, and we therefore conclude that it is "permissible" in light of the doctrine set forth under *Chevron*.

Turning away from the weightier *Chevron* analysis, we now consider the Department's additional arguments. We find none persuasive.

The Department claims that the Board's findings were not supported by substantial evidence. Specifically, the Department argues that post-January 1 production records are neither "relevant nor probative," and therefore lack any evidentiary value. Substantial evidence is "evidence of substance and relative consequence having the fitness to induce conviction in the minds of reasonable [persons]." *Borkowski v. Commonwealth*, 139 S.W.3d 531, 533 (Ky. App. 2004). Review of the Board's opinion demonstrates that the evidence underlying the Board's findings was certainly substantial. At the hearing, the Board considered

production records demonstrating the wells' rapid decline in production. It heard testimony from witnesses with experience in the oil and gas industry who corroborated the geologic vagaries of the Murfreesboro Formation and noted that wells drawing from that formation were unlikely to recharge. Based on that testimony, the Board specifically found that one well had shut down, and that all wells suffered rapid depletion. Despite the Department's claims, such evidence is indeed relevant and probative of the wells' fair market value.

The Department also claims that Petrotek's failure to offer any alternative method for calculating the fair market value of these wells renders the evidence underlying the Board's decision insubstantial. However, the Department offers no authority requiring Petrotek to submit its own method for assessing taxes. Before the Board, Petrotek need only present sufficient evidence that the Department's tax bill is inappropriately high for that year. Indeed, under KRS 132.820(1), it is up to the Department to determine taxes, not Petrotek.

This argument dovetails with another claim by the Department that because Petrotek did not object to any other year's tax assessments (assessments which were based on inordinately low production data), it would be "disingenuous" for Petrotek to cry foul when it received a tax bill that was too high.

The Department's essential premise is that using data which lag one year behind eventually results in relatively equitable taxation because what will be overvalued one year, will necessarily be undervalued the next, or vice versa. Even if that premise were dependably correct, it is irrelevant. KRS 132.820 clearly

states that the Department shall not assess taxes *greater* than the fair market value of the property; it does not prohibit the Department from *undervaluing* Petrotek's tax bill (as it suggests it did in prior years) nor does it require a taxpayer to object that his taxes are too low. The Department's complaint today that it undervalued a taxpayer's property in prior years is not a very persuasive reason for allowing taxation in violation of the statute today to make up the difference.

Furthermore, well-settled Kentucky precedent holds that each individual tax year is a separate cause of action. *Cave Hill Cemetery Co. v. Scent*, 352 S.W.2d 61 (Ky. 1961). Thus *Cave Hill*'s holding means that the Department must assess taxes at no more than fair market value each year. The Department's argument that, eventually, its tax assessments on Petrotek will be equitable is untenable. The extent to which the Department may have undervalued tax liabilities does not violate either KRS 132.820(1), or *Cave Hill Cemetery*. It does suggest, however, that the Department is capable of assessing taxes more accurately than it has chosen to do in the past.

Finally, the Department argues that the administrative burdens of incorporating post-January assessment data are too great. We read the Board's opinion simply to mean that in certain cases presenting special circumstances such as these, the Department must consider post-January 1 production data as a relevant circumstance. Here, disparities between post-January 1 data and the data traditionally relied upon by the Department was so great as to be a relevant factor, revealing, in this case, that Department's methodology for calculating taxes no

longer reflects the fair market value of the property at issue. By all accounts, the Department's formula works well in most all situations. However, while the exclusion of post-January 1 production data may still accurately reflect the fair market value of resources for a particular tax year, that supposition is not universally so that a categorical exclusion can be justified. In those rarer instances, when post-January 1 production constitutes a relevant circumstance, it is up to the Department to consider another method for accurately determining fair market value. The Board's opinion, in other words, simply says that post-January 1 production records are "relevant" under KRS 132.820(1) in some instances where it can be proven that the Department's normal method fails to accurately reflect a resource's fair market value. We agree with that analysis.

IV. Conclusion

For the foregoing reasons, the Franklin Circuit Court's June 4, 2013, order affirming a prior administrative order from the Kentucky Board of Tax Appeals is affirmed.

ALL CONCUR.

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