Appraisal of Oil and Gas Royalty Mineral Interests for Ad Valorem Tax Purposes in Texas

Mineral deeds, conveyances, assignments, contracts, and leases pertaining to oil and gas are notoriously complex legal instruments. Sometimes we encounter taxpayers who want us to make a distinction in our ad valorem tax appraisal work between "mineral interest" and "royalty interest" as if it could or should affect the appraisal district's proposed value for their property. These are in fact separate and distinct legal terms, and owners definitely need to know what specific type of interest they own for purposes of deeds or leases they sign with third parties. However, **for ad valorem tax purposes** the legal distinction between the two terms is somewhat a moot point. In effect, it's a "distinction without a difference."

The general characteristics associated with each type of ownership are as follows:

CHARACTERISTIC	ORIGINAL MINERAL INTEREST	"PURE" ROYALTY INTEREST
Execute oil, gas and mineral leases, thus conveying the right of exploring, mining, removing and marketing to third parties.	Yes	No
Receive all bonus and delay rentals.	Yes	No
Enter, occupy, and make such use of the surface as is reasonably necessary in the exploring, drilling, mining, removing and marketing of the minerals.	Yes	No
Bear the costs associated with exploring, drilling, mining, removing and marketing of the minerals.	Yes	No
Own the possibility of reversion of the minerals in fee upon expiration of the lease.	Yes	No

A "pure" royalty interest owner is one who acquired the interest separate and apart from any mineral interest ownership. A pure royalty owner by deed is said to have a "nonparticipating" interest, because this type of owner cannot participate in the execution of lease agreements and does not receive any signing bonus and/or delay rentals.

This is in contrast to a royalty interest created by contract or lease with a third party (such as an operator), which is called a "leased fee" royalty interest. This type of mineral interest owner grants or conveys some, but not all, aspects of their mineral interest, such as the costs of exploration and production, in return for a specified royalty interest that is free of such burdens. Most oil and gas lease agreements call for the lessor (original mineral interest owner, now a royalty interest owner) to receive a signing bonus and delay rentals.

In this respect the lessor's property ownership simultaneously incorporates aspects of both mineral *and* royalty interest - hence the chosen phrase "royalty mineral interest" in the title of this paper!

An owner of a mineral interest owns the minerals themselves including all the associated privileges and responsibilities. In contrast, any kind of royalty interest owner only has rights to an income stream if and when minerals are being produced and sold. An original mineral interest owner can convey or reserve each of the characteristics of ownership listed above, either separately or in tandem, in both deeds and leases, thereby altering in many instances the interests conveyed/reserved from that of a *mineral* to *royalty* and vice-versa. Unfortunately loose or ambiguous language in these conveyances often makes it difficult for many (including courts) to precisely determine if one owns a *mineral* interest or *royalty* interest. This question predominantly comes into play upon expiration of a producing lease when the issue of who actually owns any remaining minerals becomes important for future leasing possibilities.

It should be noted the first three characteristics listed in the table above are all **past events** by the time an appraisal district's valuation even enters the picture. As such they're not considerations by the appraisal district at all, because the appraisal district's value of a mineral or royalty interest is always based on a **forward-looking** projection of the property's income potential as of January 1 of any particular tax year.

So that leaves us with examination of the fourth characteristic in the table, the bearing of any costs associated with exploring, drilling, mining, removing and marketing of the minerals. In an appraisal district's discounted cashflow appraisal, the costs of operating a lease on behalf of all the interest holders are assigned only to the party who actually bears the costs, namely the "working interest" owners who took on that burden when they entered into the lease with the mineral interest owner(s). Whether a royalty interest was created by deed (a "pure" royalty) or through reservation specified by lease agreement, a royalty interest owner is not obligated for development or lease operating costs; the appraisal district's proposed value for a royalty interest owner of any kind recognizes this fact in all cases.

Regarding the fifth characteristic, an appraisal district's proposed value for ad valorem tax purposes does not add or otherwise incorporate any intrinsic value into an appraisal of a leased fee royalty interest that might be attributable to a reversion of minerals in fee upon expiration of the lease. This reversionary characteristic of a royalty interest that originated from a leased mineral interest definitely has value "in the real world." However, in practice it is impossible for the appraisal district to quantify (and defend) any additional value for this kind of intangible attribute. In addition, this consideration does not exist for a pure royalty owner by deed because they never had ownership of minerals to begin with.

In general, the purpose of a mineral oil and gas lease, as described in the Granting Clause found in the lease's opening paragraphs, is to convey **the rights of exploration and production** to a mineral development company (an operator). Due to the inherent

difficulties of quantifying exactly how much oil and gas may exist deep below the surface, the minerals themselves are not actually conveyed in mineral deeds or leases, only the **rights** to these minerals. It is these rights, however subdivided and further assigned in whole or in part, **and not the minerals themselves**, that are being appraised for ad valorem tax purposes. Both a mineral interest and a royalty interest are estates or interests in either land and/or a mineral in place and therefore qualify as taxable Real Property per Property Tax Code, Sec. 1.04(2)(F).

Mineral or subsurface rights can be, and often are, "severed" from the surface rights so that separate parties each own separate rights. A lease agreement between the mineral rights owner and an operator leaves the lessor (the original mineral rights owner) with a **leased fee estate** and the lessee (the operator) with a **leasehold estate.** In any case, whether severed or not, all these types of **separately owned** subsurface interests are appraised without regard to the value or ownership of the surface estate, and each property value is assigned to the party that owns the particular interest being appraised.

Non-producing mineral interests are not exempt from ad valorem taxation and can be valuable. However, appraisal districts do not typically assign any value above zero to them as a matter of practicality. This practice is "equal and uniform" with appraisal of producing mineral interests, as the same methodology (income approach that forecasts and discounts future net income as of January 1) is used in both cases.

All mineral rights owners in Texas have the legal authority and responsibility to monitor and administer all ad valorem tax issues regarding their separately owned and specific decimal net revenue interest ownership in oil and gas leases. These interests are income-producing and taxable Real Property to the parties receiving the income. It simply makes no difference to the appraisal district whether the decimal interest being appraised represents or is termed a royalty interest, mineral interest, royalty mineral interest, or something else altogether - the appraisal of the interest is performed in a uniform manner so that all taxpayers are treated fairly and equitably prorata to the fractional amount of interest they own.

Pritchard & Abbott, Inc., is a private valuation consulting firm founded in 1926 and based in Fort Worth, Texas. This paper is for the sole purpose of providing a broad overview and promoting our government entity clients' and taxpayers' basic understanding of the origin and nature of the "oil and gas" subject property we appraise as a contracted vendor to appraisal districts. While we are confident about the accuracy and reliability of the complex issues discussed here, this paper should not be construed as legal advice or opinion. We always recommend that attorneys specializing or having extensive background in these matters be consulted concerning questions of a legal nature.