

**BEFORE THE COURT OF TAX APPEALS
STATE OF KANSAS**

IN THE MATTER OF THE
PROTESTS OF CHEROKEE WELLS,
L.L.C. FOR THE YEAR 2010 IN
WILSON COUNTY, KANSAS

Docket Nos. 2011-3163-PR
2011-3164-PR
2011-3165-PR

AND

IN THE MATTER OF THE
PROTESTS OF LAYNE ENERGY
OPERATING, L.L.C. FOR THE TAX
YEAR 2010 IN WILSON COUNTY,
KANSAS

Docket Nos. 2011-3166-PR
2011-3167-PR

ORDER GRANTING SUMMARY JUDGMENT

Now the above-captioned matter comes on for consideration and decision by the Court of Tax Appeals of the State of Kansas. The Court conducted oral arguments on the Taxpayer's motion for summary judgment in this matter on April 11, 2012. The Taxpayer, Cherokee Wells, L.L.C. appeared by and through its attorney, Bradley Stout. The County of Wilson appeared by and through its attorney, Jill Chard. The tax year in issue is 2010.

After considering all of the evidence and arguments presented, the Court finds and concludes as follows:

The Court has jurisdiction of the subject matter and the parties, as tax protests have been properly and timely filed pursuant to K.S.A. 2011 Supp. 79-2005.

The subject matter of these tax protests are saltwater disposal wells located in Wilson county, described as follows:

Parcel ID # 103-WILLARD A-3 SWD LEASE.
Parcel ID # 103-SEIWERT A-8 SWD LEASE.
Parcel ID # 103-CLAIRBORNE K A-13 LEASE.
Parcel ID # 103-BAILEY B&B SWD 5-24 LEASE.
Parcel ID # 103-MAHAFFEY SWD 13-36 LEASE.

The Taxpayer put forward eight statements of uncontroverted fact in its

motion for summary judgment:

1. This case is the consolidated appeals of the value placed on the oil recovered from five salt water disposal (SWD) wells in Wilson County, Kansas. The value for each of the five wells was determined using the same methodology.
2. Oil and/or gas wells in Wilson County generally produce a significant amount of salt water. The five wells involved in these appeals (the "Wells") dispose of salt water produced from other leases. The Wells do not produce any oil or gas.
3. Wilson County's analysis that results in the second-tier of taxation values the SWD wells as if the SWD wells had reserves in the ground.
4. A SWD well is, essentially, a "hole in the ground" that allows the salt water to be disposed of in an appropriate zone.
5. The salt water delivered to the Wells contains very small quantities of oil. The oil cannot be economically recovered at any of the leases supplying salt water to the Wells. The oil has no market value to the owner of the lease from which it was originally produced.
6. The operations at each of the Wells include equipment that allows the salt water to be combined and the oil economically recovered.
7. In valuing the Wells, the County first determined the value using the method of valuation set forth in the Oil and Gas Appraisal Guide with certain assumptions.
8. The assumptions included an assumed oil gravity, and assumed decline rate, and the assumption there would be no expenses incurred in operating the alleged well or equipment to produce the recovered oil.

The County's response agreed with the Taxpayer's statement of facts with one exception – that the oil recovered from the saltwater does have value – and five factual additions:

1. The taxpayer claims ownership of the oil that is recovered from the salt water disposal wells.
2. The oil recovered or extracted from the salt water disposal wells is sold by

the taxpayer.

3. The taxpayer did not provide information about the oil recovered from the salt water disposal wells on its rendition for the tax year in question.
4. The taxpayer does not share the proceeds from the sale of the oil extracted from the saltwater disposal wells with the royalty interest holders.
5. The Kansas Department of Property Valuation Division directs that county appraisers impose an ad valorem tax on oil recovered and sold from salt water disposal wells.

The standard of review of summary judgment motions is well known:

“When the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law, summary judgment is appropriate. The district court is required to resolve all facts and inferences which may reasonably be drawn from the evidence in favor of the party against whom the ruling is sought. When opposing a motion for summary judgment, an adverse party must come forward with evidence to establish a dispute as to a material fact. In order to preclude summary judgment, the facts subject to the dispute must be material to the conclusive issues in the case.” *Osterhaus v. Toth*, 291 Kan. 759, 768, 249 P.3d 888 (2011).

After reviewing the pleadings and record evidence, the Court concludes there is no dispute as to a material fact and the matter is ripe for judgment as a matter of law.

The Taxpayers argue they are entitled to summary judgment on three grounds: 1) Kansas law does not impose ad valorem tax on sales of oil recovered at a salt water disposal well, 2) The oil is recovered as the result of a manufacturing process as is therefore exempt from ad valorem taxation in any event, citing *In re American Warrior, Inc.*, 30 Kan.App.2d 532, 43 P.3d 828 (2002), and 3) the County’s method of valuation is arbitrary, unreasonable, and without statutory or factual basis.

The County argues in return that state law does impose ad valorem tax on oil recovered at a salt water disposal well, the oil recovered is not exempt from ad

valorem taxation, and its method of valuation is reasonable and not lacking in legal basis.

The Taxpayers' first argument is that Kansas law does not impose ad valorem tax on sales of oil recovered at a salt water disposal well. They cite the fact that K.S.A. 79-329 only speaks of "oil and gas leases" and "oil and gas wells," arguing the statute does not extend to oil recovered from disposed salt water. The County argues the salt water disposal wells are contemplated by K.S.A. 79-329's phrase "or other material therein." The Court agrees with the Taxpayers that K.S.A. 79-329 does not authorize ad valorem taxation of oil recovered from salt water disposal wells.

The Taxpayers next argue the oil recovered from salt water disposal wells is produced through a manufacturing process and thus exempt under K.S.A. 79-201m(a)(2). The following is *American Warrior's* discussion of whether the taxpayer in that case qualified as a manufacturer:

"Manufacturing is defined by Kansas statute and refined by case law.

"K.S.A. 79-201m(a)(2) defines 'manufacturer' as any person, company, or corporation who is 'engaged in the business of transforming, refining or combining materials and labor to convert tangible personal property from one form to another including packaging.'

"In *Appeal of Water Dist. No. 1 of Johnson County*, 26 Kan.App.2d at 377, 988 P.2d 267, this court held that the initial pressurization of river water, until it reached pumping stations, is a manufacturing process. The pressurization of the water changed its character and quality and thus transformed the water.

"Earlier, the Kansas Supreme Court had found that a grain elevator operator who blended, cleaned, dried, and aerated grain produced a different product than it received. By enhancing a product's value, the taxpayer was involved in 'production, manufacture, processing, ... refining or compounding' and gained a tax exemption. *In re Tax Appeal of Collingwood Grain, Inc.*, 257 Kan. at 251-52, 891 P.2d 422.

"It is not disputed that AWI's Ness County plant pressurizes unmarketable natural gas. The result of the process is the splitting of

unmarketable natural gas into marketable helium, nitrogen, and marketable natural gas. This appears to fit squarely within the statutory and common-law definition of manufacturing used in Kansas.

“K.S.A.2001 Supp. 74-2433 binds BOTTA to the prior judicial decisions of the Court of Appeals and the Kansas Supreme Court. Therefore, we conclude, as a matter of law, that the process here qualifies as manufacturing as defined in our statute, and BOTTA's finding to the contrary was in error.”

In re American Warrior, Inc., 30 Kan.App.2d 532, 536-537, 43 P.3d 828, 831 (2002).

The Court, after reviewing the applicable statutory and case law, concludes the Taxpayers are manufacturers under K.S.A. 79-201m(a)(2) and *American Warrior*, because the separation of oil from the unmarketable salt water by the Taxpayers constitutes a process which meets the definition of manufacturing. The process used by the Taxpayers to extract the oil changes the character of the oil-tinged salt water and enhances its value in the process. The Court therefore concludes the oil recovered through this manufacturing process is exempt from ad valorem taxation.

The Court finally concludes the Taxpayers have shown there is no issue of material fact and they are entitled to judgment as a matter of law. Therefore the Taxpayers' motion for summary judgment is granted.

IT IS THEREFORE ORDERED that, for the reasons stated above, the Taxpayers' motion for summary judgment is granted in full.

IT IS FURTHER ORDERED that the appropriate officials shall correct the county's records to comply with this Order, re-compute the taxes owed by the taxpayer and issue a refund for any overpayment.

Any party to this action who is aggrieved by this decision may file a written petition for reconsideration with this Court as provided in K.S.A. 2011 Supp. 77-529. The written petition for reconsideration shall set forth specifically and in adequate detail the particular and specific respects in which it is alleged that the Court's order is unlawful, unreasonable, capricious, improper or unfair. Any petition for reconsideration shall be mailed to: Secretary, Court of Tax Appeals, Docking State Office Building, Suite 451, 915 SW Harrison St., Topeka, KS 66612-1505. A copy of the petition, together with any accompanying documents, shall be mailed to all parties at the same time the petition is mailed to the Court. Failure to

notify the opposing party shall render any subsequent order voidable. The written petition must be received by the Court within fifteen (15) days of the certification date of this order (allowing an additional three days for mailing pursuant to statute). If at 5:00 pm on the last day of the specified period the Court has not received a written petition for reconsideration of this order, no further appeal will be available.

IT IS SO ORDERED

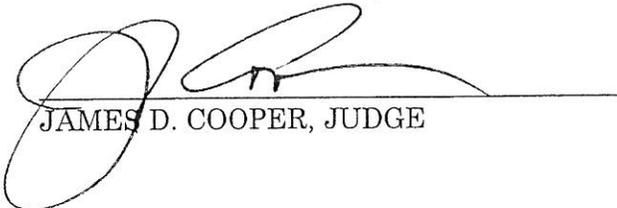
THE KANSAS COURT OF TAX APPEALS



SAM H. SHELDON, CHIEF JUDGE



TREVOR C. WOHLFORD, JUDGE



JAMES D. COOPER, JUDGE



JOELENE R. ALLEN, SECRETARY

CERTIFICATION

I, Joelene R. Allen, Secretary of the Court of Tax Appeals of the State of Kansas, do hereby certify that a true and correct copy of this order in Docket No. 2011-3163-PR through 2011-3167-PR and any attachments thereto, was placed in the United States Mail, on this 13th day of June, 2012, addressed to:

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IN TESTIMONY WHEREOF, I have hereunto subscribed my name at Topeka,
Kansas.



Joelene R. Allen, Secretary