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Learning Objectives

- Understand the changes in production and the impacts on domestic (and global) supply and demand
- Review changes in oil prices and impacts on the market
- Review rig-count changes both historically and for 2017-2018
- Understand the indirect tax impact of changes in pricing, customer and vendor requests and other unique changes in the business
- Review tax compliance issues as well as tax opportunities/exemptions
Oil Price Fluctuations

- WTI somewhat range bound since Jan 2017
- Spot prices for WTI generally $43 to $51
- Needs a fundamental or emotional shift in market sentiment to break out high or low
Oil Supply And Budgets

- Production continues to increase for 2017 but at a slower pace than H1 2017

- Capital budgets up in 2017 vs 2016 however we are seeing downward revisions in H2 2017 capital spend
Oil Supply And Budgets

- Overall CapEX for 2017 will be around 35% higher than 2016

- Cost inflation beginning to show up especially in the Permian basin with impacts to drill pipe, casing and frac sand
US Oil Production May 2007 - Current

Crude Oil Production US
Oil Supply

- US market response to OPEC cuts has been swift and more significant than analyst predicted

- Production began increasing in fall of 2016 and continues today, though at a slower pace
Oil Supply

- EIA and others have continually under forecast supply increased via lower 48 production

- This has resulting in consistent increases to estimated 2017 production from 9.1 million bpd to 9.3 (current production is 9.4)

Oil Supply

- Week ending July 28th US production was 9.43 million bpd

- Price fluctuations will continue to significantly impact the production ramp

- 2017 exit rate of 9.7 million bpd??? Plausible if prices are > $46/bbl
Oil Supply

- 2018 EIA is calling for average annual production of 9.9 million bpd

- With prices in the mid $40s this is reasonable, but lower or mid $50s and supply moves materially higher

- Lower prices will of course result in less supply
Offshore Surprise

- Capital momentum is a big deal in the offshore space

- Rig counts half of 2014 but production will continue increasing through 2018

- Offshore production will reach 2 million bpd by late 2018
Offshore Surprise

Monthly oil production from U.S. Federal Gulf of Mexico
million barrels per day

- History
- Forecast

Production from fields projected to start in 2017 and 2018

Adjustments for hurricane-related shut-ins

Production from existing fields
Production Through The Downturn

Weekly Production June 2016 - Aug 2017
Baker Hughes Rig Counts

- Oil rig count bottomed in May of 2016 at 316 rigs
- Gas rig count bottomed in June of 2016 at 82 rigs
- August 4th 2017 oil rig count was 765 and gas 189
Baker Hughes Rig Counts – 2016 and 2017

Rig Count Jan 2016 - August 2017

- Black line: Oil Rigs
- Blue line: Gas Rigs
Prices and Production

- Rig count of 475 – low 500s holds oil production flat?

- US can add production at 650 – 700 rigs especially if completions are occurring on schedule

- Gas production increasing rapidly via associated production
Global Oil Environment

- Global supply and demand hinge on OPEC and US

- 2017 forecasts of 96.8 million bpd production

- 2017 forecasts of 97.2 million bpd consumption
Global Oil Environment

- Market rebalance is occurring and storage overhang is being worked off

- OPEC is generally sticking to production cuts with some exceptions

- Non-OPEC nations, in particular Russia, is not strictly enforcing the imposed cut

Global Oil Environment

- Oil stocks on a sustained decrease at the moment
- OPEC production remains curtailed
- Will require significant OPEC discipline if drawdowns and continue

Global Oil Environment

- Market needs significant and sustained drawdowns along with increased demand

- If OPEC blinks in late 2017 or early 2018, market emotion could move prices substantially
Pricing And Supply

- Some oil price forecasts are aggressive for 2020 and beyond with prices >$80 and in some cases in the $100s.

- This is possible but requires sustained world demand increases in excess of 1 million bpd year over year.
Massive capital cutbacks since 2014 have resulted in numerous medium and long-term projects being shelved or delayed.

Supply impacts take years to trickle into the markets.
Pricing And Supply

- Prices can move quickly up or down on market sentiment.
- This sentiment may or may not be rooted in fundamental changes from the macro environment.
- If not macro driven, price changes are likely short-term in nature.
Indirect Tax Impacts
Indirect Tax Impact on Oil & Gas Changes

- Customer/Vendor Pricing Changes
- Customer/Vendor Internal Audits
- Customer/Vendor Refund Requests
- Changes in Business (e.g., Idle equipment, changes in workforce, etc.)
- Compliance Issues
- Tax Opportunities/Exemptions
Customer Pricing Changes

- How do you handle general increases in pricing?
  - For example, fracking services which are only subject to WST on equipment and labor and not materials but management wants to add one line to invoice for 5% overall increase? How does the system handle the change?

- How do you handle general credits/discounts?
  - Agreement to give customer a credit/discount after invoiced but the discount isn’t specific to the taxable or exempt portion of the invoice?
Vendor Pricing/Cost Changes

- **Vendor Pricing Changes**
  - Cost of proppants (e.g., sand) increasing but customer contracts are long-term fixed pricing
  - Look at contract terms for flexibility or changes

- **Vendor Cost Increases – Additional Taxes Due**
  - Can you pass through the cost to the consumer/customer?
  - Look at your contract terms.
  - Management relationships matter.
Customer/Vendor Internal Audits

- Are you involved when there is an internal audit being conducted by your customer or vendor?
- Are taxes included in their scope of the audit?
- What if there are errors? Do we compare to ongoing state tax audits conducted by taxing authorities?
- What if there are billing issues identified? Do they adjust the taxes too?
Customer Refund Requests

- How do you handle a customer's request for a refund of taxes paid in error, before you get the refund back from the state?
  - Look at open Accounts Receivables that you can offset
  - Can your company provide a future credit for services?

- What if the issue is gray and the customer doesn’t want to pay the taxes charged?
  - Are they willing to pay the tax and then take a credit or file a refund?
  - Look at the contract terms for an indemnification
Customer Refund Requests Continued

- Refund Assignment Forms
  - Increase in requests / Aggressive positions
  - Review request being made to verify the customer/consultant has correct facts
  - Review errors to minimize future similar errors
Vendor Tax Reimbursement Requests

- Check statute of limitations
- Consider the business relationship
- Did the state authority incorrectly assess the tax?
- What if your company paid a different states tax already? (Legally due in both states?)
Changes in the Business Due to Downturn

- Idle Equipment
  - Property Taxes
    - How do you handle for property tax purposes?
    - Opportunities for rendering in lower taxing jurisdictions?
    - Be sure not to trigger a use tax for storage
  - Equipment Transfers/Uses by Affiliates
    - Does the transfer meet an occasional sale/casual sale exemption (watch out for motor vehicle exceptions)
    - If transfer to a different division, potential use taxes due in jurisdiction used (credit for taxes paid?)
Changes in the Business Due to Downturn Continued

- Idle Equipment - Sales to Unrelated Third Parties
  - Are the sales processed through normal billing system or treated as “Gain/Loss on Sale of Asset”?  
  - Is there a standard “Bill of Sale” Agreement?
  - System set up to collect sales tax?
  - Ability to collect tax in the jurisdiction sold?
  - Who’s collecting resale certificates?
Reorganization/Reductions

- Closing Locations/Consolidating Operations - what are the tax considerations
  - Who will retain the records?
  - Lost historical intelligence when employees leave
  - Who will be responsible for closing permits, filing last tax returns?
  - Casual/occasional sale exemption apply to consolidation?
  - Use taxes due on equipment no longer for resale or exempt?
Tax Incentives for the Surviving Locations
- Increase in jobs at a single location?
- Movement of equipment causes increase in capex costs?
- Preparing for the turn around – increases in equipment costs?
- Talk to management
Tax Opportunities – Upstream Businesses - Texas

- Basic Definition of Certain downhole services (TAC 3.324)
  - (a)(3) Nontaxable services - to start or stimulate production or the labor to work on the formation outside of the well.
  - (a)(2) Taxable services – to repair, restore, remodel, or maintain TPP or RP at a lease site.

- Watch out for certain services that are just not taxable (e.g., roustabout)

- Sales Tax may have been charged when Well Servicing Tax was due

- Field tickets may not be clear/get operations involved if necessary

- Use the RRC website for additional support – new completion and local taxes
Tax Opportunities – Upstream Businesses – Texas continued

- TAC 3.332 Drilling Equipment used exclusively outside of Texas and for offshore exploration and production
  - Even if shipped into the state for further assembly before removal from the state

- 151.355(7) Water-Related Exemption
  - “tangible personal property specifically used to process, reuse, or recycle wastewater that will be used in fracturing work performed at an oil or gas well”

- TAC 3.330 Manufacturing Exemptions
  - Chemicals used to heat oil to remove impurities
  - Separators used to separate oil and water
  - Electricity used at a salt water disposal facility
Tax Opportunities – Upstream Businesses – Texas Continued

- Compressors - Manufacturing exemption
- Used to operate field dehydrators, heat treators, separators and scrubbers – NT
- Used to “boost the sales line” and located immediately before the sales meter – NT
- Used at the well head to extract oil and gas from below the ground – T
- Documentation, documentation, documentation

See Letter Ruling 201509491L
Tax Opportunities – Upstream Businesses – Texas Continued

- NT “unprocessed” sand – sorted, sized, screened, washed, and/or dried
- Taxable “processed” sand – Crushed or mixed with other material (e.g., resin coated)
- What about power washed or the use of explosives to extract??
- Use of questionnaires
Motor Vehicle Versus “Movable Specialized Equip” (Hearing No. 106,629)

- Trailer Mounted Fracturing Fluid Pumpers deemed motor vehicles
  - Must start as a road ready trailer
  - Have equipment mounted on the trailer
  - Capable of hauling other property

- What other equipment might qualify?
- What other opportunities – labor to repair NT
- Motor Vehicle Taxes Due?
Tax Opportunities – Upstream Businesses – Texas WST

- Well Servicing Tax - 2.42% imposed on service provider but may be passed through to the customer
- Only applies to
  - “Cementing a casing seat of an oil and gas well”
  - “Shooting, fracturing, or acidizing the sands or other formations of the earth in any such well” or
  - “surveying or testing such formations or the contents thereof in any such well.”
Service must be performed during drilling and completion, or reworking or reconditioning of the well. And in the case of surveying or testing, by means of equipment inside the well bore when the test or survey is performed. Opportunities for “overbillings”? Careful though, WST may have been charged in error but sales taxes may be due instead.
Tax Opportunities – Upstream Businesses – Texas WST Continued

Examples: Cementing Job

-Cementing of the casing seat of the producing string – WST due

-Cementing intermediate casing string – NT (assuming part of new completion or workover)

-Cementing a plug for well abandonment – NT

-Cementing to repair defective casing – ST due
Example: Surveying
-Dip survey performed to facilitate the drilling – WST due
-Dip survey made for the purpose of determining where to drill subsequent wells – NT

See Texas Letter Ruling 5412879L for detailed explanations of the WST
Tax Opportunities – Upstream Businesses – Mississippi

- 7% retailers sales tax due on “geophysical surveying, exploring, developing, drilling, producing, distributing, or testing of oil, gas, water and other mineral resources” (Miss Code Ann. Sec. 27-65-23)
- Contractors 3.5% tax due if “redrilling, or working over, or of drilling or completing an oil well or a gas well…when such compensation exceeds ten thousand dollars.” [Miss. Code Ann. Sec. 27-65-21(2)]
- Acceptable documentation to prove contractors tax due?
Contractors may deduct from taxable compensation when the regular retail tax has been paid by the contractor to the person making the sale or rendering the service

- Additives, casing, cement, coring, directional drilling, fishing tool rental, logging, mud, perforation, road construction, site preparation, testing, water
Tax Opportunities – Upstream Businesses – New Mexico

- NMSA SEC. 7-9-65, “Receipts from selling chemicals or reagents to any mining, milling or oil company for use in processing ores or oil in a mill, smelter, or refinery or in acidizing oil wells, and receipts from selling chemicals or reagents in lots in excess of eighteen tons may be deducted from gross receipts.”
Tax Opportunities – Upstream Businesses – New Mexico continued

- N.M. Admin Code 3.2.223.7 defines the term “lots”
- “means a parcel or single article which is the subject matter of a separate sale or delivery, whether or not it is sufficient to perform the contract”.
Runco Acidizing and Fracturing Co, Inc. v. Bureau Of Revenue, Court of Appeals, 12/11/1974

- Fracturing company that had chemicals delivered directly to the well site
- No single delivery nor any single day's delivery amounted to eighteen tons or more. To reach lots in excess of eighteen tons, Runco would combine all deliveries made pursuant to a purchase order. Runco's contention is that when it received a purchase order it had "sold that job"; in effect, that the purchase order amounted to a sale of all chemicals and reagents subsequently delivered to a particular well.
- However, purchase orders indicated chemicals and reagents “as requested” therefore purchase order was not a transfer for consideration and therefore not a sale
- Taxpayer not entitled to deduction
Tax Opportunities – Upstream Businesses – New Mexico continued

- Protest of Tucson Electric Power to the Department’s Denial of refund issued under Letter ID No. L1108271152, 6/24/2016
  - The taxpayer was a low-emission, natural-gas fired combined-cycle electricity plant
  - The taxpayer purchased natural gas via pipeline which was used to produce electricity
  - Department agreed the natural gas qualifies as the purchase of chemicals or reagents
  - Department argued that the natural gas was “commingled with other natural gas belong(ing) to the Taxpayer and other entities”
  - Therefore without more evidence on how natural gas is delivered from the seller to the buyer, a finding cannot be made one way or the other as to whether the natural gas is sold or purchased in “lots.”
N.M. Ruling 420-15-1, April 27, 2015

Can fracturing company issue NTTC for the purchase of sand and chemicals?

Determined fracturing company is the supplier of TPP along with a service and since separately stated, an NTTC may be issued to their supplier.

Chemicals are consumed during the performance of the service and even if separately stated are taxable.

No mention of 18 ton exemption.
Oil and gas well services performed downhole treated as a Contractor or a Serviceman & Retailer of TPP?

Contractor defined to include “any person who performs any improvement upon real property and who, as a necessary and incidental part of performing such improvement, incorporates tangible personal property belonging to or purchased by the person into the real property being improved.” Okla. Stat. tit. 68 Sec 1352(7)

Fracturing and Cementing services not a taxable service but what about separately stated materials (cement, proppant, chemicals, etc.)??
Okla. LR No. 15-009, 3/31/2016 and Okla. LR No. 11-071, 8/24/2011 – Company that provides fracturing and cementing services that invoices separately for their materials used to perform their services

- If providing a nontaxable service, the items of tangible personal property would be taxable to the service provider, and service provider “would not separately state charges for materials or collect sales tax thereon from its customers”.
- If “vendor making sales of tangible personal property along with the provision of a nontaxable service, serviceman must collect sales tax on the gross receipts attributable to the sales of tangible personal property…”
- No mention to whether the service provider could be considered a Contractor and therefore the consumer of all materials
Tax Opportunities – Upstream Businesses – Oklahoma

- In Okla. LR No. 2017-03-14-12, 3/14/2014
  - Refund request for sales taxes paid on materials invoiced by a fracturing company
  - Was fracturing company a “Contractor”
  - ALJ recommendation 10/11/16
  - Briefs and oral arguments had before the Commission on 3/8/17
  - Refund Claim Denied; Appeal Pending with S. Ct. Case No. TC-1159-69

- Oklahoma looks to a three part test to determine if the fixture becomes part of the realty
  - The actual or constructive annexation of the item to realty or to something appurtenant to realty
  - The appropriateness of the particular articles use to the purpose or actual use of the realty
  - The intention of the party placing the article on the realty to make the article a permanent and integral part of that realty

- ALJ: “the alleged improvements to real property benefited Claimant, not the surface owner” therefore Claimant failed to prove the Fracturing Service was a “Contractor”
Questions??

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