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Energy Resources UPDATE

Following the Shale Game

With the experiences of Eagleford, Fayettesville, Bakken and Marcellus under their belt, many oilfield services companies looking to expand operations are focusing on the next shale play. Exploration companies have invested billions of dollars acquiring land in Ohio over the last several months, and initial reports state that the first several wells drilled in the Utica shale have yielded enough natural gas liquids to prove that it has the capacity to support commercial production.

The opportunities presented by shale exploration have earned the interest of foreign energy companies as well. In fact, over the last several months foreign firms have invested nearly $6 billion in U.S. drilling projects. These investments usually involve foreign firms partnering with U.S. oil and gas companies to purchase a stake in fields that are under development. On the first day of trading in 2012, two major foreign oil companies announced their respective partnerships in U.S. shale plays. China-based Sinopec announced its $2.2 billion investment in a joint venture with U.S. firm Devon for a one-third stake in its fields currently under development. French firm Total also announced its $2.3 billion payment to U.S. firm Chesapeake for a stake in its fields – particularly those in Ohio's Utica shale.

The Utica shale is located up to 7,000 feet below the Marcellus shale, extending into eight states and two countries and, according to geological research, ranges from less than 100 feet to over 500 feet in thickness. This makes the Utica shale one of the most extensive geographic formations in North America. The Ohio Department of Natural Resources estimates a "recoverable Utica shale potential between 1.3 and 5.5 billion barrels of oil and between 3.8 and 15.7 trillion cubic feet of natural gas."

As the oilfield services industry follows exploration companies into the Utica shale, there are numerous traps that can catch the unwary. Something as simple as crossing a state border can unleash a slew of regulations, as tax laws vary significantly from state to state. Companies attempting to become active in the Utica shale will have to familiarize themselves with the local tax codes of each state or risk facing costly penalties.

A plethora of state and local taxation and filing requirements begin as soon as 30 days after entering a new state. Oilfield services companies expanding across state lines will not only need to become familiar with state income taxes, but also a number of other taxes including:

1. Sales and use tax
2. Employer withholding tax
3. County/city taxes
4. Property taxes

In addition, oilfield service companies may need to register vehicles locally and track equipment as it is moved from state to state. Tracking equipment will be especially important as companies may be required to file estimated tax payments. The impact on allocation and apportionment for state taxable income purposes may substantially affect the tax liabilities in every state in which the company operates.

Companies may also want to consider reexamining their corporate entity structures prior to a state migration as opportunities may arise that will allow companies to impact their cash flows positively.

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The shale opportunities for oilfield service companies will continue to expand as new discoveries and new technologies open new areas for development, and the most successful entities will be diligent in the proper consideration of state taxes to their overall bottom line.

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Energy Resources Update is provided by GBQ's Oil & Gas Team for our clients and other interested persons upon request. Since technical information is presented in generalized fashion, no final conclusion on these topics should be made without further review.