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Oil and gas investments for non-oil and gas investors

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The explosive growth of oil and gas offerings and direct investments in oil and gas royalty and working interests has broadened investment options for individual accredited investors. Stephen Burr explains why oil and gas offerings through the TIC distribution channel have become popular and the risks unique to oil and gas investing.

Two of the most significant developments over the past few years in broadening the investment options for individual accredited investors are the explosive growth of the real estate tenant in common offering industry and the almost equally explosive growth of the offering of direct investments in oil and gas royalty and working interests.

The simultaneous growth in these two investment options is not an accident, but rather a response to the same circumstance, i.e. the predicament of the real estate like-kind exchange investor.

Prior to 2002, real estate like-kind exchange investors often found themselves in a quandary. There were many more dollars available for investment from these investors than there were suitable investment opportunities. As a result billions of dollars in attempted real estate like-kind exchanges failed.

The biggest problem was that investors selling real estate were denied like-kind exchange treatment if they sought to buy a piece of real estate with other like-kind exchange investors using a limited partnership or multiple member limited liability company structure. This left investors scrambling to find individual pieces of real estate to buy, which was difficult in a competitive market, particularly when the investor had to find a property that was the right "size", so that he could completely reinvest his proceeds and match up the debt and equity components. The problem was further compounded by the IRS - imposed deadlines of 45 days to identify and a further 135 days to close on replacement properties.

All of this changed with the adoption of Revenue Procedure 2002-22, in which the IRS provided guidelines for structuring like-kind real estate investments involving multiple real estate investors. Because a partnership or multiple member limited liability company was clearly unacceptable, the structure which the IRS suggested in Revenue Procedure 2002-22 would work was a “Tenancy in Common”, an ancient real estate concept that allows multiple individuals to directly own an undivided interest in real estate without using an entity like a limited partnership or limited liability company.

The Revenue Procedure described in some detail the various requirements for like-kind exchange treatment for investors in a Tenant-in-Common structure. Even though the structure outlined by the IRS proved very complex, the pent-up demand by real estate like-kind investors was so great that the Tenant in Common offering industry was born overnight, and has now grown into a $4 billion in annual equity raised behemoth in 4 short years.

So what did all of this have to do with the oil and gas offering industry? The key was that the TIC Offering industry generated such demand that for the first time since the 1980s broker dealers and securities representatives across the country started devoting substantial time and effort towards identifying and organizing groups of individual accredited potential real estate investors, particularly those looking for real estate like-kind exchanges. This in turn lead to the creation of organized selling groups of broker dealers and securities representatives in the industry, and a new real estate equity distribution channel was born, hungry for products to sell.

The second piece of the puzzle was the rapid rise in recent years of prices for oil and gas. Although natural gas prices have fallen somewhat this year, the general trend is clearly upward. This has resulted in a boom in new drilling and employment of secondary and tertiary recovery techniques in many gas and oil fields in the United States that at the lower prices of the past were not economically feasible.

Financing this boom requires equity, and independent owners and operators of oil and gas assets began looking for ways to raise equity by either selling off strips of income or potential income from oil and gas assets they already owned, or buying new oil and gas assets and raising the equity from individual accredited investors.

Once this distribution channel was established, a few pioneers found an exceptional synergy between the oil and gas owners and operators looking for equity on the one hand, and TIC investors looking for attractive opportunities on the other hand. These pioneers discovered that not only were oil and gas interests considered like-kind exchange real estate for real estate like-kind exchange investors, but that the oil and gas industry had a long history of creating direct ownership of fractional interests in oil and gas assets.

As a matter of fact, even prior to Revenue Procedure 2002-22 the IRS had permitted multiple owners to hold fractional interests in oil and gas assets and to treat those interests as like-kind exchange real estate. By 2005 a new oil and gas equity syndication industry aimed primarily, although not exclusively, at real estate like-kind exchange investors and selling through the same distribution channel, had been born.

While reliable statistics are difficult to come by, the oil and gas interests sold through the TIC distribution channel now appear to total several hundred million dollars annually, even with a recent slowdown of sales due to the sharp decline in natural gas prices.

Why have oil and gas offerings through the TIC distribution channel become popular so quickly? Here are a few simple but important reasons:

Reasons why oil and gas offerings are popular

1. Simplicity.

Oil and gas offerings do not have to be structured to comply with the rigorous demands of Revenue Procedure 2002-22, although there are certain issues common to both. As the oil and gas industry had an established history of selling direct ownership in fractional interests, counsel to the sponsors are able to give "should" tax opinions without strict Revenue Procedure 2002-22 compliance, greatly simplifying the offering structure.

2. Low minimums.

The minimum investment amounts are low and very flexible, opening the doors for investors with small amounts ($100,000 or less) to invest. This also allows investors who have found a real estate investment that is not quite large enough to absorb all of their gain to place the balance in an oil and gas offering.

3. No leverage.

Oil and gas offerings are typically unleveraged, i.e. no debt. This makes the documents simpler, removes the need for the "non-recourse carve-outs" that are always an issue in the real estate side of the TIC industry, and provides margin for error compared to a fairly highly leveraged real estate investment that could wind up in a foreclosure.

4. Diversification.

Oil and gas offerings are a diversification alternative to investors who feel over-exposed to commercial real estate, or who, particularly in certain geographic areas such as California feel commercial real estate prices have "peaked."

5. Individual action.

The investors in oil and gas offerings generally do not need to act in concert. There are fewer decisions that need to be made and, because Revenue Procedure 2002-22 does not apply, more room for the investors to delegate whatever decision-making authority is necessary to the sponsor.

6. Secondary market.

Oil and gas interests should be more easily salable should the need arise. There are no lenders, so no lender approval is required. There are no call agreements and dispute resolution procedures. Also there are a number of established electronic market-places for buying and selling fractional oil and gas interests.

Given these positive aspects, why has the oil and gas side of the TIC industry not grown even more quickly than it has? There are three principal reasons. First, the broker dealers and securities representatives are just now catching up to the real estate sponsors in learning the ins and outs of real estate investments. Oil and gas is a completely different type of investment. Learning about it will take time and effort.

As long as they can make a good living selling real estate investments, some substantial portion of the securities representatives will resist learning about an entirely new asset class. Having an adequate number of well trained professional securities representatives is already a significant bottleneck on the real estate side of the industry. Adding another asset class exacerbates the problem.

The oil and gas sponsors have a lot of educating to do. In fact, one of the leading oil and gas sponsors Noble Royalties, has created its own "Noble University" for broker dealers, representatives, and investors, providing a basic course on oil and gas investing.

Second, there are a number of risks that are specific to the oil and gas industry, several of them significant, that some investors can not get comfortable with. As with the broker dealers and the securities

representatives, the investors are generally starting with less knowledge of the oil and gas industry than of the real estate industry, which makes a careful investor even more cautious.
Third, even if the broker-dealers, representatives, and investors learn enough to feel comfortable evaluating the oil and gas specific risks, they are not always able to get comfortable with the quality of the sponsors, many of whom have very little track record even on the acquisition side, much less on the management side.

Outlined below are some of the risks unique to oil and gas investing, both with respect to royalty interest and working interest offerings. Most of these risks are common to both the royalty and working interest offerings.

Royalty interests are essentially income strips more separated from the risks inherent in operating and developing oil and gas wells than working interests. On the other hand, holders of royalty interests tend to have less control over what happens on an oil and gas property than holders of working interests. If additional production is important this can be a negative, although generally the interests of royalty holders and operators are aligned.

Working interests carry the potential for more reward and therefore not surprisingly more risk. The risks inherent primarily in only working interests are specifically identified below. The first two risks listed below are by far the most significant for both royalty and working interest offerings.

1. Price volatility.

Real estate investors are used to cycles in the value of real estate, typically spread over years with a few key indicators, e.g. overbuilding, interest rates, etc. Oil and gas prices are much more volatile over much shorter periods of time than real estate, and can be affected by many more factors, e.g. foreign wars or insurrections, decisions by cartels, hurricanes, technological advances, pollution concerns, etc. An offering involving primarily natural gas wells projected to produce a 10% return assuming gas prices at $10/million btu can look pretty sad if prices fall to $2/million btu. Here are a few ways to mitigate that risk:

(a) Take a long view.

As with real estate, an investor looking for a quick buck is likely to be disappointed. If you believe that over time oil and gas prices should at least keep pace with inflation, and you have patience, you will sleep better.

(b) Look for balance.

Oil and gas prices do not always move in tandem (witness the last six months). Give some more weight to offerings with a combination of oil and gas production.

(c) Sensitivity analysis.

The offering document for an oil and gas deal should have a sensitivity analysis, assuming production at current levels, based on oil and gas prices at different levels. If you are trying to achieve an 8% return at $50/barrel oil and $4/million btu gas and today’s prices are $60 and $6, respectively, you have some room for error.

2. Depletion and decline.

Perhaps the largest risk, which is also the least understood in oil and gas investing, is the risk of depletion. Oil and gas wells are depleting assets. In other words, all wells run dry over some period of time. It is important to understand not only when the wells are likely to be fully depleted, but also what the rate of decline is. Thirty percent less production in the second year will of course dramatically affect the yield to investors even if prices are stable. Unlike real estate, there are not alternative uses for the assets in these offerings. They either produce or they do not. Here are a few ways to mitigate that risk:

(a) Diversification.

Wells in certain fields, counties, states, and regions deplete faster than others. Oil wells and gas wells can also deplete at different rates within the same field. The best protection against these variances in depletion rates is diversification. Look for portfolios with product and geographic diversification.

(b) Replacement wells.

Offerings which include interests in properties where existing wells are widely spaced afford opportunities for additional drilling. The risk associated with this drilling is not being assumed by the investors, at least in royalty interest offerings, but they can reap the benefit if the new wells are successful. If old wells are regularly supplemented by new, “in-fill” wells, production can reasonably be projected to remain stable for extended periods.

(c) Engineering.

Offerings should be supplemented by internal and third-party engineering. Great strides have been made in recording the historical performance of wells or fields and projecting that performance into the future. Look for this information, and make sure that it looks at least 10 years into the future.

3. Operating risk (primarily a working interest risk).

As the name implies, working interests involve the risk and reward of increasing production, whether by drilling new wells or improving the production of existing wells. The investors’ capital in these deals pays not only for the real estate interest, i.e. the right to drill, but also in many cases for the cost of drilling.

In a royalty deal the investor is essentially buying an income strip in producing wells, and the risks are primarily price volatility and depletion. The price paid for the royalty interest is presumably closer to the actual value of the real estate being purchased than the amount invested in an a working interest deal.

Another way of saying this is if you pay the cost of exploration and the exploration is unsuccessful, you have a greater chance of losing a significant portion of your investment in a working interest deal than in a royalty interest deal. You also have a greater upside.

Finally, State and Federal laws impose certain liabilities on holders of working interests which are not imposed upon holders of royalty interests, e.g. environmental, property damage, personal injury, plugging, subsurface damage. It is difficult to separate the investor from personal liability for these risks. Some ways to mitigate these risks with respect to working interests are:

(a) Established fields.

Look for offerings focused on historically successful locations in historically successful fields.

(b) Costs.

Understand what costs you are being asked to cover, whether those costs are reasonable and capped, and whether the capital being raised will cover those costs with a reasonable margin for error. No one likes to receive notice of an additional capital call.

(c) Tax benefit offsets.

The increased economic risks in working interest deals can be partially offset by increased tax benefits. Caution: do not count on these without expert tax advice, as the rules governing such benefits are more complex than those for real estate, and in any event never invest based only on apparent tax benefits. In particular, trying to assure maximum tax benefits may be inconsistent with trying to shield the investor from personal liability.

(d) Track record.

Nothing is a better predictor of future success than past performance. Look for a table of prior performance on the sponsor in the offering document, and make sure that that performance is recent and presented in a transparent manner.

4. Quality of sponsors.

The oil and gas offering industry is even newer than the real estate TIC industry. Many of the sponsors are newly formed with little track record, whether in terms of delivering the returns they project, asset management, financial reporting or investor relations. A few suggestions:

(a) Experience.

Some experience is better than none. Try to find sponsors who have some, even if limited, history of delivering what they promise. If they do not have any history, view the projections with additional caution.

(b) Breadth and depth of resources.

Look for sponsors who have made a substantial investment of time and money to enter the business, and have not only acquisition and sales people, but due diligence, asset management, financial reporting, and investor relations personnel.

(c) Third-party reports.

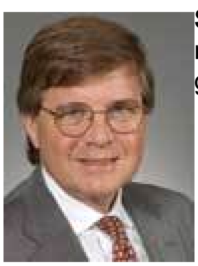
Look for third-party sponsor and project due diligence reports done by credible third-party due diligence firms, as well as third-party engineering.

(d) Who is doing the selling.

Look for offerings marketed either through a credible managing broker dealer or through securities representatives who have made a commitment to understanding the industry.

Oil and gas offerings are an attractive supplementary investment strategy for certain real estate like-kind exchange investors. However, as with any investment a little knowledge is a dangerous thing. No one should sell these offerings, or invest in them, without careful study.

The author



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