"Working Interest vs. Mineral Interest"
Or,
(Risk vs. Reward)

April 21, 2015 TEFP Meeting

Minerals the basics:

- Mineral ownership lies beneath the surface.
- Minerals can be severed from the surface ownership and sold.
- Mineral ownership takes precedence over surface ownership.
- Minerals can be Leased for development to 3rd parties by contract for:
  - Bonus – Upfront Cash Payment,
  - Royalty – Percentage of the Income (no expenses),
  - Term & Conditions – Typically 3 years, renewal options, transportation deductions, depth restrictions, Favored Nations, etc.
- Record your ownership in the county where the Minerals reside!
- Maintain a paper trail.

So, you say you want to get into the oil and gas business…

Types of Ownership, It starts with the Mineral Lease:

- **Royalty Interests**
  - Percent of the Revenue exclusive of any expenses.
- **Overriding Royalty Interest**
  - Percent of the Working Interest's revenue exclusive of expenses.
- **Working Interests**
  - The sophisticated investor,
  - Do you want to participate?
  - Working interest owners pay 100% of the Bills,
  - Receive a proportionally reduced revenue interest after Royalties & ORRI's
  - The Promote: A 1/3rd for a Quarter, Back-in After Payout, Non-Consent.
- **What do you own – *It's all about the Spacing* – examples**:
  - 40 net Acres in a 40 Acre Spacing Unit at 3/16 Royalty,
    - 40 / 40 * .1875 = .1875 or 18.75%
  - 40 net Acres in a 640 Acre Spacing Unit at 3/16 Royalty,
    - 40 / 640 * .1875 = .011718 or 1.17% Royalty,
  - 1 net Acres in a 640 Acre Spacing Unit at 1/8th Royalty ,
    - 1 / 640 * .125 = .00019531 or .019% Royalty
    - Divided by 5 Heirs (2nd Gen) = .00003906 or .003% Royalty
    - Divided by 3 Heirs (3rd Gen) = .00001302 or .001% Royalty
    - Hypothetical: Unitization Reduced further .000001025 interest
- **I am being Force Pooled and an election is due?**

- **How do you want to Own it**:
  - Individually,
  - LLC,
  - Sub-S,
  - Partnership.

When you hit, the money is great!

- **Fast Facts**:
  - The U.S. produces ~ 10 million barrels of oil per Day,
  - ~20 Counties in the US provide 50% of the production in the lower 48,
  - ~550,000 wells drilled in Oklahoma, ~80,000 producing wells,
  - The Unconventional Shale revolution combined with horizontal drilling and fracture treating has revitalized our energy economy.
- **Tax Savings**
  - Intangible Drilling Cost (IDC’s),
  - Depletion Allowances – depleting asset typically15%,
  - Reduced Severance Taxes (horizontal wells).
- **Rates of Return double digits for the successful**
- **How much depends on the regulatory spacing unit**
- **A specialty class of investment**
- **The old fashioned way – Inheritance**
- **The Division Order**
- **Royalty Checks**
  - Deposit vs. Analyze,
  - Oil, Gas, Plant Products, deductions, adjustments,
  - $100,000 / $100 Oil = 1,000 Barrels/year or 2.7 Barrels/Day,
  - Compare: A minimum distribution is $25/year /$100,000 = .00025 decimal.

There is always a downside!

- **Higher Capital Expense demands due to:**
  - Operator discretion on all activities, audit rights,
  - Rights to take oil and gas produced off lease,
  - New well proposals, Authorization for Expenditures (AFE’s) inflation,
  - Work-over operations to re-complete wells etc.,
  - Blowouts, environmental spills, personal injury,

- Regulatory, legislative or health and safety changes requiring action.**Volatility of oil and Gas Prices**
    - Significant swings in local or global market prices,
    - Changes in operating conditions requiring additional deductions to market products,
    - Oil and gas accounting and revenue checks are complicated!
- **Volume changes**
    - Geologic risk, natural depletion of the wells (volumes declining over time),
    - Encroachment of oil/gas by water (pre-mature watering out of a well),
    - Competition from other wells – (adjacent wells draining existing wells),
    - Market curtailments due to lack of market for the product (oversupply),
    - Imbalances in gas production by owner (marketing variance by owner)
    - Natural disasters interrupting product sales.
- **Insurance coverage limits**
    - Insurance claims in excess of base level of insurance coverages (liability, blowout),
    - Inadequate or unavailable insurance available,
    - Natural disasters, extreme weather conditions,
    - As working interest owner chain-of-title liability exists for past and future issues.
- **Market Risks**
    - Insufficient monies in accounts to pay Joint Interest Billings (JIB’s), capital requests,
    - U.S. economic concerns, energy policy, equipment shortages,
    - Competition by the industry increasing expenses or accelerating activity & technology,
    - Inability to expand or replace reserves.

Conclusion:

The decisions you make with regard to the mineral ownership under your control can have material consequences for the benefit, or adversity, of yourself or your client – Participant Beware!