

“The Guide for Investing Directly into Oil Wells”

This is a direct guide to help you evaluate which energy companies to invest with based off past performance, offering structure, company structure, project design and various other deal points. This guide will **NOT** take the risk out of investing directly into an oil well. From an investment standpoint, the oil industry is very risky. Inherently, oil is either in the ground or not. There's certainly an amazing upside, but the downside is you could lose **ALL** your invested money. With that being said, a “**fair**” loss most investors can handle. “Fair” being when the company you've invested with drilled the well, made best effort attempts to make the well commercial, but no oil was there - commonly referred to as a “dry hole”. “**Unfair**” is when you've invested your money and a few things happened: You cannot get any updates on what's going on, the company never drills the well, the company you've invested with is not the company actually operating the well, the well is producing but you're not getting paid, you're getting billed for costs you have no clue on, company disappears, etc. All these things result in “unfair” losses. Unfortunately, if you've already invested into oil and/or gas wells, chances are high you likely experienced “unfair” loss. There's a lot of “fly-by-night” promoters/brokers out there looking to close their next victim. Thankfully, although in minority, there are many legit and honest Oil Operating companies to invest with. This guide will help you decipher companies that are legitimate versus ones that are questionable.

CHAPTER 1: ARE YOU A RISK TAKER/OPPORTUNIST?

RISK- A four letter word that investors hate to hear. However, “greater the risk, higher the reward” is an old saying we’ve all heard that is very true.

Question is: Are you a risk taker? Not everyone has the right mindset to be an investor in oil and gas wells. It’s certainly not for everyone. For example, let’s say you’re retired with a net worth between one and three million dollars. You put your money in conservative investment vehicles such as blue chip stocks, bonds, mutuals, IRA, real estate, and/or things that you can control. Your average **Rate of Return (ROR)** per year is less than 10% and you’re content. Although you have the money to invest, more than likely you’re not one that ventures out and takes risks. Therefore, investing directly into oil wells may not be for you.

But let’s take an example of someone that fits the profile of an investor that is comfortable with risks. This person has at least a one to three million dollar net worth (and in some cases much greater), is working and creating an active income, diversified investor including movies, private placements, IPO’s, companies with limited track record, investment vehicles you do not control, stocks, bonds, real estate and etc. This investor is looking to achieve no less than 15% ROR annually, with ambition to achieve greater than 30% ROR. This makes this type of investor an opportunist, which is someone who dedicates a percentage of his or her portfolio for riskier investments that have opportunity to generate multiple **Return on Investment (ROI)**.

There are many variables that could define which kind of investor you are. The two examples above are simply a for-instance. Ultimately, taking risks yields higher rewards as long as you're willing to "roll the dice" after thorough due diligence. Now that you know you're a risk taker, lets begin to learn more about oil consumption as it relates to the USA.

CHAPTER 2: U.S.A. NEEDS MORE OIL!

Here in the USA, we use more oil than we currently produce. In late 2012, the US Energy Information Administration (EIA) reported that the US produced around 7.03 million barrels of crude oil per day and imported about 7.58 million barrels per day, for a total of 14.61 million barrels of oil per day. As of 2013, the United States consumed an average of 18.89 million barrels of oil per day. So, as you can see from simple mathematics, the US is using more oil than we currently produce and import. This creates a demand for oil in the United States. This is also the contributing factor for why we are paying so much per gallon of gas at the pump, as gasoline is refined oil. Oil is priced by the barrel (42 gallons) and as of July 2014, the price per barrel of oil is over \$100. In retrospect, in the late 90s, when gas was only \$.99 per gallon at the pump, the price of oil was between \$8 and \$15 per barrel.

As America becomes more dependent on oil exporting countries such as Canada, Saudi Arabia, Mexico, Venezuela, and Russia, which are the top 5 countries the US imports oil from, our foreign relations become increasingly vital to the price we pay per barrel. One of the leading organizations that affects US and global oil prices is OPEC (Organization of the Petroleum Exporting Countries). OPEC is an international organization and economic cartel whose mission is to coordinate the policies of oil producing countries. The member countries are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela. As of late 2012, the OPEC countries' share of world crude oil reserves was 81%. That equates

to over 1.2 trillion barrels of oil in reserves. Political risk factors affecting the price per barrel of oil in the US can be a result of political relations, international security concerns, international agreements, and domestic oil booms such as US shale discoveries. For example, the price of oil may increase when certain countries such as Iran pledges to increase its production and OPEC's informal leader, Saudi Arabia, does not agree. The escalated tensions create speculation that OPEC leaders will restrict import quantities to the US, which will result in upward pressure on oil prices. Conversely, as the US begins to discover new production trends and proven reserves, such as the US shale boom, this creates downward pressure on oil prices.

In order for the US to become more independent from foreign oil, domestic oil companies **MUST** drill and produce oil to increase proven reserves and daily oil production. In addition to lucrative returns, American investors owe it to themselves to support domestic oil exploration. How many American generations should be dependent on foreign oil?

CHAPTER 3: THE MAJORS AND THE MINORS

Major oil companies such as Exxon Mobile, Chevron Corporation, Conoco Phillips, Valero Energy, and Marathon Petroleum generate annual revenues of between 25 billion to over 400 billion dollars. The primary focus of the major companies is to consistently replace depleting reserves with new, proven reserves. By definition, this is called **reserve-replacement ratio** (RRR). Outside of spending billions of dollars in exploration attempts to find new reserves, major oil companies are constantly seeking to acquire mid-range companies that have **proven under-developed** reserves (PUD). In many cases, once major companies acquire these mid-range companies, this leaves opportunity for small independent operators to pick up leases that major companies would otherwise find too small and not meet their economic viability.

For example, XTO Energy based in Fort Worth, Texas, started out as an independent oil company in 1985 and went by the name of Cross Timbers Oil Co. As a new **exploration and production company** (E&P), XTO began developing properties in unconventional resource plays, which began to substantiate into one of the largest producers of hydrocarbons in the United States. Their main concentration was to acquire leases, drill enough wells to book proven reserves, and make it attractive enough for a major company to acquire them. After acquisition, Exxon Mobile was able to immediately include XTO's estimated proven reserves to their books, which inadvertently increased Exxon Mobile's shareholder's stock price. After Exxon Mobile acquired XTO, rapid development of XTO leases began to taper off. As soon as

they begin to produce oil wells from a proven reserve, that reserve begins to deplete its asset. Therefore, it's more of a priority for the major companies to spend an obscene amount of dollars going after bigger reserves and/or acquisitions versus depleting current assets. The amount of reserves the majors replace must be higher in percentage to ratio of reserves being depleted. By keeping the RRR higher than the rate of depleting reserves, this increases the value of the company. Understanding the process of how major oil companies absorb mid-range oil companies to fulfill their RRR is paramount in identifying opportunities available for independent small-range oil companies to acquire leases within areas that are **proven under-developed** (PUD). This is how independent operators with the right relationships and network can begin to create a portfolio/track record of producing oil wells. Of course, the other method and the most risky of methods would be for the independent company to "wildcat". **"Wildcatting"** is drilling in an area that has no proven production trends and/or wells near-by, limited geologic information, and limited engineering data. Successful wildcatting wells are **EXTREMELY** rare in today's world.

Major oil companies do not offer direct investing into oil wells, only stocks. Many independent oil companies use private investor funding to develop oil-producing properties. Identifying which of these companies are actual oil operating companies versus indirect investment firms such as broker/dealer, promoters, and etc., is most important when determining which companies to invest with.

CHAPTER 4: OPERATORS, NON-OPERATORS, BROKER-DEALERS/PROMOTERS

Oil Operators- Oil companies that are licensed/bonded and insured to drill and produce wells in the state of which they operate. Oil operators can be for-hire, meaning they don't own a lease but another entity has hired them to oversee drilling operations and production of their property. However, in many cases, an oil operator is also the owner of the lease and they themselves work to orchestrate the process of making sure a well is drilled, tested, completed, or plugged/abandoned. Oil operators that are new, just starting out, may not own their own drilling rig and use service providers to physically drill the well. A more established and seasoned oil operator may own their own equipment and physically drill the well. In any case, oil operators use vendors that provide services such as cementing, drilling, wire line services, geoscience, and etc.

Investing with an actual oil operator that owns the lease is the most direct way to participate. Investing with the oil operator limits the amount of indirect communication and third-party dilution. This is the most preferred way and most transparent way to get involved directly into an oil well.

A non-operator is an oil company that could own the lease but is not actually licensed to operate the wells. Usually, a non-operator is an industry investor, meaning they generally do not offer investments to private investors, but usually are either self-funded or invite other oil companies to invest with them. There are cases of some non-operating companies that own leases and offer

private placement investing to non-industry investors. In this case, the non-operator generally does not have the experience or wherewithal to be an actual operator. As an independent investor, it would be recommended to invest with the actual operator versus a non-operator unless you're familiar with oil and gas operations.

A broker-dealer is a person or firm in the business of buying and selling securities operating as both a broker and a dealer depending on the transaction. It's very rare that a broker-dealer offers direct ownership into oil wells. The reason for this is primarily due to the risk and limited financial history of companies of which they represent. Generally a broker-dealer is going to offer equities into the actual Corporation. If a broker-dealer has a direct placement available into direct oil drilling, generally, it's going to be in a "hedge" and the upside return potential will be less than 15%, although the investment will be spread out through multiple wells, which mitigates risk substantially.

A promoter is usually an entity that is not licensed or registered to sell securities and has no direct operational responsibilities. In most cases, promoters are usually sales people. Typically, a promoter will purchase a percentage of a well from an actual operator, mark it up substantially, create joint venture units, and sell these positions to independent investors. It is not recommended to invest with a promoter no matter how good the deal seems or what sales points they seem to make.

CHAPTER 5: DIRECT PRIVATE PLACEMENT OIL OFFERING STRUCTURES

There are different ways of which companies create investment offerings. In this chapter, we're going to explain the most common forms as it relates to direct oil investing.

JOINT VENTURE PARTNERSHIP is an entity specifically created to jointly bring partners together to share cost, risk, revenues, and assets through a venture. As it relates to direct oil investing, typically an oil company will establish a partnership and file a joint venture agreement with the state where the project or wells will be located. This type of joint venture will have its own federal tax ID number, and as a partner, you should receive a Certificate of Ownership or assignment giving you direct ownership of all assets assigned to the partnership. In addition to direct ownership, there's also liability associated with investing directly into a partnership. As a partnership, you are under joint and several liability and all sums. Meaning a claimant may pursue against any one party as if they were jointly liable and it becomes the responsibility of the defendants to sort out their prospective proportions and payment. This means, if the claimant pursues one defendant and receives payment, that defendant must then pursue the other obligors for a contribution for their share of the liability. Since this is the case, you would be considered an active investor, even though you may not make decisions in regards to the direct oil operations on a day-to-day basis. As an active investor, the benefit is you can receive substantial tax benefits from intangible drilling costs (IDCs). Therefore, investing directly into partnerships usually means dealing directly with the actual

operator. The upside to investing into direct ownership with the operator includes substantial tax benefits, high reward potential, transparency, direct revenue disbursement, and etc. Downside is liability. If liability is deterrence, it's recommended you create an LLC and use that to directly invest into a partnership for direct oil drilling. That means, liability will only flow through to your LLC and it's wherewithal versus you personally. In this case, your tax deduction can only be used for the benefit of the LLC.

JOINT VENTURE UNITS - Joint venture units is a contractual business undertaking between two or more parties. It's similar to a partnership with one key difference - you do not have assigned ownership into any assets. In most cases, as it relates to direct oil drilling offerings, units represent the percentage you receive of proceeds generated from an oil well. You'd be considered a passive investor; therefore you cannot receive the tax benefits associated with **intangible drilling costs** (IDC's). However, you're only limited in your liability to lose only the money you've invested. Without there being assigned ownership into the assets of a partnership, unit structuring is considered securities. Therefore, in order for an entity to offer these kinds of investment structuring, you must be a licensed broker/dealer. It is very common for promoters to offer these kinds of structured offerings, which lack dissemination of offering details and deal points. Because of this, it is highly recommended that you steer away from unit investments when dealing with direct oil well offerings.

JOINT OPERATING AGREEMENT (JOA) - JOA is when two entities come together to invest in oil and gas under an agreement known as the **Model Form Operating Agreement**. This is a direct approach to investing with an actual operator if you're another oil company. Generally, if you invest through a

JOA, you're very familiar with oil and gas operations and you're investing as a "head's up" partner. This means you understand enough about day to day oil and gas operations and you're willing to be billed lease operating expenses, maintenance, work-over, rework, and other costs associated with producing an oil well. This billing process is called **Joint Interest Billing** (JIB). As a JOA partner, you can be listed on the division order, which is a roster given to the gatherer or purchaser and have revenue checks sent to you directly from the buyer. This is not the recommended way for a novice oil investor as you must be able to set aside monies for lease operating and production cost. In addition, you must be familiar with regulatory state agencies with which the wells are located and how to file severance and/or ad valorem taxes. Again, most partners that invest into a JOA are industry experts and usually do a minimum of quarter million dollar investments.

CHAPTER 6: FULL TURN-KEY VERSUS NON-FULL TURN-KEY

Full turn-key as regards to direct oil investments usually means the offering company guarantees that you will not have to pay any additional expenses “through the tanks”. “Through the tanks” is a term in the oil industry that means the well has been drilled, tested, completed, and all equipment is set up and ready to produce. The benefit of a full turn-key agreement is that you only place one investment and you’re not required to invest any more monies until the well is either ready to be produced or deemed a non-commercial well (dry hole). Usually the oil company as a full turn-key profit absorbs the difference of the actual cost to drill the well vs. the amount of money raised. Conversely, if the cost of drilling exceeds the amount of money the oil company has sold the project for then they have to cover the additional expenses out of their pocket. As a novice investor, it’s best to get in on a full turn-key agreement. Therefore, you only have to invest one amount and no more additional monies are required from you. However, there could be additional costs or expenses past the full turn-key agreement and in that case, you would have to pay the additional assessments or you’d be subject to a finance fee of up to 500% to the financier or forfeit your position all together. For example, lets say you invest into a project where a company has to drill down 5,000 feet to find oil. Let’s say that the company drilled 5000 ft., ran into a series of drilling issues and went over full turn-key budget by 20%. In this case, the oil company has to cover the overage expense to honor their full turn-key obligation to the investors. For another example, if the oil company drilled the same well and stayed under budget 20%, then they would absorb the

20% as their full turn-key profit. Let's say 3 years from now, using that same scenario as an example, the well needs a work-over or additional equipment to maintain or increase production, as an investor, you would have to pay your portion based on the percentage you own as an additional assessment.

A non-full turn-key agreement is when an oil company has structured an offering where the investor is liable for all costs based on the percentage they've invested. Generally, the offering company will sell interest for a cost plus 25% basis, meaning they get a fee of 25% as a promote. In most cases, non-full turn-key investments, such as JOA agreements are structured for investors that have expertise in day-to-day oil and gas operations and understand the liabilities and cost associated with operating and drill production.

Full turn-key offerings generally allow the novice oil investor to come in at smaller levels to limit their exposure and liability; whereas non turn key agreements are generally created to accept investor that have expertise in oil operations and usually accept minimum of a quarter million dollars plus. Usually you'll pay more of a promote on a full turn-key contract but you can invest under \$100,000. This strategy will allow you to become more familiar with oil and gas so down the road you may choose to invest on a non turn key agreement where you may pay less promote, but you have more exposure to cost over-runs.

CHAPTER 7: EVALUATING COMPANIES

When evaluating companies, there are several variables and aspects to identify with. In this chapter, we will lay out the different variables and mention what we think is the norm and what may be unreasonable in investment offerings.

COMPANY PROFILE- When evaluating a company profile, the most important part is who the executives are. When evaluating bios, it should be noted of what their oil background is and credentials. A solid background in the oil business is a requisite.

SOLICITATION - How you heard about the offering is very important. Typically, most people calling you over the phone are non-operators, broker-dealers, and promoters. Not to say all of those entities are bad, but it's advisable to invest with only actual operators. Operators do solicit via cold calling, but are in the minority. This is because once an operator has a foundation of investors and they are producing oil wells and paying out revenues, telemarketing is no longer needed as the company has a foundation of investors. Use common sense when evaluating deals you learn about over the phone. If a company has been around 10-15 yrs. and have drilled many wells that have been successful, then why do they still need to cold-call? More than likely, they're not the actual operator, they're simply a sales entity/promoter and they make their money purely on the front end promote.

WEBSITE - When looking into companies, it's strongly recommended you invest with companies that have bios and even

pictures of the company executives. Steer clear of companies that have generic websites that do not really show who the company personnel is, doesn't show company news, pictures, etc. Sites that are lacking information usually are promoters and not the actual operator.

COMPANY EXECUTIVES - If it's the actual operator, it's important to see who the executives are, what their operation experience is, and their overall background. Again, companies that show the picture of their executives tend to be more legit and transparent. Steer clear of companies that only have one or two bios, as this generally means that they're lacking of enough collaborative experience to handle all facets of operations.

TRACK RECORD - As long as the company has a few projects completed that have generated returns, then that would suffice for track record. A young company that shows good "footing" by demonstrating a few successful projects could be a company for long-term success.

CLIENT REFERENCES - The Company should have at least three references of investors that you can speak with that have done business with them on past projects. It would be best if these investors can be validated through the internet through a Google search, etc.

VENDOR REFERENCES - The Company provides bank reference, contractor reference, or any other commercial reference to see how they do business.

REGULATORY VALIDATION - Company is registered, is an

operator with the state where they operate wells. For example, in Texas, all operators are licensed and bonded with the Texas Rail Road Commission and have operator numbers. If you have the operator's number, you can go online through the Texas Rail Road Commission and do an inquiry to see the status of the operator, if they're in good standing, and how much oil production they have on record.

INSURANCE - Copy of valid operator insurance. Depending on drilling cost, you'll want to see no less than a one million dollar policy.

LEASE - The oil company, such as an operator, should be able to provide a valid lease showing they have rights to drill on that acreage.

ACCOUNTING- Which system is set in place to get paid your revenue? Does it come directly from purchaser of oil (which is not advisable) or disbursed from a partnership revenue account? In addition, do they use a CPA that truly understands oil tax laws and which IDCs are applicable to the project as well as depletion allowances?

COMMUNICATION- How well does the oil company update and/or communicate with their investors? Have the oil company provide you with the last 3 updates sent to their investors. The updates should include the date(s) generated and which project(s) the context is in regards to. Communications is normally a key sign on how organized an oil company is with their offerings and management skills.

CHAPTER 8: EVALUATING DEALS

So you get a lot of prospectuses and let's say you narrow it down to only dealing with the actual operators. How do you determine which project to invest in? Unfortunately, there's no crystal ball or concrete formula to determine which deals will be successful. As a general rule of thumb, here are some things to look at and understand while evaluating deal points:

DISSEMINATION - A legitimate offering should include a private placement memorandum (PPM). Do not invest with a company that does not include a PPM. The PPM lays out all the risks associated with drilling oil and gas wells. It also includes an allocation of where all investment capital is being appropriated. This includes what the actual promote is. In addition, the PPM includes bios on all of the key executives, the full turn-key contract, operating agreement, subscription agreement, regulatory requirements, and all provisions associated with the offering, including amendments and exhibits. It also includes all geo-science data, production figures, return projections, and geologic reports pertaining to the probabilities of commercial success.

PROMOTE - Offerings are usually promoted two ways. Front-End Promote is a percentage added to the cost of drilling, acquisition, geo-science, legal, and syndication (cost to raise money such as commissions to sales people, printed literature, shipping, etc.). An excessive amount of front-end promote would be anything over 30%. For example:

Drilling cost \$1,000,000

Geo-services cost \$100,000

Legal Services cost \$50,000

Lease Acquisition cost \$50,000

Syndication cost \$200,000

TOTAL COST \$1,400,000

PROMOTE @ 30% \$420,000

TOTAL RAISE \$1,820,000

Back-End Promote is the carried (given) percentage or **Overriding Royalty Interest** (ORRI) the oil company retains for creating and managing the offering. There are three kinds of primary interest. **Working Interest** (WI) is the percentage of the cost of leasing, drilling, producing, and operating a well. It's also the percentage of ownership of the oil lease and all equipment used to produce oil from a well. **Net Revenue Interest** (NRI), is the percentage of proceeds and/or production each party receives generated off an oil well. **Royalty Interest** (RI) is the percentage the mineral owner receives from proceeds generated off an oil well. Royalty Interest is not burdened to any operational or drilling cost, only taxes. A

reasonable Back-End Promote for an oil company to retain would be to take no more than 20% of the NRI as their ORRI.

The example below represents revenue disbursement from a well that produced \$100,000 in one month:

Gross Production in July of 1,000 barrels @ \$100/barrel = \$100,000

Taxes (severance and ad valorem 5%) = (\$5,000)

Gross Net Revenue (GNR) = \$95,000

RI (Mineral Owner) @ 20% of GNR = \$19,000

ORRI (Oil Company) @ 10% of GNR = \$9,500

NRI (Investors) @ 70% of GNR = \$66,500

Lease Operating Expenses (LOE) for July (\$1,000)

Gross Net Revenue To Investors \$65,500

In the example above, 100% WI is burdened by the investors. Meaning, the **Lease Operating Expenses (LOE)**, which is the cost to maintain a producing well such as the electricity, pumper, supplies, and etc., is \$1,000. Since the investors own 100% WI, the entire LOE was deducted from their **Gross Net Revenue (GNR)**.

GEOLOGY - Geology is not always an exact science, therefore, we look for geologic opinions from a certified Geologist, Petroleum Engineer, Drilling Engineer, Production Engineer, and/or Reservoir Engineer. If an oil company has done their homework, they should be able to provide a geologic report explaining formational trends and theory of why their prospect should be viable. The report from the Geo-Scientist/Engineer should also include their resume/background.

RESEARCH DATA - Included within the offering literature, the oil company should provide details of their research and data that leads them to believe their deal is viable. For example: if they're in an area surrounded by producing wells, you should have the production figures from those wells, average life of the wells or how long they've produced, formational trends and depths at which wells have produced from, surrounding dry holes or non-commercial wellbore data, log records, cross-section, and any other data pertinent to the prospect.

PROJECTED INCOME - Ultimately, your total ROI is going to be based off cumulative barrels of oil produced over the life of the well minus lease operating expenses and oil taxes. In most cases, oil companies will give you a monthly revenue example based on how much daily oil is produced multiplied by the current price of oil per barrel. Keep in mind, there's never a case where a well produces the same daily rate for a long period of time. Normally, in order to get a more concrete calculation of what kind of reserves or cumulative production a well could have, the oil company should have an analysis done by a certified Reservoir Engineer. The Reservoir Engineer will analyze data from wells that have

produced, surrounding the drilling location, utilizing Geoscience to “guesstimate” how much potential oil can be produced from a well.

Ultimately, when evaluating deals, if a company has provided all the information as listed above and has a reasonable promote, then you should have a fair shot at making a return on your investment. **GOLDEN RULE: There’s no such thing as a guaranteed return in the oil business. If you are ever guaranteed or promised to make a certain return percentage on your money, DO NOT INVEST!**

***The Legit Meter is based off probability only. It does not guarantee you are investing with a legitimate company. It also does not take the risk out of investing directly into oil investments. You could lose all your money even if the Legit Meter scores 100% probability the company is legitimate.**