Mick & Associates, P.C., LLO

“Here to Serve Your Energy
Due Diligence Needs”

Mick & Associates, P.C., LLO, based in Omaha, Nebraska, is a specialty law firm and provider of independent due diligence services for many broker-dealers and financial advisors throughout the United States. As a result of our broker-dealer engagements, we also indirectly provide some professional guidance to firms who sponsor placement programs sold by our network of broker-dealers. In this regard, we work with such firms in an effort to help them structure programs that provide competitive investment opportunities.

Our firm’s mission is to provide our broker-dealer network with the highest level of legal representation, business advice, and service. As our clients and their industries continue to grow, we will continue to assist them in embracing current changes and industry enhancements. Our firm’s due diligence representations include, but are not limited to: oil, gas, and energy-related programs, real estate equity funds, REIT reviews, equipment leasing programs, and private equity offerings.

An Introduction to Our Gas and Oil Services. A significant component of our due diligence service is to provide comprehensive opinions to our client network on oil, gas, and energy-related investments. Among the types of oil and gas programs our firm has reviewed include: tax-advantaged drilling programs; lease-banking programs where the investment objective is to acquire development rights in unproven areas; royalty and working interest programs designed to acquire interests in producing wells; pipeline and water disposal infrastructure projects; and private equity offerings where an oil and gas company sells equity or convertible debt instruments in its own company to help enhance its operations or to acquire strategic oil and gas assets.

Our mission in the oil and gas sector is to provide our client network with a comprehensive understanding of the economics, risks, rewards, and investment objectives of these sponsored programs so that they may be able to truly understand the relative value a program can potentially bring to their investors. In addition to providing information to broker-dealers regarding a program’s management, background history, organizational documents, financials, and prior performance, our firm goes a step beyond industry norms in an effort to understand the areas where program operations will be conducted, why the sponsor has selected a particular area for drilling, and whether the proposed terms of the offering can facilitate a competitive investment return. In order to do this, our firm also supplements our internal expertise with support from some outside technical professionals that possess many years of experience in geology and petroleum engineering and are respected within their work communities. The combination of our expertise in reviewing numerous offerings, coupled with the technical assistance of these outside experts, helps us to best serve our clients’ most critical needs.
Our firm is actively involved in a number of financial industry trade organizations designed to assist broker-dealers, RIAs, and family offices with educational training in the areas of due diligence and best marketing practices pertaining to energy private placements. In this regard, our firm has actively supervised the development of workshops and training programs held at various industry conferences sponsored by The National Due Diligence Alliance and REISA. Our firm also actively serves on panels and workshops given to selling advisors at broker-dealer and family office conferences.

Our engagements in this space over the past six years include due diligence reviews of approximately 50 unique sponsors and 200 separate private placement offerings; with roughly $500 million in private placement capital raised in relation to the sponsors our firm reviewed in 2011. The oil, gas, and commodity-related programs our firm has reviewed and/or rendered opinions on in the recent past include, but are not limited to, the following:

- APX Energy, LLC (affiliated with Campbell Energy, LLC)
- Atlas Series 31 and 32
- Aztec Oil & Gas
- Bradford Energy
- Catalyst Energy, Inc.
- Energy Hunter Partners 2011
- D & L Energy
- Gulf South Holdings
- Hard Rock Exploration
- Madison Capital Investments, LLC
- Mewbourne Oil & Gas
- MDS Energy
- Noble Access 3 through 13 (2009 through 2012)
- Oil States Trading Working Interest Program
- Penneco PDA Programs
- Resource Royalty, LLC
- Rice Energy
- U.S. Energy Development Corp. (2012-A Alpha Program)
- Waveland Energy Partners 2011-A
- Waveland Energy Partners Lease Bank Program (2009 and 2010)

The Need for Due Diligence. Because of the diversity of the energy industry and its investment characteristics, and because energy firms are recovering oil and gas from geologic formations located thousands of feet below the surface of the ground, the industry has held a certain aura of mystique. Unfortunately, the industry is misunderstood by many, including investors, financial service firms, and even regulators. Investing in energy can be accomplished in a variety of ways, from buying stock in NYSE and NASDAQ listed companies to participating in private, independent projects. Although these investment opportunities are potentially profitable, financial advisors and investors alike need to understand the varying degrees of risk and reward involved.
Traditionally—and understandably—an investment in a private placement oil and gas drilling program has been thought of as a "tax shelter." There is no question that the tax advantages of oil and gas drilling are one of the key attractions, and a significant factor in analyzing the economic potential of an oil and gas investment. However, many "tax-minded" investors and advisors have forgotten, often to their sorrow, an economic truism: the **purpose of investing is to make money**. The eventual distributions paid to investors over a long-term investment horizon are of ultimate importance and the economics of the program must be carefully considered. Against that backdrop, however, is the complicating fact that the oil and gas profession speaks a language of its own, which makes it difficult to know what's important and ultimately what's driving the economics of the project. This is where due diligence can bring professional value, as it aids in the determination of which programs are competitive in their structure and economics.

A plausible definition of due diligence is the **process undertaken by professionals to determine whether or not a sponsor of an oil and gas program is technically capable of, and is carrying on business in, a proficient manner**. Acknowledging that oil and gas products are not suitable for all investors, the due diligence inquiry more importantly helps to answer the question of whether the offering or project in question is suitable for any investor. **From a regulatory perspective, due diligence is not an alternative or best practice recommendation for the broker-dealer—it is a mandate.** In fact, FINRA Notice to Members 03-71 and 10-22 reminds all of its member firms offering non-conventional investments (including private energy programs) of the obligation to conduct adequate due diligence in an effort to understand the features of the products they sell to clients. From the standpoint of an investment advisor or family office, reasonable basis due diligence also supports the advisor's fiduciary obligations to its investors.

Acknowledging the complications the financial services industry has faced over the past couple of years and the tight level of regulatory scrutiny that private placements have faced, there are private programs in the oil and gas sector that can potentially bring value to the table for suitable investors. As would be expected of the major oil and gas companies such as BP and Exxon, some of these programs are likewise served by seasoned engineers and geologists with access to cutting-edge drilling and finding technologies. In some cases, sponsors of programs have spent years acquiring a bank of leases and drilling prospects in areas where production is known to exist and many of such sponsors have become intensely familiar with an area through prior operations. While experience and opportunity are important components to the success formula, the economic components of the pro forma and potential ROI/IRR question have to be considered from a due diligence standpoint as well (with oil/gas market pricing fundamentals, drilling and operating costs, and supportable reserve expectations weighing heavy on this question). This is the kind of information our firm seeks for our broker-dealer clients. Our job is to determine what sets a particular program apart from the others and what additional value-added features the program can potentially provide to investors.

The objectives of third-party due diligence support varies among providers and can range from a cursory examination of the sponsor's management, background, financials, and past performance (i.e., a screening review), to comprehensive reviews that also incorporate meaningful reference interviews, asset file reviews, and explanations of the
sponsor’s prospect inventory, technical data, operational philosophies, and prospects for financial success. Thinking of due diligence as a two-sided object, one side of the due diligence inquiry is designed to address the question of whether or not the sponsor’s background, marketing and compliance practices, expertise, operational objectives and practices, accounting resources, financial strength, and performance history are of sufficient quality to merit a marketing relationship with the broker or advisor (which is generally determined through a sponsor-level due diligence engagement). The second side of the due diligence process is to gauge the fairness of the investment proposal in terms of economics and investor rights (which is the subject of a program-level engagement). While we strongly prefer those engagements where we are working to support both sides of the process, our services can be tailored to address one or both types of engagements.

**Our Broker-Dealer Network.** We focus our law practice upon broker-dealer, RIA, and family-office representation, and our staff of attorneys holds securities licenses, MBAs, and LLM designations (in taxation). We have represented over 200 broker-dealers throughout the U.S., and a listing of the broker-dealers who have requested our due diligence reports is shown on our website at www.mickandassociates.com/clients.

Our due diligence opinions are the product of our legal representation of the broker-dealer community. Although, in most cases, the product sponsor is the party who pays for our written opinion, the opinion is being provided for the purpose of helping broker-dealers to determine whether or not the program makes economic sense for their investors. Assuming the program has competitive features, many broker-dealers who review our reports will seek to establish a business relationship with the sponsor through a selling agreement.

**Five Points of Light about Energy Private Placements.** As previously mentioned, the oil and gas industry speaks its own language and has its own customs and course of dealing. Therefore, it can take considerable time to develop an accurate understanding of what is happening inside this industry. While the foregoing is not intended as an all-inclusive treatise of everything one should know to better evaluate oil and gas projects, the following contains a few observations we have compiled from our experience in the oil and gas sector.

1. **How Much Promote is Involved?** There’s an old adage in the oil and gas industry that 1/3 of the invested capital in an oil well should get you 1/4 of the available working interests in a drilling program. This equates to a 25% promote fee for the project originator/operator and takes into account the amount of capital paid into the program by investors (after commissions and offering costs are deducted) versus the working interest percentage purchased by the investors with their capital. Under this “rule”, if the investors are paying in 1/3 of the capital needed to drill and complete the wells, they would get back a working interest of 25% in such wells. From a practical perspective, however, you should know that many of the negotiated participation arrangements we have reviewed at the fund-operator level are structured at a promote that is less than the proverbial 1/3 for 1/4 arrangement (e.g., with the promotes in some cases being applied after the fund has received its investment capital or with the promote applying to the first well in a multi-well project).
A related and more important question that is often not considered is at how many levels does a promoted interest apply? What’s often overlooked is the collective combined effect of the offering load (generally 12%-15% of the gross proceeds), the fund manager supervision compensation (cost plus 10% to 15%, some form of carried interest paid to the fund manager, and/or monthly administration fee), and compensation that is paid by the fund to the field operators and project originators (often a carried interest or sometimes turnkey pricing premiums on development costs). It is death by a thousand cuts if you’re not careful.

While investors of the retail syndicated markets will generally participate in an oil and gas program at a higher effective cost than would otherwise be the case in an industry deal (with the industry player, for sake of completeness, not paying a load or fund supervision fee, but assuming greater operational liability risks, cost overrun risks, and higher investment contribution obligations for that privilege), investors need to consider all the moving parts of the ROI/IRR picture and how they affect the return. This requires a review of the sponsor/operator compensation at multiple levels of the transactional structure and assistance from credible outside technical experts (engineers and geologists) that can help assess the opportunities for a reasonable risk-adjusted return.

2. The Risk and Return Relationship in a Project. The actual return on investment will be influenced by a host of factors, including, among others: the area of drilling (i.e., the depth, the porosity and permeability of the target formation, and well hole pressures); the type of well involved (does it produce oil, gas, or both and multiple pay zones); the time that it takes the sponsor and/or operator to get permits from regulatory authorities and to prepare the well site for drilling (which can be a perplexing problem in some states with tough environmental regulations); the sponsor’s or operator’s access to drilling rigs, well operators, and equipment; the access to gathering/transmission lines for transport; the amount of oil and gas production actually recovered; the timing of the oil and gas production recovery; market pricing swings; and ongoing monthly operating costs. Even with careful reserve and economic analysis run by experienced engineers or geologists, reservoir characteristics in an area (porosity, permeability, and well hole pressure) can vary significantly over established formational trends and mechanical problems can sometimes arise during the drilling process. Oil and gas drilling is risky by its very nature and there is no assurance as to whether the investor will ever see a return on his or her capital (and is therefore better suited for those investors with higher risk tolerances and a desire for tax-related benefits in some cases).

For exploratory-type drilling projects (i.e., projects with high dry-hole or non-completion risk), an ROI of at least 3:1 (above 4:1 preferred) and a return of capital profile in the ballpark of 1-3 years may be a typical return profile investors might see on higher risk/higher return profile projects (e.g., on-shore Texas/Louisiana Gulf Coast); whereas an ROI of 1.5-2.25 and a return of capital profile in the ballpark of 4-8 years might be a typical return profile seen on a developmental drilling project (e.g., shale plays and shallower drilling in some Appalachian Basin projects). Higher risk commands a higher potential investment return, with development projects generally having completion rates of 80% to 95%, whereas completion rates for exploration projects will be much lower (i.e., 25% to 50%). For the production/royalty type programs (those programs that acquire interests in
wells that are already producing oil and gas), a point of comparison would arguably consider whether the private program can potentially deliver a long-term stream of cash flow commensurate with MLPs and royalty trusts (e.g., which can offer long-term annual cash flow opportunities in the neighborhood of 5% to 10% annually).

3. **Some Thoughts about Performance and Experience.** Although it can be a confusing and daunting task for investors and other stakeholders to make sense of geology reports, as well as the lines and curves from seismic studies and logs (which are sometimes provided in the program offering materials), a benchmark that can be helpful from an initial screening standpoint in determining whether a sponsor’s technical experts have done a decent job in their past work is to look at the past performance of other programs that have been offered by the sponsor. Several years of operations coupled with a very high concentration of marginal performance could very well indicate that the sponsor and investor’s interests are not aligned as they should be.

From our past experience, the sponsor’s alignment of interests with the investors has a positive relationship upon past performance. **The alignment of interest inquiry asks the question of how much risk the sponsor has if things do not go well from a production standpoint.** From our experience, sponsors that put their own money at risk or that stand to make their compensation from future production tend to perform better than those that profit in a significant way regardless of the production outcome.

At one time or another, even successful companies have suffered “bumps in the road,” so to speak, in certain programs. An often bigger question, however, is what the company is doing differently in its operations to help the investors. We tend to respect those sponsors that are open with us during due diligence about what they have learned from their years of past operations and how they used that knowledge to improve the investment value they give to the investors. On a related point, a common characteristic that is also shared by the better performing sponsors relates to their time in the oil and gas industry and their ability to manage their companies through turbulent economic times. From a project underwriting and selection standpoint, reference interviews and the presence of outside technical experts in the due diligence process can also help to determine whether the sponsor has a reasonable understanding of its project area.

4. **The Changing Gas Market Has Changed the Investment Strategies.** Five or six years ago, it was profitable to develop dry natural gas conventionally from shallow formations in the Appalachian Basin. Today, most of the established Appalachian-based sponsors that developed natural gas from shallow Upper Devonian reservoirs in 2005-2008 have transitioned their investments to horizontal gas drilling or to projects with oil and gas liquids exposure. What was once possible to drill at $250,000 to $300,000 per well has shifted upward to $450,000 to $500,000 per well in some areas (with rising drilling and completion precipitated by the advent of the Marcellus Shale Play in eastern U.S.). At natural gas prices of $4 per mcf and lower, what was once profitable to drill a few years ago is economically challenged today. While a review of a sponsor’s past performance is a decent proxy as to how well the sponsor has managed investor money in the past, the due diligence analysis doesn’t stop there and should be coupled with supported economics on present projects.
Comparatively speaking, market prices on oil have rebounded gradually yet significantly from a low point of sub-$30 per bbl in early 2009 to $90-$100 per bbl in 2011. Natural gas prices continue to remain very low in relation to what was the case prior to 2009 and with the advent of the shale gas plays over the past couple years, expert sentiment suggests that our natural gas resources could potentially cover our needs for the next 100-200 years. That said, the looming question of when natural gas prices will ever return to their pre-recession level remains uncertain and nebulous. While this sentiment does not bode well for certain companies that develop shallow and dry natural gas conventionally, not all natural gas plays are created equal either. For instance, we have observed a few instances where program sponsors in wet gas areas receive pricing premiums that range from 15% of NYMEX (e.g., West Virginia) to even 100% of NYMEX (select regions of the Hunton Play in Central Oklahoma after dewatering occurred). Also, the advent of horizontal drilling technology in certain Upper Devonian Plays in the Appalachian Basin have resulted in situations where certain companies are producing four times the natural gas they could produce vertically at two times the cost. The transitioning of operations from shallow conventional dry gas to projects with oil potential and/or horizontal drilling is clearly a major development we have observed over the past three years.

5. **Net Revenue Interest Vary by Area.** This is the share of the working interest owner’s production after all burdens, such as royalties and overriding royalties, have been deducted from the gross well interest. It is the percentage of production that each working interest participant actually receives. For example, if we assume the owners of royalties and overriding royalties are entitled to 20% of the revenues for a well (which is not reduced for expenses), this leaves the holders of the working interest with an 80% NRI (Note- the working interest owners will pay for 100% of the drilling, completion, and operating costs). In this example case, if we assume that the program fund owned 75% of the working interests in a program (which is a fairly common scenario), the fund’s NRI would be 60% (determined by multiplying the 80% NRI of the full working interest by the fund’s 75% share). Note in this regard that the NRI to the investors will also be affected by the amount of interest given to the fund manager. Thus, if the fund’s revenues are split 90/10 among the investors and the manager, the investor’s NRI is actually 54%.

In conversations with our clients, we have observed a tendency in some cases for the client to get fixated on the extent of the NRI of a project without taking into consideration the fact that a project NRI will vary by area (not to mention the fact that the NRI of a project, while important, is one of many variables that affect the pro forma and economic potential of a well). Based upon the programs we have reviewed in the past, the overall royalty burden appears to vary from 12.5-20% in the Appalachian states of Pennsylvania and West Virginia (thereby leaving the working interest owners with an 80-87.5% NRI). On the other hand, we’ve seen the overall royalty burden range between 19-25% in the Woodford and Barnett Shale Plays (and with royalty burdens of 30% and slightly higher seen in higher impact Gulf Coast projects). As alluded to previously, the load-adjusted drilling costs, monthly operating costs, production taxes, transportation charges, oil/gas pricing adjustments, anticipated reserves, and production decline are some other factors that also have a bearing on the potential return.
**Closing Remarks.** It goes without saying that private energy programs come in all shapes, sizes, and structures. The private energy sector is a competitive market, and there are many sponsors seeking capital for their operational efforts. For this reason, we hold our professional responsibilities in the highest regard in an effort to help our broker-dealer clients match the needs of their sophisticated investors to energy investments with significant and competitive economic opportunities.

*For additional information about our energy due diligence services, please contact Bryan Mick, JD, MBA or Brad Updike, LLM, JD, CSA: Mick & Associates, P.C., LLO, 11422 Miracle Hills Drive, Suite 401, Omaha, NE 68154, (402) 504-1710.*