

GUIDELINES FOR OIL DRILLING PROGRAMS

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The amount of publicly offered Oil and Gas drilling programs has been growing by leaps and bounds over the past three years and new registrations in 1970 indicate that it will be a bigger year than the \$1.7 billion registered in 1969. There has been increased emphasis by the oil operators offering these programs to register their programs early and shift money raising to the first half of the year, thereby providing more time for efficient spending of these funds in the last half. However, with the high number of registrations (many for the first time) the registration time is becoming longer and investors don't appear to be cooperating, since money raising is going very slow this year.

Selling these programs has undoubtedly been on an increase in the number of relationships between drilling program companies and prestigious investment banking firms to help place the program. However, failing to raise the expected amount of money in the first half may create the undesirable situation of high registrations in the last half to offset the shortfall. This would then force accelerated year-end drilling to spend the higher amounts of money in the 1970 tax year, under a "drill we must" atmosphere. This can cause lower quality prospects to be drilled, which is often to the detriment of both the oil operator and the investor. Although the 1969 Tax Act favors the oil investment over other tax sheltered investment, there are certain threats from various areas which may thwart the drilling program activities sufficiently to cause reduced investment in these programs in the future. These potential deterrents, which are all interrelated, are such things as, oil operator abuses of the procedure, further governmental regulations, investor disenchantment, and possible tax revisions in the future that might adversely affect the tax advantages of this type of investment. The pattern for this hard money raising period seems to be that those companies with a "good track record" and an experienced in-house sales force or significant ties with investment banking firms with oil expertise are raising 50-75% of the total amount they registered. Repeat companies with a "reasonable track record" and limited or no in-house and/or external sales capability

are raising 25 to 50 percent of their registered amount and many new companies with no sales ties are struggling to raise enough money to become effective. Some companies are reverting to small private placements while waiting for the situation to improve, and others who only made private placements in the past, are going the public offering route to avail themselves of a broader market.

Because of the high capital needs of the oil industry to finance future exploration and development to meet the projected demand, it is essential that this financing technique be preserved. The growth of this activity in this segment of the industry indicates the increased role that independent oil companies are playing in the development of oil and gas reserves; especially in the interior geologic basins neglected by the major oil companies. It also reveals that the companies' internal cash flow plus bank loans, if available, and publicly offered equity or debt/equity issues tend to fall short of providing sufficient capital to maintain the necessary level of exploration and development activity. Obviously the need for accelerated development of domestic reserves looms more and more important because of the deferred development of Alaskan North Slope oil reserves as well as some offshore U.S. reserves and the increasing uncertainty of the availability of foreign reserves.

To preserve this financing technique as an aid to the development of domestic reserves this type of investment must remain attractive to the Investor. Refinement and upgrading of the drilling program activity is needed as well as cooperative effort to bring about greater understanding between the drilling program companies, the government, professional money raisers, and the Investor.

The Oil Investment Institute, formed in 1969, is a trade association for Publicly offered drilling program companies, which has now established business standards and ethics as guidelines to help refine and upgrade the drilling program activity. We also collect and provide the facts to help bridge the educational gap. The permanent staff consists of an Executive Director with a background in the oil industry and in commercial banking, a General Counsel who is a recognized expert in the drilling program

field and a Washington Counsel who is former Chairman of the SEC. The OII has standing committees in the critical areas of business standards; governmental, public and investor relations; statistics, terminology and reporting; grievance and others. In the area of business standards the OII and other companies in the industry reached a consensus on business standards for drilling program companies and the OII adopted these standards in Washington, D.C. on October 16, 1970. To create a more meaningful prospectus the OII is working with the SEC on a revised registration statement for drilling programs. The OII's proposed revisions, which were recently submitted to the SEC, provides for additional disclosure by the companies about their programs to aid the Investor in analyzing and comparing programs.

Regarding regulation of drilling funds, SEC Chairman Hamer Budge testified in hearings before the House of Representatives that they would work with the drilling program industry to formulate a regulatory statute providing for further control of this activity. He named OII as the industry organization with which the SEC would work. Since the oil industry's complex business practices are not readily amenable to further existing regulation, such as the Investment Act of 1940, and the Investors interest are tied to certain advantages sought under the Internal Revenue code it was recognized that a potential conflict existed and additional study was needed to devise compatible regulations. A cooperative effort on this is already underway, as evidenced by Chairman Budge's statement that he was "appreciative of the work that the Oil Investment Institute is doing to help safeguard and protect the Investor in oil and gas drilling programs and the expression of willingness of the Institute to work with the Commission toward this end."

The Oil Investment Institute plans to work with financial institutions and where possible, offer educational seminars on the fundamentals of drilling programs to eliminate some of the confusion that exists regarding these programs. To fulfill their continued obligation to Investors after oil and gas is developed, drilling program companies are considering making periodic reports, which would contain an appraisal of the Investors interest made by competent independent consultants. Many companies do this for Investors now. Also better statistics are being developed that will give a more realistic representation of the overall activity. A typical example here is the confusion about the size of this industry; in 1969 there was a total of \$1.7

billion of these programs registered, but because some were multi-year programs the amount of money intended to be raised was only slightly over \$1 billion and the actual amount of money raised, based on the best estimates available, was on the order of \$500 million or about 50% of the intended amount.

The drilling program activity has grown so large and its impact is so great that the amount of money raised and the timing under which it is raised is significantly affecting the economy of various midwestern oil producing states. It also influences the plans of service companies, and related businesses who serve the companies that offer drilling programs. In fact, it may be that some states, which are highly dependent on oil activity to maintain employment and personal income, would have to seek welfare "tax dollars" from the Federal Government if they lost the oil investment "tax dollars" from high tax bracket individuals as support for their major industry. More importantly, if this happened the people would only be maintained at a subsistence level and needed oil reserves would not get developed.

Money raising and oil finding are independent activities, but because they are interdependent in the drilling program business, a cooperative effort must be undertaken to aid the flow of private capital from the high tax bracket investor, who can take the risks, to the oil operator who is offering a tax sheltered investment in his drilling program. The critical need for this is referred to in the First National City Bank's July Energy Memo, which states that this financing technique is needed and that still further adaptive and innovative financing approaches will be required to ride through the present period of extreme financial stringency if a dangerous gap in supplies of energy and capital is to be avoided.

One requirement of the newly adopted guidelines for drilling fund companies is very relevant to the SPEE members. That is the requirement that qualified independent petroleum engineers should periodically appraise the producing properties so that the operator can report the value of reserves to the investor. Although Lawrence Muir with the SEC told you in his talk that the SEC would not allow reserves to be included in the drilling fund prospectuses, we believe it is essential that reserves be evaluated and reported to the investor after a sufficient period of production has elapsed (two years or more) as a part of the proper reporting to participants in drilling funds. We also believe the SEC should give consideration to allowing independently evaluated reserves to be included in drilling fund

prospectuses. This is the only way that the success of past programs can be adequately represented. I might add that we do recognize the potential for misrepresentation, but we feel that valid appraisals can be obtained from competent engineering consultants.

To insure that good appraisals are made by independent engineering consultants, the OII added an additional requirement to their guidelines in this area. That is that the engineering consultant firm not only be independent of the drilling program company, but also must be considered favorably by financial institutions for whom they

have done work in the past. Where a consulting firm's work has been adjudged by banks, when reserves have been pledged as the only collateral on production payment loans, this has allowed a reliable list of consultants to be compiled by the financial institutions. Certainly the work of the SPEE to standardize as well as upgrade the calibre of work done by independent consultants is a significant contribution. I commend you on your effort in the SPEE and we would certainly be interested in the standards you advocate and in a list of the members of this organization.