FUNDED COMPANIES FOR OIL AND GAS EXPLORATION

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It is a pleasure to talk to you today about an increasingly important part of the oil and gas industry—the funded companies. It is my thesis that this approach to financing industry activities will grow to major significance and that its eventual size and importance may well depend on the ability of you petroleum evaluation engineers to create new concepts for evaluation of properties at all stages of their development.

Mr. Calhoun's paper surveyed both technical and ethical considerations in evaluation in the form of guidelines. Mr. Evans has given us all something to think about with his projections of the nearly overwhelming problems of meeting energy demands from available and known resources. His chart on estimated needs for all forms of energy forcefully displayed much of what I had intended to say on that subject. However, I do want to discuss what this huge growth in demand may mean in terms of the capital requirements of the oil industry and the problems associated with attracting this needed capital.

The Chase Manhattan Bank estimates that demand for oil and gas in the United States is growing at a rate of 500,000 barrels per day per year and in the Free World at a rate in excess of 3 million barrels per day per year, rates that cast grave doubts on the industry's ability to meet estimated demand by 1980[1].

The United States will require two-thirds more oil and 100 percent more natural gas in the 1965-1980 period than in the 15 years immediately preceding[2]. They estimate that at least an additional $2.8 billion must be added each year for the next 10 years to the $4.4 billion average expenditure on domestic exploration and development for the decade ending in 1967[3].

The whole Free World is the province of the oil industry and thus establishes the total capital requirement that the industry must meet. The Chase Bank esimates at least $255 billion will need to be spent from now until 1980 to satisfy the continued growth of the Free World's consumption of petroleum[4], with U. S. operations using $110 billion of that total. These estimates may well be too low. Adequate reserves do not necessarily mean adequate daily production.

Both the Bank and the United States Department of the Interior suggest that the Government and the public at large cannot just assume that the required capital will be available[5]. There are numerous alternative investments for the suppliers of capital.

How can the needed capital be supplied?

There are four traditional means of financing oil and gas operations: equity capital, long-term borrowing, internally-generated funds, and sharing an interest with a partner—including direct investors.

Common stock or convertibles are considered usual means of bringing capital into the major oil companies in "normal" times. However, times have not been normal for most oil companies in recent years. Analysts have been taught that all industries follow a bell curve and many believe the oil industry is over the top and on the way down. Thus, while still "safe", major oil companies in general are considered by these people as less exciting than the high fliers. Right or wrong, this attitude adversely affects oil stock prices. As a result, except for short periods of time, all major oil companies have been undervalued in the market. Frequently the prices of their shares do not even reflect their liquidation value; they are worth more dead than alive. Those companies, the dominant companies of the industry, cannot issue more equity shares without near-certain dilution of their stockholders' position. Can you recall the last offering of common stock by a major oil company? Yet, I believe you will see many common stock offerings in the next few years if capital is not otherwise available.

Debt ratios for many companies are well above 25 percent, a load which Kenneth E. Hill, senior partner in Eastman Dillon, Union Securities & Co., New York investment house, observes "is regarded by lenders as a high ratio for risk-taking business such as petroleum[6]." While there is still considerable room for further borrowing, *at a price,* the interest rates of past months, high as they were, have become even higher.

The interest rate for independents, historically higher than majors, has risen to 11 percent to 12½ percent, rates that are effectively stifling activity, and today money is not available even at these rates for oil and gas drilling.

Profits, while somewhat improved, trail manufacturing generally[7]. In the absence of some very dramatic, unexpected increase in earnings their availability for reinvestment cannot materially improve in the future. In fact, concentration on Alaska and offshore by much of the industry will put further strains on profits over the near term because of the long delays between investment and start of revenue. Depletion and depreciation cannot be expected to contribute much more to the increased need; in fact, Congress seems determined to reduce depletion this session.

For over a century independents have sold interests in a well or wells to investors, many of whom later became successful oil men themselves. These direct investors, of course, are not stockholders of a corporation taxed on its earnings, who must then pay taxes again on their dividends. They are operators who receive their proportionate share of the profits and pay taxes once. As operators, their share of the incentives of intangible drilling cost expensing and the depletion allowance flows directly to them, not to the company where they may not be reflected in the price of its stock.

Until the early 1950's no effort was made to reach more than a few very rich investors. In the 10 years before 1966 several companies offered direct investments more broadly to the investing public through offerings registered with the Securities and Exchange Commission,

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selling unit participations in a given project or projects. Officers of the issuer did most of the selling, with the established salesman, the broker-dealer, seldom involved or even aware that such an investment opportunity existed.

The last three years have brought a great change in the formulation of means of investing, acceptance by the investment community and significance to both the oil and gas and securities industries of this method of financing oil and gas operations. Growth has been rapid. In 1968 the dollar amount of 90 filings with the S.E.C. was $694,065,000[8] of which approximately 70% was sold and has been invested. If the present rate of filings continues it is anticipated that over $1 billion will be filed with the S.E.C. in 1969. *This is new capital not otherwise available to the oil and gas industry.*

I would like to take a few minutes to discuss the significance, as I see it, of this growth. Then we will turn to the structure of modern funded activities and your role in their future.

We have seen that the majors are not generating sufficient capital internally and will be unable to obtain the necessary amounts of additional capital from usual sources to meet the requirements of the next decade. They are beginning to be aware of the modern funded companies who, for the first time, have sufficient capital to be of real assistance. Thus, they are beginning to offer to those companies groups of projects which cannot be done under their own tight budgets. The problem is acute for the majors; it is desperate for the independents. In fact, expenditures on exploration and production by the thousands of independent producers from 1956 to 1967 declined over 50 percent ($2.5 billion in 1956 to $1.2 billion in 1967); and over 3,000 independents have been forced to quit in the last dozen years[9].

Even if he can borrow significant amounts of money, the independent has to pay a substantially greater rate of interest than the major. Yet, because of his size he is all but foreclosed from entering into big projects and more profitable areas such as offshore, Alaska and foreign. How much should he borrow against his assets at these high interest rates to do new projects, however good they appear to be? If the projects are unsuccessful he may be nearly out of business with overhead continuing until the loans are paid down out of income and he can borrow again to do other projects. The risk of failure, sooner or later, is great because he does not have enough diversification to reduce risk.

Alert independent operators have become aware of what the modern funded company can do for them much sooner than the majors and are offering increasing numbers of projects to this new source of capital. For instance, Imperial-American Resources Fund, Inc., the company with which I am associated, has committed over $40 million for projects so far this year and has a large inventory of accepted projects for partnerships next year. New submittals are coming in every day.

The independent operator does not have to borrow this new capital, thus does not risk his present assets on new projects. He leaves investor relations to a company geared to handle them efficiently and can concentrate on what he is very good at—the development of drilling and other prospects. He can keep as much of the working interest in a prospect as he desires or he may choose to retain an override with or without a backin provision, in either case doing much more than his own capital would allow. Large projects with correspondingly greater economic potential such as offshore, Alaska and foreign ventures are now possible for him. The increased activity provides the diversification he needs to reduce risk and gives him the opportunity for an increased growth rate. As long as the projects he has to offer are good and meet the investment requirements of the funded company he may "run" as hard as he wishes to with increasing amounts of capital on a continuing basis. His projects will be carefully and quickly evaluated for quality and whether they meet investment objectives and he will be evaluated as to his expertise as an operator. If he is a good operator, operations will be left with him subject to monitoring his performance, since the modern funded company does not seek to duplicate any function that can be properly left to existing qualified operators. In return, he and his counterparts throughout the industry offer investors in the funded company local technical expertise that could not be assembled in any oil company. Each good local operator has proved that he can succeed in the province he has chosen as his specialty. In fact, local independents frequently know their area better than employees of major oil companies who are temporarily stationed there and who are often moved to a new area about the time they are beginning to get a grasp of the local history and of how to solve the problems peculiar to the area.

In short, the partnership of the many qualified independents and a modern funded company serves the needs of both the independent oil industry and of the modern sophisticated investor. In doing so a new source of capital is available to the oil and gas industry to help develop the increased production which is needed now and as we have seen will be needed so greatly in the future.

The decline in drilling since 1956 has forced a large number of drilling contractors out of business, has cut the number of active rotary drilling rigs in half and has caused the associated supply industry to retrench. Rigs have been cannibalized, stacked or converted to foreign or offshore use and competent crews are hard to keep because of sporadic work. The ability to stay busy in the early months of each year, traditionally a time of reduced activity, has often been the difference between success and failure. New capital producing more drilling —particularly new capital available in the first six months of the year—is what the industry needs. The modern funded company with four quarterly partnerships each year meets those needs. Already there is some indication of the positive effect of this additional capital in the oil fields. Rigs are being reactivated and crews assembled. The future health of this vital segment of the industry may well depend upon the future of the oil and gas funded companies.

Many of the important geological ideas and technical

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innovations have come from the independent consultants. Tight budgets in the major and independent companies mean that experimentation will be reduced. However, the modern funded company is eager to support any new areas of promise and will encourage the consultant to take part in their testing. New ideas mean the potential of added profit to investors and creative consultants. We will hear about one of these pioneering projects this afternoon.

In the paragraphs above I have stressed the role of the modern funded company as it relates to some of the vital segments of the oil and gas industry. The emphasis was on the independent, not the major oil company because the former has felt the pinch first. However, as we have seen, the majors are only relatively better off. They have the projects and they need capital. Those that use the new capital available from the modern funded companies will grow faster than they otherwise could and they can maintain a better balance in their operations and greater diversification.

With this new capital the majors may not only continue their search for very large fields around the world but also increase their activity in older established areas in the United States and Canada. Existing staffs in those areas could move from a sort of low budget, stand-by status to active drilling and development of non-priority, static acreage. The importance of such a change upon the demand-supply problems of the industry and, thus, to the consumer in the years to come cannot be overstated. These established areas contain vast reserves and, what is equally important, they are reserves that are quickly useable. Pipelines and refineries are in; men, equipment and know-how are available.

Certainly the great discoveries, such as the Prudhoe Bay field, are exciting and necessary, but Mr. M. A. Wright, chairman of the board of Humble, has stated that it may be the late 1970's before they will be delivering 2 million barrels per day. With demand growing at 500,000 barrels per day per year, we can see that this country cannot rely on major discoveries alone. Projects with large possible reserves are essential to a major oil company to assure its future. Projects with lesser potential reserves are excellent for investors in oil and gas funded companies, particularly investors in those companies that specialize in development drilling. Investors are interested in a *financial* result within a reasonably short time. Reserves that may be produced far in the future have a severely discounted present value. To a direct investor the financial result of continually drilling even "second-rate prospects" in established areas with established markets is better than all but the greatest discoveries.

What has been done to the direct investment vehicle that has caused greater acceptance by the public? The older forms of direct investment in oil and gas were not competitive with alternative investments because they were not formulated to fit what the sophisticated modern investor expects and were not sold through professional channels of distribution. In fact, the formulations were, and still are in many cases, for the convenience" of the issuing company not the investor. The modern approach has considered the expectations of today's investor and within the realities of the oil and gas industry tried to meet them. As a consequence, direct investment in oil and gas operations has become competitive with alternative investments and thus finally gained the attention of the investment community and of sophisticated investors in large numbers.

There are many more affluent investors today than even 10 years ago, and they have become very knowledgeable and sophisticated in determining where their dollars should be placed at work. For a few minutes I want to talk about the expectations of these investors and how the funded companies are attempting to be competitive with alternate investments while staying within the realities of our industry. I also want to point out that the areas where we have been least successful are those in which you are the experts.

(1) An investment must have a distinct objective and character, expressed and understandable to the investor.

Traditionally, direct investments have been sold in an exploratory well or wells which, if successful, could result in development drilling. In other words, the investment was structured like the oil industry operates. However, farmouts of development wells and development programs are continuously available in the industry. The economic and risk factors of a wildcat are completely different from the economic and risk factors of a development well. Thus, the development operator can take prospects with an entirely different range of return than the wildcat operator who must have many times that potential in the projects he undertakes.

Aside from their different economic bases, wildcatting and development are recognized as two different "businesses" by many companies who assign oil-finder types of personality to exploration and more detail-oriented types of personality to exploitation. Viewed from the investor's and broker-dealer's point of view, wildcatting appears to be nearly a rank gamble, but with large potential returns; on the other hand, development is more like a normal business with no greater risk and similar potential returns. Thus, to them, these are two different "products" which will have appeal to different investors.

The funded offering of interests in producing properties to be purchased rather than drilled is undergoing changes at this time and will become more important if ABC transactions are no longer possible. This area if properly structured should appeal to the investor seeking income and represents a growth area of importance to the industry as well.

(2) Good management by men with national reputations is demanded.

The modern funded company begins with experienced oil men, who have been successful in their own right, to handle operations *for the investors* through the existing facilities of the oil industry.

Investors are not just a "necessary nuisance" with projects evaluated on the basis of company objectives, rather than investors' objectives. Long term reserves which will outlive investors are subordinated to financial results.

These managers act as an evaluation and control

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group. No effort is made to set up a whole new structure. In this country there are talented independents and consultants and experienced operators wherever oil and gas are found. They do not have to be employees of the funded company; in fact, they prefer to develop their own projects and share in the success or failure of their ideas. Local operators frequently are lower-cost operators and additional operations may be at incremental costs as well. In dealings with majors, they frequently want to operate and, of course, are fully competent.

(3) The "product" must be readily available, flexible in purchase price and have the same sales incentive to the broker-dealer (his commission) as competing opportunities.

In our affluent society every broker-dealer of any size has customers who might be interested in and benefit from a direct investment in the oil and gas industry. The industry needs their participation. Thus, the modern approach is to offer participation through any broker-dealer who is a member of the National Association of Securities Dealers.

A good broker-dealer seeks out investment opportunities that meet his customers' desires and needs and sells them the ideas. He expects to receive a competitive commission. While the oil and gas industry used to try to get by on sub-standard commissions, that is no longer the practice. Commissions are ordinarily taken out of the investment capital, reducing the amount put to work for the investors' accounts. This is in line with the traditional practice that oil and gas promoters be fully "carried."

A few of these investment vehicles, including the one with which I am associated and which pioneered this feature, pay competitive commissions out of their own funds and must recover their investment along with the investor out of profitable operations. In addition to being a desirable feature to the investor, this method assures that management's objective is operations which are profitable to the investor in order that the company, which shares in those profits, may at the same time recover its investment and then also profit.

Obviously, a direct oil investment must be at least large enough to warrant handling and processing. With modern data processing capabilities this can be very small, indeed. However, the aggregate investment may be quite large, particularly when we consider the modern sophisticated investor's desire to be able to add to an investment he likes as often as possible.

A professional man may have very irregular income. He likes the idea of a small initial commitment and the ability to add small amounts some months of low receipts or larger amounts other months when income is high. Such flexibility conforms to his ability to invest, and it provides diversification.

Some of my friends in the industry contend that no oil investment, even in proven properties, should be offered in less than $5 thousand increments. They seem to say that an investor who wants to put up less than that is not "suitable" per se. I do not think an investor who can put up more than that is suitable per se. For instance, I am sure we would all agree a widow who has received $10 thousand should not invest half of it in a drilling program.

The only real control over the suitability of the investor to be offered such an investment is, first, the judgment of his broker-dealer and, ultimately, that of the investor, himself. No offering company wants its product sold to investors unsuited to this type of investment. Is it really a protection to the investor to force him to put 5 or 10 thousand dollars to try out a new type of investment? I think an investor benefits more from the ability to make frequent small investments than from minimums which attempt to define suitability.

(4) The investment must have certainty as to size.

Assessments are undesirable from the investor's point of view and are not essential to good operations. Certainly, it is easier for the operating company to be able to assess for the cost of additional wells and for unforeseen expenses. Some operators presently may not have the budgeting and other skills necessary to operate without assessing the investor. It would profit the operator to consider this feature carefully for assessments (and the penalties for failure to respond) are an anathema to both the investor and the broker-dealer. I believe the traditional assessment was one of the major stumbling blocks to investor and dealer interest in oil and gas investments.

(5) Risk must be reduced as much as possible.

The limited partnership form of organization is essential to the modern approach, The investor is protected from unlimited liability. As a limited partner his liability is limted to his capital investment and any undistributed profits. This form of organization is also essential to the operator where he is dealing with large numbers of investors. A limited partner does not have the right to make operating decisions or bind the partnership, these powers being retained for the general partner. It would be literally impossible to canvass the many thousands of investors before undertaking projects or performing remedial work on wells, etc.

New partnerships made up of investors who have invested by a given date might be formed at any time during the year; however, quarterly partnerships are about "right" for both sales and operations. Three months is a reasonable time between major investor accounting periods and when coupled with reinvestment provides a sufficient amount of reinvestment for partners of earlier partnerships in later partnerships. Perhaps more important is the continuous availability of funds to the operating company so that drilling operations may proceed throughout the entire year.

The modern oil and gas funded company is structured to attain large size. The fact that it is sold very widely through broker-dealers who are members of the National Association of Securities Dealers provides the magnitude of funds which will allow the operator to invest in many different projects both geologically and geographically. This diversification spreads the risk association with an investment in one well or in one field. Equally important, large size means greater potential economic return. As in any other business, there are many

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operators who can drill a $40,000 or $50,000 well. There is tremendous competition with consequent limited potential economic return. But, as you get into $150,000 to $1,000,000 wells and into development programs costing millions of dollars, there are fewer and fewer operators who can undertake such obligations. Consequently, there is greater potential economic return per dollar invested. (6) The investor wants to know what his properties are worth and he expects to be able to sell them at a fair price at any time. By worth, he means both what he can get for them now and ultimate total return if he holds them; "at any time" means in a few days.

Modern funded companies have not been able to meet these desires in a way that is truly competitive with many alternative investments.

There is the inevitable delay between investment in a partnership until the project is begun, tested, completed, connected, the paper-work of ownership accomplished and income produced. During this period some of the data necessary for preliminary evaluation has been obtained. However, unless the well is a look-alike to one with which you engineers have had experience and with which you feel "comfortable," you want to know more. Knowing more means more time—further delay. In a large program of wells (even development wells) there are always some on which you want and doubtless need further production history. The problem is more complex in cases of continuing projects such as secondary recovery operations or new approaches such as we shall hear about this afternoon.

Most of the industry continues to report success ratios, cumulative results of various types for past partnerships and frequently sends to investors lengthy reports on individual prospects or projects supported by land or geological maps and replete with technical terms that have no real meaning to them. If large modern programs were to report in detail on all wells or projects the preparation and handling costs would be prohibitive, and all to a questionable purpose.

The investor tolerates the dalay, but has a difficult time accepting the fact that after months of production the absolute, ultimate value of the well is not reported. He is used to a market value of his stocks which at least is the *temporary*, ultimate value.

The modern investor demands liquidity, and yet this, as you know, is one of the most difficult things to provide in an oil and gas investment. A precise value for reserves, particularly in the early months or years of production, is, of course, impossible.

Most direct investments in oil and gas have no formal liquidity feature based upon the estimated value of an investor's assets. Some exchange interests for stock of the operator or negotiate on an individual basis with each investor who must sell out.

The company with which I am associated has approached this problem by setting forth in the limited partnership agreement the method by which future net cash receipts from oil and gas sales will be discounted to what is called a "cash surrender value." Briefly, it amounts to two-thirds of the future net revenue attributable to the investor's interest after being reduced to present value by applying an alternate use of funds percentage. Investors may file a written election any quarter and be paid the cash surrender value applicable as of the end of that quarter before the end of the succeeding quarter. I have detailed this provision merely to show one approach to bringing meaningful liquidity to the investor where he has not had it before, at least not as he is accustomed to it in the stock market. It is still far from a satisfactory solution to the problem for either the investor or the company. In the early months of operations of a partnership it can result in either a low value to the investor or else in the shifting of some of the risk to the operator, depending on how much of the work has been adequately tested and how conservatively the estimates have been made. Certainly, size gives both the company and investors considerable protection because highs and lows would tend to offset each other over many projects.

Reporting of results and liquidity are areas which must receive a great deal more attention before we are truly competitive with alternative investments. Perhaps these are areas where oil and gas investment can improve but never quite attain the seeming certainty and the liquidity provided by the market. However, as a plus feature we can justifiably point to the fact that the values of assets in oil and gas do not fluctuate like the market, and that an investor who must sell will not find himself selling as what may be a temporary low, nor will he be negotiating with the operator in a climate of emergency.

What I am saying to you is these are our greatest problems. You are all experts in the oil industry elements of these problems, but have you looked at them from the competitive view? When is the earliest time we could properly tell investors what you believe to be the ultimate value of their investments? Could you give them this opinion earlier if you added some qualifications that investors should be expected to understand? Could these qualifications be standardized and approved by the S.E.C. and others? Would averaging or a concept similar to actuarial tables in life insurance help both in the area of results and in the area of liquidity? Et cetera.

We need your ideas and your help if we are to become more competitive and thus attract the amount of dollars our industry needs.

What is the future of the funded company approach? We have seen that demand for oil and gas is growing at a tremendous rate. The need for new capital is nothing short of fantastic. Traditional means of financing oil and gas operations cannot alone meet this need. The modern funded company approach appeals to sophisticated investors in increasing numbers. By working with and through independent and major oil and gas companies good projects handled by expert operators are available to those investors. Thus, their interest, and therefore the capital they make available, will grow.

I predict that this fund-raising industry can grow in the coming year to more than $2 billion and that it can eventually furnish all the additional capital requirements of the oil and gas industry. At the same time, this approach will grow to major importance in the develop-

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ment of all of our other natural resources. However, to do these things, the S.E.C. must handle this new industry properly and with full regard to the importance of its role in furthering the development of our natural resources in our national interest. Members of Congress must get down to the facts, eschew the temporary pleasure of attacking this popular whipping-boy and provide the incentives necessary to assure the infusion of the vast amounts of capital, from whatever source, that are required. Last, but not least, you evaluation engineers must give us better and more timely methods to report results and support the propriety of their use. You can make the difference.

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