PAPER READ

by

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I am told that many of you have not had the opportunity to study and familiarize yourselves with the various types of oil and gas interests or the customs and parlance of the oil fields, so experience some confusion from time to time as you consider the problems presented to you for consideration by your public. It is my pleasure, therefore, to endeavor to explain and clarify for you such of these as time will permit in this discussion. I am sure that all of you realize that volumes might be written to cover fully so broad a subject.

Let us think of the fee simple ownership of land as consisting of two separate estates, one the *surface*, that is, the farm land, the buildings, the trees, and the hills, those things that we can see and quickly and accurately evaluate; the other, the *mineral interest* that is hidden and can be evaluated only through the mine shaft or the test well. In the same way that a landowner may partition and sell the surface of his land for grazing or farming purposes; he may also partition and sell his mineral interest, or as he may lease the surface for farming purposes he may also lease the right to explore for and produce the minerals.

When the oil possibilities of an area become interesting to the oil operator, he enters into a lease contract with the landowner, the terms and conditions of which are entirely a matter of agreement between the lessor and lessee. Custom has established certain fairly uniform practices as to the division of the oil and gas produced, as well as most of the other provisions. The lessor usually retains one-eighth of the oil produced free and clear from the obligation to bear any part of the cost of development and operation. This we know as the *Landowner's Royalty Interest*, probably so named by some lessee in times gone by who considered it as a tribute, similar to that paid in grain or other farm produce by the vassals to the overlords during the feudal system in Europe. But there is no similarity in fact, for here the landowner or lessor retains to himself a portion of the minerals which he already owns, transferring to the lessee certain rights in 7/8 of the mineral interest, which is commonly known as the *Leasehold* or *Working Interest.*

The laws of different states construe the leasehold interest differently. For instance, in some states it is construed as a conveyance of real estate, whereas in others it is a right or license to explore for and produce oil and gas. But this is a subject too intricate for discussion here so for a practical understanding, let us consider that the landowner at the time he owns the full fee simple interest in the land retains ownership of these minerals, subject only to the rights of the lessee to explore for and produce the oil and gas.

The mineral interest may be sold in whole or in part, such conveyances are usually known as Mineral Deeds which convey a perpetual interest in the minerals. However, it is not uncommon that mineral interests are conveyed in non-producing oil and gas properties by Royalty Contracts which contracts stipulate a definite expiration date.

Landowners' Royalty Interests

The *Mineral Deed* may be a *Participating* or *Non-Participating* interest. The *Participating Mineral Deed* provides that the holder will be entitled to his pro rata part of future bonuses and rentals received from the leasehold interest in addition to the pro rata part of the oil and gas produced in the event of production. Hence, it follows that in the event a lease expires and it is desired to execute a new lease, the signature of the holder of the Participating Interest is necessary. Whereas, if the interest is Non-participating, the holder does not receive any portion of future bonuses and rentals, but only his portion of the oil and gas in the event of production, and the right to execute leases is retained by the landowner.

Some states, notably Louisiana, do not permit the use of perpetual or deeded mineral interests. Here the Royalty Contract is used, but these royalty contracts are also frequently used in many other states where no such prohibition is in force. Like the Mineral Deed, the Royalty Contract may be participating or non-participating, but unlike the Mineral Deed these interests terminate at a specified time unless oil or gas is found in paying quantities prior to the expiration date, in which event they may remain in force as long as oil or gas is produced, or may remain in force only for a specified number of years of the producing life of the property. These are variable provisions of the contract.

Trustees

Many investors in landowners' royalties are confused by various provisions of the lease agreement. For instance, many leases now provide that in the event the mineral interest is divided into more than a specified number of parts (usually from six to ten) payment may be withheld by the purchaser of oil or gas until a trustee has been appointed to receive and distribute the income. This provision is made to relieve the burden on the purchaser of the oil or gas from the necessity of keeping books on and distributing a great number of very small interests, the cost of which is often in excess of the amount of the check issued. When the provisions of this clause are invoked, the trustee may be one of the owners of the mineral or some other person agreed upon, but in any event such trustee usually requires payment for his services. This fee varies from 2% to 5% of the amount to be distributed plus 10¢ for each check issued. Thus the royalty owner finds a deduction which he might at first feel is in conflict with the other provisions of the lease where it is provided that the oil and gas accruing to the royalty interest will be delivered free into the pipe line. But as the appointment of a trustee is contemplated by the original lease agreement, and as practice requires that each interest holder must agree upon the trustee appointed and the amount allowed for his services, no conflict seems to exist in fact.

The prudent investor should not only require good title to the interest acquired, but should fully understand the provisions of any lease agreement, as well as the provisions of the conveyance to him.

Leasehold or Working Interests

The leasehold or working interest, as pointed out above, is created by virtue of the lease agreement between the lessor and lessee. The provisions may vary and do vary but essentially this interest assumes the obligation to develop and operate the lease, bearing all costs therefor. Except under very unusual conditions, the lease agreement does *not* bind the lessee to drill on non-producing properties, so it is customary for the lessee to pay the lessor a cash consideration for the privileges and rights granted in the lease. This payment is commonly called the *bonus* and may vary in accounts from 10¢ per acre to a thousand dollars per acre or more in accordance with the surrounding conditions. The term of the lease may vary from one year or less to twenty years or more, generally referred to as the *"Primary Period"*. Five years is probably most often agreed upon.

Bonus and Rental

Under the terms of most commercial leases, if the lessee fails to commence a well within one year from the date of the lease, then it is required that an additional cash payment must be made to the lessor from year to year during the primary term to extend the lease. These annual payments are called *rentals* and may vary by agreement from 10¢ per acre or less to $10.00 per acre or more. From 25¢ to $1.00 per acre is customarily used.

Paid Up Lease

The "Paid Up Lease" is not uncommon in many large unexplored areas. Under its provisions the lessee pays a specified sum to the lessor at the time the lease is taken in lieu of the annual rental provisions.

Lease Forms

Most major operating companies use their own lease forms which vary principally in minor provisions to conform with the conception of each as to what constitutes an equitable agreement. Also, various publishers prepare for sale to the public, *lease forms* having yet different provisions. The substitution of one word or the omission of one clause often changes the effect of the entire lease. For instance, there is a section of every oil and gas lease commonly known as the "operating clause". Should this clause read "Operations *for* drilling will begin" on a specified date the meaning is very different from the meaning should it read "Operations *of* drilling will begin" on a specified date. In the first instance, it is only necessary that materials used in the drilling of the well be placed at the location where drilling is contemplated. In the second instance, actual drilling must be started, on the date specified.

Despite these varying provisions, most commercial oil and gas leases are equitable as between the lessor and lessee at the time they are entered into, but where these interests are sub-divided into fractional parts and offered for sale to the investing public, it is imperative that the tenor and effect of the principal provisions of each lease be well understood by the investor.

Mineral Partnership and Tenant in Common

In connection with a general discussion of working interests, it might be well for you to understand the distinction between a "mineral partnership" and "tenant in common" for undoubtedly many of those who come to you for counsel and advice may save themselves embarassing liability if they are fully aware of this distinction.

Let me say here that a mining partnership differs in several particulars from the ordinary business partnership. The principal differences might be stated as:

1. In a business partnership the death of any partner dissolves the entire partnership. This is not true in the mining partnership.

2. In a business partnership each partner is liable for acts and obligations of the other. This is not necessarily true in the mining partnership.

You will note that I have said that it is not *necessarily true.* Should the owner of the working interest subdivide and sell fractional interests to investors who, after the acquisition of such interest, refrain from any attempt to manage or operate the property, exercise no control or authority in its management, nor permit their name to be used as a part of the operating name, then such investor is very probably not a mining partner but a *tenant in common* and as such has no personal liability beyond the value of the interest held in such property. On the other hand, if by some act it can be established that this investor has exercised control over the property and permitted himself to be known as active in the management or control, then he is very likely to be a mining partner and thereby personally liable as in the business partnership. Whether his acts bring the investor into the mining partnership or whether he remains a tenant in common will very probably require judicial ascertainment in each instance.

The working interest yields the largest return yet it is attendant with the greatest hazard. Even under the most favorable conditions there always remains some chance that the lease bonus payment, the development cost and operating expense combined may be in excess of the ultimate return. Good judgment and good management are necessary in this work, but there are, of course, some outstanding examples of success where good luck was the controlling factor rather than good judgment, but certainly no prudent investor would accept the hazards of the oil business where good luck alone is depended upon for success. The hit and miss location for an oil well test without the study and approval of an experienced petroleum geologist or geophysicist is indeed a wild gamble. That is not only true in undeveloped or wildcat areas, but also in oil producing areas as well.

Creation of Other Interests

By changes in the conditions and provisions of the lease agreement, all other interests commonly traded in as oil securities are created, but however attractively these new interests might be dressed and how lovely they might be portrayed they are, in the last analysis, no stronger than the working interest remaining after their creation. To the lessor these new interests are unknown, so when the lessee creates and disposes of interests which do not carry the full obligation as provided in the lease, he has not disposed of the obligation but has merely transposed it from the new interest created as an additional burden to the working interest remaining.

These new interests are:

Overriding royalty interest
Oil and Gas Payment Assignments
Carried Interests.

Overriding Royalty Interest

The Overriding Royalty Interest is probably the most difficult interest to understand clearly so let me endeavor to explain this term and then explore the reason for its creation. I think of this interest as being nothing more or less than a working interest with the obligation to bear any part of the development cost and operating expense erased by the holder of the working interest who assumes the obligation so erased. It is *not* free from the obligation to bear its pro rata part of the development cost and operating expense despite all the statements to the contrary. That obligation is embodied in the original lease of which this overriding royalty interest is subject, just so long as the working interest remaining is able to comply with the lease obligation all will be well, but when the working interest remaining is unable or unwilling to comply with the lease provisions then the lessor may properly demand the holder of the overriding royalty interest to bear his pro rata part of the necessary development and operating costs out of his share of the income.

It is, of course, the intention when these interests are created to bring into existence an interest that is more attractive than the working interest from which it was taken, - an interest that will be as nearly as possible similar to the landowners royalty interest, - one that is free from all obligations, - and this is in fact frequently accomplished.

But why, you ask, does the owner of the working interest increase his burden so that he may create this less burdensome interest for sale to others. That is a question that can be answered only after consideration of each individual case, but most frequently it is done for the purpose of more easily raising capital for the development of the property, or in other instances the owner of the leasehold interest might assign the lease to another, retaining as his profit an overriding royalty interest.

It is highly important to understand that a true overriding royalty cannot be created except by the acquiescence in writing of the owner or owners of the *full* leasehold or working interest. For let us suppose that A is the owner of a full working interest who sells one-half to B and thereafter B divides his portion into fractions and calls them overriding royalty interests, which are purchased by investors as such. This would require that A bear all the cost of development and operation which he would certainly not be willing to do unless he had consented in writing to this change. Hence, these investors did not have and could not have anything but working interests and would therefore be required to bear their pro rata of the costs. This is not an infrequent happening, sometimes through ignorance and perhaps sometimes by design.

Oil Payments

The Oil Payment Assignment is an interest that was originated some years ago by the under-financed oil operator for the purpose of raising cash with which to defray development costs. These operators would own an attractive oil and gas lease but not the cash necessary for its development so they would assign a certain portion of the oil, as, if and when produced from the well to be drilled to some investor on a very attractive basis, say from two to three dollars for one. Thus, if A needed to raise $10,000.00 in cash for the purpose of drilling a well on a lease that he owns, he would assign to B say one-half of the oil to be produced until B had received $20,000.00 or $30,000.00 in return, at which time the obligation would be liquidated and the interest revert to A.

There are other uses for oil payment assignments, but usually as the offeror needs ready cash he assigns a certain portion of either his present or expected oil or gas production to an investor on very liberal terms until the amount so assigned has been paid.

Recently some unscrupulous promoters have offered these interests as a means for disposing of undesirable properties. For instance, in one case that I recall an operator owned a very unattractive oil lease in one of the larger oil fields and in close proximity to producing wells. He conceived the idea of selling these oil payment assignments to small investors in distant states on the basis as high as ten for one. Thus attracted, investors purchased more of these than the lease was worth including the cost of drilling the well, thereby this promoter reaped a substantial profit. But that was not all. The well was a small producer so, to evade making the payments as represented to the investors, he set up fictitious operating expenses through which he would profit, and advised the holders of these interests that the well was not paying the expense of operations, hence, no returns could be expected.

It should be remembered that the value of an oil payment assignment, like all other oil and gas rights, is dependent upon the ability of the property to produce for the interest assigned an amount of oil or gas, that when sold will yield an income sufficient to liquidate the payment. One should not be fooled by extravagant promises of three for one or ten for one. Where these interests have merit, local investors are eager to purchase these oil payments.

Carried Interest

The Carried Interest is one which pays to the holder a certain portion of the net proceeds after the operators have paid all development and operating costs. It is frequently used in the oil fields but rarely subdivided for the purpose of public offering to investors.

Brokers, Dealers, and Promoters

Now let us see who trade in these various oil interests. We have, of course, the principal oil operation companies, usually referred to as major companies; the smaller oil companies and individual producers, usually referred to as independent operators; the royalty companies that invest in oil royalties as their principal business; and also the brokers and dealers that serve this group. Then we have another group composed of dealers and promoters who sell to those not a part of the established oil industry. These may be classified as:

Wholesale Dealers
Retail Dealers
Mail Promoters

Wholesale and Retail Dealers

The wholesale dealer lives in the oil producing areas, he acquires oil interests in relatively large blocks and thereafter subdivides them for distribution to the investors through the medium of the Retail Dealers, who usually live in the thickly populated centers far removed from the oil fields.

Mail Promoters

The mail promoter depends on his ability to portray a magnificent investment opportunity through the mail that will attract small investors in great numbers. Many of these letters are masterpieces of bunk but the flamboyant and alluring statements, combined with the gullibility of some people, bring liberal returns. Where the promoter is not himself adept in the fine art of letter writing, there are a goodly number of "copy writers", men who specialize in the preparation of sales literature, to whom the promoter may turn for experienced assistance in the formulation of "letters with a pull".

Of course, the so-called "sucker list" is also indispensable to his operations. Some of these lists contain as high as 500,000 names taken from lists of investors in various mail promotions, for when one promoter has "worn out his welcome" so to speak, with a given list he sells or trades his list to some other promoter on the theory that "once a sucker always a sucker". Business-minded letter shops assemble names and sucker lists in great numbers as an aid to their promoter clients.

It is from this last group that we find those who chisel and swindle the public, the old people who fear for their financial future and believe that any oil investment will bring them independent wealth, the school teacher, the nurse, the factory worker, the clerk, the widow, and not infrequently professional men are victims of their guile.

Not very long ago, I talked to an old couple, inmates of a home for the aged maintained by a fraternal organization. Both this man and his wife were past eighty years of age. As we talked in the garden apart, I heard a story of unhappy days that threatened to take their very life in the anguish that had been theirs. This fine old gentleman had been a prosperous farmer, a leading citizen in a small North Texas town. One day a letter came. In the shade of the porch he read its wonderful message, - a promise of wealth, travel and position by just a small investment in oil. Eagerly they filled out the "Order", eagerly they purchased the money order and eagerly they awaited the good news that oil had been found. But something went wrong-- they did not just recall what, but whatever the promoter's reason it sounded truthful to them. Then another letter came telling them how an added small investment would make up their former losses with a liberal profit besides. Again they invested, again they eagerly awaited every mail, other letters came from other promoters, each more alluring than the first. In each they invested, in each they were disappointed but hoped against hope that each new investment would retrieve their former losses and that whatever had gone wrong with former investments the new one would pay. First the snug little bank account was lost, then the cattle and work stock, then the farm, and at last the little home in town was sold for the one last fling, as the promoter had sent them a dividend check and assured them that their company was on a sound financial basis - just a little more stock was available to a few good friends - they must hurry. They did, and with their last dollar. When disillusionment came, they talked of taking their lives and might have done so but for the haven opened to them by this fraternal organization.

Some might say that this old couple was so foolish that they deserved to lose, but I cannot take that view. They were honest and trusting and believed in others. They deserve protection, and giving that protection is our job.

But how may one tell a good oil investment from a bad one, is a question that I am sure all of you would wish me to answer, and I sincerely wish that I could. Unfortunately, there can be no set rule. There are many things that the prudent investor in oil securities should know before he parts with his savings for what on the surface appears to be a safe investment or an attractive speculation.

Geologists and Geophysicists

The discovery of oil is largely dependent upon the judgment of the petroleum geologist and geophysicist. As those engaged in this work will tell you, these are imperfect sciences in that they do not attempt to say definitely that oil is here or that it is not here. What they say is, "here is a favorable geological condition for the accumulation of oil, or conditions here are unfavorable for its accumulation".

I am sure that most of you have observed how in promotional sale literature great stress will be placed on such terms as "High", "Fault", "Dome", "Closure", "Structure", "Anticline", "Monocline", etc. These are the geologist's way of expressing the phrase "oil trap", for after oil has been formed, it must find its way into porous formations, such as sands and porous limestones and there be entrapped to accumulate in sufficient quantities to form oil pools, yet it does not follow that every "structure", or trap that the geologist may locate will contain oil or gas.

To illustrate something of the chances that are taken in an effort to locate new oil fields, the Vice-President of one of the larger producing companies, himself a geologist of note, recently told me that out of 149 wildcat exploration tests located and drilled under the most advanced scientific methods, 9 new oil fields were discovered, of these, three or four were of doubtful value. Yet that official expressed satisfaction with the results. But what about the investor who does not understand the great investment hazard and expects that nearly every well started results in an oil discovery?

Doodlebugs

I have told you that the ethical geologist and geophysicist do not say that "here oil may be found and here it may not, but here are geological conditions that are favorable for the accumulation of oil", the final test must be the drill. That some day scientists may be able to accomplish this is not impossible, but today it is safe to say that every oil finding device is unscientific and unable to do the things claimed for them. But scores of men go about the country with queer oil finding devices making the foolish and impossible claim that they are able to locate oil in place. These devices are commonly called "doodle-bugs".

I have seen one such device that the operator claims contains a magic fluid that both increases its specific gravity and separates into a light and dark colored fluids when over an oil pool; another that jumps up and down when over oil; others that have queer gadgets that will click and buzz in the presence of oil. I, myself, can make a gadget in ten minutes that will seem to do almost unbelievable things in the presence of oil. I once saw a man who claimed, and I am sure he believed, that when he stood over oil he would get impulses or messages from Heaven. Of course, all of these claims should immediately be recognized as unscientific and impossible, and one should not be fooled by a claim that these instruments are of the recognized geophysical variety.

Geophysical Instruments

In the hands of trained geophysicists, the seismograph, torsion balance and magnetometer, or instruments that operate on similar principles, are a splendid aid in the search for oil, but as there is no similarity in the claims of the geophysicist and the "doodle-bug" they should not be confused. Should you be confronted with the name of some high sounding device, first investigate its claim. Should the operator only claim to find favorable geological conditions for the accumulation of oil and the operator is a trained scientist, it will probably be a geophysical instrument and, therefore, an instrument of merit; but should the operaror claim to find oil in place, it should be considered unreliable.

Proration, Potential, Allowable, and "Hot Oil"

What is proration, and what do the terms "potential", "allowable" and "hot oil" mean, are questions that I am frequently asked.

Until very recent years, oil and gas were produced from each well at the maximum rate, each operator striving to produce all that he could as rapidly as he could. This practice resulted in the waste of reservoir energy as well as other physical and economic waste, so during the late depression when oil fields were able to produce considerably more oil than the market demand, various states enacted laws restricting the amount of oil that any given well might produce. This restriction is called "proration".

How may this be equitably accomplished you ask? The United States Bureau of Mines by careful compilation of statistics determines each month the approximate market demand for the nation during the ensuing month and suggests to each state regulatory body what proportion of this national demand should be produced by such state to prevent national over-production.

Each state regulatory body makes periodical tests of each well in the state to ascertain the amount of oil each is capable of producing per day, which figure is known as the *potential production*. The aggregate potential production of the wells in any pool is, therefore, the potential production of the pool.

Knowing the potential production of each pool in the state, and the amount of oil that the entire state might produce to prevent national over-production, it is determined what proportion of the entire state production may be allocated to each pool and to each well in the pool. This is known as *Allowable*.

"Hot oil" may be defined as that produced clandestinely and in excess of the *allowable*.

Payout Period

The tricks of unscrupulous promoters of oil interests are too numerous to mention as, I am sure, most of you already know. If I were asked to select the one most used, it would be the misstatements by some retail dealers to unwary investors regarding the "payout period" of oil interests offered. This I believe, is the most misunderstood phrase in oil parlance. Obviously, it means the period of time it will take the investor to receive a return of his capital investment, but how can that time be determined?

It is natural of course that an investor desires a return of his capital investment at the earliest possible time—a fact that the unscrupulous promoters well know. So in the absence of a dependable estimate of recoverable oil, the investor is shown that at the present rate of production the capital invested will be returned in a relatively short period of time that thereafter the income will be profit on the investment and is led to believe that this rate of production will continue. In too many instances this is not true. The oil interest offered may be on a fully developed property, one that has been largely depleted with no hope that the production might be increased by any means sufficient to care for the *natural decline*, which is inevitable. So what may appear as an attractive investment with a short pay-out period is, in fact, one that may never return the capital invested—the production declines, as it does, the pay-out period lengthens and like the desert mirage, is just ahead but never reached. -

On the other hand, the uninformed investor fears an investment in oil that at the time of purchase has a long indicated pay-out period, but very often these are, in fact, the choice investments. Let us assume that an interest is offered in a 160 acre tract at the time one well has been completed and that conditions warrant the assumption that the entire tract will be productive. In this case, the value of the interest is certainly in excess of the value of the oil that will come from the one completed well, so when the pay-out period is estimated it shows to be many years in the future at the present rate of income and, the investor frowns. Yet with the completion of the second well, the pay-out period will be shortened and as each successive well is completed this period continues to shorten so, in fact, what at first appeared an impossibly long pay-out period became a very short one.

And too, under severe proration restrictions, as for example in the East Texas Field, the present rate of income is relatively low, but from the most desirably located properties it is reasonable to assume that ultimately a large amount of oil will be recovered and that the severe proration restrictions will later be lifted, so prudent investors are content to purchase interests that at the present rate will not return the capital investment for eight or nine years, in some instances.

It is often said that the difference between a good and a bad oil investment is the price paid. Of course, that is true of any investment, but oil and gas are diminishing assets—values vary with time, so a good or bad investment in oil or gas production is dependent upon the amount of future recovery from the property—not what the property has done in the past.

Securities & Exchange Commission

When Congress included "oil, gas, and other mineral rights" in the definition of a security in the Securities Act of 1933, it was intended that investors in these interests should be furnished a full and fair disclosure of all the material facts relating to such securities. To accomplish this, the Securities and Exchange Commission has prescribed rules and regulations under which the issuer is required to prepare in prescribed form what is considered the minimum amount of information necessary to present to the prospective investor all the material facts and permit an intelligent study of the merits of the security before investing.

Where these interests are offered to the public in an amount in excess of $100,000.00, a Registration Statement must be filed with the Commission and a Prospectus reflecting the important facts must be furnished to each investor at the time of the initial solicitation. Where these interests are offered to the public in an amount of $100,000.00 or less the Commission has prescribed a form known as an "offering sheet" that when properly prepared must also be furnished to each prospective investor at the time of the initial solicitation. The purpose of the offering sheet is primarily to lessen the burden on the issuer yet assure the prospective investor a full disclosure of material facts relating to the interests offered.

The Commission does not presume to pass upon the merits of the security as an investment opportunity, but rather to prevent the dissemination of false and misleading representations and endeavor to provide for the investor a full and fair disclosure of facts upon which the investor might base his study and determine for himself whether the investment offered has sufficient merit to warrant its purchase.

The cooperation given the Commission by your splendid organizations has undoubtedly been a great factor in lessening the evils of the unscrupulous oil promoters. It is to be hoped that this cooperative spirit that has been so manifest may not be diminished but that through an intelligent combined effort the unscrupulous oil promoter might be eliminated from the investment picture, in which hope I can say with more than twenty years association, the legitimate petroleum industry joins most heartily.

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