Trends in Non-Traded Energy Products:
Has the Era of Acquisition-Focused
Energy Programs Arrived?

Bradford Updike, LLM, JD
Mick & Associates, P.C.
August 10, 2015

How far we have come in a year. WTI oil prices in July 2014 averaged $103 per barrel ("**bbl**"), with Brent oil pricing also pushing $110 per bbl a year ago.[1] Through 2015, however, we have witnessed oil prices fluctuate from $45-$60 per barrel. While WTI price patterns in late spring of 2015 gave the oil and gas industry a momentary glimmer of hope, the June 5, 2015 announcement by The Organization of the Petroleum Exporting Countries ("**OPEC**") to keep its production target at 30 million bbl oil per day recast an element of doubt as to when we might ever see oil price patterns that are closer to the price levels observed from 2010 through much of the fall of last year.[2] Despite significant reductions in rig counts across the country, the U.S. up-stream industry continues to pump crude at increased daily rates.[3] Also contributing to an indefinite worldwide crude glut is a weak European economy that has failed to bounce back from the world recession with the same vigor as the U.S. Such is the challenge of those dependent upon drilling and exploration to make their businesses profitable.

On top of the challenges in the oil markets, natural gas operators and producers have not fared much better, with natural gas prices fluctuating levels of $2.60 to $3.00 per mcf through much of this year.[4] This compares negatively to the $4.00-plus mcf pricing observed through the summer of last year, with mild weather patterns and horizontal drilling technologies on the domestic front supporting the notion that the U.S. is amply supplied with natural gas for many years to come. For those in drilling, different areas have different development methods and costs, which causes break-even economic points in various U.S. oil and gas basins to vary significantly (e.g., various informational sources suggesting a *broad range* of breakeven prices that include, by way of example, $28-$85 bbl for the Bakken Shale and $40-$60 bbl for the Eagle Ford Shale depending upon location and reservoirs targeted).[5] While certain U.S. basins

---

[1] *Energy Information Administration - Spot Prices*, www.eia.gov (website visited Aug. 3, 2015).

[2] Organization of the Petroleum Exporting Counties, *OPEC 167th Meeting Concludes* (June 5, 2015).

[3] *Energy Information Administration - U.S. Field Production of Crude Oil*, www.eia.gov (website visited Aug. 3, 2015); *See also*, Jude Clemente, *U.S. Oil Production Forecasts Continue to Increase*, Forbes (May 7, 2015 (Projecting 10.6 million bbls of daily oil production in 2015 versus 9.55 million bbls of daily production in 2014).

[4] NASDAQ, U.S. Average Natural Gas Price, www.nasdaq.com (website visited Aug. 3, 2015).

[5] Leonardo Maugeri, *Comment: Beware of Break Even and Marginal Cost Analysis*, Oil & Gas Financial Journal (Feb. 10, 2015) (suggesting a range of $28-$85 per bbl to support 10% IRR in various parts of the Bakkan Shale Play); John Kemp, *Breakeven and Shut-In Prices for Oil Wells*, Reuters (Jan. 13, 2015) (quoting North Dakota's Department of Mineral Resources breakeven range of $30-75 per bbl); R.T. Dukes, *What is the Breakeven Oil Price in the Eagle Ford Shale?* (Mar. 5, 2013) (suggesting $50 to $60 per bbl as range of breakeven prices prior to market downturn); Collin Eaton, *Analysts: Eagle Ford Drilling Will Get a lot Cheaper by Mid-2016* (May 18, 2015) (suggesting that Eagle Ford Shale breakeven could reduce to $1 per bbl in 2016).

may work on a pure field-level basis, breakeven cap ex points for retail syndicated drilling partnership programs ("**drilling programs**") trend perhaps 25% to possibly 30% higher than the field-level cap ex based upon offering costs and program manager compensation. Based upon our due diligence findings, certain proactive drilling program sponsors are addressing commodities pricing challenges by: (i) procuring development cost reductions from goods and services vendors, and (ii) applying improved drilling and completion technologies to old fields where oil and natural gas resources were established years ago. Even with the presence of such initiatives and the competitive income tax deductions that generate tax savings of 20% to sometimes 40% of an investment, however, some or possibly many drilling programs will be hard pressed to make their programs model at adequate returns under current market pricing conditions. *This backdrop of unfortunate events raises the specter of which non-traded energy-funded investments can potentially make sense in such challenged times.*

In spite of low oil and gas prices, note that a recent trend is developing within the non-traded retail-syndicated energy product space that is focused upon capturing some acquisition-driven upside that might not have existed at higher commodity prices. Such is the investment theme of certain acquisition-focused product structures, such as: (i) non-traded limited partnerships that are designed to mimic Master Limited Partnerships ("**MLPs**"), (ii) limited partnerships structured as diversified energy opportunity programs, and (iii) retail syndicated 1031 products designed to provide long-term income and growth to investors through strategic acquisitions of oil and gas minerals and royalty interests. Despite low oil and natural gas prices and an over-levered energy industry, the upstream energy industry has remained resilient in being able to stave off bloodbath levels of bankruptcies and bank takeovers of energy assets to this point. Notwithstanding, the feeling among some reputable industry stakeholders is that we are perhaps within the second inning of a price downturn that could last until possibly 2020.[6] Thus, while drilling-focused programs may struggle to provide investor value during the indefinite price trough, *the newer trend of retail energy programs is attempting to capture alpha for retail investors through a "buy low" acquisition mentality*. While products such as these were in the shadows of the higher demand tax advantaged drilling programs in prior years, more and more sponsors of non-traded investment programs in 2015 appear to be positioning themselves to offer these other program platforms in the wake of commodities pricing challenges and possible future buying opportunities arising out of such challenges. This article will explore these other opportunity-driven product structures.

Non-Traded MLP Designed Products

MLPs are publicly traded companies that are structured as limited partnerships for federal income tax purposes that engage in up-stream, mid-stream or down-stream operations.[7] There is also a non-traded MLP look-alike product ("**MLP designed**" products) that do not offer secondary market liquidity but that have almost the same income tax consequences as MLPs and

[6] Ronal Bousso, *et. al.*, *Shell Expects Oil Price Recovery to Take Several Years*, Reuters (July 16, 2015).

[7] National Association of Publicly Traded Partnerships – MLP Basics for Investors, www.naptp.org (website visited August 3, 2015). Please note that notwithstanding the limited partnership legal structure of MLPs, they will often be referred to in this article as "funds."

that are structured similar to MLPs in terms of their economic features and capitalization.[8] The MLP designed products are typically offered through private placements conducted under Rule 506 of Regulation D of the SEC Act of 1933 or by prospectus in an S-1 offering. By analogy to the numerous non-traded REIT products out in the retail investment market today, the MLP designed products aspire to become traded securities upon the future development of their portfolio assets.

Unlike many non-traded retail investor marketed programs that acquire passive investment interests in oil and gas projects, MLPs and their non-traded companions are set up to operate as living and breathing companies that operate energy assets on a day- to- day basis. On the public side:

- The MLP universe has a market cap of roughly $500 billion, which has grown significantly over the past 5 years;[9]
- About 75% of all MLPs today operate in the up-stream, mid-stream or down-stream energy sectors;
- A majority of MLPs today are mid-stream and down-stream, but public MLP up-stream products that engage in drilling and lease development are growing in number.[10]

Investors who buy the public MLPs want regular income that comes to them on a tax preferred basis. The public MLP distributions are generally 80-90% tax preferred because the MLPs are passing through intangible drilling cost deductions, equipment, and depletion deductions to investors. Buyer motivations differ in the context of the non-traded MLP designed products. Distributions will be moderate due to the reinvestments of earnings used to develop the assets to position the product for an MLP listing event down the road in 5-7 years.

In terms of capitalization structure, MLPs and their non-traded companion products are both managed by a **General Partner** that receives a 2% interest in the equity of the fund, with investors as a group controlling the other 98% of the equity. In the public and private arena, the General Partners receive incentive distribution rights ("**IDRs**") in addition to their 2% equity interests. In the public arena, the IDR compensation incentivizes the General Partner to distribute as much of the MLP's cash flow to investors as possible:

- Investors are generally entitled to receive a preferred distribution prior to the payment of the IDR that ranges generally between 8% and 10% annualized; and

- The General Partner's share of cash flow above the target distribution varies between 13% and 48% of excess cash flow after the preferred return is paid to the retail investors (with the IDR percentage share depending upon the investor distribution).

[8] Observations relating to the features of MLP-designed products, energy opportunity partnerships, and 1031 energy products were derived from the various due diligence engagements of Mick & Associates, P.C. over the past several years.

[9] *OFI Steelpath MLP Primer*, Oppenheimer Funds (Dec. 2014).

[10] *User's Guide to Master Limited Partnerships*, Vanguard (Sept. 2014).

On the private side, the General Partner of the MLP designed product receives IDRs that entitle it to a share of the fund's upside return if it is successful in listing its units at a certain valuation. Generally, the IDR is 20% of the upside IPO value of the fund after investors receive units that are worth as much as their initial investment. On the private side, the distributions may be moderate (i.e., 6% annual target as opposed to an 8% to 10% target) due to the fact that the fund is reinvesting its free cash flow to develop assets and build value that can be potentially recognized at a listing event. Thus, the objective on the private side is moderate income initially with investment growth as opposed to just income.

Both public MLPs and non-traded MLP designed products are pass-through entities whereby income and deductions are reported at the individual investor level. Ordinarily, a partnership whose units trade on a secondary market will be taxed as a corporation. However, special tax legislation adopted in 1987 carves out an exception for certain publicly traded partnerships engaged in natural resource development, production, and transportation:

- According to IRC §7704, 90% of the entity's income must be earned from qualified sources for the entity to qualify as an MLP; and

- The natural resources that are considered as qualifying resources include: (i) oil, gas and petroleum, (ii) coal, (iii) timber, and (iv) any resources that are depletable under IRC §613.

Public MLPs and their non-traded companions are both passive income generators due to the nature of the income (i.e., which is normally operations-driven income) and the nature of the interests being acquired by investors (i.e., which are limited partner interests). On this point, passive deductions **in a public MLP** product **only offset** passive income of that product. So, if an MLP investor has excess passive deductions from his or her investment that exceed income, those deductions will have to be suspended and will be used to offset income from the underlying MLP for several years. The **treatment of passive deductions for non-traded partnerships is different**. Those losses can offset passive income from other investments if needed.

Note that unrelated business taxable income ("**UBTI**") is a special income tax incurred by qualified plan and IRA sourced investments in partnerships that engage in energy and real estate. UBTI will be incurred in both public and private products if that income exceeds $1,000 per year. There are exceptions for royalty income, interest income, and capital gains-related income from asset sales. Operational income however is subject to UBTI.

Public MLPs must file their financials quarterly with the SEC. Financial informational rights in the non-traded MLP-designed products are generally acceptable and are patterned after the oil and gas program guidelines published by the North American Securities Administrators Association ("**NASAA Guidelines**"). The NASAA Guidelines generally require that an annual audit and semi-annual unaudited financials be provided to investors. The financials of non-traded MLP designed product financials are not filed with the SEC.

If the non-traded MLP designed product is offered by private placement, then its sales are generally limited to accredited investors until such time that a listing event occurs. An S-1 prospectus offering can also be used by a non-traded MLP designed product sponsor to generate subscriptions from a broader segment of the investment public, with NASAA's oil and gas product suitability guidelines applicable in such cases. While broker-dealer suitability requirements apply to sales of publicly-traded MLP products, sales of these products are much less restrictive in comparison to the non-traded products (as publicly-traded securities can be sold to investors fitting within a wide range of income and asset levels that fall well below the accredited investor limits).

As to the non-traded MLP designed product, the companies that have sponsored offerings to date have focused their operations on up-stream energy activities (i.e., drilling wells and developing oil/gas reserves). While the life cycle of the MLP designed product is still in its infancy, the potential reach of the product may be very significant if one analogizes to the historic marketing success of non-traded real estate investment trusts, or "**REITs**" (i.e., $20 billion sales estimated annually).[11] The investment focus of an MLP designed product will differ from that of a syndicated drilling program given the need for the MLP designed product to build a proven reserve base that can be revalued during a listing event. For this reason, the MLP-designed products will acquire working interests in full leases as opposed to wellbore assignments, and will use its cash flow in excess of targeted distributions to develop the oil and gas reserves underlying the leases.

The fund sponsor with the most success to date in raising retail capital in a non-traded MLP designed platform is Atlas Growth Partners, which raised over $150 million from retail investors through May 2015.[12] Some other sponsors, such as MDS Energy Partners, LP and American Energy Capital Partners have recently offered non-traded MLP designed products. For comparative purposes, the chart below compares the business objectives, load, fees and expenses of three non traded MLP-designed products that are marketed to retail investors.

Table 1-Features of MLP Designed Programs

	American Energy Capital Partners, LP	**MDS Energy Partners, LP**	**Atlas Growth Partners, LP**
Offering Date	May 2014 to present	April 2015 to present	2013-2015
Business Objective	Acquire, develop, operate, produce and sell producing and non-producing oil and natural gas properties	Acquire undeveloped and producing oil and gas leases and drill wells on the leases to prove reserves and enhance property values	Acquire undeveloped oil and gas leases and drill wells on the leases to prove reserves and enhance property values
Maximum Offering	$2 billion	$100 million	$500 million
Targeted Distribution	6%	7%	7%
Incentive Distribution Right Pre-Listing	Upon a liquidity event, 25% of net sale proceeds minus the	25% upon liquidity event, but the sponsor's IDR subject to a return	20% upon liquidity event, but with the sponsor's IDR subject

[11] Robbie Whelan, *What You Need to Know about Nontraded REITs*, The Wall Street Journal *(Aug. 27, 2014) (Nontraded REIT industry described as having $20 billion in investor capital raised annually)*.

[12] Form D/A filed with Securities and Exchange Commission May 26, 2015.

	excess, if any, of (i) $20 per unit less (ii) distributions paid after the offering termination date	of capital and 7% annual distribution	to a return of capital and 7% annual distribution
Load	11.5%	12.5%	12%
Acquisition Fee	3%	2.0% of proceeds may be allocated to support acquisition costs	NA
Asset Management/ Administration Fee	Fee fixed at 3.5% of amount available for investment (i.e., gross offering proceeds plus debt) prior to the close of the offering and 5% of the same thereafter, with General Partner-level administrative costs assessed**	1.5% of gross offering proceeds, plus accountable administrative expense reimbursements that exclude sponsor overhead	1% of gross offering proceeds, **plus** accountable administrative expense reimbursements of unspecified amounts
Disposition Fee	1%	NA	NA
Financing Fee	0.75%	0.75%	NA
Drilling Costs	Competitive rates	5% of capital deployed for well development plus admin. fee per well (e.g., $250,000 for horizontal wells drilled in Marcellus Shale Play)*	Competitive rates

*Assessed in lieu of a sponsor overhead pass-through to the partnership

**Manager-level overhead paid through fixed management fee, whereas General Partner-level administrative costs may include pass-through of General Partner overhead

Energy Opportunity Fund Programs

Unlike drilling partnerships that seek to deliver competitive income tax benefits and opportunities for long-term cash through drilling of wells, energy opportunity partnerships are structured to provide a non-traded investment opportunity that will focus upon a *diverse universe* of oil and gas assets that may include: (i) mineral interests, royalty interests, and overriding royalty interests in properties that produce hydrocarbons, (ii) working interests in oil and natural gas leases with undrilled locations or leases where hydrocarbon production may be enhanced through workovers or remedial operations, and (iii) interests in energy infrastructure assets, including pipelines and systems used in gathering, transporting, processing, treating, storing, refining, distributing or marketing natural gas, natural gas liquids, or crude oil products, as well as assets used to support well water disposal. To date, undeveloped and developed oil and gas leaseholds, royalties, pipelines and water disposal assets have been the primary investment focus for energy opportunity fund partnerships (with down-stream expertise not generally observed as a skill set with the group of companies that have operated in the non-traded sector of the retail investment market over the past several years).[13]

[13] *Investing in Energy Programs*, Investment Program Association (2014) (explaining on pages 7-10 the universe of oil and gas assets that can be acquired by investors, while also explaining on pages 16-25 the primary types of non-traded energy programs historically marketed to retail investors).

The primary investment strategy of the energy opportunity partnership is to provide economic value to investors in the form of income and asset growth by: (i) focusing upon acquisitions of oil and gas properties and direct investments at a time when oil/gas market developments present opportunities for favorable purchase price valuations, and (ii) focusing upon properties that provide income and opportunities for value-added growth. Similar to the investment mandates of the up-stream oriented MLP designed products, energy opportunity partnerships that acquire working interests acquire interests in the leases in order to position the program to build proven reserves that can be potentially rewarded by a future buyer in an asset sale transaction. Unlike the MLP designed products that seek to deliver growth to retail investors through a listing event and the arbitrage believed to be associated with the enterprise valuation upon listing (i.e., due to the fact that the public MLP enterprise value tends to increase, as a higher multiple of its earnings is then available), sales of portfolio assets to strategic acquirers tends to be the exit strategy of the energy opportunity partnerships.

While direct investments in assets are the focus of the energy opportunity partnership, these limited partnership-structured programs will sometimes have the flexibility to invest as an equity and/or debt investor in the business entities that own energy infrastructure assets, as well as in entities engaged in exploration, drilling, and the provision of specialized services to the energy sector (i.e., also sometimes referred to as private equity or private debt investments). While the energy opportunity partnership compares to the non-traded MLP designed product in the sense that both are seeking to deliver value to retail investors through strategic acquisitions of energy assets (i.e., as opposed to concentrating on the delivery of drilling-derived income tax deductions), energy opportunity partnerships assume a diversified investment mandate whereas the MLP will concentrate its assets in one sector of the energy industry (i.e., up-stream, down-stream, or mid-stream, but not all three sectors).

Similar to MLPs, the energy opportunity partnerships are structured to mitigate the liability exposure associated with oil and gas operations-related activities by offering limited partnership interests to investors. As energy opportunity programs are structured as partnerships for federal income tax purposes, this product will provide some income tax related benefits to investors through pass through of depletion deductions and intangible drilling costs and tangible equipment deductions. As the investors of the energy opportunity partnerships will not have material participation in the partnership, they will be subject to passive activity limitations in relation to the income and deductions associated with the program investment activities, such as drilling and mid-stream or down-stream operations. In some cases, however, royalty revenues, interest payments on debt investments, and dividends from portfolio companies or projects structured as corporations may be treated as portfolio income as opposed to passive income. As is the case with non-traded MLP designed products, the tax consequences of UBTI will apply to operations-driven revenues for investors acquiring their interests with IRA or other forms of qualified money. As is also the case with MLP designed products, accumulated unused passive deductions from energy opportunity partnerships can be used to offset passive income from other passive investments.

The chart below compares the business objectives, load, fees and expenses of four retail partnership platforms that have adopted a diversified investment approach that focused upon income and growth from multiple types of oil/gas assets. The chart makes comparisons among certain the opportunity/acquisition-based programs sold to retail investors through private placements.

Table 2-Features of Energy Opportunity Programs

	US Energy Strategic IV	**Waveland Resource Partners III**	**APX Income Fund**	**Bradford Energy**
Business Objective	Cap ex allocated to production, infrastructure, royalties, and net profits interests	Primarily leasehold investments with value add opportunity, but with production being a potential secondary asset	Working interests in production and leaseholds with value add potential, with minerals and infrastructure being potential secondary assets	Royalties, working interests in production and leases with value add potential, infrastructure, and private equity/debt
Maximum Offering	$100 million	$75 million	$75 million	$100 million
Syndication Load	12%	11%	10-11%*	12%
Carried Interest (Investor/Sponsor Split)	95/5 to 33% cash on cash; 90/10 to 67% cash on cash; 85/15 to 100% cash on cash; 80/20 thereafter	90/10 to 100% cash on cash return; 75/25 thereafter	20% after 100% cash on cash return	18% after 100% cash on cash return
Acquisition Fee/ Sponsor Front-End Compensation	Estimated up to 5% of gross offering proceeds	5% of gross offering proceeds	10% fee applied to drilling cap ex.; 5% acquisition fee applied to leaseholds and other assets	1.5% applied to property-level costs
Deployable Capital After Load and Acquisition/Sponsor Costs	83% of gross proceeds**	84% of gross proceeds	83.5%-84% of gross proceeds*	86.68% of gross proceeds
Asset Management/ Administration Fee	75 basis points of gross capital	25 basis points of gross capital	100 basis points of gross capital	100 basis points of gross capital
Disposition Fee	None	None	None	None
Financing Fee	None	None	None	None

*Load between 10-11% depending upon offering and organizational costs, acquisition costs/front-end sponsor compensation also ranges from 5.4% to 6.5% depending upon capital allocations to properties and drilling
**Assumes 5% of gross capital used to pay acquisition-related costs

Energy 1031 Programs

A third acquisition-focused product structure in the syndicated energy program market offers opportunities for retail investors to acquire interests in oil and gas properties through like-kind exchange transactions, allowing the investors to sell real estate and acquire interests in the program assets on a tax-deferred basis.[14] In fact, a majority of the royalty programs offered

[14] *IRS Revenue Rulings* 55-526, 68-331, 73-428, and 88-71 (stating that interests in oil and gas leaseholds, royalties, and overriding royalties can qualify for like-kid exchange treatment).

within the non-traded retail sector has been §1031 programs. These programs are marketed to accredited investors through private placements conducted under Rule 506 of Regulation D.

While working interests in oil and gas leases and associated production can technically qualify for like-kind exchange treatment under IRC §1031 of the federal tax code, a substantial majority of the oil and gas assets acquired in these programs tend to be mineral interests, royalties, and overriding royalty interests (due to the fact that income producing assets are generally favored by the investors who participate in the offerings). As the underlying research and buying analytics involved in buying royalty assets tend to materially differ from those of a traditional up-stream drilling company, this segment of the retail energy channel has also been underserved. The most active energy sponsors in this product space in recent years are Resource Royalty, LLC, whose 1031 product platform was launched toward the end of 2014, Palo Royalties, LLC, whose operations began in 2011, and Noble Royalties, Inc., which syndicated several hundred million in non-traded retail investments from 1997 through 2014.

Acknowledging the Delaware Statutory Trust as the product structure of choice for 1031 real estate products, the tenant in common structure continues to prevail within the retail energy offerings that provide like kind exchange opportunities. Generally, the sponsor sets up an issuer entity structured as a limited liability company ("**Issuer LLC**") that will acquire the minerals, royalties, and/or overriding royalties from a seller and that will take title to the assets. The Issuer LLC eventually will transfers title to the retail investors of the 1031 program as money is raised. In many cases, the Issuer LLC will also reserve a right in the offering documents to conduct multiple closings during the offering period so the investors that want 1031 treatment can close on the investments at needed times to meet various IRS deadlines.

In terms of asset management, an affiliate of the program sponsor will fulfill the role of asset manager and will enter into an asset management agreement with each investor. As program manager, the sponsor affiliate performs accounting and administration functions on behalf of the investors and is paid an on-going management fee. Such on-going administrative services include: (i) execution of leases, development agreements, and division orders, (ii) collecting and accounting for production revenues paid by the oil and gas purchasers to the property holders, (iii) paying expenses relating to the interests, (iv) distributing revenues and accounting information to investors, and (v) preparing tax returns. Thus, while the nature of the investment is rather passive, investors are afforded the tax advantages associated with real estate as the program assets are titled directly to the investors. As the underlying investments are direct interests in real estate, investors will receive Form 1099s from the manager and will account for their pro rata share of the income and expenses on a Schedule C of the Form 1040. The subscription documents signed by investors contain special provisions that prohibit an investor from treating his/her investment as a partnership interest. Additionally, each investor must be given a right in the management agreement to terminate the sponsor's status as the manager and to assume the asset management duties if he or she so chooses.

As to program economics, 1031 energy programs don't have tiered/waterfall distribution provisions because they are direct title programs. This is because tiered or waterfall distribution provisions violate the income tax rules that determine whether a TIC is a partnership for tax purposes (as the sponsor's compensation cannot be profit based in a legal sense in a 1031 program).[15] Note, however, that the way to pass through some of the property economics and upside to the sponsor is to have the Issuer LLC buy 100% of the interests from the seller, but issue 95% of the interests to the investors (i.e., Issuer LLC retains 5% of the properties for its own account). The Issuer LLC charges 100% of the purchase price to investors, but conveys title to 95% of the assets (thus passing some of the economics to the sponsor without running afoul of the partnership rules that apply to 1031 TIC/direct title transactions so long as the purchase price is reasonable).

From a due diligence perspective, the investor group's acquisition price should be based in substantial part upon what a reasonable buyer would pay for the properties to achieve a return that is commensurate with the investment risks (i.e., fair market value). At the end of day, investors should have a reasonable chance to earn high single digit to mid teens return on a load adjusted basis under average economic conditions (i.e., with 8-15% IRRs being the better offerings after factoring load and sponsor compensation). To maintain reserves and cash flows, it is generally a good idea to have properties where future drilling is reasonably expected. Otherwise, distributions may fall quickly in a short amount of time. Other elements of the economic structure of these investments are explained below:

- **Marketing and Due Diligence Costs**: 8% of Gross Proceeds
- **Organization and Offering Costs**: 2-3% of Gross Proceeds
- **Managing Dealer Fee**: 2% of Gross Proceeds
- **Acquisition Fee**: 2-3% of Gross Proceeds (generally applies if the sponsor is buying assets from a third party and requires reimbursements for internal due diligence of the assets)
- **Purchase Price**: 85%-88% of Gross Proceeds
- **Annual Management Fee**: 75 bps to 100 bps of Gross Proceeds

Prior Experience of These Programs

While retail drilling programs have accounted for a significant amount of the investor capital raised within investment programs syndicated through broker-dealers and their representatives, note that a number of sponsors and platforms have succeeded that offered investment platforms falling directly or substantially within the three product types described in this article. Due to the current challenging market condition, one could reasonably expect that these types of programs will not only compete with syndicated drilling programs for market share but may also prevail in terms of market share in the upcoming years. Some of the more notable capital raising efforts from the **non** IDC/tax-advantaged side of the retail-syndicated energy program market are explained below:

---

[15] See *Culbertson v. Commissioner,* 337 U.S. 733 (1949) (citing profit sharing as one of many factors that tend to weigh in favor of a common law partnership.

- ***Atlas Growth Partners***: Non-traded MLP designed partnership raising over $150 million from retail investors through May 2015. Funds are expected to be used to develop a lease position in the Eagle Ford Shale play and to possibly take advantage of acquisition opportunities of producing leaseholds.

- ***Noble Royalties, Inc***: The sponsor's prior offerings included 70-plus direct title royalties programs raising roughly $900 million from 1997-2014.

- ***Waveland Resource Partners Program Platform***: The sponsor's lease bank programs include 12 partnerships raising approximately $130 million from 2003 to present date. In 2014, the lease bank platform transitioned from focusing almost exclusively on undeveloped leaseholds to a more diversified energy opportunity platform that can acquire undeveloped leases, producing leases, and equity interests in privately-owned oil and gas companies.

- ***U.S. Energy Strategic Income Platform***: U.S. Energy's Strategic Income Platform raised in excess of $100 million within four partnerships offered from 2010 through the current date. Proceeds from the offerings were used to acquire undeveloped leases, producing leases, royalties, pipelines, and water disposal wells.

- ***Bradford Energy Capital, LLC***: The energy opportunity partnerships syndicated by affiliates of Bradford Energy Capital, LLC raised $26 million of capital within seven retail partnerships offered at various times from 1996 to 2009. The partnerships acquired mineral interests, pipelines, and gathering systems that continue to be in operation today.

Due Diligence – Is the Program Positioned for Results?

While this article is intended to address future product opportunities, we would be remiss not to mention the importance of performing thorough due diligence when considering the various product opportunities mentioned herein. The due diligence requirement that is imposed upon broker-dealers and their representatives is explained in greater detail in FINRA's Regulatory Notice 10-22 and also in Regulatory Notice 03-71. Short of providing a complete discussion of all guidelines set forth in the notices, some areas of due diligence that we would highlight in relation to the previously mentioned non-traded investments would include the following points:

1. **Asset quality**: *Just because a program sponsor tells you that its investment strategy is an opportunistic one doesn't always make it so*. Targeted assets of the program must generally present ample opportunity to capture upside from price escalation and hydrocarbon reserve development. Conversely, assets with limited growth potential may present challenges down the road from a return perspective.

2. **One must analyze sponsor pro forma returns with conservativism,** and one must not count on a quick return to better oil and natural gas prices in his analysis. Multiple return scenarios including NYMEX should be considered. Heavy reliance upon a return to pre-2015 oil pricing in a short period of time could potentially spell trouble down the road.

3. **Alignment of interests**: How is the sponsor paid? While program managers must be reasonably paid to manage the administration of assets, *a significant part of the sponsor's compensation should be based upon production-based cash flows*. If non-owners are making key investment process decisions, it would also be reasonable to ask how these key personnel are being compensated if the assets of the fund perform well. *Incentivized employees tend to perform better.*

4. **Performance/experience.** *Is the sponsor a "Johnny come lately" that thought it would be a great idea to syndicate an energy opportunity fund in a down market, or does the sponsor actually have personnel that have managed multiple opportunity/acquisition programs like the one being syndicated?* While it's hard to be perfect in the oil and gas industry, you will want to look for patterns of success in prior projects. One might also consider the experience of the sponsor's management in managing oil and gas properties in down economic cycles.

5. **Defined investment process.** Can the sponsor articulate an established process that it has used to source and evaluate oil and gas acquisitions in the past? Does the process require involvement not only from technical experts but also from people within other business disciplines with experiencing in managing business risks (e.g., accountants and legal advisors)? *Better risk management occurs when competent people from multiple disciplines of the oil and gas business are involved in the acquisition process*.

6. **Commitment to accountability.** *The sponsor's overall commitment to the retail investors can be observed in the way it has established accountability within the program's organizational documents*. Are the investors required to receive at least reviewed financials on an annual basis? Will investors receive also receive interim unaudited program financials on a regular basis (i.e., quarterly or semi-annually). Does the program give the investors as a group a practical right to remove the manager if problems should occur down the road?

7. **Ability to get in the better deal.** While this characteristic is not always the easiest to measure, it can have a bearing on the quality of assets the fund procures. Project developers tend prefer to work with reputable sponsors that have shown an ability to access investor capital in the past. Project developers also prefer to work with sponsors that have an ability to provide meaningful input on asset operational matters. *In relation to deal flow access, long-term symbiotic relations between a sponsor and proven operators/finders tend to result in better levels of performance for programs***.**

Conclusion

Historically, non-traded energy program investments have accounted for $700-$800 million in retail investor sales over the past several years, with the largest segment of the capital being raised from companies that sponsor non-traded drilling programs through private placements**.** While lower oil prices present challenges to drillers, business should continue as usual for certain drilling sponsors that can make their projects work at lower price thresholds. Against the backdrop of lower oil and gas prices, however, one can also expect the acquisition/opportunity focused programs to assume a greater share of the non-traded retail energy product market in 2015 and future years.

While the oil and gas industry has been more resilient that what we have expected to date, the bull-pen is warming with companies eyeing future opportunities. Time will soon tell whether the newer breed of programs will make the impact we expect.