# THE STRUCTURE OF THE DRILLING PROGRAM—AN OVERVIEW

E. R. R. CARRUTHERS*

*New tax incentives in Canada have given rise to the development of drilling funds as a financing vehicle for oil and gas exploration and development. This paper overviews the key features of such funds, examining the form and type of such agreements, and marketing and securities regulation. The author analyzes and compares several recent Canadian and American drilling fund offerings.*

## I. INTRODUCTION

> With the exception of a few large, highly successful independents with huge cash flows, all oil producers have a recurring need for external capital.[1]

To those of us engaged on a day-to-day basis in the various aspects of the oil industry, this statement is self-evident. Our industry is heavily capital intensive and the search for money occupies as much of our efforts as the search for oil.

Faced with the need to continually replace reserves that are being produced and sold, the risks of exploration are such that these reserves cannot be replaced using only cash flow generated from production operations. Furthermore, only a portion of costs incurred in drilling and producing are fully deductible in the year in which they are incurred; in order to achieve full deferral of taxable income and therefore maximum dollar usage, in the search for new reserves the producer must spend more money than he receives.

By attracting capital from outside investors, the oil explorer is able to expand his operations more quickly than he would if he was relying solely on internally generated capital. He is also able to spread his risk by participating in more wells.

Historically, outside capital has been attracted from the United States, where individuals have been able to expense intangible drilling costs, for both domestic and foreign exploration, for many years.

More recently, the Federal Republic of Germany has enacted laws which enable that country's investors to depreciate the costs of exploring for oil and gas, both domestically and in foreign lands, claiming these costs against income from other sources.

The risks of exploration for oil and gas are such that it is not economically justifiable for a non-principal business company to explore with after-tax dollars. After years of deploring the foreign capital infusions, the Government of Canada began to consider the desirability of allowing a tax incentive for Canadians in respect of amounts incurred for exploration and development expenditures in Canada. The first tentative steps in 1971 and 1974 produced little interest on the part of Canadians since the deductible amounts (twenty percent and then thirty percent) were not sufficient incentive. However, with the 1976 budget proposing full deductibility for Canadian Exploration Expenses, the rush was on. The fall of 1976 found several programs being marketed, even though the enabling legislation was not passed until well into 1977.

---

* Barrister and Solicitor, Blain, Carruthers, Starr, Calgary, Alberta.

1. Thomas, *The Exploration Drilling Program* 9 (1969, Tax Shelter Newsletter, Inc.).

Shortly stated, under current legislation, a taxpayer may deduct from his income, regardless of source, amounts incurred by him in the exploration for and development of petroleum and natural gas. These expenditures will normally constitute either Canadian Exploration Expenses (CEE) or Canadian Development Expenses (CDE).

Canadian Exploration Expenses are those expenses incurred in exploring for petroleum and natural gas when a well is dry and abandoned, if a well completed within six months from the end of a taxpayer's taxation year is the first well capable of production in commercial quantities from a pool not previously known to exist, or if it is reasonable to expect that the well will not go on production in commercial quantities within a year of its completion.

Canadian Development Expenses are those expenses incurred in exploring for petroleum and natural gas which are not Canadian Exploration Expenses, and land acquisition costs.

Both CEE and CDE are accrued in a pool which may be written off against income in Canada from any source, or, if the taxpayer has no income in Canada, the total of the said expenses may be carried forward indefinitely. CEE incurred between May 25, 1976 and June 30, 1979 are deductible at the rate of 100% of the amount of the pool at the end of a year; CDE are deductible at a rate of 30% per year of the amount of the pool at the end of the year on a straight line declining balance basis.

There are other tax considerations (such as capital cost allowance, earned depletion allowance, taxation of Crown royalties, resource allowance and provincial tax credits) which will bear upon the return to the investor. However, these items will be dealt with in other papers. Because of the "ability to pay" concept of progressive taxation, these incentives are proportionately more valuable to the high bracket taxpayer than to lower bracket taxpayers.

With the incentive available to investors and the need of the oil producer for funds, an obvious area of co-operation is demonstrated. In return for a source of funds, the oil producer provides a vehicle which enables the investor to utilize the available tax savings and to take advantage of the expertise and knowledge of the operator, along with his land and prospect inventory.

The advantage to the operator, other than the funds, is that it allows him to spread his risk, both by drilling more wells and by transferring some of the risk from himself to his investors. The operator, additionally, may derive some revenue from the promotional aspects of the program. However, this additional revenue will probably not cover the increased administration costs inherent in operating a program.

The investor has the opportunity to make an investment using the skill and expertise of the operator and, by joining together with other investors, to spread his risk by taking a smaller percentage of a greater number of wells.

In analyzing the various programs, this paper will point out the variables in program design and provide a short discussion of some of the concepts and principles involved.

Much of this work has been done in the excellent books by Mr. Truman E. Anderson, Jr., *Oil Program Investments*[2] and by Thad W. Thomas, *The*

2. Anderson, *Oil Program Investments* (1972).

*Exploration Drilling Program.*[3] Both of these works contain definitive investment analyses of several programs. The various Institutes of the Southwestern Legal Foundation also contain many excellent articles on the subject.

In analyzing or designing a drilling program there are three primary criteria:

(1) maximum tax advantage to a prospective high tax bracket investor;

(2) a vehicle offering the advantages of a corporation in the non-tax area, without the disadvantage of corporate taxation; and

(3) an operator capable of managing the investment.

Attached as Appendix A is a brief analysis of several different offerings which have been brought to market, both in Canada and in the United States, in recent years. A cross-section of offerings typical of those we can expect to see in Canada and the United States has been selected. The exception to this is the RANGECO offering, which will be a vehicle unique to Canada due to the particular provisions of section 66.3 of The Income Tax Act.

In order to draft the required and proper documents, "the attorney must have a clear understanding of the role that the investor plays in the oil and gas drilling program, what the program operator expects to gain from permitting the investor to participate and what the investor should be entitled to receive in return".[4]

These agreements and documents will comprise an operating agreement between the fund vehicle and the operator, the agreement (either joint venture or limited partnership) constituting the venture itself, a form of offering memorandum or prospectus outlining the program as contained in the two agreements, and dealer or other agreements with the marketing agencies.

The variables within the program break down as follows:

(a) management company organization
   (i) oil investment manager
   (ii) independent oil company
   (iii) subsidiary of independent oil company
(b) program organization
   (i) outside consultants
   (ii) inside staff
(c management fees
(d) sharing arrangements
(e) exploration philosophy
(f) area of operations
(g) amount, structure and timing of tax shelter
(h) liquidity
(i) additional assessability
(j) management
(k) size of program

3. Thomas, *supra*, n. 1.

4. Mosburg, *Mechanics of Registered and Unregistered Programs"* (1967) *18th Annual Institute on Oil and Gas Law and Taxation* 98.

(l) minimum investment

(m) term of investment.

Thad Thomas[5] analyzes funds on the basis of:

(1) risk;

(2) liquidity;

(3) diversification;

(4) assessability;

(5) liability;

(6) tax benefits.

To a degree, the type of program will be guided by the operator. For example, an investor may make a decision to participate in any program simply on the basis of the reputation of the operator. The form of program may be of little concern to him.

The single property program or well by well program (often referred to as a "Specified Fund"), is typified by the Alberta Gas Fund and PetroCan offerings. In these programs there is generally a higher percentage to the investor if a well is successful; but there is a corresponding greater risk since there is no spreading of risks over a number of wells. There is less administration for the operator. However, the operator is usually required to make a commitment prior to the time that his funding is assured. The timing delay may prevent him putting together an attractive package of prospects because of his inability to commit. Alternatively, the operator must have sufficient funds of his own that he can carry through with his commitments even if his funding program does not materialize.

The diversified program or package comprises several wells, none of which are specified in the offering. RANGECO, Ranchmen's and the U.S. programs are examples of this type. These programs will increase the risk-spreading for the investor. The investor usually will have the opportunity to participate in development drilling. Since the operator has better control over his participation, there is generally a lower percentage overhead, calculated as a percentage of the total fund. Most of these programs provide that the operator makes the selection of prospects. The programs with limited numbers of investors will often provide that the investor reviews prospects; but where there are a substantial number of investors, they must rely on the operator to review or appoint an agent. From the investor's point of view, tremendous power is placed in the hands of the operator, raising the question, "Does this operator have sufficient wisdom and integrity to wisely spend my money and give me a 'good run' for my dollars?"

The problem can be overcome to some degree by limiting the program to an area, for example Pre-Cambrian prospects in Northeastern Saskatchewan. However, the potential for conflict of interest in the operator must be carefully scrutinized.

## *II. VARIABLES IN A PROGRAM*

The program will have a number of variables to consider:

### *1. Management Company Organization*

The management company will be one of two types. It may be a "money manager" that is, a manager with expertise to locate independent

5. Thomas, *supra*, n. 1 at 156.

oil companies which in the opinion of the manager generate drillable prospects, to analyze these prospects, and to invest on behalf of the participants. Alternatively, it may be an independent oil company which will develop its own program to sell to investors. Anderson sets out what he considers to be the major advantages and disadvantages in the independent oil company approach and, in accordance with his declared bias, the advantages in the oil investment manager approach.[6]

*Independent Oil Company*

*Advantages:*

1. Closer control
2. Expertise of oil companies in their area of exploration and development
3. No middle-man taking additional compensation

*Disadvantages:*

1. Limited diversification
2. Greater potential for conflict of interest
3. Inability to invest large amounts of money
4. A tendency to use oil finders to a significant extent anyway.

*Oil Investment Manager*

*Advantages:*

1. Broad diversification
2. Flexibility
3. Ease in administration
4. A strong emphasis on performance
5. Capacity for the intelligent use of large amounts of money
6. Lack of conflict of interest.

*2. Program Organization*

The form of vehicle used for a drilling program will be either a corporation, a joint venture or partnership, general or limited. The corporate form is normally not attractive since the tax benefits earned by the drilling belong to the corporation and are therefore not available to the shareholders or investors to reduce their personal taxes. However, section 66.3 of The Income Tax Act provides a method whereby expenditures may be passed through from a company to its shareholders. The RANGECO program is an example of this. Non-deductible expenditures are represented by an investment in common shares of the company and the balance in a resource receipt. As expenditures are incurred, it is determined whether they constitute CEE or CDE, and the amounts are allocated to the investors. A separate class of shares is then issued, representing the amount of the eligible expenditures to be contributed to the respective CEE and CDE pools of the shareholders. This special class of shares constitutes inventory in the hands of the shareholders and a disposition thereof will result in income in their hands. The common shares are capital property, so any gain realized on their sale is a capital gain and taxed accordingly.

The joint venture form continues to be utilized by oil operators, but is not an attractive investor vehicle. In a joint venture, each venturer

6. Anderson, *supra*, n. 2 at 18-27.

assumes his pro rata portion of the working interest to be earned or acquired and agrees to assume a share of drilling costs, which may or may not be pro rata to his working interest. The venturer, however, is participating on a "heads up" basis and has no limitation on his liability in the event of a cost overrun, blowout or similar disaster. None of the programs which are outlined in Schedule A contemplate the use of a joint venture. However, one of the writer's clients has a very substantial individual investor participating with him on a joint venture basis.

A general partnership suffers the same defect as a joint venture in that there is no limitation of the liability of the partners. As a result, this form of program is not used.

The most popular form of program is a limited partnership. The Partnership Act, R.S.A. 1970, c. 271, Part 2, contemplates the formation and registration of a limited partnership whereby one or more of the partners are designated as general partners and the other partners, normally the investors, are designated as limited partners. The general partner may be an individual or a corporation. The general partner has all rights of management of the business and affairs of the partnership (section 55), whereas the position of the limited partner is analogous to a shareholder in a limited company. The limited partner has no rights of management and in fact may become a general partner if he takes part in the control of the business of the partnership (section 63). Unlike the general partner, the limited partner is liable only for the amount which he has contributed or agreed to contribute to the partnership (section 56).

*3. Management Fees*

The amount of management fees is variable, as is evident from a comparison of the funds in Appendix A. The balance is between a reasonable and fair fee for the services, knowledge and expertise of the operator and "an unjust or undue enrichment of the operator at the expense of persons who are not too knowledgeable."[7]

*4. Sharing Arrangement*

The manager's compensation will be derived, in large part, from the sharing arrangement. These arrangements will vary, as can be noted in Appendix A and Appendix B. The balance is between compensating the program manager for his services in formulating and marketing the program and his expertise in the industry, and the investor's concern that an operator can get rich drilling dry holes. In the writer's view, the balance is best struck by allowing the manager or operator to recover his reasonable offering expenses off the top, with a ten to fifteen percent limitation, being reimbursed for administrative costs and having a reversionary interest at payout.

*5. Exploration Philosophies*

This will have a bearing on risk. A program such as TBR Resources is nothing more than the acquisition of an income stream with a tax advantage. The risk is small, but correspondingly, the program has no chance of returning to the investor anything more than a rate of return on his invested capital. An exploratory program, while carrying with it higher risk, has glamour associated with it in that the investor may strike a bonanza. Most of the programs would indicate a balanced form of development with less than half of the funds directed to exploration. This

7. Mosburg, *supra*, n. 4 at 97.

format should permit an investor to take advantage of discoveries which are made by the fund, by being in a position to drill development wells.

*6. Areas of Operation*

This will bear upon the exploration philosophy. Obviously, there are high risk and low risk areas. Generally, the rate of return is commensurate with each. The risk is usually balanced by opportunity.

An oil company may have particular expertise in a particular area in which event the risks of operating in that area may be lessened.

*7. Amount of Tax Shelter*

This will vary in accordance with the amount of acreage acquisition, exploratory and development drilling conducted. In the case of the TBR Fund the amount of tax shelter available in the first year is in excess of 100% of the invested capital. The amount of tax shelter is very attractive due to the leveraged nature of the investment. The types of leverage is generally not available for exploratory or development drilling programs due to the risk involved; this must be balanced with the opportunity of striking a major discovery. Timing is a factor as well. It will be noted that in the Ranchmen's preliminary prospectus, the whole subscription price was to be payable immediately. In fact, by the December 21, 1976 amendment, large subscribers to the limited partnership were given the opportunity to pay their subscriptions by instalments in order to time the payments more closely to the write-offs. The Worldwide Fund contains this feature as well.

*8. Liquidity*

This is an obvious difficulty with most funds. Interests in oil and gas, especially very small interests, are not readily marketable. Accordingly, it is extremely difficult for an investor to realize on this investment. Several funds, such as Wainco B, Tideways and Worldwide, provide that the general partner will acquire a certain amount of funds in each year. This does give the investor an opportunity to "escape", although normally at a substantial discount from market.

The programs themselves also develop cash flow problems in that the funds are often received in a lump and must be spent prior to year end. The Worldwide and Tideways funds endeavour to overcome this by providing for a three year investor commitment with payment instalments to be made quarterly.

*9. Additional Assessability*

Some funds, such as Worldwide and Wainco B, provide for an additional assessment of limited partners on a mandatory basis, in the event the porgram requires further funds for development drilling. This feature means that the investor must have regard to the full amount of the initial capital contribution plus assessment, since failure to contribute to an additional assessment will result in a penalty. The lack of assessment may mean that an investor is not able to participate fully in the fruits of his discovery. "The investor must become accustomed to the idea that a successful test well does not mean he is rich, but rather that he must find the capital to develop his potential well or else give up the potential to others, on farmout or otherwise, who will provide the capital."[8]

---

8. Dauber, *Oil and Gas for the Passive Investor—Tax and Business Considerations* (1974) *25th Annual Institute on Oil and Gas Law and Taxation* 483.

*10. Management*

This is the most important aspect. No drilling fund, no matter how well constructed or designed, will be successful unless oil and gas is found. Likewise, an extremely heavily loaded fund may prove to be a bonanza if great success in drilling is encountered. The reputation of the operator is a substantial component of the funds.

The operator must be able to market the oil and gas found and have the ability to get cash flows moving quickly. The operator will want to address his mind to pipelines and plants, to determine whether or not the fund will participate in the construction of those facilities or whether the operator will construct them and charge the fund on a cost of service basis. In many cases, the fund will not be able to provide its share of these facilities, and the operator will not want to be frustrated in future development by having to carry a partner that he did not intend to carry. The fund, on the other hand, may want to take advantage of the revenue which may be generated by these facilities or the accelerated write-offs that are available for gas plants.

*11. Size of Program*

In the 23rd Oil & Gas Institute, Robert F. Greenhill commented upon the formation of an exploration fund by a major oil company, the Conoco Exploration Fund. The article is abstracted as Appendix C. It is noted that in that fund, the managers determined that $25 million was the optimum amount that could be effectively managed by Conoco's staff and had the lowest percentage overhead cost. If the program is too large in relation to the staff of the operator, he cannot possibly spend the money intelligently.

*12. Minimum Investment*

Minimum investment must be considered in the same context as size of fund since a very small fund results in a disproportionate overhead amount, and it may not give an opportunity for sufficient spreading of risks by the operator.

*13. Conflict of Interest*

Many areas of potential conflict of interest arise.

For example, in the Ranchmen's offering, Ranchmen's is the general partner of the limited partnership and is acquiring an interest in Bluemount's lands by purchase and farm-in. Bluemount is controlled by and is to be amalgamated into Ranchmen's. Thus, in effect, Ranchmen's as general partner is buying into and farming into its own properties. This creates a conflict of interest, which is not clearly set out in the preliminary prospectus. In fact, there is no heading "Conflict of Interest" in the preliminary prospectus. This defect is remedied in the final prospectus with a disclosure of the areas of potential conflict.

An operator must balance between conveying a drilling island in the middle of his acreage spread to the fund, thus giving the investor no opportunity to participate in development, and creating an unrealistically large area of interest which the fund will have no opportunity to develop due to lack of funds. There is no adequate way to deal effectively with this problem save that an operator's integrity will be stretched to the extreme. If the industry is to survive, he will have to err on the side of his investors.

### *14. Miscellaneous*

#### *(a) Recognition of Investors' Titles*

One of the overriding concerns of an investor in a partnership is that he will not be able to have his title interests recognized. Interests in fee leases may be not recordable due to section 55 of the Land Titles Act, R.S.A. 1970, c. 198, which prohibits registration of a charge or encumbrance on an interest in minerals which is less than an undivided one-twentieth of the whole. Likewise, interests in Crown leases may not be recordable due to section 176(2)(b) of the Mines and Minerals Act, R.S.A. 1970, c. 238.

The investor's interest in an unrecorded lease is personal property and subject to defeat by a *bona fide* purchaser for value without notice. The practice of oil companies in the writer's experience is that the business is conducted on a very personal basis; there is great reluctance to recognize the "et als" who may be in fact financing the operators. The operator must be extremely careful to ensure that his conveyance of an interest to his investors subsequent to earning will not create rights of first refusal in his industry partners.

#### *(b) Marketing Arrangements*

Some agreements carry an obligation on the operator to market on behalf of the fund. In these cases, a marketing fee is charged. The operator will want to maintain a lien on production in order to ensure that payments are made when due. Since the funds do face a liquidity crisis, the operator will want to examine these provisions carefully.

#### *(c) Drilling Incentive Credits*

Drilling incentive credits have created some problem since it is not always possible for funds to utilize all the credits which accumulate to them. Provision should be made for the operator to be allocated these credits or to acquire them by borrowing or buying.

#### *(d) Disposition of Interests*

The operator will want to be very careful in considering the disposition of interests provision. Obviously, he will want a right of first refusal on the fund assets in the event of sale. However, provisions might be added giving the operator the option to acquire the fund assets in the event that it defaults on a bank loan or has some other unforeseen financial catastrophe.

The agreement between the fund and the operator will not vary significantly from participating and operating agreements between oil companies. However, since the oil company is operating with a non-industry partner, special attention must be given to certain aspects. If the drilling partnership is a foreign partnership, then particular care must be taken to ensure that the participant remains in the role of the passive investor in order to minimize the likelihood of its being reviewable under the Foreign Investment Review Act, Stat. Can. 1973-74, c. 46. In this regard, the challenge to the operator provision should be deleted from the operating agreement in order to ensure that the participant will not become a controller. This creates a further conflict of interest which must be mentioned in the disclosure document.

#### *(e) Registration of Program*

The Securities Act, R.S.A. 1970, c. 333, contains a very broad definition

of "security". There is little doubt that an undivided interest in oil and gas properties, including royalties, or an undivided interest in a fund to be used for the acquisition and development of oil and gas properties, is a security within the ambit of that Act.

Therefore, when any sale of interests in the drilling fund is contemplated, it is necessary to refer to section 6, which deals with registration of persons trading in securities, and to section 35, which provides that no person or company shall trade in securities where such trade would be in the course of distribution to the public of such security until a preliminary prospectus and a prospectus have been filed and a receipt issued.

The question of what constitutes distribution to the public has not received extensive judicial scrutiny in Canada. However, on the basis of *Regina* v. *Piepgrass* (1959) 29 W.W.R. 218 (Alta. A.D.) it seems that the courts will give a broad interpretation to that phrase. In the United States, a "need to know" test is employed in considering the phrase; but this test does not appear to have been adopted by Canadian courts.

In endeavouring to sell drilling fund interests, it would appear that there are three possible courses of action to avoid a prosecution under The Securities Act. The first is to fit the trade within one of the specific exemptions provided by section 58 of the Act. The second is to apply for a ruling under section 59 that the trade be deemed not to be in the course of a distribution to the public or an order under section 20 that sections 6 and 35 do not apply to the trade. The third is to meet the prospectus requirements of section 35 and the registration requirements of section 6. The application for exemption under sections 59 or 20 may be used to obtain an exemption from sections 6 and 35.

An employee of the Alberta Securities Commission who is involved with drilling funds has advised that the Securities Commission takes the position that applications under sections 59 or 20 for exemption from prospectus requirements are available only when there is a proposed trade of interests having a substantial monetary value to a small number of persons or companies. The Commission informally has regard to the "need to know" test in its deliberations.

The employee also commented that the Securities Commission does not look as favourably upon what are often referred to as "blank cheque offerings" as offerings where there are specific properties involved. Discussions with the Alberta Securities Commission indicate that the Commission is debating that point at the time of writing, and has yet to formulate a firm policy as to whether or not this type of offering will be allowed to go forward.

Having regard to the nature of a drilling program and the oil industry and to the statements of the learned authors referred to above, if the Alberta Securities Commission were to insist on the presentation of specific lands and prospects in drilling funds, it would be a giant step backward for the infant industry.

The Securities Commission has examined the guidelines for the registration of oil and gas programs adopted by the North American Securities Administrators Association on September 22, 1976 (which are an update from the guidelines adopted on October 7, 1971), and is using them pending development of their own guidelines. These guidelines refer to the maximum levels of compensation of the manager, carried interests,

reversionary rights and the other economic aspects of the programs required by the Association in order for a fund program to be supported by the North American Securities dealers.

In attempting to draw an offering document for a drilling program, the lawyer will quickly recognize that the forms in the Securities Act are not really appropriate to such filing, especially with regard to the financial information. This problem was faced by the Securities and Exchange Commission in the issue of Release No. 5036 on January 19, 1970. This created guideline No. 55, being a guide for the preparation of prospectuses related to interests in oil and gas programs.

The guide was intended to accomplish, to the extent feasible, uniformity in both the sequence of disclosures and their general content. The items are as follows:

1. Summary of Program
   (a) Terms of the Offering
   (b) Compensation to the Manager
   (c) Participation in Costs and Revenues
   (d) Application of Proceeds
2. Risk Factor
3. Definitions
4. Term of the Offering
5. Additional Assessments
6. Plan of Distribution
7. Proposed Activities
8. Application of Proceeds
9. Participation in Costs and Revenues
10. Compensation
11. Management
12. Conflicts of Interests
13. Prior Activities
14. Tax Aspects
15. Those Items Required for Full and Complete Disclosure such as Competition, Limited Partner Agreement Summary, Agent Agreement Summary, Exploration Agreement Summary, Operating Agreement Summary and so on.

## *APPENDIX A*

1.1 *Name of Program*
RANGECO OIL & GAS LTD.

1.2 *Year of Issue and Market*
Canadian market, 1977.

1.3 *Amount of Program and Minimum Subscription*
Twenty million dollars, being 4,000 units at $5,000.00 each. Minimum subscription is 2,000 units or ten million dollars. Each unit consists of 100 common shares at $3.50 per share plus a $4,650.00 natural resource receipt.

1.4 *Type of Program*
Farm-out basis. Ranger will be taking new farm-outs and assigning a 75% interest therein to a trustee, who in turn will assign to RANGECO

reserving an overriding royalty. Ranger's existing acreage, together with a six mile corridor surrounding same (the "Ranger territories"), are excepted from the program.

A balanced fund. Monies to be spent as follows:

7% expenses (represented by common shares);
47% Canadian Exploration Expense;
23% Canadian Development Expense;
23% Canadian Development Expense (represented by royalty certificates).

Canadian Exploration Expense and that portion of Canadian Development Expense not represented by royalty certificates will be converted to Class A shares of RANGECO on the basis of 1 share for each $10.00 of expenditure.

1.5 *Compensation to Manager*

Compensation to Ranger Oil (Canada) Ltd., the operator of the program, is as follows:

(1) a 25% carried interest in the properties, carried to commercial production, expenditure of proceeds or June 30, 1979, whichever occurs first;
(2) administration fee of $250,000.00 per year to a cumulative amount of $625,000.00;
(3) administration fee of $50,000.00 administration costs.

These expenses represent an additional 7.5% on minimum subscription or 3.75% on full subscription and are in addition to the 7% paid to RANGECO for expenses.

All incentives (i.e. Alberta incentives) are for the account of RANGECO.

After the expenditures of the proceeds of the offering, Ranger will charge a fee of $185,000.00 per year to administer the properties.

1.6 *General Information*

The units are being offered on a best efforts basis by MacLeod, Young, Weir. The expenses of the offering are to be assumed by RANGECO, out of the proceeds realized for the sale of its common shares, and are estimated to be between $600,000.00 and $1,050,000.00.

Presumably, the trustee, Canada Trust, is going to charge fees, but no indication of these fees is given.

The management fees of Ranger will be classified as CEE or CDE, depending on the program.

The issue of shares is designed to assist marketability. Presumably, after the program has expended all the funds, some time after June 30, 1979, Ranger would offer to take out the RANGECO shareholders for Ranger stock and wind up RANGECO.

Ranger has endeavoured to limit conflicts of interest by agreeing not to explore for oil and gas while the proceeds of this offering are being expended except within the Ranger territories.

No specific information is given in respect to the attributes of a Class A share, except that a statement is made that no dividends may be paid on the common shares until the Class A shareholders received $10.00 per share in dividends.

By way of general comment, this is an unusual, and in many respects

attractive, form of vehicle: it combines some of the more attractive features of a corporation with the ability to flow through the eligible CEE and CDE into the hands of the shareholders. The company could, after expenditure of the initial funds, operate as an ordinary oil and gas company or be acquired by Ranger and wound up into it. Future financing for development would be done by the Corporation on a normal corporate basis.

The substantial "front-end" carry for Ranger makes it less attractive as an investment.

2.1 *Name of Program*
WORLDWIDE ENERGY FUNDS LTD.

2.2 *Year of Issue and Market*
1971 offering of limited partnership interests in the U.S. market.

2.3 *Amount of Program and Minimum Subscription*
Three million dollars, 600 units of $5,000.00 each, payable in twelve quarterly installments of $1,250.00 each. Subscription provides for a three unit minimum, payable over three years, with the proceeds being contributed to twelve different limited partnerships.

2.4 *Type of Program*
A balanced program, consisting of 40% exploration, 30% development and 30% acquisition, independent oil company managed, using own staff to develop a diversified program.

2.5 *Compensation to Manager*
The general partner, a subsidiary of the operator, receives:

(1) a 10% non-recurring management fee, based on subscribed amounts;
(2) a daily per well drilling fee of between $50.00 and $150.00, depending on the area;
(3) a monthly operating fee of between $100.00 and $400.00, depending on the area;
(4) reimbursement of expenditures, including pro rata amounts of its own staff costs;
(5) a disproportionate allocation of costs and revenues.

Limited partners bear 100% of intangibles, 20% of tangibles (capital), 100% of acquisition costs. The general partner bears excess over 20% of tangibles.

Revenue is shared 70% to the limited partners, 30% to the general partner, except for revenue from producing properties, which goes 100% to the limited partners until payout, then 70%-30%.

Costs of the offering are borne by the general partner.

2.6 *General Information*
Costs of the offering are not disclosed, since the general partner bears them. The program was registered with the Securities and Exchange Commission.

The program is also interesting because of the attempt to overcome the development fund/internal liquidity problem by obtaining a commitment of the investor over three years. This three-year commitment would serve to allow the operator to make longer term planning decisions, develop plays over a longer period of time and also commit development funds in the event of early exploration successes.

The fund does not provide for additional assessments.

3.1 *Name of Program*
TIDEWAY OIL & GAS PROGRAMS

3.2 *Year of Issue and Market*
1974 offering to the U.S. market.

3.3 *Amount of Program and Minimum Subscription*
Fifteen million dollars, being composed of 3,000 units of $5,000.00 limited partnership interests. Forming a series of limited partnerships of $250,000.00 each, minimum and $5,000,000.00 each, maximum.

3.4 *Type of Program*
A balanced program comprised of 60% exploration and 40% development. A diversified program using staff and outsiders to develop prospects. Primarily will take farm-outs.

3.5 *Compensation to Manager*
(1) 8% commission to broker/dealers
(2) 12.5% management fee, non-recurring;
(3) 2.5% administrative fee, to cover reporting, etc., cumulative on total subscriptions;
(4) disproportionate sharing ratios.

General partner bears 100% of tangible costs; limited partners bear 100% of intangible costs. Revenues and operating costs, are share 60% as to limited partners and 40% as to general partners.

3.6 *General Information*
Costs of offering borne by general partner, amount not stated. No additional assessments.

4.1 *Name of Program*
WAINOCO 76B COMPANY

4.2 *Year of Issue and Market*
1976 offering to the U.S. market.

4.3 *Amount of Program and Minimum Subscription*
Three million five hundred thousand dollars, being 350 units at $10,000.00 each. Minimum subscription of $1,000,000.00 limited partnership interests.

4.4 *Type of Program*
A balanced program:

| | |
|---|---|
| Exploration | 45% |
| Development | 30% |
| Acquisition of leases | 10% |
| Completions | 10% |
| General and administrative | 5% |

A diversified program. Will use own staff and independent consultants to develop prospects.

4.5 *Compensation to Manager*
(1) reimbursement of organizational expenses, not to exceed 8%;
(2) per diem well drilling fee of $50.00 to $125.00;
(3) monthly well operating fee of $100.00 to $400.00;
(4) will borrow from a bank to pay sales commissions, 7% to N.A.S.D. members. Bank repaid 99% by limited partners, 1% by general partner;
(5) reimbursement of overhead expenses, estimated to be $50,000.00;
(6) disproportionate sharing ratios, general partner pays 100% of tangibles and 1% of intangibles (to a minimum of 15% of total

contributions); limited partners pay 99% of intangibles. Revenues and operating costs shared 60% by limited partners, 40% by general partner.

4.6 *General Information*

Costs of offering borne by general partner, amount not disclosed, but provision made to 8% or a maximum of $280,000.00 minimum of $80,000.00.

This program calls for additional assessments, if needed for development, of up to 10% of the agreed contribution of the investor.

It should be noted in connection with the American funds that the intangible/tangible sharing ratios are based upon the peculiarity of U.S. tax which allows the investor to deduct intangible drilling costs. Therefore, within the partnership, intangible drilling costs are allocated, generally, to the investor, since these may be written off in the year they are incurred. In contrast, tangible costs must be capitalized and written off through depreciation or over their useful life. These allocations would probably not be applicable to a Canadian fund since those items which must be capitalized would normally be subject to capital cost allowance at a 30% rate, making them equivalent to incurring CDE.

5.1 *Name of Program*

ALBERTA GAS FUND #1

5.2 *Year of Issue and Market*

1976 offering to the Canadian market.

5.3 *Amount of Program and Minimum Subscription*

Four hundred thousand dollars being 16 units of $25,000.00 each, 11 units or a $250,000.00 minimum, limited partnership interest.

5.4 *Type of Program*

Specific prospect. Oriented to development drilling (close in step outs from established production).

5.5 *Compensation to Manager*

The general partner bears 35% of tangibles on initial wells, 35% of operating costs, 100% of costs of formation of the partnership. The limited partner bears 100% of intangible drilling costs, 65% of tangible drilling costs, 65% of operating costs and 7.5% of expenditures, including overall expenditures, as overhead costs.

Revenue is shared general partner 35% and limited partner 65%.

The general partner will also act as operator and get compensated for these services, but no amounts are specified.

5.6 *General Information*

This program was marketed under an exemption obtained from the Alberta Securities Commission. It is understood that it was put together by a land man and a geologist. A brokerage house handled it on a best efforts basis, but was not successful in selling it. However, the principals sold the fund themselves and made at least minimum subscription. It is not known how many were sold.

The use of tangible/intangible sharing formula appears to be an adaptation of the U.S. system. The "promotion" is obtained by having the limited partner bear intangible drilling costs in a different ratio than he shares revenue. By adding a small administration fee, the initial appearance is that the load is small.

This operator provides for an additional assessment of up to 30%,

which is a desirable feature to ensure that the investor has an opportunity to fully participate in his successes. But it may be an undesirable feature from the point of view of sales. Some sales people indicate that the investors are concerned with knowing exactly how much money they are putting at risk.

6.1 *Name of Program*
PETRO CAN OIL & GAS CORPORATION LTD.

6.2 *Year of Issue and Market*
1976 offering to the Canadian market.

6.3 *Amount of Program and Minimum Subscription*

The amount of the offering is not specified in the information received. Contributions are payable as to 30% cash and 70% by way of negotiable promissory note. The minimum subscription per investor was 10 units for $100,000.00, payable over three years.

6.4 *Type of Program*

A specific property (farm-out of large acreage block). A balanced program, but development oriented in a shallow gas area.

6.5 *Compensation to Manager*

Sharing ratio as to limited partners and general partners is 99.999% to limited partners and .001% to general partner.

In addition to anything received by general partner pursuant to the sharing ratio, general partner receives:

(1) reimbursement for overhead costs;
(2) fees of outside consultants;
(3) staff salaries;
(4) a percentage of distributions to limited partners, in a complicated formula, which we found impossible to summarize and therefore give in total:

(i) nil until the limited partners, on a collective basis, have received in such year and in respect of each previous year, on a cumulative basis, limited partner distributions equivalent to not less than 4.5% per annum of the total contributions from time to time of all limited partners; then

(ii) 1/7th of limited partner distributions until the limited partners, on a collective basis, have received in such year and in respect of each previous year, on a cumulative basis, limited partner distributions equivalent to not less than a further 1.5% per annum of the total contributions from time to time of all limited partners;

(iii) 1/3rd of limited partner distributions until the limited partners, on a collective basis, have received in such year and in respect of each previous year, on a cumulative basis, limited partner distributions equivalent to not less than a further 1/5th per annum of the total contributions from time to time of all limited partners; and thereafter

(iv) 3/5th of limited partner distributions, PROVIDED HOWEVER that neither the general partner nor the agent are entitled to a management fee if the effect of payment of that fee would reduce the net fair market value of the partnership assets determined in accordance with generally accepted valuation principles below an amount equivalent to the contributions of limited partners

outstanding at the date of such management fee would otherwise be payable.

In short, the general partner and the agent back into a healthy share of revenues.

It would also appear that the general partner is to be reimbursed for the costs of the offering.

6.6 *General Information*

This plan represents a very broad spread of acreage and is coupled with a longer term investment obligation.

The use of notes, in the particular percentages provided, is an attempt to use leverage to give the investor a deduction of the full amount of his cash contribution, notwithstanding that it is used to incur CDE which is deductible at 30% per annum. This technique can be extremely advantageous if it does not create a liquidity crisis in the operator and in fact represents a real asset to the investor. It must also be pointed out that in order to be deductible, the note must be real, that is, a full recourse obligation of the taxpayer, and represent expenditures actually incurred.

7.1 *Name of Program*
RANCHMEN'S EXPLORATION & DEVELOPMENT PARTNERSHIP (1976)

7.2 *Year of Issue and Market*
1976 offering to Canadian market.

7.3 *Amount of Program and Minimum Subscription*

Eighteen million dollars limited partnership interests. Minimum subscription per investor is $10,000.00. Minimum subscription for total program is $2,000,000 limited partnership interests plus $6,000,000 provate investors.

7.4 *Type of Program*

A balanced program purchase of an interest in all the properties of Bluemount Resources Ltd. and the farm-in of a portion of the remaining interests. The percentage amount to be purchased and farmed in to be dependent upon the amount raised by the issue.

The issue was combined with an investment by a group of private investors who purchased an interest in the Bluemount properties, but not through the limited partnership.

7.5 *Compensation to Manager*

(1) 8% fee to selling agent;
(2) fee to general partner of 8% funds from operations (working capital), paid monthly;
(3) reimbursement to general partner of all expenses incurred in managing the partnership, including overhead, administration and costs of outside services;
(4) after payout, general partner receives 8% of capital distributions;
(5) on removal, general partner receives 6% of excess value of partnership over capital contributions;
(6) disproportionate earning ratio of farm-in. Partnership pays 90% to earn 50% of 90% of Bluemount's interest in the drilling spacing unit of an earning well, if a development well and in drilling spacing unit of an exploratory well, plus the same interest in an exploration block surrounding each exploratory well. The exploration block

must contain 916 acres if it is east of the fifth meridian and 1,440 net acres if it is west of the fifth meridian.

The farm-out of the purchased acreage continues until the money is spent and borrowing is not feasible or June 30, 1980.

7.6 *General Information*

No additional limited partners may be admitted after December 31, 1976.

General partner bears expenses of the offering, estimated to be $100,000.00.

The limited partnership agreement contains provisions for voting of limited partners at a general meeting and has provisions for proxies and proxy solicitation, which have been framed in accordance with the provisions of The Companies Act (Alberta).

8.1 *Name of Program*

TBR GAS & OIL PRODUCTION FUND No. 2

8.2 *Year of Issue and Market*

1976 offering to Canadian market.

8.3 *Amount of Program and Minimum Subscription*

Two million dollars, being 100 units at $20,000.00 each, of limited partnership interests. Payable as to $5,000.00 in cash and $15,000.00 by promissory note, payable and acceptable to a Canadian chartered bank, plus assignment thereof to Turbo.

8.4 *Type of Program*

Production purchase fund. Acquisition of interests of Turbo Resources Ltd. in two producing areas.

8.5 *Compensation to Manager*

The general partner, Turbo Resources Ltd., will make an initial refundable cash contribution of $35,000.00, which will cover the costs of offering, estimated to be in the amount of $25,000.00.

The general partner will also receive reimbursement for expenses:

(1) pro rata office rental and expenses;
(2) partnership employees;
(3) retained consultants;
(4) expenses of operating partnership properties;
(5) standby fees to the bank.

Additionally, the general partner will receive 5% of the gross income of the partnership and 5% of capital distributions when made.

There is no operating agreement and no estimate of the amount of operating expenses.

8.6 *General Information*

This is a limited partnership interest. The prospectus was filed with the Alberta Securities Commission.

This is the second prospectus that Turbo filed in 1976, and they still consider their costs of offering to be $25,000.00.

The fund is open ended, meaning that any number of additional limited partners may be brought into it. There is a revaluation formula to prevent dilution upon the addition of further limited partners.

The fund is essentially an acquisition of an income stream with a tax advantage. The $20,000.00 unit produces $18,520.00 in CDE for a first

year deduction of $5,556.00. The cash payment, then, is more than completely deductible.

It is the intention that the income from fund would service the bank loan. However, "street talk" indicates that the Fund #1 may not be able to do this. The bank loan must be full recourse since no deductibility will be allowed if the investor is not liable on the loan. In this case, note *M.N.R.* v. *Mandel* [1976] C.T.C. 545 which involved a non-recourse loan in respect of the acquisition of an interest in a motion picture film.

## APPENDIX B

In a Panel Discussion reported in the 21st Annual Institute of the South Western Legal Foundation, 1970, on page 281, analysts indicated compensation formulas which were gleaned from an examination of various program offerings in the United States market. The program operators are not identified and the compensation package is indicated in a short sketch.

1. *Joint Venture Programs*

1.1 A 7.5% management fee plus 1/3 interest in all lands except exploratory wells and supporting acreage. Sponsor also participates as an investor.

1.2 A 10% management fee, a $10.00 per month participant/overhead fee, plus a 25% reversionary interest after participants recover cost.

1.3 An 8% management fee, 2.5% overriding royalty plus 25% reversionary interest in all properties at payout (including overhead fees).

1.4 A 10% management fee, plus a 50% interest for 25% of the costs.

1.5 A 10% management fee, plus 5% net profits interest before payout, convertible to a 20% working interest after payout.

2. *Limited Partnership Compensations*

2.1 General partner receives 7% management fee plus an interest in partnership equivalent to a 16-2/3% net profits interest.

2.2 General partner receives a 3% management fee, plus 5% overriding royalty with an option to convert to a 10% working interest.

2.3 General partner receives a 10% management fee, reimbursement for direct expenses and overhead, plus 50% interest by bearing all capital costs.

2.4 General partner receives a 10% management fee, plus per well allowances for drilling and producing wells. General partner pays all capitalized costs and shares production proceeds and costs in proportion to capitalized costs as a percent of total costs.

2.5 General partner receives a 7% management fee; wells are designated as exploratory or development and participants pay 100% of exploratory wells on a drilling block basis and get 100% of proceeds on a drilling block basis until they recover all costs charged to capital account on that well. After payout, limited partners get 60% and general partner gets 40%. General partner pays 100% of development wells and gets 100% of proceeds until payout of all wells (not on a block basis), then reverts to 60% to limited partners and 40% to general partner.

## APPENDIX C

Greenhill, *Formation of an Exploration Fund by a major Oil Company, The Conoco Exploration Fund* (1972) *23rd Annual Institute on Oil & Gas Law and Taxation* 291.

—Conoco put together a huge fund which was merchandized on a "regular" basis by a syndicate of brokers.

—Aspects:

1. Limited partnership.
2. 3 year spread—$25,000.00 per year.
3. Large acreage inventory—Continental contributed all of its acreage—unexplored acreage reverts to Continental at end of 3 years.
4. Expect to drill 180 direct wells and 300-400 exploratory farm-out wells.
5. Decided on an exploratory program and spread over 3 years to try and get desired results—substantial money to work with so try to spread risk by number of wells rather than mix of types of plays.
6. Investor not bound by first decision, i.e., renews his decision each year.
7. The 3 years gives Conoco's staff a level to work at—decided most cost-effective level of exploration budget was $25,000,000 per year.
8. Through acreage and geology Conoco contributes 41% of costs and gets 50% of revenues and their cost must be capitalized while investor gets all intangibles and therefore all current deductions.
9. No future calls—Development financed through borrowing—Conoco pledged to help—weight of large company.
10. Liquidity—Conoco will buy up to $10,000,000 per year of Limited Partnership interests at 70% of fair market value. This gives some liquidity and allows an investor to escape if necessary.