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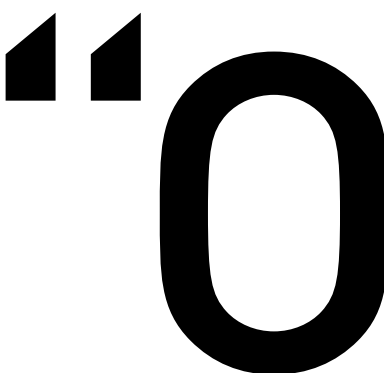
THE APPEAL OF OIL AND GAS LIMITED PARTNERSHIPS
INCREASES ALONG WITH THE PRICE OF ENERGY

BY JOHN KEEFE

INVESTING IN ENERGY HAS NOT ONLY BEEN A PROFITABLE STRATEGY LATELY, it's also been an effective hedge

against rising oil prices and the weakening dollar. The many investment options include oil company stocks, sector-specific mutual funds, exchange-traded funds, and the like. High-net-worth individuals have an additional option: limited partnerships (LPs) that drill for and produce oil and gas. Because they are direct investments in the commodities, these LPs offer a pure play in energy prices. They also appeal to a range of risk tolerances and provide effective tax benefits and portfolio diversification.





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OIL AND GAS PARTNERSHIPS PROVIDE

clients with a flow of income up front, but that's not why we're in them," says Lewis Altfest, president of L.J. Altfest, a fee-only planning firm in New York. "It's an investment that gives high re-

turns, and it's uncorrelated with stocks and bonds," Altfest says. These partnerships are self-liquidating and return capital quickly, he adds, "so they are best done as a series of investments over several years."

The possibility of over-the-top returns rather than tax breaks is the main attraction of energy LPs. The juicier tax benefits of oil and gas partnerships were lost in 1986 when tax law changes imposed "at-risk" rules, denying first-year deductions for drilling costs to passive investors, says Nancy Schabel, editor of *The Stanger Report*, a newsletter covering LP investments. At the same time, she adds, oil prices fell, disappointing investors that had bought partnership interests based on price projections of \$60 per barrel. Total capital raised for direct oil and gas ventures peaked at \$3 billion in 1983, then fell to about \$100 million per year through the 1980s and '90s.

The benefits of owning the commodities directly began to interest investors again as energy prices have risen. Nonetheless, oil and gas LPs are a niche market, attracting \$200 million in new sales in 2004.

The various types of oil and gas partnerships reflect the three stages of extracting natural resources from the earth: exploratory drilling, developmental drilling, and production. The success of all three depends heavily on the path of the commodities' prices once a project gets going, but each one has its own distinct risk and return profile.

Exploratory drilling, the riskiest option, searches for oil in new, unproven territories. These were a popular destination for LP investment during the '70s, when U.S. investors' attention was triggered by the high cost of imported oil and the upper ranges of income tax rates were especially punishing. Nowadays, few exploratory partnerships are being formed. Exploration incurs high costs although it can offer enormous reward. However, this type of partnership is the least likely to deliver an assured cash flow, which most advisers want for their clients these days.

A developmental drilling partnership is a somewhat less aggressive play because Mother Nature tends to repeat itself. "The best place to find oil is where it's already been found," says Michael Mauceli, chief executive officer of Reef Exploration, an oil and gas company in Richardson, Tex. "You go into the same areas and go deeper with new technology." The firm's success rate in developmental drilling is 82 percent during the past three years, according to Mauceli.

To encourage investment in energy exploration, the Internal Revenue Service allows accelerated tax benefits to investors in exploratory and developmental drilling ventures, which is a good thing because these deals tend to be unattractive when evaluated by operating cash flow alone. "You probably wouldn't buy a drilling program without the tax benefits attached," says Van Standke, a vice president at Lincoln Financial Advisors in Hartford, Conn. The first-year tax deduction—80 percent to 90 percent of funds invested—is attractive to those wishing to shelter large gains, such as a windfall from the sale of a business. But because the tax-motivated portion of the oil and gas market is small—just 5 percent of clients, in Lincoln Financial's case—Standke says he is considering expanding the firm's LP sales to include the third type of oil and gas LP, a production program.

Production, or income, partnerships, the least aggressive option, acquire interests in wells that have already begun producing oil or gas. These investments are exposed to swings in energy prices but do not face the additional risks inherent in exploration and drilling. Accordingly, a production partnership doesn't generate large up-front tax deductions. However, it does generate a good-size annual deduction for the depletion of the deal's energy assets.

How do you evaluate oil and gas limited partnerships? Rather than focus on price-to-earnings ratios or compound interest, investors need to consider the laws of fluid physics. Think of a liquid under pressure in a container, escaping through a small tube stuck in the top: at first the contents rush out, but for every barrel of oil that comes out of the ground, there's less pressure in the well, and it's harder to bring the remainder to the surface. Accordingly, a partnership owning a portfolio of new, successful wells creates a cash flow that's front-loaded: many projects pay out most of their return during their first three to five years.

After about the first 10 to 20 years of a well's lifespan when all the oil and gas has been extracted, the financial life of the investment ends. (Rarely is there any residual value because an investor typically owns only the energy rights and not the land itself.) "It's counterintuitive to many investors," says Arthur Budge Jr., chief executive officer of Five States Energy in Dallas. Five States is an investment company that sponsors production partnerships to acquire interests in active oil and gas wells, predominantly in the Southwest and Rocky Mountain states. "The cash flows are analogous to mortgages, except the amortization is backward," Budge says. In other words, proportional amounts of income and capital are paid back to investors each year, so that capital recovery is front-loaded, too. At the end of the well's productive life, there's nothing left.

For an adviser, measuring the performance of a portfolio



that includes an oil and gas partnership along with stocks and bonds presents challenges. Simply taking into account an LP's cash payouts will overstate the portfolio's return in the early years and understate it later. Tax effects also can be uneven and difficult to incorporate.

This much seems clear: investing in energy offers meaningful diversification to a traditional portfolio. Consider that for the past 20 years, the correlation between listed U.S. oil stocks and a portfolio invested 60 percent in the S&P 500 index and 40 percent in the Lehman Aggregate Bond index was 0.55; the figure jumps to 0.83 when shares of heavy industrial companies are substituted for oil. An oil and gas LP would have an even lower



“THE BEST PLACE TO FIND OIL IS WHERE IT'S ALREADY BEEN FOUND”

correlation than the oil stocks versus the portfolio of stocks and bonds; that's because the partnership's performance is driven by global oil and gas markets, not by the U.S. stock market.

Some oil and gas LPs are public partnerships, registered with the Securities and Exchange Commission and distributed through broker-dealer networks; others are private, limited to 35 partners or fewer, are exempt, and are exempt

from SEC registration, and often are marketed by the sponsor directly to investors. Sponsors offering public partnerships often sell private ones as well, while some firms create private deals exclusively. The leading players in public and private energy partnerships are Petroleum Development, in Bridgeport, W. Va.; Atlas America, in Moon Township, Pa., and Reef Exploration. All three firms market their drilling and production partnerships through broker-dealers. Five States Energy emphasizes production partnerships and distributes directly to advisers.

Sponsoring firms typically contribute one-fifth to one-quarter of a transaction's capital. Investors contribute the rest, usually a minimum of \$5,000 to \$10,000 for a fractional interest in a public entity, and \$25,000 or more for

private deals. (Additional calls for capital are rare but not unknown.) Sponsors that offer only public, registered partnerships often raise funds for blind pools, which do not reveal the assets in which they invest, says Rose Thomas, cofounder of RTA Investment Research, in Chandler, Ariz., which specializes in LP due diligence.

Fees can be steep and are frequently set at 10 percent of the offering price, the maximum allowed by the National Association of Securities Dealers, plus another 0.5 percent for due diligence. The figure is often higher for private partnerships, sometimes reaching 15 percent, Thomas says.

For their efforts in organizing and running the project, managing general partners (MGPs) receive a share of profits commensurate with their capital contribution to the

INVESTING IN INFRASTRUCTURE

"OIL AND GAS HAVE A PLACE IN EVERY high-net-worth portfolio as an alternative equity asset, with an allocation of 10 percent," says Tom Alvaré, founding partner of Comprehensive Investment Solutions in Yardley, Pa. "But as a fee-only investment manager, how we place the money has been a challenge for us. There are many good sponsors of drilling partnerships out there, but the exploration risk has been a deal breaker because we don't have the due-diligence expertise in-house."

The solution Alvaré fixed on is a master limited partnership (MLP), a publicly traded equity that throws off strong cash flow as well as substantial tax benefits. Rather than invest directly in energy commodities, MLPs invest in infrastructure: oil and gas pipelines, propane distribution systems, and mining operations. Their market value typically ranges from \$1 billion to \$16 billion, with most MLPs valued between \$1 billion and \$4 billion. The total market value for MLPs and the less used royalty trusts that trade on U.S. stock exchanges, is about \$35 billion, according to Kurt Wulff, head of McDep Associates, an oil and gas research firm in Needham, Mass.

MLPs are not a direct play on energy prices, but they do benefit when production rises. For example, Smith Barney research analyst John Tysseland notes that the drilling rig count in the U.S. Gulf Coast and Rocky Mountains has increased about 15 percent in 2005 over the previous year. This increase will benefit the pipeline MLPs, he adds, because their earnings are driven by quantities of gas or oil delivered.

Alvaré relied on the research of Lehman Brothers' energy group and invested in the firm's picks of public MLPs. "They bundle eight to 10 MLPs at a time, focusing on transportation, pipelines, or refining," Alvaré says. "As a group, it's crushed the S&P 500 in return and in lower collective volatility. And while they're correlated with oil stocks, they're not correlated with our main stock portfolios." Transaction costs to establish the portfolio are about 100 basis points, and annual trading incurs commissions of about 25 basis points. The Lehman MLP basket reports one- and three-year annualized returns of 18.5 percent and 23.5 percent, respectively. An index compiled by Smith Barney of 10 energy MLPs returned 47 percent in 2003 and

23 percent in 2004 and outperformed stocks from 2000 through 2002.

Pipelines in MLPs have the advantage of not being self-depleting assets like oil and gas wells; in fact, astute managers are able to increase their cash flows by acquiring and expanding their own systems. MLP yields stood at about 6 percent in early May, and cash distributions from MLPs rose between 5 percent and 15 percent in 2004, according to Matthew Jachimiak, portfolio manager at Durbin Bennett Peterson, a wealth-management firm in Austin, Tex. This high income, the prospect of income growth, and a low correlation of yields with the bond market makes energy MLPs—as well as the handful of recently introduced closed-end funds that invest in existing MLPs and several exchange-traded funds—a powerful portfolio alternative to bonds and preferred stocks.

In addition to cash from current earnings, each distribution to shareholders typically contains a return of capital, as depreciation charges on pipeline networks are passed through to shareholders. The net effect is that distributions to limited partners are typically 85 percent tax deferred. —JK

A PORTFOLIO OF NEW WELLS CREATES A FRONT-LOADED CASH FLOW, PAYING OUT MOST OF THE RETURN IN THE FIRST THREE TO FIVE YEARS



partnership and allow themselves an additional 2 percent to 7 percent of profits, for a total share of about 30 percent. For the first five years of operation, however, many MGPs limit their share to about 10 percent so that the limited partners can receive “decent” early returns, says Thomas.

Liquidity is another concern. “With some sponsors, you’ve been able to get out at a discount to estimated value” through so-called rights of presentment, says a New York adviser who asked not to be identified, “but I don’t mention it to my clients.” Presentment—a periodic opportunity to sell the partnership interest back to the sponsor at terms specified in the partnership agreement—is intended as an escape route for investors who suffer some sort of financial emergency; it’s not a general source of liquidity or a means of exit from a poor investment outcome. “If oil blew up, and everyone headed for the exits,” the adviser explains, “most sponsors wouldn’t be able to deliver.”

A strong counterweight to high fees and illiquidity are the tax breaks these deals afford investors. During a drilling partnership’s first year, investors can deduct from income their shares of intangible drilling costs (IDCs)—the services a driller buys to start a well—rather than parcel them out through amortization over a five-year period as the tax code allows. Limited partners’ deductions for IDCs alone typically amount to 80 percent to 90 percent of their total investment. The deduction is not relevant to production partnerships, as they incur little or no intangible drilling cost.

Limited partners can apply their IDC deduction only to passive income, but general partners can apply the deduction against ordinary income. Consequently, most investors take advantage of the broader deduction by signing on as “additional general partners” when the partnership is formed and then converting to limited partners in the second year. However, those who sign on as additional general partners are genuinely at risk during the first year for partnership liabilities—such as well blowouts or environmental damage—that are not covered by insurance. Sponsors generally insure the partnerships to deflect liability from partners’ personal assets. Nonetheless, liability concerns drive away some advisers. “Getting the tax write-off against ordinary income exposes you to unlimited liability, which we are not willing to do for any client,” says Judy Lau, president of Lau Associates in Wilmington, Del., “so we don’t use drilling deals.”

As a practical matter, such losses are rare. “I don’t know of a situation where the partners had to come up with their own liability insurance,” says Thomas.

Besides, there’s an additional tax benefit for these LP investors. “The beauty of oil and gas deals,” says Standke of Lincoln Financial Group, “is that the deduction for IDCs is not accretive to the alternative minimum tax. In fact, it can reduce the burden of AMT.” The Internal Revenue Code provides that for partners of qualifying “independent oil producers,” like limited partnerships, the IDC deduction can reduce income subject to AMT by up to 40 percent, says Jack Hollander, a tax attorney and chairman of the Investment Program Association, a Washington, D.C., trade association for oil and gas partnership sponsors.

Once the partnership’s production is under way, the ongoing tax benefit for oil and gas operations is an annual

DO-IT-YOURSELF OILMAN

IN THE LATE 1990s, THOMAS ZANECCHIA, president of Wealth Management Consultants in Denver, wanted to find a way his clients could benefit from the rising price of oil. "In the United States, the productivity gains that had reduced energy consumption were over. And in China, they have constructed three or four cities the size of New York in the past five years," he says. "The demand will be there, and supply is constrained, so we wouldn't be surprised to see \$100 oil in the next five years."

Zanecchia says he was seeking an investment vehicle that had low transaction costs, minimal volatility, and a three- to five-year holding period. First, he looked at futures, "but you can't go very long, and it's not an area we were comfortable with," he says, so for a time he settled for the ease of a sector mutual fund. He dropped that

strategy, however, because stock prices are driven partly by the broader market. "Next we looked at securities of the major oil companies," he adds, "but they're not pure plays, and [those companies] don't explore much." Instead, he bought shares of several independent oil companies but grew dissatisfied with their market risk and the length of time it took to build his positions.

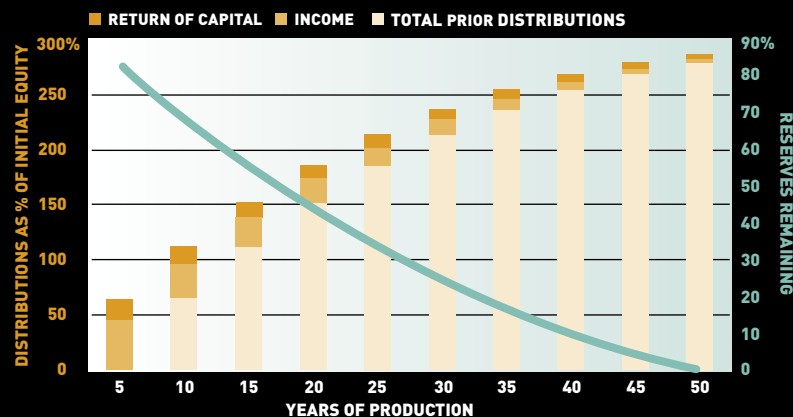
Next, Zanecchia considered limited partnerships, but he wanted to buy only the asset, not the drilling risk. "We then tried some larger royalty trusts," he continues, "which were fine, but we wondered, 'Wouldn't it be nice to get rid of the trustee that we are paying all this money to?'"

So Zanecchia put together his own royalty deals. "Being in Denver, we had the advantage of knowing people in the oil and gas business," Zanecchia says. In 2002,

he put the word out that he was looking for royalty interests in producing wells on properties too small to interest an oil company and hired a geologist. "We're careful in getting the title to the royalty interest, but once we own it, we get what comes out of the ground, times the price, and that's it," he says.

Zanecchia buys royalty packages ranging in size from \$1 million to \$3 million, and for tax reasons limits his purchases to five states. "We spent \$1 million for some gas acreage in Colorado in November 2003, and it's worth \$3 million today," he says, "and we have income in the meantime—12 to 14 percent." So far, Zanecchia has invested about \$12 million in four such deals. "You just have to be out looking around," he says, "and know some people in the oil business." —JK

THE LIFE CYCLE OF AN OIL AND GAS PARTNERSHIP



The above chart shows the expected performance of an oil and gas field in West Texas owned by a Five States Energy limited partnership. Although most projects don't last 50 years, its evolution is typical: as the wells' energy reserves decline so do the investment's cash distributions.

deduction for depletion, currently pegged at 15 percent of each year's oil and gas revenues. The deduction is based on the value of the oil or gas produced and is not tied to the partnership's capital investment in the operation.

So how does an investor size up this type of investment? The offering documents for an oil and gas program are exhaustive, covering risk, taxes, investor suitability, and so on. But finding independent evaluations is a challenge.

"As far as I know, no one compiles benchmarks of how oil and gas programs perform," says Thomas. Instead, she notes, "As part of the due-diligence process, most professionals evaluate the performance of a sponsor's prior programs and compare them with ones offered by other sponsors during the same time frame."

Thomas suggests that investors compare several different sponsors to see how much of the limited partners' investments they return over a given time period. These measures will reveal the success of an MGP's drilling efforts and the fairness of various compensation structures. Thomas also urges advisers to evaluate the sponsor's management team. Extensive experience at

big oil companies is key because it increases the chances of successfully managing programs when the materials and talent needed for drilling are in short supply, as they are now. She asks: "Are they petroleum engineers or guys that have decided to raise money for a drilling program?"

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