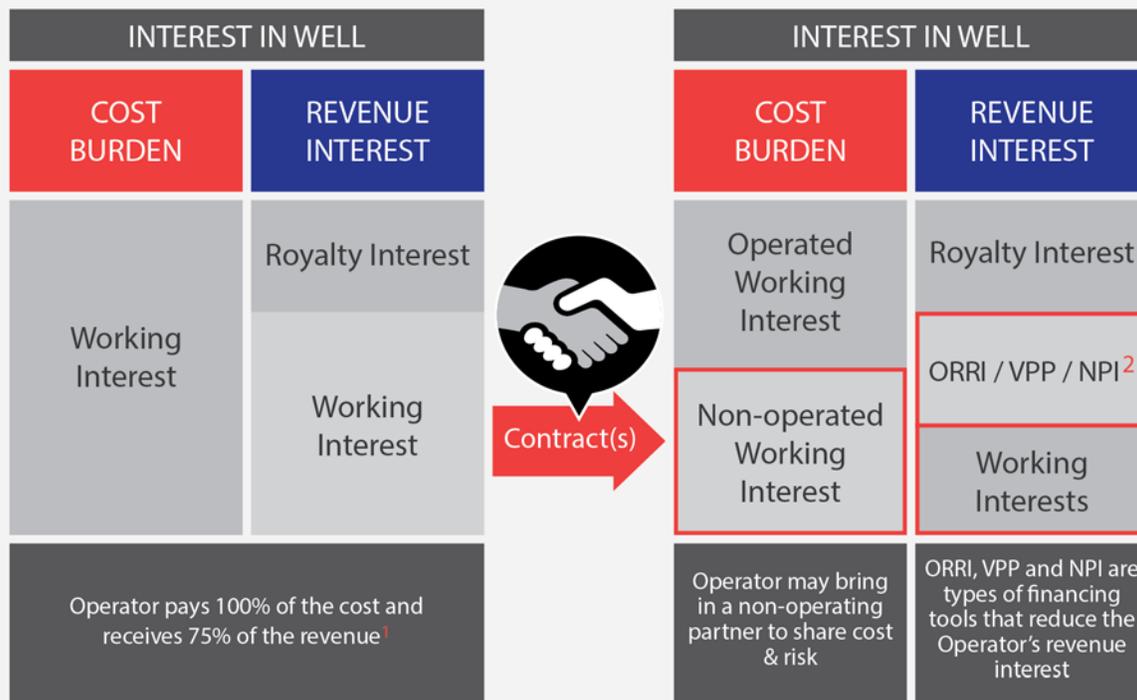


## Creation of Non-Operated Interests in a Well



<sup>1</sup> Assume 25% royalty; leases can range from 12.5% - 25% royalty

<sup>2</sup> ORRI=overriding royalty interest, VPP=volumetric production payment, NPI=net profits interest

### Overview

Volumetric Production Payment (VPP) is a form of structured investment where the owner of an oil/gas interest sells a specific volume of production. It is a non-operating, non-expense bearing, limited term overriding royalty interest (ORRI) carved out of the working interest of an oil/gas lease.

A VPP covers a fixed quantity of oil/gas to be produced from a lease. Typically a VPP

is structured to deliver to the VPP owner a scheduled quantity of the oil/gas per day over a fixed time period.

A VPP usually terminates when the oil/gas is fully-delivered or the leases that are burdened by the VPP terminate. The VPP oil/gas is typically taken in-kind by the VPP owner. There are other types of production payments which are denominated in dollars instead of volume.

### Creation of a VPP

A VPP interest is most commonly used as an oil/gas investment mechanism for banks, hedge funds, energy companies or insurance companies. VPP deals are typically set to expire after a certain length of time, or after a specified aggregate total volume of the oil/gas has been delivered. The VPP buyer will typically perform strong due diligence both initially and on an ongoing basis, having inspections done of the site while constantly analyzing production reports to ensure that the contract terms are being met.

### Advantages/Disadvantages of a VPP

The VPP is popular with sellers because it gives them a way to monetize assets without having to sell them. Because the VPP is considered a loan, the VPP seller can also receive the tax benefit of deducting interest.

Investors like the VPP because it is an interest in real-property, protecting it in the event of an Operator bankruptcy. In addition, the VPP gives the investor access to oil/gas in-kind, making it easier to hedge and lock in returns.

The VPP has 2 tax disadvantages compared to an NPI: (1) no deduction of intangible drilling and development costs, and (2) no depletion deduction.

For foreign investors, even though a VPP is considered a loan for income tax purposes, it is considered real property for FIRPTA purposes.

### Role of the VPP Buyer

A VPP interest is considered a non-operating asset, akin to a royalty. The VPP buyer has no obligation to contribute any time or capital to the actual production of the end product. Many VPP investors hedge their expected oil/gas volumes to protect against commodity risk and lock in the expected profits.

A VPP transaction allows the seller to retain full ownership of the property while monetizing some of their capital investment. This ability to "cash out" some of the value

of development allows the seller to deploy the capital in other areas.

If the operator cannot meet the scheduled supply, the operator must make up the shortfall in the next cycle, and so on until the VPP owner is made financially whole.

### Real or Personal Property

In most US states a VPP is regarded as real property. The notable exceptions are Kansas and Oklahoma, where a royalty interest, and therefore VPP, is considered personal property before and after it is produced.

On the other hand, Texas courts have consistently held that production payments, whether volumetric or dollar denominated, constitute an interest in land. The main condition is that the VPP owner's right to receive payment, either in kind or in money, is contingent on production of oil/gas, without regard to production costs. The Texas courts have made it clear that VPP would be considered an interest in land even when clearly employed as a financing device.

### US Tax Implications

The US tax code treats a VPP as non-recourse debt secured by the burdened property, and not as a depletable economic interest in the underlying property. As VPP oil/gas is delivered to the VPP owner, the loan is deemed to be repaid in installments of principal and interest. Tax treatment of related expenses for the Operator, including

depletion, depreciation and amortization (DD&A), is unchanged.

The VPP provides two distinct tax advantages to the Operator. (1) the Operator can monetize assets without having to recognize a taxable gain, and (2) the Operator can deduct the interest payments to the VPP owner, reducing taxable income.

In certain cases the seller of an oil/gas property may want to retain a VPP as the gain amount, which will be taxed at the reduced capital gains rate. In contrast, if the seller retains a royalty interest instead, the gain be considered as ordinary income.

Although a VPP is generally considered a mortgage loan for tax purposes, because the VPP has the right to share in the appreciation of minerals it is considered an interest in real property. As a result a VPP would be subject to FIRPTA withholding tax when sold by a foreign owner.

**Financial Accounting Implications**

In general, a VPP transaction would be recorded as a sale of reserves in the analysis of reserve changes. Consequently, the reserves subject to a VPP transaction are removed from VPP seller’s annual disclosure of proved reserves, reducing the reserves on the balance sheet. The owner of a VPP is permitted to record the VPP reserves on its balance sheet.

**Bankruptcy Implications**

Generally, properly-structured and documented VPPs have fared well in bankruptcy.

The Bankruptcy Reform Act of 1994 added Section 541(b)(4) to the Bankruptcy Code which allows a VPP to be excluded from the debtor’s estate in bankruptcy. The VPP for these purposes is broadly defined as an

ORRI that is contingent on production of oil/gas, in a specified volume or value, without regard to production costs.

**Environmental Liability**

VPP holders have no obligation for any environmental, remediation or plugging and abandonment expenses.

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