Habib Yunus: hyunus@w-advisory.com

WORKING INTEREST IN OIL AND GAS PROPERTIES IN THE US

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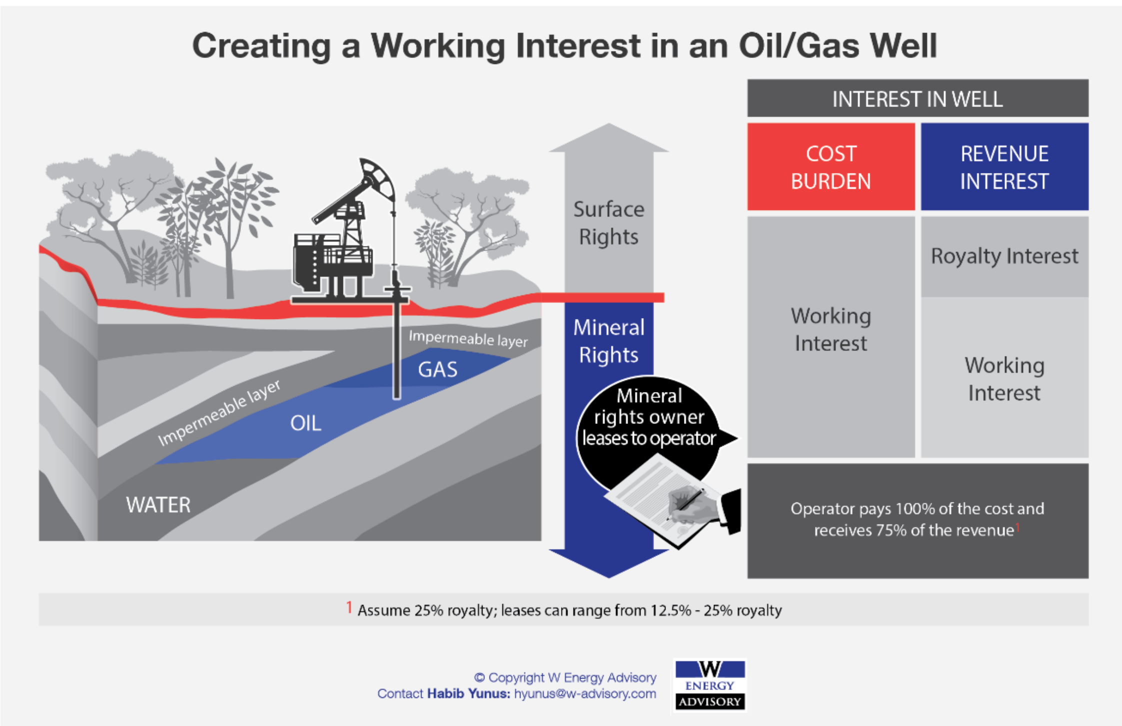
Overview

A working interest is the right to explore, produce and own oil, gas or other minerals. The working interest is created by leasing rights from the minerals owner. The lease entitles the working interest owner to (1) develop the resources, and (2) a share of the production.
The working interest owner bears all the costs of exploration, development, and operation on a cash, penalty or carried basis. In return, the working interest owner is entitled to a share of the production from the property. It may be assigned to another party, or it may be divided into other special property interests.

In contrast to a working interest, the royalty owner's cost is usually limited to the initial investment. Royalty owners pay no expenses for the production or operation, except for production taxes and ad valorem taxes.

The share of production a working interest owner is entitled to will always be smaller than the share of costs that the working interest owner is required to bear, with the balance of the production accruing to the owners of royalties.

For example, the owner of a 100% working interest in a lease burdened by a landowner's royalty of 25% would be required to pay 100% of the costs of a well but would be entitled to retain 75% of the production.



Creation of working interest

The most common way to create a working interest is with a lease. The minerals owner leases the rights to an operator. Under the lease, the operator can to explore, drill and produce minerals at its own cost. In return, the mineral interest owner an upfront bonus, a royalty on production, and sometimes delay rental fees. The lease is generally granted for a term of one to five years during which the Operator has the right to drill and obtain production. Once production is obtained, the lease remains intact as long as production continues. [i]

Types of working interest ownership

Working interests fall into two categories: operated and non-operated. Often, the working interest of an oil and natural gas lease is split between numerous owners in varying percentages.

The working interest owner designated as the "Operator" proposes wells, supervises drilling, and manages day-to-day operations, such as marketing and accounting functions associated with the lease.

Non-operating working interest owners are consulted on production decisions and incur part of the costs according to the agreements made between owners. However, non-operating working interest owners are not involved in actual operations.

	Operating working interest owners	Non-operating working interest owners	Non-working interest (royalty) owners
Involved in production decisions	✓	✓	✗
Incurs production costs	✓	✓	✗
Operates well or wells	✓	✗	✗

Overriding royalty interest

An overriding royalty interest is a fractional, undivided interest, derived from the working interest. It is not an interest in the actual minerals, but an interest in the proceeds or revenue from the oil & gas minerals sold.

Overriding royalty interests, are commonly assigned to someone that assembles a prospect, sellers who want to retain an interest, or sold as a way to raise of capital.

Working interest owner's rights to record reserves as an asset

A working interest owner is permitted to record an asset on its balance sheet. The asset is called reserves. The reserves represent the proportion, attributable to the owner's participating interests, of predicted hydrocarbon production during the economic life of the property.

To calculate the reserves, gross recoverable reserves are calculated first, and then reserves attributable to royalty interests are subtracted. The remainder is allocated to the working interest owners, based on relative working interests. The future production is calculated before deduction of state production taxes and overriding royalty interests.

US Tax Implications

A working interest is an economic interest and is therefore subject to depletion deductions. Additionally, the working interest owner can deduct intangible drilling and development costs.

The US tax code specifies that a working interest (as opposed to a royalty interest) in an oil and gas well, is not considered to be a passive activity. This means that any losses act as active income incurred in conjunction with oil/gas production can be offset against other forms of ordinary income.

A working interest in oil and gas, in situ, is an interest in real property for US federal income tax purposes. This ruling applies in all cases regardless of how the oil and gas lessee's interest is treated under State law.

An ORRI is considered an interest in real property for US tax purposes and would be subject to FIRPTA withholding tax, when sold by a foreign owner.

W Energy Advisory	
w-advisory.com	
Phone:	+1 713-518-1126
Fax:	+1 281-617-5819
Email:	hyunus@w-advisory.com
Houston Office:	Tokyo Office:
17385 Village Green, Suite C Houston, Texas 77040 USA	Toranomon 3-18-6 Asahi Toranomon Mansion #705 Minato ku, Tokyo 105-0001 JAPAN

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[i] Theriot, Robert; A Quick Primer on Mineral Rights, 2012