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Estate Planning: Making Lemonade in the Oil Patch

Now is probably the best time in decades to minimize estate taxes when transferring excess Oil & Gas assets from one generation to the next.

Executive Summary

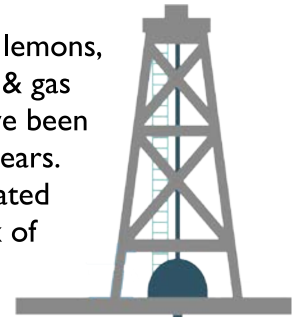
The issue:
Oil & gas prices are hovering around low prices not seen in decades. However, most market indicators are suggesting relative price stability with some appreciation over the next few quarters. For owners of oil & gas assets who've just survived the past few years of pricing volatility, they may not have considered using the current commodity-pricing environment as a wealth transfer opportunity.

The opportunity:
With energy prices so low, working interests and mineral/royalty interests are at an equally devalued state, and for owners with excess gifting capacity, now may be the best time in decades to transfer low-basis assets in oil & gas to the next generation

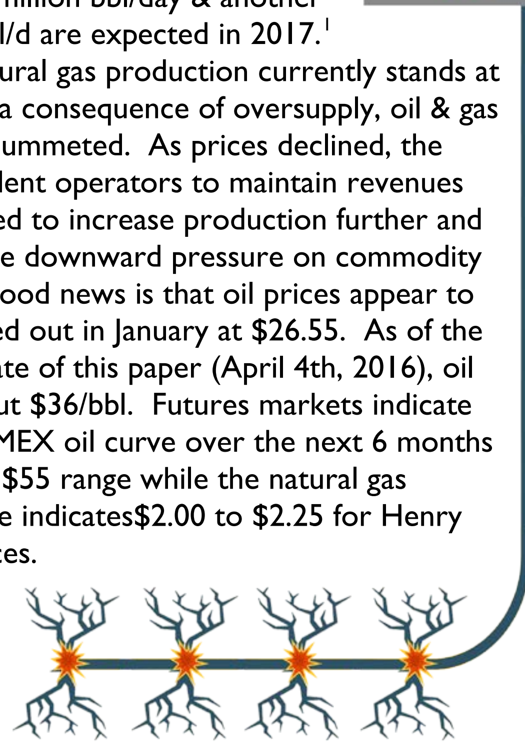
What needs to be done:
Oil & Gas interest owners should consult with their estate planning attorneys & related professionals to see if now is the time to gift oil & gas assets based upon their own unique situation. If the answer is yes, ValueScope is uniquely positioned to complete an updated valuation on their oil & gas assets for planning purposes.

- *Professional Staffing: Petroleum Engineers, Ph .D.'s, CFA's, CPA's, and MBA's*
- *Experience: over 50 Estate & Gift valuations per year*

The Issue at Hand



As the old saying goes, "if life hands you lemons, make lemonade." There is no doubt oil & gas working interest and royalty owners have been given bushels of lemons these past few years. Commodity prices are far from the elevated levels of 2014 and further from the apex of 2008. Global oil production currently stands at 1.6 million bbl/day & another 0.6 million bbl/d are expected in 2017.[1] Domestic natural gas production currently stands at 43 Bcf/d.[2] As a consequence of oversupply, oil & gas prices have plummeted. As prices declined, the need for prudent operators to maintain revenues drove the need to increase production further and put even more downward pressure on commodity prices. The good news is that oil prices appear to have bottomed out in January at $26.55. As of the publication date of this paper (April 4th, 2016), oil stands at about $36/bbl. Futures markets indicate a normal NYMEX oil curve over the next 6 months in the $40 to $55 range while the natural gas NYMEX curve indicates$2.00 to $2.25 for Henry Hub spot prices.

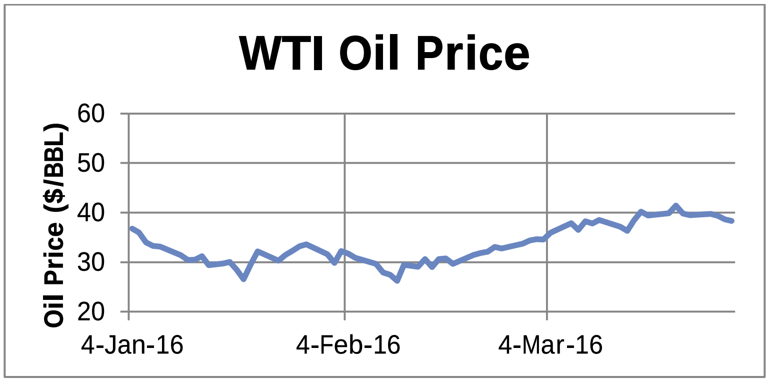


Time for Some Estate Planning Lemonade?

Given the current level of oil & gas prices, now might be the best time in decades to use trust & estate planning tools like Family Limited Partnerships (FLPs) to transfer some excess oil & gas assets from one generation to the next. Given the commodity price volatility of the past few years, it is doubtful ANY oil and gas asset holder is going to <u>*feel*</u> like they have excess transfer capacity for oil & gas assets at this point, but they should consider working closely with their Trust & Estate attorney and wealth

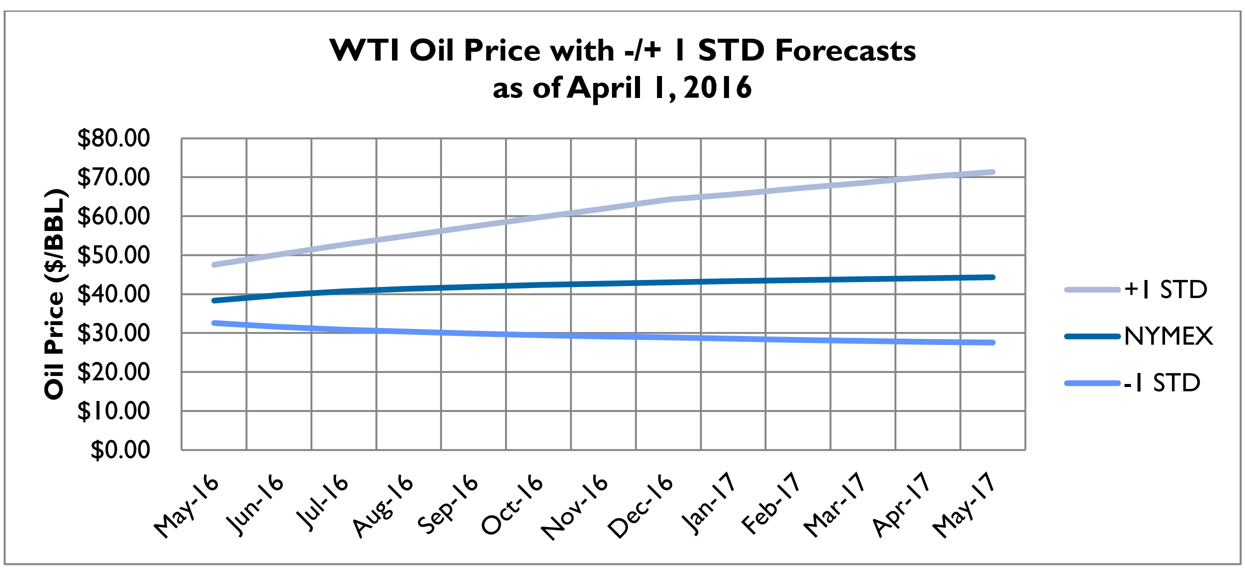
1 US Energy Information Administration, 2016.
2 Ibid

advisor to take a closer look at their individual situations. A quick examination of 2016 year-to-date prices indicates that oil has already risen 45% to 50% from its low of just over $26/bbl in January.



Said differently, prices have rebounded quickly from their lows and an excellent wealth transfer planning opportunity has already been lost. While nobody can time markets perfectly, an opportunity remains and key factors indicate there are still good opportunities to transfer these assets over the next few calendar months or even quarters. These factors include:

1. Distressed oil & gas assets are not easily marketable today; so a 30% assumption on combined discount for lack of marketability (DLOM) and discount for lack of control (DLOC) is unlikely to face scrutiny from the IRS.
2. The IRS still has not made any definitive rulings about DLOC and DLOM levels, so families with excess transfer capacity should act now before the IRS publishes official guidance.
3. Commodity futures markets expect increased pricing (by analyzing one standard deviation, or 67% of the probable outcomes) over the next 90-180 days.
4.



Oil & Gas Assets to Consider Transferring

1. Proved Developed Producing (PDP) working interests: In the current market, PDPs are the only working interest assets receiving any value by banks and equity investors. A few years ago, conservative banks may have advanced 60% to 65% asset coverage on PDP assets. Today they might advance 45% to 55% depending upon which bank you call.
2. Proved Developed Not Producing (PDNP) working interests: Like PDPs, PDNPs have seen a similar valuation drop these past few years. A few years ago, a conservative bank may have advanced on 20% of PDNP reserves, today an operator would be lucky to see a 5% to 10% advance.
3. Proved Undeveloped (PUD) working interests: PUDs might earn a holder the highest value in terms of a current transfer for future appreciation in another generation's estate. Functionally, PUDS are receiving minimal value today by any financial participant in the industry. Any PUD interests transferred now could be done with minimal basis.
4. Overriding Royalty Interests (ORRI): An ORRI is typically carved out of the working interest holders financial interest in an oil & gas property and will be treated and valued in a manner consistent with PDPs, PDNPs, or PUDs depending upon the status of the underlying working interest.
5. Mineral/Royalty interests: Typically held by the original landowners, or those who purchased them from landowners, Mineral/Royalty interest owners are entitled to a percentage of the revenue generated from the operation of wells, but do not have to participate in any of the expenses associated with the well's operation. Like ORRI, these interests are valued in a manner consistent with the underlying working interest and the expectation of future drilling.

Sample Transfer

Let's take a look at an example of the transfer opportunities that still exist with relatively modest oil & gas price increases over the next few quarters. For the purpose of this example, we will focus only on the price of oil as measured by the WTI futures pricing curve illustrated earlier. The table below assumes a family has an oil & gas asset, inside a family limited partnership (FLP), worth $16 million on a Net Present Value (NPV) basis with oil at $39/bbl. Applying a hypothetical, combined discount of 30% accounting for both lack of marketability and lack of control, the same $16 million of assets can be reduced to a discounted $11.2 million NPV. If the asset owners applies their combined $10.9 million lifetime gift exemption and transfer as much within an FLP for the benefit of future generations, only $300,000 of the asset's value will remain in their estate.

Date	Price of Oil ($/BBL)	O&G Asset NPV ($Mil)	Hypothetical Discounts	Total Transferred	Asset Appreciation Transfer ($Mil)	Timing Value of a Transfer
April 1, 2016	$39	$16.0	30%	10.9	0.0	0%
July 1, 2016	$50	$18.8	30%	12.9	2.0	15%
October 1, 2016	$60	$26.3	30%	18.1	7.2	40%

Now let's consider the odds of a price increase by examining the oil futures pricing curve above. Based upon recent volatility, there is a chance (1 standard deviation) that oil will increase to roughly $50/bbl by July 2016. In the event that happens, $2 million of asset appreciation on the underlying assets in the FLP will accrue in the recipient's estate, and the value of those assets will now be $12.9 million (assuming the same 30% combined discount). If prices reach $60/bbl by October as the futures markets predict, then the asset appreciation will reach $7.2 million in the FLP for a total transfer of $18.1 million. Said differently, in the $60/bbl case, 40% of the transfer value is a function of transferring the assets now rather than in the future when oil returns to $60/bbl. The time period that we demonstrate in our simple table analysis is, in reality, almost irrelevant. We simply chose these prices and times because the current futures markets show that there is a 1 in 3 chance these prices can move in just the next 13 to 26 weeks. In reality, even if it takes 13 to 26 months for oil prices to achieve $50/bbl and $60/bbl respectively, the wealth transfer implications are the same.

Bottom line: if a holder of oil & gas assets believes commodity prices will appreciate modestly in the next 2-3 years, let alone the next 2-3 months, they should not delay in taking action on a transfer strategy.

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