PETROLEUM OPERATIONS IN TRUSTS AND ESTATES

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Most petroleum engineers, operating personnel, and management personnel are familiar with the role of banks in commercial lending. Banks have long been involved in the financing of development drilling, workovers, secondary-recovery projects, gasoline plants, acquisitions and many other facets of the oil industry.

Another role that may be new to many operating personnel is the role of bank trust departments in management and operation of oil and gas properties. This is a relatively new segment of the century-old petroleum industry. In the last several years, numerous banks in oil- and gas-producing areas have employed oil-industry specialists to join their trust departments to provide the expertise needed to manage this type of asset. One of the first professional technical persons in this role was a petroleum engineer employed by First National Bank in Dallas about 20 years ago. The Trust Oil Department staff now includes five petroleum engineers, three petroleum landmen, and 19 other land, accounting, and technical-support personnel. These persons are involved in virtually all aspects of management of mineral properties in 26 states.

Due to First National's location in the largest oil producing state, the estates of independent oil men provide a large portion of the trust assets, and these estates rate among the Bank's most important business. Approximately 20 percent of the estates and trusts which the bank serves in a fiduciary capacity own some type of mineral interst. Types of ownership include undeveloped mineral interests, royalty interests, outside-operated working interests, and bank-operated working interests. Revenue to the beneficiaries of these trusts and estates is approximately $35,000,000 annually. This revenue exceeds that of many independent oil companies operating in the state of Texas.

The fiduciary's interest in the operation of such properties is indicated by the fact that in working interests alone, my bank represents the ownership of 4,500 barrels of oil per day and 45,000 MCF of gas per day. Thus, the bank is a not-so-small "small oil company" when co-owner approvals of development projects, drilling wells, secondary-recovery projects, etc. are required. In properties where the bank is a non-operating working interest owner, it acts like what may be described in a company as a joint-interest manager. In management of bank-operated properties, the engineer may serve as a combination reservoir engineer, geological, production and drilling engineer, or he may employ outside consultants when appropriate.

TRUST OIL DEPARTMENT ORGANIZATION

The experience of First National Bank demonstrates the functions of a corporate fiduciary which handles oil and gas interests functions in Trust Oil Department organization. Figure 1 shows the organization chart for the bank's Trust Oil Department. The nature and magnitude of the oil assets determine the type and number of staff members needed by a particular bank. For a smaller bank, some of the technical expertise may involve the use of consultants rather than bank staff. For a larger organization, a fully staffed department should be headed by an oil industry professional, typically an engineer, geologist or landman. The staff may then be divided into three areas: property management or engineering, land, and accounting. Figure 2 shows the basic functional jobs in such a

department, and Figures 3, 4, and 5 illustrate in more detail the functions of each section of the oil department.

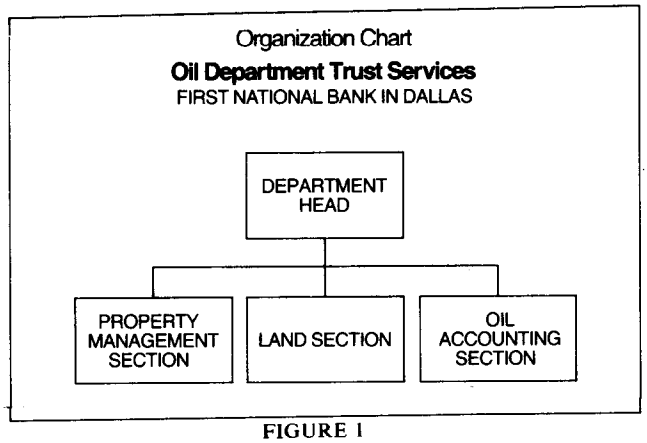

FIGURE 1

Suggested Trust Oil Department Staff

Area	Job Title or Function
Department Head	Petroleum Engineer or Petroleum Landman
Property Management Section	Petroleum Engineer Technical Assistant Engineering Clerk Secretary-Production Clerk
Land Section	Petroleum Landman Title Analyst Division Order Clerk Land Records Clerk
Oil Accounting Section	Accountant Accounting Clerk Oil Receipts Clerk

FIGURE 2

Personnel in each of these sections are involved with working-interest properties, whether these properties are bank operated or outside operated. The land section is primarily concerned with ownership documents such as mineral deeds or leases, assignments, division orders, etc., and this section works with the petroleum engineer and attorney for the account in construction or review of contracts such as gas sales or processing agreements, unitization agreements, and others. With the growth of regulatory requirements, First National has assigned a landman to follow the published rules and orders of the Federal Power Commission and the Federal Energy Administration, and to work with the engineer and the production clerks in the application of these regulations.

The accounting section performs the many tasks

Land Section

Functions

Title Verification
Property Set Up
on Asset Records
Recording of Documents
Land Records
and Contracts
Division Orders
FPC Rate Filings
Delay Rental Records
Land Files

FIGURE 3

Oil Accounting Section

Functions

Verify and Process Oil and Gas Receipts
Joint Interest Accounting
a. Pay expenses as operator
b. Bill and collect from non-operators
c. Verify and pay outside operator statements
Disburse Royalty
Bookkeeping (Company or Partnership Books, where applicable)
Employer Payroll
Accounts Payable and Receivable
Joint Venture Audits
Equipment Inventories
Payor Records
Ad Valorem Tax Rendition and Payment
Delay Rental Receipts and Payments
Accounting Files

FIGURE 4

related to proper payment for oil and gas runs and expenses related to this type of production. Invoices are first approved by an engineer, then processed and paid by the working-interest accountant. On

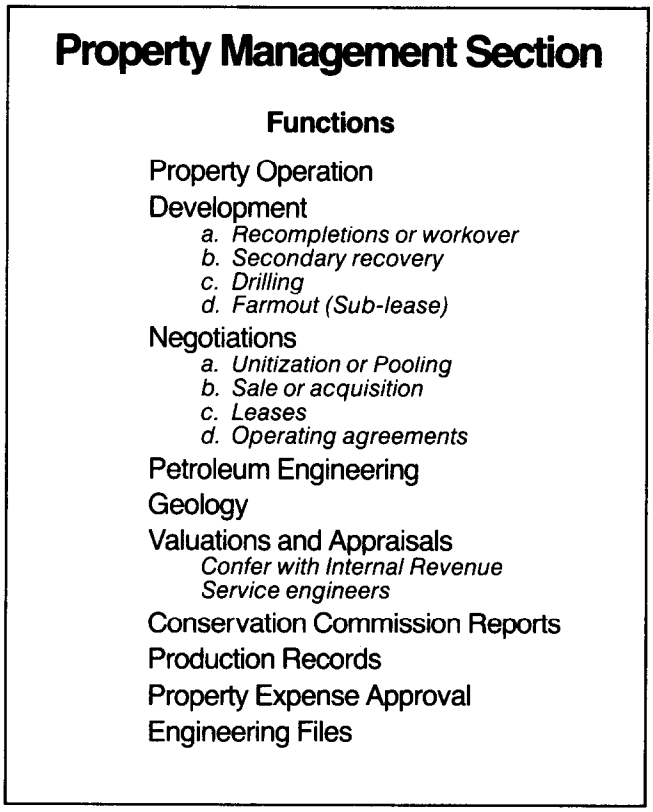

FIGURE 5

bank operated properties, the accountant pays the expenses for items such as the contract pumper, fuel and electric bills, and other vendor invoices. Then he bills the non-operating partners. On non-bank operated properties, the working-interest accountant processes and pays the operator's invoices. When royalty owners are not paid by the oil purchaser or pipeline company, the accounting section disburses these payments.

The engineer in the property-management section is most closely involved in day-to-day operations of the properties. On bank-operated properties, he hires contract pumpers or other necessary personnel; designs or sizes pumping equipment or other producing equipment needed, and arranges for the purchase of this equipment; and, with the aid of a technical assistant, oversees the day-to-day management of the properties. The engineer or technical assistant must also arrange for well tests, have the production reports prepared, and observe EPA and FEA requirements affecting the leases.

If remedial work or additional development is indicated, the engineer is responsible for preparation of procedures or well guides and AFE's and is responsible for well-site work on workovers, recompletions, and new wells. If additional expertise is needed, a consulting engineer or geologist may be employed for well-site technical supervision.

BASIC FIDUCIARY RESPONSIBILITIES

The envolvement of a bank in an oil estate or trusts may begin in two ways. Often, upon the demise of an oil owner, the bank may be named executor under his will. Other times, an oil owner, upon reaching an age where he wishes to retire, and perhaps not having a son or daughter who desires or is technically equipped to continue management of the properties, may name the bank as trustee to manage the assets with income to him initially and to future generations after his demise. In either the estate or trust, certain actions must be taken to insure the continuity of operations.

The first step in establishing the estate or trust is the gathering and compiling of assets. When the Trustor is still living, this compilation may not be difficult, but when the Trustor is dead, the Trust officer and oil department personnel must go through all available files, obtaining documents of title, lease records, run check stubs and other evidences of property owned by the estate or trust. These files must be examined immediately to determine the types of interests owned, whether the leases are productive, and whether there are obligations which require action. Producers, operators and pipeline companies are notified. Division orders must be filed with the pipeline companies so that payments for production may be redirected. Asset files and records are set up in the trust oil department of the bank. These functions are normally performed by a landman or title analyst in the Land Section. Additionally, accounting records are set up by the Accounting Section, for processing of oil and gas receipts and payment of expenses.

The second step is evaluation of the assets. This step is particularly important because the evaluation may serve as the basis for State and Federal inheritance taxes, and set the cost basis for properties that may later be sold. On smaller estates, the evaluation may be performed by a registered professional engineer within the department.

However, on larger estates, independent consulting petroleum engineers are retained to make the appraisal. In additon to freeing bank engineers for day-to-day account management, the hiring of an outside consultant has the added advantage of insureing complete objectivity in the appraisial if a dispute were to arise with the Internal Revenue Service as to the property values. Furthermore if the dispute cannot be settled out of court, the consultant may serve as an expert witness. So far, virtually all of our differences have been resolved in engineering conferences, without court action.

The third step after assets are set up and appraised, involves review of the possible dispostion of each property. Occasionally it may be necessary to sell real assets to raise cash for estate taxes or other debts or to reinvest for better diversification or to increase yield. Unless there is such a specific need to sell mineral assets however, they should be retained to permit continuation of cash flow, or for future development to the benefit of the heirs or other designees. If the property were sold, that purchaser would expect to make a profit. If the property is not sold, this projected profit, together with any future increases in oil and gas prices, will accrue to the beneficiaries. With the price increases of the last few years, and with development of new leases, the bank has seen significant increases in income to the accounts it represents, beyond what would have been received in sales at prior market values.

A fourth step in the establishment of the new estate or trust is assumption of operations or other business obligations. If operating interests are included in the account, the property management section must immediately assume operations and continue any development in progress. Partially developed leases should be evaluated to determine if further drilling is justified, or if farmout to others may be favorable. Direct contact with the pumpers or with other field personnel must be established to assure continuity. Wells requiring workovers or recompletions may require immediate attention. Co-owners will be notified, and, of course, where necessary, their approval of AFE's and other expenditures is obtained.

Another responsibility of the fiduciary is to review, at least annually, all the assets of the estate or trust to determine value, income or yield, and retention policy. Such review is necessary for compliance with banking regulations, but it also serves to keep the account officers fully familiar with all properties. As a part of this full review, a report is made to the Trust Committee and to the beneficiaries or other interested persons. This report would, of course, be in addition to the routine reports and statements issued monthly.

EXAMPLES OF OPERATING SITUATIONS

The following operating situations illustrate the types of involvement of the bank in adminstration of oil trusts. The bank as agent and trustee was operator of four flowing oil wells in a major field in Texas. The 4800-foot wells were in a highly faulted reservoir with bottom water drive. One well began producing excessive water, and oil production declined to 20 barrels of oil per day. Because of poor cement on the original completion (in 1940), workover attempts were unsuccessful. Based on engineering and geologic data, a replacement well which paid out in three months was drilled. After producing over 100 barrels of oil per day for four years, the replacement well also began cutting water, and a recompletion attempt was again necessary. The well was reperforated and again returned to top allowable, water free production.

In another case in which the bank was trustee and operator, it operated five gas wells, selling to an intrastate utility and to an industrial user. Responsibilities included the routine day-to-day operations as well as the negotiation of a new gas-sales contract. Through the price gained by negotiation of a new contract, and through improvement of operating procedures, income to the owners was more than quadrupled.

As non-operator of leases, the bank also takes firsthand interest in the profitability of the leases. The engineer approves invoices from the operator, evaluates proposals for workover and development plans and AFE's, and, with the account's attorney, reviews gas contracts and other types of agreements. Because of the wide-ranging ownership of these types of interests, this is the area where bank trust personnel are usually encountered.

Different operating philosophies are most often encountered when the bank is a non-operator of leases. The basic nature of the trust is that the

corpus, and income derived thereform, must be preserved and maintained in the most prudent manner during the life of all benefiiaries. There may be income beneficiaries now and remaindermen later; there may be beneficiaries who depend on a particular asset to furnish all their needs now, or there may be beneficiaries who have tax problems and do not need current income. One situation in which these options must be weighed is in the leasing of undeveloped lands. On one hand, the trustee may negotiate for a higher bonus and standard royalty; in another account without immediate cash needs the lessor or trustee may forego bonus, or take a reduced bonus, in favor of higher royalty reservation.

Another situation in which different account needs must be recognized is in field unitization negotiations. Normally, the bank engineer assigned to an account may serve on both the engineering and operator committees, and thus he is aware of preplanning that will affect the profitability of leases that are owned by an account as well as of the negotiation for participation formulas that will in the future affect such profitability. In an oil company where several tracts are owned within the proposed unit area, the company can look at the overall effect of the unitization formula and vote "for" or "against" as a whole. When the bank serves as trustee for a number of different trusts, each owning in different tracts, the trustee must look at the effect on each trust independently. A formula that is advantageous to some may have an unfavorable effect on another, and since entirely different beneficiary owners are involved, the trustee cannot "average out" the effects on the tracts. Each beneficiary must be treated as if that tract is his only interst in the unit, and the tract participation must be acceptable to his individual ownership without regard to other Trust accounts.

An example of such a unitization study occurred recently in one of the major fields in the eastern part of Texas where the bank represented three accounts with working interests and twenty-three accounts with various royalty interests. The bank participated in the engineering committee to observe the effects of log correlations, net pay determination, and the handling of all engineering and geologic information and in the working-interest owners' committee as various fomulas were considered. After several years of engineering studies, a formula was adopted that appeared to treat every tract equitably. However, price controls had been implemented in the meantime, and staff engineers of the bank became aware that unitization would cause the loss of what was at that time described as "new and released" oil classification. Because this was a significant factor in the income received by some of the accounts, the bank had to push consideration of a way to account for this. After several months of negotiations, the operator came up with the simple solution that tract production within the unit would be accounted for on an individual-tract basis and new oil could be obtained for those tracts that were eligible. That percentage of new oil price was then applied field wide. The unit was eventually approved by 99.9 percent of the working interest owners and more than 99.7 percent of the royalty interest owners. The income to our accounts from this upper-tier oil price was maintained to yield additional revenue in excess of $45,000 per month.

Oil department personnel perform many diverse functions in the management of mineral assets. In addition to those described above, the bank has been involved in the management of a lead mine in Arizona, the leasing of coal lands in North Dakota, core-testing to evaluate phosphate reserves in Florida, overseeing gasoline-plant operations, and (in at least two cases) investing in drilling ventures where intangible development costs may be used as a tax benefit to the account. In these last two cases, high cash flow with relatively lower requirements for income distribution to beneficiaries resulted in maximum income tax rates. In both cases, exploratory drilling is permitted under terms of the trust or agency agreement. Working with independents and small companies in 1975 and 1976, the bank has participated in the drilling of 40 semi-exploratory wells, eight of which were completed as oil wells and eleven as gas wells for success ratio of 47-1/2 percent.

In summary, a bank with extensive assets in trust and a complete staff to manage those assets, will function somewhat as a small- or medium-sized oil company. Perhaps one way to describe the main management difference is to compare a bank's trust committee to a board of directors, but to realize that instead of a group of shareholders with a common interest, the trust accounts have a widely varied group of beneficiaries with very individual needs or goals.