THE AMERICAN OIL & GAS REPORTER®
May 2006
The "Better Business" Publication Serving the Exploration / Drilling / Production Industry

Securities Law Returns To Its Beginning

McPHERSON, KS.–Like an end-around gone awry, the Kansas oil and gas industry has had to cover a lot of territory to get back to where it started in terms of not having to register oil and gas drilling deals as securities.

Three attorneys discussed the history and status of Kansas securities law and the exemption for oil and gas prospects during the Kansas Independent Oil & Gas Association's 2006 midyear meeting on April 12 in McPherson. In another workshop session, a panel put together by the North Mid-Continent Region of the Petroleum Technology Transfer Council discussed the history and growing use of coiled-tubing drilling.

Undivided interests in royalties, oil leases and mineral deeds located in Kansas are securities that historically have been exempt from registration requirements under the state's securities laws, noted KIOGA Legislative Chairman David Nickel, an attorney with Depew & Gillen LLC in Wichita. But that exemption was narrowed in 1980, he said, when the Kansas Legislature amended the Kansas Securities Act by adopting KSA 17-1262a.

The need to narrow the exemption arose from the explosion of fraudulent oil deals and "boiler room" operations during the drilling boom of the late 1970s, related Dwight Keen with Keen Oil Company, who served as Kansas securities commissioner from 1977 to 1982.

Of the numerous complaints his office received, Keen recalled, "The greatest number came from one source: KIOGA. I can't remember how many times (former Executive Vice President) Don Schnacke made the journey to our office to give us yet another offering brochure he had been provided . . . by legitimate industry members who were concerned and really appalled by some of the oil and gas investment scams being offered to unsophisticated potential investors by promoters who had limited, if any, experience in the oil and gas business."

With KIOGA's support and the assistance of an industry advisory committee, Keen said his office attempted to devise a statutory exemption for oil and gas securities that struck a balance between not inhibiting legitimate capital formation and prohibiting abuse. The result was the enactment of KSA 17-1262a, which set forth the exemption from registration under the Kansas Securities Act for sales of oil and gas leasehold interests.

"That exemption worked well from 1980 until 2004," Nickel assessed. That was when the legislature passed the Kansas Uniform Securities Act (KUSA) to conform Kansas law to a uniform securities act being adopted by states across the country. The problem, Nickel noted, was that the uniform act did not contain the exact oil and gas exemption set forth in KSA 17-1262a.

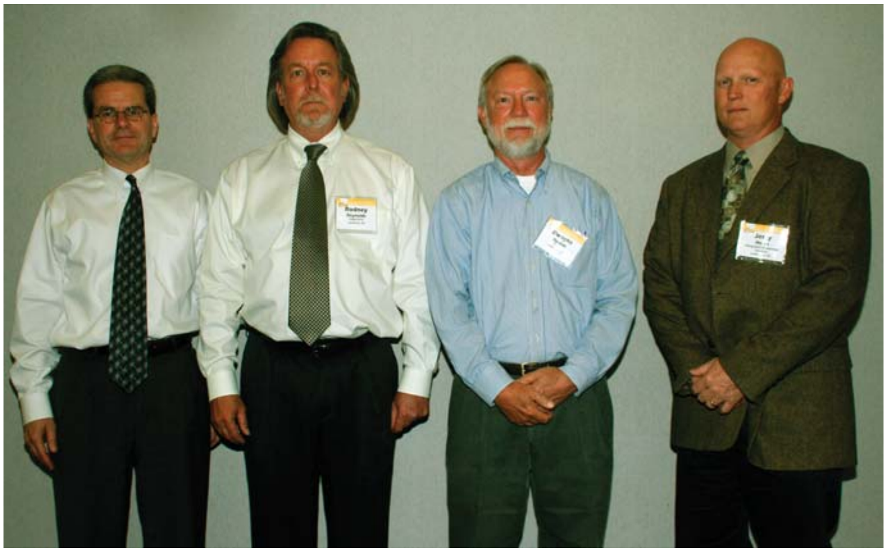
"The securities commissioner didn't want to add KSA 17-1262a to the KUSA because he wanted to maintain the uniformity," he said. "The commissioner told us he would subsequently seek to adopt by regulation an exemption for oil and gas securities that would (duplicate) KSA 17-1262a in principal part."

Unfortunately, Nickel continued, the KUSA allowed the commissioner to exempt a class of securities, "but nothing there allowed the securities commissioner to adopt a mirror of KSA 17-1262a. Legitimate operators could meet the requirements of the KUSA to be exempt from registration, but any boiler room could also."

Hence the need for HB 2663, which the Kansas Legislature passed this spring and Governor Kathleen Sebelius signed into law on March 28. Essentially, Nickel explained, HB 2663 allows the securities commissioner to limit the availability of exemptions for transactions involving interests in oil, gas or other minerals so that he can adopt by regulation the same exemption previously contained in KSA 17-1262a.

Staying Within The Law

Discussing Kansas securities law at KIOGA's midyear meeting were, from left, Diana Edmiston, David Nickel and Dwight Keen.



Comprising the coiled tubing panel during the KIOGA midyear meeting workshop session were, from left, Kent Perry, Gas Technology Institute; Rodney Reynolds, Petroleum Technology Transfer Council North Mid-Continent Region director; Dwight Rychel, PTTC consultant; and Jerry Noles, Integrated Production Services.

There are three ways an oil and gas operator can assure his offering is exempt from registration under KUSA, outlined Diana Edmiston, general counsel for Murfin Drilling Company Inc. The first is that if all the investors in a deal have been in the oil and gas business for two or more years.

If that is not the case, Edmiston continued, a deal can still be exempt if four conditions are met:

- It is sold to 32 or fewer investors.
- All parties purchase the deal for investment and not for resale.
- There is no general solicitation (i.e., mass mailing) for investors.
- No commission is paid.

Third, Edmiston added, "Your offering may still be exempt if you are selling your entire interest in a property that is producing in paying quantities at the time the property is offered and sold."

However, emphasized Keen, "There are no exemptions from the anti-fraud provisions of state or federal securities law."

Those provisions, in essence, require the disclosure of all material facts concerning a securities offering and prohibit the nondisclosure of such material facts, he said. But what constitutes a "material fact" can vary depending on the circumstances, Keen cautioned, saying, "Ambiguity as to the degree of disclosure required may arise and create a gray area about which reasonable persons may differ."

Edmiston attempted to illustrate several types of potentially fraudulent activity. Among them, she indicated, are billing for work not performed, taking money to drill a well that is never drilled, knowingly misrepresenting reserves, pretending to own a lease, and selling more than 100 percent of a property.

Taking a fee or payment upfront for drilling a well and then billing for additional drilling-related services is not fraud per se, Edmiston said, "but it could become a gray area" that could trigger an investor complaint. "Failing to assign a working interest after that working interest is earned is fraudulent activity," she added. "Assigning all the working interest when the well is a liability rather than the asset it is purported to be, can also be part of a fraudulent scheme."

Coiled Tubing Drilling

Traditionally, coiled tubing has been associated with well cleaning operations, fishing and milling, zonal isolations, stimulation and fracturing, sand-control completions, and flow management, observed Dwight F. Rychel, a Tulsa-based petroleum engineer and consultant to PTTC, during the second part of the KIOGA workshop session.

But he pointed out that CT drilling with built-for-purpose rigs was growing in popularity in Canada, where CT's share of the surface-drilling market grew from 9.6 percent in 2000 to 27.0 percent in 2005. "We have every reason to think that will be replicated in the lower-48," Rychel stated.

Driven largely by coalbed natural gas drilling in Alberta, Rychel said CT drilling began in the mid-'90s. By 2000 there were 15 first-generation CT drilling rigs. By 2005 the count had grown to 50, and, "There are 50 additional rigs scheduled to be built this year," he reported.

Their popularity lies in simple economics, Rychel held. "The day rate for a CT rig in Alberta is $12,000. It drills a hole in a day. The day rate for a rotary rig also is $12,000, and it drills a hole in three days," he detailed. "That is pretty easy math."

The Niobrara Chalk in western Kansas and eastern Colorado is home to one of the first significant CT-drilling projects in the United States, advised Kent F. Perry, director of exploration and production research for the Gas Technology Institute. He said a CT rig owned by Advance Drilling Technologies dug 220 wells for Rosewood Resources last year in the Niobrara.

GTI got involved through a Department of Energy grant to document the performance of CT drilling in marginal reservoirs. Perry said in a commercial operation near Goodland, Ks., a water-well rig was used to make an $8\frac{3}{4}$-inch open hole and set $5\frac{1}{2}$-inch casing. The CT rig was then moved in to drill to total depth, run $2\frac{7}{8}$-inch tubing for casing, cement the bottom of the hole, perforate, fracture, and put the well on production for $88,000. The cost for a conventional rotary rig, he estimated, was $125,000.

Rapidly changing day rates, steel prices and other well components make it difficult to get a direct comparison, Perry allowed, but "a 25-35 percent (cost savings) per well is easily documented," he maintained.

Rig mobilization and rate of penetration are two reasons for CT drilling's efficiency, Perry said. Rosewood is now drilling 400-500 feet an hour. The CT drilling system moves in four permit loads, with the derrick, coil and drilling platform on one trailer, he added. "These wells are drilled in one day to 3,000 feet," he attested. "That includes moving in, drilling, logging, running the casing, cementing–the whole nine yards. The next morning they go to the next site and do the same thing again."

Going Directional

There are three market sectors suited to CT drilling, suggested Jerry Noles, special services manager for Integrated Production Services in Oklahoma City. The first is regular vertical drilling in softer formations. "Anything that can be drilled with a polycrystalline diamond compact bit can be drilled with coiled tubing," he said.

The second is directionally drilled wells to enable multiple bore holes from a single drilling pad, Noles continued. Of the 5,000 CT wells drilled in Canada last year, he said, 2,000 were directional.

"The last element is horizontal, directionally drilled wells," Noles extolled. "This is by far the most technical, demanding portion of CT drilling."

It, too, is an application that is moving from north to south, according to Rychel. He said BP and ConocoPhillips began drilling deep, re-entry laterals in 1993 in Alaska. "By 2001 they had drilled 250 sidetracks and were beginning to do multilaterals," he reported. "Last year the two companies completed their 500th sidetrack, with 100 of those being the ultraslim holes, which is a 3-inch hole cutting a 2⅜-inch liner."

Integrated Production Services was involved in a project last year to evaluate the technical capability of horizontal, directional CT drilling in the Cleveland Sand, a mature tight-gas reservoir in the Texas Panhandle, Noles reported. "Whenever we talk about horizontal, directional CT drilling, we are going back into mature reservoirs to recover additional reserves," he said.

Noles said IPS did a project that he termed technically and operationally successful with radically improved production. "We are beginning to realize that reducing the amount of mud invasion greatly improves production. In the wells we drilled, on a foot-for-foot comparison with rotary drilling we got a significant improvement in production, and one of the wells is the highest-producing well in the field," he declared. ❐