

Interview

Drilling and Producing Oil and Gas

An Interview with Stewart Mills Reid, Chairman and Chief Executive Officer, Millbrae Energy LLC, and Robert King Jr., President, Millbrae Energy LLC and Millbrae Capital LLC



Stewart Mills Reid

EDITORS' NOTE Stewart Mills Reid, who has almost 30 years of experience in the oil and gas business, founded Millbrae Energy in 2001. Reid also founded SMR Energy, a private oil and gas acquisition purchaser, in 1986, and sold a controlling share in the company to his management team in 1998. Prior to entering the energy business, Reid practiced law at Simpson Thacher & Bartlett LLP. He graduated from Wesleyan University, where he has served as a trustee, and Columbia University Law School.

Bob King joined Millbrae Energy in 2005 and has primary responsibility for its sales, marketing, and legal functions. King has more than 20 years of experience in capital-raising and acquisition transactions, and has served at Clifford Chance LLP, the world's largest law firm, since 1984. At Clifford Chance, King has been a partner, Global Head of Capital Markets, Head of Corporate Finance, and a member of the executive committee. King graduated from Colgate University and Harvard Law School.

COMPANY BRIEF Founded in 2001 and headquartered in Greenwich, Connecticut, Millbrae Energy (www.millbrae-energy.com) has become a leading proponent of using advanced dewatering technologies to produce oil and gas. Millbrae and its partners have combined these technologies with horizontal drilling to find and produce substantial oil and gas reserves from fields known to contain oil and

gas, but previously bypassed by other operators due to high water saturation in the reservoirs. Over the past several years, Millbrae Energy has participated in the development of 10 fields in Oklahoma with high potential for applying dewatering technology. Millbrae and its partners have established a substantial land position in high-potential areas, creating an inventory of hundreds of potential future drilling locations. Millbrae has developed relationships with leading independent operators, including its primary partner, Special Energy Corporation.

What was the impetus for creating Millbrae Energy?

Reid: When I began Millbrae in the spring of 2001, I was seeking a new niche where I could invest large amounts of capital safely, but also achieve a high rate of return. These were my two guiding principles. My gut feeling was that the key to success was repeatability, and that this could best be accomplished by drilling low-risk wells on larger blocks of acreage. The dewatering business, which presented itself to us in 2002, met these goals almost perfectly, because dewatering is a technology that allows you to go back into reservoirs where many wells have been drilled in the past. However, these older wells encountered large water volumes, which they couldn't handle or dispose of. With modern dewatering technology, we can do so. Because we are able to access the public records of prior drilling and production, we know there is oil and gas in the reservoirs. For us, it's a matter of going back into those reservoirs and pulling out that oil and gas. In one of our early projects, called the Paradigm field in Oklahoma, we were able to drill over 100 wells, and we ultimately sold that project to a third party. That really showed that we can control large blocks of acreage and have a successful result. You can definitely repeat the process over and over again.

What are Millbrae's business goals?

King: Our goals are to preserve capital and seek high rates of return in energy projects. Having become a leader over the past six years in the dewatering business, Millbrae is well positioned to continue doing what we have been doing. We want to find significant fields, control large blocks of acreage, start with a pilot project, and then continue it for many months or years. We intend to stick to our knitting and find appropriate places where



Robert King Jr.

dewatering works in Oklahoma and elsewhere, and then repeat that process over and over again.

You've implemented a new method for oil and gas recovery. What exactly is dewatering?

Reid: Dewatering is a technological breakthrough that has really developed over the past 15 years. It involves using two key technologies to go back into fields. We go back to where people have previously drilled wells, but encountered water. For the conventional operator, water is a big problem, because you don't always know what to do with it. How do you get rid of it? How do you make sure it's all handled safely?

We have used submersible pumps to pull all the fluid out of the hole. This reduces the pressure in the formation and allows oil and gas – the hydrocarbons themselves – to flow to the wellhead and allows us to begin producing and selling them and seeing significant returns. We pump out all this water, which is actually very briny and salty. Our secret is that we drill a separate disposal well, so we can send the water straight back underground. It never sees the light of day, and it is safely disposed of. The key to dewatering is accessing the reservoirs, pulling the water out, lowering the pressure, and then seeing the oil and gas flow.

King: The other thing that has changed in the technology is the onset of horizontal drilling. In the old days, folks would drill a

hole straight down into the ground, and they would contact just a very small part of the reservoir that held the oil and gas. Today, the technology allows us to go down and make a right or left turn and go thousands of feet laterally across a formation, contacting much more oil-bearing or gas-bearing rock. We have the opportunity to produce more from a single location than we did in the past. Horizontal drilling is also more environmentally friendly up on the ground level, as we can drill wells to multiple locations from a single pad on the earth's surface.

Is there much competition in this sector?

Reid: Dewatering is not a particularly common or widely used process. There are only a handful of companies, including Millbrae, which focus on the dewatering business. It's really a niche technology, and one that is not attractive to very large or very small companies. On the one hand, our projects are substantial in size; \$1 billion of oil and gas might be found in a good project, but that's not really enough for the biggest companies. On the other hand, there's a lot of technology, expertise, and capital needed to make a pilot project work. When you combine those, it means the smaller companies are probably not able to compete effectively. So there's a select group of companies in the middle that are focused on the dewatering business.

Where do you expect your future growth to come from?

King: One of the great advantages Millbrae has today is what we like to call our land bank. Together with our partners, we have accumulated a position of over 250,000 acres of lease rights, which allow us to go in and drill for oil and gas in those areas. That could represent as many as 200 wells we could drill on land that we already control. In other words, we know there's a significant pipeline of opportunities to pursue over the next few years, simply from what we already control. In addition, our talented team is always evaluating new projects, and we do think there are a number of opportunities out there that we will be able to lead or participate in. We believe strongly in partnering with other talented companies, and do so on every deal we do. One of the benefits of being a significant player in a business niche like dewatering is that we think we see almost every interesting dewatering play that's out there, and we certainly hope we will be taking long looks at all those and doing the ones that make sense.

How does your business model work?

How do you gauge your success?

Reid: We have traditionally raised money from high net-worth investors, in part because the firm really grew out of a "friends and family" approach. We take that money and invest it into the fields we are pursuing in Oklahoma and Texas. To us, success means achieving our twin goals of capital preservation and solid rates of return.

We are a company that's focused on drilling and producing oil and gas. We see ourselves as operating at the more conservative end of the drilling business. We do what's known as developmental drilling, rather than

exploratory drilling, and as a result, we expect to find oil and gas in virtually every hole that we drill.

We believe success is ultimately measured by how much oil and gas we can find and produce in a particular field. It's all well and good to find the oil and the gas, but unless you can actually pull it up and produce it, you haven't really done yourself all that much good.

We think we have become an efficient and low-cost finder of oil and gas. We have a comfortable margin on sales at today's prices. We are also bullish on the medium- and long-term outlook for natural gas prices in particular, which would bode well for future production. We certainly hope we will continue to find it at prices like that. Over time, we expect we will be able to sell it at higher prices if, in particular, natural gas prices continue to demonstrate some strength over time.

How has the sharp move upward in oil prices affected exploration and investment?

King: Price has had a marked impact on exploration and investment. There has been a significant increase in the amount of drilling activity in the United States in response to increasing prices. Of course, there have been activity increases all over, but it's certainly noticeable in the U.S. For other companies, higher prices have made some projects more economical – projects that they might not have been able to do otherwise. For us, our projects were already economical, and it's really made our returns just more attractive at higher commodity prices.

Our projects tend to find more natural gas than oil, but we do produce both. The onset of current oil prices – over \$130 per barrel as we speak – has really changed the dynamics of the industry. Interestingly, natural gas pricing has not quite caught up to it yet. We see a big possibility for upward movement in natural gas prices over the next three to five years, simply because, at today's levels, natural gas trades at a 50 percent discount on an energy-equivalent basis to oil.

What are the biggest challenges facing your industry, and how can they be addressed?

Reid: Within the oil and gas business, one of the biggest challenges is what we call the talent gap. In our business, there is basically a missing generation of people who left or never joined the industry during the 20-year-long depression in the energy field, from the '80s to the turn of the 21st century. As a result, there really is not a middle level of folks who have the required expertise to succeed in the business. There are a lot of young people who have come into the business recently and a lot of senior people in their 50s and beyond who have been in the business for quite some time.

That said, one of Millbrae's great strengths is our management team, which has an average of over 20 years in the business and covers all of the disciplines and technical expertise that we need to run the business right, like engineering, geology, land, finance, and legal transactional expertise. All of that we now have in-house, and since finding those people can

be pretty tough, we are excited that we have put together a team that touches all the bases.

You partner with other companies in Oklahoma. What is their role in Millbrae's business initiatives?

King: In each transaction and joint venture that we have undertaken to date, we have had an operating partner working closely with us. The operating partner is the person who runs the wells on a day-to-day basis. We work together with them in terms of laying out the overall strategic plan, determining where drilling will occur and how the project should be developed, and handling a variety of operating issues day-to-day. Although we have the staff necessary to be an operator, we have not yet determined when, or if, we will take that step.

In our business, it's also important that operators – and every person involved – be given appropriate incentives, and we are very happy that our joint venture partners are significant coinvestors with us in every transaction. We all have an important amount of capital at risk and are hopefully making good returns, and we have managed to partner with virtually all of the significant experts in the dewatering niche. We regard that as another one of our strengths.

How do you decide which business opportunities to pursue?

Reid: We are looking very carefully at all dewatering opportunities that come out. We have an internal process whereby our technical staff researches and reviews all interesting opportunities that come across our radar screen, and those opportunities are looked at from a variety of angles: We review the geologic and engineering issues to determine how difficult it will be to accomplish; how likely it is that we will be able to get the land under control; and what other issues might cause concern. All of those analyses are brought together, and management makes a decision to pursue or not pursue a deal on that basis.

Traditionally, investing in oil and gas exploration has been seen as a risky venture. How do you manage risk?

King: Millbrae has a very conservative risk-management philosophy. We think there are a number of risks that are associated with oil and gas drilling that can be mitigated and controlled.

First of all, we do not focus on what we call exploratory drilling. We are going back into those reservoirs where oil and gas have previously been found. So we are simply going in and trying to pull that oil and gas out – along with the water that may have previously stopped people from exploiting these reservoirs.

Second, we are very focused on diversification in our investments. We like to have a lot of wells and a number of different fields and operators in the portfolio. We also operate without using debt. We hedge the downside of oil and gas pricing, so that if prices decline, we have some protection.

Finally, we work with quality operators. We carefully select the joint venture partners with whom we work, and we think that's an important element of being diversified and managing risk. ●