



Dec 10, 2019

Categories:

[Blogs](#)

[Private Equity Industry](#)

[Blog](#)

Authors:

[Mike Brewster](#)

Private Equity Investment in Oil and Gas through DrillCo Transactions

Despite the lack of traditional funding, the energy industry has continued to grow, with crude oil production reaching 11.9 million barrels per day in December 2018. The upward trend of increased production in the U.S. has continued into 2019, with production around 12.4 million barrels per day. This trend is the same with natural gas, as domestic production reached a new record high in 2018.

As a result of tighter capital markets, traditional financing for upstream oil and gas operations, such as drilling, is increasingly difficult to obtain. Borrowers face increasingly stringent lending standards, and lenders are ever cognizant of the inherent risk of upstream oil and gas development, especially in a low-price environment. Upstream oil and gas operators often need to employ alternative financing vehicles, which can be advantageous.

Private equity firms provide one alternative financing solution to oil and gas operations, replacing traditional funding sources such as conventional bank loans or the issuance of securities. During the last few years, a transaction structure called a “DrillCo” has emerged, which is a term used to describe a drilling joint venture arrangement. In a DrillCo transaction, an investor agrees to fund all or a significant portion of the drilling costs for a certain number of wells in exchange for a percentage interest in the oil and gas lease or the well, which is called a working interest. The drilling costs that the working interest owner funds include a portion of the costs associated with the exploration, drilling and production of a well.

In a DrillCo transaction, an operator contributes acreage, and the private equity investor contributes cash to cover most of or all the costs associated with drilling oil wells. In exchange for putting up the capital, the investor earns and is assigned a working interest in the wells drilled.^[1] In typical DrillCo transactions, the working interest assigned to the investor is subject to partial reversion to the operator once the investor achieves a predetermined internal rate of return on its investment, called an IRR Hurdle.

Operators like the use of DrillCo arrangements because, if structured properly, DrillCos preserve cash flow and avoid balance sheet liabilities. For an operator with limited access to capital who is holding acreage with development potential, a DrillCo transaction presents an attractive mechanism by which the operator can develop its acreage. Instead of using its own cash, an operator relies on the investor's funds to increase production and enhance the value of the acreage. Utilizing this strategy, the operator is more likely to obtain favorable terms in an ultimate sale, a public offering or a refinancing. In addition, a DrillCo enables drilling activities to commence, which can also provide the operator with the capital necessary to maintain its leases prior to the expiration of the primary term.

Private equity groups favor DrillCo arrangements for a variety of reasons. First, a DrillCo allows the private equity group to invest a substantial amount of capital in a single transaction while utilizing an efficient and effective means of investing. In contrast to a DrillCo transaction, when an investor funds a portfolio company, the investor undertakes the task of identifying a management team, and then the investor assumes the risk that the team can source and close on acquisitions and successfully develop the acreage. With a DrillCo transaction, the investor looks for an established operator with a proven acreage position, a track record of success and well production, which minimizes the investment risk. The investor can minimize the geological and operational risks by investing in drilling prospects that have been identified, tested, and proven. Finally, investors prefer DrillCo arrangements because they offer greater protection in the event of a bankruptcy, because the investor owns a real property interest in the assets through the assignment that it receives.

A Joint Development Agreement ("JDA") is the key DrillCo agreement and contains the comprehensive expression of the rights and obligations of the parties to the DrillCo. Key terms in the JDA include:

- the time period for completing the development plan;
- the operator's carried working interest;

- the investor's pre- and post-reversion working interest;
- the IRR hurdle; and
- the number of wells in each tranche.

Since the parties ultimately want to sell their interests in the underlying assets, the JDA addresses issues that frequently arise in the context of a sale. Terms may include a right of first refusal, tag-along rights, and drag-along rights. Arguably, the most important protections provided by the JDA are the transfer prohibitions. One transfer prohibition protects the investor by prohibiting either party from transferring its interest until a group of wells has been drilled and completed; the other protects the operator by prohibiting transfer until the development plan is fully funded.

The JDA typically incorporates a Memorandum of JDA, which puts third parties on notice of the terms and obligations of the parties under the JDA. The JDA will almost always include an Assignment, which is used to convey the working interest to the investor (subject to reversion) in the relevant leases and/or wells.

Assignments can be made on a well-by-well basis, on a well tranche basis, or simply on a periodic basis, as negotiated by the parties. The working interest earned may be on the entire lease, or it may be limited to a well-borne assignment. Both the Assignment and the Memorandum of JDA will be recorded in the real property records in the county or counties where the underlying properties are located.

A DrillCo transaction is not suitable for all cases. A DrillCo is typically used in areas where the geological formations have proven to be productive and where the geology has been developed. Because of the prior production and the tested geology, there is a reduced risk profile associated with development. For the operator, an area like this creates many possible drilling locations that will likely produce reliable cash flow. However, the operator may not have the capital to develop all of these possible locations. As a result, areas like this are attractive to both operators and investors, with the downside being that a large amount of capital is required to develop this inventory of drilling locations. In contrast, DrillCo transactions would usually be unsuitable to fund the development of new areas and untested geology, as this situation would likely present an unacceptable level of risk for the typical DrillCo investor.

While relatively new, DrillCo arrangements have proven useful in the oil and gas industry. It is unlikely that traditional funding sources will free up and provide the capital necessary for drilling in oil and gas operations. DrillCo structures are helping and will continue to help fill this funding gap, as this transaction structure provides both private equity companies and upstream oil and gas operators recognizable advantages.

For more information, contact [Mike Brewster](#) or any member of Frost Brown Todd's [Private Equity Industry Team](#).

[\[1\]](#) The investor also receives the proportionate tax benefit.

© 2026 FBT Gibbons LLP. May be considered attorney advertising in some jurisdictions.