

# Merit Energy Company, LLC Brochure

For the Year Ended December 31, 2014

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**This brochure provides information about the qualifications and business practices of Merit Energy Company, LLC. If you have any questions about the contents of this brochure, please contact us at 972.701.8377. The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission or by any state securities authority.**

**Additional information about Merit Energy Company, LLC also is available on the SEC's website at <http://www.adviserinfo.sec.gov>.**

While Merit Energy Company, LLC is a Registered Investment Adviser, this registration does not imply a certain level of skill or training.

## **Material Changes**

There have been no material changes from the last annual update done as of December 31, 2013.

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#### **Item 4 - Advisory Business**

Merit Energy Company (MEC) was formed in 1989 and is owned by William K. Gayden and Family. MEC only provides investment supervisory services to limited partnerships. We are the direct or indirect sole general partner of 26 limited partnerships which invest in oil and gas net profits interests and working interests. We also engage in over-the-counter derivative transactions for commodity price risk management practices. We do not give advice with respect to other securities. As sole general partner, we have discretion over which oil and gas interests the partnerships buy, hold and sell. On behalf of the partnerships, we locate oil and gas interests, contract for their acquisition, close their acquisition, manage them, and determine when to sell them. Although we must operate within the parameters established by the limited partnership agreements, we do not need limited partner approval to take these actions. As of December 31, 2014, MEC managed \$4.8 Billion of client's assets all on a discretionary basis.

#### **Item 5 – Fees and Compensation**

#### **Item 6 – Performance-Based Fees and Side-By-Side Management**

Our basic fee schedule is to charge a quarterly fee, payable in arrears, of 0.3125% of the greater of invested capital or net book value of partnership assets up to the amount of capital committed to the partnership, plus 0.25% of the net book value in excess of such amount. There is generally a first year minimum amount due of 0.5% of committed capital. We also receive a carried interest as a limited partner in each partnership in an agreed percentage of partnership profits after the limited partners have earned an agreed minimum return on their investment. In 22 of the partnerships, the carried interest is 13%, and in the other 4 partnerships, the carried interest ranges from 10% to 15%. We also receive a carried interest (in the 22 partnerships with 13% carried interest and one other partnership) with respect to the purchase price of the partnerships' oil and gas properties, pursuant to which the partnerships pay an additional 2% of the cost of the properties for our benefit (e.g. a partnership pays 98% of the acquisition cost of a property for a 96% net profits interest or working interest as applicable).

Our carried interest in profits is paid only after a threshold level of profits are earned, and our carried interest with respect to the purchase price of the assets is paid as properties are acquired. In addition, the general partner will be reimbursed at cost for organization costs of each partnership and its general and administrative expenses associated with managing the oil and gas properties and partnerships are allocated equitably among all of the partnerships the general partner manages.

#### **Item 7 – Types of Clients**

MEC provides investment supervisory services to corporations and partnerships.

## **Item 8 – Methods of Analysis, Investment Strategies and Risk of Loss**

We search for and analyze available oil and gas properties by researching seismic and geological data, reserve reports and production history. The properties are held for the long term and are not traded very frequently. Oil and gas properties are inherently risky due primarily to price risk when the assets are purchased and developed over time.

## **Item 9 – Disciplinary Information**

MEC or a management person has never been involved in a material disciplinary event regarding criminal or civil action in a domestic, foreign or military court of competent jurisdiction. MEC or a management person has never been involved in a material disciplinary event regarding an administrative proceeding before the SEC, any other federal regulatory agency, any state regulatory agency, or any foreign financial regulatory authority. MEC or a management person has never been involved in a material disciplinary event regarding a self-regulatory organization proceeding.

## **Item 10 – Other Financial Industry Activities and Affiliations**

MEC has no other financial industry activities or affiliations. We have no relationships or arrangements with “related persons” i.e. broker-dealers, investment companies, banks, consultants, accountants, lawyers, etc. regarding our advisory services. MEC is the only entity that advises the partnerships.

## **Item 11 – Code of Ethics, Participation or Interest in Client Transactions and Personal Trading**

As a Registered Investment Advisor, MEC has its employees sign a Code of Ethics. There are two versions of the Code of Ethics. The first is for Supervised Persons and addresses compliance with rules and regulations, avoiding conflicts of interest and actions regarding material, non-public information. The second, which is for Access or Control Persons, also addresses the tracking of Personal Security transactions.

Copies of these Codes are available upon request.

MEC is engaged in the oil and gas business for our own account, we own oil and gas assets directly, and we are in the business of operating oil and gas assets for ourselves and third party undivided working interest owners. This ownership and operation of oil and gas assets is our principal business. Since we own interests in and operate the same assets owned by our clients, it is not meaningful to break down time spent on such activities versus our investment advice activities.

For client partnerships which acquire net profits interests, we buy oil and gas working interests from third parties and then sell to our client partnerships a net profits interest carved out of such working interests. For client partnerships which acquire working interests, when we buy oil and gas working

interests from third parties, the clients acquire their working interests from the third party at the same time. We buy for our own account an undivided working interest in each oil and gas property bought by our client partnerships at the same time as the client partnerships acquire their interest. Because these transactions are economically indistinguishable from buying the net profits interest or working interest directly from the third party, we do not believe these transactions to be principal transactions as contemplated by Item 9(A) of Form ADV Part 2. However, to govern conflicts of interest, by agreement with our client partnerships the price at which we sell net profits interests to the client partnerships, or at which the clients acquire undivided interests in the same oil and gas properties as us, is a specified percentage of our actual cost to acquire the property.

We allocate investment opportunities and operational resources in a manner intended to maximize returns for all of our client partnerships in our sole discretion which may have the effect of reducing the investment returns of some client partnerships relative to other client partnerships. It is our policy to allocate acquisitions among all partnerships that have not reached their cessation date on a blind pool basis, which means that the limited partners do not pre-approve acquisitions, other than with respect to the acquisition size limitations set forth in the applicable partnership agreement. In allocating acquisitions, we prioritize capital and take diversification and other partnership impacts into account. Capital priorities generally follow this order: uninvested original capital and cash on hand in earlier partnerships; call back distributions on original capital of earlier partnerships; uninvested original capital, cash and call back capital on newer partnerships and uninvested second tier capital; and unused debt capacity. Our allocation policy does not follow a mathematical formula and some factors may be given greater weight depending on the nature of the investment opportunity. Under the client partnership agreements, we are under no obligation to follow this policy and may change our policies from time to time without notice to the limited partners.

It is the current policy of Merit that as a Merit-managed partnership approaches the end of its partnership term, the oil and gas interests of the liquidating partnership will be brought to a public auction or the fair market value of such interest will otherwise be determined. It is possible that, pursuant to the authority and consents provided in the applicable partnership agreements, the purchaser of some of these assets may be other Merit-managed partnerships at a price determined by Merit to be the fair market value of such interests and, if required by applicable law, with the consent of the majority-in-interest of the applicable limited partners. So long as it complies with the applicable partnership agreements, Merit may change its policies regarding the acquisition or disposition of partnership assets at any time without notice to any limited partner of a Merit-managed partnership.

## **Item 12 – Brokerage Practices**

Regarding broker commissions, the partnership agreement for each client partnership contains a total aggregate capital commitment, a required distribution amount, an initial investment period for investing capital, a period during which cash flow may be reinvested and a limit on the amount of partnership assets that may be invested in a single oil and gas field. The general partner's authority to acquire oil and gas interests or to pay any commissions or other broker fees associated with such acquisitions is subject to such limits set forth in the applicable partnership agreement.

Each client partnership purchases and divests of oil and gas interests. The partnership agreements with respect to each client partnership do not preclude the general partner from engaging such brokers as it determines are in the best interests of such client partnerships for purposes of the transaction, or limits the amount of fees paid in connection with such engagement. In the event the general partner was to engage such a broker, the general partner would select such third-party broker based on his, her or its overall qualifications and negotiate a reasonable fee arrangement in the context of the particular transaction.

### **Item 13 – Review of Accounts**

For client partnerships investing in oil and gas working interests, our engineers and geologists monitor the client partnerships' oil and gas investments daily by reviewing production data and drilling or other development activity reports from the field. Approximately three engineers or geologists help oversee each separate oil and gas property. They are instructed to monitor performance and propose field and well management techniques consistent with prudent oil and gas operator industry standards. A regional manager reviews production and production sales performance of the oil and gas investments, and reports from the engineers at least weekly for each client partnership's property in their region. The vice president of each division's operations reviews such information with respect to all properties. For client partnerships investing in oil and gas net profit interests, our accounting and financial personnel review debits and credits to the net profits accounts monthly. They are instructed to ensure that the debits and credits conform to the net profits interest agreement defining and creating each net profits interest. Each Division accounting Controller and the Corporate Controller review their work with the same instructions.

The limited partners of our client partnerships receive quarterly and annual oil and gas production reports and financial statements prepared in accordance with generally accepted accounting principles. Annual financial statements are audited by an independent third party accounting firm and annual reserve reports are audited by a third party engineering firm.

### **Item 14 – Client Referrals and Other Compensation**

MEC does not compensate any third party for client referrals.

### **Item 15 - Custody**

MEC has custody of our client's bank accounts and securities. We do not use a custodian for these accounts and therefore, the client's (partnerships) receive quarterly statements from MEC. See Item 13 above regarding the independent audits performed on each of our client's accounts.

### **Item 16 – Investment Discretion**

MEC has the authority to determine, without obtaining specific client consent, the securities bought and sold, the amount of securities bought and sold, the broker to be used and the commission rates paid. We allocate investment opportunities and operational resources in a manner intended to maximize returns for all of our client partnerships in our sole discretion which may have the effect of reducing the investment returns of some client partnerships relative to other client partnerships. It is our policy to allocate acquisitions among all partnerships that have not reached their cessation date on a blind pool

basis, which means that the limited partners do not pre-approve acquisitions, other than with respect to the acquisition size limitations set forth in the applicable partnership agreement. In allocating acquisitions, we prioritize capital and take diversification and other partnership impacts into account. Capital priorities generally follow this order: uninvested original capital and cash on hand in earlier partnerships; call back distributions on original capital of earlier partnerships; uninvested original capital, cash and call back capital on newer partnerships and uninvested second tier capital; and unused debt capacity. Our allocation policy does not follow a mathematical formula and some factors may be given greater weight depending on the nature of the investment opportunity. Under the client partnership agreements, we are under no obligation to follow this policy and may change our policies from time to time without notice to the limited partners.

#### **Item 17 – Voting Client Securities**

MEC invests in oil and gas assets directly and operates those assets on behalf of ourselves and our clients. While we are permitted to invest in stock or bond securities related to the oil and gas industry, we have never invested, nor do we plan to invest, in such securities which would have voting rights.

#### **Item 18 – Financial Information**

Audited financial statements of MEC are available upon request. There is no financial condition that is reasonably likely to impair our ability to meet our contractual commitments to our clients.

#### **Item 19 – Requirements for State-Registered Advisers**

MEC is partly compensated for advisory services with a performance-based fee calculated as follows. We receive a carried interest as a limited partner in each partnership in an agreed percentage of partnership profits after the limited partners have earned an agreed minimum return on their investment. In 22 of the partnerships, the carried interest is 13%, and in the other 4 partnerships, the carried interest ranges from 10% to 15%. We also receive a carried interest (in the 22 partnerships with 13% carried interest and one other partnership) with respect to the purchase price of the partnerships' oil and gas properties, pursuant to which the partnerships pay an additional 2% of the cost of the properties for our benefit (e.g. a partnership pays 98% of the acquisition cost of a property for a 96% net profits interest or working interest as applicable). Our carried interest in profits is paid only after a threshold level of profits are earned, and our carried interest with respect to the purchase price of the assets is paid as properties are acquired. As such, this performance-based compensation may create an incentive for MEC to acquire an investment that may carry a higher degree of risk to the client.