JONES DAY

FEBRUARY 2015

COMMENTARY

Opportunities in Oil Financing and Investment: Meeting the Industry's Capital Needs in Challenging Times

Reduced Liquidity—How Will Oil Companies Feel the Pinch?

With crude oil prices tumbling nearly 60 percent since June 2014 to near six-year lows, the decline in energy company stocks alone has erased more than $263 billion in market value.[1] Oil companies and investors alike are scrambling to adjust to lower oil prices. Oil producers in particular are in need of sources of capital, while hedge funds and other alternative asset investors are searching for lucrative opportunities to put capital to work. An extended period of low oil prices will hit oil companies with a one-two punch, both reducing revenues and cutting off access to traditional bank and capital market financing. Oil companies are responding by downsizing or deferring capital projects, freezing wages, and scaling back or delaying drilling programs, bringing active rig counts to their lowest level since August 2010.[2]

This spring brings two important hurdles for producers. At the end of March, companies with outstanding debt must certify compliance with financial covenants to their banks and bondholders. Some oil companies will not be able to comply with their financial covenants due to the follow-on effect on revenue declines. Lenders will be faced with the decision of whether to grant waivers or amendments for the failed covenants or else reduce unused credit lines and accelerate the maturity on outstanding debt. A second hurdle comes in April when lenders will re-value the oil reserves and other collateral securing credit facilities. The value of reserves for many oil companies will be significantly lower in April compared to the previous valuation. The result of the drop in collateral values will be reductions in the borrowing bases that underlie lines of credit. As traditional credit sources dry up, oil companies will increasingly look for hedge funds and other alternative asset investors to provide that financing. "There are a lot of people who borrowed a lot of money based on higher price levels," the Blackstone Group's chief executive officer said, "and they're going to need more capital."[3]

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How Do Low Oil Prices Create Opportunity for Investors?

Cash-strapped oil companies with geologically sound asset bases, but that are no longer able to draw on credit or access public equity markets to support capital programs, are an attractive target for alternative sources of finance. "The timing of having that capital available now really couldn't be better,"[4] according to the Blackstone Group's chief executive officer, "It's going to be one of the best opportunities we've had in many, many years."[5] A number of energy-focused funds are currently raising billions of dollars in new capital to target these sorts of opportunities. Buying debt facilities directly from banks at a discount is one avenue for hedge funds looking to invest in oil companies. Hedge funds can also issue new senior debt to cash out distressed bonds and potentially even acquire control of distressed oil companies. In addition, the unique characteristics of oil and gas assets offer additional, and potentially more advantageous, structures for investors to put capital to work in the oil field.

Sale of a Working Interest–Linn Energy / GSO Capital

GSO Capital Partners, LP, Blackstone's credit arm, pursued one such opportunity in a transaction recently announced with Linn Energy LLC. GSO has reportedly committed up to $500 million to fund 100 percent of the drilling costs of new Linn wells in exchange for an 85 percent nonoperating *working interest* (i.e., a property interest in the underlying mineral assets where the interest holder shares in the revenues and costs associated with exploration and production) in the wells, with Linn retaining a 15 percent carried working interest. Once GSO achieves a 15 percent annualized return, GSO's working interest would drop to 5 percent and Linn's would increase to 95 percent.[6] This arrangement benefits the otherwise cash-strapped Linn by enabling it to develop prospective producing assets and add a new cash flow stream with no capital outlay of its own, while mitigating drilling risk and avoiding potential loss of mineral rights resulting from failing to meet development requirements under its leases.

Will Royalty Transactions Bridge the Liquidity Gap in 2015?

In addition to working interest transactions, which include an obligation to bear costs associated with exploration and production but could provide investors with certain operational rights, a long-standing tool used in oil and gas investments has been the sale of royalty interests, which are property interests in mineral assets where the interest-holder is entitled to a share of the revenue from production but does not bear any costs of exploration and production.

A key characteristic of royalty interests (and a major reason for their relative popularity) is that they are considered real property interests, which means that once the investor acquires the royalty interest, it is generally deemed outside the bankruptcy estate of the granting company. This places the royalty investor in a superior position to other creditors of the granting company in the event of its bankruptcy. However, as further discussed below, this bankruptcy-protected status has recently been subject to challenge.

There are several types of royalty-based transactions, including overriding royalty interests ("ORRIs"), volumetric production payments ("VPPs"), and monetary production payments ("MPPs").

ORRIs. An ORRI entitles the investor to a specified percentage of proceeds from the sale of oil produced from a lease or well for as long as the lease or well continues to produce. As a defined percentage of proceeds, the return on an ORRI will fluctuate based on the quantity of oil produced and the price of oil.

Production Payments. A production payment can be structured either as a VPP, entitling the investor to proceeds from a specific volume of production, or as an MPP, entitling the investor to a fixed dollar amount generated from production. A key difference between an ORRI and a production payment is that production payments are more limited in duration as compared to an ORRI (which typically lasts throughout the productive life of the well or lease). A VPP will continue until the investor has received the sale proceeds from an agreed

volume of production, and an MPP will continue until the investor has received an agreed dollar value or an agreed rate of return from production proceeds. Production payments are thus much more akin to financial investments in that the investor is entitled to certain benefits from oil produced by the assets it has invested in, denominated in dollars, rate of return, or volume. VPPs can also be used as a hedging instrument where a large consumer or distributor of oil, in exchange for an upfront payment, can obtain the rights to a specified volume of oil as it is produced from the well or lease.

How Can These Investments Help Oil Companies?

Oil companies in need of capital stand to benefit in several ways from these forms of alternative financing. Royalty-based investments can provide oil companies access to cash to continue drilling programs and develop assets with significantly less capital outlay. Continuing drilling programs can be critical, as oil leases often require a minimum number of wells be drilled to maintain the lease. Continued drilling also provides additional revenue streams and allows oil companies to attract and retain top talent, particularly for positions requiring specialized or institutional knowledge.

What Benefits and Risks Do Investors Face in Royalty Transactions?

Use of Proceeds and Other Safeguards. In negotiating any investment, whether a royalty, working interest, or other transaction, investors would be wise to build in certain safeguards around the use of the investment proceeds. For example, investors could require oversight of the drilling program in order to steer funds to a company's best drilling prospects, increasing the likelihood the investor will realize a return on its investment. Investors could also require safeguards dictating not only where companies drill, but how they drill, and the terms on which they contract with affiliated entities and third parties. Investors should also ensure that funds are used to fully satisfy amounts owed to service company expenses to avoid materialmen's liens being placed on the assets.

Investors should note that royalty interests entitle the interest holder only to a share of proceeds from production. Unless established by contract, royalty interests do not give the interest holder recourse against or control of the oil company that owns or operates the wells.

Structural Risk. As with other alternative investment structures, there is a risk that the transaction could be challenged, particularly in the event of bankruptcy. As noted above, royalty interests are considered real property interests, and thus outside the bankruptcy estate of the company that sold the royalty interest. However, as we noted in previous *Jones Day Commentaries*,[7] any investor considering a royalty-based investment structure should become familiar with the *ATP Oil & Gas* bankruptcy case. ATP's creditors challenged whether certain royalty-based transactions should be characterized as debt financings instead of real property transactions as has been the expectation of royalty investors in the past. If the ORRI, VPP, or MPP were recharacterized as debt financing, instead of the sale of a property interest, the royalty investor's status would be reduced to that of an unsecured creditor, and the royalty interest would be deemed part of the bankruptcy estate. The Bankruptcy Court refused to dismiss the creditors' claims, saying a fact-specific analysis was required, and ultimately did not rule on the issue because Bennu Oil and Gas, LLC purchased the bulk of the assets from the estate and settled with the royalty interest owners. However, the trustee in *ATP*'s converted Chapter 7 bankruptcy has indicated that it may yet challenge certain royalty-based transactions outside of those sold to Bennu. While any such recharacterization would be a major change in what is currently established law, energy investors should continue to monitor developments in this case.

Conclusion

Oil companies needing to fund capital expenditures will increasingly find alternative financing structures attractive, as will investors seeking lucrative returns. Royalty-based investments may become even more popular than in the past due to their flexible structure, ability to target specific assets, and potential bankruptcy advantages to investors. Jones Day would be happy to discuss our extensive experience with alternative oil and gas financing structures or to answer questions related to specific situations.

Lawyer Contacts

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Jeffrey A. Schlegel
Houston
+1.832.239.3728
jaschlegel@jonesday.com

Omar Samji
Houston
+1.832.239.3639
osamji@jonesday.com

Scott Schwind
Houston
+1.832.239.3710
sschwind@jonesday.com

Thomas A. Howley
Houston
+1.832.239.3790
tahowley@jonesday.com

Isaac Griesbaum
Houston
+1.832.239.3624
iegriesbaum@jonesday.com

Kit Rockhill
Houston
+1.832.239.3836
krockhill@jonesday.com

Endnotes

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