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# Private equity JVs: Part I - DrillCos

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Despite an abundance of resource opportunities in the US, capital in the oil and gas sector remains relatively tight, with traditional financing sources—capital markets (debt and equity) and banks (secured and unsecured loans)—continuing to be somewhat inaccessible to many industry players. The inaccessibility of traditional financing sources is the result of several factors, including stricter lending standards imposed following the global financial crisis in 2008 and the wave of bankruptcies across the oil and gas sector in 2015 and 2016, as well as continued volatility in commodity prices.

Despite these headwinds, the oil and gas sector remains resilient. Crude oil production in the US is forecast to reach an average of 9.9 million barrels per day in 2018, surpassing the prior record of 9.6 million barrels per day in 1970. Similarly, record domestic natural gas production is expected to continue into 2018, with the US likely becoming a net exporter of natural gas next year for the first time. The strength of domestic oil and gas production is expected to continue for the foreseeable future, with combined oil and gas demand (globally) projected to increase for several decades (even in the most aggressive "peak oil demand" scenarios so often written about these days), a significant portion of which is expected to be provided by domestic sources.

The lack of traditional financing sources noted above, paired with the industry's projected growth in production, has created a significant opportunity for private equity (PE) firms in the last several years. Since the beginning of the commodity price downturn in mid-2014, PE firms have reportedly raised more than $100 billion for investment in the oil and gas space. Much of this capital has been deployed through the use of joint ventures across the industry, often serving as marriages of necessity between PE firms seeking to invest in oil and gas projects and industry players in need of development capital. As we head into 2018, it is expected that joint ventures will play an increasingly important role in the sector, as it appears that over half of the $100 billion raised since 2014 has not deployed, making this an opportune time to review the various joint venture structures that are commonly used by PE firms to make oil and gas investments. This article will provide a brief overview of those structures.

Before proceeding further, we should clarify this article's use of the term "joint ventures." The term does not have one, accepted definition in the oil and gas industry, and is often used loosely by industry participants to describe a multitude of commercial arrangements. Moreover, the term can have a very distinct meaning when used in the legal context, especially with regard to the allocation of liability and whether fiduciary duties exists between parties. For purposes of this article, the term is used in a very general sense to describe arrangements whereby a PE firm is making an investment with a company, either at the asset-level, in the case of drilling ventures, or at the equity level, in the case of infrastructure joint ventures and equity lines of commitment.

This article is presented in three parts, the first of which provides a brief overview of a certain type of drilling joint venture arrangement commonly referred to as "DrillCos." The second and third installments of this article will focus on PE investments through infrastructure joint ventures and equity lines of commitment with management teams, respectively.

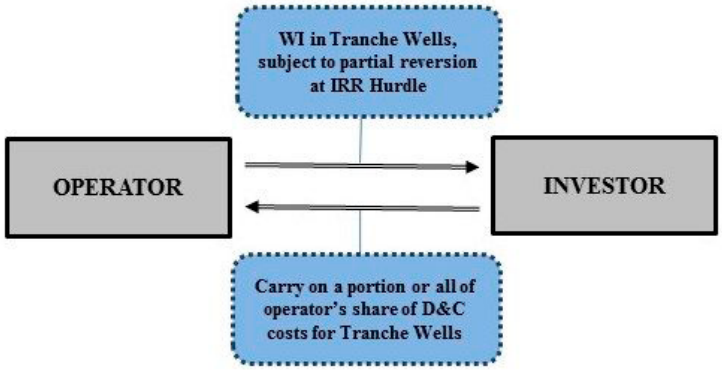
**DrillCos**

The last few years have seen the emergence of a transaction structure called the DrillCo, a large-scale drilling joint venture arrangement, the contours of which are often very similar to

a farmout of the drill-to-earn variety. It should be made clear that drilling joint ventures have been utilized in the oil and gas industry for a very long time, so DrillCos are not actually new structures. Also, for the sake of clarity, it should be pointed out that there is no new company (no "co") formed in a DrillCo. Rather, each party to the transaction will ultimately hold an interest in the properties included in the transaction, subject to a variety of agreements.

While it is tempting to try to identify what is "market" in regard to any type of transaction, there is really no market for DrillCo transactions, as each DrillCo transaction is a uniquely negotiated transaction. Nevertheless, it can be helpful to identify common terms used, and perhaps trends, in these transactions. This can be tricky, as it requires making generalizations based on a somewhat limited sample size.

In its most basic form, a DrillCo involves the contribution of acreage by an operator and the contribution of cash by an investor. The investor pays for its share of all costs and some—or, in rare instances, all—of the operator's share of certain defined costs in wells drilled. In return, the investor earns, and is assigned, a working interest in the wells drilled. The assigned interest is subject to partial reversion to the operator upon the investor achieving an agreed internal rate of return typically between 10% to 20% (or some other agreed return metric) on its investment (the IRR Hurdle). For an operator holding acreage with development potential, but with limited access to capital, a DrillCo presents an attractive mechanism by which to develop its acreage. For an investor, a DrillCo provides an opportunity to deploy large amounts of capital, while accessing management expertise and quality oil and gas assets not otherwise available to the investor. DrillCos involve significant capital commitments, typically staged in tranches, with the capital commitment for each tranche potentially being in the hundreds of millions of dollars.




The description above of a basic DrillCo highlights four key commercial points that are likely to be the first to be negotiated, and that will become the foundation of the term sheet that is typically agreed prior to negotiation and preparation of definitive agreements for the transaction: (1) the percentage of the operator's share of certain costs that will be borne (i.e., carried) by the investor in addition to the investor's share of those costs prior to reversion (i.e., before the IRR Hurdle is met); (2) the working interest (WI) to be earned by the investor prior to reversion; (3) the WI (or other interest) to be retained by the investor subsequent to reversion (i.e., after the IRR Hurdle is met); and (4) the IRR Hurdle.

| | Operator | Investor |
|---|---|---|
| (1) Development Costs | _____ % | _____ % |
| (2) Initial WI in Wells | _____ % | _____ % |
| (3) WI in Wells after IRR Hurdle | _____ % | _____ % |
| (4) IRR Hurdle | _____% | |

These four key commercial points are often reflected in the term sheet by a chart similar to the one shown below, although in the definitive agreements these commercial points would be described more comprehensively.

Of course, transactions may be structured differently. For instance, partial reversions may occur incrementally at different return levels, and any of the other commercial points could be handled differently. Nevertheless, the chart above represents a typical treatment of the key commercial points. It is only after these points are agreed that the real work begins. The term sheet will also address a significant number of additional items, which, together with the other deal terms and boilerplate, will be expanded on and addressed in detail in the definitive agreements used to evidence and implement the final agreed terms of a DrillCo.

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. The JDA typically includes some or all of the following exhibits:

- Joint Operating Agreement (JOA): The JOA is used to govern operations for each contract area. The contract area may be defined on a well-by-well basis or a tranche-by-tranche basis, or anything in between.

- Initial Work Program and Budget (Initial WP&B): The Initial WP&B is typically deemed approved upon execution of the JDA. Since capital commitments for DrillCos are typically made on a tranche-by-tranche basis, each tranche has a separate work program and budget. The Initial WP&B defines the investor's obligation to participate in the initial tranche of wells, potentially within an established time period.

- Assignment: The Assignment is used to convey to the investor the interest earned (subject to reversion) in the relevant wells upon the occurrence of an earning event. 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 is typically limited to a well-bore assignment, and may also be limited to the depths drilled or being produced under the DrillCo.

- Memorandum of JDA and Memorandum of JOA (collectively, Memoranda): The Memoranda are utilized to put third parties on notice of the terms and obligations of the parties under the JDA and each JOA. To achieve this, the Memoranda are recorded in the real property records in the county or counties in which the underlying properties are located.

- Tax Partnership Agreement: The Tax Partnership Agreement is utilized to ensure that the tax benefits derived in connection with the "carry" component of the investor's payment obligation may be realized.

- Management Services Agreement (MSA): The MSA sets forth the arrangement pursuant to which the operator may provide, for the benefit of the investor, any number of services in connection with the DrillCo activities. The services provided may include services such as accounting (including production accounting), authority for expenditure (AFE) and joint interest billing (JIB) processing and administration, royalty and tax administration, marketing, regulatory, engineering, and land (including land administration), but the services provided will vary from deal to deal. In most situations, the investor will not be in a position to perform these services for itself, at least not at the outset.

It is important that outside advisors be engaged early and often in DrillCo processes to help facilitate the negotiation of these DrillCo documents. These negotiations are often fairly time intensive, with issues frequently arising with respect to the investor's level of control over operations, transfer restrictions, "off-ramps" providing certain protections for the investor if a tranche's wells are underperforming, and methods for determining whether the IRR Hurdle has been achieved, among many others. In many cases, DrillCos are not successfully launched due to the parties' inability to reach agreement on such terms.

We hope that the first part of this article helps those faced with the task of working on a DrillCo transaction feel more prepared for those negotiations, as well as in the implementation of DrillCos once the definitive agreements have been signed.

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