DRILLING DOWN ON DRILLCOS

The game remains the same—only the players have changed.

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Drilling joint ventures—or "DrillCos"—have been used in the oil and gas industry for a long time; however, significant changes are taking place in the underlying facts surrounding these transactions. Historically, the parties to such a transaction would have been two traditional industry participants in a typical drill-to-earn farm-out. Now the parties are likely to be an operator that may or may not be an established E&P and an investor that may or may not have industry experience, but that is backed by private equity. These changes in the "players" have a profound effect on the negotiation of the transaction.

So, what is a DrillCo?

Described simply, a DrillCo involves contribution of acreage by an operator, and contribution of cash by an investor. The investor pays for its share of all costs and some or all of the operator's share of certain defined costs in wells drilled. 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 an agreed internal rate of return (or some other agreed return metric) being achieved by the investor on its investment.

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For the sake of clarity, it should be pointed out that there is no company in a DrillCo. Instead, each party to the transaction will hold an interest in the underlying properties included in the transaction, subject of course to a number of agreements. It is not a separate entity that is a "drilling company."

For an operator with limited access to capital, but holding acreage with development potential, a DrillCo presents an attractive means by which to develop its acreage. The DrillCo is, in effect, off-balance sheet financing for the operator. For an investor, a DrillCo provides an opportunity to deploy capital, sometimes in large amounts, while accessing oil and gas assets and management expertise not otherwise available to the investor.

This all sounds simple enough; but each DrillCo is negotiated and structured to fit the assets involved and the particular requirements and goals of the parties, and as such, can be anything but simple. The description of a DrillCo highlights a number of key commercial points that are likely to be negotiated first and that become the foundation of the term sheet that is typically negotiated and agreed prior to negotiation and preparation of definitive agreements.

These key commercial points are:

- the working interest to be earned by the investor prior to reversion;
- the percentage of the operator's share of certain costs that will be carried by the investor in addition to its share of those costs;
- the point at which reversion will occur; and
- the working interest (or other interest) to be retained by the investor subsequent to reversion.

These four commercial points would be reflected in the term sheet, although these would be described more comprehensively in the definitive agreements.

Capital commitments and budgeting

DrillCos require significant capital commitments, typically staged in tranches, with commitment for each tranche often being in the hundreds of millions of dollars. A tranche usually comprises the wells included in an annual work program. Because capital commitments are typically made on a tranche-by-tranche basis, each tranche has a separate work program and budget.

The initial work program and budget (containing the capital commitment for the initial tranche) is typically part of the joint development agreement (JDA) and, as such, is approved upon execution. The capital commitment for each subsequent tranche is made by approval of the work program and budget for that particular tranche. If for any subsequent tranche the parties are unable to come to agreement on the work program and budget, there is no commitment to proceed.

Assuming, however, that the work program and budget for a subsequent tranche is agreed, that work program and budget will represent the investor's capital commitment for that tranche. The capital commitment for any tranche will typically contain limits on the investor's expenditure obligations for each well and for the tranche in aggregate, but will also typically provide for deemed approval of small overages within a specified range. Outside of that range, the JDA will provide for allocation

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of the excess amount, in some cases to be borne by the operator.

The JDA may also provide that, even within an approved work program and budget, the investor has further approval rights if a well included does not satisfy certain required criteria.

Security for obligations

DrillCos involve significant capital commitments that create concerns about financial capacity and how commitments can be secured. From the operator's perspective, the concern is with the funding of the investor's financial obligations and how that can be secured.

From the investor's perspective, the concern is with the financial viability of the operator, its ability to make assignments as earned and its capability to keep the DrillCo development area unencumbered and available to be earned under the terms of the definitive agreements, and how all of those items can be secured. The need for security, and the methods used to secure obligations, are dependent on very specific facts related to the parties, their financial conditions, the acreage and the deal structure.

Depending on the creditworthiness of the investor (or maybe more particularly, the investor's parent company), the operator's concerns may be addressed by something as simple as an equity commitment letter. However, in some situations, the operator may feel it necessary to require a parent guaranty, a letter of credit or even an escrow arrangement. One can expect a letter of credit requirement and an escrow arrangement requirement to be resisted.

Bankruptcy concerns involving the operator could cause the investor to require up-front assignments (maybe as expansive as the DrillCo development area), placement of liens on the DrillCo development area or use of a deposit account control agreement, or a combination of these. Use of these approaches would further complicate the transaction, and would require periodic action on the investor's part, such as reassignments and lien releases, as operations are conducted.

Off-ramps

In a DrillCo transaction, the investor has made its capital commitment based on expected production results from an agreed work program and budget. Typically, the operator has "helped" the investor derive those expected production results, although no representation and warranty would be given in that regard. What if those expected results are not realized? The investor should consider negotiating a right to modify—and perhaps even terminate—its capital commitment if the expected results are not realized.

For a tranche subsequent to the initial tranche, if the parties are unable to come to agreement on the work program and budget, there is no commitment to proceed into that subsequent tranche. As such, there is a de facto off-ramp at the end of each tranche.

Typically, the transactions recognize that certain minimum oil prices are necessary to justify drilling out the DrillCo development area. As such, the terms of a transaction entered into in a relatively high-commodity price environment might allow either party to suspend their obligations if that floor is breached. The task then is to decide whether, after some period of suspension, the tranche (and all calculations related to it) may be truncated to the drilling done and expenditures made as of the date of the truncation.

Earning of assignments

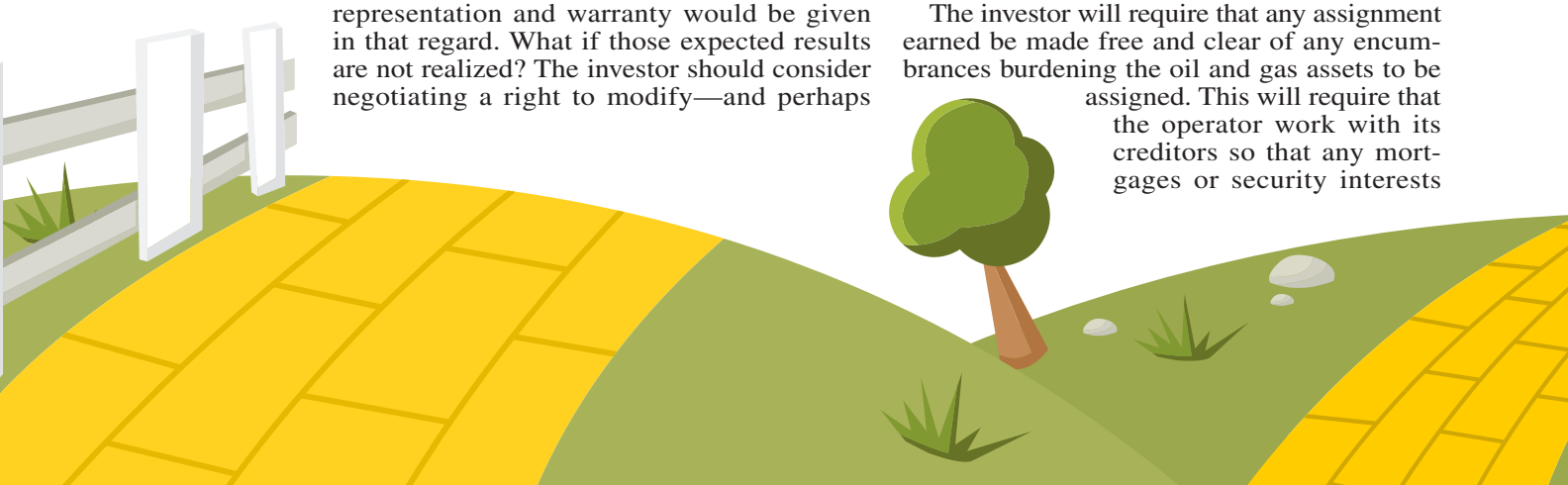
Of prime importance to the investor is receipt of the assignment of working interest (and potentially other rights) earned by the investor's participation. Assignments can be made on a well-by-well basis, on a well tranche basis or simply on a periodic basis, as negotiated by the parties. The working interest earned is typically limited to a wellbore assignment, and may also be depth limited.

If the working interest assignment is depth limited, consideration should be given to providing the investor with rights within the remainder of the wellbore as may be necessary for conducting operations within the assigned portion of the wellbore, including production and movement of hydrocarbons. The same is true of surface facilities, surface rights, contracts and any other items that might typically be conveyed in conjunction with a transfer of working interests in oil and gas properties.

Consent requirements, preferential rights to purchase and maintenance of uniform interest provisions all affect the ability to make assignments, and would typically be addressed in the definitive agreements.

The timing of the assignment is an area that typically involves a good deal of negotiation. Assignments are generally tied to payment of costs or completion of wells, or a combination of the two. However, there may be situations (related to realistic insolvency or bankruptcy concerns regarding the operator) in which the investor would not be unreasonable in requesting an up-front assignment, which may be over a greater area than just the wellbore.

The investor will require that any assignment earned be made free and clear of any encumbrances burdening the oil and gas assets to be assigned. This will require that the operator work with its creditors so that any mortgages or security interests



(or other liens) burdening the oil and gas assets to be assigned are released prior to, or contemporaneously with, the assignment.

Reversion of interests

The commercial terms of a DrillCo transaction typically require reversion of some percentage of working interest to the operator at such time as the investor has achieved the agreed rate of return hurdle. In some cases, this may actually be conversion of the working interest (all of it) to an overriding royalty interest. Typically, the hurdle is either an internal rate of return or a return on investment, and is calculated on a tranche basis.

It is important that the return hurdle calculation contains a clear description of the revenues and costs that will be taken into consideration. The costs included will typically be broader than the costs to which the carry applies. Finally, although the reversion of working interest will be stated in the assignment to occur automatically, the investor will typically be required to provide a re-assignment of the working interest to the operator, to be recorded in the county records.

Transfer of interests

As with most joint developments, each of the investor and the operator enters into the DrillCo on an informed basis, knowing the technical, operating and financial strength or capacity of the other party. Therefore, it is not unusual to see transfer restrictions. They may include outright prohibitions, restrictions based on timing (such as completion of a tranche, fulfillment of payment obligations or achievement of a hurdle rate) or preemptive rights (such as rights of first refusal or rights of first offer).

Transfer restrictions are a thoroughly negotiated area in DrillCo transactions. In addition, the investor may desire a tag-along right in the event of an operator transfer, which tends to be a matter of value preservation. Likewise, the operator may desire a drag-along right in the event that it transfers its interest, which tends to be a matter of value creation.

Provision of services

The operator will typically provide certain services for the investor in relation to operations. This is done pursuant to the terms of an agreement styled something along the lines of management services agreement (MSA). These services provide management, technical and administrative support for the investor. In most situations, the investor will not be in a position to perform these activities for itself, at least not at the outset.

The services provided may include accounting (including production accounting), authorization for expenditures and joint interest billing 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 addition, the operator may be required to provide certain periodic reports, such as monthly lease operating statements and other customary industry reports. In limited circumstances, the operator may be required to provide assistance in an investor sale process.

The operator will be compensated for the services that it provides for the investor. The compensation can take the form of cost reimbursement plus an agreed additional fee or an agreed monthly fee. In either case, it should be made clear whether the compensation is included as a cost in the hurdle rate calculation, which seems to be the norm.

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Marketing and hedging

In any scenario involving co-ownership, it is not unusual for an operator to market a nonoperator's share of production. In some instances, a nonoperator may want the right to take in-kind its share of production and to be able to do so separately. In some cases, the nonoperator is obligated to do so. In any event, this tends to be more of a joint operating agreement issue than a JDA issue, although it could certainly be addressed in the JDA. In the context of a DrillCo, in the event that the investor has the right to take in-kind, it is nevertheless likely that the operator will market the investor's production pursuant to the terms of the MSA.

If the investor or the operator desires to put hedges in place, the ability to do so is typically limited to that party's share of production. The investor would want to include its hedge gains and losses in the calculation of the return hurdle. This causes concern on the operator's part and, if hedge gains and losses are included in the calculation, would result in restrictions on investor hedging, which would be included in the definitive agreements. ☐

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