GIBSON DUNN

The New Norm: Non-traditional Financing Structures in Oil & Gas

October 22, 2019

MCLE Information (1.0 hour)

- **The Handout.** Participants must download the PowerPoint for this webinar to comply with MCLE requirements. Click on "File" in order to "Save As" to your computer.
- **Sign-In Sheet.** Participants should download the MCLE Sign-In Sheet, complete it and email it to Jeanine McKeown.
- **Certificate of Attendance.** Most participants should anticipate receiving their certificate of attendance in 3 to 4 weeks following the webcast. (Virginia Bar members should anticipate receiving it in ~6 weeks following the webcast.)
- **NY Compliance.** Individuals seeking credit in New York can expect to hear the key word during the webinar.
- **Questions.** Direct MCLE questions and forms to Jeanine McKeown at 213-229-7140 or jmckeown@gibsondunn.com.

Agenda

- Introduction
- ORRIs, NPIs, and VPPs
- Joint Ventures ("JVs") and Non-Op Structures
- Asset-Backed Securitizations ("ABS") and Preferred Equity
- Wrap-up and Q&A

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Part 1: ORRIs, NPIs, and VPPs

What are These, in Simple Terms?

- ORRI – Overriding Royalty Interest – an interest in oil and gas produced at the surface, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease
- NPI – Net Profits Interest – a share of gross production from a property, measured by net profits from operation of the property, and carved out of the working interest
- VPP – Volumetric Production Payment . . . but first, Production Payments:
  - Share of oil [gas] produced
  - Terminates when specified sum realized from sale

Production Payments, Bankruptcy Perspective

- Term overriding royalty
- Satisfaction in cash or in-kind
- Contingent on production from particular property
- From a specified volume or value

Production Payments, Tax Perspective

- Specified share of production
- From a mineral in place
- Expected economic life shorter than burdened property
- Dollar amount, quantum of mineral or period of time
- Economic interest in mineral in place
- Dollar amount, quantum of mineral or period of time

Production Payments, Tax Perspective

- Terminates upon production of not more than 90% of reserves
- Remaining present value is 5% or more of present value of entire property
- Look solely to mineral in place for recovery
- No recourse to other sources

Bankruptcy and Tax Drafting "Take-Aways"

- Burdened property identified at time of conveyance
- Economic interest in mineral in place
- Expected economic life shorter than that of burdened property
- Look solely to mineral in place for recovery; no recourse to other sources
- Absolute, present conveyance of interest in real property

Drafting Results

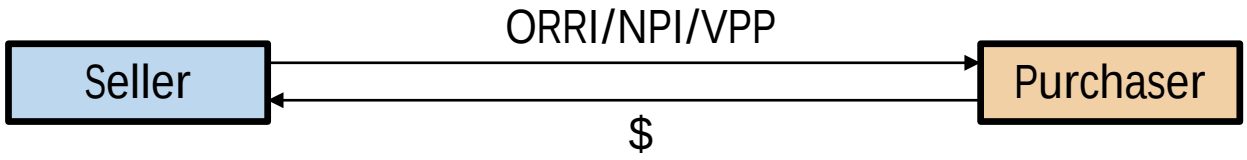
- Favorable tax treatment – loan transaction, as opposed to sale transaction
- Transaction is not voidable – for bankruptcy purposes and the PP is not part of the bankrupt estate

Volumetric Production Payment

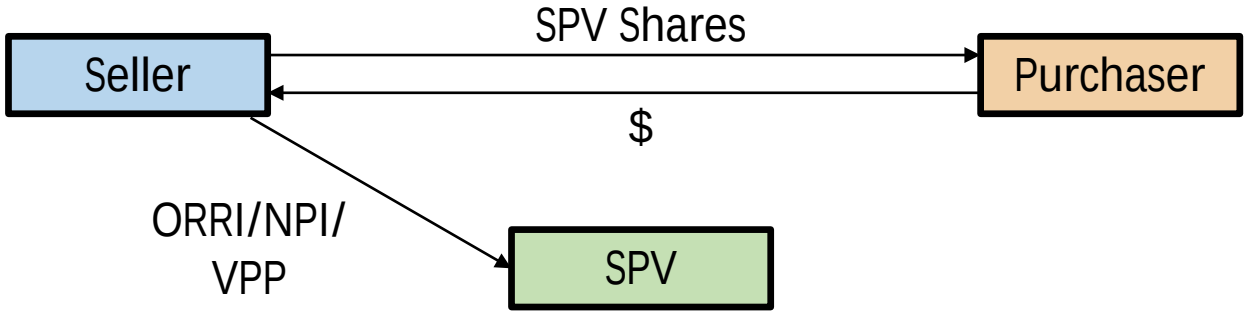
- Production payment satisfied by delivery of certain volume of hydrocarbons

Potential Structures (and Uses) as Financing Sources

– Direct Sale of ORRI, NPI or Production Payment

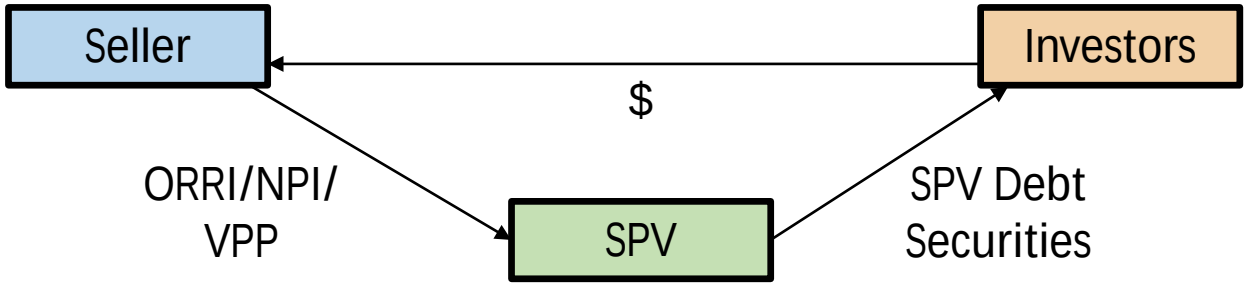


– Transfer ORRI, NPI or Production Payment into SPV, and sell SPV (or an interest in SPV)

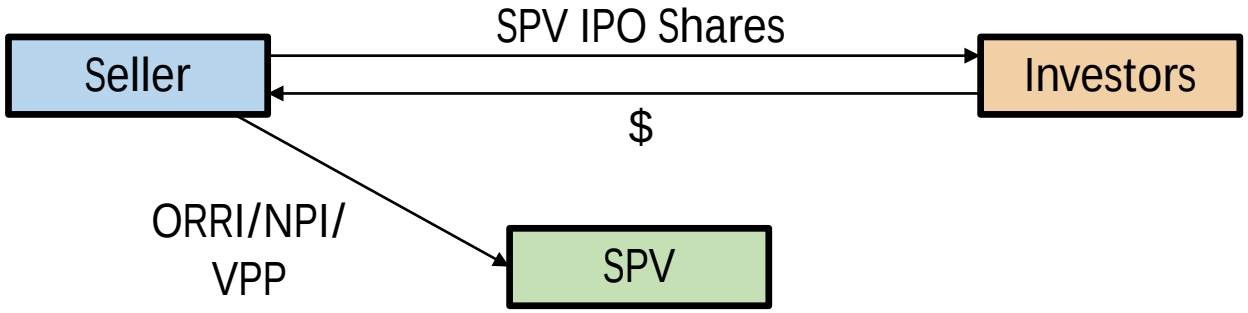


Potential Structures (and Uses) as Financing Sources

– Transfer ORRI, NPI or Production Payment into SPV, and issue SPV debt securities (backed by SPV assets)



– Transfer ORRI, NPI or Production Payment into SPV, and IPO the SPV



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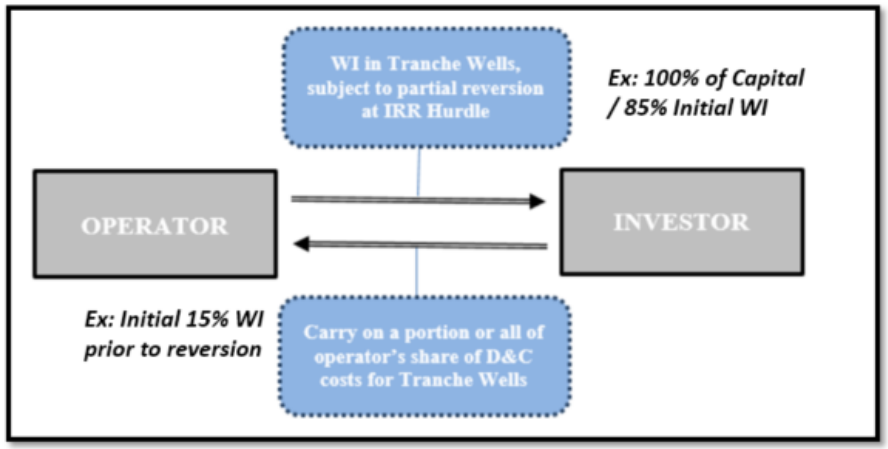
Part 2: JVs and Non-Op Structures

What is a "DrillCo"?

- Asset-level financing via drilling JV between an Investor and Company
  - Investor contributes capital in one or more tranches on promoted basis
  - Company contributes oil and gas properties (often a portfolio for wellbores)
- Typically, no "co" or JV company – each party directly owns leasehold interests
- Bespoke transactions, tailored to fit parties' needs
  - Good news: resemble drill-to-earn farmout structures
  - Bad news: complicated bells and whistles

DrillCo Structure

- Involve (i) contribution of capital from Investor and (ii) contribution of wellbores/acreage by Company
- Investor pays its share of development capital and carries Company for some, or all, of Company's development capital
  - Not a "blank check" – tight controls on use of capital
- Company assigns Investor interest in properties
  - Assigned interest is subject to partial reversion upon investor achieving agreed internal rate of return
  - Typically 10% to 15% IRR hurdle for reversion
  - Investor capital typically deployed in tranches for a specified # of wells
- Appetite for DrillCos has weakened



Oil & Gas Financial Journal, October 2017

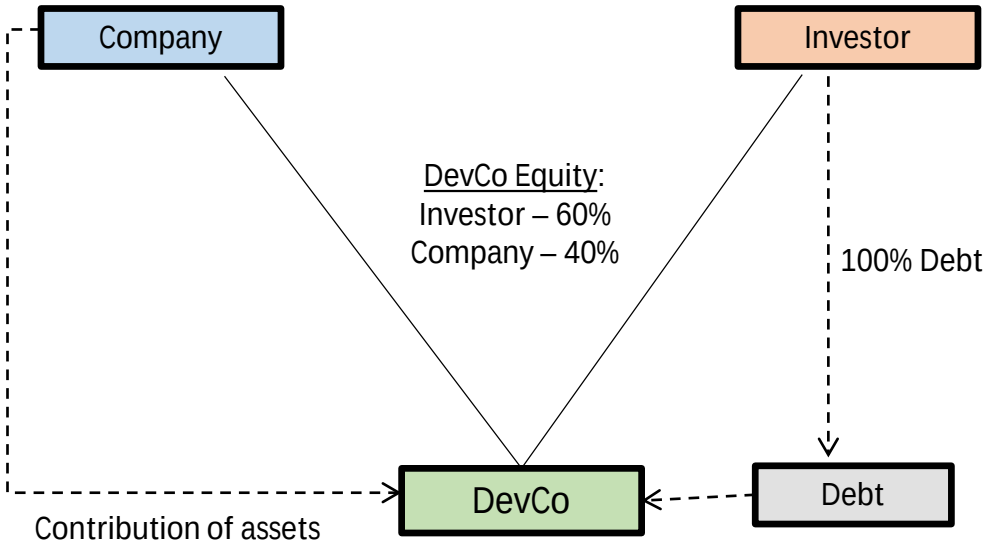
Example: Prior to reversion, Investor funds 100% of D&C in exchange for 85% WI in tranche wells, with operator retaining a 15% carried WI. After investment hurdle is met, reversion occurs.

DrillCo Key Considerations

- Complexity of deal structure – DrillCos can be derailed due to overly complicated structures
- Governance – operating committee, Company vs. Investor control, etc.
- Budgeting – work programs and budgets, cost overruns, and off-ramps
- Interest earned – wellbore, unit, formation-limited, etc.
- Retained Interest – typically 80% to 90% retained by Company after flip
- Scope of investment and/or carry – AFE limits, tranches, etc.
- Hurdle rate – IRR/ROI, well vs. tranche, etc.
- Transfer restrictions – lock-up periods, pref rights, tag rights, etc.
- Other development opportunities – e.g., AMIs
- Treatment – bankruptcy, tax, and accounting purposes (super important)

What is a DevCo?

- New entity created to facilitate financing of development operations
  - Investor and Company are members – Company often owns minority interest
  - Company assets are contributed (or, in the future, will be contributed) to DevCo
- Flexible structure to meet parties' needs
- Financing typically done on a heads-up basis, but Investor may carry portion of Company's capital obligation
- Capitalization typically involves some combination of equity and debt (target 50/50)
- Broader investor base for traditional securities
- Structure can be beneficial from accounting and tax treatment perspectives



DevCo Key Considerations

- Complexity of deal structure
- Governance
- Budgeting
- Transfer restrictions
- Asset ownership – owning assets indirectly via DevCo (rather than having direct ownership stakes in assets)
- Other development opportunities
- Economics – Company funds portion of upfront capital but with delayed distributions
- Tax and accounting treatment

What is Non-Op Funding?

- Non-op positions create challenge for Companies to stay within capital budgets – pace of non-op activity typically dictated by operator and difficult for non-op to forecast
- Companies are often forced to "non-consent" (i.e., not participate) in non-op proposals
- Many Companies are seeking opportunities to maximize potential of non-op exposure while maintaining capital discipline
- Creates need for creative funding structures

Non-Op Funding Structures

- AFE-by-AFE (well proposals)
  - Investor acquires and/or provides carry for AFE
  - Company receives cash and/or a promote on AFE operation
  - Company assigns wellbore and retains non-wellbore acreage
- DrillCo
  - DrillCo structure in non-op context
  - Executed in tranches based on time period and/or dollar amount
  - Typically applies to AMI of non-op wells
- DevCo
  - Non-op funding structure done in an entity
  - Producer typically has minority interest and associated capital obligation
  - Target 50/50 debt-equity structure

Non-Op Funding Key Considerations

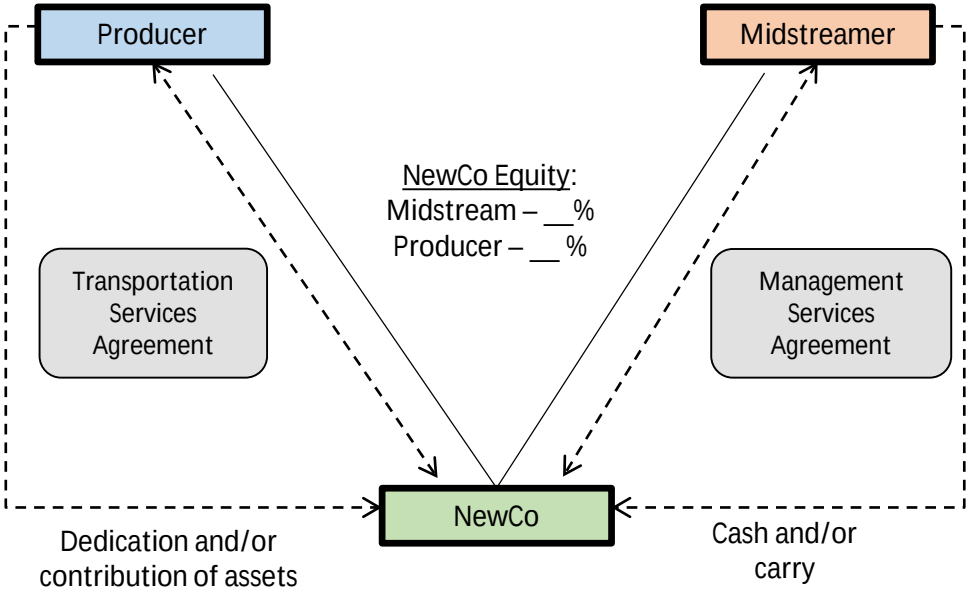
- AFE-by-AFE
  - Difficult to scale
  - Division of interest issues – e.g., maintenance of uniform interest
  - Lack of visibility on capital needs of Investor
- DrillCo
  - Investor cannot implement same level of control as in operated situation
- DevCo
  - Requires Company capital
  - Capital structure may result in limited (initial) distributions to Company

What is a Producer-Midstream JV?

- JV (typically at entity level) between producer and midstream company to develop midstream infrastructure in a particular area
- Significant capital required for unconventional development:
  - Upstream development drives build-out of midstream infrastructure
  - Midstream infrastructure is utilized à cost to transport production increases à producers to look for alternatives for getting their production to market
  - New midstream infrastructure is brought online à fees tighten to more closely align with the actual cost to transport production to market à incentivizes additional production growth
  - This cycle will repeat as new production fills the new infrastructure
- Midstream JV permits producer to focus on upstream development and reduce capital exposure for infrastructure buildout, while maintaining an ownership stake in midstream assets

Producer-Midstream JV Structure

- Producer and midstream company form JV to facilitate infrastructure buildout
  - Often via a newly formed company, in which producer and midstream companies are members
  - Producer often owns minority interest in JV
- Producer dedicates volumes and/or acreage
- Midstream company provides technical expertise and capital (often with a carry)
- JV enters into transportation agreement with producer
- Allows producer to capture upside in future liquidity events (e.g., IPO)



Producer-Midstream JV Key Considerations

- Governance structure
- Upfront consideration and/or carry consideration
- Transportation fee
- Level of service and build-out requirements
- Deliverability of volumes and scope of dedication area
- Capital structure

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Part 3: ABS and Preferred Equity

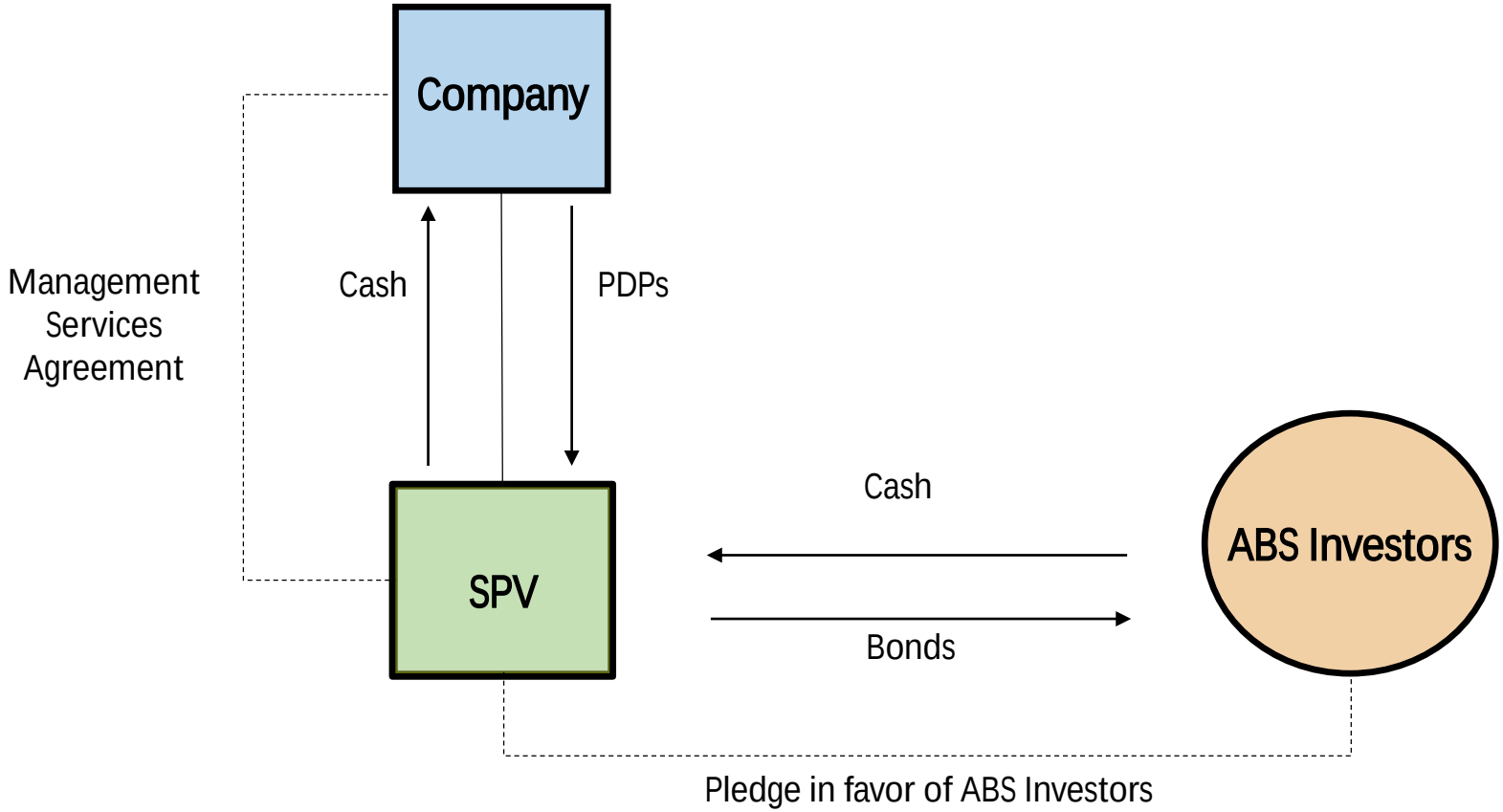
Asset-Backed Securitizations

- Alternative financing structure where an owner puts cash producing assets in an SPV and causes the SPV to issue a financial security such as a bond or note which is collateralized by pool of SPV assets
  - The pools of underlying assets vary and typically include traditional payments from credit cards, auto loans, and mortgage loans, as well as non-traditional cash flows from aircraft leases, royalty payments and movie revenues
- The credit rating of the Asset-Backed securities is based only on the assets and liabilities of the SPV, so it often is better than that of the originating owner
  - Can result in a lower interest rate on the asset-backed securities than if the originating owner borrowed funds or issued bonds

Oil and Gas ABS

- New investment grade debt securitized by PDP wells
  - Company contributes producing wells into SPV owned by the company
  - SPV:
    - pledges assets as collateral to secure bonds to be issued by the SPV
    - hedges production from assets
    - sells the bonds through a private placement and distributes cash proceeds to the company
- Revenues from assets are used to pay bonds and other SPV expenses
- Company continues to manage the assets for arm's-length fee

Oil and Gas ABS Structure



Key Considerations for Oil and Gas ABS

- Higher advance rate than alternative financing products
- Nonrecourse debt on balance sheet
- Lower-yield than alternative financing products; fixed rate
- No restrictions on use of proceeds
- No redeterminations
- Limited covenants
- Access to alternate ABS investor base
- Complexity/longer time to complete
- Learning curve for ABS investors

Preferred Equity

- Convertible preferred
  - Perpetual
  - Convertible into common equity at preset conversion valuation (e.g., 15-25% premium to current common price)
  - Issuer can typically force conversion at common pricing threshold
  - Designed to achieve partial equity credit from ratings agencies
- "Fixed Return" preferred
  - Typically issued with 5-10 year term by new subsidiary entity
  - Provides fixed return (typically includes put (after period of time)/call rights at minimum return)
  - No dilution of existing common equity holders (but can be designed with equity kicker (e.g., warrants))

Key Considerations for Preferred Equity

- Greater access in size to preferred capital than straight common equity from a public market offering
- Preferred equity terms can be customized to meet the needs of the issuer
- Preferred capital potentially issued at cheaper cost of capital than straight private equity or common public equity
- Current management/investors can maintain control of the assets operationally and in governance
- Negotiating preferred equity terms takes considerably longer than a public common equity offering
- Coupon payments likely higher than debt and can be burdensome to businesses in financial stress (can be solved with PIK coupon)
- Dilution of current investors if convertible
- Could have ratings implications on the capital structure if treated as a debt security
- The security does not improve liquidity for publicly traded companies
- If public issuer, shareholder consent can be required if amount of convertible preferred sold is above certain thresholds

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Part 4: Wrap-up and Q&A

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