Tips for Oil & Gas Transactions in the Current Global Market

Summary of Conference Call

April 22, 2020

Getting a deal done in today's environment

- While there are limitations impacting deal execution, there continues to be a path forward for completing deals with willing buyers and willing sellers. Most oil and gas M&A transactions are highly negotiated.
- We are currently seeing utilization of a variety of valuation and risk-sharing mechanisms. These include (1) use of earn-outs that reassess the value of the target business 6-12 months (or longer) after closing and make adjustments to the purchase price accordingly, (2) use of an indemnity-type (or escrow) arrangement that releases funds to the seller if certain events do not occur, (3) contingent payments that may be tied to the price of oil in the future, or future financial performance, and (4) use of royalty instruments to address future performance. We are also seeing deferred or incremental payments, as well as vendor loans for those buyers that are unable to finance an acquisition from their own balance sheet.
- MAE/MAC clauses will likely include a pandemic/epidemic carve-out. Not surprisingly, we are seeing intense negotiations over the definitions of MAE/MAC and whether a specific carve-out for pandemics or COVID-19 should be included.
- Due diligence should include the financial condition and COVID-19 impact of the target: US bankruptcy courts have the ability to look back to assess the financial merits of pre-filing transactions. If you are conducting a transaction with a company in financial distress outside of a formal bankruptcy court process, it is important to due diligence whether the seller is insolvent, has plans to file for bankruptcy, and the fair market value of the target assets or company. In addition, diligence should include the COVID-19 related response (safety and security of personnel, supply chain, customer relationships, and contingency plans; and data security).
- Representation and warranty insurance may not cover COVID-19 related breaches: R&W insurers are moving quickly to develop underwriting protocols around COVID-19 risks and/or currently many are including broad exclusions or requiring heightened due diligence to assess the impact on the target's business.
- Logistics issues will add to the overall timeline. We are recommending to our clients that extra time be built into the transaction timeline to address logistical constraints in completing a deal. These can be as straight-forward as issues around scheduling and attending a site-visit, to navigating "in person" requirements for diligence of sensitive information and notarizing documents, to delays caused by regulatory offices being closed or overwhelmed by filings.

Energy transition: Impact on renewable transactions

- Supply chain disruptions (particularly in the solar industry), the need to commence construction and continuous progress requirements to take advantage of tax incentives in the US, reluctance of financial institutions to finance new development with uncertainty on construction deadlines, ability to secure offtake and potential diminishment on returns make the project development landscape for renewables challenging.
- However, across all of our jurisdictions we continue to see projects moving forward. To get a deal done in the current environment, try to build additional cushions on the construction deadlines, negotiate extensions on interconnections to the grid if possible, and consider your offtake and its bankability. Please note, however, that financed projects currently under development may have long-stop completion dates under the financing documents that also need to be considered.
- On the positive side, ESG push by boards and other stakeholders will continue and as instability in the crude markets rises, those calls will get a bit louder. Oil and gas companies will continue their transition to energy companies with a diversified portfolio approach; however, the oil and gas industry is here to stay for the foreseeable future, so unlike the loudest of those voices, we recognize alternative energy sources/renewables will become one more investment opportunity for many of these firms, not the be all and end all. With that approach, we see many of our oil and gas clients across the globe are investing in alternative energy solutions and we continue to assist them in those efforts.

Force majeure in the context of oil and gas transactions

- Force majeure is a relatively easy concept to define, but in practice may be difficult to establish. Oil and gas companies need to do a deep dive into their contract arrangements (including Production Sharing Contracts, Joint Operating Agreements and LNG Spas) to identify whether they really are experiencing a force majeure event, and whether they can show sufficient causation between the force majeure event and their non-performance.
- Oil and gas companies also need to understand fully what the consequences of calling force majeure might be — from comprehending the economic pressure this might put on their counterparts, to assessing fully what the consequences of prolonged force majeure might be, and the potential remedies open to contract counterparties.
- Oil and gas companies may be able to identify alternative ways to postpone or defer costs under their existing arrangements, for example, by seeking government consent to postponing obligations, or by seeking co-venturer approval to scaling back operations.
- Given the issues surrounding force majeure, the ability to call force majeure should, perhaps, be viewed tactically — in many cases, the ability to call force majeure should be a precursor to discussions around cost reduction and 'sharing the pain'.

Financing issues

Upstream

- The dramatic fall in the oil price will put many upstream producers into default under their borrowing base facilities at the next borrowing base redetermination date (which will be in September or October). Lenders will have to decide whether to either waive the default (typically as part of a debt restructuring on the basis of "amend and extend") or enforce their security rights. Based on experience during the 2014-16 price slump, and given the practical difficulties and risks associated with enforcement (for example potentially decommissioning liabilities), we expect lenders to opt for the former in most circumstances. Much will also depend on lenders' view of future oil prices at the time of the borrowing base redetermination and the extent to which the borrower is sheltered from the risk of payment default in the coming months by commodity price hedges that remain in place and are in the money. Commodity hedges are typically shorter than the term of the debt, so they will provide at best a short to medium term fix, rather than a long term solution.
- Banks have strengthened their balance sheets significantly since the 2008 financial crisis, which may give them more scope to support borrowers through this period. Conversely, those banks looking to reduce their exposure to the resources sector in response to the climate change emergency and the energy transition, may look hard for an exit from distressed loans.

Midstream/downstream

- Most financing structures used, for example, availability-based structures or take-or-pay based structures, are designed to protect the lenders from market risk. Thus, whilst these structures may come under strain due to the wider impact of the fall in commodity prices and demand destruction, we would in principle expect fewer material defaults than in other sectors.
- Having said that, those projects that have achieved financial close but that are under construction or commissioning are likely to face greater challenges as a result of delays due to COVID-19. This will likely trigger defaults linked to deadlines in the financing documents linked to achieving commercial operations date and any intermediate project milestones. These deadlines in finance documents are fixed and cannot be extended for force majeure.
- Likewise, where a project has achieved commercial operations date but sponsor support remains in place, the commercial impact of the current situation will likely make it harder to achieve the release conditions, whereby the sponsor support is released and the project becomes fully non-recourse.

Commodity trading

- As financial stress flows through the sector, there is a renewed focus on credit risk associated with trading counterparties. At its simplest, this will mean more focus on the existing credit support provisions of trading contracts, which may include provisions linked to credit downgrades or other bespoke financial triggers for letters of credit to be provided, escrow accounts to be funded or other credit enhancement mechanisms.
- Where these are not available or are already fully utilised, parties are likely to consider more structured solutions. These solutions will need to be bespoke to the particular trading relationship but may well include prepayments or deferred payments in favour of the distressed party, typically with security arrangements to mitigate the credit risk being taken by the stronger party.
- Structuring the optimal security package will be a matter of the applicable local law (i.e., what security can be taken and how it can be made enforceable against third parties, especially if registration at public registries is impossible as a result of COVID-19 related lockdowns). If, as is usually the case, there are existing lenders in place, it will also be necessary to structure any security around the requirements of existing lenders and their security and contractual rights (e.g., negative pledges). This issue typically calls for bespoke intercreditor arrangements.
- In addition, it will be important to check that any proposed solution does not infringe applicable banking and other regulations, for example, any requirement that only banks can make loans.

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