Client Alert

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Securitizations by Independent Oil and Gas Companies

Introduction

Amid the downturn in the oil and gas industry catalyzed by the coronavirus pandemic and the oil price war between Russia and Saudi Arabia, many oil and gas producers are discovering their traditional sources of financing are presently unavailable or insufficient to meet their capital needs. In the current economic environment, bank lenders under reserves-based senior credit facilities, or RBLs, may be unwilling to extend further credit. Similarly, investor interest in high-yield notes offerings and traditional preferred and common equity offerings in this industry has severely waned. As a result of plummeting commodity prices throughout 2020, spring borrowing base redeterminations under RBLs will shrink significant sources of liquidity for many oil and gas producers, absent successful negotiations with their RBL lenders. In the face of looming borrowing base reductions and deficiencies, producer borrowers find themselves with few choices in sourcing sufficient capital to operate their businesses. Although a few of these companies were able to tap into the high-yield debt market in early January of 2020, the current cost of capital prices many producers out of this market. For 2020 and the foreseeable future, cash-strapped independent oil and gas companies will need to look outside these traditional sources for capital, which will be much needed and is quickly proving difficult to obtain.

Although mostly unfamiliar to the oil and gas industry over the past several decades, securitization of interests in oil and gas assets may provide a viable form of financing during and beyond this period of distress. The beginning of a potential wave of securitizations is already underway with three oil and gas producers, Raisa Energy LLC, Riviera Resources, Inc., and Diversified Gas & Oil PLC, successfully placing these structured securities in 2019. Industry news outlets have reported that several other independent oil and gas companies are taking a hard look at similar securitizations as alternatives to traditional financing sources, and Raisa Energy is planning further offerings of asset-backed securities on a “systematic basis.” These transactions may signal the tip of the structured finance iceberg for the oil and gas industry in the current economic environment.

What is securitization?

Securitizations involve a credit-enhancing financial structure in which an owner of cash flow-producing assets packages some of those assets and transfers them to a newly-formed, bankruptcy remote, special purpose entity, or SPE. The SPE then issues notes in a private placement or public offering. The notes are secured by the SPE’s assets, but are non-recourse to the sponsor. The proceeds received by the SPE from the notes’ issuance are then transferred to its parent sponsor company in exchange for the transferred assets.

Most commonly, securitization has been used for pooling mortgages, automobile loans and accounts receivable. Although the oil and gas industry has seen rare instances of securitizations prior to 2019, traditional financing sources, with their ready availability and relatively low cost, have largely fueled the growth of oil and gas producers throughout the past several decades.

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What assets can oil and gas companies securitize?

Interests in oil and gas assets can be delineated in a variety of ways. Examples include mineral interests, non-operating and operating working interests, royalty interests, overriding royalty interests, volumetric production payments, or VPPs (as described below), and net profits interests. Each of these interests can be transferred to an SPE and can serve as the source of funds to service the notes issued by the SPE. Recently in 2019, VPPs, working interests and wellbore interests have served as cash flow sources for oil and gas securitizations.

The oil and gas assets underlying any receivables selected for securitization should be limited to those able to generate stable cash flows. Accordingly, the reserves held by the SPE should be classified as proved developed producing in order to enhance the credit profile of the SPE to a point where investors will feel confident that the underlying assets can serve as a reliable cash flow stream source to service the debt. Moreover, producing properties with long production histories and low decline rates will further increase investor confidence in the cash flow stream source.

What advantages does securitization offer?

New Class of Investors.

Independent oil and gas companies should consider the several advantages posed by securitizations. The enhanced creditworthiness of the SPE, as compared to a typical independent oil and gas producer, can attract investors that would not otherwise be interested in the risk profile of typical independent oil and gas companies. The pension funds, insurance companies, large money managers and other institutional investors that invest in asset-backed securities could constitute a new class of investors for the credit impaired sector of the oil and gas industry. These investors may not harbor the same reservations regarding energy investments that traditional oil and gas investors have developed following recent industry downturns.

Investors in asset-backed securities are tasked with deploying a tremendous amount of cash, and in today's low interest rate environment, these investors may be willing to tolerate some measure of increased risk as compared to more traditional securitization products, in order to earn a more attractive yield. Oil and gas asset-backed securities could be a great fit for these investors by providing higher returns stemming from relatively stable cash flow streams tied to well-understood, proved developed producing reserves. By altering the mix of underlying assets and the nature of the oil and gas interests constituting the source of cash flows, structures could be adjusted to increase or decrease risk and return levels.

Bankruptcy Remote.

The SPE and the underlying assets must be bankruptcy remote from the oil and gas company sponsor. The securitization transaction, if properly structured, should constitute a "true sale," so that in the event of bankruptcy proceedings, the transferred assets will not be deemed to be a part of the sponsor's estate. In the context of interests in oil and gas properties, this is typically accomplished by making certain the interest being transferred to the SPE constitutes a real property interest for state law purposes with the conveyance being recorded in governmental real property records. By doing so, the sponsor's creditors cannot claim they thought the conveyed property is part of the sponsor's estate. The SPE should also include well established separateness provisions in its governing documents in order to mitigate the risk of substantive consolidation with the sponsor in the event of bankruptcy proceedings.

Credit Enhancement.

By structuring a credit that is legally separate from that of the sponsor, securitizations afford sponsors the possibility of significant credit enhancement as compared to sponsor credit, and consequently a lower cost of capital. Depending on the risk profile of the underlying assets, notes issued by an SPE in a

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securitization may achieve an investment grade rating even though the sponsor's debt securities may have a credit rating in the high yield realm.

Principal Advantages Over Traditional Oil and Gas Financing.

RBLs. Unlike RBLs, securitization facilities do not include any risk of redetermination of a borrowing base. The interest rate and principal is determined at the time the securitization facility is arranged. The amount borrowed under the securitization facility is not affected by future commodity price fluctuations. This feature may be particularly appealing to many oil and gas companies finding themselves grappling with crippling redeterminations under their RBLs. Furthermore, the asset value assigned by investors in the securitization market may exceed traditional RBL borrowing base valuations employed by commercial banks.

Oil and gas companies may find the cost of securitization to be competitive with RBLs. Some have even refinanced RBL borrowings with the proceeds received from securitizations. By doing so, these companies have decreased utilization of their RBLs and strengthened their balance sheets through newly diversified long-term financing sources. Moreover, the maturity dates for the asset-backed securities are typically longer than the RBL maturity dates. However, unlike the revolving credit of an RBL, the notes issued by an SPE in a securitization are amortizing and in that regard more akin to some traditional private placements.

Senior Notes. Currently, many oil and gas companies are finding the cost of capital implied by secured or unsecured senior notes is too high. High-yield debt investors have increasingly soured on this industry, and their lack of interest is reflected in their high cost and lack of availability. Securitization provides an avenue to lower cost debt while the high-yield debt market remains too expensive or even inaccessible to most independent oil and gas companies. Since asset-backed securities generally have flexible refinancing terms, securitization facilities could be refinanced with high-yield senior notes when the high-yield market recovers.

VPPs. Among the potential alternative sources of financing, many oil and gas companies will consider selling volumetric production payments, or VPPs. VPPs have been more widely used than securitizations in this industry when oil and gas producers look to raise capital from nontraditional financing sources. VPPs typically are in the form of overriding royalty interests over a certain term, but may consist of other oil and gas interests as well.

Pure VPPs have many similarities to securitization facilities, but also differ in significant ways. For instance, like securitizations, properly designed VPPs get beneficial treatment under bankruptcy laws and are not subject to redeterminations of a borrowing base. However, VPPs may not be as appealing as securitizations to asset-backed securities investors for a number of reasons such as:

- VPPs usually lack the interest reserve account typically included in securitization facilities, which helps reduce the risk of nonpayment should the anticipated cash flows generated by the underlying assets fall short of estimates;
- the tenor of VPPs are typically shorter than those of securitization facilities; and
- unlike a VPP, if the SPE fails to achieve a specific coverage ratio or production metric, the securitization facility may require a portion or all of the cash flows in excess of the debt service payments be swept from the SPE's bank account and used to service its debt instead of being distributed to the parent sponsor.

However, companies can combine VPPs with a securitization to benefit from the advantageous features of both. For example, in March 2019, Riviera Resources, Inc. transferred a VPP of quantities of helium to an SPE, which then in turn issued notes and delivered the proceeds to Riviera.

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What disadvantages does securitization pose?

Although there are many advantages to pursuing a securitization financing, there are a number of disadvantages companies need to consider when evaluating this form of financing.

Complexity.

One disadvantage is that securitization is a more complex financing structure resulting in higher transaction expenses. The ratings process can take more time than with more traditional financing as well. However, once the securitization facility is arranged, it is much easier to replicate it for future funding needs.

A careful review of a company's existing credit obligations will also be required to ensure those instruments do not prohibit a securitization transaction. If so, an amendment to such agreements may be required.

Reduction in Borrowing Base.

Inasmuch as securitizations fundamentally depend on the SPE and the transferred assets being outside the credit of the sponsor company, a disadvantage of securitizations is that they result in a reduction of the sponsor's proved reserves available to support its own borrowings.

Diversification.

Diversification of the underlying assets is a key consideration for rating agencies. Independent oil and gas companies that are a pure play in a single basin might not be able to obtain optimal pricing or their desired credit rating due to an inability to pool a diverse set of underlying assets. As an example of a diversified asset package, Raisa Energy combined non-operating wellbore interests that spanned five states and were operated by 35 different producers. This asset package achieved an investment grade rating, and Raisa credits the asset diversification as a significant factor in achieving that rating.

Hedging.

Another issue posed by securitizing oil and gas interests is the risk of commodity price fluctuations to which the underlying assets are subject. To mitigate this risk, companies should expect to hedge a significant portion of the SPE's production over a lengthy period. For example, as part of its securitization facility, Diversified Gas & Oil was required to hedge 85% of its SPE's production for a period of ten years and maintain corresponding basis hedges with a duration of two years determined on a monthly rolling basis. However, in the current volatile commodity price environment, effective hedging may prove to be difficult to obtain, and such long term hedging may be generally unavailable in the typical commodity hedging market. Consequently, hedging may have to be arranged with a creditworthy counterparty outside the established hedging market.

Conclusion

In these challenging times for independent oil and gas producers, securitization of oil and gas interests may be a viable alternative source of capital. Despite their inherent complexity, securitizations, with their credit enhancing attributes, could open up a new source of desperately needed capital for companies with significant proved developed producing properties to an industry in crisis.

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