Jackson Walker LLP

Legal Lessons Learned from the 2020 Oil Crisis

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Our Panel

Amanda Shaw
ashaw@jw.com

Jesse S. Lotay
jlotay@jw.com

Liz Freeman
efreeman@jw.com

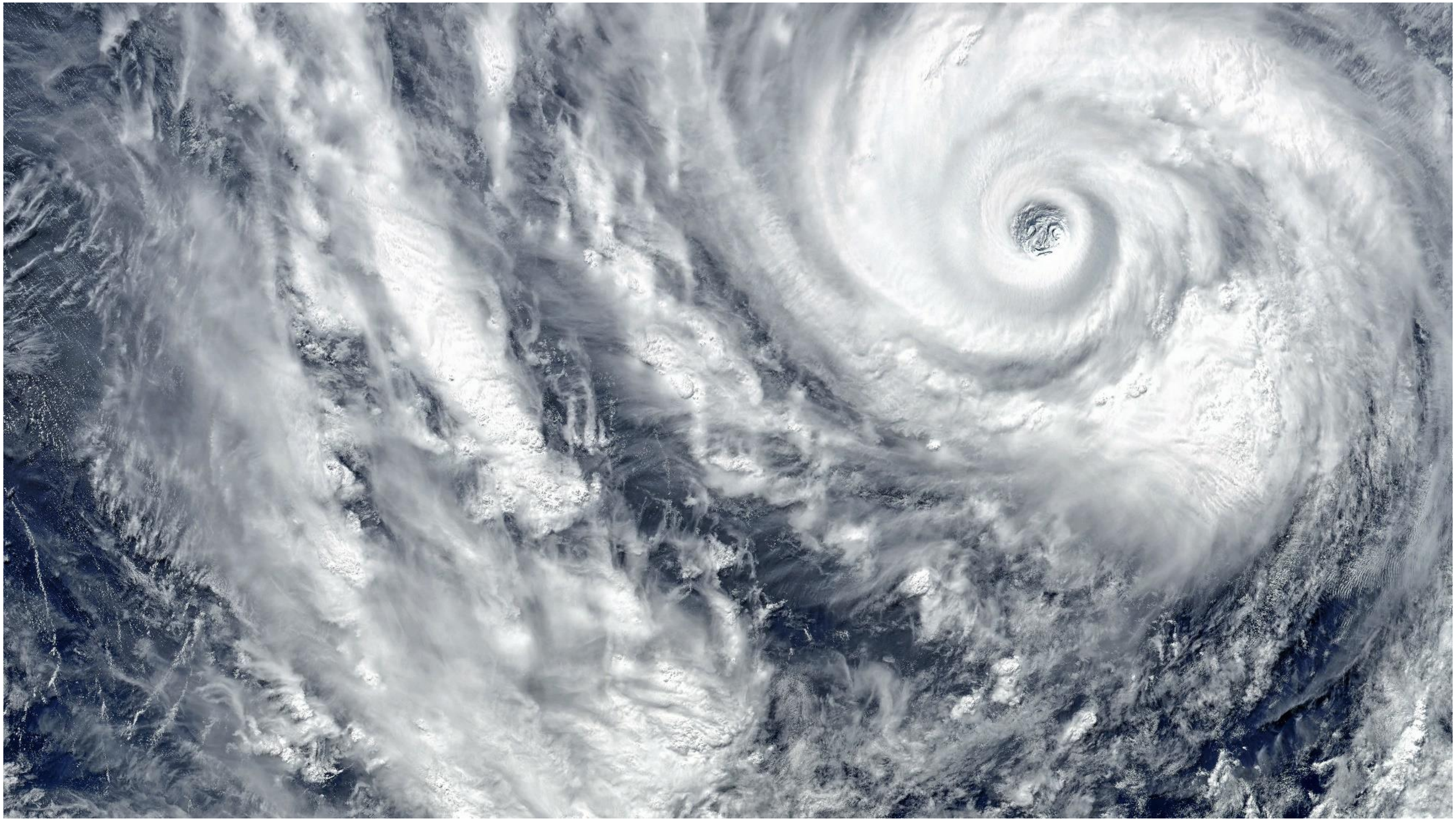
Richard A. Howell
rahowell@jw.com

Amanda Shaw

2020 Oil Crisis – Impact on the Energy Finance Industry

- Decreased Demand
- COVID-19
- Ongoing Price Wars

The Perfect Storm



Impact on the Energy Finance Industry

The factors mentioned above created a perfect storm for both lenders and borrowers in the energy finance industry.

- Collateral under reserved base loans ("RBL") is directly tied to the value of oil and gas reserves.
- How will lenders weather the storm?
  - Forbearance agreements.
    - Potentially prolonging the inevitable?
  - Foreclose on the hard assets.
    - Potential exposure to greater liability?
  - Proceeds from production.
    - What production?

Impact on the Energy Finance Industry

Most E&P companies lost significant value as a result of the 2020 oil crash.

- How will E&P companies weather the storm?
  - Default under existing credit facilities.
    - Borrowing base reductions.
    - Borrowing base deficiency.
    - Restricted cash.
  - Inability to obtain alternative financing.
  - Continuous and/or minimum drilling requirements.
    - Is it profitable (or even possible) to operate at the current prices?
    - Loss of collateral.

Jesse S. Lotay

- **Managing Market Volatility**:
  Hedging Oil and Gas Prices
- **Safe Harbor Protections**:
  Forward Contracts &
  Forward Contract Merchants

Hedging in the News

- Renewed interest in hedging oil and gas prices in the wake of the Saudi Arabia/Russia oil price war and COVID-19:

  - **Houston Chronicle**, *Experts: Companies with strong 'hedge books' will survive oil war* (Mar. 10, 2020)

  - **Kallanish Energy**, *US shale firms to benefit from record-high hedging gains* (Mar. 17, 2020)

  - **OilPrice.com**, *With Oil Hedged At $49, Mexico Saves $6.2 Billion As Prices Crash* (Apr. 22, 2020)

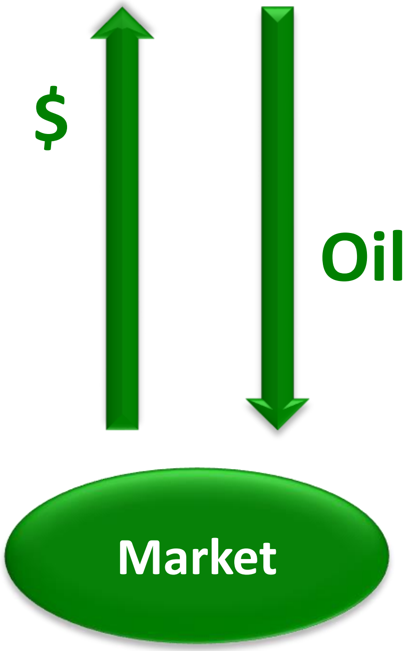
  - **Wall Street Journal**, *Some Oil Producers Have Secret Weapon in Hedging* (Apr. 24, 2020)

  - **S&P Global**, *Producers turn to hedging as shelter against oil market turmoil* (May 29, 2020)

Lessons Learned

- The recent and dramatic decline in oil prices illustrates the exposure that companies have to market volatility.
- Establishing a minimum price *in advance* that a producer will receive for its production reduces the extent to which its revenue erodes in a downward market.
- Hedging provides a measure of predictability and financial certainty, and can be a crucial component of a company's risk profile and financial management strategy.

Illustration of an Oil Price Swap



M$_1$: If the market price increases to $55/bbl:

- Producer receives the market price from the market ($55/bbl) [floating]
- Producer pays Swap Counterparty the market price ($55/bbl) [floating]
- Swap Counterparty pays Producer $50/bbl [fixed]
- Under the swap, *Producer pays Swap Counterparty* $5/bbl on a notional 100k bbls.

M$_2$: If the market price declines to $40/bbl:

- Producer receives the market price from the market ($40/bbl) [floating]
- Producer pays Swap Counterparty the market price ($40/bbl) [floating]
- Swap Counterparty pays Producer $50/bbl [fixed]
- Under the swap, *Swap Counterparty pays Producer* $10/bbl on a notional 100k bbls.

* Assumes crude oil is $50/bbl at the time the swap is entered into

The net effect of each transactions is that the Producer has hedged its production at $50/bbl.

Additional Information

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Hedging Oil and Gas Production: Issues and Considerations

DANIEL NOSSA, JESSE S. LOTAY AND PAUL E. VRANA, JACKSON WALKER LLP AND PRACTICAL LAW FINANCE

This Note discusses the benefits and limitations of oil and gas price hedges from the perspective of an oil and gas producer and analyzes the main types of hedging instruments oil and gas producers use, including their principal differences, advantages, and disadvantages.

The recent and dramatic decline in the price of oil illustrates the risk that every oil and gas producer has to energy commodity price volatility. This Note discusses the methods and transactions oil and gas producers use to "hedge" or reduce this price risk and transfer some or all of this risk to a party that is willing and able to assume and manage this risk.

Hedges are a risk mitigation mechanism and are distinguishable from speculative commodity transactions in which a party assumes, rather than transfers, price risk related to a commodity in hopes that the future increase or decrease in price is in its favor and result in trading profits. A discussion of these speculative transactions is beyond the scope of this Note. This Note also focuses on mechanisms oil and gas producers use to hedge price risk associated with the production and sale of oil and gas and not other types of risks the producer may face, such as interest rate or currency risk.

This Note:

- Discusses the benefits and limitations of oil and gas price hedges.
- Analyzes the main types of hedging instruments oil and gas producers use, including their principal differences, advantages, and disadvantages.
- Discusses the factors that oil and gas producers should consider when implementing a hedging strategy.

Hedging is a crucial component of any oil and gas producer's risk and financial management program. There are many ways a producer can achieve its hedging objectives. Oil and gas producers should be familiar with the risks and benefits of the hedging strategies typically used in the oil and gas sector to mitigate price risk. Planning ahead with the assistance of experienced financial and legal advisors that can identify the advantages and shortfalls of various hedging structures can prepare an oil and gas producer to better manage volatility inherent in the oil and gas markets.

WHY HEDGE OIL & GAS PRODUCTION?

A well-implemented oil and gas hedging strategy can provide an oil and gas producer with important benefits. The primary benefit of hedging oil and gas production is the producer's ability to reduce the impact of unanticipated price declines (known as price risk) on its revenue. Several methods exist that allow an oil and gas producer to hedge its expected production against price risk. Some methods, such as swap contracts, fixed-price physical contracts, and futures contracts, have the effect of locking in the price the producer receives in the marketplace for all or a specified portion of its future oil and gas production, but they prevent the producer from benefiting if prices rise.

Other hedging methods, such as put option contracts, establish the minimum price an oil and gas producer receives in the marketplace for its future oil and gas production. These methods protect the oil and gas producer from price declines while allowing it to benefit if prices rise. But they also require the producer to pay an upfront premium, which may be significant.

Regardless of which method is chosen, hedging all or a portion of a producer's oil and gas production against price risk can reduce the extent to which the producer's revenue erodes in a downward oil and gas market.

FINANCIAL CERTAINTY

The ability to lock in or establish a minimum price **in advance** that the oil and gas producer will receive in the marketplace for all or a portion of its expected oil and gas production gives the producer the advantage of predictable revenues in a future period and some measure of financial certainty. This certainty enables an oil and gas producer to:

- Ensure steady and reliable revenue to service its debt.
- Budget for drilling operations under its existing oil and gas leases.
- Plan for and fund future exploration and production activities and growth opportunities, even during a period of declining or volatile prices.

Hedging is, therefore, a powerful financial management tool.

In some cases, an oil and gas producer may not have a choice about whether to enter into hedging transactions. Oil and gas producers are often required to hedge a specified portion of their expected production by their lenders or investors. Lenders, whose loans are secured by

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Hedging Oil & Gas Production: Issues and Considerations

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Forward Contracts

- The Bankruptcy Code provides certain protections for a counterparty, if a contract qualifies as a “forward contract” and the counterparty qualifies as a “forward contract merchant.”

- Among these are “safe harbor” protections for:
  - Settlement Payments [11 U.S.C. §546(e)]
  - Setoff and Netting [11 U.S.C. §362(b)(6)]
  - *Ipso Facto* Clauses [11 U.S.C. § 556]

Scope

- **Forward Contract**: Generally defined as a contract for the purchase, sale, or transfer of a commodity with a maturity date more than two days after the date the contract is entered into. [11 U.S.C. §101(25)]

- **Forward Contract Merchant**: Generally defined as an entity, the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity. [11 U.S.C. §101(26)]

Lessons Learned

- Consider whether “safe harbor” provisions are applicable to a contract.
- Determine whether the scope of a forward contract and the counterparty are sufficient to meet the definitions set forth in sections 101(25) and 101(26), respectively, of the Bankruptcy Code.
- Ensure that forward contracts have been thoroughly vetted and reviewed by legal counsel to evaluate applicable events of default and remedies, including termination, liquidation, and set off rights.

Liz Freeman

- Bankruptcy Roadmap: Post-Petition Assumption and Rejection of Contracts
- Covenants Running with the Land

Bankruptcy Roadmap: Post-Petition Assumption and Rejection of Contracts

- Section 365 of the Bankruptcy Code addresses “executory contracts” and “unexpired leases.”
  - For purposes of section 365, an “executory contract” is a contract under which both parties have material unperformed obligations. A “lease” is a contractual agreement that constitutes a “true lease” under applicable nonbankruptcy law.

- State law or federal non bankruptcy law defines the rights of parties. The Bankruptcy Code is the traffic cop.

- Three Avenues with Executory Contracts and Leases
  - Assume (and cure defaults)
  - Assume (and cure defaults) and Assign
  - Reject

Bankruptcy Roadmap:
Post-Petition Assumption and Rejection of Contracts

- Ipso facto clauses are invalidated by the Code
  - Except in forward contract - This prohibition does not apply, however, to the termination of "commodity contracts" and "forward contracts" based on an *ipso facto* provision in the contract where the counterparty is "a commodity broker, financial participant, or forward contract merchant." 11 U.S.C. § 556.
    - Timing is important

- Oil & Gas Lease – not a "lease" in most states.
- Farmouts
- P&A Liablity

Covenants Running with the Land

- Gathering and Processing Agreements
- Three published decisions: *Sabine, Badlands, Alta Mesa*
  - *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC* (*In re Sabine Oil & Gas Corp.*), 550 B.R. 59 (Bankr. S.D.N.Y. 2016); *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017); *aff'd*, 734 Fed. Appx. 64 (2d Cir. 2018).
  - *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.)*, 608 B.R. 854 (Bankr.D.Colo. 2019);
  - *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, Bankr.S.D Tex. 2019 Bankr. LEXIS 3859.
- A framework of analysis is established.
- However, nothing is settled. Primary Takeaways:
  - State Law is key
  - Agreements widely vary in terms.
  - Impact on integrated agreements is an open question

Richard A. Howell

- Railroad Commission Actions
- Recent Trends in Energy Litigation
- Factors Driving Future Litigation

Railroad Commission Actions

- Motion for Market-Demand Proration
- Blue Ribbon Task Force Recommendations
- Heightened Concerns about Common Carrier and Common Purchaser Act Violations
- New Focus on Flaring and Pending Action

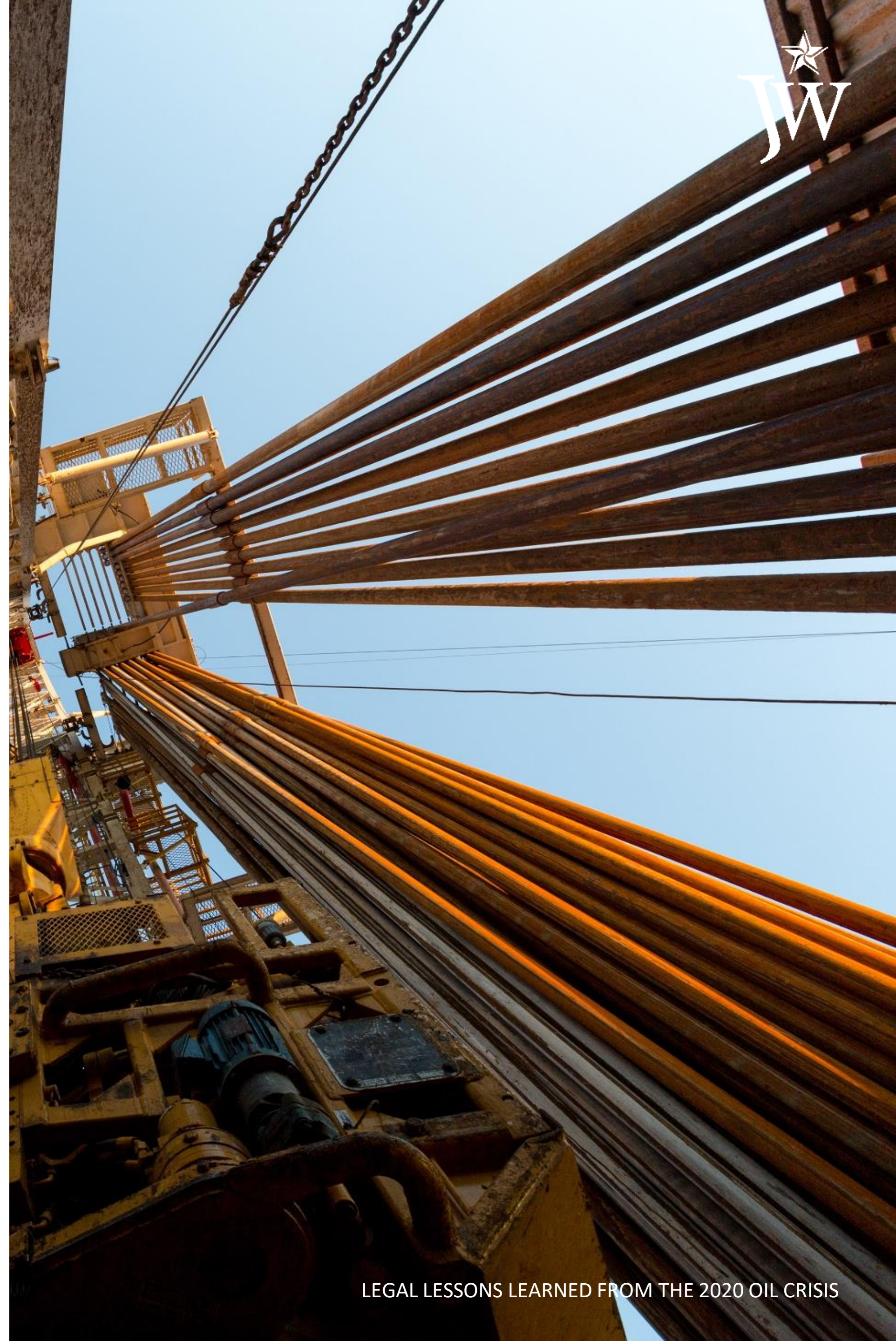
Recent Trends in Litigation

- Parties are Ready to Throw Elbows
- Impossibility of Performance and Force Majeure
- Contract Modification and Counterparty Risks
- Production in Paying Quantities

Continued Uncertainty and Risk

- Governments are Re-Opening at Different Speeds
- Risks and Opportunities in the Wave of Bankruptcies
- Fast to File – Slow to Trial
  - No Jury Trials Now – Increasing Logjam
  - But Discovery and Hearings are Proceeding in Courts and Agencies
- Alternatives to Jury Trial

Q&A

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