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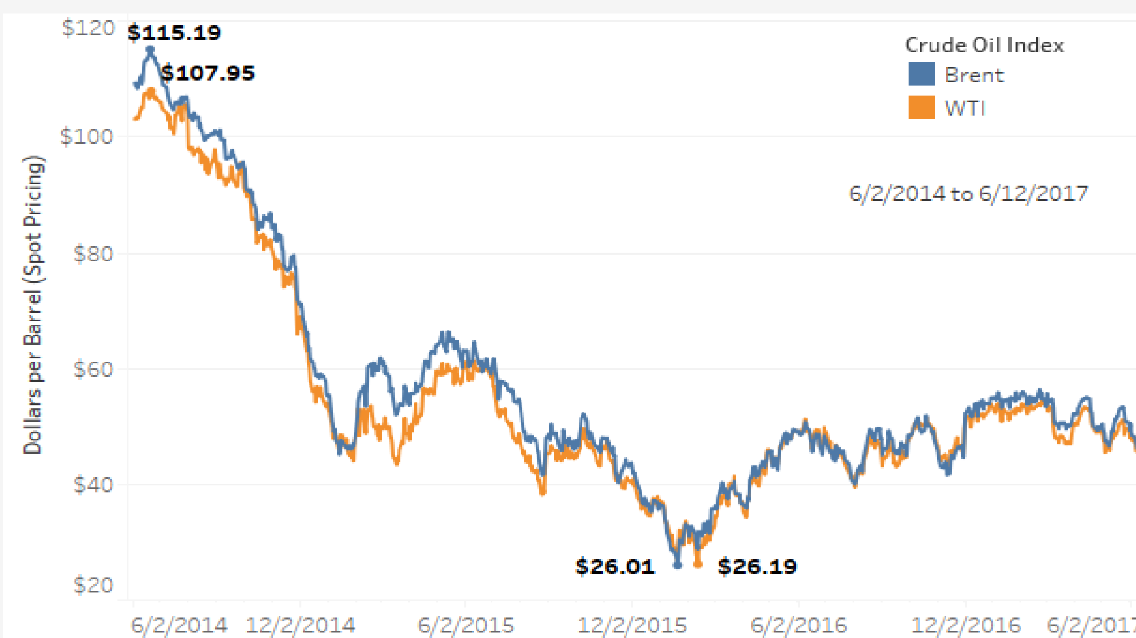
Energy Industry Lessons As The Oil Price Slump Turns 3

By **Keith Goldberg**

Law360, New York (June 19, 2017, 6:11 PM EDT) -- Three years ago Tuesday, U.S. crude oil prices climbed close to $108 a barrel, a day after global Brent crude oil prices topped $115 per barrel. They haven't hit those heights since, and lag in the $40s today.

The long slump, the first since the global recession of the late 2000s, sent hundreds of oil and gas companies into bankruptcy and largely froze major deal-making and development until a recent oil price recovery and stabilization around the $50 per barrel mark spurred a modest thaw.



While energy attorneys question whether the industry will heed the harsh lessons doled out by the slump if oil prices shoot up again, here's what they hope has been learned over the last three years.

Leverage Can Be Lethal

Oil and gas development is a capital-intensive industry, so carrying lots of debt is a price of doing business. But the companies that dramatically increased their leverage in order to fund acquisitions at premium prices when oil prices topped $100 a barrel were hit the hardest when the bottom fell out.

Approximately 123 North American oil and gas producers have gone bankrupt since the start of 2015, buried under nearly $80 billion in secured and unsecured debt, according to statistics compiled by Haynes and Boone LLP. A similar number of oilfield service firms have gone bankrupt in the same period, carrying nearly $26 billion in debt, according to the firm.

“Although leverage is helpful, it is also deadly, and you should create a capital structure that will withstand very significant price stress,” said Thomas Moore, the co-chair of Mayer Brown LLP's global energy group. “Most of the bankruptcies in the U.S. oil and gas sector were the result of people who borrowed to expand and ended up with a capital structure that simply could not withstand a price downturn.”

It wasn't just excessive leverage that drowned many companies when oil prices collapsed, it was the inability to adjust the leverage they carried — such as by refinancing debt — to relieve the financial pressure, attorneys say.

“Not only were they cash-constrained, there was no flexibility within the capital structure,” said Cliff Vrielink, co-leader of Sidley Austin LLP's global energy practice. “When prices drop, companies need to retain some ability to refinance and have the ability to adjust leverage and take it out.”

But as he watches oil and gas firms that have emerged from bankruptcy going public and starting to take on large levels of debt again, Moore wonders whether the leverage lesson has been really learned.

“I suppose that's understandable given that the debt is scaled to $50 oil prices, but I'm not sure long-term that $50 oil prices should be viewed as a floor,” Moore said. “At the bottom of the downturn, prices were in the $30s, and they can go there again.”

Can't Always Count on Counterparties

A landmark March 2016 ruling by a federal bankruptcy judge that bankrupt producer Sabine Oil & Gas Corp. could ditch midstream contracts underscores one lesson for oil and gas companies up and down the production chain: Think long and hard about your counterparties and whether your agreements with them will survive a downturn.

“That means if you're in the midstream space, think about your producers. If you have [acreage] dedications, will those survive? Will you have gathering agreements that survive?” Vrielink said. “At the end of the day, your investment, no matter who you are, is dependent on a couple of things: the actual resources and your ability to get them out of the ground and the commercial arrangement around them.”

When oil prices were riding high, many companies were solely focused on the first issue and got burned by the second when prices started to plunge, attorneys say.

“When you get into a distressed environment, everyone pulls out their agreements and looks at them, and if they don't adequately address things like inability to pay or compensation for nonperformance, you can run into difficulties,” said Baker McKenzie partner Denmon Sigler, who focuses on upstream and midstream deals.

Not only are companies now taking a harder look at potential deals and how they're structured, they're cleaning up existing agreements and adding language that clearly spells out conditions and obligations, attorneys say.

“You've seen a real focus on when you should have an operating agreement and not rely on common law for the operating regime, and a focus on the terms of the agreement,” Sigler said. “I'm hoping that's a lesson that will stay.”

There Is Strength in Shale

As oil prices fell, billions of dollars’ worth of conventional development around the world — onshore oil fields, deep-water projects, etc. — was mothballed because it no longer made economic sense to keep them running. Yet the U.S. has remained the world's top producer of petroleum and natural gas, in large part because of the ability of shale producers to drill more efficiently and cheaply. Costs per well in the major U.S. shale regions dropped by as much as 30 percent between 2012 and 2015, according to a report by the U.S. Energy Information Administration.

“The U.S shale industry and unconventional drilling industry was very resilient in terms of its ability to use enhanced technology and, frankly, squeeze the oilfield service providers in the country,” Moore said. “The lesson that OPEC learned is that driving down prices with the hopes of driving the nonconventional business out didn't work so well.”

But not all shale basins are created equal. With oil prices still struggling to stay above $50 a barrel, it's the Permian Basin of West Texas, home to some of the lowest drilling costs in the U.S. and multiple development zones, that has attracted the most development dollars.

The focus on efficiency is likely here to stay, according to Sigler.

“The onshore shale development is really going to be the swing producer in the world ... which potentially makes it more volatile,” Sigler said.

Lenders Reinforce Their Lifeboats

While the price slump drove hundreds of companies into bankruptcy, their secured lenders emerged largely unscathed. That's a testament to the use of reserve-based loans, a staple of energy industry lending. The loans are based on a company's total reserves and the price of oil and are usually revised twice a year, according to Buddy Clark, who co-chairs Haynes and Boone's energy practice group and specializes in oil and gas lending.

“By and large, the borrowing base structure works as intended as most of the senior secured credit facilities didn't suffer any loss, even after the bankruptcy process,” Clark said. “There are some outliers, but historically, you'll find the reserve-based loan structure has been rated very high for banks on recovery rates, compared to other industries.”

What took banks by surprise was when oil and gas companies borrowed large sums in anticipation of a review and reduction in their borrowing bases, Clark said. Borrowing base reductions helped topple many companies into bankruptcy.

Clark said lenders are now putting additional safeguards into their credit agreements with oil and gas companies to help ensure they remain secure creditors if the company goes belly up, such as requiring solvency representations each time a company borrows money and requiring borrowed funds to be subject to deposit account control agreements.

“If all of their expectations of creditworthiness of the borrower are wrong, are they still going to withstand the brunt of the bankruptcy and come out whole on the other end?” Clark said. “You can't beat the ride, but you can beat the rap.”

--Editing by Brian Baresch and Jill Coffey.

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