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COVID-19 Will Fray Energy Industry's Financial Lifelines

By **Keith Goldberg**

Law360 (March 24, 2020, 8:33 PM EDT) -- The coronavirus-fueled economic downturn threatens to cut off energy companies' access to credit markets that are vital to both their short-term survival and further development.

The oil and gas industry is bracing for a major reduction in their borrowing abilities that could push many drillers into insolvency. That could weigh down their partners in the oil field service and midstream sectors in the eye of their lenders, energy finance experts say.

Meanwhile, energy project developers face shallower investment pools they can tap as the economic downturn is poised to take a chunk out of the tax equity market and make other large investors skittish about sinking cash into projects unless their fundamentals are rock-solid.

Energy finance experts say companies are scrambling to ensure they can get enough liquidity from lenders to ride out the COVID-19 pandemic that has brought much of the global economy — along with its demand for energy — to a virtual standstill.

“We're in a hunker-down mode right now,” Mayer Brown LLP energy finance partner Dale Smith said. “We're not seeing a whole lot of new activity, we're seeing triage and maintenance.”

Reed Smith LLP energy finance partner Eric Holland said a fuller picture of the financing headwinds facing energy companies could emerge when they reveal their coronavirus-dented financial results from the first quarter of 2020, which wraps up next week.

“All of these leverage ratios were built on projections that [they] didn't project,” Holland said. “So I expect May to be insane, because that's when [lenders and borrowers] will discover what deficiencies exist and where they need to seek relief.”

Here are five areas where the energy sector may be pinched by tightening credit markets:

Borrowing Base Bloodbath Awaits Drillers

If there's one thing in this uncertain environment that energy finance experts can say with relative certainty, it's that the already ugly outlook for upstream oil and gas companies is about to get a lot uglier.

This spring, lenders will redetermine the borrowing bases for reserve-based loans. Those loans, a staple of energy industry lending, are based on a company's total reserves and the price of oil, and are usually revised twice a year.

Debt and equity markets for drillers were largely closed and many companies were already limping into borrowing base talks even before the one-two punch of the novel coronavirus and Saudi Arabia and Russia ramping up production sent oil prices crashing to historic lows. Drillers big and small are already taking hatchets to their budgets in order to preserve cash.

“What I'm dealing with the most, it's the upstream companies and just thinking about what's going to happen to their borrowing bases and how they meet their liquidity needs in the near term, whether it's shutting in wells or pulling back on capital expenditures,” Vinson & Elkins LLP finance partner Brett Santoli said.

Pushing drillers into bankruptcy is generally a last resort for lenders. Even during the 2016-2017 wave of driller bankruptcies that followed a similar oil price slump, experts said lenders worked with many borrowers to restructure debt or otherwise relax covenants that could have triggered defaults in the event of a breach.

But the economy-wide impacts of COVID-19 may give banks and other lenders less wiggle room to let companies kick their debt cans down the road, experts say.

“If it turns out that banks don't have flexibility, it may force companies to take extreme measures,” Reed Smith oil and gas partner Jorge Gutierrez said.

Upstream Woes Trickle Down to Oil Field Service, Midstream Cos.

Any finance crisis that hits drillers, especially one that drives them into insolvency, will have ripple effects down the oil and gas industry chain, experts say.

The first stop on that chain is an oil field services sector already weakened from the previous oil price slump. Holland said what makes oil field service firms' financing picture especially cloudy in the current environment is that they use their accounts receivable, which in most cases are their service contracts with drillers, as a main source of collateral for their loans.

“Those are going to be potentially impacted because underlying account debtors are going to struggle to pay those invoices,” Holland said.

Pipelines and other midstream companies generally don't use accounts receivable to collateralize their loans. Still, their revenue is largely based on the long-term agreements they've inked with oil and gas producers, and prolonged financial hardship for producers will have their midstream partners facing increased lender scrutiny, experts say.

“Midstream is a separate discipline, but it's contingent on the creditworthiness of their upstream counterparties,” Smith said. “If you have issues with your counterparty, that's potentially problematic. The midstream companies, even though they have these long-term contracts, we've seen their equity prices move almost in lockstep with upstream.”

Increased Skittishness From Project Lenders

For project developers, the ability to secure financing in the time of COVID-19 may largely depend on where they are in the development timeline, experts say.

For example, renewable and other power projects that are up and running, especially if they have long-term power purchase agreements locked in, are probably shielded from any credit market freeze-up. So are projects in the pre-construction stage because their financing needs aren't immediate.

The financing uncertainty will mainly hit developers with projects currently in the construction phase, given coronavirus-fueled disruptions in global supply chains and questions over available tax equity investment, Milbank LLP development and finance partner Allan Marks said.

“If you've got credit markets that are freezing up, those things matter, but they're not changing your behavior today for projects that are 2021-22 assets,” Marks said. “They're absolutely keeping you up at night if you're a 2020 deal.”

Kirkland & Ellis LLP project finance partner Rohit Chaudhry said the Term B loan market — essentially high-yield, longer-maturity, syndicated loans that attract institutional investors — is pretty much closed to energy project developers in all areas, but commercial banks that make up the Term A loan market remain willing to lend.

"If there is a good, contracted deal that needs financing, the term loan A market is still open,” Chaudhry said. “This crisis hasn't hit the commercial banks the way the financial crisis hit them in 2007-08, when the crisis really emanated from the banks."

But that doesn't mean banks aren't taking more precautions, Chaudhry said. For one thing, they're less willing to underwrite a deal that would put them on the hook for any financing they can't get other lenders to take on, he said.

“It's becoming harder to get commitments to underwrite a deal in the term loan A market,” Chaudhry said.

In such an environment, long-standing working relationships between borrowers and lenders are crucial, experts say.

“For deals where there's a strong relationship between a project sponsor and their lenders, people are willing to be more creative and patient and solving their problems,” Marks said. “The transactions that are still going forward are the financings where the sponsor and lenders have that type of relationship.”

Tax Equity Market Goes Soft

Experts say the tax equity market — a crucial source of renewable project investment — is already showing signs of shrinkage amid the coronavirus-fueled economic slowdown.

At the project level, the concern is supply chain disruptions could lead to developers blowing project completion deadlines they must meet to reap the full available value of federal tax credits whose benefits are passed through to tax equity investors, which are mainly banks. But more broadly, experts say the concern is that banks simply won't have as much income due to COVID-19.

“The lesser the income, the smaller the tax equity markets, because there's less income available to offset against the tax credits,” Chaudhry said. “It's early days in this, but it's a trend we're starting to hear about.”

Experts say there are echoes of the 2008 financial crisis which, among other things, devastated the tax equity market. In response, the federal government enacted a program where renewable project investors could collect cash grants instead of federal tax credits.

“We saw that movie play out in 2008 and 2009; the response was a cash grant [program],” Marks said. “Could you see a drive legislatively to reinstate the cash grant?”

Default Danger for Green Project Equipment Loans

Coronavirus-related supply disruptions could land renewable developers in hot water with lenders who gave them cash to buy enough equipment to keep projects eligible for the full value of available federal tax credits, experts say.

For example, solar developers remain eligible for the full federal investment tax credit if they invested at least 5% of their project's cost by the end of 2019 under Internal Revenue Service guidelines. Many developers inked loan agreements to purchase solar panels, transformers and other equipment to satisfy the 5% threshold, but those agreements contain covenants that developers must have that equipment in hand by a certain date.

With force majeure notices already rolling in from solar and wind equipment manufacturers, citing unforeseen circumstances that prevent them from fulfilling their contractual obligations to project developers, both developers and their equipment lenders must grapple with the potential for blown delivery covenants, Chaudhry said.

"The IRS did not have a hard deadline that you had to own this equipment within three-and-a-half months after the year was over,” Chaudhry said. “Some of the loan agreements that were entered into had hard covenants, which creates issues under those loan agreements in that you could be in default if you don't procure the equipment by a certain time."

--Editing by Emily Kokoll and Alanna Weissman.