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CLIENT ALERT

Alternative Financing Techniques: Asset-Backed Securitization in the Oil and Gas Industry

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Oil and gas companies seeking liquidity to operate their businesses have found themselves unable to access cash from sources that had been traditionally available to the oil and gas industry, such as reserve-based loans ("RBLs"), high-yield debt, and preferred and common equity investments. At a time when the industry is in desperate need of funds, these companies are taking a hard look at securitization financing, which, until recently, was generally unfamiliar to the U.S. oil and gas market.

How does it work?

At a high level, securitization involves packaging cash-generating assets, and then issuing bonds that are paid over time from, and collateralized by, such assets and their financial output. In the oil and gas industry, this involves the securitization of assets with a history of generating steady cash flows from producing properties, which may include wellborne interests, mineral interests, royalty interests, non-operating and operating working interests, volumetric production payments, or net interests.

To effect such a securitization, a series of financial transfers are consummated more or less simultaneously:

- Cash-generating assets are aggregated or "pooled" and transferred to a bankruptcy-remote special purpose entity ("SPE") through a sale, or a contribution of capital (or combination of both), that constitutes a "true sale" or "absolute transfer" under federal bankruptcy law.
- Concurrent with such transfer, the SPE issues bonds to investors in a private placement or Rule 144A offering ("Notes"), which Notes have been rated by one or more independent rating agencies.
- Immediately upon such issuance, the SPE transfers the proceeds from the sale of the Notes (after paying or reserving for closing expenses) to its parent or sponsor, to pay some or all of the purchase price of the asset pool and/or as an upstream dividend.

Who are the players?

SPE/Issuer:

The SPE that issues the Notes is a limited purpose entity that is structured to be legally separate or "isolated" from its parent and other affiliates, such that the SPE would not be consolidated or disregarded in the event of a bankruptcy of such parent or affiliate. The SPE is newly formed, with no operating history, no other creditors and no employees, so it is largely insulated from the common risks faced by operating companies.

Investors:

The nature of securitization, which requires the true sale or absolute transfer of a specific pool of assets to a separate bankruptcy-remote entity, shifts the focus of the credit risk analysis from the health and operation of the parent oil and gas company to the financial performance of the SPE's isolated pool of assets. The Notes rating is based on the production risk profile of the underlying pooled assets, while the credit quality of the originator is a secondary factor. Accordingly, and depending on the structure of the securitization and the amount of collateral supporting the Notes, the Notes may be able to obtain an investment-grade ("IG") rating, even if other debt securities issued by the producer/parent are high-yield, and could not achieve an IG rating. As a result, investments in securitization financing are drawing attention from investors that have not traditionally invested in the oil and gas industry, such as insurance companies, large money managers, pension funds, family offices, and other traditional investors in asset-backed securities that may favor (or require) IG ratings.

Oil and Gas Company Sponsor:

Securitization financing benefits oil and gas companies with producing properties that have long and steady producing histories, such as proved developed producing reserves. However, as explained above, the securitization of assets requires the isolation of the particular assets from the parent or sponsor, through a true sale or absolute transfer of assets to the SPE. Accordingly, companies should consider whether transferring such assets is permitted under their existing debt documents and/or whether such transfer may result in a borrowing base reduction that would outweigh the benefits of the securitization.

Hedge Counterparties:

To minimize the risk of commodity price fluctuations, issuers of Notes will be required to establish or enter into hedging arrangements to cover a certain percentage of their production—similar to the hedging typically used in RBLs.

Investment Banks:

As with any other private placement or capital markets offering, investment banks act as structuring advisors and placement agents/arrangers for securitization transactions.

Don't call it "new"

Asset-backed securities are not new structures. Similar structures have been used for decades to monetize other classes of assets, including mortgages, auto loans, accounts receivables, equipment leases and aircraft, vessels, and other transportation assets. However, the drastic cutoff of new cash into the oil and gas industry has shale companies looking at "new" financing structures to fill the void. In the past 12 months, three oil and gas companies, Raisa Energy LLC, Riviera Resources, Inc., and Diversified Gas & Oil PLC, have issued private placements of these asset-backed securities, with more expected to come in the near future. Earlier in 2019, Fitch Ratings predicted that oil and gas producers may seek securitization of proved developed reserves and issued criteria for the rating of such securitizations.

While there may be a number of attractive oil and gas assets available for securitization, the complexities of the energy industry and structured financings also present a number of potential pitfalls for energy investors. The structured finance team at Winston & Strawn LLP is a recognized leader in a wide range of both mature and emerging asset classes within the structured finance industry. In addition, our energy team has deep experience in

oil and gas transactions as well as actual operational experience spanning the entire energy value chain, from exploration and production, to midstream, marketing and storage.
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