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CLIENT ALERT

Alternative Financing: Securitization of Long-Term Supply, Offtake, and Other Forward Sale Agreements

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Securitization Generally

Securitization involves the aggregation and transfer of a pool of cash-generating assets into a special-purpose entity (SPV), which then issues bonds (Notes) that are paid over time from, and collateralized by, such assets and the collections and proceeds generated by such assets. The Notes are rated by one or more independent rating agencies and are issued to investors in a private placement or Rule 144A offering. Securitization is an attractive financing alternative because the credit risk analysis for investors focuses on the historical (and expected future) performance of the receivables of such isolated, and diverse, pool of assets and receivables, rather than the performance of a complex operating company.

The purpose of this follow-up post is intended to provide an overview of certain considerations specific to midstream and oilfield services companies servicing onshore customers that are considering securitization as a tool to monetize long-term supply, offtake, and forward sale agreements (LTSAs). For more general information on asset-backed securitizations in the oil and gas industry, see our previous commentary here: Alternative Financing Techniques: Asset-Backed Securitization in the Oil and Gas Industry.

Types of LTSAs

LTSAs are agreements pursuant to which one party purchases all or portion of the output of a project. In the onshore midstream and oilfield services industries, these types of agreements can include:

- Gathering and processing agreements;
- Transportation agreements;
- Marketing agreements;
- Hydrocarbon supply and sales agreements;
- Fractionation agreements;

- Offtake agreements;
- Storage agreements; and
- Product and services supply and sales agreements.

Key Considerations in Selecting LTSAs

Repayment of the Notes issued in a securitization relies on the continuous cash flow generated by the securitized assets. Therefore, when assembling or building up a portfolio of LTSAs, special consideration should be given to the historical information about the underlying cash flows of the assets and the counterparty risk associated with the LTSA counterparty. When rating agencies rate securitizations of contract payments, such as trade receivables, the rating agencies generally analyze risks relating to the (i) underlying assets and (ii) the structure of the financing transaction and securities issued. *Asset risks* may include not only counterparty credit risk, but also risks associated with non-payment arising from counterclaims against (or other defenses to/reasons for non-payment arising from) the payee (in this context, the payee would typically be the oil and gas company sponsor or producer). The *structural risks* that arise in such securitizations include the risks related to the timing of payments on and remaining term of the underlying contracts vis-à-vis the payment obligations under the issued bonds or notes. It is worth noting that the LTSA-backed bonds will bear interest, and that the LTSAs will not be interest bearing, such that cash flows from the portfolio will be evaluated as to their capacity to support (with appropriate excess spread) timely and ultimate payment of interest on the bonds (as well as their ability to ensure repayment of principal when due).

In discussing securitizations that rely on LTSAs, it bears mention that LTSA portfolios may minimize *price* and *distribution* concerns resulting from changes in commodity prices (which are critical risk elements, undoubtedly) that arise in the context of other forms of securitization of oil and gas interests, but do not necessarily alter *production*, *commodity price,* and *operational* risk concerns. LTSAs in the midstream and oilfield services (OFS) industries are generally at least one step removed from direct exposure to commodity prices, but are certainly still impacted by changes in commodity prices and activity in the E&P sector—a current example is that many midstream companies are receiving lower volumes for gathering, transportation, processing, fractionation, refining, or purchase due to declining output from their upstream counterparties as a result of lower commodity prices, decreased development, and other industry issues. Similarly, OFS companies are seeing less drilling activity, frac sand sales, equipment and parts sales, demand for well and oilfield services, etc. Therefore, it will be very important to consider minimum purchase requirements, mandatory payment provisions, or other terms assuring payment in the LTSA portfolio. Consequently, securitizations that rely on LTSAs will still require an assessment of risks associated with production, servicing, maintenance, business operations, etc. arising from the underlying wells and producers or the counterparties' other applicable operations, even if the ratings ultimately depend more heavily on the LTSA contract payments.

Portfolio Composition and LTSA Terms

Securitizations of contract receivables may involve either a *static pool*, in which all, or substantially all, of the securitized portfolio is identified, pledged, and transferred into the structure at closing, or a *revolving pool*, in which the pool is replenished with new contract receivables throughout a "reinvestment period," as portfolio contracts are repaid or expire, or are sold or default. At this relatively early stage of development of oil and gas securitizations, it is likely that such securitizations will predominantly finance *static pools*, thereby avoiding the additional complications associated with rating a portfolio that changes over time, including complex eligibility requirements for post-closing additions to the portfolio.

If the pool is static, rating agencies will generally expect contracts to strictly limit the circumstances in which the counterparty may terminate or change the term of the applicable LTSA—*i.e.*, defaults that the rating agencies are able to determine to be remote and that do not give the Counterparty an "option" to terminate—since repayment of the LTSA-backed notes will depend on the initial portfolio, with no expectation of regular replenishment for LTSAs that terminate. The rating agencies will likewise assess the risk of quick-trigger defaults, and will "stress" their cash flow analysis (in the absence of additional credit enhancement) to the extent that defaults, such as failure to achieve

production requirements, have short—or omit entirely—notice and cure periods, so that the producer would not have an opportunity to cure a performance failure.

Rating Considerations Related to Counterparties and Counterparty Risk Mitigation

Counterparties in LTSAs will typically consist of a few large contract counterparties forming the “anchor” portion of the portfolio (for example on a pipeline, a few anchor shippers holding the majority of the capacity on the pipe) with other smaller contracts to help round out and support the revenue requirements. Ratings and credit concerns will focus heavily on the anchor contracts, and mitigating risk associated with those counterparties will be key. The below are a few considerations relating to counterparties when assembling a portfolio for securitization:

- For a highly diversified portfolio, such as a credit card portfolio, the rating agencies examine performance on a statistical *portfolio* basis.
- For a less diversified portfolio, the rating agencies will tend to review the creditworthiness of each purchaser or payor counterparty (Counterparty).
- For a Counterparty that represents a significant portion of the total portfolio, rating agency cash flow analyses (used to assign a rating to the Notes) will consider such concentrated exposure, which may impact advance rates absent further credit enhancement (see discussion below). There may be different concentration limits (above which the LTSAs will attract lower advance rates, or require credit risk protection) for different Counterparties, depending on the rating of each Counterparty (or the lack of rating).
- The rating agency models will also consider diversity across other several vectors, including (i) geographical diversity of wells, (ii) diversity (geographical and otherwise) of customers/end users/delivery points for the oil and gas, and (iii) diversity among the products and services being provided and service providers.

The following are strategies to mitigate counterparty risks.

- For larger corporate counterparties, it may be possible to hedge/manage credit and bankruptcy risk through credit default swaps (CDS), receivable “put option” programs, or credit insurance products
- Insurance products and certain trade receivable “put option” programs typically cover bankruptcy risk only. CDS may offer a broader set of adverse trigger events.
- Note that the foregoing credit risk protections introduce a new set of counterparty risks, and the rating agency criteria may specify that the policy, program or CDS be replaced (or assigned/novated to a new counterparty) in the event that rating of the enhancement provider falls below the minimum required level.
- Depending upon the requested/anticipated rating of the Notes, rating agency cash models may call for and/or rely upon credit protection (via credit insurance or CDS) if any Counterparty represents more than certain percentage of the total portfolio of LTSAs.
- Absent credit protection (via credit insurance, CDS, etc.), rating agencies may expect the issuer to obtain a shadow rating of a Counterparty that represents more than certain percentage of the total portfolio of LTSAs.
- One structural form of risk mitigation may involve an accelerated prepayment or amortization of the bonds/notes if there occurs any one of a list of amortization triggers (typically tied to specific metrics, such as coverage ratios, loan-to-values, and production rates, at levels that are less severe/adverse than the corresponding events of default).
- Many securitizations (particularly for relatively new asset classes) incorporate reserve accounts that contain funds to cover payments of interest (and possibly scheduled principal amortization) for a specified period—typically between three and six months ahead. These reserve accounts, which have been used in recent oil and gas securitizations, mitigate the effects of temporary shortfalls and/or timing mismatches in cash flows from the

collateral (including, for example, seasonal or market-driven variations), and provide time to cure or mitigate interruptions or other issues presented by particular LTSAs.

- The sponsor and/or originator will also make detailed representations regarding the composition and characteristics of the portfolio assets as of the closing date, and will have an obligation to repurchase the relevant/affected LTSAs (or otherwise compensate the special purpose entity issuer) if it is later determined that such representations were untrue as of such date.

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, to fractionation, refining, terminaling, distribution, and export.

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