Oil & Gas Exploration & Production Bank Re-determinations: A Primer

Oil and gas companies will come under financial duress this October, when banks re-determine the borrowing base of oil & gas reserves. By some estimates, roughly 75% of borrowers expect a decrease in their borrowing base, due to the low oil and gas price environment. This re-determination of lending facilities will affect those companies that locked in higher oil and gas prices last year, but have their hedges rolling off now, at the same time as the re-determination period occurs, leaving them exposed to the current low oil and gas prices.

[According to IHS Energy, an energy information provider, approximately 11% of North American production is hedged in 2016 at an average of about $69 per barrel (bbl) for oil and $3.83 per thousand cubic feet (mcf) for gas. Today, prices are about $49 bbl and $2.48 mcf in 2015.]

What exactly is re-determination? Small and midsized exploration and production (E&P) companies most often finance their operations with revolving bank credit lines, secured by liens on their assets. Each April and October, banks re-assess the value of these assets to determine how much money they should lend to these energy companies. In bank parlance, it is called ‘reserve-based lending’. The determination (or re-determination) is a formula based on a company’s oil and gas reserve base, the price of oil and gas, and any hedges that are in place, among other variables. These other variables are solely determined by the bank, but the formula must be applied consistently across their energy lending pool.
Which firms are most at risk? Re-determinations are typically more troubling for the small and mid-size energy companies, which rely more heavily on hedging, because they do not have any downstream revenue diversification, like refining and processing, to help offset some of their financial woes. With the likelihood that new hedges will be at significantly lower prices than previous hedges, small and midcap companies will come under financial pressure. These firms depend more on the bank debt market than on the capital (bond) market. For some energy companies, the debt markets are closed. Only a few companies can get any traction in the marketplace.

What do bank regulators say? Fearing some regulatory wrath, banks have cut back on the amount of money they supply to energy companies and have added to their oil and gas loss reserves. They were more lenient during the April re-determination period because oil prices were a little higher and analysts expected the price to climb. However, the October re-determination will be a much tougher period, as the banks’ long-term price decks for oil could very likely turn to a discount over the forward strip prices, from a premium.

Some companies have noted that regulators are not letting commitments to be finalized above the strip price at the time of new commitments, and that banks are being required by regulators to hold more capital against their energy loans.

In fact, in July 2015, the preliminary results of a joint national examination by U.S. regulators revealed that many loans issued to oil and gas companies are “substandard”. This Shared National Credit review process included the Federal Reserve, Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corp. Regulators are, in fact, doubting oil companies’ ability to repay their bank loans, questioning the value of the collateral (in this case, oil and gas reserves) that back those loans. The OCC, in a semi-annual report noted that the “significant decline in oil prices in 2014 could put pressure on loan portfolios”.

Due to enhanced regulatory scrutiny on banks’ loan portfolios to oil and gas companies, some estimates are that credit to these firms could be cut by more
than 30%, resulting in a drop of about $30B in credit capacity. This amount is greater than the drop experienced in 2008 – 2009. [Note: Oil prices plummeted from ~$147 bbl to ~$40 bbl. The high price was fueled mainly by speculation, the low price spawned by the ‘great recession’].

Typically, the banks and the oil companies would normally work out a restructuring deal (for a price, of course); however, there is regulatory pressure on banks to take a much more conservative approach to lending. The banks can no longer ‘kick the can’ down the road again. Regulators will not let them.

Regulators are calling on the banks to move energy loans to their “workout” groups, if these loans appear at all to be at risk, to protect the banks against failures. These “workout” groups handle the banks’ special assets and negotiate and manage the banks’ forbearance agreements. Simply put, they try to recover as much of the loan as possible. The relationship between the borrower and the banker, which in the past the bank would try to uphold, no longer is in play!

In all, it could be a bit of a conundrum for the oil firms. Due to the plunge in energy prices, regulators are paying very close attention to the bank loans made to energy firms, and pressuring the banks to be more conservative in their lending practices. However, while regulators want to save the banks from big losses, it will likely force those energy firms under duress to sell off assets more quickly and at cheaper prices, and, thus, lose further access to financing.

Is there anything the energy companies can do? Typically, the oil and gas firms will try to pressure the banks for amendments that allow them to stretch their borrowing bases despite lower oil prices. They are also likely to review their debt documents with a fine-tooth comb to see if they can add debt, perhaps through a debt exchange. (Exchange their existing unsecured debt to a secured level, which gives the original unsecured investors more safety. However, first lien investors would still be paid out first. An exchange could also help oil companies to extend maturities or convert debt into equity).
Waivers could be another means available to oil companies. Banks could waive or loosen restrictive financial covenants, such as Debt/Ebitda, again for a price.

Finally, oil and gas firms could seek additional, more costly capital from third-party lenders, such as hedge funds and private equity firms, which have been most active on the second-lien and subordinated debt side.

Nevertheless, oil companies’ ability to borrow will be cut back, which will reduce their liquidity at a time when they need it most.

Is this just all hype? It should be noted that many companies refinanced their bank loans late last year or early this year, with good terms. They borrowed more than in the past, because of the shale phenomenon. At the time of those refinancings, reserves and production were not the issue and the banks and the industry expected prices to rise; but, that has not been the case. Price is the issue, causing firms to cut back on spending, impacting production.

The capital markets will not be completely closed to oil and gas firms; but, there will be greater reviews and due diligence on energy firms’ individual credit. Those
companies that curtailed capital spending, can still add to reserves, controlled expenses (headcount), lowered or eliminated dividends, renegotiated supplier contracts, and can operate within their cash flow will remain solvent, as there is likely still room under their bank facilities. There is also financing available from non-traditional sources, as noted earlier.

What is the credit impact? A number of companies will balance unsteadily on the precipice of bankruptcy and, thus, we will continue to see a greater number of defaults. Already, there have been at least 10 bankruptcies in the oil & gas patch in 2015. For most of these companies, as noted in American Eagle Energy’s regulatory filing, “the sharp decline in oil prices in the latter part of 2014 and continued depressed pricing has materially reduced revenues generated by the sale of oil and gas production.”

Moreover, S&P announced on Oct 2 that it lowered its rating on 16 U.S. oil and gas E&P companies, and revised the outlook on 5 others to negative, from stable. These actions were due to a revision in the rating agency’s price assumptions, which have caused S&P’s forecasted financial profile of these firms to be weaker.
Additionally, S&P noted that some firms will face liquidity concerns given the current redetermination period.

As the chart below notes, 8 of the 16 downgraded companies now have ratings precariously close to default (B- or below). This is the riskiest group, especially those such as Triangle USA Petroleum, Templar Energy, Clayton Williams Energy, Energy XXI, and American Energy–Permian Basin that also have negative outlooks.

![S&P Rating Actions – Oct 2](image)

Additionally, where there is smoke, there is most always fire. The stock market is a very good indicator of risk. Companies with the largest stock price fall could reflect that investors (the market) have identified them as having an untenable situation. For most of the companies in the table above rated B- or lower and for many other unrated entities, they are privately held, so investors cannot look to the market for smoke. Two companies in particular, however, Triangle USA Petroleum and Atlas Resource Partners, have had their stock prices drop approximately 70% since April of this year to $1.63 and $2.96, respectively.
Do banks really want to own oil and gas properties? Banks certainly do not want to own energy companies or oil and gas reserves, especially at these prices! It is very much expected that they will be creative with companies to keep the process from getting too messy. They have workout groups for a reason, as noted earlier. They are skilled at extracting all of the value out of a company that they possibly can. While any bankruptcy proceeding can be a major nuisance, bank losses and subsequent write-offs are no picnic either. During a bankruptcy proceeding, debtors come out of the woodwork. Everyone wants a piece of the pie.

While the banks secured lending is backed by the commodity reserves in the ground (or in storage), often the land in which those reserves are located was leased by the oil and gas company from the property owner. In a bankruptcy, it is possible for the property owner to now lay claim to these reserves. It all depends on the terms and conditions in the lease agreements. In the end, it can all get rather disorderly, to say the least; which is why banks prefer a more organized, pre-packaged bankruptcy or restructuring.

Summary: October 2015 will be a difficult month for the oil and gas patch, as banks re-determine reserve-based lending amounts. Small to midsize firms, that do not have diversified operations but have hedges rolling off, will be at risk to having their credit capacity notably reduced. Strict regulatory oversight on banks will make it more difficult for the banks and E&P companies to work together to waive or amend lending agreements or to exercise an exchange offering. Moreover, weak credit ratings and/or a precipitous decline in stock prices could be a tell-tale sign of trouble ahead for these companies and their investors.