Oil and gas: troubled times

October 21, 2014

The slump in the oil price means oil and gas companies are no longer insulated from the impacts of the economic downturn. We now find ourselves dealing with situations which seemed unthinkable just a few months ago – the special sensitivities of oil and gas companies in financial distress.

When Endeavour filed for Chapter II Bankruptcy protection in October, driven in the main by an excessive debt burden and issues surrounding its North Sea assets, it signalled the end of the North Sea boom. As a relatively small player, with a limited portfolio and balance sheet, it was particularly exposed to the downturn, but many other companies are encountering the same problems as those which faced Endeavour.

Small players

Much of the new exploration is driven by small players, working in joint ventures to try to spread the high risks involved. They generally lack the financial muscle and industry diversity that helps the larger international oil companies through the difficult times.

Big costs

In recent years the costs just kept getting higher. That trend has begun to reverse as the oil price slips, but oil and gas companies are already committed to minimum work and expenditure levels – these are set 12-24 months in advance of work commencing. Expenditure levels for seismic and drilling operations scheduled in 2015 will have been agreed in a period of steadily rising oil prices; once set, there is little room for manoeuvre. If commitments are not met, licence revocation becomes a real possibility.

No finance

Financing channels are frozen or at punitive rates, and the equity capital markets are an option for a very select few.

Slashed income

Brent Crude prices are at their lowest in 4 years. This sudden fall has slashed the income of those with producing assets, but across the board it has raised questions over the economics of North Sea investment.

In short, many oil and gas companies are short of cash – especially those lacking producing assets.

Some issues to bear in mind with an oil and gas company that is potentially in financial distress:

The regulator holds the trump card

The licence (or other instrument granting it its rights) is everything to an oil and gas company – without it a company has no right to explore for or produce oil and gas. The regulator – in the UK the Department of Energy and Climate Change (DECC) – will do what it thinks best to start/keep an oil and gas field producing. This may include licence revocation – which DECC may do when an oil and gas company gets into financial difficulty. The company may still be on the hook for hefty decommissioning costs. DECC has a wide discretion – oil and gas companies must keep DECC informed and do what they can to keep DECC onside.

JOA partners may have forfeiture or pre-emption rights

If a company becomes insolvent, it could jeopardise its JOA partners' obligations to government, contractors and customers. JOA partners will also have to make up shortfalls in JOA payments. They will therefore want a quick and sound solution – and might decide that the best way to achieve this is to force the insolvent company to forfeit its JOA and licence interest. If the JOA partners do not enforce forfeiture and the company wants to sell its licence interest to raise funds, it may need to negotiate around JOA pre-emption rights.

Counter-parties might terminate

Or worse – they might not. Termination might be preferable if it was the price at which the company was contracting with its counterparty that got it into financial difficulty in the first place. Renegotiation of key supply or other contracts will turn on the degree of relative dependency of the parties on each other: finding a resolution may be critical to maintaining the company as a going concern and/or making it more viable to potential bidders.

What if a counterparty becomes insolvent? The impact will depend on the significance of the counterparty – if it is a big (or sole) customer, this could be very damaging.

Lenders will want to control the company

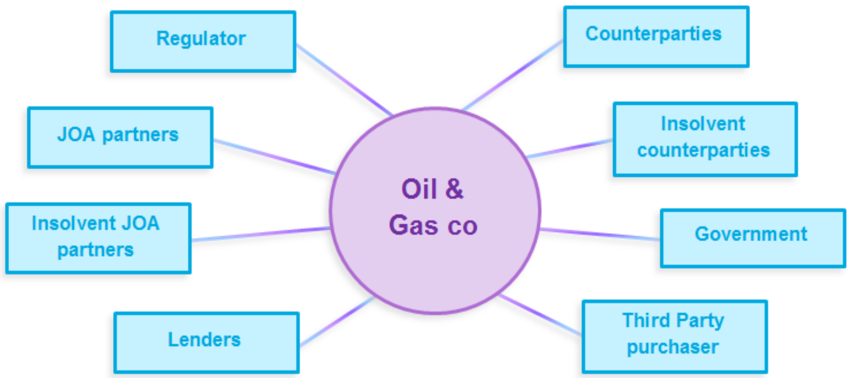
Lenders will have security over the company's assets, including the licence. However, they may be reluctant to enforce that security, as to do so could have implications in terms of statutory liabilities on the lenders (e.g. liability for decommissioning costs). Lenders will therefore try to control the company as much as possible (e.g. by monitoring whether operations are continuing as required by the licence and joint operating agreement). In particular, lenders will be looking for a strong buyer to acquire the company's interest and will need to comply with DECC's requirements for a transfer of a licence interest/change in control of a licensee.

Buyers will want to cherry-pick

The industry is consolidating. Companies short of cash are looking for buyers. Cash buyers may be treading carefully in these times of volatile oil prices, but everyone likes a bargain – and that's what they'll be seeking in acquiring interests from a distressed oil and gas company. Persuading buyers to also take on the liabilities by a share sale will prove a big challenge. In an insolvency situation, there may be a need to use pre-packaged insolvency procedures.

Government will want to keep oil pumping

In the UK, North Sea production is down in recent years – despite soaring oil prices. That's a concern for government. It wants security of supply from the North Sea, and the associated tax revenues. The industry is hoping the ongoing tax review will result in the government reforming the tax system in a way that encourages greater activity. This could change the economics an oil and gas company in financial distress and the economics of the industry in general.



Industry knowledge and expertise

The complexity and evolving nature of the North Sea makes it a necessity to have lawyers who understand and have the knowledge and capability to deliver in this market. Our extensive experience in this sector means we are ideally placed to support clients in their North Sea operations. Our oil and gas practice, with more than 70 dedicated oil and gas lawyers across our network, is widely recognised as pre-eminent for its industry expertise and experience.

We regularly advise on all aspects of upstream transactions, for international oil companies, national oil companies, independents, new entrants (such as Japanese trading companies and sovereign wealth), financial institutions, underwriters, governments and regulators

North Sea experience

- **Marathon Oil:** Advising on the multi-billion (US$) divestment of its North Sea business (including vendor due diligence and pre-sale preparation).
- **Confidential Client:** Advising confidential oil and gas operator in connection with challenging DECC action to enforce immediate shut down of operations. Work included liaising with DECC, advising on legal remedies and drafting correspondence.
- **Hurricane:** Advising on its IPO, North Sea operations and on licensing matters generally.
- **DEO Petroleum:** Advising First Energy and Merchant Securities on the reverse takeover of DEO Petroleum by the purchase of North Sea interests from Nexen and re-listing on AIM.
- **Afren:** Advising upstream oil and gas exploration and production company in relation to its crisis management policy and procedures. Work involved analysis of recent crisis; delivering legal workshops with senior management team; drafting crisis response policy and corporate plan; delivery of workshops and briefing sessions to senior level management and board members.
- **Confidential Client:** Advising a potential bidder (confidential) on its proposed corporate acquisition of RWE DEA's upstream onshore and offshore assets in various jurisdictions, including the UK, Norway, Egypt and Continental Europe. This involved undertaking a full due diligence of the assets and interfacing with the sale process.
- **Korea Capital Company Limited:** Advising on a transfer of the operatorship agreement in relation to North Sea upstream oil and gas assets.
- **Petronas:** Advising on its sale of Star Energy Group Limited to IGas plc together with the group restructuring and carve-out of a gas storage business and including long-term gas sales arrangement.

- **RBS:** Advising on taking security over various UK and Dutch North Sea oil and gas assets.
- **Wintershall:** Advising on the UK regulatory aspects of its take over of Revus Petroleum in addition to its assets in the UK North Sea. Advising on various gas North Sea interests.
- **Noble Energy:** Advising on various confidential matters in relation to its activities the North Sea.
- **Repsol:** Advising in relation to the sale of shares in the North Sea holding company by Kuwait Petroleum Corporation.
- **Sojitz:** Advising on a complex asset transaction acquiring interests in exploration and producing gas fields in the UK North Sea Continental Shelf from Newfield Petroleum UK Limited, including drafting and negotiating farmout and participation agreements and all joint operating agreements. Advising on the on-sale of some of those assets to Centrica.

Your Key Contacts

Nigel Barnett
Consultant, London
D +44 20 7320 5530
nigel.barnett@dentons.com

Humphrey Douglas
Partner, London
D +44 20 7246 7714
humphrey.douglas@dentons.com

Neil Griffiths
Partner, London
D +44 20 7320 6822
neil.griffiths@dentons.com