Oil and Gas Industry Seeks Steady Ground Following Year of Restructurings, Restrictive Lending

Skadden

01 / 30 / 17

This article is from Skadden's *2017 Insights.*

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Crude oil and natural gas prices reached multiyear lows of approximately $26 per barrel for crude oil (as of January 2016) and $1.50 per million British thermal units (mmbtu) for natural gas (as of March 2016). This represented a 75 percent decline in the price of oil from its peak of approximately $105 per barrel in mid-2014 and an 80 percent decline in the price of natural gas from its early 2014 peak of over $8 per mmbtu. At the time, many industry observers predicted that depressed commodity prices would result in numerous bankruptcy filings and an uptick in M&A activity.

Most oil and gas companies responded with heavy job and capital expense cuts. A slow but steady increase in prices during the past year — to over $50 per barrel for oil and over $3.50 per mmbtu for natural gas as of the end of 2016 — allowed many companies to avoid formal restructurings. However, the increase in oil prices arrived too late and was not enough for many others. Oilfield services companies and exploration and production (E&P) companies experienced more acute levels of distress — and accounted for the highest number of in-court restructurings in 2016.

Looking ahead, heavy debt loads among oil and gas companies are likely to slow the recovery of the industry as a whole, but if oil prices remain stable or increase, we expect far fewer restructurings this year. Opportunities for consolidation through acquisitions exist within the oil and gas space. Opportunistic buyers, including companies that recently have delevered through bankruptcy, may look to add attractive assets to their portfolios.

Oilfield Services. Beginning in mid-2014, oil prices began to fall sharply, decreasing 50 percent over the following six-month period and worsening in 2015. The prolonged, depressed oil prices meant that E&P companies reduced spending on oilfield services work, such as repairs and maintenance, putting pressure on oilfield services companies. When E&P companies did hire service companies, competitive pricing among the service providers added to that pressure. In 2016, 70 oilfield services companies filed for bankruptcy. Now that oil prices have risen, E&P companies are moving forward with deferred maintenance work, leading to higher demand for oilfield services companies and likely far fewer oilfield services bankruptcies this year.

Upstream. In response to declining oil prices, E&P companies substantially reduced their existing production operations and implemented severe cutbacks in capital spending. Moreover, because most companies use reserve-based loans (RBLs) to fund their drilling activities, they are subject to revaluation and redetermination of the value of their reserves twice annually — in the spring and fall (in addition to "wildcard" redeterminations under certain RBLs). The significant decline in prices, together with regulators' concerns about bank lenders' exposure to the oil and gas sector, constrained banks' ability to work with their borrowers during the redetermination process. Consequently, the spring 2016 redeterminations resulted in many E&P companies experiencing significant decreases in their borrowing bases and credit lines as banks took a more conservative approach to their price decks. This led to banks further lowering the forward-pricing curves they use to determine the borrowing bases.

Banks took additional steps to limit their exposure to the oil and gas sector, or to provide greater certainty regarding the ability of their E&P borrowers to repay their loans. Specifically, many lenders amended their credit agreements to tighten some of the covenants to which their borrowers are subject. For example, a number of banks imposed minimum liquidity requirements, effectively limiting their exposure to certain companies without reducing those companies' borrowing bases. Banks also added so-called anti-hoarding provisions in response to situations in which borrowers

drew down the maximum amount available under their facilities and later filed for bankruptcy. The severe decline in oil prices reduced the value of many E&P companies' assets and constrained their liquidity, forcing a number of companies to restructure. In 2016, approximately 69 E&P companies filed for bankruptcy, though the trend appears to be tapering off, with fewer E&P companies declaring bankruptcy in the past several months of the year. For 2017, while we expect continued activity for offshore drillers, the tapering should otherwise continue for E&P bankruptcies.

Midstream and Downstream. Many oil and gas companies are fully integrated (either directly or through their subsidiaries and affiliates) in E&P, midstream and downstream activities. However, in the last several years, some companies spun off their midstream and downstream businesses to focus solely on E&P, believing that establishing their midstream and downstream businesses as separate entities would enhance focus on the objectives of those businesses and their capital needs, with greater value for shareholders.

Midstream and downstream companies are involved in the gathering, transporting, processing, marketing or storing of oil or natural gas. (Downstream is sometimes defined to refer only to the sale and distribution of oil and gas and their by-products, with the refining, storing and transportation activities defined as midstream.) Produced oil and natural gas are transported to the end user through an extensive network of pipelines and gathering systems. New pipelines are constructed continually in high-growth regions, which is time-consuming and capital-intensive but integral to oil and natural gas production because hydrocarbons are difficult and expensive to transport by vehicle or vessel. The availability of adequate pipeline infrastructure and the cost to transport such crude oil and natural gas directly impact the profitability of any given crude oil and natural gas property. Accordingly, upstream E&P companies are dependent on seamless interaction with hydrocarbon gatherers, transporters and processors — participants in the midstream sector of the oil and gas industry — to maintain both profitable and environmentally compliant operations.

To date, the midstream sector has not suffered the same level of financial distress experienced by E&P or oilfield service companies. Midstream companies typically charge fees to use their pipelines and equipment (rather than drilling wells and operating rigs to produce oil and gas), and therefore are typically more insulated from commodity price cycles than E&P companies. In 2016, 12 midstream companies filed for Chapter 11 bankruptcy. Similarly, downstream companies did not experience nearly the level of distress as oilfield services and E&P companies, with only a handful of nonintegrated downstream companies filing for bankruptcy last year.

The midstream segment of the oil and gas industry seems likely to benefit from the Trump administration's change of course on the development of the Keystone XL and Dakota Access pipelines, as well as the administration's potential change of course on other major pipeline projects, providing opportunities for midstream oil and gas companies. If midstream infrastructures are improved, that should enhance economics for upstream operators as well — in particular, fully integrated oil and gas companies.

Factors to Consider in 2017. In November 2016, in an attempt to reduce record global oil inventories, the Organization of the Petroleum Exporting Countries (OPEC) agreed to its first production cuts in eight years. The agreement was broader than expected, extending beyond OPEC to include Russia and other non-OPEC countries. While the strength of the deal will depend on whether all parties deliver on their commitments, it seems unlikely oil prices will return to the $30-per-barrel levels seen in early 2016.

If the Trump administration opens more federal lands to drilling activities, which would be consistent with its emphasis on expanding U.S. oil and gas production, that could counterbalance OPEC's decision to cut production and may act as a downward pressure on oil and gas prices.

With higher energy prices, the need for financial restructuring decreases. Looking ahead, we see the need for additional restructurings in the oil and gas space even at current price levels, particularly for E&P offshore drillers who continue to experience insufficient demand for offshore rigs given the continued oversupply of oil. Even with fewer restructurings, we expect a significant amount of post-reorganization M&A activity, as credit-oriented hedge funds that now own equity of reorganized E&P companies look to monetize their investments and take advantage of increased oil prices.