MARCH 2015
VOL. 15-3

PRATT'S ENERGY LAW REPORT

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ISBN: 978-1-6328-0836-3 (print)
ISBN: 978-1-6328-0837-0 (eBook)

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT'S ENERGY LAW REPORT [page number] (LexisNexis A.S. Pratt);

Ian Coles, *Rare Earth Elements: Deep Sea Mining and the Law of the Sea*, 14 PRATT'S ENERGY LAW REPORT 4 (LexisNexis A.S. Pratt)

An A.S. Pratt™ Publication

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(2015–Pub.1898)

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Pratt's Energy Law Report is published 10 times a year by Matthew Bender & Company, Inc. Periodicals Postage Paid at Washington, D.C., and at additional mailing offices.

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Drilling Down: A Deeper Look into the Distressed Oil & Gas Industry—Part I

By Charles M. Persons*

In this first part of a multi-part article, the author examines emerging issues at the intersection of the oil and gas industry and bankruptcy law. This first part provides an overview of the oil and gas industry and a discussion of some of the unique challenges currently facing this sector. The second part will discuss the treatment of specific oil and gas property interests in the bankruptcy context.

"Please God, send me one more oil boom. This time I promise not to blow it."

—1980s Texas Bumper Sticker

After years of stable commodity prices and increasing production, turbulence seems to have once again found the oil and gas world. The West Texas Intermediate crude market, where crude oil prices had been steadily hovering between $90-$110 per barrel for nearly four consecutive years, has seen the price per barrel plummet 50 percent since July 2014 to its lowest level in over half a decade. The downturn was precipitated after the Organisation of Petroleum Exporting Countries ("OPEC"), which controls nearly 40 percent of the world crude oil market, announced on November 27, 2014 that its members failed to reach agreement to curb production. Without an artificial production cap in place from OPEC, many analysts expect crude oil prices to remain near $50-$55 per barrel for the foreseeable future, while some predict crude oil could dip as low as $35 a barrel.

FRACKING INCREASES U.S. PRODUCTION, BUT AT HIGH COSTS

While tumbling crude oil prices might have been met with great fanfare in this country as little as 10 years ago when the U.S. reached a high-water mark for oil and gas importation, the hydraulic fracturing ("fracking") boom in this country has dramatically altered the discussion. Indeed, fracking, which is responsible for unlocking previously untapped sources of oil and gas, helped thrust the U.S. into the position of world's largest producer of oil and natural gas liquids in June 2014. Much of this growth has taken place in Texas, Pennsylvania, North Dakota, and the Great Plains, where the use of fracking and horizontal drilling techniques have created opportunities (and wealth) in places traditionally considered too economically inefficient for profitable exploration. The results have been astounding. At nearly 11 million barrels per day—an increase of three million barrels per day since 2011 alone—the burgeoning U.S. oil and gas industry was experiencing growth unseen since the 1970s, all while prices stayed remarkably stable (and high).

But all crude oil is not created equal. The fracking process may open new areas for

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production, but it is a relatively expensive method of producing oil and gas. Saudi Arabia, which does not rely on fracking, can extract crude oil for $5–$6 per barrel. In contrast, Morgan Stanley analysts recently suggested that the break-even price for U.S. shale oil producers was $76–$77 a barrel.[1]

As demand for crude oil has softened on weak worldwide economic activity and the growing market share for alternative energies, it is unclear how long producers in the U.S. can weather the storm at current prices. The downturn has been so quick and dramatic that the full effects of the price drop have yet to be felt. Early estimates indicate as many as $150 billion of oil and gas exploration projects may be put on hold in 2015 alone. Industry giant ConocoPhillips has already announced it plans to cut investment spending by 20 percent this year, and similar announcements are expected to come from other exploration and production ("E&P") companies in the coming weeks and months. But planned cuts to investment spending at this juncture cannot stop the many E&P projects coming online in the first half of 2015 that will further increase supply. Many of these wells, anticipated by investors to be profitable as few as six months ago, may be coming online in an environment where they literally cannot succeed. Add to this the unprecedented levels of largely high-yield debt that were placed on energy companies during this recent stretch of prosperity and the result is an industry that could increasingly turn to professionals for restructuring advice in the near future.

THE OIL AND GAS INDUSTRY FACES UNIQUE CHALLENGES IN A DOWNTURN

The unique nature of the oil and gas industry makes it especially vulnerable economically during a prolonged down cycle. Some specific challenges facing the industry include:

Oil and Gas Production Depletes the Asset and the Borrowing Base

As oil and gas is produced from a property, the asset value of that property is necessarily reduced. As a consequence, simply cutting investment spending cannot function as a long-term strategy for most E&P companies. E&P companies that rely on revolving credit lines to provide liquidity for new exploration projects face a shrinking borrowing base and decreased liquidity if they do not continue to actively pursue new producing assets.

Failure to Explore Can Cost an E&P Company Valuable Assets

As will be discussed further in the second part of this article, E&P companies typically only hold "working interests" in a particular oil and gas lease. These working interests, which are valuable property rights, are typically subject to a reversionary

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[1] Sam Ro, Here Are the Breakeven Oil Prices for America's Shale Basins, *Business Insider* (Oct. 22 2014), *available at* http://www.businessinsider.com/shale-basin-breakeven-prices-2014-10. Costs vary significantly from shale play to shale play (and within any particular shale play), but even the least expensive U.S. shale oil regions on average still require crude oil to trade at $55-$60 per barrel for producers to break even.

interest in favor of the original grantor—in particular, the failure to produce hydrocarbons within a set period of time results in forfeiture of the interest. Loss of these property interests may reduce a company's borrowing base and leave it without necessary assets to secure additional debt.

E&P Companies May Be Unable to Control Costs or Production Levels on Their Oil and Gas Properties.

As the Seventh Circuit has noted, ". . . to convert dreams of black gold to hard cash, aspiring capitalists split the [oil and gas] property interest in oil into 'more fragments than the atom or the rainbow.' "[2] These fragmented property interests often include multiple working interests, each of which entitles the holder to its *pro rata* share of production, but also requires such holder to pay its *pro rata* costs of production. The relationship among these working interest holders is governed by a joint operating agreement, with one party frequently selected as the "operator"—the company in charge of day-to-day operation of the well. At wells where it is a non-operator, a struggling E&P company may be unable to effectively control day-to-day costs—costs it must nonetheless share *pro rata*. The struggling company may also find itself unable to affect production levels on its own properties, as other working interest holders decide the current environment calls for slowed production. These scenarios all implicate considerable liquidity concerns for the non-operator.

E&P Companies Often Have Significant High-Yield Debt

The energy sector has historically represented a large component of the high yield market because of the speculative nature of the underlying assets and the nearly constant need for capital to replenish those assets. According to Business Insider, until a recent sell-off, the energy sector accounted for more than 15 percent of the high yield debt in the U.S., with E&P and oilfield services companies responsible for 9.5 percent of such debt by themselves.[3] All told, 18.3 percent of the high yield bond debt issued in 2014 was issued by companies in the energy sector, and the downturn in crude oil prices has caused even the most recently-issued high yield debt to trade well below par. From September to December 2014,[4] high yield energy bonds posted a return of -11.2 percent, while yields widened by 331 basis points. Such a significant downturn exposes oil and gas companies that have already issued such debt to activist bondholders, but also serves to potentially freeze out companies that could normally turn to the high yield market to meet their liquidity concerns.

E&P Companies Often Have Limited Liquidity on Their Books

Because oil and gas is such a capital-intensive industry where continued investment

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[2] *Jones v. Salem Nat'l Bank* (*In re* Fullop), 6 F.3d 422 (7th Cir. 1993) (citing B. Clark, THE LAW OF SECURED TRANSACTIONS UNDER THE UCC (2d ed. 1988)).

[3] Sean Hanlon, Oil's Price Decline Weighs on High Yield Debt, Forbes (Dec. 16, 2014), *available at* http://www.forbes.com/sites/advisor/2014/12/16/oils-price-decline-weighs-on-high-yield-debt/.

[4] Jennifer Ponce de Leon and Mark Van Holland, Let's Take a Closer Look at These Energy Junk Bonds Everyone's Freaking Out About, Business Insider (Dec. 8, 2014), *available at* http://www.businessinsider.com/oil-and-the-high-yield-market-2014-12.

and expansion is paramount, many oil and gas companies have surprisingly small quantities of cash on hand, choosing instead to funnel their excess cash into new projects. In the past, companies addressed this concern either through borrowings against existing reserve-based lending revolvers or through the sale of working interests in their oil and gas leases to other E&P companies looking to invest. Though it is too early to assess the impact of recent events on M&A activity in the energy sector, E&P companies looking for quick liquidity infusions will face greater hurdles than they have in recent years as borrowing bases are reduced and willing business partners and new lenders become harder to come by.

OIL AND GAS RESTRUCTURING CONSIDERATIONS AND UPCOMING INSTALLMENTS

In part because of the relative stability of commodity prices in recent years and in part because of nature of the industry as one that prefers out-of-court M&A transactions to in-court restructurings, there have been relatively few in-court oil and gas restructurings over the past few decades. As a result, bankruptcy case law considering many of the unique aspects of oil and gas bankruptcies is sparse, confusing, and often inconsistent.

That may be changing, however. Sizable Chapter 11 proceedings like *In re ATP Oil & Gas Corporation* (now in Chapter 7), *In re Energy Future Holdings Corporation*,[5] and *In re Endeavour International Corporation*[6], as well as a number of smaller cases. The case law and strategies emerging from these cases has brought additional clarity to the confluence of oil and gas law and bankruptcy law. A greater understanding of the current state of play on these "emerging" issues in oil and gas bankruptcies—such as whether oil and gas interests are property of the estate, whether conveyances of certain oil and gas interests are unexpired leases or executory contracts, proper treatment of off-shore leases on the Outer Continental Shelf, and whether certain production payments or royalty interest conveyances should be treated as grants of property or disguised financings—will help those in the energy industry and their counsel better appreciate the issues they may soon become intimately familiar with.

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[5] Case No. 14-10979 (Bankr. D. Del. 2014).

[6] Case No. 14-12309 (Bankr. D. Del. 2014).