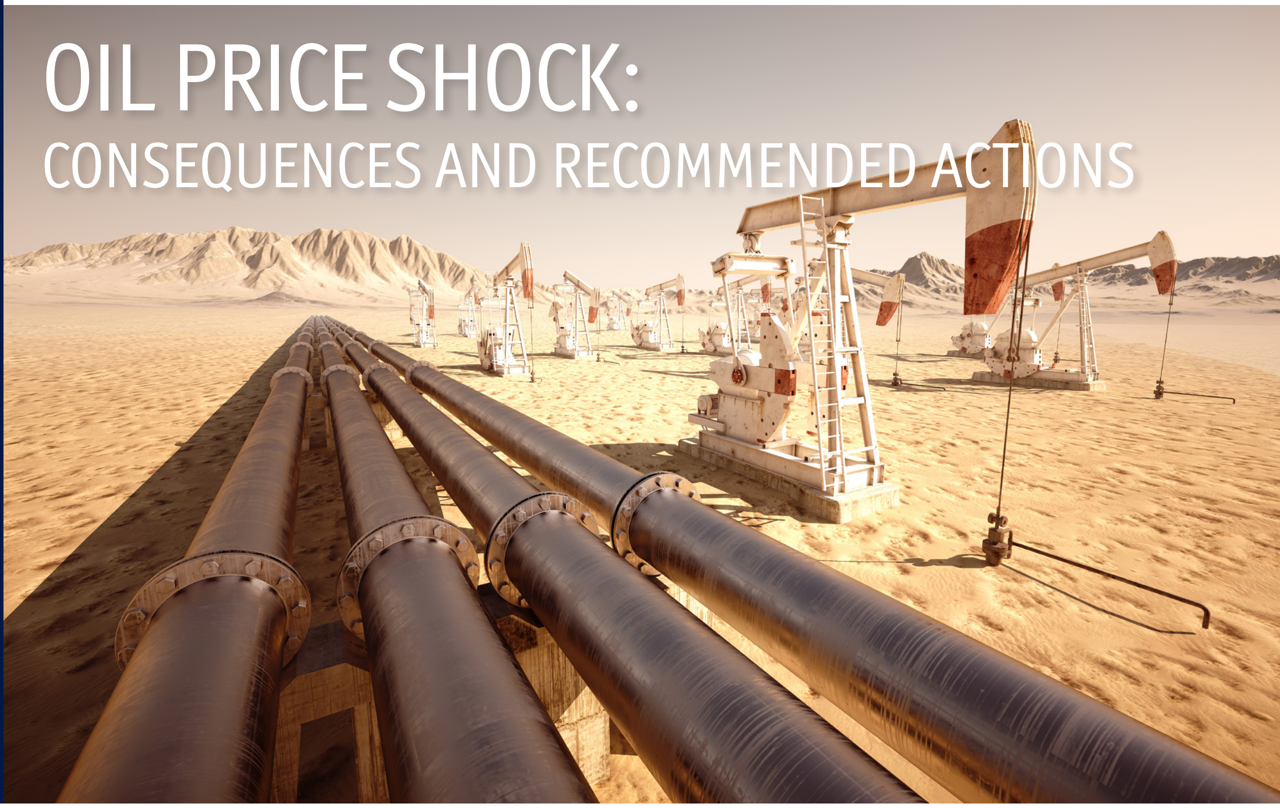
Energy

March 2015

OIL PRICE SHOCK:
CONSEQUENCES AND RECOMMENDED ACTIONS



Introduction

The recent fall in the oil price has had a significant impact on the oil and gas industry. Widely unpredicted, it is causing increasing distress, without geographical boundaries.

While it is expected that the price of oil will stabilise and recover in due course, it is unclear when or to what level. In the meantime, the price remains volatile, creating significant uncertainty which itself has a broad negative impact.

The drop in the oil price led quickly to the implementation of cost cutting measures and reductions in planned capital expenditure by oil companies. These defensive strategies have had an immediate impact on the oilfield services companies which rely on the oil companies for their business. The impact has been swift and is deepening. Many businesses are facing severe reductions in cash flow.

Already, companies are becoming exposed to counterparty failure and a number of companies have filed for bankruptcy.

It is critical that all businesses participating in the oil and gas industry understand and prepare for the circumstances at hand, and both the risks and the opportunities which will arise.

Consequences of the fall in the oil price

The fall in the oil price is causing widespread financial distress. Many oil companies, particularly those with limited or no hedging arrangements, have seen cash flow from production dramatically reduce, impacting on their ability to fund operations, service their debt or contractual obligations, or pursue existing or new projects. In turn, many oilfield services companies are encountering payment delays or defaults, project postponements and cancellations. These companies have their own sub-contractors and suppliers, with the same issues being passed along the chain. Banks, bondholders and other debt providers are encountering payment defaults, covenant breaches and requests for deferment of payments.

Contractual and loan defaults are inevitable in these circumstances. Performance of obligations may be delayed or suspended, either in accordance with, or in breach of, contract terms Some contracts will be terminated. Termination, suspension, deferment and other rights will now come in to sharp focus.

holman fenwick willan hfw



Many oil companies, particularly those with limited or no hedging arrangements, have seen cash flow from production dramatically reduce, impacting on their ability to fund operations, service their debt or contractual obligations, or pursue existing or new projects. In turn, many oilfield services companies are encountering payment delays or defaults, project postponements and cancellations.

JONATHAN MARTIN, PARTNER

It seems highly likely that there will be an increase in disputes and litigation, as defaults occur.

The spectre of bankruptcy will also have a significant impact. A business with concerns about the financial viability of a contractual counterparty will be well advised to consider carefully how bankruptcy laws may affect its rights, and to take steps to mitigate the risks flowing from counterparty bankruptcy.

Equally, a business may itself face the prospect of insolvency. Directors of a company becoming distressed must tread carefully, to ensure strict compliance with the rules on preferences, wrongful trading and other legal obligations, or face possible personal liability for contravention.

As businesses encounter these issues, many may need to shore up their own financial situation. This may include the sale of non-core (or core) assets, merging with a stronger business, renegotiating contracts, refinancing debt and restructuring.

These challenges are also creating opportunities. Businesses with strong balance sheets and cash reserves, investors with war chests and others are positioning themselves for the opportunities becoming evident. Consolidation activity is likely to increase, and private equity firms and others will acquire good businesses and assets at discounted prices.

Risks and opportunities

Businesses in the industry are considering both the risks and the opportunities which the oil price drop is creating.

Risks include:

- Counterparty risk: the risk of non-performance, delayed performance and other failures by contractual counterparties.
- Customer risk: the risk of losing customers, failing to convert backlog, and reduced or deferred cash flow.
- Supplier risk: the risk of suppliers failing, or not performing supply or sub-contractor obligations.
- Bankruptcy risk: the risk of own or counterparty bankruptcy is enhanced in the current environment.
- Political risk: the risk that States which rely on oil revenues may react in ways to the detriment of oil companies.
- Indirect risks: the risk of other parties in a supply or subcontractor chain failing or defaulting.

Opportunities include:

- Lower pricing: oversupply in the rig market, the support vessel market and in the supply of oilfield services generally will provide opportunistic pricing.
- Contract renegotiation: the altered environment may provide opportunities to seek advantageous modifications to contracts, with many contractual counterparties being in a relatively weak position to resist such requests.
- Distressed asset sales: opportunities to acquire assets from businesses in distressed situations are increasing dramatically.
- Other acquisitions: outside of distressed situations, opportunities to acquire businesses or assets are increasing, as valuations and pricing fall.



Recommended actions

1. Review of contracts

Businesses should undertake an immediate review of their material contracts, against the backdrop of the low oil price. Issues will include the continuing financial situation of the business itself, possible distress or failure of contract counterparties, risk of delayed performance, default or termination, altered project economics and viability.

Many of these contracts will have been negotiated on the basis of projections and other assumptions which are no longer tenable. This may include production sharing contracts, infrastructure project agreements and agreements for long term services.

A full understanding of contractual rights and obligations is vital, in order to:

- Manage risks.
- Ensure own performance.
- Assess suspension, postponement and termination rights.
- Identify any counterparty breach, and the contractual consequences.
- Understand the consequences of own failure to perform.
- Take appropriate mitigation steps.

Some contracts may permit some performance flexibility, for delays, down time or suspension, with specified financial consequences. Other contracts may be silent on these matters.

Some may have detailed termination provisions, with strict notice requirements and provisions dealing with the consequences of termination. Others may not. Any concerns about non-performance or possible termination will require a clear understanding of these provisions.

It is equally important to consider one's own contractual obligations and ensure performance with the precise contract terms to avoid possible adverse consequences. A contract counterparty may take advantage of a breach to terminate a contract no longer desired, or cease performing, claim rights of set off or damages for breach. Losses suffered may be significantly higher in the current environment than previously. Performance failure may even be catastrophic to an already distressed counterparty.

Own performance may be impeded by counterparty failure. The consequences of this may, or may not, be legislated for, or may be subject to the applicable general law.

Where a contract is breached, care should be taken in reacting. Its precise terms and consequences of the breach need to be fully understood. Communications should be worded carefully, and detailed records maintained. Steps to mitigate loss may be required

These are a few areas where a review of contracts now could prove to be invaluable.

2. Review of financing arrangements

Businesses should examine their debt arrangements. Lower cash flows and asset values may lead to covenant breaches or other non-performance. Financial models may require examination and stress testing. Interest cover and payment obligations will need to be reviewed against revised cash flow projections.

The precise terms of loan, bond, and other debt and security documents need to be fully understood. Similar risks to those in relation to contractual obligations should be assessed and mitigated.

Where debt repayment is due in the near term, refinancing options should be considered, against the general backdrop of reduced availability to the oil industry of conventional debt or equity.

Alternative funding options may need to be considered such as private equity, commodity streaming, off take financing and convertible bonds.

Such a review will place a business in a stronger position to make decisions. Negotiations with existing lenders may be required, to investigate refinancing options, or modifications to existing arrangements to avoid stress points or defaults. Undertaking these review steps is a critical immediate recommendation.

3. Review of insurance arrangements

WELCAR and CAR policies should be reviewed in case cover needs extending in light of project postponements. If projects fail to reach expected stages of development return premiums might be due and reinstatement schedules are likely to become out of sync with actual progress. These should be monitored.

Loss of production income, business interruption and delay in start up claims will all be impacted by the reduced prices attributable to the period of lost production if this falls within the lower price era. Where production is at a standstill, delays in construction, which would have otherwise formed the basis of these claims, will result in zero impact on future earnings, breaking the chain of causation. Premiums for these covers should be reduced and there is a risk that the lost production element of existing claims will be rejected by underwriters.

Trade credit insurances should be reviewed to check they suffice for the heightened risk of the possible insolvency of business partners.

Since M&A, joint ventures and divestment of assets are likely, a careful review of insurances may be required to ensure all interests are covered.

4. Risk review

All businesses face risks. For those participating in the oil industry, the fall in the oil price has given rise to new or increased risks.

Businesses should consider these risks in the context of their particular operations and circumstances. In addition to the risks highlighted above, a broader analysis is recommended. This might include risks arising from:

- Reductions in staffing and other resources through cost cutting.
- A reduction in new project or contract opportunities.
- Reduced cash flow.
- Increased competition for projects and contracts.
- More aggressive pricing.
- More aggressive payment term enforcement.
- A generally more hostile, defensive and litigious business environment.

5. Information gathering

Good information enhances strategic and other decision making. As part of the overall risk review a business should gather data on its customers, suppliers, sub-contractors and other business connections. Information on the financial condition of these counterparties will be highly valuable in assessing where risks may exist, where defaults or delays may be expected, whether there are bankruptcy risks, and how to mitigate these risks. Equally, this data may influence relative bargaining positions, creating opportunities to enhance contractual terms or obtain better pricing in new contracts.

6. Default management and risk mitigation

Where defaults occur or are expected, careful advance planning and management of defaults will be critical. A default may set in train unexpected and unwelcome consequences and significant advantages are likely to be available to those able to plan for and deal with such circumstances effectively.

Once a default occurs, it will be important to carefully adhere to the terms of the contract or financing document concerned, to ensure that rights are preserved. Where asset seizure or arrest is a possibility, early advice should be obtained on matters such as jurisdiction, competing claims and other factors. Product or equipment location, title to goods and, where relevant, local bankruptcy and other laws will be important in many cases.

7. Management of employment issues

One area of most severe cost cutting has been to reduce staffing levels. This unfortunate trend may continue for some time. It is essential that local employment protection laws are understood and the correct procedures followed. Failing to do so may increase liabilities, lead to legal action and harm employee/employer relations.

Redundancy programmes should be handled sensitively. It may be possible to assist staff to find new positions. Seeking to maintain goodwill makes good business sense. Among other things, a business may need to call upon ex-employees as witnesses in disputes or litigation going forward, activities which are highly likely to increase due to the stresses caused by the fall in the oil price.

8. Assessing acquisition opportunities

It is widely expected that asset sales, mergers and acquisitions and consolidation activity will increase significantly. This is creating valuable buy side opportunities.

Many oil and oilfield services companies are planning non-core, or even core, asset divestments. A business seeking such opportunities will be well advised to engage with the investment banks, private equity firms, and other professional advisers with access to these. Businesses will also speak to each other, and gather information on potential opportunities in this way.

Care must be taken in these matters to ensure that confidentiality obligations, insider dealing and other rules are complied with, and that directors comply with their duties. For listed companies, these rules are often more onerous than for private businesses.

Where a target is identified, advice may be required on:

- Consent requirements, including government or regulatory approvals.
- Potential liabilities, under local petroleum or other laws, or otherwise.
- Initial legal and other due diligence.
- Negotiation of a term sheet or memorandum of understanding.
- Exclusivity and confidentiality arrangements.
- Change of control issues.



For more information, please contact the author of this Briefing, or your usual contact at HFW.

Jonathan Martin
Partner, London
T: +44(0) 20 7264 8821
E: jonathan.martin@hfw.com

HFW's London office is part of an international network of 13 offices in 11 countries. For further information about energy related issues in other jurisdictions, please contact:

Damian Honey
Partner, London
T: +44 (0)20 7264 8354
E: damian.honey@hfw.com

Robert Follie
Partner, Paris
T: +33 1 44 94 40 50
E: robert.follie@hfw.com

Konstantinos Adamantopoulos
Partner, Brussels
T: +32 2 643 3401
E: konstantinos.adamantopoulos@hfw.com

Jeremy Davies
Partner, Geneva
T: +41 (0)22 322 4810
E: jeremy.davies@hfw.com

Dimitri Vassos
Partner, Piraeus
T: +30 210 429 3978
E: dimitri.vassos@hfw.com

Ian Chung
Partner, Dubai
T: +971 4 423 0534
E: ian.chung@hfw.com

Paul Aston
Partner, Singapore
T: +65 6411 5338
E: paul.aston@hfw.com

Peter Murphy
Partner, Hong Kong
T: +852 3983 7700
E: henry.fung@hfw.com

Nick Poynder
Partner, Shanghai
T: +86 21 2080 1001
E: nick.poynder@hfw.com

Gavin Vallely
Partner, Melbourne
T: +61 (0)3 8601 4523
E: gavin.vallely@hfw.com

Stephen Thompson
Partner, Sydney
T: +61 (0)2 9320 4646
E: stephen.thompson@hfw.com

Hazel Brewer
Partner, Perth
T: +61 (0)8 9422 4702
E: hazel.brewer@hfw.com

Jeremy Shebson
Partner, São Paulo
T: +55 11 3179 2900
E: jeremy.shebson@hfw.com

Lawyers for international commerce

hfw.com