

Oilfield Services Companies

Services in 2015 for Future Barrels of Oil - Payment in Kind for Oilfield Services

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Oilfield Servicers

Capital Solution for Producers and Oilfield Servicers Utilizing Future Production

Jazib Hasan (BAML Cross Asset Solutions and Strategies)

March 26th 2015

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Capital Solutions for Producers & Oilfield Servicers

Executive Summary

Industry Constraints

- Plunging oil prices are forcing energy producers to cancel or postpone new drilling projects
- The number of active rigs drilling for oil and gas has declined fifteen weeks in a row. Oil rig count has dropped to the lowest level since June 2011, with rigs engaged in land operations largely responsible for the recent plunge in count
- A prolonged low oil price environment would sideline capital and curtail investment in new drilling project wells into the second half of the year. This will affect producers' ability to raise debt for operations or refinancing existing obligations
- Many producers are seeing profit margins dramatically compressed and are very focused on having adequate cash and liquidity

Potential Solution

- Instead of making all-cash payments, Producer pay energy services companies partial cash and a specified hydrocarbon volume over a period of time
- Payment in the form of future delivery of hydrocarbons can materially alleviate Producers' cash-constrained position
- Oilfield services companies can then monetize the future hydrocarbon payment into upfront cash or cash as services are being provided – thereby not having reserves on their balance sheet as well as getting an alternate source for liquidity and enabling producers to continue engaging in drilling services which they might have otherwise curtailed

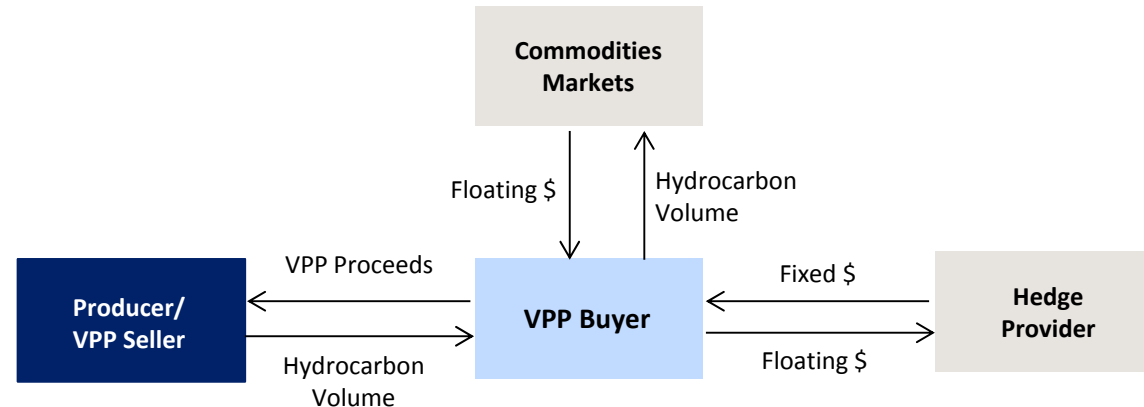
Opportunity

- Bank of America Merrill Lynch ("BAML") can potentially partner with Oilfield Servicers to structure the hydrocarbon production payments as partial payments from certain of the Servicer's Producer clients
- BAML would partner with Servicers to monetize and hedge such hydrocarbon production payments over their long term (using VPP type structures), so Servicers can navigate the current distressed oil price environment and maintain cash flow

Volumetric Production Payments (VPPs)

Introduction to VPPs

Standard VPP Structure



- A Volumetric Production Payment (“VPP”) is a financing tool whereby a specified hydrocarbon volume is delivered to the buyer over a period of time
- A VPP is a sale of future hydrocarbon production and is conveyed through the sale of a non-operating, non-expense bearing limited term volumetric overriding royalty interest in hydrocarbons contained in specific wells
- In exchange for the VPP interest, the buyer advances funds for future production upfront
- When the total specified volume is delivered to the buyer the VPP terminates and the conveyed interest reverts to the seller

Modified structure: Delayed Start VPP

- A Delayed Start VPP would allow company to receive cash proceeds on day 1 but begin delivery under the VPP at a later date
- Delayed delivery is attractive for fields with existing production and additional development opportunities
- The modified structure would allow the deliveries to coincide with production under the new development project
- Company would thus retain a share of the field’s production at all times, assuming development stayed on schedule

Volumetric Production Payments (VPPs)

Legal, Accounting, Tax and Other Aspects of VPPs



Bankruptcy	VPP buyer's scheduled production is not subject to the automatic stay. Enforcement of covenants regarding operations and ability to exercise on collateral will be stayed. Deliveries will be treated as all other royalty interest holders.
Acceleration	VPP Buyer does not have the right to accelerate the VPP under an event of default ("EOD"), but has the right to partially accelerate delivery of scheduled quantities under certain conditions.
Prepayment	Prepayments are not permitted. Sponsor may repurchase the VPP at FMV provided for in the documentation.
Hedging	Provides the sponsor an implicit hedge which does not require collateral posting.
Re-determinations	None. However, scheduled deliveries may be increased in the future if the tail reserves fall below a certain predetermined level.
Guaranty	Limited recourse. While there is no guarantee on repayment of the VPP, the sponsor may be required to provide certain covenants with respect to operations and liabilities.
Tax Treatment	VPP transferred to finance operations treated as a loan to Seller. The amounts repaid by the Seller are characterized as part principal and part interest. The Seller is entitled to an interest deduction that reduces taxable income. (If the proceeds received by the Seller are dedicated to exploration and development of the burdened property, then different tax treatment will result for the Seller.)
Accounting Treatment	Seller will record the proceeds from the VPP as deferred revenue and recognize proceeds ratably as volumes are delivered. The oil and gas properties are removed from the balance sheet. No gain or loss is recognized at close of the transaction. Volumes sold under the VPP are excluded from reserves, production and discounted future net cash flow.
Security	Secured by a real property interest in the form of a limited-term overriding royalty interest. In addition, a first lien is required against 100% of the mineral interests conveyed.

VPP Financing Solution

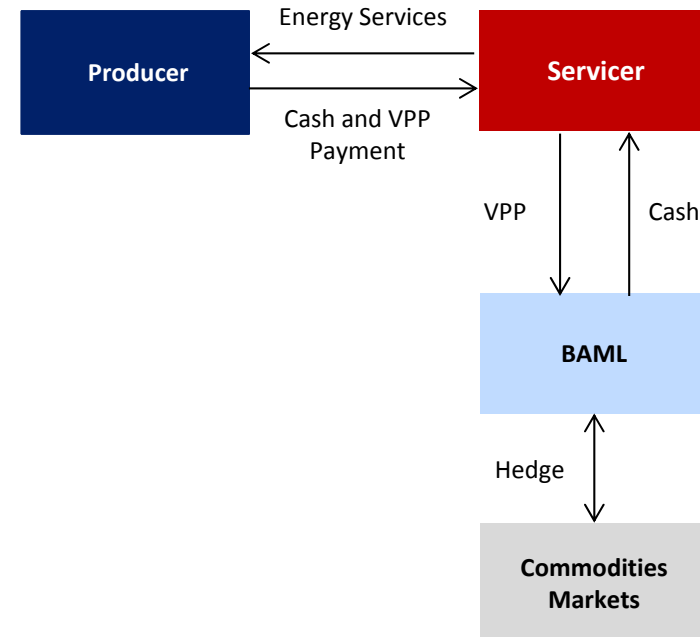
Structure Overview

Overview

- Oilfield Servicer identifies Producer client (satisfactory to BAML) who is interested in a capital solution
- Servicer provides Energy Services to Producer in exchange for part cash and part Volumetric Production Payment (VPP)
- Servicer sells (fully or partially) the VPP to BAML in exchange for cash
- VPP proceeds are calculated using the forward commodities curve (which BAML can lock in the market) and using the appropriate discount rate (depending on Producer and reserves risks)

Structuring Alternatives

- VPP financings may be structured as either:
 - A single bilateral VPP Purchase Facility for each Producer client, or
 - A single fund for multiple Producer clients
- To make Producer (Operations and Reserves) risk acceptable to BAML and to leverage Servicer's knowledge and understanding of this risk, VPPs could be structured to have VPPs tranching such that BAML gets first cashflows and Servicer get residual cashflows



VPP Financing Solution

Ideal Characteristics for VPP Solution: Producer and Asset Characteristics

The VPP Financing Solution will be better suited for Servicer's Producer clients and assets with the following characteristics:

- **Producing reserves:** Traditional VPPs have been done with 100% PDPs, with well understood geology/execution risk, with good execution history
- **Diversification:** Value distributed amongst large number of wells, field and basins reduces execution and forecast risk. Production payment risk from one well is substantially greater than that from a portfolio of wells
- **Onshore:** Strong preference for onshore assets. Offshore wells more costly and susceptible to natural disasters
- **Economical:** Underlying properties are cost competitive. Low cost properties provide financial incentives for Producer to maintain and continue production during low price cycles
- **Credit Worthy Producer/Seller:** Solid credit quality; to mitigate risk of needing to go and take over production to get the hydrocarbons purchased through VPP
- **Independent Engineer:** Competent (ample experience in the region) engineer provides acceptable report of reserves
- **Overcollateralization:** A healthy margin of excess production can reduce concerns about execution risk and accuracy of production estimates (more risk requires more collateralization)

VPP Transaction terms:

- **Tenor:** 2 to 8 years (Although expect many to be 3 years)
- **Size:** \$40mm - \$200mm standalone (portfolio approach would allow much smaller individual situations (\$20mm +))
- **Pricing:** L + 400 to 1000 (depending on risks)

VPP Financing Solution

Oilfield Servicer and BAML Collaboration

The Best Way for Solution to Work is to Leverage the Relative Expertise Oilfield Servicer and BAML bring to the table

- Standard VPP deals require purchasing only PDP assets
- Real value can be added by including PDPs and PUDs to the VPP purchase
- Servicer will have a good understanding for the operational risks and the productions risks of the acreage they are working on
- This knowledge and expertise can allow Servicer to take some risk on the future production of the underlying assets
- BAML as a bank, might not be the natural holder of some of the operational and production risks, whereas the Servicer might be more well suited to understanding and taking that risk (the Servicer would be appropriately paid for that risk)
- This way risk and returns are appropriately split between the partners
- There are many ways to structure this risk split. Two illustrative examples are:
 - BAML can take the risk on the first [75%] of the hydrocarbons and Servicer takes the risk on the last [25%]. BAML discounts the cashflows associated with its hydrocarbons at [7%], and pays Servicer upfront for it; while Servicer essentially gets a [15%] return on its 25% hydrocarbons, by applying that discount rate when calculating the value of the hydrocarbons it gets from the Producer
 - BAML can purchase the complete VPP , but pay Servicer for only [50%] of the hydrocarbons upfront, and the rest along the way as production shows up. If hydrocarbon's don't show up that Servicer doesn't get paid (a risk Servicer might have taken anyway)
- This type of risk sharing would allow the partners to provide real solutions to the Producer community; otherwise the solutions will apply to a very narrow set of clients
- One of the challenges would be for some Producers to take out the PDPs and PUDs out of the RBL asset base. But if a Servicer is purchasing them in exchange for services which would overall enhance the assets of the company, then the sale provision becomes much simpler
- The more a Servicer is comfortable with the operational, production and reserve risks and can take some of that credit risk, the more powerful and broadly applicable the funding solutions will be

Additional Solutions

Working Together to figure out Additional Structures to fit Market Needs

Participation Deals

- Another solution that is attractive to Producers is to grant an overriding royalty interest to Servicer, in which Servicer takes an [85%] interest in PUD acreage in exchange for being responsible for 100% of the well costs
- As soon as well is completed, and there are sufficient PDP assets, BAML would reimburse Servicer for the well cost under a VPP or loan; which Servicer could use for the next well, and so on
- The way the conveyance would work is, it would provide that once Servicer receives a [15%] IRR, then the interest reduces from [85%] to a floor of [20%].
- This would allow Servicer to participate in the upside of the well, in exchange for advancing the cost of each well, until reimbursed by BAML
- Where Servicer is the primary service provider on the well, Servicer doesn't actually have to make any real short term cash advancements, and just gets paid for its work, after the well is completed and sufficient PDPs created

Refracking Opportunities

- The above construct could be applied towards setting up a facility to provide capital for refracking programs
- BAML provides the funding once the work is done and more PDPs are generated
- The small size of each work and the asset conveyed associated with that particular well might make the size/scaling challenging (cumbersome on diligencing each well). A realistic solution would require broader asset base

As discussed earlier, a key to making these structures work will be for Servicer and BAML to work closely together and for Servicer to be able to take some credit risk on the underlying assets. In addition to a VPP type structure, loans or prepay swaps could be ways to implement the capital solutions.

CONVEYANCE BASED FINANCINGS FOR OILFIELD SERVICE COMPANIES

Jeff Nichols – Partner, Haynes and Boone LLP
Oilfield Services Seminar Series

March 26, 2015

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ABCs of NPIs, ORIs and VPPs

Overriding Royalty Interest

- Override, ORI, ORRI
- “A non-expense bearing interest in oil and gas produced and saved, free of the expense of production...”
 - Free of exploration and production expenses
 - “At the well” - bears its share of “post-production” expenses (transportation, processing, treatment and marketing)
 - Ad valorem, production, severance, gathering and other taxes chargeable against the Overriding Royalty Interest
- Interest in “production” – ORI holder has a right to accept production in-kind, though rarely used and often waived
- Typically limited access to well information, operations

ABCs of NPIs, ORIs and VPPs

Net Profits Interest

- “A share of gross production, measured by grantor’s net profits from the operation of the property”
- Limited to revenue from production
- Similar to an ORI, except that certain costs are deducted from the gross proceeds
 - NPI holder must bear certain costs and expenses of production
- “Net” of What? – Need to itemize permitted charges and deductions
 - “Net” calculation cannot be less than \$0, but can carry-forward losses

ABCs of NPIs, ORIs, and VPPs

Volumetric Production Payments

- “An interest limited to a fixed quantity of production, free of the expense of production...”
 - Frequently called a “Term Overriding Royalty Interest”
- The VPP will terminate when the scheduled quantities have been delivered
 - Whereas ORIs and NPIs are often perpetual
- Non-Recourse outside of production volumes
- Production is often taken in-kind

Benefit of Production Payments in Bankruptcy

Property of the Estate

Section 541(b)(4)(B) excludes
“Production Payments” from
property of the estate

If not property of the estate, then:

- no automatic stay against collection
- debtor cannot use, sell or lease
- no treatment under plan



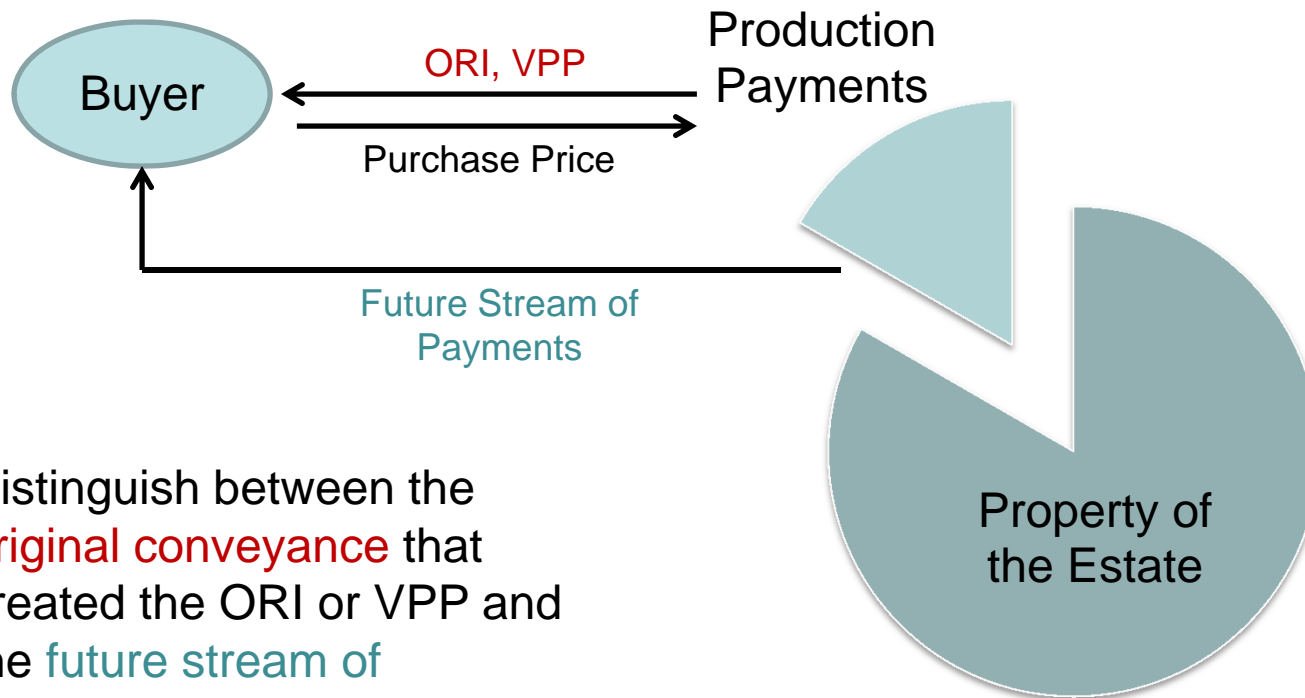
Benefit of Production Payments in Bankruptcy

Bankruptcy Code Defines “Production Payment”

- “Production payment” is:
 - Term ORI
 - Satisfiable in cash or in kind
 - Contingent on production from particular property
 - Specified volume or specified value from the hydrocarbons produced from such property
 - Determined without regard to production costs
- NPIs do not fit the definition
- 11 U.S.C §101(42A)

Financing Transactions in Bankruptcy

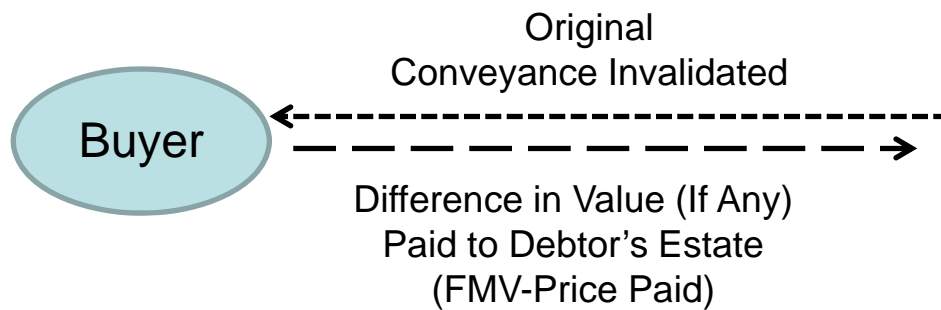
Intended Treatment



Distinguish between the **original conveyance** that created the ORI or VPP and the **future stream of payments** that flow from that conveyance.

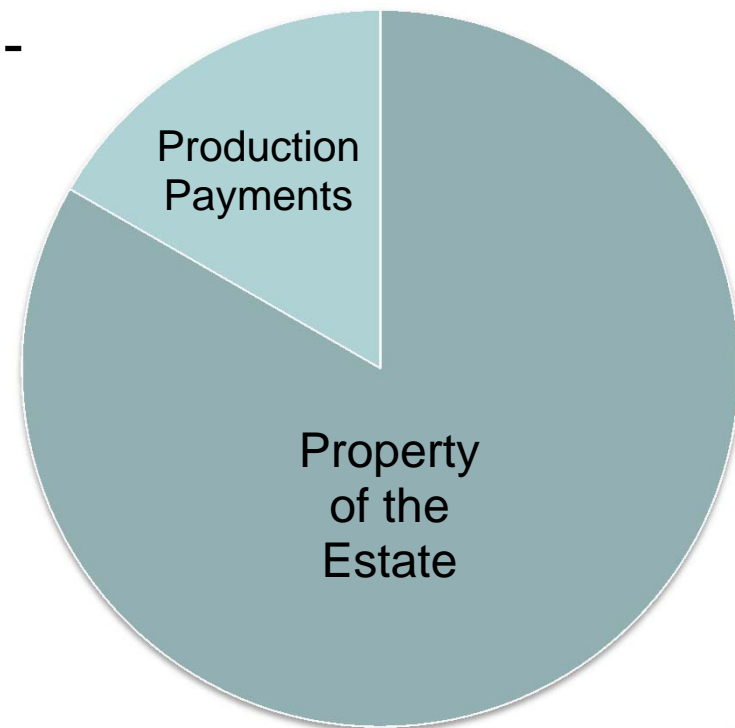
What Can Go Wrong

Fraudulent Conveyance



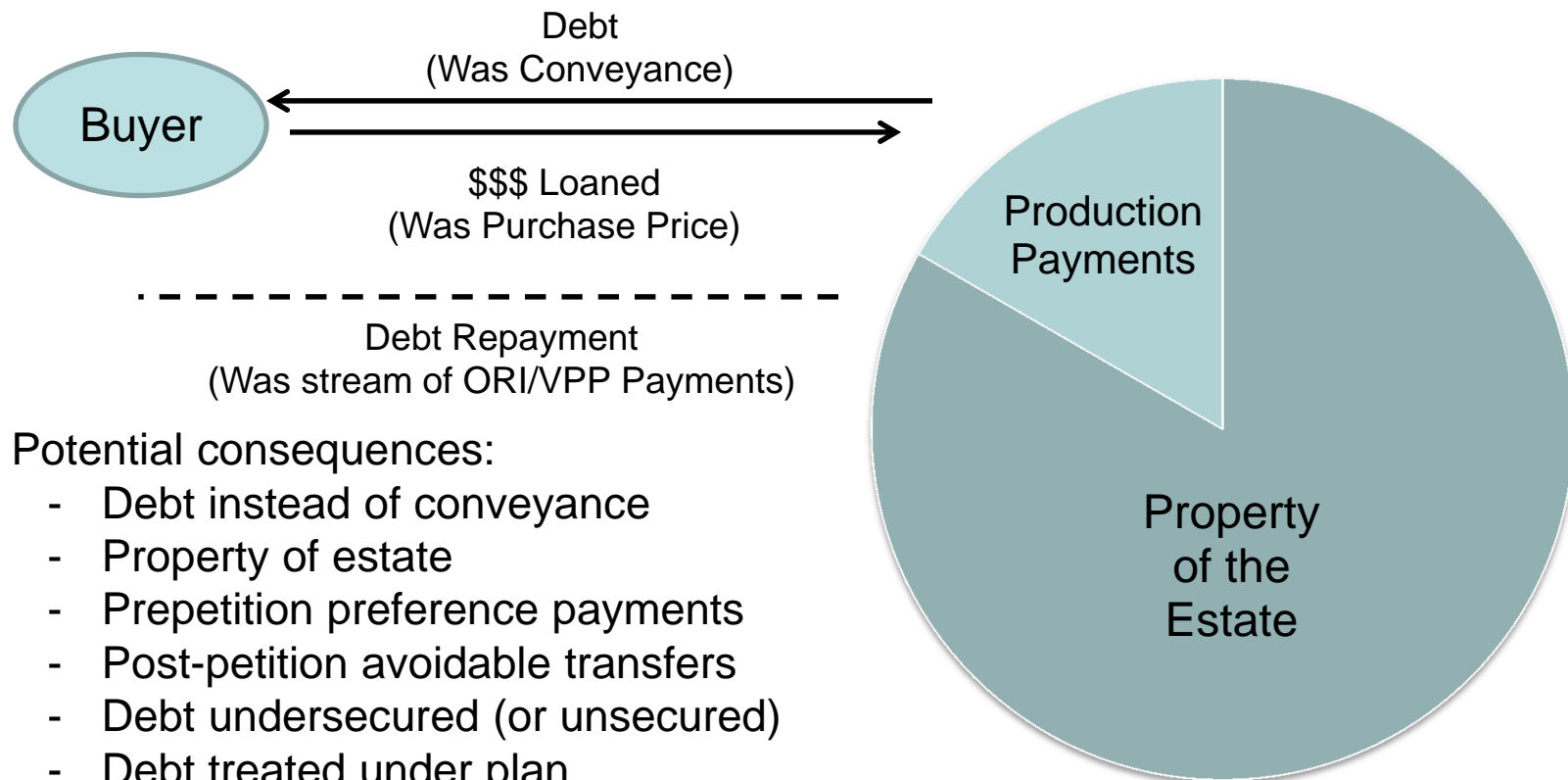
Potential consequences:

- Conveyance avoided
- Property of estate
- Unsecured claim



What Else Can Go Wrong

Recharacterized as Disguised Financing

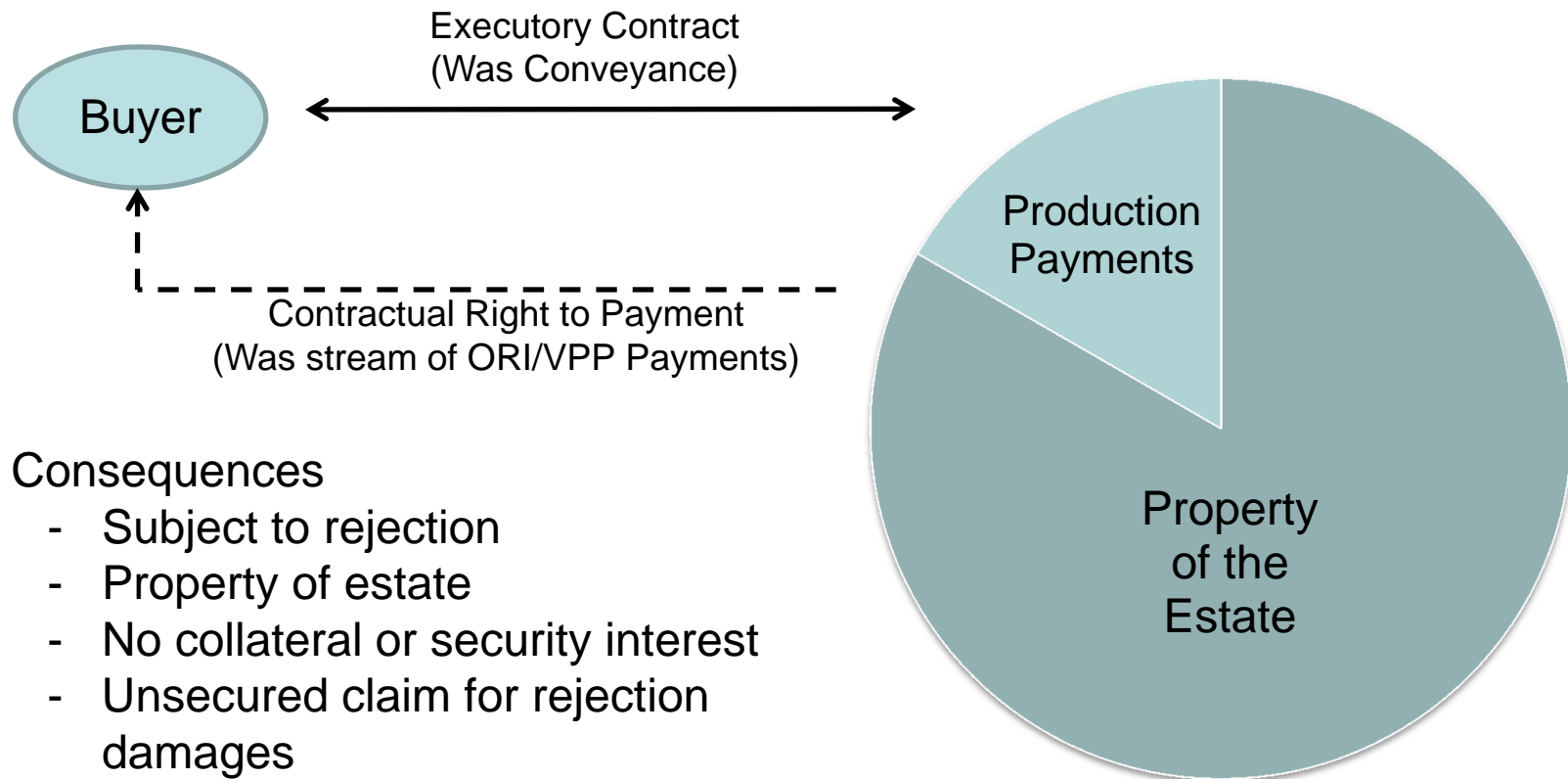


Potential consequences:

- Debt instead of conveyance
- Property of estate
- Prepetition preference payments
- Post-petition avoidable transfers
- Debt undersecured (or unsecured)
- Debt treated under plan
- 363 sale of collateral

What Else Can Go Wrong

Executory Contracts

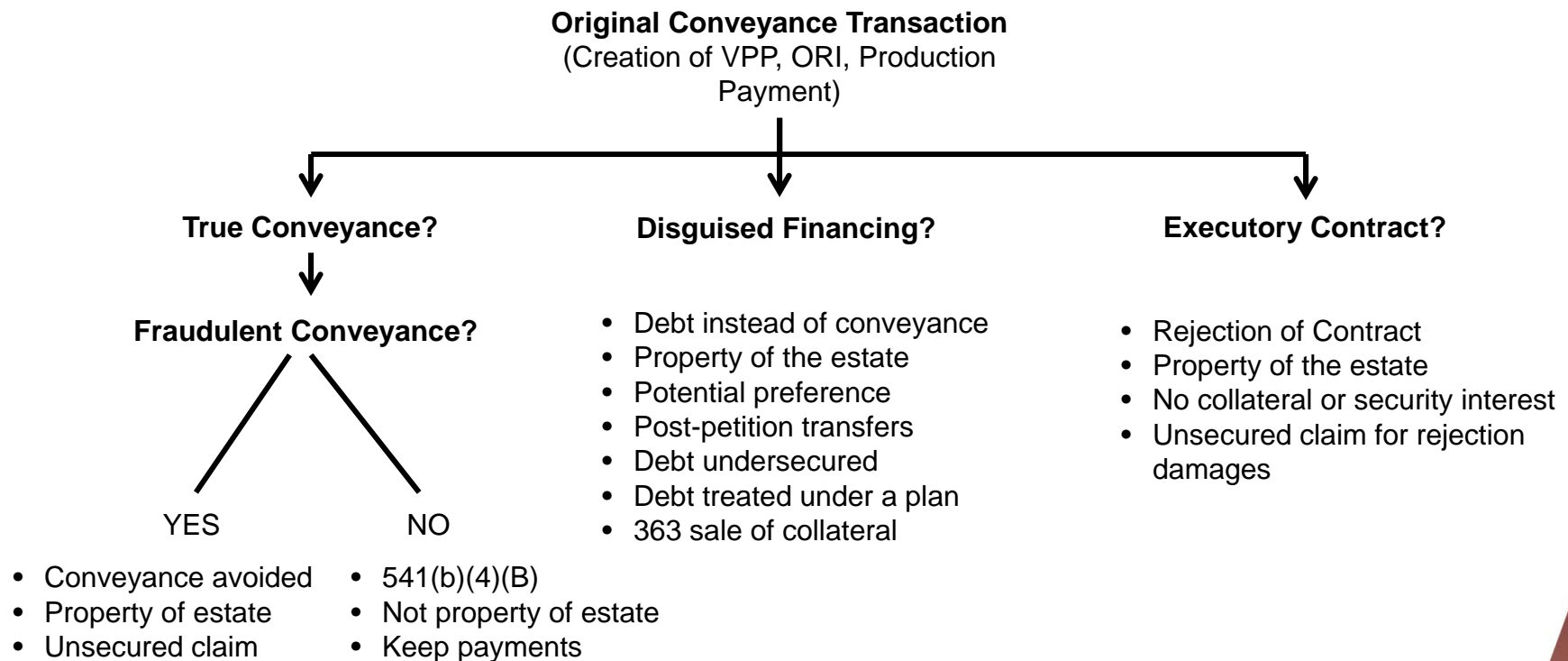


Consequences

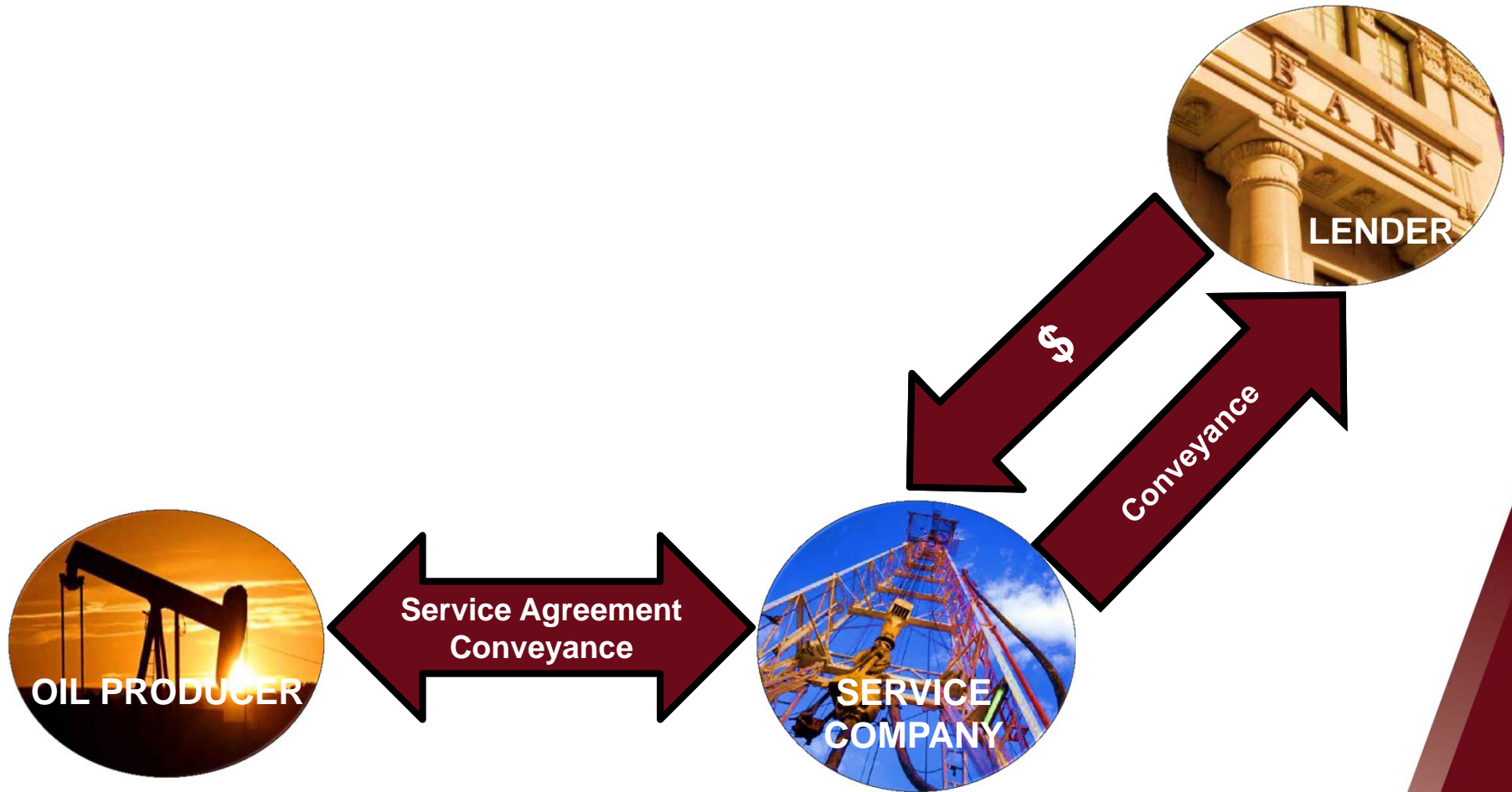
- Subject to rejection
- Property of estate
- No collateral or security interest
- Unsecured claim for rejection damages

Overview of Bankruptcy Analysis

Bankruptcy Risk Landscape

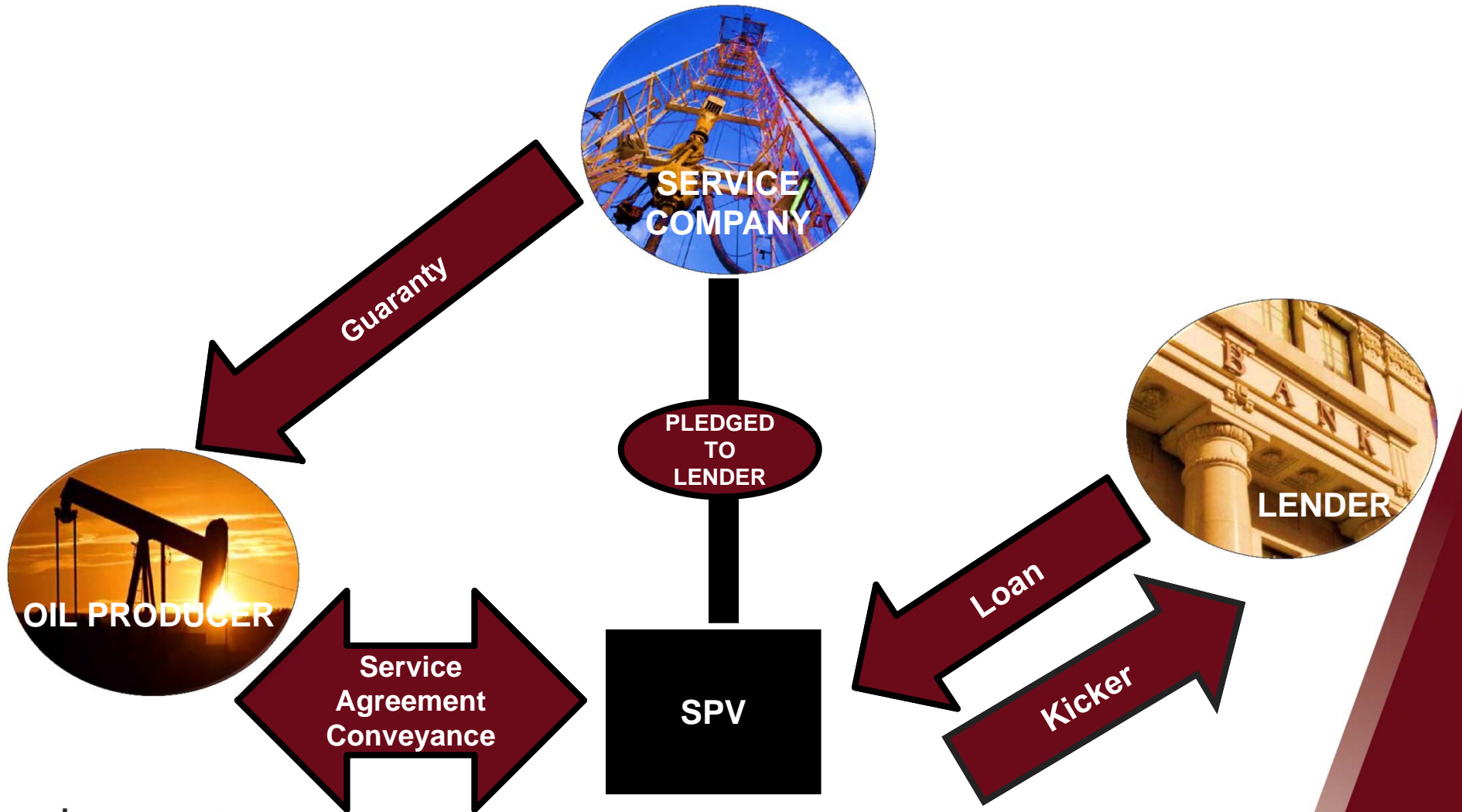


Structures



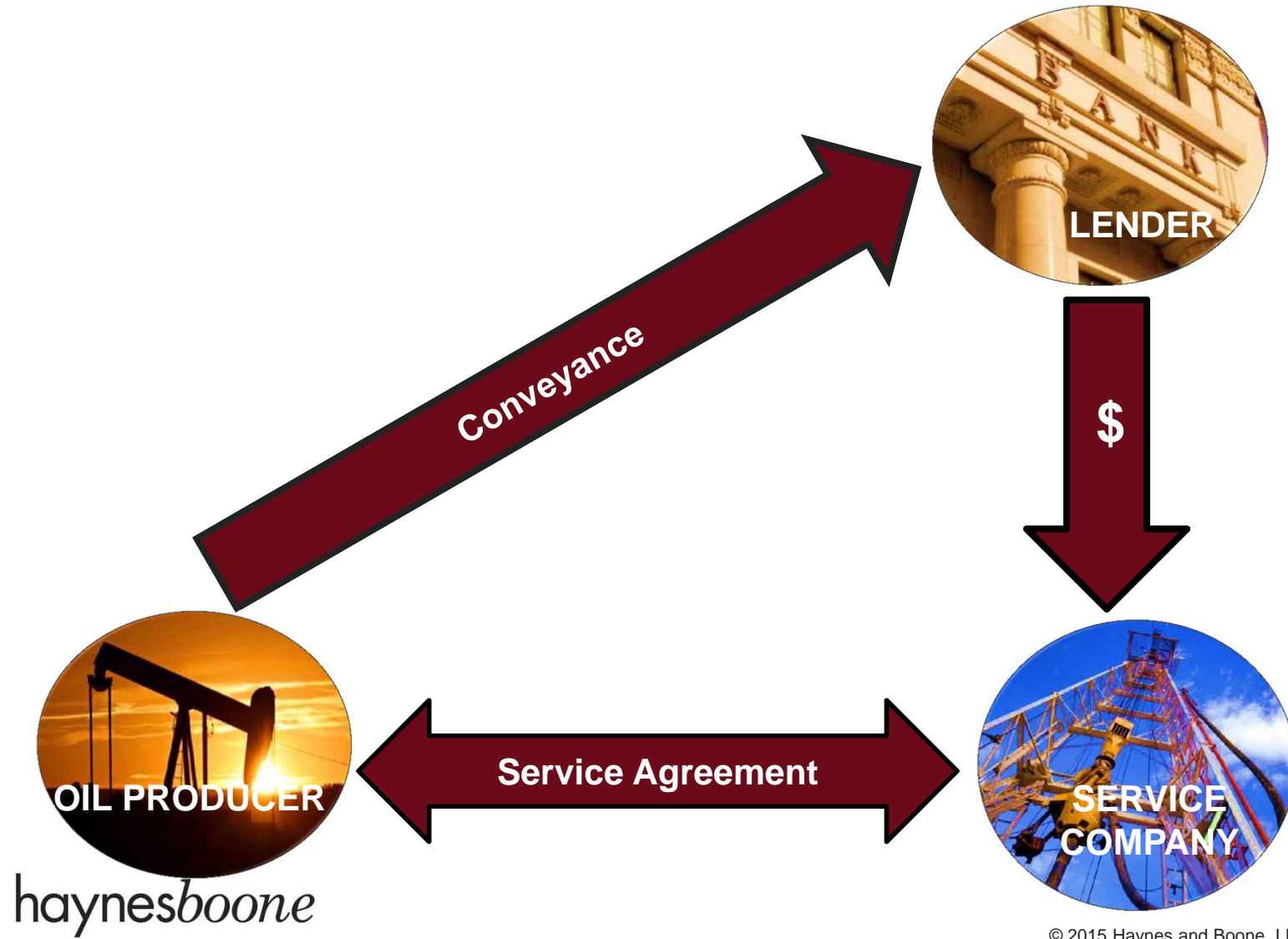
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Structures



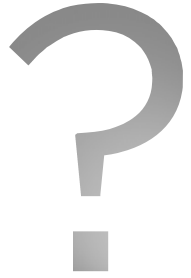
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Structures



Structures





Questions

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An Emerging Role for the Integrated Service Company?

John Bakht

Vice President, Legal

Corporate Strategy/Reservoir Development Services

March 26, 2015



Agenda

An Overview of Baker Hughes

Today's Upstream Business Environment

Examples of ISC Participation

The Evolving Role of ISCs in the Value Chain

Benefits to Operators and ISCs

Issues to Consider with ISC Participation

Concluding Remarks

Disclaimer

The views expressed in this presentation are my own and do not necessarily reflect the views of Baker Hughes or its management.

An Overview of Baker Hughes

\$24.6 BILLION
2014 Revenue

\$500+ MILLION
Research & Technology
Investment

55,000+
Employees

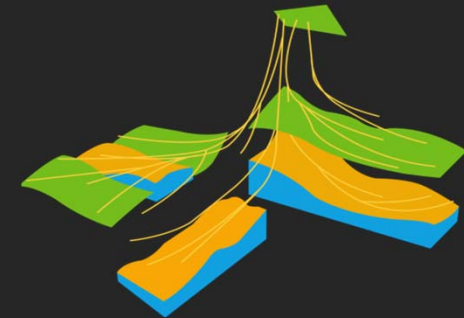
80+
Countries in
Which We Operate



EFFICIENT
WELLS

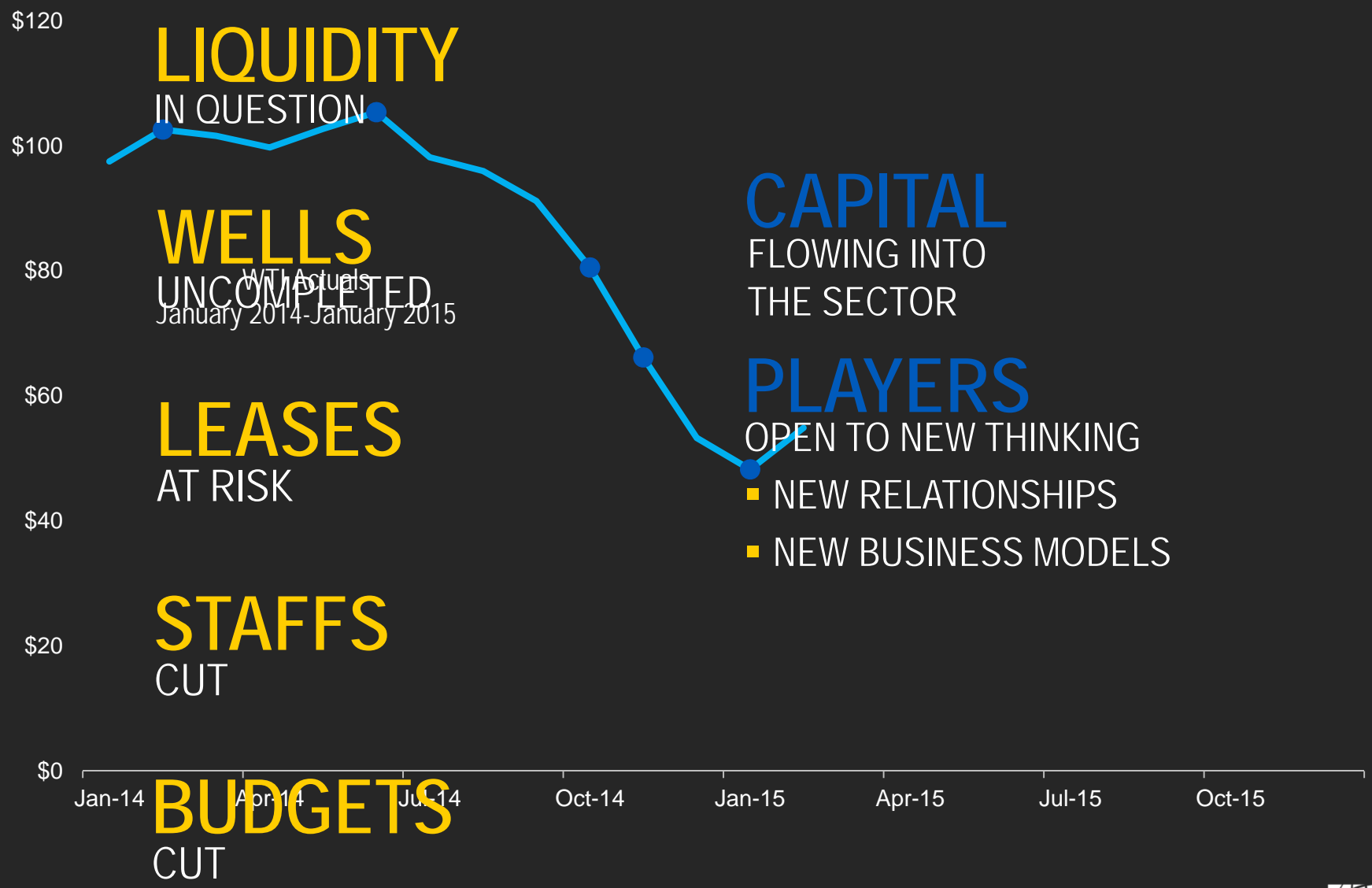


OPTIMIZED
PRODUCTION



INCREASED
ULTIMATE
RECOVERY

Today's Upstream Business Environment



Examples of ISC Participation



UNITED STATES

- Schlumberger: 50% working interest in Forest Oil Eagle Ford wells
- Halliburton/RTA Investments: Working interests in Bakken
- Baker Hughes

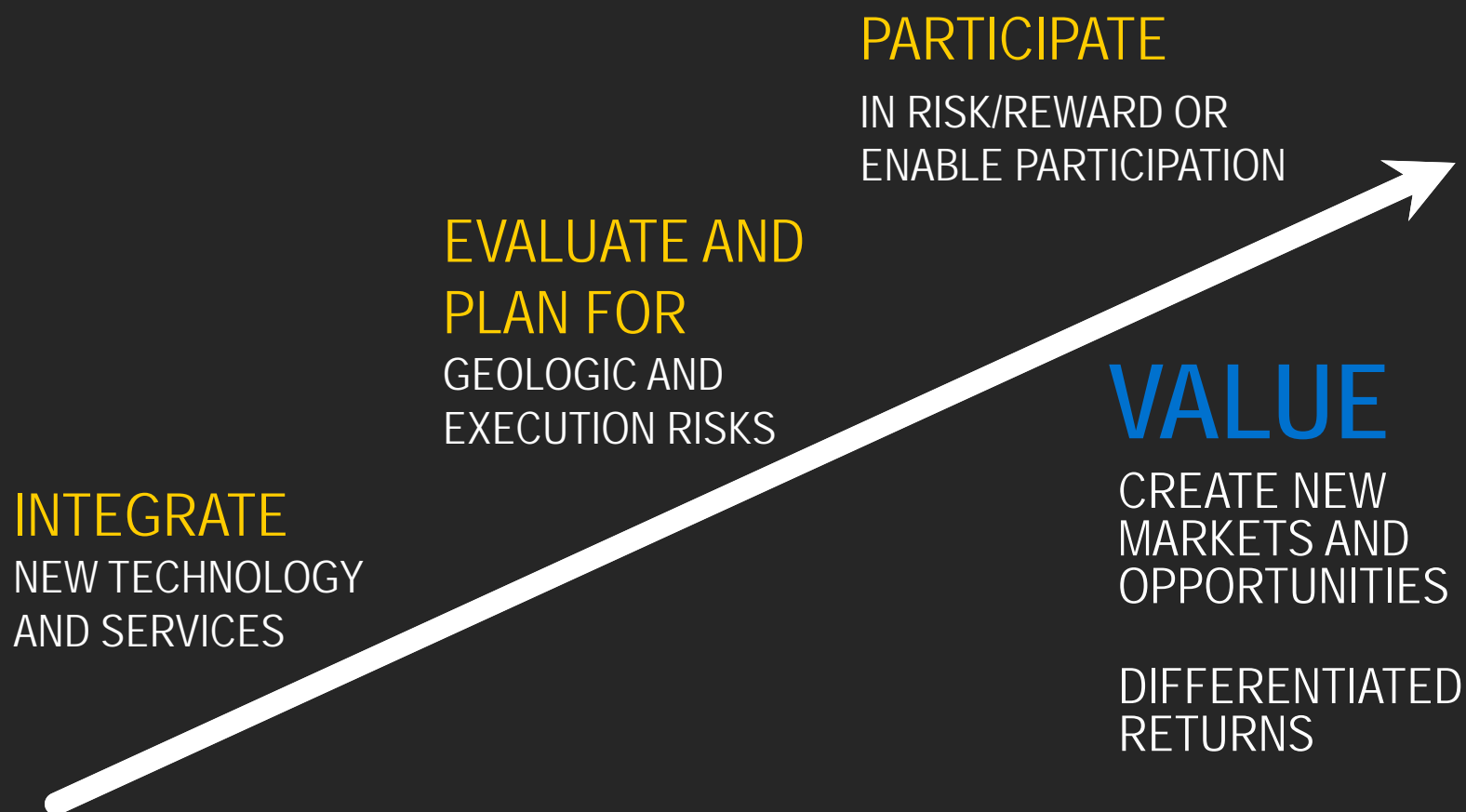
LATIN AMERICA

- CIEP model: Cost recovery plus fee per barrel produced

MALAYSIA

- ISC participates in cost and profit oil to specified percentages
- Payment from incremental production
- ISC secures exclusivity as to OFS spend in contract area

The Evolving Role of the Service Company in the Value Chain



Benefits of ISC Participation

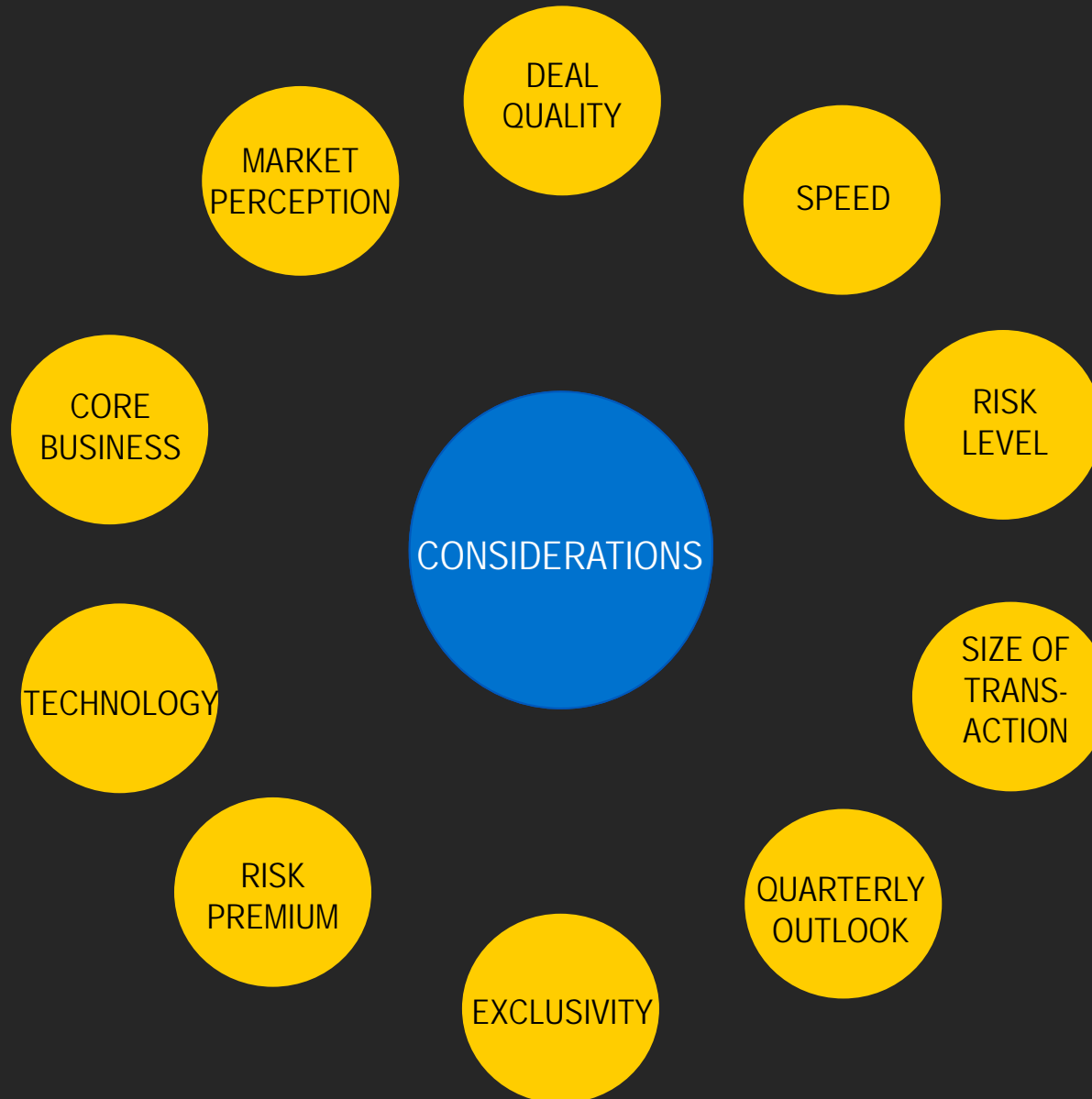
OPERATOR

- Aligns incentives between operator and service provider through shared risk/reward
- Benefits from ISC subsurface and reservoir science expertise (supports and complements existing team)
- Retains control of operations with more front end planning/support of ISC
- Deploys capital and professional resources to high-graded assets elsewhere in the portfolio
- Uses ISC to help hold acreage/lease by production with less CAPEX
- May retain reserves

ISC

- Secures market in strategic sweet spots
- Differentiates from ISCs that cannot match the offering
- Generates sales across multiple product lines, including project management
- Improves (or worsens) margins through calculated risk taking
- Learns, develops new workflows / technological improvements in key battlegrounds
- Aligns with customer at asset manager level
- Defends market share
- Leverages fixed/sunken costs

Issues to Consider with ISC Participation



Concluding Remarks

- Add ISCs to the mix of potential partners
- In a down market
 - Supplement existing oil company talent with ISC reservoir specialists
 - Leverage ISC basin-specific knowledge and contacts
 - Remain open to new models and participants

An Emerging Role for the Integrated Service Company?

John Bakht

Vice President, Legal

Corporate Strategy/Reservoir Development Services

March 26, 2015



“RISK SERVICE” CONTRACTS – A CASE FOR MEXICO?

William H. Buckley – Partner, Haynes and Boone LLP
Oilfield Services Seminar Series

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“Risk Service” Contracts

- Have historically surfaced during low-price environments.
- In a “risk service” contract, a service company (“SP”) provides services necessary to conduct specified E&P operations in exchange for a limited term cost-bearing or non-cost bearing interest. Typically, these arrangements are suitable for development, incremental production, and field reactivation projects, rarely for exploratory ones.
- There are variants to “Risk service” contracts, including VPPs (volume based term ORRI). VPPs may be attractive in this low price environment for possible price-based upside.

Other Types

- Other variants of VPPs include production payments (“PPs”) with monetary ceilings (measured by a “payout account”). The SP receives an undivided X% of the NRI until “Payout” -- when the proceeds of the SP’s share of sold hydrocarbons equals costs plus interest. Typical features include:
 - A SP (or JV of SPs) commits to drill, test, complete, and equip (and operate) a number of in-fill development wells.
 - The SP might commit to a package of wells (e.g., 5) with the obligation to undertake the next group if certain proved reserve parameters are met, or the option to do so if not.
 - The SP commits to provide its panoply of services and products for the well operations, and those of other service companies (“OSCs”) for the other services not supplied by the SP.

Other Types (Cont'd)

- The project is a “basket.” All costs and PP proceeds on all wells are accumulated.
- The SP’s services are priced at published rates. OSCs’ services are at SP’s cost plus a fee.
- The “Payout Account” bears interest at a rate commensurate with risk.
- If the SP operates the wells, the Payout Account will include LOEs.
- The PP grantor may reserve a buy out right.
- The PP is not subject to hydrocarbon price vagaries.

International Context and Challenges

- Unlike the US, international contracts (service contracts, concessions, licenses, and production sharing arrangements, and variants) do not grant subsurface rights. The owner of the contract can only convey its contract rights to production or payment. These limitations affect how “risk service” contracts are designed. In this context, “risk services” refers to payment in production or in cash, but in the latter case, tied to production results.

Participating Interest Arrangements

- The SP participates with an E&P company as a member of the PSC or other contract with the NOC or government. These structures can combine risk service and working interest elements.
 - Inclusion of a “promote.”
 - “Heads up” (except for the carry on the promote and any earn-in against services).
 - An “earn-in” via the SP’s contribution of services and products.
 - Third party procurement can be heads up or covered by the SP as part of its “earn-in.”

Direct NOC or Governmental Contracts

- Governments and NOCs occasionally set aside blocks for service companies; or are constrained only to issue service contracts for cash or production.
- These contracts are essentially E&P contracts (PSCs, association contracts, etc.) for incremental production and field reactivation.
- Constitutionally, Mexico could only issue contracts for cash – including “multiple service” and “incentivized E&P” contracts. Mexico can now issue PSCs and licenses. But, while Pemex can only issue service contracts for cash, the new law does not prohibit risk service arrangements.

PP-Style Arrangements

- An operator can assign to an SP a part of the operator's right to payment in production, to pay for services provided by the SP "at risk."

Typical Challenges

- Applicable also to Mexico
- Governmental and NOC consent to assignment, sub-assignments, and hypothecation of rights to payment or production, and to step-in rights (on default). These kinds of interests are not readily vendible or susceptible to simple financing arrangements. Pre-consent to step-in rights can be sought.
- An SP included in a consortium or “contractor group” is jointly and severally liable to the NOC or government.
- Higher risks of termination and higher performance risks than in US domestic deals.

Typical Challenges

- Local law and courts are often required or mandatory, including for enforcement against the government or NOC.
- Governmental and NOC assets may be protected.
- Local content and procurement requirements (contractual or legal) can affect how a “risk-service” structure is implemented.
- An SP not located in the country of operations will encounter the challenges that typify international operations (tax, law, structure, cost, employment, local content).

RISKY, YES, BUT WOULD YOU RATHER NOT WORK?

haynesboone

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