Bauerle's Bank Notes

E&P

March 29, 2016

The Treasury Department last Thursday tightened the noose around banks lending to exploration and production companies in America's oil patch. The Office of the Comptroller of the Currency (OCC) published an expanded and updated version of its only two year old "Oil and Gas Exploration and Production Lending" booklet, used by OCC staff in their safety and soundness examinations of national banks and federal savings associations. The word "booklet" is a misnomer, as the document comprises 89 single spaced pages of specific directions to banks by way of the federal employees who examine them. The booklet is written in the neutral, measured words of regulators. But its message is clear to those of us who spend our off hours deciphering such pronouncements: Bank credit will be more difficult to obtain and to keep available.

Bank loans to noninvestment grade E&P companies are typically made based on the value of a borrower's proven reserves of hydrocarbons and are referred to as "reserve based loans" (RBLs). Most loan agreements call for semi-annual measurement of the value of a borrower's reserves, typically done in spring and fall seasons. Because the OCC has previewed its pronouncements to banks with significant oil and gas credit concentrations, E&P borrowers should expect to feel the bite of the OCC's effort with the spring 2016 borrowing base recalculations.

Two new features of the booklet give bankers less latitude in handling oil and gas credit exposure. A short list of potential carve-outs is the one bit of relief offered.

- **Repayment Analysis Processes** specifies how RBLs are to be evaluated, including a prescribed matrix for doing so. As the underscored words below indicate, the recent collapse of oil and gas prices weighs heavily on the OCC staff's thinking.
    - "A base case analysis should use <u>prevailing market prices</u>, such as NYMEX futures prices, as opposed to the bank's commodity price deck used for borrowing base determination. The repayment test should be based on repayment capacity from unrisked and undiscounted revenues from the

borrower's total proved reserves."
  - "A reasonable repayment period for an RBL is normally within 60 percent of the economic life of the proved reserves (alternatively, 120 percent of the economic half-life), and within 75 percent of the economic life for total secured debt, in the base scenario."
  - "When determining total debt repayment capacity, banks should use sensitivity analysis in the underwriting process to estimate the impact that sustained changes in commodity prices, E&P costs, and other market conditions would have on a company's repayment ability."

- **Regulatory Risk Ratings** that bank examiners assign during bank examinations are to be made based on an expanded set of loan evaluation criteria. Prominent among them are the following financial metrics. Although the OCC booklet elsewhere says it does not profess to offer "bright lines" in its risk rating criteria, bright lines are exactly what the financial metrics below represent.

Ratio	Pass	Special Mention	Substandard or Worse
Definition		Potential Weakness	Well-defined Weaknesses
Funded Debt/EBITDAX	<3.5X	3.5-4.0X	>4.0X
Funded Debt/(Funded Debt + Equity Capital)	<50%	50-60%	>60%
Committed Debt/Unrisked and Undiscounted Proved Reserves.	<65%	65-75%	>75%

- **Borrowing Base Stretch** is a term under which the OCC groups the limited universe of exceptions available to banks to extend the boundary of their credit exposure to E&P companies. Enumerated exceptions are:
  - Providing higher advance rates (for example, over 65 percent), allowing less conservative risk factors, and increasing the value attributable to [proved developed reserves subcategorized as nonproducing] and [proved undeveloped reserves]. These actions may be supported by a variety of reasons, including borrowers backed by substantial private equity sponsors.
  - Allowing "leasehold" value when the borrower's acreage position is located in a particularly competitive area.
  - Lending beyond 100 percent of [proved developed reserves subcategorized as producing] on a temporary basis, with interest rates and fees that reflect the increased risk.
  - Giving value for the next six months' production, which is usually omitted from the borrowing base (with a monthly reduction feature).
  - Lowering the discount rate for determining the [net present value] of reserves, thereby increasing the total present value.
  - Restructuring borrowing base loans into conforming and nonconforming stretch tranches with higher fees and rates on the stretch loans.

The OCC's effort is designed to bring clarity and order to the market for E&P company bank credit. It also reduces the risk that Congress will criticize the OCC for being lax about restricting bank credit to E&P companies (even as it increases the risks of default

and insolvency for those companies due to tighter lending standards).

Friday's Wall Street Journal reported on page one that since January 2015, 51 E&P companies have filed for bankruptcy protection, listing debts of $17.4 billion. More will follow this year and next. One of the particular challenges these companies face is that leases they signed with landowners expire unless the E&P companies put them into production by drilling for oil and gas within 5-10 years of lease execution. As the price slump continues, companies have neither the operating income nor the bank credit needed to drill so as to protect their investment.

The practical effects of the bank regulatory tightening are several:

- E&P companies will need to obtain capital from equity and mezzanine debt providers instead of banks. Our Renaissance Partners boutique investment banking affiliate, www.renaissance-partners.com, has been a useful resource for multiple companies in this way.
- Suppliers to E&P companies will experience further contraction of their business. Here too, Renaissance Partners is currently sourcing alternative capital to help supplier companies survive the downturn.
- State and local governments will feel the pinch too. Washington County, Pennsylvania, saw its general fund expand by nearly 40% in the period 2009-2013 because of the imposition and payment of shale gas "impact fees". By contrast, Fairfax County, Virginia, a perennial leader on national lists of growing communities, experienced 6% growth over the same five year period. Pennsylvania Governor Wolf's proposed severance tax died a quiet death in the 2015-16 Pennsylvania budget battle because everyone recognized the temporarily distressed state of the energy industry made additional taxes impracticable, at least for now.

The OCC prefaces its listing of factors to be considered in assigning regulatory risk ratings to E&P credit exposures with the instruction, "Examiners must use judgment and reasonableness when making final regulatory rating decisions; each borrower is unique." That's good advice. To it one can add the nation's freedom from dependence on Middle Eastern hydrocarbons, and the financial burden of assuring their production and supply to Western nations, depends on the vitality of America's domestic oil and gas industry. That's a national fiscal underwriting criterion of a different order, but one not to be overlooked in the push to protect banks from overextending themselves.

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