Drilling Your Way out with DrillCos

IPAA Leaders in Industry Luncheon
April 10, 2019

Austin Elam, Partner
Drilling Your Way out with DrillCos

Alternatives to development capital in a capital constrained environment

Austin Elam
A&D Slow, As Predicted

- First quarter A&D activity down over 90% on a value basis, per drillinginfo

<table>
<thead>
<tr>
<th>US Region</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>%Δ YoY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multi Region</td>
<td>28</td>
<td>22</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Permian</td>
<td>130</td>
<td>128</td>
<td>32</td>
<td>15</td>
</tr>
<tr>
<td>Gulf Coast</td>
<td>76</td>
<td>73</td>
<td>23</td>
<td>7</td>
</tr>
<tr>
<td>Rockies</td>
<td>77</td>
<td>87</td>
<td>18</td>
<td>11</td>
</tr>
<tr>
<td>Midcontinent</td>
<td>93</td>
<td>67</td>
<td>21</td>
<td>11</td>
</tr>
<tr>
<td>Appalachia</td>
<td>47</td>
<td>24</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>Ark-La-Tex</td>
<td>32</td>
<td>19</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Gulf of Mexico</td>
<td>11</td>
<td>25</td>
<td>12</td>
<td>4</td>
</tr>
<tr>
<td>West Coast</td>
<td>11</td>
<td>13</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Alaska</td>
<td>1</td>
<td>7</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>506</td>
<td>465</td>
<td>123</td>
<td>62</td>
</tr>
</tbody>
</table>

Source: Houlihan Lokey

- New normal, particularly for private equity sponsored producers
  - The business model has changed
- See also: QEP/Vantage, Earthstone/Sabalo
Lack of Liquidity a Major Factor

- Equity markets remain quiet
- Senior lending down as well, though a case of the chicken vs. the egg with a decrease in M&A/A&D activity
The survey indicates that oil and gas companies looking to “cash out” in 2019 will struggle to do so.
Development Capital from Where?

- “Drilling within cashflow”

- Many RBL Credit Agreements permit farmouts of “undeveloped acreage.”
  - “farmouts in the ordinary course of business of undeveloped acreage to which no Proved Reserves are attributed in the most recently delivered Reserve Report and assignments in connection with such farmouts”

Source: Morgan Stanley Research – 4/4/19
To the Rescue - “DrillCos”

- DrillCo 101 – a drilling joint venture between a Producer and a Capital Provider
  - Not a company or jointly-owned entity – a “financial” farmout agreement
  - Capital Provider agrees to fund Producer’s drilling of wells in exchange for negotiated “Before Payout” and “After Payout” returns and interests
- Most commonly, the interests assigned are “wellbore only” and not acreage assignments
- Limited recourse back to the producer, with the Capital Provider accepting production and operational risk

<table>
<thead>
<tr>
<th></th>
<th>Producer</th>
<th>Capital Provider</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drilling/Development Costs</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>Payout Hurdle</td>
<td></td>
<td>13% IRR</td>
</tr>
<tr>
<td>Before Payout Working Interest in Wells</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>After Payout Working Interest in Wells</td>
<td>90%</td>
<td>10%</td>
</tr>
</tbody>
</table>
DrillCo Structure – Pre-Reversion

- Capital Provider
  - 60% Reversionary Working Interest
  - 80% of Development Costs
  - 60% Working Interest

- Producer
  - Joint Wells & Leases
  - Mortgage
  - 40% Working Interest (Pre-Reversion)

- RBL Lenders
DrillCo Structure – Post-Reversion

- Capital Provider
  - 10% Working Interest
- Producer
  - 90% Working Interest (Post-Reversion)
- Joint Wells & Leases
- RBL Lenders
  - Mortgage
Solving Problems without Creating More

Scalable based upon size of agreed budget and program

**Producer** receives:
- Access to capital to finance drilling of an agreed well program
- (Likely) no additional debt on the balance sheet
- The upside and full ownership of all in-fill and adjacent drilling locations outside of the program
- Works within existing RBL structure and potential Borrowing Base uplift from DrillCo program wells once PDP (up to the Producer’s retained working interest in each well)

**Capital Provider** receives:
- Firm obligation by Producer to drill agreed well program
- Right to a return on invested dollars (BPO) *plus* a perpetual APO “tail” working interest in each program well
- Direct non-operated working interest in each funded well, carved out of the Producer’s estate in the event of a bankruptcy, with some strings attached
Deal Points in Practice – DrillCos 201

• Push and Pull – Structural vs. Contractual Protections

• Spacing Concerns – What protects the Capital Provider’s “wellbore only” interest?
Deal Points in Practice – DrillCos 201

- **Non-Op and Non-Budget Wells** – Participation right for Capital Provider?

- **Cost Overruns and “AFE Caps”** – Who bears risk of cost increases/overages?

- **Hedging** – Included within reversion calculation? Who takes open positions upon reversion?

- **Infrastructure and Marketing** – And water issues
Broken Promises and Changing Circumstances

• Defaults and Reversion

• “Customary” JOA liens – That secure (some) obligations under the development agreement

• Acceleration Payments and Off-Ramps – Plans change

• Distressed Transfers

• Not Debt – Right?
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