Oil and Gas ABS:

The Why's and How's of O&G Asset-Backed Securitizations

September 2024

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PART 1.

Background on Oil and Gas ABS

Oil and Gas ABS: Background

- HB was one of several instrumental players working to develop the structure in early 2019 in conversations with Fitch and other market players, mostly hedge providers.
- HB has been involved with 25 oil and gas securitizations since the first in 2019 (as of September 2024).
- HB has represented hedge providers in a variety of oil and gas securitization structures, including take-out financings, mineral interest securitizations, non-operated interest securitizations, etc.
- HB has been involved in the securitization of a diversified group of underlying producing assets, including the securitization of assets in the Appalachian Basin, Anadarko Basin, Barnett Shale and Piceance Basin.
- HB has represented hedge providers in a broad spectrum of securitization transactions,.

Alternative Financing Structures

- RBLs
  - Money Center Banks
  - Foreign Banks
  - Regional Banks
  - BOKF
- TLBs
  - Expensive
  - Debt funds
- Banks + TLBs
  - Letters of credit
  - Future funding obligations
  - Administrative headaches
  - Documentation
- XYZ
  - Prepaids
  - VPPs
  - Drillcos

ABS

PART 2.

Structure of Oil and Gas ABS Transactions

Overview of ABS Structure

Oil and Gas Asset Backed Securitization Overview

Oil & Gas Asset Back Securitizations (ABS), are debt securities collateralized by wellbore working interest in producing wells that have been transferred into an issuer (producer) owned SPV. This product is investment grade, amortizing which generally requires a higher level of hedging

	ABS	RBL	High Yield	Term Loan
Advance Rate	55 - 70% of PV_{10}	40 – 50% of PV_{10}	Limited by D/E ratio	Limited by D/E ratio
Interest Rate	Fixed 7.5 – 8.5%	Floating SOFR + 3 – 5%	Fixed 12 – 15%	Hybrid 12 – 16%
No Redeterminations	✓	✗	✓	✓
Non-Recourse	✓	✗	✗	✗
No Corp. Covenants	✓	✗	✗	✗
Transferrable	✓	✗	✓	✓
No Restrictions on Use of Proceeds	✓	✗	✗	✗
Asset Ownership	Retained	Retained	Retained	Retained
Tenor	Amortizing 5 – 10 yrs	Bullet 3 – 5 yrs	Bullet 5 – 10 yrs	Hybrid 3 – 7 yrs

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https://enercomdenver.com/wp-content/uploads/2023/08/DV-Enercom-ABS-Discussion-vFinal.pdf

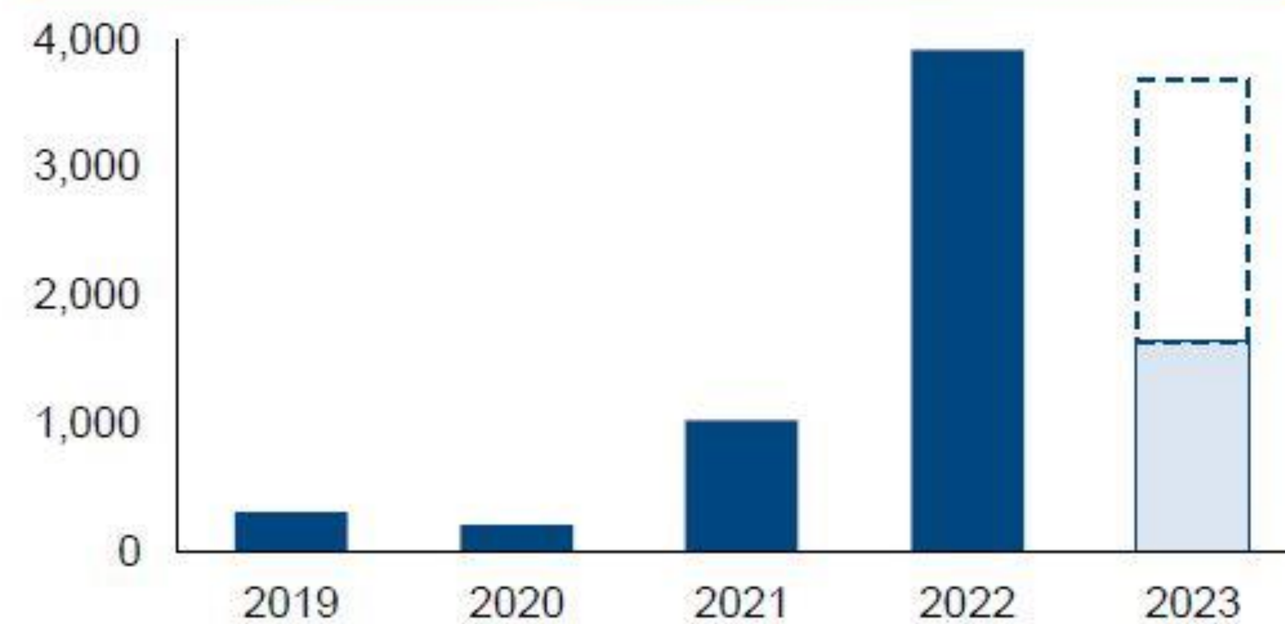
O&G ABS Market

O&G ABS Growing Market

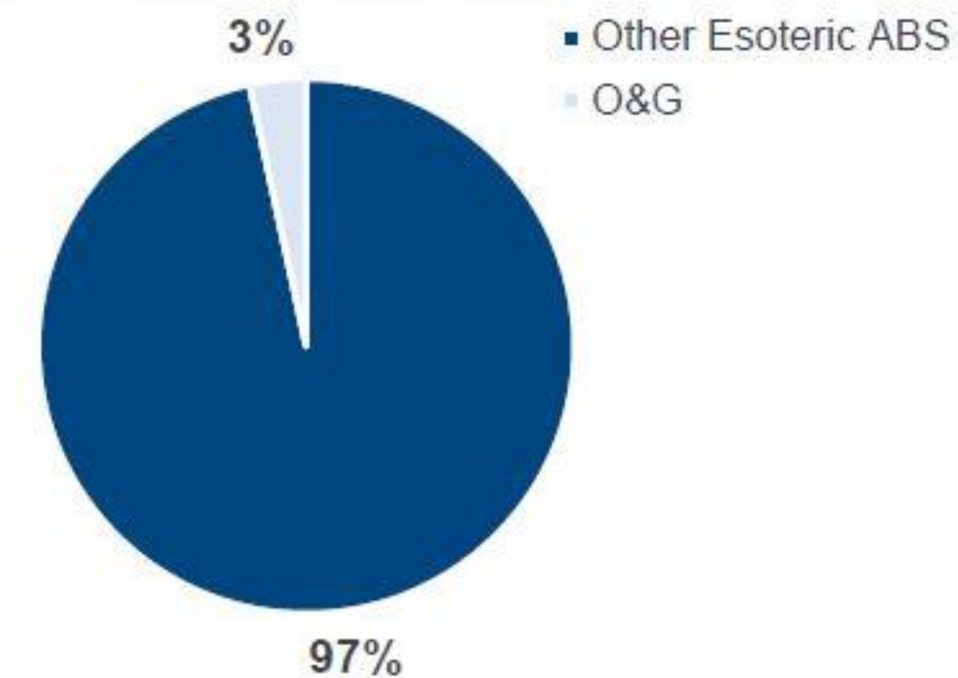
Highlights

- PDP securitizations experienced exponential growth YoY through 2022
  - 1st half of 2023 saw a slowdown in activity due to precipitous drop in gas prices and uncertain interest rate environment
- Investor appetite continues to grow as the oil and gas ABS market develops
- Oil and gas ABS is expanding to new basins and the structure is supporting smaller transactions, leading towards expected issuance growth
- Oil and gas ABS is still sub-five percent of the total esoteric ABS market, leaving room for ample growth

Oil & Gas Securitization Issuance[1,2]



Total Esoteric ABS Issuances



Source: Bloomberg.
1. YTD as of 8.10.2023
2. 144a & 4(a)2 Private Placement (US$ MM)

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Rating Agency Information

Structured Finance

Global

Future Flow Securitization Rating Criteria

Sector-Specific Criteria

This report updates and replaces the previous report of the same title, dated 4 February 2019.

Scope

This report outlines Fitch Ratings' approach to rating future flow securitizations; the methodology is applicable to both new ratings and existing ratings and for both national scale and international scale ratings. A future flow transaction securitizes a company's or infrastructure enterprise's existing and future receivables due from designated obligors and receivables originated from a specific business line. The criteria also include specific applications for future flow oil and gas royalties.

Future flow debts are hybrid debt securities, where Fitch's approach incorporates elements of structured finance, corporates/infrastructure and financial institutions' rating methodologies. Fitch does not assign an 'sf' modifier to future flow transactions.

Related Criteria

Corporate Rating Criteria (February 2019)
Global Structured Finance Rating Criteria (May 2019)
Bank Rating Criteria (October 2018)
Non-Bank Financial Institutions Rating Criteria (October 2018)
Rating Criteria for Infrastructure and Project Finance (July 2018)
Structured Finance and Covered Bonds Interest Rate Stresses Rating Criteria (March 2019)
Fitch's Foreign-Currency Stress Assumptions for Residual Foreign-Exchange Exposures in Covered Bonds and Structured Finance – Excel File (October 2017)

Key Rating Drivers

All key rating drivers listed below are equally important inputs into the rating.

Rating Threshold: Most future flow transactions have been rated on the International Scale in the 'BBB' or 'A' rating categories, due to potential diversion risk and some degree of performance risk by the originator. Fitch would assign ratings above the 'A' category if the originator was a leading financial institution or corporate rated in the 'A' category or above and the country of the originator was rated in the 'A' category or above. Fitch explicitly caps oil and gas royalty transactions at the 'A' rating category when the originator is not explicitly rated.

Originator's Credit Quality: The rating of future flow transactions is tied to the credit quality of the originator, which is measured by the Local-Currency (LC) Issuer Default Rating (IDR) of the originator. Once the originator's LC IDR is established, the rating analysis considers additional rating drivers.

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Going Concern Assessment: The originator's specific business line must continue to operate for the new receivables and cash flows to be generated to service the debt. To capture this performance risk, Fitch will assess the future generation risk of the cash flows. The going concern assessment (GCA) score is a measurement of the likelihood that the business remains a going concern and the underlying cash flow continues to be generated if the company defaults on other liabilities.

The maximum notching uplift from the originator's LC IDR allowed by the GCA score will act as a cap for the transaction's rating, However, other risks may result in lower transaction ratings.

Notching Uplift from LC IDR: The notching uplift and the ultimate transaction rating is determined through the analysis of the attributes and characteristics of future receivables; this assesses: the proportion of future flow debt to the total debt of an originator; the characteristics of the receivables and their volatility; exposure to concentrated counterparties; and the debt service coverage ratio (DSCR) under various sensitivity scenarios.

Potential Redirection/Diversion Risk: Fitch assesses potential interference by the government or the originator in terms of incentives and ease/ability to interfere. Although most transactions are structured to mitigate redirection/diversion risk, sovereign and originator interference cannot be completely eliminated and may act as a cap to the transaction.

Appendix C – Oil and Gas Royalty Future Flow Securitizations

Oil and gas royalty future flow securitizations are backed by royalties or payment obligations arising from the extraction of hydrocarbons. There are a variety of methods of creating royalties and transferring economic interests, but two of the most common forms are over-riding royalty interests (ORRI) and volumetric production payments (VPPs). Other forms may relate more to profit sharing mechanisms or non-operated working interests, but these will have greater variability due to production costs that may be associated with them.

Go to www.fitchratings.com for updates

Rating Agency Information (cont.)

Example WTI Transaction Monthly Cash Flows – 'BBB' Stress

	IE case	Fitch base case	Stress test
Monthly debt service (USD)	2,500,000	2,500,000	2,500,000
Price per barrel (WTI) (USD)	55.00	55.00	35.00*
Price differential (USD)	-5.00	-5.00	-6.00 (+20%)
Production (barrels per month)	115,000	109,250 (-5%)	103,500 (-10%)
Monthly revenue (USD)	5,750,000	5,462,500	4,956,500
Monthly Expenses (USD)	2,100,000	2,205,000(+5%)	2,415,000 (+15%)
DSCR (x)	1.46	1.30	1.02

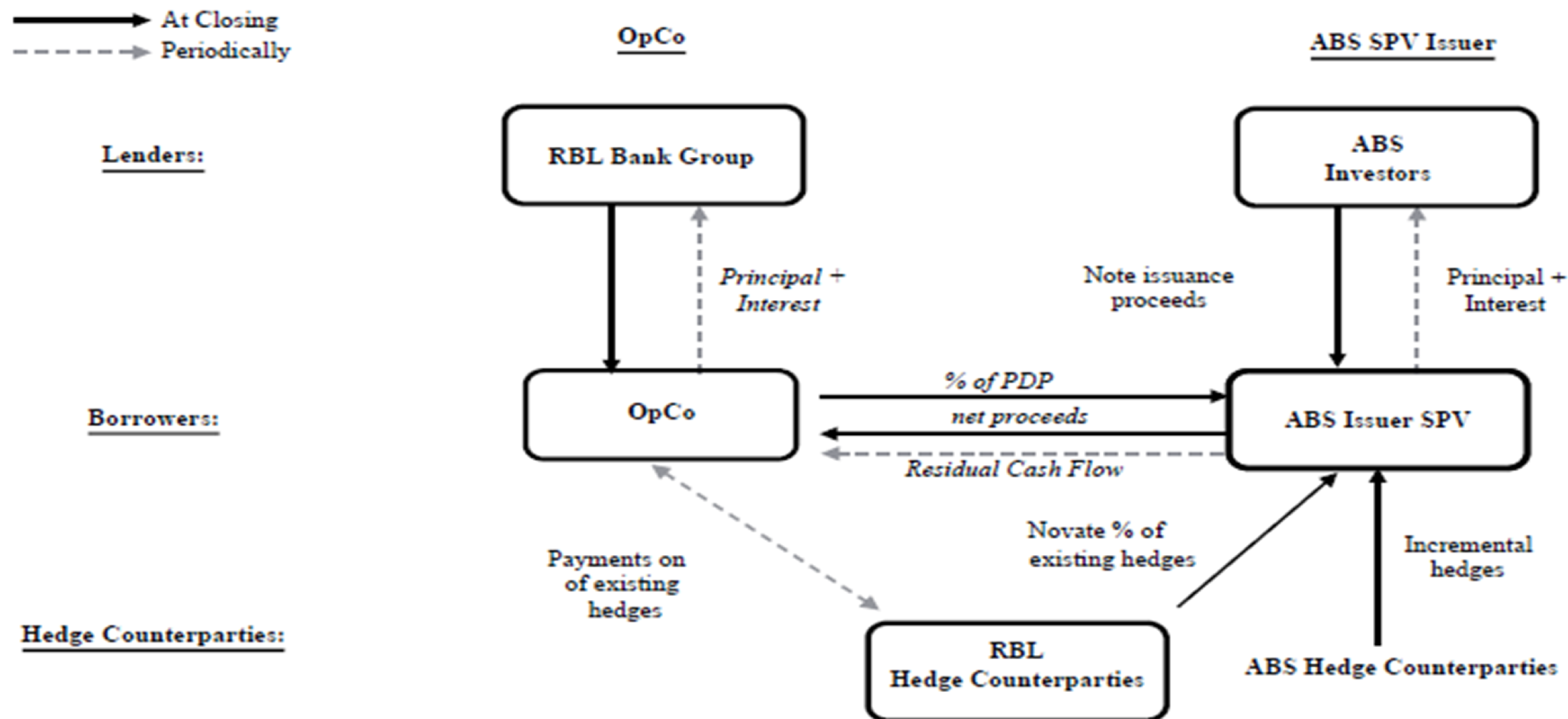
* 85% of base-case production volumes hedged at USD55/barrel
Source: Fitch Ratings

Go to www.fitchratings.com for updates

Asset-Backed Securitization: Basic Structure

- Securitization is a subset of structured finance. Structured finance transactions are generally finance transactions that involve the isolation of a pool of assets (here interests in proved developed and producing wellbores) from the owner of those assets and a loan (here a note issuance) that relies on the strength of the assets rather than the creditworthiness of the owner.
- A securitization is a transaction in which a company obtains funding by causing a special purpose entity to issue securities backed by (and paid from) the periodic cash flows from the transferred assets.
- At closing, the special purpose entity issuer will acquire the collateral backing the asset-backed securities by raising debt financing (via the issuance of the asset-backed securities) and then using such debt financing to purchase the collateral pool.
- The underlying assets are transferred to the issuer of the securities on a “true sale” basis, and the issuer is structured in such a way as to be isolated from the bankruptcy risk of the transferring affiliate and other affiliate entities of the SPV issuer.
- Documentation for the ABS (i.e., issuer organizational documents and Basic Documents) will contain requirements which:
- Restrict issuer’s purpose and powers;
- Limit issuer’s ability to incur additional indebtedness;
- Impose separateness covenants with respect to issuer’s operation;
- Restrict merger, consolidation, dissolution and any amendment to the provisions in issuer’s organizational documents related to its separateness;
- Require an independent director on issuer’s board whose vote is necessary to file bankruptcy on behalf of issuer; and
- Impose other restrictions on issuer’s ability to file for bankruptcy.

Collateral Transfer and Existing Financing



(Not So) “Basic Documents”

- Indenture
- Notes
- Management Services Agreement
- Joint Operating Agreement
- Back-Up Management Agreement
- Asset Purchase Agreement
- Note Purchase Agreement
- Assignment, Bill of Sale and Conveyance
- Hedge Agreements
- Novation Agreement
- Issuer LLC Agreement
- Holdings LLC Agreement
- Guaranty Agreement
- Pledge Agreement
- Acknowledgment Agreement
- Escrow Agreement
- Indemnity Agreement
- Mortgage
- Precautionary Mortgage

PART 3.

Drafting and Negotiating Considerations for ABS

Credit Enhancements

- Tranching & Mandatory Application of Cash Flows (ordinary course and in the default scenario)
- Overcollateralization
- Conditional Diversion of Excess Cash Flows to Accelerated Amortization
- Robust Hedging Requirements

Tranching & Mandatory Cash Flow Application

- Mandatory periodic (monthly) application of cash flows from collateral securing notes and hedges.
- Application of cash flows required to be made in accordance with negotiated payment waterfall. Ordinary course waterfall will control prior to default & acceleration, if the ABS defaults and the notes are accelerated, an acceleration waterfall will control application of payments following winding up of the ABS.
- Senior note debt and hedge payments generally paid pro rata and pari passu.
- Increased spreads on subordinated junior debt to compensate for greater payment default risk.

Overcollateralization

- ABS at original issuance will be overcollateralized (present value of securitized assets will exceed the note debt issued by the SPV issuer).
- Notes are structured to amortize at a quicker pace than decline rate for the reserves collateralizing the notes (as ABS matures collateral coverage to increase).
- Collateralization will be periodically tested to ensure that collateral coverage remains above specified thresholds as the facility matures and the notes amortize.
- Failure to meet collateral coverage requirements (i.e., deficient Loan to Value determination) will result in a host of remedial actions occurring under the ABS and are also a gateway to actions.

- In the normal course scenario, excess cash flows at the bottom of the waterfall go to equity of the SPV issuer.
- However, if the issuer runs afoul of a remedial trigger (LTV, DSCR, Production Tracking Rate) then excess funds will be swept and allocated to accelerated amortization of note debt.
- In the multi-tranche structure, cash sweeps can result in diversion of funds from junior subordinated debt to accelerate amortization on the senior class of note debt.
- To facilitate timely scheduled amortization prior to projected maturity, later in the term of an ABS, accelerated amortization will automatically commence (regardless of trigger compliance).
- Material point for junior noteholders and hedge providers to understand where they sit in the waterfall in relation to cash sweeps in favor of the senior note debt.

Hedging

- To promote timely debt service on the notes, the issuer will be required to enter into (and maintain) a robust hedge program.
- The hedge program will be put into place at close and periodically tested thereafter to ensure that the issuer maintains hedging above a negotiated floor (generally between 75% to 85% of projected production from the collateral securing the notes and hedges).
- The hedge program will also be periodically tested to confirm that the issuer does not over hedge (i.e., hedge greater than 100% of its projected production).
- If the issuer is either under or over hedged, it will be required to return to compliance with the applicable offending threshold within a negotiated cure period.

Material Considerations in Drafting

- Unitranche v. Multi-tranche Facility:
  - Spreads on junior debt, magnitude of junior debt, rating for junior debt, maturity for junior debt, etc.
  - Payment priority for junior debt.
- Master Trust Structure:
  - Ability to upsize note debt following initial closing.
  - Ability of issuer to acquire/receive contribution of additional collateral.
- Alignment v. Misalignment of Interests (noteholders v. hedge providers):
  - Rights and recourse of secured parties flows through the Indenture and Basic Documents (i.e., no intercreditor agreement).
  - Noteholders are the controlling class and hedge providers (while note debt is outstanding) do not have the ability, following a default, to trigger winding up of the ABS or direct resort to the collateral by the trustee.
- Fundamental Changes & Key Events:
  - Permitted sales of collateral securing the notes/hedges (coverage/leverage CPs, asset sale caps, required right sizing of hedges and mandatory note redemptions, use of disposition proceeds).
  - Collateral impairment (recourse to the transferring affiliate, associated note redemptions and right sizing of hedges, etc..).
  - Amendment to Indenture or key ancillary documents impacting the ABS (i.e., the Basic Documents).
  - Issuer affiliate performance under key ancillary documents impacting the ABS (i.e., Basic Documents).
  - Reduction in credit quality of hedge providers (thresholds, cure period and curative actions).

Typical Provisions

- Rating and Rating Agency Interaction Key
- “Wellbore Only” attributes
- Hedging Fundamental – hedge minimums >80% of projected production
- Generally, no true financial covenants, just increased amortization requirement
- Master Trust Structure
- Common financial metrics governing amortization
    - Debt Service Coverage Ratio
    - Loan to Value
    - Principal to PV-10 or Principal to a “base case PV-10 from closing”
    - Production Tracking (waning in frequency)
    - Actual production over prior 6-month period to projected total proved

- Hedge Provider in the Waterfall
    - Monthly payments
    - Over-hedge payments
    - Other breakage
    - “Good Waterfall” vs “Bad Waterfall”