HEDGING OIL & GAS PRODUCTION

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Overview

I. Why Hedge Oil & Gas Production?

II. Over-the-Counter Transactions vs. Exchange-Traded Transactions

III. How are Over-the-Counter Transactions Documented?

IV. ISDA Overview

V. Drafting Tips for Negotiating the ISDA Master Agreement

VI. Bankruptcy Considerations

VII. Dodd-Frank Act

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I. Why Hedge Oil & Gas Production?

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Why Hedge?

- The primary benefit of hedging oil and gas production is the producer's ability to reduce the impact of unanticipated price declines—known as price risk—on its revenue.

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Hedging Transactions

- Some transactions have the effect of *locking in the price* the producer will receive, but prevent it from benefiting if prices rise.
  - Swap Contracts
  - Fixed-Price Physical Contracts
  - Futures Contracts
- Other transactions, have the effect of *establishing the minimum price* the producer will receive, but require it to pay an upfront premium.
  - Put Option Contracts

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Hedging Considerations

- The decision to hedge is made on a case-by-case basis depending on various considerations. These considerations may include:
  - Sensitivity of the producer's business plan and capital structure to revenue fluctuations
  - Appetite for risk
  - Lender or investor imposed restrictions or requirements
  - Confidence in engineering projections of future production

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Managing Risk

- Hedging with over-the-counter products does not result in a risk-free transaction.
- Price risk may be replaced by other risks that the producer should consider:
  - Credit Risk
  - Counterparty Risk
  - Production Risk
  - Basis Risk

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II. Over-the-Counter Transactions vs. Exchange-Traded Transactions

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Differences between Over-the-Counter Transactions and Exchange-Traded Transactions

- The following table summarizes major distinctions between over-the-counter and exchange-traded transactions:

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	Over-the-Counter Transactions	Exchange-Traded Transactions
Method of Negotiation:	Negotiated between counterparties	Executed on organized exchanges
Standardization:	Low level of standardization	High level of standardization
Commonly Used Agreements:	GTCs, NAESB, and ISDA	Brokerage Agreements
Regulations:	U.S. Commodity Futures Trading Commission	U.S. Commodity Futures Trading Commission
Trade Counterparties:	Individual counterparties	Organized exchanges
Price Transparency:	Little price transparency	High price transparency

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III. How are Over-the-Counter Transactions Documented?

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Over-the-Counter Contracts

- Widely used over-the-counter contracts:
  - General terms and conditions of individual energy companies
  - Base Contract for Sale and Purchase of Natural Gas (Base Contract) published by the North American Energy Standards Board (NAESB)
  - ISDA Master Agreement published by the International Swaps and Derivatives Association (ISDA)

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IV. ISDA Overview

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What is the ISDA Master Agreement?

- A standardized framework to document and expedite the negotiation of over-the-counter hedging transactions, while providing parties with great flexibility to tailor provisions to meet their specific hedging strategies.

- Two versions of the Master Agreement:
  - 1992 Master Agreement
  - 2002 Master Agreement

Why use the ISDA Master Agreement?

- Governs multiple transactions and energy products under a single, “umbrella-type” agreement.
- Facilitates consistent interpretation of its language that minimizes disputes and uncertainty.
- Ensures all transactions are documented properly and consistently.
- Streamlines the negotiation and documentation process.
- Widely accepted and widely used among market participants.

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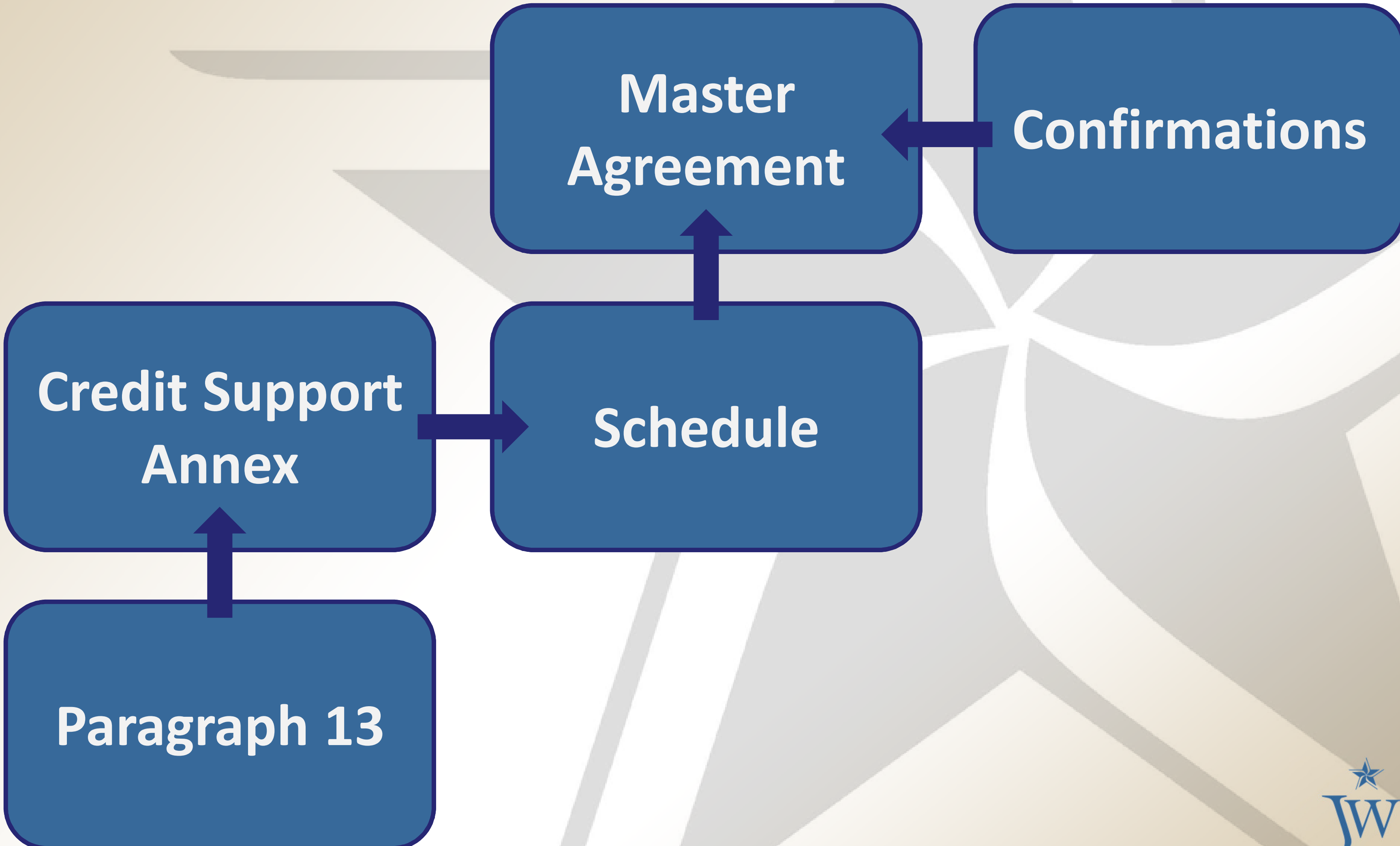
Structure of the ISDA Master Agreement

- **Master Agreement**: Preprinted text
- **Schedule**: Modifies the Master Agreement
- **Credit Support Annex**: Preprinted text that forms part of the Schedule
- **Paragraph 13**: Modifies the first 12 paragraphs of the Credit Support Annex
- **Confirmations**: Commercial terms
- **Commodity Annexes**

Relationship between ISDA Documentation



V. Drafting Tips for Negotiating the ISDA Master Agreement

Specified Entities

- A party whose relationship is so close to the producer that if certain events occur with respect to the party, it could affect the producer's counterparty. These events are:
  - Default Under Specified Transaction
  - Cross Default
  - Bankruptcy
  - Credit Event Upon Merger
- ***Drafting Tip***: *Minimize the Schedule's scope as to a producer's Specified Entities.*

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Cross Default

- Cross Default occurs when a party, its Specified Entities, or its Credit Support Providers, default or fail to make a payment with respect to an obligation for borrowed money (*e.g.*, a loan agreement).
- As written, Cross Default can occur even if there is a possibility of borrowed money being declared due and payable.
- ***Drafting Tip***: *Modifying the language to reflect a less burdensome, cross-acceleration provision.*

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Cross Default | Specified Indebtedness

- Specified Indebtedness essentially means borrowed money, but can be expanded to include other types of debt.

- ***Drafting Tip***: *Maintain the ISDA Master Agreement's definition of Specified Indebtedness.*

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Cross Default | Threshold Amount

- Essentially the risk a counterparty is prepared to accept with respect to a producer's payment obligation defaults before triggering the Cross Default event of default under the Master Agreement.
- Not to be confused with "Threshold" under the Credit Support Annex.
- ***Drafting Tip***: *Negotiate a Threshold Amount reflective of the producer's creditworthiness (preferably a high Threshold Amount).*

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Additional Termination Event

- Specific events that, if triggered, would permit the non-affected party to terminate all transactions under the Master Agreement.

- ***Drafting Tips***:
  - *Insist that the criteria for triggering an Additional Termination Event is as objective and narrow as possible.*
  - *Negotiate a cure provision into the Additional Termination Event language.*

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VI. Bankruptcy Considerations

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Safe Harbor Provisions

- Automatic stay. Notwithstanding the automatic stay, the ISDA parties can:
  - Terminate the Master Agreement
  - Liquidate all transactions under the Master Agreement
  - Exercise set-off rights and make termination payments
- Contracts that fall within the safe harbor provisions include:
  - Swap Agreements
  - Forward Contracts

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VII. Dodd-Frank Act

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Key Swaps Requirements

- Recordkeeping
- Documentation
- Reporting
- Clearing (if mandated) and exchange trading (if available)

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