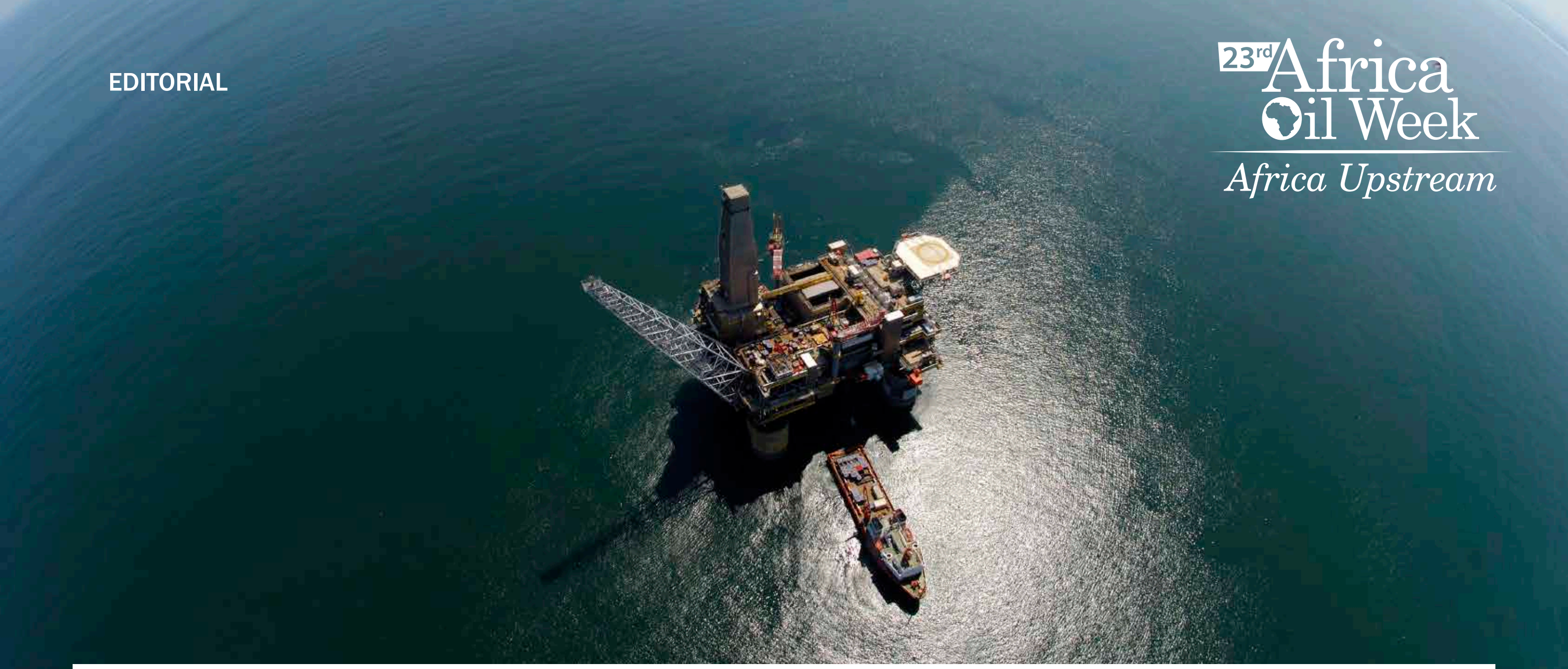

Prepayment Financing in Challenging Times

As E&P companies feel the squeeze on their bank funding lines, could prepayment agreements from traders provide an alternative source of finance?

Low oil prices, regulatory changes and general uncertainty in the markets has prompted many banks to reassess their exposure to the industry. Since 2008, many banks previously involved in oil trading and financing can no longer participate for regulatory reasons. Then, in some cases, banks were pre-financing as if they were traders and they could do this successfully because their cost of money was lower than other market participants. Some of these banks even owned storage facilities, however, since the banking crisis the regulators have forced the banks to dispose of these assets. Yet for those E&P companies with producing or near-producing assets, trader finance could be a practical alternative to fill this void.

Traders will typically prepay to producers whom they enjoy an existing trading relationship with, but some trading houses may have the risk appetite to prepay to entities with near-production assets, subject to certain assurances regarding production.

Structuring the prepayment

Commodity financiers may choose to involve a bank from the outset, or sell-down the risk post drawdown, in either case on a silent or notified basis. The latter approach can offer a speedy credit line to the producer, but the trader will need to ensure the documentation is bankable from the outset.

Documenting the prepayment arrangements

Typically, contractual documentation includes the following:

Prepayment agreement which may or may not incorporate the terms of the sale and purchase. If the commercial terms are not contained in the prepayment agreement, a separate sale and purchase agreement will be necessary. This agreement would include:

- Provisions dealing with the sum that may be drawn down (linked to the market value of the crude forecast to be produced) and how the prepayment is discharged (the application of a dollar value of crude delivered under the agreement).
- Financial covenants, which will usually include some form of cover ratio providing that the estimated value of crude oil is equal to or greater than the sum of the principle, interest and fees, plus a 'safety margin'.

- Provisions commonly seen in a loan agreement, although these provisions may be less onerous on the producer than bank finance documents, particularly where the trader is holding all/a majority of the risk.

Risk participation/loan agreement between the trader and a bank, whereby some (but usually not all) of the risk is apportioned to the lender in return for a cut of the margin/fees received by the trader.

Security package, which would typically include:

- Assignment over the delivery/prepayment agreement.
- Charge over collection accounts.

Ancillary documents, such as legal opinions, any necessary consents and a fee letter in the event the trader wishes to keep this element of the deal confidential.

Advantages and disadvantages to the trader in providing a prepayment facility

Not only will a trader benefit from the fees and interest it will earn on providing the facility, as well as securing deliveries, many traders find that the arrangement enables preferential terms relating to price and delivery of crude to be negotiated, plus it also strengthens the pre-existing relationship with the producer.

This can be further enhanced by inserting provisions into the prepayment agreement not usually seen in spot contracts, such as information covenants and commercial terms such as right of first refusals for new wells that come on-stream, or facilities such as storage terminals.

Of course, prepayments do have their disadvantages. Risks inherent in any finance transaction cannot be completely mitigated, and the trader will not usually be permitted to sell down 100% of the risk to the banks.

A key commercial risk to be borne in mind is that a fruitful relationship could be hampered should the bank wish to exercise its step-in rights in the event of, in the traders' opinion, a minor breach.

Advantages and disadvantages to the producer in using a prepayment facility

A producer will typically find that prepayment finance will be quicker to put in place than bank finance, since the trader will have a close relationship with the producer and a risk appetite geared to the commodity in question. For these reasons, traders tend to have softer information/financial reporting requirements than banks.

A producer may also look to trader financing as a way to diversify its lending base to reduce funding risk. Specific prepayment risks include the obligation in the prepayment to continue production - regardless of whether oil prices fall further - meaning that the producer could be selling oil at a loss compared to its costs.

Pre-2008, many traders could get financing from banks without putting up much capital. In essence, the bank looked through the transaction, and its ultimate source of security was to the substantial oil company selling crude. However, now traders have to put up a significant amount of equity, and this impacts on the margin ultimately paid by the producer.

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