



LATHAM & WATKINS<sup>LLP</sup>

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# Webcast

## DrillCo Transactions

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# Agenda

- What is a DrillCo, and what Inspired It?
- Recently Announced DrillCo Transactions
- DrillCo Structure
- Typical Terms
- Benefits of Transaction to Operator/Investor
- Inhibitors to DrillCo Transactions
- Typical Transaction Documents
- Governance
- Budgeting
- Security for Investor's Obligations
- Potential Off-Ramps
- Earning/Reversion of Interests
- Transfers of Interests
- Provision of Services
- Marketing/Hedging
- Other Issues

# What is a DrillCo?

- Not a “Co”
- Not a cookie cutter transaction- structure tailored to needs of parties
- Resembles drill to earn structure- generally no up-front cash consideration paid by Investor
- Basic structure involves contribution of development acreage by Operator and cash by Investor
- Can cover either a large or focused area

# What Inspired DrillCo?



CLV5 Comdty (WTI CRUDE FUTURE Oct15) Price and Volume Daily 01JAN2014-02OCT201

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# Recently Announced DrillCo Transactions

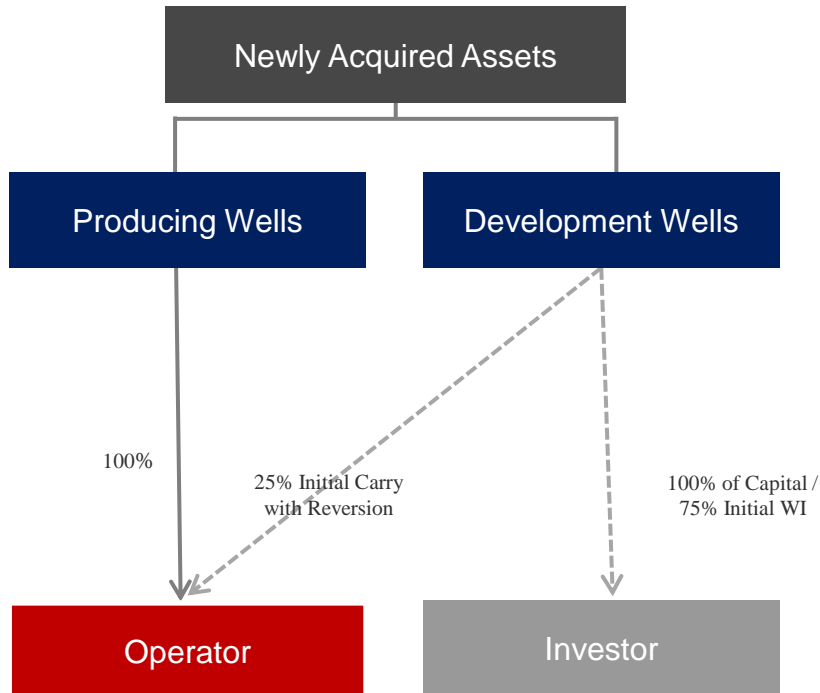
- Linn-GSO:
  - execution of transaction announced July 2015
  - GSO to make \$500MM available over 5 years
  - No defined geographic area
  - GSO to receive 85% WI, and will carry Linn's 15% WI
  - Upon Investor achieving 15% IRR, 80% WI (8/8ths) of GSO to revert to Linn

## Recently Announced DrillCo Transactions (cont.)

- Legacy-TPG:
  - execution of transaction announced July 2015
  - TPG committed to fund \$150MM available for up to 3 years
  - Permian Basin focused
  - TPG to initially receive 85% WI and will carry 60% of Legacy's WI
  - Multiple reversion scenarios based on TPG's ROI and IRR

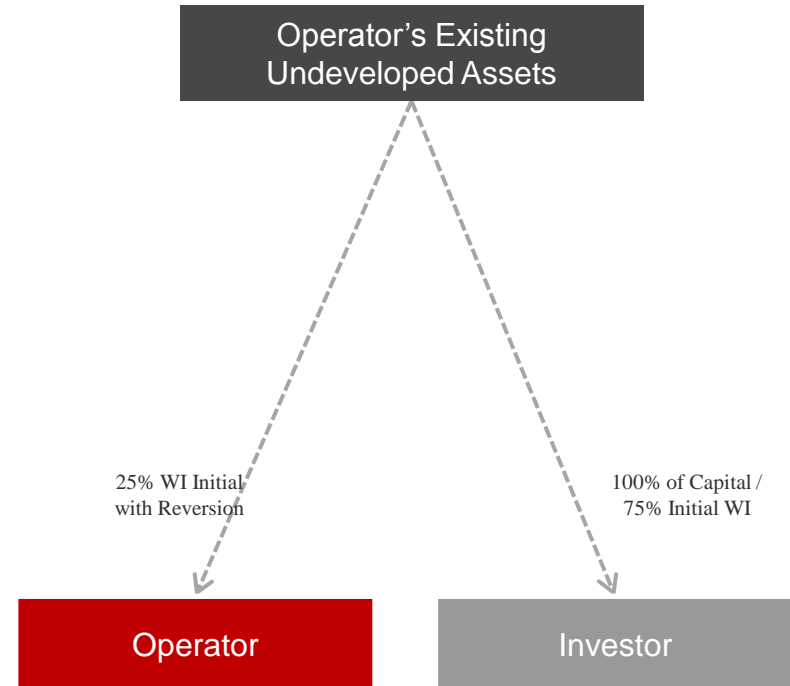
# DrillCo Structure

## OPTION #1 | Operator Acquires New Assets



- Operator pays for 100% of Acquired Assets, which include Producing Wells and future Development Wells
- **Producing Wells:**
  - Operator receives all PDPs
- **Development Wells:**
  - Investor Funds 100% of D&C costs on Development Wells in exchange for an 75% working interest in these wells (Operator receives a carried 25% working interest)
  - After Investor achieves a 14% IRR on a well-by-well basis, Operator's working interest in Development Wells increases to 75% (Investor's working interest falls to 25%)

## OPTION #2 | DrillCo Funds Existing Assets



- Operator uses DrillCo to fund development of assets within its existing portfolio
  - Investor Funds 100% of D&C costs on Development Wells in exchange for an 75% working interest in these wells (Operator receives a carried 25% working interest)
  - After Investor achieves a 14% IRR on a well-by-well basis, Operator's working interest in Development Wells increases to 75% (Investor's working interest falls to 25%)

# Typical Terms of a DrillCo Transaction

- Contribution of development acreage by Operator (retains any associated PDPs)
- Investor acquires working interest in wells drilled
- Investor pays for its working interest share of development costs and some or all of Operator's working interest share of development costs
- All or a portion of the Investor's working interest reverts to Operator upon Investor realizing an agreed IRR on investment



# Benefits of DrillCo to Operator

- Excellent structure for Operator with assets with development potential and limited access to capital
- Serves as an off-balance sheet development tool for Operator
- Benefits are even greater for MLPs:
  - Allows MLPs to participate competitively in acquisitions of less mature assets
  - Allows MLPs to develop inventory as feedstock for drop-down transactions
  - Avoids direct exposure to steeper decline curve
  - Assets can be dropped into MLP when “ripe”

# Benefits of DrillCo to Investor

- Generally, DrillCo structure is tailored for private equity investors
- Lots of capital chasing opportunities- DrillCo can provide for significant capital deployment
- Opportunity to leverage expertise of public company management and resources not readily available to private equity investors
- Structures usually involve ROI/IRR thresholds which are familiar to private equity investors

# Inhibitors to DrillCo Transactions

- Commodity Prices
- Inability of Operator to fund- no “skin in the game”
- Lack of suitable assets
- Fundamental disagreement about level of control afforded Investors

# Typical Transaction Documents

- Joint Development Agreement
- Form of JOA
- Initial Work Program and Budget
- Form of Assignment (which contains reversionary language)
- Form of Memorandum of JDA/JOA
- Management Services Agreement
- Tax Partnership Agreement

# Governance

- Addressed in JDA
- May utilize an Operating Committee, similar to those used in international JOAs or large-scale shale joint ventures
- Most important function is approval of work program and budgets

# Budgeting

- Investor will typically have a cap on total investment
- Investor commitment may be required to be used (if at all) within a certain timeframe
- Typically contemplate approval of annual work program and budgets

## Budgeting (cont.)

- Initial work program and budget generally approved upon execution of JDA
- Annual work program and budget typically provides for small deemed approved overages
- Possible to have multi-year work program approved upon execution

## Budgeting (cont.)

- Investor usually required to do most of its diligence on assets prior to approval of annual work program and budget
- Investor may want approvals over certain items within an approved work program and budget
  - E.g.- on AFE basis, over wells not meeting certain criteria, etc.
  - Operators are obviously reluctant to grant such rights
- Will need to address third party proposals, as well as unobtained consents, maintenance of uniform interest provisions and exercised preferential rights



# Security for Investor's Obligations

- Some Operators may not require, or Investors may not be willing to provide, security
- Parent Guaranty
- Letter of Credit
- Escrow Arrangement (Certain amounts paid into escrow in advance)

# Potential Off-Ramps

- Potential Off-Ramps:
  - Investor may negotiate for right to pull out on periodic basis
  - Potential suspension of activities/funding commitment for certain commodity prices
  - Initial production targets not being achieved
  - De facto off-ramp for subsequent development- failure to agree annual work program and budget

## MCLE Code

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**All Participants will need to record this code on the MCLE Activity Form to receive MCLE credit for viewing this program. Download the MCLE forms (if you haven't already done so) from the "Additional Resources" section.**

# Earning of Interests

- Interests are assigned to Investor upon earning events, which generally relate to completion of well and payment of associated costs
- Earned interests are wellbore only and depth- limited
- May be assigned on a well-by-well basis, or on a periodic basis

# Reversion of Interests

- Generally, some percentage of working interest assigned to Investor reverts upon achievement of certain hurdles based on ROI and/or IRR
- Costs to be included in calculation of hurdles must be carefully defined
- Hurdles are calculated on “tranches” or “series” of wells- usually relate to wells within an annual work program and budget
- Reversion is automatic upon occurrence of hurdle, though Operator will require documentation recognizing event to be filed of record

# Transfers of Interests

- Investor may restrict Operator transfers in wells until wells are drilled or hurdles achieved
- Operator will generally restrict transfers in wells until all development costs are paid
- Investor may also want tag rights, and Operator may want drag rights, which implicate valuation issues
- Operator may also desire ROFRs or ROFNs, especially Operators that are MLPs

# Provision of Services

- Investor may require Operator to provide certain services in connection with DrillCo activities
  - Might include accounting, regulatory, engineering, land services
  - May require specific reporting requirements
  - Might also request special assistance in a sale process
  - Operator will be entitled to cost reimbursement and may be entitled to an additional fee- do such amounts count against IRR?

# Marketing & Hedging

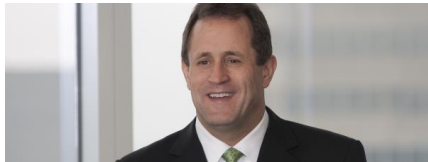
- Operator will usually want to market Investor's entitlement
- Investor may want to reserve right to take in kind
- Each Party hedges for its entitlement to production
- Are hedge outcomes included in hurdle calculations?



## Other Common Issues

- AML- should Investor have right to participate in other operations in the vicinity of DrillCo operations?
- Drainage- if no AML, should Operator's right to conduct certain operations in the vicinity of DrillCo operations be limited?
- Title- should Investor have any remedies for title issues discovered post approval of an annual work program and budget?

# Questions



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