

O'LEARY'S LAB I: FINANCING ENERGY EXEC'S PERSONAL INVESTMENTS IN OIL & GAS PRODUCTION

Energy series resource: Lessons in credit granting and credit structure

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This is a companion to Ed O'Leary's series on energy lending issues, which began with "Banking The Oil Field: Looking Back And Looking Forward."

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Many oil and gas producers have borrowing needs in multiple facets of the oil business. For example, it is rare that any experienced oil and gas executive is not a periodic or frequent investor in the drilling of oil and gas leases for his or her own account. This generates cash needs to participate in each well at the time it's drilled with cash up front--before the drill bit starts to turn.

Five Cs in energy lending

If oil or gas is found, then there is another round of cash calls for completion costs.

The original need for the initial drilling costs may be relatively easy or very difficult to finance, depending on several factors. If the borrower has little or no equity in his business or little personal liquidity, the difficulties are the same whatever the ultimate purposes of the credit. But if there's equity and liquidity, often the loans are available consistent with standards for the industry which really amount to an application of the Five Cs of Credit--as applied in context to the oil and gas industry.

"Completion" costs means that there has been a discovery. While the extent of the strike's economic value is not usually readily determinable at that stage, there is often a disposition by the bank to loan the money for completion of the

borrower's ratable portion of those costs.

The easiest situation to finance is the participation of a borrower who will acquire an economic interest in a successful completion where that borrower has a portfolio of producing properties.

Mineral interests are subject to physical appraisals. While to a layman the process may seem like a black art, it is surprisingly objective if the appraiser (or reservoir engineer) is independent and competent.

Like a real estate appraisal, an oil and gas engineering report is not necessarily precise. But it is representative of the value in approximate terms. Since all such borrowings are normally "marginied," there is always equity if the factors have been evaluated properly and if downward collateral price volatility is moderate or absent.

A few words about credit structure in energy country

I recall many situations in Midland where drilling company operators had significant portfolios of producing properties and needed to borrow to participate in ongoing drilling activity on their leases. Separately, they needed funds to periodically acquire drilling rigs for their "fleets" and perhaps operating credit facilities to provide for occasional working capital needs.

These needs represent three separate types of credit--drilling of leases, capital equipment purchases, and operating capital.

We had credit policy guidelines in place that we expected each borrower of funds for capital equipment to have tangible equity of 25 % in each equipment financing. These needs could be met by equity in producing oil and gas properties--so long as they were pledged as collateral and had been evaluated by independent engineers satisfactory to the bank within the past 12 months.

Too often, starting in 1983, we ended up with security interests in drilling rigs that were "stacked" (not operating) due to lack of rig demand. This was normally a function of the price of the oil and gas commodity. In periods of price declines, drilling activity often softened. By 1983, rig demand collapsed.

What good was 25% equity in a rig financed 18 months before, that now had no prospects for work for the foreseeable future?

How do you protect the bank against that sort of eventuality?

What happens if the price of the commodity, oil and gas, declines rapidly shrinking the equity available in the producing oil and gas properties pledged as collateral?

How can price volatility be anticipated?

What sort of structures can be put in place to protect the bank while making capital available for productive purposes by oil and gas industry participants?

Ponder those questions. I'll be getting back to you on them.

As this series continues Ed welcomes comments and questions from banker in the energy sector or who are looking at it from afar.

Use the comment section below.

About Ed O'Leary

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas,

Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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