

Sam Gandhi:

It's been the perfect storm for energy companies. Just as the Coronavirus has the whole world in crisis, and has destroyed the demand for fuel, an oil price war is now further undermining global markets and roiling the business world. The resulting turmoil is raising significant legal issues for the energy industry, from slacking demands and quarantines, to revenue hits and volatile markets. How can energy companies navigate the storm? We'll find out in today's podcast.

Cliff Vrielink:

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With commodity prices falling, there is an incentive among parties to reexamine their contracts. The Force Majeure clause may be helpful to those trying to not perform, but the payment obligation may still remain. Consolidation has to solve this problem. So, companies have to merge. Companies have to go through restructurings. There have to be fewer people in this industry.

Sam Gandhi:

From the international law firm, Sidley Austin, this is the Sidley podcast, where we tackle cutting-edge issues in the law, and put them in perspective for businesspeople today. I'm Sam Gandhi. Hello, and welcome to this special edition of the Sidley Podcast. Sidley's been responding to the Coronavirus crisis with some timely and informative guidance. It's aimed at helping businesses cope with the fast-changing international landscape.

You can find these in our special COVID-19 Resource Center at [sidley.com](https://www.sidley.com), and we'll have more on that at the end of this podcast. Today, we focus on the energy industry with Sidley partner Cliff Vrielink. Cliff is the global head of Sidley's Energy and Infrastructure practice, and the office managing partner of our Houston office. He has more than 20 years of experience advising private equity groups as well as companies, both public and private, involved in or investing in the energy industry, and he joins us today from our Houston office. Cliff, it's great to have you with us.

Cliff Vrielink:

Thank you, Sam. Great to be here.

Sam Gandhi:

Cliff, energy companies, like those in many other industries, have already been dealing with the impact of the Coronavirus, but the energy companies have been particularly affected, when the virus outbreak destroyed the demand for fuel, initially in China. But now, with the Saudi announcement last weekend about their production, we now have a price war in the global oil markets that sent the price of crude plummeting. So, what has this confluence of events meant to the energy industry?

Cliff Vrielink:

Well. It's been it's been a tough blow for the industry. It's already been a bit of a roller coaster the last few years. You may recall, in 2014, there was a big drop in commodity prices, and that was really, driven by the supply side over supply in the U.S. OPEC and working with Russia has really helped get the pricing back in line, as well as a lot of the reactions in the U.S. at that time, but the Coronavirus has been a really tough blow, because it's dropped demand, as you said, from China, which really lead to a price decrease, and then this disagreement, or schoolyard spat, between Russia and the Saudis has really exacerbated that.

For oil and gas companies that were trying to keep alive at a lower price deck, that had already cut service costs, that had already looked at their capital structure, to now see this price collapse has become really, really hard. It's widely viewed that 40-dollar oil, or 50-dollar oil is kind of the floor of what's profitable, or where companies can really break even, and with prices falling into the 30s, it's hard to see how many producers can continue to operate without some kind of drastic actions.

Sam Gandhi:

What are those drastic actions that they would have to take?

Cliff Vrielink:

Well. That's a great question. What are the drastic actions? Because as I mentioned previously, people really cut service costs. People really try to reduce their debt. On top of that, you have some really big events looming

on the horizon. For instance, the North American oil and business has 86 billion dollars in debt due in the next four years, 22 billion of which has to be refinanced this year, according to S&P Global. So, not only are cash flows impacted, but how are companies going to refinance in light of this, at this lower price deck?

So, consolidation is really, something that seems very logical, but it would probably have to be on a cash-free basis, and then of course, restructuring is something that a lot of companies will have to face.

Sam Gandhi:

And so, for investors who are looking at the energy markets, then, are there certain companies in the energy industry that are more affected than others?

Cliff Vrieling:

Certainly. The companies that are in the higher cost basins, where it's more expensive to produce oil, of course they're impacted more. Companies that already have ongoing production, that steady cash flow, for the longer term, are in better shape. So, shale production, for instance, comes on very strong, and production drops very quickly. Companies focusing on the shale have to continue to invest. Otherwise their production runs out. So, those companies in particular are really going to be in a tough spot, and then of course, depending on the death load, and the maturities, you can identify some of the companies that are in more trouble than others.

Sam Gandhi:

Three, four years ago, when we had the previous significant oil drop, you saw a lot of companies hedging their exposure. Can they do that this time?

Cliff Vrieling:

Well. A lot of companies do have hedges in place. What's curious is actually, a couple of them just announced recently that they've sold out of their hedges. They've decided to just cash it out and go unhedged. At this point in time with prices in the 30s, not sure anybody wants to spend money to hedge. It seems like if that's not economic, there's not a lot of benefit to it. To the extent you have a hedge position, that gives you some cushion, but those will run out, as well. You know, the other interesting thing on the hedging topic, since you raised it, is there's a lot of exposure

out there right now, probably trillions of dollars of hedge exposure, that's going to get called, and just like in '08, '09, the market is very sophisticated and very opaque, and it's not clear where all that exposure sits. So, it will be interesting to see also, over the coming months, where that exposure is, whether there's incredible concentration of that risk, and of course, everybody should look into the credit counterparties.

Sam Gandhi:

Let's talk a little bit about that. You know, we're talking about the...a lot of industries have been impacted by the Coronavirus. None really more so than the energy industry, but the last statement you said about, oh, their credit counterparties being affected, are there any other industries that are pretty uniquely going to be affected by what we see in the decline in the energy industry?

Cliff Vrieling:

Two-part answer. One is within the energy landscape. I think the oilfield service companies are probably going to be the most affected, because of course, they service the industry, so, they send teams out into the fields, send teams out internationally. A lot of their services are going to be cut in a cost-cutting environment, and to the extent they're not, to the extent they're quarantined in different jurisdictions, that of course affects their ability to get out and serve those clients.

From the producer's perspective, that's your issue, as well, because if your service provider can't get out there and service your wells, can't provide maintenance...you have to think about these things, you have to think about ordinary maintenance, you have to think about emergency services. So, the oil field service sector is probably hit the hardest. In terms of counterparties, now, I think a lot of industry will actually benefit from oil prices falling, of course, because it's an expensive cost item.

The airlines, for instance, struggling with their own issues on the demand side, but at least their fuel costs go down. So, while the oil and gas sector is really going to bear the brunt of this, their pain will probably help some other industries.

Sam Gandhi:

And one of the things we've seen, is that the companies in the energy space, and in most spaces lately, have seen there, a sharp drop in their share prices. So, what issues does that raise for them, and frankly, what can they be doing to deal with it?

Cliff Vrieland:

It exacerbates the situation, because the capital markets have already been very much closed to the oil and gas space for other reasons, and now with the collapse in equity prices, it's even harder to go to the equity markets. You know, typically when equity prices fall, companies worry about activists, and activists have been active in the oil and gas space.

So, it's possible that this could lead to an increase in activity. Having said that, it's not very clear what better strategies are, in light of a complete collapse in commodity prices, but to the extent producers haven't done so, they really should always be prepared, and be pro-active, and think about how to respond to different constituents, that might come knocking on their door.

Sam Gandhi:

Do you see, with the decrease in share prices, potential for consolidation, M&A activity, to stave off potential restructuring and bankruptcy?

Cliff Vrieland:

Absolutely, and of course, there's a lot of speculation about the super majors in particular. The companies that are very large and stable, and that will weather the downturn, and whether they don't take advantage of this. In the upstream producer side, and the service sector, there are three or four huge service companies that could take advantage of the downturn and really swoop up or scoop up a lot of their competitors. There question there, of course, is what price is the right price?

What's low enough? And then the other question, particularly in the oil and gas space, is in a lot of instances, you don't necessarily want to buy other companies, you'd rather just buy their assets. So, while a lot of...there probably will be a lot of consolidation, there likely will be pretty significant cuts in employment, and head count, and offices, and the like, which will of course have a lot of impact on a lot of economies.

Sam Gandhi:

This is a special episode of the Sidley podcast. Our quick take on fast-moving events in the corporate world, affected by the Coronavirus. We're speaking today with Cliff Vrielink, a partner in our Houston office, and the global head of our Energy and Infrastructure practice, about how energy companies can best deal with the twin shocks of the oil price war and the Coronavirus crisis. Cliff, do you see any government actions having effect on the energy industry? Like, for instance, do you see them fast-tracking M&A activity to try to stave off some of these bankruptcies?

Cliff Vrielink:

At this point, we haven't heard anything, and I'm not sure that I necessarily see the government fast-tracking any kind of approvals. The typical government actions that all industries have seen around quarantines, and you know, limiting travel, and the like, of course impact the oil and gas industry just like any other. The issues that are bit more acute, are the maintenance and safety of oil and gas production.

Refineries, for instance, and a lot of different production platforms and the like. Quarantines could be a serious issue there. So, we've seen companies start thinking about segregating their teams. So, that if somebody does get infected in one location, they'll have a parallel team in another location, and coming up with other contingency plans, and while those are prudent for companies to take, the other thing to think about is what happens if you contract for certain services, and that service provider starts having issues, either with the virus or with a travel ban? So, again, companies should be thinking proactively, how those government actions could affect their production.

Sam Gandhi:

So, let's talk a little bit about contracts. You brought brought up counterparty risk, and contract risk, but what are the contract issues that are arising in these times, as a result of both lower oil prices, but also kind of a significant decrease in share prices?

Cliff Vrielink:

Right. So, there are a couple of things that are happening. One is the legal, the other is the commercial, right? So, the commercial issue is with product prices falling, commodity prices falling, there is an incentive among parties

to reexamine their contracts, and perhaps consider seeing if there's a way to get out of them.

So, from the commercial side, I think the incentives have shifted dramatically overnight, and of course that drives behavior. From the legal side, the Coronavirus presents a lot of interesting legal questions, in particular, Force Majeure clauses. We've seen parties asking us to analyze whether or not those could be invoked in these situations. For instance, if there's a supply source that's impacted by the virus, does that allow a party to get out of its contractual obligations? And in the energy space, well in any legal contract, of course, the language really is what makes the difference, but in the energy space, there are a couple of issues we've already analyzed that are interesting, with respect to how the Coronavirus could impact it.

For instance, the NAESB contract, which is the base form contract used for the purchase and sale of natural gas, there's some case law around the NAESBI contract that says, the loss of a particular transportation path, may not excuse performance, unless the contract is specific about that provision. So, that's a situation where you would want to analyze your contract and look at the case law in the jurisdiction. Pipeline transportation contracts, the TSAs, they in fact, permit performance to be excused by Force Majeure, but not payment. So, the Force Majeure clause may be helpful to those trying to not perform, but the payment obligation may still remain.

So, it's a complicated analysis. In each case the jurisdiction matters, and the contractual language matters.

Sam Gandhi:

Does insurance help at all with these cases? It may or may not be a Force Majeure. The question is whether there's a revenue gap or a failure to perform, or something. Does an insurance kind of cover any of these?

Cliff Vrieland:

You'd like for it to work, of course. You'd like for it to provide coverage, but the insurance companies have been focused on epidemics for a while, and we've seen a lot of...their insurance products already have carveouts for epidemics, and to the extent they don't, we would expect to see that, in

fact, in rep and warranty insurance, which is a common product in the M&A space.

Now, those...we are now seeing additional clauses added to those policies, that specifically carve out these types of viruses. So, again you have to look at the actual policy, but in most cases, I think the insurers have already tried to accept, have tried to carve out, these types of epidemics as a Force Majeure or act of God type of event.

Sam Gandhi:

So, you've been doing this for a long, long time. You've seen a lot of changes in oil prices, and the volatility in the market. Where do you see this coming out in the near future? At some point, the Coronavirus crisis with ebb, but it seems like there's some lasting impact on the energy industry.

Cliff Vrieling:

You're right about that, without a doubt. The demand shock has been profound, but that will, over time, you know become less severe, but the supply problem at the oil and gas industry has persists, which is, there's just overproduction, and that's what we're seeing between the Saudis and the Russians, and of course North America has become one of the largest exporters of oil and gas.

So, where does this play out over the long run? There's pretty widespread agreement that consolidation has to solve this problem. So, companies have to merge, companies have to go through restructurings. There have to be fewer people in this industry. The nice thing about the oil and gas industry and one of the reasons I really like working in it, is it's a very resilient industry, and it does go through these peaks and valleys.

This is a tough valley, with the supply and the demand side, both. It's been particularly tough. Additionally, the industry has become much more sophisticated over the last few years and has already taken a lot of the steps that you would take in a crisis. They've already taken a lot of the costs out of the system.

They've already tried to reduce, their, you know, their debt expense. So, this is a really tough body blow, but eventually, after some consolidation, after some restructuring, when pricing returns to a more normalized level,

the industry will adjust. There's still tremendous demand for oil and gas throughout the U.S., and globally, and the U.S. industry is very resilient and prepared for it, but this will be a tough chapter to get through.

Sam Gandhi:

You've been speaking with Cliff Vrielink, a partner in Sidley's Houston office, the global practice leader of Sedley's Energy and Infrastructure practice, and the office managing partner of the Houston office, and we've been talking about the impact of the Coronavirus crisis, and the oil price war on energy companies. Cliff, events are moving really fast right now, and I appreciate you putting it all in perspective for us today. Thanks.

Cliff Vrielink:

My pleasure, Sam.

Sam Gandhi:

Before we wrap, a word about Sidley insights, the contents section of our website. We've set up a special page, with a COVID-19 Resource Center. You can read articles related to various legal issues impacted by the Coronavirus crisis including the effects on merges and acquisitions, securities disclosure, environmental law and contract disputes, and we're going to be posting in the coming days, and we're planning future podcasts, too. You can found our COVID-19 resource center by going to [sidley.com](https://www.sidley.com). you've been listening to Sidley podcast. I'm Sam Gandhi.

Our executive producer is John Metaxas. You can hear more episodes at [Sidley.com/sidleypodcast](https://www.sidley.com/sidleypodcast), or subscribe on Apple Podcasts, or wherever you get your podcasts.

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