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INSIGHT

Oil price volatility - risks and opportunities in 2015

February 4, 2015 | written by Philip Mace and Michael Wachtel

Update 3 - Legal issues arising in the E&P sector

In recent years, Africa and other developing markets have been a major focus for a significant number of small/mid cap E&P companies. However, with oil prices at their lowest for over five years, and indications that they may stay at this level for some time, E&P companies and the governments of the countries where they conduct their exploration and production activities are now assessing their options.

For small/mid cap players the prospects for raising substantial capital either through debt or equity financing are extremely tough or non-existent. At the same time, E&P companies are bound by the work commitments agreed to in their contracts with host governments (in most cases production sharing contracts (**PSCs**)), and perhaps budgets approved before the extent of the price fall was known. Unsurprisingly, insolvency and consolidation in the sector is now occurring as companies face the possibility of not meeting the PSC conditions and the prospect of their subsequent termination and forfeiture.

From the government's perspective it could be the case that by causing the incumbent to forfeit its PSC or licence, the government would find itself with a block which no new entrant is willing to take on, or for which potential new entrants request reduced work commitments and extended exploration periods. In short, the government could be swapping delays on the part of the existing PSC holder for potentially longer delays and reduced work commitments. Certainly for the duration of any gap, the government will not be paid any applicable rental fees or contributions to their training and development budgets as required under the PSC. These payments are often important sources of hard currency particularly in countries where oil and gas production has yet to start. Also companies that are forced to exit will lay off all locally hired staff and contractors and the resulting unemployment may not be short-lived with the attendant political cost and implications.

As it is not necessarily straightforward for a government to enforce its rights and achieve a quick and easy clean break, there may be an opportunity for the renegotiation of commitments.

Resulting legal issues:

1. **Limitations on, or consents required due to, a change of control, asset disposal or the creation of security:** this is an issue applicable to both debt and equity financing depending on the structure and the creation and/or enforcement of any security.
2. **Solvency:** is the company insolvent either under legislative definitions or as defined by any contractual undertakings? Have any prior covenants been breached as a result? Do breaches cause cross defaults under any other agreements and what are the implications?
3. **Employment issues:** are redundancies required? What is the process? How can terms of employment be amended to minimise redundancies? Do employees automatically transfer to the buyer of an asset, and if so, what are the consequences?
4. **Corporate and directorship issues:** what are the duties of directors? What is their personal liability? Will any personal liability of directors be covered by D&O insurance? What corporate authorisations are required for transactions and/or commercial renegotiations?
5. **Contractual and commercial issues:** how can you be sure that renegotiation of contractual terms is binding and effective? What local approvals are required? Are there any regulatory issues, for example, is competitive retendering required? Does a sustained drop in the oil price constitute, or could it lead to, an event of force majeure, and if so, would any relief be available as a result?
6. **Litigation:** is any protection available through investment treaties? How can the chances of a successful arbitration litigation be maximised? What is the best way of trying to ensure that enforcement of an award or judgement is achieved? Does litigation or the threat of it cause any agreement warranties to be breached and if so what are the consequences and how are they most effectively mitigated?

Fundamentally, oil companies and investors will be assessing the ongoing viability of financing their investments. Whether the decision is made to raise equity, debt, a combination of the two, manage the portfolio or renegotiate contracts or commitments, the considerations highlighted above will be prominent in the thinking of all company directors and senior managers. To make the best possible decisions, expert legal advice will be required. Our lawyers are experts in their chosen practice areas who focus their practices in the oil & gas sector. They have previously dealt with all the issues now faced by companies, shareholders and governments in the oil & gas sector and are therefore uniquely placed to provide cost effective, focused and value-adding legal advice. Please click here for further information on our global oil & gas group.

This update is the third in our series on the impact of oil price volatility. To read the previous update, please click here.

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