

THE VPP: A PORT IN A STORM

“Neither a borrower nor a lender be; for loan oft loses both itself and friend, and borrowing dulls the edge of husbandry.” So said Shakespeare’s Lord Polonius in *Hamlet*. Who knew a medieval playwright could provide prescient advice for the modern economy?

The tempest developing in commodity and credit markets presents a midsummer nightmare for oilmen seeking shelter from a pending storm. Indeed, a modern day Lord Polonius turned oil and gas investor might use the same lines to pontificate on the virtues of a volumetric production payment (VPP) or a net profits interest (NPI) to monetize a few years of oil and gas production at high per-barrel values to fund the redemption of floating-rate, short-term debt.

Interest rates and oil prices have moved to the extreme ends of their respective ranges. Interest rates languish near the bottom of their multi-decade range, with 10-year Treasuries arguably yielding less than the inflation rate—a temporary phenomenon, to be sure.

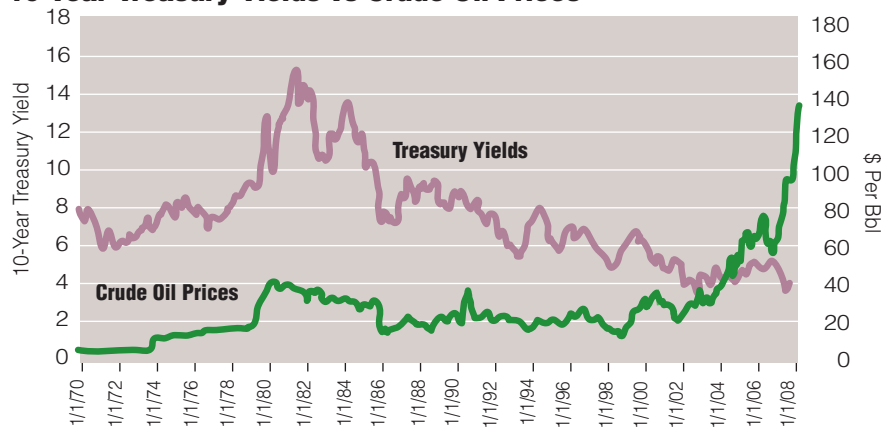
Oil and gas, on the other hand, have never traded higher, with near-month oil and gas quoted on the Nymex at \$135 and \$13, respectively, as of early July. Some might infer from this alignment that a perfect storm of opportunity exists for a producer to issue a VPP and use the proceeds to deleverage.

How will the current commodity-price cycle unfold? It is, admittedly, unfolding pretty much right on schedule with the oft-predicted peak in global oil production. But a recent stroll down Denver’s 17th Street among buoyant producers was noticeably juxtaposed with more motor passengers riding scooters than Ford F-150s. While peaking happens, demand destruction clearly happens too.

From a historical perspective, oil and gas producers need look no further than the period between 1979 and 1983, when the second oil shock of the U.S.’ last energy crisis led to a 15% decline in global oil consumption, from 62.1 million barrels per day in 1979 to only 52.6 million in 1983. And while growing demand from China suggests it’s different this time, that country recently curtailed fuel subsidies, leading to an immediate 18% fuel-price jump, and demonstrating that price signals may penetrate a managed economy from which 21% of U.S. current account deficit financing comes.

Low U.S. interest rates rely on such foreign injections of capital. In fact, the U.S. Treasury Department reports that 39% of foreign purchases of stocks, bonds and government securities come

10-Year Treasury Yields vs Crude Oil Prices



from emerging nations that are thriving on U.S.-dollar-pegged exports to American consumers, and that substantial additional inflows arrive via European accounts funneling Middle Eastern petrodollars back to the U.S.

The dollars leave and then they come back. So, as the U.S. consumer responds to high fuel prices by swapping the pickup truck for a scooter, the parallel risk is that the font of complacent cash settling for low bond yields may dry up.

Again, the period from 1979 to 1983 may prove instructive. Back then, oil demand plummeted while interest rates soared. The average long-bond yield rose from 9.3% in 1979 to 12.8% in 1982, as investors sought fixed-income yields above a runaway inflation rate. During that run, high oil prices preceded high interest rates, and high interest rates preceded low oil prices.

Another literary commodity and credit expert, Mark Twain, once offered even more enlightened insight on the matter at hand. “History,” he said, “does not repeat itself; it rhymes.” So what’s an oil producer to do?

This decade, friendly commercial bankers have supported oil producers with the low-cost capital through borrowing-base lines of credit. To be clear, these are short-term demand notes priced at short-term floating rates used to finance long-term assets. These notes have fueled a nine-year run of compounding equity returns for producers’ growing cash hoards, which have fueled more drilling, reserve replacement and a rising shareholder-equity value against a backdrop of sideways interest rates.

But if history rhymes, this same trend could reverse, temporarily draining shareholder equity as an air pocket in commodity prices meets credit-market turbulence.

Commercial bankers wisely address commodity-price risk by using borrowing-base commodity-price assumptions that are only half the current Nymex strip prices.

Commercial bankers also eschew interest-rate risk. If interest rates go up, they raise their rates too. So producers seeking value preservation over growth may find that a VPP provides safe harbor in a stormy time for oil prices and interest rates.

VPPs involve hedging, and many a producer is writing humongous hedge-settlement checks this summer due to the extraordinary commodity-price up-trend. And borrowing-base lines of credit award producers with greater advance rates if they’ve hedged downside price risk. But these hedges devour credit capacity, and in any event, they ignore interest-rate risk and changes in general credit conditions. A VPP can insulate a producer from these added risks.

The Rodman Energy Group used an old third-party reserve report to hypothetically compare a potential VPP advance with a typical borrowing-base, line-of-credit advance. The unhedged line of credit advanced at a rate of \$17 to \$18 per barrel using the current consensus bank-price outlook. Under a VPP structure, those same reserves were pushing advance rates on the order of \$100 per barrel.

Of course, such barrels would have to be sold, not leveraged, and a VPP would restrict subsequent access to the credit capacity associated with properties producing those barrels. But for the risk-averse oil producer, this trade merits a closer look.

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