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## **I. INTRODUCTION: THE GROWING NEED FOR ALTERNATIVE CREDIT STRUCTURES**

It was not long ago that credit provisions were merely an afterthought in wholesale commodity and derivative transactions. In the mid-1990s, the Base Contract for Short-Term Sale and Purchase of Natural Gas published by the Gas Industry Standards Board (the “GISB”) simply contained a one-paragraph adequate assurance provision, and many parties would enter into a Master Agreement published by the International Swaps and Derivatives Association (an “ISDA”) without the benefit of collateral margining protections afforded under an ISDA Credit Support Annex.

This relaxed attitude toward credit began to change in the late 1990s in response to various defaults by key industry players that occurred during such period. As a result, parties began to more closely scrutinize credit terms in commodity trading agreements and require a minimum level of credit support from counterparties to mitigate exposure, usually in the form of a parent guaranty supplemented by threshold margining via cash or letters of credit. While these structures offered trading counterparties some protection, a string of bankruptcies in the commodity industry in the early to mid-2000s tested the commodity industry’s reliance on guaranties as a form of dependable credit support. A number of guarantors issued guaranties that exceeded the applicable guarantor’s net worth and, in particular, the Enron bankruptcy demonstrated that a guarantor frequently was insolvent if its subsidiary trading company was insolvent. Market participants learned firsthand that guaranties did not always sufficiently protect against credit risks associated with a defaulting counterparty.

Since that time, as the commodity industry has lurched back and forth between company bankruptcies, the 2008 financial crisis and related credit downgrades of banks and commodity trading entities, companies have increasingly struggled to address two important credit-related issues:

- (i) the inability to post collateral to trading counterparties under physical and financial commodity transactions; and
- (ii) the inability to access credit markets in order to fund existing or new commodity operations.

As the cost of available credit continues to rise and managing trade exposure arguably has never been more imperative than in the current marketplace, commodity trading companies have been driven to re-analyze how they manage collateral flows and secure much-needed capital to fund operations. The purpose of this paper is to provide a high-level overview of two alternative transaction structures utilized by commodity market participants to address such needs: (i) first lien credit structures; and (ii) prepaid commodity swap transactions.

## **II. FIRST LIEN STRUCTURES**

### **A. Overview**

To the extent a commodity market participant previously has entered into a credit facility but has little or no cash or liquid credit to separately collateralize commodity trading operations,

a first lien credit structure may be useful. It is common in a secured transaction for a debtor to provide a lender with a lien on and security interest in an asset in order to secure the debtor's payment and performance obligations. However, in the commodity trading context, a "First Lien Credit Structure" specifically describes a form of credit support in which a debtor (the "Debtor"), under an existing credit and security agreement (the "Credit Agreement") relating to project-financed debt on a tangible asset (the "Asset"), provides a trading counterparty (a "Hedge Counterparty") with a first lien on and security interest in such Asset or other collateral set forth in the Credit Agreement (the Asset and any such other collateral being the "Collateral") to support the Debtor's obligations under the relevant trading agreement.

First Lien Credit Structures are particularly useful when lenders under the Credit Agreement (the "Lenders") are concerned about the repayment of the project debt due to potential market movements in a commodity related to the Asset. Frequent users of this credit tool are power plant owners who sell power generated by the Asset to Hedge Counterparties and owners of minerals in the ground who seek to hedge certain percentages of mineral production.

The Lenders allow the Debtor to provide a first lien on the Collateral as credit support to Hedge Counterparties when the products offered by the Hedge Counterparty reduce price risk or are otherwise necessary to the operation and financial viability of the Asset. To the extent that the Debtor purchases inputs from Hedge Counterparty that are necessary to run the Facility, such trading positions reduce the risk that the Asset will be unable to produce the relevant commodity. Similarly, if the Debtor sells the Facility's output to the Hedge Counterparty, then such relationship mitigates the risk that Debtor will be unable to find a purchaser for the commodity at a price sufficient to repay the project debt.

As for the Hedge Counterparty, the first lien on and security interest in the Collateral provides it with (i) equal priority of payment with the Lenders upon any liquidation of the Collateral, and (ii) some of the protections afforded to holders of a perfected security interest in the Collateral.

## **B. Types of First Lien Credit Structures**

First Lien Credit Structures can either stand alone as collateral in a transaction or supplement other forms of collateral, and they generally are used as credit tools in three distinct scenarios: (i) the first lien can wholly replace any other collateral obligations of Debtor under a trading agreement (a "Replacement Structure"); (ii) the Hedge Counterparty can assign a value to the first lien, establishing a fixed credit threshold limit for Debtor under a trading agreement, such that Debtor only provides additional collateral if Hedge Counterparty's exposure exceeds such threshold (a "Threshold Structure"); or (iii) the first lien can cover Hedge Counterparty's credit risk over and above the value of other collateral provided by Debtor (a "Tail Risk Structure").

In general, Debtor's preference is to employ a Replacement Structure because under such an arrangement, Debtor is not required to outlay any cash or provide a letter of credit or guaranty, making this structure cheaper for Debtor to implement than any other form of collateral. However, given that Hedge Counterparty receives no collateral to secure Debtor's obligations under a Replacement Structure other than the value of the first lien, this structure is

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