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HEDGING OIL & GAS PRODUCTION

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I. INTRODUCTION

The recent, dramatic decline in the price of oil illustrates the risk that every oil and gas producer has to declining energy commodity prices. This paper discusses various methods for “hedging” or reducing price risk. In particular, we discuss transactions and methods that enable a producer to transfer some or all of its price risk related to its oil and gas production to a party that is willing and able to take an opposite position and assume that price risk. Importantly, these hedge transactions mitigate an existing risk and are distinguished from speculative transactions under which a party assumes, rather than transfers, price risk related to a commodity in hopes that the future increase or decrease in its price will be in its favor and will result in trading profits. We will not discuss the use of over-the-counter or exchange-traded transactions for speculating on oil and gas prices.

In this paper we address why oil and gas producers hedge and provide an overview of over-the-counter and exchange-traded transactions. We also include a summary of the regulations mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act that are relevant to producers.

II. WHY HEDGE OIL & GAS PRODUCTION?

A well implemented hedging strategy can provide an oil and gas producer with important benefits. The primary benefit of hedging oil and gas production is the producer’s ability to reduce the impact of unanticipated price declines (known as price risk) on its revenue. Several methods exist that allow a producer to hedge its expected production against price risk. Some transactions, such as swap contracts, fixed-price physical contracts, and futures contracts (each discussed in detail below), have the effect of locking in the price the producer will receive in the marketplace for some percentage of its future production, but prevent the producer from benefiting if prices rise. Other transactions, such as put option contracts (discussed in detail below), have the effect of establishing minimum prices the producer will receive in the marketplace for its future production, which protect the producer from price declines while allowing it to benefit if prices rise, but require the producer to pay an upfront premium. Regardless of which method is chosen, hedging a percentage of a producer’s production against price risk can reduce the extent to which a producer’s revenue erodes in a downward market.

Appropriately hedging oil and gas production can provide a producer with a measure of financial certainty. The ability to lock in or establish a minimum price *in advance* that the producer will receive in the marketplace for a percentage of its expected production gives the producer the advantage of predictable revenue in a future period. This certainty allows a producer to service its debt, budget for drilling operations under its existing oil and gas leases, and plan for and fund future exploration and production activities and growth opportunities, even during a period of declining or volatile prices. Thus, hedging is a powerful financial management tool.

In some cases, producers may not have a choice about whether to enter into hedging transactions. Producers may be required to hedge a specified portion of their expected production by their lenders or investors. Lenders whose loans are secured by the producer’s oil

and gas reserves often require producers to hedge production to provide lenders with additional certainty that the producer will have steady and reliable revenue from its production and, as a result, be more likely to meet its debt service obligations. Likewise, investors may require producers to hedge as a means of maintaining the producer's revenue and increasing the likelihood that investors will receive adequate returns on their investment.

In broad terms, hedging transactions can be separated into two major categories: (i) over-the-counter transactions and (ii) exchange-traded transactions. A producer's decision to hedge using one or both of these categories must be made on a case-by-case basis depending on the sensitivity of its business plan and capital structure to revenue fluctuations; its appetite for risk; its liquidity; any lender or investor imposed restrictions or requirements; its degree of confidence in engineering projections of future production; and the timing, location, and amount of expected oil and gas production. Each category varies greatly in its processes, procedures, and risk. We explore the principal differences between these categories in the following sections and comment on the advantages and disadvantages that may influence a producer's hedging strategy.

III. OVER-THE-COUNTER TRANSACTIONS

Over-the-counter transactions are bilaterally negotiated between counterparties to meet each counterparty's specific risk and financial management strategies. With exchange-traded transactions (discussed in detail in Section IV), standardization limits a party's flexibility to hedge risk because exchange-traded contracts are one-size-fits-all instruments and a party must implement hedging strategies based on a narrow range of contract terms.¹

The ability to negotiate all aspects of an over-the-counter transaction gives an oil and gas producer control over how hedging transactions are structured, the exact quantity of production to hedge, the index price used, the collateral requirements securing the parties' obligations, the remedies in the event of a default, and so on. Over-the-counter transactions are especially useful for hedging producer risk because they can be used to hedge all or some of a producer's expected production farther into the future than may be practical with exchange-traded transactions. This flexibility allows the parties to structure a hedge that is highly correlated to the underlying commodity transaction and the business model of the producer.

Over-the-counter transactions are either financially or physically settled. Financially settled transactions result only in payment obligations between the parties, which are derived from the value of an underlying commodity as determined based on an agreed pricing mechanism. As the name implies, financially settled transactions do not involve the purchase or sale of a physical commodity. In many ways, they are less complicated than physically settled transactions, because they do not involve title transfer, transportation, quality, risk of loss, and other issues that must be considered with physical transactions.

* Jesse Lotay, Dan Nossa, and Paul Vrana are attorneys in the Energy Practice Group of Jackson Walker L.L.P. The authors would like to thank Carl Glaze and Caren Luckie for their valuable contributions to this paper.

¹ Michael Durbin, *All About Derivatives* 24 (2011).

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