a Supplement to

Oil and Gas Investor

Here's the Money: Capital Formation 2004

MAY 2004

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Oil and Gas Investor

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Here's the Money: Capital Formation 2004

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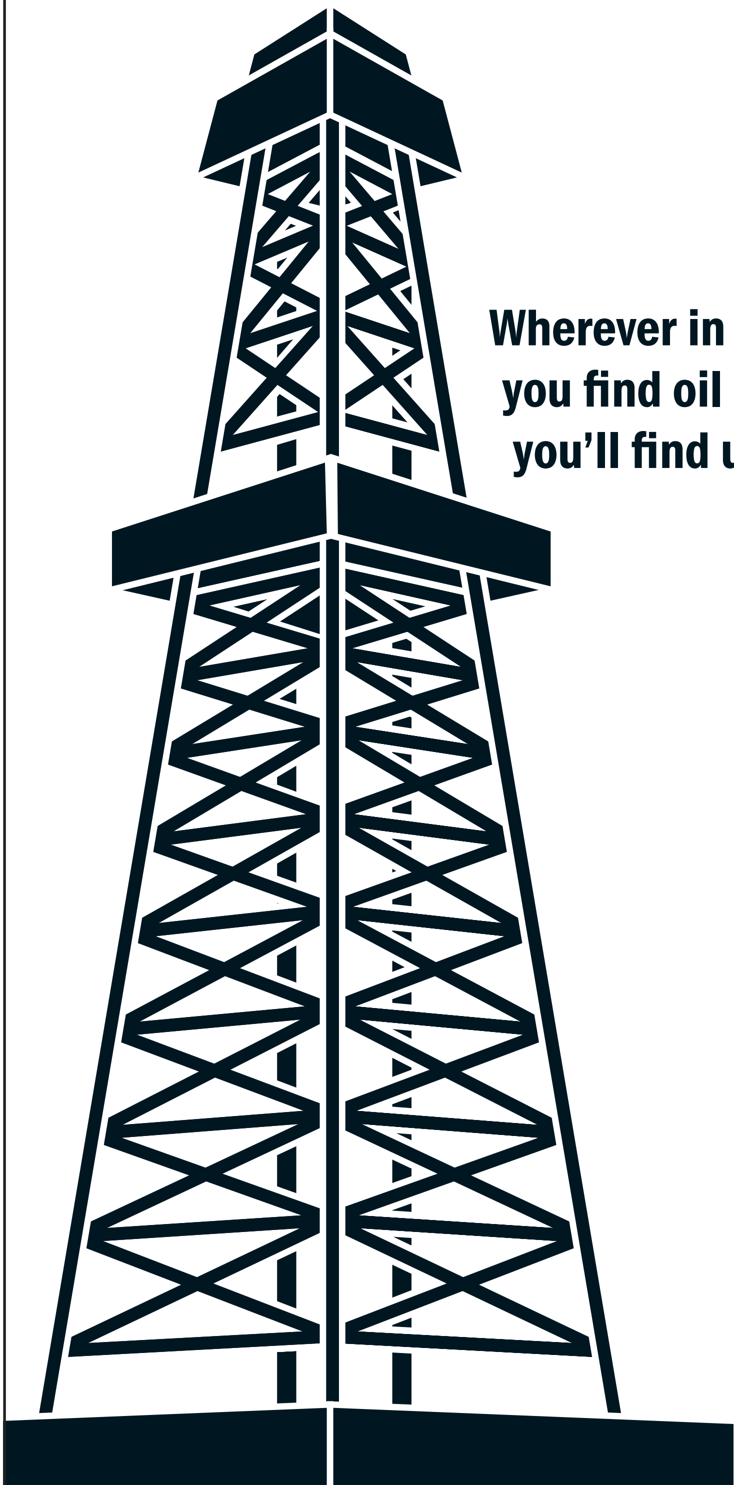


Never Better

If access to capital makes the E&P world go round, that world is spinning faster than ever. Never in 20 years have we seen as much capital available from private providers and banks as we see today. What's more, oil and gas prices seem to have reached a new and higher floor, so never has it made more sense to access those dollars and put them to work. Even the public markets are getting aboard the train, what with the initial public offering of Whiting Petroleum last fall and the pending IPO of Bill Barrett Corp. later this year.

E&P and midstream companies wanting more capital, and those providing it, share the same rosy outlook and cite the same industry fundamentals today—high commodity prices, rising demand for oil and gas, better technology for drilling and completions.

But that's not to say any financing transaction is likely to be a no-brainer. It takes judgment to figure out which deal structure and type of capital best fit the business model and risk tolerance you have in mind. That's why we are pleased to bring you this special report that outlines the various types of capital an E&P company can access. Straight bank debt and plain vanilla equity are only two of the items found on a full and creative menu.

Volumetric production payments (VPPs) are back, but they have become more sophisticated than ever before. And there are several new VPP providers courting business as well.

If traditional debt appeals to you, plenty of money-center banks and more than two dozen regional banks are eager for your business, and lately, we hear a lot about new bank players entering the market. With very low interest rates and a wide range of capital offerings in addition to reserve-backed loans, banks can serve up a variety of deal structures. They are easing up on loan covenants and pushing up their still-conservative price decks. They are giving more value to proved undeveloped reserves (PUDs) as well.

As we reported a year ago, many new providers of mezzanine capital have entered the marketplace. They, like all capital providers, provide deal-flow information in addition to dollars. Non-traditional sources such as M&A advisory firms tell us they are expanding their deal-making offerings to include capital-access advisory or deal structuring as well.

We note that some hardy investors interested in international activity or exploration drilling are starting to edge their way into this sector, which is an unusual sign and a comment on the positive mood of some institutions.

Finally, we see a trend of baby-boomer CEOs starting new companies on both the E&P and finance sides of the business. All agree that in this decade, some of the best industry fundamentals have converged to set the stage for new drilling and financial deal-making.

Many CEOs who have sold their producing assets or indeed, their entire company, are back for more, and the private-capital providers are ready to accommodate management teams with a good track record. For example, Tim Dove in Midland is putting together Concho Resources version 3.0. Graham Whaling and Glen Hart in Houston assembled Laredo Energy II and accessed capital from EnCap Investments LP for an acquisition only a month after selling version 1.0. Paul Rady in Denver sold Pennaco Energy to Marathon a few years ago but is back with Antero Resources, funded with private capital from Warburg Pincus.

And still, new entrants are welcome to access private capital. "The great thing about this business is that just when we think we know everybody, we'll get introduced to somebody new with an exciting story," says Marty Phillips, a partner with EnCap.

The anecdotal signs of plenty are plentiful. On a recent trip to New York, we visited with the energy principals of ANZ Investment Bank, which has started an energy lending office for independents. We learned that EnCap is nearing completion of its fifth private equity oil and gas fund, which will raise \$700- to \$725 million.

You know the outlook is positive when the likes of Harvard Management Co. Inc. is willing to make a presentation at the Independent Petroleum Association of America's capital-formation conference, which was also in New York in April. The university's endowment has allocated \$800 million for private-equity investment in commodity industries since 1999, through a group called Ceres.

In addition, it is forming a new investment vehicle for international equity and commodity deals called Sowood Capital Management LP, with more than \$2 billion to invest. Through these various entities, Harvard will participate in structured financings for oil and gas through VPPs, net-profits interests, subordinated notes, preferred equity, senior debt or other structures.

This report serves as your guide to who has the capital, and how to best access it. As always, we invite your feedback on the information presented. How can we help you?

—Leslie Haines,
Editor

QUANTUM ENERGY PARTNERS™

$345,500,000

Quantum Energy Partners is pleased to announce the final closing of Quantum Energy Partners III, LP and Quantum Parallel Partners III, LP which were formed to make corporate equity investments in North American oil and gas companies focused on building their reserve base through acquisitions, exploitation and exploration, as well as companies focused in the mid-stream sector.

April 2004

Big Deals

Bankers want to book assets and that's good news for producers seeking to fund growth with attractively priced, longer-term debt maturities.

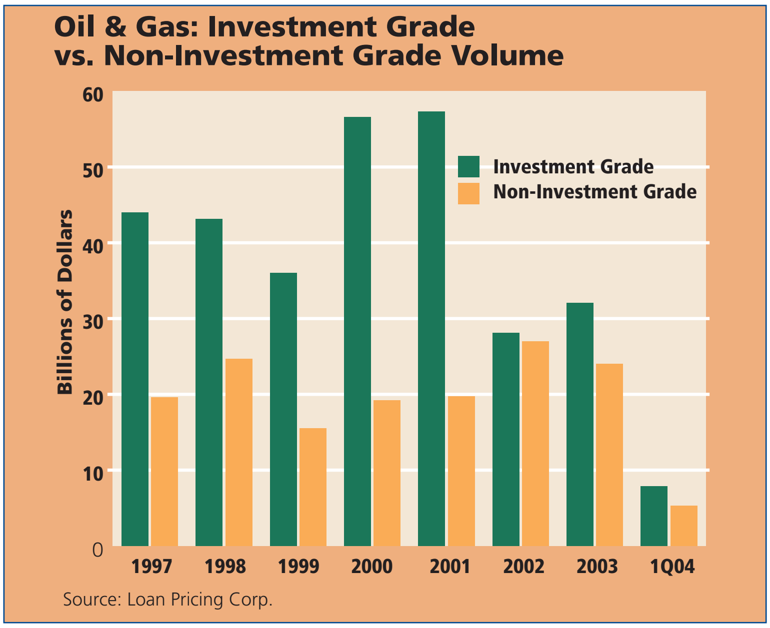
ARTICLE BY BRIAN A. TOAL

When it comes to energy lending today, it's becoming more and more of a buyer's than a seller's market.

Put plainly, with the recent commodity-price-driven increase in the sector's cash flows and the year-over-year slowdown across the energy M&A landscape, bankers have witnessed a commensurately slower transaction pace.

As a result, lenders are becoming more aggressive in their approach to courting and booking oil and gas credits. And, in today's economic environment, there are some beginning signs that increased energy deal flow may well be headed their way.

"Last year, we saw overall oil and gas loan volume edge up to $56 billion from $55 billion in 2002," says Jim Davis, president and chief executive officer of Loan Pricing Corp. (LPC).



Investment-grade loans have declined precipitously in the past two years, while non-investment-grade lending has grown.

The New York-based firm collects, analyzes and publishes loan-data activity across all industries. Its data on the oil and gas industry includes aggregate loan volume across five sectors—E&P, oil service, pipelines, refining and integrated oils.

"However, that slight uptick in year-over-year loan volume doesn't really convey the true upward spike in energy-related credit transactions we witnessed toward the end of the year," says Davis.

The first three quarters of 2003 were anemic, in terms of energy loan volume in the investment-grade sector. During that period, that sector's loan volume was only $17.46 billion. "In sharp contrast, $14.6 billion of energy investment-grade loan volume took place in fourth-quarter 2003—nearly half the aggregate $32 billion in loan volume for this group for the whole year."

Comparatively, oil and gas investment-grade loan volume in 2002 was $28 billion.

The rationale for the late 2003 rally: a lot of investment-grade oil and gas companies came into the market because conditions were extremely favorable, in terms of banks being very enthusiastic about lending. "There was no question that banks really wanted to book assets," says Davis.

"After all, it's hard to imagine the level of [M&A] activity going much lower. This, in turn, might give rise to the need for more acquisition-related credits."

—Meredith Coffey, Loan Pricing Corp.

"What you saw were borrowers with short-term, 364-day credit facilities coming in and terming out those facilities to take advantage of very attractively priced (low-interest-rate), five-year tenors (maturities) that banks were—and are still—offering. That was the real driver of deal flow."

On the non-investment-grade side, the level of 2003 energy loan volume—$24 billion—was only slightly off 2002's strong pace of $27 billion—the highest level in more than a decade.

Meredith Coffey, LPC senior vice president and director of analytics, says, "The primary reason 2003 non-investment loan volume in the energy sector was lower than the prior year is because there wasn't all that much M&A activity in 2003 and hence, not that much need for bank credits to fund acquisitions."

Indeed, the value of energy-related M&A transactions totaled a meager $4 billion in 2003 versus an only slightly less anemic $7 billion worth of such deals the prior year. By comparison, some $22 billion of energy M&A transactions took place in 2001.

The increase in Bank One's 2003 deal flow included stepped-up lending to non-investment-grade upstream borrowers, says Murphy Markham of Banc One Capital Markets Inc.

"There was not only market uncertainty last year during the Iraq war, which dampened M&A activity, but even after it was over, oil and gas prices stayed relatively high, making many companies less prone to dispose of assets that were generating an awful lot of cash," explains Coffey.

At the same time, she points out, the need by troubled utilities and diversified energy companies to dispose of assets—which propped up much of the energy M&A activity and bank-borrowings by asset buyers in 2002—was no longer a meaningful factor in 2003.

In 2004, the volume of energy-related M&A deals might pick up. "After all, it's hard to imagine the level of that activity going much lower," says Coffey. "This, in turn, might give rise to the need for more acquisition-related credits."

A bigger driver of energy-lending activity, however, is likely to be the desire of banks to pursue new business and book assets, Davis emphasizes.

"Banks have done a great job of focusing on risk-adjusted return on capital," he notes. "But clearly their bias is toward booking new business. As such, they might be willing to be a bit more flexible on loan pricing or on the elements of loan structure—something they wouldn't have considered years ago when credit defaults and loan losses were climbing."

With such receptivity toward lending on the part of banks, both Davis and Coffey foresee the possibility of a robust level of energy-loan activity in 2004.

However, Coffey cautions, "The ball today is really in the borrower's court. The level of loan volume this year will be contingent on their appetite for taking on additional debt."

Middle-market focus

Strongly reflecting the receptivity of lenders to the oil and gas sector is Bank One Corp. Last year, according to LPC, it lead-arranged 58 credit facilities within the sector totaling more than $5.8 billion—up from a 2002 level of 45 lead-arranged energy loans worth $4.4 billion.

"The increase in our 2003 deal flow was very much driven by stepped-up lending to non-investment-grade oil and gas borrowers within the sector, both existing and new credits," says Murphy Markham, managing director and head of energy financing for Banc One Capital Markets Inc. in Dallas.

Indeed, the middle-market-focused lender, with total assets of $327 billion as of year-end 2003, added 22 new upstream borrowers to its customer base last year. They include the likes of such newly formed private E&P companies as Denver's Antero Resources, Houston's Gryphon Exploration, Lafayette, Louisiana-based Marlin Energy and Oklahoma City's Quest Resources. The bank also added to its upstream client list last year Denver's Whiting Petroleum.

These new relationships are in addition to ongoing lending activity with some of the larger-cap, publicly traded independents in North America such as Devon Energy, Apache Corp., Anadarko Petroleum and EnCana Corp, as well as midcap producers like Forest Oil Corp.

"In all, we bank 90 upstream clients—40 of them public and 50 private—with loans as little as $10 million," says Markham.

The lender's largest lead-arranged credit in 2003 was a $500-million facility for Denver's Patina Oil & Gas. Above that level, it participates in virtually every investment-grade E&P credit, but not as lead arranger.

The expansion of Bank One's recent oil and gas lending activity has been largely tied to favorable market conditions for borrowers, explains Rich Hillsman, Chicago-based managing director for Banc One Capital Markets and team leader for the lender's overall oil and gas loan syndication effort.

"Pricing—that is, loan spreads and fees—has been clearly trending downward during the past six months," he says. "Meanwhile, loan structures themselves have become a little looser and more client friendly. Also, there has been ample demand on the bank side for participating in oil and gas credits."

Elaborating on deal-structure changes, Hillsman points out that a year ago, the typical tenor or maturity on an oil and gas loan was three years. Since then, however, the market has gravitated toward four-year tenors.

"By lengthening the maturities on their loans, which a lot of producers have been doing, they're lining up longer-term liquidity to support their business

2003 Domestic Oil & Gas Lead Arranger

Rank	Bank Holding Company	Lead Arranger Volume	# of Deals	Market Share
1	JPMorgan	18,561,801,500	43	33%
2	Bank of America	7,877,000,000	34	14%
3	BANK ONE Corporation	5,838,800,000	58	10%
4	Citigroup	4,165,601,500	11	7%
5	Barclays Bank Plc	3,553,000,000	3	6%
6	FleetBoston	2,227,500,000	6	4%
7	Deutsche Bank	1,702,500,000	7	3%
8	Wachovia Securities	1,492,500,000	10	3%
9	SunTrust Bank	1,175,835,705	6	2%
10	Harris Nesbitt	1,080,000,000	4	2%
11	Lehman Brothers	1,060,300,000	7	2%
12	Wells Fargo & Company	1,024,800,000	13	2%
13	RBC Capital Markets	995,000,000	4	2%
14	Credit Suisse First Boston	795,000,000	5	1%
15	Goldman Sachs & Company	700,000,000	2	1%
16	Union Bank of California	690,000,000	7	1%
17	UBS AG	645,000,000	3	1%
18	Bank of Tokyo-Mitsubishi	400,000,000	1	1%
19	BNP Paribas	305,000,000	3	1%
20	Scotia Capital	283,741,602	3	1%
21	U.S. Bancorp	271,500,000	3	0%
22	Royal Bank of Scotland Plc	250,000,000	1	0%
23	Ableco Finance/Dymas Capital	235,000,000	2	0%
24	PNC Bank	195,000,000	2	0%
25	WestLB	162,500,000	1	0%
26	Farallon Capital Partners LP	92,500,000	2	0%
27	General Electric Capital Corporation	84,000,000	1	0%
28	Fortis Bank	83,500,000	1	0%
29	Societe Generale	80,000,000	1	0%
30	Natexis Banques Populaires	60,700,000	1	0%
31	Quest Capital Corporation	2,500,000	1	0%

Nuptial-bound JPMorgan and Bank One were Nos. 1 and 3 in 2003 in upstream lending. (Source: Loan Pricing Corp.)

plans," he says. "At the same time, they're reducing financing costs because they're able to amortize those costs over a longer period."

Hillsman also points out that the number of financial covenants that a borrower is typically subject to in a credit agreement has generally contracted to just two primary ones: a current ratio (current assets/current liabilities) test and a debt/EBITDAX (earnings before interest, taxes, depreciation, amortization and exploration expenses) leverage test.

Another factor boosting Bank One's oil and gas lending activity has been its Structurally Subordinated Note (SSN) product.

"Essentially, we've put together a note similar to what might be available to an issuer in the high-yield market but cheaper," says Markham. "Subordinate to senior bank debt by virtue of a second lien, it provides the borrower more flexibility, in terms of greater debt capacity, looser financial covenants, longer maturities and higher advance ratios than a typical bank loan."

While it sounds a lot like mezzanine capital, he points out that mezzanine deals typically have attached warrants; the SSN carries interest only, at rates much closer to typical bank debt.

"While a typical oil and gas loan today will be Libor plus 125 to 250 basis points, this note is priced only another 100 to 200 basis points higher; by comparison, mezzanine interest is usually 10% to 12% plus warrants."

Despite the high dollar value of loan volume the bank did in 2003, deal flow through first-quarter 2004 has been a little disappointing, Hillsman concedes. "With continuing high commodity prices, our borrowers are generating very strong operating cash flows and hence, are in more of a debt-reduction than a debt-adding mode."

Also, because of those high commodity prices and high cash flows that upstream assets are throwing off, there's currently a huge value gap between what buyers are willing to pay for properties and what sellers want for those same properties, he adds. "That has created a stall in the M&A market."

Hillsman believes, however, that commodity prices may tail off through the balance of the year. Should this occur, that will shore up the bank's oil and gas deal flow, which is very much driven by acquisition activity.

> *"Banks have done a great job of focusing on risk-adjusted return on capital. But clearly their bias is toward booking new business."*
>
> *—Jim Davis, Loan Pricing Corp.*

"On the other hand, if I'm wrong and commodity prices don't back off, then buyers may begin to accept that a fundamental change has occurred in commodity prices. That in itself should cause the value gap to narrow between buyers and sellers, again triggering more deal flow for us."

The planned merger between Bank One and JPMorgan Chase is a good fit, says Markham. "While we've been dominant in the number of non-invest-

ment-grade oil and gas loans done in the past few years, JPMorgan Chase has been equally dominant in its deal flow on the investment-grade side. In 2003 alone, we collectively lead-arranged more than 90 oil and gas credits."

Going forward, he says, the merger means access to greater financial capabilities for Bank One's energy clients, including serving as book-runner on public equity and high-yield debt underwritings, which Bank One doesn't do, and greater product strength in derivatives, cash management and M&A.

Broadening client base

Barclays Bank Plc, with $700 billion in assets, also saw a marked increase in lead-arranged oil and gas loan activity in 2003. After wrestling with some of the banking challenges in the merchant-energy sector in 2001 and 2002, it renewed its effort in the oil and gas sector last year, making a concerted effort to broaden its target client list, says John Sullivan, director of the investment banking group for Barclays Capital in New York.

Barclays Capital oversees the origination, underwriting and syndication of loan product while its affiliated banking entities provide the actual capital commitment. Predominantly focused on investment-grade oil and gas companies, the bank last year lead-arranged major credit facilities for the likes of ExxonMobil and ConocoPhillips.

However, at the same time, it also expanded its commitment to the energy sector through participations in non-investment credits for the likes of Pioneer Natural Resources and Newfield Exploration. "This helped us increase market share in an otherwise down market for lending," says Sullivan.

The banker points out that the lack of any considerable M&A activity last year meant there were less event-driven credit financings than in prior years.

"Pricing—that is, loan spreads and fees—has been clearly trending downward during the past six months. Meanwhile, loan structures themselves have become a little looser and more client friendly."

—Rich Hillsman,
Banc One Capital Markets

"True, we did see more borrowers opting to move to multi-year credit facilities, away from 364-day loans," observes Sullivan. "But we also noticed, even before that, that oil and gas clients were enjoying record levels of excess cash flow which they were directing primarily toward debt reduction, increasing dividends and buying back stock.

"Not a lot of that excess cash flow went toward financing acquisitions or significant growth-related endeavors—despite a strong bank market."

Taking a more historical perspective, Sullivan cites increased capital-spending discipline by the energy sector as part of the cause of the recent slowdown in credit-related financings. In past price cycles—when commodity prices were at cyclical peaks—the tendency for oil and gas companies was to increase spending, he notes. "However, we haven't noticed that take place as much in this current cycle, even with $37 oil."

Barclays Bank increased market share in an otherwise down market for lending, says John Sullivan of Barclays Capital.

Turning to a recent Barclays research publication, he notes that the U.S. industrial sector as a whole last year spent about $340 billion in capex, with the oil and gas sector making up almost $100 billion of that amount. Says Sullivan, "We expect capex for the oil and gas sector to be up only a modest 1% in 2004."

While the banker expects investment-grade loan issuance in the sector will be flat to down this year, he is more sanguine about lower-tier oil and gas loan volume.

"Today, there are a number of non-investment-grade players that have investment-grade credit characteristics—producers that have been rated BB to BB-plus for several years—that the lending market would like to bank," he says.

"And in the past several months, we've seen some of those non-investment-grade companies—names like Pioneer, Newfield and XTO Energy—access the bank market for significant amounts of credit on what are usually considered investment-grade terms."

By the end of 2004, he expects to see increased loan volume within that part of the oil and gas sector as more quality, non-investment-grade producers seek to secure longer-term liquidity commitments, either for moving proved undeveloped reserves into the proved developed producing category or for small opportunistic acquisitions.

Current loan pricing and fees should certainly attract such producers. "The laws of supply and demand still work," says Sullivan. "You have a lot of banks willing to supply loans and not as many borrowers demanding those loans.

"As long as you have that kind of disequilibrium, we should continue to see loan terms continue to favor the borrower—whether evidenced by pricing, fees, tenor or covenants. It's a natural shift, when you have more dollars chasing less demand for those dollars." ■

COSCO CAPITAL MANAGEMENT LLC

CORPORATE BACKGROUND:

COSCO Capital Management LLC is an energy-focused investment and merchant bank, specializing in arranging private financing for energy companies and their projects. COSCO's technical and operational experience, coupled with its New York / Connecticut base and heritage, makes it unusually well qualified to develop sound, sustainable, and profitable relationships between the financial and operational segments of the energy business.

COSCO managing directors Cameron O. Smith, left, Lane W. McKay, middle, and William E. Weidner, right.

Since January 1992, COSCO has worked with most of the professionally managed, U.S. or Canadian-based sources of capital dedicated to, or with a history of, investing in the energy business. Over the past three years, alone, COSCO has assisted investor clients to purchase or sell over $300MM of portfolio companies and has worked with energy companies, themselves, to access approximately $230MM of private capital (see table below). In addition, during this period, COSCO has worked with over fifty buy and sell-side clients, assisting them with investment strategies, effecting mergers and acquisitions/sales, and arranging secondary placements of their securities.

In addition to its offices in New York and Hartford, COSCO has personnel and colleagues in Houston, Tulsa, Oklahoma City, and Calgary. The majority of COSCO's personnel, moreover, have worked within the energy business before joining COSCO. Two of COSCO's Managing Directors have advanced technical degrees in geology, one ran, built and sold private and public E&P companies in the US and Canada for over 15 years, and the third presided over 30+ M&A transactions in a 3 year period, on

$550+ Million — Energy Private Placements and Transactions (2001–2003)

A. Private Placements:

Client	Financing Source/Size	Purpose
CMP Funds (Toronto CA) December 2003	Undisclosed Common Shares of OPTI Canada worth $8.8 MM (C)	Secondary Sale to Achieve Liquidity
Momentum Energy Corporation (Midland TX) October 2003	Natural Gas Partners Equity Units $20MM (US)	Acquisition/Development in the Permian Basin
Vision Gas, Ltd. (Houston TX) October 2003	Undisclosed Limited Partnership Units $7.3MM (US) Initial Drawdown	To Finance Natural Gas Exploration
Southern Pacific Petroleum N.L. (Brisbane AU) April 2003	Sandefer Capital Partners Secured Convertible Bonds $30MM (US)	Development of Australian Shale-to-Oil Plant
Cannon Energy, Inc. (Tulsa OK) March 2003	Kayne Anderson Preferred Stock $18.8MM (US)	Development of CBM Resources in Rocky Mountains
SKH Energy Fund, LP (Houston TX) January 2003	Various LP Units $40MM (US)	Acquisition of Leasehold & Minerals
Purcell Energy (Calgary AB) Nov, Dec 2002	Crown Capital Partners Inc. And Others $11.2MM (C)	For Exploration and Development in NW Territories and NE BC
Aurora Gas, LLC (Anchorage AK) May 2002	Kaiser Francis Oil Company Common Stock $25.3MM (US)	For Development and Acquisitions in Cook Inlet AK
Carneros Energy, Inc. (Houston TX) May 2001	Warburg Pincus Common & Pref Stock $75MM (US)	For Exploration and Acquisitions in California
Total 9 Placements	***10 Capital Sources; $230MM (US)***	***8 Equity; 1 Mezz.; 1 Secondary***

B. Transactions:

Client	Transaction Size	Purpose
Purcell Energy (Calgary AB) May 2003	$62 MM (C) Plan of Arrangement	Acquisition of BelAir Energy Corporation (Calgary AB)
Morgan Stanley Private Capital (New York NY) December 2002	$200+MM (US) (Exact Amount Not Disclosed)	Purchase of Aquila Oil & Gas Mezzanine Portfolio
Mannix Oil Company, Inc. (Houston TX) April 2001	Williams Production $36MM (US)	Sale of Company
Total 3 Transactions	***$320 MM (US)***	***3 Acq/Inv'ts, 1 Sale***
Total Both: 12	***$550MM (US)***	***Various***

his way to building, taking public, and selling what is now the second largest insurance company in Canada. As a consequence, COSCO has unparalleled capacity to source investment opportunities and conduct primary due diligence on individuals, companies, and specific projects in the US and Canada, making it one of the preeminent energy investment specialists in North America.

COSCO Services:

Capital Formation. COSCO specializes in assisting energy companies to raise private capital, particularly corporate equity and project or mezzanine debt. Often this capital is sourced from those very same professional investors to which COSCO provides advisory services. This establishes immediate credibility for COSCO's clients, but also imposes considerable responsibility and discipline on COSCO's selection of the entities, and particularly the management teams, it represents. COSCO ensures that each client has a realistic appreciation of its own value in the private marketplace and understands the full range of financing structures acceptable to the Private Capital community. COSCO assists clients to prepare necessary descriptive documents and marketing materials, arrange meetings with financing candidates likely to appreciate them and their business plans, negotiate term sheets and agreements, and close financings on terms fair to all stakeholders. COSCO typically invests in those equity financings it arranges.

Standing, from left, are Lane McKay, Bill Weidner, Cameron Smith, and Scott Kessey. Seated, from left, are Sharon Younger, Sam Hammons, and Reva White.

Advisory. COSCO provides financial, investment, and organizational advice to both professional investors and oil and gas companies, alike. For investors, these services include consultation on investment strategies and execution, specific due diligence, and intelligence regarding peer competition. Clients have included Warburg Pincus, Morgan Stanley Private Capital, Lime Rock Partners, and Emerging Markets Partnership, among others. For companies, services include generational succession planning and financial and business advice designed to focus managements on their own competitive advantages, business opportunities, and financing potential. Advisory clients within the Industry have included Shell Canada, Arena Energy, Crutcher Tufts Resources, Novus Petroleum, and Momentum Energy, among many others.

Mergers & Acquisitions/Divestitures, Secondary Placements. Because its personnel and strategic partners are located in almost all of the principal energy centers of North America, COSCO is well positioned to match industry clients with acquisition, divestiture, or merger candidates on a negotiated basis. COSCO's experience in structuring deals and in raising capital is often crucial in completing successful transactions. Also, because COSCO has close working relationships with almost all of the Private Capital sources in the US and Canada, it is particularly adept in arranging private placements of energy securities on behalf of investors in need of liquidity through the secondary market.

Principal Investing. COSCO for its own account and on behalf of affiliates since the mid 1980's has participated as an investor in seventeen of the equity financings it has arranged. On the eight investments monetized to date, it has realized an aggregate IRR in excess of 35%.

Education. From the outset, COSCO has worked diligently to inform the energy industry in the U.S. and Canada about the virtues of Private Capital. COSCO personnel write a quarterly column on private capital for *Oil and Gas Investor* and regularly contribute articles and interviews to it and other industry publications. COSCO has founded three annual private capital conferences, two of which it continues to host each year in Houston and Calgary.

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Cash Competitor

Commercial lenders are eking out a customer base for themselves in an upstream world of strong cash flow that has reduced some producers' need for loans—for now.

ARTICLE BY DAVID WAGMAN

High commodity prices for natural gas and oil are leaving many small independents flush with cash, a boon when it comes to paying down debt, improving liquidity and even paying cash for acquisitions. But those strong cash flows are leaving some bankers feeling a little like Maytag repairmen waiting for the phone to ring.

High cash flow has become "another competitor," says Robert C. Stone, senior vice president and manager of energy lending for New Orleans-based Whitney Bank.

At current commodity prices, E&P companies are extremely profitable, reducing their need for debt, adds Mark Fuqua, senior vice president and manager of energy lending at Comerica Bank in Dallas. "We would make more money if prices would moderate some," he says.

Robust cash flow is "great for our customers," admits Mickey Coats, Tulsa-based senior vice president at the Bank of Oklahoma. He and other bankers remember past business cycles that were tough on borrowers. This time, customers appear intent on managing their cash and paying down debt.

"With loan demand down, all banks are hustling to maintain their outstanding loans."

—Andy Merryman, Frost National Bank

"We're happy for them," he says.

Despite the good wishes, Coats offers a single word to describe the effect high cash flow is having on his business: profound.

That word resonates among many bankers whose energy business is built around writing $1- to $50-million loans for independents, start-ups, small midstream operators and other players. Bankers working this small-cap end of the market face multiple pressures, says Dan Steele, senior vice president with Houston-based Sterling Bank. For one thing, high commodity prices have stalled acquisition activity. That's because of the gap between the price that a seller expects to receive for a property and the price a buyer is willing to pay.

"Not everyone subscribes to the high product price we're seeing right now," Steele says. The standoff means banks aren't writing the volume of acquisition loans they might have otherwise. All-cash acquisitions are also negatively affecting bank loan volumes.

A related problem: High commodity prices can mask potential problems with a property. Those problems may show up when prices moderate. "We have found a lot of product comes on that is high-cost and low-margin," says Charles Spradlin, senior vice president for oil and gas lending at Citizens Bank in Kilgore in East Texas.

Those marginal properties may throw off good cash flow at high prices, but a cash squeeze when prices moderate could force problems to the surface. "It's more difficult to find quality acquisitions," he says.

At Houston-based Southwest Bank of Texas, acquisitions historically made up half of the energy-lending group's deal flow, says Stephen Kennedy, senior vice president in charge of the business unit. High commodity prices along with robust cash flow have dampened acquisition activity for at least the last 18 months.

The cash flow is "good for the health of the industry, but it impacts the bank's margins," he says.

Clean slates

With acquisition activity slack, many energy companies use cash to repay debt, a second major challenge facing banks. That cleans their books along with that of their bankers. Debt is being repaid faster than most lenders anticipated, Steele says. That translates into "shrinking portfolios and limited new business."

At Southwest Bank of Texas last year, loan commitments grew 30%, but outstanding loans grew just 16%, Kennedy says. Equally troubling, only around 40% of the bank's energy loans were actually funded, down from a historical average "well north of 50%," he says. "High cash flow has created that situation."

A third factor affecting lending is the churn under way in the banking industry itself. Recent mergers have removed a number of lenders from the sector. Coats says a "strikingly smaller universe" of lenders is available to small-cap companies compared with 15 years ago.

"It's a smaller market," agrees Stone, who estimates 25 banks are currently active in small-cap E&P lending. Not only are syndications more difficult to put together as a result, but marketing has become more aggressive. That often means more than one banker is knocking on a potential borrower's door. Bank margins are also being squeezed by low interest rates.

At the same time, however, the energy sector's good health has attracted many replacement sources of debt finance. Not since the 1970s has so much capital been available, Fuqua notes.

Not every money source is a bank. Equity lenders with $400- to $600 million each reportedly are looking to invest, Steele says. Citing news reports, he estimates that as much as $10 billion in private-equity funding could be available to the sector. That means not only more potential competition for lenders, but also opens the possibility for borrowers to build balance sheets using both debt and equity.

For independents looking to borrow up to $20 million, plenty of lenders are in the market, drawn by the high commodity prices, says Spradlin. "Everybody wants a part of the action. It's made it a little tougher on us."

Citizens Bank's sweet spot loan has a value of around $2 million. For local borrowers, the bank will even go below $1 million.

One player is Guaranty Bank, a Houston-based lender that entered the market in March 2001. "Today we have $800 million in commitments and $500 million in outstanding loans," says Arthur R. (Buzz) Gralla Jr., managing director of oil and gas banking.

Larger banks have focused up-tier on larger energy players, creating opportunities for banks like Guaranty. "Our position is, we're well capitalized and don't mind using our balance sheet," he says.

The bank typically will write loans up to $60 million. In 2003, Guaranty's largest individual commitment was a $70-million loan to a producer with offshore Gulf of Mexico plays. Guaranty also was lead lender on a nine-bank, $160-million loan to a privately held West Texas independent with Permian Basin reserves.

Less conservative

Competition for business in the small-cap end of the market requires work for bankers intent on attracting available business. In some cases that means being more aggressive in evaluating loans. Or, being bankers, the better phrase might be a "less conservative" approach to lending. At least that's how Andy Merryman, senior vice president at Frost National Bank in Houston, describes his bank's strategy.

"We've become less conservative," he says, as part of an effort to be a larger player in the market. His bank writes loans up to $20 million.

For 2004, Frost uses a price deck of $24 for oil and $4 for natural gas. That's roughly in the mid-range of price decks reported by lenders to *Oil and Gas Investor*. As a cash flow lender, Frost focuses on a borrower's projected cash flows to service debt and repay the loan commitment. That means Frost waits until the end of the loan-writing process to figure what percentage of proved developed producing (PDP) reserves upon which it will loan.

As a general rule, the bank prefers to see PDP back as much as 80% of a loan's value. Nonproducing proved undeveloped (PUD) or probable reserves can make up

Some Regional Banks: A Snapshot

Bank	Lending Range $MM	2004 Price Deck Oil	2004 Price Deck Natural Gas	% PDP in Loan	Largest Loan in 2003
Citizens Bank-Kilgore, Texas	Up to $5	$27	$4.50	80%	$5.25MM
Frost National Bank-Houston	Up to $20	$24	$4.00	80%	$20MM in $80MM facility
Sterling Bank-Houston	$1-15	$24	$4.00	75%	$15MM in $100MM syndication
American National-Denver	$1-15	$25	$3.75	60-65%	$12MM revolving line of credit
Bank of Oklahoma-Tulsa	$1-30	$35	$5.43	0%	$125MM lead bank in syndication
Compass Bank-Houston	$2-25	$24	$4.00	65%	$25MM in $600MM syndication
Guaranty Bank-Houston	$3-60	$26	$4.00	65%	$70MM
Americrest-Oklahoma City	$5-18	$30	$4.00	50%	$10MM
Southwest Bank of Texas-Houston	$5-25	$28	$0.00	75%	$30MM
Whitney Bank-New Orleans	$5-15	$24-$25	$3.75-$4.50	55-70%	$45MM
Comerica-Dallas	$10-40	$26	$4.25	75-80%	$50MM

the other 20%.

"With loan demand down, all banks are hustling to maintain their outstanding loans," Merryman says. "We are working harder to find loans."

The Bank of Oklahoma maintains an aggressive pricing deck: $35 on oil and $5.43 on natural gas for 2004.

"Realistically, a producer could hedge at these prices," says Coats. His bank writes loans between $1- and $30 million and favors making loans at the higher end of the range.

Arguing that many banks already incorporate a hedge price for customers who do hedge, Coats says his bank is simply taking another step by following "conventional market wisdom" on prices.

But if Bank of Oklahoma is aggressive on price decks, it is decidedly conservative on PUDs. "We do not give value to PUDs," Coats says. That evens out somewhat the bank's aggressiveness on price decks. Last year the bank led a $125-million syndication for a small, publicly traded company with Midcontinent properties.

Southwest Bank of Texas is using price decks of $28 for oil and $4 for gas. The bank also likes to see 75% of PDP in a borrower's collateral package and has an advance rate in the 60% range for a fully diversified portfolio. The bank prefers loans in the $5- to $25-million range.

Kennedy says operating on a basis commitment of $900 million makes it hard for him to hit targeted growth goals on loans less than $5 million.

At Houston-based Compass Bank, Dorothy Marchand, senior vice president, uses price decks of $24 for oil and $4 for gas. The bank typically lends at 65% of PDP and has a policy of lending on 25% of PUD, although in practice it may be more aggressive. The bank writes loans from $2- to $25 million, up from a $20-million ceiling just six months ago, Marchand says.

The up-market move was prompted by its customers' financial strength. She says loan structures in general are loosening, responding to the pressures of slack demand and high cash flow. That means three-year revolvers in some cases are being written for four years, and 30% lending caps on PUDs may creep out to 40%.

Stone says he's reluctant to include "stale" PUDs on the books, preferring instead to see an intent to develop the resource. "I would need a sense that wells are budgeted and there is an intent to drill," he says.

Price volatility

Writing acquisition loans is a "much tougher ballgame to be in" than in the 1980s or 1990s, says Spradlin. That's because high commodity prices mean much of the upside already has been realized. During times of high prices, borrowers need to be more precise in assessing a property's potential performance.

"Lower prices hide mistakes," he says, because there's less down to the downside.

When volatility eases and "reasonable" commodity prices reestablish themselves "that will motivate people" to sell and buy again, says Steele. In the meantime, banks are looking for other ways to serve their customers.

Citizens Bank will write a bank letter in lieu of a bond for the Texas Railroad Commission, a low-profit service that keeps the bank in touch with its customers. At Comerica Bank, Fuqua thinks lending opportunities might improve on the energy-services side of the business. High steel costs and elevated rig counts suggest to him an opportunity to lend money. Evidence also suggests that the high cash flow isn't flowing down as far as energy service companies.

At Southwest Bank of Texas, Kennedy expects the exploration activity that began to pick up two years ago to begin to come to market soon, creating new lending opportunities.

Deals are still out there for aggressive people. "For the right customer we'll do about anything," says Americrest's Bob Holmes. "The quality of the customer is improving."

"Our position is, we're well capitalized and don't mind using our balance sheet."
—Guaranty Bank,
Arthur R. (Buzz) Gralla Jr.

"We've had to work harder to find the next opportunity for credit," says Todd Berryman, vice president with Denver-based American National Bank, formerly known as the Bank of Cherry Creek. "The flows have stayed the same, but we work harder."

Then, almost as a reminder to cash-rich customers all across the small-cap sector, he says, "These are 20-year relationships." ■

Natural Gas Partners

WHAT NGP IS LOOKING FOR

Compared to finding the right people, buying energy assets is easy. The character and skills of NGP's portfolio company managers form the keystone for each investment. We refer to them as "owner-managers." NGP often finds owner-manager teams already in place in small, private companies, but we also team up with employees of large companies looking to step out on their own. Beyond technical and business competence, NGP looks for people who are willing and able to:

- invest much of their liquid net worth in the enterprise;
- devote all of their efforts to increasing the equity value of a single enterprise;
- demonstrate a unique and sustainable flow of transaction opportunities; and
- buy and sell opportunistically as business conditions fluctuate.

If you become an owner-manager, our shared strategy will be to create value by accumulating energy assets by building value through a series of acquisitions. If you want to build a world-class energy company, we should be your first call. Our resources are unmatched.

GETTING STARTED

Not all capital is created equally. Before accepting capital, NGP believes that entrepreneurs should consider not only the terms of the deal *but also the relationship they expect to form with their capital provider*. Often, the differences are identifiable upon the initial introduction. With NGP, you should expect questions aimed at learning about the personal and business history of the management team, the team's ownership stake in the enterprise, and the team's technical and transactional skills.

With its sharp focus on the people involved, NGP's decision process is straightforward and can lead to the crafting of an investment proposal within a week or two. With few exceptions we will propose a purchase of common equity because it provides the most financial flexibility in the early stage of a business. We expect that the key members of the management team will buy the same security in an amount that is significant to each of them. Success in building value is recognized chiefly by management's participation in options to buy more equity, which are usually exercised when the company is sold.

WORKING TOGETHER

Once the investment closes, the differences among financial partners start to appear. NGP focuses on doing what we say we will do. We are active members of the board of directors, and we encourage more frequent and informal contact to work on any idea or problem. However, we strongly prefer to stop short of becoming overly involved in the day-to-day operations and routine decisions that are better handled by our management teams.

As the business grows, there will be a need to raise additional capital. NGP provides significant assistance to its portfolio companies in this area. Our network of banking contacts is superior, resulting in the attainment of more flexible terms, faster executions and larger commitments than companies operating on their own. Our staff of transaction specialists is ready day or night to provide sophisticated legal advice, assistance in executing a hedging strategy, or access to our proprietary research and transaction models. We take pride in setting the industry standard for portfolio company support.

Finally, NGP understands that the cyclical nature of the energy business is inescapable. We view industry downturns as a positive condition that creates attractive acquisition or expansion opportunities. We also see industry upturns, while enjoyable, as providing potential selling windows for specific assets or entire companies. We make the sell decision in consensus with our owner-managers, a function of our alignment of interests as fellow equity holders. For many industry scenarios, we caution that the rigid structure of some forms of capital available today (especially those that have recently made a comeback such as mezzanine debt and volumetric production payments), inherently results in the divergence of interests between management and capital provider.

DO YOUR DUE DILIGENCE

With our focus on finding the right people, it is no surprise that NGP checks personal references rigorously. We believe that capital seekers should evaluate investment firms in equal detail. In particular, we strongly recommend contacting the portfolio companies of each capital source under consideration. Building a relationship is the key and, as it is with any relationship, the personal chemistry between the principals is critically important. When management teams include this step in their due diligence work, NGP competes very effectively.

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Minding The Gap

The mezzanine-finance arena that lost many competitors with the Enron-et-al. meltdown is rebuilding and may be stronger now.

ARTICLE BY NICK SNOW

As mezzanine financing continues to recover from the merchant-energy meltdown, it's coming back with less raw power and more finesse and discipline. It also is more a part of a cohesive capital-resource team now.

"In the late 1990s through 2001, the merchant players saturated the market with capital. All of them followed in Enron's footsteps," recalls Kurt Talbot of Goldman Sachs E&P Capital in Houston.

"The quest was for earnings, not necessarily cash returns. In the early to mid-1990s, Enron turned the market on its head with its commodity-risk management and volumetric production payments. These were well-structured, low-risk and price-competitive. This was a model that was, and should, have been imitated."

By the late 1990s, other merchant-energy companies jumped into E&P lending with a mandate to show earnings growth and be more like Enron, he says. "Each of the merchant players was attempting to place $300- to $500 million of capital a year in the market. There was no deal that could not get done," Talbot says.

Mezzanine investing was defined more by its return expectations (mid- to high teens) than its actual structure or risk tolerance. "What started as senior debt morphed into subordinated debt, project equity and even venture capital. Ultimately, that's why many of these portfolios blew up."

Now that the dust has settled, there are far fewer players, all of whom seem to be driven primarily by economic returns, rather than by the desire for bookable earnings, he adds.

The market is not as active as it was two years ago, simply because there's not as much money available. It is rebuilding after so many players—Enron, Aquila, Shell, Duke, et al.—shut down their producer-finance units, observes Frank Weisser of Weisser, Johnson & Co. The Houston-based firm advises producers and acts as a financing intermediary.

"A modest number of deals were done last year, but it seems to be picking up," he says. "The second half of 2002 and all of 2003 was a fairly quiet period while new entrants in the market got organized and got going. High commodity prices have made a lot of transactions fairly difficult."

Mezzanine financing usually occurs now when someone wants to acquire and develop assets more aggressively. "This is where lenders and producers see the greatest possibilities," says Rob Lindermanis of Petrobridge Investment Management in Houston.

Lindermanis was formerly with Mirant's producer-finance business, and partner Mike Keener was with Shell Capital Inc. They gained a lot of financing experience before forming Petrobridge.

"Between 1998 and 2001, we put out about $1.1 billion at our respective companies," Lindermanis says. "It's interesting to get back into the market. To date, we're encouraged by what we see. We are completing our first year at Petrobridge, and we have closed six deals and have three pending. I think there will always be a role for mezzanine financing in the capital markets."

Jim McBride of Royal Bank of Scotland, another capital provider, thinks the nature of mezzanine is changing. "There's been more of what I would call second-lien paper than traditional mezzanine paper with a coupon and warrants," he says.

Basically, second-lien paper is a tranche of debt that is more aggressive than traditional senior debt. It is used to close the gap between senior debt and equity, although it requires more equity than traditional financing.

> *"Equity...wants to back top-tier management first and projects second. Mezzanine takes the opposite approach."*
> *—Frank Weisser, Weisser, Johnson & Co.*

Royal Bank of Scotland was part of the second-lien notes for Quest Energy in its acquisition of the Cherokee Basin, Kansas, coalbed-methane properties from Devon Energy recently. It was also part of the second-lien notes that Quicksilver Resources, another coalbed-methane-focused operator, put in place about a year ago.

Mezzanine or other capital?

The single biggest challenge today for borrowers and lenders is recognizing when mezzanine will work better than another capital mechanism. Equity and mezzanine finance both play a role in the typical acquire-and-exploit business model for producers, according to

Weisser. "Right now, there are more equity players because of the mezzanine meltdown that occurred in late 2001 and 2002," he says.

Bank debt still works bests for proved, developed producing reserves (PDPs), while mezzanine financing focuses on properties that are proved and undeveloped (PUDs).

Weisser says, "Equity can work with both, depending on the situation, and can substitute for mezzanine. There's an abundance of equity, but it's extremely particular. It wants to back top-tier management first and projects second. Mezzanine takes the opposite approach."

Talbot adds, "All capital competes against all other capital, and one form of capital does not exclude another. Mezzanine is somewhere between debt and equity, but still with a definite debt-orientation."

Private-equity funds such as Quantum Energy Partners, First Reserve, Lime Rock Partners and Kayne Anderson essentially are less project-focused and more focused on proven management teams who want to start over. Borrowers must be willing to give up a significant ownership interest and sometimes, control, to get the money but it comes with fewer strings attached, Talbot says.

"Equity providers understand the risk they are taking and expect to be paid accordingly. Mezzanine debt will not dilute the equity ownership of the sponsor, but it comes with more restrictions."

McBride says he sees more mezzanine deals revolve around development of existing assets or assets that come with a new acquisition. "It's in further developing assets that opportunities outstrip cash flow," he says. "In acquisitions, producers need to lever up to make the acquisitions and the capacity to develop or fully exploit the acquired assets. The challenge from our standpoint is bringing together the management team with the right skill set and knowledge of the area with the right asset base."

Traditionally, mezzanine financing for oil and gas producers has been used for projects such as drilling a specific set of properties, making an acquisition or building a pipeline or natural gas plant. Talbot says, "While there is still a lot of demand for drilling dollars, there seems to be more demand for corporate sub-debt or 'B notes' than for the traditional mezzanine dollars."

Goldman Sachs E&P Capital is in an unusual position. It is not an investment fund, so it has more flexibility in the amount and form of its capital. "Our preference is for production payments and sub-debt, but we are currently considering several drilling partnerships," Talbot says.

"We're willing to play anywhere on the balance sheet, including arranging large senior credit facilities. We can provide all of the capital or a particular piece. We like opportunities in the $20- to $50-million range, but we have the ability to arrange transactions of any size."

High commodity prices

Observers are divided on whether higher oil and gas prices have helped or hindered E&P capital markets. "They definitely have had an impact," says Weisser. "They've made transactions more difficult. People who hold producing properties don't want to sell them for anything but top dollar, while the buyer wants to finance on a basis related to historical averages. Prices haven't been higher long enough to have an effect on this.

"Mezzanine debt will not dilute the equity ownership of the sponsor, but it comes with more restrictions."
—Kurt Talbot, Goldman Sachs E&P Capital

"Also, you can't hedge a PUD, only PDPs. Hedging is even more important now. There's more perceived exposure with high prices than there is with low prices. When you go to buy something, you can hedge PDP production to an extent. But you can't hedge the PUD component you're buying. It makes it difficult for financing to close the gap."

Talbot suggests higher commodity prices and low interest rates have given producers attractive options. They can either sell a production payment that will lock in the current incredible commodity prices, or they can borrow at extraordinarily low interest rates and spreads. The commercial banking environment is very competitive and reserve-based deals are routinely getting prices at Libor plus 100 to 300 basis points.

"This naturally puts pressure on the pricing for mezzanine deals. But we also benefit because we have a big appetite for subordinated debt. We see commercial banks as our partners rather than our competition."

He adds that the firm can do long-dated commodity hedges which allow for some type of monetization, such as a production payment. "We also have in-house technical skills and risk tolerance to do subordinated financing that relies upon behind-pipe and undeveloped reserves for repayment."

Petrobridge offers financing for acquisitions, development, exploitation/enhancement, restructuring/recapitalization and monetization. "Right now, our business is evenly split between acquisitions and development drilling programs where the company has decided to accelerate. We're primarily funding through the drillbit in those cases," Lindermanis says.

Improved cash flow gives producers more choices as they step up to the financing plate. In the right situations, however, many still recognize that mezzanine financing may be just the structure that can help them. ■

The VPP Option—It's Back

A perfect storm of upstream-sector fundamentals has brought back the popular volumetric production payment method of financing acquisitions.

ARTICLE BY NICK SNOW

The volumetric production payment (VPP) option of financing acquisitions is still an appealing choice for producers who want to raise money and investors seeking good, reliable returns. It's also clear that in some respects, today's VPPs are more sophisticated than the ones made in oil and gas 20 years ago.

"We haven't seen, in recent years, demand for oil and gas investments as high as it is today," observes David L. Bole, a managing partner of Randall & Dewey, the Houston-based transaction-advisory firm that added capital-sourcing and business-management consulting to its services in 2003.

Low interest rates, high commodity prices and strong demand for oil and gas assets among investors have created this perfect storm, he says. "The financial market for oil and gas assets is larger, more liquid and more sophisticated than ever. VPPs are one of our most powerful tools for financing deals."

Jim McBride of Royal Bank of Scotland in Houston, agrees. He thinks production payments will be the financing vehicle of choice for many acquisitions this year. "We have historically high commodity prices and low interest rates," he says, so it's challenging for buyers and sellers to come together.

"The only way to bring parties together is to lock in as large a portion of the commodity-price risk as possible. Basically, if a company is looking at an acquisition that has a significant proved producing (PDP) reserves component, they owe it to themselves to look at a pre-conveyance production payment."

VPPs were born in the 1980s when commercial banks were having problems with their real estate and oil and gas loans. Producers found it hard to access funds. "VPPs provided a good alternative," recalls Fielding B. (Tres) Cochran III, a partner at the Vinson & Elkins law firm in Houston and who has extensive experience with VPPs.

The structure gives the buyer an actual interest in the reserves, so if it's properly put together, there's a potential bankruptcy safeguard in a VPP that allows an investor to deal with a producer that has lower-grade credit. "From a producer's point of view, this is an ideal time because commodity prices are high and interest rates are low," he says. "A VPP allows the producer to lock in a high [commodity] price and low interest rate."

It's a very competitive market, he adds. "There are lots of potential buyers out there who are bidding to make this type of investment."

Companies pursue VPPs for two reasons, notes Alan Rafte, a partner at the Bracewell & Patterson law firm in Houston. If a producer has sub-optimal credit, a VPP can provide some greater assurances than a secured loan, in the event that the sponsor gets into a complicated credit situation. "We haven't seen any bankruptcy cases validating this, but everyone feels comfortable about how they'll be treated," he says.

> *"Companies can get nearly full value for their PDP reserves."*
>
> *—C. John Thompson, Constellation Energy Group*

Also, there are some accounting benefits from a VPP in connection with an acquisition. Instead of selling the entire property to a buyer, a producer can sell a VPP to a financial player and the proved undeveloped reserves (PUDs), probables and other upside, as well as a VPP tail, to the buyer. This makes the acquisition costs lower on a per-barrel basis.

"There's no debt on the balance sheet, although the new morality of financial accounting makes most buyers disclose how the transaction works at least in the notes," Rafte says.

New players

A void was created when Enron, Mirant and others left the producer-finance business, opening the way for new VPP players in the past two years. C. John Thompson, a vice president of Baltimore-based Constellation Energy Group Inc., runs its new Houston producer-finance office, which has so far been involved in a couple VPP deals.

"Companies like Constellation were not as aggressive in trading and other businesses that created problems," he says. "So when the trading side of the business began to unwind, they weren't faced with a decision of having to divert capital to the financing business.

One matter that caused Constellation to look at the VPP business is that it now has throughput, through its different subsidiaries, of more than 500 billion cubic feet of gas per year. There's an inherent credit risk asso-

ciated with a short position, so if it can help hedge that position through volumes under a VPP, it replaces the credit risk with a reserve risk that's a lot more quantifiable, with better support from actual reserves in the ground, Thompson says.

Today's VPP retains the essential appeal of its predecessors, says David L. Rockecharlie, a Randall & Dewey managing partner specializing in finance. The firm closed its first VPP in December.

"The buyer acquires producing or soon-to-be-producing reserves from a property, the least risky part of the production. For the seller, they're selling a part of the production stream they can't add much more value to, while retaining control of the property," he explains.

VPPs are popular again because the buyer universe has expanded, and VPPs can work for producers of all sizes, he adds. With bonds and stocks falling a little out of favor, large institutions, endowments and large banking funds view hard assets as a good alternative. That has dramatically expanded the market for VPPs at the same time the financial long-term trading market for oil and gas also has grown significantly.

"When the market for this product started, it was one firm trying to aggregate assets," he says. "Now, insurance companies and other investors with a strong desire to invest in assets and manage risk, are participating."

Producers, meanwhile, can use a VPP to raise capital in a market where high commodity prices might make an outright asset sale unusually difficult. "The techniques that are successful in this kind of market are the more creative structures that allow for lower-cost financing while valuing the assets relatively highly," Rockecharlie says. "In the past, asset buyers didn't give much value to the forward curve. In a market where the producing asset can be fully hedged, it allows buyers to pay more for the asset without taking on more risk."

"…A buyer can provide funding while being involved in both a hedging and marketing transaction."
—Fielding B. (Tres) Cochran III, Vinson & Elkins

Randall & Dewey's two VPP deals total more than $300 million. One was for seven years, while the other was for 12 years. In the context of the sales, oil and gas prices effectively were hedged over an extended period, Rockecharlie says. "The seller still is obligated to oper-

A BALANCE SHEET PERSPECTIVE

The volumetric production payment (VPP) is a long-standing concept, so its effect on a producer's balance sheet should be fairly straightforward, right? Not necessarily—things have changed considerably in the world of VPPs since the boom days of the 1970s and early 1980s.

The buyer of a VPP during that earlier period was interested in securing a supply of oil or natural gas to use in its normal business operations. A refinery or a pipeline would be a good example. However, many transactions that masquerade as VPPs are purely financial in nature. The goal of the producer in these deals remains the same—receiving advance payment for production. However, the counterparty in a purely financing transaction has no need or desire for physical units of oil or natural gas.

Other changes in the VPP landscape relate to accounting rules. Let's focus on the unexpected impact some transactions can have on a producer's balance sheet. Accounting for a true VPP has not changed since Financial Accounting Standard (FAS) 19 was issued in 1977. A VPP involves the sale of a mineral interest that can be registered at the county courthouse. It requires the producer/seller to make physical delivery of volumes of oil or gas to the owner of the VPP from a specified well or wells, generally according to a monthly schedule.

FAS 19 requires the producer to show the gross proceeds from the VPP as unearned (deferred) revenue. No change is made to the oil and gas property account; the property costs relating to the VPP remain on the producer's balance sheet. As the volumes are delivered to the holder of the VPP, the deferred revenue is recognized as revenue.

Depletion of the property account is recorded normally as the VPP volumes are produced. An aspect of VPP accounting that typically gives heartburn to producers is the requirement that the oil or gas volumes sold under the VPP must be removed immediately from the tables that disclose the producer's remaining reserves, periodic production volumes and Standardized Measure of Future Cash Flows.

However, the quantities and amounts relating to the VPP may be disclosed in a footnote to the tables. FAS 133-Question B11 discusses the application of derivatives accounting to a VPP, noting that the normal sales exception applies.

(cont. on p. 27)

ate the property, but the financing doesn't go against any other assets. A very large, or very small, producer can achieve both the benefits of this long-term hedge and low discount rates against the property."

Essentially, this makes today's VPP a secured nonrecourse loan that's coupled with a hedge, according to Rafte. He cautions, however, that a financial player expecting pure molecule hedging over a long term won't find it in VPPs because they are set up on prices that come out of the Federal Energy Regulatory Commission at the first of each month. Someone looking to accommodate daily price changes should account for the possible variations when they're negotiating a VPP's terms, he suggests.

But a hedge associated with a VPP has one advantage over a conventional hedge because there are no margin requirements, Thompson says. "A VPP eliminates this because the volumes are being delivered as a part of the transaction. It's a much more straightforward and simple way for a producer to view its exposure," he says.

> *"[A VPP is] a much more straightforward and simple way for a producer to view its exposure."*
> *—Alan Rafte, Bracewell & Patterson*

Others emphasize that when it comes to VPPs today, one size definitely does not fit all. "The market thought it understood VPPs because they've been around for a while. But there are some new aspects," says Rockecharlie.

"If you asked two institutions what they would give for a VPP, you would get two different answers. We try

(Cont. from p. 25)

It is important to understand why the accounting rule-makers required the proceeds from the sale of the VPP to be shown as deferred revenue, rather than reducing the property account and perhaps even producing a net gain on the transaction. The following sentence from FAS 19 is key to our understanding: "(The VPP) is a sale of a mineral interest for which gain shall not be recognized because the seller has a substantial obligation for future performance."

That substantial obligation includes delivering the scheduled volumes "off the top," free and clear of all operating costs. Volumes to be delivered under the VPP do not change in proportion to overall production, as with an overriding royalty interest. Therefore, decreases in production from the specified properties directly reduce the net revenue from which the producer must cover total operating costs.

VPP look-alikes

Next, let's consider the attributes of a typical VPP look-alike, and how the accounting rules cause it to be treated differently from a true VPP. In one common VPP look-alike, the counterparty makes an advance payment that the producer repays in cash as the scheduled production volumes are sold in the normal course of business. The counterparty in this type of transaction is usually a financial institution, which is interested only in cash and not volumes of oil or natural gas.

This type of transaction was addressed by the Emerging Issues Task Force (EITF) in Issue 88-18, which covers the accounting for sales of future revenues. EITF 88-18 generally requires the producer's obligation in this type of transaction to be shown as debt because it will be repaid in cash. In addition, because the amount of the cash settlement fluctuates with the price of the underlying commodity, FAS 133 requires the producer to separately account for the debt component and the embedded derivative, which must be marked to fair value as product prices change.

In evaluating these and similar transactions, many accountants follow this basic guideline: if a financial institution is the counterparty in the transaction, the transaction is probably debt.

A second VPP look-alike is a prepaid price swap, in which the producer receives a discounted, up-front payment for scheduled production volumes at a fixed price. The scheduled volumes are hypothetical, and are not contractually tied to any specific well or wells. In return, the producer is obligated to pay the counterparty the market price of those scheduled volumes on their "delivery" date.

For convenience, the market price is usually based on a recognized index such as the Nymex. Although the underlying economics for the producer appear similar to those of a VPP, this type of transaction also is trapped by EITF 88-18. Here again, FAS 133 requires the producer to separately account for the debt and derivative components of the transaction.

A third type of transaction involves using a VPP to finance a producer's acquisition of working

(cont. on p. 29)

to get the right terms for the producer and work with the investor to make sure we're giving them the best product.

Two or three investors may have bids for a property that are very far apart. "We understand how trades and transactions are priced and executed. We also bring technical expertise that allows us to do the technical work ahead of time in the way we know investors want to see it done—with a sense of the value, and what they want to pay for it."

Successful traits

Randall & Dewey has identified two key points in a successful VPP today: addressing oil and gas prices before closing the deal, and covenants in operating the asset, Rockecharlie says. "We push the investor to identify key issues, and to also enter into a pre-hedging agreement."

This creates the ability, after about the first month of the process, to get enough of the terms done and a credit agreement in place for the seller to hedge. There's more flexibility in commodity pricing as a result, which is a much better outcome than has been the case in the past.

"Not everybody knows what reasonable market terms are," he adds. "They're looking to protect their investment. In our interactive process, we're able to get better terms while the investor manages his risk."

The seller has to continue operating the property prudently. He also has to maintain his reserve in what

(Cont. from p. 27)

interests. This structure will involve at least three parties: a producer selling the working interests (Party A), a producer buying the working interests (Party B) and a buyer of a VPP (or look-alike) from the working interests (Party C). Usually, B wishes to gain control of the working interests primarily for its exploration or exploitation potential. The proved producing reserves are not particularly interesting to B, and their sale through a VPP will offset the highest per-unit cost of the acquisition.

Accordingly, B finds a buyer for the VPP and brings C along to A's table. Voila! A simultaneous, or at least connected, VPP sale and working interest acquisition takes place. The economics of the transaction make perfect sense.

The only problem might be one for the accountants. Here's why: when a producer acquires working interests from which the seller, at an earlier date, has sold a VPP, standard accounting practice is for the buyer to record the value of the working interests net of the VPP, and to record the liability for future operating costs associated with the VPP volumes. The full market value of the volumes remaining under the VPP is not recorded by the buyer of the working interests either in property or as deferred revenue.

The important fact is that the buyer of the working interests in this second example was not a party to the earlier sale of the VPP. However, in the previous example, because Party B is a party to the sale of the VPP, FAS 19 requires B to record the "substantial obligation" for the VPP. It is only logical to conclude that A would not encumber the working interests that it has offered for sale by selling a VPP without the explicit approval of B.

This logic would hold true when the sale of the VPP occurs just prior to the sale of the net working interests, even if the two transactions are documented separately.

As a participant in the VPP transaction, Party B should record in its property account the purchase price of the working interests before considering the VPP transaction, and should record the amount paid by Party C for the VPP as deferred revenue. If the transaction involves a look-alike rather than a true VPP, B should account for the obligation according to the appropriate authoritative literature.

The concept of accounting for a transaction according to its substance is a long-standing one, and one that has received renewed emphasis during the last couple of years. The concept is particularly relevant when an obligation is involved.

In summary, as more complex financing transactions find their way into the E&P sector, they arrive subject to accounting rules created to cover similar transactions in other industries. Analogizing these transactions to the true VPP for accounting purposes is no longer an option. As a result, the accounting in FAS 19 should apply only to the true VPP.

Often, financiers promoting transactions are not focused on the contractual differences from the true VPP, or on the accounting rules that can cause unexpected results on the producer's balance sheet. Producers beware!

—*Ed Davis*

Ed Davis is a partner in the Houston office of Grant Thornton International, an accounting, tax and business advisory firm dedicated to midsize companies. He can be reached at 832-476-3617.


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is called the "tail," which is tested in both an annual reserve report and in a midyear report.

Most producers expect more covenants that hinder their operating flexibility, but in the current market, VPP providers are very flexible.

McBride cites a pre-conveyance production-payment transaction that Royal Bank of Scotland closed at the end of 2003, where it created a trust that acquired a significant portion of the PDP reserve base. "At the same time, our client acquired the residual interest, so basically they only had to pay for the potential upside of the property, which significantly lowered their acquisition cost of reserves in the ground.

"There's no such thing as a free lunch, however. Generally speaking, the buyer of the residual interest has to pay the operating expenses of delivering the VPP volumes in the future."

Constellation Energy also sees a lot of interest in VPPs. "One of their most prominent uses is in acquisitions of reserves," says Thompson. "There's still some difficulty in perceptions of buyers and sellers, however, so the number of deals actually closing is still not numerous."

With high commodity prices and low interest rates, the environment is optimal for doing VPPs, he says. "Companies can get nearly full value for their PDP reserves. Constellation is trying to act as a one-stop shop for upstream capital. We also handle mezzanine financing and project and corporate equity."

"If you asked two institutions what they would give for a VPP, you would get two different answers."
—David L. Rockecharlie, Randall & Dewey

Cochran has noticed some new players in the VPP arena recently. "There have been some situations where some people have used VPPs as a supply source for power plants or other operations," he says.

"Basically, it's still an attractive financial structure where a buyer can provide funding while being involved in both a hedging and marketing transaction. A VPP offers several elements that touch on capabilities that financial institutions can engage in, which they like. That's where we see a lot of interest, as well as among some users who see it as a way to obtain supply." ■

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Fast Money

Publicly held producers and service companies in need of quick funding can access private capital from huge institutional funds via the PIPE structure.

ARTICLE BY NICK SNOW

How often has a publicly traded producer quickly needed a few million dollars to buy a property, or a service company to buy equipment or a minor competitor that suddenly becomes available? The amount may be too small and time may be too short for conventional public equity and debt financing to work. But the situation arises frequently enough to support an alternative: private investments in public entities, or PIPEs.

The acronym may be relatively new. The process is not.

"Public companies have been doing private placements like this for a long time. It just makes too much sense not to," says Russell Weinberg of Energy Capital Solutions in Dallas. "The PIPEs market for technology and other industries has been huge. Before the acronym was formed, I actually worked on a PIPE offering for TMBR/Sharp Drilling Co. We were acquainted with the structure and realized it would be applicable for the energy industry."

These transactions happen quickly. A wide range of investment funds, some as small as $50 billion and some as large as $100 billion, are interested in PIPEs.

"There's been an explosion the last couple of years in volume for PIPE deals for all different industries," adds his associate, Keith Behrens. "Energy is a bigger part of the overall offerings. It's just in the past few years that the volumes have been this huge."

The firm has closed six PIPE transactions totaling more than $100 million since its formation in late 2001. It's working on more.

Still, PIPEs are a relatively recent addition to financing choices for oil and gas companies. "They're relatively straight-forward, but they are a new financial product," says James A. Hansen, who directs First Albany Capital's oil and gas financing operation in Houston. "As more transactions are completed, the marketplace grows more comfortable with both the liquidity and execution of the product."

There are many different types, notes Phil Keating, who leads First Albany Capital's private-capital group, focusing on raising private equity and debt for public and private companies, in New York. "We see the most volume, as a firm, in the United States. Essentially, a PIPE is a direct sale to either accredited investors, which is a fairly low threshold, and qualified institutional buyers, who have $100 million or more in assets under management."

Why PIPEs?

PIPEs become attractive when completing a deal in the public markets is challenging. Public deals have a fairly rigid set of parameters dealing with market cap, how much the offering is relative to that, and liquidity. If a company can't meet the qualifications in each of those, a public deal becomes difficult.

"It also requires a fair amount of advance notice to get the deal done," Keating says. In the PIPE market, capital-seekers have much more flexibility relative to how much they're raising, the timing and the disclosure before it's done.

> *"Timeliness is a key element in a PIPE, particularly if it involves a relatively small amount."*
>
> *—James A. Hansen, First Albany Capital*

"A private deal's whole nature is that you don't announce to the market what you're doing. That happens post-transaction. But there are limits. If you are going to do a common stock PIPE, you can only do about 20% of total market cap, for example, without consulting the shareholders. So there are safeguards."

First Albany helped Gasco Energy Inc. raise more than $20 million in a February private placement of 14,333,334 common shares to a group of accredited investors at a price of $1.50 per share. There were no warrants or other financial instruments attached to this placement of common shares. The Denver-based independent will use the proceeds to develop and exploit its Riverbend project in eastern Utah's Uinta Basin and for other general corporate purposes.

"It's a pretty good example of a common stock PIPE—common stock only, no warrants and priced at $1.50 to institutional buyers," Keating says. "The stock trades around $1.75 now."

The company had certain parameters in mind in terms of what it wanted to do and the speed of the deal. "There was some institutional interest in the stock as we approached the market. People came to us with parameters of where they wanted to price the deal, and we were able to fill the deal out in about two days."

It's important at both Energy Capital Solutions and

First Albany to match the right capital sources with the right companies that seek financing in a PIPE or any other deal. First Albany combines Hansen's knowledge of the oil and gas universe, as head of its energy group, with Keating's understanding of intricacies in various financial products.

"We work together to try and find candidates that could use capital and that might not necessarily want to do a fully public market offering," Keating says.

Hansen adds, "Timeliness is a key element in a PIPE, particularly if it involves a relatively small amount."

Behrens says, "These investors look for fundamentals that support stock prices that should, hopefully, appreciate in the short and long term, depending on their hold periods. They realize that it will take at least a year for capital to be deployed and show up in the stock price."

Not every small-cap company can do a good PIPE transaction. "It has to show a good use of proceeds, either an acquisition or drilling assets, along with good management," Weinberg says. "We also raise money for private companies. Those typically take longer, typically two months. PIPEs go fast. Hedge and investment funds are not interested in board representation. They're typical investors that are able to issue a check quickly."

Due diligence remains essential, however. Energy Capital Solutions retains an engineer for deal analysis. The funds that invest in these companies rely on that experience. "The number of our deals has gone up, but we want to make sure that any investment opportunities we put investors in go up in value too," Behrens says. "Some other groups don't do that level of due diligence; in fact, they try to bring us in for that role in some cases."

The firm has assembled a list of investment funds that are interested in energy. "That list continues to grow. They know our record and speak to us immediately," Behrens indicates. "We can answer follow-up questions. About 30 have actually made investments, and another 20 or 30 have looked hard, have not participated, but probably will. These 50 funds represent billions of dollars."

Doing a PIPE

In preparing to do a PIPE when approached by a publicly traded E&P company, Energy Capital Solutions dives into the producer's files, looks at its stock price and arrives for the first meeting with a preliminary idea of what deal would work best.

"After we dig in, we would come up with specific structures we hope to achieve, build a financial structures model and net asset valuation—something that we would be confident investors would receive well," Behrens says.

"There shouldn't be any surprises. All of the deals we've done have come in within the ranges we've projected and the periods we've planned. We get comfort in the story from that first meeting. We provide references not only from companies we've done deals for, but also investment funds we've worked with."

"PIPEs go fast. Hedge and investment funds are not interested in board representation. They're typical investors that are able to issue a check quickly."

—Russell Weinberg,
Energy Capital Solutions

Once the firm and the producer are satisfied, they sign an engagement letter and the firm helps the company put together a management presentation similar to a road show for one-on-one meetings. "The investors will have a degree of interest before we show up. We get them comfortable with management and where it's going," Weinberg says.

"We're very efficient. We work with a group of attorneys that know how to bring agreements to fruition quickly and at low cost for our clients."

PIPEs also appeal to companies with larger market caps that already have sponsorships from bigger investment banks, because of the amount of capital PIPEs, and their speed, timing and cost, he adds.

Behrens and Weinberg have found, however, that there's even more investor interest in drilling contractors and service and supply companies. "Their situation is different," Weinberg observes. "There are more smaller public companies in the E&P sector—more than 100—than in service and supply. Their business plans surfaced under IPOs long ago, or they became public via spin-offs or merging private assets."

Consolidation has occurred during the past decade among service companies. "But several are still out there, although not nearly the number there once was. We find that private-capital groups that aren't just focused on energy basically are more interested, and can get more comfortable with a service company investment than in an E&P investment."

Relationships developed in PIPEs also can lead to bigger deals later on. After Weinberg helped TMBR/Sharp raise capital through a private placement of equity, Energy Capital Solutions advised the drilling contractor when Patterson-UTI Energy bought it.

"We also have done deals for private companies and, on occasion, write senior and mezzanine debt for them. Our M&A side works with both private and public companies," Behrens says. "We also like our investment-banking focus, as opposed to a sales and trading relationship, because it doesn't create a conflict." ■

QUANTUM ENERGY PARTNERS

CORPORATE PROFILE

Quantum Energy Partners (“Quantum”) is a leading provider of private equity to the energy industry. We primarily invest in oil and gas companies focused on building their reserve base through acquisitions, exploitation and exploration, but also consider opportunities in the mid-stream, gas storage and independent power sectors. Quantum currently has over $670 million in capital under management.

Quantum is an ideal financial partner for successful energy entrepreneurs who want to take advantage of our substantial experience gained as owners, operators, financiers and advisors of oil & gas and midstream companies. Additionally, the Quantum investment team truly understands your business as its principals combine a multidisciplinary expertise in finance and tax, M&A, engineering, geology, geophysics and operations.

Quantum is seeking investment opportunities in the U.S. and Canada. Our target investment size is $10 to $50 million, with the ability to make larger investments when needs warrant. Unlike most other private equity funds, Quantum will invest in limited partnerships or LLC’s, which creates significant tax advantages for its portfolio company management teams.

Our investment strategy is to invest in companies that focus on building portfolios of assets that will be attractive acquisition candidates for larger companies, whereby the following are present:

- Proven entrepreneurs with a track record that can demonstrate a history of successful risk/return analysis and capital allocation decisions;
- Entrepreneurial management team that possesses strong technical, financial, managerial and operational capabilities;
- The company has sustainable competitive advantages within a defined geographic region or segment of the industry; and
- Management team that is willing to invest a meaningful portion of their liquid net worth alongside Quantum.

Quantum currently has 11 active portfolio companies, including:

Celero Energy, LP
Chalker Energy Partners, LP
Crown Oil Partners II, LP
Denali Oil and Gas Partners, LP

EnSight Energy Partners, LP
Linn Energy, LLC
Meritage Energy Partners, LLC
Northpoint Energy Ltd.

Rockford Energy Partners, LLC
Tri-C Oil & Gas, LP
Tripoint Energy Ltd.

In addition we have successfully realized investments in 10 other companies, including:

Aspect Resources, LLC
Cougar Hydrocarbons Inc.
Crown Oil Partners, LP
Highpine Oil & Gas Ltd.

Parks & Luttrell Energy Partners, LP
Pointwest Energy Inc.
Sago Energy, LP

Saxet Energy, Ltd.
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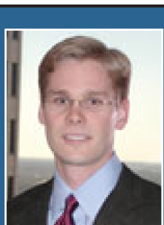

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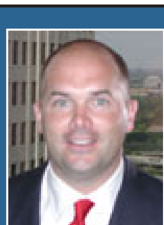

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A Start-Up's Story

Centurion Exploration's founders won private equity for their start-up despite two hurdles—they have an exploration focus and no prior record of starting a successful E&P company. Here's how they did it.

ARTICLE BY JODI WETUSKI and MICHAEL DAVIS

When Brian Ayers, Nicki Maddox and Geoff Roberts began their search for private-equity funding to start their new exploration-focused company, Centurion Exploration Co., they didn't expect to be warmly received.

They had no cash-producing assets and none had ever run an E&P company before, although each had a proven track record in the E&P industry over the past two decades. That track record would prove to be their ace.

Ayers was most recently head of Samson Resource's Houston division, and left to create Centurion. Prior to Samson, he was vice president of domestic exploration at Coastal Oil & Gas and left the company around the time it was bought by El Paso.

Roberts' background is in E&P acquisitions and divestitures. He started and exited a successful business—the M&A firm Madison Energy Advisors, which he sold in 2000.

Maddox is a recognized landman with broad experience on management teams of predominantly small independents. She was with Wessely Energy, Coastal Oil & Gas, Phillips Petroleum, Texas Meridian Resources and Xplor Energy.

"Others have gone into the equity marketplace seeking funding with no assets or production, but most had come from other companies where they had amassed a large nest egg from a sale or merger," Roberts says. Centurion began with nothing but a business plan and an extensive seismic database.

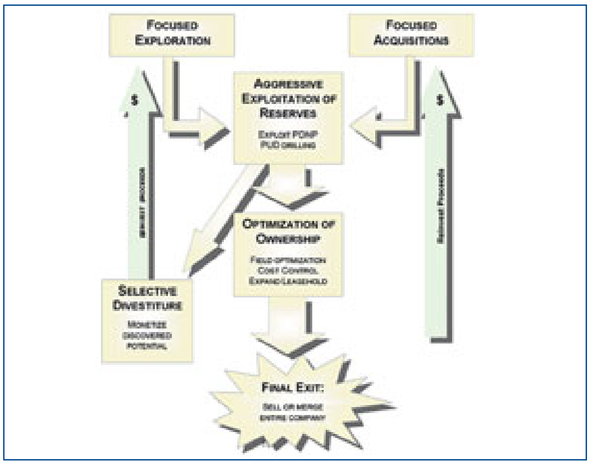
"We were a pure start-up. We didn't even have an office; we were barely a formed corporation. In terms of how far we were able to get, we felt it was an accomplishment."

Roberts and his colleagues' business plan stood the conventional approach to seeking energy equity capital on its head: They were asking someone to bet they had the team and the know-how to build a successful oil and gas company that would acquire and explore rather than acquire and exploit.

They began knocking on doors in Houston and New York last fall. And they knocked on a lot of doors.

"We were singing a different tune than the rest of the crowd," Ayers says. "They understood it; they just didn't necessarily like it."

Roberts adds, "One of the first meetings we had was with a guy who came into the room and the first words out of his mouth were 'We don't do exploration and we don't do start-ups.'"



With exploration and acquisitions, Centurion's business plan is to eventually exit through a sale or merger.

But the trio persevered and found a benefactor in Yorktown Energy Partners, which saw enough upside potential in the fledgling firm to make an initial equity commitment along with a plan to increase that commitment in the future as additional opportunities arise. And to hear Roberts tell it, additional opportunities are coming fast and furious.

"We probably see almost one new deal a day, at least two or three a week," he says. "Deal volume is believed to be low right now, but that depends on what you're looking for. We're very happy to pursue low-end or challenging properties as long as the upside is there."

Yorktown was sold on Centurion largely due to the background of its founders. Plus, Centurion has access to a large seismic database onshore Texas and Louisiana and an alliance with a seismic-processing company, giving the company the ability to generate and evaluate a vast amount of prospects after gaining access to funding.

Ayers and Maddox had earlier hired Houston-based capital-sourcing firm Weisser Johnson Capital LP to seek equity firms that might fund Centurion. Frank Weisser, managing director of Weisser Johnson, says that going in, the company was facing some long odds unless it picked up some producing properties.

"They had less than a 50-50 chance of doing a

Williams Production RMT Co.

$500,000,000

Secured Term Loan B

Note Purchaser
May 2003

$70,000,000

Senior Subordinated Notes

Co-Lead Investor
June 2003

$325,000,000

Term Loan Project Financing

Arranger
July 2003

$300,000,000

Senior Secured Credit Facility

Lead Manager
August 2003

$20,000,000

Senior Subordinated Notes

Agent
November 2003

Announcing the Creation of

FALKIRK GAS TRUST

$20,000,000

Acquisition of a Volumetric Production Payment

Lead Arranger
November 2003

$500,000,000

Senior Secured Credit Facility

Secured Term Loan

Co-Documentation Agent
January 2004

$200,000,000

Senior Secured Credit Facility

$35,000,000

Senior Subordinated Notes Purchase

Documentation Agent
February 2004

$600,000,000

Senior Credit Facility

Participant
March 2004

$175,000,000

Senior Secured Credit Facility

Co-Agent
April 2004

$150,000,000

Senior Secured Credit Facility

Lead Arranger
Book Manager
Syndication Agent

April 2004

$500,000,000

Senior Credit Facility

Managing Agent
April 2004

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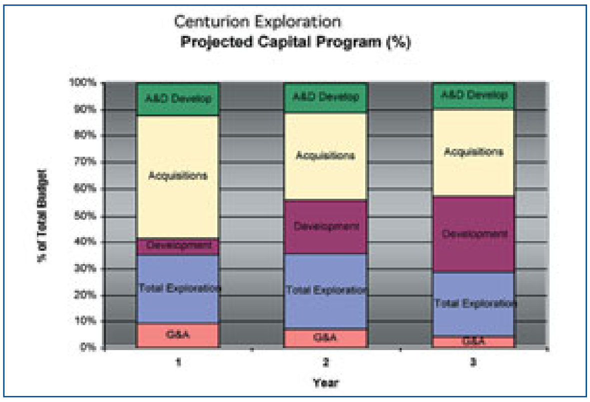

Acquisition and exploration spending will provide exploitation (development) opportunities for Centurion.

start-up without having an acquisition in hand, and an 80% or better chance if along the way, the right acquisition could be teed up to coincide with a start-up," Weisser says.

"It was never our plan to find an acquisition prior to funding," Roberts says. "We're a G&G (geology and geophysics)-oriented company and our business plan calls for us to utilize that advantage to its fullest to generate both drilling and acquisition opportunities. There's simply no way to do that without a significant capital expenditure and decent lead time.

"Catch 22: a private equity commitment based on that business plan was the only way that business plan could succeed. The Weisser Johnson team did a fantastic job of putting us in a position to make that happen."

That meant the strength of the management team would be relied upon as the key selling point.

Weisser does not believe Centurion's formula for successfully finding start-up funding will be replicated on a large scale.

"This is fairly unique," Weisser says. "It was a special combination of a team with a focus on the Gulf Coast and financially advantageous access to an unusually large seismic database and seismic processing. I don't think they have necessarily broken the mold on obtaining start-up financing."

The sort of prospects Centurion will be going after fall basically into three camps: properties currently owned by companies without the capital to develop them, properties that have yielded dry holes because the previous owner was not able to properly identify good drilling targets, or fields that are no longer relevant to the portfolio of a larger company.

The company's geographic focus will be along the Gulf Coast, from Houston to New Orleans. It is looking for properties with little production but significant upside potential, and to be the operator. "We consider operations critical to our success," Roberts says.

Ayers arranged the deals with the seismic and seismic-processing companies. He prepared a business plan and showed it to two private-equity investors last summer. Both declined because of the exploration focus. At this point, the company was just Ayers and Maddox. In July 2003 they hired Weisser Johnson to help them find capital.

Weisser Johnson introduced them to Roberts to add more of the A&D element to the company. The firm worked with the three partners to perfect their pitch, which initially opened with the business plan, then the financial model and the management team.

After a few pitches, that structure changed.

"We ended up emphasizing the partners' credentials first, the business plan second, and, 'Oh by the way, here's our financial model,'" Roberts says. "Private equity is more about people and track records. Once they believe you can be successful, the door opens."

They set out to raise $50 million, meeting with most of the Houston-based private E&P equity funds. They expected to be shown the door in 15 minutes or less by most of these companies; instead, many found their contrarian business plan intriguing and often extended the meeting. Ayers says, "They said the presentation looked more like a market analysis than a standard pitch book."

The capital providers were not that interested in seeing Centurion's financial projections. They were more interested in the people behind the company, he says.

In October 2003, Centurion and Weisser Johnson went to New York with an updated pitch book and spent four days visiting institutional investors. Three asked Centurion back, including Yorktown.

Yorktown expressed an interest in funding the company, but was concerned Centurion's efforts to grow might conflict with the operations of some of its other portfolio companies. So, Centurion management met with those Yorktown portfolio companies, presented its business plan and showed them how they could work together. Those Yorktown companies ended up becoming Centurion advocates.

"What could have been a very large negative, a deal-breaker in fact, turned out to be something positive for everyone involved," Roberts says.

The exit strategy at this point is to build the company into something attractive to a midsize or large independent.

In January, Yorktown sent its first term sheet to Centurion. The company received its initial advance March 2.

The Centurion founders have invested a significant amount of their own capital in the new company. The terms of Yorktown's investment in Centurion are not that much different from what a company with a producing field would expect, Roberts says. And Yorktown's management has already indicated that the initial commitment will likely only be the first round of funding for the company.

"They told us they'd be happy if we spent $200 million this year," Roberts says. ■

One Stop

The firm through which you want to buy an important asset may also be able to help you find financing. Here, two of these firms describe their services.

ARTICLE BY NISSA DARBONNE

You've found the perfect producing property, and at a great price—well, it's a fair price to you, when factoring in how strategic this asset is to your portfolio.

Now, it's time to secure financing. Don't leave the negotiating table yet. In some cases, the firm through which you plan to buy the property can help find capital to finance this.

"We had clients in Midland a few years ago who were buying out their partners and weren't sure if they wanted to sell or just refinance," says Jim Benson, partner and managing director of Dallas-based Energy Spectrum, which provides both asset-divestment and capital-arranging services, as well as management of two private-equity funds—one midstream and one E&P.

"We ran a parallel process. We had books out in the market to sell it and books out in the market to finance it." The clients found their potential to be greater via a refinancing rather than sale.

"We'll try to figure out the best financial alternative for our clients, and that means evaluating all of the options. That is what is very unique about Energy Spectrum: a lot of firms will either just finance it or just sell it. We'll look at both."

Energy Spectrum's principals are (clockwise from bottom left) Jim Benson, Leland White, Sidney Tassin, Tom Whitener and Jim Spann.

"We ran a parallel process. We had books out in the market to sell it and books out in the market to finance it."
—Jim Benson, Energy Spectrum

Energy Spectrum's partners have been in the upstream-finance and property-divestment business since 1987, originally with Reid Investments.

A newer provider of both services is Denver-based Meagher Dunn Capital, founded by Matt Meagher, president of asset-marketing firm Meagher Oil & Gas Properties Inc., and Bill Dunn, formerly with regional investment-banking firms First Albany, Stifel Nicolaus and Hanifen Imhoff.

Dunn's first initial public offering deal was a $75-million one in 1993 for St. Mary Land & Exploration. "Today you need to raise $300- to $400 million to really tap the IPO market," he says. "There's been a shift within the public capital markets away from the smaller transactions."

Meanwhile, with the maturation of North American basins, opportunities are getting smaller, and small production companies are most likely to try to exploit what's left. "We have this disconnect in the marketplace—high rates of returns and opportunities at the smaller end, and capital markets that are moving the opposite direction."

And the consolidation among investment-banking firms is taking financial services toward larger prizes, he adds. "They have significant revenue targets to meet. They can't chase the smaller, $5- to $10-million private-placement deals and still meet their budgets. We don't have as many small investment-banking shops chasing the smaller ideas as we did 10 years ago."

This is where Meagher and Dunn aim to carve a niche—to provide financial services to this group of producers. "Our primary focus is the sector of the market that is underserved by Wall Street. It's early but I'm feeling very good about the concept."

Doing this within an asset-divestment services firm is a good fit, he adds.

Dunn was at Hanifen Imhoff when he met Meagher. They co-managed a deal. "I was struck by the depth and breadth of his contacts within the oil and gas business and his market intelligence," Dunn says.

Meagher's client base is smaller, high-growth companies that are looking for assets to buy, and he is typically focused on the Rockies and Midcontinent. "He is focused in areas that are less competitive in an investment-banking perspective than the Gulf Coast."

Meagher Dunn Capital can draw support services from the Meagher Oil & Gas Properties staff. "I have the ability to sit down with the engineering, land and geology people here internally and review opportunities," Dunn says. "They have a wealth of technical intelligence that allows me to identify an opportunity. I am able to leverage their technical capabilities."

With this pre-existing familiarity with the asset and its potential, financings may get done faster. "I can get in there and advise a client very quickly and much more intelligently in what kind of financing makes sense, and when I convey the opportunity to the institutional market, I'm able to highlight the value and underlying fundamentals of the project."

And, the right financing may be won. "The client shouldn't waste a lot of time chasing a structure or financing alternative that is not going to work, or that at the end of the day is so different from what they originally thought they were getting into that they wish they had not gone down that path."

Some M&A Advisory Firms with a Capital-Provider Component:

— Meagher Oil & Gas Properties/ Meagher Dunn Capital
— Energy Spectrum
— Petrie Parkman & Co.
— Energy Capital Solutions
— Wells Fargo Energy Advisors
— Growth Capital Partners
— Waterous & Co.
— Wellspring Partners
— Randall & Dewey Inc.
— Albrecht & Associates/Compass Bank
— Banc One Capital Markets

Jim Benson and his partners—Tom Whitener and Leland White—were at InterFirst Bank in the 1980s and joined Ray Reid at Reid Investments. They spun out Energy Spectrum in 1997 and, with Sidney Tassin and Jim Spann, launched the midstream and upstream private-equity funds.

"The client shouldn't waste a lot of time chasing a structure or financing alternative that is not going to work…."

—Bill Dunn, Meagher Dunn Capital

Its business today is roughly 50-50 divestments and private placements, ranging from $10- to $250 milion in size and averaging some $60 million. It completes a total of eight to 10 assignments of both types a year.

"We started out doing financing work for midsize and small public and private companies. As that business grew, we began doing divestiture activity as well. Over the years, we've developed into a full-service investment-banking firm."

As a registered broker-dealer, the firm can do underwriting but chooses to stick to private-placement and M&A work. "We don't just focus on property sales, and we don't just focus on financing. We want to be there for several deals."

Ben Davis, vice president, says, "I don't know any other group that truly does what we do on both sides of the investment-banking coin, with the exception of some of the larger investment-banking groups, and that has the track record."

Benson says, "If a client needs to do some financing work, we will help on that; if they're looking to sell, we'll help on that too; or if they want to do both.

"The client deserves to understand what the options are."

The best structure around a property purchase may not be a volumetric production payment (VPP) or senior subordinated debt. "It may be a more creative transaction with a different type of investor. Exploring all of these creates a competitive process for the financing, just as in a property sale.

"This isn't a cookie-cutter business. It's not 'one deal fits all.' You have to understand the players in the marketplace and be able to fit the right peg in the right hole." ■

Parlez-Vous Capital?

Funding for overseas projects can be challenging but several capital providers are willing to back the right ventures.

ARTICLE BY JODI WETUSKI

Increasingly, independents are turning to overseas prospects to grow their companies, but finding capital providers that are equally enthusiastic about these international plans can seem daunting. Potential sources of money for internationally minded independents include private-equity providers, multilateral agencies and farm-in partners. Each route presents its own obstacles.

A new company, Dallas-based Kosmos Energy LLC, has successfully tapped the private-equity markets this year to fund its plans for exploration in West Africa. Kosmos founders, Warburg Pincus and Blackstone Capital Partners, the latter an affiliate of The Blackstone Group, have made provisional commitments of up to $300 million.

It is rare for a start-up focusing internationally to be so well-funded. Many entrepreneurial teams from the U.S., the U.K. and Australia that have set out to explore internationally have been underfunded and ended up not being able to land the big fish they catch, says James C. Musselman, Kosmos chairman and chief executive.

This deal is unique in a number of other ways as well. It is Blackstone's first upstream energy investment, and Warburg Pincus' first purely international deal.

What was it about Kosmos that inspired these private-equity providers to stretch their boundaries? For one, Kosmos has an excellent management team, several of whom could be CEOs in their own right, according to Warburg Pincus decision-makers.

Musselman is a former Triton Energy chief executive, who led that company during its discovery of the Ceiba Field in Equatorial Guinea. Triton was later sold to Amerada Hess Corp.

Also on the Kosmos team are Brian Maxted, formerly senior vice president of global exploration and new ventures at Amerada Hess and senior vice president of exploration at Triton; W. Greg Dunlevy, formerly CEO at Moncrief Oil International and senior vice president and chief financial officer of Triton; Craig Glick, formerly senior vice president of business development at Hunt Oil Co. and executive vice president, CFO and general counsel at Gulf Canada Resources; Douglas G. Manner, most recently CEO at Mission Energy and vice president and chief operating officer at Gulf Canada Resources; Paul Dailly, formerly exploration manager at Amerada Hess and senior geologist at Triton; and Kenny Goh, formerly senior geophysical advisor at Amerada Hess and chief geophysicist at Triton.

Lending further credibility to Kosmos is an agreement with Pioneer Natural Resources Co. to jointly explore an area along the west coast of Africa from Morocco through Angola, excluding Gabon where Pioneer is currently active.

Under the agreement, Kosmos will show Pioneer everything it generates, and Pioneer has the right to participate with 50% interest. "This gives us arguably $600 million to spend over the next several years—it gives us the ability to walk into any ministry with confidence and the ability to do what we say we'll do," Musselman says.

Overseas assistance

Multilateral and bilateral agencies also can help independents with international projects. However, money-seekers need to keep in mind that these agencies are not commercial banks, and different techniques are required to navigate the system.

International law firm Chadbourne & Parke LLP has created a niche practice in multilateral financing for international E&P that is staffed with attorneys who have worked for these agencies in the past.

"We understand how these agencies work," says Peter Fitzgerald, a Chadbourne & Parke attorney who used to work for the Overseas Private Investment Corp. (OPIC). "The culture of each is very, very different…These are not banks."

These agencies include the likes of OPIC, which helps U.S. businesses invest overseas; The Export-Import Bank of the United States (Ex-Im Bank), which assists in financing the export of U.S. goods and services to international markets; and the International Finance Corp. (IFC), which promotes sustainable private sector investment in developing countries as a way to reduce poverty and improve people's lives.

The top concerns of these agencies aren't necessarily financial. They are quite concerned with issues surrounding the environment, worker rights, human rights and corrupt practices. It's vital that they like you and your project; throwing around a tough attitude just won't work with them, Fitzgerald says. Unlike some bankers, the people who work at these agencies aren't too concerned about getting fired over a deal that goes south, he added.

At a recent energy conference in Houston, Rashmi Nehra, senior investment insurance officer for OPIC, talked about the requirements that her agency has for projects.

OPIC does not want to displace the private financial markets, if they are willing to back an investment. What it does want is to facilitate new investment, rather than existing projects; contribute to host-country development, such as through job-creation, for example; to back projects that are environmentally safe; to support worker and human rights; and to make sure that its investments do not result in negative U.S. economic effects, such as a loss of U.S. jobs.

For energy projects, OPIC will make direct loans of $100,000 to $10 million, and will do loan guarantees up to $400 million. It will not fund exploration, it wants an independent engineer to verify the reserves of a project, and it requires at least 25% equity participation by the U.S .sponsor.

No rush

W. Russell Scheirman, president of publicly held Vaalco Energy Inc., Houston, has had experience dealing with both private-equity providers and multilateral agencies. When his company was looking for capital for E&P activities in Gabon a few years ago, he found that U.S. lending institutions were not very interested in Gabon. And European banks, while interested in Gabon, were wary about working with an American company they did not know.

So in 2001, Vaalco went to the IFC, which had not done a project in Gabon in a while, and it was interested in Vaalco. However, IFC did not want to take any completion risk. That created a Catch-22 for Vaalco, which needed money to get its project on production.

So, executives turned to the private bank Brown Brothers Harriman, which was willing to back Vaalco with the understanding that the IFC would step into the project once the field was online.

Once Vaalco began production, the IFC came in with a $10-million financing. It was an attractive deal, in part, because of the political-risk insurance coverage the IFC offers, Scheirman says.

The IFC is a bureaucratic organization, he adds. It took 16 months after the first meeting for Vaalco to receive funding. "They don't get in a rush for anything," Scheirman says. Also, the IFC was adamant about getting letters from the oil minister and financial minister of Gabon in support of the project, which took time to collect.

Another option for funding international projects is, of course, to recruit farm-in partners. But shopping around development prospects can be quite time-consuming and difficult.

William Divine, president of Concessions International Inc., Houston, assists companies in finding partners for projects around the world. "Companies spend millions to get concessions, then can't make the project come together," he says. "You may fall in love with your deal, but will anybody else?"

Divine keeps a database of companies that are looking for farm-in partners, and organizations that want to invest in certain countries. Matches are never easy to make, but the more contacts one has, the better.

"If you're a domestic company going international and no one's ever heard of you, you need to establish relationships," he said. ■

—Jodi Wetuski

LOOK BEFORE YOU LEAP

Peter Fitzgerald, a Chadbourne & Parke attorney who used to work at the Overseas Private Investment Corp., offers this list of 10 points to remember when seeking financing from multilateral agencies for international projects.

1. Spend time getting to know the agencies. Come to town and talk to people. Become familiar with the culture of each agency.
2. Agencies attract two types of workers: ambitious people, and those who are more advanced in their careers and want to slow down. The type of person who gets assigned to your deal team greatly affects your project.
3. If you get a weak team, don't despair. Make sure you hire an outside lawyer with a long history with the agency.
4. Avoid confrontation with agency folks. You want them to like you and your project.
5. Use position papers if you're dealing with an inexperienced lawyer or financier on the other side of the table. Help them understand your issues.
6. Go over the head of your deal team only if you really must. Even then, do it sparingly. You may win the battle but lose the war.
7. Don't try to negotiate any changes to their forms.
8. Manage the loan-documentation process intensely. Make up task lists each week, and make sure you have a closing checklist.
9. Don't go home when you're making progress, especially if you've been lucky enough to gather representatives from multiple agencies in the same room.
10. Keep the number of agencies you're working with to a minimum. If you can't keep it to just one, have everyone agree to the inter-creditor principals up front.

Finance: A Directory

Although not exhaustive, the firms noted here are among known providers and/or arrangers of capital to the upstream energy industry. They include commercial banks, investment banks, capital intermediaries and advisors, and private-capital sources. In some instances, commercial banks are listed once although they may have a non-regulated capital-provider business as well.

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