To VPP or Not to VPP . . .

March 01, 2019

Wait . . . is that the question? Well, it is for many oil and gas producers. Due to limited conventional means of finance available, many oil and gas producers have been turning to VPP transactions as a means of securing funding for exploration and development expenses.

What is a 'VPP' you ask? The acronym stands for **V**olumetric **P**roduction **P**ayment and it is an oil and gas development financing vehicle that, from my experience, is recently becoming more in vogue.

A VPP transaction typically involves two parties – the producer and the investor. In a nutshell, the producer agrees to convey, and the investor agrees to purchase, a term overriding royalty interest which entitles the investor to receive a specified amount of oil and/or gas production over a specified period of time – typically three to five years or when the specified production quantity has been delivered. In exchange for such conveyance, the investor pays the producer a negotiated sum, which sum can immediately be – and is often required by the investor to be – deployed by the producer in exploration and drilling activities to enhance the production of the subject energy assets. The amount that an investor will be willing to pay in a given VPP transaction will vary based upon the production history and the future prospects for the subject oil and gas assets, the term over which such production will be delivered and the current and anticipated market conditions.

The typical transaction involves three core documents – a Purchase and Sale Agreement, a Conveyance of the Term Overriding Royalty Interest, and a Production and Delivery Agreement. The Purchase and Sale Agreement is the first agreement executed by the parties and governs the process by which the investor conducts its due diligence as well as the closing process. At the VPP closing, the producer conveys the subject interest to the investor through the execution and delivery of the Conveyance of Term Overriding Royalty Interest, and the parties also enter into the Production and Delivery Agreement, among other ancillary documents. The Production and Delivery Agreement is the key agreement which governs the relationship of the parties following the closing, and, among other things, sets forth the details of how and when the subject production will be delivered to the investor (whether in-kind or marketed and sold by the producer on the investor's behalf) and establishes what constitutes a default and provides the investor's remedies for the same.

Some of the referenced ancillary documents that are executed at a VPP closing include: (i) a deed of trust – which is filed of record in the applicable county(-ies) where the oil and gas assets are located and which, among other things, preserves the right to foreclose (in the event of a default by the producer) on the portion of the subject oil and gas assets which was retained by the producer and not conveyed through the Conveyance of Term Overriding Royalty Interest; (ii) UCC-1 financing statements – filed with the secretary of state of the producer's state of formation and sometimes also in the applicable county(-ies) where the subject assets are located; (iii) an escrow agreement – the agreement through which an escrow agent will hold change of operator forms (P-4s in Texas) executed by the producer and which will be delivered to the investor (or its operator of choice) should a default occur thereby allowing the investor to take over operations in the event of a default; and (iv) a performance guaranty for the benefit of the investor from either a parent entity of the producer or another solvent party.

In addition to the foregoing methods for securing the rights of the investor to receive the specified production, investors also face pricing risk and savvy investors will implement a hedging strategy in the derivatives market to protect against declining prices in the subject energy commodity.

VPP transactions are valuable potential sources of capital for oil and gas producers who desire or need to develop or further increase energy production to preserve their rights to produce under oil and gas leases. They, in essence, allow the producer to maintain ownership and control of the underlying working interests in exchange for a sale of a portion of the anticipated production. As they are also complex transactions, careful attention should be given to the consideration, negotiation and implementation of VPP transactions.