The stronger the financial due diligence, the better the upstream E&P acquisition. Here's how to improve the results.

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A&D for domestic upstream E&P transactions in 2007 brought an estimated aggregate valuation in excess of $45 billion, an all-time record. Fueled by higher energy prices and the resultant cash flows, along with the re-advent of master limited partnerships as an effective source of capital, oil and gas companies and sponsors find themselves in an ever-increasing competitive acquisition market for solid, upstream E&P assets.

The need for strong and effective buyside financial due diligence has perhaps never been greater as acquisition costs escalate, given a landscape in which sellers have mandated terms.

Many of the advantages afforded by effective due diligence originate with crafting a fair and equitable purchase-and-sale agreement (PSA). Generally, the PSA has customary provisions for increases and decreases to the purchase price based upon findings identified during two critical periods–the first being from the date of execution of the PSA to the initial closing and funding, the second being from the date of initial closing and funding through the date of final settlement. The initial period is typically up to two months; the latter period, up to six months following closing, and occasionally a year for resolving any adjustments needed.

Typical financial adjustments to the purchase price between the buyer and seller will generally include: cut-off of revenues and expenses of the properties to the effective date; cut-off of capex to the effective date; environmental and title defects; merchantable hydrocarbons stored in tanks and pipelines as of the effective date; and amounts held in revenue suspense by seller as of the closing date, net of escheatable balances.

With the exception of environmental defects reviewed by engineering personnel, the financial due diligence team is deeply focused on verifying all other financial adjustments to the purchase price. It has been our experience that financial findings, or reductions to the purchase price, in this area of due diligence have without exception always exceeded the due diligence costs involved.

The financial due diligence team should fully understand each adjustment to the purchase price, particularly suspended funds for legal matters. Quite often amounts are in legal suspense due to challenges of rightful ownership or disputes regarding contract compliance. It would be an unfortunate surprise if cash flows pertaining to significant properties were tied up in suspense and the buyer was not aware of this controversy following the due diligence phase.

Cash-flow analysis verification. Besides sourcing cash savings to the buyer on the identification of purchase-price adjustments, one of the most critical values brought by the financial due diligence team is making sure the buyer is aware of the net cash flows and production volumes being generated from the subject properties.

For all properties identified for sale in the exhibits to the PSA, a comparison is initially made of the net revenues and production volumes generated during the interim period (from effective date through closing date) to those projected in the engineering acquisition-pricing model. Significant variations in volumes and cash flows are investigated with seller personnel.

Although all properties are evaluated for significant variations, it is customary that detailed analysis to the independent third-party purchaser remittance advices and state production reporting is performed for all properties representing the top 80% of allocated values.

On the revenue side, findings can have financial consequence, particularly if considerable purchase-price value has been allocated to specific proved developed producing properties that later are determined to be shut-in, or where there has been an unexpected decline or cessation of production.

Such findings might even suggest misrepresentations by the seller and result in other legal implications favorable to the buyer. Once again, this is a critical area of focus by the financial due diligence team.

On the expense side, the cash-flow focus is on lease operating expense (LOE) levels reported by significant property in the lease operating statements. Generally, a three-year history of LOE, by month, is secured for all of the properties, and magnitude of dollars and pricing metrics (rates per barrel of oil equivalent or thousand cubic feet of gas equivalent) are evaluated to determine if they are reasonable, given present operating conditions.

Current expense run-rates are evaluated relative to anticipated rates in the acquisition-pricing model to more closely fine-tune net cash flows to be expected. Financial due diligence primarily helps lock down expense rates by property; however, most financial adjustments related to operating expenses generally result from the cut-off testing performed as of the effective date.

Operational/financial concerns. A fundamental goal of financial due diligence is to achieve a clear understanding of the risks assumed in the purchase of the specific properties, including any commitments and contingencies existing at the time. Hopefully, any undisclosed risks identified in the performance of financial due diligence will result in some form of concession by the seller, whether it be as provided for within the PSA or through subsequent agreement.

Generally, to get a good understanding of binding obligations and commitments, the due diligence team should review most of the critical contracts pertaining to the operations and product sales arrangements for the properties. These agreements will include, but are not limited to, joint operating agreements, gas balancing agreements, product-sales and marketing contracts, and transportation agreements.

These agreements are typically read and briefed for buyer retention, and identified problem areas are communicated to the buyer. It is also important to determine which contracts are assignable or assumable, and which ones require consent for assignment. Although the legal team will generally sort out the assignability of contracts, it is important for the financial due diligence team to be able to identify financial risks and commitments embedded in these contracts.

The buyer may very well not want to assume all contracts if financial terms are not as favorable as can be achieved through alternative means.

One topic worthy of discussion is the assumption of obligations related to existing gas-balancing positions on the properties. Through decades of working financial due diligence acquisitions, experience has shown that companies in the upstream E&P sector overall do not do a good job of maintaining current gas-imbalance positions on their properties.

Some companies maintain pretty good record-keeping through year-end for audit purposes, while others try to maintain such information on a quarterly basis. In any event, stale data is virtually always received for existing gas-balancing positions as of the effective date, particularly on outside-operated properties. Sometimes the PSA provides for the full assumption by the buyer of existing gas-balancing positions, while other times there is a financial adjustment stated in terms of price per thousand cubic feet of gas for any variations from represented gas-balancing positions by property. This latter situation is ideal for financial adjustments favorable to the buyer.

Aside from financial adjustments for misrepresentations on gas-balancing positions, it is important to get a full understanding of gas-balancing positions for cash-flow purposes. Understanding the make-up provisions as defined in the gas-balancing agreement is critical to determining available cash flow to the buyer and, consequently, in getting a realistic discounted cash-flow valuation on the property.

Quite often, the allocated value of the property for acquisition purposes does not consider all gas-balancing nuances. For example, properties with inadequate reserves to settle the assumed balancing payable have been examined. In this case, gas-balancing agreements need to be reviewed to determine how the gas-balancing payable is settled when the well is projected to be plugged and abandoned.

Some agreements may stipulate the liability is settled at the historical cash prices received when the imbalances were created, while others may say the settlement is at a current-market gas price. Obviously, the disparity in these prices can yield a huge monetary difference on settlement of the liability.

In any event, the financial due diligence team should identify whether allocated values are appropriate, given misrepresented gas-balancing positions, and recourses need to be pursued by the buyer based upon relevant information discovered.

Payables are not the only focus of the due diligence team on gas-balancing matters. Gas-balancing receivables may be viewed as favorable assets to have, but what happens if the reserves are inadequate to settle the receivable? Furthermore, what happens if the credit worthiness of the debtor party is in question?

Financial settlement of the receivable may very well be remote. Once again, the financial due diligence team needs to first identify gas-balancing problems and then see if remedies are afforded by the PSA, or whether the buyer needs to renegotiate the purchase price to the extent possible.

In closing, as to operational and financial concerns, recent trends in negotiated upstream E&P deals reflect seller efforts to convey to the buyer more of the historical risks associated with the subject properties than ever before. For example, with royalty litigation on the rise, more sellers are attempting to be indemnified for all royalty amounts payable to third parties on account of production from the assets prior to the effective date, unless arising out of or attributable to identified litigation matters or specifically identified by the buyer during a negotiated period of time following the closing.

Transaction integration. Beyond cash savings on due diligence findings, arguably the greatest value provided by the financial due diligence team is the transfer of knowledge to the buyer as the sale is completed and the buyer assumes operations. Although the review of the closing and final settlement statements and the pursuit of cash savings generally garner the most attention during the due diligence phase, the acquisition will seldom be successful if a smooth integration of the operations and reporting responsibilities of the properties does not occur.

From the initial date of contact with the seller, the financial due diligence team makes a formal written request of all information that is germane to the properties, whether financial, operational, environmental or regulatory in nature. The request is generally in the form of an all-inclusive, multi-page oil and gas acquisition request list, customized for the specific attributes of the targeted acquisition.

Interviews are held with seller representatives to fully understand these matters and considerable time and energy are dedicated to documenting the processes and procedures that the seller goes through on a monthly basis to maintain the properties. Critical focus areas include state, federal and tribal regulatory reporting; royalty distributions; severance tax and state production reporting; product-marketing arrangements; and transportation and processing arrangements.

From an information perspective, the financial due diligence team should strive to be able to replicate current reporting requirements to state, federal and other regulatory bodies so transfer of such duties to the buyer's personnel is as seamless as possible.

Not only is current information reporting important to understand, but the financial due diligence team should be involved in creating the purchase-price entry, particularly given audit procedures performed on interim net proceeds received between the effective date and the closing date.

Finally, the due diligence team should be very involved in securing all of the assumptions and ultimately deriving the plugging and abandonment accruals by specific property, which is required as of the acquisition date under generally accepted accounting principles.

In closing, buyside financial due diligence is extremely important in mitigating risk in the upstream E&P acquisition arena. Fortunately, good deals are still getting done and strong financial due diligence is playing a critical role in the success of acquisitions, specifically in terms of monetizing transaction savings, assessing acquisition risks and securing effective integration of financial and operational responsibilities. ■

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