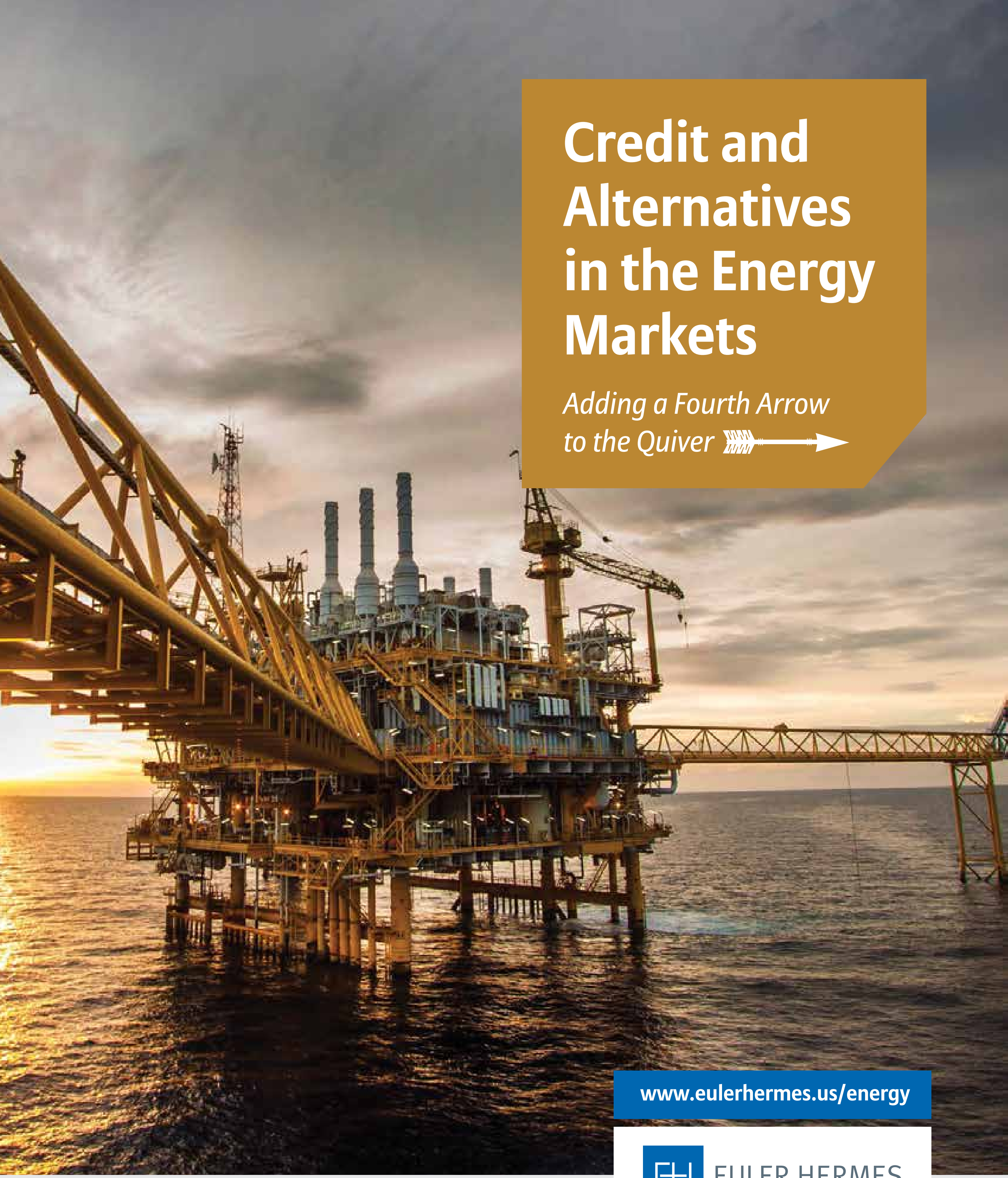
Credit and Alternatives in the Energy Markets

Adding a Fourth Arrow to the Quiver



www.eulerhermes.us/energy

EULER HERMES

A company of Allianz

Background

On the front lines of energy market credit administration, financial managers of oil and gas companies have traditionally fought the battle with three primary "arrows in the quiver:" open terms, prepayment and letters of credit (LCs).

Risk is mitigated, to some extent, in the energy industry thanks to the prevalence of expedited payment terms and regular maintenance on counterparty financial health. Nonetheless, the industry does experience defaults, despite its cautious credit practices – and when they occur, they can be catastrophic.

As comfortable as these standards have been for the industry, shifting conditions brought about by market volatility and new regulations have challenged energy companies to explore new risk mitigation options. Some energy companies have explored financial hedging tools such as credit default swaps (CDSs) and options to fill this void. Uptake of these alternatives has been limited as some markets tend to be opaque and less reliable than the established three options. There remains a need for new methods of safely extending and acquiring the needed counterparty credit while maintaining the desired risk position and meeting compliance requirements. New methods need to address three primary areas of impact:

Regulatory effects

The Dodd-Frank regulation has changed the dynamic of the U.S. energy markets, especially from a credit and risk perspective. Banks and other institutions are no longer free to offer risk and credit strategies as robust as those they offered before. For instance, banks are no longer allowed by law to engineer vertically-integrated solutions for customers. Though the exchanges and major participants now act in very similar role, they lack flexibility. This new strain has led to a decline of credit availability and liquidity across the industry.

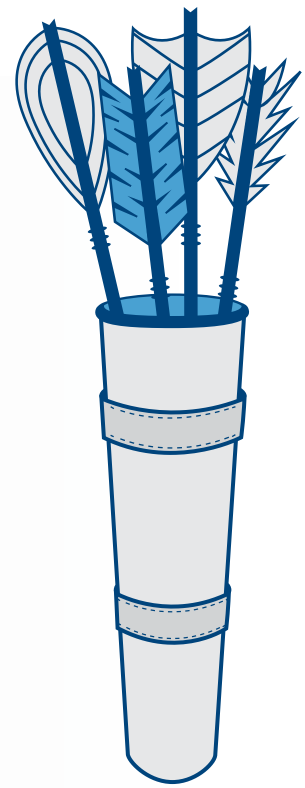
Market effects

The energy markets have endured several shock effects recently that necessitate a re-evaluation of credit and the policies by which companies govern themselves. The rules of "give and get" have changed. The decline in commodity values has made transacting more affordable, but has also stripped balance sheet value from many participants. The resulting margin compression has had a negative effect on the market as a whole. In this current environment, credit is relatively constrained. Energy companies operating under these circumstances need a tool to safely grow while not compromising their risk position.

Human effects

Today's uncertain and credit-constrained environment can create a conflicted mandate among energy company leaders. Conditions have amplified the divide between those tasked with safeguarding the assets of an organization and those tasked with growing the business. This inherent conflict is further complicated by the fact that the insulating factors of deep liquidity and high prices enjoyed a short time ago have been stripped away. With an eye toward the future, those who are able to utilize the right tools will not only survive, but thrive in challenging environments.

Adding a Fourth Arrow to the Quiver



Credit is the fuel of an energy company's growth. A constrained credit environment limits the potential for a company to increase revenue and create value. So how can a company strike the proper balance and transform risk into reward?

Over the past decade, forward-thinking energy companies have begun adding a powerful weapon to their credit arsenals, expanding upon the three established and accepted methods of credit administration. The fourth arrow in the quiver is trade credit insurance (TCI). This type of insurance has been sold in the U.S. for more than 120 years and is a very common tool in many other industries, with trillions of dollars of coverage currently in effect across the globe. So while TCI is certainly not a new concept, it has gained recent notable traction in the energy industry, lending itself particularly well to its unique counterparty credit needs. TCI allows organizations to worry less about credit capability, freeing company leaders to focus on growth.

What Is Trade Credit Insurance?

Stated simply, trade credit insurance (TCI) is a partnership with a third party underwriter to clear credit. Though there are multiple benefits to its use, at its core, credit insurance is the transfer of receivables risk to a third party in return for a small premium. If the counterparty doesn't pay, the third party insurer does.

How does Trade Credit Insurance work?

The seller executes a policy for the amount of risk they want to lay off against any buyer or group of buyers. The seller can then confidently transact on open credit to the covered counterparties, knowing that if a default occurs, it can execute a claim for payment with the insurer.

TCI can work in conjunction with existing credit tools (open, prepay, LC). However, many companies find that credit insurance can fully replace the need for other methods. Consider the following table of advantages and disadvantages of all four credit tools.

How does Trade Credit Insurance work?

(continued)

		TCI	LC	Open	Prepay
Highlights	Provides for Risk Transfer	✓	✓		✓
	Bankruptcy Protection*	✓	✓		✓
	Slow Pay Protection	✓	✓		✓
	External Credit Support	✓			
	Strong Credit Issuer	✓	✓		
	Covers All Commodities	✓	✓		✓
Implementation & Maintenance	Ease of Implementation	✓		✓	✓
	Ease of Documentation Requirements	✓		✓	✓
	Ease of Maintenance	✓		✓	✓
	Counterparty Friendly	✓		✓	
	Flexible	✓		✓	
	Industry Specific Support	✓	✓		
Cost And Valuation	Cost Effective for Company	✓	✓	✓	✓
	Cost Effective for Counterparty	✓		✓	
	Counterparty Flexible	✓		✓	
	Contract Integration	✓	✓	✓	✓
	Flexible Terms	✓		✓	

** Recent precedent suggests LCs may be vulnerable to recall in bankruptcy*

EH Energy has empowered its clients to move risk off their balance sheets and open up greater leverage – all at little to no change to their current risk position.

Introducing Energy Credit Insurance

Having long established its value in many other industries, TCI has recently reached a tipping point in the very traditional energy industry. Its flexibility and unique coverage options have transformed it from a standard B2B offering to one that is specifically tailored to the needs of the energy industry. Trade Credit Insurance has evolved into **Energy Credit Insurance**.

At the leading edge of this new evolution is Euler Hermes, a company of Allianz, and the world leader in TCI with over $1Trillion in global receivables coverage. In 2015, Euler Hermes established a specialized business unit – Euler Hermes Energy (EH Energy) – to support the specific needs and counterparty nuances of the energy markets. EH Energy has a rapidly growing portfolio already composed of several billion dollars' worth of coverage to counterparties ranging from the majors to small producers, midstream, processing, transportation and marketing firms. This specialized unit, backed by the power and stability of its parent companies, has empowered its clients to move risk off their balance sheets and open up greater leverage – all at little to no change to their current risk position.

Energy Credit Insurance Solutions

The strength of Energy Credit Insurance is enhanced by its flexibility. Along with industry-specific policy language ("endorsements") that can address specific needs, energy credit insurance can include a variety of solutions that can be leveraged by companies throughout the energy supply chain. These solutions include:

Energy Credit Insurance

- A company's standard credit insurance policy under which specific counterparties are underwritten and covered against receivables loss
- Typically provides high coverage (up to 95 percent) and can be applied to single counterparties or a pool
- Normally used for mainstream applications

Excess of Loss (XOL)

- High levels of discretionary credit limit authority
- Typically used when the customer wants to carry more risk over a larger, more complex environment
- Normally used for larger constructs and/or international applications

Transactional Cover Unit (TCU)

- Balance sheet protection for investors against political risk
- Typically more favorable lending terms for investors and exporters
- Pressure relief from financial institutions' country lines
- Capital relief for financial institutions

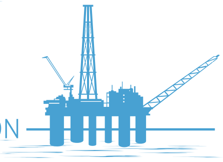
Spread Risk Loss (SRL) Endorsement

- Similar to "Mark to Market" concepts, SRL works in concert with a company's core energy credit insurance policy, bridging the gap between the contract and the market
- Ensures that when a buyer becomes insolvent, the energy provider is not only covered for the lost sale, but is also covered at the original contract value – regardless of market price
- Protects in the event you are required to dispose of or purchase commodity when a contract is abrogated
- Augments complex risk mitigation strategies, providing a simple solution to a common problem

ENERGY SUPPLY CHAIN

UPSTREAM

1 EXPLORATION



2 PRODUCTION

Products from Euler Hermes:

- Trade Credit Insurance
- TCU (Political Risk) – Rigs, Drills
- Spread Risk Loss Endorsement

MIDSTREAM

3 PROCESSING

4 TRANSPORTATION

Products from Euler Hermes:

- Trade Credit Insurance
- Excess of Loss
- Transactional Cover Unit (Political Risk) – Pipeline
- Spread Risk Loss Endorsement

DOWNSTREAM

5 REFINING

6 DISTRIBUTION

Products from Euler Hermes:

- Trade Credit Insurance
- Excess of Loss
- Transactional Cover Unit (Political Risk) – Refineries

Implementing Credit Insurance Solutions

Establishing a new energy credit insurance policy is a very straightforward process. Euler Hermes Energy works with your company's stakeholders to understand your counterparties, goals and structure.

Based on these findings, we establish a policy that includes the insurable counterparty credit limits you currently require and bind those coverages. As you add new counterparties or need to expand limits to your existing ones, it is simple to request new credit limits at any time to ensure you are protected as you seize new growth opportunities. In this way, your policy provides you another layer of credit availability.

For larger or more complex organizations and trading structures, Euler Hermes Energy will also determine whether additional solutions may make sense. The goal is to implement a suite of solutions that meets your company's unique risk position and growth ambitions.

Invisible Protection

Energy credit insurance is protection on open credit that can be invisible to the customer, unless the seller chooses to tell them they are being insured. It is designed to become a credit tool that enables companies to safely and aggressively expand their credit universe without impacting the customer relationship.

What is the Cost?

Multiple factors will inform the cost of a credit insurance solution, but the cost for the typical policy equates to approximately:

A fraction of a cent per MMBtu ¢/MMBtu

A few cents per barrel

Benefits of Energy Credit Insurance

Energy companies leverage credit insurance for these primary reasons:

Safer growth. New counterparties and new destinations for products are emerging. When receivables are insured, a company can expand open credit to new and/or existing customers with the confidence of security.

Credit management support. Energy credit insurance works in conjunction with credit and commercial teams to enhance a business' ability to offer increased credit lines to optimize margin without compromising risk positions.

Reduced concentration risk. By securing receivables, we eliminate high-volume risk to strengthen the balance sheet and protect shareholders.

AA- $

Maximize Leverage. Banks adhere to strict lending principles based on concentration and the probability of default of the underlying receivable. When domestic and international receivables are insured, they assume Euler Hermes Energy's AA- S&P rating, enabling a company to borrow more while providing Basel III compliant capital relief to the bank.

When to Consider Leveraging Energy Credit Insurance

There are two major characteristics of counterparties that are ideally suited for coverage under an energy credit insurance policy:

1) Companies that could buy more if you were able to extend them credit (or more credit)

The return on investment for such a customer is clear: by paying a fraction of a percent, you are able to make additional margin that would have been lost. When counterparties are faced with the alternatives of tying up working capital with LCs or prepays or limiting the amount they can buy, they are often willing to absorb the nominal cost of credit insurance coverage.

The advantage of leveraging credit insurance to extend credit in this way is also compelling when considering tier two, three and four customers to whom you can shift production at a better margin while laying off the associated risk through your policy.

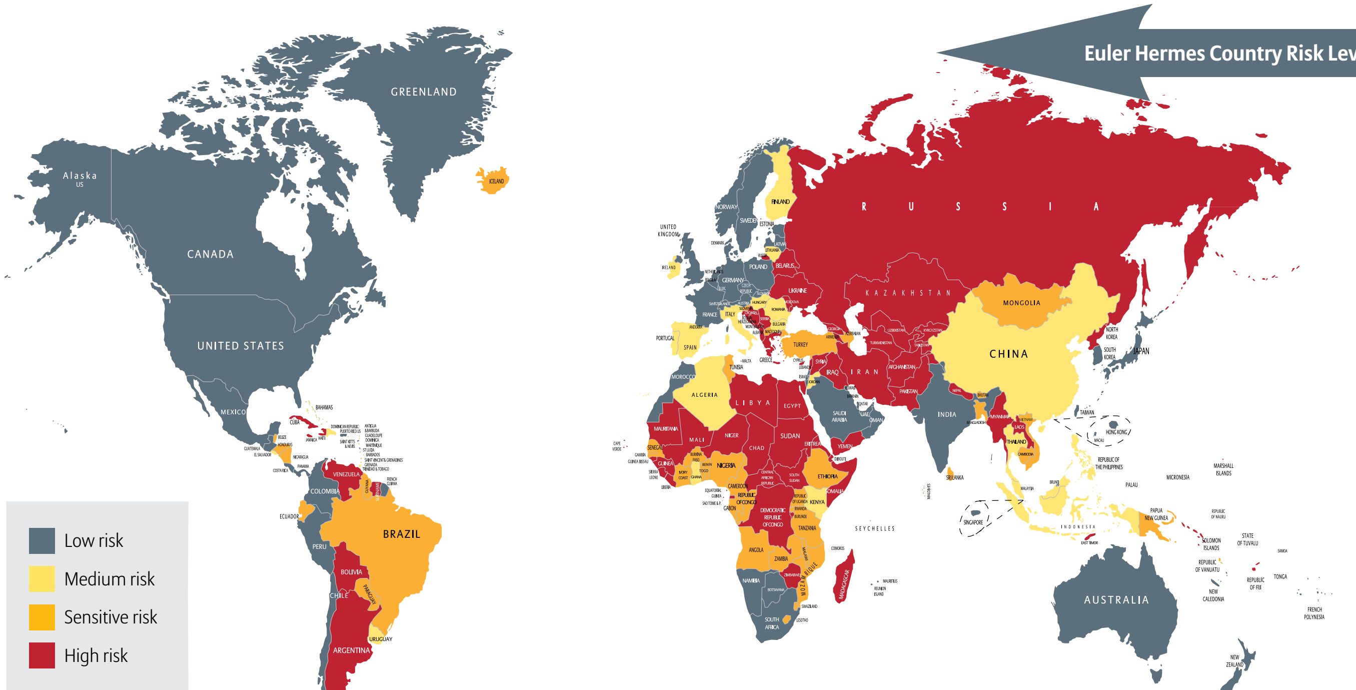
Leveraging energy credit insurance gives you a major **competitive advantage**. When you are able to provide a counterparty easy, free/low-cost open credit while your competitors insist on prepayment or LC, they will be much more likely to buy from you.

2) Companies whose receivables you are uncomfortable retaining on your balance sheet

Common scenarios in which energy companies look to credit insure counterparties include those with high receivables concentration, **foreign companies with country risk** or companies you would be more comfortable submitting for additional scrutiny for various reasons, including:

- Being non-investment grade
- Bring privately held
- Having limited "hard" assets

Euler Hermes Country Risk Levels



Source: Euler Hermes, as of October, 2015

Below are individual case studies highlighting three real-world companies that have incorporated energy credit insurance solutions from Euler Hermes Energy into their business strategies.

Case Study: Large Natural Gas Wholesaler

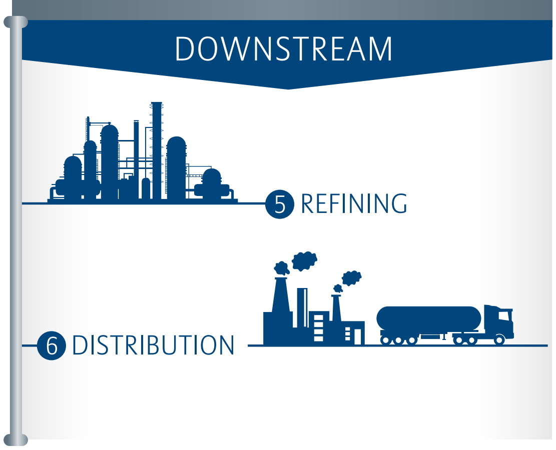
POLICY SUMMARY

Policy Type:
Whole Turnover
(all insurable counterparties covered)

Total Coverage:
Approximately $1B

Rate:
Less than ¼ cent per MMBtu

Deductible /Co-insurance:
Client elected to take large annual deductible with 0 percent coinsurance – the client chose to include the deductible into its own captive reinsurance program that happened to be backed by EH Energy parent company, Allianz



Situation

Motivated to protect the only uninsured asset on its balance sheet, its A/R, a large natural gas wholesaler worked with Euler Hermes Energy to implement an energy credit insurance policy. Though some internal stakeholders were hesitant since the company had never taken a catastrophic loss, they realized simple timing may have played a part in their luck; they had previously done business with other local gas/power wholesalers that had since filed for bankruptcy.

This client has very strong credit management practices to limit risk, but such practices also sometimes limited its opportunities. For example, the company would cap any open exposure at $50M and required a LC for all entities that were unrated or rated BBB and below.

Solution

The value of energy credit insurance became immediately apparent to the company's financial leaders – the product could allow the company to provide more open credit to sell more without compromising its risk position. The company chose a policy structure that covered all insurable counterparties, electing to take a large deductible but a 0 percent co-insurance, allowing it to make claims for the full amounts lost after the deductible is met.

Results

The policy is used to gain a significant competitive advantage in the marketplace by offering open credit where other suppliers were offering inadequate credit solutions. The energy credit insurance allowed the company's credit manager to significantly increase its open credit lines to the market at a time when liquidity was short, generating increased revenue and profit. Also, in a stroke of serendipitous timing, shortly after it bound its limits with Euler Hermes Energy, the 2014 "polar vortex" hit, causing a surge in gas demand, which roughly doubled the company's exposure. Energy credit insurance allowed the company to increase its covered limit to seamlessly capitalize on the new revenue.

Case Study: Small Marketing Company

Situation

A small energy marketing company with a natural gas C&I portfolio and wholesale crude distribution business wanted the freedom to aggressively grow revenue, a common motivator for pursuing credit insurance. However, this client had a critical secondary motivation for exploring the product – the ability to secure additional working capital to support its growth.

Solution

This marketing company worked with Euler Hermes Energy to structure a unique policy that covered both its own receivables, as well as extending its large volume producers and wholesalers with coverage on itself. This upstream and downstream benefit allowed the marketer to extend safe open terms to counterparties for which it previously required prepayment or LCs, as well as to negotiate more open credit for itself from its suppliers.

By paying for protection for its own suppliers, the marketer would be able to effectively pay – at a minimal cost – for its own open credit, freeing up working capital previously tied up with LCs. As an added benefit to its cash flow, by securing its own A/R, the company's lender was willing to increase its borrowing base from 80 percent to 85 percent once it secured its receivables with an investment-grade credit insurer (some lenders will lend up to 90 percent against insured receivables).

Results

The benefits of adding energy credit insurance have made a measurable impact to its balance sheet. The company's lender now views its previously unsecured A/R as an S&P AA- graded asset, allowing the company to borrow more working capital. The increased leverage creates $5-6M of additional working capital per month, which the marketer was able to translate into an additional $60-70M of revenue. With a 1 percent profit margin, it added $600-700K in net profit to the bottom line each month. At a policy investment of $200K, it achieved a return on investment of more than 300 percent on this benefit alone.

Further, the extension of energy credit insurance to its suppliers allows the marketer to provide required surety and "stack" its acquisition credit. When compared to the opportunity cost of tying up prepayment capital or tying up its line of credit by procuring LCs, the cost of the energy credit insurance offered a significantly lower cost.

The marketer also discovered that Euler Hermes Energy was often able to approve higher credit lines than its internal credit manager was willing to authorize, significantly increasing its credit volume offered. Its commercial team excelled, now able compete against well-established competitors by offering open credit to counterparties that would otherwise be required to provide an LC.

This client's use of insurance at the wholesale and retail level allows it to expand its credit position – both giving and receiving – while actually improving its risk position.

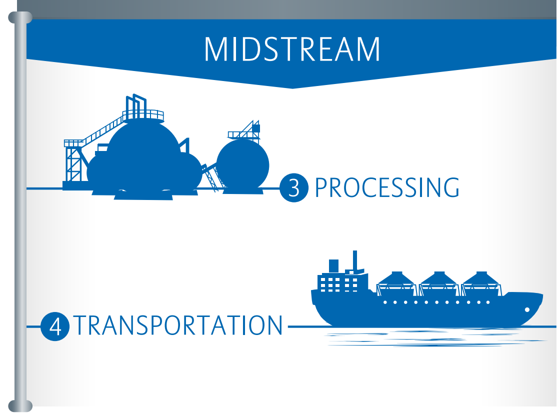
POLICY SUMMARY

Policy Type:
Whole Turnover
(all insurable counterparties covered)

Total Coverage:
Approximately $100M

Rate:
Approximately 5 cents per barrel on $60 crude /
Approximately ¼ cent per MMBtu on $2.80 gas

Deductible/Co-insurance:
Client chose a lower deductible with
5 percent co-insurance



Case Study: Large Integrated Oil and Gas Producer

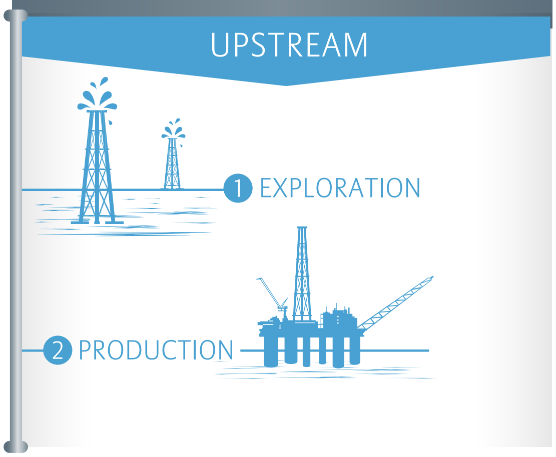
POLICY SUMMARY

Policy Type:
Whole Turnover
(all insurable counterparties covered)

Total Coverage:
Approximately $1.5B

Rate:
Approximately 3 cents per barrel on $60 Crude

Deductible/Co-insurance:
Large annual deductible with a 5 percent co-insurance, elected by client to get better coverage approvals on 9-figure coverage limits



Situation

A large integrated oil and gas producer needed help extending credit lines beyond what its internal credit department would allow from a risk position standpoint. It was cautious in extending the larger credit lines required for major growth, fearing the risk to shareholder equity in the event of a counterparty bankruptcy or a reclamation of a letter of credit by court order – a relatively rare event, but one with recent precedent.

Solution

The company's financial leadership, tasked with growing the business without sacrificing its risk position, appreciated the value of the Euler Hermes Energy credit insurance value proposition. Covering its catastrophic losses at 95 percent, it became much more comfortable extending open credit up to and including 9-figure limits. This enabled the client to flex its internal credit caps, allowing it to better compete for large contracts to tier one counterparties. It was also able to redirect a portion of its production to the tier two, three and four counterparties now covered by its credit insurance policy, optimizing margin and growing profit.

Results

The company's additional capacity to approve credit lines enabled it to dramatically grow its counterparty universe both domestically and abroad. Shortly after implementing its policy, it was able to increase its portfolio of extended credit by more than 30 percent while actually reducing its overall credit exposure by more than 90 percent. It was also able to increase its per-unit profitability by almost 25 percent.

With the revenue it was able to add by extending more credit, the policy paid for itself within the first three months. The cost of its policy, including its deductible, was less than its established bad debt reserve, yet it gave the company a far superior spread of risk.

The company further leveraged its protection on its A/R by using it to extend its operational credit line with its bank; financial institutions are typically willing to expand credit lines by up to 90 percent of the amount insured.

Conclusion

In the energy industry, credit fuels growth. The volatility of the North American energy sector, coupled with stricter banking regulations, has made it increasingly difficult for energy companies to facilitate the liquidity needed to propel that growth. Energy company leaders must evolve all aspects of their operations, including credit practices, to stay current with the global market. This evolution requires executives to evaluate their standard quivers to determine if they include all the arrows they need to fight the battle, capitalizing on opportunities and maintaining a competitive advantage. Energy credit insurance is the critical fourth arrow. Armed with this strategic tool, energy companies can better harmonize risk mitigation and commercial aspirations to safely but aggressively grow the bottom line.

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