Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 19, 2009

Interpretive Letter #1117
June 2009
12 USC 29

Re: Request for legal opinion to engage in volumetric production payment loan transactions

Dear **[ ]**:

This responds to your request for a legal opinion confirming that volumetric production payment financing transactions ("VPP Financing Transactions") are permissible extensions of credit by **[ ]** ("Bank"). For the reasons discussed below, based on the facts and representations provided by the Bank, we conclude that the proposed VPP Financing Transactions are permissible extensions of credit and are consistent with 12 U.S.C. § 29. Before the Bank may engage in the transactions, the Bank must notify its examiner-in-charge ("EIC"), in writing, of the proposed activities and must receive written notification of the EIC's supervisory non-objection**.**

A. Factual Description

The Bank proposes to engage in VPP Financing Transactions under which the Bank, either directly or through an operating subsidiary,[1] would provide financing to a hydrocarbon producer ("Producer") and, in return, would receive a limited overriding royalty interest in the Producer's lease of an identified hydrocarbon reserve (the "VPP interest"). The VPP interest would entitle the Bank to receive as repayment for the financing a designated share of the hydrocarbon produced from the reserve, over a stated term, potentially up to 15 years.

Contemporaneously with the agreement with the Producer, the Bank would enter into forward sales agreements with third-parties ("Buyers"), via Hydrocarbon Sales Agreements ("Agreements"). Under the Agreements, the Bank would pre-sell the hydrocarbons to the Buyers, who would agree to purchase from the Bank the hydrocarbons produced under the VPP

[1] This opinion addresses the legal permissibility of the proposed VPP Financing Transaction. The Bank must follow the procedures in 12 C.F.R. § 5.34 to establish an operating subsidiary.

interest for the current spot price or a price based on forward prices of the commodity. On settlement day, title to the hydrocarbons would pass from the Producer through the Bank, momentarily, to the Buyers at the delivery point.

The Bank would mitigate its hydrocarbon commodity price risk by entering into commodity swap hedges.[2] The principal effect of these hedges would be to establish the price the Bank would receive for the hydrocarbons as they are produced over the term of the VPP Financing Transaction. As such, the Bank would be guaranteed both a return of principal and a fixed amount of interest, so long as neither the Producer nor the swap counterparty defaults.

From the perspective of the Bank, the VPP interest would be free and clear of all operating costs, capital expenditures, and taxes. The Producer would retain all of the operational and environmental risks of the property. The Bank would require the Producer to carry sufficient and appropriate insurance coverage to address these risks. Conversely, the Bank's VPP interest in the Producer's leases would entitle the Bank to a share of the hydrocarbons extracted by the Producer, but would not give the Bank any control over production at the reserve. The Bank would have neither the right nor the responsibility to occupy, operate, or otherwise enjoy the property.

The VPP is recourse only to the Producer's interest in the reserve and not to the Producer's other assets. The Bank would mitigate the risk that the reserve might under-produce by obtaining, prior to entering into a VPP Financing Transaction, third-party estimates of existing and future reserves that would be further validated by in-house petroleum engineers.[3] Under the agreements governing the VPP Financing Transaction, the first production out of the subject properties would be used to repay the Bank's extension of credit. In the event the reserve under-produces in a given period during the term of the loan, the Bank would be entitled to an appropriate amount of overproduction in subsequent months (and extra reimbursement to reflect

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[2] For the Bank to permissibly engage in the commodity swap hedges, the Bank's risk measurement and management process must be of appropriate sophistication to ensure that the activities can be conducted in a safe and sound manner and in accordance with applicable law. As detailed further in the OCC Handbook: *Risk Management of Financial Derivatives* (January 1997) and OCC Banking Circular 277 (Oct. 27, 1993), an effective risk measurement and management process includes board supervision, managerial and staff expertise, comprehensive policies and operating procedures, risk identification and measurement, and management information systems, as well as an effective risk control function that oversees and ensures the appropriateness of the risk management process. The Bank's risk control processes should include the Bank's compliance with accounting and reporting as stipulated by the instructions for the Consolidated Reports of Condition and Income and generally accepted accounting principles.

[3] The Bank would engage in VPP Financing Transactions limited to proven *land-based* properties (no offshore involvement, *e.g.,* in the Gulf of Mexico). In addition, the VPP Financing Transactions would almost exclusively be based on proved develop producing ("PDP") reserves. There are three categories of reserves: PDP, proved develop non-producing ("PDN") and proved undeveloped ("PU"). PDP reserves are the highest quality reserves representing the highest probability that the hydrocarbon is actually in the ground with a proven track record of demonstrated production quantities over time. The Bank would not engage in VPP Financing Transactions based on PU reserves.

default interest). However, the VPP interest would not give the Bank any variable upside potential if there is excess production from the reserve.

B. Discussion

In the proposed VPP Financing Transaction, the Bank would provide financing to the Producer, with the financing to be repaid out of the production from the hydrocarbon reserve over a stated term. In substance, the financing substantially resembles a "production payment loan," which is a permissible form of asset-based extension of credit, frequently used in extending credit to the oil and gas industry. The OCC has long-recognized such production payment loans as a permissible means for national banks to extend credit.[4]

Under a production payment loan, a lender provides the producer with up-front financing. In return, the lender receives a limited overriding royalty interest in a designated share of hydrocarbon reserves. This interest entitles the lender, as repayment for the loan, to receive the revenues generated by a designated percentage of the production, and also serves as a security interest for the lender's extension of credit. Operation and production from the reserves remain the responsibility of the producer, as the lender has no rights to occupy, operate, or otherwise use the property. As production occurs, the lender is repaid by revenues generated. Once the lender has received the revenues generated by its designated share of the reserves, the lender's limited overriding royalty interest terminates. The lender does not share in the revenue of any future production from the reserve.[5]

The proposed VPP Financing Transaction differs from these production payment loans, in one aspect: in the VPP Financing Transaction, the Producer would repay the Bank's extension of credit with a designated share of the hydrocarbons produced from the reserve and not with the revenues generated by those hydrocarbons. Therefore, the Bank must take the additional step of monetizing the hydrocarbon output – that is, selling the hydrocarbons to generate the proceeds – to repay its extension of credit. The Bank would accomplish this here by pre-selling the hydrocarbons to the Buyers, through the Agreements, contemporaneously with the VPP Financing Transaction. As a result, as the hydrocarbons are produced, they would pass from the Producer through the Bank immediately to the Buyer, with the Bank receiving the sales proceeds as repayment for its provision of financing.

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[4] OCC Letter from John E. Shockey, Deputy Chief Counsel (March 29, 1976) (available in Lexis-Nexis); OCC Banking Circular 215, OCC Examining Circular 223. *See also* Letter from Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System (May 15, 2006); FRB Commercial Bank Examination Manual, 2150.1 - Energy Lending - Production Loans.

[5] Variants of production payment financing transactions have been around for over seven centuries. For example, in the 13th century, the English Crown borrowed funds from the Frescobaldi (an Italian merchant bank) to develop the Devon silver mines. The loan contract provided that, as repayment for the loan, the lender would have the right to operate the mines for one year and would be entitled to as much ore as it could extract during that period. John D. Finnerty, *Project Financing: Asset-Based Financial Engineering.* John Wiley & Sons, Inc. (2nd ed. 2007), at p. 4. Here, the Bank would have neither the right nor the responsibility to operate the hydrocarbon reserves.

By taking the additional step of monetizing the hydrocarbon output under the VPP Financing Transaction, the Bank takes on the risk of shifts in the hydrocarbon's price. However, the Bank then mitigates this risk by entering into commodity swaps,[6] thereby establishing the price the Bank would receive for the hydrocarbons as they are produced over the term of the VPP Financing Transaction. Thus, the Bank would receive both a return of principal and a fixed amount of interest.

Based on the foregoing, we conclude that that the proposed VPP Financing Transaction is substantively equivalent to a production payment loan and, thus, a form of extension of credit by the Bank.[7] As such, we note that the transaction will be subject to the legal lending limit imposed upon national banks by 12 U.S.C. § 84 and 12 C.F.R. Part 32.

3. Section 29 Analysis

The ability of national banks to hold "real estate" is significantly limited pursuant to 12 U.S.C. § 29 ("section 29"), which provides, in pertinent part, that:

> [a] national banking association may purchase, hold, and convey real estate for the following purposes, and for no others:
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> First. Such as shall be necessary for its accommodation in the transaction of its business.
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> Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
>
> Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.
>
> Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by the association, or shall purchase to secure debts due to it.

The OCC applies a federal definition of "real estate" to determine what constitutes real estate subject to the limitations of section 29.[8] This definition is guided by the purposes and principles underlying section 29[9] and, as a general matter, takes into consideration, but is not bound by, the treatment accorded the asset under other statutory schemes, including state law. The treatment of

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[6] National banks may enter into derivative transactions to hedge the risks arising from a permissible activity. *See, e.g.*, Interpretive Letter No. 1019 (Feb. 10, 2005).

[7] Moreover, the proposed VPP Financing Transaction is similar to a traditional *in rem* lending arrangement. In an *in rem* financing, the lender looks to specific collateral as the source of repayment for the loan. In 1982 Congress implicitly recognized the permissibility of *in rem* loans by amending 12 U.S.C. § 84 to ensure that the lending limit applied to *in rem* loans.

[8] *See* Interpretive Letter No. 1048 (Dec. 21, 2005).

[9] For example, the Supreme Court in *Union National Bank v. Matthews*, 98 U.S. 621, 626 (1878), stated that the three purposes underlying the restrictions in section 29 were "to keep the capital of banks flowing in the daily channels of commerce; to deter them from embarking in hazardous real estate speculations; and to prevent the accumulation of large masses of such property in their hands, to be held, as it were, in mortmain."

production payments varies from statute to statute – while a number of statutes define real property to include production payments, other statutes do not.[10]

The VPP interest represents a limited overriding royalty interest, which provides the Bank with the right to receive a designated share of the hydrocarbon produced from the reserve over a stated term. As described previously, it gives the Bank neither the right nor the responsibility to occupy, operate, or otherwise use the property or reserves. It entitles the Bank to a fixed quantity of hydrocarbons necessary to repay the financing as they are produced. The Bank has no right to future hydrocarbon production beyond its VPP interest, and no instance would the Bank share in any appreciation or depreciation of the property or reserves. Under this combination of circumstances, we do not believe that the Bank's VPP interest should be characterized as "real estate" subject to section 29.

But, even if the VPP interest were considered an interest in real estate subject to section 29, OCC precedents have found that the acquisition of a significantly restricted interest in real property is not prohibited if it is not inconsistent with the purposes underlying the restrictions in section 29.[11] In the circumstances present here, the VPP interest meets these criteria: (1) Acquisition of the VPP interest does not remove bank funds from the channels of commerce; (2) the Bank would not hold the VPP interest for an indefinite period of time, rather, the VPP interest would terminate when the fixed quantity of hydrocarbons is delivered; and (3) because the VPP interest does not give the Bank any variable upside potential if there is excess production from the hydrocarbons reserves or if the value of the source property should increase, the Bank could not use the VPP interest to engage in real estate speculation.

Accordingly, for these additional reasons, the Bank's acquisition of the VPP interest is not prohibited by section 29.

C. Conclusion

We conclude that the Bank may engage in the proposed VPP Financing Transaction as a permissible means of extending credit to the Producers, and that the Bank's acquisition of the VPP interest in providing such financing is consistent with section 29. Before the Bank may engage in VPP Financing Transactions, however, the Bank must notify its EIC, in writing, of the proposed activities and must receive written notification of the EIC's supervisory non-objection. This notification should include details of the specific transactions contemplated and a discussion of the appropriate risk management processes including individual and aggregate limits for VPP Financing Transactions. Our conclusions are specifically based on the Bank's representations and written submissions describing the facts and circumstances of the subject transactions. Any

[10] The different characterizations of production payments in different contexts reinforces the need for uniform treatment of production payments, specifically, and real estate, generally, under a uniform federal definition grounded in section 29.

[11] Conditional Approval No. 706 (October 6, 2005) (national bank's acquisition and holding of significantly restricted interest in real property not inconsistent with purposes underlying restrictions in section 29 and, therefore, not prohibited); Interpretive Letter No 966 (May 12, 2003) (acquisition of several circumscribed interest in residential real estate not prohibited by section 29).

change in the facts or circumstances could result in different conclusions. If you have any questions, please contact Steven V. Key, Special Counsel, Bank Activities and Structure Division, at (202) 874-5300 or Tena M. Alexander, Senior Counsel, Securities and Corporate Practices Division, at (202) 874-5210.

Sincerely,

signed

Julie L. Williams
First Senior Deputy Comptroller
and Chief Counsel