

SQUARING OFF OVER MIDSTREAM AGREEMENTS

Agreements between producers and midstream companies are being challenged in a stressed environment.

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Do midstream covenants run with the land, or are they executory contracts? A mere two years ago, few pondered the legal characterization of gas dedications contained in the thousands of gathering, processing and transportation contracts between oil and gas producers and their midstream counterparties. Today this issue is of profound importance to the U.S. energy industry.

Since the beginning of 2015, more than 85 U.S. oil and gas producers have sought bankruptcy protection in the wake of plummeting commodity prices. At the forefront of these bankruptcy proceedings—most notably Sabine Oil & Gas Corp. and Quick-silver Resources Inc.—producers and midstream companies have squared off over whether the dedications in gathering and processing agreements are real property interests—and therefore immune from the reach of the bankruptcy court—or executory contracts that may be jettisoned through the restructuring process.

The domestic shale boom has resulted in markedly increased domestic oil and gas production and a surge in the associated oil and gas infrastructure. Over the last decade and a half, midstream companies have collectively invested billions of dollars in developing the infrastructure necessary to gather, process and transport domestic oil and gas. In exchange, these midstream companies contracted with producers for a promise of

payment based on the volume of oil and gas gathered, processed or transported, and dedications of the underlying oil and gas interests/mineral interests and associated acreage. The fees charged to producers under the gathering and processing contracts are designed to provide midstream companies, over a period of time, a return of and on their capital investment.

From the midstream perspective, gas dedications operate as security. They burden the oil and gas interests, thereby binding all successive acreage owners to the terms of the original bargain. Midstream companies have historically undertaken the large capital investments, and their lenders have financed these midstream projects, with the understanding that these dedications are real property interests that bind successors to the mineral interests.

That is, regardless of any change to the leasehold ownership, any hydrocarbons produced from the subject acreage remain dedicated to the midstream company and subject to the terms of the gathering and processing contracts.

Excerpted from

**Oil and Gas
Investor**

March 2017
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Publishing LLP
1616 S. Voss Rd.
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Houston, TX 77057
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Midstream companies have traditionally filed memoranda of the agreements in the real property records to put potential transferees on notice of the dedication. This is because producers routinely transfer or otherwise divest themselves of all or a portion of their mineral interests after granting the dedication to the midstream company.

The midstream industry has historically been willing to bear the cost of developing infrastructure to transport gas because the aforementioned acreage dedications were traditionally viewed as being secure. The acreage dedication provided the midstream operator with certainty that any gas produced by the upstream operator would be delivered to the midstream operator's system, providing the midstream operator with some level of certainty that hydrocarbons would flow on the midstream operator's system. For the midstream operator, the biggest risk was that actual volumes from the dedicated wells would not match anticipated volumes.

According to claims made by the midstream sector, judicial determinations that dedications are not covenants running with the land or equitable servitudes will have negative consequences to producers and consumers. The GPA Midstream Association has weighed in on this matter. It stated that such "a determination would threaten the sanctity of thousands of bargained-for agreements between midstream companies and their producer counterparties; would undermine investor confidence in midstream companies, raising the cost of capital to invest in infrastructure; would force midstream companies and producers to include more costly assurances in their contracts, such as, reservation charges, secured collateral or other guarantees; and would undermine the market in which mineral interests are transferred by threatening the dedications that underpin midstream investments."

The Sabine bankruptcy court case is thus far the only one to rule on the characterization of dedications. Sabine sought court approval to reject four of its midstream contracts. In a landmark ruling, U.S. Bankruptcy Judge Shelley Chapman determined the gathering and processing contracts between Sabine and its midstream counterparties were executory contracts—not real property interests—and could therefore be

rejected. The judicially authorized rejection of the four gathering and processing agreements is estimated to have saved Sabine as much as \$115 million.

Sabine's rejection of the Nordheim Eagle Ford Gathering and HPIP Gonzales Holdings contracts enhanced its prospects for a successful restructuring; now other financially strapped producers will undoubtedly seek to leverage this uncertainty into more favorable commercial arrangements with their midstream counterparties. This may take the form of using the bankruptcy process to reject existing midstream agreements. Or, it may lead parties to renegotiate existing midstream agreements. Either way, the possibility of an outright rejection or renegotiation of existing midstream agreements creates substantial uncertainty for the midstream industry.

If midstream contracts can be jettisoned through the bankruptcy process, midstream companies will lose the guarantee that hydrocarbons will flow through the system. They will be forced to find other ways to secure their investments. Financially solvent producers can expect new challenges in their commercial negotiations with midstream service providers. And with the enforceability of dedications in question, midstream companies are more likely to seek additional assurances in their contracts, such as minimum volume commitments, reservation charges, secured collateral, higher rates or other financial commitments.

There is currently an ongoing appeals process in the Sabine case. It is further important to note that the Sabine decision is not binding precedent. Therefore, another court interpreting a different midstream agreement is free to reach a different conclusion.

In other producer bankruptcies where the covenant running with the land issue has been raised, most notably Quicksilver Resources Inc. and Emerald Oil Inc., the producers and their midstream counterparties resolved their differences by renegotiating existing gathering and processing agreements. These commercial agreements have prevented further court rulings on the issue.

If the new uncertainty over the security of acreage dedications results in a reduction in midstream investment, that could have a chilling effect on the country's ability to transport hydrocarbons to market. A 2014 report by the INGAA Foundation Inc., "North American Midstream Infrastructure through 2035: Capitalizing on Our Energy Abundance," forecasted that significant investment in new infrastructure for the support of natural gas will be necessary to support growing supply and demand. The report suggests that

Producers and midstream companies have squared off over whether dedications in gathering and processing agreements are real property interests.

Recent Bankruptcies Attempting To Reject Midstream Contracts

Debtor	Case Notes	Outcome
Sabine Oil & Gas Corp.	U.S. Bankruptcy Judge Shelley Chapman determined the gathering and processing contracts between Sabine and its midstream counterparties were executory contracts—not real property interests—and could therefore be rejected. It has been estimated that successful rejection of these contracts would save Sabine \$115 million.	Decision is on appeal in the New York Southern District.
Quicksilver Resources Inc.	Quicksilver opted to sell its Barnett Shale assets to BlueStone Natural Resources LLC; however, the closing of the sale was conditioned on the U.S. Bankruptcy Court for the District of Delaware issuing a final order rejecting three gas gathering and processing agreements and a joint operating agreement between Quicksilver and Crestwood Midstream Partners LP.	Settled out-of-court when Crestwood and BlueStone agreed to new, long-term gathering and processing agreements.
Magnum Hunter Resources Corp.	Magnum Hunter sought to reject a specific portion of their gathering agreement with Eureka Hunter Pipeline LLC and not the entire agreement. Normally, in bankruptcy a contract may only be rejected in its entirety.	Settled out-of-court and contract was ultimately retained.
Emerald Oil Inc.	Emerald Oil sought to reject its midstream contracts with Dakota Midstream LLC as part of its asset sale, seeking declaratory relief under North Dakota law. The court granted a TRO and found that the midstream companies “stood the likelihood of prevailing on the merits . . . that the dedication agreements do not run with the land.”	Out-of-court settlement with amended gathering agreement.
Tristream East Texas LLC	Tristream is a midstream company that sought to reject its gathering and processing agreements with certain producers, including Eagle Rock Acquisition Partnership LP. The Official Committee of Unsecured Creditors opposed this rejection.	Litigation ongoing as of press time.
SandRidge Energy Inc.	SandRidge sought to reject a number of agreements. The presiding judge stated that he was “looking for an opportunity to correct the state of New York.”	Settled out-of-court.

Source: Gray Reed & McGraw

through the year 2035, some \$313 billion will need to be invested (or \$14 billion per year) in new mainlines, storage facilities, power plants and processing facilities, etc. In order to keep up with growth, investment in infrastructure must be made and, depending upon the outcome of the current covenant running with the land issue, the midstream industry may be forced to find new ways to secure that investment.

Doubt over whether midstream agreements are as secure as parties previously believed is but one of the consequences of the recent oil and gas bust. This consequence has the potential to fundamentally change the way producers and their midstream counterparties analyze the risk involved in the large scale midstream infrastructure projects that transport oil and natural gas across the nation. □

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