AlixPartners

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MIDSTREAM OPERATORS CAN WEATHER THE E&P BANKRUPTCY STORM

Midstream operators, which until now had formed one of the most stable segments of the oil and gas value chain, are facing a new existential threat. The compounding pressures of plummeting demand and burgeoning supply have been hammering upstream companies, with an increasing number filing for Chapter 11 in 2020. In the process, the fee-based contracting mechanism that had been insulating midstream operators from the effects of commodity price changes has come under intense scrutiny in bankruptcy court.

The crux of the matter lies in whether judges find that the contracts are executory – meaning that unperformed obligations remain on both sides. Executory contracts, such as real estate or equipment leases, can be voided in bankruptcy proceedings. Thus far, the courts are finding most midstream contracts to be executory.

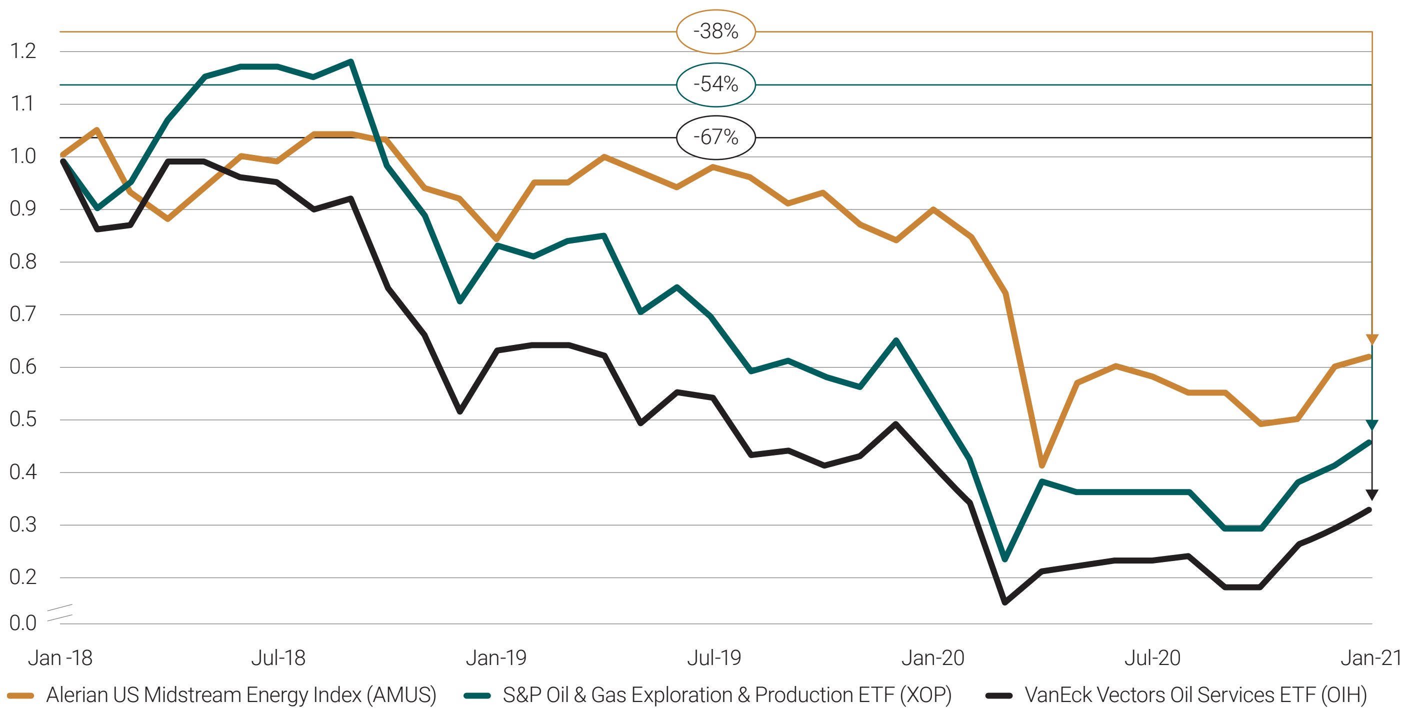
UNDERSTANDING THE IMPACT OF THE CONTRACTS

The contracting system under question first became popular during the booming 2000s and early 2010s, when commodity prices were much higher. At the time, such arrangements were simply what it took to get new production to market.

AlixPartners estimates that 80% of the industry's contracts signed over the past 10 years are fee-based, meaning that the midstream operator is paid a fixed fee per amount of volume of oil or gas that flows through the pipeline. This presents volume risk if operators choose to reduce development activity in a dedicated area but insulates gathering, processing, and transportation (GP&T) companies. Many pipeliners further insulated their risk through other contracting mechanisms such as minimum volume commitments, time-based drilling commitments, long duration contracts, and limits on the exploration and production (E&P) operators' ability to use other midstream providers in a specific area.

With the 2014 oil price crash and the gas collapse that preceded it, upstream companies began facing tremendous stress. Nonetheless, midstream companies continued to enjoy relative growth and more stable returns – until early 2020. A comparison of E&P, oilfield services and equipment (OFSE), and midstream segments from 2018 to December 2020 illustrates the relative midstream sector insulation (figure 1).

FIGURE 1: MARKET RETURNS FOR E&P (XOP), OFSE (OIH), AND MIDSTREAM (AMUS) SEGMENTS, 2018 TO 2020

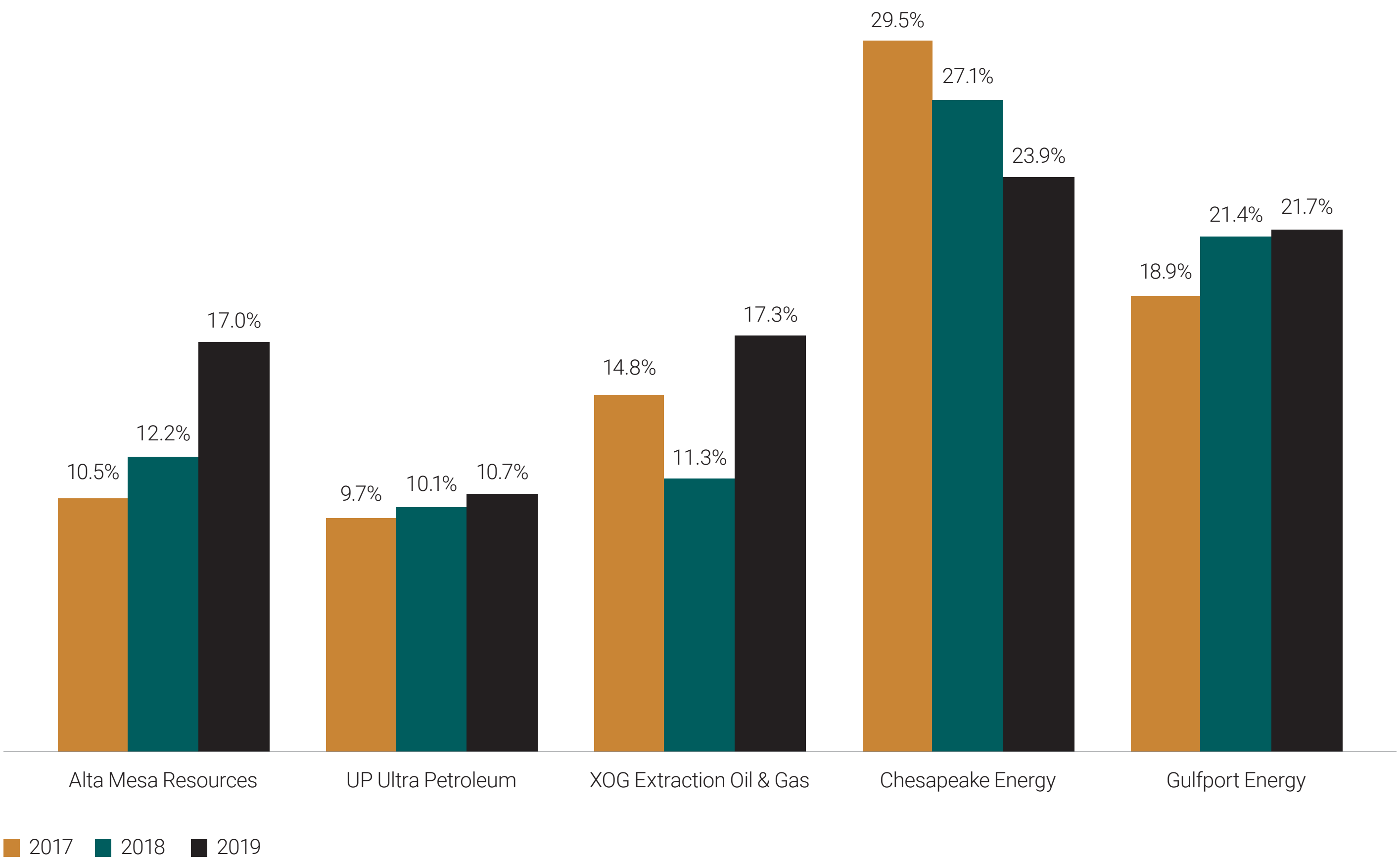


Source: Yahoo finance, Alerian; AlixPartners analysis

E&P operators carefully evaluate available gathering, processing, and transportation options and basis differential alternatives to achieve the lowest cost route to market. When existing pipelines are full, they will move product by higher cost methods such as rail and truck. Conversely, in periods of declining volumes and commodity prices, long-term, fixed-price contracts with midstream companies become more onerous. AlixPartners researched five E&P companies that recently filed for Chapter 11 protection – Alta Mesa, Ultra Petroleum, Chesapeake Energy Corporation, Extraction Oil & Gas, and Gulfport Energy. For most of these, GP&T as a percent of revenue increased from 2017 to 2019 (figure 2).

For E&P companies, bankruptcy has presented an opportunity to reject long-held executory contracts that were determined not to 'run with the land'. The legal requirements for running with the land vary across states, but generally focus on whether the agreement creates a mutual relationship with the land and minerals, touches and concerns the land, and creates a covenant that is permanently connected to the land. A 2016 decision by a federal bankruptcy court in New York in the case of Sabine Oil & Gas opened the door for debtors to successfully argue that midstream contracts did not "touch and concern" the land. Debtors argued that minerals cease to be real property and instead become personal property once they are extracted from the ground. The contracts, as the argument goes, concern the collection and transportation of extracted minerals only, and therefore, do not burden the land from which they are extracted. Subsequent bankruptcy cases have clarified and narrowed the Sabine principles based on the facts and circumstances specific to those cases (figure 3).

FIGURE 2: GATHERING, PROCESSING, AND TRANSPORTATION COST AS A PERCENT OF REVENUE BY COMPANY, 2017 TO 2019



Note: Extraction includes 50% of basis differentials cost
Source: SEC Edgar 10-K; AlixPartners analysis

FIGURE 3: MIDSTREAM CONTRACT REJECTION RESULTS BY COMPANY, GP&T CONTRACTS, NON-EXHAUSTIVE, DECEMBER 2020

OPERATOR	REJECTIONS FILED OR PENDING	REJECTIONS APPROVED	CONTRACTS RENEGOTIATED/ SETTLED	REJECTIONS DENIED
Alta Mesa Resources Filed 9/11/2019				• Kingfisher Midstream
UP Ultra Petroleum Filed 5/15/2020		• Rockies Express Pipeline (Tallgrass)		
XOG Extraction Oil & Gas Filed 6/14/2020		• Grand Mesa Pipeline (NGL) • Platte River Midstream (ARB) • DJ South Gathering (ARB) • Rocky Mountain Midstream (Williams) • Discovery DJ Services (Williams)	• DCP Operating Company • REP Processing	
Chesapeake Energy Filed 6/28/2020	• Phillips 66 Liberty • Kinder Morgan (Eagle Ford)	• Texas Eastern Transmission (TETCO) • ETF TSA (Backhaul) • Gulf South Limited	• ETC Tiger Pipeline • ETC Texas Pipeline • Enterprise Acadian • Enterprise Crude Transportation • Eagle Ford Pipeline	
Gulfport Energy Filed 11/13/2020	• ANR Pipeline Company • Columbia Gas Transmission • Texas Gas Transmission • Columbia Gulf Transmission • Rover Pipeline	• DCP NGL Services	• Rockies Express Pipeline	

Source: Prime Clerk, EPIQ LLC, KCC LLC dockets for XOG, AMR, GPOR, CHK; AlixPartners analysis

Uncertainty regarding the bankruptcy courts' treatment of contracts, including the potential for different treatment in different states, presents significant risk for midstream counterparties. Where contracts are rejected, midstream operators face an existential threat in which the contractual protections they designed and committed to are negated.

ADDITIONAL BANKRUPTCIES LOOM

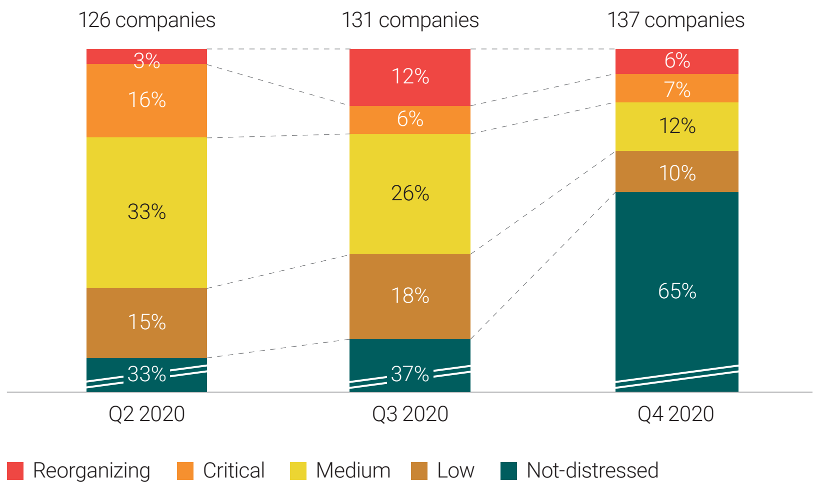
A series of factors plays into the current landscape, including Saudi Arabia disciplining the market in April 2020 with record production, combined with the COVID-19 pandemic. The increased supply combined with a precipitous drop in everything from commuting to infrastructure investments – and thus demand – contributed to the price of oil briefly dropping below zero. As a result, an increasing number of E&P companies are facing distress.

To better understand this scenario and its potential outcomes, AlixPartners built a model to assess the potential for more upstream operators to achieve such contract rejections as part of bankruptcy proceedings. The model has accurately predicted more than 20 bankruptcy filings in 2020 and shows that several dozen more E&P companies are at risk of filing for bankruptcy in the near term. The findings show that major pipelines are transporting volumes from distressed E&Ps and could face near-term contract rejection risk.

Worse, continued low commodity prices suggest that more bankruptcies are likely. Through December 2020, Debtwire cataloged 36 North American E&P bankruptcies in the year. Given expectations for continued low oil and gas prices and constrained upstream capital persisting well into 2021, AlixPartners assessed the potential for additional midstream contract rejections.

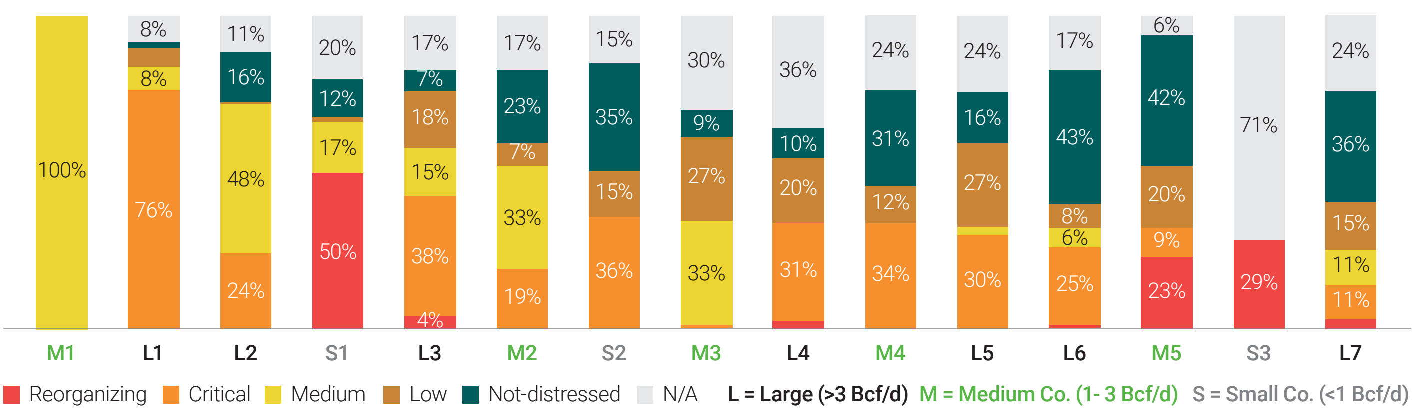
AlixPartners evaluated 137 independent E&P companies in North America with 100 or more operated wells and $300 million or more in debt. This is the type of company more likely to represent a primary revenue stream for gathering and transport pipeline operators. We compared multiple inputs, including debt ratios, bond trading values, stock price changes, and other factors. Based on this, we categorized operators from low distress to reorganizing. In our analysis, many companies that had medium or critical stress earlier in 2020 tipped into bankruptcy. Additionally, we estimate that more than 20 large independent E&P companies face high distress levels that could trigger a restructuring event (see figure 4).

FIGURE 4: DISTRESS LEVEL FOR 137 E&P COMPANIES WITH 100+ OPERATED WELLS AND MORE THAN $300 MILLION IN DEBT AS OF Q2 TO Q4 2020



Source: CapitalIQ, Debtwire; AlixPartners analysis

FIGURE 5: TOP 15 AT-RISK US NATURAL GAS PIPELINE OPERATORS BY SIZE



Source: S&P Global Market Intelligence, Debtwire, CapitalIQ; AlixPartners analysis

We also mapped the data to identify potential natural gas GP&T operators that face elevated contract rejection risk. The results indicate a high concentration and risk for specific operators, as do the corresponding results for oil pipelines. In fact, more than a third of volumes on the 10 highest risk pipelines are coming from distressed E&P companies (figure 5).

While the data is not encouraging for midstream management teams or their shareholders, companies are not wholly beholden to their E&P customers and court proceedings. There are several actions midstream companies can potentially pursue to minimize contract rejection risk:

DEVELOP MARKET-DRIVEN NEGOTIATION POSITIONS

To successfully reject a contract, E&P companies require a gathering or transport alternative to create a credible rejection or renegotiation threat. For example, E&Ps may seek to truck oil where legally permissible or construct interconnects to alternative and nearby gathering lines. For transport volumes, where interstate pipeline tariffs are a matter of public record, E&Ps may seek to tie into those pipelines through alternative gathering arrangements. Having a firm grasp on these potential alternatives and internal breakeven costs can help GP&T companies anticipate renegotiation strategies, develop responses, and improve potential settlement results.

RETHINK CONTRACTING STRUCTURES TO MANAGE RISK

Midstream parties should review their contract clauses relative to recent court rejections and identify targeted risks and mitigation responses. For example, contracts written to be associated with the land and all minerals associated with the land reinforces the covenant. Moreover, contracts without expiration dates that are dedicated to specific areas may suggest that midstream agreements are touched by and concerned with the land. Reinforcing contracting structures may be of particular benefit to gathering operators where connectivity with the land is most credible.

MAKE IMMINENT REJECTION AND CONTINGENCY PLANS

In cases where alternatives exist and threats are credible, midstream operators—particularly those with concentrated E&P customer portfolios—can face potential disruption and solvency risk. In these cases, operators should have several difficult decisions to weigh, including:

- Developing contingency plans for capturing offset volumes from other producers
- Trading off near-term rate reductions for a longer contract extension
- Offering lower rates to encourage development drilling
- Making operating and general and administrative costs variable with future volume levels, to the extent possible
- Evaluating potential merger scenarios with upstream counterparties and/or interconnecting pipelines to maintain operations

As E&P bankruptcies continue to shake up the upstream energy value chain, it is imperative that midstream companies understand their contract rejection risk exposure and actively develop renegotiation plans and strategic options. When done with the right strategy and vigilant financial analysis, midstream operators can weather the storm. Midstream players can potentially even capture volumes vis-à-vis less competitive alternatives and perhaps even attract new customers to be positioned for growth.

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ABOUT US

For more than forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.