INSIGHTS FROM BDO'S NATURAL RESOURCES PRACTICE

WEBINAR RECAP

WITH INCREASED ACTIVITY AND DEMAND, INCREASED DISPUTES IN THE MIDSTREAM

By Clark Sackschewsky and Bob Broxson

In our recent webinar, Navigating Midstream Energy Disputes: The Key to U.S. Oil & Gas Growth, BDO's Natural Resources and Energy Disputes leaders, joined by Robert Paddock of Buck Keenan, outlined for participants the most common factors leading to disputes in the oil and gas midstream, and how best to navigate and avoid them in the future to ensure continued growth in the sector.

The dual market forces of a low-price environment and digital transformation in the oil and gas sector have spurred a record production boom over the past two years in the U.S. market. While exploration and production companies have adapted to this new paradigm with increased capital discipline and operational efficiency—producing more with less, and more quickly—capacity in the less-price sensitive but construction-heavy midstream has not scaled in tandem. As the midstream juggles with increased demand for infrastructure to meet production levels and rising development and construction costs of transportation systems, the industry is seeing heightened tension within the midstream and between midstream and upstream players.

WHY DOES THIS TENSION LEAD TO DISPUTES?

The imbalance between production and takeaway capacity often manifests in disputes between partners that embody some combination of the following missteps:

- "Shotgun Weddings": The rush to construct additional takeaway capacity brings together hasty partnerships that aren't built for long-term success.
- "Trust Me": Even good partners structuring deals in an uncertain environment may overlook areas in deal documentation, which can create problems down the line when things don't go as expected.
- "One Night Demand": Deals done quickly to reduce or manage production and immediate demand, like takeaway capacity, almost invariably run into problems when demand lightens and financial times become less favorable.

WHAT ARE THE MOST COMMON TYPES OF DISPUTES THAT ARISE IN THE MIDSTREAM?

Contract or negotiation issues between would-be partners in the midstream can devastate the momentum of involved parties and projects for years. Below, we outline the most common factors that lead to disputes between partners, exemplified by cases that set precedent for the rulings around them.

1. Deals That Don't Close

Breakdowns in a deal occur more frequently when there is a very active or volatile marketplace like we see now. In such cases, participating parties sign a term sheet, start acting like partners, but never close the deal, leading to disputes when the economics of a project sour or don't go as expected.

Case Study: In *Enterprise v. Energy Transfer Partners* (ETP), the two parties signed a term sheet for a pipeline project. Before final agreements were signed, Enterprise and ETP agreed that Enterprise could begin expending funds to do design work, to be reimbursed by ETP. However, after the work began, Enterprise was unable to secure enough customers and decided not to move forward with the project. Following their decision to cancel, they began working with another partner, Enbridge, on a similar pipeline project. ETP sued for breach of joint enterprise and breach of fiduciary duty, claiming that they and Enterprise had a joint venture to build a pipeline for shipments from Cushing, OK, to the Gulf Coast, rather than Enbridge, and sought 50 percent of the discounted net profits from the Enbridge and Enterprise project.

At first, a jury decided in favor of ETP in the amount of $319.4 million alongside an order of disgorgement from Enterprise to ETP for $150 million—only for the decision to be reversed by the Texas Court of Appeals. They found that a term sheet agreement required not only board approval, but also accommodating definitive documents to define the preceding conditions for a binding agreement. The Court of Appeals found that these conditions were not met. This case is currently on appeal to the Texas Supreme Court and the decision could be significant as to whether conditions set in a term sheet can be overridden.

Key takeaways:

- Even with a term sheet, companies must remain diligent in maintaining that there is no deal until an agreement is legally finalized through proper documentation.
- Watch for the Texas Supreme Court's ultimate decision on this matter.

2. Ambiguity (Or a Lack Thereof) in Contract Terms

Despite shared interests and goals between partners, it's vital to legally codify and document the terms of any agreement. Any assumptions along the lines of, "This is how we've always done it," "They agreed to change things up from how we put it down in the contract" or "We trust each other and didn't need to amend the agreement" will not hold up in court, particularly with a very literal Texas Supreme Court at this time. Contract terms matter—now more than ever.

Case Study: *Kachina Pipeline Co, Inc. v. Lillis* offers an example of one party's subjective interpretation of a contract as legally insufficient due to a lack of ambiguity in the contract terms. Operating under a Gas Purchase Agreement, wherein Kachina was the gatherer who bought, transported and resold Lillis' gas. In the contract, it stated that "if Buyer installs compression to effect delivery of Seller's gas…" the Gatherer can install compression and charge a fee. As the gatherer, Kachina installed compression downstream from the delivery point and charged a compression fee as part of the marketing charges—arguing that the compression was necessary to get Lillis' gas to the processing station.

While the court initially ruled in favor of Kachina, the decision was overruled by the Court of Appeals and Texas Supreme Court, which found that there was no definition of "delivery" and that the only delivery being done under the contract was from Lillis to Kachina at the delivery point upstream of the compression station.

Key takeaways:

- Contract terms matter
- Just because Lillis understood these charges for years before suing and did not object, does not mean that the contract language was modified. Their subjective intent was 'parole evidence'—thus not admissible.

3. Rights of First Refusal (ROFR)

Often the urgency of mitigating immediate demand pressures (especially when there's insignificant takeaway capacity) can lead to deals being made too quickly. This is the aforementioned "shotgun wedding." In the midstream, this translates to the construction of additional gathering systems when new pipelines are brought online.

The Right of First Refusal (ROFR) is granted to midstream companies by producers to permit them additional acreage beyond existing Dedication Areas in their gathering and processing agreements, as well as to producers on behalf of midstream organization to permit the sale of gathering systems by other producers on exit. After the initial term, midstream gathering agreements or buy/sell agreements may go into evergreen or month-to-month status, with a right of first refusal.

Case Study: *Kachina Pipeline Co, Inc. v. Lillis* is also a case of misaligned and redirected interests. In this partnership, a ROFR permitted Kachina (the gatherer) to match an offer of a third party vying to do business with Lillis. Provided that this party extended a five-year offer, Kachina matched their price and *assumed* that they had won the five-year contracted deal.

A court ruling determined that Kachina had to actually match the offer on a monthly basis, leading to Kachina's argument that it would be impractical and unreasonable to permit the cancellation of their contract for each new ROFR that arose on a month-to-month case. The Court's reasoning found that in dealing with the language of the ROFR in the contract, an extension of the agreement only covered price considerations, not the time period.

Key takeaways:

- Don't forget about time in addition to cost provisions in your contract terms regarding ROFR.
- Be aware of month-to-month extension provisions to know exactly what they cover in the period after the term ends, particularly in an environment of increased volatility, low prices and rapidly shifting assets.

4. Breach of Contract vs. Repudiation

While a breach of terms is a failure to comply with an agreement, repudiation invites intention into the mix.

Case Study: In the case of *BridgeTex v. Stampede*, the two organizations began a Transportation Services Agreement (TSA) in 2014, a contract where the shipper (Stampede) needed to ship or pay. However, when oil prices collapsed at the end of the year, Stampede could not meet its shipment obligations and did not have the cash to make the deficiency agreement beginning in 2016. BridgeTex understood the environmental conditions; both parties tried to figure out a solution in good faith.

During the negotiations, Stampede informed BridgeTex that they didn't have the ability to pay and would not be doing so. At that point, BridgeTex sued for repudiation—not just that Stampede had breached the contract, but that they had *repudiated* it when they declared they couldn't perform—making Stampede liable for the remaining six years of the contract. Trial court found that Stampede's desire to renegotiate the contract in light of market conditions was tantamount to a repudiation, and BridgeTex ultimately won $225 million at trial.

Key takeaways:

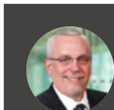
- Working in good faith is not an excuse for non-performance under a transportation services agreement (TSA).
- There is a legal difference—with significant consequences—between the *action* versus the *admission* of non-performance in an agreement.

GOOD CONTRACT LANGUAGE TRUMPS GOOD FAITH IN A VOLATILE MARKET

Due to the ongoing uncertainty and the overall increase in midstream activity, negotiating any type of agreement—including an amendment to contracted terms—calls for diligent follow-through in writing to establish performance expectations.

It's more important than ever to work with industry-experienced professionals that understand the challenges that can arise in the midstream to avoid future damage or unnecessary litigation. To avoid issues like those outlined above, ensure regular review of current contracts to determine whether they are sufficiently clear on current and future obligations.

Reducing the number and severity of disputes in the midstream will not only benefit individual companies, it will help to ensure the continued growth of both the upstream and midstream sectors in the U.S. market.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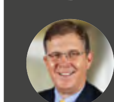
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