

CLIENT ALERT

Practical Guide for Midstream Companies: Distressed Producers

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With the recent drop in oil prices and depressed gas prices, midstream companies in the business of gathering oil and gas (“**Gatherers**”) for producer customers (“**Producers**”) should be on heightened alert concerning the effects that such events may have on existing gathering agreements with distressed Producers, as such Producers may (i) undergo a liquidity pinch affecting their ability to make payments, (ii) adjust their drilling programs, resulting in lower throughput and reduced gathering fees, (iii) seek to sell upstream assets or merge with other producers, or (iv) declare bankruptcy. This guide briefly highlights options and steps that may be available to a Gatherer with respect to its gathering agreement with a distressed Producer.

- **Right to Credit Support.** As assurance of a Producer’s ability to pay a Gatherer the applicable fees under the gathering agreement, the Gatherer may demand that the Producer provide credit support, such as a standby irrevocable letter of credit, a parent guarantee from a creditworthy entity, or a cash deposit or prepayment, with the form, terms and amount determined by the Gatherer, acting reasonably. Typically, the Gatherer’s ability to demand such adequate assurance is predicated on the Gatherer’s having “reasonable grounds” for insecurity, or objectively, if the Producer has undergone a credit devaluation to below investment grade, to the extent that it has a credit rating. In order to assert this right to credit support, a Gatherer should evaluate the payment history of the Producer, obtain third-party credit reports on the Producer (to the extent available), and engage in dialogue with the Producer (and obtain financial statements from it, to the extent that the Producer will make them available) to make a reasonable assessment of the Producer’s ability to continue to meet its payment obligations.

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- **Capacity Allocation.** A Gatherer will typically allocate firm capacity on its system to a Producer based on a view of the production profile of the Producer and/or in respect of a minimum volume commitment that the Producer has made to the Gatherer. Accordingly, if a Gatherer suspects that a Producer will modify its drilling program in response to the depressed prices, the Gatherer should request a forecast of the Producer's expected production profile so that the Gatherer can (i) anticipate capacity utilization on its system, which is particularly important in a multiuser system where unutilized capacity may be offered to other producers, and (ii) forecast throughput volumes, which is especially important in order for a Gatherer to forecast the associated gathering fees if the Producer has not made a minimum volume commitment (and a commitment to pay deficiency fees to compensate for lower throughput volumes).
- **Minimum Volume Commitments and Deficiency Payments.** Although a change in market condition is traditionally not viewed as a *force majeure* event that would excuse a Producer from making good on its minimum volume commitments, or making deficiency payments for failing to deliver the minimum volume commitment, a Gatherer should evaluate and anticipate whether a Producer will be able to achieve its minimum volume commitment or make deficiency payments, especially if the Producer has historically been unable to meet the minimum volume commitment. Depressed commodity prices may further exacerbate a Producer's ability or willingness to pay deficiency payments, which may prompt the Producer to pursue other options, such as selling its upstream assets associated with the gathering agreement, filing for bankruptcy, or seeking to intentionally breach the gathering agreement with the aim of finding a commercial solution. A Gatherer will need to be prepared for a distressed Producer to pursue any of these options.
- **Dedication and Transfers.** In order to commit throughput to a Gatherer to support such Gatherer's investment in a gathering system, similar to a minimum volume commitment, a gathering agreement may include a dedication of the Producer's interests in the upstream assets and products to the Gatherer's system (a "**Dedication**"). A Dedication is typically intended to be a covenant running with the land, binding future interest holders of such upstream assets and products. Before a distressed Producer seeks to transfer the upstream assets associated with the gathering agreement or file for bankruptcy, a Gatherer should (i) evaluate the legal sufficiency of the Dedication language in its gathering agreement, in light of recent case law that provides further guidance (see *Client Alert: [Monarch Midstream and Alta Mesa Hold Gathering Contracts Are Not Subject to Rejection in Bankruptcy](#)*) and (ii) ensure that memoranda of the gathering agreement have been filed in the applicable counties to provide sufficient notice of such Dedication to a prospective purchaser of the upstream assets.
- **Suspension of Services.** In the event that the Producer is unable to make its payments as they become due or fails to provide credit support if requested by the Gatherer, typically after a cure period, the Gatherer may elect to suspend performing services for the Producer until all past due amounts are paid or the requested credit support is provided. To the extent that the Producer has made a Dedication to the Gatherer, such suspension will not

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necessarily serve as a release of the Dedication. Thus, the Producer must work out a solution that is suitable to the Gatherer to permit the Producer to continue to have an avenue to transport its product to market.

- **Unprofitable Operations.** In response to any changes in the Producer's production profile that result in the flow of product at a receipt point below a threshold quantity for a certain period of time, the Gatherer may elect to declare that operations at such receipt point have become unprofitable, prompting the Gatherer and the Producer to negotiate in good faith a change to the gathering agreement that adjusts the economics of the agreement, and to the extent that the parties do not agree, the Gatherer would have the right to shut in such receipt point without affecting any Dedication to the Gatherer.
- **Additional Midstream Infrastructure.** A Gatherer's commitment to construct additional receipt points or expand its gathering system should typically be supported by the Producer's forecast of the production that would move through such additional receipt points or through such expansion. Accordingly, if a Gatherer suspects that a Producer will modify its drilling program in response to depressed prices, the Gatherer should revisit any construction plans and make a redetermination of the economics underpinning any such additional receipt point or expansion to the gathering system, including potentially shifting the costs and risks to the Producer with respect to the construction of such additional receipt or expansion in exchange for future discounts on gathering fees for a limited period of time to incentivize the Producer to throughput a sufficient volume of product.

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