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Dwindling Oil Storage Capacity and Impacts on Energy Companies

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Commodity prices have fallen precipitously in the first quarter of 2020 as crude producers are getting hit on both the supply side — with Russia and Saudi Arabia seeking to flood the market to capture additional market share — and the demand side — with shelter-in-place orders and other travel restrictions from the ongoing coronavirus crisis decimating global oil demand.

Both West Texas Intermediate and Brent Crude prices have collapsed by almost 70% from recent highs resulting in WTI crude front-month contracts currently trading near $20 a barrel. Further, the massive decline in index pricing does not fully reflect the extent of domestic pricing pressure as, in many basins, the downward basis differentials have increased 5–15x compared to previous levels.

As the demand dissipates and upstream producers continue to drill and/or complete new wells, the U.S. is reportedly only weeks away from running out of crude oil storage capacity (which is already occupied by more than 450 million barrels of crude, excluding strategic reserves). Given the impending storage constraints, many E&P companies and midstream service providers are evaluating whether to reduce production or pipeline capacity and/or shut in wells.

That review became more urgent over the weekend, as Texas Railroad Commissioner Ryan Sitton, one of three officials elected to oversee the state agency that regulates the oil and gas industry, reported that some oil companies are already receiving letters from shippers demanding production cuts and citing the unavailability of storage capacity.

In fact, recent reports have noted that Texas regulators are considering a reduction in oil production allowables for the first time in decades, including in the Permian Basin. The agency review comes after several oil executives reached out directly to members of the Texas Railroad Commission requesting production cuts.

In a March 30, 2020, letter to the Texas Railroad Commission, Parsley Energy and Pioneer Natural Resources (two large producers in the Permian Basin) asked the Texas Railroad Commission to hold an emergency market demand hearing no later than April 13, 2020, to determine whether economic waste is occurring in Texas (in the form of production in excess of market demand).

If such a determination is made, the letter asks the Texas Railroad Commission to essentially impose production limits beginning May 2020 via proration.

Shut-in Considerations for Producers

From a producer's standpoint, when evaluating whether to shut-in production, there are a number of considerations that should be taken into account, including (i) existing contractual obligations (such as minimum volume commitments), (ii) obligations under any debt facility(ies) and/or hedging program and (iii) operational impacts.

While these considerations are necessarily fact-intensive and the applicable agreements must be carefully reviewed, below we outline a few overall themes and general reflections.

A typical reserve-based credit agreement is unlikely to include prohibitions on shutting-in production; however, a producer should review its credit agreement(s) to understand any development plan requirements and the impact of shutting-in production on its reserve report and cash ow requirements. Since most lenders should be aligned with a producer shutting-in wells in a low commodity price environment, a prudent first step may be to discuss directly with the lenders and forge agreement on reductions in production.

With respect to other contractual obligations, a company should review not only its mineral

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leases, but also midstream agreements and joint venture arrangements. Although a review of existing JOAs is also prudent, under the unmodified 1989 American Association of Petroleum Landman ("AAPL") form Joint Operating Agreement ("JOA") and 2015 AAPL form Horizontal JOA, an operator is not required to obtain consent from non-operators in order to shut-in producing wells.

In addition to the broad grant of authority in favor of the operator to make operational decisions in Article V.A., Article VII.E. of the JOA vests in the operator the right to make shut-in elections (or return a shut-in well to production) so long as the operator provides five days' notice to the non-operators prior to taking such action. If the operator fails to notify the non-operators, then any loss of lease is borne jointly by the parties.

While a non-operator may attempt to argue that a shut-in election violates the "reasonably prudent operator" standard of care set forth in Article V.A. of the JOA, the typical damages waiver (for liabilities not otherwise arising out of the gross negligence or willful misconduct of the operator) would make recovery difficult.

When analyzing a mineral lease for this purpose, a producer should start by reviewing the shut-in royalty clauses and cessation of production clauses in the lease. While a producer's ability to invoke either of these provisions is dependent on the specific language, many of these provisions do not provide relief due solely to a low commodity price environment.

First, shut-in royalty clauses are typically limited to gas production and often require that no market exists for the production (irrespective of the price received for the production).

Second, it is unclear whether a cessation of production clause would permit even short-term relief since the decision to shut-in production is made in the producer's discretion rather than, for example, on account of mechanical failure.

However, despite the potential weaknesses, these provisions should be carefully reviewed to assess positions that may be asserted to extend the term of the lease and/or provide time for the producer to locate an acceptable market for its production. In connection with its midstream agreements, producers should determine whether any of their agreements include minimum volume commitments ("MVC"), reservation fees or other take-or-pay obligations. If so, a producer should review those agreements carefully to determine (i) whether it can shut-in its wells and assert force majeure and (ii) to the extent it does so, whether the producer's MVC obligations are excused or reduced during the pendency of the force majeure event.

Considerations for Midstream Providers

While some midstream providers have already made requests of producers to voluntarily reduce production, the question remains: What happens if producers refuse to cooperate and there is insufficient storage or other offtake options available downstream of the applicable gathering system or pipeline?

Midstream providers that offer firm service are often obligated to receive a specified quantity of hydrocarbons on a daily basis at the receipt points, provide midstream services, and either redeliver the hydrocarbons to the producer at the delivery points or market those hydrocarbons for the account of the producer. Midstream providers should review their midstream agreements to determine whether they have obligations (including marketing obligations) with respect to hydrocarbons downstream of the delivery points.

If the midstream provider merely has an obligation to redeliver the hydrocarbons at the delivery point and the producer has an obligation to take any hydrocarbons so redelivered, then the midstream provider should be able to meet its contractual obligations without invoking force majeure. If, however, the midstream provider has obligations downstream of the delivery point or the producer does not have an obligation to take hydrocarbons at the delivery point, the midstream provider may need to invoke force majeure or risk incurring a default under its midstream agreements.

The analysis may be complicated for midstream providers that have several different (but related) contracts with a producer along the infrastructure chain from the wellhead to ultimate point of sale or export. Given that many midstream providers finance pipeline projects based on minimum "guaranteed" cash flows through MVCs and deficiency payments, the midstream provider should also preemptively analyze their contracts with producers to determine whether the producer may be excused from applicable MVC obligations under the same analysis described above.

Additionally, for midstream agreements that contain a dedication (but not MVC obligations), midstream providers should carefully review the dedication provisions to determine whether the producer may eventually be entitled to permanent releases

from the dedication if downstream storage and offtake issues persist long term.

Can a Producer or Midstream Provider Invoke Force Majeure?

Many producers are now reviewing their mineral leases, and both producers and midstream providers reviewing their midstream agreements, to determine whether force majeure provisions may excuse their (or their counterparty's) non-performance.

A force majeure clause is a contractual provision that may excuse a party's nonperformance or result in the adjustment of other contract terms (including price) when circumstances arise that are beyond such party's control, cannot be avoided through the exercise of due diligence, and render performance impossible, illegal or, in some cases, impracticable. Although outside the scope of this post, if a contract does not include a force majeure clause, certain states may provide relief as the same events that would underlay a claim of force majeure (e.g., a law that is passed that makes performance illegal or exceedingly difficult) may also give rise to an impracticability/impossibility defense.

Force majeure clauses are often narrowly construed to encompass only events specified in the force majeure provision of the contract (e.g., (1) acts of God; (2) a natural disaster or epidemic; (3) war, invasion, hostilities, terrorist threats or acts, riot or other civil unrest; (4) government order or law; (5) action by a governmental authority, (6) national or regional emergency; and (7) strikes, labor stoppages or slowdowns, or other industrial disturbances).

Even force majeure clauses that appear to provide illustrative examples of force majeure events (e.g., defining force majeure events as "including acts of God and natural disasters") might be interpreted by courts as an exhaustive list of qualifying events. Force majeure clauses also generally include a "catch-all" provision (e.g., "any other cause beyond the parties' reasonable control").

When interpreting the catch-all provision, some courts rely on the principle of ejusdem generis to include only events similar in character or classification to the specific events mentioned in the clause. In addition, in most states (including Texas), economic hardship itself is generally not sufficient to invoke force majeure and is often expressly carved out of the force majeure clause itself.

In order to successfully exercise a force majeure clause, the party invoking force majeure has the burden of proving the existence of a force majeure and must show a causal link between the asserted force majeure event and such party's failure to perform its obligations under the agreement, notwithstanding the exercise of prudence, diligence and due care.

Without causation, the mere coincidence that a force majeure event coincides with the impossibility of performance is not sufficient to excuse a party's nonperformance. Finally, some force majeure clauses specifically require that the force majeure event was unforeseeable to the parties when they entered into the underlying agreement.

While most states do not impute an unforeseeability requirement where an agreement is silent on the issue, several states, including New York and California, will read an unforeseeability requirement into force majeure clauses. Texas courts also typically require unforeseeability when a specific event is not enumerated in the definition of force majeure.

If storage capacity or governmental action is restraining a producer's or midstream provider's ability to perform under the applicable agreement and making such performance impossible, producers and midstream providers could argue that the restriction should permit the use of a force majeure declaration under a standard definition.

However, if there continues to exist a market for the production at any price or other available offtake options, then the producer or midstream provider should carefully review the specific force majeure provision with counsel as there are typically counterarguments to any such force majeure declaration. Further, if the force majeure provision is included in a midstream agreement with an MVC, producers and midstream providers should analyze whether force majeure also excuses deficiency payments.

A production restriction or allocation from the Texas Railroad Commission may provide an argument to invoke a force majeure defense. However, in many cases, such action by the Texas Railroad Commission may allow producers to avoid MVC deficiency payments and have consequences under the project financing arrangements of midstream providers to the extent relying on such MVCs.

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