The New Midstream Transactions

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A recent trend in the upstream and midstream oil and gas industry is for midstream services providers to offer certain forms of additional compensation to oil and gas lessees / operators (i.e., upstream asset holders) in exchange for providing acreage dedications and entering into long term services agreements, including mainly agreements for gathering, processing, transportation and the sale and marketing of hydrocarbons, and water sourcing and disposal services. This additional compensation has taken different forms, including up-front cash payments, delayed cash payments, net profits interests, equity interests or other value premiums and, in certain cases, the creation of additional upside areas, where the upstream entity can share in growth opportunities.

The change towards this trend is interesting, and reflective of the dramatic shift in leverage between the upstream and the midstream from the beginning of the shale-boom, where upstream providers would frequently agree to long-term, minimum payment / minimum volume arrangements in order to secure take-away capacity over a long span of years for the huge future volumes that they expected. In many cases these volumes did not flow (e.g., the Barnett Shale) and in certain cases they did, but too late for the upstream company to avoid punitive deficiency payments (e.g., the Haynesville Shale). For many oil and gas transactional attorneys, working out these long-term take-or-pay type arrangements filled the gap in M&A transactional work caused by the commodity-price downturn during 2015; and, now that the private equity–fueled workout / Permian basin M&A boom has leveled out, these new "*pay-to-take*" long term contract transactions, which will be discussed in this note, have added an interesting component to oil and gas commercial practice.

A. Consideration Structures.

So far, the types of additional consideration paid by a midstream services provider ("Midstream Company") to an upstream operator ("Upstream Company") in exchange for dedicating acreage for midstream services that we have seen include:

1. Cash Payment – the most straightforward type, a cash payment by Midstream Company to Upstream Company in exchange for the dedication, based on a straightforward metric like dollar ($) per net acre dedicated or expected throughput.

2. Override – a grant by Midstream Company to Upstream Company of an interest in a certain percentage of the gross revenue received by Midstream Company from midstream services provided with respect to a certain agreed project area, without deduction for capital expenses or operating expenses.

3. Net Profits Interest after Payout (NPI - Payout) – a grant by Midstream Company to Upstream Company of an interest in a certain percentage of the net revenue received by the Midstream Company from the midstream services provided with respect to the agreed project

area, equivalent to gross revenue less certain delineated operating expenses and overhead expenses of Midstream Company, and subject to the further limitation of being payable only after Midstream Company's overall net revenue has reached a certain threshold payout number. Payout number is typically tied to capital expenditures of Midstream Company incurred to construct the gathering and processing system necessary to provide the relevant midstream services for the project area; and can include an ROI factor.

4. Net Profits Interest with a Carried Interest (NPI – Carry) – a grant by Midstream Company to Upstream Company of an interest in a certain percentage of the net revenue received by Midstream Company from the midstream services provided with respect to the agreed project area, equivalent to gross revenue less operating expenses and overhead expenses of Midstream Company, payable immediately without any payout threshold. In other words, the same as item A.3, except without a payout threshold (or, put another way, similar to item A.2, except with a deduction for operating expenses). The effect here is that Upstream Company is effectively carried for the amount of the capital expenditures of Midstream Company incurred to construct the gathering and processing system necessary to provide the relevant midstream services. One alternative version is to fix the relevant carry amount so that if, for some reason, Midstream Company is required to incur capex in addition to such fixed amount, then Midstream Company would be entitled to a preferential payout until it recovered such additional capex costs (i.e., capex amount in excess of fixed carry amount).

5. Additional Upside Area – with respect to each form of additional consideration set out in items 2, 3 and 4 above, note that the relevant project area subject to the ORRI or NPI could be made to include acreage in addition to or otherwise outside of the project area subject to dedication, thereby giving the holder of the ORRI or NPI a potential upside benefit. In other words, Upstream Company would receive its ORRI or NPI from revenue relating to services provided by Midstream Company with respect to hydrocarbons produced from the project area subject to the dedication (i.e., the area covered by the Upstream Company's dedicated minerals/leases) *plus* revenue from services provided by Midstream Company with respect to third party hydrocarbons produced from a wider AMI-type area.

6. Regular Equity in Midstream Company – a grant by Midstream Company to Upstream Company of true equity (membership interests, common stock) in Midstream Company. Under this scenario, Midstream Company would probably be formed as a special purpose vehicle, set up to own a regionally discrete gathering and processing system. Parties will need to address obligations for capital costs, including those necessary to build out the system to Upstream Company. Upstream Company may argue that the contribution of its acreage dedication should cover its share of those costs, or a certain percentage of its share of those costs (including potentially 100% of its share + a certain carry). If Midstream Company wants to avoid granting Upstream Company the types of rights that accompany a true equity interest, it may instead grant a contractual right that tracks equity interest (e.g., a "synthetic" or "tracking" equity interest), including potentially sharing upside upon exit at sale / IPO.

B. Limitations.

Note that the types of additional consideration set out in Part A above may be, and typically will be, conditioned in certain ways, including as to performance and timing. Certain limitations that we have seen include:

1. Paid Immediately – not really a limitation, but the most straightforward form, and presumably the most desirable for Upstream Company, where the benefit to Upstream Company is paid, or vests or otherwise accrues, immediately and with no claw-back effect. These deals can be set up like an M&A transaction, where, at "closing", delivery of consideration (cash, equity, etc.) occurs in exchange for execution of the midstream arrangements. Another benefit of this type of structure to Upstream Company is that it allows the consideration to be "taken off the table" going forward, so that it is not part of the valuation model upon a future divestiture of the upstream assets.

2. Payment Tied to Metric – a structure where the consideration paid to Upstream Company is tied to achieving certain metrics or hurdles. These metrics can be volumetric, such as hitting a certain cumulative throughput amount over time or reaching a certain daily throughput hurdle; or may be tied to a drilling program, where consideration is earned after a certain number of wells have been drilled in the dedicated area (calculation can be gross or net, based on the dedicating party's interest). A middle-of-the-road variation is where certain consideration is paid at dedication, but an additional hold-back payment is earned upon hitting a metric or hurdle.

3. Claw-back – a structure where the consideration is paid to Upstream Party at dedication, but a mechanism is in place whereby Midstream Company recoups some or all of the consideration in the event that certain metrics are *not* reached (e.g., volumetric or drilling), usually by a certain time deadline. Since recoupment of a cash payment is seldom assured, this "recoupment" is more likely to be tied to an NPI or equity / synthetic equity consideration structure, where the claw-back results in Upstream Company's percentage interest being eliminated or otherwise reduced (withered) for failure to hit applicable metrics. Alternatively, the reduction of Upstream Company's interest could be triggered by Midstream Company hitting certain stretch goals in an equity-consideration structure, most likely tied to third party customers – in other words, Upstream Company's upside consideration is reduced or capped when Midstream Company reaches a certain volumetric hurdle with respect to third party throughput.

C. Mineral Owner Structures

Certain additional types of structures that we have seen considered are worth noting here. Reflecting the increasing likelihood that a mineral interest owner will be a commercial industry participant (e.g., an active investor in mineral such as a PE fund), these are structures where a mineral interest owner ("Mineral Owner"), either as an owner of unleased mineral interests or as lessor of mineral interests subject to an existing lease, would contract directly with a Midstream Company to earn additional consideration in exchange for a dedication. These structures may include contingencies reflective of the current or eventual lessee ("Upstream Operator").

The main principle at work with respect to these Mineral Owner-structures is that, since an oil and gas lease is a property right that is derivative of the underlying mineral interest, any form of agreement that can be entered into by an oil and gas lessee can also be agreed by a Mineral Owner with respect to its arguably greater interest in the underlying minerals; and that any burden that is properly placed on unleased minerals that are then subsequently leased, including a dedication to a midstream services agreement, will continue to burden the lessee after it leases the minerals (i.e., the lease will be taken subject to the relevant dedication or other agreement). A secondary principle relevant here is that the Mineral Owner typically retains certain rights with respect to minerals even after leasing, including the right to take its royalty interest share of production in kind.

1. Mineral Interest Owner Dedication (Pre-Lease) – under this structure, Mineral Owner dedicates its unleased minerals within a certain project area to Midstream Company, prior to leasing the minerals. Mineral Owner receives all relevant additional consideration in exchange for the dedication, which includes execution of the midstream services agreement, including all commercial terms typically contained within the relevant type of agreement. One proviso is that the commercial terms of the midstream agreement should be sufficiently flexible to fit the development plans of one or more unknown future Upstream Operators, in order to avoid an overly negative effect on the consideration paid to the Mineral Owner for the lease itself. In this case, fees set based on a "cost of service" model, where per-MMBtu gathering, processing fees are determined based on amount necessary for Midstream Company to recover capex + opex + ROI over relevant determination period may be appropriate, together with shipper optionality as to type of midstream build-out, including options for a CDP-based model v. well-based model, etc. In either case, Midstream Company may agree to meet with prospective Upstream Operator-lessees in order to explain and, as necessary, modify services arrangements, so as to lessen any negative impact on lease terms due to prior arrangements in place.

2. Preferential Right on Dedication of Mineral Interest – Mineral Owner grants to Midstream Company a package of primary actor rights (e.g., one of, or some combination of, a right of first negotiation, right of first refusal and/or preferential right) to gain the dedication of minerals within the unleased project area. These primary rights would be triggered when the Mineral Owner is approached by an Upstream Operator to lease minerals. As an example, primary rights offered to Midstream Company could include:

(i) Mineral Owner promises give Midstream Company the opportunity to meet with Upstream Operator in order to win the business of Upstream Operator for midstream services for the applicable project area; and/or

(ii) Upstream Operator would take its leases from Mineral Owner subject to Midstream Company's preferential right to match any offer by any third party midstream provider for midstream services.

For item (i) above, the arrangement could be limited to a contractual agreement between Midstream Company and Mineral Owner covering procedures around leasing applicable mineral

packages. For item (ii) above, the arrangement could take either the form of a limited dedication of the relevant minerals that would burden the minerals with the ROFR/Pref or a limited contractual agreement whereby Mineral Owner promises Midstream Company to include the ROFR/Pref in the applicable leases; in either case, the relevant burden on Upstream Operator would be set out in its lease from Mineral Owner. Since in this case the commercial terms of the midstream agreement would be negotiated directly with the Upstream Operator, the negative impact on leasing discussed in C.1 should be lessened considerably. The additional consideration for dedication would most likely be paid by the Midstream Company to the Mineral Owner if and when the Midstream Company enters into a dedicated midstream services agreement with an Upstream Operator, although some nominal consideration could be earned upon the initial grant of the ROFR/Pref right. Arguably under either option (i) or (ii), Mineral Owner and/or Midstream Company could be given the option to offer up a certain percentage of the overall additional consideration to Upstream Operator in order to increase the likelihood of capturing the midstream business.

3. Lessor Dedication – Under this structure, the applicable mineral interests are already subject to a lease with an Upstream Operator and Midstream Company would potentially already have an arrangement in place with Upstream Operator for midstream services. Mineral Owner would dedicate its royalty interest production ("RI") to the Midstream Company pursuant to its take-in-kind rights, in exchange for additional consideration. This type of grant is most likely available in the case where the Mineral Owner has some optionality for sending its RI production to another third party midstream company. In this scenario, Mineral Owner has leverage to pick up a quick payday in exchange for granting to Midstream Company rights to the RI production that Midstream Company may already be counting on receiving. Alternatively, Mineral Owner could seek compensation from Upstream Operator, in a situation where Upstream Operator needs RI volumes in order to meet its take-or-pay or minimum volume commitments under existing arrangements with Midstream Company.

Thank you for your attention to this brief discussion on these new types of midstream transactions, which in some cases blur the lines between upstream and midstream development, and real property rights and contractual obligations. We think that this type of innovation will continue to increase as investors focus on development of high-value targets, with the current petri dish obviously being the Permian Basin.