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NOVEMBER 2017

UPSTREAM/MIDSTREAM UPDATE:

PRODUCER MIDSTREAM JVS AND DRILLCOS UNDER REVIEW

Energy Series

velaw.com

TODAY'S PANEL

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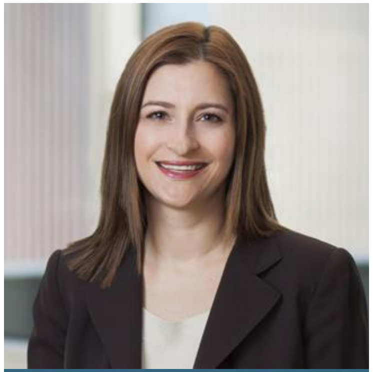

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Restatements and Late Periodic Reports

Wednesday, January 10, 2018

Speakers: **David D'Alessandro; Robert Kimball; Brenda Lenahan**

TODAY'S AGENDA

- Midstream Agreements
  - Recent Producer Midstream JV Trends
  - JV / LLC Agreement Issues – Conflicts of Interest
  - JV / LLC Agreement Issues – Formation and Operational Issues
  - Midstream Agreement Issues and Conflicts of Interest
- Drillco Update
  - Recent Drillco Transactions
  - Accounting Treatment
  - Drillco Terms

PRODUCER MIDSTREAM JVS ARE ON THE RISE

- **Producer Midstream JVs in the Delaware Basin, Scope / STACK and Niobrara are HOT!!!**
- **JVs are focused on buildouts of natural gas gathering / processing facilities and crude gathering systems**

- **Midstream counterparties are offering Incentives**
  - Upfront cash payments
  - Ongoing incentive payments
  - Equity Interests in the JV entity
  - NPI Interests in Midstream Business
  - Reduced gathering / processing fees / credits

- **Tax and Accounting Issues; Evaluate Structure Early**

PRODUCER MIDSTREAM JVS ARE ON THE RISE (CON'T)

	Antero / MarkWest Energy Partners	Matador Resources / Five Point Capital	WPX Energy / Howard Energy Partners (AIMCO and Alinda)	Charger Shale Oil Co. / Producers Midstream (Tailwater)	Gulf Coast Express (quasi-producer midstream JV)
Date:	January 2017	January 2017	July 2017	October 2017	October 2017
Area:	Marcellus (West Virginia)	Delaware Basin	Delaware Basin	Delaware Basin	Permian Basin
Interests:	50 / 50	51 (Matador) / 49 (Five Point) Matador is the operator	50 / 50	Undisclosed	KMI – 50% DCP – 25% Targa – 25%
Dedication:	Undisclosed	Undisclosed	50,000 acres	Undisclosed	Targa and DCP commit producer volumes to the system
Producer Incentives:	Undisclosed (if any)	Matador paid $171.5 mm in connection with formation (Matador contributed assets and received a special distribution) Matador can earn up to $73.5 mm in incentive payments over 5 years	WPX paid $300 mm in connection with formation of JV (WPX contributed assets and received a special distribution) Howard funds first $263 million of JV capex, including $132 mm carry for WPX	Undisclosed (if any)	N/A
MVC:	Undisclosed (if any)	Yes	No	Undisclosed (if any)	N/A

JOINT VENTURES – WHO AND WHY

- ***Midstream Companies (Strategic or Private Equity-Backed)***
  - Secure Anchor Shipper Commitment
  - Share Capital Risk
  - Mitigate Competing System(s) Risk
  - Enhance Ability to Finance
- ***Upstream Producers***
  - Capture Value of Post-Production Costs
  - Secure Production Takeoff Capacity
  - Increase Production Revenues (recapture post-production costs)
  - Share Capital Risk
  - Avoid Midstream Staff-Up and G&A Cost Centers
  - Gain Midstream Experience (Secondment)

MIDSTREAM JOINT VENTURES – STRUCTURING ALTERNATIVES

- ***Equity Joint Venture (Joint Ownership of Common Entity)***
  - Ease of Administration
  - Shared Financing
  - Common Exit Strategies
  - Segregation of Liabilities
  - Clear Jurisdictional Status
  - FERC Regulated Pipelines
- ***Asset Joint Venture (Joint Ownership of Common Pipeline System)***
  - Differing Financing Strategies
  - Differing Exit Strategies
  - Multiple Producers
  - Variability of System Expansion Alignment
  - Segregation of System Capacity (pipe-within-a-pipe)

FORMS OF PRODUCER CONSIDERATION & INCENTIVES

	Upfront Cash Payments	Earn-Outs & Incentive Payments	JV Equity Interests	Net Profits Interests	Reduced Fees & Rates
Description:	Based on Current Volumes ($250K to $3mm per well) and/or Acreage ($500 to $7,500 per net acre)	Volumetric: $X per bbl/mmcf/mmbtu Per Well: $250K to $3mm per well	X%-50% May or not include a “Carry” where midstream sponsor agrees to pay for the first $X of Producer’s capital commitment	5%-15% Net Profits Interest Can be structured as equity interest or synthetic equity interest (cash payment) Generally after return of invested capital plus an IRR hurdle	Reduced fees and rates under midstream agreements
Regulatory Issues:	Not available for FERC Crude Oil or Liquids Dedications (rebates prohibited under ICA) or FERC Gas Lines	Not available for FERC Crude Oil or Liquids Dedications (rebates prohibited under ICA) or FERC Gas Lines	None	None	May be prohibited and/or limited under FERC or state laws.
Commercial Issues	Lack of Producer Development Obligations/Guarantee Midstream Sponsor Liquidity Concerns	Incentivizes Upstream Development Credit Support Concerns Balance Sheet considerations	Common Entity JV Issues (see following slides) Producer Carry deployment Well obligations tied to Producer Carry	Equity vs. Synthetic NPI Minority Protections (Equity) Debits to NPI (Synthetic) Credit Support Concerns Accounting & Audit Rights	FERC & Regulatory issues. Easiest to administer
Tax Considerations:	Likely taxable Immediately as ordinary income	Likely taxable upon receipt as ordinary income (as long as payment is contingent)	Taxable as equity interests	Taxable as equity interests (equity NPI) or ordinary income (synthetic NPI)	None

JV / LLC AGREEMENT ISSUES – CONFLICTS OF INTEREST

- ***Producer Midstream JVs are ripe for Misalignment***
  - Collecting Third Party Volumes / Granting Third Parties Priority Service
  - Capital Expansions of the System
  - Competing Activities in the AMI
  - Future Capital Contributions v. Leveraging with Debt
  - Timing of Distributions / Capital Reserves
  - Timing and Process for Exits (interplay with potential upstream exit)
  - Transfers to upstream competitors (by the midstream) or midstream competitors (by the upstream)
  - Confidentiality

- ***Misalignment concerns are heightened by Multi-Year Dedications and Exit Plans of the Midstream Provider and/or the Producer***

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JV / LLC AGREEMENT ISSUES – FORMATION AND OPERATIONAL ISSUES

- ***Diligence / Formation Issues:***
  - Are existing midstream assets being contributed to the JV? If yes, consider diligence, reps, warranties and indemnities.
  - What acreage is being dedicated by the Producer? What are consequences of Producer losing acreage, not meeting development schedule, having undisclosed existing dedications, defaulting under commercial agreements?

- ***Operational Issues:***
  - Will the JV have officers / employees or will midstream services be provided through an Operating Services Agreement (OSA)?
  - If there is an OSA:
    - Are services provided at cost? How is G&A allocated over 5, 10, 15+ years?
    - What level of control does the midstream provider have? How do third party midstream contracts get reviewed and approved?
    - What rights does the JV have to terminate the OSA (e.g., material breaches, change in control, transfer of midstream interest, key person events, term of contract, etc.)?
    - Liability beyond gross negligence, willful misconduct?

MIDSTREAM AGREEMENT ISSUES AND CONFLICTS OF INTEREST

- ***Is My New Pipeline Subject To FERC's Jurisdiction?***
  - Jurisdictional status of facilities is not always intuitive
  - The jurisdictional tests for oil and natural gas pipelines are not the same

- ***Why Does it Matter if it is FERC Jurisdictional***
  - Whether or not new pipeline is subject to FERC's jurisdiction can impact many aspects of the agreement negotiations, the construction of the pipeline, and the ongoing pipeline operations

- ***Joint Ownership Structure Considerations***
  - Gas: Connection requirements
  - Crude: Prohibitions on undue discrimination; prohibition of rebates and concessions; protection of confidential shipper information; affiliate relationship considerations

MIDSTREAM AGREEMENT ISSUES AND CONFLICTS OF INTEREST (CON'T)

Key Provisions

- Post-Sabine Dedication Language
  - Overlapping dedications with existing assets
- Scope of Dedication
  - AMI Concept (all owned and hereinafter acquired interests)
  - Existing interests only
  - Scope of assignee burden
- Level of service (i.e. firm/guaranteed capacity)
- Minimum volume commitments (amt., term, any excused amounts)
- Term of the Agreement (roll-over rights, Early and/or Unique Termination provisions)
- Contractual change of control and assignment restrictions
- Connection obligations (of gatherer) / Infrastructure upgrade obligations of processor
- Credit requirements
- Electricity Installation and Charges

CERTAIN PUBLICLY AVAILABLE DRILLCO JVS

	GSO - Linn Energy	TSSP - Legacy Reserves – TSSP	Bayou City Energy / Alta Mesa Energy	Unidentified global investment fund/ Gastar Exploration Inc.
Date:	July 2015	July 2015	January 2016	October 2016
Assets:	TBD	Midland Basin	STACK	STACK
Commitment:	$500 mm	$150 mm (first tranche)	40 wells; $3.2mm per well max commitment	Not publicly available
DC&E Costs:	Participant - 100% Operator - 0%	Participant - 95% Operator - 5%	Participant - 100% Operator - 0%	Participant – 90% Operator – 10%
Initial WI:	Participant – 85% Operator – 15%	Participant – 87.5% Operator – 12.5%	Participant – 80% Operator – 20%	Participant – 80% Operator – 20%
Post-Reversion WI:	Participant – 5% Operator – 95%	First Reversion Participant – 37% Operator – 63% Second Reversion Participant – 15% Operator – 85%	First Reversion Participant – 15% Operator – 85% Second Reversion Participant – 7.5% Operator – 92.5%	First Reversion Participant – 40% Operator – 60% Second Reversion Participant – 10% Operator – 90%
Reversion Threshold:	15% IRR	First Reversion 1.0x ROI Second Reversion 15% IRR	First Reversion 15% IRR Second Reversion 25% IRR	First Reversion 15% IRR Second Reversion 20% IRR

CERTAIN PUBLICLY AVAILABLE DRILLCO JVS (CON'T)

	Macquarie Infrastructure and California Resources Corporation	Apollo Global Management/ EP Energy Corporation	Unidentified global investment fund/ SandRidge Energy	Bayou City Energy/ Chaparral Energy	Sequel / Eclipse Resources
Date:	April 2017	January 2017	August 2017	September 2017	Term Sheet Announced
Assets:	California	Midland Basin	STACK	STACK	Utica
Commitment:	$160 mm (first tranche)	$450 mm	$100 mm (first tranche)	$100 mm (first tranche)	$325 mm
DC&E Costs:	Participant – 100% Operator – 0%	Participant – 60% Operator – 40%	Participant – 90% Operator – 80%	Participant – 100% Operator – 0%	15% carry to Eclipse
Initial WI:	Participant – 90% Operator – 10%	Participant – 50% Operator – 50%	Participant – 80% Operator – 20%	Participant – 85% Operator – 15%	Participant – 30-50% Operator – 70-50%
Post-Reversion WI:	Participant – 25% Operator – 75%	Participant – 15% Operator – 85%	Undisclosed	Participant – 25% Operator – 75%	TBD
Reversion Threshold:	Undisclosed	12% IRR	Undisclosed	14% IRR	TBD

OTHER RECENTLY ANNOUNCED DRILLCO JVS

- **TSSP / Hunt Oil Company** (June 2016)
  - $400 million
  - Permian Basin
- **Benefit Street Partners / California Resources Corporation** (February 2017)
  - $250 million
  - California
- **ARES / Development Capital Resources and Unnamed Counterparty** (March 2017)
  - $150 million
  - Undisclosed field
- **ARES / Development Capital Resources and Endeavor Energy Resources** (April 2017)
  - $300 million
  - Midland Basin
- **The Carlyle Group L.P. / EOG Resources, Inc.** (May 2017)
  - $400 million
  - Marmaton

ACCOUNTING TREATMENT

- SEC has reviewed accounting treatment of at least two recent drillco transactions
- Requested accounting treatment was approved for one but not for the other
- No official guidance, but SEC has focused on *Risk of Loss*
  - Are reserves proven or unproven?
  - Lack of available analogous well results, sufficient geoscience and engineering data
  - Likelihood of achieving well results and return hurdles?
  - Provisions limiting downside risk (cost caps, other sources of recovery, substitute wells, etc.)?
  - Investor is assuming significant price, reserve and production risk
- Presence of Stated Interest Rate or IRR Hurdle
- Are their debt-like provisions (mortgages, make-wholes, put/call rights, etc.)?
- SEC review has been on a case-by-case basis
- Review process is timely / costly and cannot occur until material terms of the transaction have been finalized
- Unclear how SEC will react to previously announced drillco transactions

ACCOUNTING TREATMENT (CON'T)

ASC 470-10-25 (Debt)

25-2 While the classification of the proceeds from the investor as debt or deferred income depends on the specific facts and circumstances of the transaction, the presence of any one of the following factors independently creates a rebuttable presumption that classification of the proceeds as debt is appropriate:

1. The transaction does not purport to be a sale (that is, the form of the transaction is debt).
2. The entity has significant continuing involvement in the generation of the cash flows due the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary, or business segment).
3. The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
4. The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.
5. Variations in the entity's revenue or income underlying the transaction have only a trifling impact on the investor's rate of return.
6. The investor has any recourse to the entity relating to the payments due the investor.

ACCOUNTING TREATMENT (CON'T)

If a Drillco is treated as debt for accounting purposes, such treatment raises a number of other SEC accounting and disclosure questions:

- How should these transactions be disclose and accounted in public filings?
- Should Investor's interests in the wells be booked as reserves of the Producer?
- Is there a potential of an overstatement of balance sheet assets and earnings
- Should Drillco interests be included in Producer's operating earnings and LOE for purposes of operating results in income statements (with final net distributions to DrillCo investor considered payment of principal and/or debt)?
- Are there forgiveness of debt issues if wells are uneconomic or unlikely to achieve payout/reversion?
- How should the Drillco/debt be treated upon a transfer of the burdened interest and/or reversionary interests?
- How should traditional farmout agreements and non-consent penalties under JOAs be treated?

CERTAIN DRILLCO JV TERMS; WHAT STRINGS ARE ATTACHED?

- **Key Negotiated Terms**
  - Hard v. Soft Drilling Program
  - Assets Included (wellbore v. drilling unit)
  - Substitute Wells [potential concern]
  - Subsequent Tranches
  - Right of Acceleration [potential concern]
  - Cost Cap [potential concern]
  - Off-Ramps [potential concern]
  - Defaults
  - Transfer Restrictions
    - Tag, Drag and Put Rights [potential concern]
  - Expense Reimbursement

- **Carried Interest v. Disguised Financing**
  - Precautionary Mortgage
  - Bankruptcy Protections

THANK YOU

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