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Experts Say Production Shut-Ins, Contentious Bankruptcies and Force Majeure Claims Loom Ahead for E&P Companies, Midstream Operators Amid Storage Constraints

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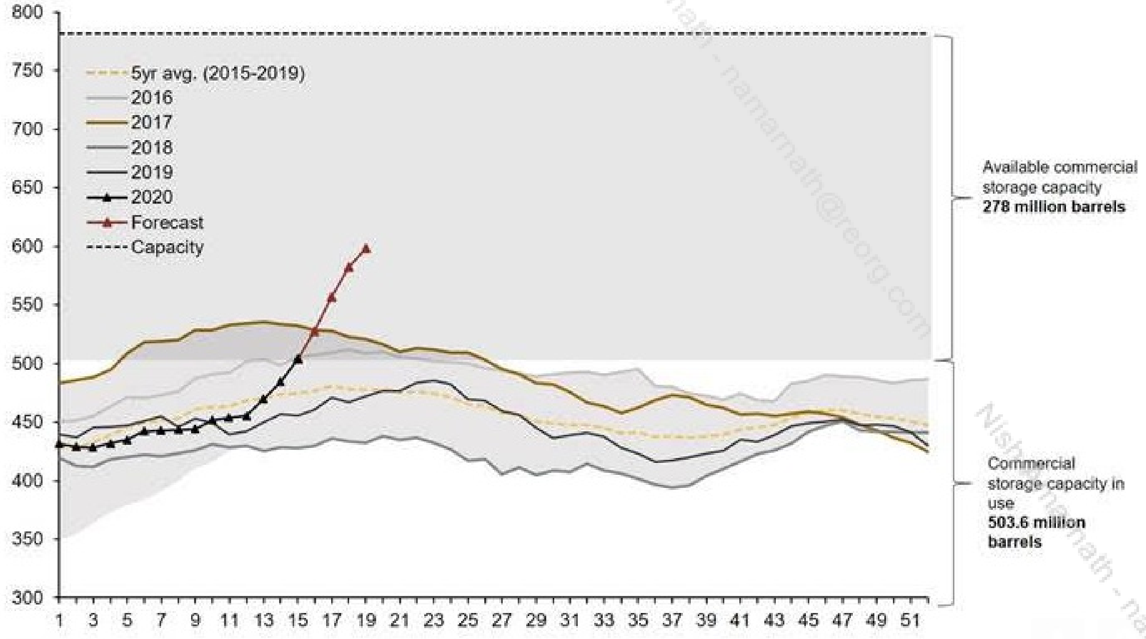
As surging U.S. crude oil stockpiles are poised to overwhelm available storage, possibly by as soon as next month, producers and midstream participants may seek to ride out the storm through production shut-ins that may in turn trigger restructurings amid a scramble among industry participants to evaluate contracts for the prospects of invoking force majeure and other protections, sources said.

Harry Pefanis, CEO of Plains All-American Pipeline LP, stated in an April 8 letter to the Texas Railroad Commission that the company had suggested to its customers in late March that they “take steps to reduce oil production” in light of the demand collapse sparked by the Covid-19 pandemic. According to Pefanis, his company estimates that commercial storage in the United States will “absorb the imbalance” at least through mid-May, but “at some point curtailments of U.S. production will be required to balance the market.”

According to a research note by Rystad Energy, U.S. oil production is likely to hold steady above 12 million barrels per day in coming weeks, with crude imports expected to hold around 6 million bpd “as an armada of Saudi cargos is fast approaching US shores.” Commercial storage in the United States is quickly approaching capacity, the firm says:

Figure 2: Total US commercial crude inventories
Million barrels



Source: Rystad Energy research and analysis, EIA

Given this scenario, sources say, Plains and other midstream companies are asking producers to demonstrate that their crude oil has a destination.

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"Some pipeline and storage operators have been sending letters to producers asking them to confirm that they have firm commitments to move products downstream of their terminals," said Gabriel Procaccini, an energy-focused partner in the Houston office of Akin Gump Strauss Hauer & Feld LLP, during an April 21 webinar addressing risk mitigation strategies.

These requests come as Cushing, Okla., a critical pipeline and storage hub, is at roughly 80% capacity, according to sources. Stacey Morris, director of research at Alerian, a Dallas-based organization that provides benchmarks and analytics for midstream master limited partnerships, said that while the Gulf Coast of Texas and Louisiana offer some more storage, shut-in announcements from producers are likely in the offing. "The expectation is that we'll see more shut-in announcements, going forward, as producers struggle with trying to find a place to put their crude," Morris said in an interview with Reorg.

"Right now, the best storage strategy may be keeping crude under the ground and not producing more than you can sell or transport," said William D. Wood, a principal in the Houston office of McKool Smith PC.

Wood added that E&P companies are looking for ways to match their production capabilities with their marketing outlets and capacities and that larger, integrated energy companies will have more options in this regard.

At its April 14 open meeting, the Texas Railroad Commission heard opinions on a motion by Parsley Energy and Pioneer Natural Resources regarding the possible prorating of oil production. While numerous E&P and midstream companies opposed the motion, the general consensus at this meeting was that storage capacity would reach critical levels by mid-May. Producer participants also arrived at a consensus of 20 million to 30 million barrels a day of excess supply, which included the OPEC+ deal to curtail production by 9.7 million barrels a day, beginning on May 1.

At the commission's April 21 meeting, Commission Ryan Sitton floated a proposal for prorationing, which included a 20% prorated cut by all operators except those producing 1,000 or fewer barrels per day. The commission is expected to vote on the motion on May 5. The commission is slated to reconvene in two weeks.

"In making these decisions as to where to cut production or shut in wells, the company has to balance lease termination risks with economic and engineering risks. These truly require input and collaboration between several departments within the company," Michael Byrd, a Houston-based partner at Akin Gump, said at the firm's risk mitigation webinar on April 21.

However, not all producers can entirely shut in production. Smaller producers with cash obligations will likely be compelled to continue production and offload crude at drastically lowered prices. "[E]ven if netbacks are pretty dismal, they need to generate cash flow," Morris of Alerian explained, adding that contractual obligations also weigh into this possibility.

Force Majeure Claims

Legal sources say that producers and midstream companies are increasingly considering and/or issuing force majeure notices, while others are flooding attorneys' inboxes with requests for their review of various contracts, ranging from oil and gas lease agreements to gathering and processing contracts and farmout agreements.

Force majeure provisions are designed to permit a temporary suspension of performance under a contract when the asserting party believes it is unable to meet its contractual obligations due to one or more unforeseeable and/or uncontrollable events. Importantly, the wording and breadth of force majeure provisions vary from contract to contract.

"One of the frequent questions I'm being asked is whether force majeure can provide an escape hatch from burdensome midstream obligations as companies consider potential force majeure claims due to storage constraints," Procaccini said on the Akin webinar, adding that midstream entities and producers should continue their efforts to find reasonable solutions to the crisis, which might include

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future discounts in exchange for honoring current commitments, in lieu of litigation.

Akin litigator Jim Wetwiska echoed Procaccini's comments, saying "we really stress that parties should consider certain factors that will impact litigation, looking at alternative performance methods and doing a thorough analysis of the contract and the force majeure provisions." "The decision to claim force majeure should be taken seriously. If you're going to claim a force majeure, it's your burden to establish it," Wetwiska said during the webinar.

Companies that decide not to declare a force majeure event separately are considering invoking material adverse change clauses and/or the covenant of good faith and fair dealings that is implied as a matter of law in most contracts, said Gilbert Porter, a partner in the New York office of Haynes and Boone.

Although the details may differ significantly between contracts, material adverse change clauses are intended to permit a party to exit from the contract or excuse performance if certain negative events that would be considered "material" changes occur relative to the parties' original expectations. The implied covenant of good faith and fair dealings holds that asserting parties that do have rights must exercise them in a reasonable fashion rather than ghosting or cutting off the other party in the event of an intent to invoke a material adverse change clause, for instance.

Restructuring and Litigation

Many upstream companies are seeking contract amendments in the form of shut-in royalty payments, extension of payment deadlines and/or extension of leases for their wells, sources say. Some of the sources said they anticipate litigation if an amicable resolution cannot be reached.

Amid production shut-ins, restructuring scenarios and bankruptcies are expected to play out. Sources said that this salvo of bankruptcies will likely be more contentious than what was seen during the 2015-'16 price war.

"Midstream participants should be prepared for the coming onslaught of contract renegotiation requests and focused on finding practical solutions to mitigate the risks which have emerged as a result of this crisis. This is not necessarily the time to stand firm and risk upsetting long-term relationships over what could be a relatively brief period of dislocation," Procaccini asserted. He said it would augur well for operators in the space to "mindfully" address counterparty relationships with their business development teams and make sure that their in-house business development professionals have an in-depth understanding of the classes of midstream contracts that their companies possess and the potential exposure thereunder so they can be best positioned to quickly respond to accommodation requests while also minimizing the risk of breach. He further suggested that midstream companies should be keenly aware of any provisions, such as hardship clauses, that might create a renegotiation obligation.

At the same time, the collapse of West Texas Intermediate to negative territory has to be taken to some extent "with a grain of salt," Morris of Alerian observed, noting that the parties that were unable to perform any physical delivery were mostly retail investors and speculative traders. "The June contract is a much better indication of where prices are," she said. "But the May contract and the lack of ability to deliver in some cases speaks to some of the physical constraints we have already been seeing."

WTI crude prices for June delivery tanked more than 65% to go as low as $6.50 per barrel on the Nymex on Tuesday afternoon before settling at $11.57. Prices for delivery in July and August settled on Tuesday at $18.69 and $21.61, respectively. Futures on the May contract traversed into negative territory, plummeting as low as negative $16.74 a barrel on Tuesday before settling at $10.01.

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