



# 46th Annual Taxation Conference APPRAISAL for AD VALOREM TAXATION

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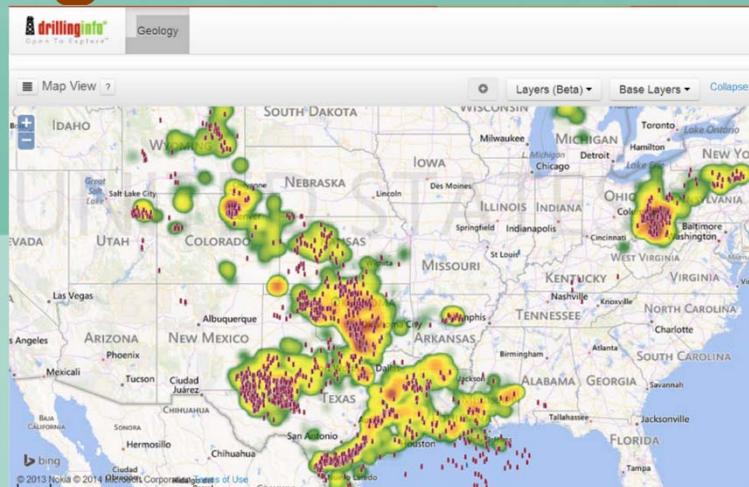
**Risky Credit Issues for Pipeline  
Shippers**

**Presented By: JoAnn Wright and  
Shelley Yetter**

# **Economic Influences Causing Bankruptcies and Credit Issues**

# What is a rig count?

The Baker Hughes rig count is an important business barometer for the oil drilling industry. When drilling rigs are active they consume products and services produced by the oil service industry. The active rig count acts as a leading indicator of demand for oil products.



**What is the highest weekly US rig county recorded by the Baker Hughes Index?**

- A. 3,569**
- B. 4,189**
- C. 4,530**
- D. 5,149**

# Rig Count History

- **On December 28, 1981, US Weekly Rig Counts hit a record high of 4,530**
- **As of July 22, 2016, there are 462 rigs in the US (58 above the record low since 1949)**
  - **80% are oil and 20% are gas**

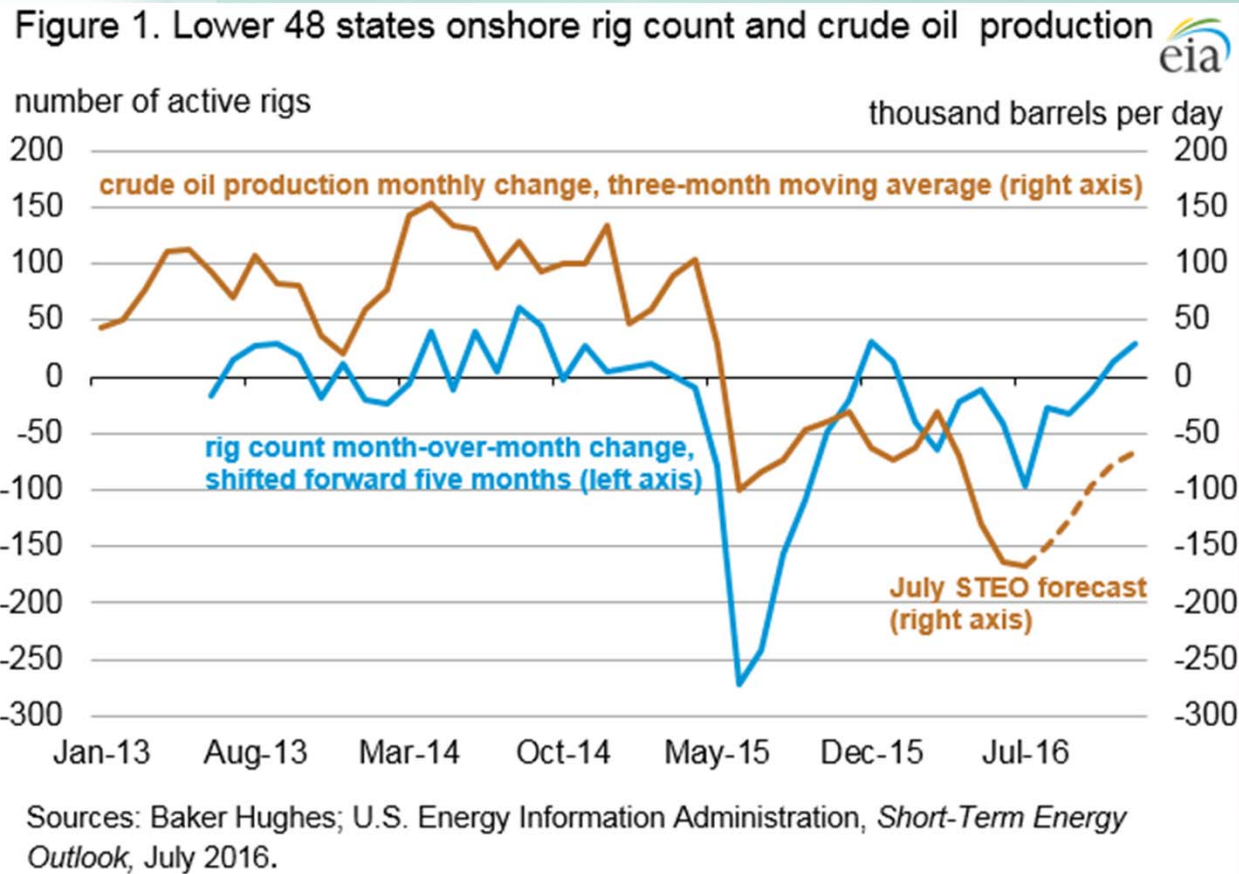
# What is the Record High Price of Crude Oil in the U.S.?

- A. \$117.27
- B. \$127.27
- C. \$137.27
- D. \$147.27

# Oil History

- On July 11, 2008, oil hit a record peak of \$147.27.
- By February 2009, it had sank below \$40 a barrel
- On January 31, 2011, oil was above \$100 a barrel again and remained there for the next three and a half years in the \$90-120 range
- Then the oil glut came, and by February 2016, oil was trading below \$30 a barrel
- Price as of July 22 is \$45.12

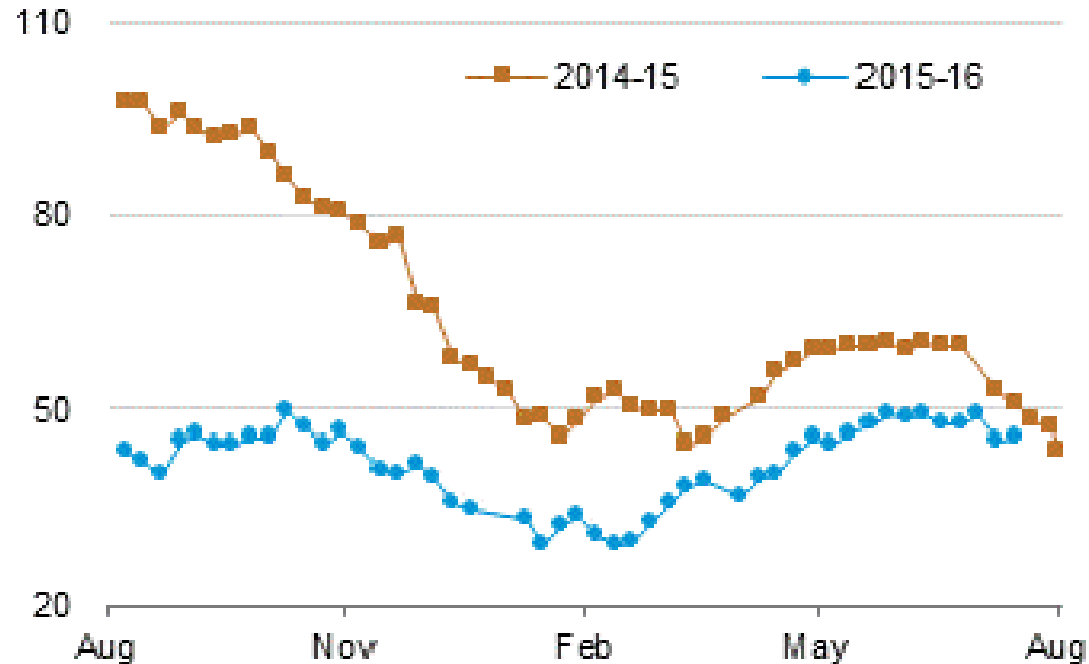
# Correlation of Rig Count and Crude Oil Prices





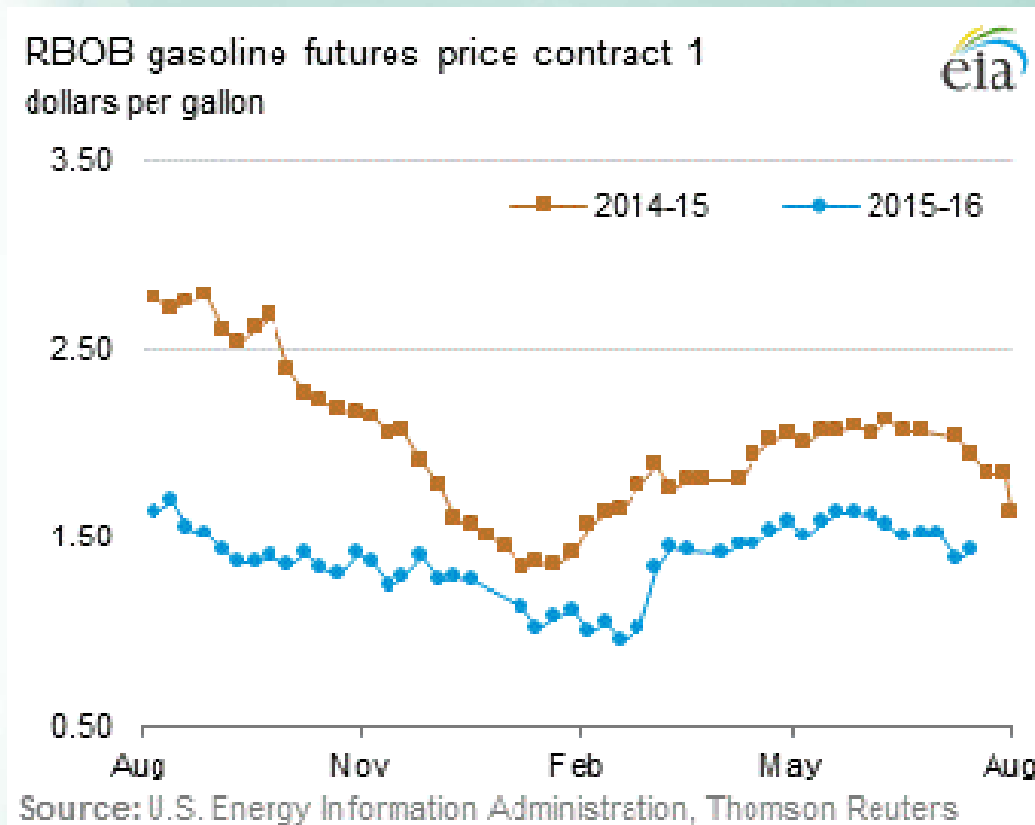
# Crude Oil Futures

Crude oil futures price contract 1  
dollars per barrel



Source: U.S. Energy Information Administration, New York Mercantile Exchange (NYMEX)

# Gasoline Price Futures



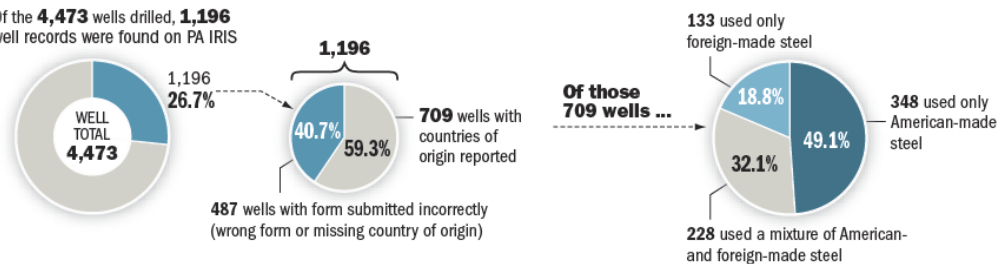
# Where does pipe come from?

## Oil and gas wells in Pa.: where the pipe comes from

Since Oct. 5, 2012, Pennsylvania has required oil and gas drillers to report the source of pipe they use at wells. After U.S. Steel closed a pipe-manufacturing plant in McKeesport, the former mayor, Jim Brewster, looked at the records to see whether drillers were using American-made or foreign-made pipe. Drillers are not required to use domestic pipe. What Mr. Brewster, now a state senator, found:

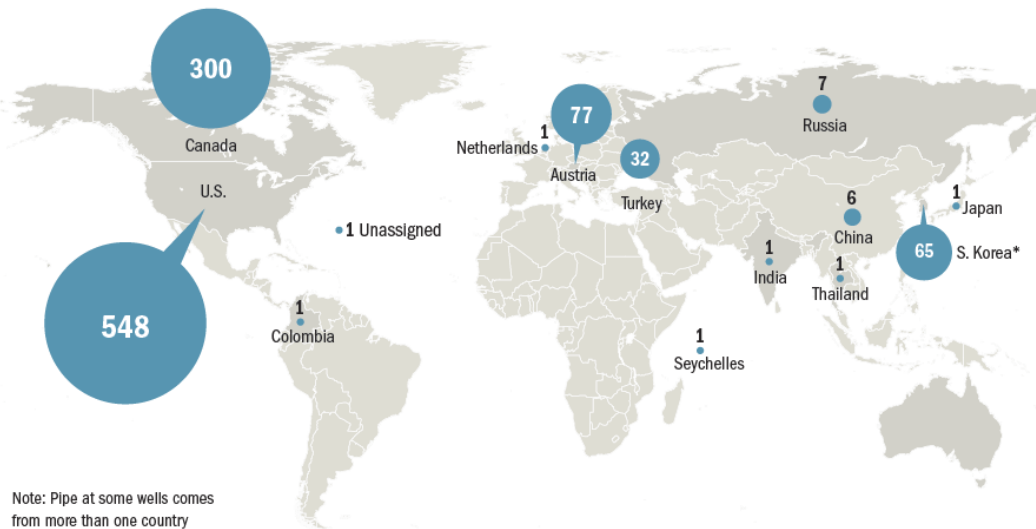
### WELLS DRILLED BETWEEN OCT. 5, 2012 AND OCT. 30, 2014

Of the **4,473** wells drilled, **1,196** well records were found on PA IRIS



PA IRIS - Pa. Internet Record Imaging System

Countries of origin and the number of instances (1,041) those countries were found on the well records:



Sources: Sen. Jim Brewster's office, Pennsylvania Department of Conservation and Natural Resources

Post-Gazette

## Considerations:

- Price is King
- Availability

# **Bankruptcy History and Current Environment**

**What was the largest bankruptcy  
in U.S. History?**

**The largest bankruptcy in U.S. history was Lehman Brothers in 2008. At the time of their filing, they had \$691B of assets.**

# Approximately How Many Oil and Natural Gas Companies Filed for Bankruptcy in 2015?

- A. At least 17
- B. At least 37
- C. At least 67
- D. At least 97

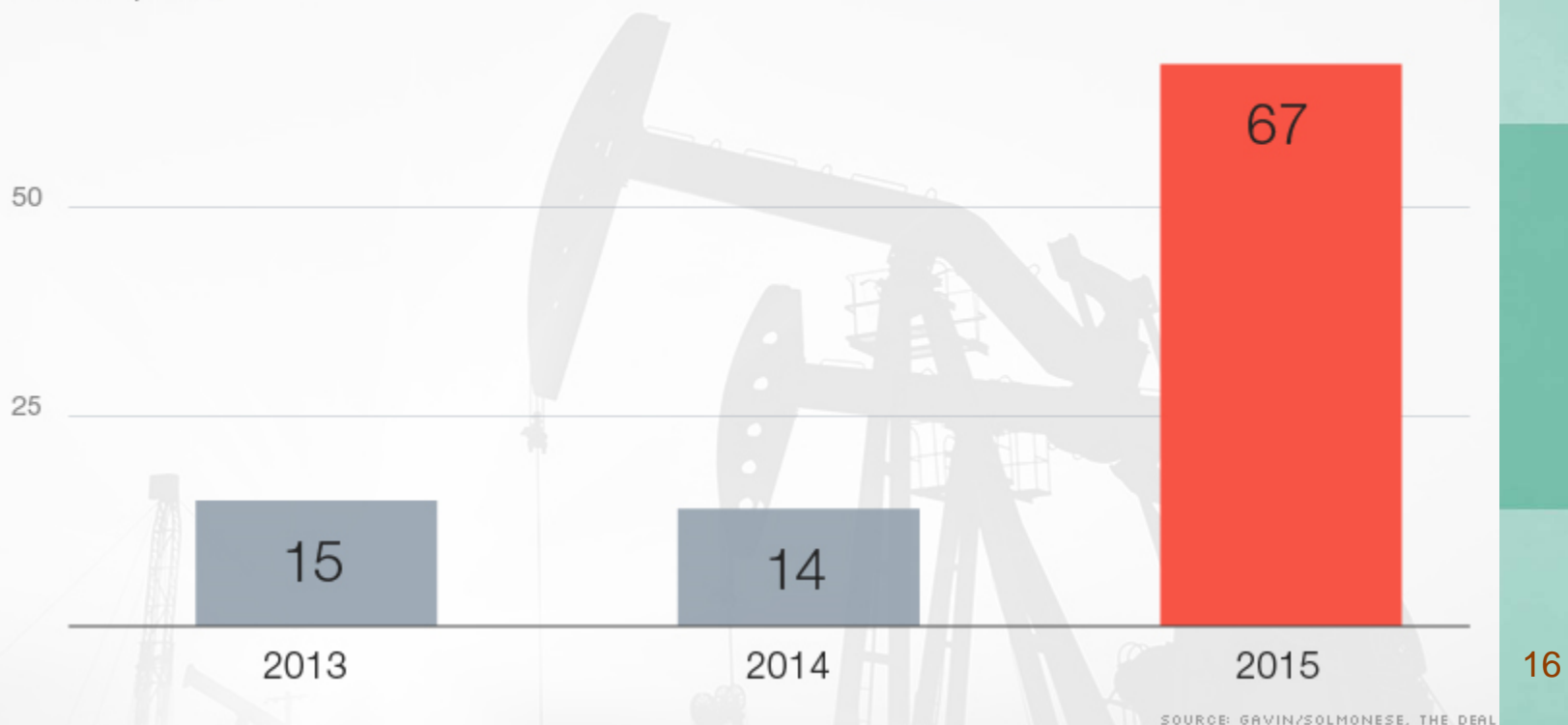
<http://money.cnn.com/2016/02/11/investing/oil-prices-bankruptcies-spike/index.html>

# Answer:

- **At least 67 Oil and Gas Companies filed for bankruptcy in 2015**

Oil and natural gas bankruptcies spike

75 bankruptcies





# What are the causes?

- **When oil and gases prices were high, companies took on a lot of debt to fund expensive drilling.**
- **With all of the excess supply, the price of oil and gas fell.**
- **When prices fell, the revenues dropped and they were unable to create enough cash to cover their debt payments.**
- **Some were able to cut expenses, but highly leveraged companies resorted to bankruptcy.**

# Notable Pipeline Shippers Declaring Bankruptcy

- **QuickSilver** – declared bankruptcy in March of 2015 due to \$2 billion of debt from Barnett Shale drilling projects – fetched 1/5 of estimate assets at the time of filing
- **Sabine Oil & Gas** – July 2015 - \$2.5B of assets and \$2.9B of debt
- **Milagro Oil & Gas, Samson Resources, Swift Energy**
- **SandRidge, LINN Energy** – May 2016

# Executory Contracts in Bankruptcy

## *Sabine (SDNY)*

- Court approved rejection of gathering agreement based on business judgment
- Non-binding ruling on “covenant runs with land”
- Nordheim and HPIP had dedications in their agreements
- Dedication does not equal conveyance to meet horizontal privity test
  - A personal covenant, such as a promise to provide utility service or environmental indemnity, does not involve a transfer of real estate, does not survive bankruptcy challenge
- Burden via dedication was as to severed minerals, thus no touching and concerning “land” in any event

Source: Porter Hedges LLP [http://www.ipaa.org/meetings/ppt/2016DEBT/Higgins\\_DefensiveStrategies.pdf](http://www.ipaa.org/meetings/ppt/2016DEBT/Higgins_DefensiveStrategies.pdf)

# Sabine Energy Facts

- **Sabine files for bankruptcy in July 2015**
- **Sabine asked a New York bankruptcy court to let it out of pipeline agreements with Nordheim Eagle Ford Gathering LLC, an affiliate of Cheniere Energy.**
- **Under the agreement, oil-and-gas producers agree to ship certain volumes of oil or gas every year at set fees, and have to make deficiency payments if they miss their targets.**

- Sabine argued it would have to pay Nordheim \$35 million over the life of the contract under the agreement, making the pacts so expensive it would be better off striking a new agreement with another company.
- Sabine also asked to get out of similar agreements with a second pipeline operator—an affiliate of High Point Infrastructure Partners LLC—arguing that it would save as much as \$80 million and avoid sinking money into unprofitable wells the company would be required to drill under the agreement.

- **Judge Shelley Chapman of the U.S. Bankruptcy Court in Manhattan agreed to let Sabine out of the deals over the objections of the pipeline companies pursuant to section 365(a) of the Bankruptcy Code, but said procedural reasons prevented her from issuing a binding decision.**
- **Section 365(a) of the Bankruptcy Code allows debtors to reject burdensome contracts. Generally, a rejected contract gives rise to a general, unsecured claim against the debtor.**

# Disputed Facts of the Case

Whether the covenants run with the land is significant because, under the Bankruptcy Code and related case law, a covenant running with the land is a property interest and cannot be rejected. Thus, for example, a minimum delivery obligation found to be a property interest would remain a "dollar for dollar" burden on the debtor.

**Gathering agreements require, among other things, that an upstream oil producer dedicate land to the midstream gatherer and commit to deliver a certain amount of gas to the midstream gatherer. The dedication and delivery provisions of the agreements are typically defined as covenants running with the land, and the Sabine agreements expressly identified those provisions as running with the land.**



**The *Sabine* Bankruptcy Court applied Texas law, which governed each gathering agreement. Under Texas law, a covenant runs with the land when:**

- 1. it touches and concerns the land;**
- 2. it relates to a thing in existence or specifically binds the parties and their assigns;**
- 3. the parties intend the covenant to run with the land; and**
- 4. the successor to the burden has notice.**

**The Bankruptcy Court also considered an additional requirement imposed by many courts, namely:**

- 5. The parties must have horizontal privity of estate.**

**The *Sabine* Bankruptcy Court determined that the covenants did not touch and concern the land because they neither affected the owner's interest in, or use of, the real property, nor impacted the value of the land "independent of collateral circumstances." The court determined that the triggers for the covenants in *Sabine* related to the products, rather than the land. The Bankruptcy Court further held that the parties lacked horizontal privity because the covenants merely set forth contractual obligations regarding the services and did not specifically reserve an interest in the real property.**

# Executory Contracts in Bankruptcy

## *Quicksilver* (Del.)

- Purchaser required rejection of gas gathering agreements as condition to closing
- Debtor argued that § 363(f) allows sale of assets free and clear of any interests including “servitudes”, “restrictive covenants” and “any dedication”
- Court took matter under advisement
- Settled before decision

# Example of Renegotiation

## Williams / Chesapeake G&P Renegotiation in 4Q 2015

	<i>Utica</i>	<i>Haynesville</i>
Fee Change	Cost of services fee changed to fixed fee with minimum volume commitments	Cost of services fee changed to fixed fee with minimum volume commitments achievable by collapsing two contract areas
New Acreage / Wells	50,000 new acres – total of 190,000 net acres	140 new wells by end of 2017,
Price Savings	\$.25 mmbtu	\$.20 per Mcf in 2016-17 \$.30 per Mcf in 2018...
Other published terms	250 mmbtu per day through Williams pipelines beginning in 2017	Term to last to 2035 Allows Williams to gather third party volumes and build scale in Utica dry gas areas

# Precedent Agreements for FERC Pipelines

- **Precedent Agreements (PA) between shippers and pipeline operators can override the FERC tariff for expansion capacity, not existing capacity**
- **PA's can terminate capacity if shipper fails to maintain creditworthiness (S&P BBB-)**
- **Example: Not less than 3 years of reservations fees for 10 years or the term of the agreement and 3 months worth there after**

# **What is a Moody's credit rating?**

**A rating is Moody's opinion of the credit quality of individual obligations or of an issuer's general creditworthiness.**

# Credit Rating Scale

	Moody's	S&P	Fitch	Meaning
Investment Grade	Aaa	AAA	AAA	Prime
	Aa1	AA+	AA+	High Grade
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Upper Medium Grade
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Lower Medium Grade
	Baa2	BBB	BBB	
Baa3	BBB-	BBB-		
Junk	Ba1	BB+	BB+	Non Investment Grade Speculative
	Ba2	BB	BB	Highly Speculative
	Ba3	BB-	BB-	
	B1	B+	B+	
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Extremely Speculative
	Caa2	CCC	CCC	In Default w/ Little Prospect for Recovery
	Caa3	CCC-	CCC-	
	Ca	CC	CC+	
		C	CC	In Default
		CC-		
D	D	DDD		

**What are the Two U.S. Non-Financial Companies with a S&P AAA debt rating?**



# **U.S. Non-Financial Companies with a AAA debt rating**

- **Microsoft**
- **Johnson and Johnson**
- **Exxon Mobil lost their AAA rating in April of this year due to unfavorable oil outlook (held rating since 1930)**
- **As recent as 2008, there were eight companies with a AAA rating**

# Midcontinent Express Pipeline

**Downgraded debt rating by Moody's from Baa1 to Baa2 on March 28, 2016 due to significant counter party risk due to contractual exposure to Chesapeake Energy's Caa2 negative rating which may lead to lost revenue.**

# What is the Typical Rating of a Natural Gas Pipeline?

- **Per Teagarden's 2016 Natural Gas Capitalization rate study, BBB- is a typical long-term debt rating**
- **Note that the lower the credit rating, the higher the debt component of the capitalization rate**

# What Does this Mean for Value?

- **Income streams are at risk when a transporter becomes bankrupt**
- **Assets are sold at reduced values in bankruptcy auctions**
- **Risk of losing volumes on pipeline to competitors**
- **Should use a risk adjusted capitalization rate**