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Midstream and Upstream Joint Ventures in Oil & Gas: Structure Options, Transferability, Tax and Other Considerations

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October 4, 2018

Upstream and Midstream Joint Ventures in the Oil and Gas Industry

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COMMON MIDSTREAM JV STRUCTURES

COMMON MIDSTREAM JV STRUCTURES

Entity Structures

- Midstream JVs are structured as an entity/equity JV, where each JV partner owns certain equity rights in an entity that holds the JV assets

Gathering/Processing JVs

- Can cover all or a combination of field-level gathering, basin-wide gathering, processing, operational storage, and export capacity to interstate transportation
- Can be a very tightly targeted venture or a cover a broad scope

Long-Haul JVs

- Typically more straightforward – due to the very high cost and long-term nature of new long-haul projects, parties often want to share the costs and risks associated with these projects
- Can be for only a single long-haul pipe or also include associated interconnections, storage, and/or terminal assets
- May also include the right of the JV (or JV partners) to utilize the assets of one or more JV partners that are located downstream of the JV assets

COMMON UPSTREAM JV STRUCTURES

COMMON UPSTREAM JV STRUCTURES

<u>Direct Ownership Structures</u>: most Upstream JVs utilize this structure, where each JV Partner has a direct, undivided interest in the JV Assets

Drill-to-Earn

- One JV party ("Producer") owns oil and gas properties and contracts with the other JV party (in such capacity "Operator" or "Investor", as applicable) to (a) drill and operate certain wells, and/or (b) pay all or an oversized portion of the costs (the "Carry") to drill and complete such wells
- Operator/Investor party typically acquires its ownership of interest in the applicable oil and gas properties only when a well is drilled and the Carry paid
- Operator/Investor party may earn only a wellbore interest in the applicable well(s) or a lease or area-wide interest in the Producer's oil and gas properties relating to such well(s)

DrillCo

- Not a "Co." or an entity - Hybrid structure that resembles the drill-to-earn structure but with certain other key features, including the concept of a portion of the Investor's earned interest reverting back to the Producer once Investor achieves a pre-determined rate of return
- Investor typically only receives wellbore interests but is not required to fund any up-front cash consideration

Acquire-and-Drill

- Producer conveys to Investor an ownership in the assets subject to the JV at the outset of the transaction
- Investor agrees to pay a Carry of a portion of Producer's share of the development costs and typically (but not always) pays some cash to the Producer up front

COMMON UPSTREAM JV STRUCTURES

Entity Structures: each JV Partner has an equity interest in an entity that owns the JV Assets

- Producer contributes oil and gas properties to the JV entity and Investor contributes cash and/or a future capital commitment
- Investor receives equity in the JV entity based on the proportion that the value of its cash contribution / commitment bears to the value of the Producer's contributed properties
- Less common where the JV partners are each industry players due to the increased restrictions and lower liquidity that is part and parcel of jointly owning an entity with other JV participants

MIDSTREAM JV PARTICIPANTS

MIDSTREAM JV PARTICIPANTS

Gathering/Processing JVs

Upstream-Midstream

- Each party brings unique benefits: Upstream partner brings the ready-made anchor shipper; and Midstream partner brings Midstream assets, contracts, and operational expertise

Midstream-Financial or Upstream-Financial

- Midstream-Financial is more common where a Financial partner is involved, as typically Upstream companies may not feel they have the expertise to “run” the JV on their own

Midstream-Midstream

- Less common if both players have the same core focus (e.g., gathering / processing), but does happen and can make sense if the parties’ respective businesses or geographic focuses are different, such as one party with an existing gathering footprint / dedication and the other party with existing processing/export capacity

MIDSTREAM JV PARTICIPANTS

Gathering/Processing JVs (cont'd)

"JV within a JV"

- Allows smaller midstream players to partner with a financial party for their portion of the JV, whether paired with another Midstream player, an Upstream player, or a Financial investor
- These types of JVs often appear "upstairs" of one of the other types of Midstream JVs and therefore only affect a single partner to the primary JV

SPACs

- Special purpose acquisition companies can target existing midstream businesses
- Brings in other equity investors, both through the SPAC IPO and the common subsequent equity raise that is needed to raise the cash for the transaction's purchase price (as SPAC IPO proceeds are typically limited / not enough to purchase the business outright)
- Offers alternative access points to public markets for existing businesses

MIDSTREAM JV PARTICIPANTS

Long-Haul JVs

Midstream-Midstream or Midstream-Financial

- Due to the usually high cost of Long-Haul JV projects, the participants are typically limited to Midstream industry players or Financial investors
- Connectivity to downstream assets owned by a Midstream player is a common link to bring additional such Midstream player into a Long-Haul JV
- It is not uncommon to see JVs within a JV utilized in the Long-Haul context, just like in the Gathering/Processing context

UPSTREAM JV PARTICIPANTS

UPSTREAM JV PARTICIPANTS

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Upstream-Upstream

- Typically used when one Upstream participant would like to share costs/risks and the other Upstream player desires certain expertise or entry into a new basin/area
- Drill-to-Earn or Acquire-and-Drill Structure is the most common for two Upstream industry participants

Upstream-Financial

- Typically used when the Upstream participant would like to share costs/risk and the Financial participant is looking to deploy capital to achieve a relatively safe and guaranteed rate of return
- DrillCo or Entity JV Structure are most commonly seen with an Upstream participant and a Financial participant

Upstream-Service Provider

- Typically used when the Upstream participant would like to share costs/risk or secure low-cost or scarce services, and the Service Provider participant is looking to guarantee utilization of its services, often with respect to the Upstream participant's future development in addition to the JV in question
- Drill-to-Earn is the most common structure for an Upstream participant and Service Provider partner

MOTIVATIONS OF MIDSTREAM JV PARTICIPANTS

MOTIVATIONS OF MIDSTREAM JV PARTICIPANTS

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Midstream Companies

1. Share cost/risk exposure or allow participation in larger projects
2. Partner with Midstream participant to obtain access to partner's assets located downstream
3. Partner with Upstream participant to secure anchor shipper / customer
4. Monetize existing asset base
5. Potentially enter new basin / expand company footprint

Upstream Companies

1. Secure midstream services for key upstream basins / assets
2. Maintain some control of those midstream services (and therefore its upstream assets)
3. Monetize existing field-level midstream assets
4. Learn Midstream business from more experienced Midstream participant
5. Share cost/risk exposure
6. Team with Midstream participant for sourcing third party volumes, if needed

MOTIVATIONS OF MIDSTREAM JV PARTICIPANTS

Financial Companies

1. Good investment
2. Reduce risk by partnering with established Midstream / Upstream participant
3. Depending on commercial structure of JV (i.e., Cost of Service model), can provide implicitly guaranteed returns
4. Provide exit upside / multiple in case of IPO
5. Bolster existing investment in current Midstream portfolio company

MOTIVATIONS OF UPSTREAM JV PARTICIPANTS

MOTIVATIONS OF UPSTREAM JV PARTICIPANTS

Upstream Companies

1. Maintain control of Assets (if operator), though may have to share control if other participant is also an Upstream player
2. Opportunity for an Upstream participant to learn more about basin and operations therein
3. Share cost / risk exposure
4. May provide opportunities to enter new basins or explore areas outside of participant's "core" area

Financial Companies

1. May provide a set rate of return
2. Reduce risk by partnering with established Upstream participant
3. Bolster existing investment in current Upstream portfolio company
4. In the case of DrillCos, deploy capital with experienced management team and minimize overhead/G&A

Service Providers

1. Secure pipeline of future services work
2. Provide opportunity to fine tune existing techniques or deploy experimental techniques
3. Diversify portfolio by acquisition of oil and gas interests

STRUCTURING CONSIDERATIONS

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KEY FACTORS IN DETERMINING STRUCTURE FOR JVS

- Characterization of Type of Interest Acquired
- State law question (upstream only)
- Transferability/Encumbrance of Interests
- Financing
- Consents/Preferential Purchase Rights
  - Effects on structure
  - When to obtain
- Maintenance of Uniform Interest Provisions (upstream only)
- Gathering/Marketing Issues
- Tax Considerations
  - Can the JV be formed in a tax efficient manner?
  - Will either party take money off the table or will the JV assume any liabilities?
- Liability Shielding
- Others

TYPICAL TRANSACTION DOCUMENTS

FOR MIDSTREAM JVS

TYPICAL TRANSACTION DOCUMENTS - MIDSTREAM

1. **LLC Agreement / LP Agreement**
   - Primary JV document – covers: governance of JV; capital contribution / Default mechanics and remedies; Transfer rights of JV participants; exit events (e.g., IPO); AMI/Capital project mechanisms; and other JV-specific topics that will vary based on asset characteristics; Allocations of Profits and Losses; Distribution Entitlements (during operation and upon liquidation)

2. **Contribution Agreement**
   - Needed where one or more JV participants will be contributing existing assets into the JV – often can be as fulsome as a Purchase Agreement (e.g., reps, covenants, indemnities) if the assets to be contributed are being ascribed significant value
   - Will typically contain title and environmental protections, which may take the form of specified indemnity coverage in addition to representations and warranties as to title and environmental matters
   - Typically sets out the tax steps associated with forming the JV, as well as their treatment

TYPICAL TRANSACTION DOCUMENTS - MIDSTREAM

3. Operating and Maintenance Agreement

- Midstream player will usually maintain day to day operatorship of JV subject to certain material controls of Board/Management Committee of JV
- Typically structured as a "no profit / no loss" arrangement for the operator – as operator is an equity owner it should not make a profit of operations (just cover G&A, etc.) – but it should also not bear an outsized risk of loss (leads to Gross Negligence / Willful Misconduct standard akin to an upstream JOA)

4. Construction Management Agreement

- In cases where JV will need to construct significant assets, a CMA is typically used (that in some cases may be combined into the O&M Agreement); in most cases the construction manager and operator will be the same party (though not in all cases)
- Typically same "no profit / no loss" structure as an O&M, though the G&A, etc. payments are typically larger as there is often more involved in the construction process

TYPICAL TRANSACTION DOCUMENTS - MIDSTREAM

5. Commercial Contracts

- Particularly in a Gathering / Processing JV, the commercial contracts are key to the economics and scope of the JV
  - Gathering Agreements, Processing Agreements, Export Services / Terminal Agreements; Storage Agreements
  - Dedications often form key economic foundation of the Gathering / Processing JV
  - Pricing can be structured in a simple or complex fashion (e.g., Flat Fee vs Cost of Service Contracts)
- In a Long-Haul JV, the transportation contracts will be more limited as they will typically need to comply with FERC requirements and regulations, including a tariff and open season

6. Initial Budget

- Whether related to construction or operations (but particularly in the construction context), the Initial Budget will be the main limitation on spending during the initial year(s) of JV operations
- Initial Budgets are typically agreed at execution and attached to the LLCA, O&M, and/or CMA
- Subsequent years are subject to Board / Management Committee approval, with “default budget” provisions where partners cannot agree

TYPICAL TRANSACTION DOCUMENTS

FOR UPSTREAM JVS

TYPICAL TRANSACTION DOCUMENTS - UPSTREAM

Acquisition Agreement [Acquire-and-Drill only]

- Identifies the oil and gas properties to be acquired by the Investor from the Producer and the amount (if any) of up front consideration to be paid
- Also contains other typical provisions found in Upstream Purchase Agreements (e.g., consideration adjustments, representations and warranties, title and environmental defect mechanisms, consent and preferential right mechanisms, indemnities, and closing conditions and mechanics)

Contribution Agreement [Entity JV structures only]

- Analog to the Acquisition Agreement in the Entity JV context
- Identifies the oil and gas properties to be contributed to the JV entity by Producer and the amount of funds (or commitment to fund) to be contributed to the JV by Investor
- Also contains other typical provisions found in Upstream Purchase Agreements (e.g., consideration adjustments, representations and warranties, title and environmental defect mechanisms, consent and pref right mechanisms, indemnities, and closing conditions and mechanics)
- Typically sets out the tax steps associated with forming the entity JV, as well as their treatment

LLC Agreement [Entity JV structures only]

- Covers the standard array of provisions that are generally found in sophisticated LLC agreements
- Typically also contains provisions found in a Participation Agreement (e.g., governance/board mechanics, budget mechanics, AMI provisions and transfer restrictions, allocations of profits and losses, distribution entitlements, etc.)

Form of Assignment [Direct Ownership JV structures only]

- May be styled as a Wellbore only assignment or cover an undivided interest across the relevant Leases, depending on the JV structure and terms
- May include reversionary mechanics [DrillCo only]

Joint Operating Agreement [All JV structures]

TYPICAL TRANSACTION DOCUMENTS - UPSTREAM

Participation Agreement [Drill-to-Earn and DrillCo only]

- Also referred to as a Joint Development Agreement, Earning Agreement, Exploration Agreement, etc.
- Covers the primary structure and management of the JV, including:
  - Carry mechanics
  - Earning rights and mechanics
  - Reversion mechanics [DrillCo only]
  - Mechanisms for the JV partners to agree on potential drilling locations
  - Formation of a Management Committee consisting of representatives of each JV partner
  - Off-Ramps that the partners may take to exit the JV in certain scenarios
  - Governance rights that are typically shaped by the structure of the JV, each partner's rights in the JV, and the underlying oil and gas properties
  - Development Plan and Budget for the JV, including provisions to set a Default Budget where the partners cannot agree
  - Often contains an agreed-upon standard of care for the Operator of the joint venture properties that is more expansive than the typical JOA provisions
  - May contain an AMI provision
  - Restrictions on the partners' ability to transfer their respective JV assets

Security Documents [All JV structures]

Tax Partnership Agreement [Direct Ownership JV structures only]

  - Typically sets out the tax steps associated with forming the JV, as well as their treatment
  - Contains provisions governing the allocations of profits and losses for tax purposes
  - Governs the ultimate entitlement of the parties to assets upon winding up the JV

Services Agreements [All JV structures]

COMMON ISSUES IN MIDSTREAM TRANSACTIONS

GOVERNANCE

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Board / Management Committee

- JV typically governed by a Board or Management Committee comprised of representatives of the applicable JV partners – with level of representation / voting power determined by ownership of JV and "role" of partner
- Will control approval of budget and other major decisions, with most of those decisions requiring simple majority vote, while others will typically require supermajority or unanimous approval

Officers

- Can be handled one of two ways – (1) only have authority to implement budget / implement directives of operator / construction manager; or (2) officers are themselves delegated certain authority to act on behalf of the JV

O&M / CM Agreements

- Will typically have their own governance / authority sections
- Usually allowed authority to act within Budgets, in some cases subject to certain limitations (e.g., nothing that would require Supermajority/Unanimous approval, other material items that don't rise to that level)

FUNDING THE VENTURE AND DEFAULTS

Funding Mechanisms

- Typically JV partners fund their % share of approved capital calls
- LLCA/LPA will set forth mechanics and may often include provisions regarding (a) timing of capital calls (usually tied to agreed Budget), (b) if agreed, capital commitment caps, and (c) overrun/shortfall capital calls

Default Consequences

- Examples include: buy-out rights; dilution rights; loss of voting and other governance rights; removal of operator/construction manager (if applicable); loss of distribution rights; accrual of interest on defaulted amount; loss of transfer rights
- Typically include more severe Default consequences during major construction periods that involve significant capital contributions
- In some cases certain Default penalties may be automatically effective and in others (typically the more severe penalties) certain extended time periods and/or covering obligations from non-Defaulting partners may be required to trigger the penalty

Security

- Depending on nature / identity of partners, security (e.g., parent guaranty) may be required to be posted to back-up significant capital contribution obligations

TRANSFER RESTRICTIONS

- These can take a variety of forms: ROFR or ROFO; Tag or Drag (where there are majority/minority partners); lock ups (typically during major construction/funding periods); forced exit events (e.g., IPO, sale of company for agreed, minimum return multiple)
- If operator or construction manager is the transferring partner, additional technical qualifications may need to be met by the transferee
- In certain circumstances, partners may negotiate certain third parties that are explicitly NOT allowed to be transferees (e.g., competitors, previous bad blood, etc.)
- Financial assurances / creditworthiness test may be required in certain circumstances (and depending on nature of transferee)

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FUTURE CAPITAL PROJECTS

- Certain JVs may specifically allow one partner or another to force the JV to undertake a particular expansion or modification of the JV assets without approval of the other partners
  - In some cases these rights are only triggered if pre-agreed financial metrics are met
  - Participating JV partners typically bear all risks and receive all rewards associated with such “sole-risk project” until a pre-agreed return has been recouped (e.g., 300% return, similar to an upstream JOA non-consent penalty)
  - Nature of JV and its assets may dictate whether, from a practical perspective, any such Capital Projects are ever likely to be pursued
- Most JVs will allow for a subset of “Required Upgrades” that can be forced on the JV by a partner (or in some cases only the operator) in order to comply with laws or significant contractual obligations
  - In these cases all partners are required to / deemed to participate due to the fundamental nature of the project for the JV

AREA OF MUTUAL INTEREST PROVISIONS

- Most JVs will establish some sort of area of mutual interest – in which area, if any partner finds or receives an opportunity, such opportunity must first be offered to the JV before such partner pursuing the opportunity on its own
- Typically will apply to both acquisitions of existing asset and development of new, greenfield project
- In some cases a partner may be entitled to force the JV to undertake such opportunity as a Capital Project without the approval of the other partners

COMMON ISSUES IN UPSTREAM TRANSACTIONS

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TRANSFER RESTRICTIONS

Common Direct Ownership JV Restrictions

1. Transfer of interest in JV assets tied to transfer of corresponding interests in JV agreement
2. Change in Control provisions
3. Transfer “lock-up” periods
4. Preferential Purchase Rights
5. Maintenance of Uniform Interest Provisions
6. Existing financing/security interest issues
7. Tag-Along/Drag-Along Rights

Common Entity JV Restrictions

1. Change in Control provisions
2. Transfer “lock-up” periods
3. Preemptive rights
4. ROFR/ROFO Rights
5. Tag-Along/Drag-Along Rights
6. Standstill for acquiring Public Company stock of a joint venture partner
7. Existing financing/security interest issues

- In either scenario - if operator is the transferring partner, additional technical qualifications may need to be met by the transferee
- In either scenario - financial assurances / creditworthiness test may be required in certain circumstances (and depending on nature of transferee)

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OTHER COMMON PITFALLS AND ISSUES

AMI Provisions

- Most JV's will establish some sort of AMI – in which area, if any partner acquires mineral interests and/or oil and gas leases within a specified area, such assets must first be offered to the JV partner or JV entity
- Need to specifically describe the size/scope of the AMI, the term of the AMI and the types of properties subject to the AMI

Termination of JV's

- "JV aspects" of Direct Ownership JVs typically exist for a delineated period of time – but partners can hold undivided interests in the JV assets in perpetuity
- Entity JV structures may allow a JV Partner to cause an "Exit Event" through the sale of its equity interest, the sale of the JV assets, or the sale of the Entity JV as a whole

Governance of JV

- Relative voting splits between JV Partners – work to avoid deadlocks
- Balance authority granted to Operator under transaction documents vs. matters which require votes from the JV Partners – and consider appropriate overhead payable to operator

Funding Mechanics

- Ownership percentages and funding obligations may not align in a number of common structures
- Usually tied to a specified budget
- Remedies for Payment Defaults: removal of voting rights, removal of rights to proceeds, dilution, loans with penalty interest, buyout rights (potentially at a discounted rate)

QUESTIONS?

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