Assessing what the new year will bring

As we head into the new year, and with the recent agreement on climate change reached in Paris just last month, the timing is ripe for energy industry participants to offset the climate of uncertainty inspired by volatile pricing by investigating business paradigms suited to the current landscape. With prices lower than anytime since the mid-2000s, these are indeed interesting times. There are a number of strategies that some oil and gas companies have begun to harness to their advantage. These include developing projects through novel financing options, maximizing opportunities south of the border, and entering into markets that are thriving despite the shifting economics.

So said energy lawyers Ken Irvin, Glenn Pinkerton, Jim Rice and Cliff Vrielink when they hosted a recent roundtable discussion for journalists in Sidley’s Washington, D.C. office. In the meeting, they discussed overall industry conditions, as well as what they expect for 2016.

“The market for transactions has been less than stellar much of 2015,” began Rice, who focuses his practice principally on transactions for the energy industry. Pointing to the volatile environment, he referenced other periods historically in the United States in which this cycle reigned. Despite slow M&A activity and a rise in the number of bankruptcy filings by U.S. energy companies, Rice is cautiously optimistic. He predicted the industry would soon begin to see more consolidation and acquisition once asset owners and capital providers feel more adjusted to “the new normal.”
Rethinking finance

“We’ll see companies who want to re-allocate. This is the playbook for the oil and gas industry,” Rice said. He mentioned that one of his clients wants to divest from a fully developed field to raise capital. “Now is the time to review different types of structures—to raise capital to develop those assets where economics support drilling at current prices,” he said. “This is a great opportunity for hedge funds, for example, to provide capital for projects.”

Vrielink agreed and suggested that choosing a formerly less desirable financing option could yield unexpected dividends for a company. “Take a look at things you haven’t done before,” he said, citing a client who had in the past felt very fortunate that his company had so much liquidity that they could finance all of their projects by themselves. “He and I are now discussing partnerships his company can engage in—the variations of that type of structure and what he would have to give up. In today’s world it’s important to say, ‘It may not be the optimal way to do things, but it’s still pretty good given the situation on the ground,’” Vrielink said.

It used to be that everyone wanted to find the next field or shale play, Vrielink said. Now, however, “It’s about quality opportunities and being in the right place. Good premium assets are still moving at premium prices.”

While energy companies seek to right-size and rethink their financing in this new economy, they are also looking to realign their focus to those commodities that have export potential in today’s low-price environment, such as propane and possibly other NGLs. “The growth in propane exports has been six-fold in recent years,” said Pinkerton, adding that low-priced U.S. propane has been a very competitive product in the international market. “As long as there is a significant U.S. gas-to-international oil differential, and capital costs of conversion are not too high, NGLs have the potential to penetrate additional international markets for petrochemicals,” Pinkerton said.

All eyes on Mexico

Energy companies should also look south of the border for opportunity in the new year, said Irvin, who pointed to Mexico’s game-changing energy reforms, which began in 2013, and have monumentally opened up the country’s once state-dominated energy sector. Irvin has witnessed this changing terrain first-hand: Mexico’s state-owned electricity company, the Comisión Federal de Electricidad (CFE), a Sidley client, has opened up bidding for a very sizeable array of new natural gas pipelines—in Mexico and in the U.S.
“What CFE is saying is, ‘I’ll take a 20+ year subscription to capacity, and I’ll pay you a rate for transporting gas that will pay for the pipeline owner to build, operate and earn a return on its investment,’” said Irvin. “It is an ideal business arrangement, well-timed for today’s market, since CFE as ‘anchor shipper’ provides Mexico with the access to historic cheap gas while getting an infrastructure built that will serve both countries long into the future.”

Before the reforms, Mexico’s natural gas pipeline system wasn’t much of a system—service didn’t even extend to every state. That meant power generators often used higher-priced, more polluting fuel oil. Now, with the reforms, CFE is contracting with private companies to develop the pipeline grid so it will extend to every Mexican state and have much better connectivity with the U.S. gas markets. This dramatic increase in access to natural gas is allowing CFE to convert power plants to use gas as opposed to fuel oil and to have new gas-fired power plants built. That’s significant because in today’s market, generating electricity with natural gas costs about one-third of the price of fuel oil, and gas is much cleaner and more environmentally friendly.

There are, however, regulatory hurdles for energy companies doing business in Mexico—the need for a Presidential Permit for constructing cross-border natural gas export pipelines from the Federal Energy Regulatory Commission (FERC) and the license to export natural gas from the Department of Energy, as well as contending with customs and tariffs. Regarding enforcement, Irvin cautioned, “FERC remains vigilant. You’ll continue to see a steady flow of manipulation cases and people getting caught on the wrong side of things.”

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—CLIFF VRIELINK
Gene Elrod, a regulatory litigation lawyer in Sidley’s energy practice, noted certain other litigation trends in the era of low commodity prices. These include an uptick in FERC litigation regarding interstate pipeline transportation rates, as oil and gas producers, marketers and other pipeline shippers look for ways to lower the costs of getting their products to market. “If possible, we attempt to resolve these cases by settlement,” he said, “to avoid the costs of full-blown litigation.” He added that there is a wide variety of pending litigation where the interests of hydrocarbon producers and transporters collide with environmental and/or consumer interests. These cases run the gamut, from headline-grabbing opposition to new pipeline construction, to more localized matters such as hydraulic fracturing litigation and challenges to state cap-and-trade and “clean fuels” legislation.

Across the industry, energy companies are in the process of adjusting business activity as they come to terms with the uncertain landscape. The forecast looks a lot different than it did just a few years ago. Despite this, pathways for success do exist: the new year will be about transforming old business models to navigate the volatility.

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