Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

What Attys Must Know About The Push For Texas Drilling Cuts

By **Keith Goldberg**

Law360 (April 3, 2020, 11:07 AM EDT) -- The historic crash in oil prices due to coronavirus-depressed demand and a growing supply glut pushed a pair of Texas shale drillers to ask state regulators to do something they haven't done in nearly 50 years: curtail oil production.

It's a request that if granted by the Railroad Commission of Texas, could affect oil and gas contracts up and down the supply chain, from production leases and joint venture deals to marketing and pipeline agreements. Litigation over the ongoing viability of those contracts would be a given, Lone Star State lawyers say.

The last time the RRC ordered a proration of oil production, in which Texas drillers had to reduce a percentage of their total production in order to align it with market demand, was in 1973. But with oil prices now in the $20-a-barrel range and global oil storage capacity growing tight as Saudi Arabia and Russia increase production, Pioneer Natural Resources USA Inc. and Parsley Energy Inc. have asked the RRC to start a statewide proration of oil production as early as next month.

The RRC plans to hold a meeting on April 14 on the companies' petition.

Pioneer and Parsley said in their petition, filed March 30, that "market demand for Texas oil is experiencing a massive collapse that threatens to destroy the state's oil industry." The idea of proration has also been floated by outgoing RRC Commissioner Ryan Sitton, though RRC Chairman Wayne Christian said in a statement last month that he has a "number of reservations about this approach."

"Crude oil has always been king and there have been complete efforts to allow producers to produce as much as they can out of the spigot," said McKool Smith PC member Willie Wood, who's handled Texas oil and gas matters since the 1980s. "This is a fairly extraordinary request, because it's for a general curtailment across the state."

Then again, experts say this is an extraordinary time for the oil and gas industry, and the RRC was established in part to ensure the state's oil and gas resources would be economically developed.

"Think about the history of the Railroad Commission: the reason it came about was people were out there going nuts, and drilling reservoirs and messing everything up," Winston & Strawn LLP oil and gas partner Mike Blankenship said. "This is a way to keep things orderly."

Here, Law360 breaks down the state's authority to curtail production and its potential ripple effects on the contracts that undergird the state's oil and gas industry.

What Proration Could Look Like

The Texas Natural Resources Code defines oil production that exceeds market demand "as waste." The law says the RRC can determine when excess production is occurring and compels the agency to issue rules to reduce waste if there is excess production.

One option is proration, which would require drillers to reduce their oil production by certain percentages until it no longer exceeds market demand. Drillers big and small are already slashing production, but Pioneer President and CEO Scott Sheffield and Parsley President and CEO Matt Gallagher told the RRC that statewide proration is a "well-established tool" that would make the expected, widespread shut-ins of oil and gas wells more orderly.

"Without commission action, operators will shut-in wells in an ad hoc and haphazard manner that will heighten industry disruption and cause economic waste," Sheffield and Gallagher wrote in a letter accompanying the companies' petition. "It is therefore incumbent on the commission to bring fairness and uniformity to any curtailment of production."

The executives said they believe a curtailment action by the RRC would help jump-start global efforts to rebalance the oil market, though the RRC's Christian has his doubts. The chairman also said prorationing could be difficult from a practical standpoint given that the RRC hasn't done it since the Nixon administration.

"We do not have staff at the agency with experience in this process and our IT capabilities to handle this process are limited at best," Christian said in a March 20 statement.

Does Force Majeure Become a Contract Killer?

Most oil and gas contracts contain force majeure clauses that cite unforeseen circumstances that prevent a party from fulfilling their contractual obligations. And attorneys say most force majeure definitions include acts of government, so a proration order from the RRC would likely help shield producers from accusations that they're breaching leases, pipeline agreements and other contracts by slashing production.

"I would think that an RRC order that requires production to be shut in on wells would probably qualify as an event of force majeure that would protect producers from claims by royalty owners that the leases terminated due to a cessation of production while the order was in effect," said Norton Rose Fulbright partner Dan McClure, who frequently represents drillers in royalty litigation.

That doesn't mean there wouldn't be litigation by aggrieved royalty owners to test that belief, attorneys say. And beyond mere contract breaches, there's the question of whether the force majeure event of RRC proration simply makes a contract unviable.

Wood said for example, RRC-ordered curtailment could prevent a company from drilling wells in a certain amount of time on properties dedicated to them by the original leaseholder under a farmout agreement, prompting the leaseholder to take those properties back.

The viability of contracts and efforts to terminate them due to RRC action would be a ripe source of litigation, and attorneys say now is the time for industry players to examine the force majeure language in their contracts and start thinking about contract frustration and whether they'll still be able to perform under their contracts.

"All the oil and gas stakeholders need to really look at their contracts to see if there's some language ... that allows them to mitigate any damages or get out of the contract without any further harm," Blankenship said.

Production Cuts Will Bite Midstream Cos.

Any oil production cuts ordered by the RRC would have a major trickle-down effect on pipeline and other midstream companies, whether it's agreements with producers to transport a certain volume of their oil or marketing agreements to ship certain amounts to refiners or other customers further down the supply chain.

Wood said it could also impact financing deals that pipelines, terminals and other midstream companies have secured in order to fund project development. Many of those companies depend on defined levels of oil throughput to meet the financial obligations of their lenders and could face penalties if they don't meet them, Wood said.

"Midstream companies may be really screaming about why they're not getting throughput through their pipes," Wood said. "They could see lawsuits and invoices go out for unused capacity."

The Texas Pipeline Association said it didn't immediately have a comment on the RRC petition when contracted by Law360.

However, attorneys say some midstream companies might also welcome less oil coming their way, given the coronavirus-fueled collapse in demand for gasoline and other refined products and global storage capacity quickly filling up. To underscore the storage issue, the U.S. Department of Energy on Thursday offered to rent out space in the Strategic Petroleum Reserve for producers to stash their oil.

"You have midstream and pipeline companies ... their marketing agreements and transportation deals would be affected, but it would be helpful relieving some of the storage issues that we're going to see," Blankenship said.

--Editing by Katherine Rautenberg.