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The Evolving Market for Acreage Dedications

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One of the more interesting developments in the oil and gas A&D market over the past couple of years has been the expanding variety of transactions between upstream and midstream companies involving acreage dedications. Acreage dedications are commitments from upstream operators or exploration and production companies in which all production from a given area is exclusively committed to a midstream company for the provision of midstream services or the midstream company's purchase of such production. Acreage dedications are one of the tools midstream companies secure a customer base and a feedstock of production for their facilities.

Midstream companies have traditionally required an acreage dedication or a minimum volume commitment, or both, to provide assurance that the midstream company will receive an adequate return on the capital invested to construct or acquire midstream assets. In certain basins where the competition to provide midstream services is robust, producers and operators holding sizeable acreage positions have successfully negotiated incentives from the midstream companies in exchange for granting acreage dedications and the associated long-term production commitment. Further, because of the continuing need by production companies for capital in a changing and tightening market, producers and operators have become more creative in obtaining value for their acreage commitments. At the same time, we have seen a significant increase in investments in midstream facilities, as midstream companies attempt to alleviate the bottlenecks that continue to exist in many basins due to insufficient infrastructure, notably a large number of pipeline projects announced in the last year and a half to provide takeaway capacity for the Permian. As these midstream projects compete to obtain sufficient volumes of production to justify their infrastructure investments, acreage dedications on material acreage positions in prolific basins have become coveted assets. Many of the recent acreage dedications have come with a variety of incentive arrangements to the producer.

Initially, the midstream companies provided producers with equity interests in the projects, allowing the producer to enjoy the upside from robust volumes through the system while having a limited exposure to the cost of the project. The equity grants were in the form of options that allowed the producer to strike the option and pay its share of the production costs after it had an opportunity to evaluate the potential success of the overall project. In some of these equity options, the strike price, or the producer's contribution obligation, was limited to a share of the original construction budget. This arrangement left the midstream company with the risk that the construction costs would be over budget. In all cases, the producer obtained only limited minority-interest voting rights.

Some midstream companies, however, prefer to retain the equity risk and upside rather than share it with the producers. At the same time, the producer's need for capital to continue the development of the dedicated acreage made the equity rights less interesting. As a result, a number of dedication arrangements provided for the midstream company to pay a cash incentive in exchange for a long-term dedication of all production from a geographically defined area. The cash payment consisted of an upfront lump-sum payment at the time the dedication was granted, and in some cases, additional payments each time the producer acquired additional interests in the dedicated area and/or for a specified payment due on the spudding of each well (up to a specified number of wells). From the midstream provider's perspective, in addition to long-term production assurance that comes from the dedication, the cash payments provide the producer a much needed source of capital to develop the dedicated properties. In turn, the development of the producer's acreage position results in the production that will generate the midstream provider's return under the midstream agreements.

More recently, we have been involved with DrillCo-dedication transactions. The "DrillCo" form of capital is certainly not new in the upstream world. Many producers use the "DrillCo" structure during their asset development life cycle to fund their liquidity needs. DrillCos are popular during commodity downturns and other times when capital sources are scarce. These DrillCo transactions consist of a hybrid form of joint venture between a producer and an "investor". The investor provides capital in exchange for a wellbore (or unit area) limited working interest in certain specified wells the producer agrees to drill. The investor pays its working interest share of the well costs and "carries" some or all of the producer's share of such costs. When the investor receives proceeds from the wells equal to an amount sufficient to achieve a stated return on its investment, the investor's working interest in the wells ratchets down either by reverting to the operator completely, decreasing in size or transforming into an overriding royalty interest.

DrillCos are bespoke transactions that can be structured in any number of ways. They typically offer investors a mezzanine level return on capital and, in some cases, the potential for upside through the ownership of an interest in the funded properties after the return hurdle is achieved. DrillCos provide producers a funding source to develop their assets without forfeiting the upside on the portion of its leases that are not developed and, in some cases, can be structured as an off-balance sheet source of liquidity.

In a recent transaction, we advised a midstream company that provided DrillCo-style financing in exchange for an acreage dedication. In this transaction, the midstream provider received a material acreage dedication from a producer in exchange for agreeing to fund a portion of the producer's development costs on that same acreage. The dedication provided the midstream company access to a large potential feedstock of production and the opportunity to build out a greenfield system to provide a myriad of midstream services for crude, gas, and produced water covering a large production area.

Dedications of production in exchange for infrastructure investment is certainly not limited to traditional oil and gas midstream services. We have advised on several recent produced water gathering and disposal transactions, many of which involved a joint venture between the producer and the water services provider. Often these transactions involve the sale or contribution of all of the producer's water disposal facilities to a joint venture entity or produced water services provider and include a dedication of that producer's acreage to the entity receiving those facilities. Infrastructure to transport, treat and dispose or recycle of

produced water is critically important to the build out of a producer's acreage position, especially in Texas, and we believe we will continue to see a significant number of transactions in this space as private capital continues to flow into investments in the water infrastructure space.

Obviously, the variations on the acreage dedication transaction model will continue to evolve with the needs of the industry. Where there is capital there is a way, however, and both producers and midstream service providers should consider the potential benefits these creative transactions may provide to both parties.