BRIDGING THE DIVIDE

Oil and gas dealmakers are utilizing contingency payments to address the valuation gap.

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Since 2014, the domestic energy landscape has changed at a Usain Bolt type of pace. Whether it be the wave of E&P company restructurings, the continuing lack of public capital available to energy companies (and the prevalence of private capital replacing it), the U.S.' emergence as the world's top oil and gas producer or the "energy transition," change has been a constant in discussions regarding the oil and gas industry. Another constant has been commodity price volatility.

In 2018 alone, crude prices (West Texas Intermediate) began the year in the $50s, spiked into the $70s, and then ended the year in the $40s. In a similar vein, natural gas prices (Nymex) began 2018 in the $3 range, spiked above $4.50, and, by early 2019, dropped into the $2.50 range. This commodity price roller coaster has kept many dealmakers on the edge of their seats, and many others on the sidelines.

By most accounts, 2018 was a decent year for dealmaking in the oil and gas industry, with aggregate transaction value up year-over-year and deal count slightly down during the same period.

A slowdown in deal activity began during the latter part of 2018, especially noticeable when excluding one-time MLP simplifications and the handful of large M&A transactions that occurred during a two-week period in late October/early November. This slowdown has continued into 2019. Much of the slowdown has been attributable to the wild fluctuations in commodity prices occurring during the same period, which has often resulted in large valuation divides between potential buyers and sellers.

As most in the industry have experienced, it is quite difficult to make a competitive bid/offer, or accept a compelling bid/offer, when there is lack of predictability on commodity prices—arguably the most important variable in asset valuations.

One tool that is used by dealmakers to address this valuation divide is a contingent payment mechanism. While these types of mechanisms are more commonly used in other industries, there is an increasing appetite to consider their use in oil and gas transactions. This article highlights (1) certain situations in which the contingent payment mechanism may be useful, (2) structuring considerations for contingent payments and (3) industry-specific considerations for contingent payments.

Common uses

The form of contingent payment mechanism used in oil and gas is similar to the "earn-out" payment mechanism often employed in transactions in other industries. When using this mechanism, the buyer pays a base purchase price at a transaction's closing, and makes one or more contingent post-closing payments to the seller upon the occurrence of certain events (for instance, increases in commodity prices) or the satisfaction of certain predefined performance metrics (for instance, earnings for a midstream company). If such events do not occur or such metrics are not satisfied during the specified period, the buyer does not make the contingent payments to the seller.

Contingent payment mechanisms can serve as effective tools in resolving valuation divides

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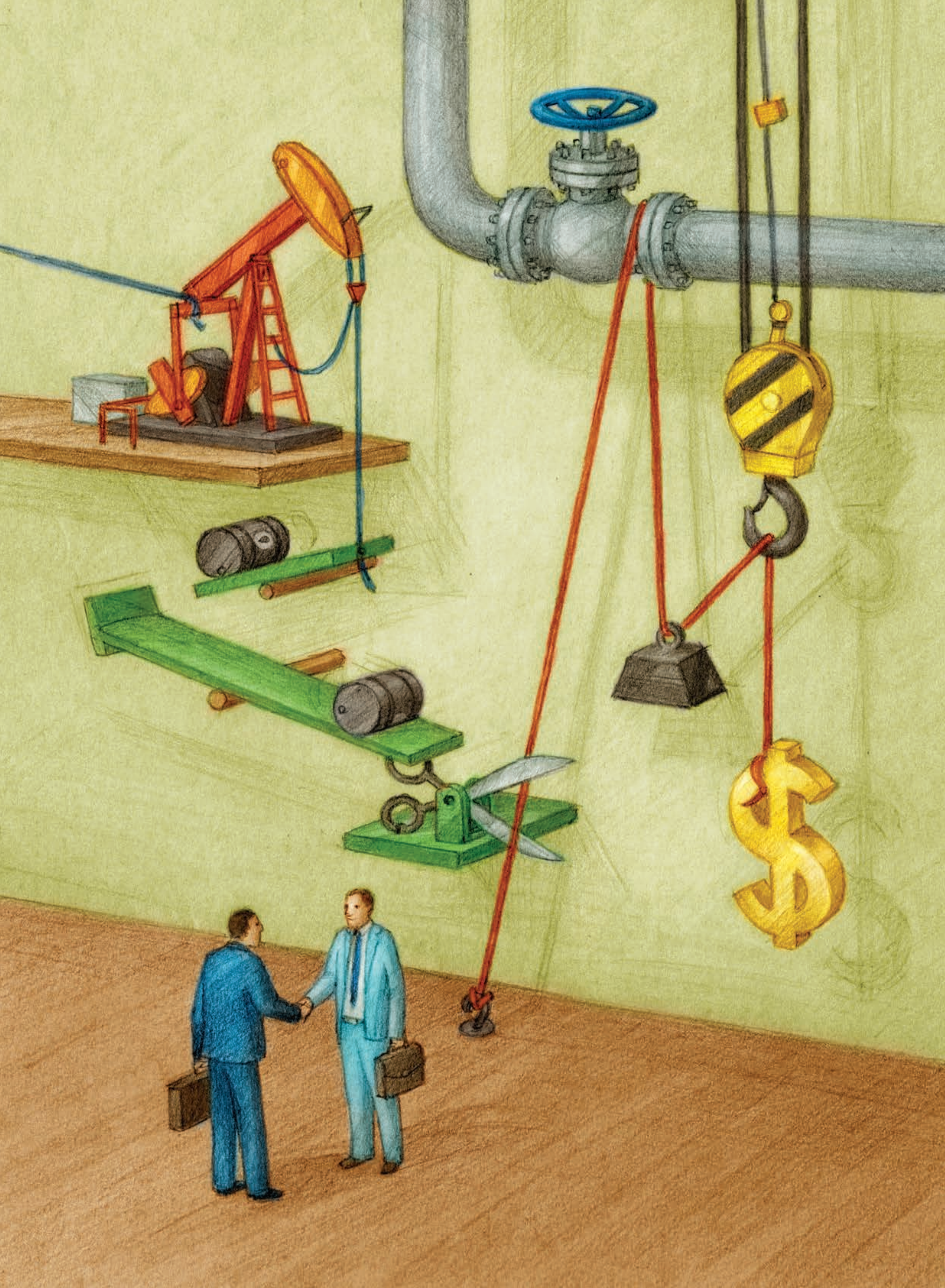
Recent Earn-outs: Upstream Transactions

	Transaction Summary	Earn-out Structure	Earn-out Term
Marcellus/Utica Transaction	Asset acquisition of Ohio natural gas assets	Up to ~5% of base & aggregate purchase price payable based on natural gas index prices during specified future time periods.	~1.5 years
North Texas/Oklahoma Transaction	Asset acquisition of North Burbank and Texas Panhandle enhanced oil recovery business	Up to 10% of base purchase price (~9% of aggregate purchase price (including earn-out amount)) payable based on target oil production volumes and average sales price therefor.	Three years
Marcellus/Utica Transaction	Asset acquisition of upstream assets in northern West Virginia and southern Pennsylvania	Up to ~9% of base purchase price (~8% of aggregate purchase price (including earn-out amount)) payable for achieving financial targets based on average natural gas index prices.	Three years

Source: Gibson, Dunn & Crutcher



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in transactions, which may arise for a number of reasons, including the parties' differing assumptions regarding commodity prices and future operational results. When structured to address the underlying issue giving rise to the disagreement over valuation, a contingent payment protects the buyer from bearing the risk of potentially erroneous valuation assumptions (and, thus, from potentially overpaying), while compensating the seller if its projections and valuation assumptions prove to be accurate.

In general, the size of the contingent payment tends to be larger (in relation to the non-contingent portion of the purchase price) when there is heightened uncertainty or volatility that creates a larger gap between the parties' expectations.

Structuring considerations

If a contingent payment is used to address differing valuation assumptions, the contingent payment's structure and terms should be tailored to address the underlying circumstances. As one might expect, several items should be considered when undertaking such a task; the following sets forth a non-exhaustive list:

- **Triggering events:** In addition to commodity price triggers, parties use a number of performance measures in contingent payment formulas based on the nature of a given industry and the entities being sold, as well as the interests of the parties to the transaction. Commonly used performance criteria include EBITDA, EBIT, sales, net income, profit, the occurrence of a specified future event or (as discussed below in the upstream and midstream context) industry-specific criteria. In many of these instances, the parties should address the proper application of accounting principles to the chosen criteria, including whether it will be consistent with the seller's or the buyer's prior application, and should address any relatively unique calculations or business-specific items upfront to avoid controversy.

- **Payment amounts/consideration:** The contingent payment mechanism can provide for such payments to be fixed or prorated in amount, paid in one lump sum or incrementally, and subject to varying time periods and time limitations. Additionally, the consideration paid as a contingent payment can take various forms, with different forms raising different sets of issues. With the use of stock consideration, for example, additional issues include how and when the stock is to be valued, what voting and registration rights the seller will have, what protections the seller will have with respect to changes in stock prices, and securities compliance matters.

- **Operating covenants:** When contingent payments are tied to the performance of the acquired business, the parties will likely need to specify post-closing operational parameters to protect each party's expectations, as the parties' objectives (and financial incentives) after closing may not be aligned. Specifically, the seller will almost be exclusively focused on the short term performance of the underlying assets/business (in the context of the contingent payment criteria), whereas the buyer will be focused on both the short-term and long-term performance of the underlying assets/business. Common covenants to address these concerns include requirements that the business be operated in substantially the same manner as before closing, as well as restrictions on specific actions that can impact the contingent payment (for instance, large expenditures and/or the retention of key employees).

- **Time periods:** Time periods during which contingent payments must be made typically range from one to five years following closing, depending on both the types of benchmarks chosen and the length of time that sellers are willing to forgo full compensation (and buyers are willing to provide continued incentives). Such periods can also be structured to continue until terminated upon the occurrence of specified events, such as the buyer's change of control or the attainment of certain nonfinancial benchmarks, including the introduction/opening of new projects or the securing of certain regulatory approvals.

- **Security:** Finally, the use of contingent payments may necessitate that the seller insist that the buyer provide some form of post-closing security with respect to the contingent payments. The financial wherewithal of the buyer, along with its post-closing capital structure, should be considered in evaluating whether such assurances are necessary. Forms of such assurance may include the provision of security (for instance, parent company guarantees), the post-closing escrowing of funds and the use of the acquired assets as collateral, among many others.

Industry-specific considerations

In addition to using the traditional contingent payment structures, companies engaged in upstream and midstream transactions can employ industry-specific mechanisms that may help the parties more accurately value the transaction:

- **Upstream:** Commodity price volatility will almost always be a concern for parties looking to accurately value certain assets in upstream transactions. This is especially true in higher-value transactions, where months of additional negotiations (and post-execution activities) following the initial agreement on a purchase price may allow for significant commodity price fluctuations, resulting in a purchase price that no longer accurately reflects the parties' initial valuation of the assets. Parties may attempt to solve this issue by tying contingent payments to specific commodity price hurdles on established exchanges. Bidders in a competitive process may also sweeten their bid by offering some post-closing upside to sellers in the event commodity prices increase. When this type of contingent payment mechanism is implemented, an index is typically specified, with the price hurdle as an average price on the applicable index over a period of time.

  Buyers concerned with the future (or continued) productivity of an asset, or wishing to address a value dispute with the seller for assets that are not yet de-risked through development, may base contingent payments on the performance of specific wells. Where the subject assets are at least partially developed and the parties have allocated value in the purchase agreement on a well-by-well basis, this can be accomplished using performance metrics for existing wells; in the case of substantially undeveloped acreage and/or value allocation on a lease or unit basis, more contingencies in the payment structure may be needed to satisfy both parties (for instance, sticking to predetermined drilling schedules or agreeing to earn-out well locations ahead of time).

- **Midstream:** In the midstream space, a large portion of a target midstream company's value is based on revenues attributable to existing contractual delivery commitments from upstream producers or other shippers. In the case of a target company with existing contracts containing such delivery commitments, the parties may structure contingent payments to be based on expected gross volumes at specified future dates (or over specified periods of time) in an effort to limit the risk that contract counterparties fail (for one reason or another) to meet their delivery obligations to the target company—a risk that may be compounded in situations where the target company has its own downstream commitments to satisfy.

  Similarly, in the case of a target company that does not yet have any such contracts in place, the parties may agree on contingent payments based upon the target company entering into such contracts (or upon the initial deliveries of volumes under those contracts to the target company) after closing and implement covenants requiring that the target company make reasonable efforts to obtain such commitments during the earn-out period.

  More (and more) dealmakers are continuing to see that, when carefully drafted, contingent payments can provide a useful tool to help bridge divides in transaction valuations, including in the context of valuation assumptions unique to the oil and gas industry. □

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Recent Earn-outs: Midstream Transactions

	Transaction Summary	Earn-out Structure	Earn-out Term
Appalachia Transaction	Acquisition of 100% of Target's equity interests	Up to ~14% of base purchase price (~12% of aggregate purchase price [including earn-out amount]) payable if certain firm natural gas transportation agreements executed meeting specified criteria.	Dependent upon in-service dates of specified pipeline segments
Permian Transaction	Acquisition of 100% of Targets' equity interests	Up to ~165% of total base purchase price (~62% of aggregate purchase price [including earn-out amount]) payable for achieving financial targets based on delivered volumes of crude oil or natural gas under certain contracts.	Two separate one-year periods
Eagle Ford Transaction	Acquisition of 100% of Target's equity interests	Up to 10% of base purchase price (~9% of aggregate purchase price [including earn-out]) payable for achieving financial targets based on financial performance and capex thresholds relating to anticipated expansion products.	Not publicly disclosed

Source: Gibson, Dunn & Crutcher