Client Alert

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Oil & Gas…& Water!

2018 was a banner year for M&A activity in the energy space, with numerous high dollar value transactions in the upstream, midstream, downstream and oil field services (OFS) segments. As investors in the public securities markets have shown a significantly decreased appetite for new issuances of equity by energy companies, the preferred exit or growth strategy for 2018 has been through strategic mergers, acquisitions or divestitures. These transactions have manifested themselves in various forms: asset acquisitions and divestitures, private equity investment into "drillcos" with strategic oil and gas companies, public-public mergers between OFS companies and upstream shale drillers, and simplification transactions by master limited partnerships (MLPs) in the midstream space. In addition to all this M&A activity, one element has become significantly more prevalent in the oil and gas industry throughout 2018 and shows no signs of letting down for 2019: water.

In the oil and gas operational context water is ever-present and companies are focusing on manners in which water, and companies that transport, dispose of, treat and sell such water, can be monetized. When oil and gas are produced from an underground reservoir, high volumes of water (usually salt water mixed with particles of hydrocarbons) rush up to the surface with extracted oil and/or gas. This water is called produced water. In an effort to provide the purest forms of oil and gas for transportation, producers separate the oil and gas from each other and also remove as much produced water as possible. Typically, once oil, gas and water have been separated from each other they are transported from the wellhead to a gathering system, which is a set of pipelines connected to the well area on one end and a downstream facility or pipeline on the other end, which then further transports those products to additional separation, processing or terminaling facilities before delivery to long-haul pipelines that transport the products farther away for additional refining and ultimately for sale and consumption. This activity of transportation from the wellhead to consumption is what is typically referred to as the midstream segment of the oil and gas industry.

The midstream business is well established and has a long operating history. Many midstream companies over the past few decades have been organized as MLPs, and we as a firm were instrumental in structuring one of the initial MLPs as we represented Transco Energy Company in the formation and initial public offering of Transco Exploration Partners Ltd. (the first IPO by an MLP) in 1983, and have advised on countless MLP transactions in the M&A and securities context ever since. Water is quickly becoming the third leg of the stool for the midstream sector, alongside oil and gas. Experienced transporters of oil and gas are able to use their expertise and existing physical (pipelines) and contractual (rights-of-way) infrastructure to install pipelines to transport, store and dispose of produced water, all for a fixed fee based on the volume of water transported. Much of the contractual architecture from oil and gas gathering agreements can be implemented in produced water gathering agreements, all making for a relatively easy way for the midstream companies to generate additional revenue and for upstream companies to efficiently manage their volumes of produced water.

But this need to transport produced water has been around as long as oil and gas have been produced, so what has changed to make produced water so interesting to midstream companies and investors alike?

Primarily, there has been a substantial increase in US oil and gas production over the last decade, and this has led to higher volumes of produced water for transportation and disposal, and saturation of existing produced water disposal sites. This presents a logistical and cost issue for producers, so the ability and interest of midstream businesses to take on more produced water have been a welcome development and provide an opportunity for producers to monetize these water assets.

Another answer lies in the rise of hydraulic fracturing, or “fracking” as it is colloquially known. Fracking a well requires a large volume of water that is injected back into the reservoir, along with proppants, to stimulate the fracturing of particles of rock, allowing for oil and gas contained therein to be released. Who better to transport and provide this fracking water than the midstream companies that are already handling produced water and connected to much of the producers’ existing infrastructure? To be clear, the water (in the fracking context, known as “fresh water”) involved in fracking is of a much cleaner specification than produced water, so it is not as easy as turning around and handing produced water back to producers to use for fracking. But midstream companies have proved resourceful in that they will take large volumes of produced water, recycle and treat that water, often blend it with fresh water (usually from local fresh water wells) and redeliver that end product to producers for use in fracking for a nice fee along the way. This creates an entirely new revenue stream for midstream companies involved in transporting produced water, and can typically be achieved through economies of scale due to existing ownership or possession of the raw product and materials and to physical presence near the receipt point of produced water and delivery point of water for fracking.

As legal counsel for numerous upstream and midstream companies, we have seen a significant uptick in the portion of our time spent on preparing produced water gathering agreements and water distribution and services agreements as our midstream clients pivot their focus toward water. What generally remains to be seen is when and how companies will seek to monetize their water assets. The energy space has already seen a handful of water-specific M&A transactions that have come in the form of water-focused companies’ (typically private equity portfolio companies) acquiring produced water infrastructure from upstream producers or integrated oil and gas companies, as well as numerous equity commitments from private equity firms to water-focused midstream portfolio companies to support future water acquisition activity. There also appears to be real potential for water transactions in the public securities markets, whether it be through initial public offerings of water companies as traditional corporations or through a water-focused MLP. While the public energy MLP market has struggled over the past few years, it will be interesting to see if a water MLP would appeal to public investors’ appetites in fashions different than traditional midstream MLPs. The conventional wisdom (and there is a private letter ruling supporting this thought) is that the combination of transporting produced water and distributing fresh water meets the standard for qualifying income and thus is eligible for MLP treatment.

BJ Walker, an executive director at energy-focused investment bank Tudor, Pickering, Holt & Co. (TPH) and a leader in TPH’s water advisory practice, believes that the next five years are likely to provide for numerous water midstream transactions as water-focused midstream businesses attempt to grow and aggregate water assets. Where the initial wave of midstream water transactions occurred through “drop-down” transactions from upstream parent companies into their affiliated MLPs, Walker is seeing more of a trend toward midstream water assets being acquired by the portfolio companies of private equity and infrastructure funds. An important part of this trend will be the continued development of reliable commercial contracts for water transportation, which should include dedication of acreage, market terms and a longer tenor. These agreements need to resemble true arms’-length transactions to provide buyers and public investors comfort in the security of the revenue stream underlying those agreements. And while M&A is likely to be the current form of water midstream transactions, Walker thinks the ultimate monetization of water midstream assets could be the public equity markets, whether that be through a C-corp structure or an MLP.

In addition to oil- and gas-related water activity, we have also seen a rise in transactional activity in the regulated water space. Over the past year we have worked with a number of water-focused strategic companies and private equity firms on a range of activity from development of water transportation infrastructure for large municipalities’ supplies of drinking water, to a joint venture for acquisitions of small, rural water provision and wastewater treatment facilities. Clearly, investors see the potential for profit in consolidation and/or scaling up of water businesses.

Whether through M&A deals or capital markets activity, we expect to see a significant increase in water-related transactions in 2019. Due to water's unique characteristics as a regulated entity, an oil and gas by-product and a component of fracking solutions, the players involved in the water market run the gamut from oil and gas producers to industrial waste businesses, oil field service companies and infrastructure/private equity firms; there is a lot of interest in the space and lots of parties involved. Our varied and extensive experience with water in the oil and gas and regulated utility space gives us deep knowledge of the market and the players involved, and we look forward to continuing to grow our presence as a leading law firm in water transactions.

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