AKIN GUMP
The Global Energy Industry: 2015 Mid-Year Energy Briefing

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Our Speakers

MODERATOR

Rick Burdick, Partner
rburdick@akingump.com
+1 202.887.4110

Chris LaFollette, Partner
clafollette@akingump.com
+1 713.220.5896

Alison Chen, Partner
alchen@akingump.com
+1 713.250.2165

Thomas McCaffrey, Partner
tmccaffrey@akingump.com
+ 1 713.220.5879

Sarah Schultz, Partner
sschultz@akingump.com
+1 214.969.4367

Justin Williams, Partner
williamsj@akingump.com
+ 44 20.7012.9660

Hank Terhune, Partner
hterhune@akingump.com
+1 202.887.4369

Ryan Thompson,
Senior Policy Advisor
thompsonr@akingump.com
+1 512.499.6268

MLP Matters: *Recent Caselaw*
In re El Paso Pipeline Partners

Christine B. LaFollette & John Goodgame

El Paso: The shot heard 'round the dropdown world

- Many MLPs go public with the express intention of having the MLP acquire assets from the sponsor (generally referred to as "dropdowns").
- For a public corporation, similar transactions ("transactions with a controlling stockholder") are very difficult to execute and typically carry significant litigation risk.
- Delaware law, MLP partnership agreements and caselaw have evolved to provide for a relatively "safe" process for MLPs – a transaction is "cleansed" if it is approved by the conflicts committee (of independent directors) in good faith, which typically requires a subjective belief by those directors that the transaction is in the best interests of the MLP.
- The *El Paso* case is the first in which a dropdown transaction gave rise to liability – the general partner was found liable for $171 million of damages in connection with its breach of the MLP partnership agreement.

El Paso: A quick overview

- Three transactions, three cases:
  - March 2010: El Paso (EP) sold 51% of certain LNG import assets to El Paso Pipeline Partners (MLP)
  - November 2010: EP sold the remaining 49% of the LNG assets, plus 15% of a natural gas pipeline, to MLP
  - March 2011: EP sold an additional 25% of the natural gas pipeline to MLP
- EP was the 100% parent of the GP.
- All claims relating to the March 2010 and March 2011 transactions were dismissed by VC Laster at summary judgment, in opinions referred to as *El Paso I* and *El Paso II* (both released in June 2014). For the November 2010 transaction, VC Laster found that "questions of fact existed requiring a trial as to the state of mind of the members of the Conflicts Committee."
- In April 2015 VC Laster released the *El Paso III* opinion, in which he found that the GP violated the MLP partnership agreement and assessed $171 million of damages against the GP.

El Paso: What happened?

- Ultimately, the judge determined – as a finding of fact – that the conflicts committee did not subjectively believe that the transaction was in the best interests of the MLP; accordingly, the transaction breached the MLP's partnership agreement.
- Primary reasons for this finding:
  - He found that the committee focused on accretion to the common unitholders, rather than value to the MLP;
  - He found – based in part on emails introduced into evidence – that committee members felt (i) that they had overpaid in the first LNG asset transaction and (ii) that it was "not in the best interests of" the MLP to acquire more of the LNG asset; nonetheless, the committee approved the acquisition and effectively paid the same price for the LNG asset in the second transaction;
  - He found that the committee acquiesced to the wishes of the sponsor and, in doing so, "consciously disregarded their own independent and well-considered views about value"
  - He found that the analysis provided by the financial advisor was flawed, was provided "to justify the deal" for the second LNG transaction, and did not appropriately disclose changes in assumptions and presentation

El Paso: What does this mean?

- This case does not change the relevant legal standard or analysis.
- Delaware courts have consistently made clear that where an MLP partnership agreement clearly and unambiguously defines the general partner's duties to the MLP, Delaware will look only to that partnership agreement to determine what duties are owed by the general partner, and whether any of those duties have been breached.
- Accordingly, common unitholders can challenge the general partner's behavior only where the general partner did not comply with the express terms of the partnership agreement or violated the implied covenant of good faith and fair dealing.
- If a MLP partnership agreement provides for "Special Approval" and requires the Conflicts Committee to subjectively believe that a transaction is in the best interest of the MLP to obtain Special Approval, then a plaintiff will have to prove the lack of that subjective belief.

El Paso: What should dropdown MLPs do? (1)

- As with anything else, email and notes discipline is important and email chats can and will be read in the worst possible light in litigation.
- Committees should reconsider the traditional “less is more” approach to minutes – at least with regard to the discussion of the strategic benefit of (and long-term value creation expected from) any transaction under consideration, as well as the addressing of any previously stated concerns or objections. (Because advisor presentations and minutes are the basic sources of director recall in litigation, that additional color may be helpful.)
- The financial advisor needs to be very clear about differences in assumptions and presentation from deal to deal and from deck to deck, especially where drops of additional interests are involved.
- The committee should be certain that they understand the work done by their financial advisor, including the assumptions used and any differences from previous work performed by that advisor.
- The sponsor should be careful on how hard they press the members of the conflicts committee to get a deal done.

El Paso: What should dropdown MLPs do? (2)

- A conflicts committee should take into account all relevant factors around a transaction's value to the MLP as a whole – and clearly document what they considered. The court specifically referred to evaluating a deal's "long-term potential to add value."
- If the committee or any of its members have initial concerns about a transaction, document those concerns and do not approve the transaction until those concerns have been addressed (and the addressing of those concerns have been documented).
- The committee should clearly understand the relevant contractual standard (e.g., how does the MLP partnership agreement define "good faith") and focus on meeting that standard in working toward a decision.
- If the transaction involves multiple assets, the committee should consider valuing (and having its financial advisor analyze) the assets separately.

MLP Matters: *New IRS Guidance*

Alison L. Chen
Partner, Tax

MLP and Qualifying Income

- **General Rule** : MLPs that meet the annual qualifying income test are treated as partnerships for federal income tax purposes and thus avoid the entity-level federal income tax.

- **Qualifying Income Test**: 90% or more of the MLP's gross income for each taxable year must be "qualifying income."

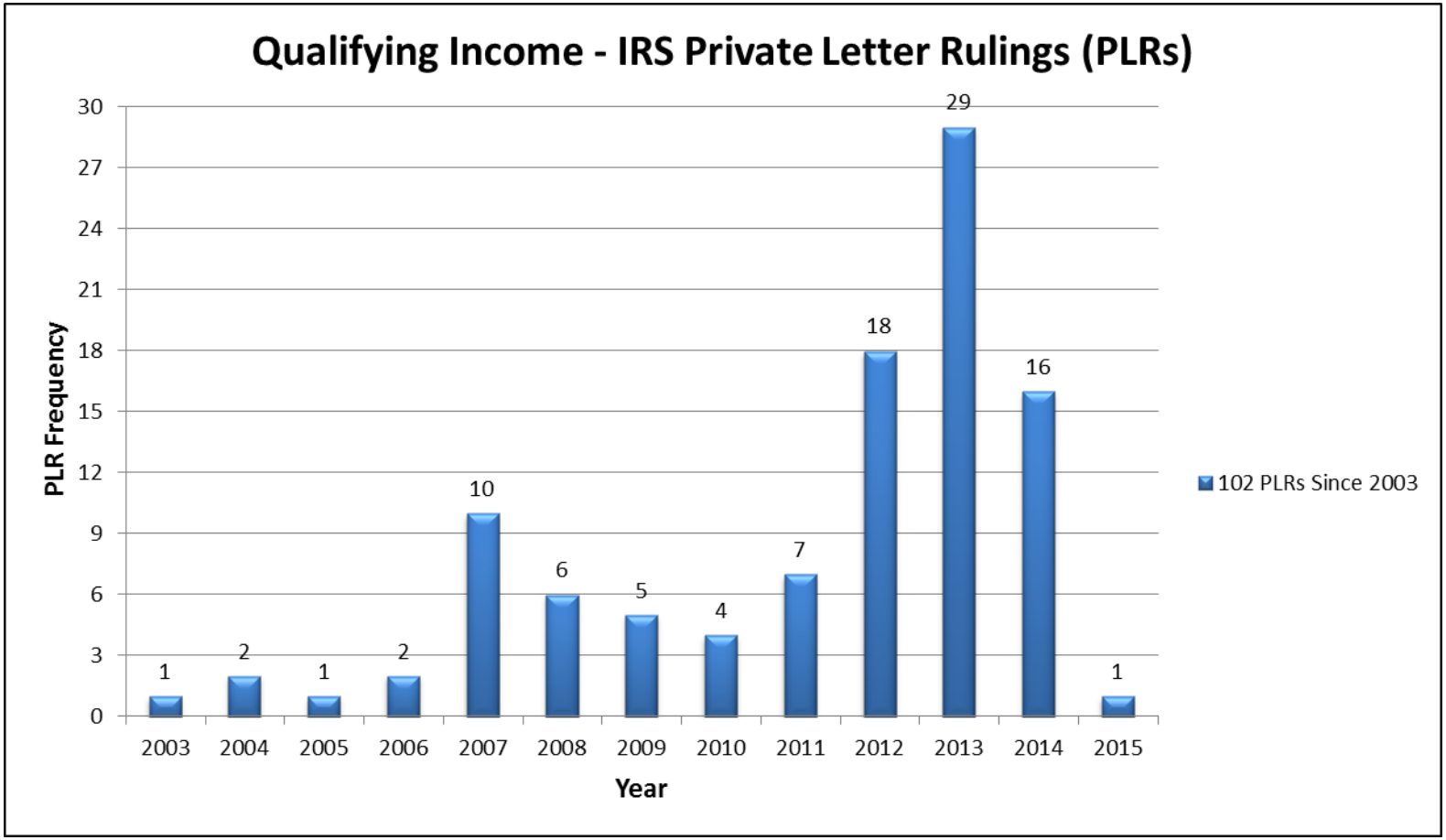
- Code Section 7704(d)(1) – "qualifying income" means:
  - Interest
  - Dividends
  - Real property rents
  - Gains from sale of real property or of capital assets
  - Natural resource exception

Qualifying Income: *Natural Resource Exception*

- Section 7704(d)(1)(E)

- "Income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resources (including fertilizer, geothermal energy, and timber), [or] industrial source carbon dioxide, or the transportation or storage of any fuel described in subjection (b), (c), (d) or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as described in section 40A(d)(1)"

Qualifying Income: *Spike in PLR Requests*



New IRS Guidance – *Proposed Regulations*

- Pause - In early 2014, the IRS announced a "pause" on processing MLP related rulings to further consider a uniform standard.

- Lifting the Pause: about a year later, on March 6, 2015, the IRS lifted the pause and resumed PLR processing. In addition, the IRS announced that proposed regulations aimed at clarifying the scope of qualifying activities were forthcoming.

- Proposed Regulations: On May 6, 2015, the IRS issued proposed regulations §1.7704-4 defining qualifying income from exploration, development, mining or production, processing, refining, transportation, and marketing of minerals or natural resources.

- Same-Day Akin Gump Client Alert https://www.akingump.com/en/news-insights/irs-comes-out-with-long-awaited-proposed-regulations-clarifying.html

Proposed Regulations on Qualifying Income

- Mineral or Natural Resource
- Section 7704(d)(1)(E) activities – “Core Activities”
- Intrinsic Activities
- Examples
- Effective Date and Transition Period

Proposed Regulations: Core Activities

- Some Highlights of the Section 7704(d)(1)(E) Core Activities:

  - Exploration
    - Conducting geological or geophysical survey qualifies
    - Interpreting data obtained from geological or geophysical survey qualifies
  - Development
    - Constructing and installing drilling, production or dual purpose platforms in marine locations qualifies
    - Oil and gas fracturing qualifies
    - Constructing and installing gathering systems and custody transfer station qualifies
  - Mining or Production
    - Extracting minerals or other natural resources from the ground

Proposed Regulations: Core Activities (Continues)

- Processing or Refining
  - Industry specific definition
  - Olefins (ethylene and propylene) produced outside of refinery not qualifying – Example 1
  - Processing methane into methanol and sale of methanol not qualifying – Example 3
  - Timber – pulp, paper, paper products not qualifying

- Transportation
  - Storage, terminalling, perating pipeline, barges, rail or trucks, construction of pipeline through interconnect agreements treated as transportation

- Marketing
  - “sales made in small quantities directly to end users”
  - Example 4 – wholesale prices and delivery in bulk to government entity

Proposed Regulations: Intrinsic Activities

Three Requirements for an "Intrinsic Activity":

- 1. The activity must be specialized –
  - Unique training – Catering services not specialized
  - Provision of tools/equipment – must have limited use outside of the core activity and not easily convertible to a non-core activity use
  - Injectant – must also collect and clean, recycle and dispose in accordance with law
- 2. The activity must be essential – necessary to physically complete the activity or comply with law
- 3. The activity includes the provision of significant services – personnel have ongoing or frequent presence at the site of the core activity
- Examples 5 and 6 dealing with water services
  - Provision of water without more is not an intrinsic activity
  - Delivery of water plus recovery and recycling of flowback constitute intrinsic activity

Proposed Regulations – *Effective Date and Transition Rule*

- Effective Date
  - Applies to income of the partnership earned in a taxable year beginning on or after the final regulations are published.

- Transition Period
  - 10 year period after the final regulations are published.
  - Applies to

    1. MLPs who have received a PLR.

    2. Prior to May 6, 2015, the MLP engaged in the activity, and treated the activity as giving rise to qualifying income, and that income was qualifying income under the statute "reasonably interpreted" prior to the issuance of the proposed regulations.

    3. The MLP engages in the activity after May 6, 2015 but before the date the final regulations are published and the income from the activity is qualifying income under the proposed regulations.

Questions

Chris LaFollette, Partner
clafollette@akingump.com
+1 713.220.5896

Alison Chen, Partner
alchen@akingump.com
+1 713.250.2165

US Energy Restructuring Considerations for Officers and Directors: What officers and directors can do before considering any restructuring actions

Presented by: Thomas J. McCaffrey and Sarah Link Schultz

- D&O Insurance
- Review of General Fiduciary Duties of Officer and Directors – A Field That is Always on the Move
- What to Watch Out For: Potential Tipping Points
- Sometimes an Art, Not a Science. Especially with 20/20 Hindsight
- Board Composition

Questions

Thomas McCaffrey, Partner
tmccaffrey@akingump.com
+1 713.220.5879

Sarah Schultz, Partner
sschultz@akingump.com
+1 202.887.4295

Akin Gump
STRAUSS HAUER & FELD LLP

Falling oil prices and the rising risk of transactional disputes

Justin Williams
Partner, Litigation and International Arbitration, London

Oil and Gas Sector prone to international disputes

- **LCIA** (London Court of International Arbitration) – 15% oil and gas industry, 7% energy and resources sector (2013)

(*The biggest sectors)*

- **ICC** (International Chamber of Commerce) – 15% energy disputes (2013)

(*Energy disputes is the second biggest sector, behind construction and engineering - 18%)*

- **ICSID** (International Centre for Settlement of Investment Disputes) – 26% oil, gas and mining (2014)

(The biggest sector, followed by electric power and other energy - 13%)

Why is upstream Oil and Gas prone to disputes?

- Big upfront E&P investments, uncertain exploration outcomes, long lead times for production revenues
- Exposure to swings in oil prices
- JVs share cost and risk
- Political risk

2014 Oil Price shock creates huge tensions

Source: FT.com - ICE Brent Crude Oil Front Month IB.1:IEU

Commercial Responses

- Delay/cancellation of exploration activity
  - $200bn capital spending on 46 O&G projects reported deferred in last 12 months
  - Global rig count down more than 1,100
  - Immediate hit for oilfield services companies and drilling contractors
- Renegotiation
  - Majors attempting to renegotiate service contract prices, license periods etc.
  - The “new normal” of no farmee promote or carry
- Use of contractual remedies to escape or amend agreements
  - Heightened risk of contractual disputes

Contractual Remedies/Disputes: Change of Circumstances and Hardship Doctrines

In common law systems the oil price shock unlikely to qualify for such relief, but it might under some civil law systems

- English law
  - Doctrine of Frustration where performance becomes impossible or fundamentally changed
- NY law
  - Doctrines of Frustration of Purpose and Impossibility to similar effect
- Civil law systems
  - Doctrine of Hardship applies in some systems to adjust contracts where performance becomes significantly more onerous, e.g. Germany, Algeria, Egypt
  - Force Majeure appears in certain civil codes, e.g. French, but usually only applies where performance impossible

Contractual Remedies/Disputes: Express Relief

- Force Majeure
  - Typically limited to war, natural disaster etc. and interpreted narrowly – very unlikely to apply for fall in prices
  - Often disputes over whether it applies and whether notice and mitigation requirements met
- Material Adverse Change Clauses
  - Used to protect purchaser prior to completion
- Hardship Clauses
  - More common in civil law jurisdictions
- Price Review
  - Long term gas sales agreements linked to oil prices
  - Trend of purchasers seeking review many now be reversed with sellers seeking review
  - Often disputes over when review is triggered and how it is calculated

Contractual Remedies/Disputes: Other Devices

- Conditions Precedent
  - Instances of buyers arguing non-fulfilment of CPs to escape M&A deals impacted by falling oil prices
- Termination
  - Some contracts permit termination for convenience or cause, e.g. O&G service contracts
  - Right often stated to arise on “material breach”, “substantial breach” or “insolvency event” – risk of disputes over what that means
  - Repudiation

Other areas where oil price shock may lead to Disputes

- Abandonment
  - E.g. Farmees threatening to walk away, surrender of licenses etc.
- Acceleration of decommissioning and the need to secure the cost
- As government revenues impacted, risk of changing regulations and laws, and increased risk of investor-state disputes

How to manage the risk of Disputes?

- Draft contracts to take into account potential remedies
- Review existing contracts to assess opportunities/threats
- Comply with contract formalities
- Consider implications of strict enforcement and whether re-negotiation preferable

Questions

Justin Williams, Partner
williamsj@akingump.com
+44.20.7012.9660

Energy Policy – An analysis of the comprehensive energy bills introduced by both the House and Senate Energy Committee: What are the similarities and differences? What is the outlook for these bills?

By Hank Terhune and Ryan Thompson

114th Congress – General Observations

- Energy: High on Agenda
- 2015 – A Critical Year in Two-Year Schedule
- Return to Regular Order*
- Energy Leadership Dynamics

Energy Policy: Three Legislative Paths

Messaging Bills

- Keystone XL Pipeline
- House Energy and Water appropriations bill contains over 20 policy riders related to the CWA, greenhouse gas regulations, dredging
- House Environment and Interior appropriations bill contains riders regarding stream buffer rule, navigable waters/fill material definition

Big Political Fights

- Largely environmentally focused
- Likely to play out during appropriations "game of chicken" at year-end

Emerging Areas of Bi-partisanship

- Authorizing Committees pursuing policy framework leaders outlined in 2013/2014
- Bi-partisan in nature
- Regular order with significant member input

House of Representatives: Architecture of Abundance

- Energy and Commerce Committee released "discussion drafts" and held hearings during the spring
- Draft bill released July 20, 2015; Subcommittee markup held July 22nd, and bill reported unanimously to full Committee
- Four titles
  - Modernizing and Protecting Infrastructure
  - 21st Century Workforce
  - Energy Security and Diplomacy
  - Energy Efficiency and Accountability
- Outlook

Senate: Energy Policy Modernization Act of 2015

- Chairwoman Murkowski and Ranking Member Cantwell released their bipartisan bill last week; marking up this week
- In May, Murkowski released 17 individual bills in an effort to scope the legislative effort and gain input from members
- The legislation is focused on five broad titles:
  - **Efficiency** - Federal buildings and other efficiency programs
  - **Infrastructure** - Cyber and grid security, SPR and 45 day clock for DOE to approve LNG applications
  - **Supply** - Hydro classified as renewable, helium reform and modernize critical minerals policies
  - **Accountability** – Creation of the Nexus of Energy and Water Sustainability (NEWS) office and various other reforms
  - **Conservation** - Land and Water Conservation Fund reforms and reauthorization

Issues Not Covered In These Comprehensive Energy Bills

- Crude Oil Exports
  - Sens. Murkowski (R-AK) and Heitkamp (D-ND) introduced *American Crude Oil Export Equality Act*. Reps. McCaul (R-TX) and Barton (R-TX) introduced similar bills in the House.
  - Sen. Murkowski plans to advance stand alone legislation this year - perhaps as early as this week.

- Tax Issues
  - Tax “extenders”
  - Tax reform

Timing and Outlook

July

- House Committee
- Senate Committee
  - Mark-up this week

August

- Congressional Recess

September

- House Full Committee
- Senate Committee

and/or Senate Floor

Remainder of year

- Complete floor action in both House and Senate on energy bills
- Conference
- Final action
- Legislative calendar will be packed for the final quarter of the year*

Questions

Hank Terhune, Partner
hterhune@akingump.com
+ 1 202.887.4369

Ryan Thompson, Senior Policy Advisor
thompsonr@akingump.com
+1 512.499.6268

Our Speakers

MODERATOR

Rick Burdick, Partner
rburdick@akingump.com
+1 202.887.4110

Chris LaFollette, Partner
clafollette@akingump.com
+1 713.220.5896

Alison Chen, Partner
alchen@akingump.com
+1 713.250.2165

Thomas McCaffrey, Partner
tmccaffrey@akingump.com
+ 1 713.220.5879

Sarah Schultz, Partner
sschultz@akingump.com
+1 214.969.4367

Justin Williams, Partner
williamsj@akingump.com
+ 44 20.7012.9660

Hank Terhune, Partner
hterhune@akingump.com
+1 202.887.4369

Ryan Thompson,
Senior Policy Advisor
thompsonr@akingump.com
+1 512.499.6268

THANK YOU

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Akin Gump Offices

ABU DHABI
Sowwah Square
21st Floor, Al Sila Tower
Al Maryah Island
P.O. Box 55069
Abu Dhabi, United Arab Emirates
Tel. +971 2.406.8500

AUSTIN
600 Congress Avenue
Suite 1350
Austin, TX 78701-3238
Tel. +1 512.499.6200

BEIJING
Suite 06, EF Floor
Twin Towers (East)
B12 Jianguomenwai Avenue
Beijing 100022, China
Tel. +86 10.8567.2200

DALLAS
1700 Pacific Avenue, Suite 4100
Dallas, TX 75201-4624
Tel. +1 214.969.280

DUBAI
Boulevard Plaza
Tower Two, 23rd Floor
P.O. Box 120109
Dubai, United Arab Emirates
Tel. +971 4.317.3000

FORT WORTH
201 Main Street
Suite 1600
Fort Worth, TX 76102
Tel. +1 817.886.5060

FRANKFURT
Opern Turm
Bockenheimer Landstraße 2-4
60306 Frankfurt/Main
Germany
Tel. +1 49.69.677766.0

GENEVA
3, rue François Bellot
1206 Geneva, Switzerland
Tel. +41 22.787.40000

HONG KONG
Unit 01-04 & 10, 28th Floor
Alexandra House
18 Chater Road
Central, Hong Kong
Tel. +852 3694.3000

HOUSTON
1111 Louisiana Street, 44th Floor
Houston, TX 77002-5200
Tel. +1 713.220.5800

IRVINE
4 Park Plaza
Suite 1900
Irvine, CA 92614-2585
Tel. +1 949.885.4100

LONDON
Eighth Floor
Ten Bishops Square
London E1 6EG
United Kingdom
Tel. +44.20.7012.9600

41 Lothbury
London EC2R 7HF
United Kingdom
Tel. +44.20.7012.9600

LONGVIEW
Austin Bank Building
911 West Loop 281
Suite 211-40
Longview, TX 75604
Tel. +1 903.297.7400

LOS ANGELES—CENTURY CITY
2029 Century Park East
Suite 2400
Los Angeles, CA 90067-3010
Tel. +1 310.229.1000

LOS ANGELES—DOWNTOWN
633 West Fifth Street
Suite 5000
Los Angeles, CA 90071-2081
Tel. +1 213.254.1200

MOSCOW
Geneva House
7 Petrovka Street
Moscow, 107031 Russia
Tel. +7 495.783.7700

NEW YORK
One Bryant Park
Bank of America Tower
New York, NY 10036-6745
Tel. +1 212.872.1000

PHILADELPHIA
Two Commerce Square
2001 Market Street
Suite 4100
Philadelphia, PA 19103-7013
Tel. +1 215.965.1200

SAN ANTONIO
300 Convent Street
Suite 1600
San Antonio, TX 78205-3732
Tel. +1 210.281.7000

SAN FRANCISCO
580 California Street
Suite 1500
San Francisco, CA 94104-1036
Tel. +1 415.765.9500

SINGAPORE
1 Raffles Place
#19-61
One Raffles Place Tower 2
Singapore 048616
Tel. +65 6579.9000

WASHINGTON, D.C.
Robert S. Strauss Building
1333 New Hampshire Avenue, N.W.
Washington, DC 20036-1564
Tel. +1 202.887.4000