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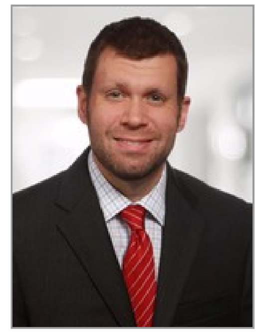
Harvey's Aftermath For The US Oil And Gas Sector

By **Thomas Ciarlone Jr.**



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Law360, New York (September 6, 2017, 12:22 PM EDT) -- Nearly fifty inches of rain inundated large swaths of so-called "refinery row" — a petrochemical mecca sandwiched between Houston and Baytown, Texas — as Hurricane Harvey roared into and then lingered destructively over the Lone Star State. This coastal slice of Texas is the epicenter of the nation's vast network of refineries, pipelines and terminals. It is here that enormous volumes of fuel are processed and transported for consumption not just domestically, but also — and perhaps more significantly — across the entire globe.

It should come as no surprise, then, that gasoline prices have skyrocketed in the wake of Harvey's cataclysmic path. Owing to the massive impairment of refining capacity along the Gulf Coast, this is a natural function of supply and demand. By contrast, however — and this is where the rubber meets the road — the prices of crude oil and natural gas have been ebbing. The opposite was true just twelve years ago, when Katrina unleashed her fury on the region, catapulting natural gas prices into the stratosphere.

Casual observers may be left scratching their heads. What accounts for this dramatic sea change in market dynamics? The answer is deceptively simple: in a word, shale. Over the last decade, the pace at which fracking and horizontal drilling have extended their tentacles across Texas — in game-changing plays like the Eagle Ford and the Permian Basin — has been furious, to say the least, and it was not long before the technological advances allowing for the extraction of oil and gas from tight rock formations percolated north into the Marcellus and other parts of Appalachia.

During this same cycle, offshore production — once the 800-pound gorilla of U.S. oil operations — began to wither on the vine, at least as a relative proposition. Indeed, taking the numbers in isolation, less than 20 percent of domestic oil production is attributable to offshore operations, whereas almost 50 percent now traces its genesis to shale.

Notably, even when the analysis is limited to onshore domestic production, Texas and its neighbor to the east, Louisiana, are no longer the unchallenged giants that they once were. After all, the shale revolution has matured from a regional into a national phenomenon, one that has undergone exponential growth in virtually every oil-and-gas-producing state in the country.

Now that offshore drilling in the Gulf is a shadow of its previous self, and as the shale boom has extended far beyond the borders of the Gulf states, a monster storm like Harvey — notwithstanding its tragic, life-altering consequences for the brave residents of Texas and Louisiana — can necessarily have only a marginal influence on domestic oil and gas prices.

All of this is another way of saying that one of the inevitable effects of the shale revolution is that the United States, after a long hiatus, has emerged again as a meaningful exporter of gas (and, for that matter, lighter crude). So gone are the days when domestic prices spiked in the face of a hurricane-ravaged Gulf region. The new normal is that gas prices elsewhere in the world — predominately in Asia and Europe — will bear the brunt of price increases, as international gas supplies constrict in the absence of U.S. exports.

This is not to suggest, however, that there are not serious domestic consequences for the oil and gas industry. Far from it, in fact — and, on this score, the environmental and safety ramifications of Harvey are the most obvious suspects. Much has already been written about these pressure points, which will not be repeated here, but suffice it to say that the legal fallout will run the gamut from pipeline integrity issues and groundwater contamination; to insurance coverage disputes; to accidental airborne emissions and related nuisance claims.

Particularly troubling for E&Ps is that force majeure clauses — which, as a general matter, excuse contractual nonperformance during natural disasters and other "acts of God" — will not necessarily provide as much cover for operators as they might think, even under conditions as exigent as the vast flooding and wind damage occasioned by Harvey. After Hurricanes Katrina and Ike, force majeure clauses were invoked with such frequency that they went from boilerplate provisions to soberly negotiated clauses that can differ dramatically from one agreement to the next.

In many instances, the doctrine of force majeure is no longer the all-encompassing, get-out-of-jail-free card that it once often was. Accordingly, now is the time for savvy oil and gas companies to get ahead of the curve by taking stock of exactly what protections they enjoy — and what exposure they have — under the force majeure provisions of mission-critical contracts.

One area that has the potential to be especially vexing are lease termination claims brought by mineral lessors. Increasingly baked into oil-and-gas leases are draconian provisions that call for the automatic termination of the lease for the nonpayment of royalties — sometimes even without notice or an opportunity to cure. This is of special significance in the current landscape, since the concept of force majeure historically has not reached the timely payment of monies.

The Houston offices of operators of all sizes — where their accounting functions are usually located — have been closed for over a week in many instances, and for some it remains unclear when they will again open the doors. Even once business officially resumes, many in the Houston area will still be struggling with personal crises that may prevent them from reporting to work.

The possibility of making inadvertently (or even unavoidably) late royalty payments is thus very real. Depending on the language of the lease and the temperament of the lessor, this could have devastating commercial consequences for unsuspecting E&Ps laboring under the misconception that force majeure clauses fully inoculate them in circumstances such as these.

Finally, it bears emphasis that force majeure clauses will not extend beyond the bounds of privity. Pipeline damage sustained during Harvey, for example, might preclude a gathering or transportation company from meeting its contractual obligations to an operator to deliver production to market.

The gathering or transportation agreement is likely to insulate the pipeline, by way of force majeure, from any liability for breach of contract. This does not necessarily mean, however, that the operator is any less obliged to the mineral owner to pay royalties in a timely fashion on the production that cannot make its way to market.

Thomas G. Ciarlone Jr. is a director at Kane Russell Coleman Logan PC, where he focuses his practice on oil and gas litigation and general commercial litigation and dispute resolution. He has played a significant role in litigating and ultimately settling many nationwide class actions, including matters involving allegations of securities and consumer fraud at Big Four auditing and accounting firms and at a wide range of publicly traded companies.

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