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New Midstream Company Achieves Critical Mass

In early 2003, Regency Gas Services LLC entered an agreement to acquire a collection of gas gathering, pipeline, and processing assets from El Paso Field Services, including the Dubach-Lisbon-Calhoun complex and Gulf States Pipeline in north Louisiana and the Hugoton-Lakin, Mocane-Laverne, and Greenwood facilities in the Mid-continent.

When it came time for an independent review of the assets, Barnes & Click was the clear choice for both Regency and its financing provider, Wells Fargo. Members of Regency's management team had worked with some of B&C's senior consultants in the past, and the bank had hired B&C for several midstream due diligence projects.

At the time the deal was struck, Regency was a new company led by an experienced team of industry executives, including Chairman David Biegler

and President Jim Bryant. Mr. Biegler was previously Vice Chairman of TXU and Chairman of ENSERCH. Mr. Bryant had been CEO of Endeveco, a pipeline company that at one time had owned the Louisiana assets Regency was planning to purchase.

The seller was in the midst of an asset restructuring and repositioning campaign in 2002 and 2003 and was motivated to seal the deal. To make that happen, the Regency team and its equity backer, Boston-based Charlesbank Capital Partners, needed to put together financing arrangements quickly. Regency called on Wells Fargo, and Wells Fargo turned to Barnes & Click for a rapid, independent review of the assets.

The bank knew B&C was the go-to consulting firm for midstream asset due diligence. Wells Fargo engaged the firm to determine whether the facilities were in good working order (a.k.a. "kick the tires"), to "scrub" the economic model Regency had put together, to determine whether Regency was paying a fair price, and to do any other due diligence necessary to vet the acquisition. "Regency was set to instantly become a pretty sizable firm as a result of this acquisition, so it was important for us to make sure that we reviewed everything critically," explained B&C Senior Consultant David Freyman.

One complicating factor was a concern that Gulf States customer Union Power Partners might be headed for commercial collapse as a result of the power industry fundamentals at the time. "In the recent two to three years, merchant power went from being everyone's darling to an industry where capacity was overbuilt, prices were cratering, and companies were teetering on the brink of receivership," Freyman explained. B&C was able to incorporate the possible bankruptcy scenarios into the economic model so that the range of possible outcomes could be thoroughly quantified.

Overall, B&C's analysis of the acquisition revealed that the assets were well maintained, in good condition, and fairly valued at the acquisition price.

Barnes & Click Goes East....



...to apply its consultants' knowledge and experience. Here Randy Miller, Senior Consultant and Olefins Specialist (left), visits a client site in China.



In addition, although the gathering/processing complexes were in mature producing areas, B&C's review of upstream operations in the surrounding areas indicated that production volumes might have bottomed, at least temporarily, and that drilling activity was improving.

"What was impressive about this deal," said Freyman, "was that Regency had put together a good analysis that held together under the scrutiny that we applied."

A Rare Opportunity. Not long after Regency closed the El Paso transaction, the company happened upon an "opportunistic" acquisition target, Duke Energy Field Services' (DEFS) Waha gathering and processing complex in west Texas. It was brought to Regency and Charlesbank when another party that had negotiated to purchase the assets was unable to close the deal.

The Waha facilities serve producers in Pecos, Reeves, Ward, and Winkler counties. The gas processing plant includes a recently upgraded 125 MMCFD cryogenic unit, inlet compression, amine treating unit, dehydration, residue compression, and residue pipeline connections providing access to ten markets. The associated gathering system comprises 630 miles of pipe and 19 field compressor stations.

When Regency decided to throw its hat into the ring, the company again sought financing from Wells Fargo. Once more, the bank called on B&C to perform due diligence on the purchase, but this time there was a new facet to the evaluation. As a prerequisite to expanding Regency's financing, the bank asked B&C to evaluate the financial viability of the combined Regency entity.

Following inspection of the major facilities, assessment of competing operations, and review of the new economic model Regency used to evaluate the acquisition, B&C determined that the west Texas assets were in good condition and fairly valued. But the job was not complete at this point. B&C went on to update its previous analysis of Regency's El Paso acquisition, evaluating the performance of those assets since Regency had taken ownership - particularly as it compared to the predictions from B&C's initial evaluation. "We did it once and came back

about nine or ten months later and re-evaluated the same assets," said B&C Senior Consultant Dan Altena. This gave the firm an unusual opportunity to look back and see if the assets had performed as predicted.

The exercise resulted in a favorable comparison. Wells Fargo's Dustin Hansen noted that B&C's predictions were "right in line." Regency, too, was pleased: "It was a good confirmation of our predictions," said Bryant.

Bryant is pleased with the company's success so far. "The first acquisition constituted, in effect, a start-up for us," he said. "We went from three people to about 90 when we acquired the El Paso assets. We kept virtually all of the field employees and some of the accounting and office personnel. Then we added two more staff when we made the Duke acquisition."

His familiarity with B&C's key personnel and midstream expertise brought some calm to an otherwise stressful situation. "It was comforting for us to have Barnes & Click undertake the independent review because they are very experienced," Bryant said. "We had a very short turnaround time on the second acquisition, and they really helped us out a lot on that." Altena said, "We were right up against the deadline, but we finished on time and were able to be part of the loan syndication process that helped make the transaction happen."

Recent Due Diligence Assignments

Since January 1, 2003, Barnes & Click has completed due diligence evaluations for these Gas Midstream transactions:

<u>Purchaser</u>	<u>Seller</u>	<u>Assets</u>
WTG Gas Processing	Enogex	Benedum plant
Regency Gas Services	El Paso	N La/Mid-Cont.
Crosstex Energy	Duke Energy	Seminole, et al
Cantera Resources	CMS Field Svc.	Company
Frontier Field Services	ConocoPhillips	Maljamar plant
Eagle Rock Energy	Williams	Dry Trail plant
Regency Gas Services	Duke Energy	Waha system
Crosstex Energy	AEP	LIGPipeline
WTG Gas Processing	Sago Energy	Jameson plant

Watch for stories about some of these transactions in future issues of Barnes and Click Solutions.



Son of “Processing Margin in Structural Decline”

In this issue one year ago, we discussed the structural decline in gas processing margins caused by gas prices increasing to near Btu-parity with crude oil. The decline has recently reversed, but recovery has been minimal. The fallout continues to bring about significant changes in processing contracts that are altering the relationship between producer and gatherer/processor and will have an impact for years to come. Unfortunately, many of the new/amended contracts do not encourage capital investment to achieve global optimization of the entire system.

Overview of contract restructuring. After the natural gas price "explosion" of January 2001, it appears that the industry made minimal progress to ensure the economic viability of all participants. The viability of processors was threatened by natural gas prices pushed to historical highs by fears of shortages from declining production and the larger than normal storage draw-downs of three years ago. An almost adversarial environment developed between producers, processors, and pipelines, especially after the latter issued operational flow orders (OFOs) to force processing even though margins were negative. As a consequence, to ensure that their high-priced gas continued flowing to market, many producers were compelled to accept restructured contracts being offered by processors at the time.

Prior to the gas price explosion, processing had historically provided significant value-added in all

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gas producing regions because of the economic upgrade from the liquids. Keep-whole (KW) processing agreements were especially popular with processors of Bottom Tier gas (i.e., gas containing less than 2 gallons/MCF of recoverable liquids) and Middle Tier

gas (2.5 to 3.5 gpm) because the high processing margins made keep-whole processing profitable and enabled processors to attract gas supplies that might otherwise have been accepted by the pipelines unprocessed. For the purpose of this discussion, keep-whole includes, but is not limited to, wellhead purchase contracts and so-called percent-of-index (POI) contracts. Whether or not the processor actually takes title to the gas, the producer is paid for all the Btus received at his wellhead or delivery point at a price often pegged to a market index such as Henry Hub or Houston Ship Channel.

Today, KW contracts in the Bottom Tier have largely been replaced or supplemented by fee-based agreements, a shift driven by pipeline OFOs requiring the gas to be processed even when the processors would otherwise exercise their contractual option to not process. The transformation away from KW processing in the Middle Tier continues, although at a slower pace because the processors are generally obligated contractually to process (and therefore have less bargaining leverage).

In regions with rich, Top Tier gas (liquids content greater than 4 gpm), percent-of-proceeds (POP) contracts have predominated. Here, the producer and processor split the revenues from the sale of residue gas and natural gas liquids (NGL). When the gas and NGL splits are the same (for example 10% of each to the processor), the producer's and processor's interests are aligned on most operating issues.

But not all POPs are created equal. Frequently, the processor will receive a greater percentage of the liquids proceeds than of the gas. The limiting case is where the processor gets none of the gas revenue, only receiving a percentage of the liquids (the "POL" contract). In any arrangement where the processor's split of the NGL is greater than his split of the gas, the processing incentive is skewed in favor of the processor relative to the overall processing margin.

In the earlier, low-priced gas market, POP contracts provided steady, but unexciting earnings for processors of Top Tier gas. Today, the lower processing



margins are more than offset by strong gas prices, and both producers and processors are generally prospering.

Growing the Pie. Unfortunately for the industry at large, increasing the size of the "profit pie" for producer and processor alike does not appear to be a top priority in structuring new contracts or restructuring old ones. While the now out-of-favor KW or POI contracts encouraged the gatherer/processor to invest capital to increase operating efficiencies, neither fee-based nor POP contracts foster the same incentives. Unexploited opportunities for greater profitability are thus left on the table.

Fee-based contracts designed to assure the processor a reasonable margin in all commodity market conditions likely do not provide incentives for either aggressive daily optimization of plant operations or longer term capital improvements because the fee is not related to how closely to optimum the processor operates.

Likewise, POP contracts provide only limited encouragement for optimization by the processor. In those where the percentage splits on gas and liquids are identical, the producer and processor are at least aligned with respect to operating decisions, such as whether to recover or reject ethane. In contrast, POL contracts and POPs with the liquids split in favor of the processor encourage the processor to maximize NGL recovery without regard to the incremental margin for such recovery or the incremental fuel expense (except in those cases where the fuel allocation is fixed). In neither case are the parties' interests aligned with respect to capital improvements since the processor puts up all the capital and reaps only a portion of the benefits. Consequently, projects are not implemented that would reduce system fuel consumption (when the allocation is based on actual) or increase production through lower or more consistent wellhead pressures.

In today's market, the benefit of even a small improvement in fuel efficiency is significant. For example, at a \$6.00/MMBtu gas price, a reduction in fuel consumption of 0.5 percentage points in a 100 MMCFD gathering/processing operation generates over \$1 million per year to the global bottom line. If such improvement were attainable on only one-fourth of the volume flowing into the total US gas market, the potential benefit is enormous.

Why is capturing these opportunities to enlarge the pie so complex? Functional fragmentation of the industry is one reason. Several factors must be considered: volatile processing margins, gas and NGL marketing, gathering system operation and optimization, daily plant operating decisions, and business relationships between the various functions of the industry. This should not be a daunting challenge in totally integrated companies where the overall corporate good is ostensibly everyone's priority. However, that situation is a relative rarity today. Mustering the organizational capability to exploit technology and achieve global optimization of overall system performance is especially problematic in the more common circumstance where producer, gatherer, processor, and marketer are all separate entities.

The structural decline in margins started a migration away from keep-whole processing because it is no longer a value-added proposition during much of the time. Processors' incentive to invest capital for efficiency improvements has largely disappeared under fee-based contracts and is minimal under POP contracts. None of the prevalent contract forms provides sufficient incentive for processors to invest in projects which would increase wellhead production volumes. In our view, gas producers should take the initiative to strike new, innovative arrangements with processors, creating mutual incentives to enlarge the profit pie. Independent, third-party assistance can help bridge the gap between producers and processors and facilitate the achievement of greater prosperity for both sectors.

