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CLIENT ALERT: OPERATORS REQUEST MARKET DEMAND ORDER

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On March 30, 2020, Pioneer Natural Resources U.S.A., Inc. and Parsley Energy Inc. filed a motion with the Texas Railroad Commission requesting a market demand hearing and order. Specifically, Pioneer and Parsley request that the Railroad Commission hold a hearing to determine the "reasonable market demand for oil" and issue an order curbing statewide production beginning in May 2020.

Railroad Commissioner Ryan Sitton, one of three commissioners in charge of the state agency, has stated that the Railroad Commission is "working towards" scheduling a hearing on the Pioneer and Parsley motion for April 14, 2020. Pursuant to the Texas Administrative Code, the Railroad Commission may hold a hearing upon 10 days' notice.

Pioneer and Parsley Allege Production Will Exceed Demand

Pioneer and Parsley allege that shocks to both oil supply and demand have significantly impacted the market for U.S. shale oil. On the supply side, the motion alleges that a market share war between Russia and Saudi Arabia has resulted "in a sudden, massive surge in the supply of oil." On the demand side, the motion alleges that efforts to scale back the American economy during the coronavirus pandemic have resulted "in the precipitous decline in oil demand."

The motion alleges that as a result of the simultaneous increase in supply and decrease in demand, 100 million barrels of oil per week could be added to inventories during the second quarter of 2020. The motion warns that an addition of 100 million barrels of oil per week to inventories could:

- quickly eclipse the approximate 1.5 billion barrels of global onshore crude oil storage capacity;
- overwhelm the handling, processing and storage capacities of the industry's other key logistical nodes (pipelines, vessels, terminals, processing units, and storage facilities);
- force spot oil prices under $10 per barrel; and
- collapse market demand for Texas oil.

As a result of the concerns expressed in their motion, Pioneer and Parsley request that the Railroad Commission hold a telephonic hearing and "issue such orders, rules or other relief as may be appropriate to set the market demand for oil in Texas for the month of May 2020." According to Pioneer and Parsley, an industry-wide curtailment of production, required by the Railroad Commission, would ensure that "the shut-in process takes place in an equitable and orderly manner across the state."

The Railroad Commission's Regulation of Waste

Section 85.046 of the Texas Natural Resources Code defines "waste," in part, as the "production of oil in excess of transportation or market facilities or reasonable market demand." Further, Section 85.046 allows the Railroad Commission to "determine when excess production exists or is imminent and ascertain the reasonable market demand."

Pioneer and Parsley contend that the Railroad Commission is "compelled" by Sections 85.042(b) and 85.051 of the Natural Resources Code to issue such rules or orders "as are necessary to correct, prevent or lessen waste." Section 85.042(b) requires the Railroad Commission, when necessary, to "make and enforce rules either general in their nature or applicable to particular fields for the prevention of actual waste of oil . . . ." Section 85.051 provides that "[i]f the commission finds at the hearing that waste is taking place or is reasonably imminent, it shall adopt a rule or order in the manner provided by law as it considers reasonably required to correct, prevent, or lessen the waste."

Multiple Production Curbs Proposed

Although Pioneer and Parsley do not propose a specific cutback mechanism in their motion, *Bloomberg* reports that the two operators propose a 20% cut to Texas production. *Bloomberg* has also reported that Railroad Commissioner Ryan Sitton has proposed a 10% cut to Texas production. On March 31, 2020 the Railroad Commission posted a "Media Advisory" on its website that stated that "the oil market [is] being oversupplied by at least 16 million BPD (likely higher)."

Production Curbs and Force Majeure

An order by the Railroad Commission requiring operators to reduce production could constitute a force majeure event, depending on the exact language used by the parties in the lease. In some lease variations, however, in order to successfully invoke the force majeure clause the lessee must challenge a government order that makes compliance with the lease terms impossible unless the challenge is likely to fail.

Planning Ahead

Within the past week, two major Texas operators and a Railroad Commissioner have proposed statewide production curbs. If the Railroad Commission schedules a hearing on the Pioneer and Parsley motion for the week of April 13 and determines that a mandatory reduction in production is necessary, producers could have two weeks or less to react to and implement the market demand order prior to May 2020 production. At minimum, lessees should begin planning for a possible market demand order from the Railroad Commission, and examine applicable lease language to determine how production cuts will affect lease termination issues.

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