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## Time Is Money: Historical Strip Prices and Valuation in Oil & Gas Bankruptcies

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Timing is key to valuation of all types and in all contexts. But in bankruptcy, valuation timing can take on heightened importance because a central element of bankruptcy involves distributing value as of a specific point in time. Higher valuation means larger creditor recoveries in bankruptcy, and lower valuation means smaller creditor recoveries. Valuation can also affect which creditors receive those recoveries and the extent to which various stakeholders retain an interest in the reorganized debtor.

Where bankruptcy valuation involves commodities, timing can be even more crucial—and more complex—than where bankruptcy valuation involves other assets. Commodities are commonly valued on a forward basis using “strip prices,” that is, on the basis of forecasted pricing assuming future delivery dates. Such forecasted pricing makes timing an inherent part of commodities valuation. In addition, certain commodities are, by their nature, subject to particularly high pricing volatility, meaning that relatively small changes in valuation timing can result in relatively large swings in value. One perhaps extreme example of this arose in the recent chapter 11 case of Ultra Petroleum Corp. There, the bankruptcy court ruled that the strip price of natural gas on Presidents' Day should not be counted, because Presidents' Day is not a “trading day” under the relevant plan provision—resulting in a \$500 million change in distributable value.

Bankruptcy courts do not often issue written decisions confronting commodities valuation—or, for that matter, the timing issues inherent in such a valuation. But the Southern District of New York Bankruptcy Court's recent decision in the Sabine Oil & Gas Corp. chapter 11 case addressed these issues head-on. Among other things, the Bankruptcy Court departed from the generally applicable rule that assets are most properly valued on the basis of the most current information and instead used *historical* strip prices (i.e., historical forecasted pricing for future delivery rather than current forecasted pricing) to value the debtor's oil and gas reserves. This new decision arguably opens or widens the door for parties to use more creative valuation methods in bankruptcy, at least in certain asset categories and circumstances.

### **Sabine Decision**

In *In re Sabine Oil & Gas Corp.*,<sup>2</sup> the Bankruptcy Court confirmed a chapter 11 plan of reorganization for Sabine, an energy company engaged in the acquisition, production, exploration and development of onshore oil and natural gas properties in the United States. The decision resolved a dispute between Sabine and the Unsecured Creditors' Committee regarding the amount of the senior secured lenders' "adequate protection claims," pursuant to section 361 of the Bankruptcy Code, against their collateral of oil and gas reserves. Sabine, supported by its lenders, argued that the adequate protection payments proposed in its plan were appropriate, notwithstanding the Committee's position that they were too high, because the value of the collateral (the oil and gas reserves) had historically been lower than it was when the confirmation hearing occurred, given the rising prices of oil and gas at the time. (A lower collateral value means higher adequate protection payments.) The Committee, however, argued that only the collateral's most up-to-date (that is, highest) value should be considered. The Bankruptcy Court thus had to consider the "value" of the adequate protection claims to be settled, which depended on the "value" of the oil and gas reserves acting as collateral.

Notably, this situation presents the reverse of the paradigmatic use of time by debtors to influence valuation—often, debtors file bankruptcy cases at a time when their asset values are in a trough, as a method of making minimum distributions to pre-bankruptcy creditors and conveying maximum upside future value potential for post-bankruptcy investors (which may include certain classes of existing creditors that receive debt for equity through a chapter 11 plan or provide new money to the reorganized debtor). Indeed, Bankruptcy Code provisions like section 1111(b) are designed to mitigate the adverse effect of that method on certain creditors.<sup>3</sup>

The Bankruptcy Court resolved the dispute in *Sabine*, first, by making a number of observations. It noted the "inherent tension involved in performing a valuation analysis using data that is subject to constant change."<sup>4</sup> It continued, "Resolving this tension is especially challenging in the context of a commodity industry such as the oil and gas industry . . . in which pricing is subject to significant volatility, seasonality, and other factors that increase the dynamism of pricing information."<sup>5</sup> The Bankruptcy Court recognized "the requirement that it use information that is sufficiently close to the Forecasted Effective Date [of the chapter 11 plan]" and ruled that the most current information is the "most pertinent."<sup>6</sup> But the Bankruptcy Court also noted that it must balance that requirement and ruling with the "practical reality" of delays within chapter 11 proceedings and with "the concern that what may be a temporary shift in commodity prices could lead to a determination of value that is inequitable to one or more parties."<sup>7</sup> The court ultimately took a broader, more circumspect position and held that it "should give consideration to all pricing assumptions submitted by the parties," sided with Sabine's position that lower historical prices supported a lower valuation (and higher adequate protection payments) than the conclusion reached with the most current pricing alone, and approved Sabine's plan.<sup>8</sup> The Bankruptcy Court reasoned that using historical data was particularly appropriate where it also "fully considered" all strip pricing data, because "the very nature of strip pricing takes into account projected future value."<sup>9</sup>

While this holding was just one aspect of a detailed and complex valuation decision, the use of historical pricing to reduce asset value is significant. The *Sabine* holding arguably opens the door in future bankruptcies (or at least future commodities-driven bankruptcies) for unsecured creditor

committees, equity committees, ad hoc groups and other constituencies to present arguments based on historical, as opposed to current, prices and other alternative evidence of valuation. There are many different ways a party in bankruptcy might use this decision to its advantage. As noted above, the use of time in valuation exercises can benefit debtors and creditors alike, depending on the circumstances of a given case, and more flexibility in valuation analysis can serve to supplement, or challenge, the interests of different bankruptcy constituencies.

### ***Mirant*: Commodities Valuation in a Prior Era**

The idea of performing a valuation analysis based on historical data is not new to bankruptcy in a general sense—theories of valuation like “retrojection” have informed bankruptcy court decisions for decades.<sup>10</sup> For example, courts will sometimes look backward from the value of a debtor’s business at a later date in order to determine whether it was insolvent when a purportedly fraudulent transfer occurred at an earlier time.<sup>11</sup> But while the analysis in such situations does involve using historical data to inform valuation, it does not purport to value an asset on a going forward basis. In this way the approach used by the Bankruptcy Court in *Sabine* does appear to mark a shift in thinking, at least within the context of the surge in oil and gas chapter 11 cases in recent years.

By way of contrast, in *In re Mirant Corp.*,<sup>12</sup> a decision from before the recent increase in oil and gas bankruptcy filings, the Northern District of Texas Bankruptcy Court held a valuation hearing to determine the enterprise value of Mirant, a power producer. The valuation turned on commodity prices (specifically gas) because as the price of gas increased, the price of power increased, with a correlating increase to Mirant’s profit margins. As in *Sabine*, the *Mirant* court made several key observations about the price of gas. First, it recognized “Gas prices will vary potentially depending on major economies . . . ; the political stability of gas producing nations . . . ; availability of liquid natural gas in the United States; development of alternative fuel sources; and other factors.”<sup>13</sup> Ultimately, it stressed using “the best, most current information available” and ordered a recalculation of the value of the debtor because the parties submitted out-of-date strip pricing.<sup>14</sup> *Sabine*, on the other hand, suggests an alternative approach—that although the most up-to-date pricing might be the “best,” historical pricing could also inform a value determination.

### **The Bottom Line**

It remains to be seen how broadly the historical strip pricing aspect of the *Sabine* decision will be emphasized by participants in future chapter 11 cases and how courts may react to any such emphasis. But the *Sabine* decision does mark a thoughtful and updated approach to commodities pricing in chapter 11 cases, and it demonstrates that creative valuation arguments and broad thinking about asset pricing can be helpful tools in chapter 11 advocacy. In short, time can be money, in more ways than one.

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<sup>1</sup> See Agenda for Hearing on Matters Scheduled for March 14, 2017, [ECF No. 1322] and Order Confirming Debtors’ Second Amended Joint Chapter 11 Plan of Reorganization [ECF No. 1324], *In*

*re Ultra Petroleum Corp., et al.*, Case No. 16-32202 (Bankr. S.D. Tex.).

<sup>2</sup> 555 B.R. 180 (Bankr. S.D.N.Y. 2016), *motion to certify appeal denied*, No. 16-CV-2561 (JGK), 2016 WL 6238616 (S.D.N.Y. Oct. 25, 2016), and *appeal dismissed as moot*, No. 16 CIV. 6054 (LAP), 2017 WL 477780 (S.D.N.Y. Feb. 3, 2017).

<sup>3</sup> See *Mastan v. Salamon (In re Salamon)*, 854 F.3d 632, 636 (9th Cir. 2017).

<sup>4</sup> *Sabine*, 555 B.R. at 272.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 310.

<sup>9</sup> *Id.* at 273.

<sup>10</sup> See, e.g., *In re Sullivan*, 161 B.R. 776, 784 (Bankr. N.D. Tex. 1993).

<sup>11</sup> *Id.*

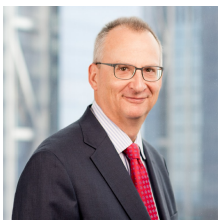
<sup>12</sup> 334 B.R. 800 (Bankr. N.D. Tex. 2005).

<sup>13</sup> *Id.* at 828 n.96.

<sup>14</sup> *Id.* at 829.

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