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CLIENT ALERT

Sponsors Monetize Midstream Cash Flows and Retain Upside through ABS

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Asset-Backed Securitization in Midstream Oil & Gas

"ABS" is a natural fit for midstream oil and gas assets because the assets generate predictable, contracted cash flows — exactly what securitization markets reward. Here's how a securitization transaction typically works:

The Core Structure

A midstream company (the originator/sponsor) isolates a pool of revenue-generating assets into a Special Purpose Vehicle (SPV) — a bankruptcy-remote entity that issues securities to capital markets investors. The SPV's debt is serviced solely by the cash flows from those assets, not the parent's balance sheet.

What Assets Get Securitized?

Midstream lends itself well to ABS because of the fee-for-service, take-or-pay contract model:

- Pipeline tariff revenues — FERC-regulated or bilateral contracts with minimum volume commitments

- Gathering & processing fees — particularly if underpinned by dedications from E&P producers
- Storage capacity contracts — fixed reservation fees
- LNG terminal throughput fees — long-term tolling agreements
- Terminal and export fees — ship-or-pay structures

The common thread: cash flows that look more like utility revenue than commodity exposure.

How the Structure Works (Step by Step)

1. Asset Identification & Ring-Fencing

The sponsor selects a subset of assets with the cleanest, most predictable cash flows — ideally investment-grade counterparties on long-dated take-or-pay contracts. These are contributed or sold to the SPV.

2. True Sale

The transfer must qualify as a "true sale" under bankruptcy law, meaning the assets are legally isolated from the sponsor's estate. If the sponsor goes bankrupt, SPV assets are beyond creditor reach — this is the foundation of the bankruptcy-remote structure.

3. SPV Issues Securities

The SPV issues tranched securities to investors:

- Senior notes (AAA/AA) — first priority on cash flows; lowest yield
- Mezzanine notes (A/BBB) — subordinated; higher yield
- Equity/residual interest — often retained by the sponsor; absorbs first losses but captures upside

4. Credit Enhancement

To achieve investment-grade ratings on senior tranches, the structure typically includes:

- Overcollateralization — asset pool generates more cash than needed to service the notes
- Debt service reserve accounts (DSRA) — a cash reserve covering several months of payments
- Subordination — junior tranches absorb losses before senior tranches

- Liquidity facilities — backup credit lines for timing mismatches

5. Cash Waterfall

Operating revenues flow into a lockbox/collection account, then distributed in strict priority order: operating expenses → senior debt service → reserve replenishment → mezzanine service → residual to sponsor.

Why Midstream Companies Do This

Balance sheet efficiency — moves debt off the parent's consolidated balance sheet (if structured as a non-consolidating SPV), preserving credit metrics and revolver capacity.

Lower cost of capital — the SPV's senior notes can achieve ratings above the parent, because the cash flows are isolated from corporate risk. A BBB-rated midstream company might achieve AAA on senior SPV notes.

Monetization without full asset sale — the sponsor retains the residual/equity in the SPV, capturing long-term upside while getting immediate liquidity from note proceeds.

Match funding — long-dated pipeline contracts can be matched with long-dated fixed-rate notes, eliminating refinancing risk on those assets.

Investor diversification — accesses insurance companies, pension funds, and structured finance buyers who may not buy midstream corporate bonds but will buy investment-grade infrastructure ABS.

Key Risks Investors and Rating Agencies Focus On

- Volume risk — do the contracts have true minimum volume commitments, or are they interruptible?
- Counterparty credit — who are the shippers? An E&P producer going bankrupt can reject pipeline contracts in Chapter 11.
- Regulatory risk — FERC rate cases can reduce tariff revenues on regulated pipelines
- Reserve tail risk — for gathering systems, does the underlying production decline faster than the debt amortizes?
- Commingling — are SPV revenues truly isolated from the parent's operating accounts?

The beauty of this structure for a midstream company is that it lets the contracted, bond-like portion of its cash flow stream be valued and financed like a bond — at bond market rates — while the sponsor retains the operational upside. It's essentially a way to arbitrage the difference between how equity markets value midstream cash flows versus how fixed-income markets do.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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