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Presents

THE THIRD NATURAL GAS CONFERENCE

How To Survive and Profit In The New Natural Gas Industry

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The Third Natural Gas Conference

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I. THE NATURAL GAS ACT OF 1938

A. The Need for Federal Regulation: Unregulated Interstate Pipeline Monopoly Power

1. States lack authority to regulate the transportation of natural gas in interstate commerce. West v. Kansas Natural Gas Co., 221 U.S. 229 (1911).

2. States lack authority to affect rates charged by interstate natural gas pipeline companies at the "city gate." Public Utility Comm'n v. Landon, 249 U.S. 236 (1918); Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924).

3. State where gas is produced lacks authority to determine the price which an interstate pipeline can charge for gas sold outside the producing state. Public Utility Comm'n v. Attleboro Steam & Electric Co., 273 U.S. 83 (1927).

4. Net effect: Local distribution company (LDC) at the mercy of the interstate pipeline concerning the price and terms for the purchase of gas.

   a. Commerce clause prohibited the states from regulating the sale of gas at wholesale, or its transportation, when the gas crossed state lines.

   b. Although the commerce clause was deemed to reserve this authority to the federal government, it had not acted to regulate the area.

5. During this same period there was substantial consolidation of gas and electric companies under the control of large public utility holding companies. This tended to magnify the monopoly position of the interstate pipeline.

B. The Natural Gas Act of 1938

1. 15 U.S.C. §§ 717 to 717w.

2. § 1(b) of the NGA <u>grants</u> authority to the federal government over:

    a. The transportation of natural gas in interstate commerce;

    b. The sale in interstate commerce of natural gas for resale for ultimate public consumption;

    c. Natural gas companies engaged in such transportation or sale; and

    d. Facilities used to conduct the regulated interstate activities.

3. § 1(b) of the NGA <u>limits</u> federal authority over:

    a. The production or gathering of natural gas;

    b. Intrastate transportation of natural gas;

    c. Intrastate sales of natural gas;

    d. Interstate sales of natural gas that are made directly to an "end user" and <u>not</u> for resale; and

    e. The local distribution of natural gas.

4. Basic goal was to "fill the gap" created by the commerce clause by exercising federal authority in areas where the states were constitutionally unable to regulate.

5. NGA required those within its jurisdiction to obtain commission (Federal Power Commission (FPC) - now the Federal Energy Regulatory Commission (FERC)) approval before it could commence or cease providing service. Must obtain a certificate of public convenience and necessity to construct or extend facilities. The regulatory scheme created "protected" market areas.

a. Rates and charges must be "just and reasonable."

b. Unreasonable discrimination in rates and charges prohibited.

c. Power to ascertain the "actual legitimate cost" of property used to provide the service.

6. Under the NGA a "cost of service" rate making approach is employed.

a. The goal is to find out what it "costs" to provide the service and then give the regulated monopoly the opportunity to recover its costs and earn a return on the assets it employs in providing the service.

b. The rate charged for the gas is determined by how much it costs to provide the "service." In addition to recouping its operating expenses, the regulated monopoly is permitted a rate of return on assets that are used in providing the service.

C. <u>Phillips Petroleum Co.</u> <u>v.</u> <u>Wisconsin</u>

1. 347 U.S. 672 (1954).

2. Whether a sale of gas by an independent producer (unaffilitated with the pipeline purchaser) to an interstate pipeline, was exempt from the NGA as a "production or gathering" activity.

3. Court held this was a "sale for resale" subject to regulation under the NGA.

a. Court thought it was necessary to have federal jurisdiction over the gas producer because a major component of the pipeline's recoverable costs (operating costs) was the price it paid for gas at the wellhead.

b. If the pipeline could properly include the price it paid for gas to calculate its rates, the federal government would not have effective control over what the consumer ultimately paid for gas.

c. However, note that the gas producer is not a natural monopoly - the producing segment of the gas industry is structurally competitive.

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4. FPC was forced to regulate thousands of gas producers.

   a. Initially attempted to use the tradional cost of service rate making approach applied to interstate pipelines.

   b. Shifted to area-wide rate making. See Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

   c. Eventually shifted to nation-wide rate making. See Shell Oil Co. v. Federal Power Comm'n, 520 F.2d 1061 (5th Cir. 1975), cert. denied, California Co. v. FPC, 426 U.S. 941 (1976).

II. THE NATURAL GAS POLICY ACT OF 1978

A. Curtailment

1. Federal regulation of gas prices tended to keep them below the value of gas in the intrastate markets. Difficulty in attracting gas sales into the interstate markets.

2. Interstate pipeline gas service began being curtailed in the early 1970s. Oil prices were rising, the NGA regulatory mechanism could not keep pace, gas was lost to intrastate markets. The shortages became severe for customers served by interstate pipelines.

B. Abandonment of Cost-Based Gas Pricing

1. NGPA abandoned cost of service rate making for setting gas prices.

2. Instead, the NGPA establishes a schedule of "maximum lawful prices" that can be charged for various types and vintages of gas.

C. Uniform Pricing for All Gas Markets

1. Federal regulation extended to intrastate sales.

2. Although the interstate/intrastate dichotomy is recognized for certain existing gas contracts, new gas sales would be treated similarly.

D. Phased Deregulation

1. Except for certain categories of gas, the NGPA pricing limitations would expire between 1979 and 1987.

2. Basic fear was once the price of gas was deregulated the price would increase.

III. THE NGA/<u>PHILLIPS</u>/NGPA LEGACY

A. NGA and <u>Phillips Petroleum Co. v. Wisconsin</u>

1. Divided the industry into three distinct functional segments:

   a. Production - Oil and gas companies explore for and extract gas which they sell at or near the field where it is produced.

   b. Transportation - Pipeline buys gas from producer at or near the field where produced and transports it to either:

      (1) Another pipeline.

      (2) A "local distribution company" (LDC).

      (3) An "end user," such as ~~the Acme Refinery~~ a factory.

   c. Distribution - An LDC buys gas from the Pipeline for resale to LDC customers - such as a homeowner buying gas, from the local gas utility company, to heat their home.

2. Producers were seldom able to deal directly with end users and LDCs because they were dependent upon the pipeline to move their gas from the point of production to its point of ultimate consumption.

3. Pipelines are not "common carriers." They could refuse to transport gas even though the producer (or end user, LDC, or an upstream or downstream pipeline) was willing to pay the requested transportation rate and there was pipeline "capacity" (space) available to move the gas.

4. Pipelines were therefore able to maintain a regulated monopoly over the gas merchant function as well as the transportation function.

a. By controlling access to transportation, they could control, or eliminate, gas sales competition by producers. At the other end of the tube, it eliminated the ability of the end user and LDC to shop around for gas.

b. By controlling access to transportation, they could exert monopsony pressure on Producers to try and obtain gas on the most favorable terms possible.

c. The transportation monopoly could be protected by using the regulatory system to make it difficult, and expensive, for other interstate pipelines to obtain the right to service areas served by an existing pipeline.

d. The only major source of competition under the NGA was from intrastate pipelines which generally served only states which had significant gas production. However, they competed against the interstate pipelines in two arenas:

(1) Gas purchases from producers; and

(2) Gas sales to end users and in-state distributors.

B. NGPA

1. It was ultimately intrastate competition for gas supplies (purchases) that gave rise to the NGPA. In effect, the NGPA eliminated price-competition for wellhead purchases of gas by establishing the maximum price that could be paid for the gas by any entity (interstate or intrastate).

2. However, the maximum price approach would (from 1979 through 1987) be phased out (for most "new gas" supplies) and market forces would presumably determine the price paid for gas at the wellhead.

3. The amount paid for gas by the pipeline could be "passed through" to its gas customers (end users, LDCs, downstream pipelines), so long as the price paid for gas at the wellhead did not exceed the NGPA maximum lawful price -- UNLESS it could be demonstrated the gas purchase was "excessive due to fraud, abuse, or similar grounds." NGPA § 601(c)(2). 15 U.S.C. §

4. The NGPA (§ 311) also attempted to integrate the

intrastate, interstate, and LDC gas transportation systems by permitting each segment (interstate pipeline, intrastate pipeline, local distribution pipeline) to haul gas for one another without pursuing burdensome regulatory procedures.

However, it remained purely optional with each segment whether it desired to deal with one or more of the other segments.

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~~IV.~~ RESTRUCTURING FOR EFFECTIVE COMPETITION

A. FERC Initiatives

1. FERC has acknowledged that only the transportation function requires regulation as a natural monopoly. The production and sales function is structurally competitive; regulation suitable for a natural monopoly is unnecessary.

   FERC is now proceeding to dismantle 35 years (and in some cases 50 years) of regulated gas marketing.

2. FERC is attempting to relieve each of the three main bottlenecks in the gas marketing system:

   a. Limitations on producer and LDC/end user access to transportation.

   b. Limitations on LDC/end user ability to shop around for gas.

   c. Limitations on producer ability to sell gas to anyone but the pipeline.

B. Eliminating the Transportation Bottleneck - Special Marketing Programs

1. Early attempts by FERC to provide access to pipeline transportation facilities: "Special Marketing Programs" (SMPs).

   a. Designed to permit producers and pipelines to compete for customers which could readily switch to competing fuels.

   b. Designed to permit producers to market increased gas volumes while providing pipeline benefits in the form of:

      (1) Reduced take-or-pay liability; and

(2) Increased throughput.

c. Permit the sale of gas at discounted prices, or provide transportation services, to permit gas transactions at unit prices below the pipeline's weighted average cost of gas (WACOG).

(1) Often the pipeline's WACOG exceeded the cost of competing fuels - such as #2 or #6 fuel oil.

(2) The pipeline's "captive customers," those that could not switch to alternative energy sources (most LDCs and their residential customers), generally had to purchase gas at the pipeline's WACOG - they were prohibited from pruchasing SMP gas. Only customers currently using alternate fuels could buy SMP gas.

2. In Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985) (MPC I) and 761 F.2d 780 (D.C. Cir. 1985) (MPC II), the court held SMPs which gave one class of customers discounted gas prices (MPC I) or access to transportation to facilitate direct sales (producer to end user) (MPC II), while denying it to another class of customers, vioated the NGA's prohibition of "undue discrimination."

3. FERC responded with Order No. 436.

C. Eliminating the Transportation Bottleneck - FERC Order No. 436

1. Pipeline given the option to seek a "blanket certificate" to provide transportation services.

2. Under the non-Order 436 regime, FERC must approve all transportation transactions and specifically authorize the pipeline to provide the service.

3. Two types of transportation authorization:

a. Certificate of public convenience and necessity issued under NGA § 7(c).

NGA § 7(c) provides, in part:

"(c)(1)(A) No natural-gas company . . . shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor . . . unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations . . . ."

b. "Self-implementing" transactions "on behalf of" intrastate pipelines or LDCs pursuant to NGPA § 311.

NGPA § 311 provides, in part:

"(a)(1)(A) . . . The Commission may, by rule or order, authorize any interstate pipeline to transport natural gas on behalf of -
(i) any intrastate pipeline; and
(ii) any local distribution company.

"(a)(2)(A) . . . The Commission may, by rule or order, authorize any intrastate pipeline to transport natural gas on behalf of -
(i) any interstate pipeline; and
(ii) any local distribution company served by any interstate pipeline."

4. Primary benefit of an Order 436 (Part 284) Blanket Certificate:

a. "Blanket" certificate of public convenience and necessity authorizing transportation by pipeline on behalf of others (e.g., interstate pipelines, end users, producers) without having to obtain a prior certificate for each transaction.

b. Generic authority to <u>engage</u> in NGA § 7(c) transactions <u>and</u> generic authority to <u>abandon</u> the service once the transaction is completed.

(1) Under NGA §7(b): "No natural-gas company shall abandon . . . any service . . . without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the . . . present or future public convenience or necessity permit such abandonment."

(2) The Order 436 blanket certificate

authorizes pre-granted abandonment upon the expiration of the underlying transportation agreement.

c. This reduction of regulatory review of transportation functions allows the pipeline to react quickly to transportation requests and compete for gas sales and transportation business.

d. Other major Order 436 incentives:

(1) Freedom to discount transportation rates within a minimum and maximum rate band approved by FERC.

(2) Availability of "optional expedited certificates" to construct facilities necessary to provide transportation services. Eliminates the traditional protracted §7(c) certificate process - but the pipeline's stockholders must assume the risk that the new facility will not generate enough income to recoup their construction investment.

e. FERC has fashioned its subsequent orders to provide pipelines with additional incentives to accept an Order 436 blanket certificate.

5. Public interests, previously protected by case-by-case review of § 7(c) transactions, are protected by the pipeline agreeing to specific blanket certificate conditions specified in Order 436.

6. The major condition is that pipelines must provide transportation on a non-discriminatory "open-access" basis.

7. Other Order 436 Conditions:

a. Pipeline must offer firm and interruptible service.

b. Pipeline capacity must be allocated on a "first-come, first-served" basis.

c. Employ generic rate conditions in developing their transportation rates. Rates must be:

(1) Cost-based (what does it cost the pipeline to provide the specified

service). Note that items (2) through (8) are merely refinements of the cost-based rate requirement.

(2) Volumetric-based (the quantitiy of gas being moved).

(3) Transportation component of the rate must be the same whether the service being requested is "sales" or "transportation."

(4) Must breakout (unbundle) the costs of pipeline services such as gathering, transportation, and storage.

(5) Based upon projected units of service.

(6) Based upon whether the service is firm or interruptible service.

(7) Based upon the time of service: peak or off-peak.

(8) Based upon the distance gas is moved.

D. Eliminating the Demand Bottleneck -

1. FERC has attempted to address the demand bottleneck by eliminating regulatory and contractual restrictions which, directly or indirectly, foreclose an end user or LDC from seeking alternative gas supplies.

2. FERC Order No. 380

a. FERC found that minimum charges imposed upon a pipeline's gas sales customers, regardless of their gas purchase levels, made it economically impossible for such customers to shop around for lower priced gas supplies.

b. Order 380 focused on the imposition of a "minimum commodity bill" for variable costs (those that vary with the level of service - the primary variable cost being purchased gas costs). The customer had to pay for a minimum amount of gas even though they didn't take any gas.

The minimum bill was designed to compensate the pipeline for having the reserves available to provide the full contracted service. The pipeline would generally contract with producers for the reserves necessary to provide the level of service its customers demanded. The minimum bill mechanism was the primary means used by pipelines to recoup their take-or-pay payments to producers.

c. Order 380 was generally affirmed in <u>Wisconsin Gas Co.</u> <u>v.</u> <u>FERC</u>, 770 F.2d 1144 (D.C. Cir. 1985).

3. FERC Order No. 436

a. Provides the firm sales customers of a pipeline the option to convert firm sales service to firm transportation service.

b. Order 436 also allowed firm sales customers to reduce the amount of gas they had contracted to purchase from the pipeline (contract demand "CD" reduction vs. contract demand "CD" conversion). In <u>Associated Gas Distributors</u> <u>v.</u> <u>FERC</u>, 824 F.2d 981 (D.C. Cir. 1987) the CD reduction part of Order 436 was remanded for FERC's reconsideration.

4. FERC Order No. 500

a. Recognizing the value of having pipelines provide backup gas supply service to its customers (sales <u>and</u> transportation), pipelines can impose a charge for maintaining gas supplies for backup service (identified by many different names: future gas supply charge, gas inventory charge, etc.).

b. This is essentially a minimum bill. FERC has described the difference between this minimum bill and the Order 380 situation as follows:

"The minimum commodity bill was an attempt to deal with this (take-or-pay) problem, but its design did not work well as competition increased. One central problem was that the minimum bill was not the result of voluntary selection from a menu of services that enabled the customer to obtain exactly the level of supply security it desired at a charge known in advance. The principles underlying future gas supply charges, as adopted here, are intended to remedy this problem."

5. Congress has acted to reduce the demand bottleneck by:

   a. Eliminating restrictions on the use of gas for certain purposes. _See_ Pub. L. No. 100-42, 101 Stat. 310 (1987). In 1978 Congress enacted the Powerplant and Industrial Fuel Use Act of 1978 (PIFUA), Pub. L. No. 95-620, 92 Stat. 3289 (1979), which restricted the use of gas to generate electricity and as a fuel for other major fuel burning facilities.

   b. Eliminating pricing mechanisms which discourage industrial use of gas as a fuel source. _See_ Pub. L. No. 100-42, 101 Stat. 310 (1987). In 1978, as part of the Natural Gas Policy Act, Congress required the imposition of "incremental pricing" to raise the cost of gas to levels that approached the "appropriate alternative fuel costs."

E. Eliminating the Supply Bottleneck

1. Even though FERC was able to open up new markets for gas (Demand), and provide access to such new markets (Transportation), two impediments on the Supply end of the pipeline had to be addressed: 1. Gas reserves tied-up by long-term contracts; and 2. Gas reserves tied-up by the service abandonment requirement of NGA §7(b).

2. Abandonment

   a. Traditional Approach - gas subject to service obligation even though the gas sales contract terminated (or the underlying oil and gas lease terminated). To obtain abandonment of the service obligation, must initiate proceeding under NGA §7(b) and demonstrate the need of the new (proposed) gas sale customers are greater than the needs of the existing customers.

   b. FERC has attempted to reduce the regulatory burden of the abandonment requirement by:

      (1) Using pre-granted abandonment when the service is certificated.

      (2) Granting limited-term abandonments.

      (3) Authorizing abandonment "legislatively"

by rule when certain conditions exist.

c. The test for determining whether the public convenience and necessity will be served by abandonment has been changed by FERC to compare the needs of existing customers with the benefits freeing-up the gas would offer to the market as a whole.

   (1) FERC takes the view that the market benefits will, in most every case, exceed the needs of the existing customers. This permits a generic (legislative vs. adjudicatory) approach to abandonment.

   (2) FERC's new comparative needs test was generally approved in <u>Consolidated Edison Co. of New York</u> <u>v.</u> <u>FERC</u>, 823 F.2d 630 (D.C. Cir. 1987).

d. FERC Order No. 490 - permit party to an expired contract to abandon the service without a §7(b) proceeding - merely give 30 days notice to other party and "report" the abandonment to FERC within 30 days after it occurs.

   (1) Applies to expired or terminated contracts where there is a NGA service obligation.

   (2) Applies to contracts to the extent a pipeline has exercised its contractual authority to reduce takes below the specified level.

   (3) Applies to contracts where the parties mutually agree to abandonment.

   (4) Producers are granted blanket certificates to resell the abandoned gas.

e. FERC Order No. 451 - authorizes abandonment if the "good faith negotiation" procedure results in a termination of the gas contract. Also give producers blanket sales certificates.

f. FERC Order No. 436 - authorizes expeditious Commission action on abandonment requests to facilitate take-or-pay settlements between producers and pipelines.

3. Long-Term Contracts - FERC Order No. 451

a. Order 451 permits producers with old low-priced gas contracts (NGPA §§ 104 & 106) to force their pipeline purchaser into negotiations (~~either~~ through voluntary action or through forced "good faith negotiations" (GFN)) to raise the price of the gas to an amount which more nearly represents the current market value of the gas.

Pipeline has a reciprocal right, against the producer triggering the GFN process, to bring ~~to the~~ table any high-priced gas which is sold with ~~low-priced~~ old gas (~~sold under the same contract~~). Pipeline can force the producer to negotiate to reduce the high-priced gas to a price which more nearly represents the current market values.

If the parties agree on a new price - the contract continues. If they fail to agree - the contract can be terminated by either party and the gas abandoned from the service obligation.

b. Target Price Used - highest price authorized by NGPA for post-1974 vintage old gas ($2.57 per MMBtu as of June 6, 1986). Spot gas price on ANR's Custer County, Okla. receipt point/zone for August 1988 was $1.30/MMBtu.

c. Before producer can use the 451 process, must have a contract which authorizes higher prices - such as an area rate clause (clause which permits the contract price to rise to ~~levels established by applicable regulation~~).

b ~~d~~. Effect of Order 451 will be to arrive at new contracts which reflect the current market environment or the termination of existing contracts to permit the parties to bargain with others.

c ~~e~~. Order 451 grants abandonment of old sales where the parties fail to agree and provides blanket certification of new sales.

V. TRANSITION PROBLEMS: TAKE-OR-PAY

A. Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987).

1. Upholds most of FERC's goals expressed in Order 436 but remands it because the court felt the new gas market was being created at the expense of the pipeline.

2. Required FERC to provide pipelines with some sort of relief from take-or-pay obligations under existing gas contracts as part of the consideration for pipelines providing open access (which will expose them to greater competition).

B. FERC's Response to Associated Gas: Order 500

1. Retains much of the Order 436 principles but conditions producer access to pipeline transportation on the producer providing take-or-pay credits for any gas shipped on the pipelines.

2. Cross-Crediting: If producer has a take-or-pay (or take-and-pay) contract (executed before June 23, 1987), and they ship gas on an interstate pipeline which owes take-or-pay to the producer, the pipeline can obtain a "credit" against its liability for failure to take the producer's gas. This credit can be applied to any take obligation (back to January 1, 1986) under any contract the pipeline has with the shipping producer.

   Each MCF of gas transported by the pipeline earns the pipeline one MCF of take-or-pay credit which it can apply to any contract it has with the producer that owned the gas on June 23, 1987 - (exception for take-and-pay obligations under cansinghead gas contracts).

C. A Guide To Take-or-Pay Crediting

1. Qualifying Dates

   a. The Contract: Take-or-pay (or take-and-pay) contract executed before June 23, 1987.

   b. The Producer: Owner of the gas on June 23, 1987.

   c. The Service: Transportation on or after January 1, 1988 (of gas "owned" by the

Producer) by interstate pipeline having a Contract with the Producer. Remember - gas ownership is determined as of June 23, 1987 - NOT when the gas is shipped.

d. The Credit: One MCF of gas for each MCF of gas transported on or after January 1, 1988. The credit can be applied to any take-or-pay obligation with the Producer accruing <u>after January 1, 1986</u> (so long as the pipeline perfromed open access transportation during some portion of 1986). → or any subsequent year in which they seek to apply the credit

2. The "Offer of Credit"

a. If you tender gas for transportation, must provide the transporter with an offer of credit - even though no credit is due.

b. Pipeline must ship the gas even if they dispute the adequacy of the offer of credit.

c. 85% Rule - Before the pipeline is obligated to ship, must have offers of credit covering at least 85% of the working interest owners of the gas to be shipped. Shipper must also provide a list of the working interest owners refusing to provide offers of credit.

The nonconsenting 15% need not offer to credit - but if any gas is ever shipped at their request (or their assignee), and they provide an offer to credit, the prior gas shipped will become subject to credits.

d. Gas Processor Exception to 85% Rule - Offer of credit for residue gas sales need to be signed only by the processing plant operator when the processor <u>purchases</u> gas from behind-the-plant producers under percentage-of-proceeds processing agreements entered into on or before June 23, 1987.

Pipeline can apply credits only against its take-or-pay obligations under pre-June 23, 1987 take-or-pay contracts with the plant operator. See FERC Order 500-C.

e. Change of Gas Ownership - if <u>A</u> owns the gas on June 23, 1987, and assigns its lease to <u>B</u> on September 1, 1987, when the gas from the lease is tendered for transport on January 1, 1988, <u>A</u> <u>and</u> <u>B</u> must provide the pipeline with offers of credit.

3. Crediting Exemptions - the following activities will not generate credits (however, the pipeline may insist upon a signed offer of credit even though no credit will be allowed):

   a. Transportation of "new" gas - gas from wells spudded after June 23, 1987. Use § 102 NGPA 2.5 mile test, 1000 feet below exisitng production test, and new reservoir test. FERC Order 500-C.

   b. Transportation which generates credits for intrastate pipeline pursuant to a release of intrastate system supply gas - subject to certain conditions. FERC Order 500-C.

   c. Gas sold to a processing plant under a percentage-of-proceeds gas processing agreement entered into on or before June 23, 1987. FERC Order 500-C.

   d. Gas sold by producer which doesn't have a pre-June 23, 1987 take-or-pay contract with the transporting pipeline.

   e. Gas previously purchased by the pipeline under a terminated take-or-pay contract.

   f. Gas released from a take-or-pay contract containing a market-out clause which gives the pipeline discretion to terminate the contract.

4. Special Situations

   a. Released Gas - pipeline can elect whether it will follow settlement agreement crediting mechanism or the Order 500 mechanism.

   b. Multiple Pipelines - where credits will be generated for more than one pipeline in a single transportation transaction, if one of the pipelines released the gas, only the releasing pipeline will receive credits.

      If the gas is not released by any of the pipelines, the transaction will generate the same amount of credits but they will be shared between the transporting pipelines. The pipelines will agree how credits will be allocated.

If gas transported and one of the pipelines formerly purchased the gas under a terminated or market-out contract, none of the pipelines are entitled to a credit.

c. Casinghead Gas - Purchaser cannot <u>use</u> a take-or-pay (or take-and-pay) credit to <u>excuse</u> taking casinghead gas under a take-<u>and</u>-pay contract. Purchaser will remain obligated to take the gas and receive a credit. However, the credit must be applied to a non-casinghead gas contract take obligation.

D. Take-Or-Pay Buyout And Buydown Costs

1. Order 500 provides an optional procedure for pipelines to recover a portion of the costs it incurs to settle take-or-pay claims with gas producers.

   a. If the pipeline agrees to absorb from 25% to 50% of its settlement costs, it may apply to recover an equal percentage of its costs through a fixed charge to its customers.

   The balance of its settlement costs, not to exceed 50%, can be recouped through its commodity charge or a volumetric surcharge.

2. Pipeline may elect not to accept any of the costs and seek to recover all <u>prudently</u> <u>incurred</u> costs in their commodity charges.

VI. NEW PROBLEMS

A. Allocating Pipeline Capacity

1. Order 436 allocates capacity in a two-step process:

   a. Capacity is first given to existing pipeline customers who convert from pipeline sales service to transportation service.

   b. Remaining capacity is allocated on a "first-come, first-served" basis.

2. Order 436 prohibits "capacity brokering" which would permit, for example, an LDC to package and sell its transportation rights to third parties - such as a gas marketer, gas broker, producer, end user, or another pipeline.

3. On April 4, 1988, FERC issued a proposed rule which would permit capacity brokering. 53 Fed. Reg. 15,061 (April 27, 1988).

   a. Proposed rule permits interstate pipelines, and those who hold firm transportation on interstate pipelines, to sell or assign their firm transportation rights.

   b. To permit capacity brokering, the pipeline must accept an Order 436/500 blanket certificate and apply for a "system brokering certificate."

   c. Any entity desiring to broker capacity on a pipeline must obtain a "blanket broker certificate."

4. Major problems:

   a. Defining the right to be traded.

   b. Policing the process to ensure the pipeline, or another entity, does not restrict pipeline access by controlling capacity rights.

5. Major benefits:

   a. Permit maximum use of the transportation service.

   b. Create a technique whereby new transportation arrangements could be readily created. Broker could repackage transportation options by adjusting receipt points, delivery points, volumes, and dispatching times.

B. Affiliate Transactions

1. Most pipelines have created marketing affiliates which participate in the new gas market as gas marketers, brokers, etc.

2. Major concern is that the pipelines will favor their affiliates in various ways that will give the affiliated entity an unfair advantage over its competitors.

3. June 1, 1988 FERC issued Order No. 497 which establishes new standards of conduct and reporting requirements for interstate pipelines that are affiliated with gas marketers, brokers, etc.

4. Defining the "affiliate": Ability to direct the management or policies of the entitiy. 10% voting rights in the entitiy creates a presumption that the pipeline has the ability to direct the entity.

5. Cannot favor the affiliate with privileged information, or provide it with advanced notice of events, or provide it with information not given to other shippers.

6. Must create similar conditions for all shippers who are similarly situated. E.g., cannot give an affiliate scheduling and curtailment priorities merely because they are an affiliate.

7. Can discount transportation rates to the affiliate within the FERC-specified rate band - but only if the pipeline has accepted an Order 436/500 blanket certificate.

8. Must file reports with FERC concerning affiliate transactions. FERC can impose a $5,000 civil penalty for each day a pipeline violates the Order 497 requirements.

C. State Issues

1. Pass-through of take-or-pay costs billed to LDC as a customer of the pipeline. Must the LDC allocate the costs according to the formula used by their billing pipeline? Can the State evaluate the prudence of the buyout/buydown costs billed under Order 500's guidelines?

2. To what extent will the States pursue "open access" policies which mirror, or coincide with, FERC's programs?

3. Bypass

   a. Open access transportation, and the optional expedited certificate, set the stage for interstate pipelines to "raid" the best customers currently served by an LDC.

   b. E.g., Panhandle Eastern Pipe Line Company initiated gas transportation services directly to National Steel Corporation - bypassing Michigan Consolidated Gas Company which was the LDC that had traditionally provided National Steel with gas sales and transportation services. The arrangement was affirmed by the Commission in Opinion No.

275-A (September 7, 1987).

Subsequently the Michigan Public Service Commission sought to exercise its jurisdiction over the delivery of gas to National Steel. In National Steel Corp. v. Long, No. L87-30 CA5 (W.D. Mich. June 16, 1988), the court held State action conerning the matter was preempted by the Natural Gas Act.

THE UNIVERSITY OF TULSA
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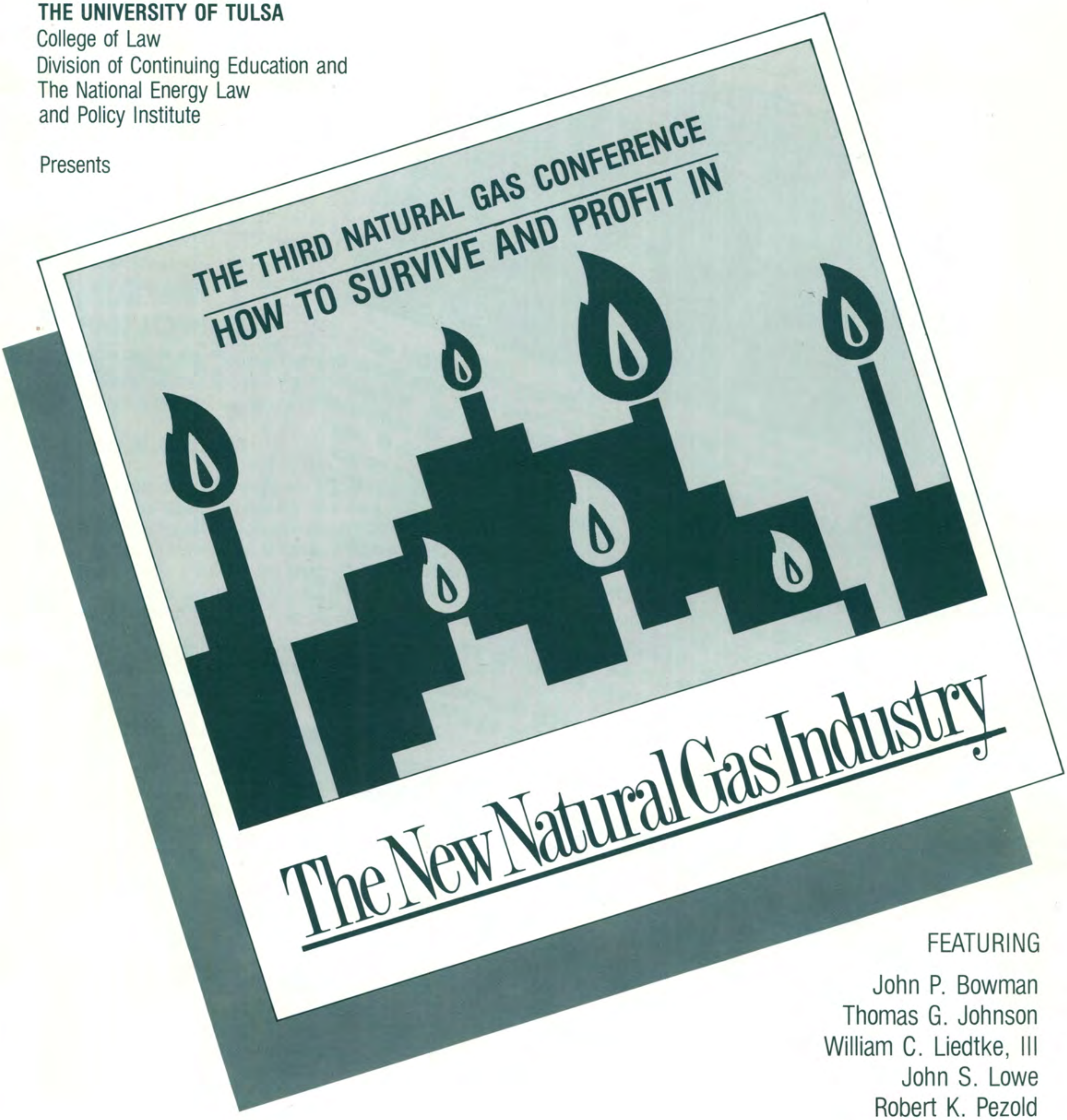
Presents



FEATURING

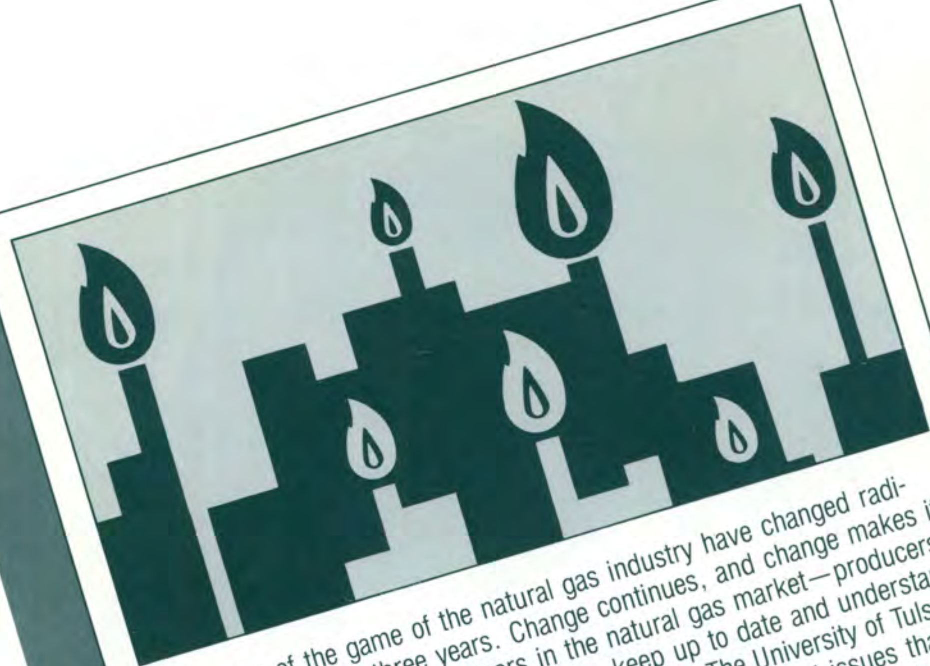
John P. Bowman
Thomas G. Johnson
William C. Liedtke, III
John S. Lowe
Robert K. Pezold
David Pierce
Randall Rich
Laurie Anne Williams

1988 FALL DATES December 7-8 Houston, Texas December 14-15 Tulsa, Oklahoma

HOW TO SURVIVE AND PROFIT IN

The New Natural Gas Industry

THIRD NATURAL GAS CONTRACTS CONFERENCE



The rules of the game of the natural gas industry have changed radically over the last three years. Change continues, and change makes it imperative that all of the players in the natural gas market—producers, pipelines, brokers and their lawyers— keep up to date and understand the implications of the new rules of the market. The University of Tulsa's Third Natural Gas Conference will focus upon the current issues that are the keys to survival and profit for everyone in the natural gas industry.

Our panel of distinguished attorneys will analyze and discuss:

- Regulation of the gas industry, including new and pending rules, and what effect they will have on you.
- How to negotiate and draft to take full advantage of what the rules will permit and the market will bear, as well as protect yourself against its swings.
- The current status of take-or-pay litigation, and other emerging litigation that will present risks and opportunities for those in the natural gas business.

WHO SHOULD ATTEND

This conference is designed for attorneys, accountants, gas industry managers, marketing representatives and contracts administrators, bankers and executives of producers, brokers, and pipelines—anyone who works in the gas industry should attend.

CONTINUING LEGAL EDUCATION

- This course has qualified for Continuing Legal Education credit in several states including Oklahoma, Kansas, Texas, and Colorado.
- Attorneys admitted to the bar of other states with mandatory CLE requirements should so indicate on the registration form so that this program can be filed for accreditation in the appropriate jurisdictions. Similar programs conducted by The University of Tulsa's College of Law in the past have been routinely approved for credit by the jurisdictions with such requirements.
- Continuing Professional Education credit for accountants is also available.
- Application has been made to the Texas Board of Legal Specialization for credit toward the Continuing Legal Education requirement for certification and recertification in oil, gas and mineral law, and civil trial law.
- This course also contains one hour of Ethics/Professional Responsibility credit.
- Application has been made to the American Association of Petroleum Landmen for recertification credits.

PROGRAM OUTLINE

What the New Rules of the Marketplace Mean to You.
- Open Access Transportation: Progress and Problems
- Status of Order 490 Abandonment
- Gas Inventory Charges
- FERC's Agenda under the New Administration in Washington

Natural Gas Litigation (or What Skeletons Do You Have in Your Closet and What Can You Do About Them?)
- New Claims and Defenses Emerging in Take-or-Pay Litigation
- Royalty Owners' Claims to Take-or-Pay Settlements: The Implied Covenant to Market Revisited
- Good Faith Bargaining Claims
- Gas Balancing Issues: The Next Wave of Gas Industry Litigation

Contract Drafting and Administration
- Key Provisions in Gas Industry Contracts
- Price Redetermination and Quantity Provisions in the 1990's
- Administering the New Generation of Contracts.

ABOUT THE INSTRUCTORS

John P. Bowman is an attorney in the Houston office of Fulbright and Jaworski. Mr. Bowman has dealt with a variety of litigation for pipeline clients and now practices primarily before the Oil and Gas Division of the Texas Railroad Commission. He will discuss current problems and issues that confront intrastate producers and purchasers of natural gas in Texas at the Houston presentation.

Thomas G. Johnson is of counsel to Dotson, Babcock, and Scofield in Houston, Texas, as well as the president of the Federal Energy Bar Association. Until recently, Mr. Johnson was General Attorney responsible for natural gas regulatory matters for Shell Oil Company. Mr. Johnson will lead the discussion of regulatory issues in Houston.

William C. Liedtke, III is an independent gas marketing consultant in Oklahoma City. Before opening his own business, Mr. Liedtke practiced law with Fulbright and Jaworski, and worked as a landman and manager of Oil and Gas Marketing for Trigg Drilling Co.

John S. Lowe teaches oil and gas law at Southern Methodist University in Dallas, Texas. Professor Lowe has written and taught extensively in the area of natural gas contracting and regulation, and frequently serves as an expert witness in litigation.

Robert K. Pezold is a partner in the Tulsa law firm of Brune, Pezold, Richey & Lewis. Mr. Pezold has litigated gas contracts for more than ten years, primarily representing producers, and has handled some of the most important take-or-pay lawsuits. He is also a member of the adjunct faculty of The University of Tulsa College of Law.

David Pierce is Professor of Law at The University of Tulsa, Associate Director of the National Energy Law and Policy Institute, and of counsel to Gable & Gotwals in Tulsa. Professor Pierce has combined a practice defending pipelines in take-or-pay litigation with a broad range of articles and lectures on FERC regulation, gas contracts, and litigation. He will participate in the Tulsa presentation.

Randall Rich is a partner in the Washington D.C., office of Houston's Bracewell and Patterson. Before joining the firm, Mr. Rich held several positions at FERC over a five-year period, and his practice is now specialized in energy regulation. Mr. Rich will lead the discussion of regulatory issues in Tulsa.

Laurie Anne Williams is a partner in the Oklahoma City office of Hall, Estill, Hardwick, Gable, Golden & Nelson. Ms. Williams has broad experience in representing pipelines, and she is currently involved in a variety of balancing and ratable taking issues before the Oklahoma Corporation Commission, which she will discuss at the Tulsa presentation.

ENROLLMENT INFORMATION

The tuition fee of $495 ($470 for two or more from the same organization) includes the detailed course notebook and break refreshments for both days. Participants should make their own hotel arrangements.

To enroll, complete and mail the attached registration form, or call (918) 631-2210 or 631-2523 for reservations. Confirmation of your registration will be made prior to the seminar.

Refunds will not be granted after the course has begun. All fees will be refunded in the event a course is cancelled. Individuals cancelling five working days or less prior to the seminar will be subject to a $50 cancellation fee. Substitutions are permitted.

DATES, TIMES, AND LOCATIONS

9:00 a.m. to 4:30 p.m.

- December 7-8 • Houston, Stouffer Greenway Plaza Hotel
- December 14-15 • Tulsa, The University of Tulsa

Individuals wishing overnight accommodations in Houston should contact the hotel directly for reservations. Specify that you are with The University of Tulsa seminar for special rates.

In Tulsa, if you desire overnight accommodations and need information about hotels convenient to the meeting site, please call (918) 631-2210 for information.

REGISTRATION FORM

Please register the following in **THIRD NATURAL GAS CONFERENCE**

☐ Houston — December 7-8, 1988 ☐ Tulsa — December 14-15, 1988

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Program:	**How to Survive and Profit in the New Natural Gas Industry**
Sponsor:	**National Energy Law and Policy Institute, University of Tulsa College of Law**
Duration:	**One Hour**