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BASIC FEDERAL NATURAL GAS REGULATION FOR THE OIL AND GAS LAWYER

1989 Washburn Law School

Oil & Gas Law Series

BASIC FEDERAL NATURAL GAS REGULATION
for the
OIL & GAS ATTORNEY

a program for
the

1989 Washburn Law School
Oil & Gas Law Series

by

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PROGRAM DESCRIPTION

The Federal Energy Regulatory Commission, in pursuit of "deregulation" and a fundamental restructuring of the natural gas industry, has created new problems for the oil and gas law practitioner. For example, a simple assignment of an oil and gas lease can no longer be made without evaluating the impact FERC Orders 451 and 500 will have on the transaction. Producers now have the ability to sell gas directly to consumers by using interstate and intrastate pipelines as gas transporters. This will result in more frequent and diverse sales by producers; gas balancing problems are sure to arise. Perhaps the greatest impact of the new regulatory regime is the creation of marketing options in an industry where options have traditionally been nonexistent.

This conference provides the oil and gas practitioner with the background necessary to understand how these fundamental federal regulatory changes directly impact the day-to-day practice of state oil and gas law. In addition to a general overview of federal natural gas regulation, Professor Pierce will focus on the more common types of problems the practitioner will encounter under various Orders of the Federal Energy Regulatory Commission. Professor Pierce will also outline the major disputes which are likely to arise from a federally-structured regulatory system which relies largely upon state statutory and common law for its implementation.

PROGRAM SCHEDULE

8:00 a.m.	REGISTRATION
8:30 a.m.	FEDERAL REGULATION OF NATURAL GAS FROM 1938 TO 1988
	Natural Gas Act of 1938
	Regulating Natural Gas Companies
	Regulating Natural Gas Sales
	Regulating Natural Gas Transportation
	Expansion of Federal Jurisdiction Over "Production"
	Federal Regulation of Production Conservation
9:45 a.m.	BREAK
10:00 a.m.	Expansion of Federal Jurisdiction Over Prices
	Area and National Rate Proceedings
	Natural Gas Policy Act of 1978
	Price Regulation and Deregulation
	Federal Transportation Initiatives
	NGPA § 311
	Special Marketing Programs
	FERC Orders 436/500
11:15 a.m.	BREAK
11:30 a.m.	Federal Market Restructuring
	FERC Order 380
	FERC Orders 436/500
	FERC Order 451
	FERC Order 490
	FERC Order 497
12:30 p.m.	LUNCH - ON YOUR OWN
1:30 p.m.	IMPACT OF FEDERAL REGULATION ON STATE OIL & GAS LAW
	Transfer of Ownership
	Assignments After FERC Order 451
	Assignments After FERC Order 500
	Contract Administration - The Gas Purchase Agreement
	After FERC Order 451
	After FERC Order 500

Operating Problems
Multiple Sales
Gas Balancing Problems

2:30 p.m. BREAK

2:45 p.m. Contract Administration - The Oil and Gas Lease
Market Value in a Soft Market
Royalty Calculation and Take-or-Pay Payments
The Prudent Operator and Federal Regulatory Options
New Marketing Options - New Marketing Obligations

3:45 p.m. ADJOURN

PROGRAM INSTRUCTOR

David E. Pierce is an Associate Professor of Law at Washburn University School of Law in Topeka, Kansas. He received his B.A. from Kansas State College of Pittsburg, J.D. from Washburn University School of Law, and LL.M. (Energy Law) from the University of Utah College of Law. Prior to accepting his current position at Washburn, Professor Pierce was an Associate Professor of Law and Associate Director of the National Energy Law & Policy Institute at the University of Tulsa College of Law. He also served Of Counsel to the Tulsa-based law firm of Gable & Gotwals.

Professor Pierce has also taught oil and gas law courses at the University of Texas School of Law, the University of Houston Law Center, and Indiana University School of Law. Prior to entering law teaching, Professor Pierce was an oil and gas attorney for Shell Oil Company in Houston, Texas and a Research Fellow at the University of Utah's Energy Law Center in Salt Lake City, Utah. Prior to that he practiced law in Kansas.

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Outline Table of Contents

BASIC FEDERAL NATURAL GAS REGULATION
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I. AUTHORITY TO REGULATE GAS PRIOR TO 1938

A. States Hoarding Their Resources

1. West v. Kansas Natural Gas Co., 221 U.S. 229 (1911).

2. An Oklahoma law in effect prohibited the transportation of natural gas to any point outside the State of Oklahoma. The basic goal of the statute was to "conserve" the gas for its exclusive use within the State of Oklahoma.

3. Kansas Natural Gas Co. wanted to build a line from its wells in Washington County, Oklahoma to Kansas so its gas could be marketed in Kansas and Missouri. This activity would be illegal under the Oklahoma statute.

4. The United States Supreme Court holds the Oklahoma statute violates the commerce clause noting: "[N]o state can by action or inaction prevent, unreasonably burden, discriminate against, or directly regulate, interstate commerce or the right to carry it on." West, 221 U.S. at 262.

5. The Court, however, takes great care to distinguish the Oklahoma statute from state regulation designed to protect correlative rights and prevent waste of natural gas.

B. State Control Over Gas Sales - Rate Paid By Distributor

1. Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924).

2. Kansas Natural Gas transported gas from Oklahoma for sale to local distribution companies (LDCs) in Kansas and Missouri. The LDCs then sell the gas to the local communities in which they operate.

3. The sale by Kansas Natural Gas to the LDC is

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essentially a wholesale transaction. The sale by the LDC to its various customers is a retail transaction.

4. Kansas Natural Gas increased the sales price of gas to the LDC from $0.35/thousand cubic feet ("MCF") to $0.40/MCF - without obtaining the consent of the public utility commissions in Kansas and Missouri where the gas would be ultimately sold at retail.

5. The Court first notes: "Transportation of gas from one state to another is interstate commerce; and the sale and delivery of it to the local distribution companies is a part of such commerce." Missouri, 265 U.S. at 307.

6. Concluding that the sale to the LDCs was not subject to regulation by the state public utility commission, the Court states:

   "[H]ere the sale of gas is in wholesale quantities, not to consumers, but to distributing companies for resale to consumers in numerous cities and communities in different states. The transportation, sale, and delivery constitute an unbroken chain, fundamentally interstate from beginning to end, and of such continuity as to amount to an established course of business. The paramount interest is not local but national, -- admitting of and requiring uniformity of regulation." Missouri, 265 U.S. at 309-10.

7. The Court notes that Congress had not acted to regulate the rates charged by the interstate pipeline to the LDC. Under the commerce clause, Congress' failure to regulate this uniquely "interstate" activity is not an invitation to the states to fill the regulatory void. As the Court notes:

   "The contention that, in the public interest, the business is one requiring regulation, need not be challenged. But Congress thus far has not seen fit to regulate it, and its silence, where it has the sole power to speak, is equivalent to a declaration that that particular commerce shall

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be free from all regulation." Missouri, 265 U.S. at 308.

"[T]he uniformity of governmental nonaction, may be highly necessary to preserve equality of opportunity and treatment among the various communities and states concerned." Missouri, 265 U.S. at 310.

C. State Control Over Gas Sales - Rate Paid By Consumers

1. Pennsylvania Gas Co. v. Public Utilities Comm'n, 252 U.S. 23 (1920).

2. Pennsylvania Gas produced gas from its wells in Pennsylvania, transported the gas in its pipeline from Pennsylvania to New York and sold the gas to customers in three New York cities through distribution lines also owned and operated by Pennsylvania Gas. The issue in this case is whether the New York public utilities commission has authority to regulate the rates at which Pennsylvania Gas sells gas to New York consumers connected to Pennsylvania Gas' local distribution system.

3. The Court first notes that it is dealing with interstate commerce:

"[T]he transmission and sale of natural gas produced in one state, transported by means of pipe lines, and directly furnished to consumers in another state, is interstate commerce . . . ." Pennsylvania Gas, 252 U.S. at 28.

4. The Court next distinguishes this case from Public Utilities Comm'n v. Landon, 249 U.S. 236 (1918), where the Court held "the retailing of gas by the local companies to their consumers was intrastate commerce, and not a continuation of interstate commerce although the mains of the local companies receiving and distributing the gas to local consumers were connected permanently with those of the transmitting company." Pennsylvania Gas, 252 U.S. at 28.

a. In Landon the interstate pipeline sold the

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gas at wholesale to the LDC. The Landon litigation concerned whether the state public utility commission could regulate the rates at which the LDC sold gas to its consumers at retail.

b. The Court in Landon held the LDC's sale of gas to its consumers at retail was intrastate commerce subject to state regulation -- even though the rates charged by the LDCs would have an "indirect effect upon interstate commerce . . . ." Pennsylvania Gas, 252 U.S. at 28.

c. However, in Landon the pipeline selling the gas at wholesale was unrelated to the LDC.

5. Making an exception to the negative implications of Congress' failure to regulate an area, the Court notes:

"In dealing with interstate commerce it is not, in some instances, regarded as an infringement upon the authority delegated to Congress, to permit the states to pass laws indirectly affecting such commerce, when needed to protect or regulate matters of local interest. Such laws are operative until Congress acts under its superior authority by regulating the subject-matter for itself." Pennsylvania Gas, 252 U.S. at 29.

6. Holding that the State of New York can regulate the retail sales rates charged by Pennsylvania Gas, the court focuses on the local nature of the retail sales portion of this interstate transaction:

"This local service is not of that character which requires general and uniform regulation of rates by congressional action . . . . While the manner in which the business is conducted is part of interstate commerce, its regulation in the distribution of gas to the local consumers is required in the public interest, and has not been attempted under the superior authority of Congress." Pennsylvania Gas, 252 U.S. at 31.

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D. Parallel Limitations On State Control Of Electricity

1. Public Utilities Comm'n v. Attleboro Steam & Electric Co., 273 U.S. 83 (1927).

2. The Rhode Island Public Utilities Commission ordered an increase in the rates charged for the sale of electricity, at wholesale, by Narragansett Electirc Lighting Company (a Rhode Island utility) to Attleboro Steam & Electric Co. (a Massachusetts utility). Attleboro purchased the electricity from Naragansett and then resold it to its customers in Masssachusetts.

3. The Court first notes this is an interstate transaction stating:

   "[T]he sale of electric current by the Narragansett Company to the Attleboro Company is a transaction in interstate commerce, notwithstanding the fact that the current is delivered at the State line. The transmission of electric current from one State to another, like that of gas, is interstate commerce, . . . and its essential character is not affected by a passing of custody and title at the state boundary not arresting the continuous transmission to the intended destination." Attleboro, 273 U.S. at 86.

4. The Pennsylvania Gas exception (see discussion at I.C. of this Outline) does not apply to this transaction because the Rhode Island Commission's regulation directly regulated the rates that could be charged in an interstate transaction — a wholesale transaction as opposed to an essentially local retail transaction.

5. Striking down the regulation, the Court offers the following analysis:

   "The test of the validity of a state regulation is not the character of the general business of the company, but whether the particular business which is regulated is essentially local or national in character; and if the regulation places a direct burden upon its interstate business it is none the less beyond the power of the state because this

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may be the smaller part of its general business." Attleboro, 273 U.S. at 90.

97% of Narragansett's business was intrastate; the remaining 3% was the interstate sale to Attleboro. Attleboro, 273 U.S. at 91, Brandeis, J., dissenting.

E. Summary Of State Authority Prior To 1938

1. States cannot restrict the sale of gas in interstate commerce in order to retain the resource for its citizens. West v. Kansas Natural Gas Co., 221 U.S. 229 (1911).

2. States cannot regulate the rates charged for gas transported interstate and sold at wholesale to the LDC (a sale to the LDC for resale by the LDC). Missouri v. Kansas Natural Gas Co., 265 U.S. 298 (1924); Public Utility Comm'n v. Attleboro Steam & Electric Co., 273 U.S. 83 (1927).

3. States can regulate the rates charged for gas sold at retail by the LDC to the ultimate consumer. Public Utility Comm'n v. Landon, 249 U.S. 236 (1918).

4. States can regulate the rates charged for gas sold at retail by an entity transporting the gas in interstate commerce -- a "direct sale" as opposed to a "sale for resale." Pennsylvania Gas Co. v. Public Utilities Comm'n, 252 U.S. 23 (1920).

5. Note that although the states lacked authority to regulate wholesale transactions, no federal regulation controlled wholesale rates.

    a. Therefore, whatever the LDC charged for gas was largely dictated by what it paid for gas.

    b. Since wholesale rates were unregulated, consumers were generally at the mercy of the interstate pipeline because, to provide the service and remain in business, the state commission would have to permit the LDC to pass through its purchased gas costs (what it

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paid the pipeline for gas in the wholesale transaction) in the LDC's retail consumer rates.

c. During the 1920s there was substantial consolidation of gas and electric companies placing them under the control of large public utility holding companies. This tended to magnify the monopoly position of the interstate pipeline.

d. The situation leading up to enactment of the Natural Gas Act was described by the Court in FPC v. Hope Natural Gas Co., 320 U.S. 591, 610, 611 (1944), as follows:

"The primary aim of the legislation was to protect consumers against exploitation at the hands of natural gas companies. Due to the hiatus in regulation which resulted from the Kansas Natural Gas Co. case and related decisions state commissions found it difficult or impossible to discover what it cost interstate pipeline companies to deliver gas within the consuming states; and thus they were thwarted in local regulation . . .

"[T]he investigations of the Federal Trade Commission had disclosed that the majority of the pipeline mileage in the country used to transport natural gas, together with an increasing percentage of the natural gas supply for pipeline transportation, had been acquired by a handful of holding companies. State commissions, independent producers and communities having or seeking the service were growing quite helpless against these combinations."

II. NATURAL GAS ACT OF 1938

A. Filling The Regulatory "Gap"

1. The basic goal of the NGA was to "fill the gap" created by the negative implications of the commerce clause by exercising federal authority in

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areas where the states were constitutionally unable to regulate.

2. The Natural Gas Act, and its electricity counterpart Part II of the Federal Power Act, have each been interpreted by employing various versions of a "gap" analysis.

3. The basic premise of the gap analysis is that Congress, in the Natural Gas Act of 1938 and the Federal Power Act of 1935, intended to confer jurisdiction on the federal government only to the extent necessary to regulate matters beyond the jurisdiction of the states.

4. For example: "[T]he [Natural Gas] Act was intended only to fill the 'gap . . . thought to exist at the time the Natural Gas Act was passed' by providing for federal regulation of those aspects of the natural gas business that the States were at that time believed to be constitutionally incapable of regulating." Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84, 104 (1963), Harlan, J., dissenting.

B. The Public Utility Model

1. The Natural Gas Act adopts the "public utility model" to fill the state regulatory gap.

2. The public utility model relies upon comprehensive regulation of industry participants to provide a desired service at a controlled price.

3. The need for comprehensive control is premised on the ability of one or more of the industry participants to monopolize the commodity being sold or the service being provided.

4. If it is more efficient to provide the commodity or service through a monopoly, then the monopoly will be permitted to operate — but will be regulated as to the activities it can pursue, the level of service it must provide, and the amount it can charge for the service or commodity.

5. In return the monopoly is generally given what

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often amounts to an exclusive franchise to provide the service and an opportunity to earn a regulated rate of return on its investment.

C. Natural Gas Act - Filling The Jurisdictional Gap

1. Exclusive Federal Authority - 15 U.S.C. § 717(b) [note - references will be to the public law section numbers which are commonly used to reference the NGA; § 717(b) = § 1(b)].

   a. NGA § 1(b) provides, in part:

      "The provisions of this Act shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to the natural gas companies engaged in such transportation or sale . . ."

   b. Therefore, the following activities are to be regulated by the federal government through the Federal Power Commission [now the Federal Energy Regulatory Commission]:

      (1) Transportation of natural gas in interstate commerce;

      (2) Sale in interstate commerce of natural gas for resale;

      (3) Companies engaged in such transportation and sales; and

      (4) Facilities used to conduct the regulated interstate activities.

2. Reserved State Authority - § 1(b) follows the express <u>grant</u> of federal authority with an express <u>limitation</u> on federal authority.

   a. NGA § 1(b) provides, in part:

      "The provisions of this Act . . . shall not apply to any other transportation or sale of

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natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas."

b. Therefore, the following activities can be regulated by the states:

(1) Production of natural gas;

(2) Gathering of natural gas;

(3) Transportation of natural gas in <u>intrastate</u> commerce;

(4) Sale in interstate commerce of natural gas for direct use by the purchaser and <u>not</u> for resale; and

(5) Local distribution of natural gas.

D. Natural Gas Act § 1(c) - Hinshaw Pipelines

1. <u>Federal Power Comm'n</u> <u>v.</u> <u>East Ohio Gas Co.</u>, 338 U.S. 464 (1950).

2. East Ohio Gas Co. received gas from interstate pipelines within the State of Ohio. East Ohio then transported this gas, through its own high-pressure lines, and delivered it to consumers in Ohio connected to East Ohio's local distribution systems. The issue was whether this constituted "interstate transportation" that would subject East Ohio to federal regulation under the NGA.

3. East Ohio asserted it was engaged in "local distribution" which is expressly reserved for state regulation under NGA § 1(b).

4. The Court interprets the local distribution provision in § 1(b) as follows:

"[W]hat Congress must have meant by 'facilities' for 'local distribution' was equipment for distributing gas among consumers within a particular local community, not the high-pressure

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pipe lines transporting the gas to the local mains. For in decisions prior to enactment of the statute this Court had sharply distinguished between the two: it had made it clear that the national commerce power alone covered the high-pressure trunk lines to the point where pressure was reduced and the gas entered local mains, while the state alone could regulate the gas after it entered those mains." 338 U.S. at 469-70.

5. Four years later Congress amended the NGA to permit State regulation in place of federal regulation of certain high-pressure pipelines, called Hinshaw pipelines (after the legislator introducing the amendment), under NGA § 1(c).

6. § 1(c), the Hinshaw Amendment, provides, in part:

"[T]his Act shall not apply to any person engaged in . . . the transportation in interstate commerce or the sale in interstate commerce for resale, of natural gas received by such person from another person within or at the boundary of a State if all the natural gas so received is ultimately consumed within such State . . . provided that the rates and service of such person and facilities be subject to regulation by a State commission. The matters exempted from the provisions of this Act by this subsection are hereby declared to be matters primarily of local concern and subject to regulation by the several States."

7. Therefore, to achieve Hinshaw pipeline status, the following two conditions must be met:

   a. First, all gas received "within or at the boundary of a State" must be consumed within the State; and

   b. Second, the company's rates, services, and facilities must be subject to the State's jurisdiction.

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E. Natural Gas Act § 7(f)(2) - The Uniform Regulatory Jurisdiction Act of 1988

1. Public Law 100-474, 102 Stat. 2302 (Oct. 6, 1988).

2. Limits federal jurisdiction over LDCs that take gas into their system in one state and transport it into another state for ultimate consumption.

3. § 7(f)(2) provides:

"If the Commission has determined a service area pursuant to this subsection, transportation to ultimate consumers in such service area by the holder of such service area determination, even if across State lines, shall be subject to the exclusive jurisdiction of the State commission in the State in which the gas is consumed. This section shall not apply to the transportation of natural gas to another natural gas company."

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F. The NGA Utility Model - Entry

1. The "7(c)" Certificate Requirement: NGA § 7(c) [15 U.S.C. § 717f] provides, in part:

   "(1)(A) No natural-gas company . . . shall engage in the transportation or sale of natual gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, 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 . . . ."

2. The definition section of the NGA, § 2 [15 U.S.C. § 717a], defines the terms "natural-gas company" and "Commission" as follows:

   a. "(6) 'Natural-gas company' means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale."

      (1) § 2(1) defines "person" as "an individual or a corporation."

      (2) § 2(5) defines "natural gas" as "either natural gas unmixed, or any mixture of natural and artificial gas."

      (3) § 2(7) defines "interstate commerce" as "commerce between any point in a State and any point outside thereof, or between points within the same State but through any place outside thereof, but only insofar as such commerce takes place within the United States."

   b. "(9) 'Commission' . . . means the Federal Power Commission . . . ." NOTE: Pursuant to 42 U.S.C. §§ 7151(b), 7171(a), 7172(a)(1), 7191, and 7293 the Federal Power Commission was terminated and its functions transferred to the Secretary of Energy with all the gas regulatory jurisdiction of interest to

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producers being placed with the Federal Energy Regulatory Commission ("FERC").

3. § 7(c) restricts entry into the federally-regulated gas transportation and sales business. Before any activity subject to the NGA can be pursued, an application must be made with the FERC for a certificate of public convenience and necessity. NGA § 7(d). [Note: the certificate requirement has been changed for certain gas <u>sales</u> under the Natural Gas Policy Act (NGPA) and for certain gas <u>transportation</u> transactions under the NGPA and various FERC Orders.]

4. NGA § 7(e) identifies some of the general criteria the Commission will consider in determining whether to grant a certificate of public convenience and necessity. NGA § 7(e) provides, in part:

   "[A] certificate shall be issued to any qualified applicant therefor, authorizing the whole or any part of the operation, sale, service, construction, extension, or acquisition covered by the application, if it is found that the applicant is able and willing properly to do the acts and to perform the service proposed and to conform to the provisions of the Act and the requirements, rules, and regulations of the Commission thereunder, and that the proposed service, sale, operation, construction, extension, or acquisition, to the extent authorized by the certificate, is or will be required by the present or future public convenience and necessity; otherwise such application shall be denied. The Commission shall have the power to attach to the issuance of the certificate . . . such reasonable terms and conditions as the public convenience and necessity may require."

5. The NGA § 7 certificate requirement creates a barrier to free entry (and exit) into the gas transportation business. This tends to create "protected" markets for the existing natural gas companies holding certificates.

6. FERC initiatives in recent years have been

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designed to reduce the § 7 regulatory burdens by authorizing "blanket certificates" which authorize a wide range of activities. This eliminates the case-by-case approach to authorizing transportation transactions under § 7.

G. The NGA Utility Model - "Just And Reasonable" Rates

1. FERC regulates the rates that be charged for a certificated activity under NGA §§ 4 and 5.

2. NGA § 4 [15 U.S.C. 717c] provides, in part:

   "(a) Just and reasonable rates and charges. All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful."

3. Under NGA § 4(c) the natural gas company must file all "schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services."

4. If the company wants to change any rate, charge, classification, or service, or any practice in administering such matters, § 4(d) requires 30 day advance notice of the proposed change.

5. During this 30 day period the Commission, either on its own motion or that of any State, municipality, State commission, or gas distributing company, may hold a hearing concerning the proposed rate change. NGA § 4(e).

   a. The Commission may suspend the effective date of the proposed rate change for up to 5

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months. NGA § 4(e).

b. If the hearings are not completed prior to the suspension period, the company can collect the proposed rate, subject to a refund obligation in the event the rate is found not to be just and reasonable. NGA § 4(e).

6. Note that § 4 is triggered by a proposed rate or service change. The initial rate is established through the § 7 certificate procedure.

7. NGA § 5 gives the Commission, and any "State, municipality, State commission, or gas distributing company", the ability to challenge any rate or practice to determine whether it is "unjust, unreasonable, unduly discriminatory, or preferential." NGA § 5(a).

   a. Once the challenge is made, the Commission must "determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order . . . ." NGA § 5(a).

   b. Although the Commission cannot order an <u>increase</u> in rates unless the company files for an increase, "the Commission may order a <u>decrease</u> where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates." NGA § 5(a).

8. The interaction between NGA sections 4, 5, and 7 is explained by the court in <u>Panhandle Eastern Pipe Line Co. v. F.E.R.C.</u>, 613 F.2d 1120 (D.C. Cir. 1979), as follows:

   "Three interrelated sections constitute the 'comprehensive and effective regulatory scheme' Congress created with regard to ratemaking. Section 7 provides that to undertake the 'transportation or sale of natural gas,' an entity must first obtain 'a certificate of public convenience and necessity issued by the

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Commission.' In issuing such certificates, the Commission has 'the power to attach . . . such reasonable terms and conditions as the public convenience and necessity may require.'"

"Once rates are authorized under section 7, a natural gas company may file for an increase under section 4. . . . The Commission may . . . suspend the new rate schedule for five months. Thereafter the increased rates may be collected but the Commission may require a bond to ensure refunds of 'increased rates or charges by its decision found not justified.'"

"On the other hand, if rates are unjust or unreasonable, the Commission may adjust them pursuant to section 5. . . . Section 5 rate adjustments may be prospective only . . . ."

9. § 4(b) [15 U.S.C. § 717c(b)] provides:

"No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service."

10. Prior to enactment of the Natural Gas Policy Act of 1978 (NGPA) producers focused primarily on the rate they were allowed to charge for gas they produced and sold to the pipeline.

    a. Ceiling prices under the NGPA essentially removed producer gas sales from the NGA rate process.

    b. However, after FERC Orders 436 and 500, the major ratemaking issues affecting producers will be the rates charged by pipelines to transport gas and provide related pipeline services.

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c. The implied covenant to market and the implied covenant of efficient operation arguably require producers to scrutinize pipeline rates to ensure they are "just and reasonable" and not "unduly discriminatory."

d. Oil and gas attorneys representing producers must become versed in public utility law - at both the state and federal level.

(1) Can encounter similar rate and access problems with intrastate pipelines, gathering systems, and local distribution companies.

(2) Since selling gas to New York City (in addition to a wellhead sale to a pipeline) is now a realistic option, it must be considered in the marketing equation to select the "best deal" available for marketing gas.

H. The NGA Utility Model - The Service Obligation

1. An important component of the NGA § 7 process is ensuring that the entity requesting a certificate is capable of rendering the "service" that will promote the "public convenience and necessity."

a. NGA § 7(e) [15 U.S.C. § 717f(e)] provides the certificate will be granted only "if it is found that the applicant is able and willing properly to do the acts and provide the service proposed."

b. NGA § 7(a) provides the Commission with authority to order the natural gas company to extend services to others when "necessary or desirable in the public interest." However, the Commission cannot compel the natural gas company to extend service "when to do so would impair its ability to render adequate service to its customers." NGA § 7(a).

2. § 7(b) [15 U.S.C. § 717(b)] in effect makes "service" a continuing obligation of the certificated entity by providing:

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"No natural-gas company shall abandon . . . any service . . . without the permission and approval of the Commission . . . after due hearing, and a finding by the Commission that . . . continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment."

3. A major concern of pipelines is the nature and extent of their service obligation to LDCs and other traditional gas sales customers when such customers begin to satisfy their gas needs through gas purchases from producers, other pipelines, and gas traders.

I. The NGA Utility Model - Exit (Abandonment)

1. Under the utility model you must obtain permission to enter and exit the business. This is closely related to the "service" obligation discussed in II.G. of this Outline. Since you are engaged in activities "affected with a public interest" the public will determine when you will enter the business and whether it is appropriate for you to get out of the business.

2. See NGA § 1(a) [15 U.S.C. § 717(a)]: "[T]he business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest . . . ."

3. Under NGA § 1(b) [15 U.S.C. § 717(b)]:

"No natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment."

4. The operation of the NGA's abandonment limitation

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is perhaps best demonstrated in Sunray Mid-Continent Oil Co. v. Federal Power Comm'n, 364 U.S. 137 (1960).

a. Sunray entered into a 20-year gas sales contract with United Gas Pipeline Company (an interstate gas pipeline). Sunray was entering into a service (a sale of gas in interstate commerce for resale) and had to obtain a certificate under NGA § 7(c) to provide the service. Sunray applied for a certificate limited to the term of its contract with United; the Commission issued a certificate unlimited in duration.

b. Justice Brennan, writing for the majority, notes the impact Sunray's ability to demand a limited-term certificate could have on "service" obligations:

"The identical provisions of the Natural Gas Act regulate pipeline companies as well as independent producers. If producers can insist in their certificates on the inclusion of a provision relieving them in advance from their obligation to continue the supply of gas, as of a date certain, pipeline companies -- whose dealings with local distribution companies generally also take the form of a 'sale' of gas to them -- could insist on a similar provision."

"If an individual producer were thus left free to discontinue his supply, the transmission company would be forced to find a supplier of gas elsewhere, and make connection with him, to continue its service; and the consumer would ultimately pay the bill for the rearrangement."

"If the pipeline company were left free to cease its service to the local distribution company, a local economy which had grown dependent on natural gas as a fuel would be at its mercy." Sunray, 364 U.S. at 143.

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c. The Court concludes, holding:

"An initial application of an independent producer, to make movements of natural gas in interstate commerce, leads to a certificate of public convenience and necessity under which the Commission controls the basis on which 'gas may be initially dedicated to interstate use. Moreover, once so dedicated there can be no withdrawal of that supply from continued interstate movement without Commission approval.'" Sunray, 364 U.S. at 156. (Emphasis added).

5. As will be seen in later sections of this Outline, the FERC has changed its analysis for determining whether a proposed abandonment of gas supplies will enhance the "present or future public convenience or necessity" under NGA § 7(b).

III. THE NGA PRODUCTION OR GATHERING EXCEPTION

A. Regulation Of Independent Gas Producers

1. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

2. Whether a sale of gas by an independent producer (unaffiliated with the pipeline purchaser) to an interstate pipeline, was exempt under NGA § 1(b) 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.

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

4. The Court reasoned: if a major component of the wholesale price of gas is the amount paid for gas at the wellhead, effective regulation of rates requires control over the independent producer of gas. Phillips, 347 U.S. at 680, 685. Since the focus is upon effective regulation of rates, the "production or gathering" exception to federal jurisdiction simply does not apply. Phillips, 347 U.S. at 680-81.

5. The Court's analysis breaks down, however, when it is applied to matters which do not directly influence federal control over rates. The Phillips "potential effect on consumer price" analysis has also been used by the Court to define the limits of state authority over oil and gas conservation regulation.

6. As a result of the Phillips decision, the FPC was forced to regulate thousands of gas producers as public utilities.

   a. Initially attempted to use the traditional 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).

B. Limitations On State Production Conservation Powers

1. Northern Natural Gas Co. v. State Corp. Comm'n, 372 U.S. 84 (1963).

2. The Kansas Corporation Commission required that Northern, an interstate pipeline, take its gas

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requirements ratably from all producers in the Hugoton Gas Field.

3. Although the Kansas ratable take statute and orders did not conflict with any federal regulation controlling gas takes, they were preempted by the "pervasive scope of federal occupation of the field." Northern, 372 U.S. at 98.

4. The Court adopted two tests to determine whether the Kansas regulation was covered by the "production or gathering" exception and therefore an area reserved for state regulation. Northern, 372 U.S. at 92.

   a. First - is the state regulation directed at "purchasers" rather than "producers" of gas?

   b. Second - is there any possibility that the regulation could effect the purchasing practices of the interstate pipeline so as to potentially impact the ultimate price consumers pay for gas?

5. The Court found the Kansas regulation failed both tests: the ratable take orders were directed at purchasers, not producers, and the reordering of Northern's takes to comply with the orders might affect the "intricate relationship" between Northern's cost structures and the eventual costs to its wholesale customers. Northern, 372 U.S. at 92.

C. Impact Of The NGPA On State Conservation Powers

1. Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board, 474 U.S. 409 (1986) ("Transco").

2. In Transco the Court considers whether the rule in Northern was altered by passage of the Natural Gas Policy Act ("NGPA").

3. Mississippi ordered Transcontinental, an interstate pipeline, to take gas ratably from various working interest owners in a well. Transcontinental had a contract with some, but not

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all, of the working interest owners in the well. The gas produced by the well was deregulated NGPA § 107(c)(1) gas.

4. The Court holds the Mississippi ratable take order is preempted by the NGA. The Court reaffirms its analysis in Northern and adds another twist - the NGPA is a Congressional determination that gas purchases be left to the marketplace, not the states. Transco, 474 U.S. at 422.

5. The Court indicates there is still a "deep federal concern" over the "'intricate relationship between the purchasers' cost structures and eventual cost to wholesale customers who sell to consumers in other states.'" Transco, 474 U.S. at 422.

6. The barometer for measuring state collision with this "deep federal concern" is the possible impact of state action on consumer prices. Transco, 474 U.S. at 423-24.

D. A Retreat From The Northern/Transco Analysis

1. Northwest Central Pipeline Corp. v. State Corp. Comm'n, 57 U.S.L.W. 4302 (U.S. March 6, 1989).

2. In Northwest Central the Court addresses whether Kansas can revise its proration rules to require producers to produce their gas "allowable" (the maximum amount of gas that can be legally produced from a well) or have their allowable cancelled after a makeup period of several years.

   a. The dispute concerns an order issued by the Kansas Corporation Commission amending "paragraph (p)" of the basic proration order for the Kansas Hugoton Field.

   b. Prior to the rule change, producers could fail to produce their full allowable and accumulate "underages" indefinitely; they could make up their allowable at any time in the future. This made the Kansas Hugoton Field a sort of gas storage haven.

   c. Justice Brennan explains the situation as

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follows:

"Many pipelines responded to the availability of new, higher-priced deregulated gas by committing themselves to long-term contracts at high prices that required them to take-or-pay for a large part of a producer's contractually dedicated gas reserves. When the market dwindled in the early 1980's, interstate pipelines reduced their takes under contracts with Kansas-Hugoton producers for 'old,' low-priced gas, in large part because these contracts included no take-or-pay penalty. As a result, production from parts of the field fell. In effect, interstate purchasers began to use the Hugoton field for storage while they took gas for their immediate needs from elsewhere -- a practice facilitated by paragraph (p) of the Hugoton Basic Proration Order, which permitted stored gas to be produced more or less at any time." Northwest Central, 57 U.S.L.W. at 4304.

3. In evaluating whether the Kansas regulation is preempted by the NGA, the Court first notes the state interests involved:

"Kansas' regulation of the Hugoton field is an effort to solve perplexing problems in assigning and protecting property rights in a common pool of gas and in preventing waste of limited natural resources." Northwest Central, 57 U.S.L.W. at 4303.

a. State conservation regulation is essential to define meaningful property rights in gas. The federal regulatory system is built upon the foundation of state conservation regulation.

b. The analysis employed by the Court in Northern Natural and Transco threatened the continued existence of this foundation. The Supreme Court in Northwest Central modifies its Northern/Transco analysis to accommodate prorationing as an acceptable state

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regulatory tool.

4. The United States Supreme Court follows the lead of the Kansas Supreme Court by jettisoning the portion of the Northern/Transco analysis which preempts state regulation that might influence pipeline purchasing practices or impact the ultimate price of gas to consumers. Northwest Central, 57 U.S.L.W. at 4308.

5. Applying the Northern/Transco analysis to prorationing would render the section 1(b) production and gathering provision meaningless. As the Court notes in Northwest Central:

   "To find field pre-emption of Kansas' regulation merely because purchasers' costs and hence rates might be affected would be largely to nullify that part of NGA § 1(b) that leaves to the States control over production, for there can be little if any regulation of production that might not have at least an incremental effect on the costs of purchasers in some market and contractual situations. Congress has drawn a brighter line, and one considerably more favorable to the States' retention of their traditional powers to regulate rates of production, conserve resources, and protect correlative rights." Northwest Central, 57 U.S.L.W. at 4308 (emphasis added).

6. The "bright line" drawn by the Court in Northwest Central places primary emphasis on whether implementation of the regulation is accomplished through the producer or purchaser. Again, the Supreme Court follows the Kansas Court's analysis by noting that Kansas' prorationing rule regulated producers and was "aimed primarily at the production of gas rather than at its marketing."

7. The Court classifies paragraph (p) as state regulation "directed to the behavior of gas producers." This regulation of "producers" is distinguished from the regulation in Northern Natural and Transco which was directed at "purchasers."

8. So long as the state's purpose is to regulate

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production, and the technique chosen is reasonably related to legitimate state concerns, the regulation will be upheld — even when it impacts matters within exclusive federal control. However, whether the state's "purpose" is to regulate production will be determined by whether the regulation is directed at producers instead of purchasers.

IV. NATURAL GAS POLICY ACT OF 1978

A. Codified at 15 U.S.C. §§ 3301 through 3432.

1. Like the NGA, references to the NGPA are usually to the section designations of the public law version of the Act.

2. For example: The reference to the codified version of the ceiling prices for natural gas dedicated to interstate commerce is 15 U.S.C. § 3314. However, we usually refer to this as § 104 (the public law nomenclature).

B. Catalyst For Federal Intervention

1. Federal regulation of gas prices under the NGA 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 was 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.

C. 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. See list of maximum lawful prices at pages 28 and 29 of this Outline.

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Table II—*Natural Gas Ceiling Prices: NGPA § § 104 and 106(a) (Subpart D, Part 271)* (continued)

Category of Natural Gas	Type of Sale or Contract	Maximum lawful price per MMBtu for deliveries made in: Feb. 1989	Mar. 1989	Apr. 1989	May 1989	June 1989	July 1989
Post-1974 gas [2]	All producers	$2.802	$2.813	$2.824	$2.833	$2.842	$2.852
1973-1974 Biennium gas	Small producer	2.366	2.375	2.384	2.392	2.400	2.408
	Large producer	1.811	1.818	1.825	1.831	1.837	1.843
Interstate Rollover gas	All producers	1.040	1.044	1.048	1.052	1.056	1.060
Replacement contract gas or recompletion gas	Small producer	1.330	1.335	1.340	1.344	1.349	1.354
	Large producer	1.019	1.023	1.027	1.030	1.033	1.036
Flowing gas	Small producer	0.671	0.674	0.677	.679	.681	.683
	Large producer	0.567	0.569	0.571	.573	.575	.577
Certain Permian Basin gas	Small producer	0.793	0.796	0.799	.802	.805	.808
	Large producer	0.700	0.703	0.706	.708	.710	.712
Certain Rocky Mountain gas	Small producer	0.793	0.796	0.799	.802	.805	.808
	Large producer	0.671	0.674	0.677	.679	.681	.683
Certain Appalachian Basin gas	North subarea contracts dated after 10-7-69	0.637	0.640	0.643	.645	.647	.649
	Other contracts	0.591	0.593	0.595	.597	.599	.601
Minimum Rate gas [1]	All producers	0.350	0.351	0.352	.353	.354	.355

[1] Prices for minimum rate gas are expressed in terms of dollars per Mcf, rather than per MMBtu.
[2] This price may also be applicable to other categories of gas. (See § § 271.402, 271.602.)

Table I—*Natural Gas Ceiling Prices (Other Than NGPA §§ 104 and 106(a))* (continued)

Maximum lawful price per MMBtu for deliveries in:

Subpart of Part 271	NGPA Section	Category of Gas	Nov. 1988	Dec. 1988	Jan. 1989	Feb. 1989	Mar. 1989	Apr. 1989	May 1989	June 1989	July 1989
B	102	New Natural Gas, Certain OCS Gas [4]	$5.058	$5.093	$5.128	$5.165	$5.202	$5.239	$5.273	$5.307	$5.342
C	103	New Onshore Production Wells [5]	3.345	3.358	3.371	3.384	3.398	3.412	3.423	3.434	3.446
E	105(b)(3)	Existing Interstate Contracts	4.879	4.909	4.939	4.970	5.002	5.034	5.063	5.092	5.121
F	106(b)(1)(B)	Alternative Maximum Lawful Price for Certain Intrastate RolloverGas [1]	1.913	1.920	1.927	1.935	1.943	1.951	1.958	1.965	1.972
G	107(c)(5)	Gas Produced from Tight Formations	6.690	6.716	6.742	6.768	6.796	6.824	6.846	6.868	6.892
H	108	Stripper Gas	5.416	5.453	5.491	5.530	5.569	5.609	5.646	5.683	5.720
I	109	Not Otherwise Covered [3]	2.771	2.781	2.791	2.802	2.813	2.824	2.833	2.842	2.852

[1] Section 271.602(a) provides that for certain gas sold under an intrastate rollover contract the maximum lawful price is the higher of the price paid under the expired contract, adjusted for inflation or an alternative Maximum Lawful Price specified in this Table. This alternative Maximum Lawful price for each month appears in this row of Table I. Commencing January 1, 1985, the price of some intrastate rollover gas is deregulated. (See Part 272 of the Commission's Regulations.)

[2] Commencing November 1, 1979, the price of natural gas finally determined to be eligible as deep high-cost gas under section 107(c)(1) of the NGPA is deregulated. (See Part 272 of the Commission's Regulations.) Prior to that date, the maximum lawful price applicable to deep high-cost gas was the price specified in Subpart B of Part 271.

[3] The maximum lawful price for tight formation is the lesser of the negotiated contract price or 200% of the price specified in Subpart C of Part 271. The maximum lawful price for tight formation gas applies on or after July 16, 1979. (See § 271.703 and § 271.704.)

[4] Commencing January 1, 1985, the price of natural gas finally determined to be new natural gas under section 102(c) is deregulated. (See Part 272 of the Commission's regulations.)

[5] Commencing January 1, 1985, and July 1, 1987, the price of some natural gas finally determined to be natural gas produced from a new onshore production well under section 103 is deregulated. (See Part 272 of the Commission's regulations.) Thus, for all months succeeding June 1987, publication of a maximum lawful price per MMBtu under NGPA section 103(b)(2) is discontinued.

[The next page is 14,167.]

Natural Gas Clearinghouse, Inc.
Survey of Domestic Spot Market Prices[a]

Markets Accessed By	Receipt Point/Zone	July 1988	Jan. 1989	Feb. 1989	Mar. 1989	Apr. 1989	May 1989	June 1989	July 1989
		($/MMBtu)							
ANR	Custer Cty., Okla.	$1.30	$1.75	$1.55	$1.30	$1.25	$1.30	$1.35	$1.35
ANR	Eunice, La.	1.45	2.20	1.75	1.45	1.50	1.65	1.65	1.65
Columbia	Onshore Laterals, La.	1.45	2.20	1.90	1.55	1.55	1.65	1.70	1.65
El Paso	Pecos/Waha, Tex.	1.45	1.95	1.65	1.45	1.50	1.60	1.55	1.60
Houston P.L.	Anywhere Onsystem	1.40	1.85	1.45	1.35	1.45	1.65	1.65	1.60
La. Intrastates[b]	Anywhere Onsystem	1.50	2.20	1.75	1.40	1.55	1.65	1.70	1.65
Natural	Amarillo Leg (Non-Triangle)	1.35	1.85	1.55	1.35	1.35	1.45	1.45	1.45
Northern	Beaver Cty., Okla.	1.30	1.90	1.50	1.35	1.30	1.40	1.40	1.40
Northwest	Opal, Wyo.	1.10	1.35	1.35	1.25	1.15	1.15	1.10	1.05
Oklahoma Nat. Gas	Oklahoma	1.25	1.75	1.40	1.25	1.30	1.40	1.40	1.35
Panhandle	Beaver Cty., Okla.	1.25	1.80	1.50	1.25	1.30	1.40	1.40	1.35
Southern Natural	S. La.	1.50	2.20	1.80	1.50	1.55	1.70	1.70	1.65
Tennessee	Vinton, La.	1.45	2.15	1.70	1.40	1.55	1.65	1.65	1.60
Texas Eastern	Zone A, Tex.	1.45	2.05	1.70	1.45	1.50	1.65	1.65	1.60
Texas Gas	Zone 1, N. La.	1.50	2.20	1.85	1.50	1.50	1.60	1.70	1.65
Transco	Production Area (Station 50)	1.45	2.15	1.70	1.50	1.50	1.70	1.75	1.65
United	Onshore La.	1.40	2.00	1.55	1.35	1.40	1.60	1.60	1.60

a/ Clearinghouse estimates of the median price for one month spot transactions at the indicated receipt points. These estimates are based on prices quoted by industrial end users and local distribution companies. The prices are not offers by either the Clearinghouse or any of the listed pipelines to purchase natural gas at the indicated median price.

b/ Represents an average of prices on Louisiana intrastate pipelines such as Faustina, Louisiana Intrastate Gas, Bridgeline and Monterey.

D. Uniform Pricing for All Gas Markets

1. Federal regulation extended to intrastate sales. See NGPA § 105 [15 U.S.C. § 3315].

2. Although the interstate/intrastate dichotomy is recognized for certain existing gas contracts, it is eliminated for new gas sales.

E. Phased Deregulation

1. Except for certain categories of gas, the NGPA pricing limitations would expire between 1979 and 1987. NGPA § 121 [15 U.S.C. § 3331].

2. See regulations detailing the deregulation process - 18 C.F.R. Part 272 reproduced at pages 29-31 of this Outline.

3. Basic fear was once the price of gas was deregulated the price would increase. This "fear" was codified at NGPA § 122 [15 U.S.C. § 3332] which gave the President or Congress the power to extend price controls for an additional 18 months. However, when the bulk of gas supplies became deregulated, the price of oil and gas had fallen so there was no potential for a price "flareup" upon decontrol.

4. Note that price controls on the lowest-priced gas [§ 104 and § 106(a)] remain in effect.

F. Effect of Deregulation - FERC v. Martin Exploration Management Co., 108 S.Ct. 1723 (1988).

1. A major issue under the NGPA concerned the effect of a "deregulation" clause when the regulated price, at the time the clause is triggered, exceeds the deregulated (current market) price. This issue is addressed in the Martin Exploration case.

2. Under the NGPA gas production may qualify for more than one pricing category. In such cases, §101(b)(5) of the NGPA provides:

   "[T]he provision which could result in the highest price shall be applicable."

3. Martin Exploration contended this permits it to elect to receive higher regulated prices instead of classifying the gas as deregulated. In many cases, classifying the gas as deregulated will

trigger a price redetermination clause which, under current market conditions, would permit the purchaser to demand a price lower than the regulated price.

4. FERC interprets § 101(b)(5) to mean that gas qualifying for a regulated and deregulated category would be <u>deemed</u> deregulated.

5. The U.S. Supreme Court, in <u>Martin Exploration</u>, holds the applicable category is determined by applying "the provision that <u>could</u> result in the highest price . . . ." Since the deregulated category <u>could</u> theoretically result in the highest price, the gas is deemed deregulated; it is always <u>possible</u> for deregulated gas prices to exceed NGPA price limitations.

PART 272—DEREGULATED NATURAL GAS

AUTHORITY: Natural Gas Policy Act of 1978, 15 U.S.C. 3301-3432 (1982).

§ 272.101 Applicability.

This part implements section 121 of the NGPA and applies to the first sale of natural gas which is deregulated natural gas.

[Order 478, 52 FR 26474, July 15, 1987]

§ 272.102 Price deregulation.

(a) No maximum lawful price applies to any first sale of deregulated natural gas.

(b) For special rules on:

(1) Circumvention of maximum lawful prices, *see* § 270.207; and

(2) Interim and retroactive collection, *see* §§ 273.202 (a)(2) and (d)(1)(i)(B), 273.203(a)(2) and 273.204(a)(2).

[Order 78, 45 FR 28098, Apr. 28, 1980, as amended by Order 406, 49 FR 46884, Nov. 29, 1984]

§ 272.103 Definitions.

(a) "Deregulated natural gas" means:

(1) Natural gas for which a jurisdictional agency determination has become final under Parts 274 and 275 that the gas qualifies as:

(i) Deep, high-cost natural gas;

(ii) Gas produced from geopressured brine;

(iii) Occluded natural gas produced from coal seams; or

(iv) Gas produced from Devonian shale.

(2) Natural gas for which a jurisdictional agency determination becomes final under Parts 274 and 275 and which is sold in a first sale on or after January 1, 1985, and such gas qualifies as:

(i) New natural gas as defined in § 271.203;

(ii) Natural gas produced from any new, onshore production well if such gas as defined in § 271.303:

(A) Was not committed or dedicated to interstate commerce (as defined in NGPA section 2(18)) on April 20, 1977; and

(B) Is produced from a completion location which is located at a depth of more than 5,000 feet.

(3) Natural gas for which a jurisdictional agency determination becomes final under Parts 274 and 275 of this chapter and which is sold in a first sale on or after July 1, 1987, and such gas qualifies as natural gas produced from any new, onshore producton well if such gas as defined in § 271.303:

(i) Was not committed or dedicated to interstate commerce (as defined in NGPA section 2(18)) on April 20, 1977; and

(ii) Is produced from a completion location which is located at a depth of 5,000 feet or less.

(4) Natural gas sold under an existing intrastate contract, any successor to an existing intrastate contract, or any intrastate rollover contract, if:

(i) Such natural gas was not committed or dedicated to interstate commerce on November 8, 1978; and

(ii) In the case of any existing or successor intrastate contract,

(A) The price paid for the last deliveries of such natural gas occurring on December 31, 1984, or, if no deliveries occurred on such date, the price that would have been paid if deliveries occurred on such date is higher than $1.00 per MMBtu, and

(B) Such gas is not subject to the maximum lawful price in section 271.502(b); or

(iii) In the case of any rollover contract, the price paid on December 31, 1984, or if no deliveries occurred on such date, the price that would have been paid had deliveries occurred on such date is higher than $1.00 per MMBtu.

(b) "Deep, high-cost natural gas" is natural gas which is produced:

(1) From any well, the surface drilling of which began on or after February 19, 1977; and

(2) From a completion location which is located at a depth of more than 15,000 feet.

(c) "Natural gas produced from geopressured brine" is natural gas which is dissolved before initial production of the natural gas in subsurface brine aquifers with at least 10,000 parts of dissolved solids per million parts of water and with an initial reservoir geopressure gradient in excess of 0.465 pounds per square inch for each vertical foot of depth.

(d) "Occluded natural gas produced from coal seams" means naturally occurring natural gas released from entrapment from the fractures, pores and bedding planes of coal seams.

(e) "Natural gas produced from Devonian shale" means natural gas produced from the fractures, micropores and bedding planes of shales deposited during the Paleozoic Devonian Period. "Shales deposited during the Paleozoic Devonian Period" means the gross Devonian age stratigraphic interval encountered by a well bore, at least 95 percent of which has a gamma ray index of 0.7 or greater. The gamma ray index at any point is to be calculated by dividing the gamma ray log value at that point by the gamma ray log value at the shale base line established over the entire Devonian age interval penetrated by the well bore.

[Order 78, 45 FR 28098, Apr. 28, 1980, as amended by Order 406, 49 FR 46884, Nov. 29, 1984; Order 406-A, 49 FR 50642, Dec. 31, 1984; Order 476, 52 FR 26475, July 15, 1987]

§ 272.104 Special rules for measuring the depth of deregulated natural gas.

For purposes of determining the depth of a completion location under §§ 272.103(a)(2)(ii)(B), 272.103(a)(3)(ii), and 272.103(b), measurement shall be the true vertical depth from the surface location to the highest perforation point in the completion location.

[Order 476, 52 FR 26475, July 15, 1987]

§ 272.105 Separate billing.

All first sales of deregulated natural gas, and gas for which an application that the gas qualifies as deregulated natural gas is pending, shall be billed separately from all other sales of gas.

[Order 78, 45 FR 28098, Apr. 28, 1980, as amended by Order 406, 49 FR 46884, Nov. 29, 1984]

G. Some Basic Concepts

1. Mcf, MMBtu, and Dekatherm:

a. Mcf — Prior to the NGPA gas measurements were generally made, at the production end of the market, using a volumetric measurement - thousand cubic feet (Mcf) at a standard pressure, temperature, and water vapor base.

The NGPA defines Mcf as: "1,000 cubic feet of natural gas measured at a pressure of 14.73 pounds per square inch (absolute) and a temperature of 60 degrees Fahrenheit." NGPA § 2(29) [15 U.S.C. § 3301(29)].

b. MMBtu — The NGPA adopted a gas measurement based upon the heating value of the gas being sold. MMBtu is defined at 18 C.F.R. § 270.102(b) (2), (3) and § 270.204 (1988).

(1) MMBtu means million British thermal units. A British thermal unit is the amount of heat required to raise one pound of water from 58.5 degrees to 59.5 degrees Fahrenheit under NGPA specified conditions. 18 C.F.R. § 270.102(b)(2) and (3) (1988).

(2) The standard conditions are specified at 18 C.F.R. § 270.204(b) (1988):

"The gas is saturated with water vapor at 60 degrees Fahrenheit under a pressure equivalent to that of 30.00 inches of mercury at 32 degrees Fahrenheit, under standard gravitational force . . . ."

c. Mcf measurements can be converted to MMBtu values: 1 Mcf of gas having a heating content of 1,000 Btu's per cubic foot equals 1 MMBtu.

d. Dekatherm is another term which describes a quantity of energy by its heating value. LDCs and other energy purchasers often use

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the dekatherm measurement. 1 dekatherm is equal to 1 MMBtu.

2. A "first sale" under the NGPA is defined broadly to include almost any sort of transaction. See NGPA § 2(21)(A). However, § 2(21)(B) carves out some specific situations which are not considered "first sales" under the NGPA.

   a. If the transaction is a "first sale" then the maximum lawful prices and other terms of the NGPA will apply.

   b. Generally the first sale will include any sale by the producer of the gas and will exclude sales by interstate pipelines, intrastate pipelines, and LDCs - unless they also produced the gas being sold.

V. NATURAL GAS DECONTROL ACT OF 1989

A. House Bill 1722 -- Provides for elimination of remaining price controls in a three phase process:

1. Phase One: Wellhead price controls are eliminated in the following situations as of the date the Decontrol Act becomes law:

   a. Gas not under contract as of the date of enactment. Sales after enactment are not subject to price controls.

   b. Gas under contract as of the date of enactment, but the contract "ceases to apply." Sales after such contract ceases to apply are not subject to price controls.

   c. Gas under contract as of the date of enactment, but the parties agree in writing that sales after a certain date will not be subject to price controls. The "writing" must be entered into after March 23, 1989 but cannot eliminate price controls before the date the Decontrol Act becomes law.

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2. Phase Two: For wells under existing contracts where surface drilling began after March 23, 1989, price controls will continue until May 15, 1991.

    a. Note that price controls on gas from such wells could be eliminated prior to May 15, 1991 if one of the three provisions in phase one (1)-(3) applies. E.g., the contract expires or is terminated. Also, if the parties renegotiate their contract and expressly provide for earlier decontrol.

    b. Apparently this provision was included to protect price incentives and tax credits associated with the sale of gas in certain high cost gas well categories.

    c. Wells spudded on or before March 23, 1989, would be subject to price controls up to January 1, 1993. This assumes the contract does not expire, terminate, or is renegotiated.

3. Phase Three: All remaining NGPA price controls are eliminated as of January 1, 1993.

B. Contract Rights Preserved

1. The Act does not alter existing contracts.

2. The effect of the Act's elimination of price controls must be evaluated under the terms of each contract.

3. Will trigger various renegotiation clauses at a time when the deregulated price may be less than spot prices.

4. May allow prices to escalate in certain situations.

5. The impact must be evaluated on a contract-by-contract basis; some of the results may be surprising.

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VI. THE NGA/PHILLIPS/NGPA LEGACY

A. NGA and Phillips Petroleum Co. v. Wisconsin

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 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. Natural gas 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.

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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 in-state 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

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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. § 3431].

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.

VII. 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

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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 <u>Maryland People's Counsel</u> <u>v.</u> <u>FERC</u>, 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.

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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 [15 U.S.C. § 3371].

      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."

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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 engage in NGA § 7(c) transactions and generic authority to abandon 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

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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.

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(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. v. FERC</u>, 770 F.2d 1144 (D.C. Cir.

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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 Associated Gas Distributors v. FERC, 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 and 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:

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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.

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(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 Consolidated Edison Co. of New York v. FERC, 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.

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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 to raise the price of the gas to an amount which more nearly represents the current market value of the gas.

b. 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 old gas. Pipeline can force the producer to negotiate to reduce the high-priced gas to a price which more nearly represents the current market values.

c. 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.

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

VIII. TRANSITION PROBLEMS: TAKE-OR-PAY

A. <u>Associated Gas Distributors</u> <u>v.</u> <u>FERC</u>, 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

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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. 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

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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.

IX. 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.

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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.

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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. <u>National Steel Corp. v. Long</u>, 689 F.Supp. 729 (W.D. Mich. 1988), appeal docketed, Nos. 88-1774, 88-1680, 88-1650 (6th Cir. 1989), (court held State action concerning the matter was preempted by the Natural Gas Act).

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IX. SAMPLE GAS MARKETING TRANSACTION AFTER "RESTRUCTURING"

A. Facts:

1. Acme Production Company owns gas near Woodward County, Oklahoma.

2. The March wellhead spot price being offered for gas in the area is the Oklahoma Natural Gas price of $1.25/MMBtu.

3. Acme decides to try and market its gas to an end user or LDC. Acme might do this on its own, or through either an affiliated or independent marketing company.

4. Acme (or its marketer) has located a buyer (NI-Gas) who will take delivery of the gas in Will County, Illinois at a price of $2.15/MMBtu. Delivery will be made to NI-Gas' interconnect with NGPL -- NI-Gas will resell the gas.

    a. To determine if this is a workable deal, Acme must consider if there is capacity available on a pipeline to get the gas to Will County.

    b. Acme must also ascertain the price for all transportation services to ensure it will exceed the spot price being offered.

    c. Acme must provide, in its sales contract with NI-Gas, for any potential problems it may encounter in obtaining access to transportation services to deliver the gas.

    d. Chances are the sale will be for 30, 60, or 90 days.

5. Acme (or its marketer) determines that the best way to get the gas from Oklahoma to Illinois is on the gas transportation system of Natural Gas Pipeline Company of America (NGPL).

    a. See system maps at pages 54 and 55 of this Outline.

    b. Acme will deliver its gas to NGPL at NGPL's

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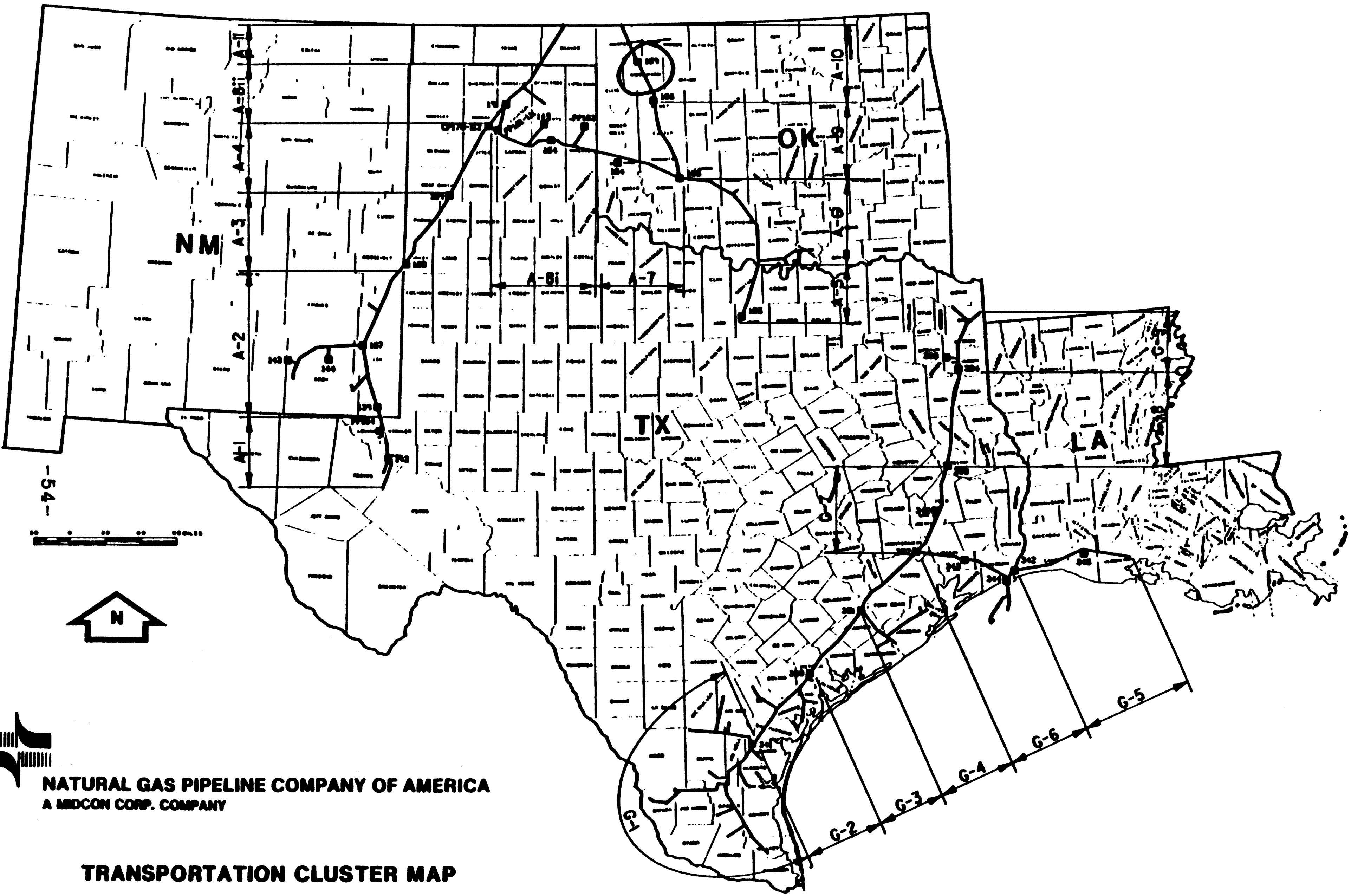
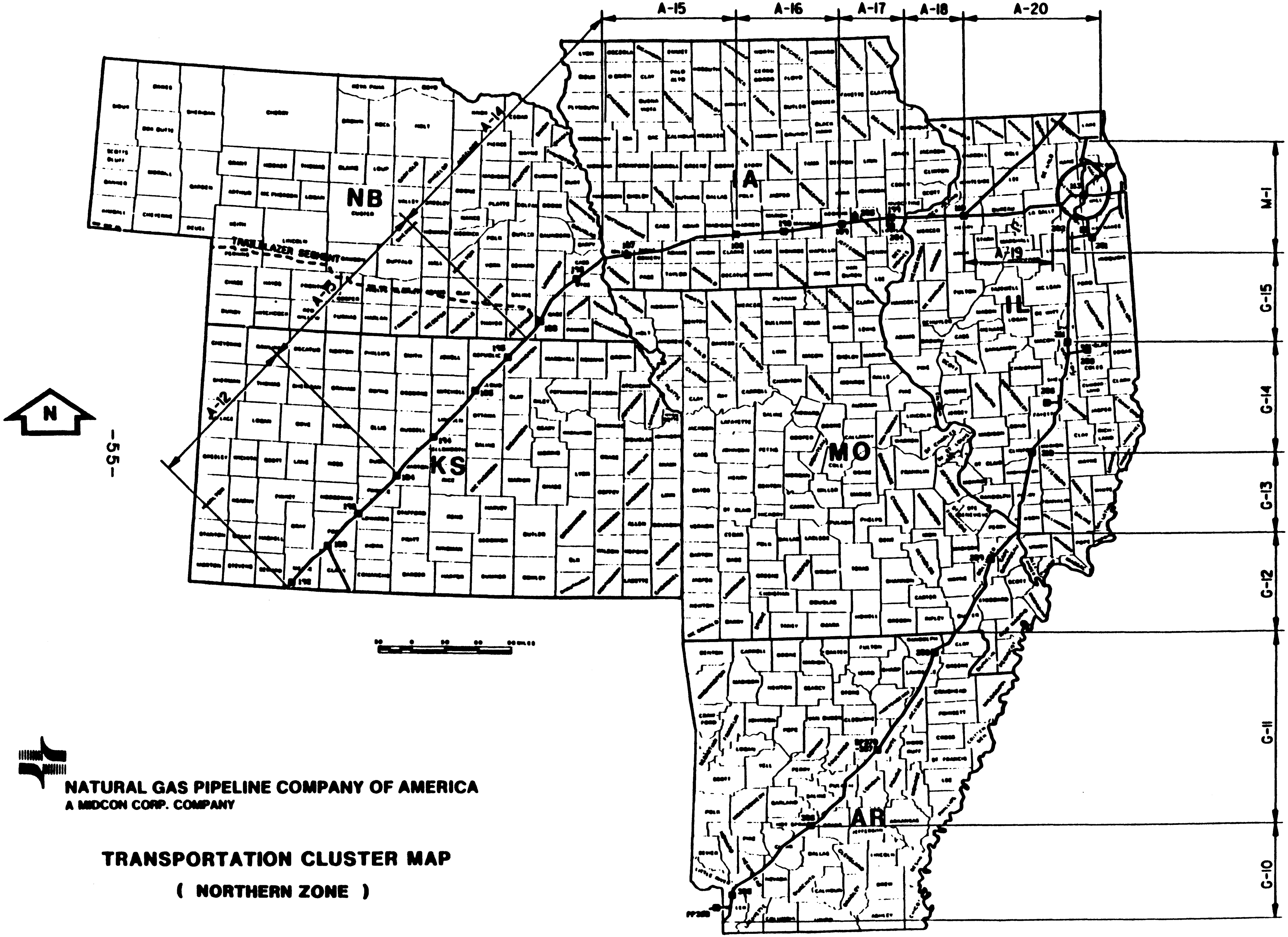


NATURAL GAS PIPELINE COMPANY OF AMERICA
A MIDCON CORP. COMPANY

TRANSPORTATION CLUSTER MAP
(SOUTHERN ZONE)



NATURAL GAS PIPELINE COMPANY OF AMERICA
A MIDCON CORP. COMPANY

TRANSPORTATION CLUSTER MAP
(NORTHERN ZONE)

Appendix A

NGPL PEAK AND OFFPEAK TRANSPORTATION RATES (CENTS/MMBTU) AND FUEL (%)

RECEIPT	G9	G10	G11	G12	G13	G14	G15	M1
	DELIVERY CLUSTERS							
A1	61.03 43.27 3.77%	61.03 43.27 3.96%	61.03 43.27 4.30%	61.03 43.27 4.64%	61.03 43.27 4.82%	61.03 43.27 5.01%	61.03 43.27 5.25%	61.03 43.27 5.39%
A2	56.89 39.76 3.77%	56.89 39.76 3.96%	56.89 39.76 4.30%	56.89 39.76 4.64%	56.89 39.76 4.82%	56.89 39.76 5.01%	56.89 39.76 5.25%	56.89 39.76 5.39%
A3	51.54 35.23 3.77%	51.54 35.23 3.96%	51.54 35.23 4.30%	51.54 35.23 4.64%	51.54 35.23 4.82%	51.54 35.23 5.01%	51.54 35.23 5.25%	51.54 35.23 5.39%
A4	47.67 31.95 3.77%	47.67 31.95 3.96%	47.67 31.95 4.30%	47.67 31.95 4.64%	47.67 31.95 4.82%	47.67 31.95 5.01%	47.67 31.95 5.25%	47.67 31.95 5.39%
A5	54.62 37.83 5.68%	54.62 37.83 5.87%	54.62 37.83 6.21%	54.62 37.83 6.55%	54.62 37.83 6.73%	54.62 37.83 6.92%	54.62 37.83 7.16%	54.62 37.83 7.30%
A6	50.27 34.15 5.19%	50.27 34.15 5.38%	50.27 34.15 5.72%	50.27 34.15 6.06%	50.27 34.15 6.24%	50.27 34.15 6.43%	50.27 34.15 6.67%	50.27 34.15 6.81%
A7	49.38 33.40 4.62%	49.38 33.40 4.81%	49.38 33.40 5.15%	49.38 33.40 5.49%	49.38 33.40 5.67%	49.38 33.40 5.86%	49.38 33.40 6.10%	49.38 33.40 6.24%
A81	47.93 32.17 4.14%	47.93 32.17 4.33%	47.93 32.17 4.67%	47.93 32.17 5.01%	47.93 32.17 5.19%	47.93 32.17 5.38%	47.93 32.17 5.62%	47.93 32.17 5.76%
A811	44.04 28.87 3.70%	44.04 28.87 3.89%	44.04 28.87 4.23%	44.04 28.87 4.57%	44.04 28.87 4.75%	44.04 28.87 4.94%	44.04 28.87 5.18%	44.04 28.87 5.32%
A9	45.58 30.18 4.85%	45.58 30.18 5.04%	45.58 30.18 5.38%	45.58 30.18 5.72%	45.58 30.18 5.90%	45.58 30.18 6.09%	45.58 30.18 6.33%	45.58 30.18 6.47%
A10	42.00 27.14 4.48%	42.00 27.14 4.67%	42.00 27.14 5.01%	42.00 27.14 5.35%	42.00 27.14 5.53%	42.00 27.14 5.72%	42.00 27.14 5.96%	42.00 27.14 6.10%
A11	41.35 26.59 3.40%	41.35 26.59 3.59%	41.35 26.59 3.93%	41.35 26.59 4.27%	41.35 26.59 4.45%	41.35 26.59 4.64%	41.35 26.59 4.88%	41.35 26.59 5.02%
A12	37.09 22.98 2.93%	37.09 22.98 3.12%	37.09 22.98 3.46%	37.09 22.98 3.80%	37.09 22.98 3.98%	37.09 22.98 4.17%	37.09 22.98 4.41%	37.09 22.98 4.55%

receipt point #159 in Woodward County.

c. However, Acme will have to transport the gas on a line owned by Oklahoma Natural Gas (ONG) to get from the wellhead to NGPL receipt point #159. The transportation charge by ONG will be $0.10/MMbtu.

d. NGPL will deliver Acme's gas to Acme's purchaser at NGPL's delivery point #113 in Will County, Illinois.

6. To determine how much NGPL will charge to transport the gas from Oklahoma to Illinois:

a. Look at the NGPL "Cluster Map" at page 54 of this Outline. Receipt point #159 is in cluster zone A-10.

b. Next, locate delivery point #113 on the NGPL Cluster Map at page 55 of this Outline. Delivery point #113 is in cluster zone M-1.

c. Now look at the NGPL rate chart at page 56 of this Outline. Find A10 on the left-hand column and then go over to M1 on the right-hand column.

d. Two rates are given: $0.42/MMBtu during "peak" winter months; and $0.2714/MMBtu during "offpeak" months.

e. The winter rate of $0.42/MMBtu applies to our (March) transaction.

f. The 6.10%/MMBtu factor is an additional deduction to account for fuel shrinkage and line loss. For our purposes, we will estimate this as representing a $0.05/MMBtu charge.

7. Charges not reflected by NGPL's tariff:

a. FERC operating charge (Annual Correction Assessment) - $0.0019/MMBtu.

b. Gas Research Institute charge - $0.015/MMBtu.

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B. Net-Back Price To Acme

	$/MMBtu
LDC Gate Sales Price	$2.1500
ONG Transport Fee	- .1000
NGPL Transport Fee	- .4200
NGPL Fuel Fee	- .0500
FERC Charge	- .0019
GRI Charge	- .0150
NET TO ACME	$1.5631

Note that Acme has beat the spot price by $0.31+/MMBtu.

XI. GAS SALES CONTRACTS

A. Purpose And General Format

1. Function: To pass title of gas (and other defined substances) from the producer to the gas purchaser. Specifies the terms of the sale and how the sale will be effected. E.g., construction of gathering lines, delivery point, custody transfer.

2. No standard form of gas contract. However, gas contracts do tend to uniformly address certain essential matters.

B. Basic Format

1. Identity of the Parties - Buyer and Seller.

2. Recitations - Consideration and purpose of the contract.

3. Representations - Title to the gas, authority to sell (or have it processed).

C. Basic Content

1. Commitment - What gas (leases, formations, etc.) is being committed to the contract?

2. Reservations - What rights to the gas are retained by the seller?

   a. Right to control operations, use gas for operations, prior commitments of gas (free gas clause in oil and gas lease).

   b. Ability to remove liquids prior to delivery of gas - or at some later time pursuant to a redelivery right for processing.

3. Price - How will the current and future sales prices be determined?

   a. Definite Price Escalators - precise schedule of periodic price increases.

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b. Indefinite Price Escalators - an event triggers a price increase; the price is calculated by reference to events outside the contract.

4. Indefinite Price Escalator Clauses - Traditional Forms:

   a. Area Rate Clause - price raised to the highest price permitted by applicable regulation.

   b. Favored Nations Clause - price raised to the level paid to another seller in the area.

5. Indefinite Price Escalator Clauses - Newer Forms:

   a. Index Pricing - price raised (or lowered) based upon reference to the price of a competing energy resource such as No. 2 Fuel Oil, No. 6 Fuel Oil, wholesale electric rates, coal, etc. The assumption is the indexed fuel will represent the current market value of the competing fuel (natural gas).

   b. Net-Back Pricing - price raised (or lowered) based upon reference to the price purchaser is able to resell the gas or gas and products. [This form of pricing has traditionally been used in Gas Processing Agreements and is now becoming more common in gas sales - especially where the gas is purchased by a marketer for resale. See the Sample Gas Marketing Transaction at page 53 of this Outline.]

   c. Another common form: Renegotiate (arbitrate).

6. Clauses Designed to Deescalate Prices - Market out, FERC out, Economic out provisions. Provide the purchaser with a mechanism to reduce the price paid when it is unable to resell the gas at the price being paid (market out), unable to recover the purchased cost of gas through its rates (FERC out), or it would be uneconomic for purchaser to

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continue purchasing under the current contract price (economic out).

7. Price-Related Matters - Tax reimbursement by purchaser to producer; Reimbursement for NGPA § 110 "production related costs" such as compression and gathering allowances.

8. Quantity - Although gas from a certain lease is "committed" to the contract, how much must the seller deliver and the buyer purchase?

9. Casinghead Gas - Purchaser's refusal to take casinghead gas may mean it will be flared in order to produce the associated oil. Many state conservation commissions prohibit or limit the quantity of gas that can be flared or vented; this means oil production will be shut in when the purchaser refuses to take casinghead gas.

    a. Take-<u>and</u>-Pay Clause - requires the purchaser to take the gas; no option to refuse to take the gas (by paying the producer money).

    b. Gas Processor has similar concerns when it sells residue gas at the tailgate of their processing plant. If the purchaser will not take the gas, processor may not be able to operate the plant.

10. Take-or-Pay Clause - requires the purchaser to take a stated percentage of the seller's gas deliverability or, instead of taking the gas, pay for it as though it was taken. Typically the purchaser has 5 years to make up the gas they paid for but did not take.

    a. A common form of take-or-pay clause provides:

        "Subject to the other provisions of this Contract, Seller agrees to sell and deliver and Pipeline agrees to purchase and receive, or pay for if made available hereunder but not taken, a daily quantitiy of gas, averaged over each accounting period (contract quantity) during the term hereof, equal to seventy-five percent (75%) of the maximum

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quantity of gas that Seller's well/s can deliver to Pipeline . . . ."

b. Note that the take-or-pay clause begins: "Subject to the other provisions of this Contract . . . ." Other provisions of the contract may relieve the purchaser from its obligation to take or pay for gas, or substantially reduce the quantity of gas "made available" for the purchaser to take.

11. Other Take Formulas - Ratable take, best efforts, no express obligation to take.

12. Gas Processor Formulas - Limit take obligation to capacity of plant, right to allocate capacity, economic operation.

13. Connection Obligations - When must purchaser connect new wells onto the system?

14. Producer Delivery Obligations - Up to allowable assigned to wells; warrant to provide a specific quantity.

a. Quality Standards - Limit impurities, heat content (Btu) limitations.

b. Delivery Point - Point where custody and liability for the gas will pass.

(1) NOTE: Today it is becoming more likely that gas produced in one state will have a delivery point far removed from the lease - such as a GM Plant in Michigan.

(2) This may change basic rights under the oil and gas lease - with the gas being sold "off the leased premises" royalty may have to be calculated using a "market value" formula instead of a "proceeds" formula. Even if a "proceeds" formula is used, where does the sale to generate the proceeds take place? In Michigan? Can the transportation and other marketing costs (gas marketer fees) be deducted?

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c. Delivery Pressure - pressure requirements to deliver gas into the purchaser's pipeline.

d. Compression - obligation or right of seller to compress gas to meet a delivery pressure.

15. Term - life of lease, life of reserves, stated duration. Right to terminate after notice.

a. "Evergreen" provisions - continues in effect for a specified period of time unless party gives notice of termination within e.g. 30 days prior to the contract anniversary date. A type of "successor to an existing contract" under § 2 (14) of the Natural Gas Policy Act of 1978.

b. "Rollover" Contract - term of art used in § 2 (12) of the Natural Gas Policy Act of 1978. A contract entered into after an existing fixed term contract has expired.

c. Regardless of the stated term in many "old gas" contracts, a sale subject to federal jurisdiction under the Natural Gas Act of 1938 is commencement of a "service" that cannot be abandoned unless FERC finds abandonment is in the "public interest." FERC is making it much easier to abandon - See FERC Order 451 and Order 490.

16. Deliveries of Gas - how will the gas be delivered from seller to purchaser? Dispatching coordination.

17. Measurement - how will the gas, and other components be measured? Type of meters, maintenance and operation of meters.

18. Tests - how will tests required by the contract be conducted? Meter tests, deliverability tests, quality tests.

19. Title - Proof of ownership or right to sell (or process).

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20. Payment Procedures - Reading meters, applying contract terms, calculating amount due, and sending the check.

    Will payment for all interests be made to the seller or will purchaser distribute payments to all persons having an interest in the gas?

21. Rights of Way - Purchaser usually given the right to use whatever easement rights lessee has under the oil and gas lease. See Delhi Gas Pipeline Corp. v. Dixon, 737 S.W.2d 96 (Tex. App. - Eastland 1987).

22. Force Majeure - Excuse for nonperformance due to specified events which relieve performance. God and government problems.

23. Notice - Contact person for each party to receive oral and written notices.

24. Disputes - Rights of parties, arbitration.

25. Choice of Law - What state's law will be used to interpret the contract?

26. Binding Effect - Contract binds the parties and their "successors and assigns."

27. Regulations - Contract subject to applicable state, federal, and local law.

28. Date - Date the agreement is executed. Typically not the date for calculating events under the contract.

29. Signatures - Signed by authorized individuals for each party.

D. Parties Bound by the Gas Sales Contract

1. Only the named producer, purchaser, and their successors and assigns are bound by the contract.

2. Typically the operator of the well will enter into the gas sales contract relying upon the terms of the operating agreement. However, the typical

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form of operating agreement does not grant the operator the right to bind the other working interest owners to a long term contract. Each has the right to take their gas in kind.

3. Gas contracts usually contain a representation by the gas seller that: "Seller owns or has the right to sell the gas."

4. To the extent seller does not actually have the right to sell the gas, the gas will not be subject to the gas sales contract. However, the seller may be liable to the purchaser under the contract warranty provision.

5. "Seller warrants the title to the Gas and that Seller has the right to sign this Contract on behalf of one hundred percent (100%) of the working interest owners in the well(s) under the lease(s) covered by this Contract."

6. Royalty owner's share of gas is probably subject to the contract unless royalty owner retains the right to take in kind.

   a. However, since the royalty owner is not a party to the contract, the provisions of the contract do not necessarily determine the lessor's rights against the lessee.

   b. For example, payment by the gas purchaser to the lessee may, in many situations, not be the basis for calculating lessee's royalty obligations under the oil and gas lease.

7. Although the royalty owner is not a party to the gas sales contract, they might be able to enforce the terms of the gas contract as a "third party beneficiary."

   a. If the lessee entered into the contract in part to discharge an obligation to its lessor (e.g. obligation to market production), the lessor may be able to assert rights under the contract as a third party beneficiary.

   b. Other working interest owners, and

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non-working interest owners, might also be able to assert third party rights.

E. Application of the Uniform Commercial Code

1. The Uniform Commercial Code, as the name implies, is a codification of rules designed to provide uniformity in dealing with commercial transaction contracts. Article 2, the Sales Article, has been adopted by all states except Louisiana.

2. Article 2 applies to transactions in "goods," including the sale of natural gas and oil.

   a. A processing agreement, to the extent there is no sale of the gas or liquids, is a service agreement governed by general contract law instead of the UCC.

   b. A sale of oil or gas while in the ground is not governed by the UCC.

   c. A transportation agreement is a service agreement and not governed by the UCC.

3. Significance of the UCC's application - special rules apply in creating, interpreting, and enforcing agreements governed by Article 2.

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XII. FEDERAL IMPACTS ON STATE LAW - FERC ORDER 451

A. Practical Considerations Regarding FERC Order 451

1. How many are there? Four documents comprise the FERC Order 451 series:

    a. Order No. 451, "Ceiling Prices: Old Gas Pricing Structure," Final Rule, Docket No. RM86-3-0000, III FERC Statutes and Regulations (CCH) § 30,701 (June 6, 1986); 51 Federal Register 22168 (June 18, 1986).

    b. Order No. 451-A, "Order Granting Rehearing in Part, Denying Rehearing in Part and Clarifying Final Rule," III FERC Statutes and Regulations (CCH) § 30,720 (Dec. 15, 1986); 51 Federal Register 46762 (December 24, 1986).

    c. Order No. 451-B, "Order Granting Rehearing in Part, Denying Rehearing in Part, Clarifying Final Rule, and Denying Stay Request," III FERC Statutes and Regulations (CCH) § 30,748 (June 3, 1987); 52 Federal Register 21669 (June 9, 1987).

    d. Order No. 451-C, "Order Denying Rehearing," 40 FERC (CCH) § 61,167 (Aug. 5, 1987).

2. FERC Order 451 is a Final Order and regulations have been promulgated to put it into effect. The primary regulation is 18 C.F.R. § 270.201 (1988); reproduced at pages 82 through 86 of this Outline.

3. Judicial review of Order 451 is currently pending in the United State Court of Appeals for the Fifth Circuit in: Mobil Oil Exploration Co. v. Federal Energy Regulatory Commission, Case No. 86-4940 (5th Cir., filed Dec. 15, 1986).

B. Order 451 Does Two Things:

1. Revises the maximum lawful price under § 104 and § 106 of the Natural Gas Policy Act (NGPA) by establishing a single alternative ceiling price for "old" (§ 104 and § 106) gas.

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a. Eliminates the previous ceiling prices for "vintages" of old gas that were based on when the gas reserves were placed in production.

b. Adopts the NGPA Post-1974 gas price as the new "alternative ceiling price."

c. Impact of this portion of Order 451:

   (a) Maximum Lawful Price for one of the lowest priced old gas categories prior to Order 451 would be $0.593/MMBtu as of March 1989.

   (b) After Order 451, the Maximum Lawful Price for this gas is $2.813/MMBtu.

d. Note that this portion of Order 451 operates regardless of what the parties do in the good faith negotiation process. This portion of the Order establishes a higher ceiling rate for old gas - however, collection of the higher price is a matter of contract.

e. The pricing provisions of Order 451 have been incorporated into the Code of Federal Regulations at 18 C.F.R. § 271.402 "Maximum lawful prices" (1988). This regulation provides, in part:

"§ 271.402 Maximum lawful prices.

(a) Ceiling prices. Unless a different rate is applicable under paragraph (c) of this section, the maximum lawful price for a category of natural gas to which this subpart applies shall be the price specified in Table II of § 271.101(a) for such category of gas. [NOTE: This table can be found at pages 28 and 29 of this Outline.]

. . . .

(c) Applicable higher rates. . . . .

(7) The maximum lawful price, per

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MMBtu, for the first sales of all categories of gas otherwise subject to lower maximum lawful prices under this subpart is the price specified in Table II of § 271.101(a) for post-1974 gas, <u>if the price is established:</u>

(i) Under a contract or contract amendment executed after July 18, 1986; <u>or</u>

(ii) In accordance with the good faith negotiation procedures of § 270.201 of this chapter." (Emphasis added).

2. Establishes a "good faith negotiation" ("GFN") process by which the producer can force the purchaser to either pay the new ceiling price or release the gas from their contract.

   a. The process for implementing the new alternative ceiling price authorized by Order 451 is unique. When the other NGPA price ceilings were implemented, the producer could collect the increased NGPA price to the extent their contract authorized collection of the higher price.

      (1) Under Order 451, you must have authorization under your contract to collect the increased NGPA price; <u>but</u>

      (2) The purchaser can refuse to pay the higher price and thereby make the existing contract subject to termination by the producer.

   b. Note that if the producer and purchaser enter into a contract after July 18, 1986 the Post-1974 gas ceiling price will apply.

C. What Contracts Are Elgible For Order 451?

1. The producer and purchaser can <u>agree</u> on a new price for old gas so long as the price does not exceed the new ceiling. 18 C.F.R. § 270.201

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(1988) provides, in part:

"(a) . . . .

(3)(i) Any existing contract under which old gas is sold may be renegotiated or amended at any time to provide for a price up to the alternative maximum lawful price under § 271.402(c)(7)(i) of this chapter without using the good faith negotiation procedures."

2. The producer can <u>force</u> the purchaser to consider paying a higher price only if their existing contract "provides authority for the first seller to collect a higher price upon the establishment by the Commission of a higher maximum lawful price." 18 C.F.R. § 270.201(a)(2)(ii)(A) (1988).

3. Guidance concerning what sort of contract authority to collect a higher price will suffice can be found at 18 C.F.R. § 270.205 "Contractual authorization to collect NGPA rates" (1988).

   a. 18 C.F.R. § 270.205 provides, in part:

   "(a) <u>Existing interstate contracts.</u> In the case of an existing contract for a first sale of natural gas to which the Natural Gas Act applies:

   (1) Any contractual provision for a change in price in such contract which by its terms specifically permits collection of NGPA rates or of maximum lawful prices prescribed by legislation, constitutes contractual authorization to charge and collect the NGPA rates applicable to such first sale.

   (2) A contractual provision described in § 154.93 (b-1) (relating to area rate clauses), or similar provision, generally will be considered to constitute contractual authorization to charge and collect an NGPA rate to the extent the parties intended to authorize charging and collection of one or more NGPA rates under the contract."

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b. 18 C.F.R. § 154.93 (b-1) (1988) provides:

"(b-1) Provisions that permit a change in price to the applicable just and reasonable area ceiling rate which has been, or which may be, prescribed by the Commission for the quality of the gas involved . . . ."

c. The Commission's preamble to Order 451-A provides:

"Producers may collect the new ceiling price only to the extent permitted by their contracts. Indefinite price escalation clauses in existing contracts provide the necessary contractual authority." 51 Federal Register at 22204.

D. The GFN Process: A One-Shot Deal

1. 18 C.F.R. § 270.201(a)(4) (1988) provides, in part:

"(4) A party to an existing contract may <u>not</u> request a nomination of a price under the provisions of this section for any gas sold under the contract, if that party:

(i) And the purchaser or first seller have renegotiated the price <u>or any other term</u> for the sale of any old gas under the contract after July 18, 1986, without using the good faith negotiation procedures of this section, <u>and have not agreed in writing to preserve their rights under this section</u> . . . ." (Emphasis added).

2. Must be careful to preserve your rights under Order 451 in conducting routine transactions which could be deemed a modification or waiver of rights under an existing contract.

a. 18 C.F.R. § 270.201(a)(2)(ii)(A) defines an "existing contract" as "a contract in effect on July 18, 1986 . . . ."

b. The definition of "existing contract" includes "an expired contract pursuant to

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which sales of natural gas are continuing on [July 18, 1986] . . . under the service obligation of a certificate of public convenience and necessity . . . ." § 270.201 (a)(2)(ii)(A).

c. In any event, the contract must be one that: "includes the sale of any old gas and provides authority for the first seller to collect a higher price upon establishment of a higher maximum lawful price." § 270.201(a)(2)(ii)(A).

d. Pursuant to § 270.201(a)(2)(ii)(B):

"An existing contract includes the sale of old gas if, on July 18, 1986, the contract encompasses the sale of any gas that has not been abandoned under section 7(b) of the Natural Gas Act and which, if sold, would be priced as old gas, whether or not any old gas is sold on that date."

E. The GFN Process

1. Tom Johnson has likened the Order 451 GFN process to "the mating dance of the whooping crane;" noting that discussion of the process is "about as exciting as watching grass grow." Johnson, "Order 451 — Market-based Pricing for 'Old' Gas" 6 Oil & Gas L. and Tax'n Rev. 253, 257 (1988).

2. 18 C.F.R. § 270.201 (1988) details the steps in the GFN process. The discussion of the actual offer/counter-offer process begins at § (b) of §270.201. A copy of this regulation is reproduced at pages 78 through 82 of this Outline.

3. The process cannot be initiated until after January 23, 1987. 18 C.F.R. § 270.201(6)(1)(i).

4. The ultimate goal of Order 451 is to permit the "market" to determine the ultimate price for old gas - with the new alternative ceiling price operating as a cap. Although the producer may have authority to collect the higher rate by the terms of their contract, the ultimate rate will be

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determined through negotiation - either by the original parties to the contract or, if they cannot agree, by negotiation with a new purchaser after the existing contract is terminated and the service obligation abandoned.

5. The GFN process can be best understood by using a hypothetical. Suppose we have a producer - "A" who has four gas sales contracts with a pipeline - "X." The contracts are as follows:

   #1 Dated July 1, 1960
   Covers NGPA § 104 Gas
   Contains only a "definite" price escalation clause: $.01/year during life of contract.

   #2 Dated July 1, 1965
   Covers NGPA § 104 and § 108 Gas
   Contains an area rate clause.

   #3 Dated July 1, 1977
   Covers NGPA § 106(a), § 103, and § 108 Gas
   Contains an area rate clause.

   #4 Dated July 1, 1980
   Covers NGPA § 102 and § 108 Gas

   NOTE: A will be unable to use the GFN process with regard to Contract #1. It is not an "existing contract" under Order 451 because it does not give A authority to collect a higher price. 18 C.F.R. § 270.201(a)(2)(ii)(A) (1988) and 18 C.F.R. § 271.402(c)(7) (1988).

   However, A and X can, by voluntary agreement, increase the price of gas under Contract #1 up to the new ceiling. 18 C.F.R. § 270.201(a)(3) (1988) and 18 C.F.R. § 271.402(c)(7)(i) (1988).

6. The Opening Shot - Only the producer can activate the GFN process. 18 C.F.R. § 270.201(b)(1)(i) (1988) provides: "At any time after January 23, 1987, a first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying old gas under any existing contract . . . ."

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a. "First seller" is defined by 18 C.F.R. § 270.201(a)(2)(iii) (1988) as:

> "(A) An owner of a working interest in an oil or gas lease that has a direct contractual relationship with a purchaser for a 'first sale' of gas, as defined in section 2(21) of the NGPA; and
>
> (B) An operator of an oil and gas lease that has a direct contractual relationship with a purchaser for a 'first sale' on behalf of any owner of a working interest in the lease that does not have such a relationship."

b. Note the producer (first seller) can initiate the GFN process "at any time" after January 23, 1987.

7. Mechanical Requirements:

   a. Any request for a price nomination or other notice under the GFN process must be in writing and sent by U.S. mail, return receipt requested. 18 C.F.R. § 270.201(a)(6) (1988).

   b. Deadlines may be altered by written agreement of the parties. 18 C.F.R. § 270.201(a)(7) (1988).

8. A decides to initiate the GFN process by sending a letter to X, requesting X to nominate the price X is willing to pay for NGPA § 104 gas sold under Contract #2. A also includes in its letter a request that X provide A with a list of all of X's firm sales customers, including the name and address of each customer's representative responsible for negotiating gas purchases. 18 C.F.R. § 270.201(b)(1)(ii) (1988).

   a. X must send A the list of customers and names within 30 days after receiving the request with a certification the list is complete and accurate.

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b. X must respond to A's price nomination [concerning the § 104 gas] within 60 days after A's letter is received or A will be authorized to offer the gas for sale to another purchaser. If A enters into a contract to sell the gas to a new purchaser, A can abandon the sale of the gas to X after giving X 30 days notice. 18 C.F.R. § 270.201 (c)(1) (1988).

c. Recall that Contract #2 covers NGPA § 104 and § 108 gas.

9. Within 30 days after receiving A's letter, X requests A to nominate a price it is willing to accept for the § 108 gas covered by Contract #2 and the § 103 and § 108 gas under Contract #3. 18 C.F.R. § 270.201(b)(2) (1988).

a. X, following A's initiation of the GFN process, can force into the process gas "under any existing contract with the purchaser that includes the sale of any old gas, whether or not named in the first seller's request . . . ." 18 C.F.R. § 270.201(b)(2) (1988).

b. Note that X has brought in the § 108 gas in Contract #2 and has also brought in the § 103 and § 108 gas sold under Contract #3.

c. A now has 60 days to nominate a price for gas covered by X's request. If A fails to respond, X can terminate its purchases of the gas named in its request at anytime upon 60 days notice to A. 18 C.F.R. § 270.201(c)(2) (1988).

10. Within 30 days after receiving X's letter, A, to bring in the low-priced § 106(a) gas covered by Contract #3 (but not included in X's letter), must request X to nominate a price for the § 106(a) gas. 18 C.F.R. § 270.201(b)(3) (1988).

If X fails to nominate a price for the § 106(a) gas within 60 days after receiving A's request, A can contract to sell this gas to others upon

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giving X 30 days notice that A will abandon the sale to X. 18 C.F.R. § 270.201(c)(1) (1988).

11. Effect of X's possible responses:

    a. If X responds to A's § 104 and § 106(a) requests by nominating the alternative ceiling price established by Order 451, sales must continue under the terms of the existing contract. 18 C.F.R. § 270.201(d) (1988).

    b. If X responds by agreeing to pay the alternative ceiling price, but demands a change in the other terms of the existing contract, then A will be able to abandon the sale to X — unless A agress.

    c. If X proposes a price less than the alternative ceiling price, A will be able to abandon the sale to X — unless A agress to the proposed price.

    d. If X proposes less than the alternative ceiling price, or proposes a change of the other contract terms, A has 30 days to accept; if A fails to accept, X's proposals are deemed rejected. 18 C.F.R. § 270.201 (e)(1) (1988).

12. Effect of A's possible responses:

    a. If A accepts the price nominated by X for the § 103 and § 108 gas, sales must continue at the agreed-upon price under the other terms of the existing contract — unless the parties agree to alter the other contract terms.
    18 C.F.R. § 270.201(e)(2) (1988).

    b. If A rejects the price nominated by X, A must continue sales to X at the existing price until the sale of gas is abandoned. However, immediately upon rejection A can seek new purchasers. 18 C.F.R. § 270.201(e)(3)(1988).

13. X has the right to make similar responses to A's price nominations, with similar results. See 18 C.F.R. § 270.201(f) (1988).

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14. NOTE: X cannot do anything to Contract #4 because Contract #4 does not cover any "old" gas. 18 C.F.R. § 270.201(b)(2) and § 270.201(a)(2)(ii)(A) (1988) ("existing contract" limited to contracts that contain some "old" gas).

F. The Impact Of Order 451 On Assignments

1. Using our previous hypothetical, recall that A and X have the following gas sales contracts:

   #1 Dated July 1, 1960
   Covers NGPA § 104 Gas
   Contains only a "definite" price escalation clause: $.01/year during life of contract.

   #2 Dated July 1, 1965
   Covers NGPA § 104 and § 108 Gas
   Contains an area rate clause.

   #3 Dated July 1, 1977
   Covers NGPA § 106(a), § 103, and § 108 Gas
   Contains an area rate clause.

   #4 Dated July 1, 1980
   Covers NGPA § 102 and § 108 Gas

2. Suppose that on July 1, 1988 A assigned all the wells producing § 108 gas covered by Contract #2 to B. B also has an existing contract [Contract #5] with X that contains some § 104 and § 102 gas.

3. On August 1, 1988 A initiates the GFN process with X with regard to the § 104 gas in Contract #2. What is the effect of A's assignment to B?

   a. Can X request A or B to nominate a lower price for the § 108 gas owned by B and covered by Contract #2?

   b. Can X request B to nominate a price for the § 102 gas covered by Contract #5?

   c. These types of assignment problems prompted FERC to adopt Order 451-B.

4. The regulations adopted under Order 451-B address

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two basic issues concerning assignments:

a. First, if the assignment restricts the purchaser's GFN rights, the rights of the assignor and assignee are similarly restricted.

b. Second, the purchaser's GFN rights will not be expanded merely because an assignment has occurred.

5. Using our hypothetical: Suppose B negotiates a clause in its lease purchase with A that A will not do anything that will trigger the GFN process with regard to the § 108 [Contract #2] gas properties being assigned. If A triggers the GFN process under Contract #3, to the extent the A-B assignment affects X's GFN rights:

A "MAY NOT REQUEST A NOMINATION OF PRICE UNDER [THE GFN PROCEDURE] FOR ANY GAS SOLD UNDER ANY EXISTING CONTRACT WITH" X. 18 C.F.R. § 270.201 (a)(5)(i) (1988).

a. This terrible event will occur unless X's GFN rights, as to the assigned gas, are "unaffected by the assignment."

b. X could argue that any sort of covenant between A and B, that might impair X's GFN rights, is an "affect" on X's rights due to the assignment.

c. However, A and B could argue that so long as X's rights were not diminished by the assignment, X's rights are "unaffected." How can an assignment between A and B reduce X's rights since the regulations provide for remedy for a failure to act by each party at each step?

6. Restrictions on assignment can also have a material effect on the assignee. To the extent X's GFN rights are affected as to the gas retained by A, B may not exercise its GFN rights as to the assigned gas. 18 C.F.R. § 270.201(a)(5)(ii) (1988). Therefore, if A retained the § 108 gas and attempted to restrict X's GFN rights as to the

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§ 108 gas, B's GFN rights as to the low-priced gas would be impaired -- to the extent X's rights regarding the § 108 gas are "affected."

7. Because of these broad statements, whenever A and B place restrictions on how their interests will be treated with regard to Order 451, they must evaluate the potential scope and effect of such restrictions under 18 C.F.R. § 270.201(a)(5) (1988).

   a. Note that some sort of restriction may be absolutely necessary to prevent the assignor (or assignee) from triggering (or not being able to trigger) a course of events that can significantly affect the value of the assigned or retained property.

   b. Also note that an inadvertent action by one of the parties may squander the GFN rights of the other. See 18 C.F.R. § 270.201(a)(4)(i) (1988) (amend a term without agreeing in writing to preserve GFN rights).

8. 18 C.F.R. § 270.201(b)(5) (1988) addresses the effect of the GFN process on the assigned and retained interests of A and B.

9. SITUATION #1: Using our hypothetical, assume A, after the July 1, 1988 assignment of the § 108 [Contract #2] gas to B, initiates the GFN process with regard to the § 106(a) gas in Contract #3.

   a. X can respond by requesting a price nomination for any gas which, ON JUNE 3, 1987, X could have reached - in this case X's request can include the § 108 gas assigned to B since on June 3, 1987 X could have reached it under Contract #2 (contract with some "old" gas and the § 108 gas). 18 C.F.R. § 270.201(b)(5)(ii) (1988).

   b. However, X cannot bring in any of the gas B owns under Contract #5. §(b)(5)(ii) covers only gas subject to an existing contract between the "purchaser and the assignor."

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10. SITUATION #2: Assume B, after the July 1, 1988 assignment, initiates the GFN process with regard to the § 104 gas covered by its Contract #5.

    a. Although X can respond by bringing in the § 102 gas covered by Contract #5, X cannot bring in the § 108 gas covered by the assignment from A [Contract #2].

    b. X's GFN rights are limited to the gas which B owned as of June 3, 1987. 18 C.F.R. § 270.201(b)(5)(iv) (1988).

    c. Note that whenever we "freeze" ownership of property for any purpose, we have to go back to the selected date - here June 3, 1987 - to ascertain the rights of the parties.

11. SITUATION #3: Lets change the facts by assuming B was assigned the § 104 gas under Contract #2 and A retained the § 108 gas. B triggers the GFN process as to the § 104 gas in Contract #2.

    a. X can respond by bringing any gas, which on June 3, 1987, belonged to A. This includes not only A's § 108 gas under Contract #2, but also A's § 103 and § 108 gas under Contract #3.

    b. Since B's GFN request was limited to the assigned gas, X's rights are likewise limited to gas owned by the assignor of the assigned gas -- as of June 3, 1987. 18 C.F.R. 270.201(b)(5)(iii) (1988).

12. 18 C.F.R. § 270.201(b)(5)(v) and (vi) (1988) address how the requests and responses will be circulated among the assignor, assignee, and purchaser.

G. "Old" Gas Is Governed By The NGA And The NGPA

1. Under the NGPA "old" gas includes § 104 gas (dedicated to interstate commerce as of November 8, 1978) and § 106(a) gas (interstate rollover contracts) for which a "just and reasonable" rate was in effect under the NGA as of November 8,

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1978. 18 C.F.R. § 271.401 (1988).

2. The sale of this old gas, after the Phillips decision, is under a § 7 certificate of public convenience and necessity.

3. Therefore, in addition to terminating the underlying gas contract, and having NGPA authority to sell the gas at a higher price, we must also cross two additional hurdles:

   a. Obtain an abandonment of the service obligation created under § 7; and

   b. Obtain a certificate for new sales.

4. Abandonment and certificate authority are both granted if you follow the Order 451 procedures to terminate the existing contract.

5. The lingering service obligation is discharged under Order 451 by giving the purchaser's firm sales customers the right of first refusal to any gas released pursuant to Order 451. 18 C.F.R. § 270.201(g) (1988).

6. If the purchaser is not an open-access transporter under Order 436/500, the producer can require that any released gas be transported on the purchaser's pipeline. 18 C.F.R. § 270.201(h) (1988).

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Subpart B—Special Rules

§ 270.201 Good faith negotiation procedures.

(a) *Applicability, definitions, and general rules.* (1) This section applies to requests for renegotiation of the price of old gas sold under an existing contract.

(2) For purposes of this section:

(i) "Old gas" means natural gas which, if sold, would be subject to a maximum lawful ceiling price under section 104 or 106(a) of the NGPA.

(ii)(A) "Existing contract" means a contract in effect on July 18, 1986, or an expired contract pursuant to which sales of natural gas are continuing on that date under the service obligation of a certificate of public convenience and necessity, that includes the sale of any old gas and provides authority for the first seller to collect a higher price upon establishment by the Commission of a higher maximum lawful price.

(B) An existing contract includes the sale of old gas if, on July 18, 1986, the contract encompasses the sale of any gas that has not been abandoned under section 7(b) of the Natural Gas Act and which, if sold, would be priced as old gas, whether or not any old gas is sold on that date.

(iii) The terms "first seller" and "party to a contract" include:

(A) An owner of a working interest in an oil or gas lease that has a direct contractual relationship with a purchaser for a "first sale" of gas, as defined in section 2(21) of the NGPA; and

(B) An operator of an oil or gas lease that has a direct contractual relationship with a purchaser for a "first sale" on behalf of any owner of a working interest in the lease that does not have such a relationship.

(3)(i) Any existing contract under which old gas is sold may be renegotiated or amended at any time to provide for a price up to the alternative maximum lawful price under § 271.402(c)(7)(i) of this chapter without using the good faith negotiation procedures.

(ii) A price for old gas that exceeds the otherwise applicable maximum lawful price under § 271.402 of this chapter may be collected under an existing contract only if the first seller and purchaser agree upon a price up to the alternative maximum lawful price under § 271.402(c)(7)(ii) in accordance with this section.

(4) A party to an existing contract may not request a nomination of a price under the provisions of this section for any gas sold under the contract, if that party:

(i) And the purchaser or first seller have renegotiated the price or any other term for the sale of any old gas under the contract after July 18, 1986, without using the good faith negotiation procedures of this section, and have not agreed in writing to preserve their rights under this section;

(ii) Has previously requested nomination of a price under paragraph (b)(1) of this section for any gas sold under the contract; or

(iii) Has been requested under this section to nominate a price for any gas sold under the contract, and the last date has passed under paragraphs (b)(2) or (b)(3) of this section to request the other party to nominate a price for gas sold under the contract.

(5)(i) A first seller that validly assigns or otherwise transfers gas subject to an existing contract on or after June 3, 1987 may not request a nomination of price under the provisions of this section for any gas sold under any existing contract with that purchaser unless the purchaser's right to renegotiate, under the provisions of this section, the terms of sale of the assigned gas are unaffected by the assignment.

(ii) A first seller to whom gas subject to an existing contract is validly assigned, or otherwise transferred, on or after June 3, 1987 may not request nomination of a price under the provisions of this section for the assigned gas, unless the purchaser's right to renegotiate, under the provisions of this section, the terms of sale of all gas sold under any existing contract between the purchaser and the assignor on June 3, 1987 are unaffected by the assignment.

(6) Any request for nomination of a price under this section, any nomination of a price in response to such a request, and any notice of abandonment of sales or termination of purchases under this section must be sent by U.S. mail, return receipt requested.

(7) Any deadline under this section for requesting a nomination of a price, or for nominating a price in response to such a request, may be extended by mutual agreement of the parties in writing. Any notice required under this section to be given before a first seller or purchaser abandons or terminates sales or purchasers may be shortened by mutual agreement of the parties in writing.

(8) A party nominating a price may propose a change in any other term of the existing contract, and for purposes of this section, the terms "nominated

price" and "nomination" may include such a proposed change.

(b) *Requests for negotiation and nomination of price.*

(1)(i) At any time after January 23, 1987, a first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying old gas under any existing contract by submitting a written request to the purchaser, and may specify the wells or category of wells under each contract for which the first seller requests a renegotiated price.

(ii) When requesting a nomination of a price under this paragraph, a first seller may also request the purchaser to provide the first seller with a current list of all of the purchaser's firm sales customers, including the name and address of an employee or agent responsible for negotiating purchases of natural gas on behalf of the customer. The purchaser must send the list of customers to the first seller within 30 days after receiving the request, and must include a certification of its completeness and accuracy. The list must be sent by U.S. mail, return receipt requested.

(2) Within 30 days after receiving a request for nomination of a price under paragraph (b)(1) of this section, the purchaser may request the first seller to nominate a price at which the first seller is willing to continue selling any gas, including old gas for which the first seller has requested a nomination of price by the purchaser, under any existing contract with the purchaser that includes the sale of any old gas, whether or not named in the first seller's request, by submitting a written request to the first seller.

(3) Within 30 days after receiving a request from a purchaser for nomination of a price for any gas under a contract that is not named in the first seller's request and that includes the sale of any old gas, the first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying any old gas under that contract, including old gas for which the purchaser has requested a nomination of price by the first seller, by submitting a written request to the purchaser.

(4) A first seller's request for nomination of a price under paragraph (b)(1) of this section constitutes an offer to release the purchaser from its contract obligation to purchase any gas sold under any existing contract with the first seller, whether or not named in the first seller's request, that includes the sale of any old gas.

(5)(i) The provisions of this paragraph apply when (A) a first seller validly assigns (or otherwise transfers) gas subject to an existing contract to another first seller on or after June 3, 1987 and (B) the assignor or assignee is eligible to request nomination of a price under paragraph (b)(1) of this section.

(ii) If the assignor requests nomination of a price, under paragraph (b)(1) of this section, for old gas sold under any contract between it and the purchaser, the purchaser may request nomination of a price under paragraph (b)(2) of this section for any gas which on June 3, 1987 was subject to an existing contract between the purchaser and the assignor.

(iii) If the assignee requests nomination of a price under paragraph (b)(1) of this section for the assigned gas, the purchaser may request nomination of a price for any gas which on June 3, 1987, was subject to an existing contract between the assignor and the purchaser, but the purchaser may not request nomination of a price for any other gas.

(iv) If the assignee requests nomination of a price under paragraph (b)(1) of this section for old gas other than the assigned gas, the purchaser may not request nomination of a price under paragraph (b)(2) of this section for the assigned gas.

(v) The purchaser must address any requests for nomination of a price authorized by paragraphs (b)(5) (ii) or (iii) of this section to the first seller currently selling it the gas for which nomination of a new price is requested.

(vi) If a first seller receives a request for nomination of a price authorized by paragraph (b)(5) (ii) or (iii) of this section with respect to an existing contract for which it did not make a nomination request under paragraph (b)(1) of this section, the first seller may request under paragraph (b)(3) of this section that the purchaser nominate a price for any old gas sold under that contract, whether or not the contract was named in the nomination request of the assignor or assignee under paragraph (b)(1) of this section.

(c) *No response to request for nomination.* (1) If the purchaser does not nominate a price in writing within 60 days after receiving the first seller's request for nomination of a price, the first seller may offer to sell all or part of the gas named in its request for nomination to a new purchaser. The first seller is authorized, upon 30-days written notice to the existing purchaser, to abandon the sale of the gas if the first seller enters into a written contract for the sale of all or part of the gas to a new purchaser after any necessary compliance with paragraph (g) of this section.

(2) If the first seller does not nominate a price in writing within 60 days after receiving the purchaser's request for nomination of a price, the purchaser may terminate its purchases of all or part of the gas named in its request for nomination at any time upon 60-days written notice to the first seller.

(d) *Purchaser's nomination of highest price.* If the purchaser nominates in writing the highest price to which an existing contract price could escalate with the purchaser's agreement under § 271.402(c)(7)(ii) of this chapter, and the purchaser does not propose a change in any term of the contract, sales must continue at the nominated price under the terms of the existing contract.

(e) *Purchaser's nomination of lower price; first seller's options.* (1) If the purchaser nominates in writing a price less than the highest price to which the existing contract price could escalate or proposes a change in any other term of the contract, the first seller must accept or reject the nominated price in writing within 30 days after receiving the nomination. If the first seller does not accept the purchaser's nominated price in writing within 30 days, the nominated price is deemed rejected.

(2) If the first seller accepts the nominated price, sales must continue at the agreed-upon price under the other terms of the existing contract, unless such terms are renegotiated by the parties.

(3) If the first seller rejects the nominated price, the first seller must continue sales to the purchaser at the existing price until the sale of the gas is abandoned under this paragraph. At any time after a rejection, the first seller may offer to sell to a new purchaser all or part of the gas for which no price is agreed upon under this paragraph.

(4) A first seller is authorized, upon 30-days written notice to the existing purchaser, to abandon the sale of any gas offered under this paragraph for which the first seller enters into a written contract with a new purchaser after any necessary compliance with paragraph (g) of this section.

(f) *First seller's nomination of price; purchaser's options.* (1) If the first seller nominates a price in writing in response to the purchaser's request under paragraph (b)(2) of this section, the purchaser must accept or reject the nominated price in writing within 30 days after receiving the nomination. If the purchaser does not accept the first seller's nominated price in writing within 30-days, the nominated price is deemed rejected.

(2) If the purchaser accepts the nominated price, purchases must continue at the agreed-upon price under the other terms of the existing contract, unless such terms are renegotiated by the parties.

(3) If the purchaser rejects the nominated price, the purchaser may at any time terminate its purchases of all or part of the gas named in its request for nomination upon 60-days written notice to the first seller.

(4) The terms of the existing contract apply until the purchaser accepts the first seller's nominated price or terminates purchases of the gas under this paragraph.

(5) A first seller is authorized to abandon sales of the gas to the purchaser if the purchaser terminates purchases of gas under this section and the first seller enters into a written contract for the sale of the gas to a new purchaser after any necessary compliance with paragraph (g) of this section.

(g) *Existing firm sales customers' right of first refusal*—(1) *General rule.* (i) If the first seller offers to sell gas subject to release due to termination or abandonment under paragraphs (c), (e), or (f) of this section ("offer") to a new purchaser that is not an existing firm sales customer of the existing purchaser, the first seller must present the same offer to all existing firm sales customers, if:

(A) The existing purchaser is not subject to the non-discriminatory access provisions of § 284.8(b) or § 284.9(b) of this chapter, and;

(B) The offer encompasses the sale of any gas subject to the Commission's jurisdiction under section 1(b) of the Natural Gas Act and is substantially accepted in principle by the new purchaser in an arms-length transaction.

(ii) Any existing firm sales customer has a right of first refusal to purchase the gas under the terms of the offer. The offer must be presented in accordance with the provisions of this paragraph.

(2) *Making the offer.* The offer to a new purchaser that is not an existing firm sales customer must be presented to all such customers of the existing purchaser not later than 10 days after the offer is substantially accepted in principle by the new purchaser. The offer must be tendered by U.S. mail, return receipt requested.

(3) *Acceptance and rejection of offer; no counteroffer.* (i) An existing firm sales customer must accept the offer in writing within 20 days after receiving the offer. The offer is deemed accepted when it is signed and placed in the U.S. mail, return receipt requested. If the offer is not accepted by an existing firm sales customer within 20 days of its receipt, the offer is deemed rejected.

(ii) Any written counteroffer by an existing firm sales customer constitutes a rejection.

(iii) If the first seller receives more than one acceptance from an existing firm sales customer, the first seller may determine which such customer will become the new purchaser.

(4) *Termination of right of first refusal.* If no existing firm sales customer accepts the offer made under this paragraph within 20 days of receiving the offer, the first seller may execute a written contract with the new purchaser that substantially accepted the offer before it was sent to the existing firm sales customers. Such written contract with a new purchaser is not subject to a right of first refusal.

(5) *Definition.* For purposes of this section, "existing firm sales customer" means a customer with which the existing purchaser has a contract for the sale of gas not subject to a prior claim by another customer or another class of service, and at the same priority as any other class of firm service, which is in effect on the date a new purchaser substantially accepts in principle an offer under paragraph (g)(1) of this section.

(h) *Transportation by existing pipeline purchaser.* A purchaser that is an interstate pipeline not subject to the non-discriminatory access provisions of § 284.8(b) or § 284.9(b) of this chapter must transport any gas released due to termination or abandonment under this section, on behalf of any shipper, to any existing customer of the interstate pipeline or to any pipeline to which the interstate pipeline is interconnected, and in accordance with § 284.225 of this chapter, if the purchaser:

(1) Does not submit a timely nomination of a price for gas under paragraph (c)(1) of this section in response to the first seller's request for nomination of a price;

(2) Nominates a price under paragraph (e)(1) of this section that is less than the highest price to which its existing contract price could escalate if it were a new or amended contract;

(3) Terminates purchases of gas under paragraph (c)(2) of this section when the first seller does not submit a timely nomination of a price; or

(4) Terminates purchases of gas under paragraph (f)(3) of this section after rejecting a price for gas nominated by the first seller.

[Order 451, 51 FR 22219, June 18, 1986, as amended by Order 451-A, 51 FR 46818, Dec. 24, 1986; Order 451-B, 52 FR 21677, June 9, 1987]

XIII. FEDERAL IMPACTS ON STATE LAW - FERC ORDER 500

A. A Guide To Take-or-Pay Crediting - Qualifying Dates

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

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

3. 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.

4. 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 after January 1, 1986 (so long as the pipeline perfromed open access transportation during some portion of 1986).

B. The "Offer of Credit"

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

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

3. 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.

a. 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.

b. Gas Processor Exception to 85% Rule - Offer of credit for residue gas sales need to be

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signed only by the processing plant operator when the processor purchases gas from behind-the-plant producers under percentage-of-proceeds processing agreements entered into on or before June 23, 1987.

4. 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, "Order on Rehearing Modifying Prior Orders and Requesting Comments," Docket Nos. RM 87-34-000 through RM 87-34-054 (Dec. 23, 1987); 52 Federal Register 48,986 (Dec. 29, 1987).

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

6. 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

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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.

7. 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.

C. As with assignments under Order 451, assignments of property that may affect your Order 500 situation should be carefully evaluated so the total economic impact of the transaction can be evaluated.

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XIV. OPERATING PROBLEMS

A. Joint Operations

1. Can have a multiple working interest owner situation created in numerous ways:

   a. Various owners of undivided mineral interests lease to different developers. For Example: A owned the minerals in Section 30 at his death. Under A's will, the mineral interest passed to A's daughters, B and C, in equal shares. B leased to X; C leased to Y. X and Y each own the nonexclusive right to develop the minerals in Section 30.

   b. A leased the minerals in the North Half of Section 30; B leased the minerals in the South Half. By order, or agreement, the North and South Halves of Section 30 are combined to form a 640 acre drilling unit.

   c. A owns all the working interest in Sections 29 and 30. B proposes to drill a well on Section 29 if A will assign 100% of the working interest in Section 29, and 50% of the working interest in Section 30, conditioned upon B completing the well as a commercial producer. A retains an overriding royalty in Section 29, convertible at payout of B's well to a 50% working interest.

      If B drills the required well, A and B will each have the nonexclusive right to develop Section 30. If the well on Section 29 "pays out," A and B may again each have the nonexclusive right to develop Section 29.

2. Anytime you have multiple ownership of the working interest, or the potential for multiple ownership, the parties owning the working interest will normally enter into a contract to coordinate development of the leased land.

   a. Called an "Operating Agreement" or "Joint Operating Agreement."

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b. NOTE: Sometimes the owners of the working interest will contract with a third party, who is not a working interest owner, merely to operate the well.

3. Operating Agreement designates one party as the "Operator," who will be responsible for daily lease operations.

   a. Operator is generally the person who contracts directly with the drilling contractor, other supply and service companies, gas processors, and production purchasers.

   b. Must ascertain operator's authority to dispose of production from the leased land.

B. Operator's Authority Under the Operating Agreement

   1. For our purposes, primarily concerned with the operator's authority to market production attributable to the other working interest owners.

   2. Typical form authorizes each working interest owner to separately market their proportionate share of gas production.

      A.A.P.L. Form 610 Model Form Operating Agreement: Each working interest owner has the right "to take in kind or separately dispose of its proportionate share" of gas produced from the contract area.

      Art. VI.C. (1982 & 1977 Model Forms); § 13 (1956 Model Form)

   3. What happens if the nonoperators fail to make any arrangement to take gas in kind?

      a. OPERATOR BUYS THE GAS. Operator may purchase the nonoperators' gas after providing the nonoperators with advance notice. If they do not enter into a gas sales contract, operating agreement permits a sale for period of time not to exceed 1 year - but nonoperator can exercise right to take in kind "at any time." Price must be "at the

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best price obtainable in the area for such production." Art. VI.C., p. 7 ('77); Art. VI.C., p. 8 alternate ('82).

b. OPERATOR ACTS AS AGENT. The operator can act as the nonoperator's agent in selling nonoperator's share of the gas. Must give notice of intent to sell as agent, must get best price, cannot contract to sell in excess of 1 year, and must account for all profits as a fiduciary.

c. OPERATOR SELLS GAS FOR ITS OWN ACCOUNT. Operator might market all the gas for his own benefit with the obligation to account for the nonoperator's gas through some form of gas balancing arrangement.

Cross-conveyance and co-tenancy problems - is each molecule of gas owned proportionately by each working interest owner?

Operating agreement, with the right of each party to take in kind, dispells the co-tenancy argument and the express terms of the 77 and 82 forms disclaim any sort of cross-conveyance.

Problem in absence of a Gas Balancing Agreement - what are the rights of the parties?

C. Effect Of Operating Agreement On Lessors And Non-Working Interest Owners

1. The lessor is not a party to the operating agreement; nor are non-working interest owners.

2. Lessee's obligations to lessor specified in the oil and gas lease and cannot be altered by other agreements to which the lessor is not a party.

3. Non-working interest owner's rights governed by the assignment between the non-working interest owner and the working interest owner. Non-working interest owner rights cannot be altered by agreements to which they are not a party.

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D. Gas Balancing Problems

1. Assume A and B each own an undivided 50% interest in an oil and gas lease covering Section 30. A has a market for his gas but B does not. Their operating agreement is silent regarding gas imbalances. Can A sell the full gas stream to its gas purchaser? Can A tender the full stream to its gas processor?

   a. What if B objects to the sale by A but makes no arrangments to take his share of the gas?

   b. Does B owe any royalty to his lessor?

2. In Oklahoma these matters have been addressed by statute and judicial decisions interpreting certain statutes.

   a. Non-selling Working Interest Owners - See 52 Okla. Stat. §§ 541-547 (Supp. 1988): Non-selling working interest owner can elect to share in the proceeds of a gas sales contract negotiated by another working interest owner. Requires the operator to offer to market each working interest owner's share of the gas. See Seal v. Corp. Comm'n, 725 P.2d 278 (Okla. 1986) cert. denied 107 S.Ct. 1265 (1986).

   b. Royalty Owners - Whichever working interest owner sells gas must pay all royalty owners within the gas pooling unit. The "Blanchard" "weighted average" approach. See Shell Oil Co. v. Oklahoma Corp. Comm'n, 389 P.2d 951 (1964). 52 Okla. Stat. § 87.1 (Supp. 1988).

   52 Okla. Stat. § 87.1 provides, in part:

   "In the event a producing well or wells are completed upon a unit where there are, or may thereafter be, two or more separately owned tracts, the first purchaser or purchasers shall be liable to any royalty owner or group of royalty owners holding the royalty interest under a separately owned tract included in such drilling and spacing

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unit for the payment of proceeds from the sale of production from the drilling and spacing unit."

"Each royalty interest owner shall share in all production from the well or wells drilled within the unit . . . to the extent of such royalty interest owner's interest in the unit. Each royalty interest owner's interest in the unit shall be defined as the percentage of royalty, including the normal one-eighth (1/8) royalty, overriding royalties or other excess royalties owned in each separate tract by the royalty owner, multiplied by the porportion that the acreage in each separately owned tract or interest bears to the entire acreage of the unit."

"The first purchaser or purchasers shall also be jointly and severally liable for the payment to each royalty interest owner of any production payments or other obligations for the payment of monies contained within the leases covering any lands lying within the drilling and spacing unit."

c. Note, however, this statute does not address the situation posed above - we do not have "separately owned tracts" in this unit. Instead we are dealing with co-tenants of undivided interests. Arguably each owns an undivided 1/2 interest in each molecule of gas.

d. The statute does not address non-working interest owners such as overriding royalty, production payment, and net profits owners, who are not "royalty owners."

3. Absent a statute, it would seem the rights of the producers would be determined through something similar to a co-tenancy analysis. Generally, the producer with a market could produce all the gas stream — so long as they recognized the right of non-producing working interest owners to balance.

a. Problems arise when one party asserts the reservoir is nearing exhaustion and the

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marketing producer is over-produced. Can they force the over-produced party to cease all production from the well(s)?

b. More often the problem is whether the imbalance must be made up by cash balancing or balancing in kind. Depending upon the current value of gas, compared to the value when produced, one party will be arguing for balancing in kind while the other insists on cash balancing.

c. If cash balancing is ordered, the next dispute is the value that will be attributed to the gas and whether interest will be paid.

d. In the two cases directly addressing the in-kind/cash and value questions, the courts generally ruled in favor of the over-produced party requiring cash balancing but refusing to penalize the over-produced party in any way for the under-produced party's failure to produce. See <u>United Petroleum Exploration v. Premier Resources</u>, 511 F.Supp. 127 (W.D. Okla. 1980); <u>Beren v. Harper Oil Co.</u>, 546 P.2d 1356 (Okla. App. 1975).

4. Gas Balancing Agreements -

   a. May pose an even greater burden to the working interest owner.

   b. Often provide for balancing in kind while producing and cash balancing upon exhaustion of the reservoir.

5. The opportunity for short-term gas imbalances will increase as producers are given more marketing options.

6. Most producers, when processing gas, will pay liquids on a current basis to all other working interest owners and royalty owners - even though they are not marketing the gas.

   See 52 Okla. Stat. § 542 (Supp. 1987) A.: "This act [right to participate in working interest

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owner's gas sales contract proceeds] shall not apply to the natural gas liquids extracted as a result of mechanical processing of the natural gas stream for the removal of liquid components of the methane."

7. Gas balancing agreements can have a producer-take-all effect: See Chevron U.S.A., Inc. v. Belco Petroleum Corp., 755 F.2d 1151 (5th Cir. 1985)(agreement provided only for balancing in kind; Chevron never took any gas from the reservoir and Belco depleted the reservoir before Chevron could produce any of its $600,000 imbalance).

XV. CONTRACT ADMINISTRATION - THE OIL AND GAS LEASE

A. Market Value In A Soft Market

1. Common form of royalty clause:

"The royalties to be paid by lessee are:

(a) on oil, and other liquid hydrocarbons saved at the well, one-eighth of that produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipe line to which the wells may be connected;

(b) on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other products therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."

This clause is from an oil and gas lease form distributed by the Kansas Blue Print Co. Inc. titled: "Form 88--(Producers) Kan., Okla. & Colo. 1962 Rev. BW."

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2. Lessor's Share of Production

   a. Royalty clause usually states lessor's right to royalty as a fractional share of:
      (1) Production, (2) Value of production, or
      (3) Proceeds from a sale of production.

   b. Most royalty clauses provide for a share of production when the substance is oil or other liquid hydrocarbons (the right to "take in kind"). If the substance is gas, most clauses provide for a share of the proceeds or market value.

   c. If the lessor has the right to take their royalty in kind, lessor retains title to a share of the substance until it is sold by lessor.

      If the lessor has a right to payment of the proceeds or market value of production, title to the substance is in the lessee when produced, subject to lessor's contractual claim for payment of proceeds or value.

   d. If lessor fails to sell or otherwise dispose of their in-kind production, the lessee is generally regarded as having the right to sell the lessor's share of production and pay the proceeds to lessor.

      However, the lessee, or purchaser, will usually obtain the lessor's written permission to make the sale by having the lessor sign a "division order."

3. Valuation of Lessor's Share of Production

   a. What is the production from the well worth? What is the market value of the production?

      (1) With oil, this has seldom been an issue because it is typically sold under short-term contracts in a market which readily reflects a value for the commodity.

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(2) Gas, however, is more difficult to value. Long-term contracts, inability to freely transport to a market, or alternative markets, and federal regulation each make it difficult to ascertain a market price for gas.

b. ILLUSTRATION:

Assume a mineral owner has entered into an oil and gas lease providing for a 1/8th royalty. If gas is being sold under a long-term contract [entered into in 1960 when $0.80/MCF was a good price for gas] for $0.80/MCF, will the lessor's royalty be calculated using the $0.80/MCF value?

Assume the current price being paid for similar gas in the area is $8.00/MCF. Should lessor's royalty be calculated using the $8.00/MCF value?

What if federal regulation establishes the maximum lawful price for this particular gas at $4.00/MCF. Should the $4.00 figure be used to calculate lessor's royalty?

NOTE: If the value of the gas is anything other than $0.80/MCF, the lessee's inability to realize the higher market prices (due to the long-term contract) will result in the lessee perhaps paying a greater royalty on the gas than it receives for sale of the gas.

4. This "market value" problem generally will not arise unless the lease requires calculation of royalty based upon the "market value" of production. Courts have taken varying approaches to this issue:

a. Oklahoma - Oklahoma courts, recognizing lessees generally must enter into long-term contracts to market gas, equate market value to the amount received by the lessee under the long-term gas sales contract. In our Illustration, the Oklahoma lessee will pay royalty using the $0.80/MCF value. However,

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lessee must have entered the gas contract in good faith and obtained the best price available at the time the contract was entered. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981).

b. Texas - Texas courts look to current market value of the gas but consider its legal characteristics. The Texas lessee will pay royalty using the $4.00/MCF value. First National Bank of Weatherford v. Exxon Corp., 622 S.W.2d 80 (Tex. 1981).

c. Kansas - Kansas courts look to current market value without considering the legal characteristics of the gas. The Kansas lessee will pay royalty using the $8.00/MCF value. Holmes v. Kewanee Oil Co., 233 Kan. 544, 664 P.2d 1335 (1983).

5. Could the market value analysis be used to pay lessor the market value of their share of production when that amount is less than the fractional share of proceeds received by lessee?

a. Kansas cases do not limit determination of market value to situations where market value exceeds value of the proceeds.

b. The Kansas approach would seem to allow lessee to use the lower, market value price, to calculate royalty.

c. In effect, the lessee is being forced to assume the risk if his gas sales contract does not keep pace with market prices. Shouldn't the lessee enjoy the benefits of his willingness to assume the risk? Especially when it is at no risk to the lessor?

d. In Piney Woods Country Life School v. Shell Oil Co., 765 F.2d 225 (5th Cir. 1984), cert. denied, 105 S.Ct. 1868 (1985), the court observes in a footnote:

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"If the price of gas declines, a market value royalty clause would benefit a lessee who has contracted to sell gas at a favorable price."

e. Lessor should consider lease clause which provides for an amount equal to <u>the greater of</u>: (1) the gross proceeds from the sale of gas; or (2) an amount equal to the market value of the substance at the well.

B. Royalty Calculation and Take-or-Pay Payments

1. No "Production" No Royalty Due

a. In <u>Diamond Shamrock Exploration Corp. v. Hodel</u>, 853 F.2d 1159 (5th Cir. 1988), the court defines the royalty obligation under federal leases of offshore lands which require the payment of "16 2/3% in amount or value of production saved, removed or sold from the leased area." The court states:

"[R]oyalties are not due on 'value' or even 'market value' in the abstract, but only on the value of <u>production saved, removed or sold</u> from the leased property. Likewise, the agency's regulations do not refer to 'gross proceeds' in the abstract, but only to gross proceeds that accrue to the lessee from the disposition or sale of <u>produced substances</u>, that is, gas actually removed and delivered to the pipeline."

b. In <u>State v. Pennzoil Co.</u>, 752 P.2d 975 (Wyo. 1988), the court holds the State of Wyoming, as lessor under oil and gas leases with Pennzoil, is not entitled to any share of take-or-pay payments made by Colorado Interstate Gas (CIG) to Pennzoil pursuant to the CIG/Pennzoil gas purchase contract.

(1) The court holds that royalty is due only on "production" and production requires the physical extraction of minerals from the ground.

(2) Since the take-or-pay payment is made

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pursuant to events unrelated to the actual production of oil or gas, no royalty is due on such payments.

2. Conceptual difficulty in associating royalty clause with gas purchase contract.

   a. For example, Kansas will not limit the potential market value of royalty by the terms of the gas purchase contract or federal price regulations. Nor will they enforce division orders which attempt to limit the terms of the royalty clause.

   b. Texas, to a lesser extent, divorces the royalty clause from the operation of the gas purchase contract. However, the nexus can be created through the division order.

3. A possible Oklahoma analysis:

   a. Apache Gas Products Corp. v. Oklahoma Tax Com'n, 509 P.2d 109 (Okla. 1973). "Value" of production for purposes of the Oklahoma Gross Production Tax would be calculated using the price producer receives for gas under the gas purchase contract.

   b. Court notes the "realities of the natural gas industry."

   c. Necessity of marketing under long-term contracts. What are the "realities" that will shape this analysis in the years to come?

   d. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981). Gas purchase contract, made by lessee in good faith, establishes the limits of lessee's royalty obligation under the oil and gas lease.

   e. Court recognizes the necessity of long-term contracts (at that time).

   f. Court acknowledges there is a nexus between the oil and gas lease and the gas sales

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contract created by the lessee's implied obligation to market production.

g. Such a rule is "fair" to producers and not "unfair" to royalty owners - producer not receiving any collateral benefit because they are limited to price set by the gas sales contract.

NOTE: Texas has applied this concept with regard to the effect of a division order. See Gavenda v. Strata Energy, Inc., 705 S.W.2d 690 (Tex. 1986) (division order effective to bar excess royalty claim only to extent lessee has not received the benefit of the incorrect division order); contrast Exxon Corp. v. Middleton, 613 S.W.2d 240 (Tex. 1981).

4. Proportionality Analysis - how will the benefits and burdens be distributed between lessor and lessee.

a. Is the lessee receiving any benefits which the lessor will be unable to share in proportionately?

b. If the lessor will not share proportionately in any benefits, has lessee traded any of lessor's rights to obtain the disproportionate benefit?

5. How is the price of gas determined in negotiating a gas purchase contract? Price tied to quantity? Obligation to take? Do you give up some per MCF value to obtain broad processing rights?

C. Third Party Beneficiary Rights

1. Lessors, dissatisfied with their lessee's actions in renegotiating a gas contract, settling a take-or-pay claim, exercising FERC Order 451 GFN rights, or giving "offers of credit" under FERC Order 500, may try to bring everything back to square one asserting the contract cannot be amended without their consent.

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2. Gas purchase contracts seldom expressly exclude the lessor as having third party rights in the contract.

3. Factors to determine whether parties intended to confer a benefit upon the lessor:

   a. Foreseeable lessor may assert an interest in the contract?

   b. Will the promisor render any performance directly to the lessor?

   c. What was the <u>purpose</u> and <u>motive</u> of the lessee and gas purchaser in making the contract?

   d. Lessor reliance upon the contract?

4. Ability of purchaser and lessee to alter contract:

   a. Can amend any time before lessor has knowledge of the contract and relies upon it.

   b. Varying degrees of acknowledging and relying upon the contract.

   c. Remember that division order where the lessor was asked to accept payments under the gas sales contract in satisfaction of lessee's royalty obligation?

D. The Prudent Operator And Federal Regulatory Options - (Macro) Proportionality Analysis

1. As one commentator has noted: There are ways pipelines can help producers.

2. All of lessee's business relations considered when lessee makes a business decision. How will this affect my <u>business</u>? What is the best option for my <u>business</u>?

   a. Prudent operator standard - What is the best option for my business which will not adversely affect my royalty <u>owner</u> (not owner<u>s</u>).

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b. Not a fiduciary - but courts will take a dim view when the benefits disproportionately favor the lessee to the demonstrable detriment of their lessor. "Ordinary" good faith in these cases tends to create some extraordinary obligations on the lessee.

3. The cases that will chart future litigation in this area:

   a. Amoco Production Co. v. Alexander, 622 S.W.2d 563 (Tex. 1981) (obligation to protect lessor against field-wide drainage--without regard for obligation to other lessors in the field).

   b. Amoco Production Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex.Civ.App. 1979), writ refused, n.r.e., (lessee breached obligation to market gas in good faith when it marketed lessor's gas at less than prevailing prices in order to obtain collateral benefits which would not be shared with the lessor).

E. Diligent Marketing Requirement

1. Diligence takes on new meaning when a lessor isn't receiving a check but their neighbor, owning a fractional share of production in the same well, is getting banner royalties because their lessee is selling the full production stream.

   a. Not much of a problem in Oklahoma where the lessors share in all production from the well.

   b. Many states have never addressed the matter because they have never had split-stream connections. Everyone traditionally sold to one pipeline and the pipeline always was able to take gas.

2. FERC "Options"

   a. Exercise rights under FERC Order 451 to enter into Good Faith Negotiations to obtain a

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release so you can find alternative markets?

b. FERC Order 500. Sell to other markets-regardless of cross-crediting problems?

c. FERC Order 490. Abandon expired contracts or contracts operating under a market-out clause.

d. Review transportation and marketing arrangements where lessor is being charged a proportionate share of the costs.

F. Prudence - Making The Best Deal

1. Best deal considering the interests of lessor and lessee.

2. Long-term contract? Release? Exercise GFN option or stay away from triggering a possible abandonment?

3. Any time marketing options are provided to the lessee there is the chance they will select the wrong option.

4. Opportunity to breach the efficient operator covenant. A "bad" choice.

5. Opportunity to breach the marketing covenant.

a. By doing nothing.

b. By losing a market.

c. By compromising lessor's position.

6. FERC Order 451 and the Marketing Covenant

a. What's best for Lessee may not be best for lessor X.

b. What's best for lessor X may not be best for Lessee's lessor Y.

c. Failure to act does not resolve the problem.

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d. Contrast this with situations where the lessee, and lessee's other lessors, will not be any worse off because of a course of action.

   For example, some contracts contain area rate clauses (allowing use of Order 451) but others do not have such clauses. Lumping all the contracts together for renegotiation is not necessary and adversely impacts the rights of royalty owners having area rate clauses in their contracts.

7. FERC Order 500 and the Marketing Covenant

   a. If lessee refuses to offer credits and transport gas, because of adverse impact on unrelated contracts, lessor X will not receive any royalty--or perhaps a reduced royalty.

      Impact will also be magnified depending upon whether lessor gets benefit of the take-or-pay rights the lessee is attempting to protect.

   b. If lessee ships to meet marketing demands of lessor X, can lessor Y (who is the beneficiary of a high-priced take-or-pay contract), complain about the cross-crediting lessee has set into motion?

8. Options for lessor <u>and</u> lessee?

   a. Try to get the lessor actively involved in the decision-making process? Not likely.

   b. Let lessor take gas in kind? If you don't like the way I'm doing it, do it yourself?

9. It appears the lessee acts at their peril when they fail to consult the lessor and obtain the lessor's actual consent to a course of action.

   a. Difficult to estop the lessor.

   b. Lessor can often sit back and let lessee

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select a course of action - and then contest the action.

c. Lessee's liability generally not limited by statute of limitations.

See Dorchester Gas Producing Co. v. Hagy, 748 S.W.2d 474 (Tex.App.-Amarillo 1988) (applying "discovery rule" to royalty payment dispute - monthly statements provided lessor did not bar lessor from claiming additional royalties for periods beyond four-year statute of limitations because lessor could not accurately audit its payments with the information provided in the statements).

10. So what should a lessee do? If a party to a relational contract desires to do something affecting the relation, they must consult the other parties - unless the contract specifically provides otherwise.

G. Shut-In Royalty Obligations

1. Is the well "shut-in" when a cotenant of your lessee is producing a million cubic feet of gas each day and you aren't getting a royalty check?

2. Like the take-or-pay clause, the courts may be inclined to look at the lessor/lessee relationship and not the precise terms of the shut-in royalty clause to resolve these disputes.

3. Although the habendum clause may be satisfied by production, courts may look to what induced the lessor to enter into the transaction - the prospect of royalty. When production, from which a royalty is paid, is not obtained, the lease will terminate unless the lease provides for the situation in some other manner - such as paying shut-in royalty.

a. Could lose a lease where there is current production and marketing under a split-stream sales situation and lessee fails to timely pay shut-in royalty to lessors not participating in the current production.

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b. New Mexico seems to be a state ripe for this sort of claim.

(1) See Darr v. Eldridge, 66 N.M. 260, 346 P.2d 1041 (1959) (royalty is lessor's "chief inducement for executing lease . . . .").

(2) See Greer v. Salmon, 82 N.M. 245, 479 P.2d 294 (1970) (common form of shut-in royalty clause created a condition on the grant as opposed to a covenant - failure to timely pay shut-in royalty caused the lease to terminate).

4. Note: In Greer the court equates production under the habendum clause with the generation of revenue from which a royalty can be paid. "'[P]roduction' must be equated with producing and paying a royalty." Greer, 479 P.2d at 297 and 298.

This could also affect the New Mexico analysis of the royalty owner's right to share in take-or-pay payments and settlements.