

# GAS BALANCING

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# INTRODUCTION

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## GAS BALANCING

There are a number of issues involved with gas balancing, which takes place at both production ends. Gas balancing is an issue among producers at the well and when the gas gets to the pipeline carrier, because the pipeline/purchaser wants to keep the sellers from using up all of the line capacity.

Since the mid-1990s, the shale plays in Pennsylvania (Marcellus), North Texas (Barnett) and South Texas (Eagle Ford) have become increasingly more important, and the issues of gas balancing become even more critical. Some producers formerly took the attitude that they would not worry about gas balancing.

Now producers without a gas balancing agreement may lose a lot of money unnecessarily.

Attached in the workbook is the gas balancing form that is presently found with the AAPL 1989 form 610E.

# INTRODUCTION

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Owners of interest in wells producing natural gas have found themselves out of balance with other interest owners.

This means that some interest owners may have produced more than their respective shares of the total well stream and thus are "overbalanced"; others have produced less than their respective shares of the total well stream and are thus "underbalanced".

Production imbalances among working interest owners in gas wells have led to disruptions in cash flow, risk that each interest owner will not recover its rightful share of the reservoir, and higher administrative problems and expenses.

# HISTORY OF GAS IMBALANCES

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Imbalances arise among producers of gas because of the physical limitations of gas, multiple ownership of gas wells, and multiple markets for gas.

Because of the deregulation of the natural gas industry, marked by the passage of the Natural Gas Policy Act of 1978 (the NGPA), the composition of these elements has shifted to produce the more pervasive imbalances confronting the gas industry today.

## The Physical Limitations of Natural Gas

- Compared to oil, gas is difficult to store, transport, and measure.
  - The most economical means of storing gas is to leave it in the reservoir.
  - Transportation of gas is generally limited to pipeline systems, which must be constructed, maintained, and operated at relatively high cost.
  - Measurement of gas requires relatively expensive metering devices.
- Gas must be produced, gathered, and transported under pressure that in many instances requires steel containment.
  - The inflammable and explosive characteristics of gas are well known.
  - Because gas is relatively difficult to handle, pipelines and producers prefer to leave it in the reservoir until it is sold.

# HISTORY OF GAS IMBALANCES

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## Multiple Ownership in Gas Wells

- No balancing problems arise if gas well ownership is unified because there are no different interests to become imbalanced.
  - Oil and gas production rights have commonly been subdivided because of the high costs of financing drilling operations, desire to spread the risks associated with drilling, and tax incentives that attract a substantial number of drilling participants from outside the oil and gas industry.
  - Working interest owners in a successful gas well own their share of the gas contained in the reservoir made accessible by the well.
- Each working interest owner in a gas well has the right to produce its share of the gas in the reservoir and take it in kind.
  - The timing of when the various owners choose to exercise their respective rights to dispose of their respective shares of gas may lead to an imbalance.
  - As long as all of the owners of the well produce their respective shares of the gas contemporaneously no imbalance arises.
  - Each owner's share of the production stream coincides with its share of the well and of gas in the reservoir.
  - When one or more of the well's owners refuses to produce its respective share of the gas that an imbalance arises.

# HISTORY OF GAS IMBALANCES

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## Multiple Markets for Gas

- When there is only one purchaser for the well's gas, all of the working interest owners choose to sell their respective shares of gas.
  - The single purchaser of gas at the wellhead is indifferent as to which owner's gas is purchased, and thus all owners should receive the same price.
  - The producers in such a case have little economic incentive to withhold their respective shares of gas from the purchaser unless they believe the price will rise.
- In the past some pipelines chose to discriminate among owners in a well or other common source of supply by choosing to buy the gas of some owners while rejecting that of others.
  - This arose in situations in which the pipeline had no market for additional gas, there was common ownership between the pipeline and the wells involved, or other business factors unrelated to the economics of a single pipeline purchaser connected to a well were present.
  - Several of the producing states enacted "common purchaser" legislation to prevent this practice.
  - Such legislation requires that the pipeline purchase gas from all owners in a well or other common source of supply ratably and without discrimination.

# SPLIT STREAM PRODUCTION

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## SPLIT STREAM PRODUCTION

- The various owners in a well have little incentive to withhold their gas from a purchaser that is required by law to purchase it at the same price and on the same terms from every owner in the well.
- This situation changes when two or more pipelines are available to gather gas from any particular well, or other common source of supply.
  - The different pipelines can pay different prices and purchase gas on different terms without violating common purchaser requirements.
  - The producers will contract to sell their gas to different pipeline purchasers and a "split-stream" connection results.
  - Some of the well stream is produced by some owners to their pipeline purchaser and the remainder is produced by the remaining owners to their pipeline purchaser.
- Split-stream connections involve economic waste because an additional gathering line is laid to accommodate more than one pipeline.
  - They also increase administrative difficulties in operating the well and accounting for production and sales.
  - Split-stream connections are generally limited to high gas producing areas that exhibit sufficient reserves to justify the added gathering/administrative expense.

# DEREGULATION

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## Multiple Markets and Imbalances

- Before enactment of the Natural Gas Policy Act of 1978 (NGPA), the price that interstate pipelines could pay for gas at the wellhead was set by federal regulation.
  - The Federal Energy Regulatory Commission (FERC) determined the price that should be paid a producer based upon its cost of making that gas available to the interstate system.
  - To the customer all of a pipeline's costs incurred in delivering "gas service" were rolled into one price.
- This changed with the advent of the NGPA.
  - The NGPA ended the distinction between the interstate and intrastate gas markets.
  - It deregulated the price that could be paid for gas, limited only by ceilings that phased out over the years.
  - The NGPA was enacted during a period of supply shortage.
  - Pipelines, freed of restraints, quickly bid the price of new gas (drilled after the NGPA) up to the new ceilings.
- The increasingly free market began to operate.
  - With gas prices skyrocketing, industrial users and other customers switched to alternative fuels
  - The demand for gas dropped as supplies increased, because of higher wellhead prices.
- When these problems were noticed, FERC began trying marketing programs that allowed certain customers to purchase gas at market- competitive prices.
  - The goal was to allow gas to be sold at a market price.
  - FERC's ordered pipeline wellhead, gathering, transporting, storage, and delivery services to be "unbundled."
  - The pipelines would charge for each component service separately.

# DEREGULATION

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## Multiple Markets and Imbalances

- The motive for regulatory changes was that pipelines had stopped buying gas when their weighted average cost of gas (WACOG) exceeded the heating fuel market cost.
  - A number of producers were left without contracts to sell their gas.
  - They had been selling their gas without written contracts but on the same terms as the operator in the well.
  - With oversupply, the pipelines honored only written contracts, leaving the uncontracted producers without a market.
- Then FERC allowed non-pipeline purchasers to fill the void left by the large interstate pipelines.
  - Gas brokers and marketers filled this void.
  - These gas marketing companies purchased gas, then transported it in a pipeline, for delivery to the customers.
  - As a result of this new marketing structure the producer is confronted with multiple market opportunities.
  - A producer may be able to choose from a variety of purchase contracts with terms ranging anywhere from one month to several years.
  - Prices vary depending upon the term to which the producer commits its gas.
  - For producers whose gas is under a contract longer than five years, alternative opportunities are available if the producer has obtained the pipeline's release from obligation.

# DEREGULATION IMBALANCES

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Imbalances have arisen for several reasons.

- Producers with above-market price contracts like to deliver their share of gas under contract.
  - Therefore, pipelines sometimes refuse to take high-price gas or have reduced the amount of their takes.
  - The remaining well stream is available for sale by other producers in the well, who may choose to sell it under a lower-price contract.
  - Creating an imbalance between the high-price producer and the low-price producer.
- Many smaller producers with small staffs have been slow to adjust to the new marketing environment
  - They have not made sales arrangements as quickly as some larger producers.
  - Therefore some producers have sold more than their reservoir share of the well stream and an imbalance arises.
- Some producers have chosen to curtail delivery of their gas based upon the belief that the current market price of gas is low.
  - They can maximize their share value of gas reserves by selling a greater share of the well stream in the future.

# THE GAS BALANCING AGREEMENT

GAS BALANCING AGREEMENTS purpose is to permit all parties in the joint operations of wells to realize the benefit of their share of production; each party may not realize such benefit it at the same time if a split stream connection should exist.

- Essential Clauses - The gas balancing agreement contains the following elements:
  - ❑ An express agreement where selling parties take up to 100% of another party's production when the non-taking party is unable to take its full share of production.
  - ❑ An agreement that liquid hydrocarbons recovered from the gas is allocated in proportion to the interest of each party.
  - ❑ The operator maintains current accounts and records of the parties who are underproduced and overproduced.
  - ❑ Each party pays royalties on a current basis each month upon its allocated share of production and pay its own severance/other taxes.
  - ❑ Underproduced parties can give notice and begin taking their full share of production and the right to take a percentage of each overproduced party's share of gas until the underproduction is balanced.
  - ❑ Overproduced parties obligated to account in cash upon depletion of any well.
- A provision specifying that the agreement shall apply separately to each well within the contract area covered by the operating agreement.
  - ❑ Prevents problems of recoupment between wells with different contract or NGPA pricing categories
  - ❑ Prevents an indefinite time for cash accounting if subsequent wells are drilled before unbalanced wells are balanced.
- The gas balancing agreement should be entered into simultaneously with the operating agreement and or before any gas contract.
  - ❑ Each gas contract should be made subject to or at least refer to the existence of the gas balancing agreement.
  - ❑ This forces the cooperation of purchasers in times when imbalances are being brought into balance and the share of production purchasers receive is altered.

# THE GAS BALANCING AGREEMENT (CONTINUED)

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## THE GAS BALANCING AGREEMENT –

- Frequent Problem Areas Regarding the Gas Balancing Agreement
- Royalty Payment Questions
  - Most agreements provide that the underproduced party is responsible for paying the royalty on such party's full share of production.
- Gas Price for Cash Balancing
  - The sample gas balancing agreement provides that cash balancing will occur for a well out of balance at depletion, based upon the price actually received by the overproduced party.

# Case Law in Texas

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## Case Law

- Texas - The Texas Compulsory Pooling Statute does not contain the language found in the Oklahoma statute and appears to contemplate a tract allocation method.
- Virtually all pooling in Texas is accomplished on a voluntary basis.
- *Puckett v. First City National Bank* involved the issue of the computation of royalties in a splitstream sale situation.
  - The royalty owners' land had been pooled and the gas produced from the unit was being sold by different lessees at different prices.
  - The court adopted a tract allocation method under which the calculation of each royalty owner's royalty would be based on the price received by his lessee.
- The court separated the Louisiana *TXO Production Corp. v. Prickett* case, which arguably could have called for a weighted average price method, based on the different language found in the pooling clauses contained in the respective leases.
- In Texas, a tract allocation method of royalty valuation is also the proper approach in a splitstream sale situation.

# CONCLUSION

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- Include a gas balancing agreement, especially in cases of oil and gas wells/gas wells which are jointly operated.
- If a gas balancing agreement is not required or not applicable, document the rationale to the client.

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