

GAS CONTRACTS AND AGREEMENTS

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Unlike oil, gas cannot be moved by truck or similar methods; it must be gathered and sent to a sales point.

- Gas from several wells is gathered through a series of small pipelines (“gathering lines”) and then the gathering lines will discharge into a larger pipeline.
- After that gas is sent to a gas plant, where the liquids are removed and sold separately.
- The dry gas - the gas that has had its liquids removed - is sold to a gas company.
- The sales of gas to the gas company are referred to as “tailgate” sales, since they occur at the backdoor of the plant.
- The gas company then transports the dry gas to facilities and other sales points, where it is used by the ultimate consumer.

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There are several issues which arise with regard to gas being handled that way.

- Gas that is being gathered may be at a different pressure than the line into which it is being sold or gathered.
- If the pressure is too high, it must be reduced; if too low, it must be increased.
- The cost of changing pressure, accomplished by compressors, so there is always an issue about who will pay for the compression.
- Gas is rarely produced in a pristine state, and is sometimes contaminated with water, oxygen, sand, grit and other objectionable materials.
- Many contracts will have requirements which specify the quality of the gas, both in its constituents and its pressure becomes extremely important.

Included in the workbook are two casinghead gas contracts, as well as a construction and operating agreement for a pipeline.

GAS PURCHASE CONTRACTS

- 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.

GAS PURCHASE CONTRACTS (CONTINUED)

President Bush signed the Natural Gas Wellhead Decontrol Act of 1989 (NGWDA). The NGWDA provides for permanent elimination of all wellhead price controls on first sales of natural gas, including all wellhead sales, on January 1, 1993, at which time the NGPA was repealed.

TYPES OF GAS CONTRACTS CURRENTLY IN USE IN THE MARKETPLACE

There are now three basic kinds of contracts now used to sell natural gas: spot purchase contracts, multi-month contracts, and long-term firm or warranty contracts, where "long-term" means any duration of time longer than one year.

The distinction between spot and long-term contracts is useful.

Short-Term Spot Contracts

Short-term revenue can be generated best in the "spot market".

- Properties best fitting the short-term revenue source are long-life properties, properties in which the producer is under-produced, new properties that can be connected within a short period of time, and properties that must produce every day (oil well gas).
- Short-term revenue is available for one to twelve months but it should not be counted on long-term as it is generally based on a thirty-day contract.
- Natural gas spot trading began on a large national scale during 1983.
- Spot prices have become seasonal, peaking sharply during the winter demand period, and again during summer periods of peak electricity generation, caused by demand for air conditioning.

Spot Market Transaction Cycle

Beginning about the middle of the month, gas marketers, sellers, and buyers communicate regarding possible gas purchase/sales transactions that will take place during the following month.

- Marketers tentatively arrange to purchase gas supplies from producers, other marketers, or from other sources.
- Approximately ten days before the end of the month, parties who will secure transportation services from one or more pipeline(s) submit written preliminary nominations for transportation capacity to pipelines, identifying gas volumes, receipt and delivery points, and other key physical and transactional information.
- Once they have received preliminary nominations for transportation services as above, pipeline capacity staff review their nominations and provide feedback to shippers as to capacity limitations, bottlenecks, and/or similar issues.
- During the last full week before the end of the month ("bid week"), buyers, sellers, and marketers again communicate with one another regarding gas volumes and prices to be agreed upon in thousands of individual transactions scheduled to flow during the following month.
- Shippers notify pipelines in writing as to final nominations, and gas routing, based on feedback received from preliminary nominations and on needs developed subsequently in market negotiations
- As the month ends, the business enters a "cleanup" phase in which the final transactions are completed for the new month, and final transportation arrangements are made.

Fixed—Term Interruptible Multi—Month Contracts

Early in the development of the spot market, transactions typically were conducted on a limited-term "interruptible" basis.

- If a buyer desired to purchase a quantity of gas and the seller had gas available for sale, a deal would be struck at a mutually agreed upon price for a given volume taken by the purchaser during a given month.
- Because quantity was interruptible, neither party considered itself legally obligated to purchase or sell any specific quantity of gas.
- Rather than enter into a new agreement every month, the limited term interruptible arrangement evolved over time to cover multiple months.
- The seller might indicate periodically that it had a package of gas available for sale.
- The buyer would nominate a volume it desired purchasing, if any, and the price at which it was willing to pay.
- The basic difference from the spot market is that the purchaser and/or producer can decline any sale or purchase prior to sale consummation.

Longer—Term or Warranty Sales in Gas Contracts

Warranty contracts characteristically call for the producer to guarantee that it will make available for sale a fixed quantity of gas each month.

- What distinguishes this commitment from firm sales is the term of the contract: it generally is for a primary term of five years or longer.
- The significantly greater risks associated with such contracts mean that more time has to be spent on negotiating and drafting.
- With pipeline open access becoming more universal, producer-marketers are beginning to shift their emphasis from spot sales to term contracting.

Longer—Term or Warranty Sales in Gas Contracts

The types of provisions contained in many contracts being entered into by LDCs are as follows:

- *Type of Commitment.* Warranty that gas will be made available; no specific source.
- *Term.* Up to ten years.
- *Quantity.* This will vary substantially depending on needs of the buyer and strength of supply position of producer. In general, a buyer will pay a greater premium for higher volumes and for greater flexibility on takes from month-to-month.
- *Pricing Mechanism.* Two part rate: (1) a reservation fee payable on maximum quantity available, regardless of quantity nominated by the buyer, plus (2) a commodity charge for each MMBtu nominated and taken. Commodity charge tracks spot price, and reservation fee is a percentage of the commodity charge.
- *Price Redetermination.* Less common for contracts with terms of five years or less. For contracts with longer terms, the mechanism for tracking spot prices can be renegotiated once after four years. If parties cannot agree, a mechanism will be set by arbitration, but the contract automatically phases out within two years.
- *Failure to Perform.* If the supplier fails to supply required quantity, and failure is not excused by force majeure, the supplier must pay the buyer some level of liquidated damages.

Longer—Term or Warranty Sales in Gas Contracts

The key issues which must be addressed by a producer/supplier to agree to a long-term sale are:

- *Price Flexibility.* Most producer/supplier longer term contracts entered into in recent years are market sensitive (tracking monthly spot prices) with respect to the commodity charge, but the reservation charge is a fixed percentage of the spot price. Some potential customers have expressed concern at locking into a particular percentage for more than a couple of years. If either party to the contract triggers redetermination of the mechanism for tracking spot prices and the parties are unable to agree upon a new mechanism, the contract offer automatically phases out over some period of time.
- *Public Utility Commission (PUC) "Out".* Many potential LDC buyers request a Public Utility Commission (PUC) "out", which would permit them to lower the price payable under their purchase contract to that which they are permitted to pass through to their customers, or in the alternative to permit them to terminate the contract in the event they are not able to pass through all such charges.
- *Price Regulation "Out" for Producer.* Some contracts provide that should the seller ever be prohibited by a regulatory body from collecting all of the price provided for under the contract, it can reduce or suspend its obligations under the contract.
- *Damages for Failure To Supply Gas.* Two distinctly different concepts are often embodied in long-term gas proposals: (1) liquidated damages, and (2) a "cap" on the total damages payable by the seller over the life of the contract: once the damages payable by seller for failure to supply gas, calculated on a per MMBtu basis as indicated above, reach an amount equal to the total of some figure agreed to by the parties and payable by the buyer over the life of the contract, no more damages are payable by seller.

GAS PROCESSING AGREEMENTS

Typical Rate Structures

Fee-based agreements

- Processor receives a fixed fee for processing gas; producer keeps 100% of NGLs
- Processor has no direct commodity exposure; returns are fixed by rate and vary only with throughput
- Considerations when contracting - Fixed fees limit upside earning potential

“Keep Whole” Agreements

- Processor retains NGLs removed from “raw stream” in exchange for keeping producer whole on a Btu basis
- Processor gets mix of commodity exposure
- Considerations when contracting - Exposure to commodity prices in NGL marketing agreements changes risk profile

Percent of Proceeds (POP) / Percent of Liquids (POL) Agreements

- In POP contract, processor sells NGLs extracted and shares a percent of the proceeds from the sale with producer; processor’s share is payment for services rendered
- In POL contract, processor takes a share of the extracted NGLs as payment for services rendered and markets them independently from producer
- Considerations when contracting – (1) POP and POL contracts expose processor to 100% commodity risk; (2) Can be useful when industrial/chemical facilities are nearby

GAS PROCESSING CONSIDERATIONS - SHRINKAGE

"Shrinkage" in both volume and the Btu value of the gas results from the removal of liquid products which have volume and Btu value.

- Gas is measured and sold on a Btu basis; shrinkage is expressed in Btu value lost.
- Residue gas/methane is used for fuel to operate the gas plant processes.
- The calculation/allocation of the cost of shrinkage is important.
- Many times the processor will bear shrinkage and fuel costs and the producer pays a flat processing fee or has a net back agreement.
 - If the producer bears all the Btu loss in the gas stream and surrenders to the processor a share of the products produced, the producer bears the major operating costs.

GAS PROCESSING CONSIDERATIONS - PROCESSING CONTRACT

PROCESSING CONTRACT

- In addition to considering the relative shrinkage and plant fuel costs and plant capacity, a processor should take other costs and factors into consideration when evaluating a processor's offer.
- A key cost is compression at both the inlet and outlet side of the plant.
 - Compression may be necessary to boost the inlet stream to the pressure necessary for processing.
 - Additional compression might be required to access the market at the tailgate of the plant.
 - The required tailgate pressure to different markets can vary widely making the markets at one plant more favorable than another because less compression is needed.
- There may be additional charges for dehydration, removal of CO₂ or H₂S by treating or blending, plant costs and fractionating charges.

GAS PROCESSING CONSIDERATIONS - MEASUREMENT AND ALLOCATION FORMULAS

PROBLEMS WITH MEASUREMENT AND ALLOCATION FORMULAS

■ Need for Audit Rights and Periodic Measurement

- The next area of importance to the producer are the measurement and the formulas for the allocation of plant fuel, shrinkage, and products which are attributable to the gas stream which the producer delivers.
- There are several practical operating problems which make these provisions critical.
- The gas can have varying amounts of NGLs and have differing volumes of impurities which interfere with the processing of the gas, make the processing more expensive.
- Producers will have different volumes of NGLs attributable to their gas because some gas is inherently richer gas.
- These variations in the plant products will be allocated different shares of plant costs.

GAS PROCESSING CONSIDERATIONS - MEASUREMENT AND ALLOCATION FORMULAS (CONTINUED)

- Hidden Shrinkage: A producer's gas will be measured at the wellhead, but because of measurement variances, more gas than measured will be delivered to the plants.
 - This line gain phenomenon frequently occurs in gathering systems and the plant operator typically retains the additional gas which arrives at its plant.

GAS PROCESSING CONSIDERATIONS - PRESSURE CLAUSE SPECIFICATIONS

PRESSURE CLAUSE SPECIFICATIONS

Gas processing agreements normally contain clauses which state that a certain quality of gas is to be delivered and that the gas should be delivered at a specific pressure, or at a pressure sufficient to enable the gas to enter the gathering system or the plant.

- These specification clauses describe exactly the nature of the gas which the producer promises to deliver.
- Specification clauses can sometimes be difficult to comply with because of vagueness and other factors.

GAS PROCESSING CONSIDERATIONS - CHECK METERS

CHECK METERS

- The producer may want to have the specific contractual right to install, maintain, and operate, at its own expense, any necessary pressure regulators and check measuring equipment.
- For practicality purposes, the reading, adjustment, operation and maintenance of its check meters should be done by the producer.

STATE REGULATORY SCHEME

STATE REGULATIONS

- Overview: A gas gathering line is not subject to regulation as a public utility under either
 - the Cox Act,
 - or the Gas Utility Regulatory Act, (GURA),
 - unless it utilizes eminent domain.
- Most large in state pipelines are utilities and are regulated under the Cox Act and GURA.
- A gas utility can be forced to transport gas at rates set by the R.R.C.

STATE REGULATORY SCHEME (CONTINUED)

STATE REGULATIONS (CONTINUED)

- The Cox Act: This act vests original jurisdiction
 - (i) in the R.R.C. for the activities of public utilities occurring outside the boundaries of incorporated municipalities,
 - (ii) in incorporated cities for such activities occurring within their boundaries.
- Appellate jurisdiction is given to the R.R.C. for appeals from the regulatory actions of cities over activities within their limits.
- Any pipeline which held itself out to the public to carry gas or which uses eminent domain is a utility unless it falls within one of the exceptions to the act.
- Exemptions to the definition of a public utility--transporting or selling gas for agricultural purposes, pumping water for agricultural purposes, transporting gas to processing or treating facilities, or gas for use as a vehicle fuel.

STATE REGULATORY SCHEME (CONTINUED)

STATE REGULATIONS (CONTINUED)

- The Gas Utility Regulatory Act (GURA) was adopted in 1975 to supplement the Cox Act and amended in 1983.
- The exemption as to gathering that is included in the Cox Act is repeated by reference in GURA and agricultural and migration uses are also exempt.
- GURA gives the R.R.C. and cities the power to regulate utilities and provides greater detail of the powers of cities and the R.R.C. in regulating utilities such as the type of reports, notices, et cetera, required.

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