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Part II: Contract Issues in the Changing Energy Industry: Introductory Remarks and Outline of Hypothetical Problem

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INTRODUCTORY REMARKS AND OUTLINE OF HYPOTHETICAL PROBLEM

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The purpose of this showcase program is to illustrate and perhaps educate as well as to some of the issues that are presented by changes that are taking place in the natural gas industry. The topic is contract issues in the natural gas industry, but in point of fact, we're going to be talking about a number of policy issues as well. This program is cosponsored by the Administrative Law Section and the Public Utility Law Section as well as the Natural Resources Law Section, primarily because lawyers from all of those sections are intimately involved with these kinds of problems.

When I was approached to work with this group on this project, I was just getting ready for final examinations at Southern Methodist University where I was a visiting professor, and perhaps as a result of my mind set at that point in time, the problem that we're using as a discussion focus today may remind many of you of the kind of problems that you saw on examinations in law school. It is also similar to those kinds of problems in that there is not any real answer to it; certainly, I am not in a position to provide any answers. I invite you, however, to review the problem with me prior to the discussion by our panel of experts.

The central fact of our discussion problems and the central fact of what is happening in real life in the gas industry is that there has been a substantial decline in demand for natural gas at the burner tip. Because of energy conservation, severe recession and competition from other fuels, total demand for natural gas in the United States fell from more than 20 trillion cubic feet in 1979 to slightly more than 17 trillion cubic feet in 1983. In just four years, total demand for natural gas at the burner tip fell approximately 16 percent.

The falloff of demand was even more dramatic in the industrial and utility sectors, which generally use about 50 percent of natural gas in the United States or 50 percent of that consumed, and which are much

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more susceptible to switching to alternate fuels when, as has happened recently, the price of natural gas goes up vis-a-vis the price of alternative fuels, such as oil. In that same period of time, from 1979 to 1983, there was a decline in use of gas in the combined industrial and utility sectors of from 11 trillion cubic feet to a 8-1/2 trillion cubic feet. That was a falloff of 22-1/2 percent in just a four-year period.

Over that same period, from 1979 to 1983, the deliverability of natural gas in this country, that is the amount of gas that could be produced in a single time period, remained about the same. The result has been a substantial gas surplus estimated by the Department of Energy at from 3 to 5 trillion cubic feet in 1983. It is estimated to be from 1 to 3 trillion cubic feet in 1984. Thus, we are talking about a percentage surplus of deliverability at the present time of between 10 and 25 percent.

The decline in demand has adversely affected every one of the parties in our discussion problem and to use a phrase coined as we put this problem together, the effects have cascaded back from the burner tip, to the local distribution company, to the pipeline, to the producer and the mineral owner. Let's examine the facts of our problem briefly.

HYPOTHETICAL PROBLEM

Facts

Oil and Gas Lease

In July 1977, Big Oil Company ("BO") took an oil and gas lease from Charles Landowner. The lease had a three-year primary term and covered 1288 acres. In April 1979, BO assigned 50 percent of its interest in the lease to Little Oil Super Exploration Resources ("LOSER"). The two producers entered into a joint operating agreement and drilled and completed two gas wells to two different formations on the premises, one in May 1980 and one in July 1981. The Landowner No. 1 well qualified as a high cost well under Section 107(c)(1) of the Natural Gas Policy Act ("NGPA") and as such was not subject to price regulation. The Landowner No. 2 well qualified as a NGPA Section 102(c) well for which there is a stated maximum lawful price through December 31, 1984, but which is price deregulated thereafter.

Producer-Pipeline Sales Contract

In July 1980, BO negotiated a gas contract to sell its share of the gas produced from the Landowner No. 1 well to the Great Northern Pipeline Co. ("Great Northern"), an interstate pipeline which was then paying premium prices to attract commitment of new reserves. To induce BO to commit the Landowner No. 1 Well, the contract provided for a price of $8.00 per MMBtu and required Great Northern to take or pay for gas at a minimum rate of 80% of the well's deliverability (but did not include a make-up provision). At about the same time, Great Northern contracted to buy approximately 15% of its estimated future needs from a Canadian producer at $4.40 per MMBtu with annual escalations to that rate. After the Landowner No. 2 well was completed, BO and Great Northern entered into a second contract providing for the sale of gas from that well at the maximum lawful price authorized by the NGPA and, after deregulation, at a price fixed at 110% of the price of No. 2 fuel oil in New York harbor. This contract included an 80% take-or-pay clause, but it also "provided for a five-year make-up period, and contained a "regulatory-out" clause and a market-out clause.

Pipeline-Distributor Sales Contract

Great Northern sells its gas to two distribution companies: Columbus Gas Distribution Co. ("Columbus"-which serves residential, commercial and industrial customers at retail in Ohio) and Acme Gas Distribution Co. ("Acme"-which serves similar types of customers in New York). Columbus has traditionally purchased all of its gas from Great Northern and has no existing interconnections with any other pipeline. Acme, however, also buys gas from the Northeastern Pipeline Company ("Northeastern") with its contract demands being the same for its two pipeline suppliers. Columbus has traditionally purchased gas from Great Northern at a 90% load factor, or higher. Acme, on the other hand, has swung back and forth, between the two pipeline suppliers depending on the relative cost of their gas, with the average load factor of takes from Great Northern ranging from 75 to 90%. Great Northern's tariff includes a 75% minimum commodity bill that requires local distribution companies to pay Great Northern for a minimum amount of gas each month even if they do not purchase and distribute that amount.

Fuel Switching

The industrial customers of Columbus have been severely affected by the recession, and some have switched to the use of residual fuel oil because the price of oil has fallen relative to the price of gas. As a result, there has been a reduction of 35% in Columbus' annual requirements. Columbus has reduced its takes from Great Northern by an equivalent amount, since Great Northern's weighted average cost of gas has soared. Such cut-backs have led Great Northern to shut-in the Landowner No. 1 well and to reduce its takes from the Landowner No. 2 well to a level of 70% deliverability. Acme's loss in total sales has been less severe because of its purchases from Northeastern, whose gas costs are approximately 30 cents per MMBtu less than those of Great Northern. However, Acme has been able to maintain its industrial sales only by reducing the takes from Great Northern to minimum bill levels.

Potential Points of Conflict

Local Distribution Companies vs. Pipeline Companies

Because of the financial pressures of the recession and fuel switching, Columbus has recently notified Great Northern that it cannot continue to pay the minimum bill amounts. Columbus has filed with the Federal Regulatory Agency to waive the minimum bill provision in Great Northern's Tariff as it applies to customers without alternative sources of supply. Acme has intervened requesting that the minimum bill provision be eliminated as to all customers.

In a related development, Great Northern has sought to preserve and recover industrial consumers who have the alternative fuel capacities by asking the Federal Regulatory Agency to approve a special marketing plan ("SMP"). Under the proposed SMP, Great Northern would offer gas at discount rates to industrial end-users with alternative fuel capacities. The additional gas supplies would be purchased at discounted prices from producers from whom Great Northern has not taken its full take-or-pay volumes who are willing to accept gas contract amendments reducing Great Northern's future take-or-pay obligations. Great Northern expects that the special marketing plan will permit it to compete effectively with residual fuel oils, as well as mitigate its take-or-pay obligations. However, competing pipelines and end-users who would not be eligible under Great Northern's SMP proposal claim it is discriminatory and will cause them financial damage.

Conflicts Between Pipeline Companies and Producers

Currently BO contends that Great Northern owes it $1,000,000 in take-or-pay payments on the Landowner No. 1 well. Great Northern denies this allegation contending that its performance is excused wholly or in part because:

a. The "take-or-pay payment provided for in the contract would result in BO recovering more than the maximum price permitted under the NGPA for the Landowner No. 2 well;
b. Market conditions in the gas industry are a force majeure event that excuses Great Northern's performance;
c. The state conservation agency has prorationed production from the lease to 50 percent of delivery capacity, relieving Great Northern from taking or paying for more than that percentage, since its obligation arises only if gas is "available" for sale.

Great Northern is honoring its take-or-pay obligation on the Landowner No. 2 well, after having redetermined the price in July 1984 under the contract's market-out clause to $3.10 per MMBtu (the maximum lawful price was then $3.73). However, BO has complained to the Federal Regulatory Agency that the price redetermination was discriminatory because Great Northern failed to invoke the clause against its producer-subsidiary at the same time.

LOSER has been unable to find a market for its share of the gas produced, but it has been required to pay its share of operating costs under its operating agreement with BO. LOSER has asked the state conservation commission either to order Great Northern to buy its share of gas or to order BO to share its revenues with LOSER. There is also legislation pending in the state legislature that would require revenue sharing between BO and LOSER. Naturally, Great Northern and BO are resisting LOSER's requests, arguing that either order would be unconstitutional under the Supremacy Clause or Commerce Clause.

Related Producer Concerns

The lease with Charles Landowner contains a shut-in royalty clause that permits the lease to be held without actual production if a shut-in royalty is timely paid. The Landowner No. 1 well was shut in on April 1, 1982, and shut-in payments were made March 1, 1983, and March

4, 1984. Both BO and LOSER are concerned with the status of the lease. As a result, BO is seriously considering a proposal from Great Northern to take gas from the Landowner No. 1 well for its SMP if BO will agree to a price of $2.40 per MMBtu and reduce the take-or-pay percentage to 50 percent. Charles Landowner has just given notice to BO that he claims the royalty share of take-or-pay payments received by BO on the Landowner No. 2 well and that he is opposed to any downward negotiation in the contract price on the Landowner No. 1 well. Landowner has also notified LOSER that he considers that it is in violation of its implied obligation to market within a reasonable time.

Contract Clause Definitions

1. Take-or-Pay Clause

A take-or-pay clause provides that a purchaser must pay for a minimum amount of gas made available by a producer based upon a percent of delivery capacity of the well whether the purchaser actually takes the gas or not. This clause guarantees to the producer a minimum cash flow from the well. For this hypothetical a simplified take-or-pay is as follows:

> "Beginning with the date of first delivery, and subject to the terms and provisions of this agreement, in addition to the actual take of casinghead gas and flash gas, Seller agrees to sell and deliver to Buyer, and Buyer agrees to take and pay for or pay for if available and not taken, during each year an average daily contract minimum quantity of gas well gas equal to eighty percent (80%) of Seller's pro rata share of the delivery capacity of the well(s) covered hereby."

2. Take-or-Pay Make-up Clause

A make-up clause is a portion of some take-or-pay clauses which permits the purchaser to credit take-or-pay payments toward additional purchases of gas above minimum take levels. The purchaser need only pay the difference between the price applicable when the gas was first made available and paid for but not taken and when the gas was actually taken. The following simplified make-up clause is applicable to Landowner No. 2 well:

"If during any one year Buyer fails to take the total contract minimum quantity of gas which it is required to take and pay for or pay for if not taken during said year. Buyer shall have the right during the next 5 years of the remaining term of this agreement, whichever is less, to receive a quantity of gas well gas which is in excess of minimum take requirements and is equal to the quantity paid for but not received during the applicable year; provided, however, that Buyer shall pay any increase in price between that upon which payments were made and that applicable at the time of taking."

3. Regulatory-Out Clause

A regulatory-out clause recognizes regulatory control over the resale of gas and shifts the risks to the producers of the Federal Regulatory Agency disallowing recovery by the pipeline-purchaser of amounts paid to the producer-supplier.

"Notwithstanding any other provisions in this agreement, the price to be paid for any gas delivered or for which payment is due hereunder including tax reimbursement, shall never exceed any of the following prices:

(a) The price Buyer is permitted to include and retain in its rates by the Federal Regulatory Agency or other authority having jurisdiction over Buyer's rates. If Buyer is precluded by any governmental authority from including and retaining in its rates all or any portion of the price otherwise payable to Seller hereunder, Buyer shall notify Seller in writing of the price Buyer can retain in its rates."

4. Market-Out Clause

A market-out clause enables the Buyer to refuse to take gas at the contract price, regardless of other contract terms, if the Buyer determines that the price is above market levels. The unilateral right of the Buyer is balanced (in many contracts, as in this hypothetical) with the right by the Seller to elect to terminate sales to the Buyer and to require the Buyer to exercise reasonable efforts to transport the gas on behalf of Seller to a new market.

> "Notwithstanding any other provision in this agreement, the price to be paid for any gas delivered or for which payment is due hereunder including tax reimbursement, shall never exceed any of the following prices:
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> * * *
>
> (b) A price which, in Buyer's sole opinion, will render the gas uneconomic to Buyer or its customers. At any time hereunder, Buyer may notify Seller in writing of such determination and of the price Buyer is willing to pay Seller for gas. The price contained in Buyer's notice shall be effective on the date specified in such notification. Seller shall have up to but not more than thirty (30) days to notify Buyer in writing whether it elects to continue sales hereunder at the price contained in Buyer's notice or to request the release of all gas subject to this agreement. Should Seller fail to give written notice of its election to have the gas released within such thirty (30) day period, Seller shall be deemed to have elected to continue sales hereunder at the price contained in Buyer's notice. If Seller elects to have the gas released from this contract, Buyer shall use best efforts to transport the gas on behalf of Seller for redelivery at a mutually agreeable point on Buyer's system. Seller's right to request the release of the gas is conditioned upon Seller's ability to sell the gas at a price higher than that contained in Buyer's notice. Such release shall be effective at the expiration of said thirty (30) day period, subject only to receipt by Buyer of Seller's request, accompanied by evidence that such other purchaser is willing to pay a higher price. Seller shall have no obligation to refund any of the price received for its gas prior to the release of such gas from the agreement."

5. Minimum Bill Clause

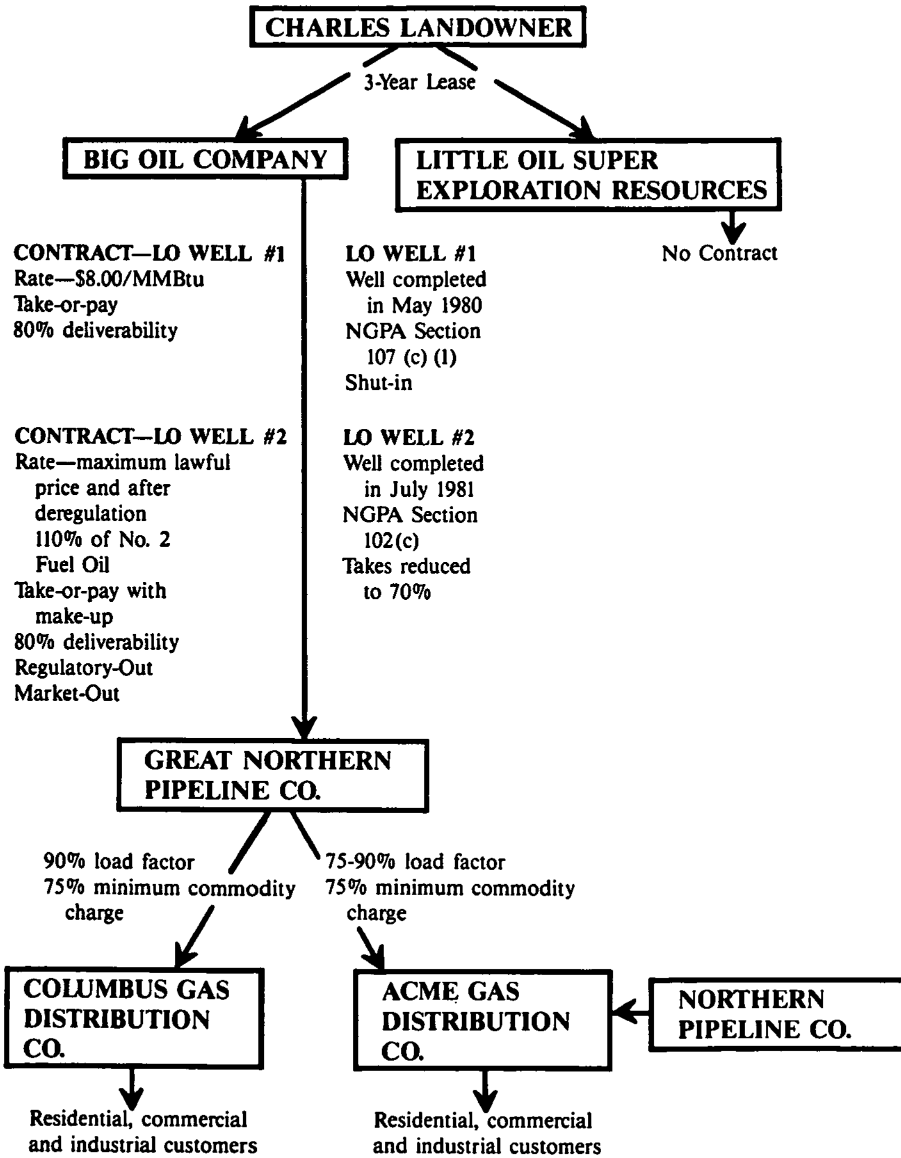
A minimum bill clause in a pipeline sales tariff is an obligation applicable to the purchaser to pay a minimum amount whether or not gas is purchased. This clause in a contract between the pipeline and its purchaser is analogous to a take-or-pay clause in a contract between a producer and its pipeline-purchaser.

> "The minimum monthly bill shall be the sum of the demand charge, plus a sum equal to the commodity charge multiplied by 75% of the contract quantity, multiplied by the number of days in the billing month, plus the amount applicable under the Purchased Gas Adjustment Clause."

6. Shut-In Royalty Clause

A shut-in royalty clause insures that after a stated period the landowner either will receive a royalty payment based upon sales from a producing lease or will receive a royalty payment to maintain the lease even though there is no gas production.

> "While there is a gas well on this Lease, or on acreage pooled therewith, but gas from such well is not being sold or used, Lessee shall pay or tender annually at the end of each period during which such gas is not sold or used, as royalty, an amount equal to the delay rental provided for... and while said royalty is so paid or tendered this Lease shall be held as a producing Lease under the habendum clause hereof."


CHARLES LANDOWNER
3-Year Lease
BIG OIL COMPANY
LITTLE OIL SUPER EXPLORATION RESOURCES
No Contract
CONTRACT—LO WELL #1
Rate—$8.00/MMBtu
Take-or-pay
80% deliverability
LO WELL #1
Well completed in May 1980
NGPA Section 107 (c) (1)
Shut-in
CONTRACT—LO WELL #2
Rate—maximum lawful price and after deregulation 110% of No. 2 Fuel Oil
Take-or-pay with make-up
80% deliverability
Regulatory-Out
Market-Out
LO WELL #2
Well completed in July 1981
NGPA Section 102(c)
Takes reduced to 70%
GREAT NORTHERN PIPELINE CO.
90% load factor
75% minimum commodity charge
75-90% load factor
75% minimum commodity charge
COLUMBUS GAS DISTRIBUTION CO.
ACME GAS DISTRIBUTION CO.
NORTHERN PIPELINE CO.
Residential, commercial and industrial customers
Residential, commercial and industrial customers

Summary and Analysis

As is indicated in the problem, because Columbus and Acme, the local distribution companies, do not need as much gas as they are obligated to pay for under the minimum bill provision of Great Northern's tariff (which obligates those local distribution companies to pay for a certain minimum amount of gas even if their customers do not need it) they are seeking to modify the minimum bill provisions of the Great Northern tariff. This threatens Great Northern.

Because Great Northern is adversely affected by the falloff in demand, it is seeking to boost its sales by what is called a special marketing program, which would offer gas at discounted rates to consumers who might otherwise switch to alternate fuels.

This special marketing program is opposed, however, by other pipelines who fear the competition, perhaps, and by end users who will not qualify for the special rates.

Great Northern also finds itself in a dispute with Big Oil Company (BO), one of the producers in our problem, over its take-or-pay obligation.

In 1980 and 1981, under the facts of our problem, BO negotiated two very favorable contracts with Great Northern Pipeline. Great Northern wanted the gas committed by BO at that point in time because it thought it needed to increase the amount of reserves that it had committed. Although the prices that were agreed to were higher than the cost of gas then in the Great Northern pipeline, the total quantity of the high-priced gas was small in comparison to that of the low-priced gas that was already in the pipeline, and therefore, the impact on Great Northern's consumers was relatively small. Thus, nobody paid much attention to these high-priced contracts that were entered into in 1980 and 1981.

Those 1980 and 1981 contracts also provided very favorable take-or-pay provisions for the producer. The take-or-pay provision was included to provide cash flow for the producer. In the event that the pipeline did not need to take the gas, it nonetheless was obligated to pay for a minimum amount, a minimum percentage of BO's delivery capacity from the wells. In this case, the percentage was set at 80 percent. One sees contracts with up to 90 percent or even higher take-or-pay obligations. There is a lot of money at stake here. In our problem, we are talking about a million dollar issue, but it has been estimated that the total take-or-pay liability of pipelines in the United States is in the vicinity of $8 billion. So we've got something to argue about.

Big Oil has its problems enforcing its take-or-pay contract. However, Little Oil Super Exploration Resources (or Loser) has it even worse.

Loser's situation is that it cannot find a market for its share of the natural gas produced from these wells, but under its operating agreement with BO, it has an obligation to pay its share of operating expenses. Thus, Loser has the worse of both worlds here: no income, but an obligation to pay its share of expenses.

It should surprise no one that Loser has sought relief both administratively and in the State Legislature.

Finally, the decline in the gas market has given both BO and Loser problems with their lessee. Because of the problems encountered by BO and Loser, Charles Landowner is questioning the validity of the oil and gas lease. The problem here is that the courts have said that the lessee under an oil and gas lease may not hold that lease indefinitely by payment of a shut-in royalty. The courts have said that the lessee has an implied obligation, an implied covenant, to market gas within a reasonable period of time and at the best available price. Loser is at risk here because Charles Landowner contends that Loser, which has been unable to find a market, has failed to market the gas within a reasonable period of time. If Landowner prevails, the lease will terminate. Big Oil Company is also at risk, however, in several respects. First of all, Landowner demands a share of the take-or-pay payments if and when they are made to Big Oil Company. In addition, there is a potential threat here of a claim against BO for a failure to market within a reasonable time, with respect to the gas that is shut-in.

On the other hand, if Big Oil Company seeks to avoid that threat, either by renegotiating its gas contracts to a lower price or participating in a special marketing program, there is a possibility that Landowner will contend that Big Oil Company has breached its implied covenant to market at the best available price. So it is a sort of "damned if you do and damned if you don't" situation.

I think you can see from this brief summary of the facts that the problem has been constructed so that the parts are interconnected. There is a cascade effect caused by the decline in demand at the burner tip. The problem has also been constructed (we hope) so that it is somewhat amusing. Let me note, however, that the problems which are depicted in this problem are not hypothetical. They're very real problems, and nobody who is involved with those problems is very amused by them.

PANEL AND PROCEDURE

I think we're ready now to turn to our panel of experts. Let me just say a word about the procedure. Basically, what we're going to do is use a modified debate or panel discussion form. We will begin by a 15-minute presentation by a speaker expressing the views of a local distribution company commenting upon the kinds of problems presented by our fact situation. There will then be a response from a representative of a pipeline company. There will then be a rebuttal period, and then we will open the floor to discussion from the other members of the panel. Finally, we will open the floor for discussion and questions from the audience.

With that background, let me introduce to you our first speaker, Richard Solomon. Mr. Solomon has had a distinguished career both in government service and in private practice. He is going to talk to us about the distribution company's viewpoint on the problems presented by this fact situation. Dick, take it away, please.