

Presented:
2010 Fundamentals of Oil, Gas and Mineral Law Primer

April 8, 2010
Houston, Texas

ISSUES IN MARKETING PRODUCTION¹

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I. Statutory Context—Uniform Commercial Code

The Uniform Commercial Code (“UCC”) is a collection of recommended, standardized state laws covering various issues that arise during commercial transactions, including sales contracts, leases, negotiable instruments, letters of credit, and secured transactions. The UCC was drafted in 1951 by the National Conference of Commissioners on Uniform State Laws and the American Law Institute, whose purpose was to create a set of uniform laws that could be adopted by each state, thereby harmonizing the widely varying commercial laws that existed in the states at that time, and thus promoting interstate commerce. Article 2 of the Uniform Commercial Code (“Article 2”) governs the sale of goods, including the sale of oil and gas and other energy commodities. Article 2, in one of its several versions, has been enacted in 49 of the 50 states and in the District of Columbia.² Accordingly, when evaluating rights and remedies in energy commodity transactions, and in the absence of countervailing contractual provisions, the provisions of Article 2 are the lens through which these energy commodity transactions are viewed.

First and foremost, it is important to note that parties may contract around, or out of, the UCC’s provisions. Indeed, § 1.302 of the UCC expressly gives the parties to a contract the ability to vary the terms of the UCC as it applies to their relationship.³ It is this provision that has allowed the development of the form contracts and standard terms and conditions which, as will be discussed in Section II below, are relied upon almost exclusively in both the gas and crude marketing contexts. However, energy market participants should recognize that the provisions of Article 2 act as default language when a contract is ambiguous or fails to address a particular topic, and in many cases, the standard form agreements used to document energy commodity transactions contain terms and remedies that differ significantly from those promulgated in Article 2.

A. Gap Fillers

Perhaps the most important characteristic of Article 2 is that if the parties have reached a meeting of the minds but have failed to reach agreement on all of the relevant terms, Article 2 will supply certain of those provisions. In the absence of express contractual terms, these default rules, which are commonly referred to as “gap fillers,” will automatically apply to the parties’ agreement.

(1) Delivery

Delivery terms in a gas or crude contract generally specify the time and place for delivery and when title and risk of loss pass from the seller to the buyer. However, if the parties fail to specify such terms in their agreement, § 2.308 steps in, and provides that the place for delivery of goods is the seller’s place of business unless the parties know at the time of contracting that the goods are located in some other place, in which case that other place is the place for delivery.⁴

² Louisiana has not enacted Article 2, relying instead on its civil and Napoleonic law tradition to govern the sale of goods.

³ TEX. BUS. & COM. CODE ANN. § 1.302 (Vernon 2009). While this section seems fairly straightforward, parties to a contract must realize that there may be instances in which an issue has been addressed in a contract, but the terms of a contract are determined to be insufficient to preempt the application of the UCC. Therefore, if the parties to a contract believe that its provisions do not adequately protect the risks they face in the specific circumstances of their transaction, it is imperative that the parties carefully draft their agreement and include provisions that are sufficiently detailed and specific to preclude application of the UCC’s default provisions.

⁴ *Id.* at § 2.308.

The application of this provision could pose a significant problem in the energy context, as most parties generally intend that the seller will ship the goods either to the buyer's location or to a specified location that is neither where the seller nor the buyer are located. Section 2.309 provides that the time for shipment or delivery or⁵ any other action under a contract shall be a reasonable time, if not agreed upon by the parties. What constitutes a reasonable time depends on what constitutes acceptable commercial conduct in view of the nature, purpose and circumstances of the situation.⁶

Sections 2.509 and 2.510 addresses when title and risk of loss pass from seller to buyer. Section 2.509 controls risk of loss in the absence of breach. This section provides that if the seller is required or authorized to ship the goods by carrier, but is not required to deliver them at a particular destination, the risk of loss passes to the buyer when the goods are delivered to the carrier.⁷ In most other cases, if the seller is a merchant, risk of loss passes only upon receipt by the buyer.⁸ Section 2.510 applies when a breach has occurred. Under this section, when the buyer has the right to reject because of breach by the seller, the risk of loss remains on the seller until cure or acceptance.⁹ Where the buyer is in breach before the risk of loss has passed to him, the seller may, to the extent of any deficiency in his insurance coverage, treat the risk of loss as on the buyer for a commercially reasonable time.¹⁰

(2) Price

Section 2.305 provides that parties can conclude a contract for sale even though the price is not settled.¹¹ In such a case, the Article 2 provides that the price is a reasonable price at the time for delivery if the parties say nothing with regard to price, or if the price is left to be agreed to the parties and they fail to agree.¹² Note, however, that this provision will apply only where the parties intend to be bound without having the price fixed or agreed upon. If the parties do not intend to be bound unless the price be fixed or agreed, and it is not fixed or agreed, there is no contract.¹³

(3) Payment Terms

If payment terms are not specified in the agreement, the default rule under Article 2 is that payment is due on delivery. Section 2.310(a) provides that unless otherwise agreed, payment is due at the time and place at which the buyer is to receive the goods.¹⁴ Under this provision, the buyer's payment obligation is tied to its receipt of the goods; thus, even though the seller will have completed its performance obligation when it delivered the goods into the hands of the common carrier, such as a pipeline, the buyer is not obligated to perform until later, when the buyer actually takes receipt of the goods. Similarly, § 2.507(a) makes tender of delivery of the goods a condition to the buyer's duty to pay for them, while § 2.511(a) further provides that tender of payment by

⁵ *Id.* at § 2.309.

⁶ *Id.* at n.1.

⁷ *Id.* at § 2.509(a).

⁸ *Id.* at § 2.319.

⁹ *Id.* at § 2.510(a).

¹⁰ *Id.* at § 2.510(c).

¹¹ *Id.* at § 2.305.

¹² *Id.* at § 2.305(a).

¹³ *Id.* at § 2.305(d).

¹⁴ *Id.* at § 2.310(1).

the buyer is a condition to the seller's duty to tender and complete delivery.¹⁵ These two sections operate in tandem to render the duty to deliver and the duty to pay concurrent obligations, with the end result being that payment is due upon delivery.¹⁶ This "payment on delivery" rule is inconsistent with most standard terms and conditions used in energy transactions, which often provide that payment is not due until the month following the month in which delivery is made.

(4) Quantity

Quantity is the one key term that Article 2 will not supply. Every contract for the sale of goods must contain a provision for a definite, or at least determinable, quantity. In effect, if the parties have not agreed to a quantity term, then they essentially have not had a meeting of the minds, and thus do not have a valid contract.¹⁷

B. Breach, Remedies and Damages

In addition to the gap filler provisions discussed above, the UCC's provisions that address breach, remedies and damages will be applicable to an energy transaction in the event that the parties fail to specify such terms in their agreement.

(1) Breach

Article 2 espouses what is commonly known as the "perfect tender" rule, which provides that any failure to conform to the obligations stated in the contract, regardless of how minor the deviation, constitutes a breach of the contract. Under § 2.601, the seller breaches the contract if its delivery fails in any respect to conform to the contract.¹⁸ Conformity does not mean substantial performance, which may often be acceptable in standard energy transactions; it means complete, perfect performance.¹⁹ However, § 2.508 somewhat relaxes the perfect tender rule by allowing a seller to cure any improper tender if the time for performance has not yet expired.²⁰ In the energy context, it may often be impossible to cure imperfect tender (as the amount and type of electricity, for example, delivered is delivered; it generally is incapable of physical rejection by the buyer); however, application of this section could potentially be used to allow a seller who does not begin delivery on the date specified in the contract, or who improperly stops and then restarts delivery at some point during the term of the contract, to cure any defects in performance or delivery.²¹

(2) Remedies

Article 2 provides remedies for both the buyer and the seller in the event of anticipated and actual breaches. Section 2.609 permits either party to request and receive assurances of performance when a breach has not yet occurred if the counter-party's performance or continued

¹⁵ *Id.* at §§ 2.507; 2.511.

¹⁶ *Id.* at § 2.511 n.2.

¹⁷ Joseph Cavinato, *The Supply Management Handbook*, 660 (7th Ed. 2006).

¹⁸ TEX. BUS. & COM. CODE ANN. § 2.601.

¹⁹ *See, e.g., Printing Center of Texas, Inc. v. Supermind Pub. Co., Inc.*, 669 S.W.2d 779 (Tex.App—Houston [14th Dist.] 1984).

²⁰ TEX. BUS. & COM. CODE ANN. § 2.508.

²¹ It is also important to note that Article 2 characterizes many energy contracts as installment contracts, and it treats the breach of installment contracts differently from the breach of other standard types of agreements. Section 2.612(a) defines an installment contract as one that requires the delivery of goods in separate lots to be separately accepted, even though the contract contains a clause stating that "each delivery is a separate contract" or the like. This section allows the buyer to reject any installment that is non-conforming if the non-conformity substantially impairs only the value of the single installment and cannot be cured. *Id.* at § 2.612(b)-(c).

ability to perform has been called into question.²² Given the price volatility of energy commodity markets, this right may be a way to ameliorate the market risk that commodity prices might change dramatically over short periods of time. Similarly, § 2.610 addresses anticipatory repudiation by either party.²³ This section provides that when a party repudiates the contract and declares that it will not render the performance still due under the contract, and that failure to perform will “substantially impair the value of the contract,” the aggrieved party has the option to either await performance by the repudiating party, or resort to any remedy available for breach and suspend its own performance.²⁴

Two key provisions of Article 2 set forth the remedies available to a seller in the event of the buyer’s insolvency or breach—§ 2.702 and § 2.703. Section 2.702 identifies the seller’s remedies upon discovery of the buyer’s insolvency.²⁵ This section provides that the seller may refuse to deliver any pending shipments of goods unless the buyer pays in cash, and allows the seller a limited right to reclaim goods that have already been delivered.²⁶ Section 2.703 applies in cases in which the buyer wrongfully rejects or revokes acceptance of the goods, fails to make payment due on or before delivery, or repudiates the contract.²⁷ This section is not used to apply any specific remedy, but merely lists all remedies that are available under Article 2 to a seller in the event of a breach by the buyer. The remedies available to a seller under § 2.703 include allowing an aggrieved seller to, under certain circumstances, withhold delivery,²⁸ stop delivery of goods already in transit,²⁹ resell the goods and recover damages,³⁰ recover damages for non-acceptance,³¹ or terminate the contract.³²

A buyer’s remedies for breach are set forth in § 2.711. Like § 2.703, § 2.711 outlines the remedies generally available under Article 2 to a buyer in the event of a breach by the seller.³³ Subsection (a) provides that when the buyer rightfully rejects or revokes acceptance, the buyer may terminate the contract, recover the price paid,³⁴ and either ‘cover’ and have damages,³⁵ or have damages for non-delivery.³⁶ Subsection (b) allows the buyer the option of (1) recovering the

²² *Id.* at § 2.609. Section 2.609 allows either party to request adequate assurances of performance when the party has reasonable grounds for insecurity and allows the requesting party to suspend performance if it does not receive adequate assurances within a reasonable period of time, not to exceed thirty days, of the request. Failure to provide the requested assurance within the thirty-day window is deemed a repudiation of the contract. *Id.* at § 2.609(d).

²³ *Id.* at § 2.610. To constitute repudiation, it is not necessary that performance be made literally impossible; repudiation can result from any action that would reasonably indicate a rejection of the party’s obligation.

²⁴ *Id.*

²⁵ *Id.* at § 2.702.

²⁶ *Id.*

²⁷ *Id.* at § 2.703.

²⁸ *Id.* at § 2.703(1).

²⁹ *See id.* at § 2.705.

³⁰ *See id.* at § 2.706.

³¹ *See id.* at §§ 2.708 - 2.709.

³² *Id.* at § 2.703(6).

³³ *Id.* at § 2.711.

³⁴ *See id.* at § 2.612.

³⁵ *See id.* at § 2.712.

³⁶ *See id.* at § 2.713.

goods (if the goods have been identified to the contract),³⁷ (2) obtaining specific performance,³⁸ or (3) replevying the goods.³⁹ Subsection (c) offers yet another option by creating an automatic security interest in goods in the buyer's possession or control for any payments made on those goods and any expenses incurred in the receipt, inspection, and transportation of the goods.⁴⁰ This subsection also allows the buyer to sell any non-conforming goods in the buyer's possession and keep the price received.⁴¹

(3) Damages

Article 2 provides for the recovery of damages by both the buyer and seller, with some distinctions between the two. Sections 2.708, 2.709 and 2.710 set forth the damages available to a seller in the event of a breach by the buyer. Section 2.708 provides that the seller's damages are determined by calculating the difference between the contract price and the market price⁴² at the time and place for tender, together with any incidental damages.⁴³ However, while the general goal of Article 2's provisions relating to damages states that an aggrieved party should be placed in as good a position as if the other party had fully performed, consequential damages⁴⁴ may not automatically be recovered under Article 2. Article 2 specifically allows for the recovery of consequential damages by an aggrieved *buyer*, but does not provide for recovery by a *seller* of consequential damages. Section 2.709 sets forth a seller's remedies when a buyer fails to pay the purchase price when it becomes due, while § 2.710 allows an aggrieved seller to recover incidental damages, including all reasonable expenses incurred in connection with the return or resale of the goods, resulting from any breach by the buyer.⁴⁵ Note, however, that this section does not allow a seller to recover consequential damages.⁴⁶

Sections 2.712, 2.713, 2.714 and 2.715 set forth the damages available to a buyer in the event of breach by the seller. Section 2.712 is Article 2's primary avenue of recourse for a buyer who attempts to minimize the damages suffered as a result of the seller's breach by obtaining substitute goods or commodities.⁴⁷ This section provides for the "cover standard" of calculating

³⁷ See *id.* at § 2.502.

³⁸ See *id.* at § 2.716.

³⁹ *Id.*

⁴⁰ See *id.* at § 2.706.

⁴¹ *Id.* § 2.711(c).

⁴² The meaning of 'market price' as used in Article 2 is generally defined as the 'prevailing price at which something is sold in a specific market.' *Id.* at § 2.708(a) (citing Black's Law Dictionary 1207 (7th Ed. 1999)). Texas courts have held that when the resale price is determined by reference to an arm's length transaction, it is an adequate reflection of market price. *Cook Composite, Inc. v. Westlake Styrene Corp.*, 15 S.W.3d 124, 138-39 (Tex. App.—Houston [14th Dist.] 2000). Texas courts also have found that the spot price may sometimes be an adequate representation of Article 2's market price of a commodity. *Id.* Article 2 specifically provides that the market price is to be determined as of the date the non-breaching party learned of the breach. TEX. BUS. & COMM. CODE ANN. § 2.723.

⁴³ TEX. BUS. & COMM. CODE ANN. § 2.708(a); see also § 2.710 for a discussion of incidental damages.

⁴⁴ Consequential damages are defined as those damages that "do not arise within the scope of the immediate buyer-seller transaction, but rather stem from losses incurred by the non-breaching party in its dealings, often with third parties which were an approximate result of the breach." *USX Corp. v. Union Pacific Resources Co.*, 753 S.W.2d 845, 856 (Tex. App.—Fort Worth 1988).

⁴⁵ TEX. BUS. & COM. CODE ANN. §§ 2.709, 2.710.

⁴⁶ *Id.*; see also, *Nobs Chemical USA, Inc. v. Koppers Co., Inc.*, 616 F.2d 212 (5th Cir. 1980).

⁴⁷ TEX. BUS. & COM. CODE ANN. § 2.712 (Vernon 2009).

damages in the event of any breach by the seller.⁴⁸ The primary purpose of § 2.712 is to provide the buyer with a remedy that enables him to obtain the goods or commodities he needs, thus allowing him to continue to run his business regardless of whether the seller performs under the contract.⁴⁹

Section 2.713 outlines the buyer's primary recourse against the seller in cases in which the buyer does *not* cover and obtain substitute goods. The primary measure of damages under this section is the difference between the market price at the time the buyer learned of the breach and the contract price, plus any incidental and consequential damages, but less any expenses saved as a result of the breach.⁵⁰ Section 2.714 sets forth the method by which a buyer who has accepted non-conforming goods may recover damages.⁵¹ Section 2.715 describes the method of calculating incidental and consequential damages available under §§ 2.712, 2.713, and 2.714. This section is intended to reimburse the buyer who incurs reasonable expenses in connection with rightfully rejected goods or in connection with effecting cover where the seller breached by delivering non-conforming goods or none at all.⁵²

II. Contract Issues

Although the UCC will supply default terms for sales of commodities like gas, most wholesale oil and natural gas marketing transactions today use standard form agreements. For gas, one of the most widely used contracts today is the Wholesale NAESB Agreement, developed by the wholesale gas quadrant of the North American Energy Standards Board. As marketplace practices have evolved, this form has gone through a couple of iterations, and certain standard addenda have also been developed. In crude marketing, the Conoco General Terms and Conditions are widely incorporated by reference into specific sales transactions. These terms were originally developed by Conoco in 1993 and have changed little since that time, although recent events associated with Gulf Coast hurricanes have prompted revisions to address such disruptions.

There are pluses and minuses to using standard forms. Clearly, the use of standard forms with which employees and counterparties are familiar can significantly reduce the cost of negotiation, documentation and administration of contracts. It also facilitates a much quicker contracting process, which is particularly useful in the context of short term transactions, such as monthly transactions, that are characteristic of much of the market today. On the other hand, a form contract suffers from the fact that it is a form, and may therefore not be well-suited to the specific transaction in question. In particular this is an issue with respect to natural gas transactions, where transportation and other logistical issues have historically prompted market participants to desire long term contracts in certain circumstances. However, broad market acceptance of the use of certain forms makes it likely most producers will not have the clout to

⁴⁸ *Id.*

⁴⁹ *Id.* at cmt. 1.

⁵⁰ *Id.* at § 2.713(a). The market price to be used in calculating damages under this section is the price for goods of the same kind and in the same branch of trade. *Id.* at cmt. 2. However, determining the applicable market price is not as simple as it may appear at first glance; parties' attempts to determine the applicable market price has led to substantial litigation in many industries. Making this determination in the energy industry can be particularly problematic, because of the volatile nature of commodity prices, and the use of different internally calculated price curves to determine the market price.

⁵¹ *Id.* at § 2.714.

⁵² *Id.* at §2.715.

insist upon the use of a home-grown contract (though in some cases in the natural gas market, discussed in more detail below, a particular gatherer or processor may use its own form for certain specialized transactions, such as percentage of proceeds transactions.

A. Natural Gas -- Sales Contracts

(1) NAESB Overview

The following hits the highlights on some of the contracting issues associated with the wholesale NAESB. Since entire day long courses can be (and are) conducted on the NAESB, what follows is only the 50,000 foot view, primarily from the perspective of the producer-seller. Note that the NAESB form itself is a copyrighted document; its use is free to members, but the form must be purchased by other users. As such, revisions should not be made except through special provisions that are identified on the cover of the contract and included in attached addenda. Additional information about NAESB, including membership and the purchase of form contracts, can be found at www.naesb.com.

The NAESB form contemplates the execution of a base agreement, the incorporation of general terms and conditions applicable to all transactions executed under the terms of the base agreement, and a transaction confirmation applicable to specific transactions that take place under the base agreement. The following will discuss each of these components in more detail, including certain contract issues that arise under them.

The base contract sets forth the names of the parties, tax identity and other entity information, contact information for contract notices, scheduling, payment and other administration, as well as a section that allows the parties to choose certain alternatives offered in the general terms and conditions, including, for example, choices about how individual transactions will be memorialized and confirmed, when payment occurs, and what performance standards apply. These will be discussed in greater detail in connection with the discussion on the general terms.

The general terms include detailed provisions applicable to all transactions under the base contract, dealing with such items as the performance obligation, transportation, imbalances, quality, taxes, billing, title, and the like. Typically, these are tailored to some degree for individual transactions through the use of an attached addendum or appendix containing special provisions.

The transaction confirmation is usually a one or two page document that establishes in writing the commercial terms, such as price, term, delivery point, and quantity, peculiar to a specific transaction. Finally, specific addenda, like one that addresses only credit issues, have been developed by NAESB over time to address certain gaps in the original form, which became apparent as it was more broadly used for transactions in addition to the largely short term trading for which it was originally developed.

(2) Selected Material Terms

Quantity and delivery obligations. The U.C.C. will supply most delivery terms for the sale of natural gas, but ideally this is a subject to cover in the written sales contract.⁵³ Among the delivery terms that should be addressed are the quantity, the type of service obligation and the location.

⁵³ Recall that the UCC generally will not supply a quantity term.

Identification of the quantity to be purchased and sold is a key commercial term; how this term is addressed in the sales contract depends on the circumstances and commercial goals of the parties. A quantity term can reflect a stated fixed quantity to be purchased and sold, a quantity that can vary between a stated maximum and minimum, a quantity that can vary from zero up to a stated maximum, or other variations, such as all of the production (whatever the level may be) from an identified well or lease, or all of the requirements for natural gas use in a certain facility. The NAESB transaction confirmation contains places to check the box and fill in the blanks for each of the first three options (the standard quantity blanks in the NAESB form reflect deliveries per day). For the last two, specific provisions will need to be included under the special conditions section of the NAESB.

Quantity commitments to purchase all available production, or to sell all requirements, carry inherent risks for the seller or purchaser, respectively, associated with the uncertainty of these measures. Thus, a gatherer agreeing to purchase with no production history from a well, may find it must add facilities to deal with an unexpected blockbuster volume. Conversely, they provide greater protection to the seller and purchaser, respectively, by shifting to the other party the risks associated with the uncertain quantity. Thus, a requirements buyer can be assured needed supply is available, without over-committing in the event of adverse changes in the market. Typically, contracts involving these uncertain quantities will also include various provisions designed to mitigate the risk associated with the uncertainty, such as maximum limits on the quantity to be purchased or sold, or limits on a requirements purchaser's ability to modify its facilities to consume (or to conserve) gas.

Given the physical nature of natural gas and the attendant logistical issues associated with delivery, gas sales agreements also need to specify the period of time over which the quantity will be delivered, typically a twenty four hour day, a calendar month, or a year. These choices can be reflected in the NAESB transaction confirmation through filling in the blank available for the "Delivery Period," and the NAESB general terms contain definitions for "Day," Business "Day," and "Month." Note that under the NAESB, a Day means the 24-hour period that commences when the applicable natural gas pipeline transporter's gas day begins, as specified in the individual pipeline's gas tariff,⁵⁴ and not necessarily a calendar day.

A gas sales contract also needs to specify the unit of sale. Typically in the United States, this reflects MMBtu, which is the abbreviation for one million British thermal units, a measure of *heat content*. This is the standard unit used in the NAESB form. It is also equivalent to one dekatherm, which is a helpful fact for the metrically challenged to remember, since many gas pipeline tariffs use dekatherms and therms as the principal unit. Alternatively, sometimes contracts use as the unit of sale the Mcf, which is short for one thousand cubic feet, and is a measure of *volume* of gas, which must also assume a specified pressure and temperature. Although coincidentally an Mcf and an MMBtu can be roughly equivalent, depending on the heat content of the gas in question, the novice gas seller should remember these units are completely different measures of gas, just as apples and oranges are completely different fruits.

As noted, the location is typically reflected under the NAESB form in the specific transaction confirmation. With respect to the type of service obligation under the contract, the most typical choices in a gas sales contract are either firm or interruptible. Generally speaking, a firm obligation is one that must be performed without interruption, regardless of changes in

⁵⁴ All gas pipelines regulated by the Federal Energy Regulatory Commission ("FERC"), and many pipelines regulated only at the state level, use documents called "tariffs," which generally speaking reflect the terms and conditions applicable to pipeline service, and operate much like general terms of any contract.

economic or other circumstances (but usually subject to certain limited excuses, such as an Act of God, which are discussed more below), with a failure in performance triggering liability for breach on the part of the non-performing party. Conversely, an interruptible obligation may be interrupted at any time and for any reason, including to strike a more favorable economic deal, without incurring liability. These are the primary choices reflected in the NAESB form of general terms, although note that the NAESB contains specific definitions of the terms “Firm” and “Interruptible” that differ slightly from the foregoing.

A gas sales contract also typically will expressly address the remedies associated with a failure to fulfill the delivery obligation, although as noted, the U.C.C. will supply applicable remedies as a matter of law, if the contract does not. Section 3.2 of the NAESB form provides for a cash settlement for failures to deliver or receive gas, an approach that is the most prevalent today, with one of two alternatives to be selected for calculation of the cash settlement. The first, known as the “cover standard” calls for a liquidated damages payment for each unit of the default quantity equal to the unfavorable difference between the cost of replacement performance, adjusted for reasonable differences in transportation costs, and the contract price. Note that any contract using the cover standard ideally should also address the appropriate calculation if a party is unable to secure cover, despite commercially reasonable efforts.⁵⁵ In addition, if a purchaser expects (or is required) to rely on a provider of last resort type of supply as a replacement, then this situation may need to be addressed expressly if it appears likely the replacement cost may exceed the cost of supply that might be available in the market generally.

The second NAESB form method for calculating liquidated damages for a failure to deliver or receive, called the “spot price standard,” calls for calculation of damages with respect to each unit of the default quantity, based upon the unfavorable difference between the current spot market price and the contract price. The NAESB base contract provides both a default index for calculation of the spot price, the *Gas Daily* Midpoint, as well as a blank for including an alternative price or prices. The appropriate price to use will depend upon commercial factors relevant to the sales contract, such as the intended location for the delivery.

The NAESB alternatives may not be appropriate in all cases, or may require some additional tweaking in order to operate correctly. For example, in contracts involving a requirements sale, if there is a default in performance, there may be no fixed quantity against which to determine the extent of the default in performance for purposes of the calculation of damages. Thus if using the NAESB for this type of transaction, it may be necessary to add a special provision to provide for determination of the quantity, such as an amount based upon historical usage over a specified prior period. Similarly, in situations in which physical receipt or delivery is crucial, it may be appropriate to specify that specific performance is required. Finally, if a hedging program is associated with the purchase or sale, it may be necessary to tweak the damages standard, or to include an additional standard, in order to ensure that the physical contract appropriately dovetails with the hedge. An additional consideration, which the NAESB also addresses to a degree, is how to allocate costs associated with transportation imbalances or other penalties that may be incurred as a result of the failure to deliver or to receive.

Note that if the parties want to assure that only expressly specified liquidated damages apply as remedies for delivery failures, it is generally necessary to state this clearly and specifically. Thus the NAESB form describes the remedy chosen in section 3.2 as the “sole and

⁵⁵ This issue is addressed in the NAESB form.

exclusive' remedy available for delivery failures.⁵⁶ Without this type of express language, a variety of remedies may be available under applicable law.

Price. The U.C.C. will supply a price term if the contract does not, but contracts for the sale of gas generally address price. The transaction confirmation section of the NEASB form contains a blank in which a fixed price per MMBtu can be stated, or another blank that allows for other provisions. Most typically today in U.S. domestic gas contracts, the price will be a fixed, stated price, a fixed price that escalates over a period of time by a stated escalation factor, a referenced price published in one of the various trade publications, such as *Gas Daily* or *Inside FERC*, or a price published on an exchange such as the New York Mercantile Exchange or NYMEX. If the parties use a published price, ideally care should also be taken to address related issues, such as the need for an adjustment to address transportation costs if the published price is for a location other than the precise delivery point location, which day or days will be referenced for the calculation, if the price is published daily, whether the referenced price is the high, low, midpoint or average published for the location, and what happens if the referenced publication goes out of business or alters the published prices in a way that causes them no longer to reflect a price appropriate for use in the transaction. The current form of the NAESB includes section 14, "Market Disruption" which is intended to address the latter issue.

It is especially important in contracts involving terms greater than one year, for parties to carefully address pricing so that it properly reflects an appropriate bargain for both sides over the entire term. A long term contract that results in an egregiously disproportionate economic advantage for either party is ripe for a breach. Thus, long term contracts, particularly those using fixed prices or fixed escalators, may provide for periodic price reopeners or renegotiations, or reopeners triggered by specific changes in circumstances. These types of provisions should ideally address a number of issues, such as the mechanism by which the reopener will be triggered, the effective date for implementation of the new price, whether or not interest is owed if the price is adjusted retroactively, and how an impasse between the parties will be addressed if the reopener relies upon a new mutual agreement of the parties to establish the new price. Because the NAESB form was generally developed for use in short term transactions, it does not contain form provisions to address these issues, and if used for long term transactions, will need to be supplemented with special provisions.

Sales contracts associated with a bundled gathering or processing service frequently use a pricing variant known as a percentage of proceeds contract. Under this type of contract, the seller is paid a percentage of the proceeds realized by the buyer in the subsequent resale of the gas (and sometimes its constituent natural gas liquids). The percentage paid varies depending on the downstream services provided by the buyer and the relevant market, but can typically reflect anywhere from 70 to 95% of the resale value. Typically the resale price will reflect one or more of the above types of pricing provisions, to which the percentage will then be applied. Sometimes, the resale price reflects an average of a number of different resale arrangements. In the latter event, it is important to address the mechanics of how the average is calculated, for example, a volume-weighted average will accord greater weight in the calculation to large volumes sold at a particular price. In addition, it may be important to address potential issues associated with a resale to an affiliate, or preferential treatment of resales of gas owned by an affiliate, so that the affiliated transaction does not unduly burden the non-affiliate (for example by according the affiliate gas resales preference in filing the volumes required under the most lucrative resale

⁵⁶ Similar language appears in NAESB section 10.6 with respect to the damages available under section 10 for defaults other than those associated with failures to deliver or receive gas.

contracts). Prohibitions against discriminatory treatment coupled with detailed audit rights may be needed to assure the validity of prices paid under percentage of proceeds contracts. None of these issues is directly address in the current NAESB form, and many of these types of agreements are not based upon the NAESB.

Payment terms. As noted, the physical characteristics of gas complicate the logistics associated with its delivery and sale. This in turn results in invoicing and payment issues that may be more complex than is the case in the typical commodity sales agreement. As a result, most gas sales contracts include extensive payment terms, rather than relying upon terms supplied by the U.C.C. In the NAESB form, these provisions are contained in section 7 of the general terms.

Because quantities delivered may be measured by a party, such as a gatherer, other than either the seller or the purchaser, it is important in gas sales contracts include provisions that address the ability to deliver estimated invoices and subsequent true ups, in the event that data needed to render an actual invoice is not available at the stated time for rendering bills under the contract. The form of payment required should also be addressed, especially if payment in immediately available funds is intended. (This is the standard method of payment called for in the NAESB form.) Payment provisions should also address what happens in the event of a dispute over the invoice—e.g. does the disputing party pay all or only the undisputed part of the invoice, and what are the payment mechanics when the dispute is resolved—as well as a party’s rights to audit relevant information within the control of the other, in order to verify the accuracy of invoices. Finally, these provisions frequently address to net payments owed under the contract. The extent of netting available can be an important factor in reducing credit exposure, especially in circumstances when the parties have multiple live transactions under the same master contract.

Miscellaneous provisions. It is beyond the scope of this paper to address all of the provisions that may be appropriate to include in a contract for the sale of gas. The following briefly highlights some additional provisions.

The NAESB form contains in Section 1 provisions intended to allow the parties to select the method by which transactions under the base agreement will be documented and confirmed. Note that the NAESB contemplates the parties can arrive at binding transactions under the base agreement through the use of oral agreements. This again reflects the original development of the NAESB for purposes of generally short term use. Contracts contemplating performance over a year or more should always be reduced to a formal writing, both to assure a meeting of the minds of the parties over the details of the transaction, and to serve as a clear expression of intent if the original negotiators do not remain available for the entire term of the agreement. Section 1.4 of the NAESB form also contemplates that either party can electronically record all conversations relevant to the transaction or contract for purposes of establishing its terms, and provides the parties’ agreement not to contest validity or enforceability of telephonic recordings made pursuant to the NAESB’s terms. Note that under many state laws, recoding of telephone conversations is illegal unless the other party has consented as contemplated in the NAESB form. Note also, that the practice of recording all trading lines, while perhaps useful to establish contract terms in the event of a dispute, has distinct disadvantages. It creates a mountain of electronic data that is likely to be discoverable in the event of a dispute or investigation, which because it is very time consuming to review and produce, can greatly increase costs of discovery. In addition, unless those using the recorded lines are carefully trained, many times the recorded conversations can contain inflammatory and unhelpful remarks.

Because the physical qualities of gas generally require that it be gathered and transported by pipeline, gas sales agreements generally must address issues related to such downstream

gathering and transportation, such as which party is responsible for making downstream gathering or transportation arrangements, how nominations of the quantities of gas expected to flow are handled and coordinated, how performance risks between the parties to the purchase and sale agreement are allocated if the downstream gatherer or pipeline fails to accept or to redeliver gas, and who is responsible for pipeline imbalances and related penalties that may be incurred. In the NAESB form, these items are generally addressed in sections 4 and 11.

Since gas production and sales are frequently subject to a variety of taxes, such as state sales taxes or severance taxes, it is important in the contract for the purchase and sale of gas to address the parties' responsibilities for payment of such taxes. In the NAESB form, this is addressed in Section 6, with alternative selections for payment of taxes imposed (i) by buyer at and after the delivery point, or (ii) by seller before and at the delivery point. Note that it is important to assure that one or the other party is responsible for payment of taxes imposed at the point of delivery. Note also that individual state taxes may include specific requirements to establish the responsibility of one party or the other to pay the tax in addition to the purchase price, and be sure the contract language conforms to these requirements. This may mean the standard NAESB term requires tweaking in a special provision.

Because there is no uniform view in the market about whether or not it is appropriate to subject disputes arising under gas sales contracts to arbitration rather than litigation, the NAESB form does not include any provision respecting the referral of all or any subset of disputes to arbitration. Thus, if the parties using the NAESB form want to rely on arbitration rather than litigation in court to resolve disputes, this issue needs to be addressed in a special provision.

A number of warranties, such as an implied warranty of merchantability, are imposed by the U.C.C. in sales contracts, unless the parties otherwise agree. The NAESB form addresses this fact by including in section 8 a title warranty, and an express and conspicuous (i.e. in all capital letters) disclaimer of any other warranties.

As a document primarily designed for use in short term transactions, the initial NAESB form of general terms did not contain robust provisions respecting creditworthiness of the parties, or steps to be taken in the event of a change in status during the term of the contract. Increasing use of the form in long-term transactions, coupled with various cycles of disruptions in gas markets that have occurred since the NAESB form gained broad acceptance, exposed this gap. NAESB has thus developed a separate credit support addendum for use with its form contract.

B. Gas Gathering Agreements

The physical characteristics of natural gas require special forms of gathering and transportation once it is produced; in the United States market this almost always occurs through the use of pipelines. Because most gas sales will also be associated with gathering by pipeline, the following reflects a broad overview of some of the material issues that need to be addressed in natural gas gathering agreements. Gathering agreements will generally reflect either a gathering service that is bundled with a purchase, that is the gatherer purchases the gas and gathers it to a market, generally paying a purchase price that reflects a netting of the cost/value of the gathering (and possibly other services, such as dehydration and/or treating). Or, the gatherer will not acquire title, but will simply provide gathering and related services necessary to render the gas marketable and deliver it to a liquid point of sale. Note that all of the types of provisions addressed above concerning gas sales agreements are relevant in the gathering context, and will not be further addressed in detail, except to the extent affected by the different context.

(1) *Dedication, connection and disconnection*

Many gathering agreements, especially those that will entail construction of new facilities, contemplate the dedication by the producer/shipper of identified production to the gathering contract or system. Sometimes this takes the form of a dedication listing specific leases or wells, and sometimes it takes the form of a designated geographic mutual area of interest. One matter to be considered in connection with dedication provisions is the scope of the dedication: whether it covers (i) only interests owned and identified at the time the dedication is entered into, (ii) interests in production acquired later, or even (iii) gas initially produced by third parties and purchased (or marketed) by the producer/shipper under the gathering agreement.

If after-acquired interests are to be covered by a dedication, it is necessary also to address how the dedication operates in circumstances in which the after-acquired interest is already dedicated elsewhere, so as to avoid a situation in which the producer/shipper has conflicting obligations and a resulting breach of one or the other. Frequently, this issue is addressed by excepting the interest from the dedication to the extent it is already dedicated at the time of acquisition. Sometimes the parties also address additional details concerning the prior dedication, for example by addressing the extent to which the producer/shipper is permitted to extend or amplify the prior dedication. Dedication provisions should also address other applicable reservations, such as a reservation by the producer/shipper of gas for lease use purposes.

In the event a gathering agreement contains a dedication provision, it will likely be necessary to address in the agreement the parties' respective obligations concerning new connections. A connection provision can take a number of forms, depending on the circumstances. For example, a gathering agreement may impose on the producer/shipper the entire cost and obligation to bring dedicated gas to the existing gathering system and ensure it is physically able to be delivered into the system. Or, the gathering agreement may impose upon the gatherer a firm obligation to hook up dedicated production at the sole cost and obligation of the gatherer. Most likely, the connection provision will reflect a hybrid of these two extremes, and may treat different production differently. For example, a gatherer may have a firm obligation to connect certain production, including even an obligation to pay monetary damages for undue delays, if the production meets criteria specified in the connection provision. These criteria can include locations on certain leases or within a specified distance from the existing system, connections whose cost falls below a stated cost (total or per mile), or connections that will realize a specified return for the gatherer in light of estimated volumes, costs, and fees. Another approach used may be to leave individual connection requests subject to future mutual agreement of the parties, which depending on the circumstances of the request, may reflect elements such as an agreement to charge an incremental fee, an agreement for the producer/shipper to reimburse or pay for some or all of the connection costs, or a combination of elements. If the gathering agreement allows for any discretion on the part of the gatherer not to connect, it must also address other alternatives that will allow the producer/shipper to nevertheless get dedicated production to market. These can include a producer/shipper option to build and pay for the connection, or a release from dedication.

Particularly in circumstances in which a gatherer is required to make substantial investment in the construction of new facilities, it may be necessary in order to permit financing and/or to induce gatherer to risk the initial investment, to agree to some type of volume commitment. This can take the form of an agreement by the producer/shipper to reserve and pay for a monthly capacity reservation, or more commonly in the gathering context, an agreement on the part of the producer/shipper to assure the delivery for gathering under the agreement of a

specified minimum throughput during a year (or other specified time period). A minimum throughput commitment, assuming a credit-worthy producer/shipper, assures the gatherer of a minimum level of cash flow over the specified period. This approach also allows the producer/shipper more flexibility than a flat demand charge payment for reserved capacity, because it permits some level of fluctuation in deliveries under the agreement that may be associated with normal operations, for example a ramp up in drilling plans. If a minimum volume obligation is used in a gathering agreement, detailed consideration should be given to the mechanics of how it will be implemented. For example, when will the volume commitment begin (and end), will the agreement allow for a period in which to physically make up deficient volumes before payment is due, and under what circumstances, if any, will the producer/shipper receive credits against the minimum volume commitment. Credits can be received, for example, for excess deliveries carried over from a previous period, or volumes that could not be delivered due to operational problems incurred by the gatherer. The agreement should also clearly specify the payment timing and other terms.

In addition to addressing connection issues, many gathering agreements will also address what happens when production through a specific connection is no longer economic to gather. This is most likely to be an issue when the gatherer owns and/or operates the connecting facilities, and when either production has materially declined over time, or operating costs have materially increased, for example due to imposition of additional legal requirements. Frequently this issue is addressed by giving the gatherer fairly broad latitude to determine whether or not a connection remains economic, with the determination then triggering either a renegotiation of fees, an option on the part of the producer/shipper to acquire and operate the uneconomic facilities, a termination of service and release from dedication, or various combinations of any of the foregoing. Note that under Texas law (and possibly the law in other producing states), limitations may exist on the ability of the gatherer to disconnect from a wellhead absent the agreement of the producer.⁵⁷

(2) Quality and pressure

A gathering agreement also needs to address the allocation between the parties of the obligations respecting the quality and pressure of gas delivered into the gathering system. At the time of severance from the ground, natural gas can reflect a wide variation in its constituent parts. At a minimum, natural gas generally requires dehydration to remove excess free water and water vapor, as well as mechanical separation to remove constituents, such as condensate, that are liquid at atmospheric pressure. Gas that is high in carbon dioxide and/or sulfur or hydrogen sulfide, must also be treated. Finally, gas that contains a significant volume of entrained heavier hydrocarbons, such as propane, typically known as “wet” gas, can have a Btu or heating content that is too high to satisfy downstream transportation specifications.⁵⁸

Gas quality can be addressed in the gathering agreement in a number of ways. Frequently, a gathering agreement will impose upon the producer/shipper some minimal obligation for

⁵⁷ Texas Railroad Commission Rule 73 (16 T.A.C. § 3.73), provides that:

- (b) No pipeline operator shall physically disconnect its facilities from or cease providing pipeline services to any well or lease without first obtaining:
 - (1) written consent of the well or lease operator for the proposed disconnect or termination; or
 - (2) written permission from the Commission. ...

⁵⁸ Downstream transporters generally have limitations of some type on the maximum Btu content of gas, because entrained heavier hydrocarbons will change from a gaseous to a liquid form with pressure and temperature changes, drop out of the gas stream, and create operational and safety issues for transporters and their downstream customers.

mechanical separation and dehydration at the wellhead, before gas is ever introduced into the gathering system. Sometimes, a producer will be required to ensure that gas delivered into the gathering system meets a set of specified quality criteria, such as no more than a specified maximum percentage of combined inert gases, such as nitrogen, oxygen and carbon dioxide. Alternatively, the gathering agreement may contemplate that the gatherer will be responsible for providing the treatment, dehydration, and sometimes, processing services needed in order to cause the gas to be able to meet the quality specifications of downstream transporters. In this latter circumstance, the gathering agreement will need to specify clearly the services to be performed by gatherer, as well as the associated fees (and any escalations over time). These types of provisions may also address limits on the gatherer's obligations to construct additional treating facilities, if gas falls outside anticipated quality specifications or the costs of such facilities exceeds expectations.

High school physics teaches that gaseous substances flow naturally only from higher pressure environments into lower pressure environments. Because gas production flows naturally at differing pressures, and because gathering systems operate at differing pressures, it is necessary for any gathering agreement to address the parties' respective obligations regarding the pressures necessary to assure that the natural gas can enter the gathering system.

Gathering agreements address pressure in a variety of ways. Sometimes, the agreement specifies a maximum (or minimum) operating pressure which must be maintained by the gatherer at the points of receipt into the gathering system; in these arrangements, the producer/shipper is obligated at its cost to install and maintain the compression, if any, needed to enter the system at that pressure, and the gatherer is required to construct and operate its facilities, which may include the operation of compression, in a manner that maintains the required pressures. Sometimes the gatherer is solely responsible for assuring pressures are maintained that permit production into the system. Frequently, when the gatherer has primary responsibilities for maintaining appropriate pressures, the gatherer will perform and charge a fee associated with, a compression service in connection with the gathering service. The parties may also wish to address what happens in circumstances when a party decides that its obligations to provide compression under a gathering agreement are no longer economic; alternatives can include a renegotiation of applicable fees and disconnection of the production in question. In order to assure that safe pressure conditions are maintained on the gathering system, gathering agreements will frequently prohibit the operation of the system or the introduction of gas at pressures in excess of a specified maximum allowable operating pressure.

(3) Service obligation and curtailment

Unlike many crude oil pipelines, natural gas gathering pipelines in Texas are not legally required to be, nor do they generally operate in practice, as common carrier pipelines. Rather, they operate as contract carriers, to the extent they gather gas for third parties. This means that the typical gathering pipeline is not obligated to receive gas from any interested prospective shipper, and to pro rate back other flowing volumes in order to accommodate the new shipper, if capacity on the system is otherwise insufficient. Nor as a general matter are gathering lines in Texas required as a matter of law to expand capacity in order to accommodate prospective new shippers. Thus, gathering contracts generally address the level of service to be provided by the gatherer, and the priority to be accorded to the producer/shipper's volumes in the event capacity is insufficient and flows must be curtailed.

As with the NAESB form, gas gathering agreement will typically call for one of two types or priority levels of service—firm service or interruptible service. In the gathering context, firm

service usually entails a reservation by contract of a stated level of capacity on the gathering system, frequently stated in terms of a maximum daily quantity or MDQ, that is dedicated to the gathering service to be performed for the producer/shipper. Except in certain circumstances, usually involving uncontrollable, defined events that affect capacity, the gatherer is obligated to provide the firm gathering service without interruption or be in breach. Frequently, but not always, the producer/shipper may be required to pay a set monthly charge to reserve the capacity and service, regardless whether or not the producer/shipper actually delivers that volume for gathering.

Alternatively, a producer/shipper may receive interruptible service, which may be interrupted for any reason. This type of service usually requires that a gathering fee be paid only with respect to the quantities of gas actually gathered, thus it does not entail a fixed financial commitment on the part of the producer (absent an agreement to a minimum throughput level, as discussed above). Contracting for this type of service exposes the producer/shipper to the risk that the gatherer will enter into gathering services with others under more attractive terms, and thus no longer have capacity needed to receive the producer/shipper's gas. Sometimes gathering agreements attempt to develop a hybrid type of service, for example, a type of service for which no set amount of capacity is reserved, but which is to have the highest priority claim on the capacity if it is insufficient. Under Texas law, particularly for gas gatherers that are directly connected to wellhead production, it is not clear that such priorities are enforceable in all circumstances, given legal obligations that such pipelines may have to take gas within a field without discrimination, and among fields without undue discrimination.⁵⁹

Gathering agreements will frequently also contain provisions, generally known as curtailment provisions, that address how flowing volumes will be prioritized in the event a disruption in operations results in insufficient capacity to gather all gas tendered. Typically, these will call for a pro rata allocation of all volumes flowing under firm service commitments, with the allocation based upon either scheduled quantities or MDQs. Then, to the extent any capacity remains for interruptible volumes, those will either be similarly pro rated; or, interruptible volumes may also be allocated capacity based upon first on last off priority system or the level of the gathering fee paid (with those paying the highest fees getting the priority to available capacity).

C. Crude Oil Sales Contracts

As with gas sales agreements, contracts for the sale and purchase of crude oil in the United States typically contain an agreed upon price, a specified quantity, a specified grade of crude, and an agreed upon delivery location. Pricing is frequently based upon referenced prices, such as a major producer's postings at a certain trading hub, a NYMEX settlement price for a certain grade of crude, or another reference such as prices published in *Platt's Oilgram Price Report*. Since many of the contracting issues relevant to these provisions have already been addressed in connection with the discussion on gas sales contracts, they will not be further discussion here.

As early as 1993, Conoco developed general terms and conditions under which it purchased and sold crude oil in the United States. Today, these terms are broadly used and accepted in the market, and are frequently incorporated by reference into specific agreements pertaining to price, quantity and delivery of crude oil sold or exchanged. Because this form is

⁵⁹ Texas Common Purchaser Act, TEX. NAT. RES. CODE ANN. §§ 111.081, *et seq.* (Vernon 2001 & Supp. 2009).

widely used in the United States crude oil market, the following is a high level discussion of some of the provisions reflected in the form Conoco general terms.⁶⁰

Because crude oil is a hazardous substance, paragraph D of the Conoco terms requires the seller to provide to buyer its Material Safety Data Sheet. Buyer acknowledges the hazards and risks of handling crude oil, and is required to read the MSDS and to advise employees and others who come in contact with the crude of the hazards, as well as of the precautionary measures for handling the crude set forth in the MSDS.

As with gas sales and gathering agreements, crude oil marketing agreements generally contain contract provisions that address the impact of unforeseen and/or uncontrollable events on the parties' liability for failure to perform. Paragraph E. of the Conoco terms addresses force majeure events whose occurrence will relieve a party from liability for the failure to perform. This paragraph, as well as a related section on balancing contained in paragraph J., have recently been revised to better address issues that have arisen in connection with the disruptions occasioned by the various recent hurricanes affecting the Gulf of Mexico and related coastal facilities. Under paragraph E., a party is excused from performance for the duration and extent of the force majeure if the failure to perform is occasioned by any one or more of a number of listed events, such as acts of God or the elements, disruption or breakdown of production or transportation facilities, delays of the carrier pipeline in receiving or delivering crude tendered, and any other causes, whether or not similar to those specifically listed, that are beyond the control of the affected party.

In addition to listing or describing the types of events that will excuse performance, a force majeure provision will typically address the affected party's obligation to remedy the situation, including whether or not alternative performance must be provided, and may also address the impact, if any, on the term of the contract. The Conoco terms required a party affected by force majeure to take commercially reasonable steps to ameliorate the cause of the force majeure so as to be able to resume performance during the agreement's term, but explicitly note that the agreement's term will not be extended (except to complete the balancing discussed below). Note that the Conoco terms expressly state that the affected party has no obligation to remedy the force majeure by supplying substitute quantities from sources of supply other than those identified respecting the original agreement. Absent such language, the commercially reasonable standard for remedying the event might require such substitute performance.

If substantially similar volumes are intended to be bought and sold under the agreement, and the party affected by the force majeure is unable to deliver all or part of its quantity obligation, the other party is permitted to reduce its deliveries to match the volume of crude delivered by the affected party. Similarly, if the affected party is unable to receive all or part of the obligated quantity of crude, the other party has the right to reduce its receipts to match the receipts of the affected party. This language allows the unaffected party to avoid the potential economic harm associated with a situation in which it has performed its full quantity obligation in one time period, and the market price for the product shifts materially before the affected party performs its full quantity obligation.

In addition, when a party affected by a force majeure event gets out of balance as between its receipt and delivery obligations during a month, if the imbalance volume has not been delivered by the end of the second calendar month following the month in which the imbalance arose, then the revised Conoco terms provide for a resolution of the imbalance in default of

⁶⁰ Note that many of the following concepts apply also to gas marketing, although typically they are addressed in somewhat different terms under the NAESB.

another agreement by the parties. Under the default remedy, the out of balance volume must be delivered in the third calendar month following the imbalance, and the crude oil delivered must be of the same type and at the same location as the crude oil received by the under-delivering party. In addition, the price will be the same price as for the crude received, except that if the price for the original is a specified price for a fixed date or dates, then that price applies without regard to the actual month of delivery; and if the price is a formula price based upon a non-specific date or dates, such as the month of delivery, then the price is calculated pursuant to the formula implemented in accordance with the actual month of delivery.

III. Regulatory Issues

A. FERC

Producer wellhead sales generally were removed from regulatory oversight by the Federal Energy Regulatory Commission (“FERC”) in the early 1990’s, so many gas buyers and sellers starting in the industry today do not expect to concern themselves with the FERC. There are certain aspects of FERC regulation, however, that remain quite relevant even to deregulated gas sales. These are summarized very generally below.

(1) Reporting Requirements

Depending on the nature of their sales activities, sellers of natural gas may be subject to certain FERC reporting requirements. One such requirement applies to sellers of natural gas who report their sales prices to the publishers of price indexes.⁶¹

The Reporting Policy requires that any sellers who report transactions to publishers of price indices must adopt and follow a number of standards. They must adopt and make public⁶² a clear code of conduct for employees to follow in buying or selling gas and in reporting data from such transactions. Further, data reported must be reported by a department or personnel of the company independent of the department or personnel responsible for trading, and which should verify the accuracy and completeness of the data before submitting it. A data provider must report all bilateral transactions between non-affiliated parties in the physical markets at all trading locations, shall not include data for financial hedges or swaps, and shall include specified information reported separately for each transaction.⁶³ This requirement is intended to provide index publishers with sufficient information to verify data accuracy. Further, to the extent any errors are subsequently discovered in data reported, the provider must correct the error as soon as possible, and must cooperate with the process and timeline for submitting corrections and responding to inquiries established by the publisher.⁶⁴ The Reporting Policy also requires all parties that submit transaction data to have an independent auditor review annually the data gathering and submission process adopted by the data provider. The audit results must be made

⁶¹ *Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121 (2003); *order on clarification*, 105 FERC ¶ 61,282 (2003); *order regarding future monitoring*, 109 FERC ¶ 61,184 (2004); *order on clarification*, 112 FERC ¶ 61,040 (2005) (“Reporting Policy”).

⁶² FERC takes the position that a code of conduct must be posted on a website available to the public in order to be “public”; it is not sufficient to publicize the code of conduct among company employees. *See, e.g.*, Docket No. PA06-13, *Audit of Price Index Reporting Compliance of Marathon Oil Co.*, p. 2 (Apr. 5, 2007).

⁶³ The specified information required is (a) price, (b) volume, (c) buy/sell indicator, (d) delivery/receipt location, (e) transaction date and time, and (f) term. *Policy Statement on Natural Gas and Electric Price Indices*, 104 FERC ¶ 61,121, at P 34 (2003); *order on clarification*, 105 FERC ¶ 61,282 (2003); *order regarding future monitoring*, 109 FERC ¶ 61,184 (2004); *order on clarification*, 112 FERC ¶ 61,040 (2005).

⁶⁴ 104 FERC ¶ 61,121, at P 34.

available to any index developer to whom the data provider submits information.⁶⁵ A safe harbor exists under which the FERC will presume that information is accurate, timely and submitted in good faith by any data provider that can demonstrate it has adopted and is following the Reporting Policy standards described above.

Another reporting obligation, the requirement to file Form 552,⁶⁶ applies to gas sellers whose transaction volumes exceed certain levels. Enacted on August 8, 2005, the Energy Policy Act of 2005 (“EPAct”)⁶⁷ added new market transparency oversight authority to FERC’s jurisdictional plate. Specifically, under section 23 of the Natural Gas Act, the FERC may prescribe rules to obtain, from any market participant, information about the availability and prices of natural gas sold at wholesale and in interstate commerce. Of relevance to gas marketers, using this authority, the FERC has instituted Form 552.⁶⁸ This form is to be filed annually by, among other sellers of gas, any corporate entity that bought or sold reportable volumes of wholesale natural gas of 2.2 million MMBtus or more (approximately 6,027 MMBtu/d on average) in the reporting year.⁶⁹ If either an entity’s reportable sales or its reportable purchases exceeded 2.2 million MMBtus, the entity must report both reportable sales and reportable purchases.⁷⁰ For this purpose, a transaction generally is reportable if it contains an obligation to deliver natural gas at a specified location and at a specified time, with the exception of futures contracts that go to physical delivery, and either used a next-day or next-month price index, or contributed to, or could contribute to, the formation of a price index during the calendar year. A transaction “could contribute” to a price index if it is a bilateral, arms-length, fixed price, physical natural gas transaction between non-affiliated companies at any trading location, which is entered into during bid week (last five business days of the month). A transaction must be reported even if natural gas was not actually delivered under the transaction (i.e., even if the transaction was traded away or “booked out”); it must be reported if a physical delivery obligation existed in the agreement when made. Needless to say, the new rules regarding transaction reporting have engendered considerable confusion, and the FERC is now engaged in an effort to clarify the process.⁷¹

(2) Capacity Release

An even more important area of FERC regulation that potentially concerns gas marketers involves the FERC’s capacity release rules. These rules govern the release and reassignment of firm transportation contracts entered into by shippers on FERC-regulated interstate gas pipelines. Such assignments generally cannot be made simply according to generic principles of contract law, but must occur in compliance with specific FERC rules intended to promote competition and transparency in the interstate gas transportation market.⁷² While a detailed discussion of the FERC’s complex capacity release rules is outside the scope of this paper, a few aspects of the

⁶⁵ *Id.*

⁶⁶ 18 C.F.R. § 260.401 (2009).

⁶⁷ Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 at pp 979-80 (2005).

⁶⁸ Transparency Provisions of Section 23 of the Natural Gas Act, 121 FERC ¶ 61,295 (2007) (“Order 704”); order on rehearing, 124 FERC ¶ 61,269 (2008) (“Order 704-A”); order denying reconsideration, 125 FERC ¶ 61,302 (2008).

⁶⁹ Order 704 at P 77.

⁷⁰ Order 704-A at P 24.

⁷¹ *Notice of Form No. 552 Technical Conference*, Docket No. RM07-10-002 (Feb. 22, 2010).

⁷² 18 C.F.R. § 284.8 (2009). Among other matters, these rules require, in specified circumstances, the posting for bid of capacity available for release.

rules have been the focus of considerable FERC enforcement activity and are important to remember.

First, the FERC is serious about enforcement of both the letter and the spirit of the capacity release rules. For example, the FERC's rules permit capacity releases at a discounted rate, but for a term of less than one month, to be contracted without posting and bidding. The rules prohibit, however, consecutive short term discounted rate releases (without posting and bidding) to the same shipper. A number of shippers have attempted to avoid the posting requirements normally attached to such capacity releases by having two (or more) affiliated shippers take turns holding the capacity in question. While perhaps technically compliant with the "letter" of the rules, since the affiliated shippers are different legal entities, the FERC considers these types of arrangements to be unlawful "flipping" transactions, for which a number of shippers have paid civil penalties.⁷³

Second, the FERC has established in its case precedents two important corollary rules to the capacity release rules. In order to prevent circumvention of the capacity release rules, the FERC requires that a shipper using interstate gas transportation capacity must hold title to all gas that is shipped under the shipper's contract. This rule, known as the "shipper must have title" rule, means that a well-operator cannot (without a prior FERC waiver) act on behalf of other working interest owners to ship their natural gas using a transportation contract held in the name of the operator, unless the operator first purchases the gas from all of the working interest owners. Further, in order to prevent circumvention of the "shipper must have title" rule, the FERC has prohibited so-called "buy-sell" transactions. Broadly speaking, these are transactions in which a shipper who has transportation capacity, purchases gas at the upstream end of the pipeline, ships it on the pipeline using the shipper/purchaser's transportation contract, and resells it at the downstream end of the pipeline to the original seller. Thus in the foregoing example of the operator, the parties would be considered by FERC to be engaged in an unlawful buy-sell, if the operator purchased the gas attributable to the working interest owners, shipped it on an interstate pipeline using the operator's contract, and resold the gas to the working interest owners at the downstream end of the pipeline. As with the "flipping" transactions, a number of shippers have paid multi-million dollar civil penalties for alleged violations of these two corollary rules.⁷⁴

(3) *Market Manipulation*

Another element of the FERC's regulatory arsenal applicable to gas marketers is the anti-manipulation provision added to the NGA pursuant to EAct.⁷⁵ EAct adds section 4A of the NGA, which prohibits market manipulation as follows:

"SEC. 4A. It shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the Commission, any manipulative or deceptive device or contrivance (as those terms are used in section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78j(b))) in contravention of such rules and regulations as the Commission may prescribe as

⁷³ See, e.g., *In re Noble Energy, Inc.*, 130 FERC ¶ 61,175 (2010).

⁷⁴ See, e.g., *In re Constellation New Energy-Gas Division LLC*, 122 FERC ¶ 61,220 (2008).

⁷⁵ Energy Policy Act of 2005, Pub. L. No. 109-58, 119 Stat. 594 at pp 979-80 (2005).

necessary in the public interest or for the protection of natural gas ratepayers. Nothing in this section shall be construed to create a private right of action.”⁷⁶

In January 2006, the FERC adopted rules implementing this new authority.⁷⁷ These new regulations, codified in Section 1c.1,⁷⁸ are patterned after the Securities Exchange Commission’s rule 10b-5.⁷⁹ Section 1c.1 makes it unlawful for any entity, directly or indirectly, in connection with the purchase or sale of natural gas or the purchase or sale of transportation subject to the Commission’s jurisdiction, (1) to use or employ any device, scheme, or artifice to defraud, (2) to make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice or course of business that operates or would operate as a fraud or deceit upon any entity.⁸⁰ As is apparent from the foregoing, this rule is not a model of clarity or precision.

The preamble to the final rule includes an interpretive discussion that reflects the rule’s broad scope. According to FERC, the rule applies to any entity, not just regulated interstate gas pipelines, regardless of the entity’s legal status, function or activities.⁸¹ The phrase “subject to the Commission’s jurisdiction” as used in the rule modifies both “purchases or sales of gas” and “purchases or sales of transportation,” such that actions taken solely in connection with non-jurisdictional activities, such as retail sales, or intrastate activities, are not covered.⁸² The phrase “in connection with” is to be construed broadly, but not so broadly as to capture every case of common law fraud; rather, there must be a nexus between the fraudulent or deceptive conduct and the jurisdictional transaction.⁸³ In committing the fraud, the entity must have intended to affect, or have acted recklessly to affect, a jurisdictional transaction.⁸⁴ The terms “contrivance or manipulative or deceptive device” are intended to be understood as used in securities law rules; FERC will look to case law interpreting rule 10b-5 for guidance in applying the new anti-manipulation rules.⁸⁵

FERC has clarified that the “no material omission” language of the new rule creates no new affirmative duty of disclosure.⁸⁶ Thus, absent a tariff requirement or other FERC order directing disclosure, there is no violation simply because non-public information is not disclosed, for example, in the context of contract negotiations. When a party voluntarily provides information or is required to do so, then omission of information necessary to make the material provided not misleading can be a violation if other required elements are present. Mere “puffery,”

⁷⁶ A similar provision, applicable to electric energy markets, was added as new section 222 of the Federal Power Act.

⁷⁷ See Order No. 670, 114 FERC ¶ 61,047 (2006); *reh’g denied* 114 FERC ¶ 61,300 (2006) (“Order No. 670”).

⁷⁸ 18 C.F.R. § 1c.1 (2007). New Section 1c.2 contains a parallel provision prohibiting governing electric energy market manipulation.

⁷⁹ 17 C.F.R. § 240.10b-5 (2007).

⁸⁰ 18 C.F.R. § 1c.1.

⁸¹ Order No. 670 at P 16.

⁸² *Id.* at P 20.

⁸³ *Id.* at P 22.

⁸⁴ *Id.* at PP 52-53.

⁸⁵ *Id.* at P 30.

⁸⁶ *Id.* at P 35.

however, is not a violation.⁸⁷ The rule does not apply to simple negligence; instead a party must act with intent or scienter. Notwithstanding implementation of the new rule, FERC expects the parties to continue to resolve most contract disputes such as fraud in the inducement, without FERC involvement.⁸⁸

In summary, the elements of a violation include (1) an entity engages in a prohibited act, *i.e.*, uses a fraudulent device, scheme or artifice; makes a material misrepresentation or material omission as to which there is a duty to speak under a FERC tariff, order, rule or regulation; or engages in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity, (2) with the requisite scienter, and (3) in connection with the jurisdictional purchase or sale of natural gas or transportation.⁸⁹ The FERC defines fraud generally, to include any action, transaction, or conspiracy for the purpose of impairing, obstructing, or defeating a well-functioning market.⁹⁰ Whether or not fraud exists is a question of fact. With respect to the disclosure requirements, a fact is material if there is a substantial likelihood that a reasonable market participant would consider it in making its decision to transact, because the fact significantly altered the total mix of information available; materiality will be determined on a case-by-case basis. The element of scienter required for violation of the rule includes knowing or intentional misconduct, as well as recklessness. Importantly, a showing of reliance, loss causation or damage from the actions in question is not necessary to establish a violation.⁹¹ While the full scope of this definition is not clear, transactions such as wash trades, transactions predicated on submitting false information, and collusion for the purpose of market manipulation, are all examples of manipulative or deceptive devices.⁹²

A five-year statute of limitations (which runs from the time the claim accrues) generally applicable under Federal law⁹³ applies to these rules in situations in which FERC seeks to impose civil penalties. Importantly, remedies under Section 4A need not be prospective from the time of a FERC order only. Instead, penalties may be applied respecting past action found to have violated the rules.⁹⁴ Penalties may only be assessed by the FERC after notice and hearing.

To date, the FERC has yet to issue any adjudicated decision on the application of its market manipulation rules, though it has approved a few settlements regarding alleged violations of the rules.⁹⁵ Most recently, an administrative law judge issued a decision finding that a gas futures trader, who did not even participate in the physical gas sales market, engaged in illegal market manipulation when attempting through trading activity to influence the NYMEX closing price.⁹⁶

(4) Civil Penalty Authority

⁸⁷ *Id.* at P 39.

⁸⁸ *Id.* at P 37.

⁸⁹ *Id.* at P 49.

⁹⁰ *Id.* at P 50.

⁹¹ *Id.* at P 48, n. 102. These elements will inform the nature of the remedy imposed, however. *Id.*

⁹² *Id.* at P 59.

⁹³ 28 U.S.C. § 2462 (2000).

⁹⁴ Order No. 670 at P 72.

⁹⁵ *See, e.g., In re Tenaska Marketing Ventures, et al.*, 126 FERC ¶ 61,040 (2009).

⁹⁶ Initial Decision, Docket No. IN07-26-004 (Jan. 22, 2010).

The FERC's regulatory authority relevant to gas marketing is particularly important to understand today, because EAct also gave FERC authority to levy civil penalties for violations of the NGA and related FERC rules and orders. Under this civil penalty authority, FERC now has the ability to levy penalties on any person that violates the NGA, or any rule, regulation, restriction, condition, or order made or imposed by the FERC under the NGA, of up to \$1,000,000 per day per violation, for as long as the violation continues.⁹⁷

FERC has issued several policy statements on enforcement, in which it set forth factors it would consider in assessing penalties under its enhanced authority,⁹⁸ including most recently, a detailed Policy Statement on Penalty Guidelines patterned after the United States Sentencing Guidelines.⁹⁹ Consistently these policy statements have emphasized certain central factors FERC will consider in pursuing enforcement penalties. According to the FERC, the two most significant factors considered are, first, the seriousness of the offense¹⁰⁰, including issues such as whether or not the alleged violation involved fraud, willful activity, or the active participation of senior management.¹⁰¹ The second factor is the "strength of an organization's commitment to compliance,"¹⁰² or its "culture of compliance."¹⁰³ According to FERC, an effective compliance program is marked by four principal factors: top-down leadership by senior management, effective prevention, prompt detection, cessation, and voluntary reporting of violations, and remediation of violations.¹⁰⁴ The purpose of the Policy on Penalties is to render the assessment of civil penalties for FERC violations more transparent and consistent. The relevant point for marketers is that the FERC has expended considerable time and effort in developing its enforcement and penalty policies; marketers should thus expect continued robust enforcement efforts.

B. Commodity Futures Trading Commission and Federal Trade Commission

In addition to FERC, the recent high energy prices have attracted the attention of the Commodity Futures Trading Commission ("CFTC") and the Federal Trade Commission ("FTC"). Like the FERC's anti-fraud and anti-manipulation rules, both the CFTC and FTC regulations are modeled on the SEC's anti-fraud provision, Rule 10b(5).

(1) CFTC

The CFTC, created by Congress in 1974, has authority to monitor and regulate certain segments of the physical and futures energy commodities market pursuant to the Commodity Exchange Act ("CEA").¹⁰⁵ The CFTC's stated mission is to "protect market users and the public

⁹⁷ See, 15 U.S.C. § 717t-1, *added by* EAct, § 314(b)(1)(B). Note that Section 314(a) of the EAct amends the NGA to (1) increase criminal penalties for knowing violations of the statute from \$5000 to \$1,000,000, (2) increase possible prison sentences from a maximum of two years in jail to five years, and (3) increase the fine payable for violation of a FERC order upon conviction from \$500 to \$50,000 for each day on which the violation occurs.

⁹⁸ *Enforcement of Statutes, Orders, Rules, and Regulations*, 113 FERC ¶ 61,068 (2005) ("2005 Policy Statement"); *Enforcement of Statutes, Regulations and Orders*, 123 FERC ¶ 61,156 (2008); and *Policy Statement on Compliance*, 125 FERC ¶61,058 (2008).

⁹⁹ *Policy Statement on Penalty Guidelines*, 130 FERC ¶ 61,220 (2010) ("Policy on Penalties").

¹⁰⁰ *Id.* at P 16.

¹⁰¹ *2005 Policy Statement.* at P 20.

¹⁰² *Policy on Penalties* at P 16.

¹⁰³ *2005 Policy Statement* at P 2.

¹⁰⁴ *Policy on Penalties* at P 16

¹⁰⁵ Commodity Exchange Act, 49 Stat. 1491 (1936) (codified at 7 U.S.C.A. § 1 *et seq*) ("CEA"); *see also*

from fraud, manipulation, and abusive practices related to the sale of commodity and financial futures and options, and to foster open, competitive, and financially sound futures and option markets.”¹⁰⁶ The CFTC primarily regulates trading on futures exchanges, such as the New York Mercantile Exchange (“NYMEX”); however, the CEA’s anti-fraud and anti-manipulation provisions apply not only to futures exchanges, but also to over-the-counter (“OTC”) markets and exempt commercial markets¹⁰⁷ that are otherwise largely exempt from CFTC regulation.

The CEA’s anti-fraud provisions prohibit fraud, attempted fraud, willful false reporting, the making of false statements, deception, or attempted deception by any person “in or in connection with” futures transactions.¹⁰⁸ The elements of fraud under the CEA are derived from the common-law action for fraud, and thus require: (1) a false representation of a material fact, (2) made with knowledge or belief on the part of the defendant that the representation is false, (3) made with the intent to induce the other party to rely upon that representation, (4) actual reliance, and (5) proximate injury.¹⁰⁹ The materiality and scienter elements have been interpreted in accordance with the FERC rule, discussed above.¹¹⁰

As under FERC’s anti-manipulation rule, the CEA’s prohibitions of attempted fraud, willful false reporting, and the making of false statements in connection with futures transactions mean that a violation may be found in situations in which there is no actual reliance by the counterparty and no proximate injury.¹¹¹ Moreover, the CEA’s anti-fraud provision is not restricted in its application to instances of fraud or deceit that are perpetrated in orders to make contracts or the making of futures contracts; by their terms, the CEA anti-fraud provisions apply to conduct “in or in connection with” futures transactions, and thus encompasses conduct that occurs prior to the opening of a trading account or the execution of any contract.¹¹²

The CEA’s anti-manipulation provisions are similarly broad, prohibiting the actual or attempted manipulation of the market price of any commodity, false price reporting, the making of any other false or misleading statements of market information, and insider trading.¹¹³ The key issue to note here is that a violation of the CEA’s anti-manipulation provisions does not require an actual market price impact, or even the existence of the ability to impact market prices. The attempted manipulation and false reporting prohibitions mean that a market participant may be indicted even if no market impact results from his actions. Indeed, within the last five years, traders have been indicted for knowingly delivering inaccurate price and volume information to

<http://www.cftc.gov/aboutthecftc/index.htm>.

¹⁰⁶ <http://www.cftc.gov/aboutthecftc/index.htm>.

¹⁰⁷ Agreements, contracts, and transactions in exempt commodities that are traded on a principal-to-principal basis on electronic trading facilities between eligible commercial entities may be traded on an exempt commercial market, or “ECM,” if the market satisfies the conditions set forth in 7 U.S.C.A. §2(h)(3)-(5).

¹⁰⁸ 7 U.S.C.A. § 6b (2009); *see also* 7 U.S.C.A. § 13.

¹⁰⁹ *See, e.g., Horn v. Ray E. Friedman & Co.*, 776 F.2d 777, 780 (8th Cir. 1985); *In re Slusser*, Comm. Fut. L. Rep. (CCH) P 27,417 (Aug. 24, 1998).

¹¹⁰ *See, e.g., Kim v. Index Futures Group, Inc.*, Comm. Fut. L. Rep. (CCH) P 25,513 (Nov. 2, 1992) (scienter); *R&W Tech. Servs., Ltd. v. CFTC*, 205 F.3d 165 (5th Cir. 2000) (materiality).

¹¹¹ *See CFTC v. Int’l Fin. Servs*, 323 F.Supp. 2d 482 (S.D.N.Y. 2004).

¹¹² *See, e.g., Hirk v. Agri-Research Council, Inc.*, 561 F.2d 96 (7th Cir. 1977); *CFTC v. Carnegie Trading Group, Ltd.*, 450 F.Supp. 2d 788 (N.D. Ohio 2006).

¹¹³ 7 U.S.C.A. §§ 5, 9, 13 (2009).

reporting firms even where no price impact was shown,¹¹⁴ and where the defendants did not have even the actual ability to affect market prices.¹¹⁵

The CFTC has the authority to assess civil and criminal penalties for violations of the CEA's anti-fraud and anti-manipulation provisions.¹¹⁶ The CFTC Reauthorization Act of 2008 significantly expanded and strengthened the CFTC's oversight authority, and increased penalties for fraud and market manipulation.¹¹⁷ The maximum civil penalty is now \$1,000,000 per violation, and the maximum criminal penalty is 10 years' imprisonment.¹¹⁸ Violators could also be subject to related third-party damage claims by, among others, sellers, royalty owners and taxing authorities.

In recent years, the CFTC has been very active in carrying out its mandate with regard to energy markets. Since December 2002, the CFTC has charged 42 companies and 31 individuals in the energy sector with violations. During this time period, the CFTC has assessed \$445 million in total energy sector civil monetary penalties and, with the Department of Justice, has directed the criminal prosecution of 47 traders and energy companies.¹¹⁹ The CFTC also has achieved some landmark settlements during this time, including a \$303 million civil penalty from BP for attempted manipulation of physical propane market.¹²⁰ Furthermore, the CFTC announced in 2008 that its Division of Enforcement has been investigating practices surrounding the "purchase, transportation, storage, and trading of crude oil and related derivative contracts,"¹²¹ and announced in 2009 that it has expanded its enforcement staff and has petitioned the Senate for funds to make significant additional expansions.

(2) Federal Trade Commission

Established in 1914, the FTC "enforces antitrust and consumer protection laws and promotes competitive markets, free of deception and undue restrictions."¹²² The FTC has more than 1,000 staff, including more than 500 attorneys and 70 economists whose mandate is to promote "the interests of all American consumers by supporting and protecting the free market."¹²³ The FTC has been very active in this role within the energy industry, conducting some 190 oil industry investigations that resulted in 44 enforcement actions as of 2007.¹²⁴

¹¹⁴ *CFTC v. Johnson*, 408 F. Supp. 2d 259 (S.D. Tex 2005) (finding that in order to prove attempted manipulation, the CFTC must show only (1) an intent to affect market price, and (2) some overt act in furtherance of that intent).

¹¹⁵ *CFTC v. Amaranth Advisors LLC*, 554 F.Supp. 2d 523 (S.D.N.Y. 2008).

¹¹⁶ 7 U.S.C.A. § 13(a).

¹¹⁷ Food, Conservation, and Energy Act of 2008, Pub.L. 110-246 (2008).

¹¹⁸ 7 U.S.C.A § 13(a).

¹¹⁹ COMMODITY FUTURES TRADING COMMISSION, *CFTC's 2008 Fiscal Year Enforcement Roundup*, (Oct. 2, 2008), <http://www.cftc.gov/newsroom/enforcementpressreleases/2008/pr5562-08.htm>.

¹²⁰ COMMODITY FUTURES TRADING COMMISSION, *BP Agrees To Pay a Total of \$303 Million In Sanctions To Settle Charges of Manipulation and Attempted Manipulation in The Propane Market*, (Oct. 29, 2007), <http://cfct.gov/newsroom/enforcementpressreleases/2007/pr5405-07.html>.

¹²¹ COMMODITY FUTURES TRADING COMMISSION, *CFTC Announces Multiple Energy Market Initiatives*, (May 29, 2008), <http://www.cftc.gov/newsroom/general:/pressreleases/2008/pr5503-08.html>.

¹²² <http://www.ftc.gov/ftc/about.htm>.

¹²³ <http://www.ftc.gov/bc/berecruit/whatweoffer.htm>.

¹²⁴ <http://www.ftc.gov/ftc/oilgas/enf-invst.htm>.

In 2007, Congress significantly expanded the role of the FTC with regard to the oil sector with the enactment of The Energy Independence and Security Act of 2007 (“EISA”).¹²⁵ EISA granted the FTC specific authority to investigate oil market manipulation, making it unlawful to use “any manipulative or deceptive device or contrivance” when purchasing or selling “crude oil gasoline or petroleum distillates at wholesale.”¹²⁶ In August 2009, the FTC issued its Final Rule implementing EISA’s prohibition of fraudulent or deceptive conduct that could harm wholesale petroleum markets.¹²⁷ The Final Rule, which became effective on November 4, 2009, states:

It shall be unlawful for any person, directly or indirectly, in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale, to:

- (a) knowingly engage in any act, practice or course of business – including the making of any untrue statement of material fact – that operates or would operate as fraud or deceit upon any person, or
- (b) intentionally fail to state a material fact that under the circumstances renders a statement made by such person misleading, provided that such omission distorts or is likely to distort market conditions for any such product.¹²⁸

While no enforcement history has yet been established, the FTC has stated that the Final Rule is intended to “prevent the same types of fraudulent or deceptive practices that the SEC, the CFTC and the FERC have pursued in the markets they respectively regulate.”¹²⁹ However, there are few actual relevant FERC or CFTC precedents, since many cases end in settlement with no admission of wrongdoing, and SEC precedents are often not relevant. Therefore, meanings ascribed to each word or phrase in the Final Rule will be critical.

¹²⁵ The Energy Independence and Security Act of 2007, Pub.L. 110-140 (2007) (“EISA”) (codified at 42 U.S.C. §§ 17001-17386).

¹²⁶ *Id.* at § 811.

¹²⁷ 74 Fed. Reg. 40,686 (Aug. 12, 2009) (to be codified at 16 C.F.R. Pt. 317).

¹²⁸ *Id.* at 40,702.

¹²⁹ *Id.* at 40,689.

Six of the key terms have been given official regulatory definitions.¹³⁰ Of these official definitions, the definition of “wholesale” is of particular importance, as it delineates the reach of the FTC’s authority. “Wholesale” has been defined as “all purchases or sales of crude oil or jet fuel; and all purchases or sales of gasoline or petroleum distillates (other than jet fuel) at the terminal rack level or upstream of the terminal rack level.”¹³¹ This definition means that the Final Rule applies to all wholesale transactions of petroleum products, not solely those related to established exchanges, like NYMEX. This language implicates the entire distribution chain, with the exception of retail sales of gasolines, diesel fuels and fuel oils to consumers. Covered entities potentially include airlines, petroleum refiners, blenders, wholesalers and dealers (including terminal operators that sell covered commodities). Similarly, the definition of “person,” which is defined as “any individual, group, unincorporated association, limited or general partnership, corporation or other business entity,” covers almost all who participate in the market, including oil traders, managers, company officers, and other individuals.¹³²

Covered products include: (1) crude oil that exists in liquid phase in natural underground reservoirs and that remains liquid at atmospheric pressure after passing through separating facilities, and crude oil that exists as shale oil or tar sands requiring further processing for sale as a refinery feedstock; (2) finished gasoline (including conventional, reformulated, and oxygenated blends); (3) conventional and reformulated gasoline blendstock for oxygenate blending; (4) jet fuels (including commercial and military specification jet fuels); and (5) diesel fuels and fuel oils (including Nos. 1, 2, and 4).¹³³ Notably, natural gas and other non-crude refinery feedstocks, heavy fuel oils, and commodity inputs, such as corn and sugar, whose predominant use is in non-petroleum products, are exempt from the Final Rule. However, the FTC has announced that it will interpret “in connection with” broadly, and will look for a “sufficient nexus” between the conduct at issue and the purchase or sale of crude oil, gasoline or petroleum distillates.¹³⁴ Therefore, products such as ethanol that are blending components for covered products might be reached under the Rule if it is determined that there is a sufficient nexus between ethanol and the targeted conduct.¹³⁵

As under the CEA, in order to be actionable by the FTC, the conduct at issue must be “knowing,”¹³⁶ and any misrepresentations or omissions must be “material.”¹³⁷ Likewise, a violation of the Final Rule does not require the FTC to show actual reliance, that the material omission or misrepresentation actually influenced the actions of the counterparty, or that the manipulative or deceptive action had a market impact. In addition, the Rule’s prohibition of both direct and indirect fraudulent or deceptive conduct means that even indirect actions can trigger liability. For example, a trader may not avoid liability under the Final Rule for preparing a

¹³⁰ *Id.* at 40,701-702 (16 C.F.R. § 317.2).

¹³¹ *Id.* at § 40,702 (16 C.F.R. § 317.2(f)).

¹³² *Id.* at 40,701 (16 C.F.R. § 317.2(a)-(b), (e)).

¹³³ *Id.*

¹³⁴ *Id.* at 40,695.

¹³⁵ *Id.*

¹³⁶ *See id.* at 40,691.

¹³⁷ *Id.* at 40,693; 40,702 (16 C.F.R. § 317.3). Note that a fact is “material” if a reasonable market participant would consider the fact important in making a decision to buy or sell a covered product. FEDERAL TRADE COMMISSION, *Guide to Complying With Petroleum Market Manipulation Regulations* at 7 (Nov. 2009), <http://www.ftc.gov/os/2009/11/091113mmrguide.pdf>

fraudulent or deceptive report by having someone else file it.¹³⁸ Examples of prohibited conduct that the FTC has specifically enumerated include: (1) making false or misleading public announcements of planned pricing or output decisions; (2) making false or misleading statements to federal, state, or local governments about current inventory or refinery operating status; (3) making false or misleading representations about the price or volumes of past transactions to a private price reporting service; (4) engaging in fraudulent or deceptive transactions designed to disguise the actual liquidity or price of a particular asset or market for that asset; (5) intentionally omitting material information from a report, such as the operational status of a refinery, terminal, or pipeline, that makes the report false or misleading; and (6) intentionally omitting material information about refinery production from statements to mislead others during an emergency.¹³⁹

In addition to the remedies available under the Federal Trade Commission Act,¹⁴⁰ such as an order to stop the illegal conduct, violations of the Final Rule carry a civil penalty of up to \$1 million per violation per day.¹⁴¹ It currently is unclear whether the Final Rule established a private right of action.

¹³⁸ FEDERAL TRADE COMMISSION, *Guide to Complying With Petroleum Market Manipulation Regulations* at 4 (Nov. 2009), <http://www.ftc.gov/os/2009/11/091113mmrguide.pdf>.

¹³⁹ *Id.* at 2.

¹⁴⁰ Federal Trade Commission Act, 38 Stat. 717 (1914) (codified at 15 U.S.C. §§ 41-58) (as amended).

¹⁴¹ EISA § 814.