CRUDE OIL AND NGL REGULATORY PRIMER RELATED TO COMMERCIAL ISSUES

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CRUDE OIL AND NGL REGULATORY PRIMER RELATED TO COMMERCIAL ISSUES - DISCUSSION TOPICS

• Basics of Common Carrier Regulation and Commercial Implications
  – FERC Jurisdiction Over Oil/Liquids Projects
  – Ratemaking
  – Capacity Allocation

• Considerations Important To New Projects
  – Coordinating Federal, State & Local Approvals; understanding regulatory jurisdiction over commercial terms and conditions of service and rates
  – Shipper Objectives
  – Pipeline Objectives
  – Open Season Requirements
  – Terms of Service
  – Shipper Commitments and Rates
  – Priority and Curtailment
BASICS OF COMMON CARRIER REGULATION AND COMMERCIAL IMPLICATIONS
FERC JURISDICTION AND REGULATION – OIL/LIQUIDS PROJECTS

• Interstate Commerce Act of 1887 (“ICA”)
  – Statute originally designed to address railroad monopolies
  – Only applied to pipelines when the statute was amended in 1912
  – Statute provides FERC with jurisdiction over a pipeline’s transportation of crude oil, NGLs and refined products in interstate commerce

• Overview of ICA Requirements
  – Pipelines must provide transportation upon reasonable request; common carriage and not contract carriage
  – Pipelines are prohibited from granting undue or unreasonable preference or advantage to any customer
    o Non-discrimination is the key regulatory principle
  – Rates and terms and conditions of service subject to FERC regulation

• FERC Jurisdiction Under the ICA is NOT as burdensome as FERC jurisdiction under the NGA
“LIGHT-HANDED” REGULATION

• Not an all-encompassing “consumer protection,” utility style statute, like the Natural Gas Act or Federal Power Act
• FERC does not regulate an oil pipeline’s entry into or exit from the marketplace
• FERC does not regulate construction or abandonment of oil pipelines
• FERC cannot order a carrier to interconnect so long as refusal to interconnect is non-discriminatory
• Lack of FERC approval process can complicate efforts to construct an oil pipeline
  – Issues associated with multiple state regulators
  – No federal eminent domain; eminent domain rights may or may not exist, depending on state law
  – Lack of certainty in connection with rates and terms and conditions of service
  – Declaratory Orders have evolved as mechanism for project developers (and their investors and lenders) to gain more regulatory and commercial certainty
FERC REGULATES TRANSPORTATION SERVICE

• ICA regulates “transportation” service provided by pipeline, not the asset itself
• ICA defines “transportation” as “all instrumentalities and facilities of shipment and carriage . . . and all services in connection with the receipt, delivery . . . transfer in transit, storage and handling of property transported.”
• Typically, storage is not jurisdictional but service at a pipeline's storage tank facilities can be subject to FERC's jurisdiction if service is "integral to transportation along the pipeline's route"
• FERC has displayed a general unwillingness to regulate storage or terminal services (although that issue is now pending in a complaint proceeding at FERC)
• Services provided by the same oil pipeline may be (and often are) subject to both FERC and state regulation
  – Interstate transportation service regulated by FERC
  – Intrastate transportation service regulated by state
• Affiliate service must be non-discriminatory; not preferential
JURISDICTIONAL ANALYSIS IS NOT ALWAYS INTUITIVE

• A pipeline wholly within a single state can be engaged in transportation of oil in interstate commerce if movement started or will continue in another state

• *Texaco Refining v. SFPP, L.P. (1997)*
  – 3.8-mile pipeline located entirely within California
  – Connected to another line that provided interstate transportation service
  – FERC held service on pipeline subject to its jurisdiction because pipeline was utilized by shippers to move product to interstate destinations
  – "Under the ICA, jurisdiction attaches to interstate movements of oil on a common carrier from the origin of the movement until the oil reaches the interstate destination"
BREAKING THE CHAIN OF TRANSPORTATION

• Key Question: What is "fixed and persisting intent" of shipper at time shipment commences its journey?
  – Is there a break in chain of transportation?
  – If there is a break in chain of transportation, such that one transaction has come to an end, the next movement is part of another chain of commerce

• FERC will look to a "group of circumstances" and "whole group of facts" to determine whether a break has occurred
  – Contractual arrangements for various stages of chain of commerce
  – Transfer of title, sale or exchange between entities during chain of commerce generally not determinative
  – Storage is not necessarily determinative
  – Transfer of product from one mode of transportation to another, e.g., movement from rail to pipe or pipe to barge, not necessarily determinative
  – Where product is transformed at a refinery or processing plant, break in chain of commerce has occurred
STORAGE MAY BREAK CHAIN OF TRANSPORTATION . . .

- *Southern Pacific Transportation Co. v. ICC (1977)*
  - Shipments were made from a point in one state to a storage facility in same state
  - Once at storage facility, some – but not all – of commodities shipped to out-of-state destinations
  - No pre-existing order to move product out of storage at a later date to either intrastate or interstate markets
  - Court concluded that intent of shipper at start of transportation was to move goods to an in-state storage facility
BUT NOT ALWAYS

- Railroad Commission of Texas v. Oil Field Haulers Association (1965)
  - It has long been recognized that carriers subject to the [ICA] may provide storage of shipments in connection with their transportation service. Such a transit privilege in itself may have the effect of converting a movement which might otherwise be intrastate into interstate transportation; that is, it ties together two separate transportation services into a single interstate movement.
NO GATHERING EXEMPTION FOR OIL PIPELINES

• Under the Natural Gas Act, FERC does not have jurisdiction over gathering pipelines
• There is no comparable gathering exemption under the ICA
• FERC has explained:
  – Although the gathering analogy may be attractive as a matter of policy, it cannot be determinative of jurisdiction because the ICA, unlike the NGA, does not provide for a gathering exception to the exercise of jurisdiction. The Commission has previously found movement over oil gathering lines to be jurisdictional. The ICA is not concerned with the function of facilities, but with whether the movements through those facilities are interstate.
PROPRIETARY LINE EXCEPTION

• "Uncle Sam Rule"
  – Courts have recognized a very narrow exception from FERC's jurisdiction for certain proprietary lines engaged in interstate transportation
  – A pipeline's transportation of product is not subject to FERC's jurisdiction if pipeline:
    o is transporting product from its own wells
    o through its own pipeline
    o to its own refinery
    o for its own use
  – The Supreme Court has held that proprietary line exception does not apply if pipeline transports product purchased at well from a third party

• States may be more tolerant of proprietary lines
"SPECIAL PERMISSIONS" WAIVER

• FERC may grant a temporary waiver of obligation to file a tariff and certain reporting requirements if:
  – pipeline requesting waivers (or its affiliates) owns 100 percent of throughput on line; and
  – there is no demonstrated third-party interest in gaining access to or shipping upon line; and
  – there is no likelihood that such third-party interest will materialize; and
  – there is no opposition to granting waivers.

• Waivers are granted subject to revocation should circumstances change such that pipeline no longer satisfies four prong test
  – A third-party complaint effectively terminates a waiver as a practical matter
INITIAL RATES FOR NEW PIPELINES

• Pipeline must justify an initial rate for a new service by either:
  – Filing a cost-of-service to support such rate (referred to as a Cost of Service Rate), or
  – Filing a sworn affidavit that the rate is agreed to by at least one non-affiliated shipper who intends to use the service in question (referred to as an Affidavit Rate)

• If an Affidavit Rate is challenged by any party, pipeline will be required to support the rate on a cost of service basis, although a negotiated or settlement rate is an exception if:
  – the negotiated/settlement rate was offered to all prospective customers in a transparent open season and
  – the pipeline has obtained a Declaratory Order from FERC approving the rate as a “settlement rate” that has been agreed to by all necessary parties
RATE CHANGES FOR EXISTING PIPELINES

• Index-Based Rate Changes (increases or decreases, depending upon index)
  – Primary method pipelines rely upon to adjust rates
  – Responds to the requirement in Energy Policy Act of 1992 for a “simplified and generally applicable” ratemaking methodology for oil pipelines
  – Rates are adjusted using an index set at the Producer Price Index for Finished Goods plus or minus a percentage
  – Index published prior to June 1 of each year
  – Percentage is reexamined every five years by FERC
  – Pending regulatory inquiry (ANOPR) could limit index rate increases

• Cost-of-Service
  – If index-based rate increase results in substantial under-recovery for oil pipeline, oil pipeline may seek to raise its rates through a cost-of-service showing

• Settlement Rates
  – A pipeline may change its rate without regard to the ceiling level if the proposed change has been agreed to, in writing, by each shipper who, on the day of the filing of the proposed rate change, is using the service covered by the rate
RATEMAKING FOR EXISTING PIPELINES (CONT’D)

• Market-Based Rates
  – Pipelines are allowed to make showings of competitive markets to justify charging market rates
  – Pipelines must demonstrate that there is adequate competition in both the origin and destination markets
    ○ Time-consuming and expensive process
    ○ Resultant flexibility is valuable
  – Market-based rates are filed with FERC and made available to all similarly situated shippers
  – To this point, market-based rate authority is regarded by FERC staff (and under FERC precedent) as being unavailable to new projects; requires a record of service to support data in market power study
OTHER RATEMAKING RULES

• Existing rates, as well as proposed changes to existing rates, may be subject to challenge
• All rates must be filed at FERC
• No deviation from filed rates, i.e., no discounting between minimum and maximum rates as with natural gas pipelines
• Volume incentive and term incentive rates are permitted, but they must be published in a FERC-filed tariff and made available to all similarly-situated shippers
CAPACITY ALLOCATION

• Common Carrier Regulation
  – Historically, no firm capacity; capacity allocated on pro rata basis
  – All interested and qualified shippers entitled to some reasonable percentage of usage
  – Pure common carrier regulation stifled development of much-needed new oil pipeline infrastructure; a shipper is not incented to backstop a project if they cannot be provided some assurance that capacity will be available.
    o Investors and lenders were hesitant to support a project without a guaranteed revenue stream

• Limited Exceptions to Common Carrier Regulation
  – Firm Capacity (committed shippers entitled to firm capacity for new pipelines or expansions of existing pipelines)
  – Historical Allocation (committed shippers can have history based on greater of actual history or committed volume)
  – Capacity must always be reserved for uncommitted or “walk-up” shippers
CONSIDERATIONS IMPORTANT TO NEW PROJECTS
COORDINATING FEDERAL, STATE, & LOCAL APPROVALS

• No FERC approvals required for the construction of new oil pipelines
  – Theoretically, FERC knows nothing about a new pipeline until tariffs are filed between 30 and 60 days before in-service
  – By contrast, FERC certificate process applicable to gas pipelines may be burdensome but there is a degree of certainty
• Federal environmental approvals may be required, e.g., Clean Water Act, Clean Air Act
• State approvals may be required prior to construction of pipeline
  – Different states have different certificate procedures
  – Complications can arise when dealing with multiple regulators
• No federal eminent domain
  – Pipelines are largely dependent on state eminent domain authority, if any, to site both interstate and intrastate oil pipelines
  – Different states have different rules and regulations regarding eminent domain
  – Some states grant eminent domain authority to “public utilities” but not “common carrier” pipelines; others require evidence of common carriage
• Determine jurisdiction over economic regulation of rates and terms and conditions of service: FERC? State? Non-jurisdictional?
NEW PIPELINE PROJECT OBJECTIVES

• Typical shipper objectives:
  – rate certainty – competitive pricing, no or minimal escalation, no project cost risk, favored nations
  – priority for volumes – “the capacity must be there when I need it”
  – mitigate project development risk: a right to walk away if development is not proceeding on agreeable schedule
  – regulatory constraints may limit ability to provide shipper what it wants
NEW PIPELINE PROJECT OBJECTIVES (CONT’D)

• Typical pipeline objectives:
  – A “bankable” project
  – Revenue certainty –“take or pay” commitments through T&D provisions in transportation services agreements
  – Rates escalate over time
  – Shared project development risk:
    o Durable commitments with long lead times to meet milestones
    o Right to walk away if the project does not go forward, without shipper recourse
  – Regulatory risk mitigation and compliance:
    o Shippers commit to support the project before FERC
TERMS OF SERVICE – OPEN SEASONS

• Common theme between liquids and gas – non-discrimination
• Open seasons are the pipeline’s chance to make favorable terms of service available to anyone who may be interested
  – Terms of service offered on a non-discriminatory basis – no “sweetheart” deals unless the same terms are offered to all (that is, cannot pre-sell a better deal than is made available to all in an open season)
• Avoiding future complaints that some shippers were offered terms that others were not
• Publicly announced – opportunity to review and commit to terms of service
• Must involve new or expanded capacity
TERMS OF SERVICE – SHIPPER COMMITMENTS

• “common carriers” – Even with no contract, any qualified shipper can move volumes at the posted rate, pay as you go
  – Referred to as uncommitted or walk-up shippers
  – Pay as you go, no contract
• Committed shippers can get “volume incentive” (discount) rates; firm shippers must pay a premium
• Preference for committed shipper volumes in allocation situations
  – More recently, “firm” service is allowed for committed shippers who pay a premium to receive it
  – Volume commitments or production dedications
TERMS OF SERVICE – PRIORITY AND CURTAILMENT

• “Firm” service under the ICA
  – FERC has approved where:
    o All interested shippers have the opportunity to secure service free from prorationing in an Open Season
    o Shippers pay a premium rate for the right to be exempt from curtailment in the ordinary course; creative ways to address premium rate requirement
      » Tiers
      » Only firm up with premium rate when needed
  – Shippers’ volume commitment is then protected from prorationing in the ordinary course (assuming no FM, etc.)
  – FERC has allowed this in a nod to commercial realities
    o However, it remains untested in the courts
• Other forms of protection from curtailment for committed shippers under the ICA
  – “Historical” prorationing
    o Reserving up to 90% of capacity for committed shippers
    o Committed shippers are allocated space based on the higher of their historical volume or their commitment, in relation to the available capacity
TERMS OF SERVICE – OTHER SHIPPER INCENTIVES

• Most Favored Nation clauses –
  – Where another shipper is offered a better rate, the shipper’s rate is adjusted
  – Contested issue - what triggers the MFN clause?

• Volume credits
  – To what do they apply, and for how long?

• Preferential rights to extend term of service

• Creditworthiness terms –
  – Shippers making long-term commitments are subject to negotiated credit support requirements, whereas all shippers, including walk-up shippers are typically subject to a lien on product under the Tariff and walk-up shippers generally do not have required credit support obligations (although the tariff typically allows for that if there is reason to question walk-up shipper’s creditworthiness)
DECLARATORY ORDERS PROVIDE CERTAINTY AS TO RATES AND SERVICE TERMS

• Project sponsors and their lenders want to know the rates and service terms that will be in place when the pipeline goes into service
• Because no certificate is issued, FERC historically did not approve rates and terms and conditions of service
• Throughput & Deficiency Agreements (“T&D Agreements”) for anchor shippers provide some level of certainty
  – Minimum revenue requirement
  – Lower “committed” rates
  – Typically not firm; subject to allocation but on preferred basis
• Declaratory orders from FERC provide a level of certainty
  – A declaratory order provides lenders and investors with certainty
  – A declaratory order provides the pipeline with protection from subsequent claims of discrimination or preference
CONCLUSION

• Oil/NGL regulation by FERC is different than gas regulation
• In some ways, oil/NGL regulation is less burdensome but also can result in less certainty for the pipeline
• Tools such as open seasons, committed or firm capacity and declaratory orders have evolved to increase new project certainty
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