KING & SPALDING

Energy Newsletter

March 2015

TRANSACTIONAL

Transactions

Opportunities in Distressed Markets: Insights into the Acquisition and Divestiture Process

Kathryn Marietta, Mark Wege, Ed Ripley, John Crespo

Volatile and unpredictable commodity markets present opportunities in the areas of acquisition and divestiture. However, industry participants face special considerations when buying and selling assets of companies experiencing financial distress. **More »**

Project Finance

A Project Owner's Primer On Delay In Start-Up Insurance

John H. Fontham

Project owners and financiers are increasingly turning to delay in startup insurance to protect themselves from the financial consequences of delays in completion of large new construction projects, particularly for projects that are financed on a nonrecourse or limited recourse basis. **More »**

Corporate/London

UKCS: Maximising Economic Recovery and the Oil and Gas Authority

Trinh Chubbock

In order to protect the UK oil and gas industry and make the most of the opportunities that the UK Continental Shelf presents, an independent review was conducted on how to maximise oil and gas recovery from the UKCS. We summarise the key issues identified by the review, the recommendations, and the status of the government's commitment to implement them. **More »**

DISPUTE RESOLUTION

Business Litigation

***Zachry Construction Corp.*: The End to Indemnity for Exemplary Damages?**

Craig Ledet, Ben Pollock

The Texas Supreme Court recently decided a case involving the enforceability of "no damages for delay" clauses that could have significant impacts on energy disputes. **More »**

Visit King & Spalding's Energy Blog at energylawexchange.com

Upcoming Events

King & Spalding Energy Forum: Cybersecurity and the Energy Sector: What You Need to Know
When: **Wednesday, March 11, 2015**
Where: **Live in Houston, Texas and Online**
For Further Details Click Here

London Energy Series: Challenges for Europe's Energy Security: Does US LNG or European shale gas offer a solution?
When: **Thursday, 23 April 2015, 5pm – 7pm**
Where: **King & Spalding, 125 Old Broad Street, London EC2N 1AR**
For Further Details Click Here

In The News

Royalty Class Actions: A New Frontier [PDF]
More »

3 Key Considerations For PE Co-Investment

REGULATORY

Oil & Gas Regulatory

Anticipating PHMSA's Crude by Rail Rule

Sara E. Peters

Recent high-profile derailments of crude-carrying trains have prompted the Pipeline and Hazardous Materials Safety Administration to address safety concerns by revisiting technical standards for rail tank cars used to transport flammable liquids on high-hazard flammable trains and requirements for shippers to properly test and classify crude oil prior to transportation. **More »**

FERC

ISO and RTO Responses to FERC Data Requests Fail to Provide Clear Support for Proposed Gas Day Rulemaking

William E. Rice

The responses to Federal Energy Regulatory Commission's recent data requests to electric power industry participants may make it more difficult for FERC to justify a rulemaking decision to redefine the "Gas Day," a 24-hour period during which shippers nominate and schedule natural gas transportation services furnished by natural gas pipelines. **More »**

Editorial Contacts

Charles J. (Tim) Engel III
+1 202 661 7800
tengel@kslaw.com
View Profile »

Jeffrey H. Perry
+1 404 572 2702
jperry@kslaw.com
View Profile »

About King & Spalding's Energy Practice

King & Spalding's energy practice has more than 300 lawyers in the U.S., Europe, the Middle East and Asia, giving King & Spalding one of the broadest and deepest benches of energy lawyers in the world. The firm is one of the most active law firms in the global energy industry advising and representing clients on a broad spectrum of transactions and disputes, and has received top rankings from *Chambers Global, Chambers USA, The Legal 500, The International Who's Who of Oil & Gas Lawyers, Euromoney's World's Leading Energy & Natural Resource Lawyers* and *The Best Lawyers in America.* For additional information, visit www.kslaw.com/practices/Energy.

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising." If you are not currently on our Energy Practice Group mailing list under your own name, and you would like to join to receive our monthly *Energy Newsletter* publication and to receive notices of future programs and occasional notices of legal developments in the industry, or wish to be taken off the distribution list for this Newsletter, you can make that request by submitting your contact information to Jeff Perry at jperry@kslaw.com.

© 2015 King & Spalding

Transactions [PDF]
More »

King & Spalding Has Leading Role in Significant Energy Industry Win
More »

King & Spalding Moves Up to the Top Five International Arbitration Practices Worldwide
More »

Chambers Asia Pacific Counts King & Spalding Among the Region's Top Law Firms
More »

Intellectual Property Litigator John H. Barr, Jr., Joins King & Spalding
More »

King & Spalding

Energy Newsletter

March 2015

TRANSACTIONAL
Transactions

Opportunities in Distressed Markets: Insights into the Acquisition and Divestiture Process

Kathryn Marietta, Mark Wege, Ed Ripley, John Crespo

Uncertainty

The projections as to the near- and medium-term future of oil and gas prices are mixed – to say the least. Irrespective of the direction prices ultimately go, industry is faced with significant uncertainty and companies in all industry sectors are evaluating their businesses and how they can best manage the uncertainty. Opportunities are surfacing for companies to strategically reposition themselves resulting in acquisition and divestiture activity. In this paper we consider special considerations when buying and selling assets of companies experiencing financial distress. We only address assets being divested outside of bankruptcy. Both the buyers and sellers will want to bring transactions to closing – understanding special issues will facilitate this mutual objective.

Selling or Acquiring Distressed Assets

When considering the acquisition of assets from a company experiencing financial distress, appropriate thought must be given to the structure of the purchase. The general legal principle is that a buyer is not required to assume corporate liability when it acquires the assets of a company. There may be risks associated with an asset purchase if the level of "distress" is approaching insolvency. Some of the post-closing insolvency risks that should be considered include: liens that may run with the asset; laws that void "fraudulent transfers" when the interests of the seller's creditors are at risk; and the fiduciary duties to which officers and directors of the seller are subject, which run not only to the shareholders but also to the creditors when the seller company is in the zone of insolvency. Forming a special purpose entity to effect the purchase of distressed assets better shields the buyer against unknown liabilities that may run with the asset. A board of directors of a company nearing the zone of insolvency should retain independent counsel and advisors to assist and advise in the sale transaction.

Due Diligence

Due diligence takes on a special focus when acquiring distressed assets. Consideration must be given to the "insolvency effect" of the contemplated sale. How will the seller's financial position change upon completion of a proposed asset sale? What credit arrangements are in place and what impact will the sale have on these arrangements? What tax liens, judgment liens and lawsuit filings exist? How will existing material contracts be impacted? Does the seller have lingering liability for environmental law violations that may affect the pre-closing solvency determination? If the acquisition involves an E&P company, what are the plugging and abandonment liabilities that will be assumed? Does the board include insiders? If so, are there sufficient

independent directors to approve the transaction without the insiders? Are employee lay-offs planned and will the WARN Act be considered? What material executive employment contracts exist? Is there an employee stock ownership plan? Will there be changes made to medical and/or workers' compensation plans? Thinking through these issues upfront will go a long way in preventing surprises at or after closing.

Safeguards Against Fraudulent Transfer Claims

It is imperative that parties to a transaction create a transparent record of a reasonable and defendable sale process (*i.e.*, one undertaken in good faith and resulting in an arm's length transaction). Interaction with the creditors on an appropriate level is key to this process and should reduce the risk of fraudulent transfer claims. Optimally, consent will be given by the creditors to the proposed transaction. The obligations assumed by seller will also serve to reduce risk. Ideally the seller will provide a covenant and some form of financial assurance that the seller will apply the proceeds from the sale to existing creditor claims. A buyer should also understand and, to the extent appropriate, provide for payment of secured claims. Claims can be identified by conducting a lien search, including a UCC-1 search on the seller. A buyer may want to make certain any secured debts are either paid or assumed under the sale. The agreement should require that no proceeds are paid to equity or insiders before all creditors are paid.

In addition, the seller should represent and warrant compliance with all applicable state and federal law and provide an indemnity against violation of either federal or state law. Coordinating with third party experts brings impartiality to the process. A distressed company or buyer should seek a solvency opinion, capital adequacy/surplus, or valuation opinion or some combination of such opinions from a qualified independent expert. Such opinions will support that the buyer is paying fair market value for the transferred assets and should reduce the likelihood that the transaction is set aside post-closing as a "sweetheart deal." No opinion, however, could guarantee the outcome of a challenge claiming a fraudulent transfer. For this reason, purchasers at times will insist that a distressed company file a "prepackaged" bankruptcy and condition the sale on court approval. Representations and warranties provided by the seller may be of limited value when the acquisition is transacted under distressed circumstances. Holdbacks, letter of credit, and escrows provide sound security to cover post-closing liability and indemnities. Post-closing holdbacks, escrows, or letters of credit should include sufficient contingency to account for creditor liability. Buyers are able to obtain holdbacks that are substantially higher than those for non-distressed assets. Creditors may resist holdbacks as it reduces the amount of cash they can be certain to receive from the sale.

Advantages and Disadvantages

There are tradeoffs when negotiating with a distressed seller outside of a bankruptcy proceeding. There are a number of advantages: (i) The transaction will proceed to closing at a much quicker pace if it is handled outside of the bankruptcy proceeding. (ii) Often times there is less scrutiny and possibly even less competition for the buyer. (iii) When working outside of bankruptcy the seller is often motivated and provides a more robust set of representations and warranties. (iv) Typically both the seller and buyer value the avoidance of hassle that is involved in formal bankruptcy proceedings. There are definite risks comprising the disadvantages of transacting outside of the proceedings: (i) Often times the buyer has less deal certainty, especially if there are non-consenting creditors involved. (ii) Buyers are often faced with limited ability to "cure" seller defaults under the purchase and sale agreements. (iii) Buyers may be faced with successor liability and certainly are confronted with an overall higher risk deal. (iv) The sale may be challenged as a fraudulent transfer and be subject to a court order unwind.

Conclusion

Volatile and unpredictable commodity markets present opportunities in the area of acquisition and divestiture. Bankruptcy proceedings are complex and time consuming and not conducive to completing acquisitions in the normal time frame. Transacting with a distressed seller outside of bankruptcy may be the best path forward under defined circumstances. Moving forward with insight as to the pitfalls, a proper structure, a plan for due diligence, and safeguards in place will help ensure that the deal will survive post-closing.

Kathryn Marietta
Houston
+1 713 276 7372
kmarietta@kslaw.com
View Profile »

Mark Wege
Houston
+1 713 751 3246
mwege@kslaw.com
View Profile »

Ed Ripley
Houston
+1 713 276 7351
eripley@kslaw.com
View Profile »

John Crespo
Houston
+1 713 276 7324
jcrespo@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.

KING & SPALDING

Energy Newsletter

March 2015

TRANSACTIONAL
Project Finance
A Project Owner's Primer On Delay In Start-Up Insurance
John H. Fontham

Project owners and financiers are increasingly turning to delay in startup insurance to protect themselves from the financial consequences of delays in completion of large new construction projects, particularly for projects that are financed on a nonrecourse or limited recourse basis. DSU insurance can provide risk transfer for power generation, onshore and offshore oil and gas, renewable energy, heavy industry and a wide variety of other complex construction projects featuring large anticipated operational revenue streams. One recent representative example is the 160-megawatt Noor 1 concentrated solar power project in Morocco.[1]

DSU insurance is typically purchased together with an erection all risks or construction all risks policy covering physical loss or damage to the project and is triggered by a delay of project completion due to physical damage from a risk insured under the counterpart EAR policy. DSU insurance is a complex product, particularly given that it resides within a larger framework of project-related contracts, and the interplay presents a number of potential pitfalls for the project owner. Asking the following four questions in advance and securing clear answers will help circumvent costly disputes and shortfalls in the project owner's expected recovery.

Who Is Responsible for Purchasing DSU Insurance?

The project owner should think twice before delegating responsibility for purchasing DSU insurance to the contractor. Although DSU insurance often is purchased together with an EAR policy that covers both the contractor and the project owner, DSU insurance is designed to cover only the project owner (and in some cases project financiers, such as in the nonrecourse or limited recourse project finance setting). DSU coverage does not benefit the contractor because the contractor has no insurable interest in revenue derived from post-completion business operations.

If the contractor controls the insurance relationship, it will be the contractor and the contractor's insurance broker negotiating policy provisions and conveying information to and from the underwriters. The project owner will be two steps removed from the process, and will be beholden to the contractor to ask the right questions, convey accurate information to the underwriters about the project owner's business and obtain the most favorable terms for protection of the revenue stream. In addition, the information conveyed to the insurer to support DSU coverage is likely confidential and project owners typically do not want to share this confidential information with the contractor.

Does the DSU Buildup Accurately Depict the Anticipated Costs of the Project Owner's Business?

The total sum insured (*i.e.*, limit of liability) under a DSU policy typically is determined by preparing a schedule of fixed costs and debt service payments (along with anticipated revenues for a policy covering gross profits — the "DSU buildup") that the project owner anticipates incurring during the policy's indemnity period. The sum insured should represent the greatest financial loss that the project owner can incur during the indemnity period, but if key items are neglected and do not make it onto the DSU buildup, there will be a shortfall.

Importantly, the DSU buildup should reflect an understanding that fixed costs and debt service obligations often evolve over the life of a project. For example, annual debt service may be limited to interest payments in the first few years of a project, with a transition to principal payments down the road. If the DSU buildup accounts only for the interest payments, the project owner may find itself underinsured.

The project owner also should determine in advance whether the DSU buildup is to be incorporated into the terms of the policy. In other words, is the DSU buildup intended merely as an estimate to help calculate the appropriate payable policy limit or is it an itemized "declaration" of the specific costs to be covered? If the latter, the DSU buildup effectively may serve as an exclusion or limitation on coverage. This will amplify the project owner's need for diligence in preparing the DSU buildup.

Does the Waiver of Subrogation Provision in the Policy Adequately Protect the Project Owner?

The project owner should carefully review waiver of subrogation language in the DSU policy to determine: (1) whether the terms satisfy the project owner's contractual commitments to secure waivers for third-party contractors; and (2) whether the waiver extends to the project owner's contractual indemnitees. In particular, the project owner should recognize that a general waiver of subrogation against "any insured party" may not afford sufficient protection. The DSU policy's additional insured provisions may not capture certain entities at all and may only confer insured status to others on a very limited basis.

If the waiver language is not sufficiently broad, the DSU insurer could push forward with a subrogation claim that is damaging to the project owner's interests, even one against a party that has a contractual right to indemnity from the project owner. Thus, the project owner could face the risk of having to reimburse the DSU insurer out of payments just made to the project owner. The project owner also could face the Faustian choice between complying with the insurer's requests for assistance in prosecuting the subrogation claim or refusing to comply and risking a damages claim for breach of the insurance policy's cooperation provision.

Does the Policy Specify Whether the Insurer May Take an Offset for Liquidated Damages?

Timely completion of the project may be encouraged by liquidated damages provisions in the construction contract. DSU policy wordings, however, often do not address the interplay between LDs and collection of DSU proceeds. Is the DSU insurer entitled to a credit or offset to account for LDs collected by the project owner? If the DSU insurer expects to benefit from LD provisions in the construction contract, this should be negotiated in advance and delineated in the policy. The project owner then can make a more informed decision about the scope of the LD provisions and the price to be paid for them in the construction contract.

If it is determined that the DSU insurer will benefit from LD provisions in the construction contract, the policy wording also should address who pays first. If the policy is silent on this issue, the insurer may take the position that the project owner must exhaust the LD route before collecting DSU proceeds. This can be very problematic because entitlement to LDs is not always clear cut for a variety of reasons, and a contractor typically will not admit fault. It could be years before entitlement to LDs is conclusively determined. Ideally, DSU proceeds should be paid without regard to the potential recovery of LDs, with the insurer retaining only a right to reimbursement if and when LD payments are made.

All too frequently, the policyholder does not discover unfavorable policy provisions until after a claim has been submitted. Policy wordings may be amended to adapt to the project owner's needs and to clarify how the parties expect the policy to respond, but this will happen only if the project owner communicates actively and effectively with its broker and insurer prior to issuance of the DSU policy.

This article was originally published as a Law360 guest column on February 3, 2015.

[1] Alternative Energy Projects Covered, Lloyd's News and Insight, Oct. 23, 2013.

John H. Fontham
Washington, D.C.
+1 202 626 5543
jfontham@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.

King & Spalding

Energy Newsletter

March 2015

TRANSACTIONAL
Corporate/London

UKCS: Maximising Economic Recovery and the Oil and Gas Authority

Trinh Chubbock

The UK's oil and gas industry is of national importance as it makes a substantial contribution to the UK's energy security, economy and employment. Some 42 billion barrels of oil equivalent (boe) have already been produced from the UK Continental Shelf (UKCS) and some sources estimate that a further 12 to 24 billion boe could be produced. As one of the world's most mature offshore basins with a diverse mix of mature fields, frontier areas and new plays, however, investors in the UKCS now face new challenges as discoveries are generally smaller and more expensive to exploit. Although UKCS investment reached a record high of £14 billion in 2013, industry experts expect investments to reduce by at least 50% by the second half of the decade. Further, production has fallen by 38% between 2010 and 2013 and there has been a sharp decline in exploration, leading to less than 150 million boe being discovered in the last two years. In order to protect the UK oil and gas industry and make the most of the opportunities that the UKCS presents, on 10 June 2013 Edward Davey MP, Secretary of State for Energy and Climate Change, requested Sir Ian Wood to conduct and lead an independent review on how to maximise oil and gas recovery from the UKCS.

Sir Ian Wood conducted the review of the UKCS and published his final report on 24 February 2014 (Wood Review). As part of the review process, he consulted with, and took evidence from: licensees and other industry players from the supply chain; government figures such as DECC, HM Treasury and senior government ministers; international regulators from the USA, Canada, Norway, the Netherlands and Australia; and other UKCS stakeholders.

The government published its response to the Wood Review in July 2014 whereupon it accepted all of the recommendations proposed by the Wood Review and provided further details on its commitment to fully implement such recommendations.

Wood Review – Key Issues

The Wood Review identifies a number of key issues facing the UKCS. Firstly, there is a lack of focus on maximising economic recovery for the UK as a whole – operators generally pursue individual commercial objectives in isolation of any shared commitment to maximise economic recovery across fields or within regions of the UKCS. This is inefficient in a number of ways including with respect to the use of new infrastructure specifically designed to develop a particular field - which generally results in higher operating costs and poorer field recovery compared to the use of existing infrastructure or new infrastructure designed to develop a number of fields or a region. Connected to this is the lack of collaboration and overzealous legal and commercial behaviour between operators – for example, to agree terms for access to processing and transport infrastructure – which has led to increased costs, delays, poorer recovery and, in some cases,

stranded assets.

Fiscal instability is also a significant factor in basin under-performance – although the introduction of certain fiscal allowances and certainty over decommissioning tax relief have been well received by industry.

Further, the "light touch" stewardship model adopted by the government, whilst suitable for the early days of large fields and large operators, does not adequately meet the challenges presented by the UKCS today – *i.e.*, the evolution of smaller new discoveries and increasing inter-dependency of exploration, development and production operations between fields. Meanwhile, the rapid fall in production efficiency indicates poor asset stewardship by industry which the existing regulator, as a result of lack of resources, is unable to adequately address. Whilst ageing assets is a factor for the decline in production efficiency, the underinvestment in enhanced oil recovery techniques is also a contributing factor.

Finally, whilst the Wood Review recognises the high quality strategic thinking by PILOT (a joint programme involving the government and industry which aims to secure the long term future of the UKCS and ensure full economic recovery of the UK's hydrocarbon resources), it considers the implementation of PILOT to be poor on issues such as exploration, infrastructure and decommissioning and suggests the need for integrated planning and collaboration to ensure the most efficient approach is adopted across the UKCS.

Wood Review – Recommendations

Recommendation 1

The Wood Review recommends that the government (HM Treasury and the regulator) and industry must adopt a cohesive tripartite approach to develop and commit to a new strategy for maximising economic recovery from the UKCS (MER UK).

The key principles of MER UK include:

- a revitalised exploration strategy which would ensure economic recovery of hydrocarbon resources from the UKCS as a whole. This would be facilitated by efficient access to well and seismic data through appropriate data sharing within regional developments. Further, the UKCS exploration opportunities should be promoted internationally;

- an asset stewardship strategy whereby operators must be held accountable for proper stewardship of their assets and infrastructure consistent with maximising economic recovery from not only their fields but adjacent fields. The operator's strategy should be shared with the regulator and the regulator should provide clear expectations with respect to production efficiency and recovery efficiency;

- a regional development strategy ensuring that the UKCS will be developed on a regional rather than individual field basis to maximise economic recovery of the UKCS. Operators should therefore cooperate with the regulator and other licence holders in the wider adjacent area with respect to all operations – from exploration through to decommissioning – for example, by making their infrastructure and process facilities available to other license holders at fair and economic commercial terms and rates;

- an infrastructure strategy to ensure that existing infrastructure is prolonged, and investment is made in new infrastructure, to facilitate the processing, transport and export of the UKCS resources on a regional basis in order to service both MER UK and the commercial imperatives of individual licence holders;

- a technological strategy to fully deploy existing technologies and invest in, or utilise, new technologies to maximise economic recovery of the UKCS. Taking full advantage of technology will also help promote the UK as experts in mature basin operations; and

- a decommissioning strategy to achieve the maximum economic field life of assets and avoiding premature decommissioning of such assets, meanwhile ensuring that decommissioning is safe, environmentally sound and cost effective.

Recommendation 2

The Wood Review recommends that, central to the implementation of MER UK, is the creation of a new arm's length independent regulatory body charged with effective stewardship and regulation of the UKCS consistent with MER UK. Given the evolution of the UKCS landscape which now includes over 300 fields, an increasing inter-dependence between fields and the large volume of disputes and disagreements between operators over new field developments and access to infrastructure, the 50 or so personnel currently dedicated to the stewardship of the UKCS is proving inadequate. The UKCS needs a stronger operator with the following responsibilities and key features:

- operational regulation of the UKCS, including licensing and stewarding of exploration, development and production activities in a manner consistent with MER UK;

- ensuring that government and industry collaborate to deliver MER UK in the next 30 years;

- an arm's length independent body;

- ability to attract top quality personnel with relevant skills and experience to effectively liaise with all parties to deliver MER UK – including with respect to leadership, commercial, legal, engineering, economic, etc.;

- sufficient operational freedom and led by an individual with significant industry experience who will work closely with the Energy Minister and other policy officials (currently DECC);

- for transparency purposes, the new regulator should publish its objectives and success criteria on which it should report on an annual basis;

- where competition law may prevent companies from working effectively to promote MER UK, the new regulator should act as an independent external party to facilitate coordination and interpretation of data; and

- funded by industry and with sufficient resources and delegated freedom to recruit high quality personnel in a competitive market.

Recommendation 3

The Wood Review recommends that the new regulator should have additional powers to facilitate the implementation of MER UK, including:

- powers to ensure that licence holders operate in a manner consistent with MER UK;

- powers to resolve disputes and disagreements between operators within an agreed timeline and structure and with the power to make non-binding recommendations, the failure to comply of which would result in certain sanctions if inconsistent with MER UK;

- rights to attend operational and technical meetings in order to fully understand challenges faced by the industry – in practice, a targeted approach would be adopted (i.e., attendance where there are key concerns) in order to best utilise the regulator's resources; and

- power to require access to data from operators in a timely manner together with certain publishing rights in order to effectively monitor UKCS assets (e.g., publishing of production efficiency and recovery efficiency).

Recommendation 4

The Wood Review recommends that the new regulator should work with industry to develop and implement the strategies of MER UK, which builds upon the work already undertaken under PILOT (for details, see Recommendation 1).

Wood Review – Government's Response and Implementation

In July 2014 the government published its response to the Wood Review whereupon it accepted all of the recommendations set out in the Wood Review, together with setting details on its commitment to fully implement such recommendations.

In order to demonstrate its commitment to the implementation of the Wood Review, DECC has established the Wood Review Implementation Team (WRIT), headed by Stefanie Murphy. The government's approach to implementation is two-fold: (1) establishing the new regulator in law as the successor to DECC with the appropriate objectives, duties, powers and functions; and (2) taking practical steps to get the new regulator up and running as quickly as possible.

The latest implementation developments include:

- the regulatory body will be a government company called the Oil and Gas Authority (OGA) and headquartered in Aberdeen with a significant presence in London. The OGA will be established as an Executive Agency in the spring of 2015 and will transition into a government company by the summer of 2016;

- an Interim Advisory Panel (chaired by Sir Ian Wood and attended by DECC, HM Treasury, competition and market authorities and industry) has been set up to advise on the implementation of the Wood Review;

- Dr. Andy Samuel, managing director of BG Group's Exploration and Production in Europe, has been appointed as the chief executive of the OGA;

- DECC is currently seeking to appoint the OGA's first chair;

- In terms of putting the OGA on a legal footing, the Infrastructure Bill includes provision permitting the Secretary of State to publish a strategy for the achievement of MER UK and to raise a levy to provide stable funding for the OGA. The Infrastructure Bill was passed with royal assent on 16 February 2015 and the OGA will receive short-term funding of £3 million per year for five years from 2016-17 onwards (it is expected that industry will fund the OGA in the long-term);

- DECC is currently working on a bill to complete the establishment of the OGA as a fully arm's length regulator, which involves developing and defining the objectives, duties, powers and functions that the OGA will need in line with the Wood Review; and

- in preparation of establishing the OGA as an Executive Agency, DECC is actively recruiting specialist staff to build the technical capacity of the OGA.

Conclusion

Against the backdrop of the Wood Review and the government's steps to implement the recommendations set out in such review is the significant decline in global oil prices today. In response to Edward Davey MP's urgent commission of January this year to assess the impact of falling oil prices on the UK oil and gas industry, Dr. Andy Samuel published on 25 February 2015 his initial findings and issued an urgent call to action for industry, government and the regulator.

Dr. Andy Samuel's report identifies two immediate risks facing companies in the UKCS:

- the profitability of current oil and gas fields will be insufficient to attract continued investment. This could potentially lead to premature decommissioning of critical North Sea assets and result in valuable hydrocarbons being left in the ground. Further, the domino effect could lead to a negative impact on all areas of the industry, including employment, supply chain development and technological innovation; and
- a loss of confidence in the future potential of the UKCS could result in the UK failing to secure the critical long-term investment necessary to implement MER UK.

In addition, the report highlights certain urgent actions industry, government and the regulator must take in order to protect the UK's oil and gas sector and sustain energy security, employment and economic benefits that the industry delivers for the UK. Dr. Andy Samuel said that: *"[s]ignificant hydrocarbon resources and economic value are yet to be delivered from the UK North Sea but to unlock this potential we must create a more competitive and efficient operating environment, where costs are effectively managed and companies have confidence to invest today and tomorrow."*

Trinh Chubbock
London
+44 20 7551 2146
tchubbock@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.

KING & SPALDING

Energy Newsletter

March 2015

REGULATORY
Environmental

Anticipating PHMSA's Crude by Rail Rule

Sara E. Peters

The Pipeline and Hazardous Materials Safety Administration's much-anticipated crude by rail rule will address over 3,000 comments, spanning a wide range of public opinion on crude by rail safety. PHMSA must address vast differences of opinion on complex issues, such as the timeline for implementing new DOT-111 tank car standards, whether tank car standards and operational restrictions should be tied to the new "high-hazard flammable train" concept and optimal speed restrictions on the shared rail network. Commenters on the proposed rule provided input on these and other issues.

In an Aug. 1, 2014, notice of proposed rulemaking, PHMSA sought comment on proposed new standards for "high-hazard flammable trains," defined as trains carrying "20 or more carloads of a Class 3 flammable liquid." [1] Crude oil and ethanol are the commodities most affected by the rule because they often are carried in high volumes on a single train. PHMSA cited recent high-profile derailments of crude-carrying trains in Lac-Megantic, Canada, Casselton, North Dakota, and Aliceville, Alabama, as prompting the need for regulatory changes to mitigate future incidents.

PHMSA requested comment on proposed revisions to the hazardous materials regulations in three main areas: (1) technical standards for U.S. Department of Transportation-specified rail tank cars used to transport flammable liquids on HHFTs; (2) railroad operational requirements for HHFTs, including routing, braking and speed restrictions; and (3) requirements for shippers to properly test and classify crude oil prior to transportation.

Timeline for DOT-111 Tank Car Standards

Among the most contentious issues is PHMSA's proposed timeline for implementing new standards for the DOT-111 tank car and phasing-out older DOT-111s. Environmentalists and public safety groups want an *immediate* end to the use of legacy DOT-111s in transporting crude, while industry groups assert PHMSA greatly underestimated the time it will take to implement the new standards. Government investigators have cited the crashworthiness of legacy DOT-111s as a contributing factor in recent derailments and explosions.

PHMSA's proposal would require all new tank cars constructed after Oct. 15, 2015, to meet enhanced regulatory standards, and all legacy DOT-111s used in HHFTs to be retrofitted or phased out, by packing group service as follows: by Oct. 1, 2017, for PG I; by Oct. 1, 2018, for PG II; and by Oct. 1, 2020, for PG III.[2] Because most light crude oil and ethanol shipments are PGs I and II, the proposal arguably requires retrofit or phase-out within *two to three years* of a final rule.

The timeline drew criticism from all sides of the debate. Environmental groups petitioned the DOT in July 2014 to immediately ban legacy DOT-111s from transporting crude oil by rail, using PHMSA's emergency order authority. Since then, those groups have filed two suits with the Ninth Circuit, claiming first that the DOT failed to act on the petition and, more recently, that the department inappropriately denied the petition.[3] On Jan. 20, 2015, an order by the court mediator stayed the case "until May 12, 2015, or pending publication in the Federal Register of the final tank car standards and phase out of DOT-111 tank cars, whichever occurs first."[4]

Industry groups, however, assert that sufficient numbers of DOT-111s cannot be manufactured or retrofitted within the two-year timeline, given the severe limitations in rail tank car manufacturing and shop capacity. The American Chemistry Council noted in its comments that the current backlog of tank car orders already is causing wait times of "two years from when a tank car is ordered to when it is delivered."[5] The Railway Supply Institute proposed a *six-year* timeline in which to retrofit or retire legacy DOT-111s, calling it "both aggressive and achievable."[6] The Association of American Railroads and American Petroleum Institute also supported a six-year timeframe. AAR and API proposed prioritizing the least sturdy of the legacy cars first (*i.e.*, retrofitting the nonjacketed, non-CPC-1232 cars within the first three years), followed by nonjacketed CPC-1232 cars and supported prioritizing retrofits of tank cars carrying crude oil and ethanol.[7]

Linking Tank Car Design to HHFTs

Many groups criticized PHMSA's proposal to tie new tank car standards to only those cars used in an HHFT. Industry groups noted that shippers have no control over how a railroad will arrange and rearrange tank cars within a "manifest train" (*i.e.*, one with mixed cargo) and that the HMR does not otherwise link container design to train composition.[8] AAR stated, "It would be unprecedented for PHMSA to adopt tank car specifications dependent on the amount of cars in a train."[9] Industry groups, including AAR, API, ACC and RSI, also noted the proposed rule would impact *every* DOT-111 tank car, not just those used on HHFTs, due to the impracticality of separating shipments with various types of DOT-111s.[10]

Environmental groups and the National Transportation Safety Board also support abandoning the HHFT limitation on tank car requirements, but for a much different reason. They claim the proposed rule would allow legacy DOT-111s to continuing transporting Class 3 flammable liquids, so long as they are on non-HHFTs (*i.e.*, trains carrying less than 20 carloads of Class 3 liquids).[11]

Linking Operating Restrictions to HHFTs

Similarly, industry groups noted PHMSA's proposed operating restrictions for HHFTs would affect negatively *other cargo* aboard those trains, even though PHMSA has not provided any justification to increase regulation of the other cargo. The Institute of Makers of Explosives, for example, "are not shippers of … Class 3 flammable liquids," but expressed concerned that restrictions on HHFTs will impact non-Class 3 cars placed on an HHFT by the railroads, leaving them "no viable options to avoid … HHFT service restrictions" for their consigned cargo.[12] For this reason, industry groups argue the costs of the rule are "dramatically underestimated."[13]

Some commenters criticized PHMSA's choice to use the HHFT concept at all, especially given that PHMSA seems most concerned with the dramatic rise in "unit trains" (*i.e.*, trains carrying a *single* commodity, typically crude or ethanol, and usually in larger quantities of 50 to 120 cars per train).[14] The American Fuel and Petrochemical Manufacturers suggested limiting the rule to "petroleum crude oil and ethanol transported in unit trains (defined as 75 cars or more)."[15] The ACC similarly proposed limiting the final rule to crude oil and ethanol "unit trains," given PHMSA's concerns about "unique" risks of those commodities on "unit trains."[16]

Speed Restrictions

Another controversial proposal is the speed restriction of 40 mph for HHFTs with tank cars not meeting enhanced standards.[17] AAR member railroads already agreed with the DOT to reduce operating speeds to 40 mph in high-threat urban areas (HTUAs) when a legacy DOT-111 tank car is used on an HHFT carrying crude and to 50 mph everywhere for trains with over 20 loads of any hazardous materials (not just Class 3 flammable liquids).[18]

Uniformly, industry groups oppose any further limiting of the speed limits, arguing that slower speeds for HHFTs will impact *all* rail traffic on the railways, including for example, grain shipments, passenger trains and chemical industry shipments. AAR likened speed limits on rail to "traveling on a two-lane highway" except "much worse because the opportunities to pass are much more constrained."[19] Industry groups also noted there is no evidence that operating speeds caused recent derailments. The most significant recent incident — the derailment at Lac-Megantic, Canada, which killed 47 people — was not caused by operating speed, but rather by a conductor leaving the train unsecured and unattended atop a hill.

Environmental and safety groups, on the other hand, favor imposing stricter speed limits on *all* crude by rail shipments, with all such shipments routed away from populated areas.[20]

Crude Oil Characterization and Classification

PHMSA's proposal requires offerors of crude oil shipments to have in place systems to accurately characterize and classify crude prior to shipment. API's comments assert that the new ANSI/API voluntary standard for "Classifying and Loading of Crude Oil into Rail Tank Cars" (Sept. 2014), known as "Recommended Practice 3000" or "RP 3000," should suffice to satisfy the rule's testing requirements.[21] RP 3000 requires a documented sampling and testing program and both initial and ongoing testing of crude oil prior to offering it for rail transport.[22]

However, AFPM — an industry group focused on petroleum refining and petrochemical manufacturing — opposed the sampling and testing program altogether, stating it has "no safety benefit" and would be "unnecessary, unduly burdensome and confusing."[23] AFPM correctly pointed out that under current regulations, there are no meaningful differences between PG classifications of crude oil, in terms of the tanks cars authorized for use, required emergency response communications, and marking, labeling and placarding of rail cars.[24] AFPM did not mention the RP 3000 standard, but rather claimed there is no need for a federally mandated testing program because crude has well-understood properties and the PG assignment is entirely "immaterial" to compliance with the HMR's safety provisions.[25]

Conversely, environmental and safety groups want PHMSA to strengthen its proposed testing requirements to be less subjective and more uniform, instead of allowing individual oil producers to decide what tests and what frequency of testing suffice under the rule.[26] Additionally, they want PHMSA to require vapor pressure as a mandatory measurement of crude oil volatility.[27]

Track Maintenance and Human Error

Equipment suppliers, petroleum industry groups and environmentalists alike claimed that PHMSA's proposal conspicuously lacks a key, cost-effective solution — requiring railways to address longstanding deficiencies in the track itself and to lower the potential for operator error.[28] PHMSA acknowledged that "broken rails, track geometry, and human factors … are leading causes of derailments" and that broken rails were responsible for nearly eight times as many derailments as the average for all other causes.[29] However, PHMSA claimed these issues are adequately addressed in other DOT initiatives and noted the purpose of this rule is "mitigating the damages of train accidents," not necessarily preventing train accidents.[30]

By not addressing the cost-effectiveness of such obvious prevention measures, however, PHMSA's rule will be much more susceptible to attack in litigation. AAR seemed to be the only major constituency approving of this approach, arguing PHMSA should not mandate more track inspections, but rather defer to the Rail Safety Advisory Committee's findings on the issue.[31]

Cross-Border, Canadian Issues

Many industry groups, including AAR, RSI and the Canadian Association of Railway Suppliers, emphasized the need for PHMSA to ensure its rules on railway safety are harmonized with that of Canada, which is revising its transportation of dangerous goods regulations now. Harmonization of the HMR and TDG is key to ensuring railways can operate consistently and efficiently across national borders.

PHMSA also drew a great deal of attention from commenters with its prediction about the future of Canadian tar sands transportation. PHMSA estimated "23,000 cars will be transferred to Alberta tar sands service" and stated "no cars will be retired as a result of th[e] rule."[32] API and RSI, however, disputed such conversion could occur without significant retrofits of existing DOT-111s, to enable heating of viscous fuel.[33] Environmental groups also took issue with PHMSA's prediction because they oppose shipping diluted bitumen (dilbit) in DOT-111s, saying it "creates unacceptable safety hazards" and is "extremely difficult to clean up after a spill."[34] They asked PHMSA to explain what "tar sands service" means and to ensure that rail transport of dilbit and heavy oils are covered by the new rule.[35]

Finalizing the Rule

PHMSA recently announced it will delay publication of a final crude by rail rule from March 2015 to May 2015. On Feb. 5, 2015, the Office of Management and Budget received from PHMSA a final rule, which now will undergo final executive review and approval at OMB, a process that may take several months to complete. When published, the rule is sure to draw more stakeholder engagement and potential litigation from various groups on these key safety issues.

This article was originally published as a Law360 guest column on February 11, 2015.

---

[1] *Enhanced Tank Car Standards and Operational Controls for High-Hazard Flammable Trains*, 79 Fed. Reg. 45015, 45017, 45075 (proposed Aug. 1, 2014) ("Proposed Rule").

[2] The highest hazard materials are in Packing Group I, followed by II and III, per DOT regulations. Currently, under an emergency order issued by the DOT, all crude oil shipments must be made as Packing Groups I or II, even if they meet the regulatory standards (*i.e.*, boiling point and flash point parameters) for a Packing Group III material. *See* U.S. DOT, Amended and Restated Emergency Restriction/Prohibition Order (Mar. 6, 2014) (amending the Feb. 25, 2014, emergency order), *available at* www.phmsa.dot.gov/staticfiles/PHMSA/DownloadableFiles/Amended_Emergency_Order_030614.pdf.

[3] *See* Pet. for Review, *Sierra Club v. United States*, No. 14-73682 (9th Cir. Dec. 2, 2014), ECF No. 1.

[4] *See* Order, *Sierra Club v. United States*, No. 14-73682 (9th Cir. Jan. 20, 2015), ECF No. 16. These sentiments were echoed in comments to the proposed rule by environmental and safety groups. *See, e.g.*, comments of the Waterkeeper Alliance (Sept. 30, 2014), at 6-9; comments of Northwest Environmental Defense Center (Sept. 30, 2014) at 2; comments of safety and environmental groups (Sept. 30, 2014), at 1-2.

[5] Comments of the ACC (Sept. 30, 2014), at 7.

[6] Comments of the RS) Committee on Tank Cars (Sept. 30, 2014), at 25-26.

[7] Joint comments of the AAR and API (Sept. 30, 2014), at 2-3; *see also* comments of the North Dakota Petroleum Council and Independent Petroleum Association of America, at 3 (suggesting a six-year phase-out or retrofit deadline for jacketed and nonjacketed non-CPC-1232 cars and a 10-year phase-out or retrofit deadline for CPC-1232 nonjacketed cars).

[8] *See, e.g.*, NDPC and IPAA comments at 23; RSI comments at 7-9.

[9] AAR comments at 32.

[10] *See, e.g.*, NDPC and IPAA comments at 2-3 ("Due to the inefficiencies of this arrangement, railroads would likely require all shippers to modify their tanks [sic] cars in case they are assigned to an HHFT."); ACC comments at 4-6; comments of the API (Sept. 30, 2014), at 17 ("it is not practical for railroads to manage a mixed fleet of these cars to ensure that there are no more than 20 noncompliant cars in any given train.").

[11] Comments of the NTSB (Sept. 26, 2014) at 3, 13.

[12] Comments of the Institute of Makers of Explosives (Sept. 30, 2014), at 1-2; ACC comments at 4-6.

[13] *See* ACC comments at 2.

[14] *See, e.g.*, RSI comments at 8-9.

[15] Comments of the American Fuel and Petrochemical Manufacturers (Sept. 30, 2014), at 46.

[16] ACC comments at 4-6.

[17] PHMSA requested comment on three options for speed restrictions — in all areas; in areas with populations over 100,000; or in "High Threat Urban Areas." 79 Fed. Reg. at 45046-48, 45017-18.

[18] Comments of the AAR (Sept. 30, 2014), at 2-3 (detailing other voluntary safety measures for such trains, including improvements to track inspections, emergency response, etc.).

[19] *Id*. at 8; *see also id*. at 5-13; comments of the American Public Transportation Association (Sept. 30, 2014), at 2; comments of the States for Passenger Rail Coalition (Sept. 30, 2014), at 1-4 (noting the deleterious impact of further reductions in freight speed on passenger rail service, an area of considerable federal investment).

[20] *See, e.g.*, NTSB comments at 9-10; safety and environmental groups comments at 3.

[21] API comments at 32-37. RP 3000 is available on API's website, at: www.api.org/oil-and-natural-gas-overview/transporting-oil-and-natural-gas/rail-transportation/api-rp-3000.

[22] *See* RP 3000 § 5.6.; *see also* NDPC and IPAA comments at 5 ("API has put forth countless manhours toward assessing analytical methods, sampling methodology and studying the relationships between vapor pressure, volatility, flammability and ignitability. We look forward to the [September 2014] release of … API RP 3000 and will support their recommendations.").

[23] AFPM comments at 44-53.

[24] *Id*. at 45-46 (asserting that any prior errors in classification were harmless and "[s]uch back-office errors … do not mandate a wholesale revision to the HMR.").

[25] *Id*. at 45-49.

[26] *E.g.*, NTSB comments at 8-9 (also proposing to expand the testing program to all hazardous materials, not just Class 3 flammable liquids); Waterkeeper Alliance comments at 20-24.

[27] *See* NTSB comments at 8-9; Waterkeeper Alliance comments at 20-24 (also seeking corrosivity measurements for crude oil in the final rule); comments of the Northern Plains Resource Council (Sept. 12, 2014), at 1.

[28] RSI comments at 3-5; AFPM comments at 7-12; comments of the Domestic Energy Producers Alliance (undated), at 3; API comments at 11; Waterkeeper Alliance comments at 35-36.

[29] 79 Fed. Reg. at 45026-27.

[30] *Id*. at 45027.

[31] AAR comments at 43.

[32] 79 Fed. Reg. at 45061.

[33] RSI comments at 38-39; API comments at 18 ("This represents a profound lack of understanding of the Canadian crude oil market."). *But see* AAR comments at 42 (strongly supporting the use of existing tank cars without retrofitting for undiluted oil sands crude oil).

[34] Safety and environmental groups comments at 3; Waterkeeper Alliance comments at 11-12. A congressionally mandated, PHMSA-commissioned study now is underway to determine whether dilbit substantially differs from other liquid petroleum products in a spill scenario, such that changes to regulations on spill response, preparedness and cleanup may be warranted. *See* Study Website, at: www.nas-sites.org/dilbit/.

[35] *See* safety and environmental groups comments at 3; Waterkeeper Alliance comments at 11-12. Other public interest groups asked PHMSA to prohibit the use of DOT-111s in tar sands crude oil service altogether. *See, e.g.*, Northwest Environmental Defense Center comments at 2.

Sara E. Peters
Washington, D.C.
+1 202 626 2951

speters@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.

DISPUTE RESOLUTION
Business Litigation

Zachry Construction Corp.: The End to Indemnity for Exemplary Damages?

Craig Ledet, Ben Pollock

In August 2014, the Texas Supreme Court decided *Zachry Construction Corp. v. Port of Houston Authority of Harris County*, 2014 WL 4472616 (Tex.). While the case involves construction issues—and specifically the enforceability of "no damages for delay" clauses—key portions of the decision could have significant impacts on energy disputes. In particular, the case resolved an issue present in many energy cases that has long divided the Texas appellate system: whether a company can shield itself from liability for exemplary damages through contractual indemnity provisions. The *Zachry* Court ruled that contracts incentivizing reckless or intentional misconduct violate public policy (even when among sophisticated parties), and exceed acceptable limits of the freedom to contract. Its reasoning and dicta are even more broad and should spell the end of indemnity for exemplary damages.

A State Divided

The Texas Supreme Court had not previously held whether or not a pre-injury release or indemnity for gross negligence claims was against public policy, and a split had developed among the appellate courts. The issue generally arose when courts were called upon to interpret contractual clauses pursuant to the "express negligence test," which requires parties expressly and unambiguously to state within the contract's four corners that a party will be granted a release or indemnity for its own negligence. There has long been ample case law in Texas instructing practitioners on how to prepare contract provisions to satisfy the "express" and "conspicuousness" tests, but the case law has been somewhat divided on whether indemnity for gross negligence should be treated differently from indemnity for ordinary negligence.

One line of cases has said that a gross negligence claim is not a separate claim from negligence, and the difference between the claims is more of degree than kind. Found primarily in the opinions of the San Antonio appellate court, these cases noted that a party should be presumed to have meant "all shades of negligence" when it agreed to release or indemnify another party for its "negligence." Accordingly, these decisions held that a release from negligence claims also released claims for exemplary damages under a theory of gross negligence. Notably, these opinions expressly stated they either were not considering issues of public policy, or instead declared a contract between business entities should be interpreted as written and matters of public policy are best left to the Legislature or Supreme Court. *See Newman v. Tropical Visions, Inc.*, 891 S.W.2d 713 (Tex.App—San Antonio 1994); *Webb v. Lawson-Avila Construction Inc.*, 911 S.W.2d 457 (Tex.App.—San Antonio 1995).

On the other hand, appellate courts such as those in Dallas and Beaumont have found that releases purporting to exempt a party from liability arising from its own gross negligence are void as against public policy. These

opinions examined the differences between negligence and gross negligence, noting that the latter includes conduct posing an extreme risk of harm to others and an actor proceeding with conscious indifference to the rights, safety, and welfare of others. Further observing that a finding of gross negligence could trigger an award of exemplary damages, these courts concluded that claims of gross negligence are not included in release and indemnity agreements concerning "negligence," even when all aspects of the express negligence test otherwise are met. *See Smith v. Golden Triangle Raceway*, 708 S.W.2d 574 (Tex.App.—Beaumont 1986); *Van Voris v. Team Chop Shop, LLC*, 402 S.W.3d 915 (Tex.App.—Dallas 2013).

As a result, contracting parties who specify that Texas law will govern their agreements have faced uncertainty concerning the manner in which indemnity and release provisions might be construed. And woe to those who had agreed to the Harris County courts as the exclusive venue for disputes, as the Houston First and Fourteenth appellate courts developed their own split along the lines cited above! *Compare Tesoro Petroleum Corp. v. Nabors Drilling USA, Inc.*, 106 S.W.3d 118 (Tex.App.—Houston [1st Dist.] 2002 (agreeing with *Newman*) with *Del Carmen Canas v. Centerpoint Energy Resources Corp.*, 418 S.W.3d 312 (Tex.App.—Houston [14th Dist.] 2013 (agreeing with *Van Voris*).

The Impact of Zachry

The *Zachry* case should be considered to have resolved this split. The dispute in *Zachry* concerned a contract provision by which Zachry agreed the Port would not be required to pay delay damages even if delays were due to the Port's negligence, breach of contract, or other fault. Instead, Zachry's sole remedy would be an extension of time to complete the project. However, a jury found the Port to have engaged in arbitrary and capricious conduct, active interference, bad faith and/or fraud, and further found such conduct was responsible for the project's delays. Under these circumstances, the Texas Supreme Court held the "no damages for delay" provision unenforceable, and that the owner could not shield itself from liability after deliberately and wrongfully interfering with the work.

Other commentators have ably recognized the impact of this decision upon parties' ability to shift risk in construction contracts, and that certain common-law exceptions are now established as applicable to limit "no damages for delay" clauses. But the language employed in *Zachry* is broader and seems clearly to apply also to general release and indemnity agreements, including those found in energy contracts. The Court declared that "exempting a party from tort liability for harm caused intentionally or recklessly is unenforceable on ground of public policy," and expressly extended this principle to contract liability. Indeed, the Court recognized that to "conclude otherwise would incentivize wrongful conduct and damage contractual relations." The Court rejected the argument that parties should maintain the freedom to contract for such provisions if they choose, flatly stating "that freedom has limits." Nor was the Court persuaded that the rule should be applied differently to a sophisticated party like a large construction company, declaring that "the law's protection against intentional injury is not limited to the helpless." 2014 WL 4472616 at *10.

Although *Zachry* was examining a "no damage for delay" clause impacted by "arbitrary and capricious" behavior, its reasoning is not so limited. The opinion's language should neuter any further argument that a party can contractually exculpate itself from liability for damage caused by its intentional or reckless misconduct. And while the Court had not decided the issue before, its opinion in *Zachry* stated that the Court had previously "indicated" that pre-injury waivers of future liability for gross negligence were be void as against public policy. As a result, release and indemnity agreements that concern "negligence" claims no longer should be interpreted to include claims of gross negligence, much less allegations requiring a higher standard. And thus, such provisions cannot shift the risk of exemplary damages awards from one party to another.

For indemnitors this result should be hailed as proper and just. It seems hardly fair for a party to agree to indemnify another for negligent acts, only to discover after a catastrophic event that it also bears responsibility for the intentional or grossly negligent acts of the indemnitee. Parties should not be incentivized to be reckless by the belief that they have contractual protection. Nor should negotiating parties be expected to evaluate the likelihood and cost of the other party acting fraudulently or in bad faith.

Best practice remains to be specific when drafting contractual provisions, and to expressly state that claims of gross negligence, malice, fraud, and other intentional misconduct are not included in any release or indemnity obligation. But after *Zachry*, a party should recognize it cannot rely upon release or indemnity provisions to shield itself from liability for gross negligence or intentional misconduct.

Craig Ledet
Houston
+1 713 276 7426
cledet@kslaw.com
View Profile »

Ben Pollock
Houston
+1 713 276 7338
bpollock@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.

King & Spalding

Energy Newsletter

March 2015

REGULATORY
FERC

ISO and RTO Responses to FERC Data Requests Fail to Provide Clear Support for Proposed Gas Day Rulemaking

William E. Rice

The Federal Energy Regulatory Commission (FERC) recently employed the somewhat unusual device of issuing data requests to electric power industry participants in an attempt to obtain information that might support a controversial proposed rulemaking that would change the ways in which the natural gas and electric power industries interact. Not only did the responses fail to provide objective support for FERC's proposal, they suggest that significant portions of the United States might not realize any benefit from the changes FERC has proposed.

In March 2014, FERC issued a notice of proposed rulemaking ("NOPR") in which it proposed to change the start of the "Gas Day" – the 24-hour period during which natural gas transportation through pipelines is nominated and scheduled – from 9:00 a.m. to 4:00 a.m. Central Clock Time (CCT), and to make other changes to the natural gas transportation nominations schedule, to better coordinate the scheduling of natural gas and electricity markets (Docket No. RM14-2-000). The NOPR is part of FERC's ongoing effort to promote electric supply reliability by encouraging improved coordination between the natural gas and electric power industries.

The proposed change in the Gas Day is FERC's response to electric industry requests to make the Gas Day coincide with the electric day, which generally begins at 12:00 midnight *local time*. Noting the benefit of a standardized nationwide Gas Day, rather than one that begins at different times, FERC has declined to make this change. Instead, FERC proposed changes in the Gas Day that it reasoned would promote electric generation efficiency by allowing generators to schedule their gas transportation and supply on a day-ahead basis. The 4:00 a.m. Gas Day would start before the morning ramp-up in electric demand. With the current 9:00 a.m. CCT Gas Day, the morning ramp-up occurs near the end of each Gas Day, a time at which there is little flexibility for generators to arrange changes in gas supply and transportation arrangements.

Over 75 individuals, groups and organizations filed comments on FERC's NOPR in late November. The comments reflect a sharp disagreement between natural gas and electric industry participants. Electric industry comments, filed by independent electric transmission system operators ("ISOs"), regional transmission organizations ("RTOs") and electric power generators, strongly support the proposed 4:00 a.m. CCT Gas Day start time. Electric sector interests generally concur that the change would achieve the benefits that FERC describes in the NOPR. Commentors aligned with the natural gas industry, on the other hand, strongly oppose the change in the start of the Gas Day, citing safety and staffing concerns. They observed that advancing the start of the Gas Day to 4:00 a.m. CCT would compel industry participants to undertake significant activities in the middle of the night, and that computer system modifications required to implement

the modified Gas Day would be costly. One commentor estimated that it would cost the natural gas industry "hundreds of millions of dollars" to implement the Gas Day change.

Shortly after receiving comments on the NOPR, FERC solicited information that might support its proposed rulemaking. In December 2014, FERC sent data requests to six ISOs and RTOs seeking information regarding circumstances that might be mitigated by the proposed rulemaking. The recipients were California ISO ("CAISO"), Southwest Power Pool ("SPP"), Midcontinent ISO ("MISO"), ISO-New England ("ISO-NE"), New York ISO ("NYISO"), and PJM Interconnection ("PJM"). FERC asked how often natural gas-fired generation facilities were declared unavailable or operated at reduced output because the generators had exhausted their daily nomination of natural gas transportation service before the end of the Gas Day. The ISOs and RTOs filed responses on January 22, 2015.

CAISO stated that it has not located any record of a natural gas-fired generator that had to de-rate a unit because the generator had exhausted its daily nomination of natural gas transportation service before the Gas Day had ended. CAISO went on to state that "natural gas-fired generators operating in the CAISO balancing authority generally do not face problems securing sufficient fuel to meet the morning electric ramp under existing electric and gas market timelines."

MISO stated that its data "does not contain the level of detail and specificity to reflect if the fuel-related outages were specifically due to the generators having exhausted their daily nomination of natural gas transportation service prior to the end of the gas day." But it noted that "MISO has not experienced any significant impacts caused by generators running out of natural gas during the morning ramp."

SPP said it does not collect data on the underlying causes of generation de-rates. SPP noted that it does not require generators to submit information related to their nominated gas transportation, and thus does not have information that would be responsive to the request.

Only ISO-NE, NYISO, and PJM indicated that they had experienced circumstances in which gas-fired generators had to de-rate because they had exhausted natural gas transportation service nominations prior to the morning ramp. Even these responses, however, were less than decisive. ISO-NE stated that "ISO-NE does not have specific information regarding whether the de-rates occurred solely due to the exhaustion of gas nominations, but given the timing of the de-rates, ISO-NE believes this is likely the cause of the de-rates."

Several organizations subsequently filed comments asserting that the RTO/ISO responses do not justify FERC's proposed changes to the Gas Day. The Natural Gas Council ("NGC"), representing ten major natural gas industry and customer associations, characterized the NOPR as based on "unsupported assertions" that generators would benefit from an earlier Gas Day. NGC stated that the "RTO/ISO responses clearly confirm that there is not a nationwide problem during the morning electric ramp associated with the current start time of the Gas Day." It was also critical of the grid operators for failing to provide details on whether generators claiming insufficient fuel had contracted for firm or interruptible transportation services. These comments mirror earlier comments that had noted generally that the change in Gas Day start time cannot overcome electric generators' election to refrain from contracting for firm services. Commenters offering this observation stated that firm contractual commitments on the part of electric generators would provide support for the development of needed pipeline infrastructure. Comments raising similar arguments were filed by American Public Gas Association, the New England Local Distribution Companies and the Coalition for Enhanced Electric and Gas Reliability.

The ISO/RTO responses to FERC's data requests fall short of providing objective support for FERC's proposed Gas Day rulemaking. At most, they suggest that the potential benefits of changes to the Gas Day would be limited to certain regions.

Before the ISOs and RTOs had filed their responses, a number of observers seemed to regard FERC's adoption of the proposed changes to the Gas Day and nominations schedule as a near certainty. These responses and subsequent comments may make it more difficult for FERC to justify a rulemaking decision that commentors argue would saddle the natural gas industry with significant costs, but may only have limited

benefits to the electric industry.

FERC is expected to act on the NOPR as early as this spring.

William E. Rice
Washington, D.C.
+1 202 626 9602
wrice@kslaw.com
View Profile »

The content of this publication and any attachments are not intended to be and should not be relied upon as legal advice.