KING & SPALDING

Energy Newsletter

TRANSACTIONAL

Transactions

First AIPN Model Contract for Unconventional Resource Operations

Trinh Chubbock

The new AIPN 2014 Model Unconventional Resources Operating Agreement (UROA) addresses issues unique to unconventional resources such as pilot projects, sub-areas, multi-pad drilling and production, and other aspects of horizontal drilling. **More »**

Corporate/London

A Cautionary Tale: English Courts Further Depart from a Traditional Approach to Liquidated Damages in *Unaoil v Leighton*

Laura Kane, Alex Blomfield

An English court recently handed down an unprecedented decision concerning a liquidated damages clause that may have a number of practical implications on contract amendments governed by English law. **More »**

REGULATORY

FERC

FERC Issues Declaratory Order Disclaiming Jurisdiction Over Proposed CNG Facility

James F. Bowe, Jr., William E. Rice

FERC recently issued a declaratory order holding that it would not have jurisdiction under the Natural Gas Act over the construction or operation of a proposed compressed natural gas facility at the Port of Palm Beach, Florida.
More »

Environmental

Pennsylvania and Ohio regulatory efforts regarding NORM/TERNORM in oil and gas production wastes

Lynn Kerr McKay

Regulators in Pennsylvania and Ohio are taking steps to address the presence of naturally occurring, and "technologically enhanced naturally occurring," radioactive materials in shale gas wastes.
More »

DISPUTE RESOLUTION

Oil & Gas Litigation

Terms & Conditions under Texas Law: A Potential Liability Trap for

November 2014

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

Upcoming Events

Bowe speaks on U.S. LNG exports for Oil & Gas Journal webcast

**When: Friday,
14 November 2014**

For further details, please click here »

LNG Roundtable Lunch, London

**When: Wednesday,
19 November 2014**

Please contact Lara Hayes at lhayes@kslaw.com, for further details.

In The News

The allocation and documentation of hydrological risk **More »**

Saudi Arabia: An economy on the up **More »**

King & Spalding Advises Patagonia on $27 Million Hawaiian Solar Fund
More »

Oilfield Operators

Brannon Robertson, Jay Goosen

In the absence of a master service agreement, operators need to be aware that an oilfield service company's terms and conditions will be legally enforceable if they are conspicuous, clearly defined, and signed by an authorized agent. **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 255 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.

KING & SPALDING

Energy Newsletter

November 2014

TRANSACTIONAL

Transactions/Mexico

First AIPN Model Contract for Unconventional Resource Operations

Trinh Chubbock

Concluding two years of work by a drafting committee comprised of more than 160 industry representatives from 26 countries spread across five continents, the Association of International Petroleum Negotiators (AIPN) on 25 September 2014 published the new AIPN 2014 Model Unconventional Resources Operating Agreement (UROA) together with relevant guidance notes. The UROA is the first operating agreement specifically to cover joint operations in shale oil and gas, tight oil and gas, coalbed methane and other unconventional production methodologies involving wellbore operations.

Based on the AIPN 2012 Model International Joint Operating Agreement (JOA), the UROA includes key modifications to address issues unique to unconventional resources such as pilot projects, sub-areas, multi-pad drilling and production and other aspects of horizontal drilling. In addition to providing guidance notes on the various modifications to the JOA, the AIPN also highlights critical issues in negotiating and securing granting instruments for unconventional resources. The AIPN also held a workshop on the UROA at its International Conference in Budapest, Hungary on 8 October 2014.

Unconventional Resource Operations vs. Conventional Resource Operations

Addressing the need for the UROA, the AIPN assesses and highlights the key operational differences between a conventional and an unconventional resource development project.

Resource Plays

Unlike conventional resources, unconventional resources do not involve reservoirs or accumulations of petroleum. Instead, shale gas deposits, for example, are located in low matrix impermeable source rocks which require significant manual manipulation in the form of hydraulic fracturing (fracking) in order to create permeability to allow migration of captive gas into an incoming well bore. As such, there is no 'discovery' but only identification of a geological horizon with hydrocarbon rich shales (*i.e.*, resource plays).

Multi-pad drilling and vertical and horizontal wells

Conventional resource drilling is targeted to exploit reservoir high points near mature source rocks to allow hydrocarbons to flow to the surface. Unconventional shale gas drilling, on the other hand, involves multiple closely spaced vertical wells and horizontal wells (increasingly through the use of multi-pad drilling) to create maximum borehole surface area in contact with the shale to allow production of greater quantities of shale gas. Given the low permeability of shale resources, vertical and horizontal drilling techniques, together with fracking, are required to create production rates of sufficient levels to make a development economic.

Pilot projects and sweet spots

Every shale is different and every shale can react differently to varying technologies and techniques. The objective of a shale gas project is, therefore, to find the best producing locations (*i.e.*, sweet spots) and determine the most effective techniques. This objective is achieved by undertaking pilot projects either as the final part of an appraisal programme or as a precursor to a development programme.

Gas production profile

Shale gas resource plays differ from conventional gas plays in that shale acts as both the source for the gas and also the zone in which the gas is trapped - gas may be held in a matrix of natural fractures or pores (similar to conventional resources) or attached onto organic material in the shale. As a result of the gas storage properties of shale, three processes are at play during production. Initial gas production is dominated by depletion of gas from the fractured network followed by depletion of gas stored in the matrix of pores. Thereafter, gas is released from the rock as pressure in the reservoir declines. The overlapping production processes results in the characteristic hyperbolic production profile of shale gas operations. Further, unlike conventional resource plays, shale gas plays provide less certainty as to how the project will perform over time.

Overall project profile

Conventional resource operations generally have well defined stages of exploration, appraisal, development and production. Unconventional resource operations, on the other hand, are less likely to be undertaken in series. Given that shale can react to different technologies and techniques, different stages can be ongoing and overlapping at any one time – the overall shale project is therefore continuously evolving. This, of course, further contributes to the variable production profile over the entire shale gas programme as wells deplete and new wells are drilled, appraised and brought on stream.

Granting Instrument Modifications

The AIPN also provides guidance on the necessary modifications to the underlying granting instrument in order to deal with the distinction between a conventional and unconventional resource project. Set out below are a few key considerations but note, however, that the contractor will be confined by the laws of the host country in this respect.

Term and project stages

The exploration and exploitation periods in an unconventional resource project should be longer in order to cater to the operational realities of unconventional resource projects. The exploration period should be as short as possible, however, in order that cost recovery (if available) can begin. The exploitation period, on the other hand, should be as long as possible in order to ensure commerciality. The AIPN suggests that this period extends for so long as there is production in paying quantities or for at least 35 years with a right to further extend (not subject to governmental discretion).

Further, the contractor must be able to delineate the resource play. Given the requirement of pilot projects to determine sweet spots and the best techniques for production, the contractor must also ensure that a pilot project is provided within the appraisal programme or, if production is not permitted prior to a declaration of commerciality and commitment to production under the granting law, is carried out during the first phase of development. Importantly, the failure of such pilot project should permit the contractor to terminate the development programme.

Contract area / relinquishment / exploitation area

The contract area should be as large as possible to cover sufficient resource to render the project commercial.

Given the geological characteristics of shale gas and the operational requirements for commercialisation of such shale gas, the contractor should resist relinquishment altogether or consider delaying the requirement to relinquish until no earlier than such time commercialisation can be established. Surface facilities, however, should not be relinquished even if the underlying resource is relinquished.

Given that there is no 'reservoir' as such but instead many potential exploitation sub-areas within the contract area, exploitation sub-areas must be defined on some basis other than by accumulation - the AIPN suggests either the area drained by multiple wells from a single pad or an area defined as a grid (*e.g.*, 3x3 km).

Joint Operating Agreement Modifications

As mentioned above, the JOA requires a number of key modifications in order to meet the requirements of an unconventional resource operation. The AIPN proposes, among others, the amendments discussed below and provides relevant guidance notes.

Definitions

The technologies and methodologies used in unconventional resource development are not adequately catered for in the current definitions of a conventional JOA. Many definitions, therefore, have been added or amended to reflect the physical requirements of unconventional resource operations such as, for example, pilot programme (and whether this forms part of the appraisal or development programme), horizontal well, multi-pad drilling facility (MPPF), sub-area and drilling pad drainage area. The AIPN advises, however, that the UROA definitions should be reconciled with the definitions in the relevant granting instrument together with the law of the host country and other applicable laws.

Scope

In a conventional JOA, property (*e.g.*, an offshore platform) is owned by all the relevant parties jointly, so if a party transfers its interests under the granting instrument and the JOA to a third party, a corresponding proportional interest of the joint property will also be transferred to the third party. Some commentators suggest, however, that for an unconventional resource project, depending on applicable law and the granting instrument, it may be more feasible to establish a joint venture company to hold property interests.

In an onshore unconventional resource project, the key property interest of the parties is the ownership of, or a right of access to, the surface area land interests from which the drilling operations will be conducted and upon which the storage of any production will take place. In some jurisdictions, land interests may be held severally between parties (for example, in accordance with each party's corresponding participating interest) but this fractional entitlement could prove difficult in practice to effect, in particular where the title interest to the land rights must be transferred (which could involve a host of formalities including registration of land rights and ownership) as part of a wider transfer of interest to a third party of the unconventional resource project.

Where a proposed MPPF would be used to process production from more than one contract area or the capacity allocation would be different from the proportion corresponding to the participating interests of the parties, then such MPPF should be built, owned and operated under a separate arrangement to the UROA.

If property (including land) is held in a joint venture company within which each relevant party hold shares, future transfer by a party of its interests in the unconventional resource project could be simplified. Alternatively, such interests could be held by the operator on behalf of the co-venturers.

Operating Committee

The decision making function of the operating committee should include the commerciality of unconventional resource, the conduct of a pilot project and the construction, installation and operation of MPPFs.

Parties should consider whether the customary non-consent right of a party under a JOA is appropriate in the context of unconventional resource projects. Commentators suggest that, given the variable economic and productive profile of unconventional resource projects, a party should not have a non-consent right in such projects – a party should be fully committed to the agreed joint operation that the agreed overall project development plan represents.

Similarly, parties should also consider whether a sole risk project is appropriate. Unconventional resource projects involve very careful management of the resource base in order to maximize the recovery of petroleum from a deposit that typically presents a very narrow range of realisable opportunity. Therefore, allowing a party to undertake sole risk operations could operate to the detriment of the wider interests of the project.

If parties wish to remove non-consent rights and sole risk operations, consideration should be given to the effect of such removal to ensure that no party should be compelled to participate in operations that it has not approved or be prevented from conducting the operations it wishes to perform. Further, parties should also consider including a mechanism to address any deadlocks in the decision making process in this respect.

Work Programmes & Budget

The work programme and budget should incorporate certain activities specific to unconventional resource operations such as the designation of an unconventional resource (rather than a discovery), the identification of sub-areas and the conduct of pilot programmes. Further, any development plan should include a description of applicable MPPFs.

Given the variable economic and operational profiles of an unconventional resource project, flexibility may be built into the work programmes and budget. For example, flexibility can be provided through increased over-expenditure limits or through defining work in terms of objectives rather than activities.

Further, the parties should consider providing the operator with a greater degree of flexibility in order that the operator may respond to changing circumstances as the unconventional resource project unfolds. The operator may be provided discretionary authority to adjust the approved development plan and the approved annual work programmes, together with the corresponding budgets, without the need for formal approval by the operating committee. Limits, however, should be applied to such greater flexibility.

Exclusive Operations

As mentioned above, some commentators suggest that sole risk operations in unconventional resource projects are not appropriate due to the need to manage carefully the resource base in order to maximise the recovery of petroleum and the potential for any sole risk operations to operate to the detriment of the wider project interests. Other commentators, however, suggest the need for sole risk operations precisely for the same reasons. If sole risk operations are permitted, the sole risk operations should be expanded to also include the conduct of pilot projects and the construction, installation and operation of MPPFs. Further, consideration should be given to the timing of any right by a non-participating party to reinstate, and the premium attributable to reinstating in, such sole risk operations.

Disposition of Production

Regardless of whether a pilot programme is conducted during the appraisal period or the exploitation period, the parties require a mechanism to allocate revenues from the sale of pilot programme production of shale gas. In the UROA, the provisions on the disposition of production is simply amended to include pilot projects where applicable.

Conclusion

Given the key operational differences between a conventional and an unconventional resource development project, it is clear that the JOA must evolve to meet the needs of unconventional resource operations such as shale gas projects. Responding to this demand, the UROA is the first operating agreement specifically to cover joint operations in shale oil and gas, tight oil and gas, coalbed methane and other unconventional production methodologies involving wellbore operations. As a model contract, the AIPN emphasises that the UROA seeks to reflect current and evolving industry practices. The UROA does not, however, solve all the problems or is fitting in all situations; instead, it offers solutions including options and alternatives. The AIPN advises that local counsel advice should always be taken.

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

KING & SPALDING

Energy Newsletter

November 2014

TRANSACTIONAL
Corporate/London

A Cautionary Tale: English Courts Further Depart from a Traditional Approach to Liquidated Damages in *Unaoil v Leighton*

Laura Kane, Alex Blomfield

In September 2014, the Commercial Court handed down an unprecedented decision, finding that a liquidated damages ("LD") clause in a contract was a "genuine pre-estimate of loss" at the time the parties entered into the contract, but later became a penalty upon amendment to reduce the contract price. The decision of Mr. Justice Eder in *Unaoil Ltd v. Leighton Offshore Pte Ltd* [2014] EWHC 2965 (Comm) ("*Unaoil v Leighton"*) breaks new ground, departs from previously well-established rules of interpretation, and may have a number of practical implications on contract amendments governed by English law.

What Happened?

In 2010, the claimant, Unaoil (a provider of services to the oil and gas sector in the Middle East, Central Asia and Africa) approached the defendant, Leighton (a leading international contractor, particularly active in the mining and resources sector), with a view to the two companies working together to obtain work on a crude oil expansion project in Iraq. Upon agreeing to work together, the parties entered into various documents concerning different phases of the expansion project pursuant to which Unaoil would act as a subcontractor to Leighton. These documents included a Memorandum of Agreement signed in December 2010 (the "MOA") in relation to the construction of an oil pipeline in the south of Iraq (the "Project") for the Iraqi state-owned South Oil Company ("SOC").

Pursuant to the MOA Leighton agreed that, should it succeed in winning the Project, it would appoint Unaoil as its subcontractor for the onshore construction works for the Project. The MOA contained an all-inclusive contract price of US $75 million, with LDs of US $40 million payable to Unaoil in the event that Leighton failed to adhere to the terms of the MOA. The LD provision of the MOA read as follows:

> *If LEIGHTON OFFSHORE is awarded the contract for the PROJECT by the Client, and LEIGHTON OFFSHORE does not subsequently adhere to the terms of this MOA and is accordingly in breach hereof, LEIGHTON OFFSHORE shall pay to UNAOIL liquidated damages in the total amount of USD 40,000,000 (Forty million US dollars). After careful consideration by the Parties, the Parties agree such amount is proportionate in all respects and is a genuine pre-estimate of the loss that UNAOIL would incur as a result of LEIGHTON OFFSHORE's failure to honour the terms of the MOA.*

Subsequently, in April 2011, the parties entered into a supplementary agreement which amended the MOA so as to reduce the contract price of US $75 million to US $55 million (the "Amendment"). Significantly, the Amendment did not vary the LD amount of US $40 million.

In or around October 2011, SOC awarded Leighton the role of main contractor for the Project.

In January 2012, Unaoil sent invoices to Leighton claiming the first two advance payments due to it under the MOA. Leighton rejected these invoices, on the basis that SOC did not approve Unaoil as a subcontractor and the MOA was therefore null and void. Unaoil remained ready, willing and able to perform its obligations under the MOA, as amended, at all material times, and issued proceedings against Leighton in April 2012 for three main claims: (1) recovery of the advance payments as a debt; (2) damages for loss of profits; and (3) LDs of US $40 million.

The Decision

Eder J upheld Unaoil's debt claim and found Leighton liable for damages, although his Honour assessed an amount of damages less than the debt and therefore such claim did not alter the total award. However, the most intriguing and perhaps controversial part of the judgment related to Unaoil's claim for LDs, which his Honour ultimately rejected on the basis that the LD clause constitutes an unenforceable penalty.

Proceeding on the assumption that Leighton failed to adhere to the terms of the MOA, his Honour accepted that (a) Leighton became, or would in due course become, *prima facie* liable to pay US $40 million by way of LDs to Unaoil, [1] (b) at the time of the original MOA (when the contract price was US $75 million), the figure of US $40 million was a genuine pre-estimate of the loss likely to be suffered by Unaoil in the event of Leighton's repudiation, and (c) the question of whether a clause is a penalty or not must be viewed as at the date of the contract. [2]

And this is where it gets interesting. Where, as in this case, the contract is amended in a "relevant respect," the relevant date of the contract is, in his Honour's opinion, the date of the Amendment, rather than the date of the original MOA. In his Honour's own words: [3]

> *So far as I am aware, there is no authority to such effect but it seems to me that this is consistent with the general principle. Here, once the original contract price was reduced by [the Amendment], the figure of US $40 million was, even on Unaoil's own evidence, manifestly one which could no longer be a genuine pre-estimate of likely loss by a very significant margin indeed…The reason why the figure of US $40 million was not reduced at the same time as when the contract price was reduced was not explained. Perhaps it was an oversight. I do not know. In any event, once the original contract price was reduced, it was, on any objective view, "extravagant and unconscionable with a predominant function of deterrence" without any other commercial justification for the clause.*

Unprecedented, Yet Perhaps the Way Forward?

Whilst the decision in *Unaoil v. Leighton* is unprecedented, it appears logical and comes at a time when recent UK authorities have demonstrated that the question of whether a clause is penal should not be answered by assuming a complete dichotomy between what is and what is not a genuine pre-estimate of damage at the time of entering the contract, and treating as a penalty anything that does not fall within the former category. [4] Rather, the Courts have shown an increasing willingness to adopt a more flexible and wide-reaching approach to interpreting LD clauses, rather than adhering strictly to the traditional approach. The following cases demonstrate this evolution:

- in 1996, in *Lordsvale Finance plc v. Zambia* [1996] QB 752, the Court held that there seemed to be no reason why a contractual provision, the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as "commercially justifiable," provided its dominant purpose was not to deter the other party from breach; [5]

- in 2004, in *Cine Bes Filmcilik ve Yapimcilik v. United International Pictures* [2004], the Court held, following *Lordsvale*, that a dichotomy between a genuine pre-estimate of damages and a penalty does not necessarily cover all the possibilities. There are clauses which may operate on breach, but which fall into neither category, and they may be commercially perfectly justifiable; [6]

- in 2005, in *Murray v. Leisureplay* [2005] EWCA Civ 963, the Court held that the fact that a clause may result in a greater recovery than the actual loss did not automatically mean that without further justification the clause was penal. Such comparison is relevant but no more than a guide to the answer to the question whether the clause is penal. Rather, a penal clause needed to be extravagant and unconscionable. Further, a clause may still be commercially justifiable, provided that its dominant purpose is not to deter the other party from breach; [7]

- in 2010, in *Azimut-Benetti SpA (Benetti Division) v. Darrell Marcus Healey* [2010] EWHC 2234 (Comm), the Court held that, although it may not represent a genuine pre-estimate of loss, the purpose of the clause in question was not deterrent and that it was commercially justifiable as providing a balance between the parties upon lawful termination. The terms were freely entered into and in a commercial contract of this kind, what the parties have agreed should normally be upheld; [8] and

- most recently, in 2013 in *Talal El Makdessi v. Cavendish Square Holdings BV* [2013] EWCA Civ 153, the Court of Appeal looked to a number of tests and distinguished between what it referred to as the "old approach" (the traditional dichotomy, referred to above) and the "new approach" (as per *Lordsvale* and *Murray*). Applying the new approach to characterising a clause as a penalty, the Court in *Makdessi* concluded that merely considering whether a clause represents a genuine pre-estimate of loss or is otherwise extravagant and unreasonable is not conclusive evidence of a penalty. Rather, the court must go on to consider whether there was a good commercial justification for the clause and if there is, a clause which is not a genuine pre-estimate of loss may not necessarily be penal. [9]

But what does it all mean?

Recent case law, culminating in *Unaoil v. Leighton*, demonstrates the Court's willingness to adopt a more flexible approach when it comes to the enforceability of LD clauses and not shy away from breaking new ground. In *Unaoil v. Leighton*, Eber J made particular note of the fact that in that case, the MOA was "very badly drafted" and that the disputes that were the subject of the proceedings were "probably due, in large part, to such bad drafting". [10]

Practically speaking, this means that during contractual negotiation and amendment, parties cannot simply seek to rely on the inclusion of express wording in the contract that the agreed LDs constitute a genuine pre-estimate of loss. Parties instead need to have a heightened sense of awareness as to whether any amount specified in an LD clause is reasonable, commercially justifiable and/or actually a genuine pre-estimate of loss *at that time*. Importantly, contracting parties should consider whether they have amended the contract in any "relevant respect" that may impact on a previously agreed LD clause. If not, the relevant date for analysing the clause will remain the original contract date. If so, the relevant date may well become the date of such amendment. Obviously a large reduction in contract price provides just one example (albeit, a very good one) and what might otherwise constitute such a relevant amendment needs to be considered on a case-by-case basis. Other examples to bear in mind include:

- an amendment to the completion, or taking over date, under a construction contract;

- a change to the price of liquefied natural gas ("LNG"), or delivery schedule, in a sale and purchase agreement for LNG;

- a change in the price of electricity in a power purchase agreement ("PPA"), or the scheduled commercial operation date under such PPA; and

- a change in the scope of a construction contract, which will delay the work of other construction contractors and increase the likelihood of delay claims by such other construction contractors, which may have an impact upon LD calculations made in the original contract.

---

[1] At para. 68.
[2] At para. 68.
[3] At para. 71.
[4] As contended by Counsel for Leighton at para. 69, referring to the judgment of *Talal El Makdessi v. Cavendish Square Holdings BV* [2013] EWCA Civ 1539, at para. 54.
[5] At page 764.
[6] At para. 15.
[7] At para. 106.
[8] At para. 29.
[9] At para. 117, with reference to the earlier notable decision of *Lordsvale*, which arguably paved the way for consideration as to whether a clause was "commercially justifiable" and not just a genuine pre-estimate of loss.
[10] At para. 15.

Laura Kane
Singapore
+65 6303 6085
lkane@kslaw.com
View Profile »

Alex Blomfield
London
+44 20 7551 2142
ablomfield@kslaw.com
View Profile »

KING & SPALDING

Energy Newsletter

November 2014

REGULATORY
FERC

FERC Issues Declaratory Order Disclaiming Jurisdiction Over Proposed CNG Facility

James F. Bowe, Jr., William E. Rice

On September 19, 2014, FERC issued a declaratory order holding that it would not have jurisdiction under the Natural Gas Act ("NGA") over the construction or operation of a compressed natural gas ("CNG") facility that Emera CNG, LLC ("Emera") proposed to construct at the Port of Palm Beach, Florida. *Emera CNG, LLC*, 148 FERC ¶ 61,219 (2014). The interest in developing CNG and liquefied natural gas ("LNG") facilities to support natural gas exports and the development of marine and vehicular fuel markets is keen as various parties seek new markets for abundant supplies of natural gas now being produced in the United States. The *Emera* order is the latest in a series of declaratory orders through which the Commission is defining its position on the jurisdictional status of small- and mid-scale CNG and LNG facilities. *See Pivotal LNG, Inc.*, 148 FERC ¶ 61,164 (2014); *Shell U.S. Gas & Power, LLC*, 148 FERC ¶ 61,163 (2014); *Gulf Oil Limited Partnership*, 148 FERC ¶ 61,029 (2014).

Emera proposes to construct a CNG compression and truck-loading facility in Riviera Beach, Florida, for the primary purpose of compressing natural gas into containers for export in the form of CNG to the Bahamas. Emera's CNG plant would include facilities to compress gas into International Standards Organization ("ISO") containers. Emera plans to truck the ISO containers a distance of approximately a quarter mile before loading them at the Port of Palm Beach onto roll-on/roll-off ocean-going carriers. In response to Emera's March 20, 2014 petition for declaratory order, the Commission determined that the proposed CNG facility would not be subject to its NGA Section 3 authority over natural gas import and export facilities or its NGA Section 7 authority to regulate interstate transportation and sales of natural gas.

The Commission noted that it has interpreted its Section 3 jurisdiction, consistent with its interpretation of its Section 7 jurisdiction, as limited to the transportation of natural gas by pipeline. It observed that is has only exercised its authority under Section 3 to regulate: (1) pipelines that transport natural gas to or from the United States' international borders; and (2) coastal LNG terminals that are accessible to ocean-going LNG tankers and connected to pipelines that deliver gas to or take gas away from the terminal. Because the Emera facility will not include a pipeline capable of transferring CNG directly into ships, the Commission found that Emera's CNG facility, which would compress natural gas into containers to be transported by trucks before being loaded onto ocean-going vessels, is unlike the border-crossing pipelines and coastal LNG terminals that it traditionally has regulated under Section 3.

The Commission went on to conclude that its Section 7 jurisdiction would not be implicated in the case of the Emera project because all of the CNG will be exported in foreign commerce, not transported by pipeline in interstate commerce. Noting that its jurisdiction over transportation and sales in interstate commerce only applies to gas transported by pipeline, the Commission held that Section 7 would not apply because Emera will compress gas into containers that will be moved by truck (not by pipeline) to a dock where the containers will be loaded on ships. The Commission held that Section 7 jurisdiction will not attach because Emera will receive its gas from a non-jurisdictional Hinshaw pipeline (Peninsula Pipeline Company's Riviera Lateral). Thus, the gas will have left jurisdictional interstate commerce before reaching Emera and will never re-enter interstate commerce (*i.e.*, will not be transported from Florida to another state).

Floridian Natural Gas Storage Co. ("Floridian") protested Emera's petition, claiming that the Commission's assertion of jurisdiction over the Emera CNG facility would be necessary to prevent a regulatory gap that would give Emera an unfair competitive advantage. The Commission has granted Floridian certificate authorization under the NGA to construct storage, liquefaction, revaporization, and LNG truck-loading facilities in Florida. The Commission rejected Floridian's position that Emera's CNG facility should be regulated as an "LNG Terminal" because CNG and LNG are different products. It went on to dismiss Floridian's claim that the possibility of a regulatory gap should lead to the assertion of NGA jurisdiction, declining to create jurisdiction where none exists under the NGA. FERC further noted that Emera's CNG facility will not escape regulation altogether because it will be subject to DOE, EPA and Coast Guard requirements.

Commissioner Bay issued a dissent in which he disagreed with the majority's Section 3 analysis. In his view, the majority's conclusion that the use of trucks, rather than a pipeline to transport CNG the short distance between the CNG facility and waterborne vessels, disregards Congressional intent to regulate imports and exports of natural gas. In his view, "[i]t cannot be that the Commission's jurisdiction turns on this 440-yard truck journey." He would hold that the Emera facility should be regarded as a natural gas export facility regardless of the manner in which the CNG leaves the compression facility.

Commissioner Bay lodged a similar dissent disagreeing with the majority's analysis in the *Shell* case, where the Commission concluded that a facility receiving LNG imported from Canada via waterborne vessel, truck, and/or train would not be subject to FERC's Section 3 jurisdiction because of the lack of a pipeline connecting it to the international border. Commissioner Bay concluded in *Shell* that the plain meaning of the statute compels a different result because, in his view, Congress identified the importance of regulating natural gas imports and exports and intended the scope of Section 3 to be broader than Section 7.

Commissioner Bay's dissents may signal a split among the Commissioners which could become more pronounced when the fifth Commissioner is seated or when Commissioner Bay becomes Chairman next April. If Commissioner Bay's interpretation of Section 3 were to become the majority view, FERC could exercise Section 3 jurisdiction over a class of CNG and LNG facilities previously deemed exempt from such regulation.

FERC has considered different types of proposed CNG and LNG facilities in 2014. In each case, the Commission determined that it does not have jurisdiction over such facilities under the NGA. These decisions reduce both the regulatory burden and uncertainty which has inhibited construction of CNG and LNG facilities designed to serve demands for natural gas that cannot be reached by traditional pipelines. This is indeed good news for developers struggling to gain a foothold in this emerging segment of the natural gas industry. But the dissents registered in the *Emera* and *Shell* cases suggest that the question of FERC's jurisdiction over small- and mid-scale CNG and LNG facilities may not be one hundred percent settled.

James F. Bowe
Washington, D.C.
+1 202 626 9601
jbowe@kslaw.com
View Profile »

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

KING & SPALDING

Energy Newsletter

November 2014

REGULATORY
Environmental
Pennsylvania and Ohio regulatory efforts regarding NORM/TERNORM in oil and gas production wastes
Lynn Kerr McKay

The following is a summary of the steps that regulators in Pennsylvania and Ohio have taken to address the presence of radioactive materials in shale gas wastes.

Pennsylvania

The Pennsylvania Department of Environmental Protection's (DEP) Bureau of Radiation Protection uses 2001 regulations requiring monitoring for and responding to radioactive material entering solid waste facilities to regulate naturally occurring radioactive materials ("NORM") in shale gas wastes. Solid waste facilities must screen loads of waste for gamma radiation exposure rates over 10 microRoentgen per hour (10 μR/hr) above background. Pennsylvania places significant restrictions on disposal of material that exceeds the radiation screening limit. If a load of waste triggers an alarm and can be traced to oil and gas production, it may be disposed of in a landfill only if it meets certain requirements. Disposing of higher concentrations and volumes, requires approval from the Bureau of Radiation Protection, additional recordkeeping and waste tracking, and the facility must be able to demonstrate that the dose from all pathways is < 25 millirem per year. The Bureau of Radiation Protection has undertaken a comprehensive study of NORM waste generated during oil and gas activities. This study will build on information gathered by the Bureau of Oil and Gas Management, and the Bureau of Radiation Protection in the 1990s when it determined that no additional regulation was required for oil and gas NORM. A final study report is anticipated by the end of 2014. Based on the scope of the study, the Pennsylvania DEP Bureau of Radiation Protection may undertake additional rulemaking to regulate oil and gas NORM in waste water discharges, and at oil field production and processing sites.

Ohio

The State of Ohio regulates technologically enhanced naturally occurring radioactive materials ("TENORM"), but not NORM. TENORM with concentrations of radium-226 and radium-228 over 5 picocuries per gram (pCi/gm) above background is subject to licensing by the Ohio Department of Health (ODH). In its regulations, however, ODH states that TENORM does not include drill cuttings, or natural background radiation. Pursuant to House Bill 59, passed in July 2013, the Ohio EPA Division of Materials and Waste, ODH and the Ohio Department of Natural Resources (ODNR) have issued a guidance document clarifying that the ODH Bureau of Radiation Protection has primary regulatory authority over NORM in oil and gas waste. Specifically, the guidance document states that oil and gas tank bottoms, spent drilling muds and pipe scale could be classified as TENORM. Beginning on September 29, 2013, solid waste facilities in Ohio that accept these materials from unconventional shale gas wells were required to analyze representatives samples from that waste to ensure that concentrations of radium-226 and radium-228 are lower than 5 pCi/gm above natural background. The guidance document requires that any purposeful blending of waste to reduce the radium concentrations may be done only with prior authorization by the ODH, and, possibly by ODNR and Ohio EPA. The Ohio EPA has also indicated an interest in developing further regulations for solid waste facilities that accept waste with TENORM from unconventional gas wells.

Lynn Kerr McKay
Washington, D.C.
+1 202 626 2944
lmckay@kslaw.com
View Profile »

KING & SPALDING

Energy Newsletter

November 2014

DISPUTE RESOLUTION
Oil & Gas Litigation

Terms & Conditions under Texas Law: A Potential Liability Trap for Oilfield Operators

Brannon Robertson, Jay Goossen

A common misconception exists that pre-printed terms and conditions on a job ticket do not rise to the level of a legal contract. This view is not correct. Terms and conditions can and will be enforced by Texas courts. Such enforcement could pose a serious liability risk in an oilfield services relationship that is not governed by a master contract. In many cases, especially those involving smaller operators and service companies, the terms and conditions included on a service company's job ticket are the only provisions that constitute the contractual relationship between the two parties. The liability risk can be avoided, or at the very least mitigated, if the two parties have entered into a master service agreement. Master service agreements are normally formal agreements that have been fully negotiated by the two sides, thus providing a greater degree of certainty when attempting to resolve future issues. In the absence of a master service agreement though, operators need to be diligent in recognizing the provisions included in the terms and conditions and ensure their employees are aware of them before signing a job ticket.

Disputes based on the validity of a party's terms and conditions have recently been addressed by Texas courts. Operators should not underestimate the risk-allocating provisions included in these terms and conditions as they might expose the operator to unnecessary liability.

The Supreme Court of Texas has held that terms in a contract must be conspicuous in order to be enforceable. *In re Bank of Am., N.A.*, 278 S.W.3d 342, 344 (Tex. 2009). Further, Courts have singled out provisions such as indemnities because "indemnification of a party for its own negligence is an extraordinary shifting of risk." *Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993). The Dresser court held that indemnity provisions must meet the conspicuous requirement that dictates "that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it." *Id*. (quoting *Ling & Co. v. Trinity Sav. & Loan Ass'n*, 482 S.W.2d 841, 843 (Tex.1972)). In many oilfield service contracts, the job tickets will include the service company's terms and conditions on the back of the ticket. In order for the terms and conditions on the job ticket to hold up in the face of future legal disputes, a service company must make clear that the job ticket includes the terms and conditions of the contractual agreement. This can be done in a number of ways including bold faced font that indicates what the job ticket represents, or language on the front of the job ticket that lays out the indemnities or warranties that a service company is seeking. Employees of an operator need to look for these indications and make sure they read the terms and conditions carefully before signing a job ticket.

Operators also need to focus on whether the terms and conditions are as specific and clear as possible. The more specific the terms and conditions are, the more likely they will be enforceable. The *Dresser* court explained this requirement through the express negligence doctrine, which states that "a party seeking indemnity from the consequences of that party's own negligence must express that intent in specific terms within the four corners of the contract." *Id*. (quoting *Ethyl Corp. v. Daniel Const. Co*., 725 S.W.2d 705, 707–08 (Tex.1987)). Operators, therefore, should be aware that it will be difficult to argue they did not understand the scope of the terms and conditions if the job ticket includes specific provisions. It is factors that like these that might be difficult for an agent to assess, and thus lend to the importance of drafting a master service agreement before doing business with a service company.

Another issue that has been especially relevant in determining the validity of terms and conditions is whether the party that signs a job ticket is authorized to bind the operator. This issue was addressed in a recent Appellate Court decision that considered whether an employee of a party hired by an operator to manage drilling operations had the "authority to sign [an] indemnity provision on behalf" of the operator with a third-party service company. *Expro Americas, LLC v. Sanguine Gas Exploration, LLC*, 351 S.W.3d 915, 920 (Tex. App. 2011). The Court determined that actual authority can be either expressed or implied, with the latter existing "only as an adjunct" to the former. *Id*. Express authority requires an examination of "the principal's words and conduct relative to the agent." *Id*. The Court found a fact issue related to the company agent's authority because neither party "conclusively established" what authority the agent did or did not have. *Id*. at 927. Based on the Court's ruling in *Expro*, it is important to be clear when allocating authority to an employee that is tasked with signing job tickets. Operators need to "conclusively establish" whether employees (or agents) have the authority to bind them to risk-allocating provisions included within a service company's terms and conditions.

Ultimately, operators should get into the regular practice of always entering into a master service agreement before hiring a service company. This practice will allow operators to avoid unfavorable terms and conditions as well as shift responsibility for assessing terms and conditions from their employees to their attorneys.

Brannon Robertson
Houston
+1 713 751 3248
brobertson@kslaw.com
View Profile »

Jay Goossen
Houston
+1 713 276 7307
jgoossen@kslaw.com
View Profile »
