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A PRIMER ON MARKETING HYDROCARBONS

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Biography

Michael P. Pearson is a partner in and Chair of the Energy Practice Group of Jackson Walker L.L.P. He has practiced in the areas of oil and gas and energy law since 1978, representing numerous Texas-based, national, and international energy companies and financial institutions in a broad range of transactional matters relating to the upstream, midstream, finance, and marketing sectors of the oil and gas industry.

Education

Mr. Pearson earned his B.A., with high honors, from The University of Texas at Austin in 1975 and his J.D. from The University of Texas School of Law in 1978, where he was an Associate Editor of *The Texas Law Review*.

Memberships

Mr. Pearson is a member of the State Bar of Texas, the Houston Bar Association, the International Bar Association, and the American Bar Association. Mr. Pearson is a Past Chair of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas.

Awards

Mr. Pearson has received a Martindale-Hubbell Peer Review Rating of "AV Preeminent" since 1988. Mr. Pearson has been listed in *The Best Lawyers in America* under Natural Resources Law and Oil & Gas Law since 2004 and has been named a "Texas Super Lawyer" by Thomson Reuters since 2007. Mr. Pearson has also been listed in "Who's Who in Energy" by The Houston Business Journal since 2012 and was listed by Legal Media Group among the "World's Leading Energy & Natural Resources Lawyers" in 2008, 2010, 2013, 2015, and 2017. In 2005, *Lawdragon Magazine* selected Mr. Pearson as one of the "500 Best Lawyers in America", in 2007 as one of the "500 Top Deal Makers in America", and in 2010 as one of the "Lawdragon Top 3000."

Publication & Speaking Engagements

Mr. Pearson has authored a number of articles relating to finance and oil and gas matters and has also been a frequent speaker at continuing legal education programs and seminars. Most recently, Mr. Pearson delivered a paper entitled "Selected Drafting Issues in Midstream Contracts" at the 2015 Gas and Power Institute sponsored by The University of Texas School of Law, the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, and the Energy Bar Association, a paper entitled "Gas Royalty Calculation 2015 – An Update" at the 2015 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course, and a paper entitled "Covenants Running With the Land" at the 2016 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course.

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A PRIMER ON MARKETING HYDROCARBONS

By Michael P. Pearson¹

I. INTRODUCTION

Although I have given, over the years, a number of presentations at the Ernest E. Smith Oil, Gas and Mineral Law Institute, this is my first opportunity to present at the “Fundamentals of Oil, Gas and Mineral Law” that precedes it. I was a member of the Council for the Oil, Gas and Energy Resources Law Section of the State Bar of Texas when, in conjunction with the continuing legal education department at The University of Texas School of Law, we developed the first “Fundamentals” course in 2010. In my view, the addition of the “Fundamentals” course to the oil and gas law CLE landscape is among the most significant accomplishments of the Council during my tenure.

This presentation will provide an overview of the basic concepts associated with a producer’s marketing of its oil and gas production, including discussions of (a) relevant provisions of Article 2 of the Uniform Commercial Code as in effect from time to time in the State of Texas (the “Texas UCC”), (b) the evolution and principal components of the “master agreement” contract format, (c) contracting practices applicable to sales of natural gas, including applicable regulatory principles, (d) contracting practices applicable to sales of crude oil, including applicable regulatory principles, and (e) drafting issues of particular interest in the current hydrocarbon marketing environment.

II. ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE

Section 2.107(a) of the Texas UCC draws a distinct line between oil and gas leases, deeds, and other conveyances of interests in minerals in place, on the one hand, and sales of minerals by the producer after their “severance” – or production – from the ground, providing, in pertinent part:

A contract for the sale of minerals or the like (including oil and gas) ... is a contract for the sale of goods within this chapter if they are to be severed by the seller but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell.²

¹ Partner and Chair of the Energy Practice Group, Jackson Walker L.L.P. Past Chair of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. The author wishes to thank Jesse Lotay, a partner in the Energy Practice Group, Ben Rhem, a partner in the Environmental and Regulatory Practice Group, and Bruce Ruzinsky and Jennifer Wertz, a partner and an associate in the Bankruptcy Practice Group of Jackson Walker L.L.P., for their help in the preparation of this paper.

² TEX. BUS. & COM. CODE ANN. §2.107(a) (2017).

In reliance on the quoted language, Texas courts, as well as courts in other jurisdictions, have consistently held that contracts for the sale of oil, gas, and other liquid hydrocarbons once produced are sales of goods governed by Article 2 of the Texas UCC.³

A basic understanding of Article 2 of Texas UCC is critical to practitioners documenting hydrocarbon sale transactions. With certain exceptions discussed below, Section 1.302 of the Texas UCC permits the parties to a contract to “vary the effect of provisions of” Article 2 in delineating their contractual relationship.⁴ In the absence of contrary contractual provisions, however, the provisions of Article 2 will act as a default mechanism in defining the terms, rights, and remedies of the parties to a hydrocarbon sale transaction when their contract is silent or ambiguous about a particular matter.⁵

A. Basic UCC Concepts

Before commencing a review of Texas UCC concepts relevant to hydrocarbon sales, a brief discussion of several basic Texas UCC concepts is appropriate.

1. Seller; Buyer; Purchaser. Under the Texas UCC, a “seller” is a person who “sells or contracts to sell” goods,⁶ and a “buyer” is a person who “buys or contracts to buy” goods.⁷ “Purchaser” is a broader concept, meaning one who takes by “sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, or any other voluntary transaction creating an interest in property.”⁸ As a convenience, since this discussion is focused on hydrocarbon sales, we will speak of “sellers” and “buyers” even when a particular Texas UCC provision refers to “purchasers.”

2. Good Faith. Many provisions of the Texas UCC are specifically qualified by “good faith.” Indeed, Section 1.304 of the Texas UCC specifically provides, “Every contract or duty within this title imposes an obligation of good faith in its performance.”⁹ “Good faith” is defined

³ *E.g.*, *New Bremen Corp. v. Columbia Gas Transmission Corp.*, 913 F. Supp. 985 (S.D. Tex. 1995), *aff'd*, 108 F.3d 332 (5th Cir. 1997); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 577 (Tex. 1996) (Phillips, C.J., dissenting in part and concurring in part); *Keyes Helium Co. v. Regency Gas Services, LP*, 393 S.W.3d 858 (Tex. App. – Dallas 2012, *no pet.*) (produced helium constitutes goods); *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157, 171 (Tex. App. – Amarillo 1996, *writ denied*) (petroleum products are goods); *Gasmark, Ltd. v. Kimball Energy Corp.*, 868 S.W.2d 925, 928 (Tex. App. – Fort Worth 1994, *no writ*). See also *Anadarko Petroleum Corp. v. Alaska Petroleum, Inc.*, 2013 U.S. App. LEXIS 16262, at 2 (5th Cir. August 6, 2013); *JN Exploration & Production v. Western Gas Resources, Inc.*, 153 F.3d 906 (8th Cir. 1998).

⁴ TEX. BUS. & COM. CODE ANN. §1.302(a) (2017).

⁵ See *Jon-T Chemicals, Inc. v. Freeport Chemical Co.*, 704 F.2d 1412, 1416 (5th Cir. 1983); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 570 (1996).

⁶ TEX. BUS. & COM. CODE ANN. §2.103(a)(4) (2017).

⁷ *Id.* at §2.103(a)(1).

⁸ *Id.* at §1.201(29)(30).

⁹ *Id.* at §1.304.

as “honesty in fact and the observance of reasonable commercial standards of fair dealing.”¹⁰ It should be noted that Texas courts have held that the “honesty in fact” component of the test for good faith is based on the actual belief of the party in question, not the reasonableness of the belief.¹¹

The test is not diligence or negligence; and it is immaterial that appellee may have had notice of such facts as would put a reasonably prudent person on inquiry which would lead to discovery, unless appellee had actual knowledge . . . that would amount to bad faith.¹²

“Bad faith”, on the other hand, is defined as “not simply bad judgment or negligence, but rather . . . the conscious doing of a wrong because of dishonest purpose or moral obliquity . . . a state of mind affirmatively operating with a furtive design or ill will.”¹³

3. Standards of Performance. Although Section 1.302(a) of the Texas UCC authorizes parties to vary the effect of the provisions of the Texas UCC by the terms of their contracts, Section 1.302(b) provides that the obligations of “good faith, diligence, reasonableness, and care prescribed” in Article 2 may not be disclaimed in any agreement.¹⁴ The parties may, however, determine contractually the standards by which the performance of these obligations will be measured, as long as the standards used are “not manifestly unreasonable.”¹⁵

4. Course of Performance; Course of Dealing; Usage of Trade. Many provisions of the Texas UCC are also qualified by references to “course of performance”, “course of dealing”, and “usages of trade.” A course of performance or dealing between the parties, as well as a usage of trade in the trade in which the parties are engaged or of which they are or should be aware, is relevant in ascertaining the meaning of the parties’ agreement and may give particular meaning to supplement or qualify specific terms of the agreement.¹⁶ The terms of the relevant

¹⁰ *Id.* at §1.201(20). Prior versions of Section 1.201(20) defined “good faith” as, simply, “honesty in fact” and contained no element of commercial reasonableness. Former Section 2.103(b)(1), however, provided that for purposes of Article 2, “good faith” in the case of a merchant meant both “honesty in fact” and the “observance of reasonable commercial standards in fair dealing in the trade.” Over time, other provisions of the Texas UCC were amended to incorporate the two-pronged test for good faith. Ultimately, Section 1.201(20) was amended to incorporate such two-pronged test throughout the Texas UCC, except for purposes of Article 5 (Letters of Credit). *Id.* at §1.201(20) cmt.

¹¹ *La Sara Grain Co. v. First Nat’l Bank of Mercedes*, 673 S.W.2d 558, 563 (Tex. 1984); *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157, 175 (Tex. App. – Amarillo 1996, writ denied).

¹² *Riley v. First State Bank of Spearman*, 469 S.W.2d 812, 816 (Tex. Civ. App. – Amarillo 1971, writ ref’d n.r.e.).

¹³ *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157, 175 (Tex. App. – Amarillo 1996, writ denied), citing BLACK’S LAW DICTIONARY 94 (6th Ed. 1991).

¹⁴ TEX. BUS. & COM. CODE ANN. §1.302(b) (2017).

¹⁵ *Id.*

¹⁶ TEX. BUS. & COM. CODE ANN. §1.303(d) (2017).

contract and any applicable course of performance or dealing or usage of trade must be construed, whenever reasonable, as being consistent with each other. In the event of a conflict: (a) the express terms of the contract prevail in all events; (b) course of performance prevails over course of dealing and usage of trade; and (c) course of dealing prevails over usage of trade.¹⁷

A “course of performance” is repeated performance by a party under a contract that is accepted or acquiesced in by the other party without objection, even if the performance does not conform with the terms of the contract.¹⁸ A “course of dealing” is a sequence of conduct by parties in previous transactions that may “fairly be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct” in future transactions.¹⁹ A “usage of trade” is any practice or method of dealing that is observed in a location or trade regularly enough that the practice may be expected to be observed in a particular transaction.²⁰

B. Statute of Frauds.

The Texas UCC expresses a basic policy of recognizing any method of expressing an agreement, whether oral, written, or otherwise. Thus, Section 2.204(a) of the Texas UCC provides that a contract for the sale of goods may be made “in any manner sufficient to show agreement, including conduct by both parties that recognizes the existence of such a contract.”²¹ If the contract for the sale of goods is for a price greater than \$500, however, then in order for the contract to be enforceable “by way of action or defense”, Section 2.201(a) of the Texas UCC provides that there must be “some writing sufficient to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought”²² A writing embodying a sale of goods will not be rendered unenforceable as a contract if it omits or incorrectly states one or more terms agreed upon by the parties, but “the contract is not enforceable ... beyond the quantity of goods shown in the writing.”²³

Obviously, the standard for satisfying Article 2’s statute of frauds is relatively low. There must only be a writing that (a) evidences a sale of goods, (b) is signed by the party(ies) against whom the contract is to be enforced, and (c) specifies a quantity.²⁴ The contract need not identify the seller and buyer, state the price, specify the place of performance, specify the quality of the

¹⁷ *Id.* at . §1.303(e).

¹⁸ *Id.* at . §1.303(a).

¹⁹ *Id.* at . §1.303(b).

²⁰ *Id.* at . §1.303(c).

²¹ *Id.* at §2.204(a).

²² *Id.* at §2.201(a). The Texas UCC defines a “writing” to include “printing, typewriting, or any other intentional reduction to tangible form.” *Id.* at §1.201(43).

²³ *Id.* Article 2 of the Texas UCC reinforces this point multiple times. *See, e.g.*, TEX. BUS. & COM. CODE ANN. §2.204(a) (2017) (“Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.”)

²⁴ TEX. BUS. & COM. CODE ANN. §2.201 cmt. 1 (2017).

goods, or provide for any remedies. All of these items can be provided by the “gap filler” provisions of Article 2 discussed below. The “gap filler” provisions will not provide a quantity, however. Since Section 2.201(a) provides that the contract will be enforceable only to the extent of the goods shown in the writing, the failure to state a quantity will render the contract unenforceable.²⁵

Because a contract for the sale of hydrocarbons almost always involves total consideration of more than \$500, such contracts will be required to satisfy the Texas UCC’s statute of frauds to be enforceable in a court of law.

C. Contract Formation.

Notwithstanding the liberal rules of contract formation set forth in Section 2.204,²⁶ Article 2 of the Texas UCC establishes more specific rules relating to offers and acceptances between merchants. The Texas UCC defines a “merchant” as a “person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction ...”²⁷ The phrase “between merchants” refers to any transaction as to which the parties are “chargeable with the knowledge or skill of merchants.”²⁸ Producer/sellers and buyers of hydrocarbons are, by this definition, merchants for purposes of Article 2 of the Texas UCC.²⁹

Current Section 2.205 of the Texas UCC³⁰ sets out the rules governing firm offers by merchants. An offer by a merchant to buy or sell goods that (a) is in writing and (b) by its terms gives assurance that it will be held open is irrevocable for a period of three (3) months, even in the absence of consideration.³¹ Section 2.206(a) provides that an offer to make a contract “shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances ...”³² This rule rejects prior rules requiring specific modes of acceptance for specific types of offers (*i.e.*, facsimile acceptance for offers made by facsimile) and allows for new methods of acceptance as new methods of communication develop.³³ With limited exceptions, acceptance of any offer to buy goods for current shipment may be made by delivery of the goods,

²⁵ *Id.*

²⁶ See text accompanying note 21, *supra*.

²⁷ TEX. BUS. & COM. CODE ANN. §2.104(a) (2017).

²⁸ *Id.* at §2.104(c).

²⁹ A person that sells “oil, gas, or other minerals at the wellhead or minehead” is a “person in the business of selling goods of that kind.” *Id.* at §1.209(a). Therefore, a person who produces oil and gas and sells those commodities at the wellhead is a merchant dealing in those goods. *Rogers v. Ricane Enterprises, Inc.*, 930 S.W.2d 157, 174 (Tex. App. – Amarillo 1996, writ denied).

³⁰ *Id.* at §2.205.

³¹ *Id.*

³² *Id.* at §2.206(a)(1).

³³ *Id.* at §2.206 cmt. 1.

regardless of whether the goods are conforming,³⁴ provided that the offeree gives notice of acceptance (orally or in writing) to the offeror within a reasonable time after commencing delivery of the goods.³⁵

Section 2.207 of the Texas UCC³⁶ makes clear that a written acceptance or other “definite and reasonable expression of acceptance” of any offer that is sent within a reasonable time after an offer is made operates as an acceptance, even though it states additional or different terms, unless the acceptance is expressly conditioned on the offeror’s agreement to the additional or different terms.³⁷ Such additional terms constitute proposals for additions to the contract and, in a contract between merchants, will become part of the contract unless (i) the offer expressly limits acceptance to the terms of the offer, (ii) the additional or different provisions materially alter it, or (iii) the offeror notifies the offeree of the offeror’s objections within a reasonable time after the offeror receives the offeree’s proposed changes.³⁸

*Gasmark, Ltd. v. Kimball Energy Corp.*³⁹ offers an example of how current Section 2.207 might operate in the context of a gas sale contract negotiation.⁴⁰ In *Kimball*, a gas producer and a gas buyer entered into a letter of intent under which the buyer would purchase gas from the producer. Subsequently, the gas buyer sent the producer a draft of the buyer’s proposed form of gas purchase contract. Thereafter, the gas buyer sent the producer a first “amendment” of the gas purchase contract that proposed to amend certain provisions thereof, but the producer did not immediately respond to such first amendment. The gas buyer then sent the producer a second “amendment” of the gas purchase contract, proposing to amend additional provisions thereof. The producer then responded by sending the gas buyer proposed revisions to the first amendment that accepted some, but not all, of the changes embodied in the two proposed amendments. Then the gas purchaser terminated the negotiations. In the meantime, the gas buyer purchased gas from the producer for three (3) months while negotiations continued.⁴¹

The Fort Worth Court of Appeals affirmed the district court’s granting of the gas buyer’s motion for summary judgment claiming no contract was formed. In the letter of intent, the

³⁴ TEX. BUS. & COM. CODE ANN. §2.206(a)(2) (2017).

³⁵ *Id.* at §2.206(b).

³⁶ *Id.* at §2.207.

³⁷ *Id.* at §2.207(a).

³⁸ *Id.* at §2.207(b).

³⁹ 868 S.W.2d 925 (Tex. App. – Fort Worth 1994, no writ).

⁴⁰ *Kimball* was decided prior to the most recent revisions to the Texas UCC enacted by the Texas Legislature. As a result, the decision in *Kimball* was based on the court’s conclusion that the parties had varied the effect of Article 2, as permitted in former Sections 1.102(c) and (d) of the Texas UCC (amended by Acts 2003, 78th Leg., ch. 542, §1, eff. Sept. 1, 2003; current version at TEX. BUS. & COM. CODE ANN. §1.302(a) (2017)), by adopting the common law rules of offer and acceptance. This author suggests that the same result would be reached by applying the current version of Section 2.207(b) of the Texas UCC.

⁴¹ 868 S.W.2d at 927.

parties agreed to attempt to negotiate a “mutually agreed formal contract.”⁴² The court stated that this agreement caused the parties to operate under the common law standard requiring a formal offer and acceptance, rather than under Article 2 of the Texas UCC. Each exchange of documents by the parties constituted either a revocation of an offer, the making of a new offer, or the making of a counteroffer. Since no formal contract was ever signed, the court concluded no contract was formed.⁴³

It is suggested that the court would reach the same result regarding the formation of a contract under the preceding facts if it applied the current versions of Sections 2.206 and 2.207 of the Texas UCC.

D. Gap Fillers.

One of the principal functions of Article 2 of the Texas UCC is to “fill in the gaps” merchants may leave in the formation of contracts for the sale of goods. These provisions give courts broad authority to supply the missing terms of any such contract. Among the most important of Article 2’s “gap fillers” are the following:⁴⁴

1. Price. If the parties attempting to form a contract for the sale of goods do not intend to be bound absent an agreement on price, no contract will be formed.⁴⁵ If, however, the parties intend to form a contract notwithstanding an open price term, Section 2.305(a) of the Texas UCC permits such a contract to be formed.⁴⁶ In that case, the price will be a reasonable price at the time of delivery if (a) the contract is silent as to price, (b) the price is left to be agreed upon by the parties, and they fail to do so, or (c) the price is to be based on some agreed upon market or other standard “as set or recorded by a third person” (such as an “index” price),⁴⁷ but the third party price is not so fixed or recorded.⁴⁸ If the third party price is not so fixed or published “through fault” of one of the parties, the other party may treat the contract as

⁴² *Id.* at 928.

⁴³ *Id.* at 928-929.

⁴⁴ For good discussions of the Texas UCC’s “gap filler” provisions, see Lake and Hoff, *Issues in Marketing Production*, 2010 FUNDAMENTALS OF OIL, GAS & MIN. L., Univ. of Texas School of Law, St. Bar OGERL Section (2010) (hereinafter, “Lake and Hoff”); Campbell, *Current Developments in the Uniform Commercial Code Relating to Oil, Gas, and Mineral Law*, 27th ANN. OIL, GAS, & MIN. L. INST., Univ. of Texas School of Law, St. Bar OGERL Section (2001) (hereinafter, “Campbell”).

⁴⁵ TEX. BUS. & COM. CODE ANN. §2.305(d) (2017).

⁴⁶ *Id.* at §2.305(a).

⁴⁷ See text accompanying notes 261-266, *infra*.

⁴⁸ TEX. BUS. & COM. CODE ANN. §2.305(a) (2018).

cancelled or fix a reasonable price himself.⁴⁹ If the contract provides that the price will be fixed by the seller or buyer, the price thus fixed by the relevant party must be in good faith.⁵⁰

In practice, it is hard to imagine a circumstance in which the parties to a hydrocarbon sale contract will choose to omit the price term. Whether the parties nonetheless intend to form a contract in such a circumstance, however, is ultimately a question for the trier of fact.⁵¹

2. **Delivery.** If a contract for the sale of goods fails to state where delivery of goods is to be made, Section 2.308 of the Texas UCC provides, as the default rule, that delivery is to be made at the seller's place of business or, if it has none, at the seller's residence.⁵² If the goods are identified goods known by the parties, when the contract is formed, to be located in a place other than the seller's place of business, the place where the goods are located is presumed to be the place of delivery.⁵³ If, however, the seller is "required or authorized" to send the goods to the buyer, but the contract does not specify a delivery location, Section 2.504 of the Texas UCC provides that, unless the parties otherwise agree, the seller must (a) put the goods into the possession of a carrier under a "reasonable" contract for their transportation, taking into account the nature of the goods and other relevant circumstances of the sale; (b) promptly notify the buyer of the shipment; and (c) obtain and promptly deliver or tender to the buyer any document necessary to enable the buyer to obtain possession of the goods.⁵⁴

If the contract fails to state when shipment or delivery is to be made, Section 2.309 of the Texas UCC provides that the time for shipment, delivery, "or any other action under a contract" shall be a "reasonable time."⁵⁵ What constitutes a reasonable time depends upon "what constitutes acceptable commercial conduct in view of the nature, purpose and circumstances" of the relevant action.⁵⁶

3. **Risk of Loss.** If a contract for the sale of goods is silent about the passage of the risk of loss, Section 2.509 and Section 2.510 of the Texas UCC establish the default rules for this issue. In the absence of a breach, Section 2.509(c) provides that, in most cases, the risk of loss passes to the buyer upon its receipt of the goods, if the seller is a merchant.⁵⁷ If the seller is not a merchant, the risk of loss passes to the buyer upon the seller's tender of delivery.⁵⁸ The primary

⁴⁹ *Id.* at §2.305(c).

⁵⁰ *Id.* at §2.305(b).

⁵¹ *Id.* at §2.305 cmt. 2.

⁵² *Id.* at §2.308(1).

⁵³ *Id.* at §2.308(2).

⁵⁴ *Id.* at §2.504.

⁵⁵ *Id.* at §2.309.

⁵⁶ *Id.* at §2.309 cmt. 1.

⁵⁷ *Id.* at §2.509(c).

⁵⁸ *Id.*

exceptions to these rules are found in Section 2.509(a) of the Texas UCC. Under Section 2.509(a), if the sale contract requires or authorizes the seller to ship the goods by carrier, and if: (a) delivery is required at a particular location, the risk of loss passes to the buyer when the goods are delivered to the carrier;⁵⁹ or (b) delivery is required to be, and is, made at a particular location by the carrier, the risk of loss passes to the buyer when the goods are tendered by the carrier to the buyer at the specified delivery location.⁶⁰

If, however, the seller breaches its tender or delivery obligations under the contract, so that the buyer has a right to reject, Section 2.510 of the Texas UCC provides that the risk of loss remains with the seller until the seller cures the breach or the buyer accepts the goods.⁶¹ If the buyer repudiates or breaches before the risk of loss passes to it, the seller may, to the extent of its effective insurance coverage, treat the buyer as having retained the risk of loss for a commercially reasonable time.⁶²

4. Title. If a contract for the sale of goods is silent about the passage of title to the goods,⁶³ Section 2.401(b) of the Texas UCC provides, as the default rule, that title to goods passes from the seller to the buyer “at a time and place at which the seller “completes his performance with respect to the physical delivery” of the goods.⁶⁴ If the contract requires the seller to send the goods to the buyer but does not require delivery at a particular location, title to the goods passes to the buyer at the time and place of shipment.⁶⁵ If, however, the contract requires delivery of the goods at a particular location, title to the goods passes to the buyer upon the shipper’s tender of the goods at the delivery location.⁶⁶

According to Section 2.403(a) of the Texas UCC, a purchaser of goods acquires all of the title that the transferor of the goods had or had the power to transfer.⁶⁷ A person whose title is voidable has the power to transfer good title to the goods to a “good faith purchaser for value.”⁶⁸ Section 2.403(b) continues by providing that any “entrusting” of possession of goods to a merchant who “deals in goods of that kind” gives the merchant the power to transfer all rights of the entruster to a “buyer in the ordinary course of business.”⁶⁹ In this regard, the term

⁵⁹ *Id.* at §2.509(a)(1).

⁶⁰ *Id.* at §2.509(a)(2).

⁶¹ *Id.* at §2.510(a).

⁶² *Id.* at §2.510(c).

⁶³ Subject to certain narrow exceptions, title to goods passes from the seller to the buyer in any manner and on any conditions explicitly agreed to by the seller and the buyer. TEX. BUS. & COM. CODE ANN. §2.401(a) (2017).

⁶⁴ *Id.* at §2.401(b).

⁶⁵ *Id.* at §2.401(b)(1).

⁶⁶ *Id.* at §2.401(b)(2).

⁶⁷ *Id.* at §2.403(a).

⁶⁸ *Id.*

⁶⁹ *Id.* at §2.403(b).

“entrusting” is defined as “any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties . . . and regardless of whether the procurement . . . or the disposition of the goods have been such as to be larcenous . . .”⁷⁰ A “buyer in the ordinary course of business” is defined as “a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person . . . in the business of selling goods of that kind”.⁷¹ A person that sells oil, gas, or other minerals at the wellhead is a person “in the business of selling goods of that kind.”⁷² These provisions operate to embody the Texas UCC’s version of the real property doctrine of the *bona fide* purchaser embodied in the Texas Property Code.⁷³

The Amarillo Court of Appeals’ 1996 decision in *Rogers v. Ricane Enterprises, Inc.*,⁷⁴ provides an interesting example of how these provisions operate in practice. *Ricane* is the fifth appellate decision in a litigation saga that persisted almost ten years.⁷⁵ Earlier decisions in this dispute had quieted title to certain oil and gas leasehold interests in the shareholders of the defunct Western Drilling Company known as the “Rogers Group.”⁷⁶ The 1996 *Ricane* decision concerned, among other issues, whether a purchaser of oil from the oil and gas producer whose oil and gas leasehold title was held to be void in favor of the claims of the Rogers Group was guilty of conversion.⁷⁷ The oil purchaser argued that, “[A]s the purchaser of oil from a merchant, in whose larcenous possession of the oil the Rogers Group had acquiesced, [the purchaser] became of good faith buyer in the ordinary course of business and was not a converter,” citing Sections 2.403(b) and (c) of the Texas UCC.⁷⁸

The court of appeals agreed with the oil purchaser and concluded that the oil purchaser was a good faith buyer within the meaning of the Texas UCC and, as such, was not liable to the Rogers Group for conversion damages.⁷⁹ In addressing the purchaser’s arguments, the court identified a three-step test for the applicability of Section 2.403(b) – there must be (a) an entrustment of goods to (b) a merchant who deals in goods of that kind, followed by the sale by the merchant to (c) a buyer in the ordinary course of business.⁸⁰ According to the court: (i) the

⁷⁰ *Id.* at §2.403(c).

⁷¹ *Id.* at §1.201(9).

⁷² *Id.* See note 29, *supra*, and accompanying text.

⁷³ See TEX. PROP. CODE ANN. §13.001 (2017).

⁷⁴ 930 S.W.2d 157 (Tex. App. – Amarillo 1996, no writ).

⁷⁵ See *Rogers v. Ricane Enterprises, Inc.*, 775 S.W.2d 391 (Tex. App. – Amarillo 1987, writ granted); *Rogers v. Ricane Enterprises, Inc.*, 772 S.W.2d 76 (Tex. 1989) (“*Ricane I*”); *Rogers v. Ricane Enterprises, Inc.*, 852 S.W.2d 751 (Tex. App. – Amarillo 1993, writ granted); and *Rogers v. Ricane Enterprises, Inc.*, 884 S.W.2d 763 (Tex. 1994) (“*Ricane II*”).

⁷⁶ *Ricane II*, 884 S.W.2d at 770.

⁷⁷ 930 S.W.2d at 164.

⁷⁸ *Id.* at 170.

⁷⁹ *Id.* at 175.

⁸⁰ *Id.* at 171, citing *Toyomenka, Inc. v. Mount Hope Finishing Co.*, 432 F.2d 722, 727 (4th Cir. 1970).

oil and gas producer from whom the oil purchaser bought the oil was a merchant dealing with such goods within the meaning of the Texas UCC;⁸¹ (ii) the jury's finding that the Rogers Group acquiesced in the oil and gas producer's actions was not clearly wrong or manifestly unjust;⁸² and (iii) the oil purchaser actually believed it was a buyer in the ordinary course of business, so that it was protected in purchasing the oil and was not acting in bad faith.⁸³

5. Quantity. As discussed above, the one key contract term for which the "gap filler" provisions of the Texas UCC do not provide a default rule is quantity.⁸⁴ A contract for the sale of goods is enforceable only to the extent of the goods shown in the writing. The failure of a contract to state a quantity will render the contract unenforceable.⁸⁵

Contracts for the sale of the seller's output of certain goods or the purchase of the buyer's requirements for such goods, however, will not fail as being too indefinite.⁸⁶ Under Section 2.306 of the Texas UCC, a quantity term based on the output of the seller or the requirements of the buyer means "such actual output or requirements as may occur in good faith", provided that "no quantity that is unreasonably disproportionate to any stated estimate, or in the absence of a stated estimate, to normal or otherwise prior output or requirements" may be tendered or delivered under such an "output contract" or "requirements contract."⁸⁷ As a "gap filler", then, Section 2.306 renders output and requirements contracts sufficiently definite as to quantity to be enforceable by reading into such contracts a quantity that is the actual good faith output or requirements of the relevant party.⁸⁸ These types of contracts do not lack mutuality of obligation because the party who determines the actual quantity is required to operate his/her business in

⁸¹ *Id.* at 171, citing TEX. BUS. & COM. CODE ANN. §1.201(9).

⁸² *Id.* at 174. According to the court, acquiescence requires "knowledge of that to which consent is implied," which can be proved by circumstantial evidence. The jury's finding of acquiescence was based principally on (i) the Rogers Group's knowledge of the relevant oil and gas lease, (ii) the fact that members of the Rogers Group lived in the same geographic area as the lease, (iii) the drilling of multiple producing wells on the relevant oil and gas lease during the same time period, and (iv) the fact that members of the Rogers Group discussed asserting an interest in such oil and gas lease. The court of appeals concluded that the jury's finding was not so against the preponderance of the evidence as to be manifestly unjust or clearly wrong. *Id.*

⁸³ *Id.* at 175. According to the court, in order to be a buyer in the ordinary course of business, the oil purchaser must have been honest-in-fact and without knowledge that its oil purchases were in violation of the ownership rights of the Rogers Group. The court concluded that the existence of a title opinion that credited the oil and gas producer from whom the oil purchaser bought oil with ownership of the working interest in the relevant oil and gas lease, even if subject to title objections, was not enough to provide the oil purchaser with actual knowledge of the claims of the Rogers Group. *Id.*

⁸⁴ See text accompanying note 25, *supra*.

⁸⁵ TEX. BUS. & COM. CODE ANN. §2.201 and cmt. 1 (2017).

⁸⁶ *Id.* at §2.306, cmt. 2.

⁸⁷ *Id.* at §2.306(a).

⁸⁸ See *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 570 (Tex. 1996).

good faith and according to commercial standards of fair dealing in the trade, so that the output or the requirements, as applicable, will approximate a reasonably foreseeable number.⁸⁹

In *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*,⁹⁰ the Texas Supreme Court considered whether a conventional “take-or-pay” gas sale contract constituted an output contract to which the “good faith” and “not unreasonably disproportionate” restrictions under Section 2.306 of the Texas UCC applied.⁹¹ The dispute arose when the successors in interest to the original oil and gas lessee/gas seller under the gas sale contract drilled additional wells on the acreage dedicated to the performance of the contract, dramatically increasing the gas volumes being sold, and correspondingly the gas purchaser’s take-or-pay obligation, under the contract.⁹²

The Texas Supreme Court concluded that the take-or-pay gas sale contract at issue did not constitute an output contract under Section 2.306.⁹³ According to the court, an output contract is one in which the buyer agrees to take the seller’s entire output of production. The contract at issue, on the other hand, obligated the buyer either (a) to take a quantity of gas equal to 85% of the seller’s delivery capacity or (b) to pay the producer an amount equal to the value of the gas. In this regard, the court characterized the payment option not as a payment for the sale of gas, but as a payment for the exclusive dedication of gas reserves for a fixed period of time. As such, the buyer was not actually obligated to receive any particular volume of gas, except for volumes nominated by the buyer from time to time.⁹⁴

Moreover, Section 2.306 applies only when the contract does not specify a numeric quantity or provide a standard for determining that quantity.⁹⁵ According to the court, the contract at issue clearly obligated the gas purchaser to take or pay for a quantity of gas equal to 85% of the seller’s delivery capacity, which was a readily ascertainable quantity of gas based on the testing procedures specified in the contract.⁹⁶

⁸⁹ TEX. BUS. & COM. CODE ANN. §2.306 cmt. 2 (2017).

⁹⁰ 925 S.W.2d 565 (Tex. 1996). For a more detailed discussion of *Lenape*, see Strohl, *Don’t Throw Me Into the Oil Patch: A Look at Applying Section 2.306 of the Uniform Commercial Code to Natural Gas Contracts*, OIL, GAS & MIN. L. SECTION MEETING, Houston Bar Ass’n (February 1996).

⁹¹ 925 S.W.2d at 567.

⁹² *Id.* at 568.

⁹³ *Id.* at 572-573.

⁹⁴ *Id.* at 569-570.

⁹⁵ *Id.* at 570.

⁹⁶ *Id.* at 570-571. The holding in *Lenape* appears specific to its facts. Even though the take-or-pay gas sale contract at issue was held not to constitute an output contract under Section 2.306, there does not appear to be any reason preventing parties from structuring future gas sale contracts as output contracts meeting the requirements of Section 2.306 if they choose to do so. See *Campbell*, *supra* note 44, at 27.

6. Payment Terms. If a contract for the sale of goods omits the payment terms, several provisions of Article 2 of the Texas UCC operate to establish, as the default rule, that payment for goods sold is due on delivery.

Section 2.310(a) of the Texas UCC provides that, unless otherwise agreed, payment is due at the time and place at which the buyer is to receive the goods.⁹⁷ Consistent with Section 2.310(a), Section 2.507(a) of the Texas UCC provides that tender of delivery is a condition to the buyer's duty to accept the goods and, unless otherwise agreed, his/her duty to pay for them;⁹⁸ and Section 2.511(a) provides that, unless otherwise agreed, tender of payment is a condition to the seller's duty to tender and complete any delivery.⁹⁹ Sections 2.507(a) and 2.511(a) operate in tandem to make the duties to deliver and make payment concurrent obligations, such that payment is effectively due on delivery.¹⁰⁰

As will be seen, the "payment on delivery" concept is rarely employed in hydrocarbon sale contracts, which usually provide for invoicing and payment during the month after the month of production.¹⁰¹

E. Breach; Remedies; Damages.

Finally, it is appropriate to review briefly Article 2's provisions regarding breach of contract, remedies for breach, and damages, which will apply to hydrocarbon sale contracts if the contract is silent on these issues.¹⁰²

1. Breach. A key element of Article 2 of the Texas UCC is its adoption of the so-called "perfect tender" rule – *i.e.*, any failure to conform to or comply with the terms or obligations stated in the contract, regardless of materiality, constitutes a breach of the contract.¹⁰³ Under Section 2.601 of the Texas UCC, the seller is in breach of the contract if the goods tendered by the seller or its tender of delivery fail "in any respect" to conform to the terms of the contract.¹⁰⁴ In this regard, the concept of "conformity" does not mean substantial performance, but rather complete, perfect performance.¹⁰⁵ Section 2.508 of the Texas UCC provides the seller with some relief in this regard by permitting the seller to cure an imperfect or improper tender if the time

⁹⁷ TEX. BUS. & COM. CODE ANN. §2.310(a) (2017).

⁹⁸ *Id.* at §2.507(a).

⁹⁹ *Id.* at §2.511(a).

¹⁰⁰ *See id.* at §2.511 cmt. 2.

¹⁰¹ *See* text accompanying notes 283, 284, *infra*; Lake and Hoff, *supra* note 44, at 3.

¹⁰² For a good discussion of the breach, remedies, and damages provisions of Article 2, *see* Enochs and Head, *A Comparison of Remedies in the UCC to Remedies Available Under the NAESB, EEI, CTA, and ISDA*, 4th ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section (2005) (hereinafter, "Enochs and Head").

¹⁰³ *See* TEX. BUS. & COM. CODE ANN. §§2.601(a), 2.703 (2017); Enochs and Head, *supra* note 102, at 2.

¹⁰⁴ TEX. BUS. & COM. CODE ANN. §2.601 (2017).

¹⁰⁵ *See id.*; *Tex. Imps. v. Allday*, 649 S.W.2d 730, 757 (Tex. App. – Tyler 1983, writ ref'd n.r.e.).

for its performance has not yet expired.¹⁰⁶ Section 2.703 of the Texas UCC treats breaches by the buyer in a manner similar to Section 2.601.¹⁰⁷

It should be noted that different rules regarding the seller's breach of "installment contracts" apply under Section 2.612 of the Texas UCC. An "installment contract" is a contract that "requires or authorizes the delivery of goods in separate lots to be separately accepted", even if the contract provides that "each delivery is a separate contract" or the like.¹⁰⁸ These rules are significant for purposes of this discussion because most hydrocarbon sales contracts qualify as installment contracts.

In the case of an installment contract, the buyer may reject any installment that is non-conforming if the non-conformity substantially impairs the value of the installment and cannot be cured.¹⁰⁹ If the non-conformity does not impair the value of the contract as a whole, however, and the seller provides "adequate assurance of its cure", the buyer must accept the installment.¹¹⁰ If, on the other hand, the non-conformity "substantially impairs the value of the whole contract, there is a breach of the whole,"¹¹¹ giving rise to a right of cancellation.¹¹² Whether any particular non-conformity justifies cancellation of the contract as to future transactions depends on whether the non-conformity is such as to impair the value of the whole contract, and not on whether the non-conformity indicates that future deliveries are likely to be defective.¹¹³

2. Remedies. Article 2 of the Texas UCC provides a number of remedies for the parties in the event of a breach of their contract for the sale of goods.

a. Remedies Available to Both Parties. If (a) either party repudiates a contract and declares that it will not render the performance due under the contract – an action known in the Texas UCC as "anticipatory repudiation" – and (b) the loss of such performance will substantially impair the value of the contract to the other party, Section 2.610 of the Texas UCC gives the non-repudiating party the option either (i) to await performance by the repudiating party for a commercially reasonable time, or (ii) to resort to any available remedy for breach under Section

¹⁰⁶ TEX. BUS. & COM. CODE ANN. §2.508 (2017).

¹⁰⁷ *Id.* at §2.703.

¹⁰⁸ *Id.* at §2.612(a).

¹⁰⁹ *Id.* at §2.612(b).

¹¹⁰ *Id.*

¹¹¹ *Id.* at §2.612(c).

¹¹² *Id.*

¹¹³ *Id.* at §2.612 cmt. 6.

2.703 (seller's remedies) or Section 2.711 (buyer's remedies) of the Texas UCC, and, in all events, the right to suspend its own performance.¹¹⁴

In addition, Section 2.609 of the Texas UCC authorizes either party to a contract to demand from the other party "adequate assurance of due performance" if "reasonable grounds for insecurity" arise regarding such other party's future performance.¹¹⁵ This right is premised on the notion that each party to a contract for sale is entitled to the expectation of receiving due performance from the other party.¹¹⁶ As between merchants, the reasonableness of the grounds for insecurity and any assurances offered will be determined according to commercial standards.¹¹⁷ Until the requesting party receives the requested adequate assurance of due performance, it may, if commercially reasonable to do so, suspend its performance.¹¹⁸

b. Seller's Remedies. Under Section 2.703 of the Texas UCC, if the buyer (a) wrongfully rejects or revokes acceptance of goods, (b) fails to make a payment when due, or (c) repudiates all or a part of the contract, the seller will be entitled to exercise one or more of the remedies listed in that provision.¹¹⁹ These remedies include (i) withholding delivery of goods,¹²⁰ (ii) stopping delivery of goods that are already in the possession of a carrier or other bailee under Section 2.705,¹²¹ (iii) reselling the goods and recovering damages under Section 2.706,¹²² (iv) recovering damages for non-acceptance under Section 2.708 or, in the case of a buyer's failure to make payment when due, recovering the price due under Section 2.709,¹²³ or (v) terminating the contract.¹²⁴

In addition, if the seller discovers that the buyer has become insolvent, Section 2.702 of the Texas UCC authorizes the seller (x) to refuse to make any pending deliveries of goods unless the buyer pays for the goods in cash and (y) to stop delivery of goods already in the possession of a carrier or other bailee under Section 2.705.¹²⁵ If the seller discovers the buyer's insolvency

¹¹⁴ *Id.* at §2.610.

¹¹⁵ *Id.* at §2.609(a).

¹¹⁶ *Id.*

¹¹⁷ *Id.* at §2.609(b).

¹¹⁸ *Id.* at §2.609(a).

¹¹⁹ *Id.* at §2.703.

¹²⁰ *Id.* at §2.703(1).

¹²¹ *Id.* at §§2.703(2), 2.705.

¹²² *Id.* at §§2.703(4), 2.706.

¹²³ *Id.* at §§2.703(5), 2.708, 2.709.

¹²⁴ *Id.* at §2.703(6).

¹²⁵ *Id.* at §2.702(a).

after the buyer has received goods on credit, the seller may also, under certain circumstances, reclaim the goods.¹²⁶

c. Buyer's Remedies. Under Section 2.601 of the Texas UCC, if the seller fails to make a "perfect tender" of the goods,¹²⁷ the buyer may reject all of the goods or accept all of, or any commercial unit or units within, the goods.¹²⁸

Similar to Section 2.703, which lists remedies available to the seller, Section 2.711 of the Texas UCC provides a list of the remedies available to the buyer in the event of the seller's breach.¹²⁹ If the seller fails to make delivery or repudiates the contract, or the buyer "rightfully rejects or justifiably revokes acceptance" of goods, the Buyer will be entitled to cancel the contract,¹³⁰ recover the price already paid,¹³¹ and regardless of whether the contract is cancelled, either (i) "cover" and have damages under Section 2.712, or (ii) recover damages for non-delivery under Section 2.713.¹³² If the seller fails to deliver the goods or repudiates the contract, the buyer may also (x) recover the goods under Section 2.502, if they have been identified to the contract, or (y) obtain specific performance or replevy the goods if permitted under Section 2.716.¹³³ Finally, if the buyer has rightfully rejected or justifiably revoked acceptance of the goods, Section 2.711(c) grants to the buyer (i) a security interest in the goods in its possession or control to secure any payments owed to the buyer, as well as (ii) the right to sell any goods in its possession and retain the proceeds, similar to an "aggrieved seller" under Section 2.706.¹³⁴

3. Damages. Finally, Article 2 of the Texas UCC establishes measures of damages for both sellers and buyers under contracts for the sale of goods, although there are differences between the two.

a. Damages Available to Sellers. The measures of damages recoverable by a seller in the event of a breach by its buyer are set out in Sections 2.708, 2.709, and 2.710 of the Texas UCC.

Under Section 2.708(a),¹³⁵ the measure of damages recoverable by the seller for non-acceptance or repudiation by the buyer is equal to the sum of (i) the difference between (a) the

¹²⁶ *Id.* at §2.702(b).

¹²⁷ See text accompanying notes 103 through 107, *supra*.

¹²⁸ TEX. BUS. & COM. CODE ANN. §2.601 (2017).

¹²⁹ *Id.* at §2.711(a).

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.* at §§2.711(a)(1) and (a)(2), 2.712, 2.713.

¹³³ *Id.* at §§2.711(b)(1) and (b)(2), 2.502, 2.716.

¹³⁴ *Id.* at §2.711(c). See text accompanying note 122, *supra*.

¹³⁵ TEX. BUS. & COM. CODE ANN. §2.78(a) and cmt. 1 (2017).

current market price at the time and place for tender,¹³⁶ and (b) the unpaid contract price, plus (ii) with any incidental damages authorized under Section 2.710, minus (iii) expenses saved in consequence of the buyer's breach. In this regard, the "market price" shall be determined based on the price of the relevant goods at the time when the non-breaching party learned of the repudiation.¹³⁷ If no evidence of a "market price" at such time or delivery location is readily available, a price prevailing within a reasonable time before or after the referenced time, or at any other place that, "in commercial judgment or under the usage of trade, would serve as a substitute", may be used, subject to appropriate transportation allowances.¹³⁸

If the measure of damages calculated under Section 2.708(a) is "inadequate to put the seller in as good a position as performance would have done," the measure of damages recoverable by the seller for non-acceptance or repudiation will equal the sum of (i) the profit (including reasonable overhead) the seller would have made from full performance by the buyer, (ii) plus any incidental damages under Section 2.710, (iii) minus due allowance for costs reasonably incurred and credit for any payments by the buyer and the proceeds of any resale.¹³⁹

If the buyer fails to pay the price as it becomes due, Section 2.709 of the Texas UCC provides that the seller is entitled to recover, in addition to incidental damages under Section 2.710, the price (i) of goods accepted by the buyer or lost or damaged within a commercially reasonable time after risk of loss has passed to the buyer, or (ii) of the goods identified in the contract if the seller is unable to resell them at a reasonable price.¹⁴⁰

As used in Sections 2.708 and 2.709, the term "incidental damages" includes any commercially reasonable charges, expenses, or commissions incurred (i) in stopping delivery, (ii) in the transportation, custody, and care of the goods after the buyer's breach, (iii) in

¹³⁶ The time and place of tender is determined in accordance with Sections 2.308, 2.309, and 2.504. *See id.* at §2.708 cmt. 1. Article 2 of the Texas UCC does not specifically define "market price", but at common law the term generally means "the prevailing price at which something is sold in a specific market." *See* BLACK'S LAW DICTIONARY 1207 (7th Ed. 1999). Under Texas law, the resale price, when it is determined pursuant to an arm's length transaction, or a "spot" or index price may qualify as a current market price under Article 2. *Cook Composites, Inc. v. Westlake Styrene Corp.*, 15 S.W.3d 124, 138-139 (Tex. App. – Houston [14th Dist.] 2000, pet. denied). In at least one case involving market value royalty calculation, prices payable for gas on the spot market were held to be probative of the best price reasonably obtainable by a reasonably prudent operator. *Hutchings v. Chevron U.S.A., Inc.*, 862 S.W.2d 752, 761-762 (Tex. App. – Dallas 1993, writ dismissed). *Contra, Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 873 (Tex. 1968) ("The mathematical average of all prices paid in the field is not a final answer to . . . determining market prices at any particular time.")

¹³⁷ TEX. BUS. & COM. CODE ANN. §2.723(a) (2017).

¹³⁸ *Id.* at §2.723(b).

¹³⁹ *Id.* at §2.708(b).

¹⁴⁰ *Id.* at §2.709(a). An action for the price under Section 2.709 is available to the seller only if the buyer has delivered the goods. *Nobs Chemical, U.S.A., Inc. v. Koppers Co., Inc.*, 616 F.2d 212, 215 (5th Cir. 1980) (Texas law). No action under Section 2.709 may be brought, however, until the price becomes due, even if the seller is aware that the buyer is unlikely to make payment. *See Custom Controls Co. v. Ranger Ins.*, 652 S.W.2d 449, 453 (Tex. App. – Houston [1st Dist.] 1983, no writ).

connection with the return or resale of the goods, or (iv) otherwise resulting from the breach.¹⁴¹ It should be noted, however, that Article 2 of the Texas UCC does not permit sellers to recover consequential damages in the event of the buyer's breach.¹⁴²

b. Damages Available to Buyers. The damages recoverable by a buyer in the event of a breach by seller are set out in Sections 2.712, 2.713, 2.714, and 2.715 of the Texas UCC.

If the seller fails to make delivery of the goods or repudiates the contract, or if the buyer rightfully rejects or justifiably revokes accepted goods as contemplated in Section 2.711,¹⁴³ Section 2.712(a) of the Texas UCC provides that the buyer may "cover" by making, in good faith and without unreasonable delay, any reasonable purchase of goods in substitution for those due from the seller.¹⁴⁴ If the buyer elects to "cover", it may recover from the seller damages equal to the sum of (i) the difference between (x) the cost of cover and (y) the contract price, plus (ii) incidental and consequential damages under Section 2.715, minus (iii) expenses saved in consequence of the breach.¹⁴⁵

If the seller fails to make delivery of the goods or repudiates the contract, but the buyer does not "cover" by procuring substitute goods, Section 2.713(a) of the Texas UCC provides that the buyer may recover damages equal to the sum of (i) the difference between (x) the market prices at the time when the buyer learned of the seller's breach, and (y) the contract price, plus (ii) incidental and consequential damages under Section 2.715, minus (iii) expenses saved due to the seller's breach.¹⁴⁶ In this regard, the "market price" used in calculating damages under Section 2.713(a) is the price for goods of the same kind and in the same brand of trade,¹⁴⁷ determined at the place of tender or, in cases when the buyer has rejected the goods after arrival or has revoked acceptance, at the place of arrival.¹⁴⁸

¹⁴¹ TEX. BUS. & COM. CODE ANN. §2.710 (2017).

¹⁴² At common law, "consequential damages" are defined as those damages that "do not arise within the scope of the immediate buyer-seller transaction, but rather stem from losses incurred by the non-breaching party in its dealings, often with third parties which were the proximate result of the breach." *USX Corp. v. Union Pacific Resources Co.*, 753 S.W.2d 845, 856 (Tex. App. – Fort Worth 1988, no writ). Consequential damages, as defined in Section 2.715(b), are, however, recoverable by the buyer. See TEX. BUS. & COM. CODE ANN. §§2.712, 2.713, 2.714, and 2.715 (2017).

¹⁴³ TEX. BUS. & COM. CODE ANN. §2.711 (2017).

¹⁴⁴ *Id.* at §2.712(a).

¹⁴⁵ *Id.* at §2.712(b). The purpose of Section 2.712 is to provide the buyer with a remedy that enables the buyer to acquire the goods it needs to meet the needs of its business. *Id.* at §2.712 cmt. 1. Presumably, the cost of "cover" will approximate the market price of the undelivered goods. See *Kiser v. Lemco Indus., Inc.*, 536 S.W.2d 585, 589 (Tex. Civ. App. – Amarillo 1976, no writ).

¹⁴⁶ TEX. BUS. & COM. CODE ANN. §2.713(a) (2017).

¹⁴⁷ *Id.* at §2.713 cmt. 2.

¹⁴⁸ *Id.* at §2.713(b).

If the buyer has accepted goods but the seller's tender is non-conforming, Section 2.714(a) of the Texas UCC provides that the buyer may recover the loss resulting in the ordinary course from the seller's breach, determined in a reasonable manner,¹⁴⁹ together with any applicable incidental and consequential damages.¹⁵⁰

As used in Sections 2.712, 2.713, and 2.714, "incidental damages" are defined in generally the same manner as in Section 2.710, but also include commercially reasonable charges, expenses, or commissions incurred by the buyer in effecting "cover."¹⁵¹ "Consequential damages", which are not recoverable by the seller under Sections 2.708 and 2.709, are defined, for purposes of the damages recoverable by the buyer, to include (i) any loss resulting from general or particular requirements known to the seller when the contract was formed that would not be reasonably prevented by "cover" or otherwise or (ii) injury to persons or property proximately resulting from a breach of warranty.¹⁵²

c. Disclaimer of Consequential Damages; Liquidated Damages. It should be noted that Section 2.719 of the Texas UCC permits parties to limit or exclude consequential damages from the damages recoverable under their contracts, unless the limitation or exclusion is unconscionable.¹⁵³ This right is significant in the case of hydrocarbon sale contracts, as to which it is common for the parties to disclaim all damages (including consequential and punitive damages) except for direct actual damages with respect to breach.¹⁵⁴

In addition, Section 2.718 of the Texas UCC permits parties to include liquidated damages provisions in their contracts, but only in an amount that is "reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or lack of feasibility of otherwise obtaining an adequate remedy."¹⁵⁵ An unreasonably large liquidated damages amount is void as a penalty.¹⁵⁶

III. NATURAL GAS

Before addressing directly the contracting practices currently employed with respect to sales of natural gas, crude oil, and hydrocarbon liquids, a brief history lesson is in order. The basic documentation used today to buy and sell hydrocarbons has been heavily influenced by the gas sale documentation that evolved out of the significant changes to the federal regulatory

¹⁴⁹ *Id.* at §2.714(a).

¹⁵⁰ *Id.* at §2.714(c).

¹⁵¹ *Id.* at §2.715(a).

¹⁵² *Id.* at §2.715(b).

¹⁵³ *Id.* at §2.719(a).

¹⁵⁴ See text accompanying notes 346-349, *infra*.

¹⁵⁵ TEX. BUS. & COM. CODE ANN. §2.718(a) (2017).

¹⁵⁶ *Id.*

structure applicable to natural gas during the 1980s and 1990s. A brief review of the regulatory history of natural gas is therefore in order.

A. Historical Gas Regulatory Framework.

1. NGA Price Regulation. In the early days of the oil and gas industry, natural gas was generally regarded as an unwelcome by-product of oil production, rather than a valuable resource in its own right. Until the 1920s, most gas was flared at or near the wellhead.¹⁵⁷ The discovery of the great Panhandle Field in Texas in 1918 ushered in an era in which the apparently vast reserves of natural gas available in the Panhandle Field became viewed as a clean and efficient source of heating and electric power generation fuel for cities and municipalities in other parts of the country. The evolution of this demand for gas sparked the construction of the large and complex “interstate” pipeline system, which by the end of World War II, was transporting gas to residential heating, industrial, manufacturing, and power generation markets in the eastern and midwestern portions of the country.¹⁵⁸ The development during and after World War II of a market for liquid hydrocarbons extracted from gas by processing (“natural gas liquids” or “NGLs”) further fueled the increasing demand for gas.¹⁵⁹

Because the pipelines provide the only path to move gas to its markets, the modern natural gas industry became premised upon the merchant role of the pipeline companies – that is, pipelines as purchasers of natural gas from the gas producers and as resellers of such gas to public utilities, industrial users, local distribution companies (“LDCs”), and other end users. By the late 1930’s, the United States government had become concerned about the development of the gas pipeline industry as a “natural monopoly,”¹⁶⁰ in response to which Congress passed the Natural Gas Act of 1938 (“NGA”).¹⁶¹ The NGA subjected to the jurisdiction of the Federal Power Commission (“FPC”) so-called “natural gas companies” – primarily pipelines engaged in the transportation of gas in interstate commerce and/or the sale in interstate commerce of gas for resale for ultimate public consumption.¹⁶² The NGA did not establish federal jurisdiction over

¹⁵⁷ *Exxon Corp. v. Middleton*, 571 S.W.2d 349, 351 (Tex. Civ. App. – Houston [14th Dist.] 1978), *rev’d*, 613 S.W.2d 240 (Tex. 1981). See Cummings, *Today’s Marketing, Yesterday’s Leases, Check Stub Statutes: The Perfect Storm?*, 30TH ANN. OIL, GAS & MIN. L. INST., Univ. of Texas School of Law, St. Bar OGERL Section, Paper 8 (2004) (hereinafter, “Cummings”).

¹⁵⁸ See *Exxon Corp. v. Middleton*, 571 S.W.2d at 351; Cummings, *supra* note 157, at 6.

¹⁵⁹ See Cummings, *supra* note 157, at 6.

¹⁶⁰ *A Brief History of Natural Gas Regulation*, FEDERAL ENERGY REGULATORY COMMISSION (May 19, 2010), <http://www.ferc.gov/students/energyweregulate/gas.htm>.

¹⁶¹ 15 U.S.C. §§717, *et seq.* (2017).

¹⁶² *Id.* at §717a(6). The principal components of the FPC’s NGA regulation consisted of limiting the construction of new pipelines to those required by the “public convenience and necessity,” restricting the ability of natural gas companies to abandon their assets or service, *id.* at §717f, and requiring that interstate pipeline transportation rates must be “just and reasonable,” *id.* at §717c. See Martin, *Federal Regulation of Natural Gas – A Primer*, 2ND GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section, Paper 13, at 2, 3 (2003) (hereinafter “Martin”).

the production or gathering of gas, gas transportation solely within a single state (“intrastate” transportation), direct gas sales to end users, or the activities of LDCs.¹⁶³

Wellhead sales of gas did not become subject to the FPC’s jurisdiction under the NGA until the United States Supreme Court so ruled in *Phillips Petroleum Co. v. Wisconsin* in 1954.¹⁶⁴ As the result of *Phillips*, producers desiring to sell gas in the interstate market were required to obtain from the FPC certificates of public convenience and necessity pursuant to which their leases and leased acreage were dedicated to serve the interstate market,¹⁶⁵ and the FPC was required to establish “just and reasonable” rates for such sales.¹⁶⁶

As a result of this economic and regulatory structure, interstate pipelines sought to assure themselves of an acceptable return on the significant investment involved in pipeline construction and adequate supplies of gas for their customers by entering into long-term gas purchase contracts with producers (for the life of the underlying reserves, or, at a minimum, for terms of as much as 15-20 years) pursuant to which the producers committed to sell to the pipelines all of the gas produced from wells dedicated to the contracts. Producers desiring to sell gas in the interstate market embraced this approach because it gave them an assured market for their production which, in turn, facilitated their ability to obtain financing and otherwise to conduct their business planning from a position of economic stability.¹⁶⁷ The pipelines performed essentially all of the off-lease gas management services required to assure the delivery of the producer’s gas to the pipeline’s customers, including transportation, pooling, balancing, storage, exchanges, and similar functions.¹⁶⁸

Ultimately, however, the FPC’s NGA-based regulation of wellhead gas sales proved incapable of responding in a timely manner to changing market conditions. Increasing prices for crude oil and oil products in the late 1960s and the early 1970s increased demand for natural gas.

¹⁶³ 15 U.S.C. §717b.

¹⁶⁴ 347 U.S. 672 (1954).

¹⁶⁵ See 15 U.S.C. §717f. Once a producer dedicated a lease or leased acreage to a certificate of public convenience and necessity, gas produced from the dedicated acreage was required to be sold in the interstate market until the FPC granted an abandonment under Section 7 of the NGA, *id.* at §717f(b), even if, prior to such abandonment, the underlying sales contract had expired, *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137 (1960), or the underlying oil and gas lease had expired, *California v. Southland Royalty Co.*, 436 U.S. 519 (1978).

¹⁶⁶ *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 684 (1954). See 15 U.S.C. §717c. Initially, the FPC attempted to establish well-by-well rates for these gas sales. As the backlog of individual well rate proceedings increased, however, the FPC first attempted to establish wellhead rates on an area-wide basis, see, e.g., *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and *Area Rate Proceedings*, 50 F.P.C. 390, 392 (1973), and later on a nation-wide basis, see *Opinion 770*, 56 F.P.C. 509 (1976), and *Opinion, 770-A*, 56 F.P.C. 2698 (1976).

¹⁶⁷ See Bruce M. Kramer, “*Royalty Obligations Under the Gun-The Effect of Take-or-Pay Clauses on the Duty to Make Royalty Payments*,” 39 INST. ON OIL & GAS L. & TAX’N 5-1, 5-4, 5-5 (1988) (hereinafter, “Kramer”); Edward B. Poitevent, II and Edel F. Blanks, *Take-or-Pay: The Aftermath*, UNIV. OF HOUSTON L. CENTER ADV. OIL & GAS SHORT COURSE, at B-1 (1991) (hereinafter, “Poitevent and Blanks”).

¹⁶⁸ See Carolyn Hazel, *The Gas Marketing Revolution: Sharing Values Between Lessors and Lessees*, 13TH ADV. OIL, GAS & MIN L. COURSE, St. Bar of Tex., Paper H, at H-1 (1995) (hereinafter, “Hazel I”).

The artificially low gas prices applicable to gas sold in the interstate market, however, discouraged the development of new gas reserves and their dedication to interstate service. At the same time, the higher deregulated prices available for gas sold to intrastate pipelines incentivized producers to develop reserves for sale in that market. Consequently, by the late 1960s, there had evolved two separate and very distinct gas markets in most producing states – a lower-priced, highly regulated interstate gas market and a higher-priced, unregulated (or more lightly regulated) intrastate gas market.¹⁶⁹

2. Movement Toward Price Deregulation. The first shots fired in the revolution in the U.S. gas market related to the decontrol of wellhead gas prices. In response to increasingly significant shortages of available natural gas supplies in the interstate gas market resulting from the bifurcated interstate/intrastate gas markets discussed above, Congress and the Federal Energy Regulatory Commission (“FERC”), which had succeeded to the regulatory responsibilities of the former FPC,¹⁷⁰ undertook numerous legislative and regulatory initiatives intended to provide price and other incentives for increased production and sales of natural gas in the interstate market, including Congress’s enactment of the Natural Gas Policy Act of 1978 (“NGPA”).¹⁷¹

The NGPA established a series of “maximum lawful prices,” subject to statutorily prescribed annual escalations, applicable to several categories of newly drilled wells, regardless of whether gas from these wells was sold in the interstate or the intrastate markets, that would expire in 1985.¹⁷² The NGPA also incorporated as separate categories of maximum lawful prices certain existing FPC/FERC approved rates applicable to existing gas production being sold into the interstate market,¹⁷³ as well as the prices being paid under existing intrastate gas sales contracts.¹⁷⁴

In large part, the NGPA worked. The separate and distinct interstate and intrastate gas markets, and their associated price disparities, were eliminated over a period of years, resulting

¹⁶⁹ For good discussions of the evolution of the disparity between interstate and intrastate gas markets during this period, see Order No. 451, *Ceiling Prices: Old Gas Pricing Structure*, [Regs. Preambles 1986-90] F.E.R.C. STATS. & REGS. (CCH) 30,700; Martin, *supra* note 162, at 3-5.

¹⁷⁰ See Department of Energy Organization Act, Pub. L. No. 95-91, 42 U.S.C. §§7131, 7134 (2014).

¹⁷¹ 15 U.S.C. §§3301, *et seq.* (2014). See Pearson, *Gas Royalty Calculation 2005 – An Update*, 30 OIL, GAS, & ENERGY RES. L. Section Report, No. 3, St. Bar of Tex., at 4 (2006) (hereinafter, “Pearson I”).

¹⁷² NGPA §102 (new onshore wells), 15 U.S.C. §3312; NGPA §103 (new onshore production wells), 15 U.S.C. §3313; NGPA §107 (high-cost natural gas), 15 U.S.C. §3317; and NGPA §108 (stripper well natural gas), 15 U.S.C. §3318, *all repealed*, Pub. L. No. 101-60, §2(b), 103 Stat. 158 (1989).

¹⁷³ NGPA §§104 (existing interstate contracts) and 106 (rollover contracts), 15 U.S.C. §§3314, 3316, *repealed*, Pub. L. No. 101-60, §2(b), 103 Stat. 158 (1989).

¹⁷⁴ NGPA §105 (existing intrastate contracts), 15 U.S.C. §3315, *repealed*, Pub. L. No. 101-60, §2(b), 103 Stat. 158 (1989).

in additional gas-focused exploration and development activity and the discovery of significant new gas reserves.¹⁷⁵

3. Continued Evolution of the U.S. Natural Gas Market. These increased gas reserves were a two-edged sword, however. By 1982, the increase in gas reserves, together with a world-wide recession, mild winters, and legislative and regulatory initiatives favoring the switching by industrial users to fuels other than gas, created a situation of weakened demand for, and excess supply of, gas.¹⁷⁶ These changed economic circumstances had adverse impacts on both the pipelines and their customers.

The principal source of the pipelines' difficulties was the presence of take-or-pay provisions in virtually all of their gas purchase contracts with producers.¹⁷⁷ Take-or-pay provisions obligate a pipeline buyer to take certain minimum quantities of gas on an annual basis (the "minimum contract quantity"), or, if the pipeline is unable to take all of the minimum contract quantity, to pay the producer for the difference between the minimum contract quantity and the volume of gas actually taken by the pipeline. Most contracts also gave the pipeline the right, over a period of succeeding years, to credit gas taken in excess of the minimum contract quantity for a particular year against previous take-or-pay payments.¹⁷⁸ As the demand for gas from the pipelines' end user customers decreased, the pipelines' economic exposure to producers under take-or-pay provisions increased dramatically. Pipelines adopted a range of responses to this circumstance, including unilateral reductions of the volumes of gas taken from producers and unilateral reductions in the price paid for gas taken. As a result of these actions, numerous lawsuits were filed by producers against pipelines pursuant to which producers sought damages for the pipelines' failure to comply with the take-or-pay and other provisions of the relevant gas purchase contracts and the repudiation by the pipelines of such contracts. With very few exceptions,¹⁷⁹ producers prevailed in these lawsuits.¹⁸⁰

In response to these changed conditions in the natural gas industry, the FERC and Congress implemented several legislative and regulatory initiatives intended further to reshape the natural gas industry. In a series of orders beginning in 1984, including Order No. 436 in

¹⁷⁵ See Pearson I, *supra* note 171, at 7.

¹⁷⁶ See *id.*

¹⁷⁷ For a discussion of whether a take-or-pay contract constitutes an output contract under Section 2.306 of the Texas UCC, see text accompanying notes 90 through 96, *supra*.

¹⁷⁸ See *Diamond Shamrock Exp. Co. v. Hodel*, 853 F.2d 1159, 1164 (5th Cir. 1988).

¹⁷⁹ See, e.g., *Atlantic Richfield Co. v. ANR Pipeline Co.*, 768 S.W.2d 777 (Tex. App. – Houston [14th Dist.] 1989, no writ).

¹⁸⁰ E.g., *Universal Res. Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77 (5th Cir. 1987); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565 (Tex. 1996); *Valero Transmission Co. v. Mitchell Energy Corp.*, 743 S.W.2d 658 (Tex. App. – Houston [1st Dist.] 1987, no writ). See J. Michael Medina, et al., *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185 (1986); David L. Roland, *Comment: Take-or-Pay Provisions for the Natural Gas Industry*, 18 ST. MARY'S L.J. 251 (1986).

1985¹⁸¹ and its landmark Order No. 636 in 1992,¹⁸² the FERC undertook, first, to transform the role of the interstate pipelines from the role of gas merchant to the more limited role of gas transporter,¹⁸³ and later, to require the unbundling of the interstate pipelines' sales and transportation services, which permitted pipeline shippers and customers to contract only for the specific service or services – such as dehydration, compression, treating, storage, and the like – required to transport that party's gas, thus lowering the transportation costs of the shipper or customer.¹⁸⁴

During the same period, Congress passed the Natural Gas Wellhead Decontrol Act of 1989,¹⁸⁵ pursuant to which all remaining NGA-regulated rates and NGPA maximum lawful prices applicable to wellhead gas sales were eliminated by January 1, 1993.

A complete discussion of these FERC orders is beyond the scope of this paper.¹⁸⁶ Suffice it to say that the foregoing market, legislative, and regulatory developments utterly changed the face of the domestic natural gas industry. As wellhead prices became deregulated and the pipeline industry was restructured, a volatile, national free market for physical gas sales unbundled from transportation and distribution rapidly evolved. As a result, it is now possible readily to identify at any time the current "index price" for gas reported by both interstate and intrastate pipelines at any one of numerous locations on the national pipeline grid.¹⁸⁷

¹⁸¹ Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regs. Preambles 1982-85] F.E.R.C. STATS. & REGS. (CCH) ¶130,665, *order on reh'g*, Order No. 436-A, [Regs. Preambles 1982-85] F.E.R.C. STATS. & REGS. (CCH) ¶130,675 (1985), *order on reh'g*, Order No. 436-B, [Regs. Preambles 1986-90] F.E.R.C. STATS. & REGS. (CCH) ¶130,688, *order on reh'g*, Order No. 436-C, 34 F.E.R.C. ¶161,404, *order on reh'g*, Order No. 436-D, 34 F.E.R.C. ¶161,405, *order on reh'g*, Order No. 436-E, 34 F.E.R.C. ¶161,403 (1986), *vacated and remanded sub nom. Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied sub nom., Southern California Gas Co. v. FERC*, 485 U.S. 1006 (1988).

¹⁸² Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Current] F.E.R.C. STATS. & REGS. (CCH) ¶130,939, *order on reh'g*, Order No. 636-A, [Current] F.E.R.C. Stats. & Regs. (CCH) ¶130,950, *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶161,272 (1992), *reh'g denied*, 62 F.E.R.C. ¶161,007 (1993), *aff'd in part and remanded in part, United Distribution Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert. denied sub nom., New York Public Service Comm'n v. FERC*, ___ U.S. ___, 117 S. Ct. 1723 (1997), and *Burlington Resources Oil & Gas Co. v. FERC*, ___ U.S. ___, 117 S. Ct. 1724 (1997).

¹⁸³ Order No. 436, [Regs. Preambles 1982-85] F.E.R.C. STATS. & REGS. (CCH) ¶130, 665, at 31,497-31,569. For an excellent discussion of Order No. 436, see Thomas G. Johnson, *Order No. 436 Revisited – The Interim Rule and Then What?*, 39TH INST. ON OIL & GAS L. & TAX'N 6-1 (1988).

¹⁸⁴ Order No. 636, F.E.R.C. STATS & REGS. (CCH) [Current] ¶130,939, at 30,402-13, 30,421-25, and 30,437-43.

¹⁸⁵ Pub. L. No. 101-60, 103 Stat. 157 (1989) (codified in scattered sections of 15 U.S.C.A.).

¹⁸⁶ For a comprehensive summary of these actions by the FERC, see Pearson I, *supra* note 171, at 8-12.

¹⁸⁷ See Kathleen R. McLaurin, *New Financing Techniques in Gas Marketing*, 6TH ANN. OIL & GAS L. INST., S. Texas College of Law, Paper G, at G-2 (1993) (hereinafter, "McLaurin"). "Index prices" are prices for natural gas that are published by industry publications and are based on actual, arms'-length transactions within a particular geographic area. See *Union Pacific Resources Group, Inc. v. Neinast*, 67 S.W.3d 275, 279 (Tex. App. – Houston [1ST Dist.] 2001, no pet.). See generally Hartrick and O'Brien, *Legal Issues Relating to Index Pricing*, 21ST ADV. OIL, GAS & ENERGY RES. L. COURSE, St. Bar of Tex., Ch. 10 (2003) (hereinafter, "Hartrick and O'Brien").

Technological advances have permitted the development of instantaneous electronic trading of both gas and pipeline capacity as truly fungible commodities.¹⁸⁸ Interstate pipelines now perform relatively few gas management functions, with most of these functions having been assumed either by gas producers or gas aggregators – marketing companies (that may be producer affiliates) that own no transportation facilities, but that purchase gas at the wellhead or in the field, arrange for transportation, engage in gas trading activities, and contract for the ultimate sale of the gas to an LDC or other end user.

B. Rise of the Financial Energy Markets.

During the same time frame as the FERC's natural gas regulatory initiatives, there has occurred a dramatic evolution in the financial markets relating energy commodities. Prior to the 1990s, financial transactions based on energy commodities were conducted by means of the highly regulated trading of futures contracts on recognized exchanges such as the New York Mercantile Exchange ("NYMEX") and the Chicago Board of Trade ("CBOT").¹⁸⁹ In the 1990s, however, with the increased volatility of natural gas prices, over-the-counter ("OTC") derivative transactions based on energy commodities (primarily crude oil and gas) began to be traded directly among individual entities.¹⁹⁰

A "derivative" is a financial instrument that derives its value from an underlying commodity but does not involve the purchase, sale, or exchange of the commodity. Derivative transactions are usually settled financially, by the payment of money from one person to another, rather than the physical delivery of the underlying commodity.¹⁹¹ The most common types of financial commodity based derivatives are swaps¹⁹² and options.¹⁹³

¹⁸⁸ See Hazel I, *supra* note 168, at H-2, H-3.

¹⁸⁹ On NYMEX, the futures contract for WTI light, sweet crude oil trades at Cushing, Oklahoma, and the futures contract for natural gas trades at Henry, Louisiana. See *Oil Futures Contract Specs*, <http://www.cmegroup.com/trading/energy/crude-oil>; *Henry Hub Natural Gas Futures Contract Specs*, <http://www.cmegroup.com/trading/energy/natural-gas> (last viewed on April 13, 2018).

¹⁹⁰ See Gammie, *Fundamentals of Energy Commodities in the Marketplace*, 22nd ANN. ADV. OIL, GAS & ENERGY RES. L. COURSE, St. Bar of Tex., Ch. 19, at 2 (hereinafter, "Gammie").

¹⁹¹ See Vrana, Enochs, and Mwamba, *How To Use the ISDA Master Agreement*, 28th ANN. OIL, GAS & MIN. L. INST., Univ. of Texas School Law, St. Bar OGERL Section, at 1 (2002) (hereinafter, "Vrana, Enochs, and Mwamba").

¹⁹² In the energy context, a "swap" is a purely financial bilateral transaction involving rights to a physical commodity in which there is an exchange of cash flow obligations determined by reference to market prices for a hypothetical agreed upon, or "notional", quantity of the specified commodity. A typical swap is a "fixed-for-floating" swap in which (i) one party pays a fixed price and the other party pays an index, or floating, price with respect to the notional quantity, (ii) on the settlement date, the two amounts are netted, and (iii) the party owing the greater amount (who is said to be "out of the money") pays the difference to the other party (who is said to be "in the money"). See Gammie, *supra* note 190, at 6 and n. 22.

¹⁹³ A financial "option" gives the holder the right, but not the obligation, either to buy (a "call option") or to sell (a "put option") an agreed upon quantity of a specified commodity at a specified location on a specific date or dates in the future at price specific for each date (each, a "strike price"). The option holder then closes out and liquidates his position by either (i) exercising the option, (ii) reselling the option or offsetting the option with another

Derivative transactions in energy commodities are, to varying degrees, subject to regulation by the Commodities Futures Trading Commission (“CFTC”) under the Commodities Exchange Act (“CEA”),¹⁹⁴ as amended by the Commodities Futures Modernization Act of 2000,¹⁹⁵ and the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”),¹⁹⁶ enacted in the wake of 2008’s “sub-prime” crisis. A complete discussion of the commercial, contractual, and regulatory issues associated with derivative transactions is beyond the scope of this paper.¹⁹⁷ Since derivative transactions are settled financially and do not involve the physical delivery of an energy commodity, however, why are we concerned about them in a paper that addresses the actual marketing of hydrocarbons? Some sophisticated oil and gas producers, particularly those with marketing affiliates, may utilize derivatives for arbitrage or speculation.¹⁹⁸ For most independent producers, however, the answer is, quite simply, that such producers are required to hedge the price risk associated their physical hydrocarbon sales under the terms of the covenants in their revolving credit facilities.¹⁹⁹

Thus, for example, assume that a producer markets the majority of its gas production at market sensitive index prices, but also is a party to long-term, fixed price gas sales contracts covering a smaller percentage of its total production. Such a producer might pursue the following two-pronged hedging strategy. In the first instance (“Swap A”), the producer would enter into a “fixed-for-floating” swap transaction with respect to a notional quantity of gas equal to the percentage of the producer’s estimated future production to be sold at index prices. Pursuant to Swap A, the producer would pay to the swap counterparty the agreed upon index (or floating) price (which may or may not be the same index price at which the producer actually sells some

transaction, or (iii) allowing the option to expire. “American” options may be exercised at any time prior to the exercise date; “European” options may only be exercised on the exercise date. See Gammie, *supra* note 190, at 7.

¹⁹⁴ 7 U.S.C. §§1, *et seq.* (2017).

¹⁹⁵ Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

¹⁹⁶ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹⁹⁷ See Gammie, *supra* note 190; Lotay, Nossa, and Vrana, *Hedging Oil and Gas Production*, 41st ANN. OIL, GAS & MIN. L. INST., Univ. of Texas School of Law, St. Bar OGERL Section (2015) (hereinafter, “Lotay, Nossa, and Vrana”).

¹⁹⁸ See Gammie, *supra* note 190, at 5; Pearson I, *supra* note 171, at 68.

¹⁹⁹ These covenants typically (a) require the producer to enter into hedging transactions with respect to a minimum percentage (*i.e.*, 80%) of its anticipated total production attributable to the proved reserves reflected in the most recent petroleum engineer’s report of estimated oil and gas reserves delivered to the producer’s lenders and (b) prohibit the producer from entering into hedging transactions with respect to more than a maximum percentage (*i.e.*, 90%) of such anticipated total production. The purposes of these covenants are, obviously, to require the producer to provide the lenders a form of insurance policy against commodity price risk (thereby enhancing the likelihood that the loan will be repaid) while restricting the ability of the producer to engage in speculation. As described by one commentator, “Purchasing a hedge in the futures market acts as an insurance policy on the price of the commodity. The buyer or seller can lock in an acceptable and effective gas cost as protection against fluctuations and unfavorable shifts in the cash market price. If a buyer or seller fails to hedge against possible adverse price changes, it suffers the same risks associated with the failure to buy liability insurance for its business. An adverse change in the market would be the equivalent to being found liable for negligence and damages. Without the insurance policy, the buyer or seller bears the entire burden of the loss.” See McLaurin, *supra* note 187, at G 4.

or all of its production), and the counterparty would pay to the producer an agreed upon fixed reference price for the same notional quantity of gas.

In the second instance ("Swap B"), the producer would enter into a similar swap transaction with respect to a notional quantity equal to the percentage of the producer's estimated future production to be sold at fixed prices. In contrast to Swap A, the producer in Swap B is the payor of the agreed upon fixed reference price, and the counterparty is the payor of the agreed upon index or the floating price. In neither case is the swap transaction linked to gas produced from a particular oil and gas lease or gas actually sold under a particular sales contract.

The effect of Swap A is to transform a portion of the producer's anticipated variable cash flow from index priced gas sales into a fixed stream of revenue.²⁰⁰ In the case of Swap B, the producer's execution of its long-term, fixed price gas contracts is inherently a form of price hedge as to the volumes sold under such contracts. So, the effect of Swap B is to permit the producer to preserve for itself, with respect to a portion of its estimated future fixed price gas portfolio, at least some of the potential price "upside" available in the index price market (while minimizing the corresponding "downside" risk).²⁰¹

As a result, it is important for oil and gas producers to educate themselves about the mechanics, documentation, and regulatory framework of derivative transactions.

C. Current Natural Gas Sale Practices.

Based on the circumstances described in the preceding sections of Article III of this paper, sales of gas in which producers are the sellers now generally fall into one of three general categories:

- wellhead sales to a gas processor, gas gatherer, or intrastate pipeline (each, a "Midstream Company") of gas that requires processing, involving a commitment by the seller of gas reserves to the contract, a "firm"²⁰² commitment by the gas purchaser to take the gas (usually up to a maximum daily quantity), and pricing based on either a designated index price (plus or minus the applicable basis differential), or a percentage of the proceeds received by the Midstream Company upon its sale of the natural gas liquids extracted from the producer's gas and the residue gas after processing. The latter type of contract is referred to as a "percentage of proceeds" or "POP" contract.²⁰³ Under these types of

²⁰⁰ See McLaurin, *supra* note 187, at G-11.

²⁰¹ See Hazel I, *supra* note 168, H-5.

²⁰² "Firm" sales service is a higher class of service for gas that is continuous without curtailment except upon the occurrence of force majeure or other occasional, extraordinary circumstances. 8 Patrick H. Martin & Bruce M. Kramer, WILLIAMS & MEYERS OIL & GAS LAW, *Manual of Terms*, at 381 (2014).

²⁰³ See *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 708 (Tex. 2008).

contracts, delivery of the gas to the Midstream Company may be made at the wellhead, one or more central delivery points in the field, or the inlet of a gas processing plant;

- short term sales, usually to gas aggregators, of gas that does not require processing or residue gas after processing at daily index prices (plus or minus the applicable basis differential) at delivery points on the transporting pipeline, in most cases without a contractual commitment of reserves (“non-source specific”); and
- short, intermediate, or long term, non-source specific, direct, firm sales of pipeline quality gas to end users (such as electric power generation plants), also known as “warranty contracts”, made at delivery points on the transporting pipeline or at the inlet of the purchaser’s facilities, at a fixed price, or at prices based on a designated index price (plus or minus the applicable basis differential) or a “forward” price curve based on NYMEX gas futures prices, or a combination thereof.²⁰⁴

The following discussion will focus on the first two types of gas sales listed above.²⁰⁵

1. Evolution of the Master Agreement. With the advent of robust, volatile national markets for gas unbundled from transportation during the 1990s came a much higher volume of rapid-fire, shorter term, or “spot”, gas sales and purchases for which traditional lengthy, labor intensive, closely negotiated gas sale agreements were clearly inappropriate.²⁰⁶ The market required the development of a contract format that permitted regular trading partners to define, in necessary detail, the legal framework under which they were willing to transact on a repetitive basis, accompanied by a “short-form” mechanism that would be used to effectuate in an efficient manner enforceable individual transactions based on a clear understanding of the commercial terms.²⁰⁷

The International Swaps and Derivatives Association (“ISDA”)²⁰⁸ led the charge in the development of so-called “master agreements” to facilitate trading transactions. In 1987, ISDA

²⁰⁴ See Pearson I, *supra* note 171, at 12, 13; Hazel I, *supra* note 168, at H-2, H-3; James C.T. Hardwick & J. Kevin Hayes, *Gas Royalty Issues Arising from Direct Gas Marketing*, 43^D ANN. INST. ON OIL & GAS L. & TAX’N 11-1, 11-8, 11-9 (1992) (hereinafter, “Hardwick and Hayes”). In the latter example, the gas price often reflects a premium over current index prices to compensate the seller for the additional risk assumed by the seller with respect to a longer term, firm sales obligation.

²⁰⁵ In our experience, relatively few producers have participated in the Texas premium gas market because of the large volumes of gas typically required by the premium gas purchaser and because of the flat-to-falling demand for new, large volume, long-term gas purchases by electric power generators and other industrial gas consumers since the early 2000’s.

²⁰⁶ See Gammie, *supra* note 190, at 2.

²⁰⁷ See Hazel, *How and When to Use the Gas Industry Standards Board’s (GISB) Contract for Short-Term Sales of Natural Gas*, 9th ANN. OIL & GAS L. INST., S. Tex. College of L. (1996) (hereinafter, “Hazel II”).

²⁰⁸ ISDA is a trade association of over 700 member organizations from 41 countries that was formed to encourage the prudent and efficient development of the OTC derivatives market. It produces standard form documentation for privately negotiated derivative contracts with terms tailored to the specific needs of the parties. See

produced the first two standard form master agreements to cover different types of interest rate swaps and a set of interest rate and currency definitions. In 2002, ISDA published a revised version of its 1987 master agreement, which became the first ISDA master agreement to be widely used to document energy based derivatives transactions (the “1992 ISDA Master Agreement”). The 1992 ISDA Master Agreement was revised in 1997 and republished in 2002 (the “2002 ISDA Master Agreement”).²⁰⁹ The 2002 ISDA Master Agreement is now the industry-standard master agreement for documenting derivative transactions of all types.²¹⁰ With the publication of its “Provisions Relating to North American Gas Transactions” (the “ISDA Gas Annex”) in 2004, the 2002 ISDA Master Agreement is also used increasingly to document physical sales of natural gas on a spot or forward basis, or options on physical gas in the U.S. gas markets.²¹¹

The Gas Industries Standards Board (“GISB”) was formed in 1994 by representatives of all segments of the natural gas industry to, *inter alia*, develop a standard form spot gas sales contract to support the physical trading of natural gas. GISB published the initial “Base Contract for Short-Term Sale and Purchase of Natural Gas”, Form GISB-BC-3/26/96 (the “1996 GISB”), for industry use in May 1996.²¹² The North American Energy Standards Board (“NAESB”) was organized in 2001 as the successor to GISB and, in 2002, published a revision of the 1996 GISB also styled “Base Contract for Short-Term Sale and Purchase of Natural Gas”, approved April 19, 2002 (the “2002 NAESB”).²¹³ A revised version of the 2002 NAESB was adopted on September 5, 2006, and

International Swaps and Derivatives Association, Inc., Who We Are, at <http://www.isda.org>; Vrana, Enochs, and Mwamba, *supra* note 191, at 5-6.

²⁰⁹ See Vrana, Enochs, and Mwamba, *supra* note 191, at 5-6; Teigland-Hunt, *Masters, Annexes and Bridges (Oh My!): A Primer on U.S. Energy Trading Documentation*, 5th ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section, at 4 (2006) (hereinafter, “Teigland-Hunt”).

²¹⁰ Derivative transactions utilizing the ISDA documentation ordinarily contain three components: (a) the 2002 ISDA Master Agreement itself, which, except for the inclusion of the names of the parties, is never modified in any way; (b) the ISDA Collateral Annex, published in 1994 (the “ISDA Collateral Annex”), which is not required to be, but is almost always, included in the 2002 ISDA Master Agreement and includes all of the credit and collateral terms related to the 2002 ISDA Master Agreement, including Paragraph 13, which contains the parties’ various credit thresholds used to determine when collateral must be provided; and (c) the Schedule to the Master Agreement (the “ISDA Schedule”), which (together with Paragraph 13 of the ISDA Collateral Annex) is where the parties include all of their negotiated amendments and customization of the 2002 ISDA Master Agreement and the ISDA Collateral Annex. See Vrana, Enochs, and Mwamba, *supra* 191, at 7-12.

²¹¹ See Edmonds, *Development of Credit Terms in Energy Trading Contracts*, 57th ANN. INST. ON OIL & GAS L. §5.05[1][c] at 5-9 (2006) (hereinafter, “Edmonds”). The principal benefit of using the ISDA Gas Annex is that it permits users to bring physical gas transactions under the architecture of the 2002 ISDA Master Agreement and to incorporate existing credit support arrangements among the parties. The ISDA Gas Annex is published as Sub-Annex E to the ISDA 2005 Commodity Definitions and may be incorporated into the Schedule for the 2002 ISDA Master Agreement by reference to such sub-annex. *Id.*

²¹² *Base Contract for Short-Term Sale and Purchase of Natural Gas*, published by the Gas Industry Standards Board on May 13, 1996 (hereinafter, the “1996 GISB”); see Hazel II, *supra* note 207, at F-2.

²¹³ *Base Contract for Sale and Purchase of Natural Gas*, published by the North American Energy Standards Board on April 19, 2002 (hereinafter, the “2002 NAESB”); see Edmonds, *supra* note 211, §5.05[4] at 5-12; Teigland-Hunt, *supra* note 209, at 4-5.

with revisions adopted in 2011 and 2015, is the most current version of NAESB's Base Contract for Short-Term Sale and Purchase of Natural Gas (the "2006 NAESB").²¹⁴

The 2002 ISDA Master Agreement and the 2006 NAESB both accomplish the principal objectives of any master commodity agreement:

- (a) standardization of the basic rules and legal framework of trading in the relevant commodity, including detailed definitions, specified events of default, events of force majeure, rights regarding netting and setoff (whether broad or narrow), and damages for non-performance;
- (b) a simplified contract formation procedure for each transaction that, if followed, assures the creation of an enforceable agreement for the relevant transaction;
- (c) a bilateral or neutral contracting perspective that allows either party to be the seller or the buyer from one transaction to the next;
- (d) the presence of detailed and standardized credit provisions that the parties can vary in negotiation; and
- (e) "no fault", bilateral liquidation of all outstanding transactions upon the occurrence of an event of default.²¹⁵

The Edison Electric Institute (EEI), which publishes the EEI Master Power Purchase and Sale Agreement ("EEI Master Agreement"), the most widely used master agreement relating to sales and purchases of wholesale electric power, has also published, in 2004, a Gas Annex (the "EEI Gas Annex").²¹⁶ In the experience of this author, however, the 2006 NAESB has achieved much greater traction as the contract platform for parties engaged in short-term, spot gas sales than either the ISDA Gas Annex or the EEI Gas Annex. As such, this discussion will now focus on some of the key provisions of the 2006 NAESB.

2. 2006 NAESB. The documentation architecture for the 2006 NAESB ordinarily contains the following components:

- (a) the cover sheet ("Cover Sheet") that contains (i) the names, physical addresses, contact information for notice purposes, wire transfer instructions, and signature blocks of and for the parties, (ii) a list of "check-the-box" elections the parties are required to make regarding certain of the General Terms and Conditions, and

²¹⁴ *Base Contract for Sale and Purchase of Natural Gas*, published by the North American Energy Standards Board on September 5, 2006 (hereinafter, the "2006 NAESB"); see Sappenfeld, *The 2006 NAESB Base Contract: What's New and What's Not!*, 59TH ANN. INST. ON OIL & GAS L. §5.01 at 139-141 (2008) (hereinafter, "Sappenfeld").

²¹⁵ See Gammie, *supra* note 190, at 3-5.

²¹⁶ See Edmonds, *supra* note 211, §5.05[2] at 5-10 - 5-11; Teigland-Hunt, *supra* note 209 at 5, 7.

- (iii) “check-the-box” spaces in which to list whether any “special provisions” or addenda will be attached to the contract;
- (b) the 2006 NAESB General Terms and Conditions (the “2006 GTCs”), which are expressly incorporated by reference into the Base Contract and which are generally not revised directly except for the elections referred to in the Cover Sheet;
- (c) the form of transaction confirmation (“Confirmation”) to be executed by the parties with respect to each gas sale/purchase transaction entered into pursuant to a 2006 NAESB, which contains the primary commercial terms of the transaction, including (i) quantity, (ii) price, (iii) duration of the transaction, and (iv) delivery points;
- (d) an exhibit setting forth any amendments to the 2006 GTCs and any customized provisions negotiated by the parties; and
- (e) in certain circumstances, the NAESB Credit Support Addendum, published in 2003 (“Credit Support Addendum”), which supplements and expands the provisions relating to “Financial Responsibility” contained in the 2006 GTCs.²¹⁷

For purposes of this paper, all of the foregoing items except for the Confirmation applicable to such transaction may be referred to collectively as the “Base Contract.”

The 2006 NAESB is copyrighted material of NAESB. As such, we are not permitted to attach a copy of the 2006 NAESB to this paper as an exhibit. It is available for download from the NAESB home page for a fee.²¹⁸

It is important to keep in mind that the 1996 GISB and all of the iterations of the NAESB contract were intended for use with respect to short-term, spot gas sales and purchases of one month or less.²¹⁹ The contract architecture, without significant modifications, is not appropriate for use in longer term transactions, such as long-term gas purchases of gas production at the wellhead. That fact, of course, has not prevented many gas producers – particularly a number of major oil companies that regularly buy the gas of other producers in the field – from forcing the 2006 NAESB’s “square peg” architecture into the “round hole” of longer-term wellhead-based transactions through the addition of lengthy and complex “special provisions” exhibits. The thinking appears to be that, because of the 2006 NAESB’s widespread acceptance among gas sellers and buyers, contract negotiations will be smoother if the 2006 NAESB Cover Sheet and

²¹⁷ See Hazel II, *supra* note 207, at F-2 – F-3; Edmonds, *supra* note 211, at 5-11 - 5-12.

²¹⁸ *Frequently Asked Questions – NAESB Base Contract for Sale and Purchase of Natural Gas*, at <http://www.naesb.org> (last visited on April 13, 2018).

²¹⁹ See Hazel II, *supra* note 207, at F-2.

2006 GTCs appear at the front of the contract, even if large portions of the contract are later re-written in the Confirmation and special provisions.

a. Contract Formation. The Base Contract itself is, of course, effective between the parties upon its execution, unless otherwise stated on the Cover Sheet. The formation and effectiveness of each gas sale or purchase transaction undertaken pursuant to the Base Contract are governed by either an “Oral Transaction Procedure” or a “Written Transaction Procedure”²²⁰ selected by the parties checking the appropriate box under the caption “Section 1.2 – Transaction Procedure” on page 1 of the Cover Sheet.

The Oral Transaction procedure in Section 1.2 of the 2006 GTCs provides that a transaction will be formed, and the parties will be legally bound, when the parties agree to an offer and acceptance embodying the transaction’s commercial terms by telephone or in an electronic data interchange transmission (“EDI”).²²¹ Such an oral agreement is expressly provided to constitute a “writing” “signed by the parties.”²²² Notwithstanding such oral communications, the “Confirming Party” – *i.e.*, the party designated in the Base Contract to prepare and send Confirmations²²³ -- is required to send to the other party a written Confirmation confirming the orally agreed upon commercial terms, although Section 1.2 expressly provides that the Confirming Party’s failure to send such a Confirmation will not invalidate any transaction agreed to orally by the parties.²²⁴ In this regard, Section 1.4 of the 2006 GTCs includes a pre-grant by each party of authority to the other party to record their telephone conversations concerning transactions formed under the relevant Base Contract without further notice to the other party.²²⁵

Alternatively, the Written Transaction Procedure requires the Confirming Party to deliver to the other party a written Confirmation setting out the commercial terms agreed to by the parties by the close of business on the business day immediately following the date on which the parties reach agreement. If the Written Transaction Procedure option is selected, no transaction will become legally binding on the parties until either (a) the parties have exchanged non-conflicting Confirmations or (b) the “Confirmation Deadline” – *i.e.*, 5:00 p.m. in the receiving party’s time zone on the second business day after the Confirmation is received²²⁶ – has passed with no objection by the receiving party.²²⁷

²²⁰ 2006 NAESB, §1.2.

²²¹ 2006 NAESB, §1.2, Oral Transaction Procedure.

²²² *Id.*

²²³ *See id. at* §2.5.

²²⁴ *See id. at* §1.2, Oral Transaction Procedure.

²²⁵ *Id. at* §1.4.

²²⁶ *Id. at* §2.4.

²²⁷ *Id. at* §1.2, Written Transaction Procedure.

Regardless of whether the Oral Transaction Procedure or the Written Transaction Procedure is selected, if a Confirmation sent by the Confirming Party differs materially from the receiving party's understanding of the transaction terms, the receiving party must notify the Confirming Party by the Confirmation Deadline, or the Confirmation will become the binding and effective statement of the transaction terms.²²⁸

The Oral Transaction Procedure's notion that the parties' agreement becomes legally binding and enforceable based upon their telephone communication or EDI exchange obviously raises issues under the Texas UCC's statute of frauds.²²⁹ Arguably, a tape recording of the parties' telephone conversation agreeing to the terms of a transaction constitutes an "intentional reduction to tangible form" within the Texas UCC's definition of "writing"²³⁰ if the recording is consented to by both parties, which is why Section 1.4 is included in the 2006 GTCs.²³¹ The risk is, of course, eliminated if parties promptly follow their oral agreements with written Confirmations. Because of the strong usage of trade among gas traders to rely on their telephone conversations as binding,²³² in our experience, most parties engaged in short-term trading transactions under the 2006 NAESB elect to use the Oral Transaction Procedure. When the 2006 NAESB is used for non-trading transactions, the parties tend to select the Written Transaction Procedure more frequently.²³³

b. Term. Each Base Contract is terminable by either party upon 30 days' prior written notice to the other party; provided that each terminated Base Contract will remain effective as to all outstanding transactions until such transactions expire.²³⁴

The duration of each transaction under a Base Contract is its "Delivery Period" – the period agreed upon by the parties during which gas deliveries will be made under a transaction.²³⁵ In a short-term gas sale, this period will typically be one or more specific 24-hour periods, a calendar month, or perhaps a year.²³⁶ The Delivery Period for each transaction will appear in the applicable Confirmation.

²²⁸ *Id.* at §1.3. See generally Enochs and Page, *ISDA and its Commodity Annexes: The New EEI or NAESB?*, 8TH ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section, at 5 (2009) (hereinafter, "Enochs and Page").

²²⁹ TEX. BUS & COM. CODE ANN §2.201(a) (2018) (For a contract for the sale of goods for a price greater than \$500 to be enforceable "by way of action or defense", it must be evidenced by a "writing" signed by the party intended to be bound). See text accompanying notes 21 through 23, *supra*.

²³⁰ TEX. BUS & COM. CODE ANN §1.201(43) (2018).

²³¹ See Hazel II, *supra* note 207, at F-3.

²³² See *id.*

²³³ See Enochs and Page, *supra* note 228, at 5-6.

²³⁴ 2006 NAESB, §12.

²³⁵ *Id.* at §2.12.

²³⁶ See Lake and Hoff, *supra* note 44, at 8.

If a Base Contract is intended to cover a single, longer-term transaction, consideration should be given to modifying the Base Contract so that the Delivery Period and the term of the Base Contract itself coincide.

c. Quantity; Standard of Service. Recall that under the Texas UCC, the “quantity” term is the one key contract term for which the “gap filler” provisions of the Texas UCC do not provide a default rule.²³⁷ In most short-term transactions under the 2006 NAESB, the quantity of gas to be sold will be reflected in the Confirmation as either a fixed quantity per day or a range of quantities between specified minimum and maximum quantities per day (in each case, the “Contract Quantity”).²³⁸ The Base Contract uses one million British thermal units, or one “MMBtu”, as the unit of sale.²³⁹ As the result, the parties to a Base Contract are actually measuring the Contract Quantity by the heating content of the gas, and not its physical volume, which is ordinarily measured per thousand cubic feet, or “Mcf”.

If the Base Contract is used for a longer-term transaction, such as the purchase of all of an oil and gas producer’s wellhead gas production or the sale to the owner of a power generation plant of the plant owner’s gas fuel requirements, the parties may agree upon “output” or “requirements”-type language to describe the Contract Quantity.²⁴⁰ Care should be taken to protect the buyer under an “output” obligation or the seller under a “requirements” obligation by building in a daily cap on the quantity of gas the buyer is obligated to purchase and receive or the seller is obligated to sell and deliver, as applicable. In this way, the parties can avoid having to determine the application of the “good faith” and “not unreasonably disproportionate” tests under Section 2.306 of the Texas UCC²⁴¹ if there is a material increase in the volume of the producer/seller’s production or the plant operator’s fuel needs.²⁴²

The Base Contract also requires the parties to define in the Confirmation the character of the delivery and receipt obligations of the seller and the buyer, respectively, with respect to each Contract Quantity specified in a Confirmation.²⁴³ Such obligations may either be: (a) “Firm”, meaning that, as a general matter, “either party may interrupt its performance without liability only to the extent that such performance is prevented for reasons of Force Majeure”,²⁴⁴ or (b) “Interruptible”, meaning that, as a general matter, “either party may interrupt its performance at any time for any reason, whether or not caused by an event of Force Majeure,

²³⁷ See text accompanying notes 84 and 85, *supra*.

²³⁸ 2006 NAESB, §2.8.

²³⁹ Section 5 of the 2006 NAESB provides that the unit of quantity measurement under the Base Contract is “one MMBtu dry.” 2006 NAESB, §5. “MMBtu” is defined in Section 2.20. *Id.* at §2.20.

²⁴⁰ See Lake and Hoff, *supra* note 44, at 8.

²⁴¹ TEX. BUS. & COM. CODE ANN. at §2.306(a) (2017). See text accompanying notes 86 through 89, *supra*.

²⁴² See text accompanying notes 90 through 96, *supra*; Lake and Hoff, *supra* note 44, at 8.

²⁴³ 2006 NAESB, §3.1.

²⁴⁴ *Id.* at §2.16.

with no liability.”²⁴⁵ It is not uncommon for transactions under the Base Contract to provide that the seller’s obligations to sell and deliver, and the buyer’s obligations to purchase and receive, gas in a transaction are “Firm” up to the maximum daily quantity (“Max DQ”) specified in the Confirmation and “Interruptible” if the seller has gas available for sale in excess of the Max DQ and the buyer has unutilized transportation capacity at the point of delivery.

d. Delivery Point. Under the Base Contract, on any day during the applicable Delivery Period, the seller’s performance of its obligations to sell and deliver, and the buyer’s performance of its obligations to purchase and receive, the Contract Quantity are measured at the “Delivery Point(s)” designated by the parties in the applicable Confirmation. In each case, the seller is responsible for causing the Contract Quantity to be transported to the Delivery Points, and the buyer is responsible for causing the Contract Quantity to be transported away from the Delivery Points.²⁴⁶

In most short-term gas sales under the Base Contract, the Delivery Point(s) will be at points of interconnection on one or more transporting pipelines. If the gas sale is not at the wellhead or in the field where the gas is produced, it is likely that the producer will have contracted for transportation to the Delivery Point, and the buyer – in most cases, a gas aggregator or, occasionally, an intrastate pipeline – will control transportation capacity at and downstream of the transporting pipeline.

A full discussion of the differences between pipelines operating in the interstate market and those operating in the intrastate market is beyond the scope of this paper.²⁴⁷ Briefly, however, as a general matter, pipelines engaged in the transportation of natural gas in interstate commerce (“Interstate Pipelines”) qualify as “natural gas companies” as defined in the NGA and are therefore subject to the jurisdiction of the FERC.²⁴⁸ Transportation of gas in interstate commerce includes storage, gas exchanges, backhaul, deliveries by displacement, and other methods of transportation in interstate commerce.²⁴⁹ FERC’s regulation of Interstate Pipelines includes, *inter alia*, (a) the review, permitting, certification, and abandonment of pipelines providing service in the interstate market, (b) the review and establishment of “just and reasonable” transportation rates, and (c) oversight of all activities intended to assure the “open access” character of the Interstate Pipeline system, including regulatory oversight of “capacity

²⁴⁵ *Id.* at §2.19. In a longer term transaction, it is not uncommon for the parties to agree on modifications of the definitions of “Firm” and “Interruptible” to customize the concepts to the circumstances of the relevant transaction.

²⁴⁶ 2006 NAESB at §4.1.

²⁴⁷ For excellent discussions of the FERC’s jurisdiction over Interstate Pipelines, see Martin, *supra* note 162; Shoneman, *Natural Gas, Midstream: FERC’s Recent NOPRs Regarding Capacity Release and Market Transparency and FERC’s Revised Enforcement Policy Statement*, 7TH ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section (2008) (hereinafter, “Shoneman”). For an excellent discussion of the regulation of Intrastate Pipelines operating in Texas, see Mann, *Texas Pipeline Regulation*, 22^D ANN. ADV. OIL, GAS & ENERGY RES. L. COURSE, St. Bar of Texas, Ch. 9 (2004) (hereinafter, “Mann”).

²⁴⁸ 15 U.S.C. §716a(6). See note 162 and accompanying text, *supra*.

²⁴⁹ See Shoneman, *supra* note 247, at slide 3.

release” programs, under which a pipeline’s shippers may release to third parties transportation and storage capacity contracted for but no longer required by the shippers so as to create a secondary market for the released capacity that would compete against capacity directly offered by the Interstate Pipelines.²⁵⁰

Pipelines that engage in gas transportation solely within a single state (“Intrastate Pipelines”) are not subject to the jurisdiction of the FERC under the NGA.²⁵¹ In Texas, however, Intrastate Pipelines general qualify as “gas utilities” under the terms of the Texas Utilities Code.²⁵² The Railroad Commission of Texas (“RRC”) is the state agency that has regulatory jurisdiction over such Intrastate Pipelines as gas utilities.²⁵³ In the RRC’s words, its regulation of gas utilities is a “light handed scheme” that contemplates “negotiated rates” for, and non-discriminatory access to, gas transportation.²⁵⁴ In this regard, the RRC is responsible for assuring that each rate made, demanded, or received by a gas utility is “just and reasonable.”²⁵⁵ Under the Texas Utility Code, a rate negotiated between two pipelines or a pipeline and a large volume customer where neither party has unfair market power will be deemed by the RRC to be “just and reasonable,”²⁵⁶ unless a complaint is filed with the RRC by one of the parties to the relevant transaction.²⁵⁷ RRC rules require each gas utility to maintain with the RRC a tariff that sets forth each rate charged by the

²⁵⁰ See Pearson, *supra* note 171, at 10, 11.

²⁵¹ 15 U.S.C. §716a(6). See note 163 and accompanying text, *supra*.

²⁵² TEX. UTIL. CODE §§102.001, 104.001, 121.051, 121.052, and 121.151 (2017). The Texas Utility Code defines a “gas utility” as:

a person who owns, manages, operates, leases, or controls in this state property or equipment or a pipeline, plant, facility, franchise, license, or permit for a business that:

(1) transports, conveys, distributes, or delivers natural gas:

(A) for public use or service for compensation; [or]

...

(D) for sale or delivery to the public for domestic or other use; [or]

(2) owns, operates, or manages a pipeline:

(A) that is for transporting or carrying natural gas, whether for public hire or not; and

(B) for which the right-of-way has been or is hereafter acquired by exercising the right of eminent domain;

TEX. UTIL. CODE §102.001(a).

²⁵³ The RRC retains jurisdiction over gas utility rates and services outside the city limits of municipalities in Texas. See TEX. UTIL. CODE ANN. §103.003 (2017).

²⁵⁴ See Mann, *supra* note 247, at 1.

²⁵⁵ TEX. UTIL. CODE §104.003(a) (2017).

²⁵⁶ *Id.* at §104.003(b).

²⁵⁷ *Id.* at §104.003(c).

gas utility to each customer or class of customers.²⁵⁸ In addition, the RRC's Transportation Standards and Code of Conduct provide that no gas utility or non-utility transporter can unreasonably discriminate in rates, terms of service, or access to service.²⁵⁹ Many Intrastate Pipelines have also obtained authorization to transport gas in interstate commerce in accordance with the terms of Section 311 of the NGPA.²⁶⁰

e. Price. The most significant commercial term included in a Base Contract is the "Contract Price" – *i.e.*, the "amount expressed in U.S. dollars per MMBtu to be paid by the buyer to the seller for the purchase of gas as agreed to by the parties to the transaction."²⁶¹ For each transaction under a Base Contract, the Contract Price will be set forth in the applicable Confirmation. Although gas sales can be priced in any number of ways (*e.g.*, fixed price, fixed price plus escalations, daily or monthly index prices, or forward curve prices based on NYMEX futures prices),²⁶² in most short-term transactions entered into under a Base Contract, the Contract Price is likely to be based on an index price – *Gas Daily*[®],²⁶³ if the Delivery Period is one month or less, or *Inside FERC*[®]²⁶⁴, if the Delivery Period is longer than a month – plus or minus the applicable basis differential.

In the case of a daily pricing care should be taken to make clear whether the "high", "low", or "midpoint" price quoted in the relevant index will apply on a particular day.²⁶⁵ Section 14 of

²⁵⁸ 16 TEX. ADMIN. CODE §7.315(a), (c)-(d) (2017).

²⁵⁹ Rule 7.7001, Natural Gas Transportation Standards and Code of Conduct, 16 TEX. ADMIN. CODE §7.7001 (2017).

²⁶⁰ NGPA §311, 15. U.S.C. §3371 (2017). Under Section 311(a) of the NGPA, FERC may authorize an Intrastate Pipeline to transport gas that has moved in interstate commerce on behalf of any interstate pipeline and any distribution company served by an interstate pipeline. Rates for NGPA §311 service must be (i) "fair and reasonable", (ii) not in excess of the rates interstate pipelines may charge, *id.* at §3371(a)(2)(B), and (iii) set pursuant to a §311 tariff proceeding at the FERC, 18 C.F.R. §§284.121, *et seq.* (2017). See Mann, *supra* note 247, at 11.

²⁶¹ 2006 NAESB, §2.7.

²⁶² As a general matter, gas futures prices, regardless of the exchange on which they are quoted, probably are unreliable indicators of current market value. By definition, futures prices represent what a buyer expects to pay for gas at a time certain in the future, not necessarily what he or she is willing to pay for gas today. See Morgenthaler, *Royalty Rights in a Changing Marketplace*, Unpublished Paper Presented to National Association of Royalty Owners, at 12 (January 1996). Moreover, NYMEX gas futures prices are based on contracts that contemplate gas deliveries at the Henry Hub, near Erath, Louisiana. See Hazel I, *supra* note 168, at H-5. Current market prices in different regions of the country often differ dramatically from the futures prices quoted at this hub.

²⁶³ See *Gas Daily*[®], published by S&P Global Platts. *Gas Daily*[®] is a subscription service that provides coverage of daily natural gas spot prices at interstate pipelines and pooling points in major U.S. and Canadian markets. Its website is found at www.platts.com. For a description of Platts' index methodology, see http://www.platts.com/im.platts.content/methodologyreferences/methodologyspecs/na_gas_methodology.pdf.

²⁶⁴ See *INSIDE FERC'S GAS MARKET REPORT*[®], published by Platts/McGraw Hill Financial. *INSIDE FERC*[®] is a subscription service that publishes natural gas spot prices at interstate pipelines in major U.S. markets as of the first day of each week. Its web page is found at <http://www.platts.com/IM.Platts.Content/ProductsServices/Products/gasmarketreport.pdf>.

²⁶⁵ See Lake and Hoff, *supra* note 44, at 10.

the 2006 GTCs provides how the parties will agree on a replacement price if the publisher of the index fails to publish a particular price on a particular day, the publication of the index permanently ceases, or some other “Market Disruption Event” occurs.²⁶⁶

A well-known treatise on the subject defines the phrase “basis differential” as follows:

The basis differential between two hubs in the pipeline network is the difference in the prices of spot gas sold in markets at the two points. When these markets are integrated, the basis differential is made up of differences in the current spot prices of gas at the origin and destination hubs, which should equal the pipeline charge for transportation of that gas from the origin to the ... point of delivery.²⁶⁷

It is important to keep in mind that basis differentials do not represent actual transportation costs. Basis differentials are theoretical constructs designed to describe the differences in the commodity values of gas at the origin or supply end and at the destination or market end of a pipeline. In periods of pipeline congestion creating capacity constraints, basis differentials will increase as the spot price for gas at the supply end of the pipeline decreases (because the gas is difficult or expensive to get to market); in periods of low pipeline congestion, basis differentials will shrink as the spot prices for gas at the origin and destination ends of the pipeline converge due to increased market efficiencies.²⁶⁸ Because of a combination of regulated tariff rates (which do not adjust to market changes as efficiently as basis does) and long-term transportation contracts that provide for negotiated rates, the actual costs of transportation do not, as a practical matter, move in lockstep with basis. Indeed, it is not uncommon, from time to time during periods of relatively flat basis, for actual transportation costs from an origin point to a destination point to exceed the basis between the two points.²⁶⁹

²⁶⁶ 2006 NAESB, §14.

²⁶⁷ Paul W. McAvoy, *The Basis Differentials on Partially Deregulated Transportation*, NATURAL GAS NETWORKS PERFORMANCE AFTER PARTIAL DEREGULATION (Ed. Paul W. McAvoy, World Scientific Publishing, Singapore 2007) (hereinafter, “McAvoy”). By way of example, assume that the origin point is the GAS DAILY® “El Paso, Permian” point in the Permian Basin of West Texas, and the destination point is the GAS DAILY® “Henry Hub point” in Erath, Louisiana, the official delivery point for the NYMEX gas futures contract. If, on a day, the midpoint index price at Henry Hub is \$2.915 per MMBtu and the midpoint index price at El Paso, Permian on the same day is \$2.880 per MMBtu, the actual basis differential on such day is “minus \$0.035 to Henry Hub.” See Fletcher J. Sturm, *TRADING NATURAL GAS: CASH, FUTURES, OPTIONS AND SWAPS* at 55 (PennWell Books 1997).

²⁶⁸ See Matthew E. Oliver, Charles F. Mason, and David Finoff, *Pipeline Congestion and Basis Differentials*, JOURNAL OF REGULATORY ECONOMICS 46, No. 3, at 261-291 (2014).

²⁶⁹ See Rusty Braziel, *Honey, I Shrank the Basis: Spread Between Max and Min Natural Gas Prices Drops Below \$1.00*, RBN ENERGY LLC (February 16, 2012), available at <https://rbenergy.com/Honey-I-Shrank-the-Basis>. In the example cited in this blog entry, on February 15, 2012, the spot price of gas at the supply point of CIG Rockies was \$2.49 per MMBtu, while the spot price at the market hub at Columbia Gas Transmission’s TCO Pool was \$2.57, resulting in a basis differential of minus \$0.08 per MMBtu to Columbia TCO. Actual transportation costs between those points on the same day were approximately \$0.25 per Mcf. Subject to appropriate Btu adjustments, a seller/shipper of gas

It should be noted that even though the NGPA's maximum lawful prices no longer apply to the wellhead sales of gas,²⁷⁰ certain sellers of gas remain subject to regulation on several levels. Among the more significant continuing regulatory obligations are the following:

i. In the wake of the collapse of Enron and, in particular, the FERC's discovery of "evidence of market manipulation" of natural gas prices at pricing points in every region of the United States,²⁷¹ the FERC, on November 26, 2003, issued Order No. 644, imposing certain standards of conduct upon holders of blanket natural gas marketing certificates who engage in the reporting of transactions to publishers of natural gas price indices.²⁷² Order No. 644 requires such sellers of natural gas to "provide accurate and factual information, and not knowingly submit false or misleading information or omit material information to any such publisher, by reporting its transactions in a manner consistent with the procedures set forth in the [FERC's] *Policy Statement on Natural Gas and Electric Price Indices*²⁷³²⁷⁴ Order No. 644 required gas sellers, following the effective date of the regulations codifying the reporting requirements set forth therein, to notify the FERC of whether they engage in such reporting activity and further requires such sellers to "update the [FERC] within 15 days of any subsequent change to [the sellers'] reporting status."²⁷⁵ The FERC's regulations provide that a violation of the foregoing requirements may result in a seller being required to disgorge any unjust profits derived from such a violation.²⁷⁶ Further, such conduct may result in the suspension or revocation of the seller's blanket sales certificate or the imposition of other remedies deemed appropriate by the FERC.²⁷⁷

ii. Further, under the Energy Policy Act of 2005 ("EP Act"),²⁷⁸ Congress amended Section 23 of the NGA to authorize the FERC to obtain, from any market participant, information about the availability and prices at which gas is sold at wholesale and in interstate

from the Rockies would make \$0.08 per MMBtu on its gas sale at Columbia TCO but lose a net \$0.17 per MMBtu on the same transaction due to the higher actual transportation costs.

²⁷⁰ See text accompanying note 185, *supra*.

²⁷¹ Final Report on Price Manipulation in Western Markets (Federal Energy Regulatory Commission: Docket No. AD03-7-000, *In the Matter of Natural Gas Price Formation*, April 24, 2003).

²⁷² See Order No. 644, Amendments to Blanket Sales Certificates, FERC Stats. & Regs. [Regs. Preambles] ¶ 31,153 at P5 (2003), *order denying reh'g and clarifying prior order, In the Matter of Amendments to Blanket Sales Certificates*, 107 FERC ¶ 61,174(2004).

²⁷³ 105 FERC ¶ 61,282 (2003), *order on clarification*, 109 FERC ¶ 61,184 (2004), *order further clarifying prior orders*, 112 FERC ¶ 61,040 (2005).

²⁷⁴ See 18 C.F.R. §284.403(b) (2005) (codifying the reporting requirements of Order No. 644 *et seq.*).

²⁷⁵ See *id.*

²⁷⁶ See *id.* §284.403(d).

²⁷⁷ See *id.*

²⁷⁸ *Energy Policy Act of 2005*, P.L. 109-58, 119 Stat. 594 (2005).

commerce.²⁷⁹ Pursuant to this authority, the FERC now requires an annual filing by any entity that sells or buys reportable volumes of wholesale gas of 2.2 million MMBtu on an annual basis.²⁸⁰

iii. Finally, in January 2006, FERC, acting under authority granted in new Section 4A to the NGA added pursuant to the EP Act, issued Order 670,²⁸¹ which established rules patterned after SEC rule 10b-5 that made it unlawful for any seller of gas – not just regulated Interstate Pipelines – to use any “device, scheme, or artifice” to defraud, or to make any untrue statement of a material fact or omit to state any fact necessary to make the statement made not misleading, in connection with any purchase or sale of gas or transportation subject to FERC jurisdiction.²⁸²

f. Billing, Payment, and Audit. The Base Contract’s billing and payment provisions are relatively typical for gas sale contracts generally. Section 7.1 of the 2006 GTCs requires the seller to invoice the buyer on a monthly basis for the actual quantity of gas delivered under the relevant Base Contract during the preceding month. If actual quantity information is not available when the invoice is prepared, the invoice will be based on the scheduled quantities of gas, subject to later reconciliation when the actual quantity information is available.²⁸³ Under Section 7.2 of the 2006 GTCs, payment is due from the buyer on the later of (a) the “Payment Date” selected by the parties on the Cover Sheet of the Base Contract, or (b) ten days after the buyer’s receipt of seller’s invoice.²⁸⁴

Section 7.2 of the 2006 GTCs establishes a procedure for resolving “good faith” disputes about the amount of an invoice, requiring the invoiced party to pay the undisputed portion of the invoice in a timely manner as provided in Section 7.2.²⁸⁵ Section 7.6 provides for audit rights for both parties to verify the accuracy of any invoice or other calculation made under a Base Contract, but limits retroactive adjustments for under- or over-payments to those arising out of claims asserted or objections made by the disputing party within two years after the month of gas delivery.²⁸⁶

²⁷⁹ *Id.* at pp. 979-80.

²⁸⁰ Order No. 704, *Transparency Provisions of Section 23 of the Natural Gas Act*, 121 FERC ¶ 61,295 (2007); *order on reh.*, Order No. 704-A, 124 FERC ¶ 61,269 (2008); *reh. denied on reconsideration*, 125 FERC ¶ 61,302 (2008). See Lake and Hoff, *supra* note 44, at 19.

²⁸¹ Order No. 670, 114 FERC ¶ 61,047 (2006); *reh. denied*, 114 FERC ¶ 61,300 (2006) (“Order No. 670”).

²⁸² Order No. 670 codified at 18 C.F.R. §1c.1 (2017). See Lake, *The Myth of “Deregulated Gas Sales” – Federal Regulation of Gas Markets*, 6TH ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section, at 8-11 (2007).

²⁸³ 2006 NAESB, §7.1.

²⁸⁴ 2006 NAESB, §7.2. Please note that this approach to the timing of payment differs from that under the Texas UCC, which, in most cases, requires payment upon delivery of the goods. See TEX. BUS. & COM. CODE ANN. §2.310(a) (2017); text accompanying notes 97 through 101, *supra*.

²⁸⁵ 2006 NAESB, §7.4.

²⁸⁶ *Id.* at §7.6.

Finally, unless the parties elect not to employ netting on the Cover Sheet of the Base Contract, Section 7.7 of the 2006 GTCs provides that each month, payments due and owing under such Base Contract will be aggregated and netted, with the party owing the greater amount paying the net amount owed by such party when due under Section 7.²⁸⁷ It should be noted that, if made applicable by the parties, netting under Section 7.7 is not accomplished on a transaction-by-transaction basis, but applies across all transactions outstanding between the parties under the Base Contract during the relevant month.

g. Financial Responsibility. If the Contract Price is the most important commercial term in a Base Contract, then the provisions concerning financial responsibility may well be next in line. Before a party's financial condition deteriorates to the point at which default and, perhaps, liquidation become likely, the financial responsibility provisions help to reduce the credit and payment risks posed by the financially distressed party to the other party and give the financially distressed party the opportunity to bolster its position under the Base Contract to avoid default. Two approaches to the issue of financial responsibility are available under the 2006 NAESB.

i. Adequate Assurance of Performance. Section 10.1 of the 2006 GTCs provides that if either party ("Party X", in the parlance of the GTCs) has "reasonable grounds for insecurity" regarding the other party's ("Party Y") ability to perform any obligation under the Base Contract, Party X may demand that Party Y provide "Adequate Assurance of Performance".²⁸⁸ The failure of Party Y to provide Adequate Assurance of Performance within 48 hours of Party X's request constitutes an Event of Default.²⁸⁹ This provision is very similar in concept to Section 2.609(a) of the Texas UCC.²⁹⁰

The 2006 NAESB does not define "reasonable grounds for insecurity," other than to state that such reasonable grounds would include "the occurrence of a material change in the creditworthiness of [Y] or its Guarantor, if applicable . . ."²⁹¹ Neither is the concept expressly defined in the Texas UCC. Section 2.609(b) provides only that, as "between merchants, the reasonableness of grounds for insecurity . . . shall be determined according to commercial standards."²⁹² The comments to Section 2.609 suggest that "a ground for insecurity need not arise from or be directly related to the contract in question." As a result, "a buyer who falls

²⁸⁷ *Id.* at §7.7. See Hazel II, *supra* note 207, at F-5; Enochs and Page, *supra* note 228, at 6.

²⁸⁸ 2006 NAESB, §10.1.

²⁸⁹ *Id.* at §10.2(vii).

²⁹⁰ TEX. BUS. & COM. CODE ANN. §2.609(a) (2017). There are also, however, several differences. The principal difference is that Section 2.609 would permit Party X to suspend performance until Party Y complies with the request for Adequate Assurance of Performance, while Section 10.1 of the 2006 GTCs does not permit suspension of performance. In addition, the time for response by Party Y is 48 hours under Section 10.1 of the 2006 GTCs, while the response period is 30 days under Section 2.609. See Enochs and Head, *supra* note 102, at 23.

²⁹¹ 2006 NAESB, §10.1.

²⁹² TEX. BUS. & COM. CODE ANN. §2.609(a) (2017).

behind in ‘his account’ with the seller, even though the items involved have to do with separate and distinct contracts, impairs the seller’s expectation of due performance.”²⁹³ The nature of the contract also “enters into the question of reasonableness.”²⁹⁴

Resort to the Texas UCC is not necessary with respect to the definition of Adequate Assurance of Performance. Section 10.1 of the 2006 GTCs defines Adequate Assurance of Performance as “sufficient security in the form, amount, for a term, and from an issuer, all as reasonably acceptable to” Party X and may include (a) cash, (b) a standby irrevocable letter of credit, (c) a prepayment, (d) a security interest in an asset, or (e) a guaranty.²⁹⁵ To protect Party Y if it provides Adequate Assurance of Performance in cash, Party X grants to Party Y a “first priority” lien against, security interest in, and right of setoff against the cash until Party X returns the cash to Party Y.²⁹⁶

The “reasonable basis for insecurity” trigger for requiring Party X to provide Adequate Assurance of Performance is obviously very subjective. In our experience, many gas sellers nevertheless find Section 10.1’s subjective approach preferable to other “triggers” that appear in financial covenants (*i.e.*, a material adverse change or “MAC” clause, or downgrades in the quality of a party’s debt by Standard & Poor’s Rating Group or Moody’s Investors Services, Inc.) because it permits quick action, rather than delaying credit decisions to await rating agency actions or stale financial statements.²⁹⁷ On the other hand, because of the subjective nature of Section 10.1’s “trigger”, a claim of “reasonable grounds for insecurity” may be disputed and result in time consuming and expensive litigation.²⁹⁸

ii. Credit Support Addendum. As an alternative to Section 10.1 of the Base Contract, the parties may elect to rely on the Credit Support Addendum, which would be attached as a “special provisions” exhibit to the Base Contract. The Credit Support Addendum is complex, raising numerous additional issues for the parties to negotiate beyond the customary issues addressed in putting a Base Contract in place. In its simplest terms, however, the underlying credit support concept expressed in the Credit Support Addendum is the determination, on each “calculation date”, of Party Y’s “Collateral Requirement”.²⁹⁹ The term “Collateral Requirement” is defined as the positive difference (if any) obtained by subtracting (a)

²⁹³ *Id.* at §2.609, cmt. 3.

²⁹⁴ *Id.*

²⁹⁵ 2006 NAESB, §10.1.

²⁹⁶ *Id.*

²⁹⁷ See Edmonds, *supra* note 211, §5.07[1] at 5-14, 5-15, §5.07[2][d] at 5-23, 5-24.

²⁹⁸ *E.g., Universal Resources Corp. v. Panhandle Eastern Pipe Line Co.*, 813 F.2d 77 (5th Cir. 1987) (gas buyer’s fear that seller would be unable to supply makeup gas under take-or-pay gas sale contract held not to constitute reasonable grounds for insecurity regarding seller’s ability to perform where there had occurred no adverse change in the seller’s gas reserves and the seller was obligated to deliver makeup gas only if the buyer had made certain payments and taken the full contract quantity in the preceding year).

²⁹⁹ NAESB Credit Support Addendum, §II.

Party Y's "Collateral Threshold" (the dollar amount representing the credit threshold for Party Y set forth for Party Y on the cover sheet to the Credit Support Addendum³⁰⁰) plus the value of all collateral already posted by Party Y with Party X, from (b) Party X's "Exposure" on the calculation date (defined as the amount, calculated in good faith and in a commercially reasonable manner, as if an "Early Termination Date" had been set under Section 10.3 of the 2006 GTCs).³⁰¹ If the foregoing calculation yields a Collateral Requirement for Party Y, Party Y is required to provide to Party X "Credit Support" having a value at least equal to the Collateral Requirement no later than the close of business on the next business day after the demand for Credit Support is received.³⁰² The types of collateral to be provided as Credit Support will be set forth on the cover sheet to the Credit Support Addendum.³⁰³

The Credit Support Addendum also contains provisions relating to (a) circumstances in which Party Y can reduce the amount to Credit Support it is required to provide,³⁰⁴ (b) substitution of collateral,³⁰⁵ (c) the resolution of disputes concerning the calculation of Party X's Exposure for purposes of determining Party Y's Collateral Requirement³⁰⁶, and (d) the handling of cash and letters of credit when provided by Party Y as Credit Support.³⁰⁷ Like Section 10.1 of the 2006 GTCs, the Credit Support Addendum also provides for the grant by each party of a reciprocal first-priority security interest in, lien on, and right of set off against all "Posted Collateral" (defined as all Credit Support, other property, and proceeds thereof, including cash, that has been physically transferred by Party Y to Party X³⁰⁸), except for letters of credit, held by, on behalf of, or for the benefit of the other party to secure the pledging party's obligations under the applicable Base Contract and all transactions thereunder.³⁰⁹

Because of its complexity, it is clear that the Credit Support Addendum is not appropriate for use in connection with the transactions formed under every Base Contract. For example, according to NAESB's User's Guide to the Credit Support Addendum, the use of the Credit Support Addendum is probably not appropriate when the seller under the Base Contract is an oil and gas producer that is only selling gas to, and not purchasing gas from, the counterparty.³¹⁰ The Credit Support Addendum would likely be more appropriate for use in the case of a Base

³⁰⁰ *Id.* at §I (Definitions).

³⁰¹ *Id.*

³⁰² *Id.* at §III(a).

³⁰³ See the definitions of "Eligible Collateral" and "Eligible Credit Support", *id.* at §I (Definitions).

³⁰⁴ *Id.* at §IV(a).

³⁰⁵ *Id.* at §§IV(b), X(b).

³⁰⁶ *Id.* at §V.

³⁰⁷ *Id.* at §§VI, VII.

³⁰⁸ *Id.* §I (Definitions).

³⁰⁹ *Id.* at §X(a).

³¹⁰ See NAESB User's Guide to the Base Contract for Purchase and Sale of Natural Gas Credit Support Addendum (CSA) (July 2003), at 4; Edmonds, *supra* note 211, §5.07[2][d] at 5-22, 5-23.

Contract between counterparties that engage in multiple gas trading transactions – in which both parties sell and buy gas – over a longer period of time.

h. Breach of Performance Obligations. If either the seller or the buyer breaches a Firm obligation to deliver or to receive gas pursuant to a transaction formed under a Base Contract, and the failure is not excused by Force Majeure or otherwise under the Base Contract, Section 3.2 of the 2006 GTCs provides that the “sole and exclusive remedy” for such a breach will be the calculation of liquidated damages using one of the alternative standards provided therein, as selected by the parties on the Cover Sheet.³¹¹

i. Cover Standard. The “Cover Standard” requires the party that has not failed to perform (the “performing party”) to use commercially reasonable efforts to buy replacement gas (if the seller is in breach, and the buyer is the performing party) or resell gas at a price reasonable for the production or delivery area (if the buyer is in breach, and the seller is the performing party), taking into account in each case, the amount of notice received from the non-performing party, the immediacy of the performing party’s gas needs, the quantities involved, and the expected duration of the failure to perform.³¹²

Thus, under the Cover Standard, if the seller is in breach, the seller will pay to the buyer an amount equal to the product obtained by multiplying (a) the excess of the Contract Quantity over the quantity of gas actually delivered by the seller on the relevant day (exclusive of any quantity of gas for which no replacement gas is available), by (b) the positive difference obtained by subtracting (i) the Contract Price from (ii) the price paid by the buyer for replacement gas pursuant to the Cover Standard.³¹³ If the buyer is unable to obtain, through reasonable commercial efforts, replacement gas to cover all of the seller’s delivery shortfall, the seller will pay to the buyer an additional amount equal to the product obtained by multiplying (x) the unreplaced quantity of the seller’s delivery shortfall, by (y) an amount equal to the “Spot Price” (defined on the Cover Sheet as the Gas Daily© “Midpoint” price at the pricing location closest to the Delivery Point³¹⁴) minus the Contract Price.³¹⁵

If, on the other hand, the buyer is in breach, the buyer will pay to the seller an amount equal to the product obtained by multiplying (a) the excess of the Contract Quantity over the quantity of gas actually received by the buyer that is resold by the seller, by (b) the positive difference obtained by subtracting (i) the price obtained by the seller for the resale of such gas, from (ii) the Contract Price.³¹⁶ If the seller is unable to resell, through reasonable commercial efforts, the full portion of the Contract Quantity not taken by the buyer, the buyer will pay to the

³¹¹ 2006 NAESB, §3.2 (Cover Standard).

³¹² *Id.* at §2.12.

³¹³ *Id.* at §3.2 (Cover Standard).

³¹⁴ *Id.* at §2.31.

³¹⁵ *Id.* at §3.2 (Cover Standard).

³¹⁶ *Id.*

seller an additional amount equal to the product obtained by multiplying (x) the un-resold portion of the buyer's receipt shortfall, by (y) the positive difference (if any) obtained by subtracting the Spot Price from the Contract Price.³¹⁷

All liquidated damages payable by either party under the Cover Standard are subject to adjustment for commercially reasonable transportation costs to or from the Delivery Point(s) and are payable by the party owing the damages within five business days after receipt of the performing party's invoice.³¹⁸

Although the 2006 NAESB's Cover Standard tracks, in many respects, the "cover" concepts in the Texas UCC,³¹⁹ the Cover Standard also differs from the Texas UCC in several respects. First, the 2006 NAESB does not adopt the Texas UCC's "perfect tender" rule.³²⁰ Rather, it defines specific breaches and Events of Default and the consequences of each. In addition, the Cover Standard requires the parties to make "commercially reasonable efforts" to buy replacement gas or resell gas not taken as a condition to being entitled to liquidated damages under Section 3.2. The Texas UCC does not contain such an obligation to mitigate.³²¹

ii. Spot Price Standard. Mechanically, the Spot Price Standard is more straight forward and less subjective in its application than the Cover Standard. Under the Spot Price Standard, if the seller is in breach, the seller will pay the buyer an amount equal to the product obtained by multiplying (a) the excess of the Contract Quantity over the quantity of gas actually delivered by the seller on the relevant day, by (b) the positive difference (if any) obtained by subtracting the Contract Price from the Spot Price. Conversely, if the buyer is in breach, the buyer will pay to the seller an amount equal to the product obtained by multiplying (x) the excess of the Contract Quantity over the quantity of gas actually received by the buyer on the relevant day, by (y) the positive difference obtained by subtracting the Spot Price from the Contract Price.³²² All liquidated damages payable by either party under the Spot Price Standard are due and payable by the party owing the damages within five business days after the receipt of the performing party's invoice.³²³

The Spot Price Standard is similar to the measures of damages recoverable by the seller for the buyer's non-acceptance of goods under Section 2.708(a) of the Texas UCC³²⁴ and by the

³¹⁷ *Id.*

³¹⁸ *Id.*

³¹⁹ TEX. BUS. & COM. CODE ANN. §§2.712, 2.713 (2017). See text accompanying notes 143-152, *supra*.

³²⁰ TEX. BUS. & COM. CODE ANN. §§2.601(a), 2.703 (2017). See text accompanying notes 103-107, *supra*.

³²¹ See Enochs and Head, *supra* note 102, at 19, 20.

³²² 2006 NAESB, §3.2 (Spot Price Standard).

³²³ *Id.*

³²⁴ TEX. BUS. & COM. CODE ANN. §2.708(a) (2017). See text accompanying notes 135-138, *supra*.

buyer upon the seller's failure to deliver goods and its election not to cover under Section 2.713(a) of the Texas UCC.³²⁵

i. Defaults; Remedies; Early Termination.

i. Events of Default. Under the 2006 NAESB, an "Event of Default" occurs for either party if the relevant party: (a) makes an assignment or general arrangement for the benefit of creditors; (b) commences a bankruptcy proceeding, has a bankruptcy proceeding commenced against it, or otherwise becomes bankrupt or insolvent; (c) fails to perform any Credit Support Obligations³²⁶ under the Base Contract or fails to provide Adequate Assurance of Performance under Section 10.1 of the 2006 GTCs in a timely manner as provided in the Base Contract³²⁷; or (d) fails to pay any amount due under the Base Contract within two business days after receipt of notice that the payment is due.³²⁸ In addition, the 2006 NAESB adds two optional "Additional Events of Default" not present in the 1996 GISB or the 2002 NAESB that must be selected by the parties on the Cover Sheet: the Transactional Cross Default and the Indebtedness Cross Default.³²⁹

A "Transactional Cross Default" is defined as a default by a party under any other physical gas sale, purchase, or other transaction designated on the Cover Sheet as a "Specified Transaction."³³⁰ An "Indebtedness Cross Default" is defined as a default by a party under any agreements evidencing indebtedness for borrowed money in an amount greater than the dollar threshold specified for the affected party on the Cover Sheet.³³¹

The election to include, in particular, the Indebtedness Cross Default as an Additional Event of Default accelerates the ability of a party to start the process of terminating a Base Contract, even if the other party has not otherwise committed an Event of Default under the Base Contract, as the result of, for example, a default by a gas seller under its revolving line of credit.³³² Please note that the Transactional Cross Default will not include defaults under non-

³²⁵ TEX. BUS. & COM. CODE ANN. §2.713(a) (2017). See text accompanying notes 146-148, *supra*.

³²⁶ "Credit Support Obligations" is defined as any obligation to "provide or establish credit support for, or on behalf of, a party to a Base Contract, such as cash, an irrevocable standby letter of credit, a margin agreement, a prepayment, a security interest in an asset, a guaranty, or other good and sufficient security of a continuing nature." 2006 NAESB, §2.13. As so defined, the concept of Credit Support Obligations is very similar to the concept of Adequate Assurance of Performance. See text accompanying note 295, *supra*.

³²⁷ See text accompanying note 289, *supra*.

³²⁸ 2006 NAESB, §10.2. Please note that breaches by the seller of its obligations to sell and deliver gas, or by the buyer of its obligations to take and receive gas, under a transaction are not Events of Default.

³²⁹ 2006 NAESB, §§10.2, 2.1.

³³⁰ *Id.* at §2.33.

³³¹ *Id.* at §2.23.

³³² See Sappenfeld, *supra* note 214, §5.02[7][b] at 146, 147; Enochs and Page, *supra* note 228, at 16, 17.

gas commodity transactions unless the parties identify such transactions as Specified Transactions on the Cover Sheet.

ii. Remedies. If an Event of Default occurs under a Base Contract, the non-defaulting party is entitled, at its election, immediately to withhold payment and/or suspend deliveries of gas upon notice to the defaulting party and/or terminate and liquidate the transactions under the Base Contract, in addition to other available remedies.³³³

iii. Early Termination/Liquidation. If an Event of Default occurs and is continuing, the non-defaulting party is entitled to declare an “Early Termination Date” as of which all transactions under the affected Base Contract will be liquidated and terminated.³³⁴ The 2006 NAESB gives the parties the right to elect on the Cover Sheet whether so-called “Early Termination Damages” will apply to the liquidation.

If the parties elect the Early Termination Damages option, the non-defaulting party will determine the amount owed by each party with respect to all gas delivered and received on or before the Early Termination Date, as well as all related charges, that in each case remain unpaid, and the “Market Value”³³⁵ of each terminated transaction. The non-defaulting party then accelerates each terminated transaction at its Market Value. If the Market Value of a terminated transaction exceeds its “Contract Value”,³³⁶ the seller will pay a termination payment to the buyer. If the Market Value of the terminated transaction is less than its Contract Value, the buyer will pay a termination payment to the seller. Any termination payment calculated under this procedure will be discounted to present value in a commercially reasonable manner.³³⁷

If the parties elect not to apply the Early Termination Damages option, then as of the Early Termination Date, the non-defaulting party will determine in good faith and in a commercially reasonable manner the amount owed by each party with respect to all gas delivered and received by the parties in the terminated transactions prior to the Early Termination Date, as well as all

³³³ 2006 NAESB, §10.2.

³³⁴ *Id.* at §10.3.

³³⁵ “Market Value” is defined as the product obtained by multiplying (a) the quantity of gas remaining to be delivered or received under a transaction, by (b) the market price for a similar transaction at the Delivery Point(s), determined by the non-defaulting party in a commercially reasonable manner. To determine the Market Value, the non-defaulting party may consider, *inter alia*, NYMEX gas futures contract settlement prices, quotations from leading swap dealers and gas traders, similar sales or purchases, and other bona fide third party offers, all adjusted for the duration of the term and differences in transportation costs. 2006 NAESB, §10.3.1 (Early Termination Damages Apply).

³³⁶ “Contract Value” is defined as the product obtained by multiplying (a) the quantity of gas remaining to be delivered or received under a transaction, by (b) the Contract Price. *Id.*

³³⁷ *Id.*

related charges, for which, in each case, no payment has been made. This amount will be the only payment owed between the parties.³³⁸

Although the provisions of Section 10.3 of the 2006 GTCs are substantially more detailed in many respects than the Texas UCC's provisions, the Early Termination Damages concept in the 2006 NAESB results in a damages calculation similar to the damages that would be owed under the Texas UCC under similar circumstances.³³⁹

j. Setoff. The final concept in the 2006 NAESB's provisions relating to Events of Default, remedies, and early termination is the concept of setoff. Setoff provisions generally permit a party to offset amounts owed to it against amounts owed by it to the other party, thus eliminating some obligations between the parties and reducing the non-defaulting party's credit and payment risk for other unpaid amounts to the extent such obligations are at least partially set off.³⁴⁰

Under Section 10.3.1 of the 2006 GTCs, on an Early Termination Date, the non-defaulting party is required to determine the amounts owed (whether or not then due) by each party with respect to gas receipts and deliveries under the terminated transactions, as well as other applicable charges, that were unpaid by the relevant party as of the Early Termination Date.³⁴¹ The non-defaulting party then nets or aggregates, as applicable, all amounts owing among the parties into a single liquidated amount payable by one party to the other (the "Net Settlement Amount"). At the parties' election as evidenced on the Cover Sheet, the non-defaulting party may then set off the Net Settlement Amount:

(i) solely against any cash margin or other collateral held under the terms of the Base Contract by the party entitled to the Net Settlement Amount (the "No Other Agreement Setoffs");³⁴²

(ii) against (A) any cash margin or other collateral held under the terms of the Base Contract by the party entitled to the Net Settlement Amount and (B) any amounts (including any cash margin or other collateral) owned or held by the party entitled to the Net Settlement Amount under the terms of any other agreements between the parties (the "Bilateral Setoff");³⁴³
or

(iii) (A) against any cash margin or other collateral held under the terms of the Base contract by the party entitled to the Net Settlement Amount, (B) against any amounts

³³⁸ *Id.* at §10.3.1 (Early Termination Damages Do Not Apply).

³³⁹ See Enochs and Head, *supra* note 102, at 21, 22.

³⁴⁰ See Enochs and Page, *supra* note 228, at 15.

³⁴¹ 2006 NAESB, §10.3.1.

³⁴² *Id.* at §10.3.2 (Other Agreement Setoffs Do not Apply).

³⁴³ *Id.* at §10.3.2 (Bilateral Setoff Option).

(including any cash margin or other collateral) owned or held by the party entitled to the Net Settlement Amount under the terms of any other agreements between the parties, (C) owed to the non-defaulting party against any amounts (including any cash margin or other collateral) owed by the non-defaulting party or its affiliates to the defaulting party under any other agreement, (D) owed to the defaulting party against any amounts (including any cash margin or other collateral) owned by (x) the defaulting party to the non-defaulting party or its affiliates or (y) the defaulting party and its affiliates to the non-defaulting party, in each case under any other agreement ("Triangular Setoff").³⁴⁴

The Triangular Setoff option represents an addition to the 2006 NAESB to permit the non-defaulting party to offset the value of other obligations between the parties and their affiliates when determining the amount due from one party to the other upon the liquidation and termination of a Base Contract.³⁴⁵

k. Limitation on Damages. As discussed above, the Texas UCC permits the recovery by the parties of incidental damages,³⁴⁶ and by the buyer of consequential damages,³⁴⁷ in a number of different circumstances. Consistent with current commercial practice in most transactions, however, Section 13 of the 2006 GTCs contains a broad disclaimer by the parties of any right to claim consequential, incidental, punitive, exemplary, or indirect damages, lost profits, or other business interruption damages in connection with a breach of the Base Contract.³⁴⁸ Such a disclaimer is permitted under Section 2.719 of the Texas UCC.³⁴⁹

3. Sales to Midstream Company. Not all gas sale contracts look alike. At a time when more and more gas contracting is being accomplished based on master agreements like the 2006 NAESB or the 2002 ISDA Master Agreement with the ISDA Gas Annex, wellhead sales to Midstream Companies of gas that requires processing frequently are accomplished based on customized contract forms developed by individual Midstream Companies that embody commercial concepts and legal architecture more appropriate to the Midstream Companies' business than the master agreements.

a. Processed Gas. As U.S. domestic drilling activity continues to increase, led by the development of the Eagle Ford, Bakken, and other shale formations and the Permian Basin, strengthening oil prices and a strong natural gas liquids market have caused many oil and gas producers to focus their attention on oil-rich and liquid-rich natural gas plays.³⁵⁰ In this author's

³⁴⁴ *Id.* at §10.3.2 (Triangular Setoff Option).

³⁴⁵ See Sappenfeld, *supra* note 214, §§5.02[7][d] and 5.02[7][e] at 147.

³⁴⁶ See TEX. BUS. & COM. CODE ANN. §§2.708, 2.709 (2017); text accompanying notes 135-142, *supra*.

³⁴⁷ See TEX. BUS. & COM. CODE ANN. §§2.712, 2.713, 2.714 (2017); text accompanying notes 143-152, *supra*.

³⁴⁸ 2006 NAESB, §13.

³⁴⁹ See TEX. BUS. & COM. CODE ANN. §2.719 (2017); text accompanying notes 153-154, *supra*.

³⁵⁰ See Duke, *Gas Processing Primer*, 16TH GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section, at slide 1 (2017) (hereinafter, "Duke").

experience, virtually all new gas production from the northern and central tiers of the Eagle Ford Shale and from the Permian Basin requires dehydration,³⁵¹ and much of such gas requires processing for the removal of natural gas liquids,³⁵² or “NGLs”,³⁵³ and contaminants such as hydrogen sulfide (“H₂S”), nitrogen (“N”), and carbon dioxide (“CO₂”) in order for the gas stream to be of “pipeline quality” and marketable.

Processing arrangements are ordinarily structured in one of three ways:

- Fee-based. In a fee based arrangement, the producer causes the gas to be delivered to the processing facility, where the Midstream Company processes the gas for a fee per gallon of Products produced and/or per Mcf of gas processed in a purely service-based arrangement. The producer retains title to the gas while in the possession of the Midstream Company and receives all of the residue gas and NGLs after processing (subject to any right of the Midstream Company to receive its fees in kind in gas or Products). The processor bears no commodity price risk in this arrangement.
- Keep-Whole. In a keep-whole arrangement, the producer sells the unprocessed gas to the Midstream Company and receives 100% of the residue gas after processing, while the Midstream Company receives 100% of the Products extracted by the processing. The Midstream Company must “keep whole” the producer, however, for gas “shrinkage”, or reduction in heating content, resulting from the processing. The keep-whole obligation may be discharged “in kind” – by delivering additional gas to the producer – or by paying the producer an agreed sum for the shrinkage. The Midstream Company’s commodity price risk is extremely high in this transaction because its costs are based on the price of natural gas and its revenues are based on the price of NGLs.
- Percentage of Proceeds. In a percentage of proceeds, or “POP”, arrangement, the producer sells the unprocessed gas to the Midstream Company at the wellhead,

³⁵¹ “Dehydration” is defined as the removal of moisture from gas before it enters a transporting pipeline. See *TXO Production Corp. v. State ex rel. Comm’rs of Land Office*, 903 P.2d 259, 262 (Okla. 1994).

³⁵² “Processing” has been defined judicially as any process designed to remove elements or compounds (hydrocarbon or non-hydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes that normally take place on or near the lease, such as pressure reduction, mechanical separation, heating, cooling, dehydration, and compression, do not constitute processing. *Western Gas Resources, Inc. v. Heitkamp*, 489 N.W.2d 869, 873 n.3 (N.D. 1992), cert. denied, 507 U.S. 920 (1993), quoting 30 C.F.R. §§206.101 and 206.151 (1991). Processing includes (a) fractionation, see *Burns v. Exxon Corp.*, 158 F.3d 336, 340 (5th Cir. 1998); (b) CO₂ removal, see *Amoco Production Co. v. New Mexico Taxation and Revenue Dept.*, 134 N.M. 162, 74 P.3d 96 (N.M. Ct. App. 2003); but in at least one case, (c) not H₂S removal, see *Exxon Co., U.S.A. v. Chevron U.S.A., Inc.*, 121 IBLA 234, CFS (OCS) 1991-184 (Nov. 15, 1991).

³⁵³ Once the wellhead gas stream has been processed into residue gas and a mixture of NGLs known as “Y-grade” or “raw make”, the NGL mixture is transported to a central fractionation facility, where the NGL mixture is separated into the following “Products”: ethane, propane, normal butane, iso-butane, and natural gasoline. See Duke, *supra* note 350, at slides 5, 7, 8.

in the field, or at the inlet of the processing plant, and the Midstream Company pays the producer based on a percentage of the proceeds from the sale of the residue gas and Products extracted by processing. The Midstream Company's commodity price risk is moderate in this transaction since the price paid for the gas is essentially a pass-through of a percentage of the revenues from the sale of the residue gas and Products.³⁵⁴

Over the last five years, this author has encountered numerous processing transactions, with the significant majority being structured as POP arrangements. For that reason, the remainder of this discussion will highlight the issues unique to POP transactions.

b. Pop Contracts. The architecture of non-NAESB-based POP gas sale contracts generally takes one of two forms: (i) a traditional unified contract with exhibits, or (ii) a two-part contract, consisting of (x) a set of commercial terms that include the names of the parties and the signature blocks, followed by (y) general terms and conditions and exhibits. In either case, the contract embodies a single transaction, so that the master agreements' use of transaction confirmations to reflect the commercial terms of multiple transactions is unnecessary. For purposes of this paper, either type of customized, Midstream Company-specific, non-NAESB-based POP gas sales contract will be referred to as a "POP Contract." Unless footnoted to the contrary, the following analysis is the author's, based on his professional experience in these transactions.

i. Contract Formation. Ordinarily, POP Contracts become legally binding on the parties upon their execution and delivery by both parties.

ii. Term. POP Contracts are ordinarily made for a term of several years, subject to "evergreen" provisions that cause the contract to remain in effect on a year-to-year basis after the expiration of its initial term until terminated upon advance written notice from one of the parties. If a POP Contract also involves the construction of gathering, processing, or other facilities, the contract will defer the commencement of the parties' delivery and receipt obligations – and perhaps even the start of the initial contract term – until the necessary facilities have been completed.

iii. Acreage Commitments and MAQ Obligations. Among the key provisions in a POP Contract that are not found in short-term, spot gas sales utilizing the 2006 NAESB are so-called Acreage Commitments and MAQ obligations.

Most POP Contracts, as well as many gas gathering, processing, and other midstream agreements between Midstream Companies and oil and gas producers (collectively, "Wellhead Contracts"), are structured so that the Midstream Company purchases, gathers, or processes all of the gas produced from certain oil and gas leases or lands that are owned or controlled by the oil or gas producer. In most cases, the Midstream Company's obligation to receive and purchase,

³⁵⁴ See, *id.* at slide 17; Harris, *Natural Gas, Focus on Midstream, Part III: A Primer on Marketing Natural Gas Liquids*, 4TH GAS & POWER INST., Univ. of Texas School of Law, St. Bar OGERL Section (2005) (hereinafter, "Harris").

gather, or process the producer's gas on a daily basis is Firm³⁵⁵ up to the maximum daily capacity made available to the producer at the Midstream Company's facilities. In consideration for this commitment by the Midstream Company, Wellhead Contracts customarily require the producer to commit to the contract of all gas produced from or attributable to its interests in the relevant oil and gas leases or lands. Hence, the term "Acreage Commitment".

Historically, a typical Acreage Commitment provided, in pertinent part:

Subject to the terms of this Agreement, Producer commits and dedicates to the performance of this Agreement, during the Contract Term, all of the Gas now or hereafter Owned or Controlled by Producer that is produced from all current and future wells located on the lands covered by the oil and gas leases described on Exhibit A, including any extensions or renewals of such oil and gas leases and any new oil and gas leases taken in replacement thereof prior to or within six (6) months after the expiration of any such oil and gas lease (collectively, the "Dedicated Leases"). For purposes of this Agreement, Gas is "Owned or Controlled" by Producer if Producer has title, whether by virtue of its ownership of a Dedicated Lease or otherwise, or, if Producer does not have title to such Gas, Producer has the right, under any joint operating agreement, unit operating agreement, or other contractual arrangement or arising by operation of Law, to commit and dedicate such Gas to the performance of this Agreement.

There are, of course, many other variations of this type of provision.

When entering into such a Wellhead Contract, Midstream Companies frequently agree to construct and install a gas gathering system, a gas processing or fractionation plant, or other facilities for use in the performance of the contract. Since the oil and gas producer rarely contributes to the costs of these facilities, Wellhead Contracts frequently obligate the producer to deliver to the Midstream Company a minimum annual quantity of hydrocarbons (in each case, a "MAQ") over the period of time that is required to permit the Midstream Company to recover its capital investment and achieve its targeted rate of return. If the producer fails to deliver the MAQ during a contract year, the producer must pay the Midstream Company a deficiency payment. In many Wellhead Contracts, the MAQ increases and then declines over the term of the contract to reflect the ramp up in production expected to result from the producer's development plan for the Dedicated Leases and the subsequent decline in production after development is complete. In this way, the parties seek to match the MAQ to the producer's anticipated production over the contract term.

³⁵⁵ See text accompanying notes 243 and 244, *supra*.

In recent years, Acreage Commitments and MAC obligations in Wellhead Contracts have been at the heart of one of the most significant legal issues facing the midstream industry. As energy commodity prices declined and then collapsed in 2014 and thereafter remained at historically low levels throughout 2015 and much of 2016, many producers were forced to reduce or even suspend entirely their oil and gas drilling programs. This circumstance resulted in a disconnect between the agreed upon MAQ in the affected Wellhead Contracts and the producers' actual production, which did not ramp up and actually began to decline faster than anticipated by the parties. Many producers thus were faced with the obligation to make increasingly large, potentially crippling deficiency payments. In an effort to avoid bankruptcy, many producers entered into negotiations with their Midstream Companies to restructure the relevant Wellhead Contracts to reduce or eliminate the economic burden of deficiency payments in the near term. Many other producers, faced with defaults to their lenders and an inability to pay their debts as they came due, were forced to seek protection under the United States Bankruptcy Code.

Once in bankruptcy, several producers elected, as part of their restructuring strategy, to "reject" the most onerous of their Wellhead Contracts.³⁵⁶ Midstream Companies, faced with the prospect of material unrecouped capital investments and the loss of significant hydrocarbon throughput on their systems, in most cases contested the right of the producer/debtor to reject its Wellhead Contracts. In this regard, the central argument posited by the Midstream

³⁵⁶ Section 365 of the Bankruptcy Code, 11 U.S.C. §365, provides that the debtor or the bankruptcy trustee may assume or reject any executory contract of the debtor. Although the term "executory contract" is not defined under the Bankruptcy Code, courts have accepted the definition that an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete the performance would constitute a material breach excusing the performance of the other." *Sharon Steel Corp. v. National Fuel Distribution Corp.*, 872 F.2d 36, 39 (3d Cir. 1989); *In re Kendall Grove Joint Venture*, 59 B.R. 407, 408 (Bankr. S.D. Fla. 1986). During the bankruptcy process, the debtor or the bankruptcy trustee will generally have the ability to reject executory contracts, if, in the exercise of its business judgment, it is in the best interest of the debtor and its estate. See *In the Matter of Tilco, Inc.*, 408 F. Supp. 389 (D. Kan. 1976), *rev'd and remanded on other grounds*, 558 F.2d 1369 (10th Cir. 1977). Rejection of a contract in bankruptcy pursuant to Section 365 constitutes a breach of the contract immediately before the filing date of the bankruptcy petition. *Aslan v. Sycamore Inv. Co.*, 909 F.2d 367 (9th Cir. 1990); *In re Continental Airlines, Inc.*, 146 B.R. 520, 531 (Bankr. D. Del. 1992) (rejection of lease) Such a rejection does not, however, terminate, rescind, or undo the contract. *Matter of Austin Development Co.*, 19 F.3d 1077 (5th Cir. 1994) (noting that rejection does not equate termination.) Instead, rejection simply constitutes a breach of the contract that relieves the debtor from future performance under the contract. *Taylor-Wharton Int'l LLC v. Blasingame (In re Taylor-Wharton Int'l LLC)*, Adv. Pr. No. 10-52792 (Bankr. Del. Nov. 23, 2010) at 6-7. The non-debtor party to a rejected contract becomes an unsecured creditor, *NLRB v. Bildisco and Bildisco*, 465 U.S. 513 (1984), with (i) a general unsecured claim against the debtor for damages for breach of contract, which claim is deemed to have arisen immediately before the filing of the petition, and (ii) an expense of administration claim for any benefits received by the debtor in possession prior to rejection. See 11 U.S.C. §§365(g)(1) & 502(g).

If a debtor wishes to assume a contract in its bankruptcy case, it must cure any defaults under the contract and provide adequate assurance of future performance. See 11 U.S.C. §365(b)(1). In connection with a sale of the debtor's assets, the debtor may seek to assume and assign the contract to a third-party purchaser. In that circumstance, counterparties to the contract can demand adequate assurance that the third-party purchaser has the ability to perform under the contract prior to the court's approval of the sale transaction. *Id.* at §365(b)(1)(C).

Companies is that their Wellhead Contracts may not be rejected because the contracts contain express covenants – usually, the Acreage Commitment – that run with the land and are, therefore, property interests that cannot be terminated by the producer’s bankruptcy.³⁵⁷

A complete analysis of this issue is beyond the scope of this paper. This author has written two articles on the subject, one presented at the 2016 State Bar of Texas Advanced Oil, Gas, and Energy Resources Law Course³⁵⁸ and one recently published in the St. Mary’s Law Journal.³⁵⁹ It suffices to say that under Texas law, a covenant will be deemed to “run with the land” if:

- the covenant in question touches and concerns the land;
- the covenant relates to something in existence or is expressly made binding on the parties and their assigns;
- the covenant was intended by the covenanting parties to run with the land;
- successors to the burden of the covenant have notice of its existence; and
- there was privity of estate between the original covenanting parties with respect to the burdened land.³⁶⁰

In 2016, in the bankruptcy case of Sabine Oil & Gas Corporation (“Sabine”), the United State Bankruptcy Court for the Southern District of New York issued two decisions in which it concluded that the Acreage Commitments in two sets of Wellhead Contracts that Sabine proposed to reject did not constitute covenants running with the land, so that Sabine’s rejection of the contracts was proper.³⁶¹ According to the bankruptcy court, the Acreage Commitments in

³⁵⁷ A covenant running with the land is an interest in real property – not a freehold estate like the surface or mineral fee or the oil and gas leasehold estate, but a right or obligation that is primarily attached to the land, rather than being contractual in nature. *E.g.*, *Gouveia v. Tazbir*, 37 F.3d 295, 299-300 (7th Cir. 1994); *City of Houston v. McCarthy*, 464 S.W.2d 381, 385-386 (Tex. Civ. App. – Houston [1st Dist.] 1971, writ *ref’d n.r.e.*). See Sims, *The Law of Real Covenants: Exceptions to the Restatement of the Subject by the American Law Institute*, 30 CORNELL L. REV. 1 (1944). As such, a covenant running with the land should not constitute an executory contract under Section 365 of the Bankruptcy Code, nor should, in most cases, a debtor in bankruptcy be able to sell his property free and clear of such a covenant under Section 363 of the Bankruptcy Code. 11 U.S.C. §§365, 363(f).

³⁵⁸ See Pearson, *Covenants Running With the Land*, 34TH ANN. ADV. OIL, GAS & ENERGY RES. L. COURSE, St. Bar of Tex., ch. 15 (2016) (hereinafter, “Pearson II”).

³⁵⁹ See Pearson, *Covenants Running With the Land*, 48 St. Mary’s L.J. 727 (2017) (hereinafter, “Pearson III”).

³⁶⁰ *Inwood North Homeowners’ Ass’n Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987); *Westland Oil Dev. Corp. v. Gulf Oil Corp.* 637 S.W.2d 903 (Tex. 1982); *Newco Energy v. Energytec, Inc. (In the Matter of Energytec, Inc.)*, 739 F.3d 215, 221 (5th Cir. 2013).

³⁶¹ *In re Sabine Oil & Gas Corp.*, 547 B.R. 66 (Bankr. S.D.N.Y. 2016) (“Sabine I”); *Sabine Oil & Gas Corp. v. HPIP Gonzales Holdings, LLC*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016) (“Sabine II”).

controversy did not satisfy the “touch and concern” and “privity of estate” elements of the foregoing test.³⁶²

The *Sabine* decisions did not kill the practice of utilizing Acreage Commitments in Wellhead Contracts. Indeed, anecdotally, Midstream Companies in the Permian Basin are paying producers a bonus if the producer agrees to enter into an Acreage Commitment in connection with a new Wellhead Contract. The challenge for producers and Midstream Companies going forward, then, is to structure future Acreage Commitments in the manner most likely to survive scrutiny in a producer bankruptcy. This author’s analysis of and suggestions regarding this issue are set forth in the two articles mentioned above, and you are referred to those articles for such further analysis and drafting suggestions.³⁶³

iv. Quantity; Standard of Service. POP Contracts almost exclusively require Firm³⁶⁴ undertakings by the seller to sell and deliver, and the Midstream Company to purchase and receive, all gas Owned or Controlled by the seller and produced from the Dedicated Leases. Most POP Contracts include a daily cap on the quantity of gas that the Midstream Company is obligated to receive, based in most cases on the Midstream Company’s available gathering capacity, if the Delivery Points are at the wellhead or at central delivery points in the field, or its available processing capacity at the inlet of the processing plant. Some POP contracts do not contain such a cap, however, with the result that the Midstream Company is left to rely on the “good faith” and “not unreasonably disproportionate” tests under Section 2.306 of the Texas UCC³⁶⁵ to protect the Midstream Company against material increases in the volume of the producer’s production.³⁶⁶

In most cases in which the POP Contract contains a cap on the Midstream Company’s Firm gas receipt obligation, the contract will provide that the Midstream Company will accept quantities of gas from the producer in excess of the cap on an Interruptible basis.³⁶⁷

The quantity provisions in POP Contracts will also contain reservations by the producer of the rights (a) to recover liquefiable hydrocarbons from the dedicated gas stream by field separation upstream of the inlet of the processing plant, (b) to use portions of the dedicated gas for lease operations and to satisfy royalty obligations, (c) to pool or unitize the Dedicated Leases, and (d) to drill, rework, plug and abandon, and otherwise operate the Dedicated Leases in its sole discretion.

³⁶² *Id.*

³⁶³ See notes 358, 359, *supra*.

³⁶⁴ See text accompanying note 244, *supra*.

³⁶⁵ TEX. BUS. & COM. CODE ANN. §2.306(a) (2017). See text accompanying notes 86 through 89, *supra*.

³⁶⁶ See text accompanying note 242, *supra*.

³⁶⁷ See text accompanying note 245, *supra*.

v. Price; Gas and Product Allocations. As the name suggests, the price paid by the Midstream Company for the producer's gas is frequently equal to a percentage of the proceeds received by the Midstream Company from the sale of the residue gas and Products extracted by processing, less costs of gathering, processing, and transportation, charges for dehydration fuel, compression fuel, plant fuel, lost and unaccounted for gas, and any gathering, processing, and treatment fees agreed to by the parties. The percentage of proceeds varies depending on the extent of the processing services provided by the Midstream Company and the relevant market, but typically fall in the range of 75% to 95% of the resale value.³⁶⁸ In some cases, rather than the price being based on actual resale proceeds, the price may be based on agreed upon index prices for the residue gas and Products extracted by processing or based on the volume weighted average resale proceeds received by the Midstream Company at its plants.³⁶⁹

Determining the quantities of residue gas and Products for which the producer is to be paid requires a complex set measurements and allocations to determine (a) the volume gas delivered by the producer at each Delivery Point, in both Mcf and MMBtu, (b) the volume of each type of Product, in gallons, present in the producer's gas stream at each Delivery Point, (c) the volumes of such Products properly allocable to the producer, usually based on a fixed recovery percentage per Product, (d) the reduction in heating value, or shrinkage, of the gas delivered at the Delivery Points as the result of processing, and (e) the quantity of residue gas (unprocessed gas minus shrinkage) allocable to the producer's Delivery Point quantity of gas. These allocations are prepared by processing engineers and should always be vetted with the producer's and Midstream Company's counsel to assure that the contract language matches the mathematical calculations.³⁷⁰

vi. Quality; Operational Matters. On the issue of gas quality, the 2006 NAESB provides only that all gas delivered by the seller will meet the pressure, quality, and heating content requirements of the receiving transporter.³⁷¹ Since there is ordinarily no "receiving transporter" to look to in a POP transaction, the POP Contract routinely contains extensive provisions not found in the 2006 NAESB concerning (a) metering and measurement of the dedicated gas at the Delivery Points and at the outlet of the processing plant, (b) the determination gas composition, gravity, and heating value, (c) requirements for delivery pressure, and (d) gas quality.

Gas quality requirements will vary from processing plant to processing plant, depending on the characteristics of the gas produced in the area of the relevant plant, the processing capabilities of the plant, and the quality requirements of the transporting pipelines to which the plant is connected at its tailgate. Such gas quality requirements will generally establish

³⁶⁸ See Lake and Hoff, *supra* note 44, at 10-11.

³⁶⁹ See *id.*; Duke, *supra* note 350, at slide 17.

³⁷⁰ For an excellent discussion of these gas and Product allocation issues, see Wright, *Natural Gas, Focus on Midstream, Part II: Gas Processing Contract – A Primer*, 4th ANN. GAS & POWER INST., Univ. of Texas School of Law, St. Bar of Tex. (2005) (hereinafter, "Wright").

³⁷¹ 2006 NAESB, §5.

tolerances for the presence in the gas stream of H₂S, mercaptan sulfur, water vapor, total sulfur, flowing gas temperature, heating content, N, CO₂, and O₂, and total non-combustible gas (or “inerts”), and require that the gas be generally free of “deleterious substances injurious to pipelines.” The Midstream Company will be entitled to refuse to take non-conforming gas, and the producer will be responsible for remedying the non-conformity.

vii. Economic Out. Most POP Contracts provide that if the Midstream Company reasonably determines, over an agreed upon period of time, that it is no longer economically feasible to receive producer’s gas at a Delivery Point or to continue to operate its processing plant, the Midstream Company may elect, upon notice to the producer, (a) to discontinue receipts of gas at the affected Delivery Point or the operation of the relevant processing plant, or (b) terminate the POP Contract either in its entirety or as to the portion of the Dedicated Leases served by the Delivery Point from which the Midstream Company no longer receives gas. Absent the termination of the POP Contract, if the Midstream Company discontinues receipts of the producer’s gas, the producer’s commitment of such gas is released until the Midstream Company resumes receipts.

viii. Failure to Deliver/Receive. POP Contracts ordinarily do not contemplate “cover” style liquidated damages like those provided for in Section 3.2 of the 2006 GTCs.³⁷² Such damages are inappropriate in a POP transaction with respect to the producer, because of the output character of his sale/delivery obligation. If the POP Contract has a MAC obligation, the producer’s obligation to pay a deficiency payment incentivizes the producer to maximize its production.

In the case of a Midstream Company’s unexcused failure to receive gas at one or more Delivery Points, Midstream Companies ordinarily will agree to release gas delivered at the affected Delivery Points from dedication to the POP Contract if the unexcused failure to receive continues for an extended period of time and is not remedied after notice and opportunity to cure.

ix. Events of Default; Termination. Historically, most POP Contracts did not include event of default provisions or contemplate contract termination upon the occurrence of a breach or default. More recently, however, the parties to POP Contracts are beginning to include event of default provisions modeled on Section 10.1 of the 2006 GTCs³⁷³ as well as provisions authorizing the non-defaulting party to suspend performance and terminate the POP Contract upon the occurrence of such an event of default. The incentive for this largely derives from Midstream Companies’ desire to maximize their chances of having their POP Contracts characterized as “forward contracts” for bankruptcy purposes.³⁷⁴

³⁷² *Id.* at §3.2.

³⁷³ *Id.* at §10.1.

³⁷⁴ See Section V of this paper, *infra*.

Parties are not, however, embracing the concept of “Early Termination Damages” as described in Section 10.3.1 of the 2006 GTCs³⁷⁵ upon the termination of the POP Contract following an event of default. Predicting accurately the quantity of gas remaining to be sold under a POP Contract at any point in time is extremely difficult. Use of the remaining MAC obligation under a POP Contract as the basis for calculating early termination damages generally produces a sufficiently large liquidated damages figure that makes both parties uncomfortable. As such, when a POP Contract expressly deals with the issue of damages upon termination following a default, the standard used is ordinarily similar to that in Section 10.3.1 (Early Termination Damages Do Not Apply) of the 2006 GTCs.³⁷⁶

IV. CRUDE OIL

Crude Oil sale and purchase agreements do not have the same long and rich history as gas sale agreements. Indeed, within the last 20 years, this author has reviewed crude oil sale agreements that were little more than telegrams containing the names of the parties, the quantity and grade of crude oil to be sold, the price, and the delivery instructions.

In 1993, however, ConocoPhillips published its initial version of its “General Provisions – Domestic Crude Oil Agreements” (the “1993 Conoco General Provisions”), under which ConocoPhillips purchased and sold crude oil in the United States.³⁷⁷ Since that time, the 1993 Conoco General Provisions have achieved widespread acceptance in the crude oil market and have frequently been incorporated by reference into the crude oil sale agreements of other parties.³⁷⁸

A. Crude Oil Master Agreements.

The 1993 Conoco General Provisions have not completely “cornered the market” with respect to crude oil sale agreements, however. Since 2000, the same market forces that drove the development of the 2002 ISDA Master Agreement, the 2006 NAESB, and other master commodity sale/purchase agreements and annexes saw the development of several master agreements for crude oil.

In 2008, ISDA published its U.S. Crude Oil and Refined Petroleum Products Annex and Confirmation (the “ISDA Crude Oil Annex”) to the 2002 ISDA Mater Agreement to facilitate physical trading of U.S. pipeline crude oil, refined petroleum products, liquefied petroleum gas, and natural gas liquids.³⁷⁹ The ISDA Crude Oil Annex was last revised in 2010.

³⁷⁵ 2006 NAESB, §10.3.1 (Early Termination Damages Apply).

³⁷⁶ 2006 NAESB, §10.3.1 (Early Termination Damages Do Not Apply).

³⁷⁷ See Lake and Hoff, *supra* note 44, at 16.

³⁷⁸ *Id.*

³⁷⁹ The ISDA Crude Oil Annex is available at <http://www.isda.org/book/isda-u-s-crude-oil-and-refined-petroleum-products-annex-and-confirmation/>.

In 2009, the Leadership for Energy Automated Processing (“LEAP”) released its Master Agreement for Purchasing and Selling Refined Petroleum Products and Crude Oil Version 2.1 (the “LEAP Master Agreement”).³⁸⁰ The LEAP Master Agreement is intended for voluntary use in physically settled transactions in the United States where oil transfers within tanks or pipelines.³⁸¹

In our experience, neither the ISDA Crude Oil Annex nor the LEAP Master Agreement has gained the traction with crude oil sales that the 2006 NAESB has gained with gas sales. Nor have these master agreements reduced the level of market acceptance for the 1993 Conoco General Provisions. Without doubt, many other purchasers of crude oil have produced their own, high quality general terms and provisions to govern crude oil sales. Nevertheless, because of the widespread and consistent use of the 1993 Conoco General Provisions over the years, our discussion will focus on selected “highlights” from the 2017 revision of that document (as revised, the “2017 Conoco General Provisions”).

Please note that the 2017 Conoco General Provisions are proprietary to ConocoPhillips Company. We have not been authorized to attach a copy of such provisions as an exhibit to this paper.

B. 2017 Conoco General Provisions.

1. Contract Architecture. The 2017 Conoco General Provisions are intended to be incorporated by reference into, or attached as an exhibit to, a transaction confirmation executed by the parties (the “Oil Confirmation”). The Oil Confirmation contains (i) the names, addresses, and contact information for notice purposes of the parties, (ii) the delivery period for the crude oil, (iii) the quantity of crude oil and its quality specifications, (iv) the locations and methods of delivery, (v) the price to be paid for the crude oil, (vi) any special payment terms, (vii) the parties’ agreement regarding confidentiality, and (viii) other “special provisions” negotiated by the parties.

Attached to the 2017 Conoco General Provisions are ConocoPhillips’ standard “Quantity and Quality Determination Guidelines.” Other exhibits may be attached to the 2017 Conoco General Provisions pursuant to references contained in the special provisions.

2. Contracting Issues. Most of the basic contracting issues presented by the 2017 Conoco General Provisions have already been discussed in connection with the 2006 NAESB and the POP Contracts. The treatment of the following issues under the 2017 Conoco General Provisions should be of interest, however.

³⁸⁰ The LEAP Master Agreement is available at <http://www.energyleap.org/document-downloads/master-agreement/>.

³⁸¹ *Id.* For a discussion of the material terms of the ISDA Crude Oil Annex and the LEAP Master Agreement, see Greenblatt, Ray, and Turner, *Summary of Industry Agreements*, 2^D ANN. MIDSTREAM OIL & GAS L. CONF. at 1 (2013) (hereinafter, “Greenblatt, Ray, and Turner”).

a. Quantity. The unit of measurement for crude oil sold under the 2017 Conoco General Provisions is the “barrel” (42 U.S. gallons). The quantity of crude oil to be sold may be expressed as a quantity per day, similar to the 2006 NAESB, or on an “output” basis, similar to the POP Contracts.

b. Quality. As indicated above, quality provisions are not embedded in the 2017 Conoco General Provisions and must be included in the Oil Confirmation or in a special exhibit to the contract. The quality specifications will generally express tolerances for the presence in the crude oil of basic sediment and water (“BS&W”), sulfur, H₂S, Reid vapor pressure (“RVP”), temperature, API gravity, viscosity, and solids, and provide that the crude oil must be commercially free of “deleterious substances injurious to pipelines.” The 2017 Conoco General Provisions are silent about the Midstream Company’s remedies if the producer delivers non-conforming crude oil, so that such provisions must be addressed in the special provisions.

c. Price. The price paid for the crude oil will generally be based on specified reference prices, such as the posted prices of large crude oil purchasers at trading hubs, the NYMEX settlement price for light, sweet West Texas Intermediate crude oil (“WTI”), or an index price such as those posted in *Platt’s Oilgram Price Report*.³⁸² The price will be subject to adjustment to reflect field location differentials, trucking and other transportation costs, gravity adjustments, and gathering, stabilization, storage, blending, and similar fees charged by the Midstream Company.

d. Financial Responsibility. The 2017 Conoco General Provisions contains a provision similar in concept to Section 10.1 of the 2006 GTCs that permits the producer, if it “reasonably believes it necessary to assure payment,” to require the Midstream Company to advance, within not less than two business days after its receipt of notice, a cash payment or a letter or letters of credit (“Payment Assurance”) in amounts sufficient to cover all outstanding deliveries of crude oil. Further, the producer is relieved of its obligations to schedule or deliver crude oil until the Midstream Company provides the Payment Assurance.

e. Default; Remedies. The 2007 Conoco General Terms and Conditions contain a very narrow definition of “Event of Default”; only a failure to make payment when due, a failure to provide Payment Assurance in a timely manner, and an “Insolvency Event” will constitute an Event of Default. Upon the occurrence of an Event of Default, the non-defaulting party may, at its option, suspend performance and/or terminate and liquidate the contract. The “Settlement Amount” to be paid upon termination of the contract is calculated on an undiscounted basis in a manner similar to the termination payment calculated under Section 10.3.1 of the 2006 GTCs. The Settlement Amount is discharged, first, through a triangular setoff, and then by payment of the balance due in cash by the party owing the same.

f. Delivery. Crude Oil may be delivered in the storage tank or into a pipeline, a tank truck, a rail car, or a barge, and the 2017 Conoco General Provisions address the delivery

³⁸² See Lake and Hoff, *supra* note 44, at 16.

mechanics for each circumstance. ConocoPhillips has also published “Marine Provisions” and “Rail Provisions” to address in more detail specific circumstances of crude oil delivery into a barge or other marine vessel or a rail car.

V. GAS/OIL SALE CONTRACT AS FORWARD CONTRACT

Section 10.5 of the 2006 NAESB provides that the transactions formed under the Base Contract constitute a “forward contract”, and that the buyer and the seller are each “forward contract merchants”, in each case within the meaning of the United States Bankruptcy Code.³⁸³ Similar provisions appear in each POP Contract and each crude oil sale agreement (including the 2017 Conoco General Provisions) reviewed in the preparation of this paper.

These “forward contract”/“forward contract merchant” characterizations are important in the cases of crude oil sale contracts and gas sale contracts because in the event of the bankruptcy of an oil and gas producer who is a party to a conventional gas or oil sale contract, the Bankruptcy Code provides several protections for the gas or oil purchaser if the contract qualifies as a “forward contract” entered into by a “forward contract merchant.”

A. Qualification as “Forward Contract”.

The Bankruptcy Code defines the term “forward contract” as follows:

(A) a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a “repurchase agreement” as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any similar agreement. (emphasis supplied).³⁸⁴

Looking at the quoted definition, courts have noted that, in general terms, “forward contracts” are contracts for the future purchase or sale of commodities that are not subject to the rules of a contract market or board of trade.³⁸⁵

³⁸³ 2006 NAESB, §10.5.

³⁸⁴ 11. U.S.C. §101(25).

³⁸⁵ *Superior Livestock Auction, Inc. v. E. Livestock Co., LLC (In re E. Livestock Co., LLC)*, No. 10-93904, 2012 Bankr. LEXIS 1469 (Bankr S.D. Ind. Apr. 5, 2012) (holding that contracts for the purchase and sale of cattle for future delivery

In addition, the Bankruptcy Court defines “forward contract merchant” as follows:

[A] Federal reserve bank, or an entity the business of which consists in whole or in part of entering into forward contracts as or with merchants in a commodity (as defined in section 761) or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade.³⁸⁶

In determining whether a particular contract constitutes a “forward contract,” some bankruptcy and appellate courts have required a contract to have “financial characteristics” in order to achieve that characterization,³⁸⁷ while other courts, including the Fifth Circuit, have not considered a contract’s financial character.³⁸⁸

Two Fifth Circuit cases are of particular interest in this regard. In *Olympic Natural Gas Company*,³⁸⁹ the Fifth Circuit construed a contract for the purchase and sale of natural gas to constitute a “forward contract” between “forward contract merchants.” In *Olympic*, Morgan Stanley entered into contracts with Olympic to purchase and sell natural gas. The contracts provided that by the 15th day of the month, Olympic was required to invoice Morgan Stanley for the gas provided, and by the 25th day of the month, Morgan Stanley was to pay the total amount due³⁹⁰. An involuntary bankruptcy petition was filed against Olympic, and the bankruptcy trustee brought a suit to avoid transfers made to Morgan Stanley as being preferential and fraudulent. Morgan Stanley asserted that the payments could not be avoided pursuant to Section 546(e) of the Bankruptcy Code, which shelters settlement payments made to a forward contract merchant.³⁹¹ The Fifth Circuit concluded that, because the transactions were contracts for the purchase and sale of a certain, specified quantity of natural gas to be delivered at a certain,

were forward contracts); *Williams v. Morgan Stanley Capital Grp., Inc. (In re Olympic Natural Gas Co.)*, 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff’d* 294 F.3d 737 (5th Cir. 2002) (holding that contracts for the purchase and sale of a certain, specified quantity of natural gas to be delivered physically at some certain, specified future date constituted forward contracts).

³⁸⁶ 11. U.S.C. §101(26).

³⁸⁷ See, e.g., *Lachmund v. ADM Investor Services, Inc.*, 191 F.3d 777, 786 (7th Cir. 1999); *Buchwald v. Williams Energy Mktg. & Trading Co. (In re Magnesium Corp. of Am.)*, 460 B.R. 360 (Bankr. S.D.N.Y. 2011) (remarking that several courts have considered a contract’s financial character). See also H.R. Rep. No. 101-484, at 3 (1990) (“The primary purpose of a forward contract is to hedge against possible fluctuations in the price of a commodity. This purpose is financial and risk-shifting in nature, as opposed to the primary purpose of an ordinary commodity contract, which is to arrange for the purchase and sale of the commodity.”).

³⁸⁸ See, e.g., *Williams v. Morgan Stanley Capital Group (In re Olympic Natural Gas Co.)*, 294 F.3d 737 (5th Cir. 2002); *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs.)*, 690 F.3d 352 (5th Cir. 2012) (rejecting argument that “ordinary supply contracts’ cannot qualify as forward contracts under the statute).

³⁸⁹ 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff’d*, 294 F.3d 737 (5th Cir. 2002).

³⁹⁰ 258 B.R. at 163.

³⁹¹ *Id.* at 164.

specified future date, they qualified as forward contracts.³⁹² Further, because Morgan Stanley's business consisted in whole or in part of entering into forward contracts, the Fifth Circuit found that Morgan Stanley constituted a forward contract merchant. The Fifth Circuit then concluded that the payments made to Morgan Stanley by Olympic constituted settlement payments within the meaning of Section 101(51A) of the Bankruptcy Code because they were payments that could be characterized as "a similar payment commonly used in the forward contracts trade" and were therefore eligible for protection under Section 546(e).³⁹³

In *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs.)*,³⁹⁴ the most recent opinion on the issue by the Fifth Circuit, the court examined an agreement in which MBS agreed to purchase from MX the full electric requirements for specified apartment complexes for two years at a set price based on actual usage.³⁹⁵ After MBS filed a bankruptcy case, the bankruptcy trustee sought to recover payments made to MX as preferential transfers under Section 547 of the Bankruptcy Code.³⁹⁶ MX argued that avoidance should not be permitted under Section 546(e), but the bankruptcy trustee disagreed, arguing that the contract was not a forward contract because it did not provide for a specific quantity of electricity to be purchased or a specific delivery date, and also that MX did not qualify as a "forward contract merchant."³⁹⁷ The Fifth Circuit disagreed, noting that if the bankruptcy trustee were correct, many natural gas, fuel, and electricity requirements contracts would be excluded from Section 546(e).³⁹⁸ Instead, the Fifth Circuit ruled that the statutory text encompassed the type of futures contract arranged between the debtor and MX, and clarified that forward contracts that are in the nature of supply contracts may be protected by Section 546(e).³⁹⁹

Based on the foregoing decisions, the gas sale contracts and the oil sale contracts commonly entered into by Midstream Companies with oil and gas producers appear to qualify as forward contracts. First, the agreements are contracts for the future purchase of gas or oil from certain oil and gas leases or lands, and ordinarily these contracts are not subject to the rules of a contract market or board of trade.⁴⁰⁰ Consistent with *Nagel v. ADM Investor Services*,⁴⁰¹ these contracts contain specific terms regarding price and quantity. Most Midstream Companies should be able to show that they are industry participants that, as part of their business, enter into forward contracts. In most cases, Midstream Companies are not end-users of the gas or oil

³⁹² 294 F.3d at 740-741.

³⁹³ *Id.* at 742.

³⁹⁴ 690 F.3d 352 (5th Cir. 2012).

³⁹⁵ *Id.* at 354.

³⁹⁶ *Id.*

³⁹⁷ *Id.* at 355.

³⁹⁸ *Id.*

³⁹⁹ *Id.* at 356-357.

⁴⁰⁰ See *In re Olympic Natural Gas Co.*, 258 B.R. 161, 165 (Bankr. S.D. Tex. 2001), *aff'd*, 294 F.3d 737 (5th Cir. 2002).

⁴⁰¹ 217 F.3d 436, 441 (7th Cir. 2000).

purchased under these contracts. Rather, they resell the gas or oil or the residue gas and the Products extracted by processing, a favorable fact under *Superior Livestock Auction, Inc. v. E. Livestock Co., LLC*, (*In re E. Livestock Co., LLC*).⁴⁰² Delivery occurs on specified dates and is not deferred forever. Finally, settlement of the account under the gas or oil sale contracts occurs each month, and outside the two-day time period in Section 101(25).

B. Rights/Consequences of Forward Contract Characterization.

1. Settlement Payments. A finding that its gas or oil sale contracts are forward contracts qualifies a Midstream Company for certain “safe harbor” provisions of the Bankruptcy Code. Among these is the “safe harbor” protection for “settlement payments” afforded by virtue of Section 546(e).⁴⁰³ Section 546(e) protects the Midstream Company from a bankruptcy trustee’s ability to recover and avoid settlement payments as preferential or constructively fraudulent transfers under Sections 544, 547, and 548(a)(1)(B) of the Bankruptcy Code, although it would not shelter a Midstream Company from a suit for recovery of an actually fraudulent transfer under Section 548(a)(1)(A).⁴⁰⁴

Under the Bankruptcy Code, a “settlement payment” is defined as a “preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement on account, a final settlement payment, a net settlement payment, or any other similar payment commonly used in the forward contract trade.”⁴⁰⁵ In *Olympic Natural Gas Co.*, the Fifth Circuit decided that the monthly payments paid pursuant to the natural gas sales contract in controversy to settle each month’s trading constituted “settlement payments” under Section 101(51A).⁴⁰⁶ In reaching its conclusion, the court stated that the term “settlement payment” should be interpreted very broadly,” rejecting the trustee’s argument that to be exempt from avoidance, a settlement payment must be made on a financial derivative contract and be cleared through a centralized system.⁴⁰⁷ Accordingly, in the event of the bankruptcy of the oil and gas producer/seller under a gas or oil sale contract with a Midstream Company, payments made to the Midstream Company by the producer under the contract prior to the bankruptcy filing should be protected from avoidance actions of the bankruptcy trustee.

2. Setoff. In addition, a party to a forward contract may immediately set off or net amounts owed to it in respect of a claim against the debtor for a settlement payment,

⁴⁰² No. 10-93904, 2012 Bankr. LEXIS 1469 (Bankr. S.D. Ind. April 5, 2012).

⁴⁰³ 11 U.S.C. §546(e). See *Williams v. Morgan Stanley Capital Grp., Inc. (In re Olympic Natural Gas Co.)*, 258 B.R. 161 (Bankr. S.D. Tex. 2001), *aff’d* 294 F.3d 737 (5th Cir. 2002).

⁴⁰⁴ *GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C. (In re GPR Holdings)*, 316 B.R. 477 (Bankr. N.D. Tex. 2004).

⁴⁰⁵ See 11 U.S.C. §101(51)(A).

⁴⁰⁶ See *Olympic Natural Gas Co*, 294 F.3d at 742.

⁴⁰⁷ *Id.*; *GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C. (In re GPR Holdings)*, 316 B.R. 477 (Bankr. N.D. Tex. 2004) (observing that a “settlement payment” is broadly defined to include any payment commonly used in the forward contract trade.”).

notwithstanding the imposition of the automatic stay.⁴⁰⁸ Section 362(b)(6) of the Bankruptcy Code provides that the automatic stay will not apply to a setoff by a commodity broker or forward contract merchant of any mutual debt and claim under or in connection with any forward contract.⁴⁰⁹ A motion for relief from the automatic stay is thus not required, although it otherwise would be required in order to exercise a right to setoff.⁴¹⁰

3. Liquidation. An final advantage provided by the Bankruptcy Code to parties to a forward contract is that forward contracts are an exception to the “*ipso facto*” clause prohibition. An *ipso facto* clause refers to a contractual provision that allows a party to terminate and liquidate a contract upon the filing of a bankruptcy by a counterparty.⁴¹¹ The bankruptcy safe harbor provisions allow a non-defaulting party to a forward contract to terminate a contract based upon the counterparty’s act of filing a bankruptcy petition. Ordinarily, such contractual right would be unenforceable against a debtor pursuant to Section 365(e)(1) of the Bankruptcy Code. But, Section 556 of the Bankruptcy Code provides as follows:

*The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract, as defined in § 761(4), or forward contract because of a condition of the kind specified in § 365(e)(1) of this title and the right to a variation or maintenance margin payment received from a trustee with respect to open commodity contracts or forwarded contracts, shall not be stayed, avoided or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title.*⁴¹²

Thus, Section 556 permits a “forward contract merchant” to liquidate a forward contract without court approval if the liquidation is based upon a contractual provision providing for default upon a counterparty becoming a debtor in bankruptcy. If a gas or oil sale contract is thus liquidated as a forward contract upon the bankruptcy of the gas or oil seller, the Midstream Company will have a pre-petition, general unsecured claim for damages in the bankruptcy pursuant to Section 502(g)(2) of the Bankruptcy Code.⁴¹³

⁴⁰⁸ See 11 U.S.C. §362(b)(6).

⁴⁰⁹ *GPR Holdings, L.L.C. v. Duke Energy Trading and Mktg, L.L.C (In re GPR Holdings)*, 316 B.R. 477 (Bankr. N.D. Tex. 2004).

⁴¹⁰ See 11 U.S.C. §362(a)(7) (providing that the stay applies to the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor).

⁴¹¹ See *Lehman Bros. Special Fin. Inc. v. Ballyrock ABS CDO 2007-1 Ltd. (In re Lehman Bros. Holdings, Inc.)*, 452 B.R. 31, 38 (Bankr. S.D.N.Y. 2011).

⁴¹² 11. U.S.C. §556 (emphasis added).

⁴¹³ 11 U.S.C. §§502(g)(2) (“A claim for damages calculated in accordance with Section 562 shall be allowed . . . or disallowed . . . as if such claim had arisen before the date of the filing of the petition.”), and 562(a) (Damages from the rejection or termination of a “swap agreement, . . . forward contract, . . . or master netting agreement shall be

VI. CONCLUSION

Gas and oil marketing are enormously complex subjects, and this paper, despite its heft, has only scratched the surface of the issues raised in the hydrocarbon marketing business. Hopefully, this paper will provide its readers with a somewhat firmer foundation from which to attack the gas and oil marketing issues that arise in your practices.

measured from the earlier of (1) the date of such rejection or (2) the date or dates of such liquidation, termination, or acceleration.”) *See, e.g., Conway Hosp., Inc. v. Lehman Bros. Holdings, Inc.*, 531 B.R. 339 (S.D.N.Y. 2015).