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Oil & Gas Transportation Service Agreements: Key Issues & Considerations

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I. INTRODUCTION

Oil and gas producers primarily focus on the exploration and production of hydrocarbons; however, the value of the produced hydrocarbons is of little value, if they cannot be gathered and transported out of the field, processed to remove contaminants and other impurities, and ultimately transported to market. Thus, the midstream segment of the oil and gas industry—broadly encompassing gathering, compression, transporting, treating, processing, fractionation, storage, and the purchase and sale of oil, gas, and natural gas liquids (NGLs)—connecting oil and gas producers to the market is a fundamental and an invaluable component of the hydrocarbon value chain.

From a conceptual perspective, the movement (*i.e.*, gathering and transportation) of oil and gas is straightforward. After oil and gas producers drill, complete, and produce a well, the produced hydrocarbons are separated into their three primary components: oil, gas, and water. The term "gathering" generally refers to the process of individually collecting oil, gas, and water from one or more wellheads in the field and their relatively short movement to various points where they are independently aggregated. However, because oil and water are typically stored at or near the wellhead in storage tanks or central tank batteries, in the case of oil, and retention ponds, in the case of water, "gathering" is a concept uniquely related to gas, but it is not uncommon for the distinction to be blurred. The term "transportation" generally refers to the process of moving the independently aggregated quantities of oil, gas, and water out of the field to downstream delivery points for treating, processing, storage, or purchase and sale via a transportation and distribution infrastructure. This may involve any combination of movement, including via truck, rail, or pipeline, in the case of oil; pipeline, in the case of gas; and truck or pipeline, in the case of water. Notwithstanding the distinctions between gathering and transportation, practitioners should nevertheless be mindful that these terms and their related concepts are commonly used interchangeably in discussions between parties and within written agreements.

As indicated above, the physical characteristics of oil and gas cause certain commercial and legal issues to differ between them. For example, oil is produced as a viscous liquid that is typically stored in storage tanks or central tank batteries at or near the wellhead pending further movement out of the field. Conversely, gas is a mixture of gaseous hydrocarbons consisting primarily of methane that is not readily stored in the field. The most efficient way to handle gas in its gaseous state is by continual movement along a pipeline, which may involve one or more stages of compression and/or points of interconnection with other pipeline systems to facilitate movement. In addition, gas is commonly treated or processed within, or within close proximity to, the field in which it was produced, in order to remove water vapor and other impurities that may damage downstream pipeline systems and related equipment during its movement. Thus, agreements governing the movement of gas inherently involve different and additional complexities and issues not otherwise found in agreements governing the movement of oil.

For purposes of this paper, I have chosen to focus on issues and considerations with respect to the transportation of oil and gas via intrastate pipeline under Texas law commencing

from their separation to their delivery at downstream delivery points for further movement or handling. In this context, this paper will present an overview of transportation issues that practitioners may encounter and consider amongst interrelated issues and concepts that are appurtenant to and negotiated together when drafting transportation service agreements. Because of the additional complexities and issues related to the physical characteristics of gas, this paper primarily focuses on issues associated with the movement of gas; however, there are noteworthy distinctions regarding oil, which are highlighted throughout this paper.

Parties that own and/or operate pipeline systems and related infrastructure (*e.g.*, gathering, compression, treating, processing, and storage facilities) to provide transportation service for oil or gas are collectively referred to herein as "*Transporters*"; parties that have engaged or will engage Transporters to provide transportation service (*e.g.*, oil and gas producers, parties that have taken oil or gas in kind, and oil and gas marketing companies) are collectively referred to herein as "*Shippers*." The point(s) at which the Shipper (or a third party on behalf of the Shipper) delivers oil or gas to the Transporter and the Transporter receives oil or gas for transportation service is referred to herein as the "*Receipt Point(s)*"; the downstream point(s) at which the Transporter redelivers oil or gas to the Shipper (or a third party designated by the Shipper) and the Shipper (or a third party designated by the Shipper) receives oil or gas is referred to herein as the "*Delivery Point(s)*."

II. KEY ISSUES & CONSIDERATIONS

There are no standard or "master" form agreements governing the transportation of oil or gas. Each Transporter may have its own preferred agreement and the circumstances regarding the oil and gas and the specific needs of the Shipper (*e.g.*, location of the wells, production quantities, quality specifications, Receipt Point(s), Delivery Point(s), existing or to-be-constructed transportation infrastructure, certainty of performance, timing considerations) will dictate the terms and conditions negotiated and ultimately agreed to by the parties. Nevertheless, there is a thread of issues that commonly presents itself in discussions regarding the transportation of oil and gas via pipeline. This section identifies those issues and the considerations related thereto that Shippers and Transporters should be mindful of when negotiating and drafting transportation service agreements. It is important to bear in mind that these issues and considerations do not exist in a vacuum and commonly implicate other interrelated issues and concepts throughout transportation service agreements, many of which are identified herein.

A. Dedication

Transporters may invest significant capital to construct or expand pipeline systems and related infrastructure. To ensure utilization of the pipeline system and an acceptable return of capital costs (via fees for transportation service), the Transporter may require the Shipper to dedicate all oil and/or gas production from certain geographic areas, oil and gas leases, and/or wells for the term of the transportation service agreement. This arrangement is equally beneficial to the Shipper, since it provides an assured path to market for the Shipper's oil or gas

which, in turn, facilitates the Shipper's ability to obtain financing and otherwise to conduct business planning from a position of economic stability.[1]

When the dedication is tied to a geographic area, the Shipper generally commits all of the oil and/or gas it owns or controls within the area for the term of the transportation service agreement. The Shipper and Transporter should pay attention to the scope of the dedication and specify whether the dedication applies only to the leases or wells owned or controlled by the Shipper at the time the transportation service agreement is entered into or also to any future leases or wells overlapping the geographic area during the term of the transportation service agreement. If leases or wells have previously been dedicated to a third party Transporter, the Shipper and Transporter should be mindful of excluding those leases and wells from the dedication, but provide for the dedication of the oil and gas therefrom upon the expiration of the third party commitment.

B. Covenants Running with the Land

Properly negotiated transportation service agreements provide that the dedication is a covenant running with the land, which has significant ramifications in bankruptcy proceedings. Oil and gas producers have elected, as part of their restructuring strategy in bankruptcy, to "reject" certain gathering and transportation service agreements.[2] Transporters, faced with the prospect of unrecouped capital investments and the loss of fees from transportation service on their pipeline systems, have, in most cases, contested the right of the oil and gas producer/debtor to reject these agreements on grounds that they contain express covenants (*e.g.*, the dedication) that run with the land and are, therefore, real property interests that cannot be terminated by the oil and gas producer's bankruptcy.[3] These arguments provide that a covenant running with the land is an interest in real property that is primarily attached to the land, rather than being contractual in nature and, as a result, it should not constitute an executory contract under section 365 of the Bankruptcy Code.[4] In Texas, a covenant runs with the land when it touches and concerns the land, it relates to a thing in existence or specifically binds the parties and their assigns, it is intended by the original parties to run with the land, successors to the burden have notice, and there is horizontal privity of estate between the original covenanting parties.[5]

In recent years, bankruptcy courts have given considerable attention to the issue of covenants running with the land. In 2018, the United States Court of Appeals for the Second

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[1] Michael P. Pearson, *A Primer on Marketing Hydrocarbons*, 44th Ann. Adv. Oil, Gas & Energy Res. L. Course, St. Bar of Tex. 21 (2018) (hereinafter, "Marketing Hydrocarbons").

[2] Michael P. Pearson, *Covenants Running with the Land*, 48 St. Mary's L.J. 727, 732 (2017) (hereinafter, "Covenants Running with the Land").

[3] *Id*.

[4] *Id.* at 753–54.

[5] *Inwood N. Homeowners' Ass'n, Inc. v. Harris*, 736 S.W.2d 632, 635 (Tex. 1987); *Westland Oil Development Corp. v. Gulf Oil Corp.*, 637 S.W.2d 903 (Tex. 1982) (requiring horizontal privity of estate between the covenanting parties at the time the covenant is created). For an in-depth analysis of acreage commitments and covenants running with the land, *see* Covenants Running with the Land, *supra* n. 2.

Circuit affirmed the District Court and Bankruptcy Court for the Southern District of New York and held in *Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC*[6] that a debtor could reject certain midstream gathering agreements pursuant to section 365 of the Bankruptcy Code, because they did not create a real covenant that ran with the land under Texas law.[7] The court found that the covenants in the agreements failed to touch and concern the debtor's real property.[8] The court reasoned that the acreage dedications in the agreements were not burdens on the oil and gas producer's real property interests; rather, the dedications concerned "only minerals extracted from the ground, which indisputably constitute personal property, not real property, under Texas law."[9] The court also concluded that if horizontal privity of estate was a requirement under Texas law for a covenant to run with the land, it was not present between the debtor and the midstream companies.[10] The court explained that horizontal privity is created when there is a "conveyance of an interest in property that itself is being burdened with the relevant covenant, not the conveyance of an interest in property that is distinct from (even if somewhat related to) the property burdened by the covenant."[11]

Despite the *Sabine Oil* decision, the issue of covenants running with the land continued to be litigated before bankruptcy courts. On September 30, 2019, departing from the *Sabine Oil* decision, the United States Bankruptcy Court for the District of Colorado in *Monarch Midstream, LLC v. Badlands Prod. Co.*[12] rejected a debtor's attempt to sell assets free and clear of a gas gathering and processing agreement and agreement for disposal of salt water, ruling that each constituted covenants running with the land that could not be rejected or eliminated pursuant to a sale of assets under section 363 of the Bankruptcy Code.[13] The court focused on the same elements as those addressed in *Sabine Oil*.

In its analysis of the touch and concern requirement, the court found that the gas gathering and processing agreement encompassed real property, making *Sabine Oil* inapplicable.[14] The court reasoned that unlike *Sabine Oil*, the dedication in the agreement

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[6] *See Sabine Oil & Gas Corp. v. Nordheim Eagle Ford Gathering, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016); aff'd, 567 B.R. 869 (S.D.N.Y. 2017); aff'd, 734 Fed. Appx. 64 (2d Cir. 2018).

[7] Richard A. Howell and Vienna Flores Anaya, *Texas Bankruptcy Court – Applying Oklahoma Law – Concludes That Gathering Agreements Created Covenants Running With the Land and Cannot be Rejected by the Alta Mesa Resources Debtors*, https://www.jw.com/news/energy-bankruptcy-alert-judge-isgur-ruling-in-alta-mesa (last visited Mar. 21, 2022).

[8] *In re Sabine Oil & Gas Corp.*, 550 B.R. at 67–68.

[9] *Id.* at 67.

[10] *Id.* at 68–70.

[11] *Id.* at 68–69.

[12] *See* Order on Wapiti Utah, L.L.C.'s Motion for Judgment on the Pleadings and Monarch Natural Gas, LLC's Motion for Summary Judgment, *Monarch Midstream, LLC, f/k/a Monarch Natural Gas, LLC v. Badlands Production Company f/k/a Gasco Production Company, et al*., Adv. Case No. 17-01429-KHT (Bankr. D. Colo. Sept. 30, 2019), ECF No. 61.

[13] Jennifer F. Wertz, Richard A. Howell & Vienna Flores Anaya, *Major Decision in Energy-Related Bankruptcies: Colorado Court in Monarch Midstream Case Departs from Sabine Oil and Finds Gathering Agreement Established a Covenant Running with the Land*, https://www.jw.com/news/energy-bankruptcy-colorado-bankruptcy-court-monarch-midstream-sabine-oil (last visited Mar. 21, 2022).

[14] *Monarch Midstream, LLC v. Badlands Prod. Co. (In re Badlands Energy, Inc.)*, 608 B.R. 854, 869 (Bankr. D. Colo. 2019).

covered "non-extracted minerals."[15] The court held that a conveyance of a real property interest for a covenant was not necessary to satisfy the touch and concern requirement under Utah law.[16] The court found that the dedicated interest in the oil and gas reserves, leases, and all other lands within the area of mutual interest sufficiently affected the use, value, and enjoyment of the debtor's interest in the oil and gas leases subject to the gas gathering and processing agreement by limiting the right to possess, develop, and dispose of the minerals and salt water.[17]

The court again distinguished *Monarch Midstream* from *Sabine Oil* in its discussion of horizontal privity.[18] The court rejected the argument that horizontal privity was absent because no real property interests were conveyed under the agreements.[19] Instead, the court found that there was in fact a conveyance (*i.e.*, the gas gathering and saltwater disposal systems) related to the land that was burdened by the applicable dedications.[20]

In December 2019, the United States Bankruptcy Court for the Southern District of Texas held that midstream gathering agreements created covenants running with the land that could not be rejected by debtors under Oklahoma law.[21] While the *Sabine Oil* decision found that the agreements failed to satisfy both the touch and concern and privity elements, the bankruptcy court in *Alta Mesa* found that both of those elements were present in the debtors' agreements with the defendants.[22] The court explained that a covenant touches and concerns the land when it requires the performance of a physical act upon the land that directly benefits the landowner.[23] The gathering agreements met that requirement because the midstream companies used their surface easements to build a gathering system, which enhanced the value of the leases.[24] On the other hand, the agreements imposed costs and restrictions on the handling of hydrocarbons.[25] In regard to the privity element, the court noted that the debtors' leases granted easements to the debtors for the development of hydrocarbons and that the debtors granted a portion of those easements to the midstream companies to provide gathering services.[26] The court distinguished its holding from *Sabine Oil*, noting that "the surface easements directly affect the lessee's underlying mineral interest" because "[w]ithout the surface easement, the lessee cannot capture reserve hydrocarbons."[27]

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[15] *Id.*
[16] *Id.*
[17] *Id.* at 869–870; *see* Wertz, Howell & Anaya, *supra* n. 13.
[18] *Monarch Midstream,* 608 B.R. at 874.
[19] *Id.*
[20] *Id.*; *see* Wertz, Howell & Anaya, *supra* n. 13.
[21] *Alta Mesa Holdings, LP v. Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, 2019 Bankr. LEXIS 3859 (Bankr. S.D. Tex. 2019); Howell & Anaya, *supra* n. 7.
[22] *Alta Mesa Holdings,* 2019 Bankr. LEXIS 3859, at *16.
[23] *Id.* at *23–24; *see* Howell & Anaya, *supra* n. 7.
[24] *Alta Mesa Holdings,* 2019 Bankr. LEXIS 3859, at *26–27; *see* Howell & Anaya, *supra* n. 7.
[25] *Id.*
[26] *Alta Mesa Holdings,* 2019 Bankr. LEXIS 3859, at *33–34.
[27] *Alta Mesa Holdings,* 2019 Bankr. LEXIS 3859, at *28–29; *see* Howell & Anaya, *supra* n. 7.

C. Service-Level Commitments

One issue to consider when negotiating and drafting transportation service agreements is the level of service that the Shipper requires and that the Transporter will provide when accepting, transporting, and redelivering oil or gas from the Receipt Point(s) to the Delivery Point(s). These levels of service generally fall within two categories commonly characterized as "firm" or "interruptible."

At its most basic, firm service provides that the Shipper and Transporter may not interrupt its performance under the transportation service agreement, unless and to the extent excused by force majeure. Conversely, interruptible service provides that the Shipper and Transporter may interrupt its performance under the transportation service agreement at any time, for any reason or for no reason, and without liability. Under this construct, oil or gas subject to firm service receives the highest priority of transportation service on the pipeline system, whereas oil or gas subject to interruptible service receives the next highest priority.

Shippers should evaluate the appropriate service-level commitments of their transportation service agreements based on commercial considerations, including their short- and long-term expected oil or gas production, transportation needs, availability of alternative transportation capacity, and downstream purchase and sale commitments. In certain situations, this may warrant a hybrid approach whereby a certain quantity of oil or gas is committed to firm service, while quantities in excess thereof are committed to interruptible service.

Transporters should similarly evaluate commercial considerations, including whether the Transporter has and can maintain sufficient transportation capacity for a firm service Shipper in light of the Transporter's firm service commitments to other Shippers utilizing the same pipeline system; the short- and long-term capabilities of the pipeline system; the scope and timing of construction of additional facilities; any maintenance that will interrupt its performance obligations; and the ability to procure or otherwise obtain easements or other surface rights or permits, licenses, or other authorizations required to operate the pipeline system and construct future expansions thereto.

D. Curtailment

Curtailment broadly encompass events or circumstances, other than force majeure, that interrupt transportation service along the pipeline system. Curtailment is less of an issue for oil or gas that is subject to interruptible service, since the nature of interruptible service provides that the Transporter may interrupt its performance at any time; whereas firm service provides that the Transporter may not interrupt its performance, unless and to the extent excused by force majeure. Examples of curtailment include scheduled maintenance or operational constraints or delays affecting transportation service along the pipeline system, including at Receipt Point(s), at Delivery Point(s), or downstream of the pipeline system.

The implications of curtailment within a transportation service agreement depend on a variety of considerations related to the operational and commercial circumstances of the Shipper and Transporter. These considerations include how curtailment is measured within a specified period (*e.g.* on a consecutive or aggregate basis); the quantity of oil and gas curtailed and the duration thereof; whether curtailment affects oil wells, gas wells, or associated gas wells; whether the Shipper has made oil or gas available at the Receipt Point(s) in compliance with the transportation service agreement; the circumstances giving rise to the curtailment (*e.g.*, curtailment caused by Shipper or Transporter vs. a third party); and whether certain tolerances for *de minimis* curtailments are permitted.

In the event that oil or gas is curtailed, the Shipper and Transporter should then consider the interrelated issues and concepts that are implicated throughout the transportation service agreement, including whether curtailments exceeding certain quantity and/or time specifications set forth therein implicate provisions governing temporary or permanent releases, minimum volume commitments, and the term of the transportation service agreement. Furthermore, the procedures for managing curtailments when they occur should also be considered. For example, curtailments affecting transportation service along a pipeline system should first impact oil or gas that is subject to interruptible service and then oil or gas that is subject to firm service; within each service level, curtailment should be allocated proportionately amongst the affected Shippers (*e.g.*, on a *pro-rata* basis).

E. Temporary or Permanent Releases

Curtailment exceeding certain quantity and/or time specifications set forth in the transportation service agreement may warrant a temporary release of the oil and gas from the terms thereof. Provisions for release generally allow the Shipper to utilize third parties during the pendency of the curtailment to perform transportation service otherwise committed to the Transporter under the terms of the transportation service agreement. The benefits of release provisions are mutually appreciated by both parties, since the Shipper can continue having its oil and gas transported to market and the Transporter is permitted time for the curtailment to be rectified. Following resolution of the circumstances giving rise to the curtailment, the release terminates and the parties continue their respective performance obligations under the transportation service agreement.

There are several considerations to be mindful of when negotiating release provisions. These include whether all or a portion of the oil or gas affected by curtailment—as measured on a volumetric, well-by-well, or Receipt Point-by-Receipt Point basis—is subject to release; whether alternative and commercially reasonable options are available (or will be available) to transport oil or gas affected by curtailment; the scope of the release, including the duration thereof following resolution of the circumstances giving rise to the curtailment and limitations on renewal or evergreen provisions within any alternative transportation arrangements; and whether curtailment exceeding certain quantity and/or time specifications set forth in the transportation service agreement warrants an eventual permanent release of the affected oil or gas. Furthermore, the Shipper and Transporter may consider whether other circumstances

warrant the utilization of release provisions, including events or circumstances of force majeure affecting and exceeding certain quantities of oil or gas or time specifications set forth in the transportation service agreement.

F. Fees & Expenses

The terms of a transportation service agreement will set forth the various fees and expenses to be paid by the Shipper for services provided by the Transporter thereunder. In the context of oil and gas, this may include fees and expenses for transportation, blending to meet certain quality specifications, storage, marketing, deficiencies related to a failure to meet the minimum volume commitments, and reimbursement for facility construction; in the context of gas, this may also include fees and expenses for capacity reservations, treating carbon dioxide (CO_2), conditioning, compression, and the disposal of hydrogen sulfide (H_2S).

Payment for transportation service generally follows two frameworks. At its most basic, the Transporter will issue periodic (usually monthly) invoices to the Shipper for services provided by the Transporter during the preceding period. Alternatively, in circumstances where the Transporter purchases oil or gas from the Shipper at the Delivery Point(s), the Transporter will pay the Shipper for the oil or gas that is purchased by the Transporter or, in the event that the Transporter is acting in a marketing capacity on behalf of Shipper, purchased by a third party; in each case, less fees and expenses for services provided by the Transporter during the preceding period.

G. Units of Measurement

The basis on which to quantify oil and gas for a transportation service agreement is relevant as it relates to measurement, metering, and the payment of fees and expenses. Oil is typically expressed in terms of dollars ($) per barrel (Bbl). A barrel is equal to forty two (42) gallons in the United States. Gas is typically expressed in terms of dollars ($) per (i) its volume, equal to one thousand (1,000) cubic feet of gas (Mcf) or one million (1,000,000) cubic feet of gas (MMcf) or (ii) its heat content, equal to one million (1,000,000) Btu (MMBtu). A "Btu" is an abbreviation for "British Thermal Unit," which is defined as the quantity of heat required to raise the temperature of one (1) pound of water (H_2O), from fifty-eight and five-tenths degrees (58.5°) Fahrenheit to fifty-nine and five-tenths degrees (59.5°) Fahrenheit.

It is not uncommon for transportation service agreements to use all three bases (*i.e.*, $/Mcf, $/MMcf, and $/MMBtu) throughout the agreement. Thus, Shippers and Transporters should be mindful of the units of measurement and any formulas governing their conversion to a different unit of measurement in order to ensure consistency throughout the transportation service agreement and that there is a meeting of the minds regarding how gas is measured and metered and how various fees, expenses, and payments are calculated.

H. Delivery Pressure & Compression

Effectuating the movement of gas along a pipeline requires a party to deliver gas to the Receipt Point(s) or Delivery Point(s), as the case may be, at a pressure sufficient to enable the gas to enter the pipeline at its prevailing working pressure, but not exceeding the maximum allowable operating pressure (MAOP) of the pipeline.

These discussions may require the Shipper or Transporter to consider the prevailing working pressures across various segments of the pipeline system along which the gas will flow; whether the construction of compression or additional facilities are needed to effectuate movement and the continued operation of the pipeline system; which party will be responsible for constructing the facilities; and how any fees, expenses, or reimbursement obligations for the use and/or construction of the facilities will be handled. For any number of reasons, including economic considerations, the Shipper or Transporter may elect not to construct facilities. In these circumstances, or in circumstances where the parties have agreed to construct facilities, but construction is not timely completed, consideration may also be given to interrelated issues and concepts throughout the transportation service agreement, including curtailment, temporary or permanent releases, and minimum volume commitments.

I. Fuel, Lost & Unaccounted for Gas

Operating a gas pipeline system and related infrastructure requires fuel to run compression and other facilities needed to effectuate the continual movement of gas. Additionally, during the course of these operations, gas may be lost or otherwise unaccounted for due to evaporation or leaks along the pipeline system. Transportation service agreements commonly refer to these collective concepts as "fuel, lost and unaccounted for gas" (FL&U).

It is common for each Shipper utilizing a pipeline system to bear its *pro-rata* share of FL&U. The Shipper and Transporter should discuss and negotiate how FL&U will be accounted for under the transportation service agreement, which may be expressed as the Shipper's *pro-rata* share of a fixed percentage of the gas received by the Transporter at the Receipt Point(s) or as the Shipper's *pro-rata* share of the actual gas consumed, lost, and unaccounted for in the Transporter's operation of the pipeline system.

J. Minimum Volume Commitments

Transportation service agreements may contain minimum volume commitments (MVCs) that require the Shipper to deliver a minimum quantity of oil or gas, as measured, individually or on an aggregate basis at one or more Receipt Points, over a set period of time (*e.g.*, daily, monthly, or annually). MVC provisions are commonly coupled with terms and conditions governing payments made by the Shipper to the Transporter when the MVC is not met. These payments are commonly calculated as the product of (i) a deficiency fee specified in the transportation service agreement *multiplied by* (ii) (x) the MVC for the particular period and

Receipt Point(s) *minus* (y) the actual quantity of oil or gas received by the Transporter during the period at the Receipt Point(s).

MVC provisions are beneficial to Transporters for a number of reasons, including the ability of the Transporter to ensure that its operations related to the transportation service agreement remain economic and allow it to recoup investments toward capital improvements that the Transporter may have invested into the pipeline system in anticipation of the Shipper's transportation service needs. These provisions are valuable when the Shipper does not deliver oil or gas to the Receipt Point(s) and, thus, the Transporter is unable to collect transportation and other service-related fees from the Shipper.

When negotiating MVC provisions in a transportation service agreement, the Shipper and Transporter should consider whether to include certain quantity tolerances that allow for *de minimis* shortfalls or operational constrains that may prevent the Shipper from delivering, or the Transporter from accepting, oil or gas at the Receipt Point(s). Additional consideration should be given to how curtailment, force majeure, and temporary or permanent releases of oil or gas, impact the calculation of the MVC. Commercial teams provide invaluable guidance when establishing the appropriate MVC that accounts for these considerations, such as establishing a daily or monthly MVC that allows for certain operational downtimes. Furthermore, the Shipper and Transporter should consider whether to add provisions allowing for oil or gas delivered during a specified period in excess of the MVC to be "credited" or "banked" against any previous or future shortfalls to the MVC.

K. Maximum Daily Quantity

As Shippers cause oil or gas to be delivered to the Receipt Point(s) of a pipeline system, the volume of oil and gas and pressure along the pipeline system fluctuates. Transporters manage these pressure differentials to ensure the continual, efficient, and safe movement of all oil and gas through the pipeline system. One way this manifests itself is through the maximum daily quantity (MDQ) provision of a transportation service agreement, which sets forth the maximum quantity of oil or gas that the Shipper is permitted to deliver, individually or on an aggregate basis to one or more Receipt Points, into the pipeline system each day.

If a MDQ is stated in a transportation service agreement, the Shipper and Transporter should consider the service-level commitment that applies to excess quantities. As discussed above, in certain situations, this may warrant a hybrid approach whereby the quantity of oil or gas equal to or below the MDQ is committed to firm service, while the quantity in excess of the MDQ is committed to interruptible service based on, for example, the operational capabilities of, and the availability of capacity on, the pipeline system to accommodate the excess. Additional consideration should be given to how quantities in excess of the MDQ impact fees and expenses to be paid by the Shipper for services provided by the Transporter; the parties' obligations to construct and install additional facilities; and, for example, in the case where a party elects not to construct and install the additional facilities or the additional facilities are not timely constructed and installed, the terms and conditions of temporary or permanent releases.

L. Quality Specifications

Quality specifications set forth the specific characteristics that oil or gas must meet when delivered by or on behalf of the Shipper at the Receipt Point(s) and the Transporter at the Delivery Point(s). These specifications are of interest to both parties, as they provide certainty to the Shipper as to the quality of oil or gas that the Transporter will accept at the Receipt Point(s) and that the Shipper will receive at the Delivery Point(s), and certainty to the Transporter that it is not obligated to accept or transport oil or gas that may contain impurities or other foreign constituents that may prevent the proper operation of or otherwise damage the pipeline system.

Transportation service agreements for oil may include quality specifications governing the oil's sulfur, viscosity, gravity, pour point, and basic sediment and water (BS&W) content; for gas it may include quality specifications governing the gas' minimum gross heating value, maximum and minimum temperature, and limitations on the amount of sulfur, hydrogen sulfide (H_2S), carbon dioxide (CO_2), oxygen, nonhydrocarbon gases, and water vapor. Furthermore, quality specifications may evolve over time depending on the operational circumstances affecting the various segments of the pipeline system along which the oil or gas will flow, including more stringent quality specifications of downstream pipeline systems. Oil or gas that does not meet the quality specifications is commonly referred to as "off-spec" or "non-conforming."

The consequences for off-spec or non-conforming oil or gas should be carefully considered, as they impact the underlying purpose of the transportation service agreement (*i.e.*, transportation of oil or gas) and may trigger certain liabilities. Here, too, the Shipper and Transporter should consider the interrelated issues and concepts that are implicated throughout the transportation service agreement, including whether to include tolerances for certain constituents that allow for *de minimis* failures to meet the applicable quality specification; at what point(s) along the pipeline system quality specifications are measured and tested, including the accuracy and calibration of measurement equipment; notice obligations between the parties upon becoming aware of the delivery of non-conforming oil or gas; temporary or permanent releases for non-conforming oil or gas exceeding certain quantity and/or time specifications set forth in the transportation service agreement; whether and when the Transporter is permitted to restrict or reject receipt of non-conforming oil or gas into the pipeline system; whether the Transporter is permitted to accept non-conforming oil or gas, is capable of providing certain treating or blending services with respect thereto, and the associated fees and expenses for treating and blending services; and any indemnification or reimbursement obligations related to damage to the pipeline system caused by non-conforming oil or gas.

M. Force Majeure

In the aftermath of the winter storm of February 2021, valuable literature has been published on key issues and considerations related to force majeure, including implications related to the operation of pipeline systems and related infrastructure and contractual provisions governing force majeure. For purposes of this paper, I will not restate those issues and considerations here, but suffice it to say that the underlying principles of force majeure that

excuse a party's performance for events beyond the control of the party are also present in transportation service agreements.

The Shipper and Transporter should consider the scope of events or circumstances that constitute force majeure in relation to the underlying transportation service provided under the transportation service agreement. This may include one or more of the following: weather events (*e.g.*, floods, high water, hurricanes, tropical storms, or other named storms or natural disasters); delays in obtaining permits from any governmental authority having jurisdiction; the inability of the parties to obtain, or delays in obtaining (at reasonable cost and after the exercise of reasonable diligence) rights-of-way, easements, servitudes, licenses, and other surface rights and related approvals; the partial or complete failure or refusal of operators of any downstream pipeline to receive or transport oil or gas delivered to the downstream pipeline; the inability of the parties to obtain, or delays in obtaining (at reasonable cost and after the exercise of reasonable diligence) necessary materials, equipment, supplies, vendors, or suppliers; and mechanical failures, breakage or accident to machinery, compressors, facilities, or pipelines in which oil or gas is transported, treated, processed, stored, or used.

Equally important to the scope of events or circumstances that constitute force majeure are the events or circumstances excluded from the scope of force majeure. These may include one or more of the following: the inability to secure funds, arrange bank loans, or other financing; economic or financial hardship, including the Shipper's ability to secure transportation of oil or gas at a lower price or more advantageous terms than provided in the transportation service agreement; the loss of the Shipper's market for oil or gas; and the loss or failure of the Shipper's oil or gas supply or depletion of reserves.

As discussed throughout this paper, the Shipper and Transporter should also consider the interrelated issues and concepts that are implicated throughout the transportation service agreement as a result of the events or circumstances of force majeure affecting and exceeding certain quantities of oil or gas or time specifications set forth therein, including temporary or permanent releases and minimum volume commitments.

III. REGULATORY FRAMEWORK

A complete discussion of the regulatory framework applicable to transportation service agreements is beyond the scope of this paper; nevertheless, no discussion is complete without a high-level overview of regulatory issues and considerations governing the transportation of oil and gas in the United States.[28]

The regulatory framework applicable to transportation service agreements is generally differentiated by the type of hydrocarbon being transported (in the case of this paper, oil or gas) and whether transportation is subject to federal or state laws. The vast array of federal and state

[28] For an excellent discussion of the historical regulatory framework in the gas industry, *see* Marketing Hydrocarbons, *supra* n. 1 at 19–25.

regulations governing the approval, construction, operation, modification, and abandonment of oil and gas pipelines, and the rates that can be established for transportation service thereon, warrant thoughtful consideration prior to the commencement of any construction activities for pipelines or the negotiation of any transportation service agreement.

A. Regulation of Gas Pipelines

Natural Gas Act of 1938. At the outset of the nineteenth century, pipeline companies raced to construct networks of interstate pipelines to satisfy increasing demand for gas across the United States. Because these pipeline networks provided the only path to transport gas to market, the gas industry became premised upon the merchant role of pipeline companies—that is, pipeline companies as both purchasers of gas from gas producers and as resellers of gas to end users.[29]

In response to concerns about the emergence of monopolistic tendencies within the gas pipeline industry, Congress passed the Natural Gas Act of 1938 (NGA),[30] which declared that the business of transporting and selling gas for ultimate distribution to the public and the federal regulation thereof were in the public interest.[31] In doing so, the NGA subjected companies engaged in the transportation of gas in interstate commerce, or the sale in interstate commerce of gas for resale for ultimate public consumption, to the jurisdiction of the Federal Power Commission (FPC).[32] The NGA gave the FPC authority to regulate all rates and charges made, demanded, or received by the companies to ensure they are "just and reasonable."[33]

Federal Energy Regulatory Commission. The Federal Energy Regulatory Commission (FERC) succeeded to the regulatory responsibilities of the FPC and was granted authority under the NGA to regulate the transportation of gas in interstate commerce. Generally speaking, pipelines engaged in the transportation of gas in interstate commerce qualify as "natural gas companies" as defined in the NGA and are therefore subject to the jurisdiction of the FERC.[34]

Acting in its capacity as an independent federal agency within the United States Department of Energy, FERC's responsibilities under the NGA and the Natural Gas Policy Act (NGPA) include the review and approval or denial of applications, and the issuance of certificates for the construction, operation, modification, or abandonment of interstate pipelines, including gas storage facilities and liquefied natural gas (LNG) terminals; the review and establishment of "just and reasonable" rates that interstate pipelines can charge for transportation service; and oversight of all activities to provide Shippers with equal and open access to the interstate pipeline system.[35]

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[29] *Id.* at 20–12.
[30] 15 U.S.C. §717, *et seq*.
[31] 15 U.S.C. §717(a).
[32] 15 U.S.C. §§717(b), 717a(6).
[33] 15 U.S.C. §717c.
[34] *See* Marketing Hydrocarbons, *supra* n. 1 at 20.
[35] *Id.*; FERC, *What FERC Does*, https://www.ferc.gov/about/what-ferc/what-ferc-does (last visited Mar. 21, 2022).

However, FERC's jurisdiction over interstate pipelines is limited. For example, FERC generally has no jurisdiction over the production of gas, which is generally left to regulation by state agencies in which the gas is produced; pipeline safety or security, which is the purview of the Pipeline and Hazardous Materials Safety Administration (PHMSA) of the United States Department of Transportation; gathering pipelines (even when crossing state lines), which are omitted from FERC's regulatory purview and authority under the NGA; and pipelines operating within a single state that do not transport gas that has traveled or will travel across state lines (*i.e.*, intrastate pipelines).

Railroad Commission of Texas. Intrastate pipelines qualify as "gas utilities" under the terms of the Texas Utilities Code.[36] The Railroad Commission of Texas (RRC) is the state agency that has regulatory jurisdiction over intrastate pipelines as gas utilities.[37] The RRC is responsible for assuring that each rate made, demanded, or received by a gas utility is "just and reasonable," so as to ensure fair and non-discriminatory access to gas transportation.[38] 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.[39]

B. Regulation of Oil Pipelines

Federal Energy Regulatory Commission. FERC's jurisdiction over oil pipelines arises under the Interstate Commerce Act (ICA),[40] which regulates common carriers engaged in the transportation of oil or other commodities (excluding water and gas) by pipeline in interstate commerce. Generally excluded from its authority are oil pipeline construction, storage facilities, terminal facilities, and truck loading facilities, unless these functions are an integral part of transportation. What constitutes interstate commerce is based on the fixed and persistent intent of the Shipper when transporting oil, including where the shipment of oil began, where the shipment of oil will come to rest, and whether there is a break (*e.g.*, storage or processing facilities) in the continuous interstate movement of the oil.

As with gas, FERC's responsibilities include ensuring fair and non-discriminatory access to pipeline networks by evaluating, amongst other things, rates (whether market- or cost-based) charged for similar transportation service and unfair advantages between contracting parties. For oil, FERC's authority is strictly economic in that it does not actually authorize or issues permits for oil pipelines.

Railroad Commission of Texas. In Texas, Transporters transporting oil generally qualify as "common carriers" under the Texas Natural Resources Code.[41] The RRC has regulatory

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[36] Tex. Util. Code §§102.001, 104.001, 121.051, 121.052, and 121.151 (2017).

[37] Tex. Util. Code Ann. §103.003; *see* Marketing Hydrocarbons, *supra* n. 1 at 36.

[38] Tex. Util. Code §104.003(a); *see* Marketing Hydrocarbons, *supra* n. 1 at 36–37.

[39] Rule 7.7001, Natural Gas Transportation Standards and Code of Conduct, 16 Tex. Admin. Code §7.7001 (2017); *see* Marketing Hydrocarbons, *supra* n. 1 at 36–37.

[40] 49 U.S.C. §§ 1–15 (1976), reprinted in 49 U.S.C. app. §§ 1–15 (1988).

[41] Tex. Nat. Res. Code (2019).

jurisdiction over common carriers, which is generally defined as anyone who owns, operates, manages, or engages in the business of operating a pipeline to transport oil to or for the public for hire. The RRC's authority includes ensuring that rates are just and reasonable and that transportation service is provided on a non-discriminatory basis.

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Jackson Walker LLP is available to assist clients with any aspect of the energy industry, including any questions or concerns that arise with respect to the issues and considerations discussed in this paper. To discuss, please reach out to Jesse S. Lotay at jlotay@jw.com or (713) 752-4364.