ELEMENTS OF GAS CONTRACTS

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INTRODUCTION

In discussing contracts for purchasing or selling gas, some emphasis should be placed on the various provisions of the agreement, but more so on the type of deal that has to be made in order to purchase gas, and on the parts of the contract which have a direct economic effect on the contracting parties. This emphasis should be made when one considers what a changing, dynamic business the energy industry now is.

This is brought out now to emphasize how very important the matter of gas contracting is in today's business. Certainly, with the enormous sums of money involved in the purchase and sale of gas, the significance of the legal instrument covering that transaction must be recognized. It follows that there is an added importance in the measurement and accounting for the product being sold and for the proper operations under the contract.

TYPES OF GAS CONTRACTS

There are currently six basic types of gas contracts which are in use today. These are:

1. Wellhead gas purchase contracts
2. Casinghead gas purchase contracts
3. Plant residue gas purchase contracts
4. Gas sales contracts
5. Gas processing contracts
6. Gas transportation and exchange contracts

The majority of the gas being purchased today is being purchased under a wellhead-type gas purchase contract. With the intense competition which exists today among the companies purchasing gas, there will of necessity be a variation in the terms and provisions of the contracts as each company tries to gain some competitive advantage over the other purchasers. Basically, however, most provisions are common to all contracts and these general provisions will be discussed.

GAS CONTRACT PROVISIONS

The gas purchase contract is introduced by "Preamble" and "Whereas" clauses which state the parties to the contract, the date of the contract, and identify the roles which each party plays in the transaction. Normally, the "Whereas" clause also sets out the basic intent of the parties and the overall scope of the contract. If there is any unusual factor surrounding the transaction, this, too, is normally included in the "Whereas" clause. For example, the Seller could install a gathering system for gathering gas from several wells prior to delivering the gas at a central point for the Buyer. This would normally be included in these introductory remarks. Basically, the "Preamble" and "Whereas" clauses describe, in general terms, the nature and scope of the entire transaction.

Definitions

The definitions are necessary at the outset of the contract to officially define words or phrases in order to avoid possible misinterpretation or to avoid repetitious explanation of the terms as they are used many times throughout the agreement. The most common terms included are "gas", "reserves", "accounting year", "day", "Mcf", "Btu" and frequently the producing formation. It is surprising how much time and space can be saved in the agreement by pro-

viding definitions at the beginning of the instrument.

Initial Procedure

In the standard form of contract, the initial procedure section states the obligations of each of the parties concerning construction of facilities, acquisition of rights-of-way, notice of completion of facilities, and dates of various obligations. Frequently, there are also provisions covering the actions of the parties if certain contingencies do not occur.

Gas Committed

This section in the contract generally outlines the gas which is subject to the terms and provisions of the agreement. In many of the current contracts, an attempt is made by the Buyer to get as much gas or acreage committed as possible. On the other hand, the Seller wants to commit as little as possible because the price for gas may go up the day after he signs the contract and his commitment would then be at a lower price.

The provision must make specific reference to the acreage which has been committed to the contract and in some cases the depth limitation of such commitment. For example, many contracts exclude commitment from those potentially productive formations which have not yet been developed. Also in this clause is a recitation with regard to reservations by the Seller. For example, the Seller may reserve the right to keep a part of the gas to meet lease obligations or to reserve the processing rights for all gas delivered. Recently, with the significant increases in the prices for natural gas liquids, this reservation of processing rights has become much more important to the Seller.

Determination of Reserves

Many of the contracts currently being negotiated provide that the Buyer's obligation to purchase gas is based upon an amount of gas reserves dedicated under the contract. This article outlines the methods to be used by the parties to mutually agree upon the total gas reserves dedicated. It also outlines the procedure to be followed if the parties are unable to agree as to the total reserves dedicated. Basically, the method to be used to determine reserves if the parties cannot agree involves outside consultants, appraisers, or arbitrators. The economic factors of hiring outsiders usually overrides any desire on the part of the parties to arbitrate. Also included in this article is a provision for redetermination of the reserves at a later date.

Quantity

This particular article in the contract normally takes up more space in the agreement and is the most difficult portion of the contract to negotiate. The Seller's primary interest is to deliver as much gas as possible in order to get as much money as possible early in the life of the well. The Buyer's interest is to have the gas available from the well for as long a period as possible in order to serve his market demand over a long period of years. In years past, the "take or pay" obligation assumed by the purchaser was based upon buying a certain daily volume in relation to the total reserves committed under the contract. For example, the purchaser would agree to a "take or pay" obligation equal to 1000 Mcf of gas per day for each 8 Bcf of reserves. This meant that the well would be depleted in approximately 22 years. More recently, with the frantic competition which exists with the high demand for natural gas, the "take or pay" obligation has been based upon some factor which will insure accelerated deliveries and a quick payout to the Seller. For example, purchasers may agree to purchase as much as 90% of the gas that the Seller's wells are physically or legally capable of producing. Because of the varying loads on the purchaser's system, it is necessary that some "swing" be provided to more effectively operate his pipeline system. There is always provision in this article for making up at a later date for those volumes that were not purchased in a particular accounting year. Normally, the purchasers agree that in the event a deficiency in takes occurs during one accounting year, the Buyer will have five years in which to make up such deficiencies. The rights of both Buyer and Seller in this regard are spelled out in detail in this article.

Price

The price clause in the contract is set up specifically to outline the method by which payment

for the product will be made. Recently, the tremendous demand for natural gas has created an arena of almost circus-like atmosphere in the area of price. For example, in West Texas, in a two-month period in 1973, the price for gas from a rather substantial well increased from around 35¢ to 53¢. In late 1973, the price jumped to about 90¢ per Mcf. It is not at all uncommon to see a price of $1.60 per Mcf to be offered in the Anadarko Basin of Texas and Oklahoma, and about $1.90 per Mcf in the Permian Basin where the competition is more intense.

For that gas which flows in interstate commerce, the Federal Power Commission has jurisdiction over the rates to be paid. Currently established area rates should provide some guideline as to the maximum price which can be paid for gas which flows in interstate commerce. This particular area is currently clouded by contested Federal Power Commission rule-making procedures, court cases, and lawsuits. Hopefully some light will appear from out of the darkness of this area soon. There has been a recent increase to 23.5¢ per Mcf as of January 1, 1976, and this will go to 27.5¢ per Mcf effective July 1 of this year.

In an intrastate contract, prices are not subject to Federal Power Commission jurisdiction. The contract states a price or prices to be paid for several years and further provides redetermination of the price at the end of a four-year period. There are several methods by which the price can be redetermined; however, this contract provides for the prices to go to the prevailing price in the immediate area. In addition to the prices to be paid, there can also be adjustments to the price based upon the heating value of the gas and other constituents which the gas may contain. For example, the price can vary up or down depending upon the variation from 1000 Btu's. There can also be a deduction from the price if the Buyer has to treat the gas for removal of CO_2 or H_2S. This contract also includes in the price clause a provision in which the Buyer assumes the obligation to reimburse the Seller for 75% of any new or increased taxes. This percentage can vary depending upon the deal that is made at the time.

Delivery Point

This article specifies the location and point of delivery to Buyer. Normally, provision is also made outlining the obligations of the parties with regard to the installation of the necessary measuring equipment.

Delivery Pressure

This article defines the maximum pressure at which Seller is obligated to deliver gas to Buyer. In most cases, the contract will make further provision as to the procedure that will be followed in the event the well is incapable of producing gas into Buyer's pipeline system. The provisions of this article can vary according to the conditions which exist during negotiations.

Quality

This article deals with the quality of the gas delivered under the contract and outlines the specifications and characteristics of the gas which is to be delivered. These specifications include:

1. The amount of water which can be contained in the gas
2. The temperature of the gas
3. The oxygen content
4. Other foreign matter in the gas
5. The heating value of the gas

Generally there is also a catch-all provision which states that the Buyer may accept deliveries of gas even if the gas fails to meet the quality specifications; however, the Buyer has no obligation to accept such deliveries.

Measurement and Tests

Because of the outstanding work which has been done in the "measurement fraternity", the measurement and testing provisions in the gas purchase contracts are generally standard and are also uniformly accepted in the industry. The American Gas Association Committee Report No. 3 is normally the standard method which is used in the measurement provision. This portion of the contract also sets out other necessary tests and procedures such as determining temperatures, specific gravities, deviation from Boyle's Law, Btu content, etc. There is also a provision regarding a degree of accuracy that will be maintained and how corrections will be made if the meter is not registering correctly. This particular provision becomes more and more significant as the value of the natural gas is increased.

Statements and Payments

This article of the contract is primarily an accounting function and simply states that in order for the Seller to be paid, certain billings and statements must be submitted on a timely basis so that all the parties to the contract will be aware of the exact amount of gas which has been delivered and the value for such production. It can also include a statement regarding the method to be used for payment of any deficiencies in "take or pay" obligations.

Warranty of Title

In this provision, Seller warrants that it has the full and clear right to sell the gas delivered under the contract and will hold Buyer harmless from any claims which may be made against the gas. Should any questions of ownership arise, the Buyer will always have the right to withhold payment for the gas until ownership of the gas has been finally determined. The determination of who pays royaltics for gas deliveries is sometimes subject to negotiation because of the expense involved.

Force Majeure

This is a statement which relieves either party from its contractual obligation in the event of an unforeseen or foreseen act which may occur but is beyond the control of either party. The term "Force Majeure" can include such items as acts of God, wars, blockades, riots, landslides, floods, etc. Normally, the party relying upon this provision for relief is given a reasonable amount of time in which to correct the problems so that the contract can again be put into full force and effect.

Term

Normally, the term of the contract is effective as of the date of the agreement and remains in effect for a specified period of time. Usually the term is for a period of 20 years; however, some contracts have been written to last for the full life of the producing field.

Control of Gas

This article simply states that Seller shall be in control of and responsible for the gas prior to its delivery to the Buyer and Buyer shall be responsible for the gas after delivery.

Miscellaneous

This is a catch-all article which includes such items as the proper addresses of the parties, the rights to assign the contract to other management of the facilities, examination of records, etc.

Governmental Regulation

All contracts are subject to the jurisdiction of various governmental regulatory agencies. The contracts simply recognize the fact that such agencies, both federal and state, have the authority to change the provisions which have been negotiated by the parties. In the case of interstate contracts, the obligations of the parties are also outlined in some detail as required by law or regulation.

Signatures and Exhibits

Each contract must have a space for execution by each of the parties. Normally, there is also a space for the agreement to be witnessed or attested to by a person other than the person signing the document.

There can also be exhibits to the contract which give details regarding acreage dedication or any other items that were not included in the body of the agreement.

CONCLUSION

This has been a very brief discussion of a lot of material; some lawyers could spend days discussing any one of the articles.

There is no perfect contract; no matter how careful the parties are, they cannot predict all of the situations which may arise in the future, so that the contract cannot be drafted to cover all situations. This means that the contract is only as good as the integrity of the people involved. Also, it should be realized that, with reasonable people involved, it simply takes a little bit of old-fashioned good faith and cooperation to make the gas contract operate properly. This cooperation and good faith can go a long way toward making a poorly drafted contract work reasonably well. If there is a problem with the contract, it is suggested that you contact the people who wrote and negotiated the contract. They have the background and the input on the negotiations and can give information as to why some unusual things may have been done. By following this course of action, a lot of internal ill will can be avoided.