WHY SPLITTING OF A CONTRACT FOR TAKE-OR-PAY PURPOSES WOULD BE A MISTAKE

The current draft of the pending Senate Energy Committee bill provides for drastic changes in the take-or-pay provisions in existing contracts between natural gas producers and pipelines. In the first 3 years following enactment the bill would allow pipelines to unilaterally reduce the amount of gas it "takes" from a particular producer to 50%, 60%, and then 70% of deliverability.

The vast majority of pipelines are not in need of this type of relief. Most can adjust to fluctuations in gas demand through the take-or-pay clauses embodied in their existing contracts. Yet this legislation gives all pipelines tremendous new contractural powers and leverage over producers whether the relief is needed or not. There is no requirement that pipelines make a showing of need or that its customers will be harmed before these powers are made available.

Nor is there a requirement that pipelines treat all producers equally when natural gas "takes" are reduced. Pipelines are allowed to keep "favored" producers at 100% of deliverability while reducing others to 50%. In future negotiations between pipelines and producers on unrelated matters, pipelines will be able to use the threat of deep cuts in "takes" of the producers' gas to force concessions.

The take-or-pay provisions of this bill could devastate small and large producers by depriving them of the cash flow needed to service debt obligations. Producers and lenders frequently rely on take-or-pay commitments to assure minimum levels of cash flow for debt repayment.

The original McClure/Johnston compromise addressed this problem by allowing producers to sell all of the "released" take-or-pay volumes and reserves. In addition to providing producers with cash flow relief, this approach redistributed natural gas reserves between those pipelines with excess

supplies and those in short supply.

In two separate steps, the Committee has now totally eliminated the producer's ability to sell released reserves. While the proposed legislation still allows producers to sell released volumes, as a practical matter it is difficult to negotiate "spot" sales of gas for small volumes and for a single year. By depriving the producer from selling the reserves which back up the released volumes, the Committee has nearly withdrawn any cash flow relief for affected producers.

When the McClure/Johnston specifications were drafted into legislative language, a new element was introduced which totally closed the door on producer cash flow relief. This provision would allow a pipeline for take-or-pay purposes to create separate contracts for each category of gas covered by the original pipeline/producer contract (Section 316(1), p.16, lines 13-17). For example, if a contract covers 9 categories of gas the pipeline may reduce "takes" by 50% from one or more categories and leave the other 8 categories unaffected. By splitting contracts into even smaller packages of gas, the ability of producers to find alternative buyers is virtually destroyed.

This change is justified on the grounds that it will allow pipelines to lower consumer costs by reducing takes from only the most expensive gas categories. It should be kept in mind that pipelines have thousands of gas contracts, and even without this provision will be able to adequately protect consumers by making selective reductions from the most expensive contracts. Any incremental benefit from further subdividing contracts can not be justified in light of the overwhelming administrative and cash flow burdens which would result.

The subdivision of contracts would also jeopardize the sound operation of the nation's gas fields. Day-to-day operations of a gas field require technical expertise to assure maximum production of the reserves regardless

of how a particular gas stream is broken down for price purposes under the Natural Gas Policy Act. For example, a single contract may cover three or four wells in a field with each well producing natural gas in a different price category. One well could be an old well drilled prior to 4/20/77 receiving a 104 price, another well could be a stripper well receiving the 108 price, another could be a new well drilled since 4/20/77 which is receiving the 102 price, and the fourth could be a well that was drilled after 4/20/77 but within 2½ miles of an existing well and receiving a 103 price. Each of the wells could produce gas from the same reservoir. The producer must coordinate the operation of each well in a manner which maximizes the ultimate recovery of reserves from that reservoir.

The impact could be severe if it is the purchaser of gas, through the exercise of his take-or-pay rights under the bill, who makes the decision as to the rates of production from the various wells in the reservoir. The operating judgment of the producer would be shifted to the buyer, whose interests are primarily in reducing costs and not necessarily in maximizing the ultimate production from the reservoir. For example, a buyer could treat the Section 102 well as a separate contract for take-or-pay purposes and cut back the production from that well. In so doing, the efficient operation of the field could be adversely affected. Contracts between sellers and buyers have historically provided that all gas produced from wells in a reservoir will be produced on a rateable basis. The decision of how any reduction in production will take place is left to the judgment of the operator of the field under the constraints of the "prudent operator standard" in accordance with state conservation laws which impose an obligation to protect the correlative rights of all owners having an interest in the field. Because of those constraints, the producer does

not have the right to produce only that gas which would maximize revenue.

Breaking a single contract into separate contracts is also objectionable due to the potential impact on the correlative rights of the various parties having ownership interests in the field. Using the previous example, a pipeline could reduce production from all wells except the Section 104 well. The pipeline, of course, would be trying to minimize his gas purchase costs. This would result in natural gas migrating from the other three wells to the Section 104 well. Such forced migration would violate state conservation and rateable take laws, would constitute a conversion of the legitimate property rights of those persons owning interests in the other three wells, and would convert gas which is entitled to receive higher prices to gas entitled to receive only the 104 price.

The example used is a simplified description of the problem. In many situations, there are several operators in a field, and many interest owners with multiple contracts covering a large number of wells. In such cases, the consequences described above would be compounded.

The proposed bill gives pipelines extraordinary powers to modify their take-or-pay commitments under current contracts. Given the magnitude of take-or-pay relief which is provided, there is little reason for allowing pipelines to further subdivide their existing contracts for take-or-pay purposes. The incremental cost savings which might result can not be justified in light of the administrative and technical problems which would result from such a provision.