CONTRACTS FOR THE NEW NATURAL GAS BUSINESS

*by Mark E. Haedicke**

I. INTRODUCTION

Two major developments in the natural gas industry are causing fundamental changes in natural gas contracts. The first development, financial markets for natural gas, began only recently. On April 3, 1990, the New York Mercantile Exchange (NYMEX) began trading natural gas futures for a twelve month forward period.[1] On the opening day, 925 contracts[2] were traded. Recently, 18,344 contracts were traded in a single day,[3] and gas futures on NYMEX are now traded for an eighteen month forward period.[4] At the same time, the market for off-exchange products, such as natural gas swaps and trade options, has expanded considerably. Shortly, it will be hard to imagine life in the natural gas business without the emerging financial markets for natural gas, if that time has not already occurred.

The second major development, deregulation of the gas industry, began with the passage of the Natural Gas Policy Act of 1978 (NGPA).[5] The NGPA was followed by several orders of the Federal Energy Regulatory Commission (FERC), including Order Nos. 436[6] and 636,[7] as well as the Nat-

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1. Barbara Shook, *Natural Gas Futures Open for Business*, NAT. GAS INTELLIGENCE, April 9, 1990, at 2.

2. Each NYMEX gas futures contract is for a quantity of 10,000 MMBtu of natural gas. *See* New York Mercantile Exchange Guide (CCH), ¶ 13,655 (1991).

3. GAS DAILY, July 27, 1992, at 4.

4. David Port, *NYMEX to List 18 Contract Months*, NAT. GAS INTELLIGENCE, Jan. 20, 1992, at 5.

5. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1988).

6. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [Regulations Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,665 (1985), *modified*, Order 436-A, [Regulations Preambles 1982-1985] F.E.R.C. Stats. & Regs. ¶ 30,675 (1985), *modified further*, Order 436-B, III F.E.R.C. Stats. & Regs. ¶ 30,688, *reh'g denied*, Order 436-C, 34 F.E.R.C. ¶ 61,404, *reh'g denied*, Order No. 436-D, 34 F.E.R.C. ¶ 61,405, *reconsideration denied*, Order No. 436-E, 34 F.E.R.C. ¶ 61,403 (1986), *vacated and remanded sub nom.*, Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987), *cert. denied sub nom.*, 485 U.S. 1006 (1988). In the Order Nos. 436/500 series, the FERC opened transportation up to third parties even further by mandating that pipelines which transport gas under Section 311 of the NGPA were required to transport for all shippers with transactions qualifying under Section 311 on a non-discriminatory basis. The FERC also offered blanket certificates to interstate pipelines authorizing them to transport gas for all shippers on a non-discriminatory basis. *See* Philip Marston, *Pipeline Structuring: The Future of Open Access Transportation*, 12 ENERGY L.J. 53 (1991).

7. 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*, III F.E.R.C. Stats. & Regs. ¶ 30,939 [57 Fed. Reg. 13,267] (1992). The April 8, 1992 issuance of Order No. 636 by the FERC takes the final steps, short of repeal of the Natural Gas Act, necessary to create a truly competitive natural gas market, by, *inter alia*, unbundling pipeline sales from transportation, requiring pipelines to provide a no-notice transportation service to

ural Gas Wellhead Decontrol Act of 1989.[8] These statutory and regulatory changes have already resulted in, and will continue to result in, materially different risks for virtually every participant in the natural gas industry. Producers no longer know before they enter into a contract the price they will receive for their gas. Pipelines must now compete with producers and marketers for industrial and other end user customers. Local distribution companies (LDCs) are at increased risk for flowing through the cost of gas purchases to their customers.[9] As deregulation of the gas industry continues, the risks for participants in the gas industry will continue to change significantly.

Each of these two developments provides a catalyst for fundamental changes in natural gas contracts. In the following paragraphs and pages, some of those changes are explored, particularly the statutory basis for, and the text of, a new family of gas contracts, the "financial gas contracts."[10] Further, this article explores, *inter alia*, the impact of these two developments on long-term fixed-price "physical gas contracts"[11] and the possible future direction of long-term fixed-price gas contracts.

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replace (and replicate) the traditional pipeline sale, mandating capacity brokering (release) programs on all interstate pipelines and allowing pipelines to make sales at negotiated rate pregranted abandonment.

8. 15 U.S.C.A. §§ 3301-3432 (West Supp. 1992). The passage of the Natural Gas Wellhead Decontrol Act in 1989, which, by amending the NGPA, provided the framework to remove the remaining first sales ceiling prices, marked another significant step forward in allowing market forces to shape natural gas sales.

9. When the LDC purchased their system supply from the interstate pipeline's system supply, the price paid for that gas was first determined to be just and reasonable by the Federal Power Commission under section 4 of the Natural Gas Act, in the period prior to enactment of the NGPA. The federal determination overrode the ability of a state regulatory body to deny pass-through of the purchased gas cost incurred by the LDC. The NGPA contained a similar statutory guarantee of pass-through of costs, in section 601, by stipulating that any price paid by a pipeline in a first sale for natural gas will be deemed just and reasonable where the pricing is in accordance with the pricing provisions of the NGPA. After the NGPA was passed, however, through deregulation of first sales and increased third party access to transportation, the role of supplier to the LDC shifted from the pipeline merchant to other marketers (producers, aggregators and the pipelines' non-regulated marketing affiliates). There was no federally approved rate dictated for these types of sales to the LDC as there had been in the past. The immunity of these gas costs from state level review and the applicability of Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953 (1986) to these sales, which are clearly non-regulated sales, is questionable. (In *Nantahala*, the Supreme Court ruled that once the FERC set a rate for the sale of power for resale in interstate commerce, a state agency could not find those FERC-approved rates unreasonable in setting the retail rates to be charged by the LDC.) Recent activity poses this as a real concern. For example, the California Public Utility Commission (CPUC) had before it for review five long-term contracts entered into by Southern California Gas Company (SoCal) with non-pipeline merchants. Indications were, before SoCal requested withdrawal of its application, that CPUC would have found that the pricing in those contracts was not just and reasonable. (*Application of Southern California Gas Company for Expedited Approval of Five Long-Term Supply Agreements*, A. 91-04-038, "Order of Dismissal" issued April 8, 1992, Decision 92-04-027).

10. The term "financial gas contract" is used for gas contracts where the primary underlying purpose of the contract is to manage price risk. As discussed below, certain financial contracts contemplate physical delivery of gas, such as the NYMEX gas contract; however, the primary underlying purpose of the contract is to manage price risk rather than deliver or receive gas.

11. The term "physical gas contract" is used for traditional gas contracts and to distinguish such contracts from financial gas contracts.

II. Financial Gas Contracts

Financial gas contracts constitute a new family of gas contracts. Financial gas contracts, which include futures contracts, swaps and options, are a direct result of the development of the financial markets in natural gas. As the financial markets in natural gas continue to grow, it will be increasingly more important that gas lawyers be well versed in the basic framework of a body of law generally referred to as commodities law,[12] which is summarized below.

A. Overview of Federal Commodities Law

1. Commodity Exchange Act

The starting point in understanding commodities law is the Commodities Exchange Act (CEA), as amended.[13] The CEA establishes the Commodities Futures Trading Commission (Commission)[14] and grants the Commission exclusive regulatory jurisdiction over "contracts of sale of a commodity for future delivery" (*i.e.*, "futures contracts") and certain other commodities contracts, such as options.[15] If a transaction is within the jurisdiction of the Commission, then (subject to certain limited exceptions) it is unlawful unless it is conducted on or subject to the rules of a board of trade that has been designated by the Commission as a "contract market" for the relevant commodity.[16] "Contract of sale" is broadly defined to "include sales, agreements of sale, and agreements to sell."[17] "Commodity" is also broadly defined to include specified agricultural products and "all other goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in."[18] The term "future delivery" excludes "any sale of any cash commodity for deferred shipment or delivery;"[19] this is generally known as the "forward contract" exception.

The Commission has plenary authority over commodity options transactions.[20] The Commission's regulations in the options area generally prohibit

12. As will be discussed below, understanding commodities law is also important with respect to physical gas contracts. For a gas lawyer new to commodities law, it is suggested that a commodities law library initially include the following materials: (i) Philip McBride Johnson & Thomas Lee Hazen, Commodities Regulation (2d ed. 1989), (ii) Commodity Futures Law Reporter (CCH), (iii) New York Mercantile Exchange Guide (CCH) and (iv) Commodities Law Letter (Commodities Law Press Associates).

13. Commodities Exchange Act, 7 U.S.C.A. §§ 1-50 (West 1980 & Supp. 1992).

14. 7 U.S.C.A. § 4a(a) (West 1980).

15. 7 U.S.C.A. § 2 (West Supp. 1992).

16. 7 U.S.C.A. § 6(a)(1) (West 1980). "Board of Trade" means any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment. 7 U.S.C.A. § 2 (West Supp. 1992). "Contract Market" means a board of trade designated by the Commission as a contract market under the Commodity Exchange Act or in accordance with the provisions of Part 33 of this chapter. 17 C.F.R. § 1.3(h) (1992). Thus far, the NYMEX is the only board of trade designated by the CEA as a contract market that trades in natural gas contracts.

17. 7 U.S.C.A. § 2 (West Supp. 1992).

18. *Id.*

19. *Id.*

20. 7 U.S.C.A. § 2a (West Supp. 1992). "Commodity option transaction" and "commodity option" each mean any transaction or agreement in interstate commerce which is or is held out to be of the

commodities options other than Commission approved exchange traded options or off-exchange options that comply with the "trade option exemption" discussed below.[21]

Since natural gas is clearly within the definition of "commodity" and most contracts to sell or buy gas in the gas industry are "contracts of sale" for delivery of natural gas at some future time, it is critical to review natural gas transactions from a commodities law point of view. A determination must be made as to whether a proposed transaction would be a futures contract, a swap or an option, or whether it would be within the forward contract exception. Once such determination is made, the transaction can then be structured or restructured and effectuated in a manner that complies with the applicable commodities law.

2. Futures Contract or Forward Contract

A futures contract is subject to the jurisdiction of the Commission; a forward contract is not. Futures contracts must be traded on a board of trade designated as a contract market by the Commission. Any futures contract not traded in this manner would be an illegal off-exchange futures contract. The consequences of mischaracterizing a futures contract as a forward contract may be material. For example, two parties execute a long-term contract to buy/sell gas at a fixed price, believing it to be a forward contract under the CEA's forward contract exception. Subsequently, it is determined that the contract is not a forward contract, but a futures contract. As a futures contract, it is illegal and unenforceable as an off-exchange contract. If the price of natural gas has moved significantly, one party will likely suffer material damages due to non-performance. Accordingly, it is important to determine whether a contemplated transaction is a futures or a forward contract.

The terms "future" and "forward" are not defined in the CEA. Instead, the CEA refers to a futures contract as a transaction involving a "[contract] of sale of a commodity for future delivery. . . ."[22] As stated above, the CEA states that "future delivery" does "not include any sale of any cash commodity for deferred shipment or delivery"; any contract for such a sale is a forward contract and, therefore, excluded from the Commission's jurisdiction.[23] The exclusion for forward contracts originates from the goal of exempting from

character of, or is commonly known to the trade as, an "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guaranty," or "decline guaranty" involving any commodity regulated under the Act, although options on certain agricultural commodities are illegal. *Id.* For a discussion of the characteristics of commodities options, *see* the interpretive statement of the Office of the General Counsel of the Commission entitled "Characteristics Distinguishing Cash and Forward Contracts and Trade Options," [1984-86 Transfer Binder] Comm. Fut. L. Rep. (CCH), ¶ 22,718 (CFTC 1985).

21. Rule 32.4(a) 17 C.F.R. § 32.4(a) (1992). The trade option exemption is subject to restrictions which require that trade options not involve agricultural products. 17 C.F.R. § 32.2 (1992). The Commission has interpreted this exemption in the *Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694 at 30,695 (1989), at note 14 to mean that the commercial offeree can be either the purchaser or the grantor of the option, so long as it qualifies as a commercial user or merchant of the commodity and is entering into the trade option for non-speculative purposes relating to its commercial business.

22. 7 U.S.C.A. § 2 (West Supp. 1992); *See* H.R. REP. NO. 93-975, 93rd Cong., 2d Sess. 129-30 (1974).

23. *Id.*

regulation ordinary supply-of-goods contracts where delivery is deferred for reasons of commercial convenience or necessity.[24] Administrative decisions and case law aid in pointing out the distinctions between a futures contract and a forward contract.

The Commission addressed the distinctions between a futures contract and a forward contract in *In re Stovall*.[25] Mr. Stovall was the sole proprietor of a business that entered into contracts to buy and sell commodities. The contracts were not traded on a designated exchange and thus would be illegal off-exchange contracts if determined to be futures contracts rather than forward contracts. The Commission stated:

> Commodity futures transactions involve standardized contracts for the purchase or sale of commodities which provide for future, as opposed to immediate, delivery, and which are directly or indirectly offered to the general public and generally secured by earnest money, or "margin." They are entered into primarily for the purpose of assuming or shifting the risk of change in value of commodities, rather than for transferring ownership of the actual commodities. Thus, while a party to a commodity futures contract may eventually perform on the contract, that is, make or take delivery, at the maturation of the contract, thereby using the futures market to make or take delivery of actual commodities in exchange for money, he need have no expectation that performance will occur. Indeed, most parties to commodity futures contracts extinguish their legal obligations to make or take delivery by offsetting their contracts with equal and opposite transactions prior to the date on which delivery is called for, accepting a profit or loss for any differences in price between the initial and offsetting transactions. *Cf. Board of Trade of the City of Chicago v. Christie Grain & Stock Co.*, 198 U.S. 236, 247-248 (1905).[26]
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> The "cash commodity" exclusion was intended to cover only contracts for sale which are entered into with the expectation *that delivery of the actual commodity will eventually occur through performance on the contracts*. The seller would necessarily have the ability to deliver and the buyer would have the ability to accept delivery in fulfillment of the contract.[27] [Emphasis Supplied]
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> Thus, a major difference between an excluded cash commodity-deferred delivery contract and contracts of sale of a commodity for future delivery is that the former entails not only the legal obligation to perform, but also the generally fulfilled expectation that the contract will lead to the exchange of commodities for money. In contrast, parties to a futures contract do not usually expect delivery and it rarely occurs.[28]

The Commission found that all the "classic elements" of a futures contract were present in *In re Stovall*.[29] The customers signed standardized contracts that were offered to the public, had no ability to take delivery of the commodities, and entered into the contracts for the primary purpose of speculating on the price of the commodity rather than for the purpose of the physical delivery of the commodity. Accordingly, the Commission determined the

24. *See In re* Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,777-78 (CFTC 1979); Commodity Futures Trading Comm'n v. Co Petro Mktg. Group, Inc., 680 F.2d 573, 577-78 (9th Cir. 1982) for a history of the exclusion for forward contracts.

25. *In re* Stovall, [1977-80 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941.

26. *Id.* at 23,777.

27. *Id.*

28. *Id.* at 23,778.

29. *Id.* at 23,779.

contracts to be illegal off-exchange futures contracts.[30]

The Ninth Circuit addressed the same question in *Commodity Futures Trading Commission v. Co Petro Marketing Group, Inc. (Co Petro)*.[31] In *Co Petro*, customers appointed Co Petro as their agent to purchase fuel through an agency agreement. The agreement did not require the customer to take delivery of the fuel, but rather provided that Co Petro could sell the fuel on behalf of the customer. The customers did not take delivery of the fuel and the Court found that "Co Petro's . . . customers were, for the most part, speculators from the general public. The underlying petroleum products had no inherent value to these speculators. They had neither the intention of taking delivery nor the capacity to do so."[32] The Ninth Circuit held that the contracts were illegal off-exchange futures contracts.[33]

In *Transnor (Bermuda) Limited v. BP North America Petroleum*,[34] the district court faced a more difficult task of distinguishing between a futures contract and a forward contract than was presented in either *In re Stovall* or *Co Petro*. Transnor had purchased Brent oil in the North Sea in December 1985 for delivery in March 1986 at a price of $24.50 per barrel pursuant to a fifteen (15) day contract for future delivery. Transnor signed a standard Brent oil market contract which provided for physical delivery. By March 1986, the price of crude oil had dropped to $13.80 per barrel, and Transnor refused to take delivery under its contract. One of the issues in the litigation was whether or not the contract, which was not traded via a designated contract market, was an illegal off-exchange futures contract or a forward contract. Transnor, seeking to avoid performance, argued that it was a futures contract. The defendants, major oil companies, were seeking performance of the contract and argued that the agreement was a forward contract because there was both a contractual obligation to deliver and the actual ability to make such delivery.

The *Transnor* court found that "[t]he predominate distinction between the two [futures contracts and forward contracts] remains the intention of the parties and the overall effect of the transaction[s]."[35] Further, the court stated:

> In determining whether a transaction constitutes a futures contract, the Commis-

30. *Id.*

31. 680 F.2d 573 (9th Cir. 1982).

32. *Id.* at 578.

33. *Id.* at 581. The Ninth Circuit rejected Co Petro's argument that its agency agreements were radically different from standardized futures contracts, finding that, although the agency agreements were not as rigidly standardized as futures contracts, traded on licensed contracts markets, neither were they individualized. *Id.* at 580. *See also* CFTC v. National Coal Exchange, Inc., [1980-82 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,424 (W.D. Tenn. 1982). The Court held that coal purchase agreements were equivalent to futures contracts and should be treated as such. *Id.* at 26,055. The Court reasoned that although the contracts provided for physical delivery, the investing public had no realistic capacity to take actual delivery of the coal and that the investing public entered into the transactions solely for investment purposes. *Id.* at 26,055.

34. 738 F. Supp. 1472 (S.D.N.Y. 1990).

35. *Id.* at 1489. Before addressing the distinctions between a futures contract and a forward contract, the district court found that the Brent oil contracts were subject to the jurisdiction of the Commission because the market for Brent oil contracts was a United States market.

> sion and the courts have assessed the transaction "as a whole with a critical eye toward its underlying purpose"[citation omitted]. Such an assessment entails a review of the "overall effect" of the transaction as well as a determination as to "what the parties intended." Although there is no definitive list of the elements of futures contracts, the CFTC and the courts recognize certain elements as common to such contracts. Futures contracts are contracts for the purchase or sale of a commodity for delivery in the future at a price that is established when the contract is initiated, with both parties to the transaction obligated to fulfill the contract at the specified price. In addition, futures contracts are undertaken principally to assume or shift price risk without transferring the underlying commodity. As a result, futures contracts providing for delivery may be satisfied either by delivery or offset. The Commission has explained that this does not mean that all commodity futures contracts must have these elements [citation omitted]. To hold otherwise would permit ready evasion of the CEA.[36]

The *Transnor* court found the Brent oil contracts to be futures contracts because the "contracts [were] undertaken principally to assume or shift price risk without transferring the underlying commodity."[37] The court observed that the contracts were highly standardized, did not generally result in physical delivery, but were settled by offset or bookout and had an investment character.[38]

The Commission responded to the industry outcry resulting from the *Transnor* decision by issuing a statutory interpretation (Statutory Interpretation) disagreeing with the *Transnor* court. The Commission set forth its view that the Brent oil contract is a forward contract and is excluded from the Commission's jurisdiction.[39] In reaching its conclusion, the Commission reasoned that the Brent oil contracts all contemplated delivery of the commodity, there was no right of offset in the contracts, an offset had to be subsequently negotiated by the parties, and therefore, the parties clearly had the economic risk of parties required to make or take delivery thereunder.[40] Further, the Brent oil contract is eventually sold/purchased by a successor seller/buyer even if the original seller/buyer to the Brent oil contract settles by a means other than delivery.[41] Finally, the Commission observed that the offsets are separate, individually negotiated, new arrangements.[42]

Activity in the Brent oil market continues but it has not returned to the level of activity that existed prior to *Transnor* for companies based in the United States. Although the Statutory Interpretation does not have the force of law, it is entitled to deference by the courts,[43] and is presumably the authority on which the participants in the Brent oil market rely. The *Transnor* case was settled, so it was never subjected to scrutiny at the appellate level.

A recent Ninth Circuit decision, *Bybee v. A-Mark Precious Metals, Inc.*,[44]

36. *Id.* at 1493.
37. *Id.*
38. *Id.* at 1492.
39. *Statutory Interpretation Concerning Forward Transactions*, Comm. Fut. L. Rep. (CCH) ¶ 24,925 at 37,369 (CFTC 1990).
40. *Id.* at 37,365.
41. *Id.*
42. *Id.*
43. Bybee v. A-Mark Precious Metals, Inc., 945 F.2d 309, 314-15 (9th Cir. 1991).
44. *Id.*

relied on the Statutory Interpretation in finding that margin purchase transactions for gold and silver coins and bullion between Keith D. Bybee, Sr. (Bybee) and A-Mark Precious Metals, Inc. (A-Mark) were exempt from the CEA as forward contracts.[45] Bybee bought the gold and silver on behalf of his customers from A-Mark on the margin. When the market price of the metals dropped, Bybee was forced to liquidate his accounts by selling the metals he had purchased to A-Mark at the lower market price. Bybee, who then did not have enough money remaining to settle accounts with his customers, filed for protection under the Bankruptcy Act.[46] The trustee in bankruptcy sought to avoid Bybee's purchases from A-Mark by arguing that the purchases were illegal off-exchange contacts and therefore unenforceable.

The Ninth Circuit reviewed several of the Commission's statements regarding forward contracts, but it focused in particular on the Statutory Interpretation. The court stated: "[t]he real innovation contained in the Statutory Interpretation is its treatment of the delivery obligations."[47] The court referred to the Commission's acknowledgement "that commercial parties often agree to 'bookout' or offset, the contractual delivery obligations," and the Commission's conclusion:

> [W]hile such agreements may extinguish a party's delivery obligation, they are separate, individually negotiated, new agreements, there is no obligation or arrangement to enter into such agreements, they are not provided for by the terms of the contracts as initially entered into, and any party that is in a position in a distribution chain that provides for the opportunity to book-out with another party or parties in the chain is nevertheless entitled to require delivery of the commodity to be made through it, as required under the contracts.[48]

Finally, the Ninth Circuit noted that "the field of commodities regulation is complex"[49] and that the Commission is entitled to "great deference" when interpreting the CEA.[50] Based on all of the foregoing, the court held that "both A-Mark and Bybee had the legal obligation to make or take delivery upon demand of the other. Accordingly, consistent with the Statutory Interpretation, we conclude section 2(a)(1) of the CEA precludes application of the exchange trading requirements to these transactions."[51] The *Bybee* decision is puzzling in a number of respects. One possible reading is that the court held

45. The court also held that the contracts in question were futures contracts but exempt as a result of the forward contract exception. *Id.* at 315. Generally, if a contract is within the forward contract exception, it is not considered a futures contract. See legislative history cited in footnote 21.

46. 11 U.S.C.A. §§ 101-1330 (West 1980 & Supp. 1992).

47. *Bybee*, 945 F.2d at 314.

48. *Id.*

49. *Id.* at 315.

50. *Id.* at 314-15.

51. *Id.* at 315. *See also* Salomon Forex v. Tauber, No. 91-1415-A, 1992 U.S. Dist. LEXIS 8787 (E.D. Va. June 1, 1992). Salomon Forex, a major currency trading company, sued Laszlo Tauber (Tauber), a very sophisticated individual with respect to foreign currencies, for non-payment of 68 foreign currency contracts maturing in July and August of 1991. Tauber counterclaimed that the contracts, all of which were off-exchange, were invalid and unenforceable as they violated the CEA since most of the contracts did not result in delivery by the parties of the foreign currency. The court held that the contracts were enforceable, they were parties that had the contractual right to require actual delivery, elected to forgo actual delivery through a new offsetting contract, and set-off is legally a delivery. *Id.* at *11.

that a contract is not a futures contract if each party is contractually bound to make or take delivery, even if the parties have a prearranged understanding that actual delivery will never occur. If the decision is read this way, it goes far beyond the Commission's statutory interpretation and should not be regarded as reliable authority.

The lesson learned from the above case law is that parties must exercise great care in drafting forward contracts. Whether a transaction will be characterized by a court as a future or a forward contract is often not obvious.[52] All the facts with respect to a transaction should be reviewed early and a preliminary determination made as to whether the contemplated transaction is a future or a forward contract. This preliminary determination should be followed by a reassessment prior to execution of documents, and thereafter the transaction should be monitored on an on-going basis for its compliance with the commodity laws.

3. Swaps

In general, a swap is "an agreement between two parties to exchange a series of payments measured by different interest rates, exchange rates, or prices with payments calculated by reference to a principal base (notional amount)."[53] A simple natural gas swap could work in the following manner. An industrial user of natural gas is currently purchasing gas supplies on a monthly basis in the spot market. The gas user wants to lock in gas prices over the next year at or below $2.00 per MMBtu. To lock in gas prices, the gas user enters into a swap agreement which provides that the gas user will pay the swap counterparty $2.00 per MMBtu for the notional quantity (the amount of gas user's actual gas needs), and the swap counterparty will pay the gas user the agreed-to index price for the notional quantity. The gas user and the swap counterparty agree to net out their respective payments, so that when the index price (the floating price) exceeds $2.00 (the fixed price) the swap counterparty makes a net payment to the gas user, and when the index price is less than $2.00 the gas user makes a net payment to the swap counterparty. The gas user continues to buy gas on the spot market, yet it has hedged its price risk as a result of entering into the swap.[54]

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52. A transaction could also be a hybrid instrument, which is generally one that combines characteristics of a futures contract with a security, such as preferred stock where the dividend is tied to the price of oil. Hybrid instruments, the discussion of which is beyond the scope of this article, may be excluded from the Commission's jurisdiction or exempt under the Commission's rules. *See CFTC Statutory Interpretation Concerning Certain Hybrid Instruments*, 55 Fed. Reg. 13,582, *reprinted in* 2 Comm. Fut. L. Rep. (CCH) ¶ 24,805 (April 11, 1990); 17 C.F.R. § 34.1 (1992); R. Nathan, *The CFTC's Limited Authority Over Hybrid Instruments*, COMMODITIES LAW LETTER (April/May 1988).

53. *Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694 (1989); [1987-90 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,494 (CFTC 1989).

54. As an additional example, a gas producer could enter into a swap, where the gas producer would pay an agreed to index price for a notional quantity of natural gas and the counterparty would pay a fixed price to the gas producer for such notional quantity of natural gas. By entering into such a swap, the gas producer would be protected from the vagaries of the spot market for natural gas. Further, a swap can be varied by adding a cap or a floor or both to the transaction. Discussion of caps and floors is beyond the scope of this article, but the general purpose of a swap with a cap and floor is to provide price protection only in the event of a material change in natural gas prices.

Swap transactions are difficult to categorize under traditional legal principles. The Commission's view of the extent to which swaps are regulated has only recently been clarified under the Commission's 1989 Policy Statement Concerning Swap Transactions[55] (Policy Statement). Pursuant to the Policy Statement, the Commission has affirmed that it "view[s]. . .most swap transactions, although possessing elements of futures or options contracts, [as] not appropriately regulated. . .under the [CEA] and regulations."[56] The Commission noted that if a transaction is a swap within the Commission's safe harbor guidelines (as set forth in the Policy Statement), it will not be subject to regulation under the CEA as a futures contract.[57] The criteria for safe harbor treatment, which applies only to cash settled swaps, are as follows:

1. *Individually Tailored Terms.* "[S]waps must be negotiated by parties as to their material terms, based upon individualized credit determinations, and documented in [one or a] series of agreements that are not fully standardized. . . .[S]afe harbor treatment [excludes] instruments which are. . .readily transferred and traded."[58]
2. *Absence of Exchange-style Offset.* The "swap must create obligations that are terminable, absent default, only with the consent of the counterparty. If consent to termination is given at the outset of an agreement and a termination formula or price fixed, the consent provision must be privately negotiated."[59]
3. *Absence of Clearing Organization or Margin System.* The "safe harbor is applicable to swaps transactions that are not supported by the credit of a clearing organization and are not primarily or routinely supported by a market-to-market margin and variation settlement system designed to eliminate individualized credit risk."[60]
4. *Undertaken in Connection with a Line of Business.* "The safe harbor. . .is limited to swap transactions undertaken in conjunction with the parties' line of business. This restriction is intended to preclude public participation. . . ."[61]
5. *Prohibition Against Marketing to the Public.* "This restriction reflects the institutional and commercial nature of the existing swap market and the Commission's intention to restrict qualifying swap transactions to those undertaken as an adjunct of the participant's line of business."[62]

Although the Policy Statement does not have the force of law, it may receive judicial deference, and it has reduced much of the uncertainty with respect to the treatment of swaps under the CEA.[63] The risk of private litigation must be considered in addition to evaluating swap transactions under federal law and enforcement actions under state law. Discussion of these matters, however, is beyond the scope of this article.

55. *Policy Statement,* 54 Fed. Reg. at 30,694.

56. *Id.*

57. *Id.* at 30,696. For a more detailed discussion of the Policy Statement, see R. Hiden & D. Sullivan, *Swap Transactions under the Commodities Exchange Act,* COMMODITIES LAW LETTER (September/October 1989).

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.* at 30,697.

62. *Id.*

63. Bybee, 945 F.2d at 314-315.

4. Trade Options

Commodity option transactions are subject to the jurisdiction of the Commission unless otherwise exempted.[64] Options are defined in the CEA as including "accounts" and "agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty' or 'decline guaranty')."[65] Generally, unless commodity option transactions are conducted pursuant to the rules of a contract market and, therefore, subject to regulation by the Commission through market regulation, the only exemption to regulation that is applicable to gas related options is the trade option exemption.[66]

Commission regulations provide that the CEA "shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products of byproducts thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such."[67] Over-the-counter options in the natural gas business can be done pursuant to this exemption.[68]

B. State Laws

Most states have enacted statutes (so-called "bucket shop" statutes) that prohibit contracts for the sale for future delivery of certain commodities where the parties have no intent to settle by delivery, but rather intend to settle by reference to a price quoted on a board of trade or similar institution.[69] Most states have also enacted gaming statutes, some of which are broadly drafted, which outlaw certain activities defined as gambling. While a review of gaming statutes is beyond the scope of this article, counsel should review such state gaming statutes to determine their applicability, if any, to the financial contracts discussed herein.

C. Bankruptcy Considerations

There are several particular bankruptcy considerations with regard to swap contracts. Typically, more than one transaction has been consummated

64. 7 U.S.C.A. § 6c(b)-c(c) (West Supp. 1992). Another exemption, the "dealer option exemption," is extremely limited in scope and has minimal applicability here. *See Id.* at § 6c(d) (West 1980 & Supp. 1992).

65. 7 U.S.C.A. § 2 (West Supp. 1992). Regulations proposed by the Commission would eliminate these restrictions. *See* 56 Fed. Reg. 43,560 (1991)(to be codified at 17 C.F.R. pt. 32 (proposed Sept. 3, 1991)).

66. 17 C.F.R. § 32.4(a) (1992). NYMEX has announced gas options will be traded on NYMEX on November 1, 1992 which shows further development of the financial markets in natural gas.

67. Rule 32.4(a), 17 C.F.R. § 32.4(a) (1992).

68. For example, a financial institution can offer a natural gas option to an industrial user if directly related to the industrial user's business.

69. *See* M.T. Schilling, *Forward Rate Agreements: The Leading Hedge or Bucket Shop Finance?* SEC. & CORP. REG. REV., Jan. 1990 [Part I], 1-12; *Forward Rate Agreements: The Leading Hedge or Bucket Shop Finance?*, SEC. & CORP. REG. REV., Feb. 1990 [Part II], 13-14.

under a single master swap agreement (see discussion below), often at different times and different prices. Certain transactions may or may not be profitable. Should the trustee in bankruptcy for the debtor counterparty be able to cherrypick only the profitable transactions and reject all unprofitable transactions?

Since a swap agreement is an executory contract,[70] absent an exception, the debtor-counterparty would generally be able to assume or reject the contract.[71] With respect to swap agreements,[72] the Bankruptcy Code provides an exception.[73] If a counterparty files for protection under the Bankruptcy Code, the non-debtor counterparty may, if it has the contractual right to do so, cause the liquidation of the swap agreement and still not be subject to the automatic stay provisions.[74] Further, pursuant to the Bankruptcy Code, the non-debtor counterparty may set-off mutual debts and claims under the swap agreement between it and the debtor.[75] If the non-debtor chooses not to liquidate its position, the trustee then has the right to reject executory contracts and cherrypick favorable transactions.[76]

The provisions of the Bankruptcy Code described above should be given full consideration when structuring a transaction. First, it is important to include in a swap contract the right to liquidate the transaction in the event a party files for bankruptcy. Second, it is important to consider the bankruptcy implications when structuring a long term fixed-price transaction. There may be an advantage in bankruptcy to a bifurcated structure consisting of a physical gas contract priced at index and a gas swap as opposed to a long term fixed-price gas contract. In the two contract structures the non-debtor counterparty could have both liquidation and set-off rights under the swap agreement (which is where the price risk resides) in the event its counterparty files for bankruptcy. In contrast, the long-term fixed-price gas contract is probably an executory contract with no applicable exception to the stay provisions in the Bankruptcy Code. Accordingly, the non-debtor counterparty has greater risk in the event the other counterparty becomes bankrupt.

70. An executory contract has been defined to include "contracts on which performance remains due to some extent on both sides." Terrell v. Albaugh, 892 F.2d 469, 471 (6th Cir. 1989) (citing S. REP. NO. 95-989, 95th Cong., 2d Sess. 58 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844; H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5963, 6303); *In re* Crippin, 877 F.2d 594, 596 (7th Cir. 1989) (citing H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6303.).

71. 11 U.S.C.A. § 365(a) (West Supp. 1992).

72. The definitions in the Bankruptcy Code regarding commodities matters are confusingly complex. Such definitions track commonly accepted definitions under the commodities laws in some respects, but perhaps not in others. For example, the term "forward contracts" includes most swaps. *See* 11 U.S.C. § 101(25) (Supp. II 1990). Yet, there is a separate definition of a "swap agreement". *See id.* § 101(55). A detailed review of such definitions and the nuances resulting therefrom is beyond the scope of this article.

73. Pub. L. No. 101-311, 104 Stat. 267 (codified at 11 U.S.C.A. §§ 101, 362, 546, 548, 553, 556, 560 (West Supp. 1992)).

74. 11 U.S.C.A. § 556.

75. *Id.* at § 560.

76. If non-debtor chooses not to liquidate its position, it should enter into an agreement with the debtor-counterparty allowing the non-debtor to liquidate at a later time. *See, e.g., In re* Amcor Funding Corp., 117 B.R. 549 (Bankr. Ariz. 1990).

D. Proposed Commodities Legislation

As of the date of this article, the United States House of Representatives and the Senate have each passed bills dealing with the Commodities Futures Trading Commission.[77] Each bill makes the Commission a permanent agency and makes changes aimed at curtailing abuses in the trading pits, such as dual trading, whereby a broker trades for both his account and his client's account on the same day. The Senate bill also makes it clear that swaps are not subject to Commission jurisdiction. The conference committee has met several times regarding the two bills — but at this point, it is difficult to predict the prospects for the bills passage.

E. Contracts

1. Futures Contracts

Gas futures are trades on the NYMEX pursuant to a standardized contract.[78] There are distinctive features of a NYMEX gas futures contract (NYMEX Contract). Each NYMEX Contract, which is for a contract unit of 10,000 MMBtu of natural gas,[79] may be settled by (i) physical delivery, (ii) an exchange for futures, or (iii) offset. The NYMEX Contract provides a detailed notice and matching procedure for those counterparties that desire to make or receive physical delivery of the gas under the NYMEX Contract.[80] Alternatively, a buyer and a seller of futures may enter into a forward contract that in effect takes the place of their respective futures contracts, which is referred to as an exchange of product for futures.[81] Futures contracts may also be settled by means of offset, *i.e.*, where one party has offsetting buy and sell futures contracts for the same period of time.

The other primary distinctive feature of the NYMEX Contract is the provision regarding margins or security.[82] Generally, margins are established on a per contract basis taking into account the credit of the party purchasing the NYMEX Contract. The margin provision has definite applicability to long-term fixed-price physical gas contracts.

2. Swaps and Option Contracts

Swaps and over-the-counter option transactions are customarily documented by a master agreement and confirmations. The master agreements set forth the core terms and conditions, such as standard representations and warranties, general obligations, events of default and termination, credit matters (including exposure limits and required security), governing law and definitions. The confirmations, on the other hand, establish (i) the pricing terms of

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77. S. 207, H.R. 707, 102nd Cong., 1st Sess. (1991).

78. See New York Mercantile Exchange Guide (CCH) ¶¶ 13,651-13,670 (1991), wherein the NYMEX natural gas futures contract is printed.

79. *Id.* ¶ 13,655.

80. *Id.* ¶ 13,661.

81. *See Id.* ¶ 13,667 where an exchange of futures or an EFP is defined. A full discussion of EFP's is beyond the scope of this article.

82. *Id.* ¶ 13,670.

a particular transaction (*i.e.*, which party is the fixed-price payor, which party is the floating price payor, what the fixed price is and what index is to be used to determine the floating price), (ii) the notional quantity,[83] and (iii) the term.

The advantage to swap documentation, at least compared to documentation for long-term physical gas contracts, is that the core of the agreement between two parties can be established through the master agreement before any transaction takes place between the parties. This allows the negotiations of credit and security issues, which are frequently difficult and time consuming, to take place early and not delay a transaction. With the master agreement in place, the parties are free to respond quickly to changes in the price of natural gas. On a telephone call, the parties can agree on the pricing terms, notional quantity and term, and soon after the call, the parties can document the confirmation and send it by facsimile to the counterparties. Such transactions can literally be done in a matter of minutes. This type of speed and flexibility of documentation is becoming as critical with respect to natural gas as it is for many other commodities.

The leading form for swaps, the 1987 Interest Rate and Currency Swap Agreement, was originally developed by the International Swap Dealers Association (ISDA) for interest rate and currency swaps.[84] Although complex, the ISDA form is an excellent starting point in dealing with any commodity swaps, including natural gas swaps, for anyone new to the swaps area. The master agreement and schedule to the master agreement are well-crafted to vary the form for almost any conceivable swap transaction. In addition, detailed explanations are available for most provisions of the form. Recently, ISDA has prepared drafts of several new forms, including the 1992 Master Agreement (Local Currency — Single Jurisdiction), which reduce the complexity of the forms and may become more accepted for gas swaps than the 1987 form.

Finally, the Energy Risk Management Association (ERMA) has prepared a draft form of Master Energy Price Swap Agreement for its members to review. Unlike the ISDA forms, this form is specifically tailored to energy swap transactions. One great advantage to both the ISDA forms and the ERMA forms, especially for companies new to the swaps area, is that they are industry-accepted forms and drafted to be fair to both parties.

3. Forward Contracts

A forward contract is the most commonly used type of gas contract in the gas industry. There is a contractual obligation on the part of one party to sell and deliver and the other party to buy and receive a quantity of gas over a period of time. Although most typical gas contracts are clearly forward contracts, as physical contracts become increasingly tailored to accommodate financial requirements (see discussions below), this determination will require greater and more careful consideration.

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83. The quantity is notional in that no exchange of natural gas ever takes place since the swap is a purely financial transaction.

84. See Kenneth R. Kapner & John F. Marshall, THE SWAPS HANDBOOK (1990) at 430 for a discussion of the development of the ISDA forms.

III. Long-Term Fixed-price Physical Gas Contracts

A. Impact of Developments on Long-Term Fixed-Price Physical Contracts

Generally, physical gas contracts have changed along with new developments in the gas industry. Over the past few years, new provisions have been developed which respond to, among other things, the hike in gas prices, the subsequent collapse in gas prices, and the gas shortages which turned into the gas bubble. In addition, new contracts have been developed, including the "spot" contract, which responded to the emergence of the spot market in natural gas.[85] Now the challenge is to respond to development of the financial markets in natural gas and the changed risks resulting from deregulation of the natural gas industry. This portion of the article will focus on appropriate changes to long-term fixed-price physical gas contracts.

1. Impact of Development of Financial Markets

To date, the development of the financial markets in natural gas has caused relatively little impact on long-term fixed-price physical gas contracts, but that is about to change. The same forces that are driving the development of the natural gas financial markets (*i.e.* managing price risk and raising capital) will spill over to long-term fixed-price physical gas contracts, the type of gas contract that is most adaptable to managing price risk and raising capital. In some respects, industry participants have for many years used long-term fixed-price gas contracts to manage price risk, but not with the level of sophistication, efficiency, and precision of contracts in the financial markets. Consequently, a change will be seen as the efficiency and the precision of contracts in the financial markets are applied to long-term fixed-price gas contracts.

What provisions must be changed or added to the physical gas contracts? For a physical gas contract to manage price risk successfully, it is critical that the parties perform for the life of the contract. Unlike financial contracts, physical gas contracts often contain numerous exceptions, both express and implied, to the performance obligations of the parties (Performance Exceptions).[86] Negotiation of physical gas contracts must focus on eliminating such exceptions, and for those that are not eliminated or for breaches of contract, it is critical that damages be assessed in a way that fully addresses price risk.

Before turning to a discussion of suggested additional provisions, as a way of highlighting the importance of these concerns, consider the following hypothetical. A gas marketer (Marketer) is purchasing gas supplies at index. The Marketer enters into a contract (Marketing Contract) to sell 10,000 MMBtu/d of gas to an end user (End User) for $1.50 per MMBtu for a term of five years. The Marketer then hedges its price risk relative to its Marketing Contract with the End User by entering into a price swap (Swap Contract) with a counterparty (Counterparty) where the Marketer is the fixed price

85. *See* Arthur J. Wright, *Gas Contracts in Transition*, NAT. RESOURCES & ENV'T, Spring 1992, at 17.

86. The Performance Exceptions include force majeure, make-up rights for buyers, the failure of transportation, obligations to deliver or take gas that are less than "firm", no clear specification of damages for non-performance and no security provisions.

payor at $1.30 per MMBtu. In this hypothetical, if index gas prices fall below $1.30 per MMBtu and the End User does not take delivery of and pay for the volumes in the Marketing Contract *for any reason at all*, the Marketer will have losses under the Swap Contract. If gas prices fall after one year an average of 20¢ per MMBtu and the End User refuses to or is unable to perform for the remainder of the term, the Marketer faces losses totalling approximately $3,000,000.[87]

2. New Provisions in Physical Gas Contracts

a. Security

One of the possible Performance Exceptions for a party to a physical gas contract is the inability of the party to perform its obligations (for any reason). If a seller does not own the molecules required for delivery under a contract and does not have sufficient funds, or borrowing capacity, to acquire the molecules for delivery, the seller will probably not be able to perform. If a buyer cannot pay for the gas already delivered and will not be able to pay for any future deliveries of gas, the buyer will probably not be able to perform. This inability to perform is a Performance Exception that has not typically been well protected against in physical gas contracts.

However, in gas futures transactions, no trade is made until security for performance is ensured through establishment of an appropriate margin.[88] For other financial gas contracts, such as swaps, as explained above, the master agreement typically contains detailed provisions regarding security. The comprehensive treatment of security in financial transactions must be translated to long-term fixed-price gas contracts in order for such contracts to be used to effectively manage price risk.

Appendix "A" suggests several alternatives to secure the risk of non-performance in long-term fixed-price gas contracts. The starting point is due diligence as to credit and an assessment of the credit risk associated with entering into the contemplated transaction with the counterparty. The credit risk may be high, dictating the need to require collateral (see alternatives noted) on execution of the contract, or low, eliminating the need for collateral, except upon the occurrence of a material adverse change in the financial condition of the party. Alternatively, collateral may be required only if liquidated damages (explained below) exceed a certain threshold level. (see "Alternative No. 3" of Appendix "A").

As further protection, long-term fixed-price contracts should contain a list of occurrences (Trigger Events) which would be cause to require additional assurances of performance or other security. (see Appendix "B"). The Trigger Events should in many respects be non-controversial and simply add specificity to the physical gas contract with respect to matters that many par-

87. 10,000 MMBtu/d x 365 days x 4 years x $.20/MMBtu = $3,000,000.

88. *See supra* discussion regarding margins in futures contracts in Section II.E.1., Futures Contracts.

ties to a physical gas contract would presume as their right even without such language. The Trigger Events are drafted so as to avoid any inadvertent termination of the contract. For instance, the failure to perform a covenant is not a Trigger Event unless the failure is not cured within 30 days after notice. (see clause (c)) However, if a Trigger Event does occur, the non-breaching party may terminate the contract as set forth in Appendix "A" (see Section 15.2) and the breaching party is required to keep the non-breaching party "whole" by the payment of liquidated damages as discussed below. Both the security provisions and the Trigger Events would be additions to a traditional physical gas contract.

b. Economic Loss as Liquidated Damages

Using long-term physical gas contracts to manage price risk also requires revisiting the way in which damages are calculated. If one party to a physical gas contract fails or refuses, through a Performance Exception or otherwise, to perform for a period of time, how should damages be calculated? By reference to current index prices of natural gas? What if the party refuses to, or is unable to, perform for the remainder of the term of the contract? What if the non-breaching party entered into a hedge of the gas physical contract when it was executed and gas prices have now moved adversely to that party?

The traditional gas contract remedy of awarding the non-breaching party the cost of cover[89] may not provide adequate compensation for damages sustained. Also, the payment by the breaching party of the difference between the fixed-price in the contract and an index price may be inadequate. Consider the following provision:

> LIQUIDATED DAMAGES. If an Early Termination Date occurs as provided in Section __ above, the Notifying Party shall in good faith calculate its Liquidated Damages resulting from the termination described in Section __. For purposes hereof, the term "Liquidated Damages," with respect to a Party shall mean the present value of the economic loss, if any (plus any costs and minus the present value of the economic gain, if any) deemed to have been suffered by the Party resulting from the termination of the Parties' obligations under this Agreement. Any economic loss deemed to have been suffered by a Party resulting from the termination of the Parties' obligations under this Agreement shall be the amount, if any, equal to the amount such Party would pay to a third party in an arm's length transaction as consideration for entering into an energy price swap (with Seller as the floating price payor if the Seller is the Notifying Party or with the Buyer as the fixed price payor if Buyer is the Notifying Party) for a term equal to the remaining term of this Agreement, with notional quantities of Gas equal to the sum of the Maximum Daily Quantity of remaining Gas to be delivered pursuant to this Agreement and with fixed prices equal to the price provided in this Agreement (in each case based on the remaining term, quantities and prices under this Agreement had it not been terminated) and with floating prices calculated by reference to the settlement price of natural gas futures contracts on the NYMEX and/or quotations from leading dealers in natural gas swap contracts, adjusted as appropriate for basis differential in the event floating prices are calculated at delivery points that vary from the Delivery Points under this Agreement.

89. U.C.C. §§ 2-706, 2-712 (1992).

If the calculation of Liquidated Damages results in a net gain due to the Notifying Party, Damages shall be deemed to be zero. The Notifying Party shall give the affected party (defined in Section__below) notice of the Notifying Party's Liquidated Damages, if any, accompanied by a statement in reasonable detail stating how the amount was calculated. The Affected Party shall pay such Liquidated Damages to the Notifying Party within ten (10) Days of receipt of such notice. At the time for payment of any amount due under this Article__, each Party shall pay the other all additional amounts payable by it pursuant to this Agreement, but all such amounts shall be netted and aggregated with any Liquidated Damages payable hereunder.

The above provision is completely bilateral. If gas prices are relatively unchanged from the date the contract was hedged, damages should be little, if any. The proposed provision could be used to address damages for all breaches, whether short in duration or through the term of the contract.[90] For any party that hedges its price risk, such a provision provides a more accurate measure of damages. Since gas prices change daily and sometimes dramatically, a party's damages are based on the cost of buying a replacement swap, which swap dealers will determine by reference to their "forward price curve,"[91] rather than the cost of gas on the particular day the non-breaching party would try to cover, or the difference between the index price on such day and the fixed price in the contract. The risk that damages calculated pursuant to the damage provision of a contract could be materially different than the non-breaching party's actual damages is a risk that should probably not be taken. Assuming the breaching party is able to pay the liquidated damages,[92] the non-breaching party can then purchase a swap to replace the physical gas contract so as once again to avoid price risk.

c. Representations and Warranties

Few traditional physical gas contracts have included standard representations and warranties. As with many of the Trigger Events, basic bilateral representations and warranties relating to a party's authorization to enter into the contract and the like should not be controversial, and such provisions should substantially increase the precision in the contract. Such precision will help to further reduce and eliminate a party's ability to avoid performance, especially in the context of litigation. It is submitted that representations and warranties (see Appendix "C") should become routine in long-term fixed-price gas contracts.

3. Impact of Deregulation

Deregulation in the gas industry has resulted in materially different risks for nearly every participant in the gas industry. Today, producers, pipelines,

90. For most failures to perform that are relatively short in duration, *e.g.* sixty (60) days or less, it may not be practical (until the financial markets in natural gas develop further) to use the liquidated damages provision. For such failures, the traditional remedies may be more appropriate.

91. A forward price curve is a party's projected prices for a commodity forward into the future, often for several years. The forward price curve is often two curves, one for bid prices, the other for asked prices.

92. *See supra*, Section III.A.2.a., Security.

and LDC's have less certainty regarding cash flow and revenues. The old regulated system, although inefficient, offered a "stability" that is not present today. Traditional physical gas contracts were drafted with this stability in mind. Without this stability, the credit worthiness of many parties is increasingly more relevant to the assurance of performance of payments in lieu thereof. When a producer faces price uncertainty, particularly when gas prices are declining, there is greater concern about the ability of a producer to perform under a long term gas contract. Likewise, where an LDC is no longer assured of flowing through all of its gas costs to its customers, there is more of a concern about the ultimate ability of an LDC to perform by purchasing gas, particularly for a long-term contract.

The increased credit risk requires provisions in physical gas contracts similar to those resulting from the development of the financial markets in gas. With the exception of the liquidated damages provision, the other provisions discussed above appropriately respond to the deregulation of the gas industry.

IV. Physical Gas Contracts of the Future

The efficiency and precision of the financial markets will continue to spill over to long-term fixed-price gas contracts. As use of the futures market in gas increases, there will be increased pressure on physical gas contracts to take on the attributes and flexibility of financial gas contracts. Parties should be able to agree to credit terms and have a master agreement covering all such future physical transactions. Physical gas contracts can be structured so that parties can respond quickly to price changes and enter into new transactions. Parties can reduce the amount of time required to negotiate and enter into a long-term fixed-price gas contract.

A. Master Gas Contract with Confirmation

One of the possible answers is the development of a master gas contract with confirmation of specific transactions, the equivalent of a master swap agreement with confirmation, discussed above. Credit issues are dealt with up front in the master agreement, and the specific terms of each transaction (price, quantity, term, and location) are addressed in the confirmation. Some parties are already using a contract similar to this for transactions priced at index (typically short-term) and for short-term fixed-price transactions. But the best and most efficient use would be for long term fixed-price transactions. Such use could be widespread within 5 years.

B. Combination Physical Gas Contract and Financial Contract

Combining a physical gas contract, priced at index, with a financial contract, gas swap, has the same economic effect as a long term fixed-price gas contract and should become more common. The advantage in this structure is the protection it affords in bankruptcy since the price risk is managed in the swap agreement rather than in the physical gas contract. As discussed above, swap agreements fall under an exception to the Bankruptcy Code's stay provisions. In addition, it may also be easier to negotiate credit terms with the

parties typically entering into swaps than it would be with parties typically entering into long term fixed-price gas contracts.

C. *Form Physical Gas Contracts*

As discussed above, ISDA developed a form swap agreement; why not an industry-developed form physical gas contract? The ISDA document provides a multitude of alternatives on most major points of contention between parties. A great deal of efficiency would be obtained by standardizing credit terms in physical gas contracts as well as traditional gas provisions regarding title, indemnities, taxes, delivery/receipt, imbalances, and quality specifications. If a form buy/sell gas contract were agreed to, time spent negotiating a physical gas contract could be greatly reduced. Physical gas transactions could then be completed more quickly and more readily respond to price swings in natural gas. The gas industry ought to follow the lead of the swap industry.

V. CONCLUSION

The emergence of the financial markets in natural gas and the deregulation of the gas business have brought fundamental change to the gas industry. It is becoming more efficient; resources from natural gas to pipeline capacity to people are now being allocated more efficiently. This development of the new natural gas business, *i.e.* a more efficient gas business, will accelerate with growth in the gas financial markets (including new products) and the implementation of Order No. 636.[93]

It is critical that the new natural gas business have more efficient gas contracts. This has already started with the development of a new family of gas contracts, the financial gas contracts. However, a big challenge lies ahead — *i.e.* bringing the efficiency and precision of the financial gas contracts to long-term fixed-price physical contracts. The gas industry needs physical contracts that allow a party to buy or sell gas, yet also to manage price and credit risk with the precision typically found in financial documents. Further, industry participants need to be able to respond quickly to changes in the price of natural gas. Such contracts will be developed. For the industry participants who use them first, a competitive advantage will be achieved from increased access to the new and developing tools of the new natural gas business.

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93. *See* Mary O'Driscoll, *Skilling: Customized Gas Services Are The Key To Profitability*, THE ENERGY DAILY (May 13, 1992) (regarding increased efficiency in the natural gas business).

APPENDIX "A"

15.1 *Security*

(1) *Seller's Security.*

In order to secure all obligations of Seller to Buyer hereunder, including, without limitation, performance of obligations of Seller hereunder and payment of amounts owed, including, without limitation, Liquidated Damages, Seller hereby [grants and] delivers to Buyer the following:

(i) *Guaranty Agreement.* Seller shall cause to execute and deliver to Buyer its Guaranty Agreement.

[REVISE AS APPROPRIATE IF RECIPROCAL SECURITY]

(2) *Buyer's Security.* **[SELECT COMBINATION OF ALTERNATIVES 1, 2 AND 3 DEPENDING UPON CREDIT RISK OF BUYER]**

In order to secure all obligations of Buyer to Seller hereunder, including, without limitation, performance of obligations of Buyer hereunder and payment of amounts owed, including, without limitation, the Contract Price and Liquidated Damages, Buyer hereby grants and delivers to Seller the following:

[ALTERNATIVE 1 - HIGH CREDIT RISK - COLLATERAL TAKEN ON EXECUTING THE AGREEMENT]

Upon execution of this Agreement, Buyer agrees to provide Seller with the following:

(a) *Guaranty.* Buyer shall cause __________ to execute and deliver to Seller its Guaranty Agreement; [or] [and]

(b) *Letter of Credit.* Buyer shall establish and maintain a Letter of Credit in an amount equal to [Liquidated Damages calculated as the date of this Agreement with such adjustments as may be necessary based upon subsequent calculations of Liquidated Damages]; [__________]; [or] [and]

(c) *Lien, Security Interest.* Buyer shall grant in favor of Seller a first priority lien and security interest in and to ***[described assets, e.g., oil and gas properties, receivables, etc. and add definitions as necessary]*** in order to secure obligations of Buyer hereunder, pursuant to documentation satisfactory to Seller.

[ALTERNATIVE NO. 2 - LOWER CREDIT RISK-COLLATERAL TAKEN UPON OCCURRENCE OF A MATERIAL ADVERSE CHANGE OF BUYER]

Upon the occurrence of a Material Adverse Change of Buyer, Buyer agrees to provide Seller with the following within three (3) Days of notice to Buyer by Seller:

(a) *Guaranty.* Buyer shall cause __________ to execute and deliver to Seller its Guaranty Agreement; [or] [and]

(b) *Letter of Credit.* Buyer shall establish and maintain a Letter of Credit in an amount equal to Liquidated Damages calculated by Seller as of the date of such notice, with such adjustments as may be necessary based on subsequent calculations of Liquidated Damages; [or] [and]

(c) *Lien, Security Interest.* Buyer shall grant in favor of Seller a first priority lien and security interest in and to ***[describe assets, e.g., oil and gas properties, receivables, etc.]*** in order to secure obligations of Buyer hereunder, pursuant to documentation satisfactory to Seller.

[Also consider trust arrangement or other security]

[ALTERNATIVE NO. 3 - MARGIN (COLLATERAL) PROVIDED UPON LIQUIDATED DAMAGES REACHING PRESCRIBED LIMITS]

If at any time and from time to time during the term of the Agreement (and) notwithstanding the fact that a Triggering Event may not have occurred) the Liquidated Damages which would be due by Buyer to Seller pursuant to Section 15.3 hereof should exceed $__________, Seller shall send a notice to Buyer of the amount of such Liquidated Damages. If at any time Buyer is so notified of Liquidated Damages which exceed $__________, Buyer shall within ___ Days following such notification from Seller, establish a Letter of Credit (naming Seller as beneficiary) in an amount equal to such Liquidated Damages or such other collateral as may be agreed upon by the Parties. If a Letter of Credit is established pursuant to this Agreement, and Seller shall determine that Liquidated Damages which would be due to it as of the calculation date are $__________ or more in excess of any Letter of Credit established in its favor, then Seller may request that a Letter of Credit be established or adjusted by Buyer for the benefit of Seller, such that the amount of the Letter of Credit shall equal Seller's Liquidated Damages rounded up to the nearest $__________ and Buyer shall within ___ business Days of request, establish or adjust such Letter of Credit. In addition, if a existing Letter of Credit arranged by Buyer exceeds Seller's Liquidated Damages, rounded to the nearest $__________, as determined by Seller, Seller shall do whatever Buyer reasonably requests as being necessary to authorize the appropriate reduction in the amount of the Letter of Credit.

15.2 *Early Termination.* If a Triggering Event (defined in Section 15.4 below) occurs with respect to either Party at any time during the term of this Agreement, the other Party ("Notifying Party") may, upon two (2) business Days' written notice to the first Party, establish a date on which this Agreement will terminate early ("Early Termination Date"), except for the obligations continued in Section __________ hereof.

APPENDIX "B"

15.4 *Triggering Event* shall mean, with respect to a Party [or its Guarantor] (the "Affected Party"):

(a) the failure by the Affected Party to make, when due, any payment required under this Agreement if such failure is not remedied within five (5) Business Days after notice of such failure is given to the Affected Party [and provided that such payment is not the subject of a good faith dispute as described in Section 7.4 (7.5) hereof]; or

(b) any representation or warranty made by the Affected Party in Sections 16.1 and 16.2 hereof shall prove to have been false or misleading in any material respect when made or deemed to be represented pursuant to Section 16.3 hereof; or

(c) the failure by the Affected Party to perform any covenant or other agreement set forth in this Agreement or any other contract between the parties (other than its obligations to make any payment) unless such performance is excused by force majeure, and such failure is not cured within thirty (30) Days after notice thereof to the Affected Party from the other Party; or

(d) an assignment or transfer by the Affected Party in violation of Article 10; or

(e) the Affected Party shall (i) make an assignment or any general arrangement for the benefit of creditors; (ii) file a petition or otherwise commence, authorize or acquiesce in the commencement of a proceeding or cause under any bankruptcy or similar law for the protection of creditors, or have such petition filed against it and such proceeding remains undismissed for sixty (60) Days; (iii) otherwise become bankrupt or insolvent (however evidenced); or (iv) be unable to pay its debts as they fall due; or

(f) the occurence, in the reasonable opinion of the Notifying Party, of a Material Adverse Change of the Affected Party; provided that such Material Adverse Change shall not be considered if the Affected Party established a Letter of Credit (naming the Notifying Party as beneficiary thereof) in an amount equal to the Notifying Party's Liquidated Damages.

(g) The Affected Party fails to [(i)] establish, maintain, extend or increase a letter of credit when required pursuant to this Agreement, or any exhibit hereto, or after reasonable notice fails to replace the issuing bank with another bank acceptable to the beneficiary Party; [or (ii) provide such other security to the other Party as required pursuant to Section 15.1(b)(ii) or 15.1(b)(iii) hereof;] or

(h) The Affected Party's activities hereunder are or become subject to regulation under state or federal law to a greater or different extent than that existing on the date of initial deliveries of Gas hereunder (or thereafter as such regulation may have changed and been accepted by said Party) and such greater or different regulation either (i) renders this Agreement illegal or unenforceable; or (ii) materially adversely affects the business of the Affected Party; or

(i) Seller shall fail to Schedule for delivery under Section 2.3 hereof Seller's Obligation Quantity for a period of __________ consecutive __________; or

(j) Buyer shall fail to Schedule for delivery under Section 3.2 hereof Buyer's MMQ for a period of __________ consecutive months; or

(k) Seller shall tender for delivery to Buyer Gas which fails to conform to Buyer's Transporter's quality specifications as set forth in Buyer's Transporter's FERC gas tariff or transportation agreement with Buyer, as applicable, under Section 8.1 hereof for a period of __________ consecutive __________; or

(l) As a result of Buyer's failure to apply sums owed Seller hereunder, Seller shall have elected to suspend further sale and delivery of Gas pursuant to Section 7.4(7.5) hereof, and such failure to pay shall have continued for a period of __________ days.

APPENDIX "C"

16.1 *Seller's Representations and Warranties.* Seller represents and warrants that:

(1) it is a corporation duly organized, validly existing, and in good standing under the law of the State of __________ and is duly qualified and in good standing as a foreign corporation in the State of __________. Seller has all requisite corporate power and authority to enter into and perform this Agreement.

(2) This Agreement [and any other documents and instruments to be delivered by Seller pursuant hereto,] and the transaction contemplated hereby [and thereby,] has [have] been duly authorized by Seller; and this Agreement has been, [and each such other document or instrument will be,] duly executed and delivered by Seller and constitutes, [or upon such execution and delivery will constitute,] legal, valid and binding obligations of Seller, enforceable against Seller in accordance with its [represpective] terms, subject, however, to applicable bankruptcy, insolvency, reorganization, moratorium, or similar laws affecting creditors' rights generally and except as the enforceability thereof may be limited by general principles of equity (regardless of whether considered in a proceeding in equity or at law).

(3) All consents, licenses, approvals and authorizations of and registrations or declarations with any governmental or regulatory authority or with any third party which are required in connection with its execution and delivery of this Agreement or performance of its obligations hereunder have been obtained or effected, and are in full force and effect.

(4) The execution, delivery, and performance by Seller of this Agreement [and the other documents and instruments to be delivered by Seller pursuant hereto,] and the transactions contemplated hereby [and thereby,] do not [and will not] (i) violate or conflict with any provision of Seller's certificate of incorporation or bylaws, (ii) violate or constitute a default under any agreement or instrument to which Seller is a Party or by which Seller is bound, which violation will have a material and adverse effect on Seller's ability to perform its obligations hereunder, (iii) violate any existing statute or law or any judgment, decree, order, regulation or rule of any court or governmental authority applicable to Seller, which violation will have a material and adverse effect on Seller's ability to perform its obligations hereunder.

(5) There are no judicial or administrative actions, proceedings or investigations (including, without limitation, bankruptcy, reorganization or insolvency actions, proceedings or investigations) pending or, to Seller's knowledge, threatened that (i) challenge the validity of this Agreement or the transactions contemplated hereby, (ii) seek to restrain or prevent any action taken or to be taken by Seller in connection with this Agreement, or (iii) if adversely determined, would have a material and adverse effect upon Seller's ability to perform its obligations hereunder.

(6) Seller is not in, and has not received notice of the existence of, any default under [name any agreement specific to this contract or] any transportation, purchase or other agreement material to Seller's performance under this Agreement, nor is there existing any event or circumstance that with notice or lapse of time or both would give rise to a default on the part of Seller thereunder.

16.2 *Buyer's Representations and Warranties.* Buyer represents and warrants that:

(1) It is a corporation duly organized, validly existing, and in good standing under the law of the State of __________ [and is duly qualified and in good standing as a foreign corporation in the State of __________.] Buyer has all requisite corporate power and authority to enter into and perform this Agreement.

(2) This Agreement [and any other documents and instruments to be delivered by Buyer pursuant hereto,] and the transactions contemplated hereby [and thereby,] has [have] been duly authorized by Buyer; and this Agreement has been, [and each such other document or instrument will be,] duly executed and delivered by Buyer and constitutes, [or upon such execution and delivery will constitute,] legal, valid and binding obligations of Buyer, enforceable against Buyer in accordance with its [respective] terms, subject, however, to applicable bankruptcy, insolvency, reorganization, moratorium, or similar laws affecting creditors' rights generally and except as the enforceability thereof may be limited by general principles of equity (regardless of whether considered in a proceeding in equity or at law).

(3) All consents, licenses, approvals and authorizations of and registrations or declarations with any governmental or regulatory authority or with any third party which are required in connection with its execution and delivery of this Agreement or performance of its obligations hereunder have been obtained or effected, and are in full force and effect.

(4) The execution, deliver, and performance by Buyer of this Agreement [and the other documents and instruments to be delivered by Buyer pursuant hereto,] and the transactions contemplated hereby [and thereby,] do not [and will not] (i) violate or conflict with any provision of Buyer's certificate of incorporation or bylaws, (ii) violate or constitute a default under any agreement or instrument to which Buyer is a Party or by which Buyer is bound, which violation will have a material and adverse effect on Buyer's ability to perform its obligations hereunder, (iii) violate any existing statute or law or any judgment, decree, order, regulation or rule of any court or governmental authority applicable to Buyer, which violation will have a material and adverse effect on Buyer's ability to perform its obligations hereunder.

(5) There are no judicial or administrative actions, proceedings or investigations (including, without limitation, bankruptcy, reorganization or insolvency actions, proceedings or investigations) pending or, to Buyer's knowledge, threatened that (i) challenge the validity of this Agreement or the transactions contemplated hereby, (ii) seek to restrain or prevent any action taken or to be taken by Buyer in connection with this Agreement, or (iii) if adversely determined, would have a material and adverse effect upon Buyer's ability to perform its obligations hereunder.

(6) Buyer is not in, and has not received notice of the existence of, any default under [name any agreement specific to this contract or] any transportation, purchase or other agreement material to Buyer's performance under this Agreement, nor is there existing any event or circumstance that with notice or lapse of time or both would give rise to a default on the part of Buyer thereunder.