Not All Pipelines Are The Same: Regulatory Differences Impacting Oil Versus Natural Pipeline Development

April 12, 2012

Kirk Morgan, Partner
The Regulatory Environment Impacts Pipeline Development

- Differences between the regulation of natural gas pipelines and liquids pipelines will impact the pace at which natural gas and liquids pipelines are developed.
- Differences include:
  - Approval process for new projects
  - Eminent domain
  - Certainty as to rates and terms and conditions of service for new projects
  - Allocation of capacity
  - Flexibility in negotiating rates
Gas: Natural Gas Act of 1938 (“NGA”)

- Protect consumers against the potential exercise of monopoly power in the interstate market
  - Monopolistic prices
  - Discrimination in favor of affiliated or preferred customers
- Pipelines subject to significant FERC oversight
  - Rates
  - Terms and conditions of service
  - Barriers to Entry: construction and operation of pipelines require FERC authorization
  - Barriers to Exit: termination and abandonment of pipelines must be approved by FERC
Oil: Interstate Commerce Act of 1887 ("ICA")

- Originally governed railroads and telegraph companies; later extended to oil pipelines
- Not a consumer-protection statute
- Protect producers from monopolistic practices of pipelines
- Compared to natural gas, oil is subject to light-handed regulation
  - Rates assessed by interstate oil pipelines for interstate movements
  - Terms and conditions of service
  - No Barriers to Entry: construction and operation of pipelines NOT regulated by FERC
  - No Barriers to Exit: termination and abandonment of pipelines NOT regulated by FERC
Regulatory Overview: The Construction of Natural Gas Pipelines
FERC’s Regulation of Natural Gas Pipeline Construction

• “Mother, may I?”
• Pipeline may not construct facilities or initiate service without prior FERC authorization
• Pipeline bears the burden to show that proposed facilities are required by the “public convenience and necessity”
• Pipeline files proposed rates, tariff, and service agreements with certificate filing
How The Issuance of a Certificate Facilitates Pipeline Development

• FERC Certificate comes with:
  – Federal Eminent Domain
    • Certificate holder negotiates a right-of-way easement with each affected landowner
    • If agreement cannot be reached with the landowner, then the certificate holder may acquire the land by eminent domain
  – Federal Preemption
  – Initial approval of:
    • Rates
    • Service Agreements
    • Terms and Conditions of Service
Access to Natural Gas Pipeline Capacity

• Open Access Pipeline Regulation
  – Contract carriage
  – Firm capacity
  – Rates, terms and conditions of service must be non-discriminatory
• Encourages customer-backed projects
Regulatory Overview: The Construction of an Oil Pipeline
No FERC Approval Required

- FERC does not regulate an oil pipeline’s entry into or exit from the marketplace
- Lack of FERC approval process can complicate efforts to construct an oil pipeline
  - Issues associated with multiple state regulators
  - No federal eminent domain
  - Lack of certainty in connection with rates and terms and conditions of service
  - Lack of firm capacity
  - Limited ability to negotiate rates or offer discounts
Coordinating Federal, State, & Local Approvals

- Federal environmental approvals, e.g., Clean Water Act, Clean Air Act
- State approvals may be required prior to construction of pipeline
  - Different states have different certificate procedures
  - Complications can arise when dealing with multiple regulators
- No federal eminent domain
  - Pipelines are largely dependent on state eminent domain authority, if any, to site both interstate and intrastate oil pipelines
  - Different states have different rules and regulations regarding eminent domain
  - Some states grant eminent domain authority to “public utilities” but not “common carrier” pipelines
Lack of Certainty with Respect to Rates and Service Terms

• Project sponsors and their lenders want to know the rates and service terms that will be in place when the pipeline goes into service

• Because no certificate is issued, FERC historically did not approve rates and terms and conditions of service until pipeline was constructed

• Throughput & Deficiency Agreements (“T&D Agreements”) for anchor shippers provide some level of certainty
  – Minimum revenue requirement
  – Lower “committed” rates
  – Typically not firm; subject to allocation but on preferred basis

• Declaratory orders from FERC also provide a level of certainty
Lack of Firm Capacity

• Common Carrier Regulation
  – Historically, no firm capacity
  – All interested and qualified shippers entitled to some reasonable percentage of usage
  – Historically, capacity allocated on a pro rata basis
  – Recent movement towards limited firm capacity

• Make a financial commitment without guarantee that capacity will be there?

• Issue can be partially mitigated through:
  – Historically-based prorationing
  – Premium rates for capacity free from prorationing
Limited Ability to Negotiate Rates

- A natural gas pipeline has the ability:
  - To negotiate a rate between the minimum and maximum rates set forth in its tariff
  - To negotiate rates, subject to certain parameters, that do not fall within the minimum and maximum rates set forth in tariff

- An oil pipeline is more limited in its ability to negotiate rates
  - ICA contemplated the establishment of rates by tariff without exception
  - Oil pipeline tariffs set forth stated rates – not range of minimum and maximum rates
  - Limited exceptions are relatively recent and rare:
    - Volume Discount Rates
    - Term Discount Rates
Conclusions
Conclusions

• The Shale Revolution has dramatically impacted the natural gas and liquids industries
• Will much needed new pipelines be constructed to move production from new supply basins?
• Answer will depend on large part on whether existing regulatory framework can accommodate new market realities
• Natural gas and liquids are linked, but regulatory challenges differ, especially as to infrastructure development
• Regulatory innovation is as important as technical innovation
Thank you

Kirk Morgan
Bracewell & Giuliani
202.828.5854
kirk.morgan@bglllp.com