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## Gas Marketing by the Operator Under a JOA—Unrecognized Regulatory Risks and Practical Solutions

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# GAS MARKETING BY THE OPERATOR UNDER A JOA—UNRECOGNIZED REGULATORY RISKS AND PRACTICAL SOLUTIONS

WILLIAM F. DEMAREST, JR.\*

## *I. Introduction*

Wellhead natural gas deregulation under the Natural Gas Policy Act of 1978<sup>1</sup> (NGPA) and the Wellhead Natural Gas Decontrol Act of 1989<sup>2</sup> (Decontrol Act), coupled with restructuring of the interstate natural gas pipeline industry under Commission Order No. 636 (Order No. 636),<sup>3</sup> have led to significant changes in the way natural gas is marketed and sold. Yet the role of operators of natural gas production properties (Operators) in marketing of joint working interest owners' production has changed comparatively little despite wholesale changes in the regulatory structure of the natural gas supply chain. Indeed, traditional arrangements under Joint Operating Agreements (JOAs) often do not reflect current federal regulatory policies. Many Operators continue to market or dispose of natural gas attributable to the interest of other joint working interest owners under JOAs developed long before, and without regard to, current natural gas transportation policies of the Federal Energy Regulatory Commission (Commission or FERC).

Recent changes in the enforcement powers of the Commission, particularly the ability to impose "civil penalties" of up to \$1 million per violation per day for violations of the Natural Gas Act (NGA)<sup>4</sup> or the

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1. Pub. L. No. 95-621, 92 Stat. 3350 (codified as amended at 15 U.S.C. §§ 3301-3432 (2006)).

2. Pub. L. No. 101-60, 103 Stat. 157 (amending 15 U.S.C. § 3431 (2006)).

3. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. STATS. & REGS. ¶ 30,939 (1992) [hereinafter Order No. 636], *order on reh'g*, Order No. 636-A, F.E.R.C. STATS. & REGS. ¶ 30,950 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *notice of denial of reh'g*, 62 F.E.R.C. ¶ 61,007 (1993), *aff'd in part and vacated and remanded in part*, United Dist. Cos. v. FERC, 88 F.3d 1105 (D.C. Cir. 1996), *order on remand*, Order No. 636-C, 78 F.E.R.C. ¶ 61,186 (1997).

4. Energy Policy Act of 2005, Pub. L. No. 1009-58, § 314(b)(1), 119 Stat. 594, 690-91 (2005) (adding new NGA § 22, 15 U.S.C. § 717u (2006)).

NGPA<sup>5</sup> and the Commission's continuing demand for strict compliance with the Shipper-Must-Have-Title Rule raise significant questions for Operators of natural gas production properties who market or otherwise dispose of natural gas attributable to non-taking working interest owners under out-dated JOAs. Failure to adjust traditional operating and marketing practices under JOAs containing problematic or ambiguous language could expose Operators to multi-million dollar civil penalties.

This article explores the regulatory risks associated with reliance by Operators on typical provisions of JOAs and suggests solutions based on well-recognized property law concepts.

## *II. Interstate Natural Gas Transportation Policy*

The Shipper-Must-Have-Title Rule and the related prohibition against certain "buy/sell" transactions are recognized hallmarks of federal open-access natural gas transportation policies. The evolution of these policies to favor uniform "capacity release" mechanisms over pipeline-specific "capacity brokering" programs, as well as the Commission's jurisdictional concerns relating to allocation of interstate transportation capacity, provide the context in which the Shipper-Must-Have-Title Rule and the related buy/sell prohibition were developed.<sup>6</sup> Understanding this context is important to appreciate fully the risk of violation of the Shipper-Must-Have-Title Rule or the buy/sell prohibition posed by some natural gas marketing arrangements under potentially problematic JOAs.

### *A. Origins of the Shipper-Must-Have-Title Rule*

Prior to Order No. 636, the Commission approved a number of pipeline-specific programs for "brokering" the firm transportation capacity of shippers (primarily converting firm sales customers) on interstate pipelines.<sup>7</sup> The common characteristic of these programs, the details of

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5. *Id.* § 314(b)(2), 119 Stat. at 691 (amending NGPA § 504(b)(6)(a), 15 U.S.C. § 3414(b)(6)(A) (2006)).

6. The term "buy/sell" refers to a "commercial arrangement where a shipper holding interstate pipeline capacity buys gas at the direction of, on behalf of, or directly from another entity (e.g., an end-user), ships that gas through its interstate pipeline capacity, and then resells an equivalent quantity of gas to the downstream entity at the delivery point." RRI Energy Inc. & RRI Energy Wholesale Generations, LLC, 132 F.E.R.C. ¶ 61,267, at P. 4 (2010) (citing *Williams Energy Marketing & Trading Co.*, 92 F.E.R.C. ¶ 61,219, at pp. 61,715-16 (2000)). As discussed below, these transactions are prohibited because they act as a barrier to open access transportation on interstate pipelines.

7. *E.g.*, *Algonquin Gas Transmission Co.*, Docket No. CP90-134-000, 53 F.E.R.C.

which varied from pipeline to pipeline, was the use of the firm shipper's capacity and priority-of-service to transport gas owned by a third-party.

Notably, the Shipper-Must-Have-Title "Rule" is nowhere to be found in the Code of Federal Regulations where formal regulations of the Federal Energy Regulatory Commission are codified. Rather, the "Rule" derives from a precedent established in a pipeline-specific tariff proceeding that has come to be applied generally to the interstate natural gas pipeline industry.

Thus, in *Texas Eastern Transmission Corp.*,<sup>8</sup> the Commission addressed perceived threats to open and non-discriminatory access to interstate pipeline transportation capacity posed by brokering of *transportation* capacity by interstate pipelines' converting firm *sales* customers. Jurisdictional sales customers had the ability to convert from firm sales service to firm transportation service. The Commission perceived the priority that these customers would enjoy for non-specific transactions as a threat to the competitive framework of open-access transportation. Consequently, the Commission imposed a tariff condition requiring that all shippers have title to the gas at the time the gas was delivered to Texas Eastern for transportation and while the gas was transported by the pipeline. This tariff condition is the origin of the Commission's Shipper-Must-Have-Title Rule.

In adopting the Shipper-Must-Have-Title Rule in *Texas Eastern*, the Commission stated:

The firm sales customer that transports gas to which it has title need not use that gas to supply the needs of its system. It may have Texas Eastern transport gas that the firm sales customer has bought in the field specifically for a customer. In short, the firm sales customer may use its priority to the pipeline's capacity to

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¶ 61,417 (1990); *CNG Transmission Corp.*, Docket No. CP86-311-004, 55 F.E.R.C. ¶ 61,189 (1991); *Columbia Gas Transmission Corp.*, Docket No. RP86-168-000 *et al.*, 49 F.E.R.C. ¶ 61,071 (1989); *High Island Offshore System*, Docket No. CP90-406-005, 53 F.E.R.C. ¶ 61,126 (1990), 57 F.E.R.C. ¶ 61,420 (1991); *Kern River Gas Transmission Co.*, Docket No. CP89-2047-000 *et al.*, 50 F.E.R.C. ¶ 61,069 (1990); *Mojave Pipeline Co.*, Docket No. CP89-1-000 *et al.*, 47 F.E.R.C. ¶ 61,200 (1989); 50 F.E.R.C. ¶ 61,069 (1990); *Oklahoma-Arkansas Pipeline Co.*, Docket No. CP90-187-000, 53 F.E.R.C. ¶ 61,019 (1990); *Texas Eastern Transmission Corp.*, Docket No. CP88-136-007, 48 F.E.R.C. ¶ 61,248 (1989), *clarified*, 48 F.E.R.C. ¶ 61,378 (1989), *order on reh'g*, 51 F.E.R.C. ¶ 61,170 (1990), *order on reh'g*, 52 F.E.R.C. ¶ 61,273 (1990); *Texas Gas Transmission Corp.*, Docket No. CP88-686-001, 55 F.E.R.C. ¶ 61,208 (1991); *Transcontinental Gas Pipe Line Corp.*, Docket No. CP88-328-004, 52 F.E.R.C. ¶ 61,277 (1990); *U-T Offshore Sys.*, Docket No. CP90-1874-000 (1990); 57 F.E.R.C. ¶ 61,418 (1991).

8. 37 F.E.R.C. ¶ 61,260 (1986).

act as an agent, or broker, of gas. What requiring the shipper to have title does is to limit the firm sales customer's use of that priority to the situation intended, namely, the situation where the customer assumes the risks of having [the interstate pipeline] transport gas the customer owns for the purpose of reselling.<sup>9</sup>

Notably, the Shipper-Must-Have-Title Rule predates FERC Order No. 636<sup>10</sup> and finds its roots in the Commission's unwavering commitment to promoting competition in natural gas markets by maximizing the opportunity for new market participants to gain access to interstate pipeline transportation capacity.

In this respect the Commission's focus on enforcement of the Shipper-Must-Have-Title Rule is more than slavish attention to a procedural technicality. The Shipper-Must-Have-Title Rule is the means by which firm interstate transportation capacity, previously controlled largely by converting pipeline system-supply sales customers, i.e., local distribution companies and municipal distribution systems (collectively LDCs), became available to independent natural gas marketers and producers. Without the Shipper-Must-Have-Title Rule, LDCs would likely have continued to control substantial amounts of firm interstate transportation capacity in excess of their system supply requirements. As a result, it is likely that many markets which are competitive today, especially end-use markets located "behind" LDC city-gates, would be far less competitive due to the inability of marketers and producers to access the firm pipeline transportation capacity to serve those markets. For these reasons, the Rule represents a distinguishing characteristic of the Commission's natural gas transportation policy. Violation of the Rule is properly perceived by the Commission as a fundamental threat to open and non-discriminatory access to interstate transportation capacity.<sup>11</sup>

#### *B. Evolution of the "Buy/Sell" Prohibition*

As a consequence of efforts by market participants to comply with the Shipper-Must-Have-Title Rule on interstate pipelines on which Commission-approved capacity brokering programs were in operation, a

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9. *Id.* at p. 61,685.

10. *See N. Ill. Gas Co.*, 70 F.E.R.C. ¶ 61,099, at p. 61,270 (1995); *Tex. E. Gas Corp.*, 62 F.E.R.C. ¶ 61,015, at p. 61,082 (1993).

11. *See, e.g., In re Tenaska Mktg. Ventures*, 126 F.E.R.C. ¶ 61,040 (2009) (Order Approving Stipulation and Consent Agreements). Ironically, the shippers who were the largest beneficiaries of the Rule, i.e., producers and independent gas marketers, have frequently violated the Rule.

practice developed within the industry whereby the shipper, the holder of the interstate transportation capacity, would: (i) purchase the gas to be transported (either from the ultimate recipient of the gas or from a third-party supplier designated by the ultimate recipient) at or prior to delivery of the gas to the interstate pipeline for transportation;<sup>12</sup> (ii) transport the gas utilizing the shipper's firm capacity on the transporting interstate pipeline; and (iii) resell the gas to the ultimate recipient following completion of the interstate transportation service.<sup>13</sup> Obviously, buy/sell transactions involving LDCs held the potential to provide discriminatory access to interstate pipeline transportation capacity to end-users behind the LDC-shipper's city gate. Consequently such arrangements are inherently anticompetitive. For that reason, such transactions became an early target of producer-shippers who feared they would be disadvantaged in competing for access to transportation capacity under such schemes.

As previously indicated, well before FERC Order No. 636, the Commission itself recognized policy concerns respecting capacity brokering in general and buy/sell programs in particular. Thus, in 1989, the California Public Utility Commission (CPUC) approved buy/sell programs for Southern California Gas Company (SoCal) and Pacific Gas and Electric Company (PG&E) to utilize with respect to their interstate transportation capacity on the interstate pipeline systems of El Paso Natural Gas Co. (El Paso) and Transwestern Pipeline Co. (Transwestern) serving California.<sup>14</sup> In February 1991, a group of producer/shippers filed a motion in the El Paso and Transwestern capacity brokering certificate proceedings<sup>15</sup> requesting the Commission to direct SoCal to conduct an "open season" in connection with its capacity brokering program.<sup>16</sup>

On March 20, 1991, a year prior to Order No. 636, the Commission issued a pair of orders amending El Paso's and Transwestern's blanket open-access transportation certificates under which the capacity brokering programs of each pipeline had been authorized.<sup>17</sup> The Commission also issued limited jurisdiction certificates to SoCal and PG&E authorizing their

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12. The "buy" in buy/sell transactions.

13. The "sell" in buy/sell transactions.

14. *In re* Gas Util. Procurement Practices & Refinements to the Regulatory Framework for Gas Utils., Dec. No. 90-09-089, 37 C.P.U.C.2d 583 (1990).

15. F.E.R.C. Docket Nos. CP88-433 and CP88-133.

16. Theoretically an "open-season" could have reduced the opportunity for anti-competitive discrimination by expanding access to the LDC's brokered capacity on a nondiscriminatory basis to all parties, not merely to end-users behind the LDC's city gate.

17. *El Paso Natural Gas Co.*, 54 F.E.R.C. ¶ 61,318 (1991); *Transwestern Pipeline Co.*, 54 F.E.R.C. ¶ 61,319 (1991).

participation in the pipelines' capacity release programs, effectively asserting federal regulatory jurisdiction over the operation of the LDCs' buy/sell programs.<sup>18</sup> SoCal and PG&E were required to file written procedures describing how they planned to implement the open access, nondiscriminatory requirements for the assignment of capacity imposed by the Commission.<sup>19</sup>

On April 19, 1991, both SoCal and PG&E made compliance filings seeking approval of buy/sell programs previously established under the auspices of the CPUC. SoCal included an overview of its buy/sell program, triggering another round of controversy over the CPUC-approved buy/sell programs. As a result, on August 14, 1991, the Commission issued orders rejecting SoCal's and PG&E's proposed capacity brokering programs and vacating the Commission's prior orders authorizing capacity brokering programs on the El Paso and Transwestern systems.<sup>20</sup> While the Commission acknowledged that it had previously approved transactions that shared characteristics of the CPUC-approved buy/sell programs, the Commission determined that it was necessary to examine more thoroughly SoCal's and PG&E's buy/sell programs.<sup>21</sup> The Commission therefore established a technical conference

to reexamine whether and to what extent "buy/sell" programs, such as are proposed in California, may have caused a shift of the regulatory control and allocation of interstate pipeline capacity away from the Commission to the state commissions and the LDCs they regulate.<sup>22</sup>

The Commission expressed its belief that access to interstate pipeline capacity must remain under the Commission's exclusive jurisdiction,<sup>23</sup> a belief that the Commission has continued to espouse in subsequent orders.<sup>24</sup>

This same jurisdictional concern had previously lead the Commission to reevaluate more generally its capacity brokering policies in a Notice of

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18. The assertion of federal jurisdiction effectively preempted CPUC authority over key aspects of SoCal's and PG&E's buy/sell programs previously approved by the CPUC. *See* 54 F.E.R.C. ¶ 61,318, at p. 61,988.

19. *See id.*

20. *El Paso Natural Gas Co.*, 56 F.E.R.C. ¶ 61,289 (1991); *Transwestern Pipeline Co.*, 56 F.E.R.C. ¶ 61,288 (1991).

21. 56 F.E.R.C. ¶ 61,288, at p. 62,120; 56 F.E.R.C. ¶ 61,289, at p. 62,133.

22. 56 F.E.R.C. ¶ 61,288, at p. 62,120; 56 F.E.R.C. ¶ 61,289, at pp. 62,132-33.

23. *Id.*

24. *See, e.g., N. Ill. Gas Co.*, 90 F.E.R.C. ¶ 61,308, at p. 62,000 (2000).

Proposed Rulemaking (NOPR).<sup>25</sup> This NOPR ultimately produced Order No. 636.<sup>26</sup> In its August 14, 1991 orders in *El Paso* and *Transwestern*, the Commission determined that the concerns regarding capacity brokering identified in the Order No. 636 NOPR were equally applicable to buy/sell transactions.<sup>27</sup>

### C. Order No. 636 and Companion Orders

In Order No. 636, the Commission adopted a uniform capacity release program applicable to all open-access interstate pipelines. The uniform capacity release program replaced the pipeline-specific capacity brokering programs which the Commission had previously approved.<sup>28</sup> In order to ensure that interstate pipeline transportation capacity was reallocated on the same basis on all pipelines, Order No. 636 mandated that all open-access interstate pipelines implement a capacity release program through which existing shippers could voluntarily reallocate all or part of their firm transportation capacity rights to any person who wanted to obtain that capacity.<sup>29</sup> Consistent with this mandate, the Commission also stated that it would not approve any new pipeline-specific capacity brokering programs.<sup>30</sup>

In a companion order to Order No. 636, the terms and conditions of all existing capacity brokering certificates were conformed to the Order No.

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25. See Notice of Proposed Rulemaking, *In re Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transp. Under Part 284 of the Comm'n's Regulations*, F.E.R.C. STATS. & REGS. ¶ 32,480, 56 Fed. Reg. 38,372 (1991) (codified at 18 C.F.R. Part. 284).

26. Order 636, *supra* note 3.

27. 56 F.E.R.C. ¶ 61,288, at p. 62,120; 56 F.E.R.C. ¶ 61,289, at p. 62,132-33.

28. Order No. 636, *supra* note 3, at 30,939; 18 C.F.R. § 284.8 (2008).

29. Order No. 636, *supra* note 3, at 30,418; 18 C.F.R. § 284.8. Under the Commission's capacity release program, the "releasing" firm transportation capacity holder advises the interstate pipeline of the conditions and extent under which the capacity holder wishes to release capacity. Unless the transaction involves a "prearranged" release, the pipeline posts the capacity release information and prospective replacement shippers have an opportunity to agree to the releasing customer's terms and conditions or to bid for the released capacity. The pipeline is required to resell the released capacity to the replacement shipper meeting the releasing customer's terms and conditions. In the case of a posted prearranged deal, the pipeline must contract with the replacement shipper if no better offer is received. If a better offer is received, the pipeline is required to give the firm entitlement holder's replacement shipper an opportunity to match the better offer, thereby preempting the prospective bidding shipper. *El Paso Natural Gas Co.*, 59 F.E.R.C. ¶ 61,031, at p. 61,078 (1992).

30. Order No. 636, *supra* note 3, at 30,416.



636 capacity release mechanism.<sup>31</sup> These adjustments were designed to eliminate the potential for firm capacity holders to discriminate unduly in their assignment of capacity, while facilitating the development of a secondary market in transportation capacity, a development that would itself be pro-competitive.<sup>32</sup>

In a second companion order to Order No. 636, the Commission specifically addressed the SoCal and PG&E buy/sell programs.<sup>33</sup> While these buy/sell arrangements technically satisfied the Commission's Shipper-Must-Have-Title Rule, they threatened attainment of the Commission's pro-competitive transportation policies by undermining the Commission's ability to control the secondary market in interstate pipeline transportation capacity, an objective the Commission sought to achieve through its capacity release program under Order No. 636.<sup>34</sup> The Commission viewed its jurisdictional responsibilities as requiring the Commission to prohibit the allocation of pipeline capacity through new buy/sell agreements after the effective date of a pipeline's capacity release program established under Order No. 636.<sup>35</sup> The decision to prohibit any new buy/sell transactions was premised, in large part, on the Commission's concurrent action in Order No. 636 to ensure that all interstate pipeline capacity reallocation was done under a uniform set of rules. The Commission expressed the belief that to permit new buy/sell transactions to utilize interstate pipeline capacity after the capacity release mechanism went into effect would frustrate the Commission's objective of a nationally uniform program.<sup>36</sup> The Commission concluded that allowing new buy/sell arrangements to be negotiated outside the capacity release mechanism would provide a major loophole, potentially inviting substantial circumvention of the capacity release program.<sup>37</sup>

The foregoing illustrates that, despite sound commercial reasons for arrangements that on their face satisfy the Shipper-Must-Have-Title Rule, the Commission has not hesitated to strike down such arrangements when necessary to preserve the Commission's commitment to its capacity release

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31. *Algonquin Gas Transmission Co.*, 59 F.E.R.C. ¶ 61,032, at p. 61,095 (1992).

32. 59 F.E.R.C. ¶ 61,031, at p. 61,080.

33. *El Paso Natural Gas Co.*, 59 F.E.R.C. ¶ 61,031.

34. *Id.* at pp. 61,079-80.

35. *Id.* at p. 61,080. Nevertheless, the Commission concluded that its "exclusive jurisdiction over access to interstate pipeline capacity" did not require the Commission to terminate all existing buy/sell transactions. *Id.*

36. *Id.*

37. *Id.*

program as one of the foundations of federal open-access transportation policy.

*D. Waivers of Shipper-Must-Have-Title*

Since establishing the capacity release program, the Commission has granted few waivers of the Shipper-Must-Have-Title Rule, generally preferring that the industry modify its commercial arrangements to accommodate the Rule rather than vice versa. Thus, the Commission has issued limited waivers of the Shipper-Must-Have-Title Rule to facilitate state retail unbundling programs,<sup>38</sup> but denied a request for waiver of the Shipper-Must-Have-Title Rule and capacity release regulations to permit a shipper to transfer title in transit in order to avoid the state gross receipts tax in New York.<sup>39</sup> Indeed, although the Commission granted a limited waiver of the buy/sell prohibition to facilitate the Minerals Management Service's Royalty-In-Kind program,<sup>40</sup> the mere fact of the waiver illustrates the reach of the Rule in that no exception to the Rule could be implied from the existence of another agency's regulatory program.

More recently, in Order No. 712, the Commission has approved limited exceptions to aspects of the capacity release program under narrowly defined circumstances.<sup>41</sup> Significantly, these limited waivers did *not* waive the requirement that the shipper have title to the gas.<sup>42</sup> Equally significant, for purposes of evaluating the potential application of the Shipper-Must-Have-Title Rule to gas marketing arrangements under JOAs, Order No. 712 did not extend the waivers granted in the Order to such gas marketing arrangements.

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38. *E.g.*, *Atlanta Gas Light Co.*, 84 F.E.R.C. ¶ 61,119 (1998), *order on compliance filing*, 85 F.E.R.C. ¶ 61,102 (1998); *Nat'l Fuel Gas Distribution Corp.*, 86 F.E.R.C. ¶ 61,179 (1999); *Atlanta Gas Light Co.*, 88 F.E.R.C. ¶ 61,150 (1999).

39. *Enron Energy Servs., Inc.*, 84 F.E.R.C. ¶ 61,222 at p. 62,063 (1998), *order granting clarification and denying reh'g*, 85 F.E.R.C. ¶ 61,221, at p. 61,905 (1998) (clarifying that the Shipper-Must-Have-Title Rule applies even when an emergency arrangement exists between the shipper and a third party).

40. *Williams Energy Mktg. & Trading Co.*, 92 F.E.R.C. ¶ 61,219 (2000).

41. Order No. 712, *Promotion of a More Efficient Capacity Release Market*, 123 F.E.R.C. ¶ 61,286, at PP 148-53 (2008) (codified at 18 C.F.R. § 284.8 (2008)).

42. *Id.* at P 152 n.147. The Commission did grant a limited exception to the buy/sell prohibition. *Id.* at P 165.

### III. Regulatory Issues for Operators of Gas Producing Properties

#### A. Interstate Pipeline Tariff Issues

For Operators, the threshold inquiry concerning potential risks posed by the Shipper-Must-Have-Title Rule is the extent to which such risks are obviated by pipeline tariff language. As demonstrated below, subject to a single limited exception, Commission-approved tariff language does not provide protection against imposition of substantial civil penalties on Operators/shippers who market natural gas attributable to non-taking working interest owners pursuant to common JOA language if such arrangements violate the Shipper-Must-Have-Title Rule.

##### 1. *Florida Gas Transmission Co.*, 64 FERC ¶ 61,302 (1993)

In *Florida Gas Transmission Co. (FGT I)*,<sup>43</sup> as part of a settlement of restructuring dockets implementing Order No. 636 on the pipeline system of Florida Gas Transmission Co. (Florida Gas Transmission), the pipeline included tariff language providing a “good right to acquire title” exception to the rule that a shipper must have title to the gas it transports. The Commission noted that it had barred “most exceptions” to the Shipper-Must-Have-Title Rule, including one for shippers who merely have the “good right to deliver” the gas but who otherwise lack title.<sup>44</sup> Consequently, the Commission required Florida Gas Transmission to eliminate the offending tariff language except insofar as it permitted a shipper with authority to market gas on behalf of a co-working interest owner to satisfy the title requirement by warranting that it has good right to deliver the gas.<sup>45</sup> Regrettably, neither *FGT I*, nor its later companion case, *Florida Gas Transmission Co. (FGT II)*,<sup>46</sup> provided any further explanation or discussion of the authorized exception to the Shipper-Must-Have-Title Rule for gas owned by a co-working interest owner where the shipper is authorized to market the gas.

To the author’s knowledge, the tariff language approved by the Commission in *FGT I* is the only express tariff exception to the Shipper-Must-Have-Title Rule for Operator/shippers transporting gas owned by a

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43. 64 F.E.R.C. ¶ 61,302 (1993).

44. *Id.* at p. 63,206 n.25.

45. *Id.* at pp. 63,206-07; *see also Fla. Gas Transmission Co. (FGT II)*, 65 F.E.R.C. ¶ 61,336, at p. 62,593 (1993). The language the Commission ordered deleted would have allowed a much broader exception, which in the Commission’s view would have permitted the reinstatement of capacity brokering in the market area. 65 F.E.R.C. 61,336, at p. 62,593.

46. 65 F.E.R.C. ¶ 61,336.

joint working interest owner where the Operator/shipper is authorized to “market” the gas, typically under the terms of the JOA covering operations of the producing property from which the gas was produced. A search of tariff language through the Commission’s e-Library failed to disclose any other interstate pipeline tariffs with similar language.

2. “*Right To Deliver*” vs. “*Title*” To Gas

A number of interstate pipeline tariffs contain language under which the shipper must warrant that it either has “title” to the gas to be transported or the “right to deliver” such gas. The threshold question, therefore, is whether such tariff language constitutes an implied exception to the Shipper-Must-Have-Title Rule for Operators of natural gas properties delivering gas of non-operating working interest owners under the provisions of a JOA. Commission precedents directly on point strongly suggest that such tariff language does not provide such an exemption and that reliance on such tariff language by Operator/shippers may unwittingly expose them to substantial civil penalties for violation of the Shipper-Must-Have-Title Rule.<sup>47</sup>

a) *Northern Natural Gas Co., Docket No. RP89-23-000*

In another Commission proceeding, Docket No. RP89-23-000, Northern Natural Gas Company (NNG) proposed, and the Commission initially approved, tariff language which would have permitted transportation of gas by NNG for shippers who warranted having *either* title to the gas or “good right to deliver” the gas.<sup>48</sup> *NNG I* was *not* the Commission’s final word on the subject, however. On April 10, 1989, the Commission granted NNG’s request for rehearing<sup>49</sup> and approved deletion of the phrase “or good right to deliver” from NNG’s tariff, provided that NNG included language consistent with the Commission’s “current policy.”<sup>50</sup> The Commission subsequently made clear precisely what its “current policy” was.

Following Commission action on an intervening compliance filing by NNG,<sup>51</sup> on September 22, 1989, the Commission issued an order explaining that the Commission’s “current policy” referenced in *NNG II* was to “allow shippers . . . to transport gas only if they have good title to the gas or a

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47. *E.g.*, 64 F.E.R.C. ¶ 61,302, at p. 63,206 n.25.

48. *N. Natural Gas Co. (NNG I)*, 45 F.E.R.C. ¶ 61,410, at p. 62,297 (1988).

49. *N. Natural Gas Co. (NNG II)*, 47 F.E.R.C. ¶ 61,040 (1989).

50. *Id.* at p. 61,115.

51. *N. Natural Gas Co. (NNG III)*, 47 F.E.R.C. ¶ 61,463 (1989).

contractual right to acquire title to such gas.”<sup>52</sup> *NNG IV* made clear that it was not sufficient for the shipper to have only the “right to acquire title” *at the time of delivery* of the gas to NNG for transportation.<sup>53</sup> Rather, the Commission unequivocally stated that “the Commission’s policy is that the shipper must have actual title to the gas at the time of delivery, i.e., before the pipeline commences service.”<sup>54</sup>

Notably, in *FGT II* the Commission responded to the contention by an LDC supplied by Florida Gas Transmission that the Commission had acted arbitrarily and capriciously in rejecting an exception to the Shipper-Must-Have-Title Rule in the market area, while permitting a supply-area exception for Operator/shippers marketing gas of joint working-interest owners. In *FGT II* the Commission cited *NNG I* for the dubious proposition that the Commission had properly differentiated the market area from the supply area.<sup>55</sup> In light of the reversal of *NNG I* in *NNG II* and *NNG IV*, the Commission’s citation of *NNG I* in *FGT II* can, at best, be described as inexplicable. More importantly, this questionable citation cannot be viewed as breathing new life into *NNG I*.

*b) Columbia Gas Transmission Co., Docket No. RS92-5-000*

In *Columbia Gas Transmission Corp.*,<sup>56</sup> the Commission accepted language in the tariffs of both Columbia Gas Transmission Corp. (Columbia) and Columbia Gulf Transmission Co. (Columbia Gulf) authorizing transportation for a shipper which had either title to the gas or

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52. *N. Natural Gas Co. (NNG IV)*, 48 F.E.R.C. ¶ 61,350, at p. 62,147 (1989) (citing *W. Tex. Gathering Co.*, 45 F.E.R.C. ¶ 61,483, at p. 62,508 (1988)). *NNG IV* also granted NNG’s request for rehearing with respect to the *timing* of when the shipper must warrant it has title. Notably, the question of whether the shipper must have title at the time the gas was delivered for transportation (and not merely a “good right to deliver” the gas) was no longer at issue. The Commission explained:

The Commission stated in *West Texas Gathering* that a shipper is required to submit a letter with a request for service, certifying that the shipper has title to the gas or a contractual right to acquire title. As Northern correctly states, allowing shippers to guarantee that they have the right to acquire title to natural gas, as an alternative to requiring that they have good title, is appropriate *at the time of the request for transportation service* . . . .

*Id.* at p. 62,148 (emphasis added).

53. *Id.* at p. 62,148.

54. *Id.*

55. *FGT II*, 65 F.E.R.C. ¶ 61,336, at p. 62,595 (1993).

56. 64 F.E.R.C. ¶ 61,060 (1993).

the “right to receive gas . . . at the delivery point.”<sup>57</sup> In explaining these provisions, the Commission stated:

Columbia proposes to add two new sections to its General Terms and Conditions. Section 23 provides that shippers have good title or right to receive gas free of liens at the delivery point, and indemnifies Columbia from adverse consequences in the event of breach of the warranty. Section 24 provides that the gas delivered to Columbia at the receipt point be eligible for transportation in interstate commerce and under the Commission’s regulations. This section also indemnifies Columbia from adverse consequences in the event of breach of the warranty. In reply comments, Columbia proposes to revise these sections to clarify that these requirements may not be used to hold a releasing shipper liable for a replacement shipper’s conduct.<sup>58</sup>

Subsequently, in *FGT II*, the Commission explained that this provision of the Columbia and Columbia Gulf tariffs does not serve to circumvent capacity release. Rather, the Commission explained that it had relied on Columbia’s explanation that the language exists so that a releasing shipper may not be held liable for a replacement shipper’s conduct.<sup>59</sup> Notably, in *FGT II* the Commission also observed that section 24 of Columbia’s tariff provides that the gas delivered to Columbia at the receipt point “must be eligible for transportation in interstate commerce under the Commission’s regulations”—in other words, that the shipper must have title to the gas.<sup>60</sup> This observation is significant because many interstate pipeline tariffs also contain similar generic regulatory compliance provisions which, under the rationale expressed by the Commission in *FGT II*, would trump generic “right-to-deliver” tariff language<sup>61</sup> and prevent interpretation of such language as constituting an implicit exception to the Shipper-Must-Have-Title Rule.

The Commission’s explanation in *FGT II* that its approval of “right to deliver” language in *Columbia Gas* did not establish an exception to the

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57. *Id.* at p. 61,559 (emphasis added). The pertinent provisions of the Columbia and Columbia Gulf tariffs were identical. *Id.* at p. 61,498.

58. *Id.* at p. 61,559.

59. 65 F.E.R.C. ¶ 61,336, at p. 62,593.

60. *Id.*

61. The “right to receive” language in the Columbia tariff is a variant on the “right to deliver” language more commonly found in interstate pipeline tariffs.

Shipper-Must-Have-Title requirement, where the purpose of the language was indemnification,<sup>62</sup> is consistent with the Commission's rejection of such language in *NNG II* where the purpose of the language was to establish such an exception. In this respect, therefore, both *Columbia Gas* and *FGT II* are consistent with *NNG II* and *NNG IV* in rejecting an exception to the Shipper-Must-Have-Title Rule based on "right to deliver" language.

c) *Kansas Pipeline Co., Docket No. CP96-152-29*

The *Kansas Pipeline* proceeding is better known for the Commission's actions to collapse a scheme under which KansOk Partnership and its affiliates sought to avoid NGA certificate regulation through a linked series of "intrastate pipelines," providing NGPA Section 311 service<sup>63</sup> with interconnecting "sausage link" interstate pipelines located only at the actual crossing of state borders.<sup>64</sup> Following the Commission's determination that the affiliated pipelines were a single, integrated jurisdictional interstate pipeline subject to regulation under the NGA,<sup>65</sup> the Commission had occasion to address tariff language proposed by Kansas Pipeline in a Compliance Filing.<sup>66</sup> The proposed tariff language provided that "... both Shipper and Kansas Pipeline warrant that it shall, at the time of delivery of Gas to the other, have good title to or good right to deliver all such Gas, . . ."<sup>67</sup> In ordering the language struck from the tariff, the Commission stated, "This language is rejected without prejudice to Kansas Pipeline revising this language to be compliant with the 'Shipper has title rule'."<sup>68</sup> Thus, the *Kansas Pipeline* proceeding provides further explicit rejection by the Commission of tariff language which, if accepted, might arguably have constituted an implicit exception to the Shipper-Must-Have-Title Rule.

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62. 65 F.E.R.C. ¶ 61,336, at p. 62,593.

63. Under NGPA Section 311(a)(2), a non-jurisdictional "intrastate" pipeline may provide "interstate" transportation service "on behalf of" statutorily identified "eligible beneficiaries" without becoming subject to regulation as an "interstate pipeline" under the NGA. 15 U.S.C. §§ 3371(a)(2), 3431(a)(2) (2006).

64. *KansOk Partnership*, 71 F.E.R.C. ¶ 61,242 (1995) (Order to Show Cause); *KansOk Partnership*, 73 F.E.R.C. ¶ 61,160 (1995), *stayed in part*, 73 F.E.R.C. ¶ 61,293 (1995); *Kan. Pipeline Co.*, 81 F.E.R.C. ¶ 61,005 (1997), *order on reh'g*, 83 F.E.R.C. ¶ 61,107 (1998).

65. 81 F.E.R.C. ¶ 61,005, at p. 61,001.

66. *Kan. Pipeline Co.*, 87 F.E.R.C. ¶ 61,020 (1999).

67. *Id.* at p. 61,072, app. A (quoting proposed tariff Section 18.1).

68. *Id.*

*d) Cheyenne Plains Tariff*

Another variant on tariff language which could be argued to constitute an implicit exception to the Shipper-Must-Have-Title Rule appears in the tariff of Cheyenne Plains Gas Pipeline Company, LLC (Cheyenne Plains). Section 7 of the General Terms and Conditions (GT&C) of Cheyenne Plains' currently effective tariff merely requires that the shipper have the "right to ship" the gas delivered for transportation. Standing alone, this tariff language arguably might not require the shipper to have title to the gas being transported, so long as the shipper has "the right to ship the gas."

Several affiliated shippers, who held capacity on Cheyenne Plains, claimed to have "the right to ship" gas owned by their common parent using the capacity held by each of the shipper-affiliates.<sup>69</sup> Despite the quoted tariff language, Commission Enforcement Staff asserted that the affiliates violated the Shipper-Must-Have-Title Rule by transporting gas owned by the affiliates' common parent on capacity held by the affiliates.<sup>70</sup>

The question of whether the "right-to-ship" language constitutes an exception to the Shipper-Must-Have-Title Rule may not turn on construction of Section 7 of the GT&C of the Cheyenne Plains tariff itself. Rather, as the Commission noted in *FGT II* with respect to the Columbia Gas and Columbia Gulf tariffs, the issue may turn on Section 4.13 of the GT&C of the Cheyenne Plains tariff:

4.13 Statutory Regulation

The respective obligations of Transporter and Shipper under the [Transportation Service Agreement] are subject to the laws, orders, rules and regulations of duly constituted authorities having jurisdiction.

This provision, like those in the Columbia/Columbia Gulf tariffs construed by the Commission in *FGT II* as requiring compliance with the Shipper-Must-Have-Title Rule, could be interpreted to preclude reading the "right to ship" language of Section 7 of the GT&C of the Cheyenne Plains tariff as an implicit exception to the Shipper-Must-Have-Title Rule.

*3. Conclusion*

Absent language as explicit and narrow as that found in the tariff of Florida Gas Transmission, interstate pipeline tariff provisions do not

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69. *Nat'l Fuel Mktg. Co.*, 126 F.E.R.C. ¶ 61,042 (2009) (Order to Show Cause and Notice of Proposed Penalties).

70. *Id.*



provide an exception to the Shipper-Must-Have-Title Rule for Operator/shippers who transport natural gas attributable to a joint working interest owner. Commission precedents clearly preclude reliance on “right to deliver” or equivalent tariff language<sup>71</sup> as creating an implicit exception to the Shipper-Must-Have-Title Rule. Indeed, other tariff language requiring that transportation service under the tariff be fully compliant with all applicable Commission regulations, which implicitly includes the Shipper-Must-Have-Title Rule, may also preclude reliance on such tariff language to establish an exception to the Shipper-Must-Have-Title Rule.

*B. Issues Posed By Joint Operating Agreements*

The implications of the Shipper-Must-Have-Title Rule for transportation of gas attributable to the ownership interest of non-taking interest owners and marketed by an Operator under a JOA are made clear by a letter order issued by the Commission to Southern Natural Gas Company in Docket No. RP01-205-017.<sup>72</sup> In that order, the Commission approved a “Master FT Agreement” setting forth “one overall contractual entitlement to service, which [several] shippers share.”<sup>73</sup> In approving the Master FT Agreement, however, the Commission imposed several conditions “[i]n order for [the] arrangement to comply with the Commission’s Shipper-Must-Have-Title Rule.”<sup>74</sup> Among these is the requirement that “all shippers under the Master FT Agreement are jointly and severally liable for all payment obligations for the total Master contract transportation quantity.”<sup>75</sup> The Commission explained that if the individual shippers under the Master FT Agreement are not liable for the total charges under the Agreement, they “would be in violation of the Commission’s shipper-must-have-title policy to the extent they used capacity in excess of that for which they were liable to pay.”<sup>76</sup> Typical Operator marketing arrangements fail to meet this test, potentially exposing the Operator to civil penalties for violation of the Shipper-Must-Have-Title Rule.

Determining whether specific transportation activities of an Operator violate the Shipper-Must-Have-Title Rule may turn on specific language of a JOA or application of state property law. Specifically, determination of who “owns” the natural gas being transported by an Operator of a

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71. Such as the “right to ship” language in the Cheyenne Plains tariff.

72. *S. Natural Gas Co.*, 124 F.E.R.C. ¶ 61,145 (2008).

73. *Id.* at P 12.

74. *Id.*

75. *Id.*

76. *Id.*

producing property, where the gas is attributable to the interests of third-party working interest owners who did not take and dispose of their share of production, appears to be critical to compliance. As discussed below, typical JOA language authorizing the Operator to “market” or “dispose of” production attributable to non-operating working interest owners who do not take their share of production may *not* provide protection against violation of the Shipper-Must-Have-Title Rule. By contrast, reliance on the law of cotenancy-in-common generally provides a sound foundation for assuring compliance with the Shipper-Must-Have-Title Rule.

It is impossible to draw specific conclusions respecting the regulatory risks posed by Joint Operating Agreements because the pertinent language varies so much among JOAs. Admittedly, the regulatory risks identified in this article are not associated with every JOA. Nevertheless, the magnitude of the potential economic consequences of violating the Shipper-Must-Have-Title Rule warrant examination of specific JOA language to determine whether the JOA presents a substantial regulatory risk. While it is not possible to do so comprehensively in an article such as this, examination of representative JOA language is illustrative and can provide useful guidance for examination of specific JOA language.

The following representative language, typical of that found in many JOAs, is excerpted from an actual JOA:

In the event any party shall fail to make the arrangements necessary to take in kind or separately dispose of its proportionate share of the oil and/or gas produced from the Contract Area, *Operator shall have the right, . . . but not the obligation, to purchase such oil and/or gas or sell it to others . . . for the account of the non-taking party at the price which operator is receiving for its production. Any such purchase or sale by Operator shall be subject always to the right of the owner of the production to exercise at any time its right to take in kind, or separately dispose of, its share of all oil and/or gas not previously delivered to purchaser. Any purchase or sale by Operator of any other party's share of oil and/or gas shall be only for such reasonable periods of time as are consistent with the minimum needs of the industry under the particular circumstances, but in no event for a period in excess of thirty (30) days.*

The italicized language of the illustrative JOA text clearly contemplates one of two transactions:

1. a “purchase” by the Operator of the “non-taking party’s” share of production (option 1); or
2. a “sale” by the Operator of the “non-taking party’s” share of production “to others . . . for the account of the non-taking party” (option 2).

This ambiguity is a source of regulatory risk which may manifest itself as exposure to civil penalties.

The first construction (option 1) generally would not expose the Operator to risks of civil penalties from violation of the Shipper-Must-Have-Title Rule because the Operator would own the gas. However, absent documentation (which is frequently missing or non-existent) that the Operator has *actually* purchased the gas under option 1, there is little to assure that the JOA will be construed in such a favorable manner. This risk is heightened if the actual conduct of the Operator contradicts such a theoretical construction, which is often the case where the Operator’s “marketing” activities are more consistent with an agency relationship than an outright purchase.

If not accompanied by a prior “purchase” transaction (option 1), the second option involves characteristics of an agency relationship which, in practice, is typical of the “marketing” activities undertaken by many Operators with respect to gas attributable to a “non-taking party’s” working interest. If the JOA is construed as establishing an agency relationship (option 2), **the utilization by the Operator/shipper of its own interstate pipeline transportation capacity to transport natural gas owned by a non-taking working interest owner in connection with the “marketing” of such gas by the Operator is likely to be found to violate the Shipper-Must-Have-Title Rule and thereby expose the Operator/shipper to substantial civil penalties.**<sup>77</sup>

#### *IV. Alternatives to Reduce Regulatory Risks*

The foregoing discussion of potential regulatory risks raises the question of how to reduce the risks inherent in ambiguous JOA language and thereby increase the likelihood of regulatory compliance. What follows are three alternatives to reduce regulatory risk:

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77. Marketing of a non-operating working interest owner’s gas under a JOA would present regulatory problems under the Commission’s buy/sell prohibition only in the unlikely event that the Operator sold the gas back to the non-operating working interest owner following the transportation of the gas in interstate commerce.

- The first alternative is to revise potentially ambiguous JOA language to recognize expressly the issues associated with compliance with the Shipper-Must-Have-Title Rule and to eliminate the ambiguity which typifies “traditional” JOA provisions dealing with disposition of production attributable to the working interest of a non-taking interest owner. For reasons discussed below, this is often easier said than done.

- The second alternative is to establish documentation and accounting practices which comport with a reading of existing ambiguous JOA language in a manner which reduces the risk of violating the Shipper-Must-Have-Title Rule. This alternative has the practical advantage that it may be easier to implement. Nevertheless, this alternative is not without its own drawbacks as discussed below.

- State property law principles governing ownership of property as cotenants-in-common may provide a third alternative to reduce or eliminate regulatory risks posed by ambiguous JOA language.<sup>78</sup> **Depending on state law, reliance on common law principles governing cotenancy-in-common may be preferable for reducing regulatory risk to either of the alternatives considered in this article.**

#### *A. Amending Existing JOA Provisions*

As suggested, one alternative is to revise potentially ambiguous JOA language to recognize expressly the issues associated with compliance with the Shipper-Must-Have-Title Rule and eliminate the ambiguity which typifies “traditional” JOA provisions dealing with disposition of production attributable to the working interest of a non-taking interest owner. In each case, the amendatory language must be tailored to the specific, potentially problematic JOA language. In this regard, the problematic language on which an amendment must focus is any language which can be construed as establishing an agency relationship under which it may be argued that an Operator/shipper, who is marketing a non-taking interest owner’s share of production, lacks “title” to the gas during transportation of the gas by an interstate pipeline. The amendment must render such language inoperative. By contrast, JOA language which clearly places the Operator in an ownership position, e.g., language under which the Operator purchases the non-taking interest owner’s share of production, should be preserved and

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78. Ironically, in at least one respect, the law of cotenancy-in-common *increases* the risks inherent in ambiguous JOA language by reducing the likelihood that such language will be construed as consistent with a low-regulatory-risk purchase by the Operator (option 1) rather than a sale (option 2) under a high-regulatory-risk agency relationship.

made the **exclusive remedy** for the non-taking interest owner's failure to take.

This approach is not without practical difficulties. First, this approach requires a case-by-case review of JOA language. Where a single Operator operates different properties under multiple JOAs, such case-by-case review can become especially burdensome. In addition, where multiple JOAs exist, this approach may entail multiple "fixes" tailored to curing differing JOA language. The need for different amendments to specific JOAs can be difficult to implement and challenging to administer over time. Second, JOAs are typically complex documents with multiple interrelated provisions. Drafting targeted amendments to such Agreements presents its own challenges.

However, an even bigger challenge for the Operator desiring to implement such amendments may be anticipated in the form of requests by non-operating interest owners to modify *other* provisions of the JOA (with which the Operator may be perfectly content). Non-operating interest owners may be expected to be unsympathetic to the "problem" facing the Operator—the common view may be that it is, after all, the Operator's problem. Moreover, the inherent complexity of most JOAs may tend to make non-operators leery of any modification, with the "if it ain't broke, why fix it" mentality coming to the fore. Under such circumstances, obtaining affirmative consent of all the joint interest owners to a single amendment may be especially difficult.

#### *B. Documentation and Accounting Procedures*

The second alternative involves development of documentation, including accounting procedures, to support the contention that the actual practice of the Operator under arguably ambiguous JOA language has been consistent with a construction which does not lead to violation of the Shipper-Must-Have-Title Rule. This alternative is not without its own challenges. Such documentation would be designed to confirm the "purchase" of the non-taking working interest owners' gas by the Operator. The difficulty is that the most credible forms of such documentation would involve some confirmation from the non-taking interest owner. For some of the same reasons that it may be difficult to obtain the consent of the non-taking interest owner to amend the JOA, non-taking interest owners may be reluctant to execute documentation confirming a sale of the non-taking interest owner's gas to the Operator.

In addition to appropriate documentation, the effectiveness of this alternative requires the Operator's internal accounting practices to be

consistent with a wellhead purchase and sale transaction. The degree of difficulty involved in assuring such consistency will vary depending on the company and its historic accounting policies. The challenge of assuring compliance should not, however, be underestimated.

This solution is also not without risks of undesirable economic consequences. This is likely to be an especially serious concern where federal royalty rules apply, and may also be a concern under non-federal leases depending on the royalty calculation principles in effect under the royalty language of the leases involved.<sup>79</sup>

### *C. Property Law—Ownership Of Oil And Gas*

Depending on specific state property law, the third and (in the author's opinion) preferable alternative is to rely on the law of cotenancy-in-common to avoid the problems presented by ambiguous JOA language regarding the Operator's actions with respect to gas attributable to the interest of the non-taking interest owner.

#### *1. Cotenancy-In-Common*

The seminal case in the field is *Earp v. Mid-Continent Petroleum Corp.*<sup>80</sup> *Earp* defined the relationship among and between working interest owners in oil and gas leases as that of cotenants-in-common. The courts of Oklahoma and other producing states have strictly adhered to the principle established in *Earp*.<sup>81</sup> In *Torgeson*, the Supreme Court of Wyoming succinctly described the critical rights of such cotenants under circumstances pertinent here:

The owners of undivided portions of oil and gas rights in and under real estate are tenants in common and each of them may enter upon the premises to explore for and develop gas and oil.<sup>82</sup>

While courts have consistently recognized one cotenant's general right to develop and dispose of a well's production without the consent of another

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79. Analysis of the application of royalty rules to the Operator's purchase of the non-taking interest owner's gas is beyond the scope of this article. It is sufficient to note that such a purchase arrangement may affect the royalty burden for the non-taking interest owner.

80. 27 P.2d 855, 858 (Okla. 1933).

81. See, e.g., *Anderson v. Dyco Petrol. Corp.*, 782 P.2d 1367, 1371 (Okla. 1989); *Byrom v. Pendley*, 717 S.W.2d 602, 605 (Tex. 1986); *Fife v. Thompson*, 708 S.W.2d 611 (Ark. 1986); *Dilworth v. Fortier*, 405 P.2d 38, 49 (Okla. 1964); *Torgeson v. Connelly*, 348 P.2d 63, 70 (Wyo. 1959).

82. *Torgeson*, 348 P.2d at 70.

cotenant, several cases have also addressed the narrower question of whether this right enables one cotenant to sell one hundred percent of current production when another cotenant is unable or chooses not to sell its proportionate share of the production.<sup>83</sup> In *Anderson*, Panhandle Eastern Pipeline Company (Panhandle) purchased natural gas from various working interest owners with which Panhandle had contracted. Panhandle refused, however, to purchase gas from the working interest owners of the well with which Panhandle had not contracted. The non-contracted owners brought an action against Panhandle for conversion of their gas, seeking an order requiring Panhandle to purchase the uncontracted working interest owners' share of production (or to pay the uncontracted working interest owners their proportionate share of the proceeds from Panhandle's purchase of the full well stream). The Oklahoma Supreme Court rejected the premise of this claim on the ground that "because each cotenant has the right to . . . market production under the common law," sale of the production by one cotenant ordinarily does not involve conversion of the uncontracted cotenant's gas by the purchaser.<sup>84</sup>

**Thus, the "majority rule" is that when one cotenant-in-common chooses not to take and dispose of its proportionate share of oil or gas, the other cotenants have the right to take, sell and dispose of the non-taking owner's share of the oil or gas** (subject to the obligation to account) and an imbalance is created.<sup>85</sup> Although the courts generally do not speak in terms of who holds "title" to the production taken by the taking interest owner in excess of its proportionate working interest share (where not all working interest owners exercise their right to take their share of production in kind), **it appears to be reasonably well settled that title to the production vests in the taking interest owner at the time of production** and no "purchase" of production from the non-taking interest owner by the taking interest owner is involved.<sup>86</sup> Thus, application of the

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83. *E.g.*, *Anderson*, 782 P.2d 1367; *Kaiser-Francis Oil Co. v. Producer's Gas Co.*, 870 F.2d 563, 569-70 (10th Cir. 1989).

84. *Anderson*, 782 P.2d at 1371-72. Much of the case law relating to cotenancy-in-common of natural gas pertains to the obligation of a selling cotenant to "account" to the non-selling cotenant.

85. *Torgeson*, 348 P.2d at 70. This is true unless a contemporaneous accounting occurs, in which case no imbalance exists. Any imbalance which is created may be resolved by balancing in-kind or by cash balancing, either on a periodic basis or at the end of production. *See Kaiser-Francis*, 870 F.2d at 569-70 (discussing forms of balancing); Eugene Kuntz, *Gas Balancing Rights And Remedies In The Absence Of A Balancing Agreement*, 35 ROCKY MTN. MIN. L. INST. 13.03[2] (1989) (discussing majority and minority rules).

86. David E. Pierce, *The Law of Disproportionate Gas Sales*, 26 TULSA L.J. 135, 140

common law rules governing cotenancy-in-common should be dispositive of the “ownership” issue for natural gas regulatory purposes.

### 2. JOAs and “Cotenancy-Like” Relationships

The subject becomes more complicated (not to say muddled), however, where so-called “cotenancy-like” relationships are created under other contractual arrangements, including, for example, Joint Operating Agreements.<sup>87</sup> Professor Pierce points out that “reported cases have failed to clearly distinguish between common law cotenancy and cotenant-like relationships created by contract.”<sup>88</sup>

A number of cases discuss whether language in JOAs establishes the existence of “cotenancy like” ownership of the natural gas or oil production.<sup>89</sup> Unfortunately, the cases are far from clear as to the attributes of “cotenancy like” relationships created under JOAs as compared to the well-established characteristics and consequences of common law cotenancy-in-common. Also less than clear is the potential for provisions of a JOA to undermine the otherwise applicable consequences of the law of cotenancy-in-common to ownership of oil or natural gas in excess of a cotenant’s proportionate working interest share, where the other cotenants choose not to “take” their share of production in kind. Thus, the case law is consistent with the previous observations in this article respecting the inherent ambiguity in common JOA language and the potential regulatory risks flowing from such ambiguity where ownership rather than an agency relationship is essential to compliance with the Shipper-Must-Have-Title Rule.

### 3. Structuring Transactions To Reduce Regulatory Risk

Relying on the existence of common law cotenancy-in-common under the oil and gas leases is preferable to reliance on the terms of the JOA as the basis for the shipper’s “ownership” of the production not taken by the non-operating working interest owner in the leases. Unlike the first alternative, which may require the consent of the non-operating interest owners to

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(1990) (the production “is owned” solely by the taking cotenant); Kuntz, *supra* note 85, at 13.03[3] (non-taking cotenant has no “ownership” in production taken by the taking cotenant).

87. See Pierce, *supra* note 86, at 141; Harrell v. Samson Res. Co., 980 P.2d 99, 103 (Okla. 1998).

88. Pierce, *supra* note 86, at 141.

89. See, e.g., Harrell, 980 P.2d at 103; Doheny v. Wexpro Co., 974 F.2d 130, 134 (10th Cir. 1992) (rejecting cotenancy-like ownership under JOA); Questar Pipeline Co. v. Grynberg, 201 F.3d 1277, 1285-86 (10th Cir. 2000) (distinguishing *Doheny*).



differing amendments tailored to complex JOA language, reliance on common law principles of the law of cotenancy-in-common may be implemented unilaterally by the Operator on a uniform basis. This can have distinct advantages for the Operator who administers numerous JOAs with large numbers of non-operating interest owners.

Thus, typical JOA language gives the Operator the “right but not the obligation” either: (a) to purchase (option 1) or (b) to sell (option 2) the non-taking interest owner’s share of production. As noted, typically such JOA language does not *require* the Operator to elect either option. Under such circumstances the Operator can avoid application of potentially problematic JOA language by unilaterally notifying the non-operating interest owners that the Operator will not exercise either “option” under the JOA. Rather, the Operator may achieve its objective of minimizing its own risk of violating the Shipper-Must-Have-Title Rule by announcing that the Operator will instead exercise its right as a cotenant-in-common of the non-taking interest owner to take the production in excess of the Operator’s share as its own, creating an imbalance in the ground.<sup>90</sup>

JOAs often contain language for resolution of any imbalance created by the exercise of the Operator’s common law rights as a cotenant-in-common. Typically, accounting mechanisms of JOAs are consistent with the common law requirement for the working interest owner who “takes” more than his proportionate working interest share to “account” to its cotenants. In theory, no substantial economic difference needs to follow from (1) the Operator exercising a contract-based option to dispose of the non-taking interest owner’s gas under the JOA<sup>91</sup> or (2) the Operator proceeding under the law of cotenancy-in-common. Such might be the case in theory, but in practice, whether the imbalance is resolved “in-kind” or by “cash balancing,” the timing of such imbalance resolution or “accounting” and the precise formula for cash balancing generally make resolution of imbalances under the balancing provisions of JOAs less than optimal from the viewpoint of the under-produced interest owner.

Thus, opposition to the Operator’s unilateral action may be anticipated from non-taking interest owners. This anticipated opposition may be diminished, however, by an agreement by the Operator to “account” *contemporaneously* for the value of the gas taken in excess of the

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90. If an amendment to the JOA is nevertheless still deemed desirable, the threatened exercise of this common law remedy may “soften” non-operator resistance to such an amendment.

91. Whether by “purchase” (option 1) or “sale” (option 2) of the non-taking interest owner’s share of production.

Operator's working interest share of production, where value is determined *in the same manner* as the Operator historically accounted to the non-taking interest owners under the JOA.<sup>92</sup>

**Neither the balancing language of the JOA, nor the terms of an agreement between the Operator and non-taking interest owners respecting the method of accounting by the Operator to the non-taking interest owner, should have regulatory consequences under the Shipper-Must-Have-Title Rule.** Although the issue is an open one, it may prove to be determinative that rarely could either such balancing language or the terms of such an accounting agreement be construed as a subterfuge to escape NGA jurisdiction, as the buy/sell transactions prohibited in Order No. 636<sup>93</sup> and *El Paso*<sup>94</sup> were construed. Where a transaction is otherwise properly structured under the law of cotenancy-in-common, the arrangement should not violate either the buy/sell prohibition or the Shipper-Must-Have-Title Rule.

#### *V. Conclusion*

The Commission is armed with substantial remedial powers, including civil penalties under the NGA (and NGPA), that can make an error in structuring transportation and related arrangements extremely costly. These regulatory risks warrant careful attention to the structure of natural gas transportation arrangements to assure that regulatory risks are minimized.

**Particular care must be taken by Operators who utilize their own interstate transportation capacity with respect to "disposing of" or "marketing" a non-taking interest owner's share of production under a JOA.** While the law of cotenancy-in-common provides a sound basis for avoiding undesirable regulatory consequences, JOAs sometimes threaten to muddy the waters. Ambiguous JOA language, in conjunction with the practice of the Operator, may lead to construing the conduct of the Operator as selling the non-taking interest owner's share of production under an agency arrangement. If so construed, violation of the Shipper-Must-Have-Title Rule would likely follow as, with a singular exception, interstate pipeline tariffs do not provide an implied exception to the Rule under such

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92. It may be anticipated that non-operators would be more willing to execute such a simple agreement than a more complex amendment to the JOA because the economic consequences of such an agreement would be favorable to the non-operator as compared to those which would flow from the Operator's refusal to continue to "market" the non-operator's gas and to proceed under the balancing provisions of the JOA.

93. Order No. 636, *supra* note 3, at 30,416.

94. 59 F.E.R.C. ¶ 61,031 (1992).

circumstances. Wherever possible, therefore, **reliance on the law of cotenancy-in-common is preferable to relying on “cotenancy-like” relationships created under JOAs.**

The provisions of JOAs should be carefully reviewed for consistency with the law of cotenancy-in-common on which critical regulatory consequences may depend. Where necessary, appropriate amendments or agreements should be considered to confirm that the Operator/shipper acquired “ownership” of production otherwise attributable to the interest of another working interest owner under the common law principles of cotenancy-in-common. Amendments to the JOA are particularly important in jurisdictions which do not apply the majority rule of cotenancy-in-common, as the JOA may then provide the only defense to a potential regulatory violation. Failure to do either may lead to undesirable and costly regulatory consequences under ambiguous JOA language.