PRESENTED AT

44th Annual Ernest E. Smith Oil, Gas and Mineral Law Institute

April 19, 2018
Houston, TX

A PRIMER ON MARKETING HYDROCARBONS

Michael P. Pearson

Author Contact Information:
Michael P. Pearson
Jackson Walker L.L.P.
Houston, TX

mpearson@jw.com
713.752.4311

Michael P. Pearson
Jackson Walker L.L.P.
1401 McKinney, Suite 1900
Houston, Texas 77010
Telephone: (713) 752-4311
Facsimile: (713) 752-4221
mpearson@jw.com

Biography

Michael P. Pearson is a partner in and Chair of the Energy Practice Group of Jackson Walker L.L.P. He has practiced in the areas of oil and gas and energy law since 1978, representing numerous Texas-based, national, and international energy companies and financial institutions in a broad range of transactional matters relating to the upstream, midstream, finance, and marketing sectors of the oil and gas industry.

Education

Mr. Pearson earned his B.A., with high honors, from The University of Texas at Austin in 1975 and his J.D. from The University of Texas School of Law in 1978, where he was an Associate Editor of *The Texas Law Review*.

Memberships

Mr. Pearson is a member of the State Bar of Texas, the Houston Bar Association, the International Bar Association, and the American Bar Association. Mr. Pearson is a Past Chair of the Council of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas.

Awards

Mr. Pearson has received a Martindale-Hubbell Peer Review Rating of "AV Preeminent" since 1988. Mr. Pearson has been listed in *The Best Lawyers in America* under Natural Resources Law and Oil & Gas Law since 2004 and has been named a "Texas Super Lawyer" by Thomson Reuters since 2007. Mr. Pearson has also been listed in "Who's Who in Energy" by The Houston Business Journal since 2012 and was listed by Legal Media Group among the "World's Leading Energy & Natural Resources Lawyers" in 2008, 2010, 2013, 2015, and 2017. In 2005, *Lawdragon Magazine* selected Mr. Pearson as one of the "500 Best Lawyers in America", in 2007 as one of the "500 Top Deal Makers in America", and in 2010 as one of the "Lawdragon Top 3000."

Publication & Speaking Engagements

Mr. Pearson has authored a number of articles relating to finance and oil and gas matters and has also been a frequent speaker at continuing legal education programs and seminars. Most recently, Mr. Pearson delivered a paper entitled "Selected Drafting Issues in Midstream Contracts" at the 2015 Gas and Power Institute sponsored by The University of Texas School of Law, the Oil, Gas and Energy Resources Law Section of the State Bar of Texas, and the Energy Bar Association, a paper entitled "Gas Royalty Calculation 2015 – An Update" at the 2015 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course, and a paper entitled "Covenants Running With the Land" at the 2016 State Bar of Texas Advanced Oil, Gas and Energy Resources Law Course.

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE 1

A. Basic UCC Concepts 2

1. Seller; Buyer; Purchaser 2

2. Good Faith 2

3. Standards of Performance 3

4. Course of Performance; Course of Dealing; Usage of Trade 3

B. Statute of Frauds 4

C. Contract Formation 5

D. Gap Fillers 7

1. Price 7

2. Delivery 8

3. Risk of Loss 8

4. Title 9

5. Quantity 11

6. Payment Terms 13

E. Breach; Remedies; Damages. 13

1. Breach 13

2. Remedies 14

a. Remedies Available to Both Parties 14

b. Seller's Remedies 15

c. Buyer's Remedies 16

3. Damages 16

a. Damages Available to Sellers 16

b. Damages Available to Buyers 18

c. Disclaimer of Consequential Damages; Liquidated Damages 19

III. NATURAL GAS 19

A. Historical Gas Regulatory Framework. 20

1. NGA Price Regulation 20

2. Movement Toward Price Deregulation 22

3. Continued Evolution of the U.S 23
B. Rise of the Financial Energy Markets. 25
C. Current Natural Gas Sale Practices. 27
1. Evolution of the Master Agreement 28
2. 2006 NAESB 30
a. Contract Formation 32
b. Term 33
c. Quantity; Standard of Service 34
d. Delivery Point 35
e. Price 37
f. Billing, Payment, and Audit 40
g. Financial Responsibility 41
i. Adequate Assurance of Performance 41
ii. Credit Support Addendum 42
h. Breach of Performance Obligations 44
i. Cover Standard 44
ii. Spot Price Standard 45
i. Defaults; Remedies; Early Termination 46
i. Events of Default 46
ii. Remedies 47
iii. Early Termination/Liquidation 47
j. Setoff 48
k. Limitation on Damages 49
3. Sales to Midstream Company 49
a. Processed Gas 49
b. Pop Contracts 51
i. Contract Formation 51
ii. Term 51
iii. Acreage Commitments and MAQ Obligations 51
iv. Quantity; Standard of Service 55
v. Price; Gas and Product Allocations 56
vi. Quality; Operational Matters 56
vii. Economic Out 57

viii. Failure to Deliver/Receive 57
ix. Events of Default; Termination 57
IV. CRUDE OIL 58
A. Crude Oil Master Agreements. 58
B. 2017 Conoco General Provisions. 59
1. Contract Architecture 59
2. Contracting Issues 59
a. Quantity 60
b. Quality 60
c. Price 60
d. Financial Responsibility 60
e. Default; Remedies 60
f. Delivery 60
V. GAS/OIL SALE CONTRACT AS FORWARD CONTRACT 61
A. Qualification as "Forward Contract" 61
B. Rights/Consequences of Forward Contract Characterization. 64
1. Settlement Payments 64
2. Setoff 64
3. Liquidation 65
VI. CONCLUSION 66

A PRIMER ON MARKETING HYDROCARBONS

By Michael P. Pearson[1]

I. INTRODUCTION

Although I have given, over the years, a number of presentations at the Ernest E. Smith Oil, Gas and Mineral Law Institute, this is my first opportunity to present at the "Fundamentals of Oil, Gas and Mineral Law" that precedes it. I was a member of the Council for the Oil, Gas and Energy Resources Law Section of the State Bar of Texas when, in conjunction with the continuing legal education department at The University of Texas School of Law, we developed the first "Fundamentals" course in 2010. In my view, the addition of the "Fundamentals" course to the oil and gas law CLE landscape is among the most significant accomplishments of the Council during my tenure.

This presentation will provide an overview of the basic concepts associated with a producer's marketing of its oil and gas production, including discussions of (a) relevant provisions of Article 2 of the Uniform Commercial Code as in effect from time to time in the State of Texas (the "Texas UCC"), (b) the evolution and principal components of the "master agreement" contract format, (c) contracting practices applicable to sales of natural gas, including applicable regulatory principles, (d) contracting practices applicable to sales of crude oil, including applicable regulatory principles, and (e) drafting issues of particular interest in the current hydrocarbon marketing environment.

II. ARTICLE 2 OF THE UNIFORM COMMERCIAL CODE

Section 2.107(a) of the Texas UCC draws a distinct line between oil and gas leases, deeds, and other conveyances of interests in minerals in place, on the one hand, and sales of minerals by the producer after their "severance" – or production – from the ground, providing, in pertinent part:

> A contract for the sale of minerals or the like (including oil and gas) … is a contract for the sale of goods within this chapter if they are to be severed by the seller but until severance a purported present sale thereof which is not effective as a transfer of an interest in land is effective only as a contract to sell.[2]

---

[1] Partner and Chair of the Energy Practice Group, Jackson Walker L.L.P. Past Chair of the Oil, Gas and Energy Resources Law Section of the State Bar of Texas. The author wishes to thank Jesse Lotay, a partner in the Energy Practice Group, Ben Rhem, a partner in the Environmental and Regulatory Practice Group, and Bruce Ruzinsky and Jennifer Wertz, a partner and an associate in the Bankruptcy Practice Group of Jackson Walker L.L.P., for their help in the preparation of this paper.

[2] TEX. BUS. & COM. CODE ANN. §2.107(a) (2017).

In reliance on the quoted language, Texas courts, as well as courts in other jurisdictions, have consistently held that contracts for the sale of oil, gas, and other liquid hydrocarbons once produced are sales of goods governed by Article 2 of the Texas UCC.[3]

A basic understanding of Article 2 of Texas UCC is critical to practitioners documenting hydrocarbon sale transactions. With certain exceptions discussed below, Section 1.302 of the Texas UCC permits the parties to a contract to "vary the effect of provisions of" Article 2 in delineating their contractual relationship.[4] In the absence of contrary contractual provisions, however, the provisions of Article 2 will act was a default mechanism in defining the terms, rights, and remedies of the parties to a hydrocarbon sale transaction when their contract is silent or ambiguous about a particular matter.[5]

A. Basic UCC Concepts

Before commencing a review of Texas UCC concepts relevant to hydrocarbon sales, a brief discussion of several basic Texas UCC concepts is appropriate.

1. Seller; Buyer; Purchaser. Under the Texas UCC, a "seller" is a person who "sells or contracts to sell" goods,[6] and a "buyer" is a person who "buys or contracts to buy" goods.[7] "Purchaser" is a broader concept, meaning one who takes by "sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, or any other voluntary transaction creating an interest in property."[8] As a convenience, since this discussion is focused on hydrocarbon sales, we will speak of "sellers" and "buyers" even when a particular Texas UCC provision refers to "purchasers."

2. Good Faith. Many provisions of the Texas UCC are specifically qualified by "good faith." Indeed, Section 1.304 of the Texas UCC specifically provides, "Every contract or duty within this title imposes an obligation of good faith in its performance."[9] "Good faith" is defined

---

[3] *E.g., New Bremen Corp. v. Columbia Gas Transmission Corp.*, 913 F. Supp. 985 (S.D. Tex. 1995), *aff'd*, 108 F.3d 332 (5th Cir. 1997); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565, 577 (Tex. 1996) (Phillips, C.J., dissenting in part and concurring in part); *Keyes Helium Co. v. Regency Gas Services, LP*, 393 S.W.3d 858 (Tex. App. – Dallas 2012, *no pet.*) (produced helium constitutes goods); *Rogers v. Ricane Enterprises, Inc.,* 930 S.W.2d 157, 171 (Tex. App. – Amarillo 1996, *writ denied*) (petroleum products are goods); *Gasmark, Ltd. v. Kimball Energy Corp.*, 868 S.W.2d 925, 928 (Tex. App. – Fort Worth 1994, *no writ*). *See also Anadarko Petroleum Corp. v. Alaska Petroleum, Inc.*, 2013 U.S. App. LEXIS 16262, at 2 (5th Cir. August 6, 2013); *JN Exploration & Production v. Western Gas Resources, Inc.*, 153 F.3d 906 (8th Cir. 1998).

[4] TEX. BUS. & COM. CODE ANN. §1.302(a) (2017).

[5] *See Jon-T Chemicals, Inc. v. Freeport Chemical Co.,* 704 F.2d 1412, 1416 (5th Cir. 1983); *Lenape Resources Corp. v. Tennessee Gas Pipeline Co.,* 925 S.W.2d 565, 570 (1996).

[6] TEX. BUS. & COM. CODE ANN. §2.103(a)(4) (2017).

[7] *Id.* at §2.103(a)(1).

[8] *Id.* at §1.201(29)(30).

[9] *Id.* at §1.304.

UT LAW CLE THE UNIVERSITY OF TEXAS TEXASLAW

Find the full text of this and thousands of other resources from leading experts in dozens of legal practice areas in the UT Law CLE eLibrary (utcle.org/elibrary)

Title search: A Primer on Marketing Hydrocarbons

Also available as part of the eCourse
Answer Bar: Oil, Gas, and Energy Agreements and Contracting Essentials

First appeared as part of the conference materials for the
2018 Fundamentals of Oil, Gas and Mineral Law session
"A Primer on Marketing Oil and Gas"