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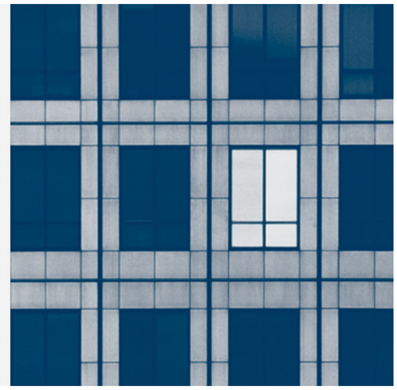
On the Subject



Energy & Derivatives Markets

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These cases add to FERC's growing enforcement precedent in the area of capacity release.

FERC Fines Companies More Than $9.5 Million for Pipeline Capacity Release Violations

On June 30, 2009, the Federal Energy Regulatory Commission (FERC) approved four stipulation and consent agreements in which natural gas companies agreed to pay civil penalties and disgorgement, and to adopt various compliance measures to resolve alleged violations of FERC's rules and policies governing capacity on natural gas pipelines. The alleged violations include circumvention of the competitive bidding requirements for long-term, discounted rate capacity releases (flipping); failure to comply with the shipper-must-have-title requirement; and breach of the prohibition on buy/sell transactions.

Description of the Rules and Alleged Violations

FERC's regulations, at 18 C.F.R § 284.8, require that companies holding firm capacity rights on a gas pipeline or storage facility may release such rights to another party, known as a replacement shipper. Releases of capacity exceeding a month-long term must be posted for competitive bidding if they are at a rate less than the maximum tariff rate. Releases at less than that maximum tariff rate for period of one month or less must be posted (unless the release is part of an asset management agreement), but for informational purposes only. However, the regulations prevent such short-term releases from being rolled over or extended without complying with the posting and competitive bidding requirements. Flipping violations occur when a party avoids the bidding requirements for discounted rate firm capacity. A typical flipping arrangement consists of a series of short-term releases (i.e., one month or less) of discounted rate capacity to two or more affiliated replacement shippers on an alternating monthly basis, without complying with the competitive bidding requirements. The result is a series of short-term releases that, when combined, result in a long-term, non-competitive discounted rate release.

The shipper-must-have-title requirement provides that the holder of title to natural gas must be the capacity holder for the transportation as well. In other words, gas transported through a pipeline or in storage must be owned by the same party holding such transport or storage rights.

Prohibited buy/sell transactions are commercial arrangements 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. FERC announced the buy/sell prohibition as part of its efforts in the early 1990s to create a secondary market for capacity (see El Paso Natural Gas Co.) The buy/sell prohibition was designed to effectuate FERC's capacity release scheme by preventing parties with priority to pipeline rights from acting as brokers of such capacity.

FERC Orders Approving Settlements

In In re Sequent Energy Management, L.P., FERC approved a settlement containing a civil penalty of $5 million, disgorgement of $53,728.18 plus interest, and submission of compliance monitoring reports from Sequent for flipping violations, violation of the shipper-must-have-title requirement and certain prohibited buy/sell transactions. The disgorgement represents the amount of unjust profit Sequent accrued from the flipping violations, and will go to certain energy assistance programs that receive and distribute funds from the U.S. Department of Health and Human Services (HHS). The investigators found that Sequent did not earn unjust profits from the shipper-must-have-title or the buy/sell transactions. Sequent admits the flipping and shipper-must-have-title violations. With respect to the alleged buy/sell violation, Sequent identified and self-reported a limited number of transactions involving a single counterparty on one pipeline, in which Sequent structured a concurrent purchase and sale of gas pursuant to a standard netting agreement with the counterparty as a way to enable the counterparty to transact with Sequent while minimizing the company's credit exposure with the counterparty. Notably, Sequent neither admitted nor denied Enforcement Staff's conclusion that the buy/sell transactions were violations.

The Staff had already opened an investigation into Sequent's activities, but Sequent self-reported the violations before being notified of the investigation. Thus, the company received credit for self-reporting and for exemplary cooperation, which reflected an extensive voluntary internal review of its capacity release transactions.

In another order, a natural gas marketing company agreed to pay a civil penalty of $3 million, disgorge $195,959.44 plus interest, and submit compliance monitoring reports in order to resolve violations of the FERC's open access transportation program. The violations include flipping, the shipper-must-have-title requirement and the prohibition on buy/sell transactions. FERC found that the company violated the shipper-must-have title requirement by improperly transporting 6.7 Bcf of gas owned by the company on capacity held by others, which was ultimately delivered to third parties. The buy/sell transactions involved the purchase of gas by the company from its customer, transportation of that gas over the company's capacity and the re-sale of the gas back to customer at the point of delivery. The disgorgement results from the Staff's finding that the company unjustly profited from the shipper-must-have-title violations. The sum will be disgorged to energy assistance programs that receive and distribute funds from HHS. The violations were self-reported, and the company received credit for exemplary cooperation. As a basis for granting cooperation credit, Staff cited the company's efforts, such as engaging outside counsel to assist with a comprehensive review and providing Enforcement staff with a thorough written self-report, ceasing all violations promptly and revising its operational practices to avoid future incidents of violations. Staff also noted that senior management fully supported the internal review and did not attempt to conceal the violations.

In In re Piedmont Natural Gas Company, Inc., FERC approved a settlement containing a civil penalty of $1.25 million and semi-annual monitoring reports for up to two years for Piedmont's flipping violation. Piedmont did not self-report the flipping transactions, which occurred over two years. Staff concluded that Piedmont did not receive "unjust profits" on account of the flipping, though Staff found that the violations impeded transparency in the natural gas market. Piedmont admitted making the releases in question, but neither admitted nor denied that it violated the posting and competitive bidding requirements.

In In re Wasatch Oil and Gas Corporation and Wasatch Energy, LLC, FERC approved a settlement providing for a civil penalty of $320,000 for flipping violations, and will require a one-time compliance monitoring report should either Wasatch Oil and Gas or Wasatch Energy become involved in interstate natural gas operations within four years of the order. The companies neither admitted nor denied that they violated FERC's rules. The Wasatch companies did not self-report the violations. The civil penalty reflects Staff's assessment of the nature and scope of the flipping transactions, from which the Wasatch companies did not receive unjust profits, but which were determined to have impeded transparency in the natural gas market.

These cases add to FERC's growing enforcement precedent in the area of capacity release. In each of these cases, the agency continued its practice of combining civil penalties with prospective compliance measures and, when applicable, disgorgement of unjust profits.For more information, please contact your regular McDermott lawyer, or:

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