Morgan Lewis

OIL AND GAS:
REGULATORY ROUNDUP

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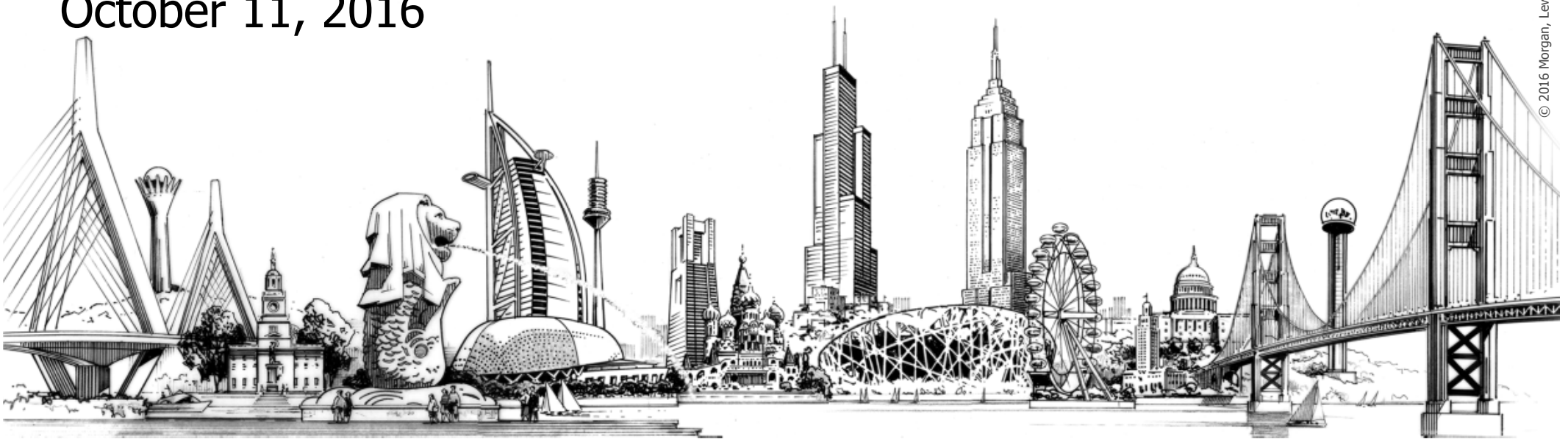

FERC Tax Allowance Policy

- On July 1, the D.C. Circuit rules that that FERC policy permitting a tax allowance for pass-through entities may unjustifiably permit "double-recovery" of tax expense.
  - In *United Airlines v. FERC*, the DC Circuit determined that FERC "failed to demonstrate that there is no double-recovery of taxes for partnership, as opposed to corporate, pipelines."
  - The court, in turn, ruled that FERC's policy as applied in the case was arbitrary and capricious in violation of the Administrative Procedure Act. The court vacated that portion of the FERC decision and remanded for further proceedings.

FERC Tax Allowance Policy

- The case before the DC Circuit concerned the cost-of-service governing and rates paid for transportation on common-carrier oil pipeline facilities owned by SFPP, LP.
  - The DC Circuit was faced with determining whether a crude oil pipeline partnership such as SFPP should be permitted to claim an income tax allowance, which accounts for taxes paid by partner-investors that are attributable to the pipeline entity.
- Shippers claimed that FERC's tax allowance policy (discussed further below) permits partners in a partnership pipeline to "double-recover" their taxes. The SFPP shippers argued that such double-recovery occurs because FERC's ratemaking methodology already provides for an after-tax rate of return sufficient to attract investors, and partnership pipelines do not incur entity-level taxes.

FERC Tax Allowance Policy

- The DC Circuit's decision and its underlying analysis threaten to upset long-established FERC-permitted rate recovery of tax expense by pass-through entities and may create far-reaching rate implications for affected interstate pipelines and for electric transmission providers that have opted to be treated as partnerships for tax purposes.
  - The open questions for the industry are whether FERC's decision on remand will justify granting income tax allowances to both pass-through and taxable entities, or if FERC will conclude that it cannot justify granting similar tax allowances to entities in taxable and pass-through structures, or if FERC attempts to identify some other means of permitting tax recovery.

Capacity Turnback and Restructuring

- New provisions provide pipelines with flexibility in light of significant changes in the commodity markets that have affected the financial conditions of some shippers.
- Pipeline filings to allow reduction or early termination of contracts, if agreed to by shipper.
- In return for reduction or early termination, shipper will pay all or a portion of the reservation charges for the contract's remaining term.
- Pipeline must have an exit fee provision in its tariff to exercise this option.

Exit Fee Provisions

- New tariff provisions allow MEP and a shipper to agree to reduce the Maximum Daily Quantity of an existing Rate Schedule FTS transportation agreement or terminate an existing agreement .
- In return, the shipper would pay all or a portion of the reservation charges for the agreement's remaining term.
- This option is available if there is an observable deterioration of a shipper's financial ability to pay the obligations due to MEP over the term of the agreement.

Exit Fee Provisions (cont.)

- FERC rejected MEP's proposal to allow for an MDQ buyout or reduction as part of a transfer of producing acreage or other producing assets from an existing shipper to another entity because it could allow for potential discrimination.
- If a pipeline wants to provide the buyout or reduction option, the pipeline's tariff must have exit fee provision.
  - E.g., Gulf Crossing Pipeline

ROE Issues

- FERC's policy concerning the applicable pre-tax rate of return once again became an issue in a Section 7 certificate proceeding in August 2016.
- Transcontinental Gas Pipe Line Company, LLC (Transco) sought a certificate of public convenience and necessity authorizing it to construct, lease, and operate pipeline, compression, metering, and appurtenant facilities in Virginia, North Carolina, and Georgia (Dalton Expansion Project).
  - Transco requested a 15.34 percent pre-tax rate of return for the proposed recourse rate.

ROE Issues

- State Commissions took issue with Transco's proposed use of a pre-tax return of 15.34 percent in calculating its proposed incremental recourse rates in its applications for its Dalton Expansion Project proposal.
  - The State Commission's argued that although FERC policy requires use of the specified pre-tax return most recently approved in a Section 4 rate case, Transco's most recently approved return was from a case fifteen years ago.
  - The incremental recourse rates approved in the current proceedings should take into account the significant changes in financial markets since then.
- FERC stated that since Transco's most recently approved general section 4 rate case settlements in Docket Nos. RP12-993-000, and RP06-569-004, were both "black box" settlements that did not specify the rate of return or most other cost of service components used to calculate the settlement rates, Transco calculated its proposed incremental rates in this certificate proceeding consistent with Commission policy by using the last Commission-approved specified pre-tax return of 15.34 percent from its prior rate proceeding in Docket No. RP01-245.

ROE Issues

- Parties in that future rate case will have an opportunity to review Transco's pre-tax return and other cost of service components in the next rate case.
  - In addition, given the possibility that that rate case could result in another settlement for rates that are not based on a specified rate of return and, as discussed above, the Commission's policy in section 7 certificate proceedings is to require that a pipeline's initial rates for expansion capacity be designed using a Commission-approved, specified rate of return, the Commission would advise that parties in the rate case use that opportunity to address issues of concern relating to the rate of return that should be used in calculating initial rates in Transco's future certificate proceedings.
- Shippers must be mindful of this policy in future rate cases as settlement positions are negotiated between a pipeline and its customers.
  - At least 26 Section 4 rate cases are due to be filed within the next 5 years.

Environmental Permitting Issues

- Parties Raising Concerns:
  - Environmental Organizations
    - E.g., Sierra Club, API, Galveston Baykeeper, EarthReports
  - Affected Landowners
  - Native American Tribes
    - E.g., Standing Rock Sioux Tribe and Klamath Tribes

Types of Environmental Challenges

- Induced gas production
- Cumulative environmental impacts of the pending LNG projects when combined with other export projects
- Environmental impacts of increased domestic gas prices
- Environmental impacts of end user consumption of LNG

Rulings on Environmental Challenges

- Each agency must perform an adequate NEPA analysis.
- The environmental consequences challenged must be tied to the order or decision being challenged.
  - DOE is responsible for considering indirect effects of increased domestic gas production; challenges on increased production must be raised in the appeal of DOE's order.
- Requiring a cumulative impact analysis that takes into account approved or pending projects nationwide is too expansive.

Environmental Permitting Issues

- Issues raised but not addressed in DC Circuit's Freeport opinion:
  - The propriety or scope of FERC's delegated authority under the Natural Gas Act or the interplay between FERC and DOE when FERC is acting as the "lead agency" in the environmental review;
  - Whether FERC impermissibly segmented its review of the Freeport Projects from the larger inter-agency export authorization process and failed to address the true scope and impact of the activities that should be under consideration;
  - Whether FERC's environmental analysis would have been adequate to satisfy DOE's independent NEPA obligation in authorizing Freeport to export natural gas; and
  - Whether FERC's construction authorizations and DOE's export authorizations qualified as "connected actions" for purposes of NEPA review.

Rise in Opposition by Tribes

- Dakota Access Pipe Line – Opposition by Standing Rock Sioux Tribe
  - Proposed pipeline will pass half a mile upstream of the tribe's reservation boundary and may pass through areas of great cultural significance including sacred sites and burial grounds.
  - An oil spill will be catastrophic culturally and economically.

- Jordan Cove LNG Project – Opposition by Klamath Tribes
  - Proposed pipeline will pass through lands that are within the traditional territory of the Klamath Tribes and lands where there are many significant cultural resources of historical importance.
  - Route will go under rivers that are important sources of fish for Tribal members.

FERC NGA Jurisdiction

- In July, the City of Clarksburg, TN filed a petition for review with the DC Circuit raising questions concerning FERC's jurisdiction under the NGA over gas transport and sales of a municipality.
- At issue in the case is whether a municipality is subject to the NGA's certification requirements under Section 7 if that municipality:
  - Sells gas to another municipality;
  - Transports that shipper-municipalities' gas across a state line; and
  - The shipper-municipality resells the gas to end-use customers.

FERC NGA Jurisdiction

- In its orders, FERC ruled that Clarksville's sale to a municipality and transport of gas across a state line is a FERC-jurisdictional activity that is subject to the NGA.
- Despite existing precedent purporting to support Clarksburg position, FERC determined that:
  - "Our reconsideration of the cited precedents leads us to conclude that those orders' interpretation of the municipal exemption created by operation of the NGA's definitions was overly expansive, at least to the extent it would allow municipal gas utilities to avoid NGA jurisdiction over the transportation and sale of gas for consumption in *other states*, because such an interpretation would create a regulatory gap."
  - "While the legislative history of the NGA sheds little light on Congressional intent, it is reasonable to infer from the fact that NGA section 2(3)'s definition of "municipality" includes a "city, county, or other political subdivision or agency of a state," that Congress believed these entities' activities and facilities, like exempted local distribution services and facilities, are matters primarily of local concern which states can choose to regulate and Federal regulation, therefore, was not necessary to protect the public interest. It is not reasonable to infer that Congress intended that a municipality's status as a political subdivision of its state make it exempt from NGA section 7 jurisdiction if the municipality transports or sells gas for resale and consumption in another state, since the state cannot assert jurisdiction over such transportation or sales by the municipality.

FERC NGA Jurisdiction

- The case is pending in Case No. 16-1244
- Applicable schedule:
  - Petitioner's Brief – October 25, 2016
  - Appendix – October 25, 2016
  - Respondent's Brief – December 27, 2016
  - Intervenor for Respondent's Brief – January 3, 2017
  - Petitioner's Reply Brief – January 24, 2017
- The American Public Gas Association and American Public Power Association have notified the Court of an intention to file a joint brief as *amici curiae.*

Expanded CFTC Jurisdiction

- CFTC proposed amendments to whistleblower awards process and anti-retaliation enforcement authority.

- Purpose of amendments:
  - Enhance transparency of award evaluation and review process
  - Clarify CFTC staff authority award whistleblower program
  - Reinterpret authority to take enforcement action where whistleblowers are retaliated against.

Expanded CFTC Jurisdiction

- CFTC Whistleblower Program
  - First established in 2011
  - Whistleblowers who voluntarily provide the CFTC with original information about a violation of the CEA may receive a monetary award if the information provided leads to the successful enforcement of a CFTC action and results in monetary sanctions of more than $1 million or the successful enforcement of a related action.
- Only about 40 awards have been sought by claimants since the program's inception (fewer than five awards have been granted).
- Until now, the CFTC has not considered its enforcement authority as covering retaliation against whistleblowers.

Expanded CFTC Jurisdiction

- New rules would amend CFTC's existing whistleblower awards process
  - Increase transparency
  - Create more defined mechanism for whistleblowers to pursue award claims

- New rules would expand CFTC's authority to include the ability to take enforcement actions against employers that retaliate against whistleblowers.
  - CFTC previously held that it lacked the statutory authority to conclude that an entity could be found to have retaliated against a whistleblower.
  - Under proposed changes, CFTC would set aside its interpretation such that the CFTC's whistleblower program would be more consistent with the SEC's whistleblower program.

Expanded CFTC Jurisdiction

- Potential Impact of Proposed Amendments
  - More resources devoted to the whistleblower program
  - Possible increase in the number of awards claims and/or retaliation claims
  - Greater exposure to enforcement actions

- Entities subject to the CEA should ensure their compliance programs and policies are up to date and consistent with the CFTC's regulations, revised guidance, and industry best practices.

CFTC Manipulation Burden of Proof

- Recently, the SDNY issued an opinion ruling on a summary judgment motion that addressed fundamental questions concerning the burden of proof that the CFTC must meet in price manipulation actions.
- The court rejected the CFTC's view of its legal requirements, and rejected both the CFTC's motion for partial summary judgment and the defendants' motion for summary judgment related to this matter overall.
- The court's decision reaffirmed over 30 years of CFTC and judicial precedent, which has distinguished unlawful price manipulation from legitimate market activity by requiring proof of a specific intent to create an "artificial price," rather than intent to merely influence price.
  - The decision represents a setback in this particular enforcement action as well as for the CFTC's overall effort to broaden its scope of its longstanding anti-manipulation authority.

CFTC Manipulation Burden of Proof

- The Commodity Exchange Act prohibits manipulation and attempted manipulation of the price of a commodity.
  - Under precedents dating 40 years, in order to prove price manipulation, the CFTC must show the defendant specifically intended to cause an artificial price
  - In *DRW* (and in some recent CFTC settlement orders), the CFTC has attempted to lop off the artificial-price component at least for purposes of proving an attempted manipulation.
- The CFTC charged the defendants with attempting to manipulate and manipulating the settlement price of an interest rate future. The CFTC moved for summary judgment on its attempted-price-manipulation claim, arguing in its brief that it need only prove that the defendants: (i) intended to affect the price of a commodity (but not to create an artificial price) and (ii) took an overt act in furtherance of that intent.
- Defendants opposed the CFTC's motion, and their legal views were echoed by five industry organizations who appeared as friends of the court and claimed that the CFTC was applying the wrong standard. They all argued that the CFTC should be required to prove—consistent with prior case law—that the defendants intended to create an artificial price not solely to affect price, a much lesser burden, as the CFTC charged.

PHMSA Reauthorization

- The PIPES Act (Securing America's Future Energy: Protecting our Infrastructure of Pipelines and Enhancing Safety Act of 2016)
  - Extended DOT's PHMSA authority through 2019
  - Expanded PHMSA's oversight and enforcement authority
  - Implemented various pipeline and oil-by-rail transportation safety initiatives and mandates
  - Authorizes PHMSA to set federal minimum safety standards for underground gas storage facilities.
  - Authorizes PHMSA to issue emergency orders to owners and operators of natural gas and hazardous liquid pipeline facilities without prior notice or opportunity for hearing.

PHMSA Reauthorization (cont.)

- Impact of PIPES Act:
  - Underground gas storage facilities are currently under state regulation. Reauthorization act authorizes PHMSA to set federal minimum safety standards.
  - Prior to PIPES Act, PHMSA could issue corrective action and safety orders only after notice and opportunity for hearing. Now, PHMSA can issue emergency orders without prior notice and opportunity for hearing.
  - PHMSA will be preparing and completing numerous studies and report over the next two years. The topics include:
    - Safety, regulatory requirements, techniques, and best practices applicable to petroleum gas pipeline facilities storing or transporting to 100 or fewer customers
    - Materials and corrosion prevention technologies for gas and hazardous liquid pipeline facilities.

PHMSA Emergency Orders

- PHMSA Interim Final Rule implements PHMSA authority to issue emergency orders without notice and comment.
- Emergency orders can impose conditions, restrictions, prohibitions and/or safety measures.
- Emergency orders can apply to multiple owners/operators
  - E.g., natural disaster that affects many pipelines in a specific geographic region
- Interim Final Rule outlines procedures to challenge emergency orders
  - 30 days to issue final order on any petition for review

PHMSA Reauthorization

- Expect significant regulatory activity at PHMSA that will have a substantial impact on gas and hazardous liquids pipeline facilities, gas storage facilities, their respective owners, shippers on the pipelines, and others.
- Market participants should monitor the activity at PHMSA as it promulgates new regulations and implements the PIPES Act.
  - 60 day comment period on Interim Final Rule on emergency orders.
- Market participants should consider providing data and information to PHMSA, where possible, for inclusion and consideration in the studies PHMSA is required to conduct under the PIPES Act.

Questions?

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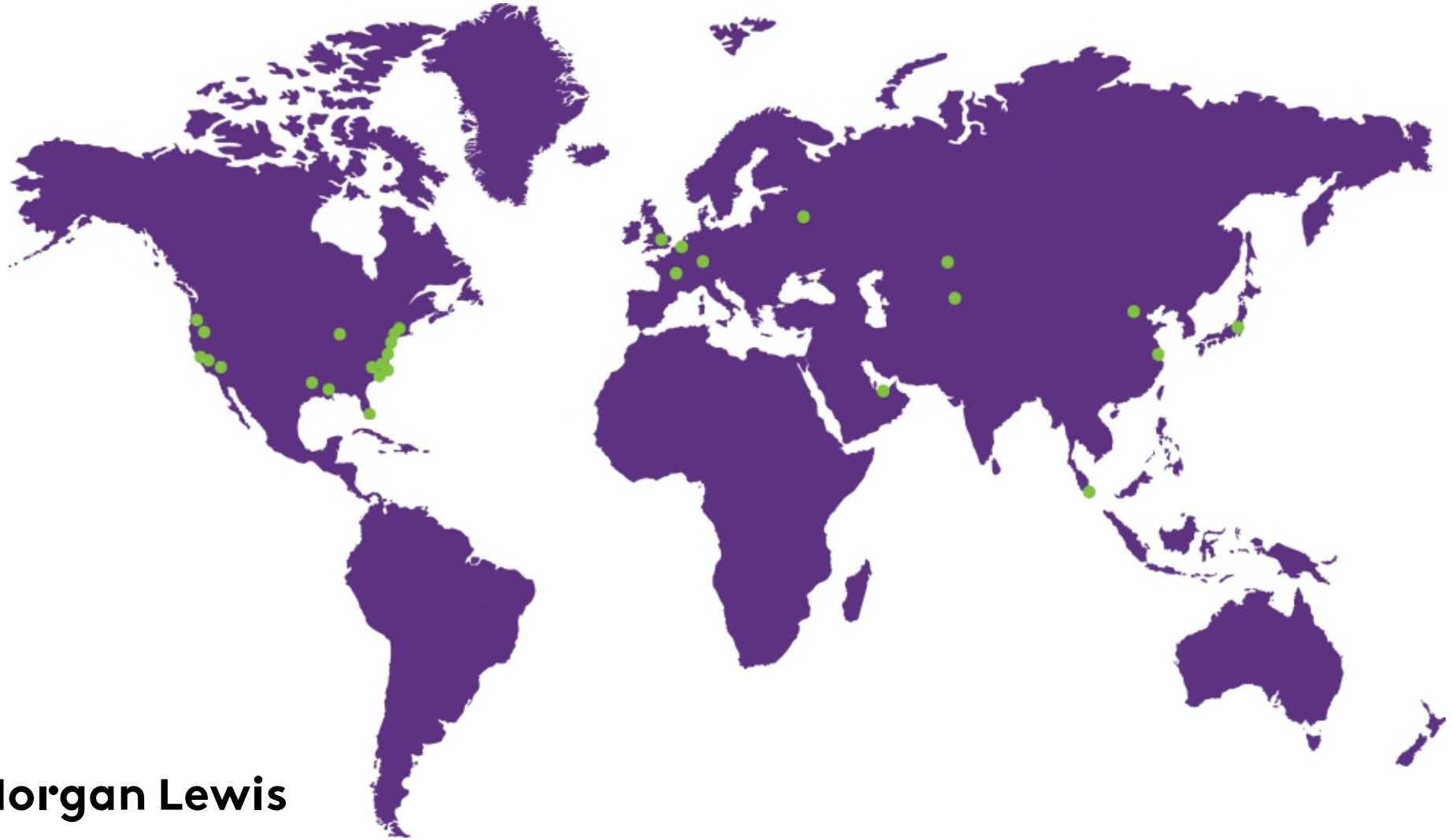

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THANK YOU