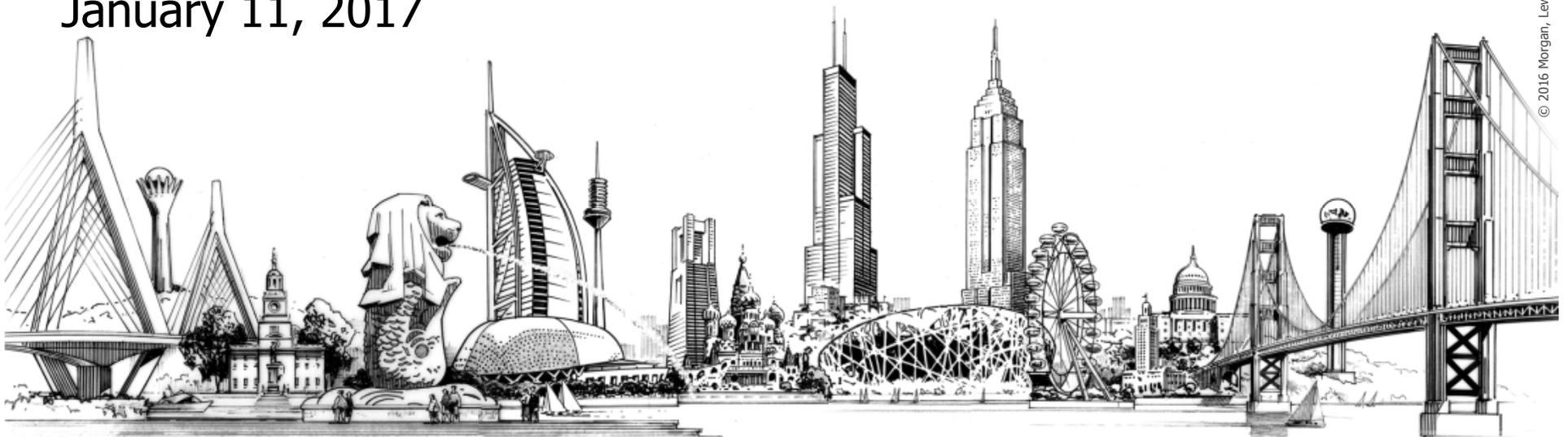


Morgan Lewis

OIL AND GAS: *REGULATORY ROUNDUP*

Levi McAllister and Pamela Tsang Wu
January 11, 2017



FERC Unauthorized Overrun Policy

- In October 2016, FERC reiterated its existing unauthorized overrun policy and rejected a pipeline's attempt to circumvent that policy.
- FERC's actions concern a Section 4 filing by an interstate pipeline that proposed to "simplify" and "update" its existing tariff.
 - One proposed change was to increase the penalty for unauthorized overrun during non-critical periods.
 - The pipeline proposed to change the penalty for unauthorized overruns during non-critical periods to the higher of \$2.00 per Dth or 150 percent of the spot market price and during a critical day to the higher of \$10.00 per Dth or 150 percent of the spot market price.
 - The existing provision for a non-critical period was \$2.00 per Dth or the spot market price.
 - This change will make the penalties more of a deterrent in a time of low spot market prices.

FERC Unauthorized Overrun Policy

- FERC initiated a procedure under Section 5 to determine whether the pipeline's existing penalty for unauthorized overruns during non-critical period is unjust and unreasonable and must be modified.
- Although FERC had previously accepted the pipeline's provision, the provision did not comply with FERC's policy set forth in Order. No. 637.
 - A pipeline can propose a nominal penalty for unauthorized overruns during non-critical periods, not to exceed twice its IT rate, that is sufficient to provide an incentive to nominate overrun volumes but also takes into account the lessened impact such unauthorized overruns will have on the system.

FERC Oil Pipeline Indexing Policies and Form No. 6 ANOPR

- On October 20, FERC issued an Advance Notice of Proposed Rulemaking for comments on:
 - (1) Potential modifications to its policies for evaluating oil pipeline indexed rate changes; and
 - (2) Potential changes to the data reporting requirements reflected in FERC Form No. 6, page 700.
- Purpose:
 - To ensure that index rate increases do not cause pipeline revenues to unreasonably depart from oil pipeline costs.
 - To ensure that FERC and oil pipeline shippers have sufficient information to assess the relationship between oil pipeline rates and costs.
- Initial comments are due on January 19, 2017, and reply comments are due on March 17, 2017.

FERC Oil Pipeline Indexing Policies and Form No. 6 ANOPR (cont.)

Indexing Policies

- Potential new policy would involve a two-part evaluation of index filings:
 - (1) The new “exacerbate” test would deny any ceiling level increase or indexed rate increases for pipelines in which a pipeline’s page 700 revenues exceed page 700 total costs by 15% for both of the prior two years;
 - Shippers will be able to raise objections to proposed rate increases when pipeline revenues already appreciably exceed costs.
 - (2) The new percentage comparison test would deny a proposed increase to a pipeline’s rate or ceiling level greater than 5% of the barrel-mile cost changes reported on page 700.
 - Limits the pipeline’s ability to carry-forward the full indexed increase to a future period.
- FERC is also considering requiring pipelines (whether they modify the indexed rates) to make an annual filing showing changes in their ceiling levels.

FERC Oil Pipeline Indexing Policies and Form No. 6 ANOPR (cont.)

Modifications to Page 700

- FERC is considering requiring pipelines to file supplemental page 700s for (a) crude pipelines and product pipelines, (b) non-contiguous systems, and (c) major pipeline systems.
- FERC is also considering the potential requirement that pipelines report additional information on page 700 and supplemental page 700s regarding (a) cost allocations used to prepare the supplemental page 700s, and (b) separate revenues for cost-based rates (e.g. indexing), non-cost-based rates (e.g. market-based rates or settlement rates), and other jurisdictional revenues (such as penalties).

Oil Pipeline Capacity Allocation

- A September 13 Order opened an investigation into all aspects of an oil pipeline's capacity allocation program.
 - The Commission is generally "investigating the allocation of capacity on [the pipeline's] system, including but not limited to history transfers, to determine whether that program and any related policy or program is consistent with the [Interstate Commerce Act ("ICA)]."

FERC Staff White Paper on Trading Compliance Practices

- FERC Staff issued a White Paper on Effective Energy Trading Compliance Practices in November.
 - Responds to requests for additional guidance.
 - Supplements Commission’s Policy Statements on Enforcement.
 - Provides concrete examples of compliance practices, procedures, training, and review that will help participants design, implement, and maintain strong compliance programs.
- Effective compliance practices are divided into three categories:
 - (A) Designing an effective trading compliance program;
 - (B) Establishing, implementing, and enforcing effective practices to deter and detect market manipulation and other misconduct; and
 - (C) Assessing the performance of the compliance program on a regular basis.

FERC Staff White Paper on Trading Compliance Practices (cont.)

Designing an Effective Trading Compliance Program

- A compliance program must have a strong foundation and requires appropriate decisions relating to:
 - (1) The organizational structure and composition of the compliance function;
 - (2) Human resources issues, such as hiring standards, compensation, and discipline;
 - (3) The types of training used to disseminate compliance information; and
 - (4) The technological resources dedicated to the compliance function.

FERC Staff White Paper on Trading Compliance Practices (cont.)

Establishing, Implementing, and Enforcing Effective Practices to Deter and Detect Market Manipulation and Other Misconduct

- Staff found that a compliance area that organizations struggle the most is in monitoring their traders' activities to identify potential misconduct.
- Practices that organizations can implement include:
 - (1) Establishing appropriate rules and restrictions for its traders that will further reduce the risk of misconduct;
 - (2) Consistently monitoring trading activities for violations of those rules and for any other suspicious activity; and
 - (3) Strictly enforcing all compliance rules and following up on all potential issues.

FERC Staff White Paper on Trading Compliance Practices (cont.)

Assessing the Performance of the Compliance Program on a Regular Basis

- The Penalty Guidelines state that an organization with an effective compliance program shall take reasonable steps “to evaluate periodically the effectiveness of the organization’s compliance program.”
- Regular evaluations help to:
 - (1) Ensure that the program’s compliance tools continue to be effective;
 - (2) Uncover compliance gaps and failures; and
 - (3) Identify where updates are necessary.

FERC Staff White Paper on Trading Compliance Practices (cont.)

Examples of Ineffective Trading Compliance Practices

- Overreliance on standardized and long annual training.
- Providing insufficient funding for the organization's compliance program.
- Allowing commercial trading staff to overrule compliance advice.
- Overreliance on the use of off-the-shelf compliance tools without customizing them for specific needs.
- Setting compliance-related rules, limits, and restrictions, and then failing to monitor for violations or discipline those who violate rules in a meaningful way.

Environmental Permitting Issues

- On November 4, D.C. Circuit issued a Judgment denying Sierra Club's appeal of FERC order approving the Corpus Christi Liquefaction LNG export project.
 - Rejected arguments on FERC's consideration of the projects' indirect and cumulative effects under NEPA.
 - Held that FERC did not violate the hard look doctrine.
 - Held that Sierra Club's arguments on greenhouse gas emissions have no merit and restate prior arguments that the Court has already rejected.

Environmental Permitting Issues (cont.)

- FERC denied requests for rehearing of its order granting section 3 authorization for the Elba Liquefaction Project.
 - Sierra Club and individuals argued that FERC’s environmental review violated NEPA.
 - Rejected Sierra Club’s “connected actions” argument.
- DOE continues to grant authorizations for other projects to export LNG to non-FTA nations.
 - Magnolia LNG (Lake Charles, Louisiana)
 - Southern LNG’s Elba Island Terminal (Chatham County, Georgia)
 - Carib Energy (USA) LLC (southeastern U.S. port)

Pass-Through Entity NOI

- In its last open meeting of calendar year 2016, FERC took several steps signaling its intention to continue robust oversight over the energy industry.
 - Among those steps, perhaps none has more potential to impact all sectors of the energy industry than FERC's notice of inquiry (NOI) concerning the treatment of income taxes for ratemaking and cost recovery purposes by pass-through entities.
- This past summer, the Court of Appeals for the D.C. Circuit found that FERC's existing income tax allowance policy and rate of return policy, when applied to pass-through entities such as master limited partnerships (MLPs), creates a possibility of double recovery for income taxes.

Pass-Through Entity NOI

- Recognizing the magnitude of the issue created by the court's order, FERC declined to address the D.C. Circuit's ruling in the limited context of the SFPP docket.
 - Rather, on Dec. 15, 2016, FERC issued the Notice of Inquiry requesting all industry participants to weigh in on the issues, asking for any proposed methods to adjust FERC's income tax allowance or rate of return policies to resolve any double recovery of tax costs.
 - Comments are due 45 days from the date of publication in the Federal Register.
- The NOI requests that commenters consider the concepts presented by the D.C. Circuit's ruling in *United Airlines*, and sets forth several specific concerns mirroring the concerns of the court. FERC also asks commenters to provide a detailed explanation of their proposals, including "evidentiary support and how any adjustment to the Commission's tax allowance and/or ROE policies should be specifically implemented."

Pass-Through Entity NOI

- The D.C. Circuit's opinion together with FERC's NOI make two points clear:
 - FERC's current income tax allowance policy cannot continue in its current form; and
 - The far-reaching implications of the court's ruling concerning FERC's policy renders FERC open to any and all suggestions for a feasible path forward.
- At this point the alternatives are wide open — FERC does not appear to have a preferred alternative. Everything from eliminating the income tax allowance for pass-through entities to removing all investor-level tax costs from the DCF-calculated return is on the table.
- In the oil and gas sectors, interstate pipelines subject to regulation under the Natural Gas Act and the Interstate Commerce Act will unquestionably feel the effects of any resulting FERC action.
 - Any change by FERC to its existing policy raises material questions concerning the justness and reasonableness of existing rates for those pass-through entities that receive an income tax allowance and compute return on equity based on a DCF methodology.
 - Likewise, potential changes to FERC's existing policy raise questions concerning the manner in which pass-through entities compute future rates that might be proposed in accordance to the terms of the Natural Gas Act or the Interstate Commerce Act.

PHMSA Underground Storage Safety Standards

- PHMSA Interim Final Rule, Safety of Underground Natural Gas Storage Facilities:
 - Section 12 of the PIPES Act requires PHMSA to issue minimum safety standards for underground natural gas storage facilities.
 - On December 14, PHMSA incorporated two recently adopted American Petroleum Institute (API) Recommended Practices (RP) into its federal pipeline safety regulations to address safety and environmental concerns.
 - Prior to this, downhole facilities such as wells, wellbore tubing, and casing, were not subject to Federal safety requirements.
 - State authorities will continue overseeing intrastate underground gas storage facilities and can continue adopting regulations.

PHMSA Underground Storage Safety Standards (cont.)

- PHMSA advised operators to complete 12 actions items including:
 - verifying that the pressure required to inject intended natural gas volumes does not exceed the design pressure limits of the reservoir, wells, wellheads, piping, casing, tubing, or associated facilities;
 - monitoring wells for annular gas or liquids periodically;
 - inspecting the wellhead assembly and attached pipelines for each of the wells used;
 - conducting periodic functional tests of surface and subsurface safety valve systems and wellhead pipeline isolation valve(s) for proper function and ability to shut off or isolate the well and remediate improperly functioning valves;
 - developing and implementing a corrosion monitoring and integrity evaluation program for piping, casing, wellhead, and tubing including the usage of appropriate well log evaluations; and
 - performing ongoing verification and demonstration of the integrity of the underground storage reservoir or cavern using appropriate monitoring techniques for integrity changes.

PHMSA Underground Storage Safety Standards (cont.)

- PHMSA added reporting requirements that require operators to submit:
 - an annual report that provides general specifications, operational information, maintenance information of the facility;
 - an incident report for any event that involves the release of gas, death or personal injury necessitating in-patient hospitalization, estimated property damage of \$50,000 or more, or unintentional estimated gas loss of three million cubic feet or more;
 - a safety-related condition report on findings that compromise the safety of the well or reservoir; and
 - National Registry information that identifies the facility operator with primary responsibility for operations through an assigned Operator Identification Number.

PHMSA Underground Storage Safety Standards (cont.)

- Compliance obligations:
 - Operators must assess the operational safety of their facilities and may need to modify their business operations to comply with the API RPs.
 - Operators may deviate from the API RPs if they provide sufficient technical and safety justification in their programs or procedural manuals on why compliance with a provision of the API RPs is not practical or necessary for the safety of the facility.
 - PHMSA will notify operators of variances that should be avoided and will incorporate lessons learned into inspection protocols and inspector training programs.
 - Operators must also document how they implemented the safety solutions.
- Minimum federal safety standards become effective on January 18, 2017.
- Operators should expect that PHMSA will inspect their facilities to enforce the requirements.

CFTC's Whistleblower Program

- CFTC Staff issued the 2016 Annual Report on the Whistleblower Program and Customer Education Initiatives.
 - Report covers the period from October 1, 2015 through September 30, 2016.
 - During this period, CFTC issued 11 Final Orders that addressed 16 whistleblower award applications, two of which granted applications.
 - CFTC paid three whistleblower awards during the period:
 - September 29, 2015: \$290,000 for providing valuable information about violations of the CEA.
 - This was awarded in the last fiscal year, but was paid during this period.
 - April 4, 2016: \$10 million for providing key original information that led to a successful CFTC enforcement action.
 - July 26, 2016: \$50,000 for providing key original information that led to a successful CFTC enforcement action.

CFTC's Whistleblower Program (cont.)

- CFTC's Whistleblower Office received 273 whistleblower tips and complaints by mail or fax or through the "File a Tip or Complaint" portal on the CFTC's website.
- The Whistleblower Office also received 92 separate non-whistleblower tips and complaints.
 - When appropriate, the Whistleblower Office communicates with non-whistleblower correspondents and invites them to become whistleblowers by submitting a Form TCR.
- The Whistleblower Office forwards all tips and complaints to the CFTC's Division of Enforcement for evaluation and disposition.
- The Whistleblower Office posted 39 Notices of Covered Actions (judgments and orders that impose more than \$1 million in monetary sanctions) and received 59 whistleblower award claims.

Questions?



Levi McAllister

- levi.mcallister@morganlewis.com
- +1.202.739.5837



Pamela Tsang Wu

- pamela.wu@morganlewis.com
- +1.202.739.5199

THANK YOU

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Links provided from outside sources are subject to expiration or change. Attorney Advertising.

© 2016 Morgan, Lewis & Bockius LLP

Morgan Lewis