

# Gas Purchasing—Business, Legal, and Contracting Issues

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“Competition”

“Choice”

“Restructuring”

“Deregulation”

“Market Pricing”

“Marketers”

“Aggregators”

“Unbundling”

These are the buzz words of a new era in the energy business. While the daily newspapers and radio are full of articles and advertisements concerning the impending opening up of the electric industry to customer choice of supplier, little attention is being given to choice in the natural gas markets.

The fact is, however, that except for California and some scattered pilot programs, retail electric markets are not yet open and even the imminent deadlines for retail access may prove to be illusory. For example, Rhode Island retail electric markets, by law, were open to competition July 1, 1997 but a month later less than a handful of customers had chosen alternative suppliers. In contrast, customers everywhere are already able to choose their own gas supplier, other than the local gas utility that had supplied all customers for so many years.

With this new freedom of choice comes not only a number of benefits, but also risks. This article seeks to provide customers some guidance in obtaining such benefits and avoiding the risks. Ultimately, that is accomplished through a careful selection process, best done by means of an RFP with expert assistance, and through a negotiated gas contract. Before addressing specific contracting issues one must understand the legal and regulatory framework which governs the transportation of the natural gas.

## LDC TRANSPORTATION ISSUES

Although a customer generally is able to choose a supplier other than its local utility, often referred to as a local distribution company, or LDC, that customer will still have to take transportation service from that LDC for delivery of the gas supply from the city gate to the customer's delivery point.

Such transportation service is governed by tariffs filed with the state utilities commission. Generally, such service is available to all commercial and industrial customers and, in some cases, residential customers. Some LDCs, however, have not updated their transportation tariffs and may restrict transportation service to customers that have a certain level of usage. Also, the terms and conditions applicable to LDC transportation can be very important to the feasibility of the customer shipping its own gas.

The primary area of risk to a transporting customer and the biggest area of dispute concerning LDC transportation terms and conditions are those provisions concerning balancing of gas supplies delivered and consumed. Such repeated or significant imbalances can lead to substantial penalties by the LDC. Such penalties can be straight charges, very high prices for overtakes (essentially a sale of gas by the transporting LDC, very low prices for undertakes (gas essentially sold back to LDC) and additional charges for costs that the LDC may incur that result from such imbalances.

Such charges are well accepted and must be considered in the choice of type of transportation service, the type of supply service and even the supplier itself. Some transportation customers even contract with the LDC for transportation quantities much greater (e.g., 20%) simply to avoid the risk of imbalance penalties.

The nature of transportation service and the balancing provisions is relevant to choices of services and suppliers as follows. Depending on the factors such as price for different types of transportation service (e.g. with or without built-in balancing service) and the availability and price of any separate balancing services, a customer may wish to enter gas supply arrangement where the marketer agrees to take responsibility for all balancing requirements and has the operational capability and financial strength to do so.

Other characteristics of transportation service that may be important to a customer arranging for its own supply are those

concerning pipeline capacity release (i.e. long line capacity for delivery of supply to the city gate) and availability of storage service. Both are relevant to the gas supply arrangements.

For example, a voluntary capacity release to former LDC sales customers that arrange their own supply allows significant flexibility to customers and interested marketers. Some marketers may want the capacity while others may not need it.

On the other hand, if an LDC has a mandatory capacity release program, that fact may restrict the number of interested marketers or the prices they can reasonably bid. In fact, in Massachusetts there is a pending proceeding on that very topic: how capacity release implementation has created hurdles to competition.

All natural gas market players must recognize the implications of local transportation terms and conditions, such as balancing and capacity release, and plan their transactions accordingly. Because of that importance of the LDC transportation tariffs, all parties should participate in regulatory proceedings (and even legislative efforts) that are relevant to the developing competitive markets.

One other service that an LDC may provide is storage service (or "virtual storage service"). Storage service can allow a customer greater flexibility in the amounts of gas and type of service for which he contracts. Regulatory agencies are increasingly looking at such services as a potential means of aiding competition and choice.

## SPECIFIC GAS PURCHASE CONTRACT ISSUES

### **Pricing**

Pricing, of course, is the central focus of any customer's purchasing decision. Determination regarding which supplier is offering the best price and which pricing option from a given supplier is most advantageous requires some degree of expertise and experience with such matters.

Considerable education may be obtained from the suppliers themselves, but whether a customer's purchasing manager can efficiently distinguish among different offerings and make the best supply choice is questionable. Especially, if that customer has not had prior experience in purchasing its gas supplies, the assistance of a consultant can be very helpful for customers that lack the expertise

in their own staff.

One question that customers who are new to the energy purchasing process raise is the extent to which they are at risk for price fluctuations. If the customers entered a fixed price contract, they should not have such risk. If the customer specifically bargained for exposure to price risk, he should benefit from a lower price, at least initially. One might legitimately fear that a supplier who has agreed to a price that becomes very favorable (to the customer) relative to the market may seek to renege on the contract. From the legal perspective, that should not be a concern, assuming a well-drafted contract.

Nor should the supplier have an economic incentive to act in that manner. Most suppliers that a customer ought to be doing business with would have hedged their price upon entering the contract. By hedging its price for a given supply at the time of contract entry, the marketer is insulated from the market risk the customer fears will trigger a breach. The nature of such hedging may be a legitimate point of inquiry for a customer. Contracting issues such as the time period for which a price is available (usually one year for a one year contract) and load level for which a given price applies may also exist.

### **Balancing Issues**

As discussed above, the preferable approach from the purchaser's perspective is to have its seller undertake all responsibilities relative to balancing. In fact, this is more the norm. In those cases, the marketer will make all arrangements for transportation of the supply to the customer meter to eliminate all such efforts for the customers. Note also, that the marketer with a larger portfolio of customers will be in a much better position to balance the load than the customer.

Where the marketer undertakes balancing responsibilities, however, the marketer may reasonably seek: (i) detailed historical usage information; (ii) advance notification of any operational changes that would result in changed gas consumption, and other relevant information such as customer plant outages. Flexibility regarding these issues may be a major negotiating point. For example, a marketer will seek to impose costs on the customer that result from the customer's failure to provide adequate information.

### **Contract Volumes**

The basic quantity of gas a customer contracts for is largely a business/operational issue. To the extent, however, that a customer foresees the possibility of significant changes in its load (e.g., due to growth, relocation etc.) it should negotiate for flexibility. Such flexibility can result in concrete savings to the customer.

### **Nature of Service**

A customer may take firm or interruptible service, or any variation of either (e.g. 330 day firm). The customer's operational needs and capabilities will be the basis for this determination, but the different levels of service should bear different prices. Knowledge about the supplier's needs and resources may be helpful in negotiation.

Also, if service is firm, the contract must reflect that and the customer should have elicited information in the due diligence process to be confident that the supplier has adequate capabilities to fulfill that commitment to firm service.

### **Liability and Indemnification**

Another contracting/legal issue that can be a fairly significant concern is liability and indemnification. Following the sound rule of allocating risk to the party best able to control that risk, the general rule, as in most gas contracts and tariffs, is to allocate liability for any damages to the party whose control the gas was in at the time of a problem.

Similarly, liability may follow title to the gas. Some contracts will provide for indemnification by one or both parties. Such matters can be negotiated, but in any event a customer should be aware of the extent of any indemnification required by the contract. Some contracts will be of even greater concern in that they continue the long standing utility policy of freedom from liability for damages. It is unlikely that a seller would agree to assume liability for consequential damages, but a customer should be aware that its supplier will assume only limited risks.

### **Billing and Payment Issues**

Typically, marketers have strict provisions regarding time of payment and application of interest in the absence of timely pay-

ment. Customers should take care to ensure that such provisions which comply with applicable law are not overly onerous.

### **Miscellaneous Issues**

Some contracts may require a customer to pay for metering equipment. The extent to which metering costs will be an issue depends partly on size and type of supply and nature of balancing services that a customer takes. Smaller customers, or customers that take a comprehensive balancing source may not necessitate complex metering and can avoid such costs.

Also, some competitive suppliers see metering and associated information systems as a means of offering more services, (e.g. load management) and thereby distinguishing themselves from competitors. A savvy customer may be able to negotiate some benefits in this area.

One contract provision that requires careful attention concerns provision of the customer's electric supply. Marketers frequently insert into gas contracts some obligation on the customer relative to a future electric supply contract. Such a provision may be as innocuous as the grant of a right to the gas supplier to participate in an RFP, or as anti-competitive (and potentially illegal) as requiring the customer to purchase electricity from the same seller once retail choice was available for electricity.

### **SUMMARY**

These are but a few of the issues relevant to the gas purchasing efforts in the new era of customer choice. As the marketplace develops and as the sophistication of buyers and sellers increase, it is likely that many new forms of service and pricing will develop and the associated contracting issues will also increase.

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### **ABOUT THE AUTHOR**

**Eric J. Krathwohl**, a member of the Boston firm of Rich, May, Bilodeau & Flaherty, P.C., concentrates on energy, telecommunications and regulatory matters, including corporate and finance work for energy and telecommunication companies and electric, gas and

water utility companies. He is a *magna cum laude* graduate of the University of Connecticut and has a law degree from Cornell Law School and is a member of the academic honorary societies, Phi Beta Kappa, and Phi Kappa Phi.

For nearly 20 years, Mr. Krathwohl has had an active practice before the Massachusetts Department of Public Utilities, having represented utility companies in dozens of adjudicatory and rulemaking proceedings. Also, his practice has included numerous proceedings before the New York Public Service Commission and the Federal Energy Regulatory Commission and transactions throughout the northeastern United States. He has been active in matters relating to restructuring of the electric, gas and telecommunications industries, increasing competition in those industries, and unbundling the service offerings of public service corporations.

Mr. Krathwohl has represented clients in several matters before the Massachusetts Supreme Judicial Court and has been a speaking panelist with top industry and government officials at conferences on electric restructuring and increasing competition in the utility industry and telecommunications matters. Mr. Krathwohl has also considerable experience in a variety of corporate and contractual matters in the telecommunications and energy fields.

He is the chairman of the Boston Bar Association Energy Law Committee and is a member of several other energy and bar associations. Along with two of his partners, Mr. Krathwohl authored the portion of an administrative law treatise dealing with public utility regulation.