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What You Need to Know About NAESB Contracting

Midstream Energy Series

Part II

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Today's Presenters

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Overview of NAESB Base Contract

- The Base Contract for Sale and Purchase of Natural Gas (Base Contract) is a standardized contract form published by the North American Energy Standards Board (NAESB).
- The current version of the Base Contract is the 2006 version adopted by NAESB on September 5, 2006.
- The Base Contract has become the most commonly used contract for the **PHYSICAL** purchase and sale of natural gas, and can be used for both long term and short term purchases.
- The Gas NAESB and NGL NAESB utilize a similar form of agreement, with a couple of key differences that will be highlighted.

Benefits of the NAESB Base Contract

- Standardization of the basic rules and legal framework of trading in natural gas and NGL(s).
- Simplified contract formation procedure for each transaction that, if followed, assures the creation of an enforceable agreement.
- Bilateral or neutral contracting perspective that allows either party to be the seller or the buyer from one transaction to the next.
- The presence of detailed and standardized credit provisions that the parties can vary in negotiation.
- "No fault", bilateral liquidation of all outstanding transactions upon the occurrence of an event of default.

Components of the Base Contract

- "**General Terms and Conditions**": This is the boilerplate agreement and contains industry approved terms that will govern the relationship between the parties.
- "**Cover Page**": This is the front page where the parties make certain elections as required in the General Terms and Conditions and provide specific organizational information.
- "**Special Provisions**": An attachment to the Base Contract where the parties make additions and amendments to the pre-printed Base Contract form.
- "**Addendum**": NAESB publishes certain addendum (like the Model Credit Support Addendum) setting forth additional terms.

Transaction Confirmations: Overview

- Once the Base Contract is finalized, the parties can transact under the Base Contract by entering into a transaction confirmation setting out the economic terms of the transaction.
- Multiple transactions can be outstanding under a NAESB Base Contract at any time.
- A party can be both a buyer and a seller at the same time under a NAESB Base Contract.

Transaction Confirmations: Commercial Terms

- Performance Obligation: FIRM or INTERRUPTIBLE
  - FIRM: A party's failure to perform will only be excused if the party is subject to an event that is beyond the party's control, a “force majeure” as defined in the Base Contract.
  - INTERRUPTIBLE: A party's failure to perform under an interruptible transaction for any reason will incur no consequences.
- Contract Quantity: Typically Fixed or Variable (i.e., a minimum to maximum range)
- Price: $/MMBtu (usually on a daily or FOM price basis)
- Delivery Location and Delivery Period

Transaction Confirmations: Contract Formation

- Parties will Select either the Oral Transaction Procedure (Default) or the Written Transaction Procedure – Cover Page (Section 1.2) Election.
- Oral Transaction Procedure: EDI/Telephonic conversations can form a transaction. The oral confirmation is considered a "writing" and "signed" by the parties.
  - The Confirming Party confirms the parties' agreement in a Transaction Confirmation within 3 business days (but other party may also send Transaction Confirmation).
  - Failure to send a written confirmation will not invalidate the oral agreement.

Transaction Confirmations: Contract Formation

- Written Transaction Procedure: The transaction will not be effective until the parties agree on non-conflicting terms of the confirmation (unless deemed acceptance).
- Confirm Deadline: The date by which the receiving party must object to the Transaction Confirmation or it is otherwise deemed accepted. The Parties elect on Cover Page (Section 2.7) (default is 2 business days).
- Confirming Party: The Parties elect on Cover Page (Section 2.7) (default is seller).

Transaction Confirmations: Contract Formation

- If both parties send Transaction Confirmations, the transaction will not be binding until either an exchange of non-conflicting Transaction Confirmations or deemed acceptance has occurred.
- Any provision in a Transaction Confirmation that does not relate to the commercial terms of a transaction (i.e., amending the definition of "force majeure") cannot be agreed by deemed acceptance, but instead requires express agreements by the parties.

Performance Obligation: Liquidated Damages

- If a party fails to perform its obligations under a FIRM transaction, this will not automatically be an event of default under the Base Contract, but rather will subject the non-performing party to the payment of liquidated damages (Section 3.2).
- The calculation of liquidated damages will either be calculated based on the "Cover Standard" or the "Spot Price Standard" depending on which standard is elected by the parties on the Cover Page (Section 3.2).
- Cover Standard is the default election and is the most commonly elected remedy.
- Parties can elect "Alternative Damages" in a Transaction Confirmation.

Cover Standard: Overview

- If "Cover Standard" is elected, the performing party will use commercially reasonable efforts:
  - If the buyer is the performing party, to obtain replacement gas, or
  - If the seller is the performing party, to resell gas
- Parties must use the "Cover Standard" (i.e., take into consideration factors such as notice, quantity involved, length of failure, etc.) to determine a reasonable cover price.
- If gas cannot be replaced or sold after commercially reasonable efforts, the gas not replaced or sold will be compensated by an amount equal to the unfavorable difference between the Contract Price and the actual price obtained, multiplied by the quantity not sold or taken.

Cover Standard: Overview

Seller failure to deliver

- Seller pays buyer the positive difference between: (Cover Price minus Contract Price (adjusted for differences in transportation)) multiplied by the undelivered quantity.

Buyer failure to take

- Buyer pays seller the positive difference between: (Contract Price minus Cover Price (adjusted for differences in transportation)) multiplied by the unreceived quantity.

Spot Price Standard: Overview

- If "Spot Price Standard" is elected, the performing party is not required to try to mitigate damages by replacing or reselling the gas, but rather it can determine its damages based on the Spot Price.
- The Parties elect on the Cover Page (Section 2.31) what their spot price will be, which is used for either the Cover Standard or the Spot Price Standard:
    - Gas Daily Midpoint (default) or another spot price, as agreed
    - The price listed under the listing applicable to the geographic location closest in proximity to the delivery point(s) for the relevant day
    - NAESB specifies how to calculate based on whether there is a published price or range of prices (or neither) on a relevant day

Spot Price Standard: Overview

Seller failure to deliver

- Seller pays buyer the positive difference between: (Spot Price minus Contract Price) multiplied by the undelivered quantity.

Buyer failure to take

- Buyer pays seller the positive difference between: (Contract Price minus Spot Price) multiplied by the unreceived quantity.

Invoicing

- The Base Contract's billing and payment provisions are set forth in Section 7 of the General Terms and Conditions and are typical for gas sale contracts generally.
- Section 7.1 requires the seller to invoice the buyer on a monthly basis for the actual quantity of gas delivered during the preceding month.
- If actual quantity information is not available when the invoice is prepared, the invoice will be based on the scheduled quantities of gas, subject to later reconciliation.
- Payment is due from the buyer on the later of (a) the "Payment Date" selected by the parties on the Cover Sheet (Section 7.2) of the Base Contract, or (b) ten days after the buyer's receipt of seller's invoice.

Invoicing

- Section 7.2 establishes a procedure for resolving "good faith" disputes about the amount of an invoice, requiring the invoiced party to pay the undisputed portion of the invoice.
- Section 7.6 provides for audit rights for both parties to verify the accuracy of any invoice or other calculation made under the Base Contract, but limits retroactive adjustments for under- or over-payments to those arising out of claims asserted or objections made by the disputing party within two years after the month of gas delivery.

Invoicing

- Finally, unless the parties elect not to employ netting on the Cover Page (Section 7.7), Section 7.7 provides that each month, **undisputed** amounts due and owing under the Base Contract will be aggregated and netted, with the party owing the greater amount paying the net amount owed by such party when due under Section 7.
- Importantly, payments related to Credit Support Obligations and Cover Damages/Alternate Damages are **not** subject to netting.

Adequate Assurance of Performance

- Under Section 10.1 of the Base Contract, either party is entitled to demand adequate assurance of performance if it has reasonable grounds for insecurity regarding its counterparty's performance under the contract.
- "Reasonable" grounds for insecurity specifically includes the occurrence of a material change in the creditworthiness of the counterparty or, if applicable, its guarantor.
- "Adequate Assurance of Performance" is defined as sufficient security in a form, amount and term that is acceptable to the requesting party and may include, without limitation, cash, a letter of credit, prepayment, security interest, or a performance bond.
- Failure to provide such requested assurance within 48 hours (but at least one business day) of demand will constitute an Event of Default.

Adequate Assurance of Performance

- There is no specific test to determine whether reasonable grounds for insecurity have been met, however substantial arrears in payments, change in ownership, material litigation with a shareholder, impending bankruptcy, credit downgrades and late payments of invoices have all been deemed "reasonable grounds."
- Counterparties will often try to limit their obligations to post Adequate Assurance (i.e., a Parent Corporate Guaranty). Often, such a Guaranty will be subject to a dollar limitation/cap amount.
- Counterparty Adequate Assurance requirements will be transaction and counterparty specific.

Events of Default

- While the failure to deliver or take gas under the NAESB Contract does not lead to an event of default (although the parties can agree to a Termination Option under Section 3.4), other failures will, including a party or its guarantor being subject to:
    - an insolvency type event;
    - a failure to perform under an obligation to provide credit support;
    - a failure to provide Adequate Assurance of Performance (within 48 hours of request, but at least one business day);
    - a failure to pay, subject to a two business day cure; and
    - any "Additional Event of Default."
- Each of these events are considered an "Event of Default" under the Base Contract.

Events of Default

- Additional Events of Default are elected on the Cover Page (Section 10.2) and consist of "Indebtedness Cross Default" and "Transactional Cross Default."
- The Additional Events of Default allow a party to declare an Event of Default under an NAESB Contract even though its counterparty may not have defaulted under the NAESB Contract, but has defaulted under another significant agreement entered between the parties.
- Indebtedness Cross Default: A party or its Guarantor experiences a default under one or more agreements relating to indebtedness for the payment or repayment of borrowed money in excess of a specified threshold.
- Thresholds include a fixed dollar amount, a percentage of shareholder's equity or a percentage of net asset value.

Events of Default

- Transactional Cross Default: A default under any other transaction or agreement between the parties for the purchase, sale or exchange of physical gas, and any other transaction or agreement identified in the Cover Page.
- Parties often negotiate additional Events of Default in the Special Provisions:
  - Material breach of a representation or warranty;
  - Loss of any regulatory approval required for performance;
  - Potential or threatened litigation that would impair a party's, or if applicable, its Guarantor's, ability to perform under the agreement;
  - Judgment in excess of a certain threshold against a party;
  - Merger or similar transaction where remaining entity is materially weaker or where surviving entity does not assume the party's obligations;
  - L/C Event of Default; and
  - Change of control of ownership of a party or, if applicable, its Guarantor.

Remedies and Early Termination

- Upon a continuing Event of Default, the non-defaulting party may, by giving notice to the defaulting party, immediately withhold all payments or deliveries and terminate the Base Contract by designating a date which must be within 20 days of notice for the liquidation and termination of all transactions under the NAESB Contract (the "Early Termination Date").
- In the Cover Page (Section 10.3.1), the parties can elect whether or not "Early Termination Damages Apply."
- The election that "Early Termination Damages Apply" is the default election and industry standard.
- If "Early Termination Damages Do Not Apply", the non-defaulting party will simply determine the amount owed by each party for gas delivered on or before the Early Termination Date and any other applicable charges.

Remedies and Early Termination

- If the parties agree that Early Termination Damages Apply, the Non-Defaulting Party determines:
  - Amount owed by each party for gas delivered or received either on or before the Early Termination Date;
  - Other applicable charges related to deliveries and receipts; and
  - Market Value of terminated transaction.
  - NOTE: Parties will also negotiate to include certain specified costs like hedging breakage costs, attorneys' fees, etc.
- To determine the Market Value, the non-defaulting party will determine, for each terminated transaction, the amount of gas remaining to be delivered or purchased under a transaction multiplied by the market price.
- Valuation factors: NYMEX futures, quotations from leading dealers, market data, bona fide third party offers.

Remedies and Early Termination

- The non-defaulting party then accelerates each terminated transaction at its Market Value.
- If the Market Value of a terminated transaction exceeds its "Contract Value" (i.e., the amount of gas remaining to be delivered or purchased at the Contract Price), the seller will pay a termination payment to the buyer.
- If the Market Value of the terminated transaction is less than its Contract Value, the buyer will pay a termination payment to the seller.
- Any termination payment calculated under this procedure will be discounted to present value in a commercially reasonably manner.

Aggregation and Setoff

- Whether the parties have elected Early Termination Damages Apply or Early Termination Damages Do Not Apply, the non-defaulting party will net or aggregate, as appropriate, any and all amounts owing between the parties, and such amounts will be netted or aggregated to a single liquidated amount payable by one party to the other.
- The party owing the largest amount will make a net payment to the other, regardless of which party was in default.
- On the Cover Page (Section 10.3.2), the parties elect whether set-off will only apply between the parties (bilateral), whether they will bring in their affiliates (triangular) or whether set-off will not apply at all.
- If Set-Off has been elected in the Cover Page, the non-defaulting party can then set-off amounts it owes against amounts owed to it.

Aggregation and Setoff

- If parties have more than one agreement in common, they typically apply setoff against the early termination amount calculated in Section 10.3.1. Bilateral set-off is the default and industry standard.
- Market participants with affiliates that have agreements with their counterparty may want to expand the setoff right to include amounts owed under agreements with affiliates (i.e., triangular set-off).
- Bankruptcy jurisprudence indicates that triangular set-off is not enforceable.
- Section 13 contains a broad disclaimer by the parties of any right to claim consequential, incidental, punitive, exemplary, or indirect damages, lost profits, or other business interruption damages in connection with a breach of the Base Contract.

Governing Law

- The parties agree to the governing law of the NAESB Contract and specify on the Cover Page (Section 15.5).
- Note that there is no dispute resolution clause in the NAESB Contract, so the parties will need to add (i.e., venue, jury waiver, etc.).
- Some counterparties will ask for a binding arbitration provision.

Confidentiality

- The parties elect on the Cover Page (Section 15.10) whether they will be subject to a confidentiality requirement.
- Confidentiality is the default and should generally always apply.

Special Provisions

- Special Provisions really run the gamut and can be transaction specific. The following are indicative:
  - Additional Events of Default
  - Costs definition for calculation of early termination damages
  - Clarification to tax allocation
  - Revisions to invoicing mechanics
  - Adequate Assurance modifications
  - Transactional reps and warranties (including Dodd-Frank)
  - Bankruptcy savings provisions
  - Force majeure modifications
  - Governing law/venue/arbitration
  - Regulatory/compliance with laws

Closing

- By its terms, the Base Contract, together with all Transaction Confirmations entered into between the parties, form a single legal agreement, the benefits of which are well established in the industry.
- The same applies to industry-standard GTC(s) like P66 or Conoco.
- Absent, express contract terms, UCC gap-fillers will apply.

QUESTIONS OR COMMENTS?