### Oil and Liquids Pipeline Regulation at the Texas Railroad Commission

Presented by John K. Arnold, Shareholder



# Texas regulation of oil and liquids pipelines is increasingly important

- Hydraulic fracturing and horizontal drilling boom means new areas of significant natural gas, crude oil, and natural gas liquids ("NGL") production in the US, with Texas chief among them.
- Despite sufficient pipeline capacity to facilitate the initial phase of the boom, capacity is now increasingly limited.
- More pipelines must be built to maximize production potential and move commodities to market centers (refineries, Mont Belvieu).
- In Texas, production, gathering and transportation functions are often wholly intrastate and are thus regulated almost exclusively by the Railroad Commission of Texas (RRC).
- Regulation by the RRC is key to determining the economic conditions for a pipeline, as well as to ensuring the lawful operation of the pipeline.

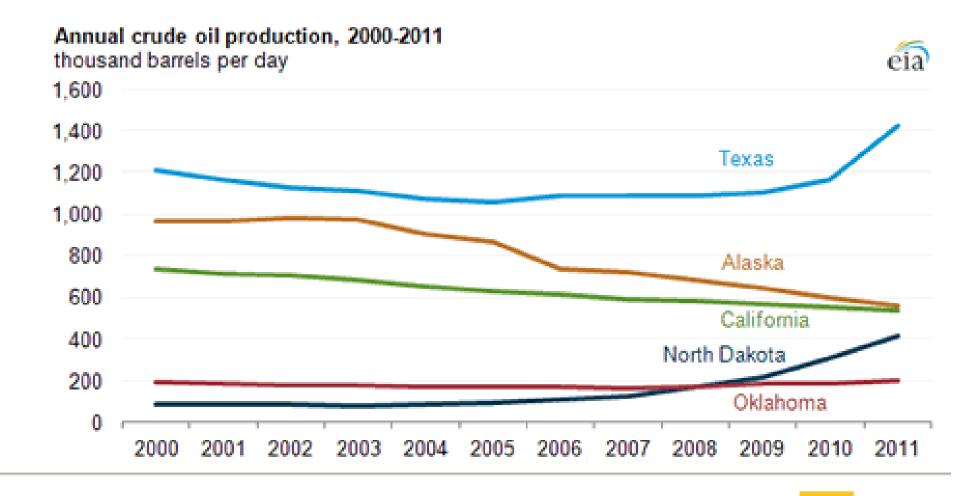


#### **U.S. Oil Production Metrics**

- Crude oil production increased by 790,000 bbl/d between 2011 and 2012, the largest increase in annual output since 1859.
- Crude oil output is forecast to rise 815,000 bbl/d this year to 7.25 million bbl/d, and by another 570,000 bbl/d to 7.82 million bbl/d, highest annual average since 1988.
- Principal sources of new production: Texas and North Dakota



# Crude production in Texas and North Dakota is growing rapidly



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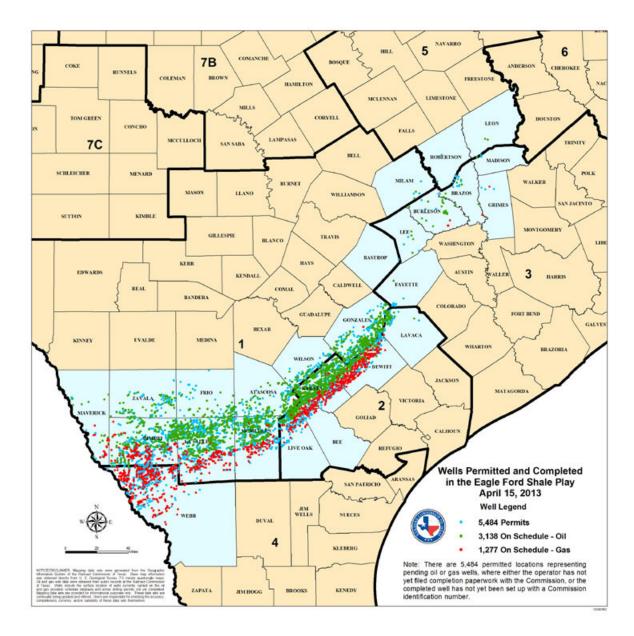
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# **Eagle Ford Shale Metrics**

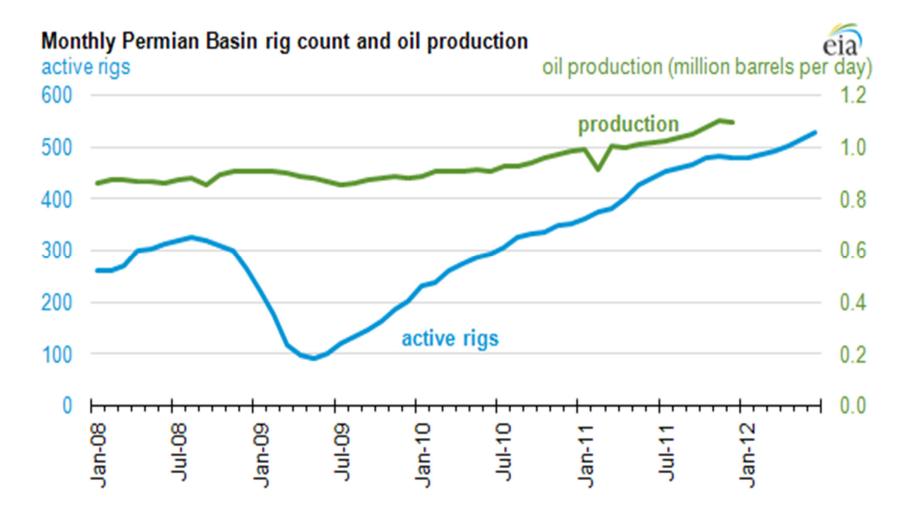
- "Eagle Ford" Shale is a 23-county area that stretches from Laredo to Bryan/College Station
- More drilling permits in 1Q 2013 than all of 2010
- Value of production has grown to approximately \$10 billion
- Crude oil production increase 54% ('07 '11)
- Liquids production increase 541% ('07 '11)
- 370,000 bbl/d in 2012, on pace for nearly 470,000 bbl/d in 2013
- Similar trend occurring in the Permian Basin



#### **Eagle Ford Shale Permitted Wells - 2013**



### **Permian Basin Rig Count and Production**





### **Problem: Insufficient pipeline infrastructure**

- Conditions needed for investment in pipeline infrastructure:
  - Stable, attractive commodity prices
  - Available capital, financing
  - Long term transportation/gathering commitments from producers, i.e., shippers on the pipeline
  - Regulatory certainty regarding the commercial operation of the pipeline, as well as the lawful operation of the pipeline



# Overarching issues: Rates and access to capacity

- Texas law has no "anchor shipper" legal framework, i.e., capacity cannot be guaranteed to a shipper or shippers who commit early in the pipeline's development to subscribe to a certain level of transportation/gathering capacity.
- FERC increasingly recognizes that revenue from a committed shipper is critical to obtaining financing for the capital outlay for a pipeline and allows certain capacity commitments to be made to shippers.
- In Texas, broad non-discrimination principles govern rates and access for oil gathering (common purchasers) and such principles govern transportation (common carriers) at both the federal and state level.



### Gathering of crude petroleum: Texas Common Purchaser Act

- § 111.091 of the Texas Natural Resources Code ("TNRC") defines a crude oil "common purchaser" to mean:
  - every person that purchases crude oil that is affiliated with a common carrier;
  - every person that operates a crude oil gathering system, whether or not it is a common carrier or affiliated with a common carrier;
  - the business of purchasing and selling crude petroleum by the use of a gathering system
- RRC: If you gather, you're a common purchaser, unless you're merely transporting crude from a property in which you own an operating interest.



## **Duties of a common purchaser**

- Rate regulation. TNRC § 111.085 gatherers are subject to rate regulation by the RRC
- Non-discrimination. TNRC § 111.086 Common purchaser shall purchase oil offered to it for purchase without discrimination in favor of one producer against another producer in the same field and without unreasonable discrimination between fields.
  - "field" means a certain geographic area of production, <u>Railroad</u> <u>Comm'n v. Rio Grande Valley Gas Co.</u>, 405 S.W.2d 304 (Tex. 1966).
- Own production. TNRC § 111.087 -- No common purchaser may discriminate between or against crude oil of a similar kind or quality in favor of its own production.



## "Ratable take" – TNRC § 111.087

- Ratable take. Production shall be taken in the ratable proportion that the production bears to the total production offered for market in the field.
- Establishing formula. Pipeline may establish the formula for the ratable take, but RRC has the authority to "make inquiry in each field" and if discrimination is found shall issue an order to make reasonable extensions of its lines, reasonable connections, and ratable purchases that will prevent discrimination. TNRC § 111.091
- Ratable take over contract. When in conflict with respect to volumes of takes, the applicable ratable take requirements control over contractual take provisions. <u>Railroad Comm'n v. Permian Basin Pipeline Co.</u>, 302 S.W.2d 238 (Tex. Civ. App.—Austin 1957, pet. denied).
- Action for damages. If a person is discriminated against by a common purchaser in favor of the production of the common purchaser, the person may bring an action for damages against the common purchaser. TNRC § 111.095



# **Regulation of common carriers**

#### • Who is a common carrier?

- Own, operate, manage, or engage in the business of operating a pipeline to transport crude oil to or for the public for hire. TNRC § 111.002(1).
  - § 111.002(2) and pipeline is on, over, or under public right-of-way;
  - § 111.002(3) and pipeline is on, over, or under right-of-way of railway or other common carrier;
  - § 111.002(4) owns, operates, manages pipeline to transport crude oil, bought of others, from place of production in TX to distributing, refining, marketing, or reshipping point in TX;
  - § 111.002(5),(6), (7): coal, CO2 and carbon gasification pipelines

#### Who is not?

– Common carrier statutes do not apply to pipelines that are limited in their use to the wells, stations, plants, and refineries of the owner and that are not part of the pipeline transportation system of a common carrier. TNRC § 111.003.



### Key non-discrimination principles

- Transportation without discrimination Common carrier shall receive and transport crude oil delivered to it for transportation without discrimination. TNRC § 111.015.
- Discrimination between shippers A common carrier shall not discriminate between or against shippers with regard to facilities furnished, services rendered, or rates charged under the same or similar circumstances. TNRC § 111.016.
  - A common carrier shall not discriminate in the transportation of crude oil produced or purchased by itself.
- Equal compensation for like service No common carrier may charge, demand, collect, or receive from anyone a greater or lesser compensation for a service rendered from another for a like and contemporaneous service. TNRC § 111.017.



## **Allocation of capacity**

- Equitable apportionment if more crude oil is offered for transportation than can be transported immediately, it shall be apportioned equitably, and the RRC may make and enforce rules for equitable apportionment. TNRC § 111.142.
- RRC Rule if offer for transportation exceeds amount that can be immediately transported, capacity shall be apportioned among all shippers in proportion to the amounts offered by each; but no offer shall be considered beyond the amount that is immediately ready for shipment. 16 Tex. Admin. Code § 3.71(16).
- Enlargement/Extension of Facilities RRC may require common carrier to extend or enlarge pipelines if found to be reasonable and in public interest. TNRC § 111.137



### **Transportation rates**

- TRRC employs <u>extremely</u> laissez-faire rate regulation.
- TNRC § 111.181 RRC shall establish and promulgate rates of charges for gathering, transporting, and delivery of oil. But, the following provisions are rarely used:
  - TNRC § 111.183 Basis for Rate
  - TNRC § 111.186 Reparation and Reimbursement
  - TNRC § 111.187 Reimbursement of Excess Charges
  - TNRC § 111.188 Annual Rate Hearing ("shall hold")
  - TNRC § 111.221 Complaint Proceeding
- Key to establishing rates tariff filing pursuant to TNRC § 111.014
  - Tariffs to be filed by a pipeline shall specify separately the charges for gathering of the oil, for transportation, and for delivery. 16 Tex. Admin. Code § 3.71(8)



### Key right of a common carrier – Eminent domain

- TNRC § 111.019 Common carriers have the right and power of eminent domain.
- <u>Texas Rice Land Partners v. Denbury Green Pipeline-</u> <u>Texas, LLC</u>.
  - Must prove "public use" by proving you are a common carrier.
  - How do you prove you are a common carrier?
    - Must demonstrate evidence of a reasonable probability that at some point after construction the pipeline will "serve the public" by transporting gas for at least one unaffiliated shipper
  - Limited to CO2?
    - Not likely.
- Attempts to enact a conclusive "common carrier" hearing at the RRC in 2013 Legislature were unsuccessful
- RRC rulemaking next?



## Post-Denbury Case Law

 <u>Rhinoceros Ventures Group, Inc. v. TransCanada Keystone</u> <u>Pipeline, L.P.</u>

- Beaumont Court of Appeals (<u>Denbury</u> panel) - Nov., 2012

- Trial court denied Landowner's MSJ, arguing:
  - Trial Court lacked jurisdiction and TNRC did not apply because pipeline was interstate line
  - Pipeline transporting crude petroleum from outside Texas contravenes Texas's oil and gas laws, which is to conserve Texas's oil and gas resources.
- Court of Appeals affirmed:
  - TransCanada is a Common Carrier under § 111.002(1) of the Tex. Nat'l Res. Code, which does not delineate between interstate and intrastate pipelines.
  - If an entity meets the requirements of 111.002(1), then it does not also have to meet the requirements of 111.002(6); rejecting the argument that *Denbury* effectively adds the (6) requirements into (1).



# *In re Texas Rice Land Partners*: must status be determined before possession?

- Mandamus in which TRL alleged the TC abused discretion by not resolving its challenge to TransCanada's status <u>before</u> granting writ of possession
- COA: Prop. Code 21.021 allows condemning party to take possession "pending results of further litigation" if condemnor pays damages into registry BUT evidence in the record must reasonably support assertion of authority; error for TC not do so.
- BUT harmless error because the evidence here showed:
  - open season
  - binding TSAs with unaffiliated third party shippers who hold title
  - tariff to be filed at FERC
  - pure pipeline company with no affiliated refiners, producers, or marketers
- COA holds that TC must make a "preliminary finding" of common carrier status before awarding temporary possession to a pipeline company.
- Texas Supreme Court denied petition for review



### Legislative responses to <u>Denbury</u>

#### HB 2748 by Lewis

- One hearing at the RRC to conclusively determine common carrier status for entire pipeline route.
- Notice to be provided to landowners on a countywide basis, i.e., not just those on route, 21 days to answer notice
- Conclusive effect in landowner challenges to right to take.
- Backed by Texas Pipeline Association and industry but died
- HB 3547 by Oliveira
  - Hearing to occur in county where land is located and conducted by SOAH, not RRC.
  - Opposed by Texas Pipeline Association and industry
  - Passes Land and Resource Mgmt. Committee, dies in Calendars Committee
- SB 901 by Fraser
  - Last ditch attempt in the Senate to define common carriers as providing public use because they eliminate pollution and limit damage to roads.

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- RRC given exclusive jurisdiction to determine who is a common carrier

### Parties' positions on legislation

#### Landowners:

- Hearing in Austin at the RRC removes the challenge from landowner friendly forum and places it in pipeline friendly forum
- If determination in administrative hearing is given conclusive effect, landowner is deprived of meaningful challenge to constitutional issue of public use
- Insufficient notice regarding potential presence on property and time to intervene

#### • Pipelines:

- Certainty of infrastructure development critical to oil and gas boom
- Inconsistent decisions not just between counties but within counties
- Public use does not mean public purpose
- Public use constitutional challenge remains in courts, common carrier determinations made at RRC
- SOAH has no authority independent of agency for which it renders decisions.
- Parties to the dispute include wealthy, powerful families on both sides



# Going forward with common carrier condemnation

- RRC rulemaking?
  - political and legal obstacles
- Recommended course:
  - Board resolution
  - Open Season
  - Tariff issues (interstate vs. intrastate)
  - At least one TSA with unaffiliated shipper
    - Confidentiality issues
  - Proactive engagement with landowners, cooperative stance, and rigorous compliance with LOBOR.

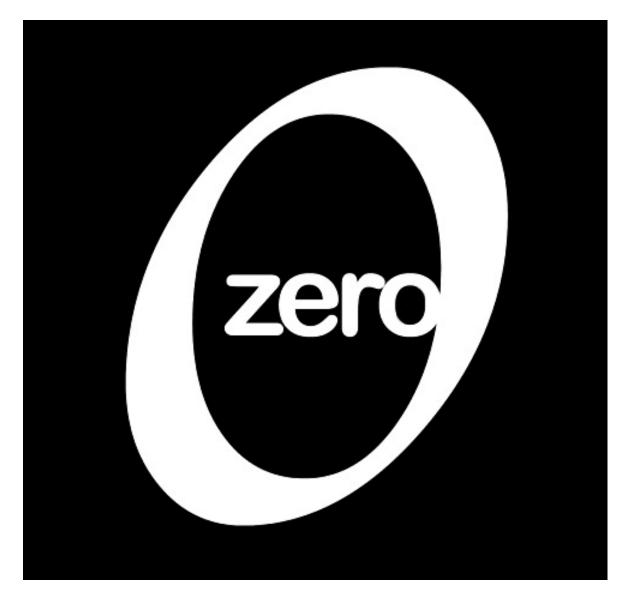


#### Growth of the NGL mid-stream sector

- Highest average monthly production in the Eagle Ford is coming from the formation's liquids-rich window.
- Rig counts declining in shale areas without liquids or crude oil (gas rig count lowest in 18 years).
- Industry projected to bring more than \$30 billion of new midstream infrastructure online by 2015 to accommodate the shift to NGLs.
- New NGL pipelines are coming.



# Texas laws specifically regulating NGL common carrier pipelines



# Does RRC have common carrier jurisdiction over NGL pipelines?

- Southern Union Gas Energy, Ltd. complaint against Louis Dreyfus Pipeline, LP
- Interconnection complaint (i.e., demand for access to and capacity on NGL pipeline) filed at the RRC by shipper of liquids against pipeline
- Louis Dreyfus filed petition in Travis County civil district court contending the RRC had no jurisdiction over NGLs because they are not identified in Chapter 111 TNRC
- Southern Union responded that RRC had primary jurisdiction over NGL pipelines
- Parties settled and RRC complaint and civil suit were dismissed, leaving speculation about whether and to what extent a rate or access complaint can be brought against a NGL pipeline at the RRC.
- New decision: <u>CrossTex NGL Pipeline v. Reins Road Farms-1, Ltd.</u>



# RRC has jurisdiction over common carriers of "oil products"

- "When the evidence before the court indicates that a pipeline carrying oil products (such as ethylene) has subjected itself to the authority of the [RRC] to regulate its activities, then it is a common carrier." Vardeman v. Mustang Pipeline Co., 51 S.W.3d 308 (2001).
- Oil products include "any and all . . . by-products derived from crude petroleum oil or gas . . . . By definition ethylene is a gas "derived from natural gas and petroleum." Bullock v. Shell Pipeline Corp., 671 S.W.2d 715 (1984), citing American Heritage Dictionary (1973).
- So, "oil products" appears to be broad enough to include NGLs and, if a pipeline has submitted itself to the RRC as a common carrier of NGLs, it might be regulated as a common carrier under Chapter 111. Often the safest course.



### **CrossTex: are NGLs crude petroleum?**

- CrossTex NGL Pipeline sought injunction for survey access
  - CrossTex argued that Ch. 111 definition of crude includes NGLs
  - Reins Road Farms argued they are not, and CrossTex could not condemn
- Two issues: Chapter 111 TNRC and Section 2.105 of TBOC
- First issue, Chapter 111
  - COA Distinguished between crude in natural state and by-products of crude to conclude that TC did not abuse discretion in ruling NGLs are not crude
  - What about Vardeman and Bullock?



# CrossTex: are NGLs crude petroleum? (continued)

- TBOC 2.105: COA concludes evidence supports inference that pipeline would not be for "public use"
  - extension of existing private line
  - transportation between CrossTex affiliates
  - no tariff
  - most of capacity dedicated to affiliates (70K bbls of 77K capacity)
  - after unsuccessful open season, had not conducted another
  - 4 transportation Ks, but CrossTex was purchaser
- ALSO not persuaded that Denbury is limited to CO2



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