

**REPORT OF THE
NATURAL GAS PIPELINE COMPETITION STUDY
ADVISORY COMMITTEE
TO THE
RAILROAD COMMISSION OF TEXAS**

July 1, 2006

NATURAL GAS PIPELINE COMPETITION STUDY

ADVISORY COMMITTEE MEMBERS

Mary Ann Pearce, Chairman
ConocoPhillips Company

Jon S. Brumley
Encore Acquisition Company

Steve Howell
Howell Oil & Gas, Inc.

W.H. (Bill) Easter, III
Duke Energy Field Services

Mackie McCrea
Energy Transfer Company

Richard A. Erskine
Atmos Energy – Mid-Tex Division

Lee Parsley
E. Lee Parsley, P.C.

Stephen A. Holditch, P.E.
Texas A&M University

William Warnick
Texas General Land Office

CONTENTS

EXECUTIVE SUMMARY.....	v
Background.....	v
The Committee's Charge.....	v
Recommendations to the Commission.....	vi
<i>Informal Complaint Procedure</i>	vi
<i>Transparency</i>	vii
<i>Marginal Wells</i>	vii
<i>Gathering and Transportation Fees</i>	viii
INFORMAL COMPLAINT PROCESS.....	1
The Commission's Charge.....	1
Background.....	1
Recommendations.....	2
<i>Recommendation 1—Include Everyone</i>	2
<i>Recommendation 2—Allow an Independent Mediator by Agreement</i>	3
<i>Recommendation 3—Set-Out the Commission's Policy and Publicize the Process</i>	4
<i>Recommendation 4—Clarify the Non-Retaliation Provisions</i>	5
<i>Recommendation 5—Give the Commission Enforcement Power</i>	6
TRANSPARENCY.....	8
The Commission's Charge.....	8
Background.....	8
<i>Transparency and the Code of Conduct</i>	8
<i>Information Gathered at the Workshops and the Rulemaking Request</i>	9
<i>The Committee's Analysis</i>	10
Recommendations.....	12
<i>Recommendation 1—Strengthen the Informal Complaint Process</i>	12
<i>Recommendation 2—Education</i>	13
<i>Recommendation 3—Confidentiality in Future Contracts</i>	13
REACH OF POLICY CHANGES.....	14
The Commission's Charge.....	14
Recommendations.....	14
MARGINAL WELLS.....	15
The Commission's Charge.....	15
The Importance of Marginal Production.....	15
The Difficulty in Subsidizing Marginal Wells.....	17

Recommendations.....	18
<i>Recommendation 1—Continue Tax Abatements</i>	18
<i>Recommendation 2—Enhance the Informal Complaint Procedure</i>	19
<i>Recommendation 3—Educate Operators about the Ability to Commingle Gas from Marginal Wells</i>	19
GATHERING & TRANSPORTATION FEES.....	20
The Commission’s Charge	20
The Committee’s Work.....	20
Recommendation	21
OTHER STATES.....	23
The Commission’s Charge	23
Recommendation	23

EXECUTIVE SUMMARY

Background

The Texas Legislature, by inclusion of a rider to the 2006-2007 appropriations bill, required the Railroad Commission of Texas to “conduct a study that examines and determines the extent to which viable competition exists in the Texas natural gas pipeline industry from wellhead to burner tip. The study shall recommend solutions to bring market competition to any non-competitive segments of the industry. The study also shall include an assessment of the effectiveness of current laws, regulations, enforcement and oversight in addressing abuses of pipeline monopoly power and made recommendations for changes that may be necessary. In addition, the study shall include a comparative review of competition in the Texas interstate pipeline industry administered by the Federal Energy Regulatory Commission. The Railroad Commission shall submit a report of its findings to the Legislative Budget Board and the Governor on or before November 1, 2006.”

By rule effective April 3, 2006, the Commission established the Natural Gas Pipeline Competition Study Advisory Committee. *See* 31 Tex. Reg. 2850; 16 TEX. ADMIN. CODE § 7.7201. “The purpose of the committee is to give the Commission the benefit of the members’ collective business, technical, and operating expertise and experience to help the Commission review competition in the Texas intrastate pipeline industry, assess the effect of current statutes and rules on such competition, and develop recommendations for changes to statutes or rules that may be necessary.” The Committee was required to report its advice and recommendations in writing to the Commission no later than July 1, 2006.

The Committee’s Charge

The Commission announced the appointment of the Natural Gas Pipeline Competition Study Advisory Committee on April 11, 2006, and charged the Committee with evaluating:

- Whether further improvements to the Commission’s informal complaint process are warranted.
- Whether additional transparency is needed in the natural gas pipeline industry.
- What transporters should be affected by any change in policy or law.
- Whether to give special treatment to marginal wells.

- Whether the Commission should exercise oversight regarding the types and categories of fees charged related to gas gathering and transportation.
- Whether other states methods for addressing discrimination relative to gas gathering and transportation should be adopted in Texas.

The Committee met ten times between May 1st and June 30th, 2006. This report is the result of the Committee's work and is intended to address the six issues presented to the Committee by the Commission.

Recommendations to the Commission

The Committee makes the following recommendations.

Informal Complaint Procedure

In regard to the informal complaint process the Committee recommends—

- That the Commission's proposed enhancements to the informal complaint procedure be adopted and further strengthened by the modifications proposed by the Committee.
- That the rule codifying the informal complaint procedure provides that the informal complaint process applies to *all* complaints about natural gas purchasing, selling, shipping, transportation, and gathering.
- That the informal complaint procedure allows the parties to agree to employ and pay an independent mediator rather than being required to use Commission staff.
- That the Commission publicize the informal complaint process in a manner it believes will be effective to reach a majority of natural gas producers, and inform and encourage producers to use, and encourage pipelines, gatherers, and industry trade associations to promote, the informal complaint process as an available, low-cost mechanism for resolving complaints regarding the transportation, treatment, and sale of natural gas.
- That the Commission include a clear policy statement in the informal complaint procedure rule to assure all natural gas purchasers, sellers, shippers, transporters and gatherers that the Commission is committed to a process that is fair, timely, and affordable.
- That the Commission's proposed rule, which prohibits retaliation by gathers and transporters, be adjusted slightly to:
 - Remove the requirement that the mediator decide in advance whether service can be discontinued or denied because the

- requirement may cause unwarranted delay when safety or other immediate concerns are present; and
 - Amend the provision allowing a gatherer or transporter to discontinue or deny service for out-of-specification gas in cases in which the gatherer or transporter is accepting such gas from other shippers in the area.
- That the Legislature give the Commission specific authority to enforce its statutory duty to prevent discrimination in natural gas gathering and transportation, to enforce the requirement that parties participate in the informal complaint process, and to punish purchasers, transporters, and gatherers for retaliating against shippers and sellers.

The Committee has included with this report a draft informal complaint procedure rule that incorporates its recommendations.

Transparency

In regard to Transparency, the Committee recommends—

- That the informal complaint procedure rule require mandatory participation and full access to contract information and any other materials requested by the mediator in accordance with Commission rules after an informal complaint is filed, which provides transparency in specific cases in which a party believes it has been treated in a discriminatory manner.
- That the Commission educate industry participants, and encourage industry trade associations to educate their members, about the amount of information already available through the Commission's website, through tariff filings with the Commission, and through the Comptroller of Public Accounts.
- That the Legislature provide by statute that producers have the option of not having a confidentiality provision in future sales, gathering, and transportation contracts.

Marginal Wells

In regard to marginal wells, the Committee recommends—

- That the Commission educates market participants, including royalty owners, of the benefits of commingling gas, as is allowed by Statewide Rule 26(b), to extend the economic viability of marginal wells.

- That the Legislature extend indefinitely the severance tax abatement applicable to marginal wells currently codified in Texas Tax Code § 201.059.
- That the Legislature continue in effect indefinitely the franchise tax abatement applicable to natural gas wells producing less than 250 Mcf per day that was included in H.B. 3 adopted by the 79th Legislature in its Third Called Session.

Gathering and Transportation Fees

- That the Legislature give the Commission the ability to use either a cost-of-service method or a market-based method (using the Oklahoma statute as a model) for setting a rate for natural gas gathering and/or transmission in a formal rate proceeding.

INFORMAL COMPLAINT PROCESS

The Commission's Charge

The Commission's charge to the Committee notes that the Commission has already initiated improving the existing informal complaint process, but asks if the Committee suggests any additional improvements. The Committee agrees that the Commission's proposed changes are appropriate and that other improvements to the informal complaint process should be made. The additional changes recommended by the Committee are outlined in more detail below.

Background

The Commission has in place an informal process using Commission staff to mediate disputes regarding the gathering and transportation of natural gas (called the "informal complaint process"). There, however, is no formal rule or statute codifying the process.

From November 2005 through January 2006, the Commission held workshops in seven Texas cities to take public comment on natural gas gathering- and transportation-related issues. Commission staff then aggregated the comments and compiled the following list of issues raised at the workshops about the informal complaint process (which are not presented verbatim).

1. Some producers testified that the informal complaint process is costly, time-consuming, and ineffective; that the Commission takes no action on enforcement measures; and that the Commission favors pipelines over producers.
2. Some producers complained that the Commission does not get involved in pricing disputes.
3. Several producers who testified at the workshops were not aware of the informal complaint process.
4. A number of producers indicated that they were afraid of retaliation or retribution by gatherers and transporters if they pursued an informal complaint.
5. Witnesses testifying on behalf of the pipeline companies generally supported the informal complaint process, stating that they believed that a case-by-case approach was the best way to address alleged abuses.
6. Taken together, the witnesses suggested that the informal complaint process could be improved by, among other things—

- a. Requiring that participation in the informal complaint process be mandatory;
- b. Setting deadlines for the expeditious resolution of disputes through the informal complaint process;
- c. Requiring a reasonable amount of discovery in the informal complaint process;
- d. Prohibiting retaliation by gatherers if a producer chooses to pursue a complaint through the informal complaint process;
- e. Allowing the mediation to take place in the Commission's district offices rather than in Austin only;
- f. Allowing reimbursement for costs incurred in the informal complaint process;

Based on the testimony received at the workshops, Commission staff recommended that the informal complaint process be codified as a rule and that the following six changes be made to the current process—

- 1. Require participation in the informal complaint process.
- 2. Allow the Commission staff to require the parties to provide needed information at any time during the process.
- 3. Prohibit retaliation by the gatherer/transporter against the producer for pursuing an informal complaint.
- 4. Institute specific deadlines for each step in the informal complaint process.
- 5. Allow the parties to choose to have the mediation conducted in a Commission field office.
- 6. Require the mediator to send to the parties a confidential memorandum stating the mediator's conclusions, if the mediation fails.

Recommendations

The Committee discussed the informal complaint process in detail. The Committee agreed that the informal complaint process should be codified as a rule and that the Commission's proposed changes are necessary. The Committee agreed that other changes also are necessary. The Committee drafted a revised rule for the Commission's consideration, and that proposed rule is attached to this paper. The proposed rule incorporates the Commission's proposed changes as well as those recommended by the Committee. The Committee's recommended substantive changes are outlined below.

Recommendation 1—Include Everyone

Based on the information garnered at the workshops and the experience of the Committee members, the Committee believes that real or perceived abuses can

involve both utilities (as defined by statute) and non-utilities. The Commission is required by statute to prevent discrimination and has authority to address discrimination by all entities, whether a “utility” or not. The Committee therefore recommends that the Rule explicitly provide that the informal complaint process applies to *all* complaints about natural gas purchasing, selling, shipping, transportation, and gathering. This is intended to include wellhead purchasers and producer-owned gathering systems that transport and/or purchase third-party gas.

The Committee recognizes that the Commission does not have the authority to set natural gas purchase prices, and the Committee does not intend that its recommended changes to the informal complaint process be construed as giving the Commission authority to set natural gas prices through any process. Purchasers, however, often perform several functions (such as gathering and purchasing) in the natural gas supply chain, and the Commission has authority to prevent discrimination by any entity in the supply chain. The Committee, therefore, believes it appropriate to include purchasers in the group of market participants who may be compelled to participate in the informal complaint process.

Two parts of the Committee’s proposed rule are intended to implement the Committee’s recommendation. First, the opening paragraph provides that the informal complaint procedure “applies to any complaint within the Commission’s jurisdiction, including, but not limited to, complaints about natural gas purchasing, selling, shipping, transportation, and gathering practices.” Second, paragraph (b)(4) then defines “informal complaint proceeding” to mean “[t]he process set out in this section for addressing disputes among entities within the Commission’s jurisdiction, including, but not limited to, natural gas purchasers, sellers, shippers, transporters, and gatherers.”

Recommendation 2—Allow an Independent Mediator by Agreement

To address some producers’ concerns that the Commission favors the pipelines over producers, the Committee believes that the informal complaint-resolution process should allow the parties to agree to employ and pay an independent mediator. If the parties do not agree to use an independent mediator, the informal complaint-resolution process would be conducted using Commission staff as the mediator.

This recommendation is expressed in paragraph (d)(4) of the proposed rule, which provides that a mediator “may be either a Commission employee or a non-Commission employee.” If the complainant and respondent desire a mediator who is not a Commission employee, they must submit a written request to the Director of the Gas Services Division by which they must agree to share all costs of mediation. The proposed rule provides for the Commission to provide a “monitor” to act as a technical advisor to the mediator when the mediator is not a Commission employee.

The Commission's monitor, at the direction of the mediator, may participate in the mediation. The proposed rule further provides that a non-Commission-employee mediator be given the same duties and obligations as a Commission-employee mediator, including the authority to compel the parties to provide information to the mediator for use in the mediation.

Recommendation 3—Set-Out the Commission's Policy and Publicize the Process

Testimony from the workshops showed that some producers did not know about the informal complaint process, while others were doubtful of its effectiveness, concerned about perceived bias by the Commission, and worried about the cost of participating in the informal complaint process. The Committee believes these issues should be addressed in two ways. First, the Commission should publicize the informal complaint process in a manner it believes will be effective to reach a majority of natural gas producers. The Commission should endeavor to inform and encourage producers to use the informal complaint process, and encourage pipelines, gatherers, and industry trade associations to promote the informal complaint process, as an available, low-cost mechanism for resolving complaints regarding the transportation, treatment, and sale of natural gas.

Second, the Commission should assure all natural gas purchasers, sellers, shippers, transporters and gatherers that the Commission is committed to a process that is fair, timely, and affordable. This second goal may be achieved in part by including a clear policy statement in the informal complaint procedure rule. The Committee proposes the following policy statement, which is included in the Committee's proposed rule, which is attached.

(1) It is the policy of the Commission to encourage the resolution and expedient settlement of disputes regarding natural gas purchasers, sellers, transporters and gatherers and to prevent discrimination among similarly situated shippers and sellers as is prohibited by the Texas Natural Resources Code, Chapter 111, entitled "Common Carriers, Public Utilities, and Common Purchasers," and Texas Utilities Code, Title 3, Subtitle A, entitled "Gas Utility Regulatory Act, and Subtitle B, entitled "Regulation Of Transportation and Use," and other matters of dispute subject to the Commission's jurisdiction. This section is adopted in furtherance of that policy.

(2) To accomplish the policy set out in this section, Commission employees, acting pursuant to this section, will attempt to facilitate, encourage, and promote resolution and settlement of disputes among natural gas purchasers, sellers, shippers, transporters, gatherers, and other parties subject to the Commission's jurisdiction consistent with the public interest and without lengthy and potentially expensive formal proceedings. The informal complaint procedure is intended to establish a forum for communication with the goal of achieving mutually acceptable compromise and resolution that is in the public interest.

Recommendation 4—Clarify the Non-Retaliation Provisions

The Committee agrees with the Commission's concept to prohibit gatherers and transporters from retaliating against producers who pursue an informal complaint, but believe the retaliation provision should be broadened to include all parties, as proposed in Recommendation 1 above. In addition, there are two other points the Committee believes need clarification.

The Commission's proposed rule suggested that, once an informal complaint procedure was commenced, a natural gas gatherer or transporter could not discontinue or deny service to a producer unless the mediator determined that one of five listed exceptions applied (such as the insufficient capacity on the transporter's facility, or improper quality of gas, or because of environmental or safety concerns). The Committee was concerned that requiring the mediator to make such a determination before service could be discontinued was unworkable because of the time lag between filing the informal complaint and obtaining the mediator's decision. If, for example, the gas is of improper quality or a safety issue is present, the gatherer or transporter is not in a position to wait for the mediator's decision. Instead, in those circumstances, the gatherer or transporter must take immediate action.

By recommending this change, which is included in the Committee's proposed rule, it is not the Committee's intention to encourage or facilitate retaliatory actions by purchasers, transporters, or gatherers. The Committee's opinion is that the Director of the Gas Services Division should commence an enforcement action—as the Director is allowed to do under paragraph (d)(9)—any time a purchaser, transporter, or gatherer retaliates against a shipper or seller for commencing an informal complaint procedure.

The other point at which the Committee has differed slightly from the Commission's proposed rule has to do with the exception allowing the purchaser/gatherer/transporter to discontinue or deny service if the natural gas does not meet the quality specifications of the purchaser, transporter, gatherer, or downstream processors, pipelines or customers. The Committee feared that the Commission's formulation might allow discrimination. Consequently, the Committee suggests the following proviso, indicated by the underlined text below:

(7) A transporter or Gas Purchaser shall not discontinue or deny service to a Shipper or Seller during the pendency of an informal complaint resolution proceeding in which both are participants unless one of the following reasons applies for discontinuing service:

* * *

(B) the natural gas does not meet the quality specifications of the gatherer, purchaser or downstream processors, pipelines or customers; unless the natural gas is flowing under an agreement and at the impending termination of that agreement there is sufficient capacity and Transporter is blending out of spec gas for other shippers in the area, and the acceptance of such volumes from Shipper will not jeopardize downstream market deliverability of the gas, then Transporter shall continue to take the gas until the conclusion of the Informal Complaint Process, charging blending fees applicable to similarly situated shippers;

Recommendation 5—Give the Commission Enforcement Power

The Committee believes that the Legislature should give the Commission authority to enforce its statutory duty to prevent discrimination in natural gas gathering and transportation, to enforce the requirement that parties participate in the informal complaint process, and to punish purchasers, transporters, and gatherers for retaliating against shippers and sellers. Currently, the Commission's authority in regard to these matters is limited. A draft statute giving the Commission the proposed enforcement authority is provided below.

§ _____. ADMINISTRATIVE PENALTY. (a) The commission may impose an administrative penalty against a purchaser, transporter, or gatherer of natural gas who is found by the commission to have:

(1) violated the commission's natural gas standards and code of conduct, as provided in § 7.7001 of Title 16 of the Texas Administrative Code; or
(2) unreasonably discriminated against a seller of natural gas in the purchase of natural gas from such seller; or

(3) retaliated against a shipper or seller of natural gas for the shipper or seller having pursued at the commission a formal or informal complaint against the purchaser, transporter, or gatherer related to the purchaser, transporter, or gatherer's provision of natural gas transportation services or the purchase of natural gas.

(b) The commission may impose an administrative penalty against a purchaser, transporter, gatherer, shipper or seller of natural gas who is a party to an informal complaint resolution proceeding conducted pursuant to § 2.001 (proposed) of Title 16 of the Texas Administrative Code and found by the commission to have:

(1) failed to participate in the informal complaint resolution proceeding; or
(2) failed to provide information requested by a mediator in the informal complaint resolution proceeding.

(c) The penalty for a violation may be in an amount not to exceed \$5,000. Each day a violation continues or occurs is a separate violation for purposes of imposing a penalty.

In regard to paragraph (a)(2), the Committee has recommended that the informal complaint process be broadened to include purchasers and sellers. Paragraph (a)(2) is included in this proposed penalty statute to make the administrative penalty provision parallel with the Committee's recommended changes to the informal complaint procedure. The Committee, however, is aware that unreasonable discrimination is not currently defined in the Commission's code of

conduct or otherwise. Consequently, the Committee believes that the Commission will be required to define unreasonable discrimination in the purchaser/seller context in order for the Committee's recommendations to be fully effective.

TRANSPARENCY

The Commission's Charge

The Commission's charge to the Committee asks if additional transparency is needed in the Texas natural gas pipeline industry to better foster viable market competition. As part of this question, the Commission asks the Committee to consider:

- a. How much transparency is needed? (e.g., full mandatory public disclosure of contractual terms and conditions; mandatory filing of contracts with the Commission with limited public disclosure or with public disclosure upon mutual agreement of the parties; mandatory electronic posting of terms and conditions by shippers on their websites or on the Commission website; etc.)
- b. What specific items should be made public and how should they be made public? Should the Commission revise its tariff information rule to require filing of additional information?
- c. Are there other market-based solutions that serve to provide the same effect as total transparency?

In response to these questions, the Committee recommends that the informal complaint procedure be strengthened to provide additional transparency in that process, that market participants be educated about the information currently available from the Commission and the Comptroller of Public Accounts, and that the Legislature be asked to prohibit gatherers and transporters from requiring confidentiality in future contracts so that producers may freely share information among themselves.

Background

Transparency and the Code of Conduct

In May 1997, the Commission published a proposed administrative rule "relating to natural gas transportation standards and code of conduct." *See* 22 TEX. REG. 4134 (May 13, 1997). In its preamble to the proposed rule, the Commission explained—

The commission first began discussing a code of conduct in early 1996 to develop standards by which a gas gatherer or transporter must conduct business relative to any affiliated companies, adding information disclosure as a second step. The August 1996 decision by the D.C. Circuit Court of Appeals in *Conoco, Inc. v. FERC*, Number 94-1724, provided further impetus regarding the need for a

rulemaking to govern interstate gathering and transportation of natural gas. The court upheld the Federal Energy Regulatory Commission's disclaimer of jurisdiction over the divested gathering facilities of interstate pipelines, leaving the state regulatory agencies as the institutions charged with protecting against unfair conduct by gatherers. Consequently, this commission has begun, through various methods, to collect relevant information on gas gathering for the purpose of identifying, preventing, and remedying unlawful discrimination. ... The results of these efforts have led the commission to conclude that the potential for discriminatory gathering practices exists, and that a system for timely information disclosure is needed to provide the public and the commission with the information necessary for making clear determinations of undue discrimination or the lack thereof.

An information disclosure system is also fundamental for participants in all segments of the natural gas industry to compete fairly in a market-based environment. Information transparency is necessary for the existence of a competitive environment, and at present, the timely basic information regarding gathering and transportation rates is unavailable, not only to the commission, but also to industry members needing these types of services.

In August 1997, the Commission adopted a rule "concerning natural gas transportation standards and code of conduct, with changes to the proposed text as published in the May 13, 1997, issue of the *Texas Register*." See 22 TEX. REG. 8617 (August 29, 1997). At the time it adopted the rule, the Commission explained that "commenters challenged the need for industry-wide information disclosure ... argu[ing] that the mandatory information disclosure provisions in the proposed rule would be unduly costly and would impose a level of regulation that would yield little benefit, if any. Some further contended that the information disclosure provisions would actually result in a non-competitive environment in which transporters would offer fewer options in order to avoid the information disclosure obligation in the proposed rule." Consequently, the Commission determined that the information disclosure requirements in the proposed rule were "not warranted" and "in the adopted rule, the commission has eliminated the information disclosure requirements." The current Code of Conduct does not require information disclosure. See 16 TEX. ADMIN. CODE §§ 7.7001, 7.115.

Information Gathered at the Workshops and the Rulemaking Request

Among the complaints raised by participants at the Commission's seven workshops were complaints about contract terms and conditions and transparency. At the conclusion of the meeting, the Commission's staff prepared a summary of the comments received at the workshops (which are not presented verbatim) on these issues.

1. Some producers who appeared at the workshops expressed their belief that the gatherers and transporters' contracts include onerous pricing terms.

2. Some producers alleged that gatherers and transporters charge unnecessary fees with no supporting documentation for metering, compression, dehydration, and lost and unaccounted-for gas, etc. and that contracts are renegotiated with less favorable terms simply because pipeline ownership changes.
3. Some producers testified that standard contract provisions restrict information exchange or require producers to waive the ability to seek Commission relief or legal resolution of their complaints.
4. Some producer witnesses also testified that, because of the lack of transparency, there is no way for producers to determine if their particular contract terms and conditions are reasonable and that the current tariff information filed with the Commission is inadequate because much of the information is kept confidential by the Commission.
5. Some witnesses testifying on behalf of the pipelines asserted that the pipelines are faced with rising costs from pipeline safety, environmental, and other state and federal regulations.

Additionally, in early 2006, a petition for rulemaking was filed with the Commission asking the Commission to promulgate a rule requiring disclosure of all contract terms related to the gathering and transporting of natural in Texas. The Commission declined to engage in rulemaking. Instead, it has sought the advice of the Committee.

The Committee's Analysis

With both the decade-long debate and the workshop testimony in mind, the Committee engaged its own debate about “transparency” in the natural gas market. Reaching a consensus on the main question proved to be as difficult for the Committee as it has been for the Commission and market participants.

In evaluating this issue, the Committee learned that there is a significant amount of information currently available to market participants. Commission staff demonstrated the availability of information accessible through the Commission’s website on natural gas wells and pipelines. The Commission’s website appears to be a user-friendly, interactive system that allows the user to view gas, oil and pipeline data, including data about the location, size, and ownership of pipelines. This data can be cross-referenced with severance tax records available from the Comptroller’s office to give a meaningful amount of information about specific wells. This publicly available information, however, does not provide a complete picture. It is not possible to tell from publicly available information the rates being charged for gathering, treating, compressing, processing, or transporting natural gas produced from a specific well, or the charges for connecting with a particular pipeline at a particular location.

Several Committee members expressed the view that “full transparency” would be detrimental to the market. Several members articulated that view as follows—

The current gas market is a robust competitive market with an appropriate level of transparency. Complete transparency of contract information is unnecessary given the public information available to market participants, and significant harm will occur if transparency is increased significantly beyond existing levels. Transparency of contract information will damage the gas market for a number of reasons including: (i) transporters of gas will know what fees are being charged by their competitors and could increase rather than lower fees; (ii) complete transparency of contract information could lower prices being paid to producers once the lowest price paid in an area is made public; (iii) complete transparency will drive more standardization in contract terms making the industry less responsive particularly in light of the varied nature of gathering and transportation contracts and the need to be creative in negotiating specific terms to meet the requests of each producer/shipper; (iv) complete transparency will drive standardized pricing and create subsidies as production which could otherwise get a higher price gets a standard price while production which would otherwise get a lower price gets a standard price; (v) consumers on distribution systems that pay regulated cost of service rates may face higher costs due to the loss of industrial loads which carry some of the burden of costs on those systems; and (vi) complete transparency may disadvantage some producers in competing with other producers for acreage.

In addition, concerns exist about creating an uneven playing field if less-than-complete transparency exists between various market segments and competitors within a market segment, as well as with imposing burdens (*e.g.*, administrative, electronic bulletin boards, tariff filings, *etc.*) on all market participants when the informal complaint process gives the Commission authority to address discrimination on a case-specific basis. The Commission should first adopt a more conservative approach given the existing availability of information identified by the Committee and the proposed changes to the informal complaint process.

Conversely, some members of the Committee expressed the view that, in order for the market to function properly, complete information about rates charged for gathering, treating, compressing, processing, and transporting natural gas must be available to market participants. As one Committee member expressed it—

The proposed improvements made to the Informal Complaint Process represent incremental progress by those who wish to avail themselves of the existing complaint-based system. Many feel, however, that true and meaningful progress will not occur until the natural gas marketplace in Texas is made more transparent for the benefit of all stakeholders. Under the current regulatory approach, timely basic information is unavailable to producers, royalty owners, and working interest owners seeking a level of detail that can be employed to confirm that they are being treated fairly. It is the position of many independent producers, working interest owners, and royalty owners that the lack of available significant information regarding the basis upon which their gas price is paid is the single greatest hindrance to their ability to make reasonable decisions concerning prospect generation and gas

sales arrangements. These parties believe that a meaningful level of transparency regarding price basis and fees will do more to encourage competition and curb discrimination in the natural gas sales and gathering marketplace than any other item being discussed with regard to this issue and that competition in a marketplace cannot be measured where information being kept confidential only protects buyers from each other at the expense of the suppliers and consumers.

Clearly, the Committee could see that a great deal of information is currently available, but that all information that might be desired is not available. Given the limitations of time and resources, the Committee could not ascertain with any certainty the extent to which the majority of market participants' desire transparency. All that the Committee could ascertain with certainty was: Some producers have publicly objected in the past to disclosure of their contracts while others have demanded full transparency; divergent views were expressed at the workshops about the need for greater transparency; and there are divergent views within the Committee about whether more transparency is necessary and if so, how best to achieve it without adversely affecting the gas industry.

Recommendations

Texas is the largest producer of gas in the United States and plays a critical role in meeting the energy needs of the state and nation. Texas has historically engaged in a market-based approach to regulation which has allowed the industry to remain responsive to meeting the needs of local and national energy markets as evidenced by the recent increase in the number of drilling permits, well completions, production, and pipeline construction in Texas. In many areas, the Commission has relied on agreement of the parties in lieu of cost-based rates and regulation to maintain a responsive and competitive natural gas industry in Texas. The Committee supports a market-based approach as the best way to maintain a responsive and competitive gas industry and has tried to make targeted changes based on the specific issues raised in the seven Commission workshops. The Committee is conscious of its obligation to avoid recommending changes that could have unforeseen or unintended consequences on the competitive gas gathering and transportation market that currently exists in many parts of Texas.

Recommendation 1—Strengthen the Informal Complaint Process

The Committee has recommended enhancements to the informal complaint process that provide for additional transparency. The enhancements to the informal complaint process require mandatory participation and full access to contract information and any other materials requested by the Commission after a complaint is filed. The Committee believes these enhancements will improve the level of transparency in cases where a party believes it has been treated in a discriminatory manner.

Recommendation 2—Education

A great deal of useful information is already available, but the availability is not generally known and the sources are not fully utilized within the industry. The Committee recommends the Commission and industry trade associations work together to educate industry participants on the current availability of information.

Recommendation 3—Confidentiality in Future Contracts

The Committee recommends that the Legislature provide producers have the option of not having a confidentiality provision in future sales, gathering, and transportation contracts. This will allow producers and their trade associations to freely compare fees and services. The Committee believes that the Legislature cannot lawfully apply this requirement to existing contracts containing confidentiality provisions. Consequently, the Committee recommends that any such statute be prospective in its application, applying only to new contracts.

The Committee discussed whether the requirement should be mandatory in all new contracts or whether producers should have the option to maintain confidential treatment of their contracts. The Committee recommends that confidentiality be allowed to the extent producers consent to the inclusion of confidentiality in any new contracts. This approach allows producers to determine the level of transparency they desire, but gives them the opportunity to review information with other like-minded producers. Additionally, it avoids putting administrative burdens on the Commission or other industry participants.

REACH OF POLICY CHANGES

The Commission's Charge

The Commission's charge to the Committee asks: "What transporters should be affected by any change in policy or law?" The Commission specifically inquires whether the changes in policy or laws recommended by the Committee should cover traditional gatherers and transporters that perform services for a fee, marketers, and producer-owned systems. The Commission further inquires whether "all gathering/transport systems [should] be open access and be required to provide service for any shipper?"

Recommendations

The Committee has attempted to answer these questions while addressing other issues presented in the Commission's charge to the Committee. As is discussed in the section addressing the Informal Complaint Process, the Committee believes the rule codifying that process should specifically apply to purchasers, gatherers, transporters, sellers and shippers. The rule proposed by the Committee is broadly worded to cover any complaint falling within the Commission's jurisdiction.

In the section addressing Transparency, the recommendation that the Legislature enact a statute providing that gatherers and transporters cannot require confidentiality clauses in contracts touches regulated utilities as well as unregulated non-utilities.

Finally, in the section addressing Gathering & Transportation Fees, the Committee specifically recommends against expansion of the current scope of open access.

MARGINAL WELLS

The Commission's Charge

The Commission's charge to the Committee notes that "[m]arginal gas well production ... is important to the State of Texas" and asks:

- a. Should these wells be given special gathering/transportation and other consideration to make them more economically viable?
- b. In underserved regions where need is determined, would alternative market-based solutions or tax incentives provide for a more competitive environment.

As is discussed below, the Committee concluded that marginal wells are economically important to the State and Nation and that there is value in keeping marginal gas wells producing for the longest possible time to allow the development of new technologies that often increase production from marginal wells. The Committee, however, did not conclude that these wells should be given special consideration other than to continue the existing severance and franchise tax abatement for marginal natural gas wells.

The Importance of Marginal Production

"A producing oil or natural gas well is considered to be 'marginal' if it is producing at such a rate that it is at the limit or margin of profitability. Obviously, this rate varies and is dependent upon many factors including: operating costs, product prices, tax rates, debt service, environmental costs, and plugging and abandonment liabilities to list just a few."¹ Despite the fact that marginal profitability varies from well to well and from time to time, both the Interstate Oil and Gas Compact Commission (IOGCC) and the Commission have a specific definition of marginal or stripper wells. Both define marginal or stripper wells as producing no more than 60 Mcf per day of natural gas.²

Using the IOGCC and Commission's definition, 36,946 (34.9%) of Texas's 105,827 total natural gas wells were classified as marginal wells in the fourth quarter of 2005. This calculation of the number of marginal wells is probably low because

¹ Duda, Covatch, Remson & Wang, PROJECTIONS OF MARGINAL WELLS AND THEIR CONTRIBUTIONS TO OIL AND NATURAL GAS SUPPLIES at 1 (Doc. # SPE 98014, Sept. 2005) (presented at the 2005 Society of Professional Engineers Eastern Regional Meeting, September 14-16, 2005) (hereafter, "PROJECTIONS OF MARGINAL WELLS").

² House Bill 3, passed by the 79th Legislature in its Third Called Session, gives a franchise tax abatement for gas wells whose production averages less than 250 mcf a day over a 90-day period.

30,901 wells did not report any production in the fourth quarter. Many of those wells likely belong in the marginal category. Thus, a total of 67,847 (64.1%) of the natural gas wells in Texas probably qualify as “marginal wells.” Texas’s marginal wells produced a total of about 77 Bcf of gas during the final three months of 2005, while all Texas natural gas production totaled 1.3 Tcf during that same period. Thus, the marginal wells (64.1% of all natural gas wells) contributed only 6% of the natural gas produced in Texas during the fourth quarter of 2005. For the year, marginal gas wells produced 371 Bcf (7.1%) of Texas’s 5.2 Tcf of natural gas production.

If the average sales price at the wellhead of natural gas in Texas in 2005 was \$7.50 per Mcf,³ these marginal wells contributed almost \$2.8 billion in direct economic activity. According to the Texas’s Comptroller of Public Accounts, each dollar of direct economic benefit from the production of oil and gas results in a total economic benefit to the State of almost six times the direct benefit. Consequently, Texas’s marginal natural gas wells provide a total economic benefit to the State of about \$16.8 billion in 2005.

Additionally, the State collects a severance tax of 7.5% on the producer’s net proceeds from sales of natural gas. Approximately 40% of the marginal wells were exempt from the severance tax in fiscal year 2005, but the remaining 60% were not. In fiscal year 2005 (which ended August 31, 2005), Texas collected \$1.66 billion through the severance tax on natural gas.⁴ Assuming 222 Bcf (60% of the 371 Bcf) of marginal-well production generated severance tax, Texas’s marginal gas wells generated around \$125 million in severance tax revenues for the State of Texas in 2005.

Thus, these “marginal” wells—while individually insignificant—are collectively important. They provide a substantial economic benefit to the State and its citizens, and contribute a meaningful amount of natural gas to the Nation’s energy supply. There, however, is another important reason to keep these wells in production. Marginal wells “serve as access to much of the remaining oil and natural gas resources.” “To this day, the potential remains for advanced technologies to enhance the recovery of crude oil and natural gas both residual and by-passed in discovered reservoirs. If these wells are shut-in, and subsequently plugged and abandoned, it becomes much more unlikely these remaining reserves will ever be produced due to the significant costs associated with drilling, completing, and equipping new wells.”⁵

³ U.S. Energy Information Administration, *Natural Gas Navigator*, available at <http://tonto.eia.doe.gov/dnav/ng/hist/n9190us3m.htm> (giving national average monthly wellhead price for 2005 as follows: January-\$5.52; February-\$5.59; March-\$5.98; April-\$6.44; May-\$6.02; June-\$6.15; July-\$6.69; August-\$7.68; September-\$9.50; October-\$10.97; November-\$9.54 and December-\$10.02); also available from the Texas Comptroller of Public Accounts at <http://www.cpa.state.tx.us/ecodata/ecoindecoind4.html#natural>.

⁴ See *Comptroller of Public Accounts, Texas Revenue History by Source*, available at <http://www.window.state.tx.us/taxbud/revenue.html>.

⁵ PROJECTIONS OF MARGINAL WELLS at 1-2.

In sum, the Committee agrees with the Commission's conclusion that "marginal gas well production is important to the State of Texas.

The Difficulty in Subsidizing Marginal Wells

It is undisputed that "not all gas is created equal." Differences in quality, quantity and location affect the value of natural gas. Producers, gatherers and transporters of natural gas face increasing costs as wells age and volumes decline. Transporters and gatherers are faced with increasing costs related to pipeline safety and environmental and other regulations. Additionally, end users of gas require a specific volume of gas having a uniform and specific quality. The failure to deliver the full amount of gas required, or the delivery of gas of a lesser quality, can have a significant negative impact on an end user and exposes the transporter to significant liability. Consequently, gatherers and transporters have an economic interest in obtaining stable quantities of high-quality gas.

Marginal wells sometimes produce gas of inferior quality, at low pressure, and in uneven quantities. Often, these wells require regular maintenance to ensure production. Furthermore, many marginal wells have been in production for a number of years and are served by gathering lines of the same age that require maintenance or replacement. In most cases, treatment and compression of the gas is necessary to ensure that it enters the pipeline under the appropriate pressure and having the proper characteristics. The equipment used to treat and compress gas is expensive, as is pipeline maintenance and replacement.

In the bundled environment that existed more than a decade ago, in which pipelines were allowed to be merchants, higher volume wells essentially subsidized marginal wells because transporters spread the costs of pipeline repair and construction, and the costs of treatment and compression, over their entire system. Under today's market-responsive regulatory framework, each well or group of wells must stand on its own. Gatherers and transporters charge the producer for the cost of maintaining or replacing the gathering lines associated with the particular well, and the cost of treatment and compression of gas associated with the particular well. The costs depend on the quantity and quality of the gas and the location of the well.

Producers appearing at the Commission's workshops provided a significant amount of testimony that some gatherers/transporters are gouging producers in regard to their charges for gathering, compressing, treating and transporting their gas. Many producers testified—correctly, the Committee believes—that the economic realities of marginal wells give them no real alternative for moving their gas to market than to continue to do business with their current gatherer/transporter. In a nutshell, these producers have little market power and are susceptible to being taken advantage of by unscrupulous gatherers/transporters. Additionally, many producers appearing

at the workshops either did not know about the informal complaint process, did not believe it would be effective to address these problems, or were afraid of retaliation by the gatherer/transporter if they pursued a complaint.

Recommendations

As noted above, the Committee is convinced that it is important to maintain production from marginal gas wells for the longest period of time. A majority of the Committee, however, is not convinced that government regulation is superior to the self-regulation inherent in a free-market.

Continued production from marginal wells benefits society as a whole; not necessarily other gas producers. Arguably, it is unfair to other gas producers to spread the costs of gathering and transporting marginal-well gas across an entire gathering or transportation system. The cost, instead, should be carried by society generally. But there is no clearly appropriate method for subsidizing marginal wells given that no two wells are the same.

Recommendation 1—Continue Tax Abatements

The Legislature appears to have recognized this predicament in the past. Currently, Texas Tax Code § 201.059 provides for severance tax relief for marginal wells. Section 201.059 defines a “qualifying low-producing well” as “a gas well whose production during a three-month period is no more than 90 mcf per day, excluding gas flared pursuant to the rules of the commission.” It requires the Comptroller to “certify the average taxable price of gas, adjusted to 2005 dollars, during the previous three months based on various price indices available to producers, including prices reported by Henry Hub, Houston Ship Channel, Mississippi Barge Transport, New York Mercantile Exchange, or other spot prices, as applicable.” It then sets up a formula for severance tax abatement for low-producing wells if the price is at or below a certain level. Under § 201.059, an operator of a qualifying low-producing well is entitled to credit on the tax otherwise due on gas produced and saved from that well during a month of: 25 percent if the average taxable price of gas for the previous three-month period is more than \$3 per mcf but not more than \$3.50 per mcf; 50 percent if price of gas is more than \$2.50 per mcf but not more than \$3 per mcf; and 100 percent if the price of gas for the previous three-month period is not more than \$2.50 per mcf. Section 201.059 will expire on September 1, 2007, unless extended by the Legislature. Additionally, House Bill 3, passed by the 79th Legislature in its Third Called Session, provides that the franchise tax does not reach “total revenue received from ... gas produced ... from ... a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.”

Based on the importance of marginal wells detailed above, the Committee suggests that Commission recommend to the Legislature that these franchise and severance tax abatement provisions be extended indefinitely.

Recommendation 2—Enhance the Informal Complaint Procedure

The Committee has recommended a number of changes to the informal complaint procedure. Because much of the producer feedback received at the seven Commission workshops related to this marginal wells issue, the Committee is hopeful that the changes recommended to the informal complaint process will alleviate producers' concerns about that process and that producers will use the informal complaint process to obtain relief when a gatherer or transporter is perceived to be taking advantage of the producer in regard to the rate charged for services.

Recommendation 3—Educate Operators about the Ability to Commingle Gas from Marginal Wells

A provision allowing the commingling of natural gas produced from marginal wells already is in place. An explanation of the process and its exceptions is contained in the Commission's Statewide Rule 26(b). Under Rule 26(b) operators, with the consent of the royalty interest owners, can aggregate marginal volumes of gas at a common separation/treating facility and sell the gas through a single meter. This process for aggregating and selling gas from marginal wells allows operators to eliminate the expenses associated with having multiple meters. In addition, there is an exception in Statewide Rule 27 to eliminate meters on marginal wells, identified in the rule as 20 Mcf per day or less. The Committee believes that few operators know of these provisions. The Committee therefore recommends that the Commission undertake to educate market participants, including royalty owners, of the benefits of commingling gas and eliminating metering requirements to extend the economic viability of marginal wells, and that the Commission amend Statewide Rule 27 to conform the marginal wells standard consistent with the Texas Tax Code § 201.059 definition of 90 Mcf/day.

GATHERING & TRANSPORTATION FEES

The Commission's Charge

The Commission's charge to the Committee asks if the Commission should exercise oversight regarding the types and categories of fees related to gas gathering and transportation. Should some pricing terms in gas gathering arrangements be standardized?

The Committee's Work

In considering the Commission's inquiry, the Committee viewed gathering and transportation fees in the broader context of the entire midstream portion of the natural gas value chain—from the producer's wellhead through gathering, processing, treating, transportation, storage and marketing. The Committee notes that the kind and number of midstream operations and transactions vary substantially by specific application and are conducted by many different parties. The transactions are often unique, with each transaction being tailored to the specific application and to the parties' needs and market conditions existing when the transaction was negotiated. Because of the complexity and variety in the different businesses involved in midstream operations, and the cost and time consumed in the regulatory process, the committee recommends that no additional regulations be imposed on the parties doing business in the midstream portion of the energy sector at this time. In the context of discussing the midstream portion of the natural gas value chain, the specific decisions the Committee made were—

- Producer-owned systems that transport only the producer's production, not production by a third-party, should not be subject to additional regulation.
- A producer owned gathering system should not be required to transport natural gas for a third-party.
- The criteria for becoming a gas utility, open-access pipeline, or common carriers should not be expanded.
- Regulating pipelines or gatherers based on a cost of service and requiring parties to file rate cases should be avoided. Rate cases are costly, time consuming, and do not encourage competition. A simple rate case can cost over \$300,000 and take months to complete. A complex case can cost millions of dollars and take over a year to prosecute. This type of regulation would not work efficiently in Texas's competitive gathering and transportation market.
- A heavily regulated environment is not workable because of the complexity and uniqueness of gathering, processing and transportation transactions. A lightly regulated market, on the other hand, allows for beneficial variations in

the agreements between the market participants. For example, a producer and pipeline may agree to higher fees in return for lower pressures or more services. Or the parties may agree to a different fee than is charged to others in return for capital investments by one of the parties.

- Regulation in general and the informal complaint process in particular should not be used to abrogate the terms of an existing contract while it is in force.
- Given the number and variety of parties involved in the natural gas value chain, regulating one portion, such as gathering, could create the opportunity for parties in other parts of the value chain to find a “loop hole” to improve their position, thus negating the anticipated benefit of the regulation.

Recommendation

The one area in which the Committee believes additional statutory authority—not regulation—will benefit the Commission’s oversight of the natural gas value chain is in regard to the standard for setting rates when a formal complaint is filed. Currently, in a formal proceeding, the Commission is required to set rates based on cost of service. The cost-of-service methodology does not reflect the environment in which gatherers and transporters conduct their business. These entities are market-based businesses that simply do not keep books with cost-of-service regulation in mind. Furthermore, whether a gatherer or transporter is unfairly discriminating among similarly situated shippers is a market-based determination, not a cost-of-service-based determination. The Committee believes that the Legislature should give the Commission the ability to use either a cost-of-service method or a market-based method for setting a rate in a formal rate proceeding. The Oklahoma statute provides a model for a market-based methodology. It provides—

D. In determining and setting a fee or terms and conditions of service, or both, ... the Commission shall determine a fee or terms and conditions of service, or both, which would result from arm’s-length bargaining in good faith in a competitive market between persons of equal bargaining power and shall consider all economically significant factors for gathering which it determines to be relevant which may include, but are not limited to:

1. The fees and terms and conditions of service which such gatherer receives from the complainant and other shippers for analogous levels of service for gathering within an area the Commission determines to be relevant;

2. The fees charged and the terms and conditions of service provided by other gatherers for gathering within an area the Commission determines to be relevant;

3. The reasonable financial risks of operating such a gathering system;

4. The reasonable capital, operating and maintenance costs of such a gathering system; and

5. Such other factors which the Commission determines to be relevant.

Provided that neither such fee nor such terms and conditions of service shall be computed on a utility rate of return basis and that gatherers shall not be

regulated like public utilities in the setting of fees and terms and conditions of service.

OKLA. STAT. ANN. § 52-24.5.

OTHER STATES

The Commission's Charge

The Commission's charge to the Committee asks the Committee to study how other states address discrimination issues relative to gas gathering and transportation services and asks if their methods should be adopted in Texas.

Recommendation

The committee reviewed the statutes and rules pertaining to the complaint process associated with natural gas gathering and transportation in Oklahoma, Kansas, New Mexico, Arkansas and Louisiana. Of these states, Oklahoma and Kansas are the most advanced in their complaint procedures. The procedures in place in Oklahoma and proposed in Texas include conditions the Committee believes are essential to a successful complaint process, including a requirement to disclose pertinent information, confidentiality, speedy decisions, and prohibiting discrimination during the complaint period. Several states' regulations include specific fine and penalty provisions, which is consistent with the Committee's recommendation to clarify the Commissions' enforcement capabilities.

The Committee believes that Texas's informal complaint process, as proposed by the Commission and enhanced by the Committee, is superior to the procedures in place in other states. Like other states, Texas requires disclosure of pertinent information, confidentiality, and speedy decisions; and it prohibits retaliation during the complaint period. Texas's procedure is better than other states' procedures because it covers gathering, processing, and transporting natural gas while other states limit their procedure to gas gathering.

The one provision from another state that the Committee finds to be advisable is the Oklahoma provision discussed above under Gathering & Transportation Fees allowing the Oklahoma Corporation Commission to set rates based on a market-based methodology.