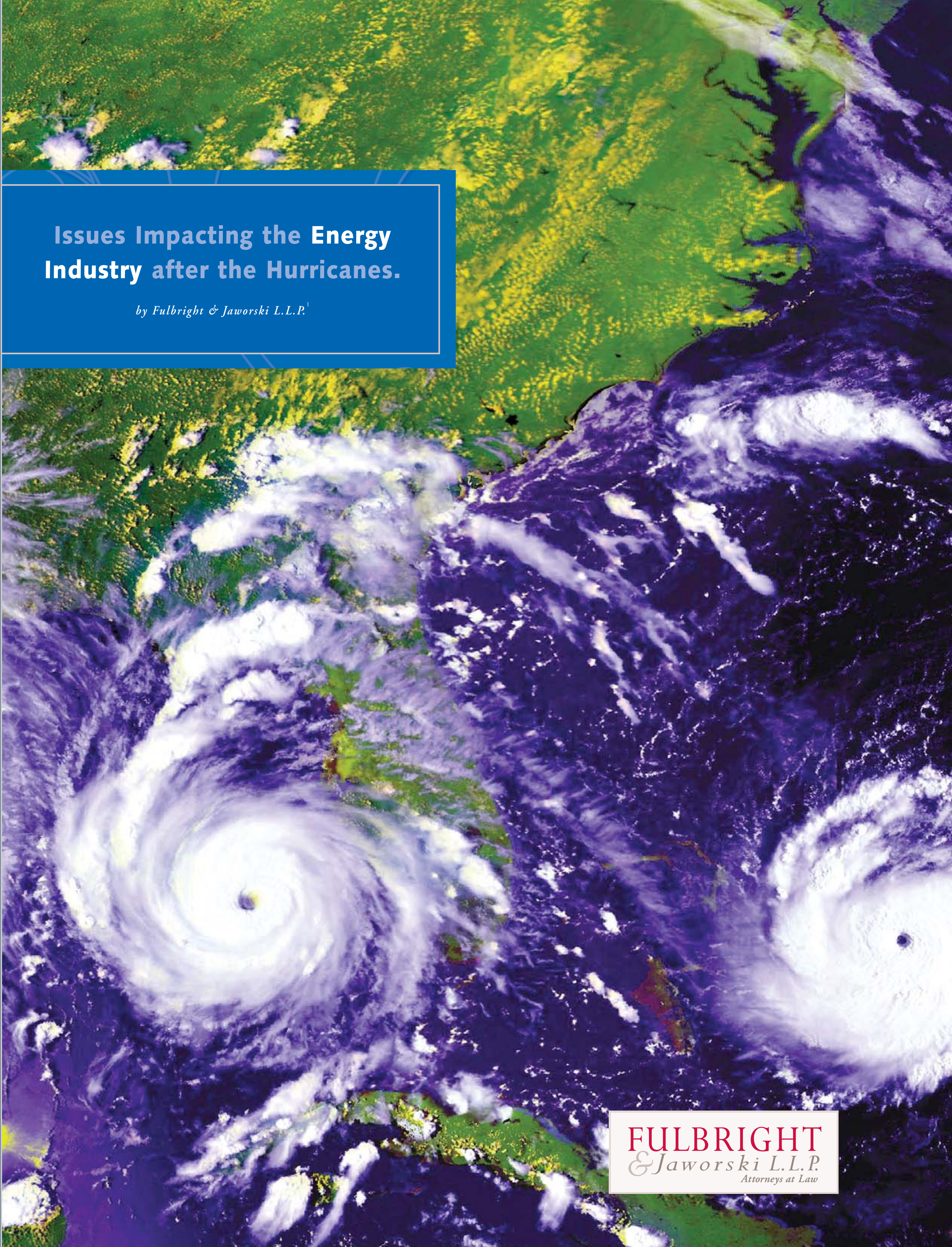
Issues Impacting the Energy Industry after the Hurricanes.

by Fulbright & Jaworski L.L.P.[1]



FULBRIGHT
& Jaworski L.L.P.
Attorneys at Law

The effects of the 2005 hurricane season are likely to ripple through the energy industry for some time. Accordingly, companies in all sectors of the energy industry should reexamine their own business practices in this period of interrupted operations, price spikes and reactions in the political arena.

Energy companies, large and small, face a broad array of issues stemming from the hurricanes. This article will identify a few of the key legal issues, which have received considerable publicity in the energy industry: (1) contract disputes surrounding force majeure clauses, (2) the Federal Energy Regulatory Commission's (FERC) enhanced authority to bring claims of market manipulation, (3) the filing of property damage and business interruption insurance claims, (4) gasoline price-gouging allegations and antitrust concerns, and finally (5) the appearance of global warming on the court docket as a new vehicle for lawsuits. Much more could be said on each of these issues, but this article will highlight the concerns and questions that are being raised.

Force Majeure

Hurricanes Katrina and Rita did extensive damage to the Gulf of Mexico oil and gas infrastructure, from drilling rigs to production platforms, pipelines and processing plants. According to the MMS, as a result of the damage, the flow of oil and gas from the Gulf at one point was cut by more than 90%. The MMS projects that in excess of 20% of volumes of both oil and gas will remain shut in as late as March 2006. The hurricanes and their aftermath have truly left an unprecedented number of broken links in the energy chain. Each of these links in the energy chain must look to their contracts to determine their rights and obligations in light of the massive reductions in available volumes of oil and gas and the specific causes of the delays or failure in delivery. In particular, where the chain is broken, the participants will be focusing on the *force majeure* clause contained in the contract and in many instances a participant may be both sending and receiving "excuse of performance" claims. Therefore, before a party begins to "rattle its chains," it would be well-advised to consider its position vis-à-vis its suppliers as well as its customers and the positions taken by its affiliates.

Force majeure literally means "greater force." These clauses excuse a party from liability if some unforeseen event beyond the control of that party prevents it from performing its obligations under the contract.

Typically, *force majeure* clauses cover natural disasters or other "Acts of God", war, or the failure of third parties - such as suppliers and subcontractors - to perform their obligations to the contracting party. There should be little doubt that the circumstances in the Gulf of Mexico beginning late August will meet most definitions of *force majeure* in the industry contracts for some period of time. There is also little doubt that disputes over the relative safety of the *force majeure* harbor will arise in various segments of the distribution chain.

For hundreds of years the courts have encouraged parties that seek to be excused from a contract to write into the contract the events which will excuse a party from strict performance of its terms. *See, e.g., Paradine v. Jane*, 82 Eng. Rep. 897 (K.B. 1647). Yet, the paradox inherent in drafting *force majeure* clauses is that it requires defining unanticipated and unforeseen events that may occur at some uncertain point in the future. Although admittedly, the crystal ball is often cloudy, the parties are nearly always better served to attempt to define those events that are of enough severity to allow suspension of performance without liability. Many contracts now define the physical *force majeure* events that provide relief to a party, as well as, the economic events that will not constitute *force majeure* and will provide no relief. A party that determines that the contractual definition of *force majeure* fits the events confronted by it, is nearly always required to give notice of the *force majeure* and usually in writing. Relief under a claim may be contingent on the notice being given.

Absent a *force majeure* clause, the parties will contend with the common law doctrines of frustration or impossibility or, when the sale of a good, like oil or gas is involved, the parties must look to statutory clauses, including §2.615 of the Uniform Commercial Code (U.C.C.) The parties, without a *force majeure* clause, leave the courts to determine when and if a party is excused, by looking back at the time the contract was made to try to discern the "basic assumptions" of the parties. In states like Texas, where the U.C.C. has been adopted, and the transaction involves a sale of goods, the parties to an oil or gas transaction should pay particular attention to §2.614 Substituted Performance, §2.615 Excuse by Failure of Presupposed Conditions and §2.616 Procedure on Notice Claiming Excuse. Parties with well-defined *force majeure* clauses may also be subject to the requirements of these sections which may supplement or override the agreed terms.

An in-depth analysis of the U.C.C. is not the goal of this article, but because §2.614, §2.615 and §2.616 may play a part in a company's response to the hurricanes, a short overview of these important sections follows:

U.C.C. Section 2.614 requires both tender and acceptance of commercially reasonable substitute performance when the agreed manner of delivery becomes commercially impracticable. With the major transportation disruptions in the Gulf, creative participants in the energy industry are finding different methods of delivery, whether or not required by law or contract. Whether it be alternative pipelines or delivery points, or the use of barges rather than pipe, unless the manner of delivery is the essence of the contract, §2.614 may impact the rights and obligations of both the buyer and the seller.

In addition to potentially relieving a seller from liability for failure to deliver, §2.615 requires a fair and reasonable allocation of volumes when only part of the seller's capacity to perform has been affected. Most suppliers of any size, despite the widespread impact of the hurricanes, at some point will have volumes of oil

or gas sufficient to meet part–but not all–of the needs of its buyers. Although most contracts address *force majeure*, a relative few consider the question of allocation, and therefore may be subject to §2.615. Any allocation scheme will entail multiple, complicated and difficult decisions, and despite the application of §2.615, will be a point of contention between sellers with limited supply and buyers demanding full volumes. Sellers should also be aware of the buyers' rights under §2.616, as well as additional concerns raised in this article in the FERC and Market Manipulation section below.

U.C.C. Section 2.616 allows a buyer to terminate the contract if the delivery failure impairs the value of the entire contract and does not permit the buyer and seller to agree to a lesser obligation by the seller. Under §2.616, the contract may lapse if the buyer fails to respond to notice of indefinite delay or an allocation under §2.615. But note that this is a section designed to protect the buyer and may not be available for the seller to argue cancellation of the contract. "A seller cannot employ this thirty-day termination provision to deprive an unwary buyer of his U.C.C. rights and remedies. Such an approach would frustrate [§2.616's] purpose of protecting the buyer confronted with a claim of excuse under § 2.615." *Eastern Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F. 2d 957 (5th Cir. 1976).

In summary, the unprecedented, multiple breaks in the chain present many challenges to the participants in the oil and gas industry. In preparing to meet these challenges energy companies would be well advised to:

- *Analyze their various contract positions and realize they could be on both sides of the coin.*
- *Determine whether and to what extent the UCC applies to their situation. Energy companies are not constrained by the UCC, but neither are they free to ignore it.*
- *Carefully consider precedent setting implications of their actions.*
- *Document their communication with counter-parties.*
- *Be prepared to defend their course of action.*

FERC and Market Manipulation

With the Department of Energy predicting that residential natural gas bills will increase on average by 50% this winter, the FERC can be expected to actively monitor, investigate, and enforce regulations prohibiting market manipulation using its new regulatory authority. Following the passage of the Energy Policy Act (EPACT), Pub. L. No. 109-58, on August 8, 2005, FERC now has civil and criminal penalty authority over violations of the Natural Gas Act (NGA) and Federal Power Act (FPA). This expanded authority, combined with FERC's existing Market Behavior Rules, give the agency enormous power to punish violations. The extent of FERC's power is particularly disturbing when you realize how vague FERC's market manipulation regulations really are.

Despite the new market manipulation authority codified in EPACT, FERC has chosen to maintain the Market Behavior Rules issued in November 2003. These rules are deliberately open-ended and prohibit actions or transactions that are without a legitimate business purpose and are intended to or foreseeably could manipulate market prices, market conditions or market rules for natural gas. 18 C.F.R. §§ 284.288(a) and 284.403 (a).

The Market Behavior Rules also impose an extremely broad three-year record-keeping obligation on all marketers and traders which requires the retention of all data and information upon which customers are billed, including recorded trader calls. The consequence of non-compliance with the market behavior rules can be severe. Remedies for violations include: 1) disgorgement of unjust profits; 2) revocation of authority to sell at market-based rates and 3) other appropriate non-monetary remedies.

Under the market manipulation provisions codified in the Energy Policy Act,

> [i]t shall be unlawful for any entity, directly or indirectly, to use or employ, in connection with the purchase or sale of natural gas or the purchase or sale of transportation services subject to the jurisdiction of the FERC, any manipulative or deceptive device or contrivance... Section 4A, 15 U.S.C. § 717c-1.

The standard for market manipulation under EPACT is completely different from that of the Market Behavior Rules. While the Market Behavior Rules forbid actions "without a legitimate business purpose,"

> *"...Rules also impose an extremely broad three year record keeping obligation... The consequence of non-compliance with the market behavior rules can be severe."*

EPACT makes it unlawful for any entity to use any "manipulative or deceptive device or contrivance," the meaning of which is defined by the Securities

Exchange Act of 1934. In determining whether an entity has violated the market manipulation provisions of EPACT, FERC has stated that it will look to SEC precedent regarding market manipulation. Under the SEC standard, there must be a false statement or omission of a material fact, made with scienter. While courts disagree regarding whether recklessness alone is sufficient to establish scienter, the scienter requirement is significant, because it requires more than negligence to establish a violation of the market manipulation provisions.

As is the case with the Market Behavior Rules, penalties for violating the market manipulation provisions are severe. FERC has clarified that it will require disgorgement of unjust profits in addition to penalties. Civil penalty authority for violations of the NGA and FPA and FERC's orders, rules and regulations are now $1 million a day, per violation, leading to potentially astronomical penalties.

Not only does FERC have increased penalty authority, but the agency clearly plans on using it.

In determining remedies for violations of its regulations, FERC has looked to the enforcement policies of the SEC, the CFTC, and the Department of Justice (DOJ) and has adopted many of the factors articulated in DOJ's "Thompson Memo." When assessing penalties, FERC considers 1) the seriousness of the violation; and 2) the actions of the entity that engaged in the misconduct, including company efforts to remedy the violation and cooperate with any investigation. FERC has also stressed that it expects companies to have formal compliance programs in place that require self-reporting and cooperation with FERC.

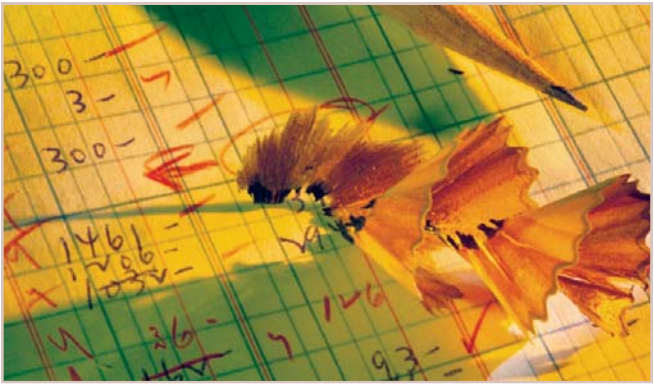
Not only does FERC have increased penalty authority, but the agency also clearly plans on using it. On November 2, 2005, Chairman Kelliher testified on natural gas prices before the House Committee on Energy and Commerce. The Chairman was repeatedly asked what FERC is doing about high prices and Kelliher repeatedly pointed to the agency's new authority under EPACT. Aside from his congressional testimony, the Chairman has issued some very aggressive public statements stating that FERC intends to use its new enforcement power.

Business Interruption and Property Damage Insurance

When a disaster occurs causing business losses, the two piers of the risk management foundation are property insurance, providing coverage for real and personal property damaged or destroyed by insured events and losses from an interruption in business activity caused by those events.

Physical property damage claims can help to corroborate business interruption losses. Assets covered can include buildings, machinery, office equipment, valuable papers, electronic media, fine art and debris removal/demolition costs. Items typically disputed in property damage claims are betterments, code upgrades, disputes in valuing "As Was" configurations, like-kind repair vs. replacement, replacement cost vs. actual cash value and salvage values.

It should be noted that property damage issues can have a dramatic impact on determining the period for which certain losses can be claimed. Proceeding expeditiously is important, because typical policy language states: the loss shall not exceed the time it takes to repair/replace with like-kind and quality and to exercise due diligence and dispatch. Claims should, of course, always be documented with copies of invoices, purchase orders and reasonably-detailed



descriptions of expenses, including why they are necessary. Business interruption insurance should always be part of an energy company's insurance coverage. It pays for any reduction in gross sales, less expenses which do not necessarily continue, plus any extra expenses.

Factors to consider in calculating losses include the actual experience of the business before the loss, expected experience of the business after the loss, actual experience of the business after the loss and reasonableness of the repair period (time required with due diligence and dispatch to repair and/or replace the damaged property).

Other key factors are the loss of potential new customers, delays in introducing new products, changes in market prices and in market demand, cost-cutting measures anticipated during the loss period, seasonality issues (e.g., meeting energy demands for the winter heating season), changes in competitors and their activities (particularly those that may not be as negatively affected by the disaster and therefore, can seize competitive advantages) and any new supplier agreements impacted by the event.

Expenses that do continue, of course, beyond the loss period include but are not limited to: fixed expenses, payroll expenses for key employees, some utilities, depreciation, rent, contractual obligations and advertising.

Examples of non-continuing or saved expenses are raw materials and supplies, ordinary payroll vs. "key" employees, utilities, maintenance, rental equipment and sales commissions.

When making a business interruption claim, there is a duty to report mitigating revenue, which then must be credited against the claim. Costs incurred to mitigate are added to the claim. An example of mitigation would be renting a temporary warehouse so that deliveries can continue after a hurricane damages the insured's permanent warehouse. Any revenue received from selling inventory from the temporary warehouse must be credited against the claim. However, the cost of renting the temporary warehouse should be added to the cost of mitigation. If the temporary warehouse is some distance from the business' normal operating location, causing additional transportation costs, those costs may be added to the claim as a cost of mitigation.

Standard policy language generally defines extra expense as the excess of the total cost during the period of recovery of the damaged property chargeable to the operation of the Insured's business over and above the total costs that would normally have been incurred to conduct the business during the same period had no loss or damage occurred. Key attributes of extra expenses are that they are "reasonable and necessary," are incurred to continue operations after the loss, are excess costs over normal costs and economic justification is not required for them.

An extra expense endorsement would contain language stating: "This policy is extended to cover (1) the reasonable and necessary extra expenses incurred to temporarily continue as nearly normal as practicable the conduct of the Insured's business and (2) the reasonable and necessary extra costs of temporarily using property or facilities of the Insured or others."

A business purchasing competitors' products to fulfill its customers' orders would be an example of an extra expense. Others are warehouse rental to store damaged product special marketing/PR programs to maintain market share, expenses to secure the property and the costs of reworking products.

In summary, business interruption coverage considers lost sales, continuing expenses, saved expenses, mitigation and extra expenses. Companies filing claims resulting from Hurricanes Katrina and Rita should not delay in submitting claims. They should do so monthly or quarterly and request advances where appropriate.

With U.S. property insurers currently inundated by hurricane claims in Florida, Mississippi, Louisiana and Texas, it is especially important for companies submitting claims to document their contacts with their insurance companies and press for reasonable and timely adjustments without making questionable or excessive claims. Generally, a forthright approach will produce the same in return.

Price Gouging Allegations and Antitrust Concerns

In the aftermath of Hurricane Katrina, at least 43 states have joined forces to investigate and prosecute claims of gasoline "price gouging." Price gouging is a term often used in the wake of natural disasters, but there is little, if any, guidance on how "gouging" is defined and considerable uncertainty about what laws apply. Although there is currently no federal statute prohibiting "price gouging," the Federal Trade Commission (FTC) and the Department of Justice investigate complaints to determine if the price charged violates Section One of the Sherman Act, which bars collusion among competitors in setting prices. There are, however, a multitude of state laws providing a basis for a claim that "price gouging" is illegal, even without collusion among competitors.

"Texas Governor Rick Perry issued an emergency disaster declaration, which... activates the anti-gouging provision of the DTPA and allows the Texas Attorney General to pursue claims of price gouging of up to $20,000 per violation..."

At least 28 states have consumer protection statutes to prohibit "excessive" or "exorbitant" or "unconscionable" prices to consumers during states of emergency, sometimes limited to key commodities. For example, the Texas Deceptive Trade Practices Act (Tex. Bus. & Com. Code § 17.46(23)) (DTPA) contains a specific provision, added in 2003, prohibiting taking advantage of a disaster declared by the Governor "by selling or leasing fuel, food, medicine, or another necessity at an exorbitant or excessive price; or demanding an exorbitant or excessive price in connection with the sale or lease of fuel, food, medicine, or another necessity."

On September 6, 2005, Texas Governor Rick Perry issued an emergency disaster declaration, which among other things, activates the anti-gouging provision of the DTPA and allows the Texas Attorney General to pursue claims of price gouging of up to $20,000 per violation and an additional penalty of $250,000 if the act is committed against a person who is 65 years or older.

To handle the expected surge in complaints after Katrina about gasoline "price gouging," the Department of Energy (DOE) added a toll-free hotline to its online, gas price reporting system. Some states also launched or brought attention to their own consumer price hotlines and/or online reporting systems. Even though the DOE does not have the authority to prosecute "price gouging," its gas price reporting system is routinely monitored by the Federal Trade Commission.

In response to Katrina, moreover, the FTC sent Congress a report, entitled "Market Forces, Competitive Dynamics, and Gasoline Prices: FTC Initiatives to Protect Competitive Markets."[2] The FTC explained its efforts to monitor what it deemed "unusual" movements in gasoline prices, which it defined as any "movement in the price of gasoline that is significantly out of line with the historical relationship between the price of gasoline in a particular area and the gasoline prices prevailing in other areas."

Using statistical models, the FTC scrutinizes movements in several wholesale and retail markets across the country and monitors consumer complaints received by the DOE and state Attorney General offices. If a price spike cannot be explained by "natural causes" (i.e., movements in crude oil prices, supply outages, or changes in and/or transitions to new fuel requirements imposed by air quality standards[3]), then the FTC typically launches a formal investigation to determine whether the price is the result of unfair trade practices or anticompetitive conduct.

Numerous proposals are also now pending before Congress to provide for a federal statute to bar unilateral "price gouging." Proposed bills use different terms to define price gouging, such as "gross disparity" or "unconscionably excessive." Others discuss applying a 10 or 15 percent increase in "average prices." The bill that has received the most publicity is H.R. 3893, otherwise known as the "Gasoline for America's Security Act of 2005," which was passed by the House of Representatives in a close vote in October 2005. Under this statute, "price gouging" is specifically prohibited during a "major disaster." However, there is no definition of price gouging. The bill merely requires the FTC to issue rules to define the term.

The FTC, nevertheless, has not been pleased with this proposal. In a statement presented before the Senate Energy and Commerce Committees on November 9, 2005, FTC Chairman Debra Majoras explained to the Senate that the FTC opposed any federal price gouging law. This position was approved by the Commission in a 3-0 vote with one commissioner abstaining. Chairman Majoras explained that price gouging laws, in essence, create price caps that may distort supply and demand, and that price increases actually help by lowering demand and making shortages of gasoline shorter-lived. Furthermore, she emphasized that price-gouging laws are difficult to enforce since the concept is difficult to define. And in any event, the FTC believed that state and local governments could handle this problem if there is a problem at the local level.

The best defense to a charge of price gouging is likely to be increased costs for sellers, which requires careful documentation. Whether or not discovery requests are coming for energy companies, this is also a good time to provide employees with antitrust training with a focus on price-fixing among competitors, because a violation of the Sherman Act is a felony.

Global Warming Post Katrina

In three recent cases prior to the recent hurricanes involving "global warming" claims, federal district courts dismissed two of them, but denied a defense motion for summary judgment in the other. In another case, *Cox v. Nationwide Mutual Insurance Company* (S.D. Miss.), following Hurricane Katrina, three plaintiffs have filed a class action complaint for damages and declaratory relief against several insurance and oil companies.

The insurance companies determined that the plaintiffs' property losses were caused exclusively by flooding, which the policies do not cover. The plaintiffs assert that the "homeowners or other property casualty loss insurance" they purchased purported to insure against any damage caused by hurricanes, and that their losses resulted from hurricane winds, not flooding. The complaint includes a list of contract and tort claims against the insurance companies.

In the second part of the amended complaint, the plaintiffs claim that oil and refining companies operating in Mississippi contributed to the phenomenon of global warming by emitting greenhouse gases and other by-products into the atmosphere. Essentially, they are claiming that global warming, caused in part by the defendants' emissions, enabled Hurricane Katrina to develop "unprecedented strength." The damages they seek range from loss of property to loss of loved ones to mental anguish and emotional distress. Whatever the outcome of this particular litigation, more plaintiffs may try to use the issue of global warming as a vehicle in the courtroom.

Conclusion

The issues highlighted in this article do not exhaust the myriad of issues facing energy companies after the hurricanes. Indeed, almost every agency of the federal government has prepared special hurricane guidelines and rules, including the IRS, SEC, and FTC. This article, however, provides a quick overview of some of the issues that have attracted the most attention.

Endnotes

1 Contributors to this article include William D. Wood, Peggy A. Heeg, Raymond P. Albrecht, Stephen P. Pate, Layne E. Kruse, Eva Fromm O'Brien, and Jeff Dykes. All are in the Houston office of Fulbright & Jaworski L.L.P.

2 A copy of the FTC statement is available at http://www.ftc.gov/os/testimony/050907gaspricestest.pdf.

3 The FTC's report entitled "Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition" is available at http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf.

Raymond P. Albrecht
Counsel, Houston
ralbrecht@fulbright.com
T: +1 713 651 5455

- *Force Majeure*

Eva Fromm O'Brien
Partner, Houston
eobrien@fulbright.com
T: +1 713 651 5321

- *Global Warming & Environmental*

Jeff Dykes
Partner, Houston
jdykes@fulbright.com
T: +1 713 651 5545

- *Force Majeure*

Stephen P. Pate
Partner, Houston
spate@fulbright.com
T: +1 713 651 5132

- *Business Interruption*

Peggy A. Heeg
Partner, Houston
pheeg@fulbright.com
T: +1 713 651 8443

- *FERC and Market Manipulation*

William D. Wood
Partner, Houston
wwood@fulbright.com
T: +1 713 651 5537

- *Force Majeure*

Layne E. Kruse
Partner, Houston
lkruse@fulbright.com
T: +1 713 651 5194

- *Price Gouging & Antitrust*

HOUSTON
T: +1 713 651 5151
F: +1 713 651 5246

NEW YORK
T: +1 212 318 3000
F: +1 212 318 3400

WASHINGTON, D.C.
T: +1 202 662 0200
F: +1 202 662 4643

AUSTIN
T: +1 512 474 5201
F: +1 512 536 4598

DALLAS
T: +1 214 855 8000
F: +1 214 855 8200

LOS ANGELES
T: +1 213 892 9200
F: +1 213 892 9494

MINNEAPOLIS
T: +1 612 321 2800
F: +1 612 321 9600

SAN ANTONIO
T: +1 210 224 5575
F: +1 210 270 7205

HONG KONG
T: +852 2523 3200
F: +852 2523 3255

LONDON
T: +44 20 7010 8300
F: +44 20 7010 8383

MUNICH
T: +49 89 242 930
F: +49 89 242 93222

www.fulbright.com

FULBRIGHT *& Jaworski L.L.P.*

866-FULBRIGHT
[866-385-2744]

11/05 MO