

Precedent agreements: A delicate dance between builders and shippers

By Bill White,
Researcher/Writer for the Office of the Federal Coordinator

The proposed Alaska natural gas pipeline projects are engaged in the “precedent agreement” phase of development.

A pipeline developer that has signed enough precedent agreements with enough shippers for enough of its pipeline capacity holds strong evidence that the market is willing to pay for the project. The developer then can seek formal government permission to build the pipeline and go to financial markets for construction financing – two steps usually needed before construction can begin.

Precedent agreements arise from the open seasons at which pipeline developers advertise their pipeline project, similar to a real estate agent hosting an open house to hook buyers. (In Alaska’s case, the open seasons ended in the second half of 2010 for the projects that propose moving Alaska North Slope gas through Canada and toward Lower 48 markets or to Valdez for export.)

Gas owners that might want to use the pipeline typically speak up during the open season, but they also can express their interests before or after it.

Then ensues commercial negotiations between the pipeline builder and the gas shippers about exactly how their arrangement will work. Generally, the shippers are gas producers, or gas marketing firms or utilities that buy the gas and pay for shipping it themselves. The result of these negotiations, if they reach a deal, are contracts known as “precedent agreements.”

While the precedent agreement talks are under way, other pipeline development work typically continues separately, including routing work, right-of-way surveys, environmental studies, engineering and design.

Precedent agreements for interstate gas pipelines are fundamentally alike in some ways – they cover how much gas will be shipped, where it will go and the price the pipeline owner will charge.

But they also typically differ from each other in key ways because each pipeline project has unique aspects that require customized terms.

For example, the Alaska pipeline sponsors propose a project vastly more expensive than any other U.S. gas pipeline, with a longer construction timetable than is typical and with a multibillion-dollar gas treatment plant that they would build and run on the North Slope to clean the gas of water, carbon dioxide and other impurities before it is placed in the pipeline. Any precedent agreements they achieve likely will include language customized to reflect these differences from other pipelines. For now, those negotiations are occurring in private.

DIVERGENT INTERESTS

Precedent agreement negotiations are a delicate dance between the pipeline developers and the potential gas shippers.

The big picture is that they both want the same thing: A pipeline.

But the financial and other interests of the pipeline owners and gas shippers are imperfectly aligned. A project that works well for a pipeline owner might be a bad bargain for a shipper, and vice versa.

Who bears the risk if the construction schedule slips? What if cost overruns occur? What if so little gas is committed to the pipeline that the project is abandoned? Can a shipper back out before construction starts? What if a pipeline shutdown temporarily disrupts the shippers' promised deliveries to their customers?

The precedent agreements reached for a huge Lower 48 gas pipeline called [Ruby](#) now under construction pulls back the curtain to show the give-and-take between the developer and gas shipper.

El Paso Corp. started construction of Ruby in the summer of 2010 and hopes to finish the 677-mile, \$3 billion natural gas pipeline this summer. Ruby runs from Wyoming to the Oregon-California border and will carry up to 1.5 billion cubic feet of gas a day through a 42-inch pipe. (By comparison, the Alaska project to Alberta would run about 1,700 miles, cost \$30 billion to \$40 billion for a pipeline and gas treatment plant, take five or six years to build and carry up to 4.5 billion cubic feet of gas a day in a 48-inch pipe.)

In all, El Paso reached precedent agreements with 14 shippers committed to using roughly 75 percent of Ruby's capacity. The length of the contracts ranged from five to 15 years, with almost all of them for 10 years. That was enough to launch the project, with El Paso continuing to make the surplus space available to new shippers that might want to use Ruby.

The details of the contracts reflect the divergent interests of El Paso and the gas shippers. El Paso agreed to:

- Apply by a specified date for government permission to construct the pipeline.
- Order steel and pipeline pieces by certain dates.
- Start and finish construction by certain dates.

These clauses revolve around an important concern of the shipper: That it is positioned to promise customers – power plants, local gas utilities, etc. – they will get specific volumes of gas by a given date at agreed-to prices.

In the Ruby precedent agreements, the shippers made their own promises:

- They will ship a specified volume of gas for a set number of years.
- They will be responsible for taking their gas out of Ruby and getting it to its ultimate destination.
- The gas will be what is called "pipeline quality" – stripped of water, carbon dioxide, nitrogen, sulfur and other impurities.
- They won't oppose or intervene in the pipeline builder's effort to get government permission for construction.
- They will maintain a specified level of financial strength. This is important because the pipeline builder wants to be sure the shipper will be around to fulfill its obligation, and the builder wants to use the precedent agreement as a sort of collateral when it borrows money for construction.

The precedent agreements also covered such items as how the shipping tariffs the pipeline builder charges will be determined, how cost overruns will be handled, who will pay if Congress imposes new greenhouse-gas taxes that affect pipelines, and what happens to the construction timetable if a court or government agency stops the work.

The agreements are binding, provided that both sides fulfill all the terms detailed in the contracts – construction starts and ends on time, the gas shipper doesn't go bankrupt, etc.

HOW LONG DO THEY TAKE?

Precedent agreements between pipeline developers and gas shippers can be reached quickly – within a few days of the open season ending – or take many months to work out the details.

A rule of thumb is that the bigger, more complicated or pricier the project, the longer the agreements take as both sides try to minimize the risk that they will pay if something goes wrong.

El Paso held two open seasons in 2008 for Ruby, although it got bids from shippers in only the first one, which ended in April 2008. Before the open season, El Paso secured a precedent agreement with an “anchor” shipper – Pacific Gas & Electric, a West Coast gas and electric utility – that signed up for one-fourth of the pipe's capacity. An anchor shipper is like a department store in a mall, it takes up a lot of space and it likely gets a better deal from the mall owner than smaller stores get.

For the Ruby Pipeline, most of El Paso's 14 precedent agreements got signed in June 2008, within six weeks of the first open season ending, although months would pass before they became known publicly. The unsuccessful second open season followed in September and October as El Paso looked for more gas shippers.

Meanwhile, El Paso continued to negotiate with potential shippers that surfaced during the first open season.

In November 2008, El Paso signed up Anadarko, which committed to using nearly 20 percent of Ruby's capacity. It now had two major shippers committed to using almost half of the pipe's capacity.

In early 2009, nine months after the first open season ended, El Paso signed precedent agreements with the last two of the 14 shippers.

The 14 precedent agreements became public on Jan. 26, 2009 – over seven months after most of them were signed – when El Paso applied to the Federal Energy Regulatory Commission for a certificate to build and operate Ruby. As support for its application, El Paso submitted the precedent agreements to demonstrate that the pipeline is needed.

Although the Ruby precedent agreements are public documents, that is not often the case. Sometimes, the pipeline developer asks FERC to seal them, except for the name of each shipper, how much gas each has committed to the pipeline and how long that commitment lasts. FERC sometimes unseals the agreements as a result of a Freedom of Information Act request, or a court can order the files opened.

Ultimately, precedent agreements are temporary contracts.

As the FERC process progresses, the pipeline developer and gas shipper eventually replace them with a final contract, called a Firm Transportation Service Agreement. These are sometimes called FTs, and they fine-tune the terms between the pipeline and shipper.

The commission requires that these FTs be inked – although the pipeline builder doesn't necessarily file them with FERC – before the ground is cleared, the earth is dug up and construction goes forward. FERC has enormous power over a pipeline project. If the commission rules that the public needs the project, it will regulate the pipeline as a public utility.

THE ALASKA DIFFERENCE

The proposed Alaska gas pipeline is far more vast in scope than any pipeline project FERC has ever seen.

The Ruby Pipeline was big, at \$3 billion.

Another recent pipeline project was the [Rockies Express](#). It was finished in late 2009 and stretches from Wyoming to far eastern Ohio. Rockies Express is longer than Ruby and can carry 20 percent more gas -- 1.8 billion cubic feet a day. Its owners call it "one of the largest pipelines ever constructed in the United States." Its price tag topped \$5 billion.

Enter the Alaska project: A bigger pipe, one-third more capacity to North American markets than Ruby and Rockies Express combined, and a cost estimated at three to four times the combined expense of those two recent major Lower 48 pipeline projects.

This makes the risks of getting the precedent agreements wrong very high for the companies negotiating them.

Both the Alaska Pipeline Project (TransCanada/ExxonMobil) and the Denali project (BP/ConocoPhillips) filed prospective precedent agreements with FERC in advance of their open seasons last year. [Here is a link to APP's proposal](#). [Here is a link to Denali's](#).

Although their ongoing negotiations with gas shippers are private and confidential, the pipeline sponsors show in their sample precedent agreements how their projects differ from Ruby, Rockies Express and other recent U.S. pipeline projects:

- Both Alaska projects call for the developer to build a roughly \$10 billion plant to clean up produced gas before it flows into the pipeline. It's rare these days for a pipeline operator to play a role other than piping the gas from Point A to Point B. The gas treatment plant would be massive – the biggest of its kind in the world. It would scrub from the raw gas such impurities as carbon dioxide, hydrogen sulfide and water. The draft precedent agreements call for negotiating terms on volume, service and cost of treating the gas.
- Both Alaska projects call for shippers to commit to using the pipeline for *at least* 20 years. This is much longer than the typical Lower 48 contract, where 10 years is a common term for big, multibillion-dollar pipelines.

In addition, construction would take an estimated five to six years, raising the risk of cost-overruns and construction delays. (For example, steel prices can fluctuate a lot in that time – and this project is estimated to need 2.5 million tons of steel.) In precedent agreement negotiations, developers and shippers each typically want the other to bear these risks.

Other uncertainties that complicate negotiations between an Alaska pipeline developer and gas shippers include:

- The ongoing dispute between the state and oil companies over rights to the huge Point Thomson gas field, the North Slope's second largest gas resource.
- The risk that Lower 48 shale gas production could glut the market with supply and depress prices, pushing shippers to seek to delay the project.
- The lack of long-term clarity from the state of Alaska about its tax and other fiscal terms if North Slope gas production ramps up. This will require separate talks between gas producers and the state.
- The pipeline would cross an international border, adding another layer of government approval and oversight.

DISCLOSURE OF PRECEDENT AGREEMENTS

As was said, precedent agreements usually get unveiled, in whole or part, when a developer applies to FERC for a certificate to construct and operate a pipeline. The agreements are the developer's affirmation that the project is needed.

For the Alaska pipeline projects, those certificate applications aren't planned until the fall of 2012 for the Alaska Pipeline Project and 2013 for the Denali project.

In an unusual move, FERC decided in 2005 to handle disclosure of the Alaska projects' precedent agreements differently. FERC's Alaska-specific regulations disallow withholding from the public the existence of signed agreements until the certificate filing.

The developer must issue a press release within 10 days of executing each precedent agreement disclosing the name of the shipper, the amount to be shipped and how many years the shipping will last. Then the developer must file the actual precedent agreement with FERC within 20 days of signing it, although the developer can ask FERC to seal the agreement so the public can't see its details. In handling past pipeline projects, FERC typically granted requests for sealing these documents.

To date, neither the Alaska Pipeline Project nor the Denali project has filed any precedent agreements with FERC.

Bill White is a former editor at the Anchorage Daily News. He joined the Alaska Office of the Federal Coordinator in March as a researcher/writer. He can be reached at bwhite@arcticgas.gov.