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Chapter 9

Pitfalls Associated with Affiliate Transactions in the Gas Industry[1]

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1 The hypotheticals, analysis, and comments contained in this chapter are purely for academic discussion purposes and not based upon any specific cases or entities, nor intended to constitute legal advice or legal positions applicable to any particular case or on behalf of any particular entity.

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§ 9.01. Introduction.

The unbundling of the oil and gas industry by Orders issued by the Federal Energy Regulatory Commission ("FERC") in the 1990s resulted in a restructuring of the industry and a separation of merchant and pipeline functions. Many companies reorganized, spun-off or spun-down production, marketing, gathering and transmission entities. Additionally, many companies have also created subsidiary and affiliate entities as prudent business practice to recognize they may perform different functions and have a different focus, and to limit or control legal liability and risk.

As a result, the question frequently arises in litigation whether parents, subsidiaries, or affiliates are liable for the acts or omissions of each other and can be joined as parties under theories of alter ego, piercing the corporate veil or other liability theories. There are risks of exposure for the unwary if attention is not scrupulously paid to observing the corporate form. In an attempt to avoid risk, the following techniques should be utilized: properly drafting contracts to anticipate the risk of exposure for acts or omissions of affiliates, proper and periodic due diligence, and on-going analysis of risks associated with affiliate dealings and operations.

This chapter is not intended to be an exhaustive analysis of all of the potential risk associated with parent, subsidiary or affiliate transactions; instead, it is intended to provide examples of some of the risks that may be encountered by typical operations in the oil and gas industry. In order to illustrate the aforementioned risks, this chapter outlines a sampling of the risks and risk avoidance suggestions, in the context of some hypothetical facts.

§ 9.02. Hypothetical Facts.

[1] — The Leases.

Lease 1 from royalty owner ("RO") to ProdCo provides royalties are to be paid on the market value of the gas at the wellhead based upon the average price paid in the field or locality near the wellhead. Lease 2 from RO to ProdCo provides that when gas is sold on the lease, royalties are to be paid based on the amount realized from the sale; when gas is sold off the lease, royalties are to be paid on the amount realized from the sale, but not less than the market value of the gas.

[2] — The Gathering of the Gas.

ProdCo and JVCo enter into a joint development agreement and Leases 1 and 2 are included in an area of mutual interest ("AMI"). ProdCo is the operator of both leases, but assigns a 50 percent interest in the leases to JVCo. ProdCo and JVCo also combine their on-lease pipelines and off-lease gathering systems and assign various pipeline easements to a new jointly owned company, GathCo. All gas from the AMI will be shipped through GathCo, which also, off the leases/AMI, accepts third party gas for shipment to an interstate pipeline operated by TransCo. Part of the motivation to form the joint venture and enter into the AMI is to lock up future capacity on GathCo so MarketCo can sell all the gas from the AMI