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Overview

NAESB Contract for the Sale & Purchase of Natural Gas

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Introduction

The purchase and sale of natural gas is a "forward transaction" which can be performed under a number of different agreements, both bespoke and industry accepted standard forms. This overview discusses the industry standard form published by the North American Energy Standards Board ("NAESB").

NAESB is an industry association with a mandate to develop and encourage standards for the wholesale and retail natural gas and electricity markets. NAESB was established in 2002 as the successor to the Gas Industry Standards Board ("GISB"). GISB, initially formed in 1994 at the urging of the Natural Gas Council, the U.S. Department of Energy and the Federal Energy Regulatory Commission, had a narrower mandate of only proposing standards for the wholesale gas market. GISB while in existence created a standard form agreement for the purchase and sale of natural gas - the "Base Contract for Short-Term Sale and Purchase of Natural Gas" (the "GISB Base Contract"), which, as its name implies, was meant to govern short term transactions. The disclaimer on the first page of the contract provides:

> *"This Contract is intended for Interruptible transactions or Firm transactions of one month or less and may not be suitable for Firm transactions of longer than one month."*

While the short-term contract was well received, the gas industry called for a contract that could be used for both long and short term transactions. Long term contracts require provisions that protect a party's rights in the event its counterparty's profile deteriorates during the term of the transaction. As a result, in 2002 NAESB published the "Base Contract for Sale and Purchase of Natural Gas", which is a more robust agreement than the GISB Base Contract. In 2006, after the 2002 contract had been in use for a few years, it was amended to reflect industry practice and the 2006 Base Contract for Sale and Purchase of Natural Gas was published (the "Base Contract"). The Base Contract has become the most commonly used contract for the purchase and sale of natural gas, and can be purchased through NAESB.

The Base Contract

The Base Contract is a master agreement, which means that once executed it provides its parties with the ability to enter into transactions for the purchase and sale of natural gas indefinitely, or until the agreement is terminated. The complete contract consists of:

1. The "***General Terms and Conditions***" – This is the boilerplate agreement and contains industry approved terms that will govern the relationship between the parties.

2. The "***Cover Page***" – This is part of the General Terms and Conditions. Parties complete this standard form by making certain elections as required in the General Terms and Conditions and providing specific organizational information.

3. The "***Addendum(s)***" – In addition to the General Terms and Conditions, NAESB has published standard form addenda to address specific requirements that parties may have. For instance, if parties choose to collateralize their obligations, they can apply the Model Credit Support Addendum which was published by NAESB in 2003, or if parties will be transacting in Canada or cross border US-Canada, they can apply the Canadian Addendum, published on April 19, 2002, which incorporates terms for Canadian or cross border trading.

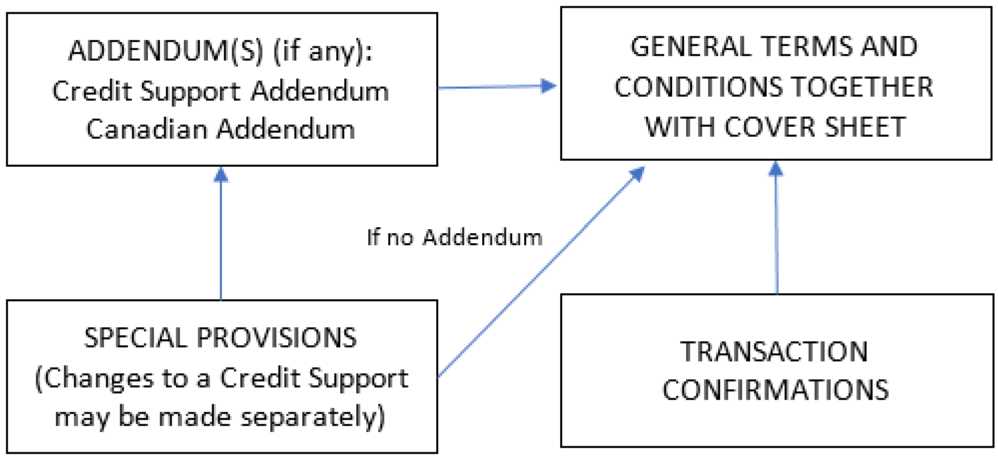
4. The "***Special Provisions***" – Like most other master agreements, when negotiating the agreement, parties do not amend the pre-printed form General Terms and Conditions. Elections (other than those made in the Cover Page), additions and amendments to the pre-printed form are made in the Special Provisions to the master agreement.

Collectively, documents one through four are referred to as the Base Contract.

5. The "***Transaction Confirmations"*** - Once the Base Contract is finalized, the parties can transact under the Base Contract by entering into a transaction confirmation setting out the economic terms of the transaction. Note however that parties can elect under the Base Contract to enter into transactions orally.

The Base Contract together with each Transaction Confirmation entered thereunder form one agreement referred to as the "NAESB Contract".

The chart below illustrates the NAESB Contract structure:



The NAESB Contract

Either party can be a "buyer" or a "seller" of gas under the NAESB Contract. The parties elect whether their transactions will be entered into on a "firm" or "interruptible" basis. If a transaction is entered into on a firm basis, a party's failure to perform will only be excused if the party is subject to an event that is beyond the party's control, a "force majeure" as defined in the NAESB Contract. If there is no force majeure, the non-performing party will be subject to liquidated damages. Conversely, a party's failure to perform under an interruptible transaction for any reason will incur no consequences. Performance by the parties consists of the seller selling and the buyer purchasing, on an agreed upon date:

- an agreed quantity of gas;
- at an agreed purchase price;
- at an agreed delivery point.

Transaction Confirmations

Gas transactions are typically executed between traders by telephone or electronic messages and later confirmed with a written confirmation. The Base Contract provides for the ability to confirm a transaction either:

- orally – by electronic data interchange or telephone conversation,
- orally followed by a written confirmation, or
- in a written confirmation.

If the parties agree to oral confirmation, either party can send a written confirmation to confirm the oral understanding. However, the failure to send a written confirmation will not invalidate the oral agreement. The oral confirmation is considered a "writing" and "signed" by the parties. If the parties prefer to have a written confirmation govern their transaction, the transaction will not be effective until the parties agree on the terms of the confirmation. However, if the party receiving the transaction confirmation does not object to its terms by the Confirm Deadline, the transaction confirmation will be deemed accepted. It is important to note, however, that any provision in the transaction confirmation that does not relate to the commercial terms of a transaction, for example amending the definition of "force majeure", cannot be agreed by deemed acceptance, but instead requires express agreements by the parties.

Liquidated Damages

If a party fails to perform its obligations under a firm transaction, this will not automatically be an event of default under the NAESB Contract, but rather will subject the non-performing party to the payment of liquidated damages. The calculation of liquidated damages will either be calculated based on the "Cover Standard" or the "Spot Price Standard" depending on which standard is elected by the parties in the Cover Page.

Cover Standard

If *"Cover Standard"* is elected, the performing party will use commercially reasonable efforts:

- if the buyer is the performing party, to obtain Gas, (or an alternate fuel if elected by the buyer and replacement Gas is not available), or
- if the seller is the performing party, to sell Gas.

In either case, at a price reasonable for the delivery or production area, as applicable, consistent with:

(i) the amount of notice provided by the non-performing party;

(ii) the immediacy of the buyer's gas consumption needs or the seller's gas sales requirements, as applicable;

(iii) the quantities involved; and

(iv) the anticipated length of failure by the non-performing party (the "Cover Price").

If the buyer cannot purchase Gas after using commercially reasonable efforts or if the seller cannot sell gas after using commercially reasonable efforts, the gas not replaced or sold will be compensated by an amount equal to the unfavorable difference between the price contracted between the parties (the "Contract Price") and the Spot Price, multiplied by the quantity not sold or taken.

The cover standard formulas are as follows:

> *Seller failure to deliver.*
>
> Seller pays buyer the positive difference between: (Cover Price minus Contract Price (adjusted for differences in transportation)) multiplied by the undelivered quantity.
>
> *Buyer failure to take.*
>
> Buyer pays seller the positive difference between: (Contract Price minus Cover Price (adjusted for differences in transportation)) multiplied by the undelivered quantity.

Spot Price Standard

If *"Spot Price Standard"* is elected, the performing party is not required to try to mitigate damages by buying or selling the gas, but rather it can determine its damages based on the Spot Price. The Spot Price used by the performing party is the price listed in the publication indicated on the Cover Page, under the listing applicable to the geographic location closest in proximity to the delivery point(s) for the relevant day, provided that:

- if there is no single price published for such location for such day, but there is published a range of prices, then the Spot Price will be the average of such high and low prices.
- If no price or range of prices is published for such day, then the Spot Price will be the average of the following:

  (i) the price (determined as stated above) for the first day for which a price or range of prices is published that next precedes the relevant day; and

  (ii) the price (determined as stated above) for the first day for which a price or range of prices is published that next follows the relevant day.

The Spot Price Standard formulas are as follows:

> *Seller failure to deliver.*
>
> Seller pays buyer the positive difference between: (Spot Price minus Contract Price) multiplied by the undelivered quantity.
>
> *Buyer failure to deliver.*
>
> Buyer pays seller the positive difference between: (Contract Price minus Spot Price) multiplied by the undelivered quantity.

In addition to the Cover Standard or the Spot Price Standard, parties can elect "Alternative Damages" in a Transaction Confirmation executed in writing by both parties, or make such change in the Special Provisions. Alternative Damages are damages, expressed in dollars or dollars per MMBtu, as the parties agree upon.

Events of Default

While the failure to deliver or take gas under the NAESB Contract does not lead to an event of default, other failures will, including a party or its guarantor being subject to:

- an insolvency type event;
- a failure to perform under an obligation to provide credit support;
- a failure to provide Adequate Assurance of Performance (within 48 hours of request, but at least one business day);
- a failure to pay, subject to a two business day cure; and
- any "Additional Event of Default".

Each of these events are considered an "Event of Default" under the Base Contract.

Adequate Assurance of Performance

Under the Base Contract, either party is entitled to demand adequate assurance of performance if it has reasonable grounds for insecurity regarding its counterparty's performance under the contract. "Reasonable" grounds for insecurity specifically includes the occurrence of a material change in the creditworthiness of the counterparty or, if applicable, its guarantor. "Adequate Assurance of Performance" is defined as sufficient security in a form, amount and term that is acceptable to the requesting party and may include, without limitation, cash, a letter of credit, prepayment, security interest, or a performance bond. Failure to provide such requested assurance within 48 hours (but at least one business day) of demand will constitute an Event of Default. There is no specific test to determine whether reasonable grounds for insecurity have been met, however substantial arrears in payments, change in ownership, material litigation with a shareholder, impending bankruptcy, credit downgrades and late payments of invoices have all been deemed "reasonable grounds".

Additional Event of Default

Additional Events of Default are elected on the Cover Page and consist of "Indebtedness Cross Default" and "Transactional Cross Default". The Additional Events of Default allow a party to declare an Event of Default under an NAESB Contract even though its counterparty may not have defaulted under the NAESB Contract, but has defaulted under another significant agreement entered between the parties.

Remedies upon an Event of Default

Upon a continuing Event of Default, the non-defaulting party may, by giving notice to the defaulting party, immediately withhold all payments or deliveries and terminate the NAESB Contract by designating a date which must be within 20 days of notice for the liquidation and termination of all transactions under the NAESB Contract (the "Early Termination Date"). In the Cover Page, parties can elect whether or not "Early Termination Damages Apply". If "Early Termination Damages Apply", the non-defaulting party will determine the amount owed by each party for gas delivered or received either on or before the Early Termination Date, and any other applicable charges related to deliveries and receipts and the market value of the terminated transaction. To determine the market value, the non-defaulting party will determine, for each terminated transaction, the amount of gas remaining to be delivered or purchased under a transaction multiplied by the market price for a similar transaction at the delivery point as determined by the non-defaulting party in a commercially reasonable manner. To ascertain the market value, the non-defaulting party may consider, among other valuations,

- any or all of the settlement prices of NYMEX Gas futures contracts,
- quotations from leading dealers in energy swap contracts or physical gas trading markets,
- similar sales or purchases, and
- any other bona fide third-party offers, all adjusted for the length of the term and differences in transportation costs.

If "Early Termination Damages Do Not Apply", the non-defaulting party will simply determine the amount owed by each party for gas delivered or received either on or before the Early Termination Date and any other applicable charges related to deliveries and receipts.

Whether the parties have elected Early Termination Damages Apply or Early Termination Damages Do Not Apply, the non-defaulting party will net or aggregate, as appropriate, any and all amounts owing between the parties in accordance with the agreed calculation method, and amounts will be netted or aggregated to a single liquidated amount payable by one party to the other. The party owing the largest amount will make a net payment to the other, regardless of which party was in default. If Set-Off has been elected in the Cover Page, the non-defaulting party can then set-off amounts it owes against amounts owed to it, in accordance with the terms of the agreement .

By its terms, the Base Contract (including its Cover Page, Special Provisions and Addendum(s), if any), together with all Transaction Confirmations entered into between the two parties, form a single legal agreement, the benefits of which are well established in the industry. While the Base Contract is well accepted document in the industry, it remains subject to amendments required to reflect the specific circumstances of the relationship to be established between the parties. Some of the most common changes and elections are discussed in the Cover Sheet Drafting Guide.