

MEMORANDUM

TO: Pipeline Users
FROM: First Gas
DATE: 20 December 2017
RE: Reasonable and Prudent Operator Definition in the GTAC

Introduction

This memorandum:

- Summarises First Gas' review of definitions of "Reasonable and Prudent Operator" (**RPO**) that are commonly used internationally in pipeline contracts; and
- Sets out the reasons why the RPO definition in the GTAC as submitted to the GIC on 8 December 2017 (**GTAC**) differs from the definitions used in the VTC and MPOC.

The VTC and MPOC definitions of RPO

The VTC defines RPO as follows:

Reasonable and Prudent Operator means, in relation to the performance of obligations under a TSA:

- for Vector, an operator of a high pressure gas transmission system whose standard of performance is equal to or better than good high pressure gas transmission system operating practice as determined by reference to proper and prudent practices recognised internationally as applying to the operation of such systems; and*
- for a Shipper, a shipper of gas whose standard of performance is equal to or better than good gas shipping practice as determined by reference to proper and prudent practice recognised internationally as applying to shippers of gas;*

The MPOC definition of RPO includes a wider class of operators (although it uses the same formulation for each operator):

"Reasonable and Prudent Operator" means, in relation to the performance of obligations under this Operating Code:

- for TSP and each TP Welded Party, an operator of a high pressure gas transmission system whose standard of performance is equal to or better than good gas transmission operating practice as determined by reference to proper and prudent practices recognised internationally as applying to the operation of such systems;*
- for a Welded Party (excluding any TP Welded Party and Notional Point Welded Party), an operator of gas facilities (which include production and treatment and gas consuming facilities, as the case may be) whose standard of performance in relation to those facilities is equal to or better than good gas facility operating practice as determined by reference to proper and prudent practice recognised internationally as applying to the operation of such facilities;*
- for a Shipper, a shipper of gas whose standard of performance is equal to or better than good gas shipping practice as determined by reference to proper and prudent practice recognised internationally as applying to the shippers of gas; and*
- for an operator of a Trading Platform (including a Notional Point Welded Party) an operator and manager of a Trading Platform whose standard of performance is equal to or better than*

international practice for the operation and management of wholesale gas markets on gas transmission systems as determined by reference to proper and prudent practices recognised internationally as applying to such markets.

The common parts of each definition in the VTC and MPOC are:

“standard of performance is equal to or better than good [] operating practice”

“by reference to proper and prudent practices recognised internationally”

International RPO Definitions

Following the release of the first draft of the GTAC in August 2017, stakeholders encouraged First Gas to consider different formulations for the definition of RPO (points raised via Trello). First Gas then reviewed RPO definitions contained in a number of different types of contracts and jurisdictions overseas.

The examples below differ from the VTC and MPOC definitions which are rather less specific. However, there are a number of key phrases, which are not in the MPOC and VTC definitions that are common to several examples.

The following (almost identical) definitions of RPO were taken from searches of English language long term energy contracts in use in Europe (US examples were also reviewed, however these were less helpful given the different nature of resource ownership in the US and the particular relationship between State and Federal law):

- *Reasonable and Prudent Operator means a person acting in **good faith**, with the intention of performing its contractual obligations and who, in so doing, and in the general conduct of its undertaking, exercises that **degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be exercised by a skilled and experienced person** complying with applicable law engaged in the same type of undertaking in similar conditions and circumstances¹*
- *RPO (reasonable and prudent operator) means a person seeking in **good faith** to perform its contractual obligations and in so doing and in the general conduct of its undertaking exercising that **degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator** complying with all applicable laws, engaged in the same type of undertaking, under the same or similar circumstances and conditions, and any reference to the standards of a Reasonable and Prudent Operator shall be construed accordingly.²*
- *a Person seeking in **good faith** to perform its contractual obligations and, in so doing and in the general conduct of its undertaking, exercising that **degree of skill, diligence, prudence and foresight** which would **reasonably and ordinarily be expected from a skilled and experienced operator** engaged in the same type of undertaking under the same or similar circumstances and conditions, and the expression the 'Standard of a Reasonable and Prudent Operator' shall be construed accordingly.³*

This second type of definition is from a Norwegian contract and does not use the “good faith” standard:

*“Reasonable and Prudent Operator” shall mean **that degree of diligence, prudence and foresight reasonable and ordinarily exercised** by experienced operators engaged in the same line of*

¹ Grid Trade Master Agreement from the Futures Industry Association European Principal Traders Association. Contract for all contracts on the UK National Grid (<https://fia.org/commodities-agreements>).

² Forties Pipeline System Transportation and Processing Agreement, BP, ([https://www.bp.com/content/dam/bp-forties-pipeline/en/pdf/FPS%20Standard%20TPA%20Section%202%20\(April%202014%20-%20Final\)_1.pdf](https://www.bp.com/content/dam/bp-forties-pipeline/en/pdf/FPS%20Standard%20TPA%20Section%202%20(April%202014%20-%20Final)_1.pdf))

³ Scottish Power UK Plc v BP Exploration Operating Company Ltd & Ors [2015] EWHC 2658 (Comm)

*business under the same or similar circumstances and conditions having due consideration to the interest of the other Party under this Agreement.*⁴

These formulations include either a good faith test or a duty to consider the interest of the other party. In the UK, the courts have held that a particular RPO definition containing a good faith clause had two distinct limbs and in order to comply, a party must:

- be seeking in good faith to perform its contractual obligations; and
- be exercising the degree of skill, diligence, etc. reasonably and ordinarily expected of an experienced operator.

The references to skill, diligence, prudence and foresight appear to be almost universal as do the references to skilled and experienced, (or merely skilled), operators engaged in the same undertaking, (or line of business), under the same or similar conditions or circumstances.

Comparison between VTC/MPOC and international definitions

Apart from the good faith requirement (or the requirement to consider the interest of the other party), the main difference between the existing definitions in the VTC and MPOC and the international examples is the test that is applied to decide whether an Operator has acted as an RPO.

The VTC and MPOC formulations refer to “good ... practice as determined by reference to proper and prudent practices recognised internationally”. The international examples we have cited refer to “exercising that degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled *or* experienced operator, engaged in the same type of undertaking, under the same or similar circumstances *or* conditions”. The latter would likely be easier to evaluate should there be any dispute - as the former requires reference to international practices which may vary and may not be explicit on matters of judgement or discretion which are necessary due to local conditions.

In terms of the good faith requirement, this has been problematic to apply in the contracts where it has been used. It can be difficult to objectively determine the behaviour that meets the good faith standard. Constructions around an operator ‘purporting to act in good faith’ have been attempted to broaden the test, but these become too favourable to the operator to be meaningful. Based on industry feedback on this point, First Gas considers that a more specific test which considers the interests of other users of the pipeline system is preferable to the uncertainty of including a general “good faith” test in the definition.

GTAC definition

Based on the above analysis, First Gas considers that the RPO definition should include the following elements:

- the same objective standard for all parties;
- consistency with international best practice; and
- common standards for:
 - the degree of skill; and
 - identifying whose interests should be considered when performing obligations.

The following definition has been included in the GTAC to include all of these elements:

*Reasonable and Prudent Operator or RPO means, in relation to the performance of obligations under this Code, the application by the relevant party of that **degree of diligence, prudence and foresight reasonably and ordinarily exercise by experienced operators engaged in the same***

⁴ General terms and conditions for trading at Gas Hub Norway

line of business under the same or similar circumstances having due consideration to the interests of the other users of the Transmission System;

The elements described above are met as follows:

- The definition is the same irrespective of which party's conduct is being evaluated – the words 'the same line of business' allow it to apply to shippers, interconnected parties and First Gas;
- There is consistency with international best practice – the wording in the definition has been used overseas in numerous agreements and anyone applying this test will be able to draw on legal opinions and decisions from elsewhere; and
- The definition creates common standards for:
 - Degree of skill – the wording around 'degree of diligence, prudence and foresight' is a test that can be applied in a New Zealand context. This removes the potential ambiguity that the VTC/MPOC test introduces. The use of the phrase "proper and prudent practices recognised internationally" potentially elevates international practice above local market and physical conditions which some submitters regarded as undesirable: and
 - Good faith – the reference to '*having due consideration to other users of the Transmission System*' is a better proxy for the '*good faith*' concept used in other definitions. This ensures that parties exercise their rights in accordance with the contract in a manner that considers the impact on all other users (regardless of whether they have a contract with that user).