Denver Law Review

Volume 34 | Issue 4 Article 10

May 2021

Independent Gas Producer's Case Before the Federal Power Commission

John E. Jones

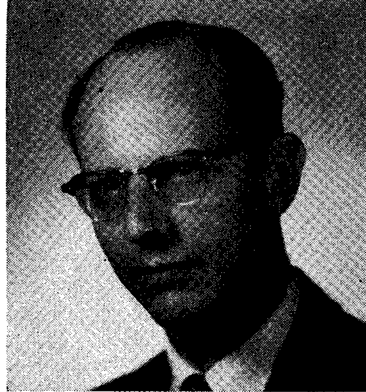
Follow this and additional works at: https://digitalcommons.du.edu/dlr

Recommended Citation
John E. Jones, Independent Gas Producer's Case Before the Federal Power Commission, 34 Dicta 276 (1957).

This Article is brought to you for free and open access by the Denver Law Review at Digital Commons @ DU. It has been accepted for inclusion in Denver Law Review by an authorized editor of Digital Commons @ DU. For more information, please contact jennifer.cox@du.edu,dig-commons@du.edu.

THE INDEPENDENT GAS PRODUCER'S CASE BEFORE THE FEDERAL POWER COMMISSION

By John E. Jones



John E. Jones is a senior at the University of Denver College of Law. This note was awarded third prize in the writing competition sponsored by the Rocky Mountain Mineral Law Foundation.

Despite certain prior conclusions apparently to the contrary and the obvious language of the Natural Gas Act,[1] the Supreme Court held in the *Phillips* case[2] that an independent natural gas producer which sold gas to interstate pipe line companies for interstate transportation and resale, was a "natural gas company" within the meaning of the act.

The Commission, acting in recognition of the powers held extended to it, issued its Order 174 series[3] promulgating regulations applicable to its new subjects, those persons deemed to be independent producers of natural gas. These orders were designed to implement, among other parts, section 4 of the act which requires every natural gas company to file with the Commission schedules of its rates and charges in such form as the Commission may designate in regulations.

It is with this class of persons, those subject to the Natural Gas Act, and the application to them of section 4 as implemented by Order series 174, that this Note is primarily concerned.

Particular attention is directed to section 717c (c) of the code the pertinent provisions of which are set forth below.[4] Note that the code specifically provides that the natural gas company is required to file, in the first instance, schedules showing all rates and charges for any transportation or sale subject to jurisdiction of the Commission.[5] This so-called rate schedule is defined in section 154.93 of the regulations[6] as meaning the basic contract and all

[1] 52 Stat. 821 (1938), 15 U.S.C. § 717 (1952).
[2] Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).
[3] 18 C.F.R. § 154.92 (Supp. 1957).
[4] 52 Stat. 821 (1938), 15 U.S.C. § 717c (c) (1952) "Under such rules and regulations as the Commission may prescribe, every natural gas company shall file with the Commission . . . schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission . . . together with all contracts which in any manner affect or relate to such rates . . .
"(d) . . . no change shall be made by any natural gas company in any such rate . . . except after thirty days' notice to the Commission and to the public . . ."
[5] *Id.* § 717c (c).
[6] 18 C.F.R. § 154.93 (Supp. 1957).

supplements or agreements amendatory thereof, effective and applicable on and after June 7, 1954, the date the *Phillips* case was decided. Such schedule must show the service to be provided and the rates and charges, terms, conditions, classifications, practices, rules and regulations affecting or relating to such rates or charges, applicable to the transportation of natural gas in interstate commerce or the sale of natural gas in interstate commerce for resale subject to the jurisdiction of the Commission.

Thus, a natural gas producer who sells gas which moves in interstate commerce must file, as a component part of his rate schedule, the gas sale contract he has made with the gas purchaser. Sales of natural gas by producers are made under long terms contracts. The purchaser of gas, having constructed or planned to construct facilities for gathering and transporting gas at great cost to himself, is primarily interested in securing for his present and future commitments vast reserves of gas sufficient to justify his cash outlay and his obligations to deliver in years to come. Moreover, if he is transporting in interstate commerce, the Commision will require him to show he has sufficient reserves committed to provide the service contemplated for the ensuing twenty years. Such long term contracts usually provide, inter alia, for certain specified lands from which gas is produced and which are potentially capable of producing gas to be dedicated to the terms and provisions of the contract, for the price to be received for the sale of gas to be escalated at certain specified periods of time to increase rates, and for some type of favored nation clause. These provisions conform to the practices and usage in the industry for reasons peculiar to it. The Commission must thus consider the gas sales contract in its determination of what shall be a just and reasonable rate for the producer to obtain for his gas.

Other than the contract, what criteria must the Commission use to determine whether or not the rate charged is just and reasonable? It must be remembered that the statute itself provides no standard. Nor has the Commission any means based upon experience by which to establish a just and reasonable rate. Although the Natural Gas Act was approved and became law in 1938, its applicability prior to the *Phillips* decision had been limited to persons other than producers and gatherers, as the act provided. Bearing in mind that the producer of natural gas furnishes a commodity, a non-replaceable natural resource, it is easily apparent that any

We Will Render Any Possible Assistance in Connection With Your Law Book Needs

American Jurisprudence
Am Jur Legal Forms, Anno.
Am Jur Plead. & Prac. Forms
***U. S. Reports, Law Ed.**

***American Law Reports**
***A.L.R. 2d Series**
Federal Code Anno.
Texts on all Subjects

**Available in MICROLEX Editions*

BENDER-MOSS COMPANY

Lawyers Co-Op Publishing Company

91 McAllister Street **San Francisco 2, California**

just and reasonable rate must be established so as to encourage further exploration and development of natural gas resources. Such rate cannot be limited in its contemplation to the protection of the ultimate consumer. Although certain pro-regulation interests have characterized the ultimate consumer as a captive of the gas producers, pipeline companies and retailers, actually the converse appears to be true—the producer is now the captive.

If the producer's rate is to be limited to the more or less standardized lines of regulation of public utilities based on the theory of determining the value of a service by determining the investment in facilities to provide the service, plus operating expenses, he is without means of showing that his discovery has a tangible value or that its replacement is a matter of known or estimated value. The interstate pipe line companies who, prior to the *Phillips* decision were the principal subjects of rate regulation by the Commission, supplied the greater part of their needs from their own reserves, but were not permitted to claim depletion even as a cost item in determining the cost of service.[7] Nor have the courts indicated with any degree of certainty that the Commission may consider depletion in determining rates for independent producers. The latter are justifiably confused as to just what evidence they may present in support of a claimed just and reasonable rate. The Federal Power Commission is not bound "to the service of any single formula or combination of formulas"[8] in fixing rates. The Commission may, for rate-making purposes, select any permissible formula or combination of formulas which it considers appropriate under the circumstances.[9] Nowhere has the writer found any degree of certainty in the decisions reflecting upon the use of depletion as a positive criterion for the determination of a fair rate.

The Supreme Court stated in the *Hope* case:

> The rate-making process under the Act, i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests . . . . From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business . . . . By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[10]

By what other standard may the prudent investor in the industry be confidently assured of the financial integrity of the enterprise than a thorough review of the company's proven reserves and its aggressive determination to develop new reserves to replace those depleted? Certainly one of the considerations under which the independent producers proceed with exploration activity is the tax relief granted them through the depletion allowance.

[7] 58 Pub. Util. Fort. 366-67 (1956).
[8] Panhandle Eastern Pipe Line Co. v. FPC, 143 F.2d 488, 493 (8th Cir. 1944), *aff'd*, 324 U.S. 635 (1945).
[9] FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 586 (1942).
[10] FPC v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

The fair value criterion, on the other hand, has apparently received preferential treatment in the decisions. In the *Hope* case the Court's reasoning appears to have been that fair value of a discovery is not includable in the rate base, but that only actual legitimate costs are includable. The court, quoting from *Block v. Hirsh*[11] stated, "The fixing of prices, like other applications of the police power, may reduce the value of the property which is being regulated. But the fact that the value is reduced does not mean that the regulation is invalid."[12] And continuing, the Court said:

> "It does, however, indicate that 'fair value' is the end product of the process of rate-making not the starting point as the Circuit Court of Appeals held. The heart of the matter is that rates cannot be made to depend upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated."[13]

It is submitted that the Court failed to consider fully the peculiar attributes of "value" of developed property. That a discovery has a fair value without regard to the aspect of rate control must be urged, if for no other reasons than these: Suppose the operator does not know at the moment his discovery is evaluated by engineers whether or not he will commit his gas to movement in interstate commerce? It nevertheless has a fair market value in the ground. Or, suppose he may wish to commit his gas wholesale to an industrial user? In neither case does the Commission have jurisdiction over the gas, its movement or its sale price, yet it does have a fair market value in place. Or, suppose he negotiates to sell the discovery in place together with his rights to produce and market it. If his successor in interest sells the gas in interstate commerce, cannot the successor claim his cost as part of his rate base?

In another case, *Panhandle Eastern Pipe Line Co. v. FPC*[14] the Eighth Circuit asserted that although the Commission was not bound to give weight to evidence of replacement or reproduction cost of the properties, no court had at that time ruled that the Commission may, at a rate hearing, refuse to receive the evidence.[15] So it would appear that the way was yet open through a proper

[11] 256 U.S. 135 (1921).
[12] 320 U.S. at 601.
[13] *Ibid.*
[14] 143 F.2d 488 (8th Cir. 1944), *aff'd*, 324 U.S. 635 (1945).
[15] *Id.* at 493.

YOUR OFFICE SAFE

may be safe enough for ordinary purposes but your important documents should be in a SAFE DEPOSIT BOX in our new modern vault, designed for both safety and convenience.

A whole year for as little as $5 plus tax.

COLORADO STATE BANK

OF DENVER—SIXTEENTH AT BROADWAY

Member Federal Deposit Insurance Corporation

showing of necessity to include fair value but for the language in the *Colorado Interstate* case[16] where the Court asserted that it could not say as a matter of law that the Commission erred in including the production properties in the rate base at actual legitimate cost. The Tenth Circuit in *Cities Service Gas Co. v. FPC*,[17] apparently rendered the issue moot in holding that fair value was no longer deemed essential to find an economic rate base for rate making purposes.

It is significant, however, that in none of the cases did the proponent of a rate increase show as a matter of necessity the inadequacy of an existing rate or that an increased rate would be just and reasonable for preservation or the financial integrity of the company. It would seem that a proper showing of costs for exploration and development to replace the value of the gas being depleted would be convincing evidence looking toward the preservation of financial integrity.

As mentioned above, an essential and required part of a producer's rate schedule is the gas sale contract under which he disposes of his gas, such contract usually containing a price escalator clause and probably some form of favored nations clause. Notwithstanding that such a contract may have been found by the Commission to have been entered into by arms length bargaining in good faith, the producer is precluded from unilaterally bringing the contract price increases into effect by the provisions of section 717c (d) and (e) of the code.[18] Section 717c (d) provides that no change may be made by any natural gas company except after thirty days' notice to the Commission and to the public. Section 717c (e) provides that upon such notice the Commission shall have authority to enter upon a hearing concerning the lawfulness of the proposed rate change, either on its own motion or upon complaint of any state, muncipality or state commission.

Thus, the producer is faced with a problem at the time or times specified in the contract when automatic price changes are to take effect. Assuming he has filed his rate schedule, whether it has or has not resulted in a certificate of public convenience and necessity, if he has such a contract as described above conditioned upon certain automatic price changes, he will be required by the code provisions just noted to file with the Commission, at least thirty days prior to the effective date of such increase, a new rate schedule or a supplemental rate schedule proposing an increase in rates. Since the Commission is bound to determine that any rate is just and reasonable it may, on its own motion, without intervention by any complainant, hold a hearing concerning the lawfulness of such proposed rate change. The question arises, what is the effect of the established contractual relationship between the producer and the buyer upon the Commission's determination of a just and reasonable rate?

Probably the strongest argument the producer feels he can advance to justify the proposed rate increase would be that it

---

[16] Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945).
[17] 155 F.2d 694, 701 (10th Cir.), *cert. denied*, 329 U.S. 773 (1946).
[18] 15 U.S.C. § 717 (1952).

resulted from arms length contract negotiation, and that the resultant price increase is no greater than the competitive field price or the reasonable market price prevailing in the pricing area. This argument was advanced in the first series of cases before the Commission relative to this issue.[19] The Commission found the contracts before it to have been negotiated after arms length bargaining and entered into in good faith, but stated that such finding did not make the contracts immune from regulation in the public interest. It further stated that neither did the producer's contract terms per se indicate that the prices agreed upon were just and reasonable either initially or as subsequently increased pursuant to escalation clauses or otherwise. The Commission did not mention the latter part of the proponent's argument respecting field prices.

The field price element was considered in an earlier case, *City of Detroit v. FPC*[20], where the Court of Appeals for the District of Columbia set aside an FPC rate order in which the Commission had used a field price formula, in lieu of the traditional rate base method, for valuing company produced gas sold by a pipe line company. The court did not reject the field price formula as a means of determining the rate, but stated in effect that the rates resulting from the use of such a formula must be compared with those resulting from the rate base approach in determining whether or not the former rate is within the primary aim of the Natural Gas Act, that is, to guard the consumer against excessive rates, and if the former results in a higher rate then the Commission must justify such rate. Moreover, the court noted that the Commission had favored the use of the field price over the rate base in its consideration of a method which would best serve the ultimate public interest in that:

> "the base rate sysem (1) tends unduly to accelerate consumption of gas, (2) does not sufficiently encourage its discovery and development, thus failing to promote the national interest in both the production and use of natural gas, and finally, (3) that the interest of the public definitely lies in the direction of natural gas production by pipe line systems themselves as distinguished from their complete

[19] Union Oil Co., 5 Oil & Gas Rep. 166 (F.P.C. Nos. G-4331, G-4332, G-4505 1955).
[20] 230 F.2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956).

MARSOLEK'S HARDWARE & APPLIANCE STORES

Complete stock of Radios, Sporting Goods, Garden Supplies
Hardware, Television Sets, Hi-Fi Phonographs and Records

Main Store — 2606 E. Colfax **FR. 7-2764**

Open Evenings and Sundays 10:30 A. M. to 4:30 P. M.

TV Service Center — 3539 E. Colfax **DE. 3-1595**

Lawn Mowers Sharpened and Repaired

Bring your Radio and TV to us for repair — 90-Day Guarantee

> dependence for gas upon purchases from other producers."[21]

While the first mentioned consideration was quickly eliminated by finding that the Commission could not base its order on considerations of conservation, some validity was lent to the second and third considerations, although the court found that the Commission, when using the field price method, should show that the increase in rates thus resulting could not be more than would reasonably be necessary for the purposes advanced for any increase.[22]

Amid the confusion, the Commission gave notice of proposed rule making, inviting suggestions as to the principles and methods to be applied by it in its regulations of rates to be charged by independent producers for the transportation and sale of natural gas subject to its jurisdicition. The Commission later concluded that on the basis of the information gained it should not lay down any rule as to what would be necessary or appropriate for consideration in determining a just and reasonable rate. Thus the independent producer found himself out in left field, a situation undoubtedly recognized in the dissenting opinion of Comissioner Digby rendered following the order of the Commission issued in *Cities Service Gas Co.*[23] Commissioner Digby asserted:

> "Our present rules do not require very much information to be supplied by the independent producer who desires a certificate. Presumably, the rules relating to independent producers were drawn with a view to obtaining from the producer all of the infromation which we would need to have in our determination of whether or not the certificate would be in the public interest. We do not require any financial data to be supplied by the producer, we do not seek any economic data from him, nor do we even ask that he submit data so that his contract price may be compared to others in the same area. In short, in the producer applications we do not require and thus we do not have the in-

[21] *Id.* at 812-13.

[22] As an aide, and of interest to independent producers, the court further found that the Commission should have given attention to the processing of natural gas on interstate lines applying profits realized therefrom as credits to operating costs. The Commission had done this in the past, but elected not to so do in this case on the ground that the rates prescribed should not be subject to fluctuating prices of gasoline.

[23] F.P.C. Docket Nos. G-2569, G-2570, Op. No. 288 (1955).

Best Wishes to the Bar Association

NEWTON OPTICAL COMPANY

GUILD OPTICIANS

V. C. Norwood, Manager

309 - 16TH STREET **DENVER**

Phone KEystone 4-0806

Oculists — Prescriptions Accurately Filled

formation upon which to ground a finding as to what would be a reasonable and just initial rate as we have in the pipeline applications."

Three representative cases before the Commission illustrate the possibilities available to the producer, yet amply demonstrate that no definite standards have as yet been established in the administration of the Natural Gas Act as it is applied to the producer.

In one case[24] the petitioner filed a notice proposing to increase his rate from 5.2¢ to 10¢ per MCF in accordance with an escalator clause in the contract. At the hearing, the Presiding Examiner approved the increase. The petitioner bought casinghead gas at the well head, gathered and transmitted it to its processing plant, and sold the residue gas in interstate commerce for resale to an interstate transmission company. Evidence was introduced showing arms length bargaining leading to the contract, cost of service, and the prices at which other producers were selling residue gas to pipe line companies in the same state. Upon the record the Commission found the proposed increase to be just and reasonable, but in so finding stated that it did not pass on the question of whether evidence of the character then before it would in any other case substantiate a rate as just and reasonable.

In another case[25] the applicant had filed notice for a rate increase in conformity with its gas sale contract basing the proposed increase upon a favored nation clause in the contract. The proposed rate increase was to 10¢ per MCF from 5.2¢ per MCF. Here, the Presiding Examiner refused to allow the increase on grounds that the rate was reflective of only two gas wells owned by applicant from which gas was sold under the subject contract, and not of the petitioner's entire gas business which the Examiner held to be the correct representative unit. The petitioner appealed, and the Commission then allowed the rate increase after concluding that the unit applied by the applicant was appropriate in the circumstances. The Commission found that the petitioner used a cash payout basis for substantiating its claim of a just and reasonable rate, the method being to compute the difference between total revenues over the life

[24] Wunderlich Development Co., 5 Oil & Gas Rep. 1090 (F.P.C. No. G-3940 1956).

[25] Davidor & Davidor, 5 Oil & Gas Rep. 1081 (F.P.C. No. G-8550 1956).

Rubber Stamps
Try Us for FAST SERVICE
DENVER'S EXCLUSIVE STAMP SHOP
827-14th St.
Wm. J. Smith The Rubber "StampSmith"
Anything for STAMPING STENCILING MARKING
TAbor 5-3334
Everything in
Rubber Stamps
for the Legal Profession
Rapid, Personalized Service
827 - 14th St. Denver, Colo.

of the wells and the direct costs necessary to obtain revenue, including costs of producing less revenues obtained from sale of distillate produced with the gas. Evidence of current prices for comparable sales of natural gas in the same area and of arms length bargaining toward the contract were found to be pertinent and relevant. The Commission computed the applicant's cost of service using a rate of return of 9%, finding a rate approximate to the 10¢ rate proposed to be just and reasonable in comparison with other rates in the area.

In a third case,[26] growing out of an escalator clause in a producer's contract, the petitioner filed notice of a proposed increase of from 6¢ to 10¢ per MCF. At the hearing the Presiding Examiner allowed a portion of the cost of drilling three dry holes to the exploration and development expense amortized over a period of six years, the estimated life of the producing well. The Commission distinguished this treatment from that followed in the pipe line company case where the non-productive well costs were not considered. A rate of return of 10% was allowed on an original cost rate base. The Commission, in reviewing and passing the examiner's findings, confessed it could not say what effect *City of Detroit* would have over this case, but that the instant circumstances seemed to satisfy the requirements there stated, *i. e.*, that the rate base method must be used as a comparison with rates founded upon any other theory. The proponent here introduced in evidence (1) a showing that the contract was completed after arms length bargaining; (2) FPC gas rate schedules indicating the current recognized rate for gas upon terms and conditions similar to this was 10¢ per MCF in that general area of that state; (3) well costs and payout periods upon a reasonable assumption of available reserves, pressure, rate of depletion, and operating costs after taxes and royalties; (4) the operator's rule-of-thumb ratio for determining in his usual business operations the rate of payout over cost of a production venture and that of a venture involving drilling risks; (5) actual costs including (a) drilling, completing, connecting and operating the well from which gas was being sold, (b) exploration and development expenses including cost of lease, rentals and costs

[26] Christie, Mitchell & Mitchell, 6 Oil & Gas Rep. 385 (F.P.C. No. G-3669 1956).

Expert
Brief Printers

- Commercial Printing
- Catalogues & Brochures
- Year Books — Magazines
- Books — Book Binding
- House Organs

THE Golden Bell PRESS

ALpine 5-0481
AMherst 6-0873

2400 CURTIS STREET
Denver, Colorado

of drilling three dry holes, (c) production and excise taxes, (d) royalties and (e) cost depletion. The Commission was careful to point out that the elements in this case were far from standard, and due to the differing pecularities in the thousands of varying types of enterprises entered into by the independent producer, the approach used here afforded no opportunity to assume this data would be effective in any other case.

CONCLUSION

In attempting to justify an initial rate or a proposed change in rate for the sale of gas in interstate commerce for resale, the independent producer must come face to face with reality and muster the most appropriate essentials looking toward the necessity of the proposed rate, not only with respect to his own financial integrity but also with respect to the interests of the public. While fair value of the gas in place is out, the producer may show economic and financial data or a comparative schedule of the average field prices in the pricing area, or some other appropriate not-yet-discovered basis for claiming an increase. Aside from considerations of FPC as to the prices he receives; yet as we have seen, the usual price escalator clause and favored nation clause may not be given full effect without justification before the Commission.

Perhaps one of the reasons for the difficulties experienced in the regulation of the independent producer is that his is a highly competitive industry, not a public utility free of emulation in its field. Whatever may be the opinion of either of two sharply divided camps, whether the Congress intended by passing the Natural Gas Act that is should embrace the independent producer, or whether the Court in the *Phillips* decision furnished that intent, it is almost certain that Congress must sharpen its pencils, or better yet its thinking, and provide some reasonable standards upon which the Commission may regulate. Better yet, Congress might exempt the independent producer altogether in order that he may concentrate more upon exploration and development and less on expostulation and retrospection.

HEART OF DOWNTOWN: 1409 Stout - TA 5-3404
FAST SERVICE — NOTARY AND CORPORATION SEALS
Stock Certificates, Minute Books, Stock Ledgers

ACE-KAUFFMAN

RUBBER STAMP & SEAL CO.
Operating Denver Novelty Works Since 1873
W. E. LARSON, Proprietor

ANNOUNCING

Winners of Rocky Mountain Mineral Law Institute Student Research and Writing Prizes

Several months ago the Rocky Mountain Mineral Law Foundation granted $350.00 to the University of Denver College of Law to encourage student research and writing in the mineral law field. The law faculty in turn gave this money to DICTA to be awarded as prizes for the three best pieces of student work in this field. This issue of DICTA contains the three winning student law notes. The editors of DICTA, with appreciation to the Rocky Mountain Mineral Law Institute, take pride in announcing the winners:

FIRST PRIZE—$200—DWIGHT D. MURPHEY

SECOND PRIZE—$100—PAULINE NELSON

THIRD PRIZE—$50—JOHN E. JONES

MOST RELIABLE FOR PUBLICATION OF LEGAL NOTICES

Oldest Legal Newspaper in Colorado

The ROCKY MOUNTAIN HERALD

- Court minutes checked daily—Expert proof reading by legal editors *(Proof submitted before publication, if desired)*
- Short notices made out, if desired
- Affidavits furnished with bill at completion of publication

P. O. Box 1047, Denver 1 • KE. 4-6072 • 1832 Curtis St.