

19. DETERMINATION ON THE REASONABLE MARKET VALUE FOR ROYALTY GAS PRODUCED UNDER STATE LEASES IN NORTHERN CALIFORNIA - W 9738.

During consideration of Calendar Item 19 attached, Mr. William F. Northrop, Executive Officer, explained the background on this matter.

Mr. Jack Fallin, attorney representing Pacific Gas and Electric Company, appeared in opposition to the staff's recommendation. Mr. Fallin submitted a written statement which is on file in the office of the Commission. One of Mr. Fallin's primary objections to the staff's method in arriving at the market value for natural gas was the use of non-market prices--prices set by the Federal Power Commission and prices set by the Canadian government. At this point Chairman Cory stated that this was not what the staff had done, and he wanted the record to be made clear. He explained they used the weighted average of those factors which includes the one PG&E wants the Commission to use--i.e. the Northern California market. Mr. Fallin then stated that if the staff added in the \$1.20, it would mean there is only one market figure in their price formula--that of the prevailing price of Northern California. The other two are regulated prices. Mr. Cory said that with Mr. Fallin controlling the definition of "market", he would consent to his statement.

Mr. Fallin contended that there has been no finding as to the policy implications of the Attorney General's opinion, referred to in the staff's report, which states that administrative prices can be used to set market value. He stated it is PG&E's opinion that the Commission stating there is an overriding constitutional problem with accepting the prevailing price set in the relevant market is wrong because the Commission for years has accepted as reasonable market value the prevailing prices in Northern California. In addition, the argument that because PG&E is big and because of that the problem has changed is incredible. He stated if anything had changed, it is that competition had increased. Mr. Fallin then stated that except for the gas producers that would benefit from the Commission's action, no producer could complain that a price set by reference to the prevailing rate in the Northern California market is unconstitutional. The rate has been accepted by the vast majority of these gas producers with the option of having the rate set by arbitration.

Mr. Fallin went on to say that using the figures Henry Lippitt, 2nd, the Commission's consultant, used was wrong. He stated that if his figures are approved in the pending arbitrations, the Northern California consumers would be confronted with an increase of \$22 million through June 1978. He also stated that it does not end at \$22 million, but because PG&E's California contracts will be renegotiated next July, these same figures will be used in those negotiations and the cost to the consumer could be in the order of \$90 million.

MINUTE ITEM 19. (CONTD)

Mr. Fallin testified as to "new gas" prices stating discoveries have little or no relationship to the issue in this case inasmuch as the gas involved here is not a new gas supply.

Ms. Betty Jo Smith, Commission alternate, asked how PG&E reached the figures of the impact on the consumer from these prices. Mr. Fallin stated that PG&E took the figures in the calendar item, applied them against PG&E's existing volumes of purchase and simply came up with a number. Mr. McCausland asked if there was a time frame associated with the \$90 million. Mr. Fallin said it was an annual increase.

Ms. Smith then asked 1) if the crux of his testimony was that the Commission took factors into consideration in determining the reasonable market value which are illegal to take into consideration; and 2) is PG&E saying that as a matter of policy there are certain factors which should not be included in reaching the price of a reasonable market value. Mr. Fallin stated that the use of Canada's cartelized prices is contrary to the public policy of this state and nation. However, he stated he would not say whether or not it was illegal. Mr. Cory then stated the reason he rejects the whole argument is that when PG&E goes before the PUC, it take the higher prices by choosing to buy the Canadian gas rather than more California gas and asks the PUC to allow higher rates to the consumer. Mr. Fallin said that this is really a complaint of the ratepayer as opposed to the Commission's staff's position, and stated it is their feeling it is not reasonable to do the same thing on this matter. Mr. Fallin also stated that California gas is used heavily for peaking purposes but that is not its only use.

Ms. Smith asked on what basis did PG&E determine that the staff's method of calculating the reasonable market value is against public policy. Mr. Fallin stated that the method used was to include Canadian prices which have no relationship to the contract standard which says "market value". They are not set in any market. With respect to how those prices are determined, it is PG&E's contention they are determined in a way that makes their use in California contrary to public policy. The public policy is that contained in the laws of this nation and State which indicate that any combination of producers or sellers, or any other instrumentality which exists for the sole purpose of setting prices and allocating markets is disfavored. To clarify the record, Mr. Cory stated that having the capacity for setting prices and allocating markets is against public policy, and not whether you combine for the sole purpose. If you combine for another purpose, that would still be against public policy. To sum up Mr. Fallin's position, Mr. Cory stated it is that Canadian gas prices should be excluded from the market determination because they are the result of price fixing. Mr. Cory stated it is implicit there should be a finding as to what the market is. The staff has taken the position the market is the sum total of the various sources of gas that PG&E acquires. He stated it is Mr. Fallin's suggestion that the only true market the State should consider is PG&E's market for California source

MINUTE ITEM 19. (CONTD)

gas and exclude all others. Mr. Fallin commented that the definition of "market" is the place the gas is produced and sold in California. Mr. Cory stated then that Canadian gas is produced in Canada and sold in California and that PG&E would like to exclude that from the market. Mr. Fallin stated that the Commission is a seller and not a public utility. Mr. Cory then said that PG&E as a public utility has the right to go to Canada and buy their gas. However, they suggest that we must not consider such purchases in evaluating the market for our gas. Mr. Fallin stated there is no question that PG&E must go to Canada to buy gas. Mr. Cory then asked if there was any question that they are buying Canadian gas at roughly \$2.15 per mc' and bringing it into the California marketplace and selling it to the consumer. Mr. Fallin replied, none that he was aware of. Then Mr. Cory asked him if he believed that this was not part of the market. Mr. Fallin stated there is no question PG&E is paying very high prices for Canadian gas. Mr. Cory then asked Mr. Fallin if it was his opinion that Canadian gas should be excluded because it is not produced in California and that PG&E would choose to define the term "marketplace" as being California produced gas, not gas consumed in California. Mr. Fallin stated that the issue of what the relevant market is is a legal question. In addition, the staff has not produced any case in this country which ever held that in interpreting the standard for determination of market price it was valid to go outside of even the region in question. That question is a legal issue and Mr. Fallin stated it is his opinion the law is that the market is the region--in this case the State--where the material is produced. Ms. Smith asked if Mr. Fallin had found cases which expressly prohibited the use of prices set by government regulation. Mr. Fallin stated he did not think so. Mr. Cory then asked if the Occidental arbitration panel used this mechanism to derive the reasonable market value. Mr. Fallin responded that they did. Mr. Cory stated there is then court acceptance. Mr. Fallin stated there was not. He indicated PG&E took the case to the Superior Court in San Diego and the judge indicated that the issues raised by this mechanism posed questions he thought should be addressed by the Legislature, but under the restraints of the arbitratio mechanism he could not alter their findings. Mr. Cory stated that he too has some problems with the mechanism but he cannot find a better solution to the problem.

Mr. Cory then asked Mr. Fallin if Chevron is a net gas consumer or purchaser, because it is important to note for the record whether or not Chevron sells PG&E more gas or buys more gas from PG&E. It is important to note for the record whether or not Chevron has an interest in keeping prices up or down in this particular transaction. Mr. Fallin replied that they probably buy more than they sell. Mr. Cory summarized by saying that the fundamental issue is defining the market. The staff and the Occidental arbitrators used the mix of all sources of gas and the court upheld the arbitration.

MINUTE ITEM 19. (CONTD)

More discussion followed concerning the arbitration award. Mr. Cory asked Jan Stevens, Assistant Attorney General, if the contract uses the term "reasonable" or just the term "market value". Mr. Stevens indicated it is "market value". He advised there is no formal opinion from the Attorney General's office in this matter, but they advised the staff the Commission has the discretion to consider the market as it finds it, and not a hypothetical free market--it is proper to consider regulated prices as well as other prices when it determines what the market constitutes for this purpose.

Mrs. Sylvia Siegel, Executive Director representing Toward Utility Rate Normalization, appeared in opposition to the staff's recommendation. Mrs. Siegel pointed out that the Commission's constitutional mandate to protect the public interest applies to the 22 million citizens of California and not just the fact of trying to establish what a reasonable market value is. Another point she contested was the staff's hiring of its consultant, Mr. Lippett. She stated that this was a conflict of interest since he works for the California Natural Gas Producers Association.

Mrs. Siegel's main contention was that the Commission should define the prevailing market value by using the Northern California market and not the Canadian or any other market. If the Commission does not adopt that market, she stated the consequences to the California consumer would be frightful.

After Ms. Siegel's testimony, Mr. Cory emphasized that the crux of this problem is that the Commission is granting a public resource-state owned gas. The prior Commission entered into contracts which he would have voted against. However, the present commission is now charged with administering them. He stated the gas which is the subject of this discussion is owned by all the people of California, but the ultimate effect of these sales contracts is given to a few--3 million Northern Californians. He stated that because of these facts, the dilemma is whether to get the highest possible price or give it away--whether the benefit does or does not flow to the non-PG&E Californians.

At this time Commission-alternate Sid McCausland inserted that he had read the subject calendar item but that it had made little reference to the August 11 testimony. In that line, he stated that before voting on this matter he felt compelled to spend time reading and reviewing the August 11 record.

Mr. Earl Radford, attorney, representing Shell Oil Company, appeared in opposition to the staff's recommendation. Mr. Radford spoke to Leases PRC 3743.1 and PRC 3896.1 (Ryer Island) which Shell is co-lessee with Chevron in the Ryer Island Unit. He stated that the State has presented no evidence of a gas buyer either in Ryer Island or in the nearest field who is purchasing or offering to purchase gas at prices in excess of \$1.20. He further stated the Commission should now confirm that \$1.20 should be used until conditions in the market change. He submitted that whether Mr. Lippett defines

MINUTE ITEM 19. (CONTD.)

a "fair market value" or "reasonable market value" these terms are not in the Ryer Island leases to which he is speaking, and cannot be added in without the consent of the lessees until the lease is renewed. He concluded that the Commission should confirm that \$1.20 is the current market price in the Ryer Island field, that this price should continue to be used until the circumstances change, and that the other markets should not be used as a basis to formulate the market value in Northern California.

Mr. Leonard Snaider, Deputy City Attorney, representing Mr. Thomas O'Connor, City Attorney of the City and County of San Francisco, appeared in opposition to the staff's recommendation. Mr. Snaider stated he opposed the retention of Mr. Lippett as the Commission's consultant and that the Commission should have used another State agency which had expertise in the field. In summary, Mr. Snaider stated the Commission's rate as to the market value was unreasonable and that the consumers of California would be the ones who suffered.

Ms. Smith asked Mr. Snaider if he attended the August 11 hearing. Mr. Snaider stated he did not because the PUC appeared which is responsible for protecting the interests of the ratepayers. Ms. Smith then asked if anyone requested to cross examine Mr. Lippett at the hearing. Mr. Northrop explained the hearing was not conducted as an adversary proceeding. Mr. Snaider contended that Mr. Northrop specifically prohibited cross examination and that it was similar to a kangaroo court. Mr. Northrop then stated that Alan Hager, Deputy Attorney General, approved the hearing format and in his opening statement instructed staff on the methods of handling the hearing. Mr. Jan Stevens, Assistant Attorney General, interjected that there were no denials of due process, that this type of hearing does not require cross examination, but that it does require an opportunity for rebuttal and this was provided at the hearing.

Mr. Greville Way, Chief Gas Engineer, Public Utilities Commission, appeared. Mr. Way's prepared statement is on file in the office of the State Lands Commission. He briefly stated that three of the five Public Utility Commissioners urged the Commission to adopt the \$1.20 as the fair market value in Northern California. Mr. McCausland asked if the vote was in a public session or was it a "straw" vote. Mr. Way stated at the time the PUC statement was presented in August, there were only three Commissioners sitting; two of the Commission agreed with the \$1.20 figure and the third prepared his own statement. Since then Mr. Way contacted the four Commissioners and three of them supported the \$1.20; the fourth did not. Mr. Cory then asked Mr. Way, as someone who looks at the consumers side constantly, if he could help the Commission on how it could deal with this issue. He asked, based on the silence of the PUC statement as to the arbitration award, how it could ignore that. Mr. Way stated that the PUC was a party in a legal proceeding to overturn the arbitration award. He further stated that since the majority of the Northern California producers have agreed to the \$1.20 price, and looking at what may be the

MINUTE ITEM 19. (CONTD)

market value, it is his opinion that \$1.20 is the market value. He also stated if the staff had wanted to go beyond the Northern California market, it should have attempted to determine what the wellhead prices were in the various areas. Mr. Cory then asked Mr. Way to explain the PUC policy and concept that the State should minimize its consumption of California gas. Mr. Way stated that California gas is used for peaking and compared to gas received from Canada and El Paso, California gas is not a major item. He also said that California gas should probably be conserved since Canada has raised the issue of curtailing its gas deliveries out of Canada. Mr. Cory asked why California gas is only used for peaking, instead of constant. He stated he would be more inclined to seek \$1.20 or even a lower price if the companies were showing evidence of good faith in using California gas first instead of using it only for peaking and using the higher priced gas on a constant basis.

The question was raised that if the State decides not to produce this gas would PG&E's capitalized cost of their gathering system still be in their rate base. Mr. Way stated it would and if the State cut off production, a rate increase would be involved.

More discussion continued concerning the intrastate regulation of gas by California, and the arbitration award formula. At the conclusion of Mr. Way's testimony, Mr. Cory asked him to pursue with the Public Utilities Commissioners whether or not they had any worthwhile suggestions in resolving this issue.

Mr. Robert Peckham, representing Chevron U.S.A., Inc., appeared in opposition to the staff's recommendation. He indicated his previous statement at the public hearing on August 11 contained Chevron's basis of their position. This statement is on file in the office of the Commission.

Mr. Cory then stated for the record that both the House and Senate versions of the energy bill have some mechanism to provide for a freeze or regulation of intrastate gas. In this line, he stated if the Commission fails to act, it is taking a risk of having its options curtailed or the decision made by another party.

Mr. McCausland then restated that he was not willing at this time, on the basis of a two page calendar item and an hour of totally negative testimony, to adopt the staff recommendation without reviewing the record. Mr. Cory asked what time frame the Commission was looking at in reconsidering this matter. Mr. McCausland then asked if the August 11 record set forth in layman's terms the methodology which was utilized by staff and whether or not they considered other types of methodology.

Mr. Donald J. Everitts, Manager, Energy and Mineral Resources Development, stated that the record sets forth clearly what the staff did and the source of its data. Ms. Smith asked if memoranda of points of authorities on the definition of market

MINUTE ITEM 19. (CONTD)

value were prepared. Mr. Stevens stated that none were because it was not a legal question. It was treated as an object of expert testimony rather than a question of law, mainly because there is little case authority on this matter. Mr. Cory asked how long it would take to get a formal Attorney General's opinion on the question of the definition of market value and the legal propriety of including the Canadian market. Mr. Stevens said an informal letter could be issued in a week, but with the many reviews and approvals a formal opinion requires, it may take a month. He then stated that at this time he would like to solicit views from interested parties who would like to contribute information. However, the actual opinion would not be circulated for comments.

Ms. Siegel requested that the interested parties be notified when the matter has been rescheduled to come before the Commission.

In conclusion the Commission by a vote of 3-0 deferred the item until the next Commission meeting.

CALENDAR ITEM

19.

9/77
W 9738
Willard

DETERMINATION ON THE REASONABLE MARKET
VALUE FOR ROYALTY GAS PRODUCED UNDER
STATE LEASES IN NORTHERN CALIFORNIA

On September 30, 1976, the State Lands Commission approved an interim price for its royalty gas from State leases operated by Chevron U.S.A. Inc., of \$1.20 per MMBtu, for a period of six months commencing July 1, 1976, with the understanding that such approval would not be deemed a determination by the State of the current reasonable market value of the royalty gas. The approval was subject to the right of the State at the end of the six-month period or any time thereafter, to make a determination of the reasonable market value of the royalty gas, for the purpose of establishing the price to be paid the State for the royalty gas, beginning January 1, 1977.

On August 11, 1977, the Executive Officer conducted a public hearing for the purpose of receiving evidence for the Commission's consideration in its determination of the reasonable market value of Chevron's natural gas deliveries to PG&E from the Rio Vista, River Island and Ryer Island Fields.

Based on the material presented at the hearing, it is proposed that the "reasonable market value" be determined in accordance with the cost of competitive purchases of natural gas by PG&E in the Northern California gas market. Except for the Ryer Island Field (exchange deliveries to Chevron's refinery in Richmond), the reasonable market values under this method would be derived from the weighted average border price of PG&E's purchases of El Paso out-of-state gas, the Pacific Gas Transmission Canadian gas deliveries and PG&E's purchases of California produced gas. Such weighted average prices would be adjusted for the load factor or "peaking value", i.e., the flexibility premium PG&E pays for having gas available for peak day needs, and Btu content. The reasonable market value of Ryer Island Field (exchange) deliveries would be derived by taking the alternative cost of gas delivered to Chevron's Richmond refinery by PG&E at the interruptible industrial gas rates less appropriate transportation costs. The resulting prices are as follows:

A 5, 9, 10, 12

S 4, 6, 7

CALENDAR ITEM NO. 19. (CONTD)

Reasonable Market Value

(\$/MMBtu)

| <u>Lease</u> | <u>Field</u> | <u>Load Factor</u> | <u>Jan.-June 1977</u> | <u>July-Dec. 1977</u> | <u>Jan.-June 1978</u> |
|--------------------|------------------------|------------------------|---------------------------|---------------------------|---------------------------|
| E 415 | Rio Vista | 33% | \$1.75 | \$1.91 | \$2.08 |
| E 415 | Isleton | 65% | 1.62 | 1.77 | 1.93 |
| PRC 714 & 729 | River Island | 33% | 1.75 | 1.91 | 2.08 |
| PRC 3743 & 3896 | Ryer Island (Exchange) | | 2.05 | 2.31 | 2.42 |

The above values are based on deliveries of 1,000 Btu per cubic foot and will be adjusted for the heat content of gas actually delivered.

PG&E and Chevron contend that the use of alternative costs in determining the "reasonable market value" is improper because it employs prices set by government regulations rather than prices paid in a freely functioning market. They cited as the only evidence of Northern California gas prices obtainable in a freely functioning market the \$.20 per MMBtu price offered by PG&E to Northern California producers.

It would appear that the market to which Chevron and PG&E refer is not freely functioning because of PG&E's dominance as a gas purchaser. PG&E so dominates this market that most Northern California producers have no viable alternative to selling their gas to PG&E.

Furthermore, it is the staff's position that any determination of the "reasonable market value" must consider the nature of the market as it exists. The Northern California natural gas market is broader than that pictured by Chevron and PG&E. It is a market in which there are purchasers of considerable quantities of gas subject to governmental price regulation. Therefore, it is appropriate, to include regulated prices in the determination of the "reasonable market value" of the gas produced from these Northern California gas fields. The Office of the Attorney General has advised that the use of regulated prices in determining market value is not without legal support and concurs with its use in the "reasonable market value" determination under consideration by the Commission.

CALENDAR ITEM NO. 9. (CONTD)

IT IS RECOMMENDED THAT THE COMMISSION DETERMINE THAT THE REASONABLE MARKET VALUE FOR ROYALTY GAS PRODUCED UNDER THE FOLLOWING LEASES SHALL BE:

| <u>Lease</u> | <u>Field</u> | <u>Load Factor</u> | Reasonable Market Value (\$/MMBtu) | | |
|-----------------|------------------------|--------------------|---------------------------------------|-----------------------|-----------------------|
| | | | <u>Jan.-June 1977</u> | <u>July-Dec. 1977</u> | <u>Jan.-June 1978</u> |
| E 415 | Rio Vista | 33% | \$1.75 | \$1.91 | \$2.08 |
| E 415 | Isleton | 65% | 1.62 | 1.77 | 1.93 |
| PRC 714 & 729 | River Island | 33% | 1.75 | 1.91 | 2.08 |
| PRC 3743 & 3896 | Ryer Island (Exchange) | | 2.05 | 2.31 | 2.42 |

THE ABOVE VALUES ARE BASED ON GAS DELIVERIES OF 1,000 BTU PER CUBIC FOOT AND WILL BE ADJUSTED FOR THE HEAT CONTENT OF GAS ACTUALLY DELIVERED.

FOR THE PERIODS AND LEASES LISTED ABOVE THESE VALUES SHALL BE USED FOR THE PURPOSE OF DETERMINING ROYALTY PAYMENTS TO THE STATE.

EXHIBIT: 1. Location Map.