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Natural gas prorationing v. take-or-pay: The risk-shifting battle continues

by Gary D. Allison

Northwest Central Pipeline Corp.
v.
State Corporation Comm'n.
(Docket No. 87-1856)

Argument Date Nov. 29, 1988

ISSUES

Section 1 (b) of the Natural Gas Act of 1938 gives the states exclusive jurisdiction over the natural gas production and gathering activities within their borders. In this case, the Supreme Court will decide whether state-ordered production limits on natural gas wells unconstitutionally interfere with federal authority to regulate the gas acquisition and sales practices of interstate pipe lines.

Such production limits could confront interstate pipe lines with the choice of purchasing more gas than they currently desire, or suffering a reduction in the ultimate volume of gas they may acquire from the wells covered by their gas-purchase contracts.

The Court must decide whether these potential impacts on interstate pipe lines 1) violate the supremacy clause by interfering with the exclusive authority of the Federal Energy Regulatory Commission to regulate the gas acquisition and sales practices of interstate pipe lines and to control the abandonment of natural gas dedicated to interstate commerce, or 2) impose impermissible burdens on interstate commerce in violation of the commerce clause.

FACTS

Like many gas-producing states, Kansas has established a gas prorationing system as a part of its gas conservation program. Under this system, the Kansas Corporation Commission (KCC) sets production limits, called allowables, for each well in certain gas fields. This case arises out of a dispute concerning how Kansas handles the drainage caused by some wells failing to produce at their allowable levels.

Kansas' gas prorationing system permits producers whose wells fail to recover their allowables to accumulate the underage for possible recovery in the future. This underage may be recovered in the future if the well involved becomes capable of producing in excess of its allowable. Then, the KCC will permit the well to produce over its allowable until the accumulated underage is recovered, provided that the recovery occurs over a reasonable period of time.

Kansas does impose a limit on the right of producers to accumulate and recover underage. The limit equals six times the allowable set for the well during the January prorationing preceding the well's decline into underage status. Once this limit is reached, no further underage may be accumulated and any excess underage is cancelled.

Prior to Feb. 16, 1983, Kansas would restore their cancelled underage anytime upon a showing that the wells involved "are in an over-produced status; that the purchaser is willing and able to take the amounts of gas; and that the length of time proposed by the applicant for the production of the amount of gas to be reinstated is reasonable under the circumstances." See paragraph (p) of the 1944 Basic Proration Order.

On Feb. 16, 1983, the KCC put time limits on the right to recover cancelled underage. Under the new reinstatement rule, cancelled underage will not be reinstated unless the producer seeks reinstatement within three years of the cancellation. Reinstated underage must be fully recovered within five years of the reinstatement. Thus, for the first time, Kansas may permanently cancel all or part of a producer's excess underage.

Wells suffering permanent cancellation of excess underage might recover less gas over their production lives, because allowables are set in part to give producers a fair opportunity to recover the gas originally beneath their gas properties (the acreage in which they own drilling rights).

When a well produces below its allowable level, the flow of gas in its direction may be reduced so much that the gas property on which it is located may be drained by wells that are producing at the allowable level on surrounding gas properties. To regain the volume of gas so drained, it is necessary to create a reverse flow of gas strong enough to drain the surrounding properties even though the wells thereon are producing at the allowable level.

Therefore, owners of gas properties that have suffered drainage during times of underage accumulation may never recover their fair share of gas if their wells are never permitted to produce in excess of assigned allowables.

A well cannot produce gas for which there is no purchaser, since, unlike oil, natural gas cannot be stored economically. Often, a well accumulates underage because of a reduction in purchases by those who have contracted to purchase its output. Under Kansas' new cancellation of underage

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policy, purchasers of gas from wells that face permanent cancellation of underage may have to increase their purchases sooner than they desire in order to avoid the possibility that these wells will suffer a reduction in ultimate recovery.

Northwest Central Pipeline Corp., an interstate pipe line, alleges that the KCC's new cancellation policy will force it to buy gas it does not need to avoid a reduction in the ultimate recovery of gas from the Kansas wells from which it has contracted to purchase gas. Northwest argues that this "use it or lose it" choice violates the supremacy clause by impeding the exclusive authority of the Federal Energy Regulatory Commission to regulate the cost structures of interstate pipe lines and to control the abandonment of natural gas dedicated to interstate commerce.

Finally, Northwest contends that the new cancellation policy violates the commerce clause to the extent it causes gas dedicated to interstate commerce to be drained away into intrastate commerce.

Northwest's allegations were rejected by the District Court of Gray County, Kan., on Nov. 7, 1983, and by the Kansas Supreme Court on May 10, 1985. On Feb. 24, 1986, the U.S. Supreme Court remanded the case back to the Kansas Supreme Court for consideration of whether the opinion in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd.*, 474 U.S. 409 (1986) (known as "*Transco*") compels a different result.

The Kansas Supreme Court reaffirmed its earlier opinion on Feb. 20, 1987. The Kansas courts essentially held that the KCC's cancellation policy constitutes regulation of production, over which the states have exclusive jurisdiction, and that this regulation has only an incidental impact on interstate commerce. In its second opinion, the Kansas Supreme Court distinguished this case from *Transco*, reasoning that *Transco* involved state restraints on purchasers and purchasing practices while this case concerns state restraints on producers and production practices.

BACKGROUND AND SIGNIFICANCE

The goals of the Kansas gas conservation system are to prevent the physical waste of gas resources that might occur if gas is produced from a reservoir in unbalanced drainage patterns, and to provide producers with a *fair opportunity* to recover all the gas originally located beneath their gas properties. Given the design of its conservation system, Kansas must rely on certain market incentives. To understand why, you need to know the basic mechanics of natural gas production and the Kansas conservation system.

Before it is penetrated by a well, a natural gas reservoir possesses pressure, the force of which is in part determined by the volume of gas and the capacity of the reservoir. When a well is drilled into a natural gas reservoir, the well bore releases the reservoir pressure and provides room for gas to expand. Gas expands from high pressure areas toward low pressure areas.

The combination of pressure release and gas expansion causes natural gas to migrate toward the well bore, thereby enabling producers to capture the gas through their wells. Over time, the depletion of gas will reduce the reservoir pressure and hence the production capability of each well.

If a gas reservoir is sufficiently large, one well will not be capable of draining it because the reservoir pressure will eventually become insufficient to move the gas that is farthest from the well to the well bore. When the first well can no longer produce, gas is left behind unless another well can be drilled in a location positioned to capture it.

The remaining recoverable gas will be left in the ground permanently if its volume is too small to make the drilling of a second well economical. This situation, called physical waste, will arise if the gas remaining in the reservoir lies in a pattern so skewed by migration toward the first well that a second well cannot recover enough of it to be profitable.

The Kansas gas conservation system is designed to combine with normal market incentives to encourage the balanced drainage patterns necessary for reducing the physical waste of natural gas. Spacing rules limit the number of wells drilled into a reservoir roughly on the basis of how many acres a well can efficiently drain. Despite the spacing rules, gas wells in Kansas often drain gas properties adjacent to those on which they are located. To help ensure that such drainage does not become unbalanced to the point of causing waste, Kansas implements a gas prorationing system.

Under this system, the KCC sets production allowables by using a formula with three major variables. First, the KCC estimates the market demand for the field twice a year from purchaser nominations and data reflecting "the reasonable current requirements for current consumption and use within and without the state and such other factors, conditions, or circumstances that would aid in establishing the market demand." Kans. Stat. § 55-703.

Second, the KCC calculates the acreage attributable to each well, which usually is set at 640 acres per well. Third, the KCC determines each well's capacity to produce in absence of production limits. This capacity to produce, called deliverability, is determined by pressure tests.

From the foregoing factors, the KCC calculates the production allowables, assigning a share of the estimated market demand. The allowables are essentially based on the ratio of each well's acreage and deliverability to the sum of the acreage and deliverability of all the wells in the field. Such allowables permit each well, at least in theory, to achieve a production rate at which—given its production capacity, its location in relation to other wells, and the other wells' allowables—the flow of natural gas toward it will be sufficient to keep other wells from draining the gas property on which it is located.

Thus, gas is prevented from migrating out of the production range of the wells best positioned to capture it and toward wells that can never capture it because they are too far away.

This type of prorationing best prevents unbalanced drainage when all producers in a reservoir drill their wells within a fairly short period of time and thereafter operate them at the

allowable level as continuously as possible. In the real world, gas reservoirs are not depleted in such an orderly manner. A well may undergo periods of low or no production due to either mechanical problems or the reduced takes of those who purchase gas from it. As a consequence, Kansas' gas prorationing scheme leaves open the possibility that gas will drain from one gas property to another.

Until recently, Kansas assumed that normal market incentives would induce producers to bring the production rates of their underproduced wells back to allowable levels as soon as possible. In recent years, however, market incentives have been skewed by a combination of factors, including the effects of phased deregulation of natural gas wellhead prices on the purchasing practices of interstate pipe lines.

Specifically, after enduring artificial shortages caused by wellhead prices being regulated at levels too low to induce producers to sell gas in interstate gas markets, interstate pipe lines reacted to deregulation by contracting to purchase, at historically high prices, massive volumes of deregulated gas supplies on a take-or-pay basis. The high purchase costs have combined with a virtual collapse of world oil prices to cause demand for natural gas at the burner tip to fall drastically.

The gas shortage has become a gas surplus, and interstate pipe lines have for at least seven years been forced by their take-or-pay contracts to buy gas for which they no longer have markets. As a result, interstate pipe lines facing huge take-or-pay liabilities (now in the billions) have tried to make room for their take-or-pay gas by reducing their purchases of lower-priced gas they contracted to buy under contracts without take-or-pay clauses.

In effect, interstate pipe lines are attempting to shift the risks of interstate gas markets away from their owners, customers and high-priced take-or-pay suppliers, and onto their low-priced suppliers.

Kansas producers in the Hugoton Field, the nation's largest source of low-cost gas, entered into an inordinate number of low-priced non-take-or-pay contracts years ago when they were desperate for a market for their gas. Such contracts bind the producers to sell only to their original purchasers for the life of the contract, which in many cases is for the productive life of the well involved.

As a consequence, many Kansas producers have had to shut-in their wells or operate them below allowable levels because their purchasers refuse to take their gas or to allow them to seek other purchasers. Another consequence is that overall demand for natural gas from the Hugoton Field has declined significantly, making the Kansas economy accept a larger portion of the risks of interstate gas markets.

Other Hugoton producers sell gas under contracts with more favorable terms largely because they contracted to sell their gas to the intrastate market, which was unregulated prior to the enactment of the NGPA. These luckier producers continue to have a market for their gas, and therefore operate their wells at allowable levels.

As previously discussed, under the Kansas gas prorationing system, wells producing at their allowable levels may drain gas from surrounding gas properties on which wells are shut-in or operated at low production rates. This might be occurring in the Hugoton Field, where some wells are either shut-in or operated at low production rates to accommodate the take-or-pay problems of interstate pipe lines. As a result, Kansas not only is facing short-term revenue losses from the reduction in demand for its gas, it also may be facing long-term physical waste of its natural gas resources because of unbalanced drainage patterns.

Kansas has few tools available for ending this intolerable situation. Normal market incentives, which dictate that gas purchasers prefer lower-priced gas over higher-priced gas, have been rendered inoperative by improvident take-or-pay contracts. Prior to 1963, Kansas would have used its common purchaser and ratable take statutes to equalize the production rates of all the wells in the Hugoton Field. It would have directed those purchasers with high demands for gas to make some of their gas purchases from the wells being affected by the reduced takes of the interstate pipe lines.

But, in 1963, the U.S. Supreme Court held in *Northern Natural Gas Corp. v. State Corp. Comm'n*, 372 U.S. 84, that state common purchaser and ratable take statutes were preempted as to their application to interstate pipe lines by exclusive federal regulation of interstate pipe lines' gas purchasing practices under the Natural Gas Act (NGA). Subsequently, in 1986, the Court held in *Transco* that its holding in *Northern Natural* remained in effect after the passage of the NGPA.

With no other acceptable tool available, Kansas is attempting to use its gas prorationing system to shift the risks of interstate gas markets back to the interstate pipe lines. It is doing so in two ways. First, the KCC recently has been estimating demand for natural gas from the Hugoton Field at levels higher than it would have if it had given the low nominations of the interstate pipe lines greater emphasis.

These higher demand estimates result in the setting of higher allowables, and the higher allowables may cause wells which operate at allowable levels to drain an increased volume of gas from the properties on which wells are operated below the allowable levels. To the extent this indeed is occurring, interstate pipe lines are suffering an accelerated drainage of the reserves attributed to the wells from which they purchase to wells which serve the Kansas intrastate market.

Second, by changing its policy on reinstating underage, the KCC has increased the possibility that wells serving the interstate pipe lines will suffer a reduced ultimate recovery unless the interstate pipe lines increase their purchases of gas from such wells. This confronts the interstate pipe lines with a Hobson's Choice: Either buy more Kansas gas now, thereby helping to balance drainage patterns while incurring higher short-term acquisition costs; or suffer an increased possibility that the volume of their contractually assured supplies of low-cost gas will be drained away, thereby driving up their long-term cost structure and reducing their long-term supply security.

By appealing the KCC's new prorationing policy, Northwest has upped the possible economic consequences of this game of economic chicken.

Read broadly, the rationale of the *Northern Natural* and *Transco* decisions is that state conservation regulation is federally preempted to the extent it reduces the flexibility of interstate pipe lines and the FERC in their attempts to keep down the costs of acquiring gas for interstate gas markets.

The theory of Northwest's appeal is that although the Kansas prorationing system directly affects production activities rather than purchasing activities, it still negatively affects Northwest's attempts to keep down its short-term and long-term gas acquisition costs. Therefore, Northwest contends, Kansas' prorationing system is preempted by federal regulation to the extent that it permits gas reserves attributable to the wells from which it purchases gas to be drained by other wells in the Hugoton Field.

Should Northwest prevail on its theory, Kansas would be forced to use its prorationing system essentially to protect each gas property from being drained by wells located on other gas properties. Such a result could force Kansas to lower the production rate of most or all wells in the Hugoton Field whenever an interstate pipe line reduced its purchases from the Hugoton wells from which it contracted to buy gas.

Not to be outdone, an amicus curiae brief filed by several natural gas-producing states argues that the Supreme Court should use this case to reverse its holdings in *Northern Natural* and *Transco*. This argument is based on legislative history suggesting that Congress never intended the NGA to preempt legitimate attempts of producing states to prevent the physical waste of their natural gas resources or to protect the correlative rights of their producers.

Moreover, the amici argue, because any state conservation practice may affect the cost structures of interstate pipe lines, the Court must reject the broader rationale of *Northern Natural* and *Transco* if it wishes to leave the states with any method for conserving their gas resources. Should this argument prevail, states could order other gas purchasers to take gas from the wells serving interstate pipe lines if such takes are necessary to equalize production rates within a common reservoir. This could drastically complicate the already debilitating take-or-pay problems of the interstate pipe lines.

Obviously, the Court faces a difficult choice. Congress certainly meant something when it gave the states exclusive jurisdiction over natural gas production activities in Section 1 (b) of the NGA. Adopting Northwest's theory of the case would render Section 1 (b) practically meaningless. On the other hand, Congress could have legislatively reversed *Northern Natural* when it enacted the NGPA. This it did not do. If the Court now reverses itself, not only will it provide a rare example of the Court reversing its own legislative interpretation, it could set in motion state action that would undermine the long-term supply security of many interstate pipe lines.

The Court does have one option that would not produce a drastic impact on either the states or interstate pipe lines. It could sustain the KCC underage reinstatement policy on the narrow ground that it directly affects production activities and therefore is distinguishable from the offending state regulations in *Northern Natural* and *Transco*.

This approach may be attractive in this case, since it is not clear whether Kansas' underage reinstatement policy will produce any long-term drainage of gas from the gas properties with wells serving interstate pipe lines. On the other hand, exercising this option could be judged as an intellectually unsatisfying example of putting form over substance, especially since it is clear that the KCC hoped its new underage reinstatement policy would force interstate pipe lines to buy more gas from Kansas' Hugoton producers.

ARGUMENTS

For Northwest Central Pipeline Corp. *(Counsel of Record, Harold L. Talisman, 1050 17th Street N.W., Suite 600, Washington, D.C. 20036; telephone (202) 331-1194):*

1. Kansas' underage reinstatement policy is preempted by the NGA as applied to interstate natural gas companies.
2. Kansas' underage reinstatement policy impermissibly burdens and discriminates against interstate commerce in violation of the commerce clause.

For the State Corporation Commission of Kansas *(Counsel of Record, Frank A. Caro Jr., 4th Floor, Docking State Office Building, Topeka, KS 66612; telephone (913) 296-3361):*

1. Kansas' underage reinstatement policy is not preempted by the NGA.
2. Kansas' underage reinstatement policy does not violate the commerce clause.

AMICUS ARGUMENTS

In Support of the State Corporation Commission of Kansas

Three separate briefs were filed on behalf of the KCC. The U.S. Department of Justice and the FERC filed a brief arguing that the KCC's underage reinstatement policy does not concern a field occupied by federal regulation under the NGA, is not inconsistent with federal regulation under the NGA, does not conflict with the FERC's authority over the abandonment of interstate natural gas service, and constitutes legitimate exercise of state authority in a manner that produces only incidental effects on interstate commerce.

Several natural gas producing states (Texas, Louisiana, New Mexico, North Dakota, and Oklahoma) filed a brief which raises, in addition to the arguments raised by the Justice Department and the FERC, an argument that the Court should overturn its holding in *Northern Natural* and *Transco* to avoid invalidating state conservation actions, all of which affect prices of natural gas in interstate markets.

Finally, a brief containing arguments parallel to those above was filed jointly by the Council of State Governments, the International City Management Association, the National Association of Counties, the U.S. Conference of Mayors, and the National League of Cities.