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Ratable Taking v. Take-or-Pay: Hijinks in the Gas Patch

by Gary D. Allison

Transcontinental Gas Pipe Line Corp.
v.
State Oil and Gas Board
(Docket No. 84-1076)

Argued October 8, 1985

ISSUES

In this case, the Supreme Court will reconsider its holding in *Northern Natural Gas Corp. v. State Corporation Commission* (372 U.S. 84 (1963)) *[Northern Natural]* that state ratable taking and common purchaser regulation of interstate pipe lines is preempted by federal regulation of the interstate natural gas market under the Natural Gas Act of 1938 (NGA). This involves determining whether:

1. Congress, by enacting natural gas deregulation mechanisms in the Natural Gas Policy Act of 1978 (NGPA), so altered the federal regulation of resale and transportation of gas in interstate commerce as to permit a revival of state ratable taking and common purchaser regulation as applied to interstate pipe lines, and
2. In light of current conditions within domestic natural gas markets, state ratable taking and common purchaser regulation imposes impermissible burdens on interstate commerce.

FACTS

In 1978, *Transcontinental Gas Pipe Line Corp. (Transco)* began purchasing deregulated natural gas produced from a common pool in Mississippi under about thirty-five different long-term take-or-pay contracts. Transco did not contract with every person owning percentages of the working interests in the wells from which it purchased gas. Instead, Transco contracted with the major interest owners, who generally were the operators of the wells, and for a while took on the same terms as specified in its gas purchase contracts all the gas produced from each well. By the spring of 1982, Transco was having difficulty selling its natural gas. In response to its market-clearing problem, Transco announced it would no longer take gas from the non-contract owners unless they would agree to accept flexible market-out prices that were generally lower than those Transco was paying the contract owners.

Coastal, a non-contract owner, refused to accept Transco's offer and petitioned the Mississippi Oil and Gas Board for a ratable taking order requiring Transco to purchase gas from all the owners in the common pool on a non-discriminatory basis. The Oil and Gas Board entered an order requiring Transco to "ratably take and purchase gas without discrimination in favor of one owner, operator or producer against another in the said common source or pool" (457 So.2d 1298, 1328 (Miss. Sup. Ct. 1984).

Transco appealed the Oil and Gas Board order to the Mississippi Supreme Court. That court upheld the Oil and Gas Board order as to its applicability to interstate pipe lines and its requirement that Transco allocate its demand for natural gas from a common pool ratably among all owners. The court further ruled that as a matter of state law, the Oil and Gas Board lacks the authority to require Transco to offer non-discriminatory prices to every owner from which it purchases gas. However, the court did rule that "to comply with its ... obligations, the pipeline must offer in good faith reasonable terms, including a reasonable price, determined by reference to prevailing market conditions and other appropriate economic considerations."

BACKGROUND AND SIGNIFICANCE

The Supreme Court's *Northern Natural* holding was a logical extension of its ruling in *Phillips Petroleum Co. v. Wisconsin* (347 U.S. 672 (1954)), that federal regulatory authorities applied to interstate sales at the wellhead. After *Phillips*, the Federal Power Commission (now the Federal Energy Regulatory Commission [FERC]), with some prodding from the federal courts, determined that just and reasonable wellhead prices should be based on producer costs rather than the market value of gas. Such prices were well below the market value of natural gas.

Ten years later, after *Northern Natural* was decided, states provided producers some measure of protection refusing to regulate the wellhead sales of natural gas in intrastate commerce. It did not take long before the market prices available in the intrastate markets were so much higher than the cost-based interstate prices that producers increasingly refused to sell natural gas in

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interstate commerce. By the 1970s, the intrastate/interstate price differentials were producing severe natural gas shortages within the interstate market.

Seeking an end to the natural gas shortage crisis, both houses of Congress developed new natural gas legislation designed to bring the intrastate and interstate markets under a common structure. After over a year of acrimonious debate, conflicting House/Senate bills were finally rationalized into the Natural Gas Policy Act of 1978 (NGPA). The NGPA extended wellhead price regulation to the intrastate markets, severely curtailed the wellhead price setting authority of the FERC by establishing legislatively-determined price ceilings containing their own escalation mechanisms, and set in motion an 8.5 year phased-in deregulation of wellhead prices on most natural gas categories.

Fresh from the discomforts of the interstate natural gas shortages of the 1970s, in 1979-81, many interstate pipe lines rushed to contract large supplies of deregulated deep and high-priced gas. In the process of acquiring these new supplies, the pipe lines offered astronomically high prices on a take-or-pay basis obligating them to pay producers for a high percentage of the contract volumes even if they did not actually take any gas.

Meanwhile, to reduce their high energy costs, American industries have achieved unprecedented energy conservation gains. The prices of refined oil products such as industrial grade fuel oil, have fallen dramatically in real and absolute terms with the fall in crude oil prices since 1981.

This combination of interfuel competition and industrial conservation, stagnation, transformation and competition has kept the market clearing burnertip prices for industrial fuels at unexpectedly low levels. Burdened with the obligation to pay high wellhead prices on a take-or-pay basis, natural gas pipe lines have often been unable to retain their industrial loads. As a result, a gas deliverability surplus, known as the gas bubble, has overhung the natural gas wellhead and burnertip markets for the last five years. Energy experts differ as to when, if ever, this gas bubble will dissipate.

In attempts to retain their non-captive industrial loads, pipe lines and local distribution companies have offered preferential prices to their price-elastic industrial customers, imposed higher rates on their residential and captive industrial customers, and curtailed purchases of gas from producers lacking contracts and from producers having contracts which do not contain irrevocable take-or-pay obligations. Facing enormous take-or-pay liabilities, some pipe lines have discontinued purchasing lower-priced gas to purchase high-priced gas under take-or-pay contracts.

The pipe lines' attempts to deal with the gas bubble at the burnertip have produced a confusion-generating bubble at the wellhead. Many minority working interest owners, who by custom in some states have sold their gas without contract to the pipe lines with which their operators have contracted, have lost their purchasers. As a consequence, gas from their wells is being sold under contract by majority owners/operators while their gas is being left in the ground. Should this continue, these minority owners may be faced with the choice of leaving their remaining gas reserves in the ground forever, or selling them at distressed prices to either the majority owner or the connected pipe line. Other curtailed producers face drainage problems because their wells are within the drainage range of the wells of others who still have a market for their production.

At the same time, many producing states are finding demand prorationing to be an unattractive way of contending with the gas bubble. Absent all states adopting demand prorationing, states which do adopt it run the risk that pipe lines will nominate demands far below their contract volumes to acquire a regulatory excuse for not honoring their take-or-pay obligations. For take-or-pay clauses may not cover gas volumes a producer is capable of delivering but is prohibited from producing by reduced production allowables set during the demand prorationing process. Given the opportunity to reduce take-or-pay obligations by regulatory manipulation, pipe lines have a positive incentive to understate their demands for natural gas from demand prorationing states to gain financial room for fully honoring take-or-pay obligations to producers in states refusing to engage in demand prorationing. The end result may be that producers in a demand prorationing state will lose much of the economic value of their take-or-pay contracts, and as a conseqence, the treasuries of such states will lose millions of tax dollars.

The unattractiveness of demand prorationing has revived interest in ratable taking/common purchaser regulation. Ratable taking/common purchaser regulation requires purchasers to distribute ratably their demands for gas at the wellhead among all producers who are willing to accept reasonable prices and who can reasonably be connected to the purchasers' gas transportation system. Through this type of regulation, the state can more evenly spread the detrimental effects of a declining market demand so that no single producer or class of producer has to bear the total burden.

The practical significance of this case is that it may determine who must bear the brunt of risks inherent in a stagnant or declining deregulated natural gas market that is severely distorted by past regulatory and contracting practices. Producers with long-term take-or-pay contracts, interstate pipe lines with large take-or-pay liabilities and the customers of such interstate pipe lines will be the short-term winners from a holding that ratable taking/common purchaser regulation continues to be unconstitutional as applied to interstate pipe lines.

Among the losers of a ruling that *Northern Natural* has continuing vitality would be producers not fortunate or powerful enough to lure pipe lines into long term take-or-pay contracts. Such producers would face enhanced risks of total production shutdowns during times of market downturns.

To the extent that producing states must continue to combat waste-causing production patterns with demand prorationing instead of ratable taking/common purchaser regulation, they will be faced with permanent losses of significant tax revenues with their only choice being whether to take most of the losses up front by reducing well allowables to prevent waste—or to defer some of the losses to later years by tolerating the waste that will occur in absence of well allowable reductions. If this Hobson's choice results in a significant waste of natural gas, the future supply security of all American natural gas users will be threatened.

The legal significance of this case is narrow. In fact, the only legal issue that may be settled here is whether the NGPA's deregulation mechanisms eliminated as to certain categories of natural gas the federal regulation which the Court in *Northern Natural* found to be preemptive of state ratable taking/common purchaser regulation.

It is unfortunate that the arguments in this case, and therefore its probable legal significance, are so limited. The waste issue has been the primary emphasis of other producing states that have chosen to reapply ratable taking/common purchaser statutes to the purchasing practices of interstate pipe lines. These waste prevention ratable taking orders have not been confined to purchases of deregulated natural gas. For these reasons, other state challenges to the vitality of *Northern Natural* provide settings more optimal than *Transco* for reassessing the conflicting state/federal interests involved in state exercises of ratable taking/common purchaser regulation.

ARGUMENTS

For Transcontinental Gas Pipe Line Corp. *(Counsel of Record, John Marshall Grower, 1400 First National Bank Building, P. O. Drawer 119, Jackson, MS 39205; telephone (601) 948-3101)*

1. Mississippi's ratable taking regulations are preempted by federal regulation of natural gas.
2. Mississippi's ratable taking regulations impermissibly burden and discriminate against interstate commerce.

For Coastal Exploration, Inc. *(Counsel of Record, Glenn Gates Taylor, Suite 112 Capital Towers, P. O. Drawer 2132, Jackson, MS 39225; telephone (601) 354-0123)*

1. Mississippi's ratable taking regulation is not preempted by federal law.
2. Mississippi's ratable taking regulation does not violate the Commerce Clause.

For the State Oil and Gas Board of Mississippi *(Counsel of Record, Ed Davis Noble, Jr., P. O. Box 220, Jackson, MS 39205; telephone (601) 359-3680)*

1. When the price of certain natural resources was deregulated as provided by the NGPA, Congress ceded to the states the authority to impose its ratable taking-/common purchaser regulations on interstate pipe lines.
2. Mississippi's ratable taking regulations do not offend the Commerce Clause because their operations are reasonably calculated to protect the legitimate state interest of insuring the opportunity of receiving a fair share of the benefits.

AMICI ARGUMENTS

In Support of Transco

The United States and the FERC, the Associated Gas Distributors and the Interstate Natural Gas Association of America filed separate briefs emphasizing that state ratable taking regulation conflicts impermissibly with the FERC's federal regulatory authority over the purchasing, transportation and resale practices of interstate pipe lines—and with the primary goal of the NGPA to create a unified national natural gas market.

In Support of the State Oil and Gas Board of Mississippi

The state of Texas in one brief, and the National Governors' Association, the National League of Cities, the National Association of Counties, the International City Management Association and the United States Conference of Mayors in another, contend that the passage of the NGPA repealed the preemptive power of the NGA and *Northern Natural* over state ratable taking laws as applied to deregulated high-cost gas and that state laws should not be invalidated under the Commerce Clause unless they discriminate against interstate commerce.