

1978

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Recommended Citation

Harley W. Thomas, *Natural Gas--Lessee's Dedication of Gas to the Interstate Market Binding on the Reversionary Interest*, 14 Tulsa L. J. 431 (1978).

Available at: <https://digitalcommons.law.utulsa.edu/tlr/vol14/iss2/6>

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RECENT DEVELOPMENT

NATURAL GAS—LESSEE'S DEDICATION OF GAS TO THE INTERSTATE MARKET BINDING ON THE REVERSIONARY INTEREST. *California v. Southland Royalty Co.*, 98 S. Ct. 1955 (1978).

Unprecedented escalations in the price of energy have stunned and confused industrial, public, and federal regulatory sectors alike. Particular attention has focused on the gross disparity between controlled prices in the interstate market and substantially higher uncontrolled prices in the intrastate market.¹ This price discrepancy has created some unique regulatory issues and answers. *California v. Southland Royalty Co.*² is but one example. In *Southland*, the United States Supreme Court upheld a Federal Power Commission ruling that the natural gas from leased property had been dedicated by the lessee to the service of the interstate market.³ Once the gas had been dedicated,⁴ the Court concluded, the Commission had the statutory power under the Natural Gas Act⁵ to require the reversionary interest holder to obtain the Commission's authorization to abandon interstate service of gas, even though the lease had expired.⁶ This result in *Southland*, however, has been somewhat limited by the passage of the Natural Gas Policy Act of 1978.⁷ This recent development will analyze the decision in *Southland* and the effect of recent congressional action on its importance.

In 1925, Gulf Oil Corporation executed a lease under which it

1. See F.P.C. No. 770 (July 27, 1963), *aff'd sub nom.* American Public Gas Ass'n v. Federal Power Comm'n, 555 F.2d 852 (D.C. Cir. 1976). It should be noted, however, that the reduction of this disparity is a central purpose of the Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3350 (1978).

2. 98 S. Ct. 1955 (1978).

3. 54 F.P.C. 2821 (1975). See 54 F.P.C. 145 (1975).

4. Dedication to the interstate market under the Natural Gas Act, 15 U.S.C. §§ 717-717w (1976) means to place the gas within the Federal Power Commission's jurisdiction. 98 S. Ct. at 1960. See note 10 *infra*.

5. 15 U.S.C. §§ 717-717w (1976).

6. 98 S. Ct. at 1960.

7. Pub. L. No. 95-621, 92 Stat. 3350 (1978).

agreed to pay royalties to the lessor in return for the exclusive right to produce and market oil and natural gas from the leased property for fifty years.⁸ Some years later, Gulf contracted to sell natural gas to El Paso Natural Gas Company, an interstate pipeline company.⁹ In conjunction with this sale, Gulf obtained from the Federal Power Commission¹⁰ a certificate of public convenience and necessity of unlimited duration authorizing its interstate service.¹¹ Shortly before the expiration of the lease, Southland Royalty Company, the reversionary interest holder,¹² arranged to sell the remaining natural gas at a higher price to an intrastate producer.¹³ El Paso, in order to preserve its source of supply, sought a Federal Power Commission determination that the remaining natural gas could not be diverted from the interstate market without the Commission's authorization to abandon the service.¹⁴

The Commission concluded that once the gas began to flow in interstate commerce, Southland could not, upon termination of the lease, sell gas in intrastate commerce without prior permission from the Commission.¹⁵ The Court of Appeals for the Fifth Circuit, however, re-

8. 98 S. Ct. at 1957 & n.1. The lease involved in *Southland* was one with a fixed term. It should be emphasized, however, that a fixed-term lease is not the type of lease normally used in gas production. Rather, the typical lease includes a fixed primary term and a secondary term which can extend the lease for an indefinite period of time. The lease is generally extended if commercial production continues, or some other contractual provision is satisfied. *See generally* 3 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§ 603-04 (1977).

9. 98 S. Ct. at 1957.

10. The Federal Power Commission is now called the Federal Energy Regulatory Commission.

11. 98 S. Ct. at 1957. Under § 7(e) of the Natural Gas Act, 5 U.S.C. § 717f(c) (1976), a permanent certificate is to be issued to an applicant if it is found that he is able and willing to perform properly the service proposed and to conform to the Act and to Commission regulations. Additionally, the proposed service or sale must be required by present or future public convenience or by necessity. After the decision in *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954), natural gas companies already supplying gas to the interstate market were required to dedicate that gas to the interstate market by applying to the Federal Power Commission for approval of the service. Although the term "dedication" is not found within the Natural Gas Act, it has been judicially defined. Some commentators believe that certification is not dedication, and that dedication only arises upon commencement of service. *See generally* Conine & Niebrugge, *Dedication Under the Natural Gas Act: Extent and Escape*, 30 OKLA. L. REV. 375, 806 (1977).

12. Southland Royalty Company bought its reversionary interest in the mineral fee in 1926 from the lessor-owners of the property. At the time of the litigation, Southland Royalty Company owned approximately 47% of the acreage involved. Trustees under the will of Warren Wright owned 25.7%. Exxon Corporation owned 14%, and more than 100 other persons owned the remaining shares.

13. 98 S. Ct. at 1957.

14. *Id.*

15. 54 F.P.C. 145, 150 (1975). Section 7(b) of the Natural Gas Act states:

No gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing,

versed the Commission's decision.¹⁶ The Fifth Circuit held that Gulf, as a tenant for a term of years, could not legally dedicate to the interstate market the gas which Southland owned upon expiration of the lease.¹⁷

On appeal, the United States Supreme Court resolved this conflict between basic property rights and regulatory power by affirming the Commission's ruling.¹⁸ In support of its determination that Southland's gas remained within the Commission's jurisdiction, the majority opinion expounded three justifications: (1) the legislative purpose of the Natural Gas Act; (2) the continuing nature of the federal obligation to provide interstate service; and (3) the practical consequences of allowing the expiration of a lease to terminate all obligation to the interstate market.

The majority found that the fundamental purpose of the Natural Gas Act was "to assure an adequate and reliable supply of gas at reasonable prices."¹⁹ To effect this end, the Court noted that the Commission was empowered with control over the terms on which service was to be provided to the interstate market.²⁰ Conversely, the Commission had the authority to establish the conditions on which this interstate service could cease.²¹

The majority opinion went on to discuss the continuing nature of the obligation to serve the interstate market. Relying on the Court's holding in *Sunray Mid-Continent Oil Co. v. Federal Power Commission*,²² Justice White concluded that the obligation to serve at-

and a finding by the Commission that the available supply of gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment.

15 U.S.C. § 717f(b) (1976). Once abandonment has been granted, however, the jurisdiction of the Commission is terminated until some new jurisdiction-granting activity occurs. See Conine & Niebrugge, *Dedication Under the Natural Gas Act: Extent and Escape*, 30 OKLA. L. REV. 735, 772-73 (1977).

16. 543 F.2d 1134 (5th Cir. 1976).

17. *Id.* at 1138. Judge Clark held that under Texas law a lessee under a 50 year fixed-term lease did not have the power to dedicate to interstate commerce the gas remaining in the ground at the expiration of the term. Under Texas law, the rights of the producer were those of a tenant for a term of years, and were thereby restricted in scope and power to the limited term of the lease under which they were created. Furthermore, the court of appeals held that the reversionary interest holders acceptance of royalty payments during the term did not constitute a ratification of the lessee's dedication of the gas to interstate commerce.

18. 98 S. Ct. 1955 (1978).

19. *Id.* at 1958 (citing *Sunray Mid-Continent Oil Co. v. Federal Power Comm'n*, 364 U.S. 137, 147 (1960) and *Atlantic Ref. Co. v. Public Serv. Comm'n*, 360 U.S. 378, 388 (1959)).

20. *Id.*

21. *Id.*

22. 364 U.S. 137 (1969). In *Sunray*, a producing company owned all the gas in controversy.

tached to the gas as a matter of law and bound everyone with dominion and power of sale over the gas, including the lessor to whom it reverted.²³ Once gas began to flow in interstate commerce under a certificate of unlimited duration, the obligation could not be terminated by a private lease arrangement.²⁴ Rather, only the Commission could authorize an abandonment of service.²⁵

In this regard, the majority rejected Southland's contention that no man can dedicate to the interstate market what he does not own.²⁶ The Court held that dedication did not mean the surrender of the gas to the public.²⁷ Instead, dedication simply meant a change in the regulatory status by placing the gas within the jurisdiction of the Commission.²⁸

Finally, Justice White asserted that there could be "practical consequences" for a "local economy which had grown dependent on natural gas as a fuel" if the expiration of a lease to produce natural gas terminated all obligations to serve the interstate market.²⁹ Without the continuation of this obligation after the lease term, producers and natural gas companies would be free to negotiate arrangements which could frustrate the Natural Gas Act's ratemaking and supply goals.³⁰ The structure and purposes of the Natural Gas Act, therefore, required broad authority for the Commission over the abandonment of interstate service.³¹

It contracted with a interstate pipeline company to supply gas for a 20 year term. The producer applied for a certificate of public convenience and necessity from the Federal Power Commission limited to the 20 year term. The Commission, however, issued a certificate of unlimited duration pursuant to its recognized regulatory authority. Subsequently, Sunray commenced production under the certificate. This commencement of service lead the Supreme Court to conclude the unlimited certificate had been accepted. Because of the acceptance, the producer was held to have undertaken a service obligation which survived the expiration of the contract term. Interstate service, therefore, could not be abandoned without Commission approval. The Supreme Court emphasized that the obligation imposed on the producer survived the contract term and was in accordance with the purposes of the Natural Gas Act.

23. 98 S. Ct. at 1959.

24. *Id.*

25. *Id.* See note 15 *supra*.

26. 98 S. Ct. at 1960.

27. *Id.*

28. *Id.*

29. *Id.* at 1961.

30. *Id.*

31. *Id.* at 1962. The majority also concluded that the reversionaries were bound by the service obligation because they had acquiesced in the lessee's action. The premise was based on the notion that Southland could have objected to the dedication of the gas to interstate commerce at the time Gulf applied for the certificate. *Id.* at 1960. Moreover, Southland ratified Gulf's action by accepting royalties. *Id.* Finally, by implicitly authorizing Gulf to make interstate sales, the reversionary interests knew that the gas would become subject to regulation and could not have expected later sales of gas to be free from regulatory control. *Id.*

The dissent argued that the majority's reliance on *Sunray* to justify a broader view of the Commission's authority was misplaced.³² This expansion of jurisdiction, Justice Stevens asserted, was inconsistent with the purposes and structure of the Natural Gas Act.³³ Moreover, it was argued that the majority's analysis ignored traditional property concepts.³⁴ To permit the Commission to retain jurisdiction over the reversionary interest holder after the lease's expiration would be tantamount to allowing the lessee to create an obligation binding on the lessor that would endure beyond the lease term.³⁵ The dissent, rather, claimed that this radical change in the property interests relating to natural gas was not what Congress intended in the Natural Gas Act.³⁶ Finally, Justice Stevens asserted that, contrary to the fears of the majority, the long-term nature of natural gas development leases realistically limited the ability of producers and gas companies to frustrate the Natural Gas Act's fundamental purpose of providing interstate service.³⁷

Despite the holding in *Southland*, recent congressional action has somewhat limited the impact of the decision. The House Report on the National Gas Policy Act of 1978³⁸ specifically noted the circumstances

32. *Id.* at 1965-66. The dissent urged that there were key factual distinctions between *Sunray* and *Southland*. They noted that in *Southland* there were essentially three parties: a lessor, a producer, and a pipeline company. The lessor held the reversionary interest; while, the producer-lessee dedicated the gas. In *Sunray*, on the other hand, there were only two parties, a producer and a pipeline company. The producer who dedicated the gas owned the reversionary interest.

33. *Id.* at 1966. Citing Federal Power Comm'n v. Panhandle Eastern Pipe Line Co., 337 U.S. 498, 502 (1948), the dissent emphasized that the Natural Gas Act did not represent a congressional exercise of full power under the commerce clause of the Constitution. 98 S. Ct. at 1966.

34. *Id.* at 1967. The dissenting opinion stated that there is a "well-settled doctrine of property law that 'one having a limited estate in land cannot, as against the person entitled in reversion . . . , create an estate to endure beyond the normal time for termination of his own estate.'" *Id.* (quoting 1 H. TIFFANY, THE LAW OF REAL PROPERTY § 153, at 247 (3d ed. 1939)). The dissent also argued that, contrary to the Commission's finding, *Southland* was not a successor-in-interest, who took the property subject to burdens created by the lessee. 98 S. Ct. at 1966-67.

35. *Id.*

36. *Id.*

37. *Id.* at 1968-69. There are few short-term development right leases in existence. See 3 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§ 601.1-602.6 (1977); Walker, *The Nature of Property Interests Created by an Oil and Gas Lease in Texas*, 7 TEX. L. REV. 1 (1928). The magnitude of the capital investment required for exploration and development of oil and gas makes a short-term lease extremely unattractive. Accordingly, this would dispell the notion that producers and pipeline companies would agree to short-term leases as a means of frustrating the purposes of the Natural Gas Act. The dissent also responded to the ratification argument of the majority by stressing that the reversionaries lacked knowledge. Ratification, they noted, requires knowledgeable choice. By accepting royalties during the term of its lease, *Southland* had committed no action inconsistent with its reversionary right. The reversionary interests, therefore, had no knowledge that receipt of royalties would be tantamount to ratification of the lessee's action. Moreover, reversionary interest holders had no legal right to interfere with or to control the lessee's sale of gas during the lease term.

38. Pub. L. No. 95-621, 92 Stat. 3350 (1978).

of *Southland* and attempted to limit its further extension.³⁹ Only natural gas which had been "dedicated to interstate commerce" prior to the new act remains subject to the regulatory requirements of the Natural Gas Act.⁴⁰ Section 2(18)(B)(iii) of the Natural Gas Policy Act of 1978 expressly excludes from the definition of "dedicated to interstate commerce" gas which would otherwise have been considered dedicated if two requirements are met. First, a party, on May 31, 1978, must not have had any right to explore for, to develop, to produce, or to sell the gas from the property. Second, on May 31, 1978, the gas must not have been sold in interstate commerce for resale.⁴¹ Therefore, if the gas was not "dedicated" on May 31, 1978, any obligation to provide interstate service would automatically end. Applying this exclusion, if a lessor had no development rights and no gas was being sold in the interstate market on May 31, 1978, the obligation to serve the interstate market would be terminated. If, however, the lessor's reversionary interest vested after May 31, 1978, the exclusion would not apply. Although the Natural Gas Policy Act of 1978 would not have altered the result in *Southland*, it does remove certain reversionary interest holders who acquire their interests prior to May 31, 1978 from the Commission's jurisdiction.

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39. H.R. REP. NO. 1752, 95th Cong., 2d Sess. 71, *reprinted in* [1979] U.S. CODE CONG. & AD. NEWS 9161, 9166.

40. Pub. L. No. 95-621, § 601(a), 92 Stat. 3409 (1978). Natural gas which remains committed or dedicated to interstate commerce on the day before the date of enactment of the Natural Gas Policy Act of 1978, or which is not specifically exempted from the jurisdictional consequences of commitment or dedication by the Act, remains subject to all the non-price regulatory requirements of the Natural Gas Act. An important aspect of continued Natural Gas Act regulation is the requirement that a producer must still file an abandonment application with the Commission before terminating services to the interstate market or before abandonment of facilities used for interstate service.

41. Pub. L. No. 95-621, § 2(18)(B)(iii), 92 Stat. 3354 (1978).