ltc

ORIGINAL

Decision No. 84729

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY: (1) For Authority to Adjust Its Rates as Necessary to Reflect Its Participation in a Funding Agreement to secure Certain Rights to Alaskan Natural Gas; (2) For Authorization to Give Its Consent to an Assignment to Atlantic Richfield by Pacific Lighting Gas Development of Certain Rights Pursuant to an Agreement Related to the Funding Agreement.	Application No. 55599 (Filed April 3, 1975)

(Appearances listed in Appendix A)

O P I N I O N

This is an application by Southern California Gas Company (SoCal) for an increase in its rates to reflect its participation in a certain funding agreement (Exhibit 2) of its affiliate Pacific Lighting Gas Development Company (PLGD) and the Atlantic Richfield Company (ARCO). Under the terms of Exhibit 2 ARCO has agreed to grant to another SoCal affiliate, Pacific Interstate Transmission Company (PIT), the exclusive right to negotiate for 60 percent of ARCO's proven gas reserves in its solution gas and associated gas cap in the Prudhoe Oil Pool on the North Slope of Alaska. ARCO's reserves are estimated to be approximately seven trillion cubic feet (tcf). PIT and SoCal have entered into an agreement (Exhibit 4) by which SoCal will purchase any gas thus acquired by PIT. SoCal and PLGD have executed an agreement (Exhibit 3) under which SoCal will guarantee that PLGD has the funds necessary to meet its payment obligations under its agreement with ARCO. The proposal is called the North Alaska Funding Adjustment (NAFA) and contemplates an increase in SoCal's rates to its customers in a sum sufficient to pay all the carrying costs and other charges on a $420,000,000 loan to be made to ARCO from various lending institutions. The costs and charges are estimated variously to be between $320,000,000 and $340,000,000. The actual amount will vary depending upon final financing arrangements and then current interest rates.

In order for SoCal to pay this sum it is necessary for SoCal to collect from its ratepayers a sum in excess of twice that amount to cover the charges for uncollectibles, franchise fees, and state income taxes, and the large amount necessary to pay federal income taxes of 48 percent on the total revenues collected. This will necessitate a total collection of revenues from its ratepayers somewhere between $588,000,000 and $897,000,000, depending on interest rates and assumptions made.

On April 25, 1975 SoCal filed a ruling (Exhibit 29) with the Internal Revenue Service proposing that income taxes should not be assessed on the revenues collected under NAFA, based on either of two theories: (1) The Conduit Theory - Since this is a sum of money collected by SoCal for a specific purpose which is to be segregated from all its other funds, which will have no effect on earnings, and which is to be used only for the purpose for which it is intended, i.e., to pay the carrying cost on ARCO's loan and associated taxes and for no other purpose, SoCal is acting merely as a conduit for these funds between the ratepayer and ARCO; or (2) The Capital

Contribution Theory - Since the amounts being paid by the ratepayer to pay the carrying charges on ARCO's loan are a contribution to the capital of SoCal, which are excluded from gross income under Section 118 of the Internal Revenue Code, these funds are not income and thus not taxable. SoCal's tax counsel has testified that it is unlikely that the IRS shall rule in favor of SoCal.

SoCal estimates that the maximum annual amount necessary to be included in its rates as a result of NAFA will be approximately $136,200,000. This amount includes approximately $63,400,000 as the estimated annual amount to cover the carrying costs; the balance represents the amount to be recovered for the additional income and franchise taxes and uncollectible charges. SoCal proposes to file quarterly advice letters requesting authorization for the adjustment of its rates. Such quarterly advice letter filings will adjust differences between estimated and actual interest costs and sales volumes and shall be made on a uniform cents-per-therm, or equivalent, basis. As its quid pro quo, SoCal's affiliate obtains the right to negotiate exclusively for the purchase of gas totaling 60 percent of ARCO's Prudhoe Oil Pool gas reserves.

Under various circumstances set forth in Exhibit 2 ARCO is required to refund amounts paid pursuant to the agreement. Upon refund of any sums paid pursuant to the agreement by ARCO, SoCal will make appropriate refunds to its customers including such amounts as may be necessary to refund to the customers the taxes previously collected under NAFA. To assure ARCO that PLGD will meet its obligations under the funding agreement PLGD will assign to ARCO its rights to payments from SoCal and SoCal is requesting that it be authorized to consent to this assignment. Several of the provisions in Exhibit 2 were revised as a result of negotiations between various members of the Commission and ARCO to provide somewhat more favorable terms to PLGD.

These revisions are contained in a letter admitted as Exhibit 5 and to be incorporated in the agreement, in the event of an acceptable approval of the proposal by the Commission, with the contractual language set forth in Exhibit 36. In general, these provide for a 100 percent refund obligation upon ARCO (instead of the original 87 percent); that any such repayment should include interest to the date of notice, requiring such repayments at the current legal rate of seven percent from the date of the original payment; and that in the event the price under the to-be negotiated gas purchase contract shall be determined without regard to regulation or government controls either directly or indirectly PIT is entitled to deduct from the amount otherwise payable to ARCO the sum of seven cents per Mcf of gas delivered. In addition, ARCO has agreed to a Commission proposal (if all other terms and conditions of NAFA are approved) to accept a direct loan from SoCal of $420,000,000 payable at the rate of $10,000,000 per month until fully paid, in lieu of the payment of the carrying costs as proposed in NAFA, which sum would be repaid by ARCO commencing in 1982 at the rate of $70,000,000 per year.

Extensive hearings were held between May 27, 1975 and July 25, 1975 over a period of 14 days before various Commissioners with final arguments en banc before Commissioners Sturgeon, Ross, and Batinovich and Examiner Phillip E. Blecher. The matter was submitted for decision on the latter date.

The Evidence

Exhibit 2 (the funding agreement between PLGD and ARCO): The major provisions in this agreement may be summarized as follows: (1) The purpose of the agreement is to have PLGD pay the carrying costs on a $420,000,000 nonrecourse loan secured by a carved out production payment from certain of ARCO's proven reserves. The nonrecourse aspect means that the lender may only look to the payments from the proven fields pledged for the repayment of the money, and not to ARCO's general credit. The production payment owner (ppo) is to be chosen by the lender, and is contemplated as being a charitable organization, thus avoiding any additional tax implications. Under Section 636 of the Internal Revenue Code this type of loan is considered to be a mortgage loan with the production payments pledged as security; therefore, the interest on the loan which will be paid to the lender will be deductible as interest expense to ARCO just as though it were an ordinary mortgage loan. This will offset the payments by PLGD to ARCO which are classified as income. (2) PIT will receive the right to negotiate for 50 percent of ARCO's share of the Prudhoe Oil Pool and associated gas caps to be dedicated under the gas purchase contract to be negotiated. This is estimated to be approximately four tcf of gas.[1/] The length of the contract shall be twenty years which may be extended for such period of time as is necessary for PIT to obtain its proportionate share (60 percent) of ARCO's reserves. This is essentially being treated as a contract for the life of the

1/ The actual amount is not guaranteed and may vary, depending on when transportation facilities are ready, the amount of gas used for oil pressure maintenance, and other factors.

field. (3) The funds are to be drawn down by ARCO in $60,000,000 quarterly installments commencing August 1, 1975 (or upon acceptable PUC approval) and ending 18 months thereafter.[2/] Repayment by ARCO is estimated to commence in the year 1978 and extend through 1987 but in no event shall result in an average life exceeding 7.5 years. Interest costs will vary with the prime rate and will be computed as 116 percent of the total of prime plus certain add-ons. Other charges include a one-half percent per annum commitment fee (which has not yet been negotiated), a quarter-percent per annum facility fee on the unused commitments, a balance fee on the unused commitments equal to 10 percent of the prime rate, a management fee to the lead bank estimated to be $700,000, legal fees to special counsel to the banks estimated to be between $500,000 and $600,000 and fees associated with documentation and recording of the transactions. Institutional borrowing costs include a one-half percent per annum commitment fee of the unused commitments, and an estimated interest rate of 10-1/2 to 11 percent per annum. The fee to the ppo is estimated to be $50,000 per year maximum over the entire life of the loan. (4) The funds obtained by ARCO under this loan may be used for any corporate purposes and are not limited in any manner. (5) In the event the gas purchase contract contemplated by the funding agreement is not negotiated PLGD has the right to terminate and receive a refund of all funds previously paid to ARCO together with interest at the rate of seven percent per annum from the time the funds were paid to ARCO. (6) In the event the gas purchase contract is negotiated it may be rescinded at any time by either party prior to the time gas begins to flow, at which time the foregoing repayment requirements may be invoked. In the event gas begins to flow the gas purchase contract

---

2/ See page 4 for the alternate draw-down and repayment arrangement.

is irrevocable regardless of the amount of gas that is eventually determined to be available or is actually delivered. (7) The agreement shall be governed by Texas law. (8) The transportation mode must be approved by all the required regulatory bodies not later than January 1, 1978.

Exhibit 3 (the gas purchase contract): This agreement, yet to be negotiated, provides essentially (1) that the price to be paid for gas shall be the highest price paid for any other substantial volumes of gas from Prudhoe Bay if unregulated (and subject to escalation to such price), or the highest applicable regulated price; (2) the seller shall be obligated only to separate the oil from the gas at the flow station which is the delivery point for the gas and where title to the gas shall pass; (3) all the other facilities necessary to gather, process, handle, and condition the gas to prepare it for shipping to the lower 48 shall, at seller's (ARCO) option effective at the date of initial delivery period or within five years thereafter, be purchased in proportional shares by buyer (PIT); (4) this same option shall apply to any royalty gas that ARCO may deliver to PIT; (5) ARCO shall retain the right to take all constituents removed from the gas, in kind; and (6) in the event this contract is terminated for any reason prior to gas delivery any funds paid to ARCO shall be refunded by ARCO and the applicant represents that any refund from ARCO shall be flowed through to the ratepayer in such a manner that all monies heretofore paid by the ratepayers under this proposal would be refunded to the ratepayers including those amounts collected for taxes.

The agreement entered into between ARCO and PLGD contemplates California Public Utilities Commission (PUC) approval not later than 90 days from the date of filing, which was April 3, 1975, taking us to July 3, 1975. A decision of the FPC (Exhibit 13) caused applicant to ask for an extension of time and postponement of the hearing originally set to commence on May 27, 1975. Because there was a postponement of approximately one month ARCO extended its deadline to August 2, 1975 and has refused other Commission requests to further extend that deadline. The passage of the deadline without Commission approval will give either party the right under the funding agreement (Exhibit 2) to cancel the agreement.

Policies of Applicant and ARCO

The proposed agreement was negotiated pursuant to ARCO's solicitation for bidders for its gas reserves, to which SoCal responded for the purpose of obtaining additional long-term supplies of natural gas for the southern California area. Many witnesses testified about the impending shortage of natural gas that may be severe enough to require curtailment of firm general service (which includes residential customers) by 1979 without additional gas supplies. This was substantially corroborated by the staff witness. Thus, the questions arise: Does the impending shortage require infusion of ratepayer's funds to assist regulated utilities and unregulated multi-national corporations to obtain additional gas supplies? Is the proposed method of acquiring the right to negotiate for such gas a proposal which, under the existing circumstances and conditions, warrants approval by the Commission? It is apparent from the testimony of SoCal's witnesses that this proposal was fashioned after the GEDA (Gas Exploration and Development Adjustment) procedure which was approved for SoCal by the Commission in Decision No. 81898 dated

September 25, 1973. GEDA provides, under specified conditions, for approval of various projects for the purpose of assisting in the exploration and development of new supplies of natural gas. This procedure is limited in size, scope, and method and is to provide an incentive for the exploration necessary to develop new supplies. It is here that the resemblance between GEDA and NAFA ends, as NAFA contemplates not the exploration for new supplies of gas but a method of paying for the costs necessary to finance a loan to a producer for the production.

SoCal's policy witness testified that PLGD is a wholly owned subsidiary of the Pacific Lighting System and is being used to obtain additional gas supplies as a conduit only and will itself have no substantial assets or earnings. All personnel of PLGD are paid by SoCal. The purpose of the formation of this subsidiary is three fold - to avoid regulation by the Federal Power Commission, to avoid the Federal Holding Company Act, and to avoid certain legal limitations. Substantially the same applies to PIT. This company is a wholly owned subsidiary of Pacific Lighting, as is SoCal, and is organized to buy and sell gas outside of California, primarily as a transportation entity. PIT is presently a member of the Gas Arctic Group which is a consortium of pipeline companies which has a pending plan before the Federal Power Commission (FPC) to transport natural gas from the North Slope through the MacKenzie delta in Canada down to the American border where it will then be split between a pipeline to California and a pipeline to the mid-west and east. The proposed pipeline to California will join at the Nevada border, a proposed 242 mile pipeline to be constructed by SoCal solely within California to bring the gas to the Los Angeles area.

An alternate proposal for transporting natural gas from the North Slope to the lower 48 states is sponsored by El Paso Natural Gas Company (El Paso). El Paso would build a pipeline straight south from the North Slope to the southern coast of Alaska where the gas will be liquefied, shipped on LNG super tankers to various terminals in southern California where the gas will then be deliquefied and transported via pipeline to the Los Angeles area and through the El Paso system to points east. SoCal supports the pipeline system in which its affiliated company is a member. The FPC has not yet rendered a decision on the merits of the alternate transportation proposals. California and the California PUC have intervened in the pending proceeding before the FPC (El Paso Alaska Company et al. Docket No. CP 75-96 et al.)

SoCal has another recently formed affiliate, Western LNG Terminal Company (a subsidiary of Pacific Lighting), which proposes to build three liquefied natural gas (LNG) facilities from Point Conception southward along the coast of California to handle LNG from Alaska, if El Paso's proposal is approved, and to handle LNG that SoCal and its affiliated companies have contracted for with Indonesia.

The policy witnesses for SoCal and ARCO both testified that the primary consideration in negotiating these contracts was to obtain competitive financing at competitive rates in a manner to avoid carrying debt on each company's balance sheet, thereby not affecting their credit rating, times interest coverage, or ability to issue both debt and equity financing. SoCal also desires to keep its debt-equity ratio approximately 50-50 as it has historically maintained. ARCO acknowledges that it is capable of financing this loan, but needs large sums of money to build its North Slope facilities. ARCO has received offers from several other interstate pipeline companies for all or any portion of the subject gas. Since the execution of this agreement ARCO has entered into FPC-type 499 agreements, which are entitled Gas Advance Payment agreements, one dated May 30, 1975 with Panhandle Eastern Pipeline Company (Panhandle), and the other dated June 30, 1975 with Texas Eastern Transmission Corporation (Texas Eastern), the parent company of Transwestern, a major supplier of SoCal. Both these agreements comply with the kind of advance payment agreement heretofore approved by the FPC for the purpose of providing incentives to drill and explore for natural gas.

Exhibit 12 is an order of the FPC in Re Natural Gas Pipeline Company of America (Natural), Docket No. RP 75-90, in which Natural asked for approval of and rate relief for its agreement with Exxon Company, for an exclusive right to negotiate for purchase of 20 percent of Exxon's interest in Prudhoe Bay gas reserves, as well as other matters not pertinent hereto. Natural agreed to make semi-annual payments of the interest expense Exxon would incur if it borrowed funds to finance the exploration, development, and production costs involved. Natural asserted this procedure was consistent with the objectives of FPC Order 499 (Exhibit 10). Responding, the FPC said:

> "However, the purpose of our advance payment programs has been to provide additional capital for producers in order to stimulate exploration, development, and production for the interstate market. . . .These programs are not intended to provide that jurisdictional ratepayers pay interest through pipeline rates on capital which the producer is demonstrably able to acquire. It is apparent that from the nature of these agreements that Exxon does have the ability to acquire the capital associated with these projects. . . ."

Exhibit 13 is an order in Re Northern Natural Gas Company (Northern), FPC Docket No. RP 75-89, where the FPC in a virtually identical matter to RP 75-90 reached the same result based on the same reasoning. Exhibit 14 is an order in Re Michigan-Wisconsin Pipeline Company (Mich-Wis), FPC Docket No. RP 75-96, with similar facts and the same result, which cited the language used in Exhibit 12 set forth above. In the three matters, the FPC indicated that it would be more appropriate to consider this kind of proposal in the context of any future rulemaking extending the advance payment program. The FPC 499 program is presently scheduled to expire December 31, 1975.

ARCO's two 499 type of agreements, substantially identical, are subject to FPC approval. Each provides for the pipeline's payment of 20 percent of ARCO's costs incurred in relation to the exploration, development, and production of natural gas at Prudhoe Bay, not to exceed $150,000,000, and the purchase of 20 percent of the gas gathering, handling, compression, and conditioning facilities on the North Slope in return for the pipelines's acquisition of the right to purchase an undivided 20 percent of ARCO's working interest in its North Slope gas. Under these and other 499 agreements the funds are to be loaned by the pipeline interest-free to ARCO. (The funds may be provided by the pipeline either from its internally generated funds or on its credit so that ARCO is not providing any of its credit or properties as security for the monies to be advanced.) The advance must be repaid, either in kind or cash, within five years from the time gas starts to flow subject to various time and regulatory limitations. In addition, prior to approval by the FPC, the pipeline in each case will advance the sum of $16,400,000 and thereafter semiannually will make an advance payment equivalent to 20 percent of ARCO's expended costs, up to the maximum limit of $150,000,000. These advances by the pipeline may be included in its rate base upon which the then authorized rate of return shall be recovered from the pipeline's customers.

ARCO's policy witness testified that ARCO solicited agreements similar to the 499 type, and that it would prefer a 499 type of agreement for several reasons: (a) ARCO would receive funds from the pipeline before regulatory approval, (b) ARCO would not extend its general credit or any security for the funds, as the raising of the funds would be the pipeline's responsibility, (c) no repayment would be necessary until after the gas started to flow or five years after it was determined no gas would flow. The only advantages apparent to ARCO from the proposal of SoCal here is the apparently expeditious review and approval of this matter by the PUC which was represented to ARCO by SoCal. There is also a slightly faster draw-down of funds available under the proposal herein than under the typical 499 proposal. (This minimal difference would be canceled by ARCO's acceptance of the slower draw-down of $10,000,000 a month proposed by the Commission.)

Under SoCal's proposal the monies advanced by the ratepayer to SoCal, which would vary between $588,000,000 and $897,000,000 over the life of this proposal, would be capitalized on its books and amortized over the life of the gas purchase contract (expected to be approximately 25 years) when gas begins to flow. This means that if the gas started to flow in the year 1980 the total amortization would run through the year 2005. It is during this period that all funds paid by the ratepayer under this proposal would be returned, albeit with less valuable dollars and to the next generation.

The entire production plan of the North Slope and all the agreements relating to the production and acquisition of this gas must be approved by the regulatory agencies of the State of Alaska. No plan has been submitted because there has not yet been a "unitization" agreement among the producers of the North Slope, though the producers are trying to complete this agreement by March 1976. A unitization agreement is a pact between producers proportionately dividing the revenues and expenses of and from the North Slope reserves of gas and oil.

Prior to the delivery of gas PIT must build a gas conditioning plant at a cost of about $185,000,000. Based on current estimates of costs by both SoCal and ARCO it is presently estimated that SoCal's share of gas handling and gathering facilities would be $93,000,000. The cost of the 242-mile pipeline from the Nevada-California border to Los Angeles would be approximately $130,000,000.

In addition, the total estimated share of SoCal, in 1975 dollars, of bringing the gas via the Gas Arctic project portion of the pipeline from just north of the Canadian border to the Nevada-California border is approximately $480,000,000. Thus, simple addition indicates not less than an additional $888,000,000[3/] is required by SoCal and its affiliates to bring the ARCO gas to the Los Angeles area. SoCal will be directly responsible for providing $130,000,000 for the 242-mile California pipeline for which it will apply to us for approval and rate relief. The balance of this sum will be included in PIT's cost of service tariffs, which must be approved by the FPC before becoming effective.

SoCal and ARCO discussed alternative means of financing but none were found acceptable to them, within the earlier described limitations. SoCal advised that it did not analyze ARCO's cost of debt financing compared to the cost of financing this agreement, which under various assumptions as to interest rates and proportions of financing, range from 9.51 percent to 15.06 percent.

In Exhibit 8, the 1974 Pacific Lighting Corporation annual report and supplement, under the heading "The Gas Supply Challenge" SoCal's parent sets forth its basic policies which, in our opinion, underlie the instant proposal.

> "The size of gas supply projects and the remoteness of prospective sources are such that we can no longer depend solely upon the efforts of our present out-of-state suppliers (El Paso Natural Gas Company and Transwestern Pipeline Company). <u>We also realize that government regulators would not permit us to obtain and use large volumes of natural gas while neighboring areas face severe shortages</u>. Our goal

---

3/ This sum does not include the monies needed for the LNG terminals, any LNG tankers involved, or its share of the balance of the Gas Arctic pipelines.

of acquiring gas to supplement traditional domestic sources, therefore, is intended also to be beneficial to other western states, where gas distributors are faced with energy shortages similar to ours. This marks a departure from our historic role as primarily a gas distributor. It proclaims our readiness to assume a new role, within the limits of our financial capabilities. As such we plan to participate in the larger, more capital-intensive and potentially more profitable areas of exploration, development, transportation and construction of terminals for gas supplies from sources once considered far beyond the reach of our distribution activities." (Emphasis added.)

This became company policy in 1969. In the same report under the heading "Pacific Lighting's Views on the Natural Energy Outlook" there is the following statement:

> "There is a substantial resource base of potential gas supplies in the U. S. (in addition to proved reserves of 250 tcf at the end of 1973, estimates of potential reserves range from 1,400 tcf to nearly 3,000 tcf.)"

Applicant's gas supply witness testified that some sources had revised these figures downward though some had not and that the total consumption of natural gas in United States in 1974 was approximately 22 tcf. Another quote from the same page 11:

> "Bringing liquified natural gas from foreign sources is a more realistic approach to energy acquisition than total United States dependence on imported oil to meet the domestic energy deficiency. This is because LNG importation increases the security of supply by diversifying source locations."

and:

> "Also important is coastal Alaska with its vast untapped potential and relatively short shipping distance to U.S. west coast markets. Estimates of gas reserves in Alaska, both offshore and onshore, have been conservatively put at 439 tcf (nearly twice as large as present total U.S. crude reserves). The lower Cook inlet, the Gulf of Alaska, and the Bering Sea appear particularly promising to us."

Under the heading of "Conservation" on page 14 we again quote:

> "Our various energy conservation programs have been quite effective. We estimate that during the past year our residential, small commercial, and small industrial customers[4/] have cut their usage of natural gas by about eight percent. This means a reduction in usage of about 40 billion cubic feet of gas per year."

4/ These are the General Service firm sustomers.

Gas Supply and Requirements

SoCal's gas supply witness indicated in his testimony that SoCal and its affiliates have three other viable gas supply projects now in various stages of development, as follows:

(1) Cook Inlet or South Alaska Project - There is a pending FPC application for this project. The evidence before the FPC, shown by SoCal, indicates that Phase I of this project (called PAC Alaska) should start producing by 1978 and reach full production by 1980. This amounts to approximately 100 M^2cfd and 400 M^2cfd when Phase II is fully completed. The capital cost for the first phase is estimated at $810,000,000 including the affiliated cost of LNG terminals and the total capital costs for this project are estimated at 1.2 billion dollars, which is an estimate based on 1975 dollars with an inflation factor of approximately seven percent added through year 1979. In 1975 dollars the estimated cost of gas in the first phase will be $2.50 per Mcf and for the full project $1.90 to $1.98 per Mcf.

(2) Coal Gasification - This is a 50-50 joint venture with Transwestern Pipeline Company, (one of SoCal's present major suppliers), to convert coal into usable gas. In 1975 dollars the estimated cost of this project is $853,000,000. In 1975 dollars the estimated cost per Mcf of this gas will be $2.34. The total expected volume is 250 M^2cfd of which applicant's share will be 75 percent or approximately 187 M^2cfd which is estimated to come on line in 1979.

(3) Indonesian LNG - Capital costs are estimated in 1979 dollars (which include six percent inflation per year) as $259,000,000 without considering the cost of the LNG ships that are necessary to transport the liquefied gas to southern California (and are estimated as costing just under one billion dollars). The contracted volume of delivered

> gas expected is 523 M^2Btu which is initially expected to start arriving in 1978 but which will not reach full delivery until 1981. In 1981 dollars the cost of this gas is estimated as \$2.51 per M^2Btu. The base price of this gas to SoCal is \$1.25 per M^2Btu at this time, but there is an escalation clause which is based partly on the cost of Indonesian crude oil.

If all three projects come on line as projected, SoCal does not estimate any curtailment of firm general service under average temperature conditions until 1987. SoCal estimates that the total volume of new gas under its four projects (including the ARCO project) equals 1,500 M^2cfd, all coming on line sometime between 1978 and 1981. Gas from North Slope is expected in 1981 or 1982. All the figures supplied by the gas supply and requirement witnesses assumed growth in the number of customers (60-70,000 per year) and an increase in the average use per customer with no adjustment for conservation.

It was admitted that the FPC can reallocate gas by order and there is nothing that the company could do to prevent this.[5/] SoCal's major suppliers, El Paso and Transwestern, are currently attempting to develop more sources of gas. If they are successful, SoCal will obtain a portion of such new supplies, depending on FPC allocations and curtailment schedules.

SoCal has not prepared any estimates on a "no growth" basis. The recorded conservation for 1974 shows approximately eight percent of all its firm general service, approximately 40 bcf. Several witnesses testified that the unitization agreement now being negotiated among the North Slope producers will determine the exact amount of gas to which each producer is entitled. Such agreements,

---

5/ The FPC has ordered curtailment of contractual deliveries and such curtailment is presently in effect for SoCal's two major suppliers.

as well as any production plans, are subject to the approval of Alaskan regulatory agencies, which may alter the amounts to be produced and delivered. Therefore, the actual amount that can be produced and delivered is uncertain regardless of the contracted amounts. A witness for ARCO indicated that the manner of gas utilization will have a major effect on the ultimate recovery of the amounts of "in place gas". There is approximately 90 tcf of potential reserves in the North Slope of Alaska other than Prudhoe Bay which, added to Prudhoe Bay's approximately 24 tcf, gives a total potential reserve in the North Slope of 114 tcf. The MacKenzie delta area of Canada has an additional potential in excess of 50 tcf.

SoCal recommends a uniform rate spread as it must recover its costs on a current basis to be able to stay in business; the deliveries made to customers on a current basis should be surcharged for the replacement of that gas in the future. The witness would charge regular interruptible and electric utility customers on a current basis even though they may have to switch to alternate fuels in the future as a result of their inability to obtain any meaningful gas supplies. SoCal shows that for 1976 and 1977 the ratio of residential to total firm requirements estimated are 70 percent (rounded). Therefore, assuming a constant ratio, to the extent that curtailment of the commercial and industrial firm service can be had without curtailing contiguous or adjacent residential customers there must be in excess of 30 percent curtailment of firm nonresidential service prior to any curtailment of residential service. This would mean that, based on the latest data, there would be no curtailment of firm residential customers until 1982 without additional supply; there would be no curtailment of firm residential until some time after 1993 with the projected additional supply of the other three projects, and sometime beyond with all four projects. In the event that conservation is taken into account these figures would all be extended approximately one year since that is the stated goal of the conservation program.

The representative of the California Gas Producers Association indicates that the proposed ARCO supply of gas is estimated to be received in southern California about 1982; optimistically new Indonesian gas will be received in 1979; but that there are at least four trillion cubic feet of probable natural gas reserves available from onshore California sources and an additional trillion cubic feet of natural gas available from offshore California sources, a volume in excess of the proposed ARCO supply.

Financial and Tax Consideration

The estimated project debt and other off-balance sheet financing for the gas supply projects will amount to an additional $180,000,000 to $190,000,000 in 1976. SoCal attempts to finance its gas supply projects on an individual project basis; funding by revenues generated by the project and not by other financing or general credit of the utility. SoCal attempts to finance these projects at a 75 percent debt - 25 percent equity basis. The kind of financing proposed here is necessary, according to SoCal, because its credit and financing ability are needed for other projects. The net worth of the Pacific Lighting group is slightly under $600,000,000 and its assets total one and a half billion dollars.

In the instant project SoCal does not anticipate any equity financing on its part. SoCal did not prepare an exhibit comparing the cost of the standard FPC 499 arrangement to the instant proposal or to any of the other proposals set forth by its financial witness. The costs for the instant project are based on a capital structure of approximately 50 percent debt and 50 percent equity. Debt costs are 10 percent, the equity return is 15 percent, and the average total return is 12-1/2 percent. SoCal determined that the appropriate way to raise money to bring gas to the customers of California is to use the credit of others and in the case of the particular project here, that the cost of financing be collected from the customers directly without the requirement of capital contribution or capital requirement from SoCal. SoCal cannot fund a 499 arrangement with ARCO and do all the other financing required to bring necessary gas supplies to southern California. Even assuming no coal gasification project (which is presently unfinancable under a current FPC order) the ARCO funding still would be handled as proposed. SoCal estimated that it will require approximately one billion dollars over the next four or five years to finance additional gas supply projects. It expects to obtain approximately half of that sum from internally generated funds. This excludes NAFA, which would be independently funded if this proposal is approved, but includes the equity participation of SoCal in new storage deals. The evidence shows various methods of financing of the NAFA proposal. These may be categorized as (1) capitalizing the total funds required to pay the carrying costs and putting it in rate base and (2) capitalizing the principal amount of the direct loan into rate base at a 12-1/2 percent return. Another alternative shows a direct loan to ARCO from the ratepayers being repaid commencing in 1982 at the rate of $70,000,000 a year. In general, the NAFA proposal, on the assumptions made in the computations compare well in most areas with the alternate plans, except regarding the direct loan plan, since the total cost to ratepayers there is zero (though no potential tax consequences are considered there). The total cost to the customers under NAFA is $327,000,000 which is less than the other proposals, though its present worth is greater. The staff presented varying exhibits relating to the total cost and present worth of various alternative financing methods using entirely different assumptions than SoCal. Though the numbers are substantially greater than SoCal's, the relationships are constant because the assumptions are constant. The staff indicates that NAFA is the poorest of the four alternatives computed in regard to total cost and net worth, though it is fair to say that the assumptions made are not as realistic as SoCal's.

The tax problem mentioned earlier arises because of the insistence of the contracting parties in keeping the loan to ARCO, and the carrying costs on the loan, off the balance sheet of both companies. No calculations were made by SoCal for various alternative amounts of taxes as a result of the alternative financing arrangements and their potential adverse tax consequences. The NAFA funds to be used for taxes would go into Pacific Lighting's consolidated tax return. Since SoCal's tax liability might be offset by losses of the parent and/or its subsidiaries, the total tax liability of the parent would be reduced though the collection from the ratepayer would be the same. It was SoCal's testimony that there would be no benefit to the company as a result of this because the taxes due on the amounts collected from the ratepayer would still be the same and would reduce any tax benefit otherwise accruing to the parent as a result of other losses or tax reductions.

A policy witness for San Diego Gas & Electric Company (SDG&E) reluctantly supported this proposal though he stated that if the South Alaska project and coal gasification had been completed as originally scheduled, approval of this project would not be necessary. SoCal still projects these projects as coming on stream prior to the realistic date of delivery for the North Slope gas, and this witness estimates that the North Slope gas would most likely be delivered to the lower 48 states by 1982.

Final argument en banc was held on the last date of hearing. SoCal, ARCO, and Pacific Gas and Electric Company unconditionally supported the proposal. All other parties who argued opposed the concept of the proposal, but reluctantly (our characterization) supported the proposal as a means of obtaining severely needed gas supplies for southern California, though many of the parties, including the staff, suggested certain conditions to be placed on the contract.6/ The California Manufacturers Association and Southern California Edison Company opposed any form of rate spread for this proposal which would penalize their clients, as they would be entitled to minimal, if any, deliveries when this gas began to flow. Many alternate rate structures were discussed. The staff and SoCal submitted alternate rate structures which exempted residential customers, or exempted the first hundred therms of service, or increased the first hundred therms less than the remainder. All other appearances supported a uniform cents-per-therm rate spread at this time.

6/ ARCO and SoCal testified that any conditional approval of the funding agreement, other than already agreed, would be unacceptable.

Discussion

We are accepting the proposal for one reason only: necessity. We see no alternative means for assuring an adequate supply of natural gas for California. Under any other circumstances, we would readily reject a plan so ill-defined and unfair. ARCO has informed SoCal and the Commission that, in the event this plan is rejected, ARCO will sign a similar agreement with an interstate pipeline company, and California will lose all or a large fraction of the gas supply. We have substantial reason to believe this to be the case. The Prudhoe Bay gas producers are attempting to circumvent FPC regulation by, in effect, offering the gas to the highest bidder in an auction in which the sellers are few and the buyers are desperate. While we hope that the FPC will reject such transactions, and that it will abolish its prepayment program, we have no basis for predicting future FPC action. Thus we are faced with a choice between accepting a proposal which we regard as unconscionable, or rejecting it and placing our faith in some as yet unborn scheme of federal allocation to assure California's gas supply. With great reluctance, we have chosen the course of prudence. The stakes for California are simply too high for us to refuse to deal on the terms the producers have established. We do wish, however, to record our strong disagreement with the regulatory policies which have made this decision necessary, and our specific conviction that the terms of the proposed gas purchase contract are not in accord with the Natural Gas Act.

The basic character of this transaction, and the Order No. 499 transactions between Prudhoe Bay gas producers and interstate pipelines, is the same: in each case, the ratepayer is asked to supply risk capital to a multinational oil company, through the intermediary of a utility or a pipeline. We do not feel it is appropriate for ratepayers to be made involuntary investors in oil and gas development, much less in the "general corporate purposes" for which ARCO is seeking the funds.

But the difficulty we face is that the FPC has, in the past, approved prepayment transactions similar to this. The asserted reason has been to supply risk capital, otherwise unavailable, for natural gas exploration. The real effect, in our opinion, has been to provide an extra bonus on top of the regulated price of natural gas.

We are sympathetic to the argument that the regulated FPC wellhead price of new natural gas has been kept unrealistically low; even more, regulatory policies have been chaotic and uncertain. Thus there is real reason for concern about the unavailability of adequate venture capital for natural gas exploration. But the solution, we submit, is to provide a realistic, firm, and predictable wellhead price, rather than a series of makeshift contrivances.

We can understand why gas producers, dealing with realities rather than ideal solutions, should pursue advance payments if the FPC makes them available. We do not criticize ARCO for taking advantage of this program. We do, however, believe that ARCO and the other Prudhoe Bay gas producers are overreaching in the terms of the deal they have proposed.

Specifically:

Treatment costs and ownership of by-products. ARCO's proposed contract terms would have SoCal pay for the high cost of gas conditioning, while giving ARCO the option to take all the by-products separated as a result of the conditioning process. We will urge the FPC to reject this one-sided arrangement by reestablishing the delivery point of the gas and by treating the value of the by-products as a credit against the cost of gas production.

Price under regulation. Rather than stipulating the price under regulation as the applicable FPC just and reasonable price, the proposed contract attempts to provide the possibility of a higher price. We will urge the FPC to set a single, firm price for Prudhoe Bay gas.

In addition to FPC review of the gas purchase contract, we intend to review the contract to insure that there will at least be no further disadvantaging of the buyer.

<u>Credit for advance payments</u>. We feel that the full value of the money advanced by SoCal, including interest to the time of gas delivery, should be a credit against the regulated price for the gas. Since that price will be based on producer costs, including debt service and return on capital, full allowance should be made for costs which will have been borne by SoCal's ratepayers rather than by ARCO.

<u>Deregulation</u>: For over two decades, the gas producers have attempted to eliminate federal regulation over wellhead prices. Recently, many observers have come to the conclusion that wellhead regulation was doing more harm than good. Some members of this Commission who are joining in this opinion have expressed that view. But they have been forced to reconsider as a result of this transaction.

The outline of a proposed purchase contract contemplates a price, in the event of deregulation, set according to the highest of three measures: (a) the highest price obtained by any producer in any other substantial, long-term Prudhoe Bay contract; (b) the commodity value of the gas less treating and transportation costs; (c) a negotiated minimum price not otherwise defined. The key term is the first, known as a "most favored nations" clause. Quite simply, it states that ARCO will receive not only what it negotiates for, but any higher price received by any other Prudhoe Bay producer. The other producers' contracts contain similar terms. Under this clause the price of gas will be set, not at a bargaining table, but in a hall of mirrors. The price arrived at by the most desperate buyer, dealing with the most powerful seller, will be the price for all.

Such a clause might be less worrisome if there were many competitive sellers who could serve a market; scholars have argued that, in the past, the domestic market for natural gas has been more competitive on the sellers' side than on the buyers'. If ever true, this argument no longer holds. Four major companies control the Prudhoe Bay gas supply, by far the largest reserve of natural gas uncommitted to the United States market. Alternative major supplies involve risks of technology and international relations, as well as future regulatory policy. Bluntly, "most favored nation" pricing in Prudhoe Bay is cartel pricing.

In discussions with ARCO, our staff has pursued alternatives to the "most favored nations" clause. ARCO rejected all such alternatives (although it did discuss minor modifications of the most favored nations clause, which it finally refused as well). The choice, then, seems to us to be a simple one: either the price for Prudhoe Bay gas will be set by five Federal Power Commissioners, or by four oil companies. Whatever the frailities of regulation, we are unwilling to risk the consequences of a monopolistic market. We urge Congress to oppose deregulation of natural gas.

Tax Treatment. The possible adverse federal income tax consequences and the resulting "two for one" effect have been described above. Because of the unsettled state of the tax issue we have included in our order certain provisions intended to safeguard the ratepayers' interest in the revenues collected on account of the prospective tax liability.

We emphasize our own position on this issue: The "interest payments" are nothing more than advance payments from the ratepayers to the gas producers for the gas. The purpose of these payments is to avoid the regulation of gas prices by the FPC - the producer collects the regulated price, plus the advance payments (assuming regulation). In our view the payments to the gas company become income to the gas company at the time that the gas starts to flow. The total amount of the advance should be amortized on the basis of the life of the contract and the "income" attributable to these advance payments should be allocated accordingly. We contend that the income effect must be deferred to this future period, and we expect SoCal to aggressively make this contention, and others, while exhausting its legal remedies on this matter.

In our order we require SoCal to take the revenues allowed for possible federal income tax liability and to place those funds into separate accounts created for this sole purpose. We require SoCal to file within 30 days its own proposed program for the placement of these funds. There shall be no payments of these funds to any person for any purpose without prior Commission approval and the order so provides. We order SoCal to litigate with the Internal Revenue Service in the event of an adverse ruling on its proposal. We commit this Commission as a party on behalf of the California ratepayers in the event of such litigation. We invite the other parties to this proceeding to make similar commitments.

Conclusion: Conservation Program.

We wish to make clear that none of our criticisms are meant to apply to SoCal or its affiliates, which have faced the difficult problem of negotiating for a vital resource in dwindling supply. It is SoCal's obligation, which it has pursued vigorously, to explore all possibilities for supply. It is also the company's obligation to pursue, with at least equal vigor, all possibilities for conservation to lessen our dependence on exotic technologies or arbitrary terms. We commend SoCal's conservation efforts to date, and we note that our decision to approve this new, extremely expensive source of supply is made in large part because we feel SoCal recognizes its paramount responsibility to encourage conservation. In the future, the vigor, imagination and effectiveness of a utility's conservation efforts will play a key role in all our decisions on supply authorization and rate relief. Where available, we plan to develop quantitative measures of these efforts (for example, the number of homes insulated as a result of a company's programs); where quantification is impossible, we plan to make an informed subjective evaluation of the utility's conservation efforts. The effort we expect is not limited to exhortation, advertising, and traditional means for promoting conservation. We expect utilities to explore all possible cost-effective means of conservation, including intensive advisory programs directed at large consumers, conservation-oriented research and development, subsidy programs for capital-intensive conservation measures, providing customers with detailed, intelligible information on appliance energy use by brand name ("shoppers guides"), appliance service, repair or retrofit by utility representatives.

Findings

1. There is now and shall continue to be a shortage of natural gas in California.

2. The North Slope gas shall be needed by California ratepayers when it begins to flow.

3. SoCal's proposal is a means of obtaining a dedication of proven reserves of North Slope gas for the long term.

4. The proposal, though expensive, is necessary to obtain a dedication of the subject gas and warrants our approval.

Conclusion of Law

The public interest requires the granting of this application.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company is authorized to adjust its rates as necessary to reflect its participation in a funding agreement to secure certain rights to Alaskan natural gas as proposed in its application, including refund provisions.

2. Southern California Gas Company is authorized to give its consent to an assignment to Atlantic Richfield Company by Pacific Lighting Gas Development of certain rights pursuant to an agreement related to the funding agreement as proposed in its application.

3. Southern California Gas Company shall physically segregate, as collected, all money authorized by this order for federal income tax liability.

4. Southern California Gas Company shall not disburse the money segregated for federal income tax purposes pursuant to Ordering Paragraph 3 for any purpose without further order of this Commission.

5. Within thirty days from the effective date of this order Southern California Gas Company shall present a plan for the Commission's approval setting forth its method of segregating the federal tax money, its plan of investment, and the institutions to be utilized as depositories.

6. Southern California Gas Company shall affirmatively contest any alleged federal income tax liability arising from the collection of money pursuant to this order.

7. Filings for adjustment of the NAFA surcharge authorized herein shall be made semiannually, on October 1 and April 1 of each year by the filing of an application.

8. Within thirty days after the effective date of this order Southern California Gas Company shall file proposed tariff schedules and serve copies thereof on all appearances in this proceeding. Such tariff schedules shall become effective on October 1, 1975, unless modified or suspended prior to said date by further order. Such tariff schedules shall comply with General Order No. 96-A and shall apply only to service rendered on and after the effective date of the schedules.

The effective date of this order is the date hereof.

Dated at San Francisco, California, this 1st day of AUGUST, 1975.

President

William Symons Jr.

Vernon L. Sturgeon

Leonard Ross

Robert Batinovich

Commissioners

Commissioner D. W. Holmes, being necessarily absent, did not participate in the disposition of this proceeding.

APPENDIX A

LIST OF APPEARANCES

Applicant: Jeffrey A. Meith, Attorney at Law.

Protestants: Hyman Finkel, for Seniors for Legislative Issues; Sylvia M. Siegel, for Toward Utility Rate Normalization; and Charles J. Salinas, for himself.

Interested Parties: William A. Norris and Ronald C. Peterson, Attorneys at Law, for Atlantic Richfield Company; Leonard L. Snaider, Attorney at Law, for Burt Pines, City Attorney, for the City of Los Angeles; Frederick H. Kranz, Jr., Attorney at Law, for Los Angeles Department of Water and Power; Robert W. Russell, for Los Angeles Department of Public Utilities and Transportation; John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for City of San Diego; Henry F. Lippitt 2nd, Attorney at Law, for California Gas Producers Association; Brobeck, Phleger & Harrison, by Gordon E. Davis and Thomas G. Wood, Attorneys at Law, for California Manufacturers Association; Robert J. Henry, for VFW., Old Age Pensions, etc.; Robert E. Woodbury, Robert J. Cahall, William E. Marx, H. Robert Barnes, Attorneys at Law, for Southern California Edison Company; Malcolm H. Furbush and Gilbert L. Harrick, Attorneys at Law, for Pacific Gas and Electric Company; McCutchen, Doyle, Brown & Enersen, by Graig McAtee, for Exxon Corporation; Jules Kimmett, for himself; Chickering & Gregory, by Donald Richardson and David A. Lawson, for San Diego Gas & Electric Company; Gordon Pearce, Attorney at Law, for San Diego Gas & Electric Company; Robert David Breton, for Jay Shavelson, for the Attorney General of the State of California; and A. Barry Cappello, Attorney at Law, for the City of Santa Barbara.

Commission Staff: Lionel B. Wilson, Attorney at Law, and Greville Way.