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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company and Pacific Lighting Gas Supply Company for Authorization to Include Purchase Gas Costs Relating to the Pitas Point Offshore Project in the Approved PGA Procedure Pursuant to Commission Decision No. 83160	Application 82-07-21 (Filed July 9, 1982)

(See D.82-10-040 and D.82-12-047 for appearances.)

O P I N I O N

Summary

Southern California Gas Company (SoCal) and Pacific Lighting Gas Supply Company (PLGS), also jointly referred to as SoCal, request authorization to include in SoCal's Purchased Gas Adjustment (PGA) procedure gas costs of a new long-term supply known as the Pitas Point Project. This decision grants SoCal's request. However, the Commission notes that the contract with the gas producers contains contractual provisions which could cause the price of this gas to become uneconomical to the ratepayer. Accordingly, SoCal is put on notice that failure to eliminate these contractual provisions could expose it to cost disallowance in future proceedings.

Procedural Summary

This application was consolidated for hearing with Phase II of A.82-09-12, SoCal's Consolidated Adjustment Mechanism (CAM) application. Public hearing was held before Administrative Law Judge Bertram Patrick in San Francisco.

Testimony for SoCal was presented by R. K. Landers and L. K. Harrington. Testimony for the Commission staff was presented by D. L. King. Following oral argument, this matter was submitted on October 22, 1982.

Description of Project

The Pitas Point Project involves the purchase and transportation of dry gas by PacInterstate Offshore Company (Offshore) from Texaco Inc. (Texaco) and Union Oil Company of California (Union) from a recently erected platform, Platform Habitat, owned by Texaco and located in federal waters, approximately 8.2 miles offshore Carpinteria, California. The gas is jointly owned by Texaco and Union, the shares of ownership being approximately 38% for Texaco and 62% for Union. Texaco is the unit operator.

The project requires Offshore to construct a pipeline from the Platform Habitat to 530 feet inland of the shore. Offshore's facilities will include 8.2 miles of 12-inch offshore pipeline and 540 feet of 12-inch onshore pipeline. This pipeline will connect with a metering and odorization facility and 1,840 feet of 12-inch pipeline owned by PLGS. The gas will be delivered by PLGS to SoCal's existing 16-inch diameter Line No. 1004. The investment by Offshore and PLGS is approximately $16.5 million and $800,000, respectively.

Offshore was formed specifically for this Pitas Point Project. It will be an interstate pipeline transmission company under Federal Energy Regulatory Commission (FERC) jurisdiction. It is a wholly-owned subsidiary of Pacific Interstate Company, which is, in turn, a wholly-owned subsidiary of Pacific Lighting Corporation, the parent company of SoCal and PLGS.

The sale of the gas to Offshore will be pursuant to gas sale and purchase agreements between Texaco and Union and SoCal's affiliate, Pacific Offshore Pipeline Company dated December 29, 1981 and October 1, 1981, respectively. These gas sale agreements were subsequently assigned to Offshore which will, after purchase from

Texaco and Union, make the sale of the gas to PLGS which, in turn, will sell the gas to SoCal. Under the gas sale and purchase agreements, Offshore as buyer will receive, over a fifteen-year period, a minimum of two-thirds of the gas production from Platform Habitat.

The agreements with the producers (Exhibit 31) provide that Texaco and Union each have the right to sell the remaining one-third of their production to Offshore on a contract-year basis by giving ninety days written notice. The producers have exercised this right for the first year of the contract.

The Pitas Point supply represents about 1% of SoCal's annual purchases. Compared to SoCal's principal supplies, El Paso at 37.6¢ per therm and Transwestern at 42.0¢ per therm, at this time Pitas Point is competitively priced at 36¢ per therm. (Exhibit 58). The anticipated annual deliveries of gas, based on reserves proved up to the time of filing this application, will be 10,215 MMcf in the first year increasing to 13,680 MMcf by the third year. Significant additional reserves may be confirmed as a result of the producers' drilling program.

SoCal's Position

SoCal requests the Commission issue an order providing PGA and balancing account treatment for the Pitas Point gas costs and a finding that the purchase of the natural gas by PLGS from Offshore and by SoCal from PLGS meets the Commission's economic guidelines for long-term gas supplies.

SoCal also requests the Commission to state at the outset whether this project is prudent and if such a determination is made, SoCal seeks assurance that it will not be later penalized for making such a purchase. In the event the project does not meet the economic test, SoCal requests that the Commission provide guidelines as to what aspects would require change. SoCal notes that in attempting to renegotiate the contract, it risks losing the supply.

SoCal's economic analysis of the cost of the Pitas Point supply is set forth in Exhibit 38. Because of the uncertainty created by the FERC on incentive prices for deepwater gas, SoCal calculated the wellhead price of Pitas Point gas based on several scenarios: (1) a "contract price", the price actually contemplated by the parties when the original contract was signed; (2) a proposed incentive for deepwater gas which would set the FERC ceiling at 65% of the national refiners' acquisition cost of crude oil; (3) an incentive price of 150% of the Natural Gas Policy Act (NGPA) Section 103 ceiling; (4) a "worst case scenario", namely an incentive price of 200% of the NGPA Section 103. According to the assumptions made by SoCal, the 15-year weighted average cost of gas based on the contract price delivered at the California Border is $6.835/MMBtu; with a 65% of crude incentive price it is $6.066/MMBtu; with a 150% of Section 103 incentive price it is $6.539/MMBtu; with a 200% of Section 103 incentive price (worst scenario) it is $8.584/MMBtu. As a comparison, the 15-year weighted average cost of crude oil is $8.695/MMBtu. Based on this analysis, SoCal submits that the Pitas Point gas meets the Commission's economic test for new supplies.

Staff Position

Staff recommended that the Commission authorize the inclusion of Pitas Point gas in SoCal's PGA/CAM. However, staff further recommended SoCal be put on notice that failure to eliminate the risk that the price of Pitas Point gas will exceed the Commission's economic test will expose SoCal to cost disallowances in subsequent reasonableness review proceedings.

Staff did not take exception to SoCal's analysis which concluded that over the 15-year life of the project, the Pitas Point gas supply represents a prudent acquisition under the Commission's economic test. On the other hand, staff notes that different, but equally plausible assumptions regarding future petroleum refinery acquisition costs, combined with the potential for deepwater incentive pricing of up to 200% of the NGPA Section 103 ceiling price, could result in the imprudent acquisition of a long-term gas supply.

Staff suggests that since the project has not yet been certificated by the FERC, an opportunity exists for SoCal to eliminate the risk of potentially excessive gas costs through a renegotiation of the pricing provisions of the gas purchase contracts, based on changed circumstances because the potential for deepwater incentive pricing was not recognized at the time the pricing provisions in the present contracts were agreed upon. Although the staff does not recommend that the Commission dictate contract provisions for SoCal, the staff witness indicated that a contract clause which provides for a wellhead price no greater than 70% of the composite U.S. petroleum acquisition cost, upon deregulation, and further provides for a current price which is the lesser of the deregulated price or the applicable NGPA ceiling, would assure the delivery of Pitas Point gas to SoCal at a price below the threshold of presumed imprudence under the Commission's economic guideline.

Staff's 70% figure takes into account the relatively low cost of transporting Pitas Point gas to SoCal's system. Since the alternative to this gas supply is LSFO, staff believes that such a price ceiling would assure that Pitas Point gas will always be competitively priced at the burner tip.

<u>Discussion</u>

There is no disagreement that SoCal has a need to acquire new long-term supplies of competitively priced gas to meet the need of its customers in the southern California market area. Therefore, the issues relate to the economics and contractual provisions related to this gas supply.

D.83160 authorized establishment by SoCal of its PGA procedure which provides an administratively practical mechanism for adjusting rates in a timely manner to reflect changes in prudently incurred gas costs.

In approving the PGA procedure, we directed SoCal to seek specific authorization from this Commission to add costly new increments to its basic gas supply (Finding 15). Subsequently, in D.82-04-116, we set forth an economic test for determining the prudency of acquisition of new long-term gas supplies as follows:

> "If the net cost of a new gas supply at the California border exceeds the cost of imported crude delivered to California refiners over the life of the gas supply project, acquisition of that gas supply will create a presumption of imprudency. (Finding 28, page 81.) D.82-04-116."

At page 57 of the same decision (D.82-04-116), we stated:

> "Our adoption of an economic test for new long-term gas supply projects should not be construed as a prejudgment of economic issues to be raised in future supply project certification proceedings. Consistent with its constitutional responsibilities and its own practices and procedures, the Commission will make a de novo review of an application for certification of a new gas supply project under the circumstances existing at the time of the filing. It is a practical, if not legal, maxim that we cannot bind the actions of a future Commission.
>
> "Nor are we attempting the impossible task of devising a single economic test which will universally encompass all of the economic factors which should be considered in determining the prudency of a future gas supply project. Rather, our adoption of the staff's test, which is the most reasonable alternative based upon review of the record evidence, should serve as a useful planning tool for SoCal.

> "The economic test is intended as a signal to SoCal and perhaps indirectly to SoCal's suppliers that "gas at any cost" is not an acceptable gas acquisition policy in California. It is our signal that we expect SoCal to demonstrate that it has made a rigorous economic analysis long before it comes before this Commission requesting certification of a new gas supply project. SoCal will be expected to employ the economic test in planning future supply acquisitions, in negotiating with its domestic and foreign suppliers, and in requesting certification of new supply projects before FERC.
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> "Of course, we cannot bind the actions of SoCal in planning, negotiating, and applying to FERC for acquisition of new gas supplies. However, this Commission can state that in any future proceedings in which SoCal asks approval of costs associated with new long-term gas supply projects, SoCal will be expected to demonstrate that it considered the adopted economic test in the planning, negotiating, and certificating phases of acquiring the new gas supply. Failure to so demonstrate will create a presumption that the new gas supply purchases are imprudent."

On February 5, 1982, Offshore filed an application with the FERC for a certificate of public convenience and necessity under Section 7(c) of the Natural Gas Act, requesting authorization for the transportation and the sale for resale of this gas. Offshore expects to receive its necessary federal authorizations to proceed with this project in the near future.

Since it is not necessary for SoCal to apply to this Commission for certification, our observations concern the economics of the project and the reasonableness of long-term gas costs.

At this time, we will permit SoCal to include Pitas Point gas costs in the PGA/CAM; however, we cannot give SoCal assurance that it will not be later penalized if Pitas Point gas costs are not economical over the life of the project.

We now turn to a discussion of the contract provisions which cause us concern.

The price agreed in the Pitas Point contracts (Exhibit 31) is a price equal to the maximum lawful ceiling price under the NGPA, including incentive prices under Section 107, plus any allowed increases in the price and add-ons.

Effective January 1, 1985, about one-sixth of the Pitas Point gas will be deregulated. Upon deregulation, the applicable gas shall be priced at the higher of 85% of the Btu equivalent of No. 6 fuel oil, as reported by Southern California Edison Company (Edison) and San Diego Gas & Electric Company (SDG&E) on FERC Form 423, or the highest price paid by Offshore or any other pipeline companies for gas under similar delivery conditions from offshore California between a line drawn due south from Point Dume and the line which is the northern boundary of OCS Sale 48 held June 29, 1979. If neither of the previous two pricing schemes are applicable or allowed, then the price will be $4.75 per decatherm as of October 1, 1981, which price will increase each quarter thereafter by an amount equal to 1-1/2% above the price then in effect.

Our concern is that SoCal has not provided itself with a market-out clause which releases it from the contract take-or-pay provisions if the price of Pitas Point gas does not continue to remain economically priced at the burner tip compared to the price of alternate fuel, No. 6 LSFO.

Further, we note staff's concern that deepwater incentives and add-ons which SoCal will be forced to pay could cause the FERC-regulated portion of this supply to become uneconomically priced. Therefore, staff's suggested cap on wellhead prices is another approach for SoCal to consider in renegotiating this contract.

Turning to the portion which will be deregulated, we note this portion is subject to a favored nation clause and a clause tying prices to Edison's and SDG&E's Form 423 oil prices. These clauses could cause Pitas Point gas to be uneconomically priced if oil prices do not increase as expected by SoCal. Further, we are at a loss to understand why Form 423 oil prices were adopted as an escalator when it is generally known that Edison and SDG&E are attempting to renegotiate these oil contracts to reflect falling world oil prices.

We note that on August 6, 1982, W. B. Wood, Jr., President and Chief Executive Officer of PLGS, testified before the U.S. House of Representatives House Committee on Energy and Commerce. In his testimony, Wood denounced such practices as take-or-pay clauses,[1] favored nation clauses,[2] and indefinite escalator clauses.[3] He further noted that unless modified, these contract clauses in pre- and post-NGPA contracts will result in instant and massive price increases which will not reflect market forces. We further note that the same type of contract clauses, which Wood spoke against, are included in the Pitas Point contracts with the producers.

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[1] Take-or-pay clauses obligate the purchaser to pay the producer for a specified volume or percentage of production from a well, whether or not the purchaser actually takes delivery.

[2] Favored nation clauses obligate the purchaser of the gas to pay the producer the highest price paid to other producers within a defined area.

[3] Indefinite escalator clauses tie gas prices upon deregulation to certain fuel indexes.

Wood also noted that:

> "New gas purchases must stand on their own. This means wellhead prices must reflect the cost of competing fuels in the marketplace, and the costs of transporting and delivering the gas to the ultimate customers."

Based on Wood's testimony, we can only conclude that SoCal is now well aware of what is unacceptable in the contracts which have been negotiated with the producers. Therefore, it is hardly necessary for this Commission to advise SoCal how to renegotiate these contracts. It is up to SoCal to make sure it does not have to take and pay for gas which is not economically priced at the burner tip.

Findings of Fact

1. There is a need for SoCal to acquire new long-term supplies of competively priced gas.

2. The Pitas Point gas supply, at this time, is competitively priced and should be included in SoCal's PGA/CAM.

3. The gas supply contracts, as presently framed, contain price provisions which could result in an uneconomical gas supply to SoCal's customers over the life of the project.

4. Because the pricing provisions contained in the Pitas Point contract are variable and subject to potentially wide fluctuations, the Commission is unable to determine whether Pitas Point gas will satisfy the economic test for large new increments of supply over the life of the project.

5. Failure to eliminate the risk of an uneconomical project through a renegotiation of the pricing provisions of the gas purchase contracts will expose SoCal to gas cost disallowance in subsequent annual reasonableness reviews if the present pricing provisions result in delivery of gas to the SoCal system which is uneconomical.

Conclusions of Law

1. It is reasonable at this time to include the cost of Pitas Point gas in SoCal's PGA/CAM.

2. The following order should be effective today since there is a need to expedite further contract negotiations.

O R D E R

IT IS ORDERED that, consistent with this decision, Southern California Gas Company and Pacific Lighting Gas Supply Company may include costs of Pitas Point gas supply in their PGA/CAM.

This order is effective today.

Dated March 16, 1983, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Joseph E. Bodovitz, Executive Director

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