

CONTRACT REGIME IN GAS AND OIL MATTER IN THE USA

Daniel Wm. FESSLER

SUMMARY: I. *Introduction*. II. *Understanding your neighbor's circumstances and perspective*. III. *Some useful vocabulary references*. IV. *The market structure serving California*. V. *The reform agenda*. VI. *Acquiring the physical infrastructure*. VII. *Refocusing regulation*. VIII. *The federal agenda*. IX. *California's New Regulatory Framework*. X. *The increasing role of contracting*. XI. *Mexico's challenge/Mexico's choice*. XII. *Appendix A*.

I. INTRODUCTION

Permit me to begin with an expression of gratitude for having been included as a participant in this seminar. The title of Visiting Professor at this most illustrious University ranks as one of the most prized recognitions I have ever received. Placing my appearance in context, I note that over the course of the past several weeks you have delved into a variety of topics affecting energy markets and, in the process, contributed substantially to articulating Mexico's maturing role as both a provider and consumer. I also applaud your vision which adopts a North American perspective in the assessment of both promise and problems inherent in this vital field. I share that judgment. In the course of my service on the California Public Utilities Commission I have sought to promote a perception of my state and its thirty four million inhabitants as part of a regional, transnational market for energy services and products.

Your gracious invitation was premised on my experience with the Commission but also embraced my near quarter of a century as a professor of contract law at the University of California. Drawing upon this dual background you defined a task which, at first glance, is imminently reasonable. You have asked that I speak of the role of contracts in both the oil and gas markets. I intend to do so, but am forced by my many limitations to tailor a presentation which may fall well short of your opti-

mistic, if not charitable, assessment of my abilities. As you are about to learn in some detail, my experience with these subjects has given me a somewhat developed theoretical understanding of contract law and an academician's perspective on the customs and mores of modern commercial practice.

My duties at the Commission have acquainted me with the fundamentals of the natural gas industry. My knowledge of the oil industry is less satisfactory. In the classroom the political and developments centering on petroleum in the 1970's are used as a case study in dramatic change which forced the development of the law of commercial impracticability and tested the practical application of the concepts of breach and excusable non-performance.¹ Nothing in my public life has occasioned a study of emerging trends in the oil industry for its affairs are conducted beyond the purview of my Commission's jurisdiction. Further, my knowledge of the gas industry is strongly colored by my service on the Commission where I seek to guard the interest of the many millions of consumers who use natural gas as a domestic heating fuel in addition to critical industrial, commercial and agricultural pursuits. Equally important to me are the emerging markets for the commodity as the environmentally dictated fuel for generating electricity, and as a propellant for a new generation of transportation vehicles. In the context of these many alternative uses, contracts are vital in linking producers with end users and defining use of transportation and storage infrastructure as well as the role of such market participants as aggregators, brokers and local distribution utilities.

Yet a description of the realm of contract would leave you with an excessively theoretical perspective. In order to understand the natural gas industry may I respectfully suggest that you must first focus on the circumstances of the potential market participants and the social or political objectives which they have defined for accomplishment. It is only in this setting that one can appreciate the risks as well as the rewards of private conduct. There is nothing original in this thought. It was better expressed

1 The sweep of the unfolding events is sometimes reflected in the fact pattern of a single case. See, for example, *Eastern Air Lines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429 (1975). The dispute surrounded the obligations of the buyer and seller under a requirements contract for aviation fuel which had been renewed for a five year period in 1972. By March, 1974 the economic terms were being assailed by the seller as hopelessly at odds with the post-OPEC world. For a summary of the facts, contentions of the parties and judgment of a talented United States District Judge, see Appendix A.

more than two hundred years ago by the Scottish wit and skeptic, David Hume who observed that: “As the obligation of promises is an invention for the interest of society, it is warped into as many different forms as that interest requires, and even runs into direct contradictions, rather than lose sight of its objet”.² To assist us in firts framing and then keeping that objetct in sight, and recognizing that you have a Californian as a guide, may I suggest what we begin by recapturing the goals of the State of California with respect to its regional role in the natural gas industry. We will then examine the structure which both public and private interests have put in place to realize those goals at which point I will briefly recap the highlights of the implementation efforts wherein that structure has been deployed in quest of those objectives. Only then will I step back and share my perspective on what as been accomplished to date in California. Finally we will arrive at the point which makes all of this discussion relevant to you: the opportunities which flow from Mexico’s recent decision to build natural gas distribution facilities in the State of Baja (California) as extensions of this infrastructure. It is appropriate that I end my talk at that point for the next critical chapter will reflect your goals and strategic choices and, in turn, will define the role of contracts as Mexico begins to influence and shape our shared market.

II. UNDERSTANDING YOUR NEIGHBOR’S CIRCUMSTANCES AND PERSPECTIVE

From the vantage point of bestowing natural resources there is strong evidence that God has a tender regard for Mexico. There are alarming indications that He has forgotten California. At the human level what cannot be forgotten is California’s historic and future role as the major consumer in its regional market. Virtually every other jurisdiction, save for the State of Baja (California), is a net exporter of energy in general and natural gas in particular. By contrast, California is the largest importer of gas in North America. We are less than 15% self-sufficient in terms of our daily need for the commodity and that sobering circumstance will never change. The regional impact of our frank dependency is startling. Sixty percent of the natural gas consumption in the western United States is accomplished within my state.

2 See generally, Hume, David, “Of the Obligation of Promises”, *Treatise of Human Nature* (quoted and discussed in Fessler and Loiseaux), *Contracts; Morality, Economics and the Market-place*, West Publishing, 1982, pp. 21-22.

III. SOME USEFUL VOCABULARY REFERENCES

When I arrived at the Commission in 1991 I soon learned that each of the regulated industries —energy, telecommunication and water— had developed a specialized vocabulary. As I generalist with a policy objective of making the issues understandable to the broadest number of citizens, I have spent nearly six years in a largely unsuccessful attempt to translate the discussion into everyday terminology. The strongest evidence for my failure is the suggestion that I am about to make that we learn and employ some of the more descriptive terms as we seek a policy perspective on the industry. Parties who desire to contract in this context will have to go well beyond our initial efforts to familiarize themselves with the language as well as the emerging customs and mores of this realm of commerce. Let us concentrate our attention on terms which depict the industry both in terms of the implicated governmental jurisdiction as well as its fundamental physical characteristics.

Issues of jurisdiction and governmental authority were relatively unimportant in the period 1802-1920 because society's early experience using gaseous fuels for lighting and heating was with a very different commodity. Manufactured or "towns gas" had been discovered in England as a derivative of coal. This circumstance was critical to the early success of the fuel given available transportation technologies. Railroads could be employed to move the coal significant distances from the point of production to urban centers. Such an infrastructure was useless for the movement of a gaseous commodity which was not only lighter than air but also flammable and explosive! Early applications of small diameter pipe proved useful in local distribution of this derived methane [CH₄] where it achieved widespread success in municipal and domestic lighting applications. Yet it was precisely this success which prompted an economic analysis which has dominated the subsequent history of the commodity. John Stuart Mill is credited with being the first to observe that fundamental economics of gas distribution exhibited the characteristics of a natural monopoly.³ Through a strong proponent of competitive markets, Mill concluded that the market for this commodity would be characterized by qualities that rendered rival offerings wasteful. A town gas industry required a large initial investment in infrastructure. The deployment of the infrastructure would be disruptive to the urban population and, once in-

3 See, Mill, J.S., *Principles of Political Economy*, 1848.

stalled, would present significant safety hazards. Finally, the advantage of this infrastructure to both the owner and society would increase over time with the addition of more and more end users.

Mill may have put forth the theoretical case for a “natural monopoly” but it would take positive governmental intervention to translate theory into the award of an “exclusive franchise”. And it was the exclusive franchise which nullified the try anything aspirations of rival town gas purveyors. This move to a government sanctioned monopoly had a safety justification which swept beyond the pursuit of economies of scale. And it was these twin concerns that were mirrored in the assumption of essentially local governmental control over the terms of the franchise. The town gas monopolist was granted a privilege of exclusive presence in exchange for an assumption of the duty to serve the local populace with safe, reliable service at reasonable rates.

In the United States jurisdictional issues erupted as the industry began to expand its geographic scope. While the limits of local franchise control were tested by the ambition of town gas providers to extend service beyond the municipal boundaries, the truly innovative developments were made possible by dramatic improvements in transportation which, in turn, made possible the shift from derived methane to natural gas. The breakthroughs came in the use of high tensile strength steel in the fabrication of pipe and the application of electric welding techniques to piece together this durable material into a pipeline which could be buried in the ground, extended over long distances and difficult terrain, and pressurized so as to propel a gaseous content. For the first time natural gas, an almost inevitable by-product of oil extraction, could be moved hundreds, even thousands of miles from points of production to the urban centers where the economies of scale justified a distribution system. The advantages of natural gas over methane were numerous. It had a higher BTU content which not only made it more suitable for established uses but extended the range of industrial applications. Given the massive scale of oil extraction, the sudden ability to derive income from the sale of what had been a waste product flared at the wellhead led oil producers to offer natural gas at prices which undercut the production costs of town gas. The manufactured methane industry died.

The jurisdictional implications of the death of one industry and the birth of a successor were, from the perspective of the politician or lawyer, equally startling. It was now possible for natural gas to be gathered and conditioned for transport in one state, moved across the territory of inter-

mediate states and delivered at the “city gate” of the urban center which, until recently, had regulated the town gas monopolist.

Each of the implicated governments could and did assert a legitimate jurisdictional claim. Government authority in the state which hosted production worried about the depletion of a now valuable asset as well as safety concerns with the gathering and other infrastructure built on a scale made rationale only by a distant market. There was also a local economic or business development issue: how would sales to these non-state interests affect the price of the commodity in local markets? The intermediate states crossed by the transportation pipelines had land use and safety concerns but also entertained ambitions to develop distribution facilities to serve local populations. Finally, the urban government which had totally dominated the presence of the wholly contained town gas industry was forced to admit that it had been reduced to the status of superintending what were essentially distribution facilities only. But it, too, had concerns with safety and the pricing of the commodity in the market which had justified the elaborate infrastructure. Thus were born the potentially conflicting claims federal *vs.* state and local authority over “inter *vs.* intrastate” natural gas transactions, as well as the conflicting ambitions of producer *vs.* consumer jurisdictions. If this were not sufficiently complicated, post war developments in western Canada were soon to lend international issues to the jurisdictional puzzle.

This spreading infrastructure also attracted the descriptive efforts of those interested in economics and markets rather than focusing on jurisdiction and regulation. Thus we find a second useful set of vocabulary references. Writers who began to describe and debate the characteristics of the resulting markets drew an analogy to a physical “stream of commerce”. It became fashionable to speak of the producers and gathering infrastructure as occupying the “upstream” position. End users and local distribution infrastructure were “downstream”. Insofar as I have been able to determine, this casual descriptive terminology was not completely extended for I am unaware of a popular usage that referred to the pipeline which moved the gas under compression as the “stream”.

IV. THE MARKET STRUCTURE SERVING CALIFORNIA

Adopting this terminology, the circumstances of California as chief consumer and ultimate downstream end user of natural gas were hardly

encouraging. An overview framed at the beginning of the 1980's revealed that California had developed two essentially isolated distribution infrastructures. In the north natural gas customers were wholly dependent upon Pacific Gas and Electric. In southern California, the dependence was upon Southern California Gas Company and, by extension into San Diego county, San Diego Gas & Electric. When viewed from the vantage point of supply, each system had originally depended upon the production basins in Texas and Oklahoma and a pipeline infrastructure which served the transport function. Shortly after the Second World War, major gas discoveries in western Canada prompted Pacific Gas and Electric to sponsor the development of a rival upstream supply basin and a pipeline to link that basin to its northern California service territory.⁴ There was no comparable development in the south which continued a pattern of near exclusive dependence centered on the Permian and Anadarko Basins.

The natural consequence of placing the largest population of natural gas consumers in the United States downstream of producers and transportation facilities which regarded them as a captured market would have been perilous in the best of regulatory climates. In fact, it was made worse by one of the most inept. Federal intervention, beginning with a grossly flawed decision of the United States Supreme Court in 1954⁵ and continued through the end of the 1970's so distorted the ability of producers to track the fundamentals of supply and demand that the nation had experienced an artificially induced crippling shortage of natural gas in the

4 The nature of the utility's investment in those assets and facilities were to become highly controversial in the 1980's and spawned discord between the Government of Alberta and the California Public Utilities Commission that were resolved as recently as 1994. From California's perspective the "market" which was developed featured the functional equivalent of a producers' cartel dealing with a monopsony buyer (PG&E) and using a transportation pipeline owned by PG&E. In such a stifling atmosphere, the potential for competition among the numerous producers and end users was totally thwarted. Happily, these issues have been largely resolved and the vital trading relationship between Alberta and California in natural gas continued to develop and expand.

5 *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672. The initial federal attempt at regulation had been framed by the United States Congress in the Natural Gas Act of 1938. The target of the 1938 legislation was the interstate pipeline infrastructure and the perception that it constituted a natural monopoly which had to be regulated so as to protect both shippers and consumers from monopoly abuse. The act granted the Federal Power Commission (the precursor of the modern Federal Energy Regulatory Commission) the power to regulate sales for resale in interstate commerce; transportation in interstate commerce; and, facilities used for such transportation and sales. See, 15 U.S.C. § 717.

In 1954 a badly divided Supreme Court interpreted this nearly twenty year old act of Congress and concluded that it obliged the federal government to regulate the sales by producers to the interstate pipelines.

period 1975-77.⁶ The reaction of both politicians and end users was to reduce consumption and shift to rival fuels. By the time the distorting hand of federal regulation began to relax,⁷ producers dramatically expanded production only to find a shrunken demand. The resulting plunge bankrupted many producers and yet the distorted market offered no price relief to disgruntled consumers.

In California, state regulation, predicated on a “cost of service” model, insured that each of these blows would be telegraphed to end users. Our technique was to make the distribution utility, upon whom customers were forced to rely for gas procurement as well as distribution, cost indifferent to the price it paid for the commodity. It simply passed these costs through to customers in rates.⁸ The customer was helpless and the utility indifferent to the containment of cost. Only the most enduring commodity could have survived that combined governmental assault and emerged with a commercial future.

At some point in the early 1980’s my predecessors at the Commission resolved to break out of this cost plus spiral. A strategic reassess-

6 In its attempt to follow the Supreme Court’s mandate that it regulate the terms of transactions between producers and the pipelines, the Federal Power Commission made a number of false starts. Using administrative proceedings to set a maximum rate for each producer predicated upon its historic costs proved totally impracticable. An area rate approach caused the commission to set long term rates predicated upon regulatory assumptions as to the cost of finding and producing gas. When these assumptions proved to be low the impact upon the industry was disastrous from the vantage point of both producers and consumers. Unable to recover in rates their actual costs of exploration and drilling new production simply dried up. Beginning in the mid-1970’s this shortage began to reflect itself with downstream supply disruptions. Those who did not experience disruption were condemned to pay rapidly escalating prices. The combination of loss of reliability and expanding costs drove many users to search for alternative fuels.

7 In 1978 Congress enacted the Natural Gas Policy Act, Pub.L. No. 95-621, 92 Stat. 3351, codified as 15 U.S.C. §§ 3301-3432. The act provided for a gradual deregulation of gas producers. At the same time Congress addressed the shortage by prohibiting the use of gas in many industrial applications and as a fuel in the generation of electricity. The pernicious impact of the deregulation strategy and further curtailment of demand exacerbated the damage to consumers and distributors but also created misery for pipelines. Prices remained high, producers withered in the face of a growing surplus. The predicament for the pipelines grew out of their strategy to deal with the period of shortage. They had signed contracts at high prices with what were known as “take or pay” provisions designed to protect the producers. In a world of curtailed markets, the pipelines were now forced to pay for gas they were unwilling to take because there were no customers able or willing to absorb the supply.

8 The relationship between the California utilities and their supply basins reflected the then prevalent cost of service form of regulation wherein the utilities were simply able to pass onto consumers their cost of acquiring the commodity plus what was in effect, an administration charge. In such a climate the utilities had no incentive to minimize commodity costs and the resulting high price structure reflected these failures of regulatory perspective.

ment of California's consumer posture revealed that it had the potential to become the competitive focus of four production basins; Canada, the Rocky Mountain overthrust, the historic Anadarko and Permian Basins, and the promising coal seam gas reserves centered in northern New Mexico. Two factors precluded an effective exploitation of this potential basin in basin competition. The first was a transportation infrastructure which would allow the shift of customer load to pursue favorable pricing opportunities. The second was a set of regulatory issues beginning with a federal tolerance of vertical integration wherein the existing pipelines combined a transportation function with investment or ownership in certain production sources. From the vantage point of the end user this lethal combination incited the pipelines to further restrict the potential for supply competition by discriminating in favor of affiliate shippers in the allocation of transportation capacity. If the federal government was responsible for regulatory failures in the interstate transportation of the commodity, state regulation could be faulted for blunting the ability of end users to appreciate the cost components of their natural gas charges and respond to price signals.

V. THE REFORM AGENDA

The clearly framed goals of the California Commission in the 1980's centered on the reform of these three anti-competitive features. The cumulative consequences of these reform efforts is what sets the stage for an increased role of private, unregulated contracts to shape the terms of service and, over time, identify successful business strategies in the industry. Let me briefly explain.

VI. ACQUIRING THE PHYSICAL INFRASTRUCTURE

By the time I entered office in February, 1991, the Commission had taken advantage of the explosion in natural gas demand in California to put in place a "let the market decide" policy on new pipeline construction.⁹ The to be predicted result was a rush to build new or expanded facilities from

⁹ *Re Interstate Natural Gas Pipeline Supply and Capacity*, D.90-02-016, 35 C.P.U.C.2d 196 (1990).

The growth in natural gas consumption coincided with an even more dramatic population growth in the period from 1980 to 1992. In slightly more than a decade the number of Californians increased by nearly thirty percent from twenty-five to thirty-two million. In addition to these population statistics, air quality concerns in southern California were compelling an abandonment of oil and the substitution of natural gas as a fuel for electric generation.

each of the historic production basins and to complete an infrastructure which would enable coal seam production to begin to flow toward the California market. By 1994 the necessary physical infrastructure for basin to basin competition was complete.¹⁰

VII. REFOCUSING REGULATION

A regulatory regime which first induced an artificial shortage and then a surplus was devoid of credibility when viewed from the perspective of any segment of the industry. To their mutual credit, both the Federal Energy Regulatory Commission and my predecessors began to devise a reform agenda at about the same time and in pursuit of nearly identical goals. For the federal regulators the task was to withdraw from interference in the affairs of producers and end-users and concentrate on the pipelines as the segment of the industry which threatened monopoly abuse. As I shall explain, the pursuit of this goal took the form of moving the pipelines out of the merchant function and concentrating their activities on transportation. Once this was accomplished, the potential for self-dealing was eliminated. The final step was to define the duty to serve in terms of open access, non-discriminatory provision of transportation services. At the state level, our task has been to reexamine the monopoly nature of the local gas distribution utility seeking to transform what had been a single commodity offering and to transform the service terms into a menu of components which would enable end-users to tailor their demand. An allied objective has been to open as many of these facets as possible to competitive entry by such new market entrants as gas marketers or brokers. Finally, for those customers who are unlikely to draw the attention of competitive providers, we have transformed the regulation of the remaining monopoly services into one that mimics the pressures of a competitive market.

10 The infrastructure development involved the construction of a wholly new facility and the "looping" or enhancement of three others. The Kern River Pipeline was constructed as a new facility to provide transportation from the Rocky Mountain overthrust. Completed in March, 1992, it could transport 700 mmcf/d. The historical El Paso Pipeline was looped to increase deliverability into California from the Southwest by 400 mmcf/d. The rival Transwestern Pipeline was also looped adding 340 mmcf/d. Both of these projects were completed in March, 1992. Further improvements expanded these systems into the San Juan Basin enabling coal seam gas to find a California market. Alarmed by these dramatic expansions of deliverability from domestic supplies, Pacific Gas and Electric and its affiliate, Pacific Gas Transmission Co., looped the pipeline from Alberta adding 755 mmcf/d by November, 1993.

VIII. THE FEDERAL AGENDA

The Federal Energy Regulatory Commission initiated a series of actions beginning with Order 380 in May 1984.¹¹ This order was intended to promote greater availability of supplies on the spot market with the objective of encouraging a competitive sales market. This was accomplished by eliminating the obligation of local distribution companies to purchase gas from interstate pipelines. As a result, long-term contracts at fixed prices with fixed escalations with pipelines began to be replaced with contracts arranged directly between the distribution utility and producers. These buy/sell contracts tended to be of very limited duration, with prices negotiable from month to month. By 1985 spot market purchases accounted for 33% of end-use consumption, up from 5% in 1983. The growth in the spot market led to the emergence and expansion of a new segment in the gas industry, gas marketers and brokers.

Order 380 created the potential for conflict with the pipeline which saw its traditional role of buyer/transporter/re-seller of gas rendered superfluous by spot market transactions. Indeed, the pipelines found themselves under increasing pressure to become providers of “transportation-only” services.

The difficulty many pipelines found themselves in with take-or-pay contracts, combined with their monopoly/monopsony position in the markets served, prompted calls for regulatory changes in the carrier status of gas pipelines. In October 1985 the FERC instituted “voluntary open access carriage” by issuing Order 436.¹² The intent of this order was to create new rules for nondiscriminatory access to pipeline transportation service. Order 436 permitted a pipeline to transport gas already owned by utilities or end-users. These customers now had the right to reduce their contract demand quantities and demand charges for pipeline-owned gas incrementally over a five year voluntary transition period. Transportation rates were unbundled, so that they no longer included the gas itself.

In 1987 the U.S. Court of Appeals remanded Order 436 to the FERC instructing it to address the issue of how producer take-or-pay contracts with pipelines could remain in force, while pipeline customers could exercise contract demand reductions which were provided in Order 436.¹³

11 Order No. 380, *Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, F.E.R.C. Stats & Regs. 30.571, 49 Fed. Reg. 22,778 (1984).

12 Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, F.E.R.C. Stats. & Regs. 30.665, at 31.474, 50 Fed.Reg. 42,408, 42-413 (1985).

13 *Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987).

FERC addressed this issue with Order 500 adopted later in 1987.¹⁴ Order 500 readopted much of Order 436's regulation and added rules addressing the take-or-pay issue. The inherent unfairness of permitting producers to pursue a new market opportunity with customers who were no longer obligated to take bundled service from a pipeline while attempting to hold the pipeline to its own take-or-pay contract was directly addressed. The order stated that a pipeline could refuse to transport to the new customer unless the producer offered a volume-for-volume credit against the take-or-pay liability.¹⁵

Finally, in April 1992 FERC issued Order 636 that established rules allowing customers that hold firm capacity rights on interstate pipelines to assign or release the rights to other parties.¹⁶ In addition, Order 636 established rate design methodology for firm capacity rights and established cost recovery rules for the recovery of transition costs as a result of this order.

IX. CALIFORNIA'S NEW REGULATORY FRAMEWORK

Complementing this series of federal initiatives, the California Public Utilities Commission embarked on a process in the mid-1980s to overhaul the state's natural gas regulatory structure. Within two months of FERC's issuance of Order 436, the California Commission acted to extend the opportunities for the shipment of customer-owned gas over the intrastate transportation facilities of California's gas utilities.¹⁷

In June of 1986 the Commission commenced a comprehensive reform effort by issuing a rulemaking and companion investigation into what it termed the "New Regulatory Framework of Gas Utilities",¹⁸ Less than six months later, the outlines of a new market structure had been

14 Order No. 500, 52 Fed.Reg. 30,334, 30,341-46 (1987).

15 Two alternative mechanisms were adopted for pipeline recovery from customers of the cost for resolving past take-or-pay obligations. The pipeline could attempt to recover all of its prudently incurred take-or-pay costs in its commodity charge. In the alternative, it could recover up to 50% of its take-or-pay cost through a volumetric surcharge on total pipeline throughput if it agreed to the status of an equal access carrier and absorbed at least 25% of its take-or-pay costs.

16 Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead De-control*, 57 Fed.Reg. 13,267 (April 16, 1992).

17 *Re Transportation of Customer-Owned Gas*, D.85-12-102, 20 C.P.U.C.2d 6(1985), and D.86-03-057, 20 C.P.U.C.2d 628 (1986).

18 I.86-06-006 and R.86-06-006.

signaled. The role of competition was to be dramatically enhanced but with a realization that not all historic ratepayers are likely to find themselves eagerly courted as tomorrow's customers.¹⁹

It would be fair to conclude that the Commission's ultimate objective is to empower the forces of customer choice and competition as a replacement discipline for an industry which has heretofore been regulated on a cost of service basis. But it is equally clear that the Commission suffers no illusion that such an objective can be achieved in the short term of that progress will be uniform with respect to all classes of customers. If, for the foreseeable future, the markets will continue to exhibit both competitive and monopolistic qualities the immediate goal has been to devise a regulatory regime which honors both realities.

The first step involved taking a hard look at natural gas customers or "ratepayers" as they have been traditionally termed. One of the innovations of recent California regulation has been the division of customers into two classes predicated on their likely status as targets of competitive providers. Large customers exhibit load patterns that will attract the initial competitive overtures. By contrast, residential and small commercial ratepayers present substantial difficulties as targets of competitive offerings for their individual loads are not attractive and the aggregation of such loads is problematic. The Commission has termed the large users "non core" while the smaller ratepayers are termed the "core".²⁰

In the transitional period, residential and small commercial customers are deemed to be vulnerable to abuse owing to their relative lack of market clout. These "core customers" continue to depend upon the distribution utility to procure the commodity, arrange for its long distance transport and local distribution in what is termed a "bundled service". By contrast, non-core customers are encouraged to select among what are termed "unbundled" components of their natural gas service.²¹

19 *Re Rate Design for Unbundled Gas Utility Services*, D.86-12-009, 22 C.P.U.C.2d 444 (1986), and *Re New Regulatory Framework for Gas Utilities*, D.86-12-010, 22 C.P.U.C.2d 491 (1986).

20 See, D.86-12-009 22 C.P.U.C.2d 444 (1986), and *Re Rate Design for Unbundled Gas Utility Services*, D.87-12-039, 26 C.P.U.C.2d 213, 244 (1987). Our 1987 decision added to the "small" vs. "large" criteria by recognizing that a small customer with fuel switching capabilities had market choices and thus could be classed by the utility as "noncore".

21 In December of 1987 the Commission implemented the rate design for unbundled gas utility services called for in its policy orders. *Re Rate Design for Unbundled Gas Utility Services*, *supra* 26 C.P.U.C.2d at 213. This regulatory structure was put in place on May 1, 1988 and represents the chronological continental divide for the restructuring of this industry in California.

Subsequent and ongoing efforts have further refined this basic restructuring. Much of our work is focused in two areas. In the first we seek to further “unbundle” the offerings of the local distribution utilities to their customers. The term references a policy to separate the various components of natural gas service so that the customer may pick and choose those that are desired.²² A further virtue of the unbundling strategy is that it permits the emergence of niche competitors who can offer certain but not all of the services traditionally furnished by the distribution utility.

The second area where mucho work continues is rationalizing the regulatory approach to an industry characterized by both monopolistic and competitive aspects. In this regard, the Commission has issued decisions to implement a more market based approach to allocating the cost and designing the rates for local distribution service in 1992²³ and 1993.²⁴ Efforts have also been undertaken to move away from traditional cost of service ratemaking to reliance on performance based ratemaking tied to market forces. Examples of this effort are most readily seen in various Commission decisions approving market based performance incentives for utility procurement of natural gas for its residential and small commercial customers who continue to rely on the utility for this service.²⁵

Refinements continue to take place in response to the evolution and maturation of this hybrid industry with elements characterized by competitive forces as well as elements that continue to have natural monopoly characteristics.

X. THE INCREASING ROLE OF CONTRACTING

In the wake of the Commission’s campaign to unbundle historic utility services and to open contestable markets to competitive entry, contracts have begun to play an increasing and non-regulated role deploying

22 This has included the unbundling of interstate pipeline capacity charges pursuant to orders issued in December, 1991, and the Commission’s July 1992 capacity brokering rulemaking. See, *Re Natural Gas Procurement and Reliability Issue*, D.91-11-023, 41 C.P.U.C.2d 668, 127 PUR4th 417 (1191), and *Re Natural Gas Procurement and Reliability Issues*, D.92-07025, 45 C.P.U.C.2d 47, 134 PUR4th 97 (1992). Underground storage services were unbundled and customer choice introduced in D.93-02-013, 48 C.P.U.C.2d 107 (1993).

23 *Re Rate Design for Unbundling Gas Utility Services*, D.92-12-058, 47 C.P.U.C.2d 438, 139 PUR4th 298 (1992).

24 *Re Rate Design for Unbundled Gas Utility Services*, D.93-05-066, 49 C.P.U.C.2d 409(1993).

25 See, e.g., *Re San Diego Gas and Electric Company* D.93-06-092, to C.P.U.C.2d 185, 145 PUR4th 137 (1993), and *Re Southern California Gas Company*, D.94-03-076, 53 C.P.U.C.2d 663, 150 PUR4th 271 (1994).

consumer demand in response to favorable market opportunities. Non-core customers are free to contract for the commodity and to arrange for its transportation. Other elements of the infrastructure, such as storage, are also on the large customer's shopping list. These choices are not forced upon eligible customers who are free to continue a traditional relationship with their local distribution utility. Further, they have the right to employ middle persons such as marketers, aggregators and broker who can, in essence, rebundle the components of the commodity, transport, and storage while relying upon the local utility only for the distribution of the end product to the burner tip.

The distribution utilities have begun to use varied contractual arrangements to procure gas for both their core portfolio and electric generating loads. While they have developed individual market strategies, the portfolio approach recently employed by Pacific Gas & Electric will give you some idea of available contract terms. When it comes to the purchase of gas on behalf of their core customers, the utility divides its purchase of around 800 mmcf/d into: 60% monthly baseload or multi-month contracts with pricing tied to monthly gas price indices, 15% contracts for California source gas predicated on a monthly pricing index, 15% daily spot or "swing" purchases, and 10% made on fixed price purchase agreements. The purchase of 450 to 500 mmcf/d for the utility's electric generation needs is far more aggressive with 30% being made on terms of monthly baseload or multi-month indexed contracts and the 70% balance made on daily spot purchases.

While the increasing role of contracts can be traced to regulatory liberalization, market predicated initiatives have significantly enhanced the opportunities. None has been more useful than the deployment of the "hub". The hub is simply a market center, and over the past two years a number have grown up with respect to the California market. By providing alternate receipt and delivery points hubs make supply transactions more flexible and dramatically improve market efficiency. A hub presents market participants with both physical and commercial assets. A hub presents market participants with both physical and commercial assets. It stands ready to provide capacity, storage, pipeline interconnection and system gas supplies. Viewed from a commercial vantage point it has the financial strength to guarantee transactions to market participants who elect to use it for short term transportation, storage and accounting services. Since the natural gas is the ultimate fungible commodity, the hub

provides parking,²⁶ loaning,²⁷ wheeling,²⁸ and title transfer to gas volumes. For immediate traders such services enhance the likelihood that contract obligations can be met rather than breached. From a societal perspective, the smooth performance of contracts, and the opportunity for quick market predicated remedies, translate into enhanced reliability.²⁹

XI. MEXICO'S CHALLENGE/MEXICO'S CHOICE

The recent decision of the Mexican government to introduce natural gas into Mexicali as an extension of the pipeline infrastructure in California extends the benefits of basin on basin competition for supply and transportation to Mexican end-users. The design of the downstream market is entirely in your hands. I have briefly reviewed a long and often unhappy history of flawed governmental interventions in the operation of these markets. I envy you a fresh beginning which is unburdened with the weight of this history and able to capitalize and improve upon our recent success.

Thank you for permitting me the privilege of sharing these thoughts.

XII. APPENDIX A

Eastern Airlines Lines, Inc. v. Gulf Oil Corporation, 415 F.Supp. 429 (E.D. Fla. 1975) involved a dispute between the refining seller and a large consumer of a petroleum derivative product-aviation fuel. The case was tried in the United States District Court for the Southern District of Florida under what is termed the “diversity jurisdiction” of the federal courts. In the United States commercial law is regulated by state rather than federal

26 Parking involves the deliver of gas into the hub and deliver out of the hub one or more days later.

27 Loaning is the inverse of a parking transaction. Here gas is removed from the hub and returned one or more days later.

28 Wheeling is the simultaneous receipt of gas into the hub and the delivery of a corresponding quantity of gas out of the hub through displacement.

29 The presence of a hub as both a price point and transaction center enables a disappointed buyer to “cover” for a breach on the part of a seller or transporter by the simple expedient of drawing upon hub facilities for replacement gas. By the same token, a seller facing a breach by the buyer can “resell” the gas volumes using the hub to secure a replacement business opportunity. By prompt recourse to cover and resale the disappointed party fixes the consequential damages as the difference, if any, between the terms of the contract and the market cost of a replacement transaction. Incidental damages are also dramatically contained.

law. The controlling legal principals may be found in what are termed common law decisions or in statutory law. The obvious weakness of a such a system from the vantage point of national commerce is that the legal framework may come to resemble the Blakans with fifty jurisdictions creating and enforcing rules and regulations which may differ if not actually conflict. A partial solution has been the willingness of state legislatures to adopt the recommended content of what is termed the Uniform Commercial Code. As we shall see, the United States District Judge attempts to apply the substantive law of the State of Florida, including that state's version of the Uniform Commercial Code to resolve the dispute between these two corporate traders.

Summary of the facts: Eastern Airlines commenced the suit as the plaintiff seeking a declaration that a requirements contract for aviation fuel renewed in 1972 for a five years period was still valid and that the announced intention of the defendant, Gulf Oil, to cut off supplied unless Eastern consented to a price increase was a threatened breach of contract by anticipatory repudiation. Eastern sought a permanent injunction from the court which would force Gulf to continue to honor the terms of the contract for the balance of its three year duration. In its answer Gulf Oil advanced two arguments as to why it should no longer be bound by the terms of the agreement. The first centered on the contention that Eastern's behavior in the face of dramatically changed market condition was so abusive of the seller as to amount to a present breach by the airline as buyer. In the alternative, Gulf sought to invoke commercial impracticability, one of the three recognized common law theories of excusable nonperformance. More specifically, Gulf asserted that Eastern's demand manipulation practice termed "fuel freighting" was a breach of its obligation to deal in good faith under the terms of the requirements contract, and that international petroleum developments since the fall of 1973 destroyed the ability of the agreed upon contract pricing mechanism to reflect the true price of the underlying commodity with the consequence that the contract was beset with commercial impracticability.

Fuel freighting: Gulf complains that under the requirements contract Eastern assumed exclusive purchase obligations with Gulf at some but not all of its service points. Eastern is accused of breaching its obligation to deal in good faith with Gulf by manipulating its requirements depending upon whether the price at a Gulf serviced airport is higher or lower than that prevailing at a proximate airport not serviced by Gulf but at which

Eastern may refuel the aircraft. In these circumstances it is said that Eastern artificially lowers its demand when the price charged by Gulf is disadvantageous and inflates that demand when it is unilaterally advantageous to Eastern. This conduct, which the record reveals to have been a long standing industry practice, is said to be particularly abusive of the requirements contract relationship in the period since 1972 given the instability in international petroleum markets with the consequent upward pressure on domestic derivative fuel prices.

Commercial impracticability: Gulf contends that Section 2-615 of the Uniform Commercial Code is applicable to the requirements contract. Gulf has two theories of impracticability. First, that the contract machinery for passing on crude price increases has broken down; second, that the steep rise in international crude prices without a concomitant rise in aviation fuel prices under the Eastern contract renders the obligations avoidable on a theory of hardship.

In 1972 the present contract was formed as an extension of contractual arrangements between Eastern and Gulf going back to 1959. It is evident that the parties anticipated increases in costs of raw crude and that there should be contract machinery for sharing this price rise between both seller and buyer. Thus the contract specifically cited prices of West Texas Sour as posted in Platts Oilgram as the mutually agreed barometer of crude costs. Gulf was entitled to add to the basic contract price of aviation fuel one half of any price rise in West Texas Sour as reflected in the posting reported by Platts.

In 1970 the government of the United States began to control the price of domestic crude. At that time it was higher than the price of foreign, uncontrolled crude. 1970 marked the formation of OPEC, as well as the year in which domestic oil production peaked. Since 1970 foreign oil prices have risen and the percentage of domestic fuel refined from foreign crude increased. All this was within the experience of Gulf and Eastern when they formed the renewal in 1972. However, in the fall of 1973, following war in the Middle East, the United States was made the target of an oil embargo. By January, 1974, OPEC had effectively increased the price of foreign crude by 400%. It was now twice as costly as the controlled price of domestic crude oil.

As these developments were dramatically impacting an American economy increasingly dependent upon non-domestic production the federal government moved to revamp the price controls. The new approach

differed dramatically from prior practices. In an effort to incent new domestic production the price controls were revised to reflect a two-tier approach. Production equivalent to the prior year was denominated “old oil” and remained under price controls which were less than half the market value of uncontrolled oil. Production from new wells, or increased production from established ones, was classed as “new oil” and could be sold free of price controls quickly rising to reflect the international price for the fungible commodity. However, the private entity, Platts OILGRAM, made a unilateral decision that it would not publish posting for new domestic production and would, instead, restrict itself to the historic practice of posting the controlled price of “old oil”.

Gulf contends that these developments, coupled with Platts’ decision not to report new domestic oil postings produced a breakdown within the machinery of the contract establishing commercial impracticability since Gulf was effectively precluded from an ability to pass on crude increases in the cost of Eastern’s aviation fuel.

As a second theory of impracticability, Gulf cites the very dramatic increase in the post-boycott era for crude and notes that there has been no concomitant rise in the price Eastern is paying under the terms fo this five year requirements contract. Gulf claims a substantial hardship in these circumstances notwithstanding evidentiary admissions that 1973 was the best year for Gulf’s overall profit picture in history. Further, Gulf has admitted that its evidence as to the price rise in the international price of crude and fuel derivatives includes intra-corporate profit made by various of its subsidiaries and operating affiliates. Finally, it has refused to give evidence on its specific profit or loss with respect to a gallon of aviation fuel.

The issues to be decided by the trial court: In the eyes of Judge King the controversy between Eastern as buyer and Gulf Oil as requirements seller could be resolved by posing and resolving three issues:

1. In the circumstances depicted by prior course of dealing and the usage of the trade, did proof of “fuel freighting” by Eastern constitute a breach of its duty to deal with Gulf in good faith under the terms of this aviation fuel requirements contract?

2. Has the failure of Platts OILGRAM to track the decontrolled price of “new” West Texas Sour rendered the requirements contract between Gulf and Eastern “impracticable” within the meaning of UCC 2-615, when price quotations in Platts were expressly made the barometer for

passing price increases experienced by Gulf for crude onto Eastern as an aviation fuel customer?

3. Irrespective of the failure of Platts, does proof of the general and very dramatic price increases with reference to crude oil coupled with evidence that they have not been reflected in a concomitant rise in the price of aviation fuel under the machinery of this requirements contract shown that contract to be impracticable on a theory of hardship experienced by the seller?

Judge King's decision: At the conclusion of a non-jury trial, Judge King decided each contested issue in favor of the plaintiff, Eastern Airlines. Not only was Gulf not excused from its obligations under the terms of the requirements contract, but it was specifically ordered to continue adherence to its sales obligation for the balance of the contract term. Here is a summary of the rulings on specific issues.

1. No, fuel freighting was an established industry practice well known to Gulf at the time it framed the renewal terms of this requirements contract. At that time it had an opportunity to seek to restrict or prohibit the practice and did not do so. This proof of course of dealing and trade usage establishes that Eastern did not exhibit "bad faith" such as would constitute a breach of its duties as a customer under a requirements contract.

2. No, the contract expressly references Platts, a publication which continues to publish and to track the very price schedule for West Texas Sour which was in effect at the formation stage. There has been no breakdown of terms in this contract.

3. No, while it might have been possible for Gulf to prove extreme hardship such as to lead to excusable nonperformance under UCC 2-615, it has failed to do so for two reasons:

a. Gulf has failed to prove that the price developments since the 1973 war were not reasonably foreseeable at the formation of this contract in 1972. If they were foreseeable (an objective test) as elements of risk and the contract language failed to shift or apportion that risk then it remained with the seller.

b. Even if non-foreseeable, Gulf has refused to prove its actual profit or loss and has thus failed to establish actual hardship.

The court's rationale: Gulf has sought to justify its notice to Eastern that it would no longer observe its obligations as seller under this aviation fuel contract by two theories: first, that Eastern is in a state the present

breach owing to its fuel freighting practices, and second that after-arising developments have rendered the seller's obligations impracticable within the meaning of Section 2-615 of the Uniform Commercial Code. Neither theory has been established in the facts and circumstances of this record.

Gulf's submission that its customer is in breach of contract rests on a theory that a buyer in a requirements contract governed by the Uniform Commercial Code is obligated to deal with the seller in "good faith" with respect to its actual need for the subject matter and duty to satisfy that need with the seller as its exclusive supplier. As a general proposition Gulf is correct, but when the record and terms of the contract are taken in their market context there has been no proof of a violation of this standard of good faith dealing. The contract was a renewal of an arrangement which dated back nearly fifteen years and was drafted by Gulf. It makes utterly no mention of fuel freighting and yet Eastern has proven that it is a practice which has been regularly pursued by buyers within the industry and is well known to sellers. Thus a continuation of this buying pattern cannot be said to violate a buyer's duty as defined in the terms of the contract. Looking to the commercial background, the Code acknowledges that "course of performance", "course of dealing" and "usage of trade" are all factors which can be looked to in determining the likely intention of the contracting parties. Course of dealing is defined in Section 1-205 as the prior conduct of these parties and is deemed a trustworthy evidence of their understanding of the terms of an after-arising contract. Fuel freighting was sanctioned by the course of dealing prior to formation in 1972. Further, usage of trade, defined in Section 1-205 as the behavior or conventions widely practiced by others in the relevant market, also points to the acceptability of fuel freighting. In these circumstances there is utterly no proof that Eastern has breached its duty to deal with Gulf in "good faith".

Nor has Gulf established that its obligations under this requirements contract have been rendered "impracticable" within the meaning of applicable provisions of the Uniform Commercial Code. While it is clear that Section 2-615 applies to a requirements contract for the sale of goods, the court finds in Official Comment 4 grounds for hesitation before concluding that price escalation alone could serve as grounds for excuse. Further, Comment 8 establishes that if an event was reasonably foreshadowed at the formation stage then the contract should be read as having been made with reference to such risk. When read together, Judge

King finds that three criteria must be satisfied before commercial impracticability can be claimed for a particular contract. With respect to each the party asserting the claim of excuse bears the burden of proof:

1. There must have been a failure of a presupposed condition which was an underlying contract assumption.

2. This failure must have been unforeseeable at the formation stage (meaning that it would have escaped the apprehension of a reasonable person).

3. The risk of this failure was not specifically allocated to the complaining party.

These criteria must now be applied to evaluate Gulf's two theories of impracticability: rooted in the alleged failure of Platts OILGRAM to serve as an accurate barometer for a pass through of the seller's increased costs of crude oil to its customer for aviation fuel; and, the more general assertion that an uncompensated price rise of such magnitude has occurred as to impose hardship upon the seller of a magnitude as to render its obligation to supply excusable. As a preliminary, King notes that case law rooted in the Suez Canal crisis has not favored an expansive interpretation of the Code language and has been especially wary of using it to excuse a party to a contract who merely demonstrates that after arising events have rendered its performance obligations "burdensome or unattractive". Movement of market price is a risk which lies at the heart of any long term contract. Indeed, it is the purpose for which contract are made!

In Judge King's view, Gulf's first claim for impracticability does not surmount the initial hurdle because Platts is still publishing and reporting the precise data with respect to West Texas Sour expressly referenced in the contract. The contract looked to Platts to report the average postings for West Texas Sour for three sellers. This it does. At the formation stage those postings were for controlled oil, and Platts still reports the postings for this commodity. As an aside, King notes that Gulf's assertion that a posting restricted to "old" oil is irrelevant to the after-arising market cannot stand given its admission that it uses this criteria to fix the terms of contract conducted between and among its own affiliates.

Gulf's hardship claim, is rejected on grounds that it has simply failed in its burden of proof to establish hardship as a fact. While it may be true that on this specific contract, the failure to pass onto its requirements customer for aviation fuel its "costs" has depressed Gulf's earnings, the court cannot overlook the fact that in 1973 Gulf as a conglomerate has

experienced record profits. Further, the costs cited by Gulf reflect intra-corporate profit taking. Hardship must rest on real not contrived numbers and Gulf has declined the opportunity to supply them. Further even if there had been such proff, the claim fails to surmount the second hurdle or criteria for in the eyes of the cour it is clear that price rises were foreshadowed at the formation stage. Only hardship stemming from an unforeseeable after-arising development could set the stage for a claim of excuse.