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VIA FEDERAL EXPRESS

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Royalty Management Program
Rules and Procedures Staff
Building 85, Room A-606
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Lakewood, CO 80215

Re: PanEnergy Comments Regarding MMS's Proposed "Amendments to Gas Valuation Regulations for Federal Leases"; 60 Fed. Reg. 56007 (Nov. 6, 1995)

Dear Minerals Management Service:

This letter sets forth the comments of Texas Eastern Transmission Corporation, Panhandle Eastern Pipe Line Company, Trunkline Gas Company, Algonquin Gas Transmission Company, and PanEnergy Corp (collectively herein referred to as PanEnergy) on the captioned proposed rulemaking.

PanEnergy Corp is the new corporate name, effective January 1, 1996, under which Panhandle Eastern Corporation is conducting business. Texas Eastern Transmission Corporation, Algonquin Gas Transmission Company, Panhandle Eastern Pipe Line Company, and Trunkline Gas Company are the pipeline subsidiaries of PanEnergy Corp. These four pipeline systems, especially Texas Eastern Transmission and Trunkline Gas, provide interstate gas transportation service for a significant share of Gulf of Mexico outer continental shelf production. Together, PanEnergy's pipelines constitute one of the major North American pipeline systems, including 35,000 miles of natural gas pipeline transporting natural gas produced from Gulf Coast and midcontinent fields to markets in the midwestern and northeastern United States.

I.

These comments are submitted under the informal rulemaking provisions of the Administrative Procedure Act, 5 U.S.C. 553. PanEnergy expects that this letter will be included in the agency's record of the rule-making, and will be included in its official record when and if judicial review is sought of any final rule arising out of this proposed rule.

PanEnergy commends the Interior Department for responding to the royalty issues raised by the significant changes that have taken place in the markets for natural gas over the last five years. PanEnergy welcomes the agency's recognition that its January 1988 regulations relying on "gross proceeds" as value are no longer appropriate in light of the prevalence in the market of sales of aggregated gas at market centers or transportation hubs, without reference to or commitment of the source of supply for those sales.

II.

Until the restructuring of the natural gas industry over the last dozen years, PanEnergy's subsidiaries contracted with gas producers, irrespective of whether the properties were federal, Indian, state or private, under long-term gas supply agreements. Under these supply contracts, our pipelines had to assure that they had, under contract, enough gas to meet their gas resale obligations to the local distribution companies (LDCs) to which that gas supply was committed. This occurred under comprehensive federal regulation (from wellhead first sale price regulation, through bundled, regulated pipeline carriage and resale to the LDCs).

The restructuring of the natural gas industry fundamentally and irrevocably altered this regime. Pipelines locked into these long-term gas supply agreements were put at significant economic risk during the course of restructuring. Payments made by pipelines to settle their take-or-pay and other disputes under their long-term gas supply agreements, or to terminate them outright, were motivated by the forces unleashed in this restructuring.

Rather than re-describe the causes of, and chief milestones in, the restructuring of the natural gas industry, we attach here pages 7-18 of the brief amicus curiae filed by the Interstate Natural Gas Association of America, the American Gas Association and the United Distribution Companies (INGAA, et al.) in the Court of Appeals for the District of

Columbia Circuit last month. This narrative history of restructuring makes clear that pipelines, including PanEnergy's, were not buying gas with settlement payments. They were terminating non-viable contract obligations.

With pipelines no longer needing to acquire long-term, committed gas reserves for bundled resale service, and the spot market having developed around pipeline capacity released to serve shipments by LDCs, marketers and producers under "unbundled" transportation service, less and less gas is being sold under sourced, or dedicated, sales contracts. Clearly MMS's current (January 1988) regulatory approach assumes dedicated sales of gas--the producer delivering to a purchaser or group of purchasers under contracts identifying specific wells or fields as the committed source of the contract volumes of gas. The rules assume that the producer can identify the specific purchaser, and the specific contract price paid, for specific gas production. In this central assumption MMS's regulatory approach is becoming more and more inappropriate for valuing production in the modern gas markets.

III.

The focus of PanEnergy's comments is on one central impropriety in the proposed rule--section 206.454(a)(6) and the preamble inquiries related to it (60 Fed. Reg. at 56011). In this material, MMS treats the subject of the purported "incremental value" of production sold, non-dedicated and unsourced, in the new gas market. MMS bases this purported "incremental value" on payments producer-lessees may have received to settle long-term gas supply agreements during the course of the industry restructuring described by INGAA, et al., in their brief amicus curiae (attachment). MMS created this purported "incremental value" in a Dear Payor Letter issued May 3, 1993, on the subject of contract settlement payments. This Dear Payor Letter, and the royalty liability it asserts producer-lessees have when they receive contract settlement payments, are under challenge in the Court of Appeals for the District of Columbia Circuit in IPAA v. Babbitt.

PanEnergy objects to proposed section 204.454(a)(6), and to the agency's suggestion in the preamble that it might promulgate additional provisions of the same nature for the following reasons:

A) As a legal, policy and factual matter, PanEnergy asserts that the agency has no authority to impose royalty on contract settlement payments, as they are not payments made for production. The OCS Lands Act (43 U.S.C. 1337(a)(1)) and the oil and gas leasing provisions of the Mineral Lands Leasing Act (30 U.S.C. 226) authorize royalty on the value of production only; payments not for production are not subject to royalty. This legal conclusion is clear in the statutes, and is reflected in MMS's existing regulations, e.g.: 30 CFR 206.152(b)(1)(ii)--"consideration actually transferred either directly or indirectly from the buyer to the seller for the gas" (emphasis added); and 30 CFR 206.150--"consideration . . . for the disposition of . . . gas . . . produced."

This legal conclusion was directly applied to payments under a natural gas supply agreement that the parties to the supply agreement did not credit against the price of any delivered production, in the decision of the Fifth Circuit Court of Appeals in Diamond Shamrock Explor Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988). Diamond Shamrock did not involve contract settlement payments, but if the payments under the gas supply contract in Diamond Shamrock were not royalty bearing, then a payment to settle disputes over non-royalty bearing payment obligations must also be non-royalty bearing. Identical principles have been litigated and established for take-or-pay payments and settlements involving take-or-pay, and buyouts and buydowns of gas supply agreements, in Associated Gas Distributors v. FERC, 893 F.2d 349 (D.C. Cir. 1989), and these principles were adopted by the Department both in Santa Fe Energy Co., MMS-85-0046-OCS (Oct. 14, 1988) (final agency action by the Assistant Secretary), and in the gas royalty rulemaking in which the Department conformed to Diamond Shamrock, 53 Fed. Reg. 45082 (Nov. 8, 1988).

The foregoing assertions must be addressed by the agency in this rulemaking, before any final section (a)(6) may be promulgated.

B) MMS correctly framed the index valuation proposal on the principle that the use of the relevant index to value non-sourced gas sales for royalty purposes constitutes an alternative to the "gross proceeds" valuation system that will continue to govern royalty computation for sourced, dedicated sales of gas produced from federal leases. E.g., 60 Fed. Reg. at 56008-10. Each of these two valuation methods is, in concept and in operation, an alternative to the other, an independent and complete method for valuing production for all purposes pertaining to the lease royalty obligation. Gas is either to be valued for royalty purposes under one regime or the other; both systems of valuing gas cannot apply to one unit of gas.

The Assistant Secretary, in promulgating any final rule, should adopt a logically coherent set of rules. Proposed section 206.454(a)(6) is grounded, wholly and entirely, in MMS's employment of "gross proceeds" as the regulatory definition of the statutory royalty basis "the value of production." This is clear from the numerous references to the gross proceeds definition of "value of production" in the Dear Payor Letter of May 3, 1993 (at 1 and throughout), and in both the 1994 Samedan Decision, at 4-9) and Shell Offshore, Inc. (MMS-91-0087-OCS (Sep. 2, 1994)), in which cases different offices of the agency affirmed MMS billing demands that apply the Dear Payor Letter of May 3, 1993. It is also clear from the government's briefs in defense of the Dear Payor Letter and the Samedan decision in IPAA v. Babbitt.

The alternative proposed on November 6 is not based on "gross proceeds." The entire proposal, including its transportation allowances and its safety net calculation, is based on the concept that royalty value will be determined without any attempt to determine which dollars received by the producer-lessee constitute price paid for which specific volumes of gas produced from which specific federal lease properties. Instead, as a complete and sufficient alternative, royalty value will be determined by reference to the applicable index price, whether that is higher or lower than the amount that might be calculated under the gross proceeds regulatory system.

The alternative index price valuation system must not employ leftovers or add-ons that are part of the gross proceeds system. The gross proceeds system is specifically to be rendered inapplicable to valuation of production to be valued based on index prices. Section 206.454(a)(6) must be deleted from any final rule. The question posed in the preamble regarding the date of any contract settlement is simply answered--contract settlement payments made under a settlement post-dating any index valuation system final rule are at least as irrelevant to index-based valuation as are settlement payments made under a settlement that pre-dates the final index-based valuation rule. There should be no treatment of payments in future contract settlements under the index valuation system either.

This comment is wholly independent of the force and consequence of PanEnergy's other comments. Even if the agency were to prevail in IPAA v. Babbitt or otherwise have the Dear Payor Letter and its "attributable by MMS" "incremental value" upheld, such a construct for royalty valuation is not compelled by statute, and is wholly tied to the use of "gross proceeds" as the regulatory valuation method applicable to the specific production thus valued. There is no place for section (a)(6) in a valuation system that is not a gross proceeds system, even if contract settlement payments can be subjected to a royalty under the gross proceeds regulations.

C) In IPAA v. Babbitt the producer-lessees challenge the Dear Payor Letter both on substantive and procedural grounds. PanEnergy reiterates here for the record the principles underlying that challenge:

(1) payments made to settle take-or-pay, or other contract disputes, and to terminate gas supply contracts, made during the course of the restructuring of the natural gas industry, were not, as a matter of fact, made for production;

(2) a take-or-pay payment, or an advanced payment, was and is not royalty bearing under the statutes, and under the gross proceeds regulations under those statutes, unless and until and then only to the extent that, the parties involved credited the take-or-pay or advanced payment to the price of production delivered to the entity making the advance payment;

(3) if the legal principles in point (2) are true, then a fortiori the same principles apply to settlements involving these same kinds of payments;

(4) the Department of the Interior, including the Assistant Secretary, Land and Minerals Management, acknowledged and recognized that the principles in point (2) applied to contract settlement payments as well; and

(5) the Department has not announced any sustainable basis on which to convert payments not made for production into payments made for production, and this includes the attempt to convert, by fiat, payments not credited by the parties to post-settlement production into payments "attributable by MMS" to post-settlement production.

PanEnergy endorses these propositions as correct statements, as matters of both fact and law. As indicated above, PanEnergy submits these principles should govern this MMS rulemaking. Any rule issued by the Assistant Secretary which does not incorporate such principals and which does not set forth the factual and legal grounds relied upon for such rejection would be contrary to the Administrative Procedures Act.

IV.

In conclusion, PanEnergy appreciates the time and effort that the agency has invested in this rule for index-based valuation of non-sourced sales of federal lease gas production. This effort to keep MMS royalty valuation somewhat abreast to the major changes in the natural gas markets is, however, fatally flawed by the inappropriate, unwarranted and illegal importation of section 206.454(a)(6) into the proposal. This section must be deleted, both as to contract settlements pre-dating any final rule, and as to the preamble's suggestion regarding contract settlements that post-date the adoption of the final rule. With this correction made, the agency may proceed to address the other comments on the mechanics of the welcome, index-based alternative to gross proceeds valuation.

Respectfully submitted,

Richard J. Kruse Jr.

RICHARD J. KRUSE, JR.
Vice President & General Counsel
Texas Eastern Transmission Corporation
on behalf of
Texas Eastern Transmission Corporation
Panhandle Eastern Pipe Line Company
Trunkline Gas Company
Algonquin Gas Transmission Company

Attachment
Brief Amicus Curiae in Support of Appellants
in IPAA v. Babbitt, pp. 7-18

IV. ARGUMENT

A. IN THE RESTRUCTURING OF THE NATURAL GAS INDUSTRY, CONTRACT SETTLEMENT PAYMENTS WERE NOT PAYMENTS FOR DELIVERED GAS PRODUCTION

1. Gas supply contracts. During the last decade, the natural gas industry has been extensively restructured. Under the governing regulatory framework prior to restructuring, interstate natural gas pipelines were the primary marketers of natural gas. Interstate natural gas pipelines were built on a showing of adequate market and adequate gas reserves committed to that market. They bought gas from producers at the wellhead and transported it for delivery and sale to LDCs at the "city gate" (the pipeline connection to the LDC's system). The pipeline service provided to LDCs was a "bundled" commodity merchant service, combining supply assurances with both transportation and sales service. These services were provided under long-term agreements between the LDCs and pipelines, with the pipelines reselling the gas they bought from producers at cost.[2]

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[2] In Associated Gas Distributors, et al. v. FERC, 824 F.2d 981 (D.C. Cir. 1987)(AGD I), this Court discussed this background and the operation of, *inter alia*, section 7 of the Natural Gas Act of 1938, 15 U.S.C. 717f.

The gas supply contracts that gave rise to this case are best understood in the context of the market and regulatory forces that existed when they were executed. One market force was the seasonal and annual variation in the end user's demand for gas. One regulatory force was the service obligation imposed on an LDC at the state level, by its public utility commission, to assure adequate retail gas supply for maximum system demand situations. Another regulatory force was the corresponding need of the interstate pipeline to assure gas supply to meet maximum demand by the LDCs it served, up to the capacity of the pipeline. Another regulatory force was pervasive federal regulation of the wellhead price of gas (which no longer exists), and of the terms and rates for pipeline carriage of gas (which have also since undergone significant change).

2. <u>Allocating risk with take-or-pay</u>. Given these market and regulatory forces, producers developed mechanisms to ensure a minimum cash flow necessary to provide them "a continuous source of revenue to cover investment, operations, and maintenance." <u>Diamond Shamrock</u>, <u>supra</u>, 853 F.2d at 1167 (footnote omitted). The take-or-pay mechanism was developed to meet these revenue requirements, and compensate producers for "the associated risks of exploration, production and development." <u>Id</u>. at 1167. Under a typical take-or-pay provision, the pipeline promised the producer a minimum payment even when the pipeline was unable to take a minimum level of production. In turn, the accrued balance of these payments

(made in the absence of production) could be "recouped," that is, credited against the price of production later delivered in amounts above the contract minimum. The delivered gas paid for in this fashion is generally called "make-up" gas.[3]

These take-or-pay risks for pipelines were balanced by the "minimum bill" provisions often found in pipeline tariffs approved by the Federal Energy Regulatory Commission (FERC), and in contracts between pipelines and LDCs. Under these minimum bill provisions, the LDC paid the pipeline for an entitlement to purchase gas on demand even if the LDC had need for the gas only to serve peak demand requirements.

3. The restructuring of the natural gas market. A series of market, legislative and regulatory forces, beginning in the 1980's and culminating in 1992 with FERC Order No. 636, destroyed the historic basis upon which gas was purchased and sold. During the period prior to the mid-1980's, pipelines and producer-lessees had set long-term supply contract prices to reflect the market conditions at that time. During the nationwide natural gas shortages of the late 1970's, these contracts often provided for prices at or near FERC ceiling prices under FERC's maximum lawful price (MLP) regime implementing Title I of the Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. 3311-3333. With respect to unregulated gas, these contracts often provided for prices using the

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3 Take or pay provisions are further described in Diamond Shamrock, supra, 853 F.2d at 1164, and in Interior's Samedan Decision (App. 120 n. 6).

highest price or pricing formula being paid at the time the contractual commitment was made. An economic slowdown, rising gas prices, the prohibitions in the Powerplant and Industrial Fuel Use Act of 1978[4] against certain uses of natural gas, and the NGPA's release of formerly intrastate gas into the interstate market, all combined to reduce demand for and increase the supply of gas.

In 1984, FERC ruled in Order No. 380 that LDCs should not have to buy higher-priced gas under the minimum bill provisions of their contracts with pipelines, and should be able to take advantage of available lower-priced gas supplies.[5] This began to undermine the market justification for some pipelines' long-term (higher or MLP priced) contracts with the producer-lessees. The pipelines had entered these supply contracts to serve their LDC customers, but as LDCs bought more short-term, lower-priced "spot market" gas, they bought less gas from their pipelines under the long-term, bundled service gas supply contracts. The take-or-pay obligations of some pipelines to producer-lessees dramatically increased. As this happened, it became less likely that pipelines could recoup their take-or-pay obligations to producers through make-up deliveries. FERC recognized the potential take-or-pay problem in Order No. 380, but deferred action.

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[4] P.L. 95-620, 42 U.S.C. 8301-8484, since repealed by the Act of May 21, 1987, P.L. 100-42, 101 Stat. 310-14, and by Section 3011 of the Energy Policy Act of 1992, 106 Stat. 3128.

[5] 49 Fed. Reg. 22778 (June 1, 1984). This Court addressed this regulatory change in Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1152 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986).

FERC's Order No. 436 was the next milestone in the restructuring. There, FERC provided for pipelines to offer transportation service on a non-discriminatory, "open-access" basis.[6] This further altered pipelines' historic relationships both with LDCs and with producers. The restructuring of the transportation service has culminated in the recently implemented Order No. 636, in which FERC required pipelines to "unbundle" (separately price and contract) their sales, transportation and other services, and allowed their former LDC customers unilaterally to terminate their purchases from pipelines.[7] FERC's restructuring Orders have resulted in pipelines becoming transporters of gas owned by others rather than gas that they own. As a result, pipeline purchases of gas from producer-lessees are now at an all-time low.[8]

Throughout the period from Order No. 380 through Order No. 636, FERC failed to address adequately the pipelines' ever-increasing take-or-pay problems. Twice this Court remanded FERC "open access" orders because it found that FERC had failed to

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6 50 Fed. Reg. 42408 (Oct. 18, 1985).

7 57 Fed. Reg. 13267 (April 16, 1992), on rehearing, Order No. 636-A, 57 Fed. Reg. 36128 (Aug. 12, 1992), review pending _sub nom_. _UDC v. FERC_, No. 92-1485, _et al_. (D.C. Cir.).

8 Of total gas delivered by interstate pipeline, the percentages of gas sold by pipelines and transported for others swung as follows: 1984--92% sold, 8% transported; 1988--37% sold, 63% transported; 1992--13% sold, 87% transported. INGAA, Rate and Policy Analysis Department Report No. 93-2, "Issue Analysis, Carriage Through 1992," Table A-2 (July 1993). See also Sen. Rep. No. 101-39, on the Natural Gas Wellhead Decontrol Act of 1989, 101st Cong., 1st Sess. at 6.

address, or to address rationally, the problem of take-or-pay and the pipelines' underlying supply obligations.[9]

This only exacerbated the fact that pipelines' contracts with producer-lessees were more and more non-viable. The developing spot market offered end users and LDCs cheaper gas, and the pipelines' prospects for recouping prior take-or-pay payments virtually disappeared.

4. The industry works to resolve non-viable gas supply contracts. Some pipelines with take-or-pay problems sought to escape increasing take-or-pay exposure by arguing that the take-or-pay obligation, when added to the (high or maximum lawful price) sales prices in the long-term supply contracts, would result in payments to the producer-lessees in excess of the applicable MLPs under Title I of the NGPA. Pipelines sought declaratory or rulemaking relief from FERC that they were not obligated to continue to make these payments because of this asserted violation of the MLP regime. FERC denied this relief, ruling that "take-or-pay payments are not attributable to gas delivered at the time the payment is made, and are instead attributable solely to gas taken pursuant to

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[9] E.g., AGD I, supra, 824 F.2d at 1023: "FERC's decision to do nothing more than reaffirm [its earlier] policy statement . . . fails to meet the requirement of 'reasoned decisionmaking.'" American Gas Ass'n, et al. v. FERC, 888 F.2d 136, 147 (D.C. Cir. 1989) (AGA I): "during the two years since we decided AGD, the Commission . . . has failed to engage in reasoned decisionmaking . . .." Id. at 148: "[FERC's] half-explained cunctation here convinces [the Court] that [FERC] delays in order to avoid having to do the analysis that we required in AGD until after the take-or-pay problem has disappeared . . .."

the make-up provisions of the [gas supply] contract." When make-up deliveries occur, "a sale takes place at the time of delivery and the MLPs are applicable at that time." ANR Pipeline Co. v. Wagner & Brown, Nos. GP86-54-000, et al., 44 F.E.R.C. ¶ 61,057 at 61,157 (1988), approved in Associated Gas Distributors v. FERC, 893 F.2d 349, 357-59 (D.C. Cir. 1989)(AGD II).[10]

Neither the pipelines nor their suppliers (again, wherever federal or Indian leases were involved, the producer-lessees) could wait for FERC to respond to the judicial reversals and remands in AGA I and AGD I.[11] Confronted with immense and mounting take-or-pay problems, the pipelines and producer-lessees negotiated to terminate or to amend (reform, modify) their unworkable long-term, high-price supply contracts.

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10 In issuing this Order, FERC specifically relied on its prior "policy statement stating that payments to producers as consideration for amending or waiving take-or-pay provisions in contracts are not payments for the first sale of gas and accordingly do not violate [NGPA] Title I [MLPs]." 44 F.E.R.C. ¶ 61,057 at 61,155 n.1, referring to 18 CFR 2.76, 50 Fed. Reg. 16076, 16080 (April 24, 1985).

This FERC Order is discussed, quoted and applied in Diamond Shamrock Explor. Co. v. Hodel, supra, 853 F.2d at 1167-68, discussed in Part IV.B. below.

11 In AGD I, supra, 824 F.2d at 1021-23, this Court discussed several of the regulatory proposals for dealing with accumulating take-or-pay liability that FERC considered and refused to adopt. The incomplete regulatory treatment continued through American Gas Ass'n, et al. v. FERC, 912 F.2d 1496, 1520 (D.C. Cir. 1990) (AGA II).

The resultant termination and amendment of gas supply contracts was not only consistent with market reality, but also with Congressional mandates and the FERC implementation of those mandates. In 1978 Congress had provided in the NGPA for a phase-out of wellhead price regulation of some categories of natural gas. In 1989, Congress enacted the Natural Gas Wellhead Decontrol Act[12] which, inter alia, repealed all remaining wellhead price controls effective January 1, 1993, because it found controls were "not in keeping with the evolution of natural gas markets and the regulatory environment." S. Rep. No. 39, 101st Cong., 1st Sess. at 2 (1989). The House Committee Report on this legislation emphasized the movement to market competition from failed wellhead price regulation:

> All sellers must be able to increasingly reach the highest-bidding buyer in an increasingly national market. All buyers must be free to reach the lowest-selling producers, and obtain shipment of its gas to them on even terms with other supplies. Both the FERC and the courts are strongly urged to retain and improve this competitive structure in order to maximize the benefits of decontrol.

H.R. Rep. No. 29, 101st Cong., 1st Sess. at 6 (1989). The FERC restructuring Orders (Nos. 380, 436, 500, et al.,) were in keeping with Congressional intent to encourage competition. In 1990 FERC stated:

> [T]he natural gas industry is in a time of major change owing to the fundamental changes made by Congress in the way prices are determined in the wellhead markets. The Commission and the natural gas industry must steer through this transition period from the old environment to the new reality . . .. The benefits are those that

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[12] P.L. No. 101-60, 103 Stat. 157, 15 U.S.C. 3301 note (1989).

> are fundamental to the Natural Gas Act [of 1938]: sufficient supplies at a reasonable price. Congress has determined that competitive wellhead markets are the best way to accomplish that. All segments of the natural gas industry (producers, pipelines, LDCs and consumers) will benefit from the change from the old way of doing business to the new.

FERC Order No. 500-I, 55 Fed. Reg. 6605, 6621 (Feb. 26, 1990).

As pipelines settled non-viable gas supply contracts with producer-lessees, LDCs and other end users entered into new, often short-term gas supply contracts with producer-lessees in the new competitive wellhead market for gas. Pipelines and LDCs no longer have long-term supplier-purchaser contracts between them. Nor do pipelines and producer-lessees have any of their pre-restructuring economic relationship or affiliation regarding the ownership or sale of natural gas. The new gas supply contracts between LDCs or shippers and the producer-lessees are wholly independent from the pipelines' settled contracts with producer-lessees. The new gas supply contracts price gas production and delivery separately from transportation services. These separate contracts have their own independent economics.

In this new market, producer-lessees are contracting to sell and deliver gas to LDCs and to the ultimate consumers--residential, commercial and industrial end users. Pipelines provide mainly transportation service. While pipeline affiliates[13] may still buy production and sell to LDCs or end users, pipelines no longer

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[13] Pipeline affiliate transactions are kept totally separate from the regulated pipeline entity and its transportation functions, according to FERC Order No. 497, 53 Fed. Reg. 22139 (June 14, 1988).

provide commodity merchant service to LDCs and end users. The result is a highly competitive environment largely governed by market prices for short-term supplies of natural gas. In this market, price differentials of pennies per Mcf determine what sales and deliveries of gas occur.

Only with this restructuring of the gas industry essentially completed, and after producer-lessees have contracted afresh to sell the gas that could not be economically produced and sold under the settled contracts, did defendants improperly issue the May 3rd letter with its revised royalty demands.

5. Settlement payments did not buy gas. In its May 3rd letter, Interior is wrong as a matter of fact when it makes the generic assertion that settlement payments to producer-lessees were for production and are thus subject to royalty. The payments that pipeline members of *Amici* made to settle their non-viable supply contracts did not buy gas from producer-lessees. The producer-lessees' receipt of settlement payments was not for any gas produced and delivered.[14] Both pipeline and LDC members of *Amici* (to the extent pipelines are still buying gas) are now purchasing gas from producer-lessees at competitive market prices, and under terms that have virtually nothing in common with the gas supply contracts that were settled. Defendants' wholesale attribution of

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[14] The payment was in compromise of risks under the pre-restructuring gas supply contract that defendants as lessor did not share with lessees, and of rights and obligations in the supply contract to which defendants as lessor were not a party. See Part IV.B. below.

past settlement payments to current production under these new, market-driven contracts completely ignores the causes, purposes, and effects of the industry restructuring described above, and is foreign to the experience of the members of Amici that made settlement payments.

The fact situation in Interior's Samedan Decision is consistent with the history of restructuring set out above. The pipeline (Southern) was accruing take-or-pay liability that it had no hope of recouping in the changing gas market, and it paid to terminate this non-viable supply contract. The supply contract had been entered into before restructuring, and with price provisions that were, at the time of settlement, way above foreseeable market prices for the duration of the contract.[15] Southern did not purchase gas with the payment (App. 152 ¶18), nor did it purchase any gas from Samedan over what "would have been" the remaining period of the terminated contract had it not been terminated (App. 152 ¶19; App. 161 ¶19). Defendants admitted both that Southern did not intend to buy gas (App. 172 ¶18), and that it in fact bought none after the settlement (App. 172 ¶19).

Southern's actions confirm what transpired across the industry in the course of its restructuring, namely, rights and obligations under the long-term supply contracts were being terminated or amended because the contracts were no longer viable in a changed

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[15] $6.04 per Mcf (App. 160, ¶14) as compared with between $1.19 and $1.72 per Mcf (App. 113) in market priced, post-settlement sales to others.

market and a changed regulatory environment. The settlement payments bought no gas; they were not for production.

Defendants are only entitled to royalties on the value of production. A payment made to a producer-lessee that does not buy production is not subject to a royalty claim by defendants. Southern's payment to Samedan was just such a payment. Interior's position contradicts the underlying fact regarding settlement payments--they were not made for production. Interior's royalty claim cannot stand when it is inconsistent with the facts of the case.