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January 28, 1977

House Special Committee and
Senate Special Committee to
Consider the Sale of Royalty Gas
The Legislature of the State of Alaska
State Capitol
Juneau, Alaska 99811

Gentlemen:

You have requested my review and analysis of the contracts by and between the Commissioner of Natural Resources of the State of Alaska acting pursuant to AS 38.05-.183(d), seller, and Tenneco Alaskan, Inc., El Paso Natural Gas Company and Southern Natural Gas Company, buyers. The contracts in question are each in two parts, one part denominated "General Terms and Conditions," and the other denominated "Royalty Gas Sales Agreement."

I express no opinion on matters relating to title, taxes, or compliance with State contracting requirements. My opinions here offered are limited, as requested, to a legal analysis of the contracts, and an assessment of the merits, and demerits, of the various provisions thereof.

To submit my opinions in these areas, I have reviewed the contracts in question, and a summary of Commissioner Martin's negotiations as furnished to me by the Office of the Attorney General of the State of Alaska. I believe these materials to be sufficient to render the requested analysis, but my comments are necessarily limited to the materials which were available to me for review.

I wish to make clear also that I do not arrogate to myself the formulation or expression of an opinion as to whether the contracts in question should, or should not, be approved by the Legislature. The vote of each member must necessarily be cast in terms of his own appraisal of the contracts, giving due and

appropriate regard to the constituency which he represents, their wishes and best interests, and his perception of where the interests of the State lie. It would be most presumptuous for me to offer an opinion on a matter so peculiarly within the responsibility of elected representatives, particularly when my exposure to the people, the economy and the planning of the State of Alaska is as limited as it is.

Finally, it must be clearly recognized that an analysis of contracts already negotiated, and an appraisal of whether those contracts are, on balance, "good" or "bad," if undertaken as an abstract proposition, can be most misleading and unfair to the negotiators. A contract takes shape through a process of bargaining, and many provisions may not be precisely as one of the contracting parties would wish. The provisions are forged through negotiation and compromise, and if one gauges the contract only by reading the final contract after the negotiation process has run its course, it might appear that certain agreements have been embodied in the contract which are less than desirable and which should be modified or eliminated. Were one familiar with the negotiation process, however, he might realize that the apparently undesirable provisions were in fact necessary if an agreement was to be reached. I would caution, therefore, against an interpretation of my comments and opinions as critical of the officials who negotiated on behalf of the State.

Having offered these preliminary explanatory comments, let me turn to the contracts themselves.

I append, as Attachment A, a detailed summary of the contracts, section by section. Rather than reiterate this summary, I would prefer to offer my generalized perception of the relative merits and demerits of the contracts in terms of probable benefits and areas of concern. The Committee may wish to explore the concerns which I set forth with the Commissioner of the Department of Natural Resources, for indeed his experience in the negotiation process may well substantiate the view that the contracts as presented to the Legislature, even though containing certain problem areas, do in fact represent the best bargain that could have been struck under all of the attendant circumstances.

* * * * * * * * *

I would speak first on a positive note, addressing the obvious benefits which accrue to the State under the contracts as submitted to the Legislature for approval. I suggest that the benefits are material and substantial and, specifically, there are the following factors to be considered:

1.

The State has secured an agreement for full reimbursement of all costs related to the State's taking of its gas in kind. (Article II, Sections 2.2 and 2.3.) I consider this to be a significant concession in behalf of the State. When the State takes its gas in kind, it is quite possible that the taking will occur at the point of production, so that all costs incurred downstream from that point, such as for transportation to a processing plant, processing, and redelivery to a pipeline transporter, must be borne by the State in ratio to its percentage of the production taken. I do not believe that anyone can guarantee that the State would not be exposed to claims for substantial costs resulting from the in-kind taking. The royalty sales agreement clearly insulates the State from cost exposure with respect to the initial arrangements necessary to an in-kind taking, whether or not the costs reimbursed to the State by the buyers of the royalty gas are collectable by the buyers in their jurisdictional resale rate structure.

2.

The State has sold only a portion of its Prudhoe Bay royalty gas, and has secured the contractual right to withdraw volumes sold under the contract for Alaska in-state needs. (Article III, Sections 3.1 through 3.6.) If an alternate market for the State's royalty gas develops between the present time and the time when the buyers under the contract are in a position to take delivery, the State may take and dispose of its royalty gas in any manner that it chooses, so long as such taking and/or disposition does not interfere with the State's ability to deliver to the buyers when they are in a position to take. (Section 3.8.) The State is not committed by contract to a warranted volume of gas to be sold and delivered under the contracts, and has no stated minimum delivery obligation. (Section 3.2.)

I consider these provisions to be extremely favorable to the State. It is prudent to retain a portion of the State's royalty gas even when a decision has been made to sell part of that royalty gas, since holding a portion free of commitment permits negotiation at a later time when operating conditions have been established, and when circumstances may indicate that significantly different contractual arrangements are in order. Thus, sale of 2.6 Tcf under the contracts in question, rather than a sale of all of the State's Prudhoe Bay royalty gas is, in my judgment, proper.

It has, of course, been essential from the outset that the future needs of the State for natural gas for in-state uses must be in some manner accommodated throughout a royalty gas sales arrangement. It would obviously be unacceptable for the State to sell its royalty gas for transportation out of the State without some provision for meeting future natural gas needs within the State. The arrangement worked out in the contracts to accomplish this objective is favorable to the State. The State may withdraw, over time and upon suitable notice, up to 100 percent of the gas contracted for sale under the instant agreements; the rights of withdrawal must, of course, be exercised for the sole purpose of the State meeting the intrastate domestic and industrial needs of the State of Alaska, and the withdrawal is scaled from 25 percent through 100 percent over 20 years; nonetheless, the withdrawal provisions are more favorable than I would have anticipated and they represent a major element of strength in these contracts.

3.

The State has excepted and reserved from the sale, all liquids removed from the State's royalty gas prior to its delivery to the pipeline (Article IV, Section 4.4), and the State has retained processing rights for the recovery of liquefiable hydrocarbons other than methane, whether exercised before or after delivery to the buyer. (Article IX.) If the liquids are not removed from the gas stream so that the liquid content of the gas stream delivered for sale produces a higher than 1,000 Btu per cubic foot average, the State will be compensated for the greater heating content through adjustment of the sales price. (Article VI, Section 6.6.)

These arrangements for the State to retain the benefits of the liquid content of the gas stream should prove beneficial to the State over the life of gas production from Prudhoe Bay. Liquids and liquid products can provide a significant source of additional revenue to the State if they are sold on the open market and, conversely, if there is need for liquid products in the State (such as a need for propane for its multiple uses, or a need for butane and natural gasoline as feedstocks for petrochemical or other operations), the State is free to direct the liquids and the liquid products to their highest and best use. The inclusion of these provisions in the contract is a distinct plus.

4.

The contract permits State withdrawal from the contract, without penalty, in the event of the occurrence of several different circumstances: If the State is prevented from taking its gas in kind by federal action, the sales agreements shall be void (Article II, Section 2.1); the contracts can be terminated if a decline in production results in nonprofitability to the State (Article VIII); the sales agreements may be terminated by the State if the State so elects following Federal Power Commission certification of an Alaskan gas transportation proposal, except that this right of termination would not exist if the Commission's grant of a certificate is to the El Paso project (Article XI, Section 11.5); and the State may terminate the royalty sales contracts if, by January 1, 1979, all regulatory approvals which the State deems necessary to enable the State to perform its obligations under or receive the benefits of the contract have not been received (Article XI, Section 11.2).

The cumulative effect of these termination options is sufficient, in my opinion, to safeguard the State against reasonably foreseeable adverse developments which might occur. Their inclusion in the contracts is of significant value to the State.

* * * * * * * * * *

I must now turn to certain aspects of the contracts which are of concern to me. These relate to the pricing of the State's royalty gas when sold to the buyers under these contracts.

1. Section 6.1 imposes an upper limit on the price which the state will receive for its royalty gas, and this limitation will be operative unless and until appropriate Federal legislation deregulating Alaska gas is passed. The Section 6.1 limitation, in full, is as follows:

> "In consideration thereof, the price which buyer shall pay seller for gas purchased hereunder shall be determined in accordance with Section 6.2 or Section 6.3 or Section 6.4 or Section 6.5 and shall be subject to the adjustment as provided in Section 6.6; however, the price paid seller for gas which buyer reflects in its rates to jurisdictional customers shall never be higher than the price buyer is permitted to retain in its jurisdictional resale rates so long as such rates are subject to regulation by the Federal Power Commission (or any successor governmental authority having jurisdiction in the premises)."

The underscored proviso is thus given controlling affect, irrespective of the price indicated under Section 6.2 (price fixed at the highest price permitted by the Federal Power Commission to any working interest seller from the Exhibit A reservoirs); irrespective of the price indicated under Section 6.3 (in the event of deregulation at the time of first deliveries, the price is fixed at the level of the highest price being paid by any interstate gas purchaser for gas produced from the Exhibit A leases); irrespective of the price indicated under Section 6.4 (in the event of the cessation of federal regulation after such has once commenced, the price is to be fixed by redetermination and/or arbitration); and irrespective of the price which would result from redetermination in accordance with Section 6.5

The limitation holds as a ceiling on the State's sale price "so long as such rates (buyer's jurisdictional resale rates) are subject to regulation by the Federal Power Commission ...."

It is inescapable that the buyers under these contracts will become transporters of natural gas in interstate commerce, and that they are purchasing gas for resale in interstate commerce. The rates at which the buyers sell for resale will be within the jurisdiction of the Federal Power Commission under the Natural Gas Act, and I know of no foreseeable set of circumstances that would produce legislation, or a Commission decision, changing this result.

Section 6.1 may not be unduly burdensome if legislation is passed which denies the Federal Power Commission the power to refuse recovery of purchased gas costs in an interstate transporter's jurisdictional resale rates, for then it could be argued that the buyers under this contract must necessarily be "permitted to retain" in their jurisdictional resale rates the amounts paid to the State and, therefore, the ceiling limitation in the Section 6.1 proviso would not interfere with operation of the other pricing alternates in the contracts. Such legislative language was employed in the bill which passed the United States

Senate in October 1975, S. 2310, and the same type of language now finds expression in the most recent deregulation legislation offered in the current Congress by Senators Pearson and Bentsen, S. 256.

I do not think the language of the contracts to be altogether clear, however, that Section 6.1 becomes inoperative in the event of Congressional deregulation. If it is the intent of the contracting parties that "flow through" language in a deregulation bill would effectively eliminate the Section 6.1 proviso, then I would suggest that an appropriate letter be obtained and made a part of the contracts before they become effective.

2. Even if Section 6.1 is clarified as suggested, you must understand that Section 6.1 will still subject the State's royalty sales to FPC rate regulation, and such will continue unless and until the Congress enacts appropriate deregulation legislation.

While the State has uniformly and steadfastly maintained that its sales of royalty gas are not subject to direct regulation by the Federal Power Commission because the State is not a person within the meaning of the Natural Gas Act (and I agree with this position), the State does by these contracts consent to indirect rate regulation by the Commission by conceding that the State's sale price is limited to that amount which the Commission will permit the buyers to retain in their jurisdictional rates.

3. At this time, the State cannot determine its sale price, or anticipated revenues at time of first delivery. Section 6.2 does not yield a present price, for there are no FPC-set rates for Alaska gas at this time. Neither Section 6.3 nor 6.4 yields a present price, for their conditions precedent (deregulation) have not occurred. I am at a loss, therefore, to advise the Committee on the sale price which will be applicable at the time of first delivery. If the status quo prevails through the time for first delivery, I assume -- although the contract is silent on the point -- that the buyers and the State would agree to an interim price which would be paid to the State, subject to refund.

4. You should note that the pricing mechanism agreed to in Article VI results, in every reasonably probable circumstance, in the State's sale price being determined by parties other than the State. If federal regulation continues, or if deregulation legislation is not appropriately drafted, the FPC sets the rate for the State. If deregulation occurs, before or after first delivery, the sales price negotiated by private firms making comparable sales will determine the State's sales price.

5. I cannot guess what rate the FPC will set for private sales of natural gas from Prudhoe Bay, but the prospects for a relatively low rate -- because the gas is associated and many costs can be allocated to oil, and because the size of this discovery and these reserves may operate to distort initial well-head rates downward -- are not to be ignored. It will, in my judgment, be easier for the FPC to find reasons why a private seller's rate should be low than it would be for the Commission to deny to the State public funds for public needs. Thus, the contract tying arrangement to private firms' prices -- not yet negotiated -- may deprive the State of a strong argument for adequate prices: namely, that State revenues will be public monies devoted to public needs and public uses, and that, therefore, the State's sales rate should not be judged by traditional FPC concerns of windfall profits to private firms.

6. In Article VI, redetermination rights under Section 6.5 are not clearly granted if deregulation occurs prior to first deliveries. Such rights should exist to protect the State adequately over the twenty-year term of these agreements, and should be provided in Section 6.3, or through re-wording of Section 6.5. Incidentally, re-determination <u>downward</u> at the buyer's request, as permitted in Section 6.5, is not frequently seen. If Section 6.5 is modified, revision to eliminate the possibility of price reductions in the future should be explored.

7. Under the pricing scheme in the contracts, the probable mechanism for Federal Power Commission review of the State's royalty sales rate will be either (a) in the various pipeline rate cases where the cost of purchasing gas from the State is submitted to the Commission as a recoverable item by the pipeline in its resale rate structure; or (b) in a producer sales proceeding where one of the Prudhoe Bay working interest owners requests FPC sales authority; or (c) a rule-making procedure to determine as Alaska ceiling rate for producer sales. The State will be forced to seek intervention, and participate forcefully if allowed to intervene, in one or more of these proceedings in order to have an opportunity of making a direct presentation to the FPC on the appropriate rate level for sales by the State.

Are these problems sufficient to condemn the contracts as inprovident? To some -- those whose sole concern is specificity of price and certainty of revenue -- the answer will be "Yes". But that answer may apply too narrow a standard if -- as may well be true -- there are no reasonable pricing alternatives available to the State.

If all prospective pipeline buyers, present and future, would insist on a pricing structure similar to the one in these contracts, then the alternative to rejection of these contracts

is the alternative of having no contract for the sale of the State's royalty gas. Viewed in this light, the pricing structure before you may be unpalatable, but it may be necessary. If you say "no" to this pricing structure, you may really be saying that the State should not contract at all; that the State should play a less affirmative role in the routing decision; and that the State can strike a better bargain for its gas after the Federal decisional process has run its course.

This choice is yours to make. It requires a broader understanding of the State's goals and needs than I possess, and accordingly, I would be foolish to attempt to recommend a course of action to you. The best I can do is make you aware of the problems, so that your decision will be an informed one.

I would add two footnotes. If these contracts are approved, appropriate deregulation legislation by the Congress becomes terribly important to you. If Alaska gas is deregulated, most of your pricing problems disappear. On the other hand, if deregulation does not occur, the FPC becomes terribly important to you. That agency's pricing regulations will directly impact on your revenues. In the absence of deregulation, the State will be required to become an active, and effective, advocate at the FPC.

* * * * * * * * *

As a final area of general discussion, I would like to call the Committee's attention to several of the provisions in the contract which I think are significant. I do not classify these provisions as being either "good" or "bad" since, in most instances, one's perception of the provisions will depend upon considerations other than legal analysis.

In Article XI, Section 11.4, it is provided that the Governor of Alaska may give notice to the buyers of his decision to support a project other than the trans-Alaska pipeline, and if the Governor does so, with appropriate notice to the buyers, then the newly selected project will be considered the "pipeline" for the purposes of the contract. The buyers need not concur in this change in the State's official position, and if they do not agree, then they are given the right to terminate the contracts.

Second, the selection by the State of Tenneco and Southern as buyers of a portion of the State's royalty gas brings a promise of support by those two organizations of the trans-Alaska gas pipeline system. The involvement, and support, of these two concerns adds a new element to decisional process in Washington with respect to the selection of the routing of a North Slope gas transmission system.

Third, it should be noted that the contracts grant certain options on State royalty gas which are triggered if the State effects a withdrawal of all or any portion of the gas committed under these contracts in order to satisfy in-State needs. The options are not exercisable unless the gas covered thereby is surplus to the needs of the State, and unless the surplus gas is to be transported to market through the trans-Alaska pipeline system. I do not find the option provisions objectionable, but I felt that they were significant enough to require separate mention.

Finally, the contract does not speak to one element of revenue loss that the State will probably sustain by reason of an in-kind taking. The severance tax payable on the State's royalty gas if the State did <u>not</u> take in kind will probably be lost if the State does take in kind. No treatment of this problem appears in the contract.

I will stand ready to respond to such questions as the Committee might have during its hearing on February 2, 1977, and if there are any matters contained in this letter or in its attachment which are not clear, I trust that I will have an opportunity to speak to any such problem at that time.

Respectfully submitted,

Rush Moody, Jr.

RM:bw
Attch.

ATTACHMENT "A"

SUMMARY OF MAJOR CONTRACTUAL PROVISIONS

A. "General Terms and Conditions"

Section 1 defines the terms essential to an understanding of the contract. The definitions are standard, and require no comment except to note the definition of the term "domestic and industrial needs of the State of Alaska" as set forth in Section 1.11. This term is defined to mean "those present and projected residential, commercial and industrial uses for gas within Alaska as determined by the Alaska Royalty Oil & Gas Development Advisory Board in accordance with AS 38.05-.183(d)."

This definition is critical to the structure of the royalty gas sale inasmuch as it forms the basis for the State's rights of withdrawal of royalty gas from the contract as set forth in Article III of the various royalty gas sales agreements.

Section 2 delineates the respective responsibilities of buyer and seller for damage or injury occurring in connection with the movement of royalty gas. The State is responsible prior to delivery to the buyers, and the buyers are responsible after receipt of the gas, except that while the gas is being processed by or on behalf of the State, the buyers are not responsible.

The contract does not fix responsibility, as between buyer and seller, for the processing stage.

Section 3 governs metering of gas sold under the contract; the provisions which essentially require the buyers to install necessary meters to measure accurately the gas purchased under the agreement, but which permit the State to install check meters and otherwise periodically review the accuracy of the purchaser's metering activities, are standard and reasonable. In one respect these provisions are more favorable to the State than might be expected; the contract calls for correction of inaccuracies, when they occur, for a period extending back one-half of the time elapsed since the date of last calibration of the metering equipment. Frequently, gas sales contracts limit the period of time of recalculation, with it being fairly standard that such period is limited to a correction period of two weeks, or at most one month.

Section 4 contains standard provisions relating to the definition of the unit of volume sold.

Section 5 sets forth technical standards for gas measurement, and is standard in the industry.

Section 6, dealing with billing and payment, provides for the rendition of monthly statements, by the 15th day of each

month, setting forth the amount of gas delivered by the State and purchased by the buyers during the preceding calendar month, and for payment to be made by the 25th day of the calendar month in which the run statement is rendered. These provisions are standard.

Section 7, entitled "Receipt of Available Gas," imposes upon the buyer the obligation to proceed diligently to seek such authorization as required to receive gas then available for delivery by the State. As will be discussed later, the intent of Section 7 with respect to Tenneco Alaskan, Inc. and Southern Natural Gas Company is not altogether clear since neither of these buyers appears to be so situated that an authorization "to receive gas" would be required. Neither of these two buyers is in the present posture of seeking certificates permitting the transportation of royalty gas, or permitting construction of facilities to transport gas in interstate commerce and, accordingly, Section 7 is probably inappropriate in their contracts.

Section 8 contains a standard warranty of title by the State.

Section 9, force majeure, permits either party to the contract to suspend its performance if reasons force majeure supervene. The force majeure provisions are standard, but it is

interesting to note that, in a case such as this where the State is a contracting party, the State can effectively relieve itself of any obligations under the contract by the imposition of "future rules, regulations, orders, laws or proclamations." The State can thus create a force majeure situation through its own action, and if the effect of force majeure is to require suspension of the State's performance under the contract, the State incurs no liability by reason of nonperformance to the buyers. Conversely, if the State, by future rule, regulation, order, law or proclamation makes it impossible for the buyers to perform, the buyers have no liability for nonperformance to the State.

Section 10 makes the contract subject to all present and future valid laws and valid regulations of the United States, the State of Alaska or any duly constituted agency thereof. This is a standard provision.

Section 11 permits assignment of rights under the contract; it is expressly provided that either buyer or seller may assign its rights under the agreement to a security holder without such security holder incurring personal obligation under the contract, and without such security holder being required to qualify to do business in the State of Alaska.

Section 12 is not a standard contractual provision normally encountered in gas contracts. Section 12 provides, in essence, that if a producer of gas, of which the State's in-kind royalty gas is a part, enters into a contract of sale which contains provisions more favorable to the seller than the terms and conditions set forth in Sections 3, 5 and 6 of the "General Terms and Conditions," then the State has the option to include such more favorable terms and conditions within this contract "within 90 days after approval by the Federal Power Commission of said working interest owner's contract for the sale of its gas." The limitation of the State's right to move to more favorable terms is, as noted, limited to changes in the sections of the State's contract dealing with metering, measurement, and billing, and since these provisions are fairly well standard, it is doubtful that Section 12 will be of consequence. It should also be noted that if deregulation of new gas occurs, and if Prudhoe Bay gas is included within the definition of new gas so that the producer sales of that gas never become subject to FPC review, then Section 12 becomes meaningless inasmuch as the State would never have a matured right to demand favorable changes in Sections 3, 5 and 6.

Section 13 contains miscellaneous provisons to aid in the interpretation and application of the contract. The provisions of Section 13 are not remarkable.

B. "Royalty Gas Sales Agreement"

Three separate "Royalty Gas Sales Agreements" have been negotiated, but all are identical in terms, with the exception that Tenneco Alaskan, Inc. is the buyer of 50 percent of the State's royalty gas covered by the total sales transaction, Southern Natural Gas Company is the buyer of 25 percent, and El Paso Natural Gas Company is the buyer of 25 percent. Since all contracts are identical, the following summary of the provisions of the El Paso contract will apply to the others also.

Article I sets forth the mutual promises of buyer and seller each to support actively and seek before appropriate authorities the ultimate selection and implementation of a trans-Alaska gas pipeline system. For purposes of this article, "pipeline" means a large diameter gas pipeline commencing at Prudhoe Bay, crossing Alaska in approximately the same route as the present trans-Alaska pipeline system oil pipeline, and terminating in the Prince William Sound area.

Article II, denominated "seller's royalty gas," covers several matters: Section 2.1 sets forth the State's warranty of

its right to take royalty gas in kind, and its royalty share as being 12-1/2 percent. The leases identified in Exhibit A to the agreement set forth the specific acreage and royalty shares covered by the contract. If the State is prevented by federal action from taking its gas in kind, the gas sales agreement shall be void. [It should be here noted that Exhibit A was not furnished to me for review; I have assumed it to be no more than a listing and description of those State leases from which royalty gas will be sold under this contract.]

Section 2.2 provides that in addition to the sales price provided for elsewhere in the contract, the State will be reimbursed for the State's pro rata share of costs attributable to "the preparation and transportation of gas to be delivered hereunder." These costs are identified as being those costs which the State may incur as a result of its election to take its gas in kind, and which costs would not have been incurred if the State had not elected to take the royalty gas in kind.

Section 2.3 provides, however, that if the buyer is not able to include within its jurisdictional cost of service as determined by the Federal Power Commission, the cost reimbursement provided for in Section 2.2, then the buyer may terminate the gas sales agreement six months after giving notice of termination. If the

right of termination is exercised, the buyer must nonetheless reimburse the State for those costs identified in Section 2.2 which become due and payable by the State prior to termination.

Article III governs the quantity of gas to be sold under the sales agreement. The structure of this article is as follows:

Section 3.1 establishes the State's agreement to sell 25 percent of seller's royalty gas available at the prescribed delivery points. (The Southern contract also calls for 25 percent of seller's royalty gas, while the Tenneco contract calls for 50 percent of the State's royalty gas.)

Section 3.2 establishes the base volume of gas to be sold by the State and purchased by the buyers during the term of the gas sales agreement. For El Paso, the base volume may be less than, but under no condition shall it be in excess of, 650 Bcf. The same base volume applies in the Southern contract, while the Tenneco contract specifies a maximum base volume of 1,300 Bcf.

Sections 3.3 and 3.4 relate to the right of the State to withdraw from the contract certain volumes to meet the present and future needs of the State. The schedule of reductions is as follows:

From date of first delivery through the fifth anniversary thereof, the State has the right to reduce the

quantity of royalty gas otherwise available for sale under Section 3.1 by up to and including 25 percent.

Commencing on the fifth anniversary date of first delivery and continuing through the tenth anniversary date thereof, the State has the right to reduce the quantity of royalty gas available for sale under Section 3.1 by up to and including 50 percent.

Commencing on the tenth anniversary date of first delivery and continuing through the 15th anniversary date thereof, the State has the right to reduce the quantity of royalty gas available for sale under Section 3.1 by up to and including 75 percent.

Commencing on the 15th anniversary date of first delivery and continuing until termination of the agreement, the seller has the right to reduce the quantity of royalty gas available for sale under Section 3.1 by up to and including 100 percent.

Reductions by the State of the quantity of royalty gas available for sale and delivery shall not become effective until after 12 months have elapsed from the date that the State gives written notice to the buyers of its desire to reduce deliveries.

It is further provided that the State may change the percentages set forth above at any time during the term of the gas sales agreement, but such changes cannot become effective prior to the expiration of 24 months following the State's written notice to the buyer of its modification of the percentages.

Section 3.5 limits the State's rights of withdrawal of royalty gas volumes by stating that the rights of the State "shall be for the sole purpose of the State meeting the intrastate domestic and industrial needs of the State of Alaska ...." It will be recalled that the phrase "domestic and industrial needs of the State of Alaska" is specifically defined in the "General Terms and Conditions." The right of the State to withdraw gas from the contract for certain uses is further explained by the following provision in Section 3.5:

> "This provision shall not limit the right to export from the State any products manufactured from said gas."

Section 3.6 requires the State to reduce, pro rata, deliveries to all three purchasing companies in the event that a State decision to withdraw gas from any of the contracts is made.

Section 3.7 has the effect of granting to the buyers an option on State royalty gas other than that produced under the leases identified on Exhibit A to the gas sales agreement. Under

the provisions of 3.7, if the State in fact withdraws royalty gas to meet State needs and if, during the term of this agreement and five years thereafter, the State has additional royalty gas which is surplus to State needs, and which will be transported by a trans-Alaska pipeline, then the State agrees to offer to sell to the buyers under the provisions of this agreement (except as to price and term) such additional and excess royalty gas. The option is granted to the three purchasers ratably. As to such "option gas," the price to be paid is the highest price available to the State for such gas from any other interstate bona fide purchaser; if there are no other such purchasers, the price for such "option gas" will be the price then being paid under the instant gas sales agreement.

Under Section 3.7(b), an additional right of first refusal is granted to the buyers. If royalty gas becomes available to the state which, in the State's sole discretion, is determined to be surplus to the intrastate domestic and industrial needs of the State of Alaska, the buyers under the instant agreement are given a right of first refusal to purchase additional royalty gas from the State to the extent of one-half times the volume that the State's exercise of its rights of withdrawal under Sections 3.3

and 3.4 in fact diminishes the amount of gas the buyer would otherwise have purchased and received under the instant agreement.

Section 3.8 permits the State to take and dispose of its royalty gas produced under the leases identified in Exhibit A at any time after the effective date of the instant agreement and prior to the time of first deliveries hereunder; the State may utilize, market or otherwise dispose of its royalty gas in any manner it choses, at its own expense, so long as such taking or disposition does not prevent the State from making available for sale to the buyers on the date of first deliveries the quantity of gas committed under the contract.

Section 3.9 commits the State to the burden of advising the buyer at the beginning of each calendar year its best estimate of volumes which will be available under the agreement during each calendar year of the next succeeding five calendar years.

Section 3.10 expresses the agreement of buyer and seller to cooperate in minimizing "any charges levied on gas liquefied and transported from Alaska to the contiguous 48 states."

Section 3.11 provides that if the State exercises its rights of withdrawal of gas from the agreement, then the State will reimburse the buyer for a percentage of any then undepreciated investment made by the buyer in any facilities upstream of the

pipeline. The percentage of reimbursement is the percentage that the State's reserved gas is of the total gas which otherwise would have been sold to the buyer under the agreement.

Article IV of the royalty gas sales agreement deals with delivery points and delivery pressures. Section 4.1 provides that the State's royalty gas shall be delivered at the point where the working interest owners of the leases make delivery of gas to their purchaser, or at any other point mutually agreed upon by the buyer and seller under this agreement.

Section 4.2 provides that if the State is required to take delivery of its royalty gas at a point upstream from the delivery point determined under Section 4.1, then the buyer under this agreement is required to accept delivery at the point where the State receives its royalty gas.

In Section 4.3, it is provided that gas sold and delivered by the State under this agreement shall be received by the buyers at the same pressure as the pressure the working interest owners deliver their gas to their purchasers, or at the pressure the State receives its gas from the working interest owners if delivery is made upstream of the specified delivery point.

Section 4.4 reserves to the State the right to receive all liquids removed from the gas prior to its delivery to the

pipeline, whether the liquids are removed before or after delivery of the gas to buyer.

Article V of the royalty gas sales agreement specifies that the gas delivered by the State shall conform to the quality specifications applicable to the gas sold by the working interest owners at the same delivery point.

Article VI of the royalty gas sales agreement is concerned with price. Three alternate methods of determining the sales price are set forth in Sections 6.2, 6.3 and 6.4. Price redetermination rights are set forth in Section 6.5. Irrespective of which section governs the manner of establishing price, the sales price is subject to two important limitations:

Section 6.6 requires that the sales price reflect 1,000 Btu's per cubic foot, and if the heating value of the gas actually delivered is either greater than or less than 1,000 Btu's per cubic foot, then the price will be adjusted upward or downward.

Secondly, and more importantly, Section 6.1 sets forth an absolute upper limit on the price paid to the State. It is there provided that the price paid the State shall never be higher than the price which the buyer is permitted to retain in its jurisdictional

resale rates "so long as such rates are subject to regulation by the Federal Power Commission ...."

The four alternative methods of pricing are as follows:

Section 6.2 provides that if at the time of first delivery of gas, the price of gas purchased under the contract is subject to FPC regulation because of the Commission's authority to regulate resale rates, then the initial price to be paid shall be the highest rate allowed by the Commission to be paid by any interstate gas purchaser to any working interest owner in the leases identified in Exhibit A under contracts where at least 50 Bcf of gas are sold. Thereafter, the price to be paid would change in accordance with the applicable and governing portions of the rules and regulations of the Federal Power Commission. In the event any producer sells gas from the leases identified in Exhibit A at a price higher than the generally applicable FPC ceiling rates, through utilization of FPC special pricing procedures, then the State sales price would escalate to that higher price. In no instance will the State receive less than the price paid producers for their gas from the same reservoir for same or similar sales in interstate commerce.

Section 6.3 provides that if at the time of first deliveries of gas under the agreement the price of gas sold from the leases

identified in Exhibit A is not regulated by the FPC, then the initial price for gas delivered under the agreement shall be the highest price being paid by any interstate gas purchaser for gas under contracts of at least 50 Bcf and produced from the leases identified in Exhibit A.

Section 6.4 deals with the eventuality of deregulation at the federal level; if the FPC ceases to exercise jurisdiction over interstate sales for resale after having once commenced jurisdiction, and if deregulation is in such form that it prevents the FPC from excluding the price the buyer pays under this agreement from its cost of service, then the State may elect, by the giving of written notice, to call for redetermination of the sales price as permitted in Section 6.5.

Section 6.5 sets forth redetermination rights of both buyer and seller. Each party has the option to cause the price being paid for gas sold under the agreement to be redetermined every 12 months, such redetermination to be effective on the anniversary of such redetermination. If either party requests redetermination, the parties shall attempt to agree on a new price, and in doing so shall observe the following: The redetermined price shall be the higher of (1) the highest price being paid for gas sold in interstate commerce from Prudhoe Bay of Alaska under a

contract selling at least 50 Bcf of gas executed in the previous 12 months, or (2) the highest price being paid under a renegotiation or redetermination clause of any contract for gas sold in interstate commerce from the North Slope covering the sale of at least 50 Bcf of gas. If there are no comparable contracts executed in this one year period, or no contracts under which the price has been renegotiated or redetermined, then the parties are to attempt to agree to a new price, but failing this, the matter will be submitted to arbitration as provided in Article VII of the royalty gas sales agreement. In no event shall the redetermined price be less than the price being paid to the State immediately preceding the initial redetermination.

Article VII of the royalty gas sales agreement covers arbitration procedures. Any dispute arising under the agreement can be settled by arbitration if either party requests arbitration. Normal arbitration procedures are set forth, whereby each party names one arbitrator and the two so named select a third. The action of a majority of the board of arbitrators and their decision on matters submitted to them for adjudication shall be final and binding on the parties.

Article VIII of the agreement specifies that the agreement shall become effective upon execution and approval, and shall

continue for twenty years from the date of first deliveries or until the base volumes of gas set forth in Section 3.2 have been delivered, whichever is earlier. Earlier termination can occur if, for any reason, a decline in production is sustained to the extent that further production of gas would no longer be profitable for the State, or further operation of the transportation facilities would no longer be profitable to the buyer.

Article IX reserves certain rights to the State. The State retains the right to process the gas or have the gas processed before and/or after delivery to buyer for the recovery of liquefiable hydrocarbons other than methane; the State agrees that such processing shall not reduce the heating content of the residue gas below 1,000 Btu's per cubic foot, and the State agrees to reimburse the buyer for all transportation charges, liquefaction charges and regasification charges attributable to volumes removed by processing, including fuel and shrinkage.

Article X of the royalty gas sales agreement specifies the form of notices to be used in those instances where formal notification is required by the agreement.

Article XI specifies certain "conditions precedent." First, the buyer has no obligation to perform any of its undertakings in the agreement, other than its agreement to support the government's

selection of a trans-Alaska pipeline, unless and until all necessary government approvals for building, construction and operation of the pipeline are granted. The only exception here is that any costs incurred by the State by reason of the State's election to take its royalty in kind shall be reimbursed by the buyer as provided in Section 2.2.

Second, if all necessary regulatory approvals have not been issued and accepted by December 31, 1978, either party to the agreement may thereafter terminate the agreement by giving 10 days written notice.

Third, after approval of the agreement by concurrent resolution of a majority of each house of the Alaska State Legislature, the buyer is to proceed with diligence in the filing and prosecution of such pleadings and applications with the FPC as may be required to obtain all necessary rate, tariff and certificate authorizations related to the buyers' obligations under the agreement.

Fourth, it is provided in Section 11.4 that prior to the time that a Federal Power Commission order granting a certificate of public convenience and necessity to the pipeline becomes final and nonappealable, the Governor of the State may give written notice to the buyer of his decision to support a project other than the trans-Alaska pipeline as defined and identified in the

agreement. Such notice is not a default by the State under the agreement, but if the buyer decides not to concur in the Governor's change of position, then the buyer may terminate the agreement in its entirety. If the buyer agrees to support the project designated in the Governor's notice, the new project shall be considered the "pipeline," and the agreement remains in force.

Fifth, the royalty gas sales agreement may be terminated by directive of the Governor and service of notice on the buyer if the Federal Power Commission denies the El Paso-Alaska application in Docket No. CP75-96, or if the Commission grants a certificate of public convenience and necessity to a project or system other than the "pipeline" as defined in the agreement.

Finally, it is stipulated that the agreement shall not take effect until approved by concurrent resolution of a majority of each House of the Alaskan Legislature.

Article XII incorporates the general terms and conditions and Exhibit A into the agreement and makes them a part of the agreement for all purposes.

LEGAL ANALYSIS OF ISSUES RELATING TO NATURAL GAS TRANSPORTATION

Prepared for the Joint Gas Pipeline Impact Committee of the Legislature of the State of Alaska

Submitted by
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I.

THE FEDERAL-STATE RELATIONSHIP

A. Federal Regulation of Natural Gas

1. General Description of Federal Authority.

Federal regulatory authority over natural gas arises from the Constitutional grant to Congress of the exclusive power "To regulate Commerce. . .among the several States." U.S. Const., Art. I, Sec. 8. Congressional exercise of its authority is reflected principally in the Natural Gas Act, 15 U.S.C. 717(a) et. seq.

The Natural Gas Act does not reflect Congressional intent to occupy the natural gas field to the full extent which the Commerce Clause of the Constitution would permit; rather, the Act contemplates only partial Federal regulation which is pre-emptive only within the limits of the Act. The Supreme Court, in Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507 (1947), has said:

> [T]he essence of [appellant's] position, apart from standing directly on the commerce clause, is that Congress by enacting the Natural Gas Act has "occupied the field," i.e., the entire field open to federal regulation. . . .
>
> "The exact opposite is the fact, Congress, it is true, occupied a field. But it was meticulous to take in only territories which this Court had held the states could not reach." 332 U.S. at 519 (footnote omitted).

The Court in Panhandle also emphasized that under Section 1(b) of the Gas Act:

"Three things and three only Congress drew within its own regulatory power, delegated by the Act to its agent, the Federal Power Commission. These were: (1) the transportation of natural gas in interstate commerce; (2) its sale in interstate commerce for resale; and (3) natural gas companies in such transportation or sale." 332 U.S. at 516.

The Courts have on several occasions rejected non-legislative attempts to expand the jurisdiction of the FPC beyond the bounds fixed by the Gas Act. In Mobil Oil Corp. v. FPC, the FPC contended that it had jurisdiction over the sale of the royalty owner's interest in a natural gas stream sold in interstate commerce. The FPC argued that such jurisdiction was necessary to protect the consumer against unreasonable demands by the royalty owner. Rejecting that argument, the Court said:

"The FPC is to be commended for attempting to further that objective, but it is not sufficient justification upon which to base an expansion of the Act to activities clearly not within its term. Congress did not give the FPC carte blanche to take whatever action it might consider appropriate infurtherance of this purpose. The FPC is limited by the provision establishing its jurisdiction, and we do not find in that provision, rooted as it is in a sale in interstate commerce, any basis for reaching out to cover the landowner's lease or its royalty payments." 149 U.S. App. D.C. 310, 317, 463 F.2d 256, cert. denied, 406 U.S. 976 (1972).

The Court reached a similar conclusion as to the limits of the Gas Act in another case of the same name, Mobil Oil Corp. v. FPC, involving the question of whether the FPC's jurisdiction over interstate transportation of natural gas gave it jurisdiction over the rate for transporting natural gas liquids. The Court said:

"The Commission cannot gain jurisdiction over an activity simply by characterizing it as a part of a "total transaction" of which another part happens to be subject to the FPC's control. The Commission has jurisdiction over sales of natural gas at the wellhead for resale in interstate commerce." 157 U.S. App. D.C. 238, 245, 483 F.2d 1238, 1248 (1973) (footnotes omitted).

Congress, by its limited grant of authority to the FPC under the Gas Act, undertook only to fill the hiatus created by lack of state authority constitutionally to regulate aspects of interstate sales and transportation of natural gas and did so with "unusual legislative precision." Panhandle Eastern Pipe Line Co. v. Public Serv. Comm'n., 332 U.S. 507, 516, 517 (1947).

The legislative history of the Gas Act is explicit on this point:

"The States have, of course, for many years regulated sales of natural gas to consumers in intrastate transactions. The States have also been able to regulate sales to consumers even though such sales are in interstate commerce, such sales being considered local in character and in the absence of congressional prohibition subject to State regulation. . .There is no intention in enacting the present legislation to disturb the States in their exercise of such jurisdiction. . . The basic purpose of the present legislation is to occupy this field in which the Supreme Court has held that the States may not act.

". . .The bill takes no authority from State commissions and is so drawn as to complement and in no manner usurp State regulatory authority." H.R. Rep. No. 709, 75th Cong., 1st Sess. 12 (1937) (citations omitted).

2. Detailed Description of Federal Regulation.

The Commission's power to regulate interstate transportation, sales for resale in interstate commerce, and

persons engaged in such transportation or sales is exercised through five basic mechanisms:

1. Rate regulation pursuant to Sections 4 and 5 of the Natural Gas Act.

2. Service regulation pursuant to Section 7 of the Act.

3. Curtailment regulation pursuant to Sections 1, 4 and 5 of the Act.

4. Import and export regulation pursuant to Section 3 of the Act.

5. Reporting and accounting regulation pursuant to Sections 6, 8, 9, 10, and 14 of the Act.

For the purposes of this analysis, attention is centered upon the service and import/export areas.

a. Section 7--Control Over Service and Facilities.

It is through Section 7 of the Natural Gas Act that the FPC exercises its greatest degree of control over natural gas sales, transportation and marketing.

Through the language of Sec. 7(c), the Commission controls the following activities:

1. All sales for resale in interstate commerce;

2. All transportation of natural gas in interstate commerce; and

3. All facilities needed to make a sale or effect a transportation.

This control is exercised through the power to grant, deny, or conditionally grant a "certificate of public convenience

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and necessity" to one who proposes to engage in interstate sales or services. Without a certificate, the activity is unlawful.

Thus, before a producer may sell to an interstate pipeline, the producer must obtain a certificate from the Commission. Before an interstate pipeline may install facilities to receive gas from a producer, to transport gas, or to effect a sale to a customer, it must obtain a certificate from the Commission. Before an interstate pipeline may use its existing facilities to transport gas for someone else, it must obtain a certificate from the Commission. See, Atlantic Refining Company v. Pub. Serv. Comm. of N. Y., 360 U.S. 378 (1959); FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961); Illinois Natural Gas Co. v. Central Illinois Pub. Serv. Co., 314 U.S. 498 (1942).

The Commission's powers of certification are not exercised through strict application of readily determinable rules; while Commission action must not be arbitrary, and must have support in substantial evidence, "public convenience and necessity" is a shifting standard which has meaning only in terms of the incumbent commissioners' perception of the public interest. The Commission's actions in the certification area are largely discretionary. See, California Gas Producer's Association v. FPC, 383 F.2d 645 (C.A. 9, 1967); International Paper Co., v. FPC, 438 F.2d 1349 (C.A.N.Y., 1971) cert. denied 404 U.S. 827.

In this connection, the discussion in Henry v. FPC, 513 F.2d 395 (C.A.D.C., 1975) is particularly significant. In that

case the Court reviewed a Commission order which disclaimed jurisdiction over a coal gasification facility, but which asserted jurisdiction under Sec. 7 to certificate the movement of commingled artifical and natural gas. The court noted:

> "Of particular and almost paramount significance for the subject under discussion is FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1, 81 S.Ct. 435, 5 L.Ed.2d 377 (1961), where the Court expressly held that the Commission's power under § 7 to consider matters of the public interest when deciding whether to issue a certificate for jurisdictional facilities extends generally to a consideration of "all factors bearing on the public interest," and specifically extends to matters that are excluded from the direct regulatory jurisdiction of the Commission. That case involved an application for the certification of the transportation by an interstate pipeline of gas to be sold directly by a Texas producer to a New York purchaser for use under boilers for the production of steam. The Court held that § 7(e) of the Act embraces FPC consideration, when passing on an application for certification, first, of the end use of the gas to be transported and its possible preemption of reserves to the detriment of domestic consumers--though the FPC has neither general allocation authority nor jurisdiction to regulate direct sales to industrial consumers once the facilities are certificated; and second, of the prospect that the high price of the sale would be an upward lever on natural gas prices in general--even though the Commission had no jurisdiction over the underlying sale or any authority to regulate its price.
>
> "Although Justice Harlan, joined by Justices Frankfurter and Stewart, dissented from another feature of the decision, he joined in the ruling now under discussion, and indeed put the matter so succinctly as to merit quotation. See 365 U.S. at 36-37, 81 S.Ct. at 453-454 (footnotes omitted):
>
> "Basically, I think it was open to the Commission to decide whether the particular transportation service before it would tend to waste gas, unduly preempt pipeline capacity, or raise field prices. I think the Commission can properly assert this

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more limited power as an incident of its transportation certificating powers. It is quite true of course that Consolidated Edison need not have resorted to the Federal Power Commission if the purchase transaction had been possible without the interstate transportation of the gas in jurisdictional pipelines, since this was not a purchase of natural gas for resale.

"'However, it does not follow that the Commission had to blind itself to the effects of the purchase and use of the gas when its authority to certificate the transportation of the gas was invoked. To recognize that the transaction was, as a practical matter, impossible without the use of jurisdictional facilities for the interstate transportation of the purchased gas is to acknowledge that this transportation is an integral a part of the transaction as was the sale itself. Whether the adverse effect of the transaction be a waste of a scarce resource, or pre-emption of pipeline capacity, or a substantial boosting of field prices, the transportation is as responsible for the effects as is the original sale. I see no reason why the Commission must certify, as in accord with the "public convenience and necessity," transportation which tends materially to further such undesirable results which are within the area of the Commission's legitimate concern when it is considering the public convenience and necessity of certificating a jurisdictional sale.' (Emphasis added.)"

The Commission's powers under Sec. 7 of the Natural Gas Act do not end with the mere issuance or denial of a certificate of public convenience and necessity. Of perhaps equal significance are the provisions of Sec. 7(b) and 7(e) of the Act.

Under Sec. 7(e), the Commission can attach any conditions to a certificate that it finds are required by "the public convenience and necessity", and under Sec. 7(b), the Commission may require the continuance of a certificated

service until it determines that "the public convenience and necessity" will permit abandonment.

The conditioning power, and the abandonment power, each operate to supplant private contractual arrangements between producer and pipeline, and pipeline and customer. Atlantic Refining Co. v. Public Service Commission of N. Y., 360 U.S. 378 (1959); Sunray Mid-Continent Oil Co. v. FPC, 364 U.S. 137 (1960); United Gas Pipe Line Co. v. FPC, 385 U.S. 83 (1966).

b. Section 3--Imports and Exports of Natural Gas.

Under Sec. 3 of the Act, Commission approval must be obtained for any natural gas import into or export from the United States. The Commission is to approve such import and export applications unless it finds that the proposal "will not be consistent with the public interest." The Commission is empowered to prescribe terms and conditions to any import or export if such are found to be "necessary or appropriate."

The generalities of Sec. 3 have seldom been construed and applied by the Commission or the Courts, but it is reasonable to conclude at this time that the Commission has the power, and probably the inclinaton, to treat import/export cases substantially the same as Sec. 7 certification cases. Distrigas Corp. v. FPC, 495 F.2d 1057 (C.A.D.C. 1974). Accordingly, the discussion under subsection (a) immediately above is applicable to the import/export power and need not be restated.

B. State Control of Natural Gas

1. State Regulatory Powers

Since the earliest days of oil and gas production the states have promulgated conservation legislation designed to regulate the production of oil and gas. There have been innumerable court challenges to such legislation; however, the courts have generally approved conservation legislation on one of three theories: (a) it is within the police power of the state to pass legislation protecting the correlative rights of owners of land within a common source of supply of oil and gas; (b) it is within the police power of the state to safeguard the public interest in oil and gas by preventing waste of such natural resources of the state; and (c) the state may exercise its police power to prevent or abate surface nuisances resulting from the production of oil and gas. The states have adopted a broad variety of conservation statutes generally granting a state agency the authority to regulate such matters as well spacing, proration of production, plugging of abandoned wells, and compulsory pooling and unitization. See e.g., Summers, Oil and Gas § 106; Williams and Meyers, Oil and Gas Law, §§ 940-948.

The Supreme Court of the United States has made it clear that state conservation legislation is a valid exercise of the state's police power even though the oil or gas is intended

to be, or is in fact, immediately placed into interstate commerce:

> "Plaintiff contends that the Act and proration orders operate to burden interstate commerce in crude oil and its products in violation of the commerce clause. It is clear that the regulations prescribed and authorized by the Act and the proration established by the commission apply only to production and not to sales or transportation of crude oil or its products. Such production is essentially a mining operation and therefore is not a part of interstate commerce even though the product obtained is intended to be and in fact is immediately shipped in such commerce. Oliver Iron Co. v. Lord, 262 U.S. 172, 178. Hope Gas Co. v. Hall, 274 U.S. 284, 288. Foster Packing Co. v. Haydel, 278 U.S. 1, 10. Utah Power & Light Co. v. Pfost, supra. No violation of the commerce clause is shown."

Champlin Refining Co. v. Corporation Commission, 286 U.S. 210, 235 (1932). See also Thompson v. Consolidated Gas Utilities Corp., 300 U.S. 55, 77 (1937).

It may be helpful to note the types of conservation statutes and administrative orders which have been upheld by the courts as valid exercises of State power to prevent waste and protect correlative rights:

(a) Well Spacing: see, Brown v. Humble Oil & Refining Co., 126 Tex. 296, 83 S.W.2d 935, motion for reh. overr'd. 126 Tex. 314, 87 S.W.2d 1069 (1935); Patterson v. Stanolind Oil & Gas Co., 182 Okla. 155, 77 P.2d 83, app. dismd., 305 U.S. 376 (1939); Hawkins v. Texas Co., 146 Tex. 511, 209 S.W.2d. 338 (1948); Oxford Oil Co. v. Atlantic Oil & Producing Co., 22 F.2d 597 (5th Cir.); cert. den. 277 U.S. 585 (1928).

(b) Proration of Production: see, Henderson Co. v. Thompson, 300 U.S. 258 (1937); Thompson v. Consolidated Gas Utilities Corp., 300 U.S. 55 (1937); Bandini Petroleum Co. v. Superior Court, 284 U.S. 8 (1931); Texas v. Donoghue, 302 U.S. 284 (1937).

(c) Plugging of Abandoned Wells: see, Commonwealth v. Trent, 117 Ky. 34, 77 S.W. 390 (1903); Gant v. Oklahoma, 150 Okla. 86, 6 P.2d 1065, app. dism'd. 284 U.S. 594 (1932); Guffey v. Stroud, 16 S.W.2d 527 (Tex.Comm.App. 1929, opinion adopted) Atkinson v. Virginia Oil & Gas Co., 72 W.Va. 707, 79 S.E. 647 (1913); Martel v. Hall Oil Co., 36 Wo. 166, 253 P. 862, 255 P. 3 (1927); Clarke v. Blue Licks Springs Co., 184 Ky. 827, 213 S.W. 222 (1919).

(d) Compulsory Pooling and Unitization: see, Hunter Co. v. McHugh, 202 La. 97, 11 So.2d 495, app. dism'd, 320 U.S. 222 (1943); Crichton v. Lee, 209 La. 561, 25 So.2d 229 (1946); Superior Oil Co. v. Foote, 214 Miss. 857, 59 So.2d 85, error overr'd, 59 So.2d 844 (1952); Palmer Oil Corp. v. Phillips Petroleum Co., 204 Okla. 543, 231 P.2d 997, app. dism'd., 343 U.S. 390 (1952).

(e) Restrictions on Use: Ohio Oil Co. v. Indiana, supra; Henderson Co. v. Thompson, supra; Herkness v. Irion, 278 U.S. 92 (1928); Walls v. Midland Carbon Co., supra, Thompson v. Consolidated Gas Utilities Corp.; supra.

(f) Secondary Recovery and Gas Recycle: Champlin Refining Co. v. Corporation Comm., supra; Railroad Comm'n of Texas

v. Manziel, 361 S.W.2d 560 (Tex.Sup.Ct. 1962); Corzelius v. Harrell, 143 Tex. 509, 186 S.W.2d 961 (1945); Syverson v. North Dakota State Industrial Comm'n, 111 N.W.2d 128 (N.D.Sup.Ct. 1961); Jackson v. State Corp. Comm'n, 186 Kan. 6, 348 P.2d 613 (Kan.Sup.Ct. 1960). See, Bandini Petroleum Co. v. Superior Court, supra; Brown v. Humble Oil & Refining Co., supra; Henderson Co. v. Thompson, supra; Ohio Oil Co. v. Indiana, supra; Commonwealth v. Trent, supra; Shannon v. Shaffer Oil & Refining Co., 51 F.2d 878 (10th Cir. 1931).

The question of whether state oil and gas conservation statutes and regulations can be applied to leases of Federal lands has been decided in the affirmative by Texas Oil and Gas Corp. v. Phillips Petroleum Corp., 277 F.Supp. 366 (W.D. Okla.); aff'd, 406 F.2d 1303, cert. denied, 396 U.S. 829 (1969). Plaintiffs owned oil and gas leases on Federal lands in Oklahoma, which leases were executed pursuant to the Federal Mineral Leasing Act, 30 U.S.C. § 181 et seq. By way of request to quiet title, plaintiffs sought to challenge an order of the Corporation Commission of the State of Oklahoma whereby the reservoir underlying plaintiffs' leases were forced into a pool for purposes of production.

In holding that the leases were subject to regulation by the State of Oklahoma, the Court explained as follows:

> "Article IV, Section 3, Clause 2 of the United States Constitution provides:

'Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States;***.'

"This clause does not place the exclusive control of the federal public domain in the United States Government. It only confers this power on Congress and leaves to Congress the determination of when and where and to what extent this power will be exercised. United States v. Hatahley, (10 Cir. 1955). 220 F.2d 666, reversed on other grounds, 351 U.S. 173, 76 S.Ct. 745, 100 L.Ed. 1065 (1956). Therefore, we must look to the acts of Congress and specifically those relied upon by the Plaintiffs as above set out to ascertain if the Congress has undertaken to exercise exclusive control over federal lands which have been leased by the Government for oil and gas mining purposes.

"Nothing in these cited statutes (nor the entire Act itself) specifically indicates that Congress has undertaken to reserve unto itself exclusive control over federal lands leased for oil and gas development to the exclusion of the States.

"Section 187 does provide that no lease issued under the said Act shall be assigned or sublet except with the consent of the Secretary of the Interior, and authorizes the Secretary of the Interior to promulgate rules for the prevention of undue waste and that the lease shall contain a provision that such shall be observed. However, said Section further provides at the end thereof that: 'None of such provisions shall be in conflict with the laws of the state in which the leased property is situated.' This language is not aimed at putting the lands under the exclusive control of the Federal Government to the exclusion of the States. Contrary to the position of the Plaintiffs, the Federal Mineral Leasing Act of 1920, as amended, seems to leave to the States the power to exercise State police power over Federal oil and gas leases. For instance, Title 30, United States Code, Section 189 of said Act provides:

'Nothing in said sections shall be construed or held to affect the rights of the States or other local authority to exercise any rights which they may have, including the

right to levy and collect taxes upon improvements, output of mines, or other rights, property, or assets of any lease of the United States.'

"Furthermore, the authorities treating with the matter of exclusive control of federal lands by the Federal Government clearly and definitely hold that State law and the State police power extends over the federal public domain unless and until Congress has determined to deal exclusively with the subject. State of Colorado v. Toll, 268 U.S. 228, 45 S.Ct. 505, 69 L.Ed. 927 (1925); McKelvey v. United States, 260 U.S. 353, 43 S.Ct.132, 67 L.Ed. 301 (1922); International Bridge Company v. People of the State of New York, 254 U.S. 126, 41 S.Ct. 56, 65 L.Ed. 176 (1920); Omachevarria v. State of Idaho, 246 U.S. 343 38 S.Ct. 323, 62 L.Ed. 763 (1918); United States v. Hatahley, supra.

"But whereas the Congress may not desire to assume exclusive control over the federal lands it may desire to prescribe certain limited controls. From an examination of the said Federal Mineral Leasing Act the Court concludes that the Congress has not undertaken to assume exclusive control of federal mineral lands under the Act but it has imposed two significant controls which must be satisfied before the State police power in the area of conservation may ultimately attach. One is that a federal mineral lessee may not assign his lease without the consent of the Federal Government. 30 U.S.C. § 187. Another is that a pooling or communitization agreement involving federal and non-federal lands must be approved by the Federal Government. 30 U.S.C. § 226(j). . . ." Id., pp. 368-369.

The result in Texas Oil and Gas Corp. is consistent with Wallis v. Pan American Petroleum, 384 U.S. 63 (1966), wherein the Supreme Court ruled that state law governs transactions between private parties with respect to an oil and gas lease validly issued under the Mineral Leasing Act. The Mineral Leasing Act is, of course, generally applicable to

federal lands in the State of Alaska. Cf., Udall v. Tallman, 380 U.S. 1 (1965); Standard Oil Co. of California v. Hickel, 317 F.Supp. 1192 (D. Alaska); aff'd 450 F.2d 493 (9th Cir. 1971).

2. State Ownership Rights

The rights of a State as an owner of property should be no less than the rights of the Federal government as an owner of property; in this contest, the Supreme Court has held:

> "The power of Congress to dispose of any kind of property belonging to the United States 'is vested in Congress without limitation'. . . 'For it must be borne in mind that Congress not only has a legislative power over the public domain, but it also exercises the powers of the proprietor therein. Congress may deal with such lands precisely as an ordinary individual may deal with. . .property. It may sell or withhold them from sale.' Article 4, Section 3, Cl. 2 of the Constitution provides that 'The Congress shall have power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States.' The power over the public land thus entrusted to Congress is without limitations. And it is not for the Courts to say how that trust shall be administered. That is for Congress to determine."

Alabam v. Texas, Rhode Island v. Louisiana, 347 U.S. 272 (1954) at 273-274, citations omitted.

The Supreme Court of California has said:

> "In the absence of Constitutional limitations, and there is none here, the Legislature is free to dispose of the state's. . .lands in any way deemed by it from time to time to be for the public interest."

South San Joaquin Irrig. Dist. v. Neumiller, 42 P.2d 64 (1935). See also Ashwander v. Tenn. Valley Authority, 297 U.S. 288 (1936).

State powers arising from property ownership are probably thus more extensive than State regulatory powers. While the latter are subject to Constitutional limitations relating to the supremacy of Federal law, and control of interstate commerce, ownership powers are arguably not so limited. See U.S. v. California, 281 F.2d 726 (C.A. 9, 1960), where the Court said:

> "If the State had seen fit to impose conditions upon issuance or upon transfer of property it has wholly created, that is the state's prerogative so long as its demands are not arbitrary or discriminatory. The federal government has no power to command the state in this area. It has no power to direct that property be created by the state for the purpose of federal seizure." 281 F.2d at 728, emphasis supplied.

I would not imply that State ownership powers are totally without limits. In the Neumiller opinion, supra, it was said that the State's actions must not be "arbitrary" or "discriminatory." I would judge that the Courts may well proceed substantially in accord with the Ashwander discussion:

> "The constitutional provision [Art. 4, Sec. 3, Cl.2] is silent as to the method of disposing of property belonging to the United States. That method, of course, must be an appropriate means of disposition according to the nature of the property, it must be one adopted in the public interest as distinguished from private or personal ends, and one may assume it must be consistent with the foundation principles of our dual system of government and must not be contrived to govern the concerns reserved to the States."

297 u.s., at 388. Language such as this may be construed to mean that a State may not exercise its ownership to "contrive" to "govern the concerns reserved" to the Federal government; that is to say that Federal supremacy may still be a controlling doctrine when aligned against State ownership actions repugnant to a Federal interest.

3. State Powers of Taxation

A brief summary of certain generally accepted principles of state taxation may serve as parameters for discussion of specific issues:

(a) The taxing power may be exercised solely for public purposes;

(b) Uniformity and equality of rates and valuation between similarly situated parties is generally required by state law although distinctions based upon classification of property rights, business endeavors and the like, are permissible if not palpably arbitrary or capricious.

(c) Extreme flexibility in state taxation is the rule, but due process, equal protection and other federal constitutional rights or prerogatives can be effective limitations.

(d) Taxing schemes that burden (by discrimination or otherwise) interstate commerce, or have even incidental regulatory effects, are suspect.

(e) Tax structures that on their face conflict with federal constitutional interests or areas of federal preemption will nearly always be invalidated, but a similar and constitutionally valid effect might be achieved indirectly.

(f) Since the invalidation of a taxing statute results in total and irrevocable loss of several years' revenues, a conservative approach is preferable.

(g) Tax statutes are strictly construed against the taxing authority.

(h) The current trend in public policy is to permit state and local tax jurisdictions greater latitude in the face of spiraling local fiscal needs.

The specific tax questions which we have considered are as follows:

A. What are the limits of the power of a state to impose severance taxes?

1. Amount: The only apparent limitations on the amount of a tax are the due process and equal protection clauses of the 14th Amendment. However, even these limitations may be questioned in light of Magnano Co. v. Hamilton, 292 U.S. 40 (1934), wherein a state tax on oleomargarine, which had a destructive effect on the oleomargarine industry, was upheld aginst due process attacks.

> "Except in rare and special instances, the due process of law clause...is not a limitation upon the taxing power conferred upon Congress by the Constitution...and no reason exists for applying a different rule against a state...That clause is applicable to a taxing state...only if the act be so arbitrary as to compel the conslusion that it does not involve an exertion of the taxing power, but constitute in substance and effect, the direct exertion of a different and forbidden power, as for example, the confiscation of property...Nor may a tax within the lawful power of the state be judicially stricken down under the due process clause simply because its enforcement may or will result in restricting or even destroying particular occupations

> or businesses...unless....its necessary interpretation and effect be such as to plainly demonstrate that the form of taxation was adopted as a mere disguise, under which there was exercised, inreality, another and different power denied by the Federal constitution to the State."
> 292 U.S. at 44-45.

See also, Veazie Bank v. Fenno, 75 U.S. 533 (1869); Lehnhausen v. Lake Sho e Auto Parts Co., 410 U.S. 356 (1973).

2. Property Ownership considerations:

a. Generally, a state may levy a tax upon the severance of natural resources regardless of the ownership of the fee to the realty. There are, however, several special situations in which ownership by the United States or ownership or production by Indians could impose a ban to certain applications of such a tax.

b. No severance tax may be levied in a state where the property from which the minerals are severed is considered to be within the exclusive jurisdiction of the federal government by virtue of Article 1, Section 8, Clause 17 of the United States Constitution. Humble Pipeline Co. v. Waggoner, 376 U.S. 369 (1964). Such lands are those purchased from

a state for certain purposes (for example, military bases). "Purchase" has been held to include acquisition by gift, Humble Pipeline Co. v. Waggoner, supra, and Mississippi Power Fuel Corp. v. Cocreham, 382 F. 2d 929 (1967) cert. denied, 390 U.S. 1014 (1968). The determinative factors are: (i) acquisition from a state: (ii) for specific purposes; (iii) by purchase or gift. Indeed, absent special waiver or prior reservation by the state of power to tax a state may levy only income or gross receipts taxes with respect to these lands. 4 U. S. C. A. §104 - 110 (the "Buck Act").

Most federal lands including national forests and Indian lands, are generally not subject to exclusive federal jurisdiction; therefore, private lesses may be subjected to severance taxes. International Paper Co. v.

County of Siskiyou, 515 F. 2d 285 (9th Cir. 1974); Wilson v. Cook, 327 U.S. 474 (1946).

c. Severance taxes apparently may not be levied where Indians are producing gas from Indian lands. In Moses v. Kinnear, 490 F. 2d 21 (9th Cir. 1973), the Court, in construing 28 U.S.C.A. §1341, said, "The United States has a special interest in its ward Indians, with respect to which the government 'has charged itself with moral obligations of highest responsibility and trust' Seminole Nation v. U.S., 316 U.S. 310 (1942). This 'special interest" has manifested itself in the form of a federal policy to protect Indians and Indian property from state taxation...'State laws generally are not applicable to tribal Indians on an Indian reservation except where Congress has expressly provided that state law shall apply. It follows that Indians and Indian property on an Indian reservation are not subject to state taxation except by virtue of express authority conferred upon the state by act of Congress." McCalanhan v. Arizona State Tax Commission, 411 U.S. 164 (1973). (See also, cases collected in footnote 5 to text of Agua Caliente Ban of Mission Indians v. County of Riverside, 442 F. 2d 1184 (9th Cir. 1971),

cert. denied, 405 U.S. 933 (1972), rehearing denied, 405 U.S. 1033 (1972), rehearing denied, 409 U.S. 901 (1972), where Indian lands are said to be federal instrumentalities).

Under these rules, Indian producers from Indian lands should be exempt from severance taxes. It has been held, however, that non-Indian lessees of Indian property may be subjected to state taxes since such taxation is not a tax upon Indian property per se, United States v. Detroit, 355 U.S. 466 (1958). Note, however, that the view has been expressed that the prohibition of a direct tax also bars an indirect tax. See, Dissenting opinion, Agua Caliente Band of Mission Indians v. County of Riverside, supra.

3. Federal Instrumentalities: A state-imposed severance tax would be inalid if applied to property, instrumentalities, or agents of the United States, and clearly the tax could not be assessed against the federal government as a mineral lessee or producer. McCullough v. Maryland, 4 Wheat. 316 (1819); United States v. Detroit, supra.

4. Taxes levied only on natural gas: A state is not required to tax the severance of all minerals equally. A tax levied only upon the severance of natural gas, or levied upon natural gas at a rate different from that imposed upon the severance of other natural resources, will usually be free of federal constitutional problems, Charleston Federal Savings and Loan Association v. Alderson, 324 U.S. 182 (1945).

B. Can a very high severance tax be imposed, coupled with some form of rebate or tax credit to Alaskan users, or would such be struck down as a burden to interstate commerce?

1. Direct Rebates or Credits: Any plan under which a producer is given severance tax rebate for sales of reserves to intrastate users, where interstate commitments do not entitle the producer to substantially similar rebates, will be struck down as clearly discriminatory against interstate commerce. "In each case, it is our duty to determine whether the statute under attack, whatever its name may be, will in its practical operation work discrimination against interstate commerce." Best and Co. v. Maxwell, 311 U.S. 454, 455-456 (1940). See also Pennsylvania v. West Virginia, 262 U.S. 553 (1923). A tax levied only upon lessees of federal lands would of course be discriminatory and palpably arbitrary. International Paper Co. v. County of Siskiyou, supra; Phillips Chemical Co. v. Amos Independent School District, 361 U.S. 376 (1960) rehearing denied, 362 U.S. 937 (1960).

2. Indirect rebates or credits: A taxing statute under which deductions or credits for the cost of the severance tax are allowed against unrelated taxes that are born primarily by Alaskan residents, will probably be valid

if carefully constructed. Even if such tax credit should be held invalid, the severance tax itself ought not be affected. Thus the effect of invalidation would be to increase the burden on Alaskan residents and increase revenues.

Example: Alaska could grant a deduction or credit against its state income tax for expenses of a consumer of natural gas which are attributable to "passed-on" severance taxes. The producer would pay the severance tax to the state. The consumer would in effect reimburse the producer through a commensurate increase in the purchase price of the gas, perhaps being billed separately for the cost to the producer of the severance tax. The consumer would be made "whole" by the credit against the state income for the cost to him of ultimately bearing the severance tax. If the Alaskan income tax liabilities of the producers/consumers for interstate sales were such that a deduction or credit for "passed-on" severance taxes would be of small value, then, in effect, only interstate gas would bear the cost of severance taxes.

A simpler approach would be to lower by the amount of the anticipated revenues from the severance tax the rate of an unrelated tax which is now borne primarily by Alaskan residents. The overall effect of such reduction would be to lower the burden of residents.

C. How, and in what forms, can a state tax an interstate pipeline?

1. Franchise taxes: It is clear that a state may levy and collect franchise taxes even on a purely interstate pipeline, if such taxes are reasonable and non-discriminatory, i.e. payable by all corporations of the same legally valid classification (see subparagraph III. (d) below) doing business in the state. Colonial Pipeline Co. v. Traigle, 421 U.S. 10 (1975); Memphis Gas Co. v. Stone, 335 U.S. 80 (1948). The tax must be properly apportioned, or based solely on in-state pipeline property (and not on commodities actually in commerce; i.e., the gas being transported), in order to be reasonable and non-discriminatory. Methods of apportionment and valuation are not within the scope of this memorandum. However, the primary consideration is that Alaska tax only that portion of the pipeline's activities which are attributable to endeavors within the state.

2. Ad Valorem taxes: It is equally clear that the pipeline and accompanying right-of-way may be subject to a property tax, even though the pipeline carries gas in purely interstate commerce.

3. Income taxes: The state income tac may also be imposed upon an interstate business, provided that a proper allocation formula is employed, Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450 (1959).

4. Separate classification for tax purposes of natural gas pipeline: While a state may subject an interstate gas pipeline operating within its borders to its general tax laws as indicated above, the state may wish to place a separate tax on such business which is not applicable to other businesses within the state. A separate tax will be valid as long as its purpose is to regulate the business, and the amount of the tax is reasonably limited to the costs of such regulation. However, where the purpose of the tax is to produce revenue, the classification of the business into a separate category from all other businesses must be justified both under state law requirements that taxation be equal and uniform and under equal protection clause of the federal constitution.

As far as the equal protection clause of the federal constitution is concerned, the Supreme Court has displayed a consistently lenient attitude toward the states' powers to single out specific types of businesses for separate taxation. See, e.g. Independent Warehouses, Inc. v. Schule, 331 U.S. 70 (1946) (upholding annual franchise or license tax applicable only to commerical storage facilities, where only one such facility existed in the taxing municipality); New York Rapid Transit Corporation v. New York, 303 U.S. 573 (1938) (Upholding taxation of public utilities at higher rate than was imposed upon business generally); Illinois Cent. R. Co. V Minnesota, 309 U.S. 157 (1940) (gross receipts tax levied on railroads but not other business).

Thus a tax should have a reasonable chance of surviving an attack on Constitutional grounds as long as it is applicable generally to all corporations similarly situated throughout the state (e.g., all corporations doing business in the state whose business consists of operating a natural gas pipeline) even if, at the time in question, there is only one corporation in the state which falls within the category of corporations subject to the tax. See Independent Warehouses, Inc. v. Schule, supra. However, we have found no decision in which not only was a single corporation subject to the statute, but that corporation was engaged exclusively in interstate commerce. It may be that the combination of the classification of the single business along with the effect on interstate commerce would cause a court to invalidate such a tax. If such a tax were upheld a court might find that the amount thereof must bear some reasonable relationship to the value of the privelege being granted, and that the principles of Magnano Co. V. Hamilton, supra Part 1 (a), which didnot involve a taxpayer involved solely in interstate commerce, are not applicable.

On balance, we believe that such a tax would probably withstand constitutional attacks, but that a more reliable subject of a high tax rate is the severance tax.

D. If gas reserves are contractually committed to an interstate pipeline, and dedicated to interstate service through an FPC certificate, can the value of the reserves be taxed as an asset of the pipeline?

While a state, under the strictures of Article 1, Section 10 of paragraph 2, of the United States Constitution, may not levy a tax on an item of property by reason of its exportation, a tax levied generally upon all property is nevertheless valid unless the property is "in commerce". See 71 Am. Jur. 2d, State and Local Taxation, Sections 117-121 and the authorities discussed therein. Moreover, it is believed that gas would not be "in commerce" until it begins to move in commerce and that a contractual right to withdraw could never be deemed "in commerce". See Kosydas v. National Cash Register Co., 417 U.S. 62 (1974); Cornell v. Coyne, 192 U.S. 418 (1904).

A state may classify property in multiple categories for taxation purposes and such classification will be upheld absent a finding of "palpable arbitrariness". Alaska might provide than an FPC certificate creates a separate property interest in real property or minerals, which interest would then be subject to an ad valorem tax. For an example of a separate estate in non-severed resources, see, International Paper Co. v. County of Siskiyou, supra (standing timber. By attributing taxable value to the con-

tractual right to the reserves, it seems likely that value of the reserves to the holders of the legal title thereof would be commensuratley reduced. If both interests in the reserves are considered as separate estates in the real property, it will probably be necessary to tax them at the same rate. If, however, the pipeline's contractual right to purchase the reserves can be son idered an "intangible" property right under Alaskan law, it may be possible to tax such right at a higher rate, since there is authority which approves of differing tax rates for tangibles and intangibles. See Randolph v. Simpson, 410 F. 2d 1067 (5th Cir. 1969) (Intangibles taxed at lower rate than tangibles). It seems clear that such intangibles would have a "situs" in Alaska within the rule of Wheeling Steel Corporation v. Fox, 298 U.S. 193 (1936), that intangibles may be taxed at other than the owner's domicile if such intangibles have be ome an integral part of some "local business".

E. Can a State require payment of a tax in any form other than money? For example, could a state impose a 4% tax on severed minerals and require delivery of 4% production in kind?

No; see 31 U.S.C.A. §392, (Supp. 1965), the predecessor of which was held constitutional in Guaranty Trust Co. of New York v. Henwood, 307 U.S. 247 (1939). Section 392 reads in relevant part as follows:

"All coins and currencies of the United States... shall be legal tender for all debts, public and private, public charges, taxes...." (emphasis added)

4. The power of the State to construct and operate a pipeline.

(a) May the State of Alaska create a State instrumentality to (1) purchase North Slope gas, (2) transport such gas by pipeline to Southern Alaska, (3) make resales of gas along the route and at the southern terminus to intrastate users, and resell the surplus for delivery in interstate commerce?

(b) If such were done, which aspects, if any, would be subject to Federal regulation, by whom, and to what extent?

(c) Could such a state-owned entity obtain rights-of-way over Federal lands, by condemnation or otherwise?

A. Power of a State to Own and Operate a Pipeline System.

There are no apparent legal impediments precluding enactment of legislation authorizing the creation of a State instrumentality to purchase, transport and resell North Slope gas.

The texts often describe a general rule that states have no power to authorize municipal corporations to engage in business of a private nature. 12 McQuillin, Municipal Corporations §36.01 et seq. (1970 Revised Vol.); 56 Am. Jur. 2d, Municipal Corporations, etc. §210 (1971) 64 C.J.S., Municipal Corporations §1842 (1950). This "rule" is based upon a series of 19th Century cases which apply the doctrine that the power of taxation possessed by governmental bodies is limited to taxation for a public purpose. See e.g. Loan Association v. Topeka, 87 U.S. (20 Wall) 655 (1874), Parkersburg v. Brown, 106 U.S. 487 (1882) (bonds issued to encourage establishment of manufacturing plants held invalid). However, even in the Topeka case the Supreme Court recognized the possibility that a municipality could engage in such activities if funds were available from a non-tax source.

> "If these municipal corporations, which are in fact subdivisions of the State, and which for many reasons are vested with quasi legislative powers, have a fund or other property out of which they can pay debts which they contract, without resort to taxation, it may be within the power of the legislature of the

State to authorize them to use it in aid of projects strictly private or personal but which would in a secondary manner contribute to the public good."

Over the years, the "rule" that municipal corporations may not engage in business of a private nature, as a result of everbroadening concepts of public purpose. For example, by 1937, public programs to assist in the establishment of manufacturing plants was found to be sufficiently related to the public interest to withstand constitutional challenges. Albritton v. Winona, 178 So 799, (Miss., 1938), app. dismissed 303 U.S. 627 (1938). Similarly, the public ownership of a yard for the sale of wood, coal and other fuels which, during the 19th century, was private business in which municipalities were not permitted to engage, In Re Opinion of Justices, 30 N.E. 1142 (Mass., 1892), was, by 1917, a public purpose for which taxes could be levied without violating the 14th Amendment to the Constitution. Jones et al. v. Portland, 245 U.S. 217 (1917).

The question of what is a "public purpose" has long been recognized as a question which is susceptable to local differences. The Supreme Court has indicated that in considering such matters great deference must be given to legislative and state court determinations. Jones et al. v. Portland, 245 U.S. 217 (1917); Green v. Frazier, 253 U.S. 233 (1920); and Carmichael v. Southern Coal Co., 307 U.S. 495 (1937).

The question of Constitutional authority for a state-owned natural gas pipeline system should be easily resolved. There can be little doubt that natural gas pipelines perform a public purpose. Indeed, the grant to privately-owned pipeline companies of the power of eminent domain must necessarily be grounded upon their public nature. The authority of municipalities to own and operate electric utilities and gas distributions systems, absent state statutory or constitutional restrictions, has long been clear. See e.g. 12 McQuillin Municipal Corporations, 3rd Ed. (1970) §35.04. The authority of the Federal Government to own and operate wholesale power systems has similarly been sustained. Tennessee Electric Power Company v. TVA, 306 U.S. 118 (1939) Aswander v. TVA, 297 U.S. 288 (1936).

The statutes of at least two states authorize state-owned natural gas pipeline systems. La. Rev. Statutes §30.557 et seq.; Miss. Code 1942 Annotated §5950.

The nature of the Alaskan project is such that it is feasible to construct only a single facility to bring North Slope gas to market. Since the deliverability required to make the line feasible will far exceed anticipated intrastate demand, it is inevitable that the bulk of the gas delivered through the system will be sold interstate. The question this suggests is whether, assuming the state ownership of a pipeline facility is generally permissible, such

ownership is permissible where the vast majority of the gas is destined for ultimate consumption outside of the state. No reported case addresses this issue. However, if the State can argue that its ownership of the facilities is necessary to assure service to its citizens, it should be able to argue that the service to interstate markets is merely incidental to the performance of services for its citizens.

B. Federal Regulation of Natural Gas Pipeline Companies.

Federal regulation of natural gas pipeline companies is accomplished primarily under the Natural Gas Act, 15 U.S.C. §717 et seq. and the Natural Gas Pipeline Safety Act, 49 U.S.C. §1671 et seq. Under the Natural Gas Act the Federal Power Commission has plenary jurisdiction to regulate natural gas pipeline companies which transport or sell for resale gas in interstate commerce. The Natural Gas Pipeline Safety Act provides for the establishment and enforcement of Federal minimum safety standards for natural gas pipelines.

As discussed in greater detail in Part II of this analysis, the construction and operation of pipeline facilities by a state instrumentality would probably be exempt from regulation by the FPC under the Natural Gas Act. As noted in that discussion, the operative sections of the Natural Gas Act are phrased in terms of regulation of "natural gas companies". The relevant terms under the Natural Gas Act,

i.e. "natural gas company", "person", "corporation", and "municipality" when read together would seem to exclude state-owned pipeline systems from the definition of "natural gas company" and thus from FPC regulation. 15 U.S.C. §717a, but see, FPC v. Corporation Commission of the State of Oklahoma, 362 F.Supp. 522 (W.D. Okla. 1973), aff'd 415 U.S. 961 (1974).

Although a literal reading of the Natural Gas Act would seem to preclude FPC jurisdiction over state-owned pipeline facilities, the assertion of such jurisdiction cannot be ruled out. Indeed, in view of (1) the willingness of the Court in the Oklahoma case essentially to ignore the definitions, in order to find that the Corporation Commission was a "person" which could be sued by the FPC under the Natural Gas Act, (2) the existence of two competing applications before the FPC at this time to construct pipeline facilities to bring North Slope gas to the United States, including one application involving a line through the State of Alaska, presumably along or close to the route which a State system would traverse, (3) the natural inclination of regulatory agencies to attempt to protect their own jurisdiction, and (4) the economic interest of the pipelines proposing to build systems to attach North Slope gas, it seems unlikely that the State would be able to construct and operate its facilities without litigating the issue of FPC jurisdiction.

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Assuming that the FPC does not have jurisdiction over the facilities, the most significant Federal regulation would be pursuant to the Natural Gas Pipeline Safety Act, 49 U.S.C. §1671 et seq. Under the Act, the Secretary of Transportation is authorized to establish minimum Federal safety standards for the transportation of gas and for pipeline facilities. The standards apply to the design, installation, inspection, testing, construction, operation, extension, replacement and maintenance of such facilities and are set out at 40 C.F.R. §190.1 et seq. Each person engaging in the transportation of gas or who owns or operates pipeline facilities is required to comply with the applicable safety standards and to file and comply with a plan of inspection and maintenance. 49 U.S.C. §1677. Unlike the Natural Gas Act, the term "person" in the Pipeline Safety Act specifically includes states and municipalities. 49 U.S.C. §1671. The Act provides an exemption for certain pipeline facilities and the transportation of gas not subject to FPC jurisdiction. To qualify however the safety standards and practices applicable to the facilities must be regulated on essentially the same basis as under the Act. The state agency must submit an annual certification that (1) it has regulatory jurisdiction over the pipeline facilities or transportation, (2) has adopted and is enforcing each of the Federal safety standards applicable to such facilities and transportation (3) has the authority to require record maintenance reporting an

inspection substantially as provided under the Pipeline Safety Act, and (4) that state law provides for the enforcement of safety standards by way of injunctive and monetary sanctions substantially the same as provided under the Pipeline Safety Act. The Pipeline Safety Act provides both civil penalties (not to exceed $1,000 per day for each violation or $200,000 for a related series of violations) and the authority to obtain injunctive relief to restrain violations of the Act including the restraint of transportation of gas or the operation of a pipeline facility. 49 U.S.C. §1678, 1679. States are authorized to establish a more stringent safety standard applicable to intrastate facilities but are precluded from doing so with respect to interstate transmission facilities. 49 U.S.C. §1672. United Gas Pipe Line Company v. Terrebonne Parish Police Jury, 319 F.Supp. 1138 (D.C. La. 1970) aff'd 445 F.2d 301 (5th Cir. 1971).

Unless Alaska creates an agency with jurisdiction to regulate and enforce safety standards for the transportation of natural gas within the state, which agency would have the authority over the proposed state-owned pipeline, the pipeline would be subject to regulation by the Secretary of Transportation. If the State adopts such a regulatory scheme, the regulatory authority of the Secretary of Transportation would probably be ousted.

C. Methods by Which the State Could Obtain Rights-of-Way Over Federal Lands.

As an initial matter, it should be noted that the law seems clear that the rights of a state to obtain property by condemnation could not be used to obtain such rights-of-way over federal land. In Utah Power and Light Co. v. U.S., 243 U.S. 389 (1917) the U.S. Supreme Court noted that the Federal Government has the full power under the Constitution "to protect its lands, to control their use and to prescribe in what manner others may acquire rights in them". 243 U.S.C. 404. The Court went on to state that:

> "State laws, including those relating to the exercise of eminent domain, have no bearing upon a controversy such as is here present, save as they may have been adopted or made applicable by Congress."

I have found no indication that Congress has authorized the condemnation of Federal lands by states for pipeline rights-of-way. If the State determines to construct its own pipeline system, it could probably obtain right-of-way over Federal lands under the provisions of the Mineral Leasing Act, and several other Federal Statutes.

The basic statutory provisions authorizing rights-of-way for pipeline through Federal lands are contained in the Mineral Leasing Act 30 U.S.C. §185. Under the Act

> "Rights-of-way through any Federal lands may be granted by the Secretary of the Interior or appropriate agency head for pipeline purposes for the transportation of oil, natural gas, synthetic liquid or gaseous fuels, or any refined product produced therefrom to any applicant possessing

> the qualifications provided in Section 181 of this title in accordance with this section. 30 U.S.C. §185(a).

Although it is not clear that a State agency would be "an applicant possessing the qualifications provided in Section 181" it seems unlikely that the right to acquire rights-of-way would be denied to it. Section 181 provides that rights-of-way may be granted to

> ". . . citizens of the United States, or to associations of such citizens, or to any corporation organized under the laws of the United States, or of any State or Territory thereof, or in the case of coal, oil, oil shale, or gas, to municipalities. Citizens of another country, the laws, customs or regulations of which deny similar or like privileges to citizens, or corporations of this country, shall not by stock ownership, stock holding, or stock control, own any interest in any lease acquired under the provisions of this chapter."

Under the Act, a right-of-way may be obtained through all lands owned by the United States except those "lands in the National Park System, lands held in trust for an Indian or Indian Tribe, and lands on the Outer Continental Shelf". 30 U.S.C. §185(b)(1). It should be noted that there is separate statutory authorization for oil and gas pipeline rights-of-way through National Wildlife Refuges. 16 U.S.C. §668(d), and Indian Reservations 25 U.S.C. §321. General provisions authorizing the grant of oil and gas pipeline rights-of-way through national parks, are not apparent, nor do the specific statutory provisions relating to the National Parks within Alaska authorize such rights-of-way. If the proposed pipeline must cross national park lands,

separate congressional authorization of the rights-of-way would be required.

II.

PERMITTED AND PROHIBITED STATE ACTIONS

As we have seen in Section I, certain aspects of natural gas production, transportation, and marketing are subject to Federal control, while others lie within the sphere of State control. What happens when Federal and State interests conflict? The potential for conflict is well illustrated in FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961), where it was said:

> "When Congress initially enacted the Natural Gas Act in 1938, all the indications were that Congress intended the States to be the primary arbiters of conservation problems. The 1938 Act was based on a 1936 report rendered by the Federal Trade Commission and the section in that report devoted to conservation stresses the powers of state bodies to adopt corrective measures. The final recommendation of the Federal Trade Commission in regard to conservation contemplated primary state authority, with federal agencies being relegated to a reporting function. This recommendation formed the basis for § 11 of the Act as ultimately passed and that section reveals a secondary role for the Commission in this regard.
>
> "However, in 1940, the Commission reported its dissatisfaction with the limited scope of §7. The 1938 version of § 7 restricted the Commission's jurisdiction to certification of transportation into areas where the market was already being served by another natural gas company; if a pipeline wished to extend service into virgin territory, the Commission had no power to act. The Commission felt that this limitation barred it from considering "the broad social and economic effect of the use of various fuels" in a § 7 proceeding, Kansas Pipe Line & Gas Co., 2 F.P.C. 29, 57, and, in its 1940 Annual Report, the Commission urged that the restriction be deleted in order that conservation considerations might be weighed.

The Commission implemented its recommendation by submitting to Congress a proposed amendment to § 7 with the restrictive language eliminated, and an amendment substantially similar to the one drafted by the Commission was enacted in 1942.

". . .

"There is a broader principle here which also stands in opposition to respondents' contentions. When Congress enacted the Natural Gas Act, it was motivated by a desire 'to protect consumers against exploitation at the hands of natural gas companies.' Sunray Mid-Continent Oil Co., v. Federal Power Commission, 364 U.S. 137, 147, 80 S.Ct. 1392, 1398, 4 L.Ed.2d. 1623. To that end, Congress 'meant to create a comprehensive and effective regulatory scheme.' Panhandle Eastern Pipe Line Co. v. Public Service Commission, 332 U.S. 507, 520, 68 S.Ct. 190, 197, 92 L.Ed. 128. See Public Utilities Commission of Ohio v. United Fuel Gas Co., 317 U.S. 456, 467, 63 S.Ct. 369, 375, 87 L.Ed. 396. It is true, of course, that Congress did not desire comprehensive federal regulation; much authority was reserved for the States. But, it is equally clear that Congress did not desire that an important aspect of this field be left unregulated. See Panhandle Eastern Pipe Line Co. v. Public Service Commission, supra. Therefore, when a dispute arises over whether a given transaction is within the scope of federal or state regulatory authority, we are not inclined to approach the problem negatively, thus raising the possibility that a 'no-man's land' will be created. Compare Guss v. Utah Labor Relations Board, 353 U.S. 1, 77 S.Ct. 598, 603, 1 L.Ed.2d 601. That is to say, in a borderline case where congressional authority is not explicit we must ask whether state authority can practicably regulate a given area and, if we find that it cannot, then we are impelled to decide that federal authority governs.

In this case, the dispute is over the "economic" waste of gas which has been committed to transportation in interstate commerce outside the producing State. The Commission has not attempted to exert its influence over such "physically" wasteful practices as improper well spacing and the flaring of unused gas which result in the entire loss of gas and are properly of concern to the producing State; nor has the Commission attempted to regulate the "economic" aspects of gas used within the producing State. Respondents contend that, even in this posture, the Commission has usurped the functions of state regulating bodies but we cannot agree.

> In the 1936 Federal Trade Commission Report, upon which respondents so heavily rely, there was some mention of control of the end use of gas and, as we have said, this report was strongly oriented towards state regulation. However, as the Court of Appeals pointed out, the primary emphasis was on physical waste of gas within the producing State and the reference to end use probably contemplated the use of gas in gasoline extraction and the manufacture of carbon black. 271 F.2d at page 947. There is no indication that the Federal Trade Commission or Congress was thinking in terms of state-controlled "economic" conservation of gas committed to interstate commerce. Moreover, it is questionable whether any State could be expected to take the initiative in enforcing this type of "economic" conservation. A producing State might wish to prolong its gas reserves for as long as possible but producing States have no control over the use to which gas is put in another State. See Michigan-Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157, 74 S.Ct. 396, 98 L.Ed. 583, Com. of Pennsylvania v. State of West Virginia, 262 U.S. 553, 43 S.Ct. 658, 67 L.Ed. 1117; State of Oklahoma v. Kansas Natural Gas Co., 221 U.S. 229, 31 S.Ct. 564, 55 L.Ed. 716. Consuming States may control the end use of gas, Panhandle Eastern Pipe Line Co. v. Michigan Public Service Commission, 341 U.S. 329, 71 S.Ct. 777, 95 L.Ed. 993, but the deficiencies of this system in the present context are apparent--unless all States cooperate in enforcing a common regulation, the producer may pick a State which is sufficiently anxious for this scarce resource that it will take gas irrespective of the use. Therefore, it appears that, consistent with the congressional purpose of leaving no "attractive gap" in regulation, we must conclude that the "end-use" factor was properly of concern to the Commission.

We have, therefore, a system of dual regulation but one which the Court recognizes has no hard and fast lines of demarcation. Since the areas of present and future Federal-State conflict cannot be mapped with precision, it would perhaps be instructive to look at a number of specific issues to see which State actions may be permissible, and which State actions are probably prohibited.

1. The State may not embargo the movement of gas in interstate commerce through the exercise of conservation powers. The Supreme Court has consistently struck down state legislation designed to prohibit or limit the exportation of oil and gas to other states even where the state alleges that the supply of gas is no longer sufficient to meet the state's needs and that the legislation is necessary to conserve the resources of the state:

> "We turn now to the principal issue, whether a State wherein natural gas is produced and is a recognized subject of commercial dealings may require that in its sales and disposal consumers in that State shall be accorded a preferred right of purchase over consumers in other States, -- when the requirement necessarily will operate to withdraw a large volume of the gas from an established interstate current whereby it is supplied in other States to consumers there. Of course, in the last analysis, the question is whether the enforced withdrawal for the benefit of local consumers is such an interference with interstate commerce as is forbidden to a State by the Constitution. The question is an important one; for what one State may do others may, and there are ten States from which natural gas is exported for consumption in other States. Besides, what may be done with one natural product may be done with others, and there are several States in which the earth yields products of great value which are carried into other States and there used. But, notwithstanding the importance of the question, its solution is not difficult. The controlling principles have been settled by many adjudications, -- some so closely in point that the discussion here may be relatively brief.
>
> "By the Constitution, Art. I, § 8, cl. 3, the power to regulate interstate commerce is expressly committed to Congress and therefore impliedly forbidden to the States. The purpose in this is to protect commercial intercourse

from invidious restraints, to prevent interference through conflicting or hostile state laws and to insure uniformity in regulation. It means that in the matter of interstate commerce we are a single nation -- one and the same people. All the States have assented to it, all are alike bound by it and all are equally protected by it. Even their power to lay and collect taxes, comprehensive and necessary as that power is, cannot be exerted in a way which involves a discrimination against such commerce. Ward v. Maryland, 12 Wall. 418, 430; Welton v. Missouri, 91 U.S. 275, 280; Webber v. Virginia, 103 U.S. 344, 350; Coe v. Errol, 116 U.S. 517, 525-526; Guy v. Baltimore, 100 U.S. 434, 442-443; Robbins v. Shelby County Taxing District, 120 U.S. 489, 498.

"Natural gas is a lawful article of commerce and its transmission from one State to another for sale and consumption in the latter is interstate commerce. A state law, whether of the State where the gas is produced or that where it is to be sold, which by its necessary operation prevents, obstructs or burdens such transmission is a regulation of interstate commerce, -- a prohibited interference. West v. Kansas Natural Gas Co., 221 U.S. 229; Public Utilities Commission v. Landon, 249 U.S. 236, 245; United Fuel Gas Co. v. Hallanan, 257 U.S. 277; Dahnke-Walker Milling Co. v. Bondurant, 257 U.S. 282, 290-291; Lemke v. Farmers Grain Co., 258 U.S. 50; Western Union Telegraph Co. v. Foster, 247 U.S. 105; Minnesota v. Barber, 136 U.S. 313; Brimmer v. Rebman, 138 U.S. 78. The West Virginia act is such a law. Its provisions and the conditions which must surround its operation are such that it necessarily and directly will compel the diversion to local consumers of a large and increasing part of the gas heretofore and now going to consumers in the complainant States, and therefore will work a serious interference with that commerce."

Pennsylvania v. West Virginia, 262 U.S. 553, 595-597 (1923); and see Haskell v. Kansas Natural Gas Co., 224 U.S. 217 (1912); West v. Kansas Natural Gas Co., 221 U.S. 229 (1911).

2. The State may not establish a natural gas pricing structure for gas sold for resale in interstate commerce. Any attempt by a State to establish minimum or maximum prices for gas produced in the State but sold in interstate commerce would be invalidated by the courts. The decision in F.P.C. v. Corporation Commission of Oklahoma, 362 F.Supp. 522 (W.D. Okla.), aff'd 415 U.S. 961 (1974), establishes beyond question that the States cannot directly or indirectly affect the price of gas sold in interstate commerce:

> "The State has no authority, either directly or indirectly, to fix the price at which natural gas is sold in interstate commerce. The Supreme Court stated in Northern Natural Gas Co. v. State Corporation Commission of Kansas, 1963, 372 U.S. 84, 83 S.Ct. 646, 9 L.Ed.2d 601 that:
>
> ...[O]ur inquiry is not at an end because the orders do not deal in terms with prices or volumes of purchases, cf. Dayton-Goose Creek R. Co. v. United States, 263 U.S. 456, 478, 44 S.Ct. 169, 172, 68 L.Ed. 388. The Natural Gas Act precludes not merely direct regulation by the States of such contractual matters...
>
> The federal regulatory scheme leaves no room either for direct state regulation of the prices of interstate wholesales of natural gas, Natural Gas Pipeline Co. v. Panoma Corp., 349 U.S. 44, 75 S.Ct. 576, 99 L.Ed. 866, or for state regulations which would indirectly achieve the same result. pp. 90-91, 83 S.Ct. p. 650.
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> "In Phillips Petroleum Co. v. Wisconsin, supra, it was argued that Peerless and Phillips Petroleum Co. v. Oklahoma, 1950, 340 U.S. 190, 71 S.Ct. 221,

95 L.Ed. 204, established that the states could regulate interstate sales, and, therefore, such sales were not within the gap which the Natural Gas Act was intended to fill. The Supreme Court, however, was of a different view:

> Those cases upheld as constitutional state minimum price orders, justified as conservation measures, applying to sales of natural gas in interstate commerce. But it is well settled that the gap referred to is that thought to exist at the time the Natural Gas Act was passed, and the jurisdiction of the Commission is not affected by subsequent decisions of this Court which have somewhat loosened the constitutional restrictions on state activities affecting interstate commerce, in the absence of conflicting federal regulation. [Citation omitted] The Federal Power Commission did not participate in the Cities Service and Phillips Petroleum cases, the appellants there did not assert a possible conflict with federal authority under the Natural Gas Act, and consequently we expressly refused to consider at that time '[w]hether the Gas Act authorizes the Power Commission to set field prices on sales by independent producers, or leaves that function to the states...'

"Shortly after the decision in Phillips the Supreme Court was called upon in Natural Gas Pipeline Co. v. Panoma Corporation, 1955, 349 U.S. 44, 75 S.Ct. 576, 99 L.Ed. 866 to review the validity of certain minimum price orders of the Oklahoma Corporation Commission. The Supreme Court of Oklahoma had affirmed the orders, reasoning that they were primarily conservation measures, rather than pricing regulations, and that it was immaterial that they would have an incidental effect on prices. Natural Gas Pipeline Co. v. Corporation Commission, et al., 1954, Okl. 272 P.2d 425. The United States Supreme Court reversed, holding that the case was controlled by Phillips, supra. Holding essentially that Peerless was no longer authority for states to regulate interstate natural gas prices, the High Court stated:

> We disagree with the contention of the appellees that Cities Service Gas Co. v. Peerless Oil

and Gas Co., 340 U.S. 179, 71 S.Ct. 215, 95 L.Ed. 190, and Phillips Petroleum Co. v. Oklahoma, 340 U.S. 190, 71 S.Ct. 221, 95 L.Ed. 204, are applicable here. In those cases we were dealing with constitutional questions and not the construction of the Natural Gas Act. The latter question was specifically not passed upon in those cases. p. 45, 75 S.Ct. p. 576.

"In Federal Power Commission v. Transcontinental Gas Pipeline Corp., 1961, 365 U.S. 1, 9-20, 81 S.Ct. 435, 5 L.Ed.2d 377, it was held that the Federal Power Commission, through its certification power, could prevent the waste of gas committed to its jurisdiction. In so holding, the Court noted a distinction between 'economic waste' and 'physically wasteful practices'. The former involves a general monitoring of natural gas supply through manipulations of rate structure and determinations of gas use priorities, while the latter involves such matters as improper well spacing and the flaring of unused gas. The regulation of 'economic waste' is properly within the jurisdiction of the Federal Power Commission, leaving the state authority to regulate 'physically wasteful practices,' so long as such do not interfere with Federal jurisdiction.

"In Northern Natural Gas Co. v. State Corporation Commission of Kansas, 1965, 372 U.S. 84, 83 S.Ct. 646, 9 L.Ed.2d 601, the Kansas Corporation Commission had issued orders which required an interstate pipeline company to purchase natural gas ratably from all wells connecting to its pipeline system. The United States Supreme Court reversed an affirmance of the order by the Kansas Supreme Court. In so doing, the High Court held that a purpose, 'however legitimate to conserve natural resources, does not warrant direct [or indirect] interference by the States with the price[s] of natural gas wholesales in interstate commerce.' [Italics ours] The orders were struck down because they necessarily impaired the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sale of natural gas and to achieve the uniformity of regulation which was the objective of the Natural Gas Act.

"The problem in Northern Natural, supra, as here, was:

...not as to the existence or even the scope of a State's power to conserve its natural

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resources; the problem is only whether the Constitution sanctions the particular means chosen by...[the state] to exercise the conceded power if those means threaten effectuation of the federal regulatory scheme. [Emphasis supplied]

"The Defendant also relies upon Section 1(b) of the Natural Gas Act, 15 U.S.C. § 717(b), which states in part that the provisions of the Act 'shall not apply...to the production and gathering of natural gas.' Accordingly, Order No. 93,381, paragraph 19, states that:

> All we do is prohibit the production of gas under circumstances which we find will produce waste; and to prevent that waste, we will order wells to be shut in. Our Order and our regulatory action is complete before any sale takes place.

"The state courts, which were reversed in Panoma and Cities Service, had relied upon identical rationale in upholding state minimum price orders. The Oklahoma Supreme Court had observed in affirmance that 'the sale is made before any movement of any kind starts and before any thing in the nature of interstate commerce occurs.' supra, 272 P.2d at 431. Similarly, the Kansas Supreme Court had observed the order of the Kansas Commission 'fixed a minimum price to be paid for gas before cessation of production.' 180 Kan. 454, 304 P.2d 528 at 535.

"In the case at bar, the Defendant seeks to do precisely what the United States Supreme Court held that the Kansas Corporation Commission could not do. Here, as there, a certain price level must be satisfied as a condition precedent to production. The High Court said in the Northern, supra, case, 'It has been consistently held that 'production' and 'gathering' are terms narrowly confined to the physical acts of drawing the gas from the earth and preparing it for the first stages of distribution.' The Defendant is not concerned herein with the mere physical problem of production; it is concerned with the price of the sale." Id., pp. 538-540.

3. A State may not accomplish by indirection that which is prohibited through direct action. The courts have not been hesitant to disregard a state contention that a statute

or regulation was designed to promote conservation where the court determines that the state's real intent was otherwise. A good example of this is the attempt by the State of Texas to force interstate pipelines to purchase ratably from all producers in a field. The Common Purchaser Act of 1931 compelled the purchase of gas from all producers in the field, and was held unconstitutional in Texoma Natural Gas Co. v. Railroad Commission, 59 F.2d 750 (W.D.Tex. 1932). The State of Texas then attempted to accomplish the same goal by indirection through the issuance of proration orders. Proration orders designed to prevent waste have been held to be a constitutional exercise of the state's police power. In this instance, the interstate pipelines owned their own gas wells and were able to satisfy the needs of the pipeline through their own production. The result of the proration orders was to so decrease the amount of production from all wells, including the pipeline-owned wells, that the pipeline was forced to purchase from other producers in order to fill the pipeline. The State contended that the action was necessary to prevent correlative rights of owners in a common reservoir -- approximately 20% of the gas in the reservoir was owned by persons who had no market other than the interstate pipelines, and the only way these owners could prevent drainage would be to produce oil and gas for which there was no market. However, the Supreme Court ruled that the State's action was an impermissible interference with interstate commerce:

"...We assume that the prohibition of any wasteful conduct, whether primarily in behalf of other owners of gas in the common reservoir, or because of the public interests involved, is consistent with the Constitution of Texas and that of the United States, and that to prevent waste production may be prorated. We assume, also, that the State may constitutionally prorate production in order to undue drainage of gas from the reserves of well owners lacking pipe line connections. If proration were lawfully applied for any such purposes, the fact that thereby other private persons would incidentally and gratuitously obtain important benefits would present no constitutional obstacle. And the fact that plaintiffs' gas is to be sold in interstate commerce would not preclude such exercise of the State's power. Compare Champlin Refining Co. v. Corporation Commission, 286 U.S. 210, 235.

"But the sole purpose of the limitation which the order imposes upon the plaintiffs' production is to compel those who may legally produce, because they have market outlets for permitted uses, to purchase gas from potential producers whom the statute prohibits from producing because they lack such a market for their possible product. Plaintiffs' operations are neither causing nor threatening any overground or underground waste. Every well owner in the field is free to produce the gas, provided he does as appears, physically free to provide himself with a market and with transportion and marketing facilities. There is no basis for a claim that his right, or opportunity, will be interfered with by a disproportionate taking by any one of those who may legally produce."

Thompson v. Consolidated Gas Utilities Corp., supra, at pp. 76-77. (Footnotes omitted).

The prohibition on attempted State direct action which conflicts with the Federal regulatory scheme is also reflected in Northern Natural Gas Co. v. Kansas Corp. Comm., 372 U.S. 84 (1963), where the Supreme Court ruled invalid an order of the Kansas State Corporation Commission requiring

an interstate pipeline to purchase gas ratably from all wells in each field within the State where the pipeline's facilities were located. The Court held that while the proration of production was a legitimate exercise of the State's police power, the means chosen conflicted with the federal regulatory scheme:

> "The danger of interference with the federal regulatory scheme arises because these orders are unmistakably and unambiguously directed at purchasers who take gas in Kansas for resale after transportation in interstate commerce. In effect, these orders shift to the shoulders of interstate purchasers the burden of performing the complex task of balancing the output of thousands of natural gas wells within the State, cf. Miller Bros. Co. v. Maryland, 347 U.S. 340 - a task which would otherwise presumably be the State Commission's. Moreover, any readjustment of purchasing patterns which such orders might require of purchasers who previously took unratably could seriously impair the Federal Commission's authority to regulate the intricate relationship between the purchasers' cost structures and eventual costs to wholesale customers who sell to consumers in other States. This relationship is a matter with respect to which Congress has given the Federal Power Commission paramount and exclusive authority. See Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 610. The prospect of interference with the federal regulatory power in this area is made even more acute by the fact that criminal sanctions imposed by state statute for noncompliance fall upon such purchasers and not upon the local producers. Therefore, although collision between the State and federal regulation may not be an inevitable consequence, there lurks such imminent possibility of collision in orders purposely directed at interstate wholesale purchasers that the orders must be declared a nullity in order to assure the effectuation of the comprehensive federal regulation ordained by Congress."

Justice Harlan, dissenting with two other Justices, noted that enforcement of proration orders through the pipelines was the most efficient way to accomplish the State's

purpose, and argued that any threat to federal regulation from such an order was no different than that resulting from other valid conservation measures. Justice Harlan also argued that all conservation legislation constituted an interference with interstate commerce; therefore, the ultimate effect of the majority's ruling would be to invalidate all conservation powers of the states.

> "The ratable take orders here were intended as conservation measures -- to protect the correlative rights of producers taking gas from a common source of supply by preventing drainage from underproduced wells to overproduced wells. It has always been recognized that the States possess the power to conserve scarce resources such as natural gas and to prevent unfair and discriminatory production of this resource by some wells at the expense of others. See, e.g., Patterson v. Stanolind Oil & Gas Co., 305 U.S. 376; Lindsley v. Natural Carbonic Gas Co., 220 U.S. 61; Ohio Oil Co. v. Indiana, 177 U.S. 190. It is difficult to imagine any exercise of this conservation power that would not carry with it the possibility of affecting the costs incurred by those who purchase gas from producers. Regulations requiring the casing of wells, prohibiting the use of pumps, restricting production to a certain percent of a well's 'open flow,' imposing a particular gas-oil ratio, controlling drilling operations and pipeline pressure, prescribing the permissible spacing of wells, and enforcing pooling or unitization may reduce the amount of gas available for sale by a particular producer (at least in the short run) and thus force a purchaser to buy from it or someone else probably at greater cost. Yet it has never been suggested that such state measures are for the reason invalid.
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> "Indeed, the most direct interference with the availability of gas for interstate sale is the 'allowable' order. It places a ceiling on the amount of gas that may be produced by a particular well during a given period of time and inevitably makes pipelines

spread their demand among many wells. Obviously its possible effect on cost is precisely the same as that which may be caused by a ratable take order, for the two orders are merely variations of the same regulatory measure; both are designed to prevent the disproportionate taking of gas from some wells to the disadvantage of others.

"In Champlin Refining Co. v. Corporation Comm'n, 286 U.S. 210 (1932), this Court sustained, against a challenge under the Commerce Clause, a state allowable order. Since the States had the power to issue such an order at the time the Natural Gas Act was passed, nothing in that Act can now be considered to withdraw it. This is so because it is beyond dispute that when Congress enacted the Natural Gas Act in 1938 it did not intend to deprive the States of any regulatory powers they were then deemed to possess under the Constitution. Rather, the Act was intended only to fill the 'gap . . . thought to exist at the time the Natural Gas Act was passed' by providing for federal regulation of those aspects of the natural gas business that the States were at that time believed to be constitutionally incapable of regulating. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 684, 685-687. As was specifically stated in the House Committee Report, the Act 'takes no authority from State commissions, and is so drawn as to complement and in no manner usurp State regulatory authority.' H.R. Rep. No. 709, 75th Cong., 1st Sess., p. 2.

"If an allowable order is now valid, what is the distinction between such an order and the ratable take orders in the present case? The Court points to no difference in terms of effect on cost structure, but only to the fact that the orders here are directed at purchasers and not producers. For reasons already discussed, supra, pp. 100-102, this difference is illusory.

"Quite apart from the absence of any significant difference between the possible general cost ramifications of an allowable and a ratable take order, the very facts of the case before us demonstrate the folly of determining whether or not the jurisdiction of the Federal Power Commission has been invaded on the basis of general possibilities unsupported by specific data. Appellant is paying a higher price for gas to Republic than to any other producer in the Kansas Hugoton Field. If appellant could reduce its take from Republic wells without contractual liability, the over-all cost of its

gas purchases would in all likelihood decrease. Surely such a beneficial effect on appellant's cost structure is not inconsistent with the purposes of the Natural Gas Act. And we have no way of knowing the extent to which the same is true of other Kansas purchasers. The lurking danger of collision with federal regulation that the Court fears may be completely nonexistent. Yet on this insecure foundation the Court builds a rule that, if consistently applied, may well destroy the conservation powers of the States. And this in the name of an Act expressly intended to preserve existing state powers." Id., pp. 103-106. (Footnotes omitted).

The most important aspect of Justice Harlan's pessimistic outlook for the future is his recognition that the states' traditional control over conservation can be eroded under the preemption doctrine. While a particular conservation statute or regulation may not be held unconstitutional as an interference with interstate commerce, that same statute or regulation may be invalid if it conflicts with an area preempted by the Federal government. This is illustrated again by reference to F.P.C. v. Corporation Commission of Oklahoma, supra, wherein the District Court discusses the fact that state regulations establishing minimum prices for the sale of natural gas in interstate commerce were originally upheld by the Supreme Court as valid conservation matters. However, in the wake of the Phillips case wherein the Court determined that the FPC had jurisdiction over producers the attempts by the states to set minimum prices were held invalid in light of conflicting federal regulation. Thus, it must be concluded that Congress could act to preempt any state control over production and that such legislation would probably be constitutional.

4. The State May Not Effectively Block Construction of an Interstate Pipeline by Denying Permission to Cross State Lands.

The power of eminent domain granted to an interstate natural gas pipeline is found in Sec. 7(h) of the Natural Gas Act, 15 U.S.C. § 717(f), which is as follows:

> "When any holder of a certificate of public convenience and necessity cannot acquire by contract, or is unable to agree with the owner of property to the compensation to be paid for, the necessary right-of-way to construct, operate, and maintain a pipe line or pipe lines for the transportation of natural gas, and the necessary land or other property, in addition to right-of-way, for the location of compressor stations, pressure apparatus, or other stations or equipment necessary to the proper operation of such pipe line or pipe lines, it may acquire the same by the exercise of the right of eminent domain in the district court of the United States for the district in which such property may be located, or in the State courts. The practice and procedure in any action or proceeding for that purpose in the district court of the United States shall conform as nearly as may be, with the practice and procedure in similar action or proceeding in the courts of the State where the property is situated: Provided, that the United States district courts shall only have jurisdiction of cases when the amount claimed by the owner of the property to be condemned exceeds $3,000."

As can be seen from the foregoing quote, Sec. 7(h) makes no reference to public or state owned lands; moreover, there appear to be no reported cases which specifically address the issue of whether Sec. 7(h) provides the authority to condemn state owned lands.

It has been determined that the power of eminent domain under the Federal Power Act, 16 U.S.C. § 814, includes

the power to condemn state owned property. In State of Missouri ex rel. v. Union Electric Light & Power Co., 42 F.2d 692 (C.D. Mo. 1930), the State of Missouri brought an action to enjoin construction of a hydroelectric project which had been approved by the FPC. The State alleged that construction of the project would result in the accumulation of a large body of water which would submerge "both public and private property, including the courthouse and the jail in the village of Linn Creek, a large number of school districts, and at sundry points inundate the public highways." In response to the State's allegation that the utility company could not appropriate land already dedicated to public use the Court stated as follows:

> "9. While it is well settled that the Legislature may authorize the taking of property already devoted to a public use, it is equally well established that a general delegation of the power of eminent domain does not authorize the taking of property already devoted to a public use, 'unless it can clearly be inferred from the nature of the improvements authorized or from the impracticability or constructing them without encroaching upon such property that the legislature intended to authorize such a taking.' 10 R.C.L. § 169; Western Union Telegraph Co. v. Pennsylvania R.R. Co., et al., 195 U.S. 540, 25 S.Ct. 133, 49 L.Ed. 312, 1 Ann. Cas. 517. In this connection it cannot be questioned but that the Congress had the power to confer the right of eminent domain upon the defendant Union Electric Light & Power Company. 10 R.C.L. § 167.
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> "In the instant case the Congress must have contemplated this identical situation; hence the requirement of notice. Moreover, the proposed improvements could not be accomplished, except through the exercise, if necessary, of eminent domain against property already

dedicated to public use. To deny the right of eminent domain as against this public property would not only defeat the functions of the national government, but would run contrary to the obvious intent of the Congress as expressed in the Water Power Act. Stockton, Attorney General v. Baltimore & New York R.R. Co. (C.C.) 32 F.9; 20 C.J. § 90, P. 602; Vermont Hydro-Electric Corporation v. Dunn et al., 95 Vt. 144, 112 A. 223, 12 A.L.R. 1495; Imperial Irrigation Co. v. Jayne, 104 Tex. 395, 138 S.W. 575, Ann. Cas. 1914B, 322." Id., at p. 698.

While this case appears to be the only one to have ever addressed the issue at hand, it is clearly consistent with other cases holding that the federal government can condemn state lands:

"The power of eminent domain is essential to a sovereign government. If the United States has determined its need for certain land for a public use that it is within its federal sovereign powers, it must have the right to appropriate that land. Otherwise, the owner of the land, by refusing to sell it or by consenting to do so only at an unreasonably high price, is enabled to subordinate the constitutional powers of Congress to his personal will. The Fifth Amendment, in turn, provides him with important protection against abuse of the power of eminent domain by the Federal Government.

"While in its early days the Federal Government filed its condemnation cases in the state courts, this Court, in Kohl v. United States, 91 U.S. 367, disposed of the idea that this was necessary. In that case, which has become the leading case on the federal power of eminent domain, Mr. Justice Strong also said:

'It has not been seriously contended during the argument that the United States government is without power to appropriate lands or other property within the States for its own uses, and to enable it to perform its proper functions. Such an authority is essential to its independent existence and perpetuity. These cannot be preserved

if the obstinacy of a private person, or if any other authority, can prevent the acquisition of the means of instruments by which alone governmental functions can be performed. The powers vested by the Constitution in the general government demand for their exercise the acquisition of lands in all the States...'." United States v. Carmack, 329 U.S. 230, 236-237 (1946).

It is noteworthy that the Natural Gas Act did not provide interstate pipelines with the power of eminent domain until the Act was amended in 1947 to add Section 7(h). The legislative history of the 1947 amendment makes it clear that Congress intended to confer on interstate pipelines the same power of eminent domain as contained in the Federal Power Act:

> "In some States the right of eminent domain is expressly denied to companies which may have qualified under the Natural Gas Act. For instance, in the State of Arkansas the State constitution provides that a foreign corporation shall not have the power to condemn private property (Constitution of Arkansas 1874, as amended, art. 12, sec. 11). The State of Wisconsin grants the right of eminent domain to only those gas companies which are Wisconsin corporations (Wisconsin Statutes, 1945, ch. 32.02(6)). Nebraska grants the right of eminent domain to gas pipe line companies distributing gas within the State (Nebraska Rev. Stat., 1943, ____).
>
> "Therefore, the Congress of the United States in carrying out its constitutional authority to regulate interstate commerce should correct this deficiency and omission in the Natural Gas Act by the passage of Senate bill 1028 which confers the right of eminent domain upon those natural gas companies which have qualified under the Natural Gas Act to carry out and perform the terms of any certificate of public convenience and necessity acquired from the Federal Power Commission under the act.
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> * * *
>
> "It has also been suggested that the granting of the right of eminent domain is a matter peculiarly within the

legislative and constitutional purview of the States and that it is proper that such rights should rest with the States in order that the States may therefore be in a position to require a natural-gas pipeline company entering the State to serve the people of that State as a condition to obtaining the right of eminent domain. This argument defeats the very objectives of the Natural Gas Act. Under the Natural Gas Act, the Federal Power Commission is given exclusive jurisdiction to regulate the transportation of natural gas in interstate commerce, the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and natural gas companies engaged in such transportation or sale. The Commission, through its certificate power, is authorized to grant certificates of convenience and necessity for the construction of interstate natural-gas pipe lines from points of supply to certain defined and limited markets. If a State may require such interstate natural-gas pipe lines to serve markets within that State as a condition to exercising the right of eminent domain, then it is obvious that the orders of the Federal Power Commission may be nullified.

"As stated above, it is within the constitutional authority of Congress to regulate interstate commerce. In the performance of that constitutional authority, it is proper for the Congress to furnish proper and necessary protection of the free flow of interstate commerce. S. 1028 is designed for that purpose with respect to the movement of natural gas in interstate commerce and the sale in interstate commerce of natural gas for resale for ultimate public consumption, and is identical to congressional protection granted under the Federal Power Act with respect to licensees under that act for the construction, maintenance, or operation of any dam, reservoir, diversion structure, or the works appurtenant or necessary thereto.

"S. 1028 does not invade or interfere with the right of the States to impose any proper regulation upon intrastate activities, since its application is limited to exclusive interstate operations with respect to which the States may not constitutionally legislate." Roach and Gallagher, Natural Gas Act Legislative History, Part II, pp. 886-888. (Emphasis added.) And see, Nichols on Eminent Domain, supra, pp. 5-272; Doggett "Exercise of the Power of Eminent Domain As Authorized By the Natural Gas Act," 1969 Eminent Domain Inst. 33, 38.

It must be assumed that Congress was aware of the State of Missouri v. Union Electric Light & Power Co., supra, when it amended the Natural Gas Act to give interstate pipelines the same power of eminent domain as contained in the Federal Power Act:

> "It is interesting to note that the procedural and jurisdictional portions of the new subsection were copied verbatim (with minor insignificant exceptions) from the section of the Federal Power Act which grants to hydro-electric licensees the power to condemn property for dams and related facilities. The importance of the similarity of language lies in the fact that the pertinent section of the Power Act had been on the statute books since 1920 and had been interpreted numerous times by the courts. Under well-recognized rules of construction, by adopting substantially the same language at a later time, Congress must be presumed to have put its stamp of approval on the prior decisions. It cannot be denied that Congress was aware of the similarity of language, because the House Committee Report contained a letter from the chairman of the Federal Power Commission specifically calling attention to the fact." Doggett, supra, pp. 37-38 (Footnotes omitted).

Consequently, one must conclude that an interstate pipeline would have the power to condemn state lands if necessary to fulfill the obligations of its certificate of public convenience and necessity.

5. The State May Not Block Construction of an Interstate Pipeline by Assertions of Police or Zoning Powers.

The courts have determined that § 717f(h) is a constitutional exercise of congressional power. Tennessee Gas Transmission Co. v. Thatcher, 180 F.2d 644, cert. denied 340 U.S. 829 (1950). Moreover, the courts have consistently

enjoined municipalities from enforcing zoning ordinances which prohibit the construction of interstate pipelines within the city limits. After concluding that the Natural Gas Act had not totally preempted the states' exercise of police power over natural gas pipelines, the court in Transcontinental Gas Pipe Line Corp. v. Borough of Milltown, 93 F.Supp. 287 (D.N.J. 1950), concluded that the municipality's zoning ordinance could be sustained only if reasonable, justifiable and not an undue burden on interstate commerce. The municipality argued, to no avail, that the ordinance was reasonable because the pipeline could be rerouted around the town:

> "The defendant stands only upon the suggestion of its mayor that other routes are available, which is corroborated by another witness. Neither is qualified to testify as to the engineering feasibility of the transportation of natural gas with relation to the installation of the pipe line or the maintenance and operation thereof. The only efficacy of this testimony rests in the statements that the pipe line could be otherwise routed. This is almost axiomatic for as one of the defendant's witnesses on cross examination admitted a pipe line can be laid practically anywhere, including the side of the Empire State Building if expense is of no consideration.
>
> "On the other hand the plaintiff has shown logical, efficient and economical reasons for following the right-of-way of the Public Service Electric and Gas Company in this particular congested industrial portion of this state. By doing so it insures a minimum of inconvenience to, and destruction of, property of others.
>
> "In a somewhat similar situation dealing with the condemnation of land for pipe line purposes the court in the case of Williams v. Transcontinental Pipe Line Corp., supra, stated:

'The claim is merely that, in the exercise of its rights, the defendant should have run its line across the property of some one else, or crossed petitioners' property at a different place.

'It is obvious that such a contention must fail. If a landowner, merely by showing that it would be possible for a utility line or highway to avoid crossing his property, could compel the condemnor to relocate its line, no power line, railroad, pipe line, or highway could ever be located properly to serve the public. The determination of what property is needed to accomplish the public purpose for which the right of eminent domain is given must of necessity rest primarily with the agency charged with carrying out the public work. There may be cases where the condemnor so abuses its discretion or acts in such bad faith in locating its line that the court would be justified in intervening; but usually no Judge would take upon himself the burden of deciding the best location for a utility line.' 89 F.Supp. 488-489.

"This reasoning is equally applicable to this plaintiff, although it was not necessary for it to exercise its right of eminent domain in the instance under question here. The fact remains that the mere claim by defendant that its ordinance requires plaintiff to locate its pipe line in an alternative route, suggested as available, does not fortify it with power to impede the plaintiff in the prosecution of its legal objective in the field of interstate commerce. Such an attempt to obstruct interstate commerce under guise of an assertion of exercise of the police power must fail." Id., p. 295. (Footnotes omitted)

Nor can the State assert, successfully, a supervening interest in public safety; the State has no power to control safety standards for interstate natural gas pipelines. The Natural Gas Pipeline Safety Act, 49 U.S.C. § 1671 et seq., provides that:

"§ 1672(a)* * *

(b) Not later than twenty-four months after August 12, 1968, and from time to time thereafter, the Secretary

shall, by order, establish minimum Federal safety standards for the transportation of gas and pipeline facilities. Such standards may apply to the design, installation, inspection, testing, construction, extension, operation, replacement, and maintenance of pipeline facilities. Standards affecting the design, installation, construction, initial inspection, and initial testing shall not be applicable to pipeline facilities in existence on the date such standards are adopted. Whenever the Secretary shall find a particular facility to be hazardous to life or property, he shall be empowered to require the person operating such facility to take such steps necessary to remove such hazards. Such Federal safety standards shall be practicable and designed to meet the need for pipeline safety. In prescribing such standards, the Secretary shall consider -

(1) relevant available pipeline safety data;

(2) whether such standards are appropriate for the particular type of pipeline transportation;

(3) the reasonableness of any proposed standards; and

(4) the extent to which such standards will contribute to public safety.

Any State agency may adopt such additional or more stringent standards for pipeline facilities and the transportation of gas not subject to the jurisdiction of the Federal Power Commission under the Natural Gas Act as are not incompatible with the Federal minimum standards, but may not adopt or continue in force after the minimum Federal safety standards referred to in this subsection become effective any such standards applicable to interstate transmission facilities."

The act has been construed as preempting any state or local control over pipeline safety regulations with respect to interstate natural gas pipelines. United Gas Pipe Line Co. v. Terrebonne Parish Police Jury, 319 F.Supp. 1138 (D.C.La.), affirmed 445 F.2d 301 (5th Cir. 1971).

6. If the State Initially Elects to Take Its Royalty in Valu. Rather Than In Kind, The State Probably Could Not Thereafter Withdraw the Royalty Share From Interstate Commerce Without FPC Approval. Section 7(b) of the Natural Gas Act provides as follows:

> (b) No natural-gas company shall abandon all or portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permits such abandonment. 15 U.S.C. §717 (b)

Under this language, once a producer or pipeline commences jurisdictional service, it cannot thereafter terminate the service, without abandonment authorization from the Commission. United Gas Pipe Line Company v. FPC, 385 U.S. 83 (1966). This is true whether or not there are valid contractual agreements with respect to the service.

Unless and until the State has exercised its right to take gas in kind, the producer owns and is legally entitled to dispose of all gas in interstate commerce. His obligation to the State is to pay royalties in value, such being calculated on the basis of a percentage of the value of the production obtained from the lease. In at least the conventional situation where royalty is paid in value, the

payment of royalty has been held by the Courts to be a non-jurisdictional transaction. Mobil Oil Corporation v. FPC, 463 F.2d 256 (D.C. Cir. 1972). In that case the Court stated that an economic interest in the proceeds of sale unaccompanied by authority to determine the incidents of sale does not make one a seller. 463 F.2d at 262.

If the producer undertakes to sell all of the gas produced from the lease and is issued a certificate authorizing the sale of all of the gas from the lease, the producer may not be able to thereafter release the royalty gas for a taking in kind. Superior Oil Company, Docket No. CI71-879 (Letter Order issued 6/13/75). In Superior, the State of Texas had the right under its leases to take its royalty gas in kind. Initially the gas was sold by Superior Oil Company under Certificates of Public Convenience and Necessity issued by the Federal Power Commission. When the State decided to commence taking its royalty gas in kind, it notified the Federal Power Commission asserting, among other things, that an FPC Order issued February 11, 1975 in Docket G-5354, et al, had authorized the State to take its gas in kind. The Commission responded that "the February 11, 1975, Order did not authorize either Superior or the State of Texas to divert natural gas from interstate commerce" and advised the State that:

"before any natural gas produced from the leases dedicated under Superior's contract dated May 7, 1971, as amended June 25, 1974, with Natural Gas Pipeline Company of America can be diverted from interstate commerce Superior must file for and receive abandonment authorization from this Commission in accordance with requirements from Section 7 (b) of the Natural Gas Act and the Commission's regulations thereunder. Any action by the State of Texas which would require Superior to take action inconsistent with said Act and regulations would be in violation of the Supremacy Clause Doctrine (Northern Natural Gas Company v. State Corporation Commission of Kansas, 372 U.S. 84)."

While it is therefore clear that the Commission will take the position that abandonment authorization is required before a State can exercise its right to take royalty gas in kind after delivery of the full gas stream in interstate commerce has once commenced, the validity of the Commission's assertions has not yet been ruled upon by a Court. The issues involved are: (1) the extent to which the certification and abandonment requirements of Section 7 of the Natural Gas Act can be construed as permitting, or indeed requiring, a natural gas company to continue to dispose of property where it has no contractual or legal rights (other than such rights as may be created by the Natural Gas Act) to do so; and (2) the extent to which a royalty owner may be bound by agreements made and actions taken by its lessee. Similar issues are, however, before the Courts at this time. See e.g., Southland Royalty Company, et al. v. FPC (5th Cir. Case No. _____, filed July __, 1975).

The first case to present these issues to the Commission was El Paso Natural Gas Company v. Perry R. Bass,

et al., 48 FPC 1269, Opinion No. 638 (1972). In that case Bass had farmed out certain acreage to Shell Oil Company retaining a 1/8th overriding royalty convertible to a 50% working interest on payout. The agreement expressly provided that during any period that both parties had working interests either party could take its gas in kind and that nothing contained in the agreements could be construed as giving Shell the right to sell or otherwise dispose of Bass' share of the gas without express authorization to do so. Shell entered into agreements to sell gas from the properties to El Paso. During the period prior to payout all of the gas from the lease was, in fact, sold to El Paso pursuant to certificates of public convenience and necessity issued by the Commission. On discovering that payout had occurred, Bass exercised its right to convert its overriding royalty to a working interest, and entered into agreements for the sale of its gas to Natural Gas Pipeline Company of America. El Paso filed a complaint and sought a Declaratory Order requiring Bass to obtain Section 7(b) abandonment authorization before diverting any gas to Natural. The Commission concluded that El Paso's right to purchase gas from the lease could rise no higher than Shell's right to sell. Since the lease agreements precluded Shell from selling gas attributable to Bass' working interest without permission and Shell had only purported to sell "gas from its properties" the Commission

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concluded that neither party could be heard to say that the contract between Shell and El Paso impaired the pre-existing rights of Bass to take and dispose of its gas.

In Bass, the Commission seemed to recognize that sales of gas by a producer under the Natural Gas Act would not destroy pre-existing rights of other parties to the gas. With respect to rights to gas acquired after a producer has commenced jurisdictional sales, the Commission in a series of cases has made clear that those rights may be subject to and restricted by the abandonment provisions of the Natural Gas Act. See, for example, Blair-Vreeland, ____ FPC ____, Opinion No. 724 (March 18, 1975) reh. denied, Opinion No. 724-A (May 14, 1975); Mitchell Energy Corporation, ____ FPC ___, Opinion No. 733 (June 11, 1975); United Gas Pipe Line Co. v. Billy J. McCombs, et al, ____ FPC ___, Opinion No. 740 (August 20, 1975) reh. denied, Opinion No. 740-A (November 7, 1975). In each of those cases, the new interest owner acquired his rights from a producer which had previously made jurisdictional sales from the properties. Since, in each case, the rights were acquired after the property had become dedicated to interstate commerce, the conclusion that the property remained dedicated in the hands of the new owners is not necessarily inconsistent with the holding in Bass.

There is one recent case, however, which is clearly inconsistent with Bass; See El Paso Natural Gas Co., et al,

____ FPC ____, Opinion No. 737 (July 11, 1975) reh. denied, Opinion No. 737-A (September 3, 1975), on appeal sub nom, Southland Royalties Co. vs. FPC, 5th Cir. Case No. ___ filed July __, 1975, referred to here as the "Southland" case. Southland involved the question of the rights of certain mineral interest owners to dispose of gas after termination of leases. In 1925, Gulf Oil Corporation had acquired a fifty-year lease to the properties. Gulf developed oil and gas reserves on the property and sold gas produced from the properties to El Paso in transactions subject to FPC jurisdiction. On July 14, 1975 Gulf's lease expired. The question of the right of the mineral interest owners to possession of the properties was adjudicated in State court proceedings. Gulf Oil Corp. v. Southland Royalty Co., 496 S.W.2d 547 (1973). The mineral interest owners who, on expiration of the lease, were entitled to possession of the property and all gas produced therefrom, agreed to sell that gas to an intrastate pipeline company.

In response to petitions for declaratory order filed by El Paso and Texaco, Inc., the Commission concluded that all gas produced from the properties remained dedicated to interstate commerce notwithstanding the termination of the leases. The Commission held that the leasees, owners, and the operators of the plant in which the gas was processed, all must obtain abandonment authorization prior to disposing of the gas to other purchasers. The Commission stated

"Because of the termination of the fifty-year leases the leaseholders, Gulf et al., lose their leases and their rights pass to Southland, et al. in one case and to Goldsmith, et al. and Texaco in the other case. Of course we have determined that gas may not be withdrawn from interstate commerce by the assignment of leases from one lessee to another." Cumberland Natural Gas Company, 34 FPC 132 (1965); Blair-Vreeland, ____ FPC ____, Opinion No. 724, Docket No. CI 74-331, March 18, 1975. But we do not rest our conclusion on these cases, but on the principle established by Section 7(b) that 'service' may not be abandoned without our permission. Thus it makes no difference whether a lease is transferred or terminates, the obligation of service imposed upon the dedicated gas continues. As said in Hunt v. FPC, 306 F.2d 334, 342 (C.A.5, 1962), rev'd on other grounds, 376 U.S. 515 (1964), the duty to continue to serve is like an ancient covenant running with the land." Opinion 737 mimeo at 6.

On rehearing, the Commission stated that

"Here, however, we are solely concerned with the service commenced by Gulf to El Paso in interstate commerce. Under Section 7(b) of the Natural Gas Act this service may not be abandoned without the permission of the Commission. Nor, as we said in Opinion No. 737, can this service be discontinued by transfer to a successor interest. For the practical purposes of the Act it makes no difference whether the successors happen to be assignees, purchasers or reversionary interests. While the contractual right to control and sell the reserves herein involved has passed from Gulf to the various mineral interests, this does not mean that under the Natural Gas Act the gas flowing in interstate commerce may be diverted to the intrastate market. As said in Huber Corp. v. FPC, 236 F.2d 550, 558 (C.A. 3, 1956), Congressional power to regulate interstate commerce in natural gas includes authority to regulate abandonment of sales." Opinion 737-A mimeo at 2.

In its initial opinion in Southland, the Commission distinguished the Bass case describing the latter as involving a situation in which only a part of the interest (i.e., Shell's

interest) in the property was dedicated to interstate commerce. By contrast, it concluded that Gulf had dedicated all of the reserves from the properties. On rehearing, the Commission again attempted to distinguish Bass, emphasizing that in Bass, the sale agreement "pointedly made it clear that Shell was only selling gas from its interests in the properties involved". Opinion 737-A mimeo at ____. However, to the extent that Bass might not be distinguishable, the Commission stated:

> "To the extent, however, that Bass can be said to stand for the proposition that the service initiated by the leaseholder based upon certain gas reserves covered by the lease can be terminated without Commission approval, it is overruled. It should be noted that Bass did not involve the shift of gas reserves from interstate to intrastate commerce and did involve the public interest in the encouragement of farmouts, and these circumstances, in part, explain the result in Bass." Opinion 737-A mimeo at 3.

In responding to arguments that the Commission's holding unconstitutionally deprived the mineral interest owners of property without due process of law, the Commission responded that since the leases contemplated that the lessors would develop and sell oil and gas produced from the properties, the lessees were bound by the legal consequences of such sales.

> ". . .the essence of the argument appears to be that we are in error in holding that the leaseholders, Gulf, et al., had power to encumber the property with the result that the mineral leaseholders are forced to enter into an interstate sale against their will. We assume that in 1925, when the leases were made the lease owners did not contemplate that the Natural Gas Act would

be enacted with a provision that service might not be abandoned without approval of the Commission. They clearly did contemplate that the leaseholders would drill for oil and gas and sell oil and gas to outside parties, and there was no reason that these sales could not be in interstate commerce, and may have had a duty to do so under the facts in law at that time. After the Natural Gas Act was enacted in 1938 and the Phillips case was decided in 1954 the interstate sales of gas became subject to FPC jurisdiction. The leaseholders who had a duty to exploit the wells were the appropriate parties to seek FPC certification. Upon the commencement of interstate sales under FPC certification, the sales became imbued with the public interest. The law of Texas preserved for the leaseowners their property interests, and we do not change this, but Section 7(b) of the Act will not permit the abandonment of interstate sales without our authority once such sales have commenced. The mineral lease owners who entered into a lease that permitted the leaseholders to make interstate sales are not deprived of this property by being required to permit such sales to continue, and they will be compensated under the just and reasonable rates promulgated under the Natural Gas Act." Opinion 747 mimeo at 4.

In view of the Commission letter order in Superior Oil, supra and its decision in Southland, it seems most probable that the FPC will assert that abandonment authorization must be obtained if the State of Alaska allows lessees of state property to commence sales of gas in interstate commerce and thereafter seeks to take a portion of the gas in kind. It is conceivable that the agreements between the producer and the purchaser could be structured to bring the transaction within the rationale of the Bass decision, but in view of the Commission's recent arguments and holding in Southland, it seems likely that Bass has been

overruled and that the Commission will require the producer to obtain abandonment authorization notwithstanding such agreements.

7. While the issue is not free of doubt, the State probably may sell for resale or transport natural gas in interstate commerce without F.P.C. authorization. The operating sections of the Natural Gas Act by their terms apply to the regulation of transactions involving natural gas companies. For example, Section 7(c) of the Natural Gas Act which requires certification of any transportation or sale provides as follows:

> "(c) No natural-gas company or person which will be a natural-gas company upon completion of any proposed construction or extension shall engage in the transportation or sale of natural gas, subject to the jurisdiction of the Commission, or undertake the construction or extension of any facilities therefor, or acquire or operate any such facilities or extensions thereof, unless there is in force with respect to such natural-gas company a certificate of public convenience and necessity issued by the Commission authorizing such acts or operations:. . . 15 U.S.C. §717f(c). (emphasis added)

Similarly, Section 7(b) of the Act provides that

> "no natural-gas company shall abandon all or any portion of its facilities subject to the jurisdiction of the Commission, or any service rendered by means of such facilities, without the permission and approval of the Commission first had and obtained. . . " 15 U.S.C. §717f(b).

Similarly, Sections 4 and 5 of the Act which provide for regulation of rates charged for jurisdictional sales and

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services, are by their terms applicable to rates and charges of "natural-gas companies".

The term "natural-gas companies" is defined in Section 2 of the Natural Gas Act to mean a "person engaged in the transportation of natural gas in interstate commerce or the sale in interstate commerce of such gas for resale". 15 U.S.C. §717a(6). The term "person" is defined to include "an individual or a corporation". The term individual is not defined in the Act, however, "corporation" is defined as including "any corporation, joint stock company, partnership, association, business trust, organized group of persons, whether incorporated or not, receiver or receivers, trustee or trustees of any of the foregoing, but shall not include municipalities as hereinafter defined". 15 U.S.C. §616a(2) Municipality is then defined to mean "a city, county, or other political subdivision or agency of a State". 15 U.S.C. §717a(3)

This series of definitions leads to the conclusion that the sale of gas by a state agency (if not by the State itself) is not subject to the jurisdiction of the Federal Power Commission. In the only reported case of which we are aware, the Commission after reviewing the above-quoted series of definitions stated

> "[f]rom this it is clear that municipalities cannot be 'natural-gas companies' as that term is used by the Act. We are not, therefore, vested with jurisdiction to regulate municipalities, even though they are engaged in the

sale of natural gas to interstate pipeline companies." Panhandle Eastern Pipe Line Company v. City of Rolla, Kansas, 26 FPC 736 (1961).

In that case, the issue involved was the rate which should be paid by Panhandle to Rolla for gas produced from natural gas units in which the townsite of Rolla was included. Panhandle was the operator of the unit and under the unitization agreement was obligated to pay Rolla a "proportionate share of the runs from said well at the minimum price established by order of the Kansas Corporation for natural gas in the Hugoton Field of Kansas" 26 FPC at 737 (emphasis in original).

The language of the Act and the Commission's holding in Panhandle suggests that one alternative under which the State could allow interstate sales to commence without precluding later diversion of the gas to intrastate markets if circumstances then demanded would be for the State to exercise its right to take gas in kind, ab initio. Even if the State sold the gas initially to an interstate pipeline company, under the language above-discussed, the sale would appear to be nonjurisdictional and abandonment authorization would not be a precondition to later diversion of the gas to an intrastate market. The agreements between the state and the interstate pipeline company would, of course, have to permit such diversion. It must be remembered, however, that the pipeline would still require FPC certificates for

necessary facilities, and FPC certificate authority to perform interstate transportation services. Thus the Commission would be in a position of exercising indirect control of State transactions cf. FPC v. Transcontinental Gas Pipeline Corp., 365 U.S. 1 (1961).

Despite the apparent clarity of the definitions, and the holding in Panhandle, there is no assurance that the Commission would not assert jurisdiction over the transactions particularly if it viewed such jurisdiction as necessary to prevent diversion of gas from the interstate to the intrastate market. In one case, the Clorts have concluded that a state agency is a "person" within the meaning of at least one section of the Natural Gas Act. Federal Power Commission v. Corporation Commission of the State of Oklahoma, 362 F.Supp. 522 (W.D. Oklahoma, 1973) aff'd 415 U.S. 961 (1974). That case involved the validity of a minimum price order issued by the Oklahoma Corporation Commission relating to the wellhead price of natural gas. The Federal Power Commission contended that the orders impinged upon the FPC's jurisdiction, and were an unconstitutional burden on interstate commerce and used to enjoin enforcement of the order. Under Section 20 of the Natural Gas Act the Commission is authorized to bring suit

> "whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions

> of this Act, or of any rule, regulations, or order thereunder. . . to enjoin such acts or practices and to enforce compliance with this Act or any rule, regulation, or order thereunder. . . " 15 U.S.C. §717s(a).

The Oklahoma Commission argued, among other things, that as an agency of the state it is immune from suit under Section 20. The Court concluded that the Oklahoma Commission's orders were unconstitutional, and that the Oklahoma Commission was not immune from suit. To accomplish this result, the Court emphasized the difference between the use of the words "means" and "includes" in defining terms under the Natural Gas Act. It viewed the word "means" as a verb of limitation and the terms "includes" as a verb of enlargement. Since the term "person" is defined as <u>including</u> an individual or a corporation, it reasoned that the term is not limited to individuals and corporations. Thus it argued that

> "an 'agency of the state' is excluded from the definition of 'corporation' but is not excluded from the word 'person' . . . Whether the defendant Oklahoma Corporation Commission is a non-individual 'person' against which the Plaintiff may proceed, is to be determined by the 'legislative environment'." 362 F.Supp. 544.

The Court then reviewed two cases, one involving taxes on "persons" selling intoxicating liquors, the other involving the meaning of a "person" entitled to sue under Section 7 of the Sherman Act. The Court made no attempt to discuss the legislative history of the Natural Gas Act.

The District Court's opinion in the Oklahoma Corporation Commission case was affirmed on appeal to the Supreme Court without opinion. However, Mr. Justice Rehnquist, joined by Justices Stewart and Powell, dissented solely on the grounds that the Oklahoma Commission was not a "person" which could be sued under Section 20 of the Natural Gas Act.

> "I do think the convoluted statutory construction of the District Court withstands analysis. The Federal Power Commission is given statutory authority to sue any 'person,' defined in the Act to include an 'individual' or a 'corporation'. While use of the word 'include' would in some circumstances permit suits against 'persons' who could not fairly be classified as either 'individuals' or 'corporations', the term hardly can be said to cover an agency with corporate characteristics which is nevertheless specifically excluded from the definition of 'corporation'". 415 U.S. at 967.

In a footnote, Justice Rehnquist noted that an examination of the use of the term "person" in other sections of the Act clearly indicates that regulatory agencies were not intended to fall within that definition. Among the sections he noted as examples in which "person" clearly could not be defined to include a state regulatory agency was the definition of "natural gas company".

> "Furthermore, in the same section, 'natural gas company' is defined to mean a 'person engaged in the transportation of natural gas in interstate commerce of such gas for resale.' (emphasis added) Obviously, inclusion of a state regulatory body within the definition of 'person' in that section would be meaningless." 415 U.S. at 967.

Justice Rehnquist also noted that under Section 19 of the Act any "person, State, municipality, or State commission" aggrieved by the Commission order may apply for a rehearing. He reasoned that if States, State commissions, or municipalities were included within the term "person" the specific inclusion of those terms in Section 19 would be superfluous.

8. Again, while the issue is not free of doubt, it is arguable that the State may, in its capacity as the owner of natural gas, retain State-owned gas for instate use through appropriate leasing provisions. As previously noted, the general rule is that a State may not restrict or interfere with the sale of gas in interstate commerce. Pennsylvania v. West Virginia, 262 U.S. 553 (1923); Oklahoma v. Kansas Natural Gas Company, 221 U.S. 229 (1911); and Northern Natural Gas Company v. State Corporation Commission of Kansas, 372 U.S. 84 (1963).

The Federal courts have invalidated: (1) state attempts to regulate the price of gas sold in interstate commerce, whether directly, FPC v. The Corporation Commission of Oklahoma, 362 F.Supp. 522 (W.D. Okla.), aff'd 415 U.S. 961 (1974), Cities Service Gas Company v. State Corporation Commission, 355 U.S. 391 (1958), Natural Gas Pipeline of America v. Panna Corp., 340 U.S. 44 (1955); or indirectly Northern Natural Gas Co. v. State Corporation Commission of Kansas, 372 U.S. 84 (1963); (2) attempts to require an interstate pipeline company to make sales or connections

for sales within a state where no FPC certification has been granted, Illinois Natural Gas Co. v. Central Illinois Public Service Co., et al., 314 U.S. 498 (1942); (3) attempts to require state approval for the transfer of facilities by companies subject to the jurisdiction of the Federal Power Commission, Cabot Corp., et al. v. Public Service Commission of West Virginia, 332 F.Supp. 370 (S.D. West Virginia 1971); (4) efforts by municipalities to preclude construction of interstate pipeline facilities through the use of zoning ordinances, Transco Gas Pipeline Corp. v. Borough of Milltown, 93 F.Supp. 287 (D.N.J. 1950); New York State Natural Gas Corp. v. Town of Elma, 182 F.Supp. 1 (W.D.N.Y. 1960) and (5) orders requiring interstate pipeline companies to take ratably from all wells connected to its systems in a field, Northern Natural Gas Co. v. State Corporation Commission of Kansas, 372 U.S. 84 (1963).

While the above-cited cases would most certainly prohibit any attempt by the State of Alaska to directly or indirectly restrict interstate access to natural gas produced within the State, it is not clear that Alaska cannot restrict such access with respect to state royalty gas and, perhaps, other gas produced from state leases. The most recent session of the Texas Legislature passed a statute designed to achieve the latter result. V.A.T.S. Article 5382F. The statute made it unlawful for certain state agencies and

officers empowered to execute oil, gas and mineral leases on the various categories of state lands, to execute any such leases which did not contain provisions that none of the natural gas or casinghead gas produced from the mineral estate could be sold or contracted for sale for ultimate use outside the State of Texas unless and until the Texas Railroad Commission found that such gas was not needed for certain designated purposes within the State. Although the statute clearly affects and restricts interstate access to natural gas produced in Texas, it is not clear that the restriction is constitutionally invalid. As discussed below, the nature of state activity in executing oil, gas and mineral leases is proprietary, not governmental.

In Foster-Fountain Packing Co. v. Haydel, 278 U.S. 1 (1928) the Court held unconstitutional a Louisiana statute which would have prohibited interstate shipment of shrimp from which the head and hulls had not been removed but would have allowed such shipment after the shrimp had been hulled and de-headed. The purpose of the Act was to cause a shift in the shrimp processing industry from Mississippi to Louisiana. The Court had no trouble concluding that the statute violated the commerce clause of the Constitution.

> ". . . Interstate commerce includes more than transportation; it embraces all of the component parts of commercial intercourse among States. And a state statute that operates directly to burden any of its essential elements is invalid. Dahnke-Walker Company v. Bondurant, 257 U.S. 282, 290. Shafer v. Farmers Grain Co., supra, 199. A State

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is without power to prevent privately owned articles of trade from being shipped and sold in interstate commerce on the ground that they are required to satisfy local demands or because they are needed by the people of the state. Penna. v. West Virginia, 262 U.S. 553, 596. Oklahoma v. Kansas Nat. Gas Co., 221 U.S. 229, 255." 278 U.S. at 10-11.

The Court indicated, however, that on the basis of cases such as Geer v. Connecticut, 161 U.S. 519 which holds that a state owns and has a right to control all of the game and fish within its boundaries, Louisiana could have retained all of the shrimp for consumption and use within the state.

". . .As the representative of its people, the State might have retained the shrimp for consumption and use therein. But, in direct opposition to conservation for intrastate use, this act permits all parts of the shrimp to be shipped and sold outside of the state." 278 U.S. at 13.

In a separate concurring opinion Mr. Justice Reynolds stated

"Manifestly, Louisiana has full power absolutely to forbid interstate shipments of shrimp taken within her territory. These crustaceans belong to her and she may appropriate them for the exclusive use and benefit of citizens. If the state should conclude that the best interests of her people require all shrimp to be canned or manufactured therein before becoming part of interstate commerce, nothing in the Federal Constitution would prevent appropriate action to that end. This would not interfere with any right guaranteed to an outsider. How wildlife may be utilized in order to advantage her own citizens is for the producing State to determine." 278 U.S. at 15.

In an earlier case, the Court had concluded that the state of New Jersey could constitutionally prohibit the transportation of water outside the State. Hudson Water Co. v. McCarter, 209 U.S. 349 (1908). The stated purpose of the Act was to

preserve New Jersey's fresh water for the benefit of New Jersey citizens. The Court upheld the statute on the theory that the state, on behalf of its people, owned rights to all of the water in question and could prohibit its interstate transportation.

While these cases certainly do not suggest that States may regulate interstate access to natural gas in general, they may suggest that the more limited control of access to those minerals which are actually owned by the State may be a permissible form of state action. An argument can be made that a State, as owner of the minerals, has as much right to develop and dispose of those minerals, whether in intrastate or interstate commerce as does an individual. That a state may choose to develop its resources by leasing them to others, need not necessarily destroy its right to dictate their disposal, particularly, where the state has retained such a right in the leases themselves.

The Courts have consistently held that governmental bodies in dealing with their lands have essentially the same latitude as similarly situated individuals. For example in United States v. General Petroleum Corporation, 73 F.Supp. 225 (S.D.Cal., 1946) a case involving the right of the Secretary of Interior to establish the minimum value for royalty gas (the lease so permitted in certain circumstances), the Court stated:

> "In resolving the foregoing issue it must be remembered that the government's role is taken to be no different from that of any private lessor

> or proprietor, for while the Kettleman Hills lands involved are public mineral lands, and as such until their disposition are under supervision and control of Congress, the government as to such lands acts in a proprietary capacity, and treats with them in the same way as does a private landowner. Regardless of the type of lease Congress might authorize, a lease executed in accordance with what it has authorized becomes a private contractual matter and is to be interpreted according to the general rules of law respecting contracts between individuals. And regardless of what Congress has authorized, unless the authorized provision is mandatory, it may not be 'read in' if the Secretary omitted to include it." 73 F.Supp. at 234 (footnote omitted).

In determining the validity of the Texas Relinquishment Act of 1925, V.A.T.S. Art. 5367 et seq., the Supreme Court of Texas noted that

> "A sale or lease by the state is subject to the same rules of law that are applied to ordinary business or commercial leases." Greene v. Robison, 8 S.W.2d 655, 662 (Tex. S.Ct. 1928)

The reported cases where State "embargo" actions were held invalid all dealt with situations in which the State was attempting to regulate the manner in which its citizens or citizens of other States may carry on transactions in interstate commerce. Insofar as the recent Texas statute (V.A.T.S. Article 538v) purports to restrict only the disposition of gas from State-owned lands, and to do so only in the context of newly-executed lease agreements, it may be distinguishable. While it cannot be said with assurance that the Act is valid, there is at least a chance that it would be upheld.

9. The State may, for valid conservation reasons, protect oil and gas deposits from physical waste by prescribing reasonable regulations governing production. The State of Alaska may have primary interest in conservation legislation with respect to regulations which would require the reinjection of all or a portion of, natural gas in order to maintain proper reservoir pressure. This issue will be of principal importance if it develops that the failure to reinject a sufficient portion of gas to maintain reservoir pressure will cause a loss of gas drive in the reservoir and a resulting loss of oil reserves otherwise recoverable.

Under the traditional principles of law discussed earlier, it would appear that the State of Alaska can, by regulation, require the recycle of gas in order to prevent waste. In this regard, the very early proration statutes and/or regulatory orders had as their basic purpose the prevention of waste due to loss of reservoir pressure, as may be seen from the description in Champlin Refining Co. v. Corporation Commission of Oklahoma, supra:

> "Crude oil and natural gas occur together or in close proximity to each other, and the gas in a pool moves the contents toward the point of least resistance. When wells are drilled into a pool the oil and gas move from place to place. If some of the wells are permitted to produce a greater proportion of their capacity than others, drain ge occurs from the less active to the more active. There is a heavy gas pressure in the Oklahoma City field. Where proportional taking from the wells in flush pools is not enforced, operators who do

not have physical or market outlets are forced to produce to capacity in order to prevent drainage to others having adequate outlets. In Oklahoma prior to the passage of the Act, large quantities of oil produced in excess of transportation facilities or demand therefor were stored in surface tanks, and by reason of seepage, rain, fire and evaporation enormous waste occurred. Uncontrolled flow of flush or semi-flush wells for any considerable period exhausts an excessive amount of pressure, wastefully uses the gas and greatly lessens ultimate recovery. Appropriate utilization of gas energy is especially important in the Oklahoma City field where, because of the great depth of the wells, the cost of artificially recovering the oil would be very high." Id., p. 228.

Also see, Bandini Petroleum Co. v. Superior Court, 284 U.S. 8 (1931); Brown v. Humble Oil & Refining Co., 126 Tex. 296, 83 S.W.2d 935, motion for reh. overr'd, 126 Tex. 314, 87 S.W.2d 1069 (1935); Henderson Co. v. Thompson, supra; Ohio Oil Co. v. Indiana, 177 U.S. 190 (1900); Commonwealth v. Trent, 117 Ky. 34, 77 S.W. 390 (1903); Shannon v. Shaffer Oil & Refining Co., 51 F.2d 878 (10th Cir. 1931).

The subject of gas recycle is generally regarded as indistinguishable from other secondary recovery operations such as waterflooding. See e.g., Williams & Meyers, supra § 204.5; Methvin, Secondary Recovery Operations: Rights of the Non-Joiner, 42 Tex. L.Rev. 364 (1963-64).

Williams & Meyers note that fluid injection is generally regulated by the states and may not be undertaken without approval of the appropriate state regulatory agency, and quote as an illustration Rule 701 of the North Dakota Industrial Commission:

> "Permit for Injection of Gas, Air or Water
>
> "Where correlative rights of all operators are protected and waste will not occur:
>
> "(a) The injection of gas or air or water into any reservoir for the purpose of maintaining reservoir pressure, for secondary recovery operations or for water disposal, shall be permitted only by order of the Commission after notice and hearing. Orders approving the application will not be made within 15 days of the filing of the application unless the written consent of all persons entitled to notice is filed with the Commission within such time. . . ." Id., pp. 58-59.

An order by the North Dakota Commission permitting water injection despite the objection of certain owners in the unit was sustained by the Supreme Court of North Dakota, where the Court held that the parties who refuse to join into a voluntary unitization and pressure maintenance program should not be allowed to frustrate legitimate conservation efforts. Syverson v. North Dakota State Industrial Commission, 111 N.W.2d 128 (N.D. Sup. Ct. 1961); accord, Arnstad v. North Dakota State Industrial Commission, 122 N.W.2d 857 (N.D. Sup. Ct. 1963). The Syverson case was among the cases quoted with approval by the Supreme Court of Texas in affirming orders of the Railroad Commission of Texas which likewise approved a

permit for waterflooding over the objection of a lease owner who objected to the order. Railroad Commission v. Manziel, 361 S.W.2d 560, 570 (Tex.Sup.Ct. 1962):

> "These authorities, in principle, support our view that it was the purpose of the Legislature in adopting our conservation laws that in any oil or gas field the Commission should have power, even the duty, to prevent undue drainage of oil across lease lines. The Commission has two primary duties in the administration and control of our oil and gas industry. It must look to each field as a whole to determine what is necessary to prevent waste while at the same time countering this consideration with a view toward allowing each operator to recover his fair share of the oil in place beneath his land. In carrying out these duties, there has devolved upon the Commission the power to promulgate rules, orders and regulations that control the industry, and such are issued pursuant to the police power of the state, and that power may invade the right of the owner of the land to the oil in place under his land as long as it is based on some justifying occasion, and is not exercised in an unreasonable or arbitrary manner. See: Brown v. Humble Oil and Refining Co., 126 Tex. 269, 83 S.W.2d 935, 87 S.W.2d 1069, 99 A.L.R. 1107, 101 A.L.R. 1393 (1935).
>
> "The rules of ownership are of prime importance, but in this consideration the rights of one do not exceed the rights of another. As to oil and gas, the surface proprietors within the field have the coequal right to take from the common source of supply. It follows from the nature of oil and gas that the use by one of his power to seek to convert a part of the common reservoir to actual possession may result in an undue portion being attributed to one of the possessors of the right to the detriment of the other. Hence, it is within the Commission's power to protect the vested rights of all the collective owners, by securing a just distribution, and to reach the like end by preventing waste.
>
> "There is no dispute as to the necessity of injecting larger amounts of water into the reservoir to prevent waste in the field, ..." Id., pp. 571-572.

The Railroad Commission's orders in Manziel were issued pursuant to its powers under Articles 6029 and 6008b Tex.Civ.Stat. The former provides the Commission the power to make and enforce rules to prevent waste, and the latter specifically authorizes the Commission to approve voluntary unitization and secondary recovery operations:

> "Article 6029: The Commission shall make and enforce rules, regulations or orders for the conservation of crude petroleum oil and natural gas and to prevent the waste thereof, including rules, regulations or orders for the following purposes: . . . ."
>
> "Article 6008b, § 1: Subject to approval of the Railroad Commission of Texas * * * persons owning or controlling production, leases, royalties, or other interests in separate properties in the same oil field, gas field, or oil and gas field, may voluntarily enter into and perform agreements for the following purposes:
>
> "(A) To establish pooled units necessary to effect secondary recovery operations for oil or gas, including those known as cycling, recycling, repressuring, water flooding, and pressure maintenance and to establish and operate cooperative facilities necessary for said secondary operations; . . . "

As stated above, gas recycle is generally indistinguishable in theory from other secondary recovery operations, and the Manziel case appears to be one of the few cases to address the question of whether the state may order the undertaking of secondary recovery in order to prevent waste.

Corzelius v. Harrell, 143 Tex. 509, 186 S.W.2d 961 (1945) is worthy of mention. The facts of the case are summarized by the Supreme Court of Texas as follows:

> "The Bammel Field was classed primarily as a gas field, and covered about 3200 acres. The Bammel Field was practically all under lease to Harrell in 1939, when he applied to the Railroad Commission for a permit to install a recycling plant. Under authority from that body, the operations were begun by drilling production wells around the periphery of the field and two injection wells in the center. The gas was taken from the production wells through the recycling plant, where the liquid hydrocarbons were extracted; then the dry gas was pumped back into the producing sand through the injection wells. The recycling plant had a capacity of thirty-five million cubic feet of gas per day, but because of an unavoidable loss of two million dubic feet per day, only thirty-three million cubic feet were reinjected into the reservoir. This continuous process had the effect of pushing the wet gas from the center of the field toward the

edges where it could be produced and processed, the purpose being to extract practically all of the valuable liquids from the gas and leave only dry gas in the reservoir, with the only drop in pressure being that entailed by the daily loss of two million cubic feet of the gas. Harrell intended to forego producing the dry gas for light and fuel purposes until the recycling process had progressed to a point where it would no longer be economically feasible. In fact, the reinjected dry gas fingered out unevenly into the wet gas area, and a certain amount of blending of the wet and dry gas took place.

"In October of 1941 leases belonging to Harrell on approximately four per cent of the field lapsed, and Corzelius acquired control of this acreage. He drilled one well thereon and began production in January of 1942, supplying gas to two distributing corporations owned by him, through a pipe line from the well to Houston. This was the first time that any permanent withdrawals had been made from the field to supply a light and fuel market, and to the time of trial it was the only outlet to a market. The average daily market demand amounted to four or five million cubic feet. By a relatively simple process, Corzelius extracted a portion of the liquids from the gas he produced before delivering it to the pipe line. This process did not recover as great a percentage of the liquids as did the recycling process.

"Harrell applied to the Railroad Commission for an order prohibiting permanent withdrawals from the field until the conclusion of the recycling process; and in the alternative he asked that withdrawals be prorated. Upon a hearing the Commission found that production up to twenty million cubic feet daily would entail no appreciable waste. Therefore withdrawals up to that amount were authorized. This order was extended from time to time. After several futile attempts to obtain mandatory relief from the Supreme Court (see Harrell v. Thompson, 140 Tex. 1, 165 S.W.2d 81), Harrell filed this suit in the form of an appeal from the above-mentioned order and the various extensions thereof." Id., p. 970.

On appeal the Court of Civil Appeals enjoined Corzelius from further production. Following that decision the Commission

effectively mooted the issue by vacating its earlier order and issuing a new order regarding production of gas in Bammel Field. Thus, the order complained of was no longer effective and no one appealed from the subsequent order, which included, inter alia, the following requirement:

> "(4) That all gas produced from the Bammel Field shall be processed for its liquid hydrocarbons and condensates therein efficiently extracted and the residue gas either returned to said sand from which it was produced or utilized for light and fuel and other lawful uses as provided by Article 6008, Revised Civil Statutes of Texas, as amended. Provided, however, that not more than 20,000,000, cubic feet per day of the allowed production from the same Bammel Field shall be utilized for light and fuel and other lawful purposes." Id., p. 971.

Despite the fact that the case was moot, the Supreme Court ruled that the Court of Appeals had erred, reversed the Court of Civil Appeals' decision, and dismissed the case, so as not to leave any doubt as to whether the Commission could regulate production in Bammel Field.

In sum, there are a number of cases which extend the states' power to enact conservation laws and regulations to secondary recovery operations, including gas recycle. These cases are premised on the well established principle that a state may exercise its police powers to prevent the physical waste of oil and gas. It is therefore arguable that the State of Alaska can require the reinjection of all gas so long as it can be shown that such action is necessary to prevent waste of oil in the reservoir. This is clearly the implication of Henderson Co. v. Thompson, 300 U.S. 258

The leading case is Walls v. Midland Carbon Company, 254 U.S. 300 (1920). Wyoming had enacted a statute which provided that:

> "The use, consumption or burning of natural gas taken or drawn from any natural gas well or wells, or borings from which natural gas is produced for the products where such natural gas is burned, consummed or otherwise wasted without the heat therein contained being fully and actually applied and utilized for other manufacturing purposes or domestic purposes is hereby declared to be a wasteful and extravagant use of natural gas and shall be unlawful when such gas well or source of supply is located within ten miles of any incorporated town or industrial plant." Wells at 309.

In addition, Section 2 of the statute prohibited "the use, sale or other distribution of natural gas, the product of any well owned, leased or managed by any person, for the purpose of manufacturing or producing carbon or other resultant products from the burning or consumption of such gas, without the heat therein being fully and actually utilized for other manufacturing purposes or domestic purposes". Walls at 310.

The statute was attacked on the grounds that (i) the statute transcended the police power of the State of Wyoming, in that its purpose and effect was not to regulate and conserve natural gas but to prohibit the use thereof; (ii) the statute made a discrimination between owners having equal rights, and thereby violated Article I, §10 of the United States Constitution and the Fourteenth Amendment thereof; (iii) the law deprived the companies of their property by the ruin of their business, and (iv) the statute impaired the obligation of pre-existing contracts.

(1937), wherein the Supreme Court of the United States upheld a Texas statute prohibiting the use of sweet gas in the production of carbon black. Although the State did not prohibit production from the wells in question, the effect was the same because there was no other market for the sweet gas at that time.

10. It is probable that the State may be able to require that a producer of natural gas extract liquid hydrocarbons from the gas before the gas enters an interstate pipeline.

No cases have dealt with the precise issue here under consideration, and accordingly an unconditional opinion cannot be given. There is, however, an abundance of authority recognizing that a State may validly regulate production of oil and gas by virtue of the police power inherently possessed by the State. Summers, The Law of Oil and Gas, § 106 (1927). These authorities are set out above in the discussion of the general power of a State to control production of oil and gas.

The cases dealing with questions most closely related to the one at hand were decided by the United States Supreme Court in 1920 and 1937. Those cases dealt with the authority of a State to regulate and/or prohibit the use of natural gas for the manufacture of carbon black.

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> "The use, consumption or burning of natural gas taken or drawn from any natural gas well or wells, or borings from which natural gas is produced for the products where such natural gas is burned, consummed or otherwise wasted without the heat therein contained being fully and actually applied and utilized for other manufacturing purposes or domestic purposes is hereby declared to be a wasteful and extravagant use of natural gas and shall be unlawful when such gas well or source of supply is located within ten miles of any incorporated town or industrial plant." Wells at 309.

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The United States Supreme Court held that while the prohibition contained in the statute is upon the use or consumption of the natural gas, and not the production thereof, the statute was constitutional. Unfortunately, the Supreme Court's opinion is dedicated to a detailed analysis of the facts, and the opinion cites little authority and few principles of law in reaching its decision.

The Court stated that while it was clear that carbon black has many uses and great utility, this fact is of incidental importance.

> "The determining consideration is the power of the State over, and its regulation of a property in which others besides the companies may have rights in and which the State has an interest to adjust and preserve, natural gas being one of the resources of the State. And in this consideration it is more important to consider not for what a particular owner uses the gas, but the proportion of his use to that of others, or it may be, the prevention of the use by others. . . ." Walls at 319.

The Court also said that Wyoming was not "required by the Constitution of the United States to stand idly by while these resources were disproportionately used, or used in such a way that tended to their depletion, having no power of interference." Walls at 324.

The decision in Walls was re-affirmed in Henderson Company v. Thompson, 300 U.S. 258 (1937). Again, the Supreme Court's opinion cited little authority, its decision resting upon a finding that the facts demonstrated that the legislature had acted reasonably.

In Henderson, the plaintiff attacked the validity of orders entered by the Railroad Commission of the State of Texas pursuant to a statute prohibiting the use of "sweet gas" for the manufacture of carbon black. Sweet gas was defined by the statute as any natural gas containing more than one and one-half grains of hydrogen sulfide per 100 cubic feet, or more than 30 grains of total sulphur per 100 cubic feet of gas, or "gas which in its natural state is found by the Commission to be unfit for use in generating light or fuel for domestic purposes." Henderson at 260, n.1. Once again a claim was made that the statute violated the equal protection clause of the Fourteenth Amendment, as well as that the statute violated the due process and contract clauses of the United States Constitution.

The Supreme Court cited Walls for the proposition that "the needs of conservation are to be determined by the Legislature." Henderson at 264. While the plaintiff conceded this, it urged that in the absence of waste, the legislature of the State of Texas lacked the power to regulate production, since in that State the law gives the owner of land title to the gas in place and to that which may migrate to formations under his land. The Court rejected this argument, stating:

> "One principal established by the Walls case is that the Legislature may, for the purpose of conserving natural resources, regulate their production and use. The findings of the district court in this case

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support the reasonableness of the present statute on that basis. It is also urged that there is this vital difference in the facts: that in the Panhandle field [Texas] the challenged prohibition will not prevent waste, or conserve the supply of sweet gas, since the sweet gas, if not used, will drain into the sour gas area, because of the lower pressures there. Moreover, it is insisted that, unlike the Walls case, there is here in the record convincing evidence that the use of sweet gas in the manufacture of carbon black is not wasteful. Our decision in that case rested upon no particular theory of the nature of the carbon black industry. It was based simply upon the determination that the statute in question was not shown to have been an arbitrary exercise of legislative power." Henderson at 267 (emphasis added).

Thus, there is authority from the United States Supreme Court that a State may, under its police powers, regulate the use, as well as the production, of oil and gas for purposes of conservation. The State has discretion in deciding what is wasteful production and use. However, in both Walls and Henderson, the Court took great effort in discussing the facts to demonstrate that the legislature had not acted unreasonably in prohibiting the use of the gas for the manufacture of carbon black. And in each case the States of Wyoming and Texas were able to demonstrate that the statutes involved were reasonably related to conservation measures.

It is arguable that, under the authority of Walls and Henderson, a State could require that liquid hydrocarbons be removed from any natural gas produced as long as it reasonably could be demonstrated that such a requirement

would prevent waste or otherwise would be in the interest of conservation. For example, if it could be demonstrated that the dry gas (after the liquids had been removed) was of sufficient B.T.U. content to generate enough heat for its needed uses, and that the extracted liquids themselves could then be used as an energy source, or as a valuable raw material or feedstock, waste is prevented (and conservation is thereby served) - that is, more total utility is derived from the gas produced than if the liquids were not so extracted. Obviously, the questions of whether conservation will be served and waste prevented, are scientific, fact questions which will have to be answered by qualified experts, and accordingly the power to require extraction should be vested by the Legislature in the State's conservation agency where decisions may be reached with appropriate protection of the rights of all.

The Walls case has been cited many times by Courts for the proposition that a state has complete authority to regulate the use, as well as the production, of natural gas. One case cites Walls in stating that "its [the gas] extraction and use is subject to regulation, or even complete restriction or suppression, by the state." Herkness v. Irion, 11 F.2d 386, 388 (E.D. La. 1926).

One Texas case was found wherein the Supreme Court of Texas upheld the general authority of the Railroad Commission to regulate the production of oil and gas through

proration and other orders. One of the orders entered by the Railroad Commission directed "that all of the gas from the Bammel Field shall be processed for its liquid hydrocarbons and condensates therein efficiently extracted and the residue gas either returned to said sand from which it was produced or utilized for light and fuel and other lawful uses. . . ." Unfortunately, this order was not attacked in the Courts, and therefore the Texas Supreme Court never ruled on the enforceability of the order. However, the Court was aware of the order and made clear that the Railroad Commission did have the power to regulate the manner of production in the Bammel Field. Corzelius v. Harrell, 186 S.W.2d 961, 971 (Tex. 1945).

PLEASE NOTE: THE PRECEDING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT.

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December 10, 1975

The Joint Gas Pipeline Committee
of the Legislature of the
State of Alaska
c/o Legislative Affairs Agency
Pouch Y
Juneau, Alaska 99801

Attention: Mr. Gregg K. Erickson
Director of Research Services

Gentlemen:

This will constitute my interim progress report on the preparation of a legal analysis undertaken pursuant to your request and authorization concerning natural gas transportation issues and related concerns of the State of Alaska.

At the outset, I should express my belief that no action should be taken by the State with respect to permanent commitment to any particular course of action concerning natural gas development, sale, or transportation until mature consideration has been given, and a reasoned decision reached, with respect to a number of interrelated problems. My work thus far leads me to the conviction that the State has several very significant, and very difficult, decisions to make; and that, unfortunately, clear-cut, black-and-white answers do not always present themselves. I think it premature to commit State royalty gas at this time; or to lend unqualified support to either pending application for transport of North Slope gas.

Legal?

I believe further that it is imperative to secure as satisfactory an answer as possible to the questions raised by Interior's study concerning the effect of gas production on recoverable oil reserves. I hope your December hearings provide answers, but if not, I offer the unsolicited advice that this matter should be vigorously and immediately pursued. An informed judgment on this issue is basic to development of policies which will best serve the State.

Legal?

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I expect to have the legal analysis completed by January 31, 1976. Much of the preliminary research and briefing is now behind us. I attach copies of the research papers which have been completed thus far; please bear in mind that these are unrefined and still subject to further work. The enclosures do not necessarily reflect any final opinions, but are submitted to you to indicate the work which is in progress.

I have begun a draft of the final report, and am now in the process of drawing together the research and analysis which has been completed as well as seeing that additional research is completed and correlated.

In general, I expect to offer advice on the options which are open for State consideration with respect to natural gas; I will attempt to delineate between those State actions which are permissible and those which are prohibited. I will address the specific questions posed in Mr. Erickson's "Issues in Natural Gas Policy Requiring Legal Analysis", but it will probably be necessary to move beyond this framework to articulate a full range of issues for the Legislature's consideration.

In sum, the analysis is proceeding on schedule and will, I hope, be of assistance to the Committee.

Very truly yours,

Rush Moody, Jr.

RM:lmp

cc: Martin A. Farrell, Jr.

Alaska State Legislature

LEGISLATIVE AFFAIRS AGENCY

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December 17, 1975

The Honorable John Rader, Chairman
Joint Gas Pipeline Impact Committee
Box 2068
Anchorage, Alaska 99501

Dear John:

Enclosed is a copy of Rush Moody's interim report. The most significant items are found in his letter and in the analysis of "Topic 6" by Jay Golub.

I am sending copies of the letter (but not the accompanying memos) to all committee members. The memos themselves, however, will be on file at the committee's office in Anchorage, and here in Juneau, for any members who wish to review them.

I will be in Mr. Moody's office in Washington next week on Monday and Tuesday, the 22nd and 23rd. If you have any questions or would like to discuss this material with us I would suggest that you contact us then. I will be back in my office on Monday, the 29th.

Best wishes for a happy holiday.

Cordially yours,

Gregg K. Erickson
Director of Research Services

GKE:jm
Enclosure

cc: Eric Eckholm

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January 14, 1976

Senator John Rader, Chairman
Joint Gas Pipeline Impact Committee
The Legislature of the State of Alaska
Juneau, Alaska 99801

Dear Senator Rader:

Your Committee has asked me to address certain issues relative to the transportation of Alaska natural gas, assuming for the purpose of my analysis that there will be gas available for sale from the North Slope. 1/

I propose to set forth in this letter the conclusions that I have reached as a result of my research and my knowledge of the Federal Power Commission, together with certain alternatives which the State might wish to consider. To this letter I will append the legal analysis which leads to the conclusions expressed herein.

1/ You are aware of the possibility that natural gas production for sale may have a detrimental effect on the recovery of oil. Studies conducted by the Department of the Interior and by H.K. Van Poolen and Associates raise questions in this regard which are now being examined by the Committee. This issue is, I agree, of critical importance to State consideration of natural gas transportation issues, inasmuch as the State may find it necessary, for reasons of conservation, to limit natural gas production or require reinjection of associated natural gas for maintenance of reservoir pressure. Such conservation actions are, in my opinion, legally permissable if necessary to prevent waste, see pp. 85-94 of attached analysis, but might result in an indefinite postponement of a natural gas transportation system.

From the outset, I need to make clear my recognition, that State policy relative to natural gas will develop, as it should, through processes of government, and that these policy decisions will involve consideration of far more than questions of law and Federal policy. What I offer can be only a part of the whole which the State will consider as the State moves forward to a sound an productive policy of resource management. 2/

As a substantive starting point in my report to you, it is my judgment that the State should, from the standpoint of legal consequences, decide as quickly as possible the ultimate goals of State natural gas policy. If the State has a strong concern for a retention of a portion of Alaska gas for future Alaska needs, affirmative and aggressive State action will be necessary. Non-action by the State with respect to disposition and transportation of North Slope natural gas threatens permanent loss of the gas resources insofar as Alaska consumers are concerned; non-action creates a risk that natural gas produced in Alaska will not be available to fulfill future Alaska residential or industrial needs.

Let us assume that the El Paso, Trans-Alaska transportation route is authorized. Non-action by the State will result, sooner or later, in producer sales of eight-eighths of the natural gas stream in interstate commerce, either to an interstate pipeline, to distributors in the lower 48 states, or to direct users in the lower 48 states; and non-action by the state will result in the construction and operation of an interstate transportation system designed for, and financed on, the expectation of the flow of eight-eighths of the deliverable natural gas from the North Slope. If the State permits, by non-action, these developments, then certain legal consequences may be expected.

2/ I would ask it to be understood that my opinions do not reflect considerations outside my area of knowledge and training; I have no basis, for example, for advice on environmental or economic factors; nor can I gauge the will of the citizens of Alaska concerning economic growth and industrial development; nor can I estimate how strong will be the demand for revenue because of programs which the State may determine are necessary.

The issues which I address are, therefore, approached only from the relatively narrow standpoint of law and Federal regulation. I do not presume to prescribe what is "right" or "good" for the State. These determinations are peculiarly within the province of this Legislature, which will, I am sure, look to a much broader range of considerations, information, and analysis than are within my capabilities.

1. If producers market Alaska natural gas in interstate commerce, paying the State a one-eighth royalty in cash, the Federal Power Commission can assert jurisdiction over eight-eighths of Alaska production, and thereby attempt to prevent any later efforts by the producers, or by the State, to withdraw the State's one-eighth royalty share for an in-kind taking by the State for use in the State. (pp. 64-73) 3

2. In the event of such a sale by producers to an interstate pipeline, and in the event of FPC denial of a request to withdraw State royalty gas, the only means for securing gas service in Alaska would be through a future demand by Alaska municipalities or distributors for service by the pipeline; such a request may be treated by the FPC, and lower 48 pipeline or distributor customers, as a request for new service which cannot lawfully be authorized. If the pipeline, at the time of the demand, is unable to render adequate service to its non-Alaska customers, or if grant of the Alaska demand would require to enlargement of pipeline transportation facilities, the Commission may be required, by law, to refuse demands for Alaska service -- even for residential and public service needs.

3. If Alaska can successfully claim -- contrary to the hypothesis in Paragraph 2 -- status as an existing customer, pipeline natural gas supplies would be shared by Alaska and non-Alaska customers on the basis of FPC curtailment priorities and allocation orders.

4. In the event of direct sale by producers to end users in the lower 48 states, or sale to distribution companies in the lower 48 states, there is no clear legal mechanism available to the State of Alaska to secure any portion of the natural gas produced in Alaska for future Alaska needs as they may develop.

Non-action by the State, in my judgment, creates serious risk that Alaska natural gas will not be available for future Alaska needs, even if the El Paso transportation proposal prevails. It is not just the

3/ Page references here and later in this letter are to the attached legal analysis.

potential industrial gas demand (which may or may not be a matter of State concern, dependent on the will of the citizenry with respect to industrial development) that is at risk. The needs of Fairbanks, and other communities, for residential service and service to schools, hospitals, and the like is also threatened.

The risk can be lessened by appropriate State action, as hereinafter discussed, if a trans-Alaska routing is authorized. If a trans-Canada routing is selected, whereby North Slope natural gas leaves Alaska north of the Arctic Circle, the State has no means of protecting its future gas needs. The routing question is, therefore, critical to the State -- at least in the context of future availability of Alaska gas for future Alaska needs. 4/

I am of the firm opinion that neither of the present proposals for transportation of North Slope natural gas offers a substantial guarantee that Alaska natural gas needs will be met. If either the El Paso or the Arctic Gas proposal is approved as presently submitted, the State could well find itself unable to draw upon its own gas resources to meet the future needs of the State.

The problems here are inherent in the nature of the applications and the Natural Gas Act: if the Arctic gas proposal prevails, there is no physical means to move gas from North Slope areas to the State's population centers; the Arctic gas routing will simply preclude gas movement within the State since the gas will leave the State north of the Arctic Circle. If, on the other hand, the El Paso proposal prevails on the basis of present filings with the FPC, the full natural gas stream will begin movement in interstate commerce, and even though it may be physically possible to withdraw gas where and when needed in Alaska, it may be legally impermissible to do so.

4/ Whatever the transportation route, natural gas production and transportation may reasonably be expected to contribute significant revenues and economic activity to the State. Accordingly, even if the transportation system which is Federally authorized does not lend itself to serving state natural gas needs, benefits to the State still might result from natural gas production, and transportation. A decision in this regard involves a balancing of economic, environmental, and political considerations which are beyond the scope of the requested analysis, and outside the scope of my knowledge and experience.

The State's present danger stems from the fact that certificates may issue, and interstate service may commence, without formal recognition of the State's needs. Interstate service unconditioned to Alaska's rights, creates grave problems concerning later attempts by the State to withdraw gas from the system -- problems which arise under Granite City Steel Co., v. FPC, 320 F2d 711 (C. A. D. C.. 1963) which suggests that gas customers in Alaska may not be added as pipeline customers if the pipeline is, at the time service to new customers is sought, then unable to meet the needs of existing customers; under Sec. 7(b) of the Natural Gas Act as interpreted by the Commission, which suggests that a partial diversion of the interstate natural gas stream will not be permitted without prior Commission authorization; and under Louisiana Public Service Commission v. FPC, 359 F2 524 (C. A. 5, 1966) cert. den'd. 385 U.S. 833, which holds that commingling of non-jurisdictional natural gas with jurisdictional natural gas results in a single gas stream which is wholly jurisdictional.

It does not follow, however, that Alaska is powerless to influence the movement of North Slope gas in a manner more nearly suited to the State's future gas needs than the proposals now pending. To the contrary, I believe there are reasonable courses of action which the State can pursue.

The State may exercise the option set forth in its oil and gas leases to take royalty gas in kind, and market this production separately from working interest gas; the State need not seek FPC authorization for royalty sales, and should limit the term thereof to the extent possible.

I believe that it would be most unwise, under present circumstances, to permit the producing companies which hold leases on State lands to market the State's royalty share of gas production. If marketing occurs, with the gas moving in interstate commerce, the problems summarized above -- and particularly the Sec. 7(b) abandonment problem -- stand as very real threats to later withdrawal of State royalty gas from the marketing arrangements made by the producers. Most simply put, if 8/8ths of the gas stream is committed to interstate commerce by delivery under an unconditional producer certificate of public convenience and necessity, withdrawal of the royalty 1/8th at a later date may require

FPC approval -- which may, or may not, be forthcoming. This is the lesson of FPC Docket N. C171-879, Superior Oil Company, Letter Order issued June 13, 1975. (pp 64-73).

This particular problem can be mitigated if the State exercises its option, prior to the delivery of any gas, to take its royalty share in kind, with appropriate notice to producer, purchaser, and FPC that the producer is without authority to market the State's natural gas.

The State should, therefore, negotiate for separate sale of its royalty gas or the best terms available, giving due consideration to a relatively short-term sale. The State should take the position that it is not subject to the Natural Gas Act, nor to the jurisdiction of the FPC, and that the State is therefore free to make sales for resale in interstate commerce (or in any other market), without certificate authority, and without restriction as to rates or terms of service. This position, though clouded by the Court decision in FPC v. Corp. Comm. of Oklahoma, 362 F. Supp. 522 (W.D. Okla., 1973) aff'd 415 U.S. 961 (1974) is, I believe, legally sound and legally sustainable.

State marketing of its royalty gas is not a complete answer to the basic problem. That gas must be transported, and the only available means of transport will be through the facilities of an interstate pipeline. The FPC can, therefore, exercise indirect control of royalty gas through its certification powers under Section 7 of the Natural Gas Act, even to the extent of denying the right of transportation if it is opposed to the end-use to which the gas will be put, or the price paid for the gas. See FPC v. Transcontinental Gas Pipeline Corp., 365 U.S. 1 (1961), and pp.3-9 of the attached analysis. Thus, it will still be necessary for the State to involve itself in transportation negotiations and see that FPC approval of transportation arrangements is obtained, even if the State markets its own gas by sale at the wellhead or sale downstream. The protection which the State must have is advance FPC approval of State withdrawal of its gas from interstate commerce, but this approval should be sought and obtained by the transporter in connection with its certificate applications and related tarriff findings.

In suggesting these actions, I hold to the view that the State's power to call upon the gas resource when needed in the future can, in reasonable probability, be exercised if the State's rights and obligations are fully spelled out, fully presented to the FPC, and accepted by the FPC as an integral part of the transportation system which is certified by the FPC.

While all problems relating to future in-State use of State-owned gas may not be wholly solved by advance agreement, and advance FPC clearance, of specific production, transportation, and sales arrangements, it is my judgment that the problems are reduced to the levels of acceptable risk-taking if the FPC, prior to construction and operation of a transportation system, expressly conditions all necessary certificates of public convenience and necessity and pipeline tarrifs to permit and approve such arrangements as are negotiated by the State with respect to its royalty gas.

The State may consider the enactment of legislation to hold State owned resources within the State unless such are surplus to the needs of the state.

Discussed in some detail in the appended legal analysis is a recent Texas statute which is designed to secure for the benefit of the State the resources which are publicly owned. The statute is prospective in operation, and simply requires that all State-issued oil and gas leases shall contain appropriate provisions to prohibit sale of natural gas produced from State-owned lands outside the State unless it is found that such gas is surplus to the needs of the State. (pp. 79-85).

While the State clearly may not "embargo" natural gas through exericse of its regulatory powers, (pp. 43-45) it may be argued that the State's powers incident to ownership of public lands are different from, and greater than, mere regulatory powers. Cannot the State decide to withhold its lands from development? if so, (and about this I can see little argument), does not this right include the lesser right to permit development only upon terms acceptable to the State as a property owner? (pp. 15-17).

I do not offer an unqualified opinion that such legislation would withstand court challenge; I acknowledge that a challenge would probably be forthcoming, and that the legislation might fall as an undue burden on interstate commerce. Nonetheless, there is some chance of upholding protective legislation, and enactment could serve as a clear Legislative expression of Alaska's determination to retain a fair share of Alaska's resources. (pp. 79-85).

The State may consider various means of encouraging conversion of natural gas to methanol, or encouraging extraction of all natural gas liquids, prior to movement of natural gas in interstate commerce.

If North Slope gas is converted to methanol before becoming committed to interstate commerce, the conversion facilities, the methanol itself, and the transportation of methanol would not be subject to FPC control. Since the natural gas would be produced and "consumed" (i.e., converted to something other than natural gas) within the State, the natural gas would never become subject to FPC jurisdiction.

Similarly, if ethane, propane, butane, and other liquids are removed from the natural gas stream prior to transportation or sale in interstate commerce, the extraction facilities, the liquids themselves, and the transportation of the liquids should not be subject to FPC control.

It is beyond the scope of my knowledge to explore the economic feasibility of these alternatives; nor can I judge whether the oil pipeline now under construction can, from an engineering standpoint, serve as a conduit for methanol or other liquids. I believe, however, that the State should be aware that a natural gas stream has enormous potential value other than its obvious value as a heat source. It would be imprudent not to explore all potential uses of the gas stream; particularly where conversion within the State, or liquids extraction within the State, diminishes the range of FPC controls, and where, as here, the use of liquids for generation of heat represents a waste of valuable raw material.

Encouragement of conversion or extraction may be given through legitimate State tax incentives or through dedication, on favorable terms, of State-owned gas to a conversion or extraction project. The most effective means of encouragement should be determined at the time full exploration is made of economic and engineering feasibility.

Legislative action may be considered with respect to extraction operations, but probably may not be considered with respect to a conversion project. The latter situation would almost surely require an impermissable degree of interference with interstate commerce, since any statute directing the flow of natural gas to a con-

version plant would, in actual operation, preclude movement of gas in interstate commerce. Such a restriction would not, in my judgment, withstand Court challenge.

Legislative direction that liquids extraction occur prior to movement of the residue gas in interstate commerce may, on the other hand, be a valid exercise of State regulatory powers to prevent waste. This issue is discussed in some detail in the attached legal analysis (p4-10), and I conclude that mandatory extraction, if based on appropriate finding that extraction is necessary to prevent waste of a natural resource, and if properly applied to preclude the possibility of an unconstitutional confiscation, has a reasonable basis and can, therefore, be defended.

In addition to the foregoing alternatives relating to possible State action to retain a portion of the State's gas resources for State use, other, and different, alternatives exist.

What Actions Can the State Pursue to Achieve Benefit from the State's Gas Resources?

Until this point, we have focused on natural gas transportation issues; I suggest that there are other matters which deserve consideration as the State of Alaska moves toward resolution of its basic energy policies. These other matters are not strictly within the request made of me for legal analysis, and indeed some require far more exhaustive consideration before a firm recommendation can be made; I touch upon each briefly because they are germane to the general issues under discussion, and because some, or all, may emerge as part of an overall State strategy of resource management.

1. State leasing policies should be re-examined.

   (a) The State is presently leasing on the basis of a one-eighth royalty. Other producing states, notably Texas and Louisiana, now demand, and receive, a one-fifth or one sixth royalty. Alaska should re-asses its bargaining position, its revenue needs, and whether the greater degree of control which in-kind royalty permits, justify leasing on terms other than those presently employed.

   (b) Consideration whould be given to the possibility that the leasing of State lands, or the withholding of state lands from leasing, is a valid instrument of State policy which can be used to assist in holding State resources for State needs; for example, can

leasing schedules be tied to changes in intrastate supply and demand? Can development be held until the State needs the resource? Here again revenue considerations and State desires regarding the optimum level of drilling and production activity must be weighed, but I suggest that one of Alaska's greatest strengths lies in its ownership of oil and gas bearing lands; thought should be given to the best use of that strength.

2. State taxing policies should be re-examined.

(a) The State presently provides for a production tax on natural gas of 4% of the gross value at the well; other producing states impose a much higher tax--for example, Texas exacts a severance tax of 7-1/2% of the market value of the gas when produced, and Louisiana imposes a basic severance tax of 7 cents/Mcf on natural gas. In considering whether revision of Alaska production taxes is appropriate, thought should be given to the Louisiana form: Louisiana's revenue levels are not controlled by the FPC, while Texas' are, at least to the extent that Texas gas is sold interstate. A further defect in the Texas structure lies in its requirement, in the final analysis, that Texas consumers bear a higher tax than out-of-state users; since the State tax is tied to value, intrastate sales at higher rates than interstate sales produce a higher tax bill for the intrastate producer than for the interstate producer.

(b) Alaska can consider the enactment of a franchise tax on interstate pipelines. Colonial Pipeline Company v. Traigle, 421 U.S. 100, decided April 28, 1975, upheld a Louisiana statute that imposed a franchise tax on a pipeline coany that was admittedly engaged exclusively in interstate commerce.

In 1969, a Louisiana Court held that the commerce clause of the Federal Constitution was violated by a state tax "payable for the

privelege of carrying on or doing business... in this state." The Louisiana legislature then amended the offending provision by providing that the tax was levied upon "(t)he qualification to carry on or do business in this state in a corporate form". The Supreme Court of Louisiana upheld the tax as constitutional levy for priveleges enjoyed by corporations in the state carrying on business, interstate or local, in the corporate form. 289 So. 2d 93 (1974). The U.S. Supreme Court affirmed. The Court cited Memphis Natural Gas Company v. Stone, 335 U.S. 80 (1948), a case that sustained a similar franchise tax imposed by Mississippi on a foreign pipeline corporation exclusively engaged in interstate business. The Court quoted Justice Reed's opinion in the 1948 case: "This is a tax on activities for which the state, not the United States, gives protection and the state is entitled to compensation when its tax cannot be said to be an unreasonable burden or a toll on the interstate business". The "activities for which the state gives protection" included "protection of... maintaining, keeping in repair, and otherwise manning the facilities of the system," the Court said.

Conclusion

As must be evident, it is my view that from the standpoint of legal consequence, the State should pursue an affirmative, aggressive course of enlightened self-interest if the present and future natural gas needs of the State are to be met. The State must decide what it wants, and then set out to achieve its goals.

My judgment is that the State may reasonably expect success in its negotiations. Consider the pressure points available to the State as bargaining levers:

1. Equity favors the State; it seeks nothing more than a share of the resources which it owns. Further, the State of Alaska alone bears a substantial environmental cost as North Slope resources are developed and transported; since this burden exists, an offsetting benefit should be made available to the people of Alaska.

2. The State has as-yet unused regulatory powers which can materially affect the flow of oil and gas.

3. The State has as-yet unused powers of ownership which can materially affect the flow of oil and gas.

4. The State has as-yet unused powers of taxation which can affect the price of oil and gas.

5. The State probably can retain some control of its royalty gas if the State takes effective action; by non-action the State stands to lose control of its royalty gas. The State's position on its royalty gas is of critical significance because it is doubtful that any North Slope transportation system can go forward without committment of royalty gas to the system, either as part of system supply or as the subject of a continuing transportation agreement. The transportation system needs the royalty gas volumes to support claims of economic viability.

These factors lead me to believe that the State can bargain effectively.

I believe negotiations with both transportation groups are in order. The Arctic Gas proposal has encountered significant opposition, and the FPC staff has only recently concluded that the Arctic Gas group should consider an alternative routing to bring its line down the Alyeska corridor to Fairbanks, and then south eastward. This routing offers an opportunity for physical movement of North Slope gas to, or near, population centers through an Arctic Gas line, a possibility which did not exist so long as Arctic Gas proposed to move eastward out of the State while still within the Arctic Circle.

El Paso should obviously also be approached in definitive negotiations. It has historically supported the principal that a portion of the Alaska gas should be made available for Alaska usage and the El Paso proposal can serve State needs with fewer major revisions than Arctic Gas.

It is, therefore, appropriate for the State to open negotiations with both transportation proponents. It is time to ask, and obtain, positive answers to one basic question: How can Alaska retain the benefit of its natural gas resource under your proposal?

What must be made clear is that the Alaska Legislature and the State Administration, have affirmative duties to ensure, to the fullest possible extent, that the needs of Alaska are served. Others may, and should, consider private interests. But it must be unmistakeably clear that Alaska will judge its present and future position on leasing, regulation, taxation, and royalty gas disposition with due regard to Alaska's present and future needs.

It seems to me that if Alaska can derive no benefit from natural gas produced within its borders in the sense of sharing in the use of the resource, then clearly Alaska can protect its citizen's rights only by looking to natural gas as a source of revenue. Every legitimate means of using gas to raise revenue should be explored. If, on the other hand, Alaska is permitted to share in the benefit of a secure and reliable source of natural gas for use as a non-polluting heat source and as a raw material feedstock, then Alaska need place less emphasis on direct revenue and more emphasis on cooperative development.

If men of good will make an intelligent effort at accommodation and understanding, there is no reason why the mutual problems of producer, transporter, and consumer cannot be solved in a manner which balances fairly their respective interests, and which also serves the interests of national and state government as well.

Respectfully submitted,

Rush Moody, Jr.

RM/ap

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December 3, 1976

Ms. Elke Tallab
Legislative Affairs Agency
State of Alaska
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Dear Elke:

Advice to the Legislature with respect to the contracts for sale of the State's royalty gas would involve the following:

(1) Review of contracts.

(2) Review of Commissioner Martin's negotiation files, or summaries of those files, to understand the areas of compromise.

(3) Preparation of an analysis of the contracts from the standpoint of the benefits and burdens accruing to the State.

(4) Conferences in Alaska with appropriate legislative and executive department people.

(5) Appearance at a hearing for exposition of my opinions.

It is difficult to assess the time necessary for the accomplishment of these tasks since I do not know what volume of material is involved for an intelligent appraisal of the contracts, and, accordingly, it would be difficult for me to establish a fixed fee for the Legislature's consideration. I would prefer, therefore, to consider this representation on the basis of my standard hourly charge of $100 per hour, plus reimbursement of necessary travel and telephone expense.

On the basis of the best guess that I can make at this time, it seems to me that the total effort should not involve more than 70 to 80 hours. In arriving at this estimate, I am assuming that the Legislature would be interested only in my opinions concerning the contracts as negotiated; if my representation involved redrafting or renegotiation efforts, in conjunction with a possible Legislative conditional approval of the contracts if they are amended in certain respects, then, of course, the time involved could be substantially greater.

If this work is undertaken, I would expect to begin it immediately upon receipt of the necessary documents and files, and I would anticipate that I would be prepared to come to Alaska anytime after February 1, 1977 for the necessary conferences and hearings. I would expect to regard the representation as completed upon exposition of my views to the appropriate Legislative committee. I understand, of course, that it would be wholly inappropriate for me to accept any other representation with respect to these contractual matters while I am representing the State.

Please let me hear from you at your earliest convenience. I can hold my calendar open to meet the time schedules suggested in this letter for a reasonable period of time, but the necessity for other commitments will arise fairly soon.

If you need anything further from me, please do not hesitate to call.

Best regards,

Very truly yours,

Rush Moody, Jr.

RM:bw