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of the record you have right now is you have to assume there is no cost justification for these rates.

If the justification comes it's got to come from just the reasonable market value standard. You also have to exclude, because there is no evidence that in fact it will happen, the notion that if you drum the consumer with this amount, magically, it's going to be converted at a 90-percent rate into exploration for new gas. That's not a fact that's in front of you. If it were puttable, I'd say it would be fine and, all right, let's go on that basis, but it isn't.

We have talked with the producers and with the Commission about trying to set up a tiered pricing system which would include specific new gas incentives. Again, you're looking at the reason why it hasn't worked. Because any new gas price we put up, there is going to be somebody that wants to turn around and use it to jack up flowing gas prices, and this is flowing gas we're dealing with. It was discovered in 1930. I imagine, again without seeing the numbers, that there are precious few costs that haven't been recovered.

I can point out a couple of numbers in the Occidental arbitration. There wasn't a single field that, as far as I can recall, was recovering under about 30 percent; and there was one that was 140 or 150 percent, and that would

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have been at 75 cents.

Maybe that was an unusual case. People mutter about it. Fine. If it is, I'd like to find out about it. I sense from some of the things that have been said here that you'd like to find out about it. In fact, some of the independent producers, at least, seem to be willing to lay some of those facts out; but they're not here today.

Okay. I've extemporized. Now --

MR. McCAUSLAND: That was valuable extemporizing. I followed all of that, too. I hope your written presentation today is as clear and lucid.

MR. FALLIN: I'll do it again. That's about the fourth compliment. I've got to say, the truth, when you strike it, it rings.

(Laughter.)

MR. McCAUSLAND: It's clear you've become a legend in your own mind.

(Laughter.)

MR. FALLIN: I might say, too, when we talk about procedures, I'm not sure that it might not have been the case where it would have made sense for one or more of the members of the Commission to sit on quote evidentiary hearings, and maybe that's something --

MR. McCAUSLAND: I think this case has probably presented us with a number of problems we can look at closely

13 in terms of whether or not tried and true historical procedures meet the full test of the 1978-79 environment, but clearly I think we were using time-honored and tested procedures here that we believe will stand the test of a court case.

MR. FALLIN: Before I come into the steps that brought us here, I'd like to list the events that PG&E and the other parties feel if the Commission accepts the border price formula advocated by Mr. Lippitt. Here I will say that the border price is Mr. Lippitt's. If Mr. Lippitt is out, there is precious little support left for that border price formula.

MR. McCAUSLAND: What about the weighted average formula. Would you capture that from a border price?

MR. FALLIN: Absolutely.

MR. McCAUSLAND: You better discuss it.

MR. FALLIN: I will.

Some of these numbers I can perhaps quantify for you. The State Lands Commission we estimate would receive from PG&E and its ratepayers an additional $1.46 million for the 18-month period through June of 1978. That's the period from January '76 through June of '78, and thereafter some $1.15 million annually for gas produced at Rio Vista. That would be that increase carried forward into the future.

Ryer Island, where PG&E is not involved, might yield another $1 million, although having sat through the

14 earlier proceeding, perhaps that would be 500,000.

Mr. Lippitt -- in this sense, he can't be left out -- will use the Commission's acceptance of the formula -- by the formula, I mean what you have in Northern California plus FERC, plus Canada -- in pending arbitrations in which, so far as I can tell, he's already been retained to testify. I don't know that it's been clear here, but he testified in the Occidental arbitration. Before he was hired here, I think he was probably retained to testify against us in the Texaco/Superior/Aminoil case before he was hired to work here, an_ he will go from here into those arbitrations which in fact are pending and will come off, I think, in February.

Strictly on the arbitration, there is a situation where, contrary to the allusions about mixing, the companies have been successful in running a merged proceeding with such tiny fellows as Texaco and Superior and Aminoil, which happens to be a division of R. J. Reynolds, I think.

I was asked this question before: Well, what about these guys for whom arbitration is a significant price barrier? The answer is, as was indicated with the 90 cent price discussion we had last time, our position has always been that until we had a substantial number of people signing at a given price, we didn't consider that one riding or prevailing as reasonable market value. We went back and

15 picked up those 90 cent prices. They all went to $1.20.

The way the process works, effectively, the price is set by the people most capable of fighting it because it's the largest producers who end up holding out the longest; and, for them, the arbitration cost is a lot less significant than it is for us even.

Anyway, Mr. Lippitt takes your approval of Canadian prices -- I'm not talking about a number here. All he has to do is have you come down and say it's reasonable for us to look at these prices, they ought to be included. That result is carried into arbitrations that are already pending.

If successful, at the staff's number, that would cost us quickly another $24 million. This is retroactive. This would go from '76 to July of '78.

Third, the Commission's acceptance of the border price would be used to get an arbitrated or renegotiated prices in all of our other gas contracts coming up this July. Now, if that's successful, this effort could cost the consumer some $110 million. As indicated earlier, that number reflects our actual 1977 consumption, a figure which we didn't have available until, whenever it was two or three weeks ago.

The point was made or mentioned by Chairman Cory, what do we do about normal increases that might have occurred? I think you'll find that Mr. Lippitt has been very careful.

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I'm not the only one who's careful in here.

The 2.08 stops on July 1st. I have every reason to believe from the past track record that there will be an inflation element put in on January 2nd to pick that price up higher. What we're assuming is that conventional inflation would have worked through both systems so that the answer to your question, the $110 million a year will continue. That's an annual amount. Just as the State's return is, whatever it is, whether it's a million or two million, that's an annual amount that will continue.

As a consumer of gas, the State will see its own annual rates for natural gas increase by some $1,219,000 in Northern California. That $500,000 from Shell might be kind of important because that might throw the net transaction. That's without a ripple effect.

All in all, this is not a bad piece of work for Mr. Lippitt. At our hearing January 12th, Mr. Leineke appeared for the first time on behalf of CIPA, and he expressed, as he's expressed again, the consequences of accepting those prices. Mr. Leineke indicated that there wasn't much to worry about since Commission acceptance of the formula will only, quote, trigger 15 percent of PG&E's gas purchases.

That doesn't sound bad at all except 15 percent equals 128,304,752 MCF a year. When increased by the staff's

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formula, that's $110 million.

As Mr. Way said in his own quiet way at the last hearing, for this Mr. Lippitt should be paying you, not vice versa.

The beginning of all this came with Mr. Lippitt's position that in determining reasonable market value, the Commission should ignore the fact that the price for the State's gas set by negotiation between Standard Oil, Chevron and PG&E -- that's a $1.20 MCF -- was at or above the prevailing price for all other gas supplies sold in Northern California.

In order to find a higher price level, Mr. Lippitt invited the staff to look at Canada, a worthy choice. The evidence is undisputed that Canada, by governmental edict has linked its gas prices to the price of, quote, alternate fuel. Quote, alternate fuel price, of course, works out to be the OPEC dictated price of oil, and its gas prices have mounted at a pace closely matching the cartelized oil prices.

Mr. Lippitt's theory was presented by him at a hearing held last August before the staff's director, Mr. Northrop. At that same hearing PG&E pointed out the fact that the prices paid for gas comparable to the State produced throughout Northern California fully supported the $1.20 per MCF price. We also explained at that time that

18 there is no support for the proposition that non-wellhead prices from total distinct producing areas can ever be used in setting reasonable market value.

Chevron USA testified as to the bargaining that surrounded negotiation of that price and to its opinion that it represented reasonable market value.

There has been quite a few tosses of secret agreement around in the hearing earlier. The question was asked what about this deal where PG&E agreed with Chevron that it would pick up increases that the Commission imposed under this reasonable market value standard. Ask yourselves, where would we be today if PG&E weren't a party to this proceeding?

You'd be right back at whatever that number was back in August. The only way we could guarantee a foot in the door when you were finding, as a public agency charged with some element of public interest what reasonable market value was was to take that and become a party. So, here we are.

CHAIRMAN CORY: The date of that agreement was what?

MR. FALLIN: That agreement was signed, I imagine, in spring of 1976.

There was a slight discrepancy earlier. The price that you are currently getting from PG&E is the $1.20 price.

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Using a $1.20 won't change that at all.

CHAIRMAN CORY: The problem I have with you coming here as representing PG&E in a clean hands statement is that about that time, as I recall, PG&E was offered a $1.31 less 11 cents, and you rejected that offer, or your employer did.

MR. FALLIN: My quick answer is that a $1.31 isn't a $1.20. It wasn't offered to me, and I really have no say one way or the other in that. I will say this, that we have a problem that you can obviously proceed in entering into any "secret" settlement with the Commission that we're not ordered to enter into. We come up with a dollar figure that isn't justifiable.

CHAIRMAN CORY: Pardon me. I thought we got here with your justifying a secret deal which enabled you to be a participant in the proceeding.

MR. FALLIN: It's hardly a secret deal, Chairman Cory. I wouldn't be here but for the fact that everybody knows about it.

Quickly, to answer your question honestly, I didn't have anything to do with that offer if it was made, and we have obviously --

CHAIRMAN CORY: You're doubting that it was made?

MR. FALLIN: I don't know that it was made or wasn't made.

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CHAIRMAN CORY: I'd like the record very clear on the point. It was made. It was rejected. That is incontrovertible. Lots of witnesses, lots of people participating. Go ahead.

MR. FALLIN: What I can say about that is it's not market value. That's our position. The $1.30 --

CHAIRMAN CORY: Less 11. A $1.31 less 11 cents. That's the deal I offered, net a $1.20 to PG&E. That's what they pay for gas, and they said, up your ear, friend.

MR. FALLIN: Why didn't you just take a $1.20 whatever it was?

CHAIRMAN CORY: I don't know why you didn't take a $1.20. It's your move. The ball is in your court.

MR. FALLIN: If that's an offer, I'll take it. If you're saying that you don't see any increase in the royalty amount because a $1.20 is a fair price, I'll take it right here and now. I don't think I need authority to take a $1.20. If that's up on the table, let me know about it, and we'll take it. We can all go home.

CHAIRMAN CORY: It was offered and rejected.

MR. FALLIN: A $1.20 --

CHAIRMAN CORY: That is correct.

MR. FALLIN: -- which would mean no increase in royalty payments at all.

CHAIRMAN CORY: At that time they were saying to us,

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no, the market value is not a $1.20, but 90 cents.

EXECUTIVE OFFICER NORTHROP: Compression value was involved.

MR. McCAUSLAND: We offered a $1.31 less 11 for compression, and it came to a $1.20.

MR. FALLIN: Oh. So your valuation for compression was 11 cents at that point. This is a piece of evidence -- staff has never admitted to any value in compression in this whole case. Chevron USA had to put a 17 cent compression value. Every piece of testimony you have calls our price to you a $1.20 when it's really a $1.37; is that correct?

CHAIRMAN CORY: We had no evidence of what it was, but based upon the limited record, we made that offer.

The record has been substantially expanded since then, and there are a lot more facts on the table, but I think it's important --

MR. McCAUSLAND: It was a compromise 11 cents.

MR. FALLIN: Let me get into that a little bit because if in fact -- the record you have before you now, and this is clear, there is no controversy with respect to compression value. There is only one piece of evidence in the case, 17 cents. Staff never put up any opposition to that number. Now, if I hear an objection to that, let's hear it now.

CHAIRMAN CORY: I think there is a substantial amount of things from the Paschall report and others that the true value of compression is substantially less.

MR. FALLIN: Gathering.

CHAIRMAN CORY: Pardon me. You are correct.

MR. FALLIN: I'd asked Mr. Paschall if he was asked to look at compression cost, and the answer was no.

CHAIRMAN CORY: I stand corrected on that.

MR. FALLIN: The important thing is now that this is on the table. I think I try my best to be honest even when you ask me about settlement offers. If you mean what you say about considering values, the value of Rio Vista that you're getting at Rio Vista today is a $1.37, and that's what you've got on the record. What you have to find is a price that indicates that $1.37 is unreasonable.

Okay. Too bad it wasn't on the table because, as I said, if a $1.20 is there, I'm going to take it.

Okay. That was the first hearing where I had the experience which, you may be right, is wholly defensible but it's not wholly pleasant at not being able to cross examine people but being cross examined myself. On September 29th we came to this Commission. At that hearing staff presented this scheme for raising California gas prices, began with the prevailing Northern California price of a $1.20. Use of those Northern California prices as a base is absolutely unavoidable.

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I guess I should deal with the issue that's been raised now at this hearing, which wasn't before, about $1.20. It's tough. It's in the staff's analysis. I can say, well, we've just got it in there and let's stick with it, but I'll respond to that point.

PG&E is a big buyer. There is no question about it. Our competition is, I think, primarily Dow and Shell. There is some competition and some of the prices you're looking at, we have no gas prices at a $1.20 that were set in direct competition with Dow and Shell.

PG&E's position hasn't changed. It's been a big buyer ever since the season was assigned, ever since these contracts were entered into. It's a fact of the market.

The opinion you have before you with respect to the law takes the position, which I think is right, that you have to take the market as it is. You can't pretend that these producers are in Texas or Canada or Louisiana. They are in Northern California.

PG&E is big. What that means is we have a market advantage that is measurable by the size of our service area. In other words, if you want to use it out, you've got to build a pipeline in. No question.

What the witness said earlier is that there is that competition on the fringe that still exists. If it's worth someone's while to build transmission into the service

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area and take it out, they can get it.

The important thing to understand is that that position has not been abused. A, the contracts all have the arbitration out to reasonable market value; and, in effect, the prices that we pay are set by the biggest of the people, the people for whom arbitration is no significant barrier. I know, because they're coming up in February with three of them now combined.

B, when you look at the statistics, you will find that on average California producers have done better than producers anywhere else that we know of in this country. Mr. McCausland, watch it. That's a careful statement. I'm not saying they are doing better at the margin right now. I'm not saying they don't wish they were in Texas at the marginal prices that are being paid now. What I'm saying is when you look at the mix of all the prices for old and new gas, they're doing better here than they're doing in Texas; and that's significant when one of the questions you're asking is, is there some terrific reason why we should throw out Northern California prices.

I mention that only in passing because the staff's position is our position. Northern California prices have to be used. I think Mr. Hager's opinion fully supports and indicates that use has to be made.

We agree, of course, with the actual wellhead prices. After that, we depart company with the staff. Despite the fact that it has over 180 flowing gas contracts, each of which was renegotiated to cover the period, the staff went further to use Mr. Lippitt's FERC and Canadian prices. Why? The only way to get prices up is to go to them.

At the hearing we pointed out the total lack of legal support for such an adventure along with the cartel link character of Canadian prices. We pointed to the fact that this Commission has for years viewed the prevailing Northern California price as the measure of reasonable market value despite the obvious differences between those prices and Canada's border price.

In 1975, the 75 cent per MCF figure was approved. At the time Canada's price was a $1.14. At the hearing the Commission began asking why it should be using Canada's OPEC-linked price if it doesn't have to. Accordingly, the hearing ended with the direction that a formal opinion of the Attorney General be secured dealing with the question whether Canadian prices should be so used.

The hearing last September was attended by some publicity. I've already talked about this section. I'll mention it here. Afterwards Mr. Lippitt was quoted as saying, quote, "All we want is our cost back plus a fair profit."

Fine. Mr. Lippitt and staff would have you believe that prices in Northern California have been totally

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unresponsive to changing energy values and that the producers here h[illegible] suffered terribly. That's the proof of the pudding of this terrible, mean monopoly claim. If you've got a real monopolist in a buying situation, he's going to be buying stuff at one cent over the cost of dropping out, and he's going to be paying a different price to each producer because each producer is going to have a slightly different dropping out price.

You will find that we've always equaliz[illegible] he amounts we've paid throughout California and the prices here have risen over 400 percent in the last six years. I don't think there is any dispute about that. External factors like Canadian prices have influenced the market. They haven't dictated it, as Mr. Lippitt would have them do.

Let's go further and actually compare the producer's production with conditions in Canada and elsewhere. The California producer after royalties will experience a return between a dollar and $1.05 of flowing gas supplies at a $1.20 price. That's assuming about a 16 percent royalty, which I think is conventional.

Canadian wellhead prices after royalty in Alberta and British Columbia now are in the 78 to 79 cent range for old gas. Even for new gas, the range is only 96 to $1.03. At a $1.20, California producers already are doing better than their Canadian brethren.

There is no page 187 due to numbering error

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If your staff succeeded in boosting the California price to the 2.05 level they proposed, California will become a virtual paradise for producers of old gas.

Lest Mr. Lippitt now say that it's somewhat unfair to look so closely at the Canadian situation as he urges you to do, you can also look with the rest. The Bureau of Mines publishes annually the overall wellhead prices in each of the gas producing states. Latest data for 1976, the year in which a $1.20 went into effect in California in the principal gas producing states the totals were: Arkansas, 53 cents; Kansas, 42 cents; Louisiana, 46; Nebraska, 41; New Mexico, 56.5; Oklahoma, 50.2; Texas, 71.8 and West Virginia 57. Those are prices for both new and old. In California the old gas price went to a $1.20.

In '76 the weighted average wellhead price for the entire country was 58 cents.

MR. McCAUSLAND: What value was reported in that report for California that year?

MR. FALLIN: The mid-year cross-over value would have been probably 83, 84 cents. Staff claims that in California --

CHAIRMAN CORY: The figure you gave, are you doing that from your memory of what the prices were or your memory of having read it in the document?

MR. FALLIN: As I believe, I can check, it was

83 cents that would have been California's.

CHAIRMAN CORY: The question I'm trying to get at is whether or not the base year is arrived at from the year of publication, '76, or the year to which the data --

MR. FALLIN: That's why there is no more current numbers available, because the report came out in '77 for the year 1976.

CHAIRMAN CORY: So you're going back from your memory of what PG&E was generally paying.

MR. FALLIN: No. No, 83 cents was the reported wellhead average in California because it only picked up half of a $1.20. Another point that might be made, there is reference in Mr. Hager's piece to the unusual situation in California where we're a net importer or gas producing our own.

It's not really that unusual. There are a lot of other states that also produce their own and import some, and the prices run in the same general scheme: Colorado, 48; Illinois had a high 198; Indiana, 52; Kansas, 42; Kentucky, 55; Louisiana, 46. I should say for the bulk of those contracts those are full-year prices, and they're not picking up the increase that occurred the next year with a $1.20.

We had no objection to having the Attorney General take an objective look at the market value issue. In fact, we welcomed it; but somehow the staff maneuvered it so that the only opinion written was an informal note written by the lawyer assigned to the staff for his client, the staff. In fact, the lawyer chosen to do this little job, Mr. Hager -- there's a little confusion over that -- we were informed by staff was the man who arranged for Mr. Lippitt's hiring in the first place.

MR. STEVENS: Mr. Chairman, I have to take some exception in support of the staff on this point. The assignment of the informal letter of advice that went to the Commission was made in our office, represents the best views that we could give you within the time that we had to do it. There was no maneuvering or other steps taken by division staff in that respect. It was entirely our work and our advice.

MR. FALLIN: Thank you, Mr. Stevens. I would like to carry it further, though, and point out the extremely difficult position that the mechanics of that operation placed Mr. Hager in.

He was required to produce an opinion for the people he was assigned to represent with respect to a case whose preparation he participated in. You don't have to be a lawyer to see the difficulty placed upon him.

I happen to have a very high opinion of Mr. Hager's integrity. That cuts both ways in an issue like this. I think it's got to be taken into account that what you have in front of you in fact is advice from an attorney to his client. You take it on its face value. The good parts are good and the bad parts are bad, but it's no direction from the Attorney General that you are bound to follow. That is not so, and I don't want there to be any confusion on the record on this score.

MR. McCAUSLAND: I think it's clear to the members of the Commission that an informal letter of opinion of the Attorney General is treated essentially as a counsel/client communication.

MR. FALLIN: Okay. Mr. Hager was forced to accept the fact that staff's references to industrial gas rates and alternate fuel oil costs had to be thrown out since the cases simply do not "permit consideration of market prices of alternate fuels as determinative of the market value of gas whose market prices are available."

In quote, "unless the lease provides otherwise, the market value of the wellhead is the proper measure."

I'm quoting from Mr. Hager's letter to Mr. Northrop at page 13 and 14. However, Mr. Hager's valiant effort not to completely scuttle staff's attempt to use Canadian prices forces him to depart from the very principles he described.

He's right. The cases are absolutely clear that establishing the value of gas sold at the wellhead can only be done at the wellhead. FERC and Canadian prices are not wellhead prices at all. There is simply no way around the fact.

Mr. Hager was unable to locate any case anywhere authorizing use of postproduction, postgathering, post-compression, post transmission prices in setting wellhead value. It might be argued that if one were able to strip off the postproduction values, the law would permit use of only the wellhead component of FERC and Canadian prices, but that won't work either since it's clear that the only wellhead price paid for gas under substantially the same circumstances prevailing at the wellhead can be used.

The reasons are obvious. The gas is produced in Northern California, not in Texas or Canada. No amount of wishing can move it there. The only case cited by Mr. Hager on this issue actually illustrates the weakness of the argument. The Hugoton case prices from other states were allowed only because the producing region -- as mentioned earlier today, it's a great name, the Hugoton embayment -- happens to cross state lines. If any producing region under consideration here happened to cross into Nevada or Oregon, it might well be helpful to look at prices there. It just isn't so.

Producing regions in Southern California don't cross even one state line, let alone the three states and two provinces needed to get the Canadian gas.

It's also worth noting, as I think Mr. Perez aptly pointed out, that the court in Hugoton was careful to stress that there was no proof of any substantial difference in the governmental or regulatory climate in the states in question. The inference was if there had been such proof, prices might well have been excludable even though they came from the same producing regions.

In this case the proof could hardly be more conclusive that there are radical differences between the governmental conditions under which gas is produced in Canada and the system prevailing in this state, which brings us to the crux of the matter: What does Mr. Hager have to say about Canada?

He acknowledges the fact that Canada's gas prices are precisely analagous to OPEC's oil prices, the oil prices he defines as clearly "unfair and unjust." One would think that that would end the analysis, particularly in view of the inability to find any support for the proposition that non-wellhead prices paid for gas produced under wholly different circumstances can be used; but in fairness to Mr. Hager, he had his client to look out for.

Mr. Hager did not say that Canadian prices must be used, nor did he say that rejecting Mr. Lippitt's scheme would in any way conflict with law, logical economics on the gift question. All he was going to say was that in view of the broad scope of administrative discretion, et cetera, the Commission might be able to get away with using non-wellhead, nonmarket "unfair and unjust" prices.

Of course, we disagree with the notion that the Commission will be able to hide behind administrative discretion if it chooses to inflict Mr. Lippitt's price levels on us. Mr. Hager's own opinion states that the law requires use of wellhead values. That alone hits the Canadian prices.

The same letter rejects the use of alternate fuels as a way of reaching market value, yet Canada's prices are based on that very system.

Finally, the proposition that cartel-linked unfair and unjust prices can be called reasonable without anybody noticing is silly. Obviously, we should not be using unfair and unjust prices. The use of those prices is contrary to case law unless you are compelled to do so.

This brings the other question. Perhaps there was some compunction that says if you don't do that something terrible is going to happen. You're violating the Constitution.

I think that if you ask Mr. Hager directly he probably would agree with the proposition that use of Canadian prices is not compelled. Hopefully, he could also agree that if you reject the Canadian prices under the record you have in front of you, that would not carry with it any significant legal problems, even apart from the volunteered statement that the producers won't test it.

What I'm saying, in a familiar phrase is ask not what you can get away with, but ask what you should be doing. The inescapable --

MS. SMITH: Who should we be asking?

MR. FALLIN: You should be asking the figure that sits somewhere between Mr. Hager and myself.

MS. SMITH: Who is that?

MR. FALLIN: That's the Attorney General in the sky that we never got the opinion from.

MR. STEVENS: The Attorney General is and always will be counsel to the State Lands Commission, Mr. Chairman, I'm afraid pursuing this isn't going to get us very far. We always have a duty as counsel to the Commission.

MR. FALLIN: What I'm saying in more precise answer is that I think the evidence shows and the law more specifically shows that there is no justification for bringing in Canadian prices; and if that's so, it should not be used unless there is some compulsion, and no one has intimated that you're compelled to use them.

Apparently the next step I think perhaps concerned about the writing on the wall after the last hearing. A new effort was made. Essentially Mr. Lippitt and the staff -- now we move into the combined thing -- seek to have the Commission believe that unique new gas arrangements should be used to set prices for old gas sales.

There was a time when new gas and old gas were mysterious terms to the general public. It's not so any more. President Carter said last November we should reward individuals and companies who discover and produce new oil and gas, though we must not give them huge windfall profits on their existing wells at the expense of the American people. The effort to pass off new gas for old focused on PG&E's purchases from the largest new gas discovery in a decade, Union Island. Rio Vista was discovered some 40 years ago. Since if included in the base Union Island would constitute about 12.9 percent of the relevant California production, its desirability from the producers' point of view is obvious. It's a fairly big weighting in the equation.

We dealt in detail with Union Island at the last hearing held January 12th. Essentially, some 47 cents of the Union Island price is due solely to the elements that were unique to it as a large new discovery.

Mr. McCausland, I caught from your earlier statements that you were hung up on the special delivery agreement. I'm not sure. I think it's clear enough in the statement we put in what that was designed to do and what it did. The reason why we used the standard that you referred to, which is the low sulfur fuel oil price, only for those small increments if they occur was the fact that that was what would have to physically be employed to replace the supplies. We actually have the right to pre-empt someone who has a purchase from that field at the most critical point in the year completely. The price that was set in there simply replaces or substitutes for what he's going to have to do to replace that gas.

A point, you don't have in front of you a contract that says, as some do, in Southern California the royalty shall be based on border prices. It could have been written that way. It wasn't. The same is true of this LSFO business. It's possible to write a royalty of a contract.

There have been contracts in California that based gas prices on oil. The last one disappeared about 10 or 15 years ago. They were rejected because prices have never tracked one another.

MR. McCAUSLAND: They may start to now.

MR. FALLIN: May or may not start to.

The staff -- I think this is true -- has not disputed the values ascribed to the peaking premium element in that contract or the values ascribed to the additional wellhead expense.

MR. McCAUSLAND: Let me understand that. When you speak of peaking premium value, are you describing the special delivery agreement itself or the peaking elements of the base contract?

MR. FALLIN: As an element in the price. It's both.

MR. McCAUSLAND: Okay.

MR. FALLIN: Because what was obtained at the margin, at the edge of our supply was a package that provided for three years' purchase, ten years' security, and it was a ten-year figure that enabled us to defer and reform construction of the LNG plant.

CHAIRMAN CORY: Can I follow up? Let me follow up on that one. Are they the same, the peaking that is done at Union Island versus the peaking done on our field?

MR. FALLIN: Actually, no. Perhaps it shouldn't be that way, but it is. Rio Vista is an old field. It's got some really serious problems. I think it's about a 40-percent wet well minimum, which means in fact it can't be peaked anywhere close to one-third load factor.

I'll tell you what a wet well minimum is quickly. That means in certain fields, although contractually you can cut them back completely as long as you use one-third of their total production every year, because you've got a water incursion problem you can't do that. In other words, we can't cut Rio Vista back past about 40 percent or something like that.

CHAIRMAN CORY: You heard Mr. Willard's testimony earlier comparing the peaking value of Rio Vista to the peaking value of Union?

MR. FALLIN: No, I --

CHAIRMAN CORY: My recollection was that he did that, and I would --

MR. FALLIN: I think he was giving a daily maximum production figure.

MR. WILLARD: Actual peaking characteristics of the Rio Vista field. It produces in excess of 200,000 MCF per day.

MR. FALLIN: That's a baseload figure. Peaking becomes a peculiar value only if you can cut back and then increase. Union Island in the last ten years is a solely peaking contract. In other words, there is no baseload at all.

CHAIRMAN CORY: Union Island is.

MR. FALLIN: It's pure peaking in those last years now.

MR. McCAUSLAND: You're saying the fact that you can only roll Rio Vista back to 60 MCF per day -- these are 1976 production numbers -- versus our peak load day of 230, almost 240,000 MCF per day, is that base of 60,000 that disturbs you?

MR. FALLIN: Well, the question --

MR. McCAUSLAND: It seems to me like you use it for peaking.

MR. FALLIN: In the parlance of the trade, Rio Vista is almost a 50-percent factual load factor contract.

CHAIRMAN CORY: It doesn't look like it from the testimony here.

MR. FALLIN: If that's wrong, the staff can answer me. The wet well minimum is pretty high, I think.

CHAIRMAN CORY: We have a substantial period where, according to this chart, Exhibit 2, that from May through October I would say the average, looking at it on the graph, is 60,000; and November-December was 220,000.

MR. FALLIN: To be an equivalent on an MCF basis to Union Island, you'd h ve to be able to set that out totally in all of those months, and your only contractual requirement would be to take it on in the winter. But that's the measure of your flexibility. That's how much storage space you save.

CHAIRMAN CORY: Okay. Your contractual obligation, as I understand it from the testimony thus far in the record, for our Rio Vista field is only for peak. You can use it. You can cut it back if that's your contractual obligation. There may be some technical --

MR. FALLIN: We hav to use at least -- we're always talking one-third. I think that's a one-third load factor contract.

EXECUTIVE OFFICER NORTHROP: That's correct.

MR. FALLIN: Theoretically that means -- no, it's not just for peaking. It's not just for two weeks in winter. We have to use at least one-third of the field's total production, which is always going to be more than just peaking. That's contractually. Factually, because of the wet well minimum -- and maybe this should be considered too -- no longer performs as a one-third load factor contract because we have to take that base amount all the time in order to protect the wells.

MR. McCAUSLAND: Is that why you're taking quite a bit of it down to Moss Landing and other places for utilization?

MR. FALLIN: We have to keep pulling from that to save the field. For those who are economists instead of lawyers, there is a real question whether the wet well minimum isn't something that you could justify paying the guy who takes it for, because if he doesn't take it, your wells fail. It actually has a negative economic value. We will pass that for the moment.

MR. McCAUSLAND: I bet you put it to good use anyway.

MR. FALLIN: I think there's a question that you may have -- the fact is that Union Island's value occurred at the margin. It had that unique value to us because it happened when it did and was as big as it was. There's no question that when Rio Vista came in, it may have had a heck of a big value too. I think Rio Vista is still about the biggest field in the state. I think that probably -- well, I can this clearly. If part of what Union Island says to the producing population, depending on how badly we get drummed with it here, is that if you bring in a field that's that big and fits our situation that closely, you're going to get paid for it. There's no question about it. What we're doing here is trying to compare things. You're trying to compare that price with the price of what you've got. What you've got is something that was contractually committed for years ago.

(Thereupon a brief recess was taken.)

CHAIRMAN CORY: Okay.

MR. FALLIN: I think we lapsed on Union Island. As I explained, the difference really was where it happened. Specifically at the time, in order to cover -- how shall I describe it -- the tip of the peak, we had some questions about is there a difference between needle peaking and peaking. It's probably subjective, but I think there is. When we talk about needle peaking, we're talking about the top and the insurance. That's both the capacity to see the peak when everything is operating and also to satisfy it, hopefully, if something goes wrong, the pipelines ruptured or compressor failed or something else.

At the time Union Island came along we were in the process of putting together something called an LNG needle peaking facility. That's a plant where you essentially either buy or make or create the LNG, put it in storage containers and keep it there against these peak day requirements. It's a very efficient but very expensive way of meeting needle peaking requirements, push the button and it goes, but it also has some disadvantages because your depletion of storage once it's gone it takes a considerable amount of time to build it back up.

CHAIRMAN CORY: Let me make sure I understand this concept. You're talking about not the concept of importing LNG from outside of California, but taking our existing domestic supply, liquefying it for storage purposes and meeting peak needs there.

MR. FALLIN: Yes. Theoretically, it can be done either way. In the time span we were looking at, it would have had to have been manufactured here.

CHAIRMAN CORY: Syn gas.

MR. FALLIN: It would be LNG. It would be liquefied natural gas.

CHAIRMAN CORY: The manufacturing you refer to is the liquefication manufacturing, not the creation --

MR. FALLIN: Yes. It would be made from natural gas.

Union Island coming in when it did with 110,000, 118,000 -- I can't remember what it is -- MCF a day deliverability probably not only allowed us to change that, but in terms of valuation, it got us out of a very difficult situation. In other words, it wasn't clear at all that even if we carried out all the programs, the timing on that LNG plant, it would have been on stream in time to protect against the perceived problem.

Getting Union Island didn't mean we could cancel the plant entirely. It's not a one-for-one substitution. What it meant was, if I recall correctly, we could defer construction of the entire 400,000 MCF plant for "X" number of years, perhaps three or four. When it was built, it would only have to be build to 300,000 MCF out to the tenth year, and it was only in the tenth year that that storage element would have to be added.

That's the calculation we've given you with respect to the peculiar peaking premium that Union Island was able to command. It should also be stressed that we do pay peaking premiums. Under a one-third load factor contract you get 18 cents an MCF more than the fellow who has a 100-percent load factor. You are getting a premium right now in your contract.

The other element that Union Island -- and at this point we cross into what I think can be defined specifically as a new gas incentive -- was the -- I think it works out to be about 16 cents that we were willing to go to. I have to stress here, too, because we're dealing with economics and we're dealing with future situations, I'm not saying that we're always going to be willing to pay "X" amount of dollars under any formula for every new gas supply that comes along.

I am saying that if we have the same situation, the same supplies, we'd do it again.

It may be, and if it happens, we're going to -- I'm in a very difficult area because I don't want to say too much because part of what I'm saying is dependent on whether you use this new gas contract to pull up old gas prices. I can make commitments with respect about what we'd be willing to do, but those commitments don't ride if it's used to pull up old gas prices.

CHAIRMAN CORY: I'd be more interested in where you're going to be philosophically on this problem of using LNG from other sources if somebody finds $1.20 gas here and you've already built the LNG facility and contractually obligated yourself. Are we, as California consumers, going to pay the 3 and $4 for that figure because you've made the decision to go ahead and do it? Are we going to be protected from that?

MR. FALLIN: That gets us quickly to an issue that was alluded to before. All the things we're doing here stop July 1, 1978. There is no supply of LNG or anything else that's going to arrive here within the time period we're talking about.

CHAIRMAN CORY: Mr. Fallin, let me try to tell you why I'd like an answer to that question.

MR. FALLIN: I think the answer was would we like to have California gas --

CHAIRMAN CORY: No. No. I'm trying to find out with what kind of clean hands you come to this hearing as a representative of PG&E and how much value I can place upon your good will in what you say generally. I'm trying to find out where the company is philosophically when they say they need LNG facilities and that when they have to bite the bullet of deciding that if a new field comes in, a new Union Island field was available, domestic producers find that and they can produce gas for, given for inflation, arbitrarily a buck fifty, a buck seventy-five, are you willing to not use the LNG facility and have the stockholders eat the cost of interest payments in those, or are we, the consumers, going to pay for that anyway?

MR. FALLIN: The answer is that we're going to do as far as --

CHAIRMAN CORY: It's the other side of the --

MR. FALLIN: I'm going to do and everybody else that I know is going to do exactly what is reasonable under the circumstances. If it was reasonable to have taken the chance and put in a facility considering that you wouldn't develop this much thereafter, then that should be treated conventionally.

CHAIRMAN CORY: I understand your answering. Go ahead with your point. Sorry to interrupt you.

MR. FALLIN: Okay. In this case something additional was there, too. The new gas incentive was cost justified. That was important to us, you might even say essential to us in terms of ultimate justification to anybody who would come and say, well, how on earth did you dream up this kind of amount?

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Mr. Leineke thankfully was at our last hearing and was able to confirm the accuracy of the numbers I gave then about just how much more expensive drilling at Union Island was. There is no dispute between us on those amounts. With respect to the amounts at Union Island I've used in this piece and I think I used in the last submittal I made at the January 12th hearing, Mr. Paschall's numbers for the years 1976 through 1978.

Mr. Paschall, of course, is the man from the Board of Equalization. He used '76 to '78 as the period under consideration. He can watch this if he will. I think he's probably already seen it. Maybe he's not here anymore. Somebody has probably checked it.

The combined value he comes up with for the years in question is a $1.52. That's including the gathering fee and making no offsets for the new gas, the peculiar aspects, what I've said are the peculiar aspects of Union Island.

I think I've laid out what happens if you take 47 cents of that number. You get to a $1.05. The gathering fee is the only thing the staff I think really disputes. There have been a couple of numbers around. All I can say -- I will be open on this -- is that we went into that with the understanding that it was to be basically set off against bare expenses. We have asked. We haven't been able to get

Union any detailed workup of their gathering system cost. For the time being you can treat that 8 cents up or down. It doesn't make a lot of difference. It's either a $1.05 or 97, taking out what I think we rightfully say are unique features.

Now, let me give you something else that I provided already. What does this do? What is Union Island's impact? If you decide to use it, if you decide to use Mr. Paschall's figures for 19 -- this was in the supplemental submittal after the January 12th letter -- if you use that number and don't make a single adjustment to it, you don't take out of it the amount we're willing to pay because of the additional drilling expense, you don't take out of it the needle peaking premium, that's not just -- as you mentioned there is a whole separate contract that goes with that that we don't have. Leave it at a $1.50 and put it in with the Northern California price, you come up with a $1.23. That's the impact we're talking about.

So, why am I so concerned, everybody asks themselves. The reason I'm concerned goes back to the point at which I think we and the producers link up. Again, we are very interested in new gas. And Union Island, because it happened when it did, was an effort to try new gas incentivating, if that's a word. Whether we can continue with that constructively depends in large part on how these prices

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are treated, but that's their impact.

If you use Union Island, it's 12.9 percent. Well, the numbers are in evidence. You use his numbers for those last two years, for '76 to '78, it has a 3 cent impact on the overall Northern California price.

There is an issue raised. Staff departs from Mr. Paschall in ways that I frankly don't follow completely. Frankly, I would urge that you use his numbers. One thing I can see that they've done is talked about liquidating the exchange gas balance after the third year.

What does that mean? Union and Phillips have delivered gas to us which we have used. Under the contract we have a right to call that gas back in the future or, within certain limits, to liquidate it for cash. The fact is that it doesn't make any sense at all for them to liquidate it for cash. It would cost them more to replace than they would get for selling it to us. To replace they'd have to buy it at industrial rights. It's not going to happen.

The equation then becomes what is the difference between the gas that you use that you are able to get income from and earn the interest on that income out to the point where you had to replace it from your supply. As we've testified, that works out to be a wash for a couple reasons.

For one thing, our gas in the system is a mix of

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old and new. We have some in storage which theoretically goes back to the 75 and 45 cent prices. When we pay it back, it wouldn't be paid back at the margin anyway. Add to that, in case you are interested at this late date, the transportation fee, which is -- there is no incremental cost incurred for that, if you understand what I mean. In other words, we get a fee for the exchange gas, but it doesn't cost us anything to move around.

CHAIRMAN CORY: It doesn't cost anything to move it around?

MR. FALLIN: Yes, because it's actually an exchange. It's not a transportation. We deliver out of the pipeline that already goes to their refineries. You don't take a package and have to line out some different supply of gas and move it around until you get it there.

CHAIRMAN CORY: I'm not sure that I understand, but go ahead.

MR. FALLIN: We don't even have to change a valve or do anything else to do it.

CHAIRMAN CORY: But the utilization of the facility, as I understand PG&E's testimony, is not worthy of income.

MR. FALLIN: We earn a return on it, but it's no incremental cost to us and, in fact, it's a return that we wouldn't have earned but for the exchange. If you're trying to analyze overall value --

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CHAIRMAN CORY: I'm just trying to decide where you are with relation to the PUC on income.

MR. FALLIN: You would set it off as a detriment or you would set if off against any detriments.

Okay. The staff has now, at least judging from their agenda item, not pinning any specific increase on Union Island. The item for this meeting, while jiggering the price upwards -- remember, too, that we stopped in July of '78 the issue of whether they might hypothetically extend it to '78 will become relevant at the next meeting we have on those prices. The prices now are the three-year schedule.

Why wouldn't they exercise it is another question. The answer is it was designed to provide them with protection at not getting short with their pipeline not built. If their pipeline is built, I would imagine they'll go ahead and use it rather than having it sit there with that investment.

Now, as to the agenda item, it's presented only as one "high price" without any specific claims to relevance. The answer is that properly adjusted it's not a high price, and unadjusted it's wholly incomparable to the State's old gas supply. As we have said before, the most direct indication of Union Island's remoteness from this case is the fact that Union Oil Company, one of the participants, accepted a $1.20 as a reasonable value for all its own old gas supplies after Union Island.

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Where does it all leave us? The answer lies in the staff's presentation again today. They have returned to Canada and are once again asking the Commission to punish us with prices their own advocate equates with "unfair and unjust" cartel-driven prices. Something you've got to keep in mind, you can't get to the prices they're talking about without going to Canada.

I have a thing back here somewhere. Mr. Cory will probably remember back in those soft autumnal days of September we had a release on what might happen at that hearing, and staff had listed in the attachment you had to that our El Paso prices. They are a $1.12.

As I pointed out in our last submittal, if you combine the flowing prices for gas supplies in Northern California with the FERC regulated prices, you get a $1.17. I had written here, and it's true, I'm almost out of words. If you guys can't see now the legal, logical and political unacceptability of this Canadian scheme, I can't be of much further help; but remember, you start from an agreed base of Northern California prices that fully support a $1.20 in MCF. The burden is on the staff to show that it's necessary to go beyond those prices.

CHAIRMAN CORY: You're not out of words.

(Laughter.)

MR. FALLIN: I can see the end right now. The staff

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hasn't done that. There is no moral, legal, economic or political compulsion for you to go to Canada for those prices. Remember, too, as Mr. Hager pointed out, alternate prices don't work. He didn't say why. One of the reasons they don't work is there has been talk monopolies.

CHAIRMAN CORY: Did you lose sight of the end?

(Laughter.)

MR. FALLIN: Having been so successful or unsuccessful with my first, I'll extemporize at the tag end. Because it's another issue that deserves ventilation. I discuss the monopoly argument --

CHAIRMAN CORY: Are you paid by the hour?

(Laughter.)

MR. FALLIN: Actually, I just work for wages, which is pathetic. That's the way it is.

Anyway, the Canadian price is what the market will bear. That is a monopolist price. It's not just that it's determinedby the monopoly, but going to that price incurs the same problem.

The quickest answer is look at the cases, the ones that are cited. There has been a lot of litigation about what reasonable market value means, and you won't find a one, unless Mr. Hager and I have both failed in our efforts, that lets you go to Canada. I don't think you'll find a one that lets you go to El Paso, but on the other hand, what

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does it do? Under the conditions you described earlier and under the state of the record now, you would have to find -- with respect to Rio Vista; I don't know what the Ryer Island situation is -- you'd have to find a price higher than a $1.37 to find that a $1.20 paid for Rio Vista was unfair, and that's it.

(Thereupon a brief discussion was held off the record.)

MR. FALLIN: I have to admit that I have done my best to build this record.

MR. McCAUSLAND: Yes, you have.

(Laughter.)

CHAIRMAN CORY: Increase the size.

MR. McCAUSLAND: But I want to say that today I followed you. As I read through the earlier transcripts, I found that sometimes I had to go back and reread several times to make certain that I had understood when you qualified something you really had qualified it. I think you were very direct today, and I appreciate that. It's a complex issue. So, I know why you --

MR. FALLIN: Extemporizing the transcript probably doesn't follow as logically as the statements do.

MR. McCAUSLAND: Does PG&E use the maximum of California produced gas that's available? Do you use a minimum amount? How do you determine that you're going to

14 use California gas?

MR. FALLIN: That's a subject that is in contention. You heard a lot of people talk about it earlier.

MR. McCAUSLAND: As a quasi-capitalist, it would be my intent to take the maximum amount of cheapest gas that I could get into the system.

MR. FALLIN: I think you've managed to find yourself at the point at which Sylvia and I can be severed.

MR. GRAVELLE: We'd welcome you to come to one of our hearings.

MR. FALLIN: I don't know the mechanics, to tell you the truth, of why it works this way or how it works this way. It's my understanding that the Commission has taken a position that there is a conservation ethic involved in use of California gas that involves husbanding it. You may remember back before Alan got rid of industrial rates, we were talking about this issue, and the fact that in a sense they are dedicated to --

MR. McCAUSLAND: He's not all bad. He did some good things for you.

MR. FALLIN: I think that writing an opinion for his client and having to support a position they'd taken and understood that way, yes. That's my only point about it.

MR. McCAUSLAND: But you really don't have an answer to my question. Your answer to my question regarding

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the PUC is that we husband California gas and don't exploit that low price.

MR. FALLIN: If you want to put it another way, that's another way in which we're not acting like a monopolist.

MR. McCAUSLAND: All right. You described to me during the break a little bit on the arbitration process. I'm close to the point of believing that all of the burdens placed upon this Commission in terms of its statutory role as keeper of resources and generator of cash makes it very difficult for us to also set ourselves up as a rate-making body, and I'd like to explore the notion of the fact that you have cases in arbitration and how that relates to the matter before us.

MR. FALLIN: That's just about your whole problem, the reason why we talk about this decision reverberating, because you have to understand the arguments that I've made. I think the arguments are good ones -- at least they haven't been answered by anyone so far -- against using Canadian prices, against the Canadian prices. Those arguments are largely -- to a point they are conventional. Up to the point where FERC and Canadian prices break, the arguments are largely the same. There is just no support for using non-wellhead, non-market prices.

Every case cited by both of us used wellhead prices except where it was wet gas and you had to get it to dry gas

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to sell it. Where we part is in the fact that Canada's different. It's not just that it's outside the ordinary scope of law; it's because of the peculiar mechanism used is hinged automatically to what OPEC does. It is a reflection of OPEC's prices. When you talk about using that price --

CHAIRMAN CORY: When you make that point, will you help me by telling me how you in good conscience entered into the Union Island contract in which you used the same mechanism?

MR. FALLIN: Sure. The only point -- well, let me put it this way. The point at which the mechanism was used was a special delivery agreement where it's a physical requirement. If we pull the gas out from there, use it at their refinery, they have to replace it with LSFO; and they could argue, whether we felt it was justified, --

MR. McCAUSLAND: That's not the only place you used it. You rejected an extension price because --

MR. FALLIN: The quicky argument with respect to the other place is that it's never used until after the period you have under consideration. It's never used until after July of '78 under any circumstances.

MR. McCAUSLAND: But the problem that we're faced with is we view this -- and you can help me define a word better than value since I'm not an attorney and obviously none of the attorneys like my use of the term value. We have

17 a very precious commodity in the Delta which, as a landlord, we want to husband probably as much as the PUC wants to husband. Also as a group with fairly broad statewide interest, we realize the state has a long-term energy need that you're probably as sensitive, if not more sensitive, to than we are; and we look at that precious commodity and the fact that you have already conceptually found an equivalent value to low sulfur fuel oil indexes. It's very hard for us as a landlord not to believe that it's incumbent upon us to look at that same conceptual framework.

MR. FALLIN: Well, A, it's not because it doesn't occur in the time period you're talking about. B --

MR. McCAUSLAND: No. That's a fiction.

MR. FALLIN: B, it isn't -- we don't think it's going to occur. To the extent that you are looking at the thing and you are asking yourself was a bargain struck, as of right now the answer it was clearly the other way. We turned it down --

CHAIRMAN CORY: But previously you allowed the other side to unilaterally impose it upon you.

MR. FALLIN: It's not been exercised.

CHAIRMAN CORY: You contracted away the right to do that.

MR. McCAUSLAND: Let's follow that for just a second because the difficulty that we have, my difficulty is

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that I believe even though we've got sloppy fields that are falling apart at the seams -- I'm not sure I should stipulate to that as a landlord.

MR. FALLIN: No, it's not quite that bad.

MR. McCAUSLAND: It's not quite that bad, but our fields are extremely valuable to you during peak need situations. We could probably even help you with some of that insurance policy you described.

MR. FALLIN: Not unless y.u incur out in front.

MR. McCAUSLAND: Not unless we what?

MR. FALLIN: Not unless that peaking occurs at the margin. You're already counted into the equation that requires us to go out and build this stuff.

MR. McCAUSLAND: All right. We really are precious.

CHAIRMAN CORY: We really are precious because we've been had.

MR. FALLIN: It's already been contracted for.

MR. McCAUSLAND: Preciousness and virginity go hand in hand. But the fact that you are able to continually forestall the day of reckoning in terms of not being able to meet peak demand someday has a lot to do with the fact that our commodity is available to you when you need it, and that's to me the exact same terms of an agreement that you've entered into that runs until 1985, by my reckoning, that allows you to pull off 50,000 MCF when you need it on a specified number of days under specific circumstances.

MR. FALLIN: Completely ignoring everything else, that would be a much better peaking contract because it's total.

MR. McCAUSLAND: It's a beautiful contract.

MR. FALLIN: You're never obligated to take the gas when you may not want to have it. It's pure peaking. The fact is that if you come up with Rio Vista tomorrow or anything close to it, and in fact you may not fit the situation so well now because it depends on where our plans are and whether, as you say, whether you can change them or not, you get the same premium. That's important because that's what calls for new gas supplies. You just can't get it. It's too bad. I guess you can reflect on the fact, but it is true that the market price for old gas currently sets a premium at 18 cents, which is what we're paying you.

Strictly, it may be a little overpayment because of the wet well minimum.

I don't want to keep ducking this LSFO in the last year. A, it's hypothetical. If it could occur, you've got to say, when the bargain was struck a price was thrown out in the fourth year that was set on a standard. If this easement said alternate fuels or if we had a series of contracts that tied gas to oil, fine. It could be done. It could be done, and you can consider it: and I have no

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question that starting in 1978, if they do exercise that right, that's going to be a big issue. Of course, what we're going to say, there's a lot of things that the projection didn't come true. Our fears weren't realized. That's why we didn't take the option.

If that price was a good price to us, we certainly would have taken it for another three years because that's a big supply, and with the pipeline built, it's simply gone.

MR. McCAUSLAND: I think I can accept the rationale that was utilized in trying to project the future costs back to the negotiated --

MR. FALLIN: You've got to realize the fact price that they've given you, you'd have to take out the liquidation. It's never going to make sense for them to liquidate for the reasons I mentioned which would take that price back to a $1.60 something or other. That's going to have perhaps a four cent impact on the prevailing rate. It will bring it up to about a $1.84.

MR. McCAUSLAND: Let me describe for a moment why I embarked on that dialogue with you. The last time that we met as a Commission and you made your testimony, you were quite concerned about the kind of evidence that was before us at that time; and it struck a sympathetic chord, and I felt guilty that I hadn't been through the record. Now that I'm through the record, I feel compelled to

21 consider evidence that you find totally unacceptable. I also feel, though, even more uncomfortable with my role as a ratesetter and am trying to demonstrate to you that I want to know how arbitration could be any worse than dealing with me.

MR. FALLIN: It's not a pleasant experience. Let's say I like to see Henry over and over again. The point with Canada -- this is the kind of thing that I have said before and I don't think -- I have never said that Canada is irrelevant. I have never said that oil prices are irrelevant. If you went to Canada and could see that, God, look at that price increase they've had over the last two years. You come to California and you find four percent, five percent. Inflation. What was inflation, 10, 11 percent? The price you're now looking at, a $1.20, was, what, a 60-percent increase? I think that's right. From 75 to $1.20 is something on the order of 60 percent. What we're talking about is 140 percent.

There is no question looking at the numbers you cannot deny that Canadian prices had an influence on that price. The important point is they didn't dictate it, they didn't come in just because they were "X" amount of weight or whatever. They entered into both sides eyeballing of what the price was and what they could get if they went to arbitration.

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MR. McCAUSLAND: Could you describe to me the procedures that are utilized in arbitration in terms of fulfilling the requirements for fact finding and due process and those things that I am guilty of?

MR. FALLIN: If anything they are -- well, it's all set largely by agreement. If the two sides don't agree on things, it goes in -- well, literally anything comes in. There are no restrictions. The arbitrators not only set all the rules and all decisions, but all proceedings. That's why it's such a damnably difficult thing to go past. That's why the judge in San Diego felt he was constrained to stay with the Occidental arbitration.

It can have a downside, it's true. If you came out and said, we've looked through this thing, and boy, we're convinced PG&E is paying too much, the stuff is only worth about 95 cents, and that was cranked into an arbitration and it was held up, they'd have the same problem. They're almost impossible to move.

MR. McCAUSLAND: Have you had any of those lately?

MR. FALLIN: Ninety-five centers?

MR. McCAUSLAND: Well --

MR. FALLIN: If I had any, I wouldn't be telling you.

CHAIRMAN CORY: You'd have a problem, wouldn't you, before the PUC if we came up with that in terms of the

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bootstrap up? Wouldn't the bootstrap go down in terms of reasonableness of your position?

MR. FALLIN: Probably would. I'll take it. Sylvia?

MS. SIEGEL: I'm listening.

MR. McCAUSLAND: All right. Thank you.

MS. SMITH: I've read your statement more than once, as I have the other material. I listened to you all day today, and I don't have any more questions to ask you that might cause you to extemporize.

(Laughter.)

MR. FALLIN: I misspoke on one of the numbers that I gave you in terms of what the State would have to pay. It's $1,219,000. That's to keep this building warm.

CHAIRMAN CORY: There is enough hot air in this building on any day that we don't need any gas.

(Laughter.)

CHAIRMAN CORY: Mr. Lippitt.

MR. LIPPITT: My name is Henry F. Lippitt, II, and I'm executive secretary of the California Gas Producers Association. Since my consulting contract with the Commission has terminated, having completed the work, I'm happy to say that what I put on the record maybe you can use for part of your decision.

Let me first -- I was asked to put in two statements

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by two producers, and they are in the form of letters. Other than reading them into the record and making an oral statement, let me deliver the letters to you and just put them in the record. They are statements on behalf of Buttes Resources Company and Anacapa Oil Corporation. There are a number of copies here which the parties can pick up.

CHAIRMAN CORY: Does the staff have a copy of these?

MR. LIPPITT: If they don't, they're there if you'd like to pick them up.

CHAIRMAN CORY: Grab them because I can't hang on to anything.

MR. LIPPITT: I understand. The gist of Anacapa's statement at the bottom is:

> "Under the circumstances, Anacapa, as a small producer, felt that it had no economic alternative to accepting PG&E's offers."

Buttes, in effect, said the same thing. It said:

> ". . . like other relatively small producers, did not want to assume the expense of arbitration which was the only alternative to accepting PG&E's offer."

In any event, it is somewhat similar to the other letters which you have received, and I ask that this be made a part of the record rather than reading it.

Let me make a couple of comments first about Canada, second about Union Island and then third about other contacts in Northern California, other pricing landmarks.

First as to Canada, as Mr. Fallin has said, it is part of the market in Northern California. That is to say the delivery of Canadian gas in Northern California is over one-half of all of the gas which is delivered in Northern California. It is a fact of the market. It cannot be ignored.

The reason it cannot be ignored is not only the factual basis it cannot be ignored, but Judge Yale, William A. Yale, in his decision upholding the Occidental arbitration stated in so many words that it was a factor and that it had to be considered, or certainly that it could be considered, and that if it should not be considered, it was a matter for the Legislature rather than for the arbitration in that particular case.

That's the same situation here. Until there is legislation, it is a factor. It must be considered. You cannot disregard an impact of over 55 percent of the Canadian gas in Northern California.

Second, with respect to Union Island, there has been a good deal of discussion about the fact that the wells and so forth were more expensive. Let me point out

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that this is PG&E's justification for paying the higher price. The interesting thing is how little this looms in the entire flow of payments in the Union Island contract. There are some 14 wells in the field at a cost of $800,000 apiece. That's a total of $11.2 million. The cash flow from that field at 20 billion feet per year is $27 million a year, which means that you amortize the cost of those wells in less than six months. In other words, if PG&E really feels that costs should be considered in negotiating these contracts, they could certainly have asked Union Oil Company whether or not the felt they would make a fair rate of return, or more, with respect to the Union Island gas.

Obviously, this factor was not considered by PG&E in its determination, and what they would like to do is ask all of us smaller producers to cough up all of their costs; but they have not in their most recent negotiations used those costs as a factor in determining a price that they would pay for gas in Northern California.

Now then, with respect to peaking, I direct your attention to Mr. Willard's exhibits and his exhibits three, four, five and six, which have to do with the peaking characteristics of the gas that are involved in this case. You take the largest one, which is the Rio Vista gas unit, and you take peak day deliveries of 150,000 MCF per day, and the so-called wet well minimum is 40,000. That is a

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peaking factor of over three-to-one, not less than three-to-one so that, if anything, the Rio Vista gas is more valuable than a three-to-one contract.

The interesting thing is that in addition to needle peaking, which you can see from the characteristics of the charts -- and what looks like needles are needles, and that's why they are called needle peaking -- you also have seasonal peaking. Take the North River Island unit. It's shut off completely in March and April and May and June and July. Then when it's turned on, it's turned on to get the peaking value, the needle peaking; but in addition to that, from these fields you also get seasonal peaking.

It is a more valuable field if you can get from it not only needle peaking, which you get from Union Island, but in addition to that throughout the wintertime generally, rather than only the very coldest days, you also get seasonal equation. So, on that basis the Rio Vista gas is more valuable, not less valuable, than the Union Island gas.

Let me also point out that the staff's analysis of the Union Island gas has only to do with the cost, top word, cost analysis of the cost of this gas to PG&E. It does not cover the value of the gas to Union Oil Company. Of the total deliveries at Union of about 30 billion cubic feet in the course of three years, 12 billion cubic feet are exchanged. If you put a value on that exchange gas, and that's

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40 percent of the total, you would do it by taking the value that Union Island, the cost that Union Oil has to pay for gas at its refinery. That price is presently $2.29 which PG&E charges. There is a nine cent per million Btu exchange fee.

So, as far as Union Oil's production department is concerned, they get a value of over $2.20 for the gas which they are delivering today which they have been delivering for the past three years, or 40 percent of their gas to their refinery. That has not been taken into account in that cost analysis. It is an additional value which has to be considered if you're considering reasonable market values rather than just costs.

Let me refer to you other prices, particularly in California, and then elsewhere. Before I do, I'll make one comment, and that is with respect to cost.

First off, Mr. Fallin stated that one of the cost analysis that he had shown that had shown the producers, in this case the Lathrop field, was making 100 percent rate of return. Mr. Fallin's study carefully put in the wells which were drilled in the Lathrop field and a couple of development dry holes, but he posited that you could a Lathrop field without drilling any dry holes elsewhere.

I will tell you that if the oil and gas business can be run on that basis, we are entering a new era. The

29 100 percent figure for a rate of return for a field like Lathrop, not taking into account anything except development dry holes in the field after the field is developed, is certainly worthless for determining the rate of return which a producer will earn.

Mr. Williams referred to ten-to-one --

CHAIRMAN CORY: Pardon me. I just want to make sure I understand the point of that. Are you saying that the point of your statement is that before you get to Lathrop --

MR. LIPPITT: You drill a lot of dry holes.

CHAIRMAN CORY: You had to do something else to get there unless you're incredibly lucky?

MR. LIPPITT: Exactly. For instance, when the Federal Power Commission --

CHAIRMAN CORY: May I ask a question? There is a gentleman -- I'm sorry. It's getting late.

MR. LIPPITT: Mr. Williams?

CHAIRMAN CORY: Mr. Williams testified a return of $3.00 for $1.00.

MR. LIPPITT: Let me talk to you about that. That's exactly what he was talking about. In other words, once you've got a well, if that well will return $3.00 for $1.00, you've got a successful return. If it only returns $2.00, you will not get all of your money back because you have to

30 put additional money besides the actual drilling in the cost of operation and maintenance and so forth. So, a two-to-one basis, you sort of maybe you'll make it, maybe you won't. On a three-to-one basis, you've made it. On a ten-to-one, obviously you've made it; but that does not include the dry holes.

From the point of view of determining whether Mr. Williams is earning a fair return or not, you have to take into account all of his experience with dry holes. In determining the price generally in Northern California, you would certainly have to take into account not only Mr. Williams' dry holes, but the dry holes of the industry.

CHAIRMAN CORY: When you say dry hole, are you talking about the total exploration cost including seismic?

MR. LIPPITT: Oh, yes.

CHAIRMAN CORY: All the other things you do?

MR. LIPPITT: All the other things, yes.

CHAIRMAN CORY: And that was not included in Mr. Williams' three-to-one ratio?

MR. LIPPITT: No, it was not.

MR. SUMPF: He didn't state it completely, if I may interrupt. I'm Mr. Williams' partner. He just omitted that from his statement. He said profit --

CHAIRMAN CORY: I just want to make sure that Mr. Lippitt is not putting incorrect words into Mr. Williams'

31 mouth.

MR. SUMPF: We asked Mr. Lippitt to correct that.

CHAIRMAN CORY: If there is a correction that needs to be made, go ahead. I'm sorry.

MR. LIPPITT: That's all right. I wanted you to point out that certainly overall we're not making an unfair rate of return. You look at the National City Bank rates of return for oil companies, and their rate of return on the average is less than manufacturing companies. You make less rate of return putting your money overall into the oil business than you do in the radio business.

CHAIRMAN CORY: Can more specificity be given to those numbers?

MR. LIPPITT: Well, yes. Put it this way. There is five volumes about his high that have just been submitted to FERC in what is called the Biennial Study to show what the overall costs are of developing gas supplies, and those are the types of figures which would have to be used to determine what the costs were. Does that help?

CHAIRMAN CORY: I think all sides have been somewhat guilty of using the generalization and asking us to decide, and I'm not trying to be argumentative, but one of the questions which I think may be relative in the long run to someone who is -- and I'm really not sure that this is our long-range interest to remain in this field -- but it would seem to me that I personally could not function as a member of the PUC if I didn't force people to produce that kind of hard evidence as to what's happened.

MR. LIPPITT: Well, they already have the evidence with respect to the stuff that's put into the Biennial in the FEC.

CHAIRMAN CORY: Would the producers generally be willing to produce that sort of data to the PUC? Would your organization be willing to provide that information to the PUC?

MR. LIPPITT: Some producers would and some wouldn't. That's all I can say.

Mr. Williams is willing to do so. I've had a couple of others that have volunteered material. I put cost figures in before the CPUC a couple of times, and it's generally ignored.

CHAIRMAN CORY: That area of the record was sort of left hanging. I thought we ought to try to pin it down as best we can.

MR. LIPPITT: Some will and some won't. That's about all I can say.

CHAIRMAN CORY: Do you believe that the PUC has the right to compel that information?

MR. LIPPITT: Well, I couldn't tell you. Put it this way. The answer is that it would be doubtful until they

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have jurisdiction over us; and after they have jurisdiction over us, then there is no question about it. I think the question of whether they have jurisdiction over us depends upon, in my estimation, legislation. Whether or not they can do it as part of an overall legislative proceeding, I'm not sure. In other words, whether if one of the committees say, we want a lot of data, I think they can get existing data; but what is required is putting that existing data into the form of exhibits and dividing the figures and so forth. I think you'd have to turn a team of people from the CPUC, half a dozen people -- oh, it would take more than that. It would take a dozen of them, and they would have to work the better part of a year or so.

In the Federal Power Commission it took a long time to develop the figures, and that's what happened and that's why we are in the trouble we're in. The figures that came out were so low that we've just gradually lost our gas supply.

CHAIRMAN CORY: Go ahead with your point.

MR.LIPPITT: In any event, with respect to gas supplies in California, let me direct your attention to a couple of things which I just think you ought to have in mind.

First off, in Southern California there has been a lot of talk about the impact. At the present time today gas is being sold in Southern California for a $1.35. That's

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100 percent load factor gas per million Btu's. If you add to that the peaking, which is roughly, the way Mr. Fallin puts it, 18 percent, 18 cents on a $1.02 -- it will add another 25 cents to it. The price of natural gas in Southern California, which is comparable to the prices we are talking about today in Northern California for gas of 33-percent load factor, would be a $1.60. That price goes up in accordance with the offer of Southern California Gas Company to buy another 14 cents on the 1st of July so that the equivalent price in Southern California generally offered for gas would be a $1.85. So, the figures we're talking about here are sharply lower than those which are presently being offered for gas supplies in Southern California.

MS. SIEGEL: Up till July 1st?

MR. LIPPITT: Up to July 1st it's a $1.35 plus 25 cents peaking, a total of a $1.60. After July 1st it's a dollar and a half plus 25 cents peaking, which would be a $1.75.

Edison Company in Southern California purchases gas also. Their gas purchases are made at a $1.98 in million Btu's. In Northern California the staff has put in the record the Amstar contract with Chevron. That contract calls for three price levels: the highest price PG&E pays, or the price which Amstar has to pay for gas from PG&E or 90 percent of LSFO prices.

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Let me tell you what they are. The price that PG&E pays in the field is -- presently the highest price is the Union Island price -- which is maybe a $1.76 if you take all the freebies. The price which would be paid by PG&E is $2.29, so that would normally set the price; but it shall be not higher than 90 percent of the LSFO price. The LSFO price at the present time is $2.35. Ninety percent of that is $2.11. At the present time the gas under this new Chevron contract with Amstar/Spreckels Sugar is going for $2.11.

This is just to point out to you that the general pattern of prices is a good deal higher than those which have been discussed by PG&E today. With respect to border prices and what my figures were to provide the staff with was a calculation of what the weighted average border price would be for gas. And the reason I did that was that this is widely adopted in Southern California.

Mr. Gravelle has advised the California PUC innumerable times that it is appropriate to use a border price for determining the price of gas in Southern California. He has signed orders which permit that border price to be used in calculating the cost of gas to Southern California Gas Company. That policy, that method of doing it, has just been translated to Northern California. Northern California, the figures are different, and that's what's been used.

36 In any event, let me just touch a point on Canada. In Canada the prices have risen even more sharply than they have here. I was involved in an arbitration case in 1971 at 17 cents, not 30 cents, and the price Mr. Fallin talks about is a dollar at the present time; but Mr. Fallin does not tell you that the Canadian producers also get what is known as the market pool payback price. That is to say, the Canadian gas prices are equalized because of the difficulties of delivering gas to Toronto, and they get a higher price for gas which is physically delivered to the United States; but in order to equalize the Canadian producer, he gets a payback from the excess revenues which are generated by the sales across the international boundaries, and that has to be taken into account in determining the total. In California also we've made sales at $2.25.

CHAIRMAN CORY: Mr. Lippitt, could you quantify what that --

MR. LIPPITT: It's about 25 cents.

California producers, as Mr. Williams pointed out, negotiated contracts for $2.25. We negotiated a number of them, quite a number of them. I mean a dozen. And we were ready to make deliveries under those contracts. They would be made within the state, sold actually to the Natural Gas Pipeline Company of American which delivers gas in the Chicago area. What would happen is the additional gas would

37 be delivered in California. That would mean a smaller request forecast to come from El Paso, and gas which would otherwise go to El Paso in West Texas and in the Texas Panhandle would then be delivered to Chicago.

We were ready to do that, and PG&E deliberately, in my estimation, determined not to permit the exchange to be made; and as a result of that, we were unable to make the deliveries. The contracts were signed, an order was issued out of Washington by Mr. Dunham who was then Chairman of the Federal Power Commission, requiring PG&E to do it; but the time finally elapsed and the authority under the Emergency Act expired.

But the answer is, if we are given a chance to deliver our gas on the fringes, as Mr. Fallin puts it, it's very clear that we've got a price of $2.25 which is readily payable by a number of other purchasers.

CHAIRMAN CORY: You would have to deduct from that some transmission cost.

MR. LIPPITT: No, no. In addition to that, the transmission costs have to be added. In other words, Natural Gas Pipeline Company of Chicago has to pay an additional transmission charge for El Paso gas.

CHAIRMAN CORY: That is not to the producer in those contracts?

MR. LIPPITT: That's net to the producer.

38 Finally, let me say that Mr. Fallin gave you a number of prices of gas in other areas that he indicated were lower than the price of our gas. That is so only because Mr. Fallin has included controlled prices of those gas which were controlled by the Federal Power Commission. In other words, you take all the gas in Arkansas and two-thirds of it is exported from the state at a price which has been held down by federal regulation. That's why we've had all the problems, because holding those prices down has inhibited the production; and that's why we've had a natural gas problem.

But in any event, you cannot do that here. You can not take a mix of interstate prices and intrastate prices and import them into California. You can do it by taking other states -- Ohio, Michigan, New York -- but Mr. Fallin was very careful that he didn't give you those figures.

The only one that he gave you of a state which wholly imports gas and didn't import any intrastate gas was Illinois, which was 98 cents.

In any event, there are other criteria which have to be considered. Obviously, he talked about the net back in Canada. The net back in Texas is $2.00, and this is true of the gas prices which are available for intrastate gas in Texas. I may say that that includes not only new intrastate gas, but generally renegotiated prices for old intrastate gas.

Those are the only points that I thought you might like to have which would tend to set the record straight.

MS. SIEGEL: Is he subject to cross examination?

CHAIRMAN CORY: Do the Commissioners want to ask any questions?

Thank you, Mr. Lippitt.

MR. FALLIN: Mr. Cory, I'm afraid because there are some new things that were brought in there -- it should be very quick.

First --

CHAIRMAN CORY: Wait. I would like to know what the Commissioners want to do. Once we start this, at some point we've got to come to an end. If the Commissioners wish to -- but it seems to me if Mr. Fallin is allowed to do this, then we get into another round --

MR. FALLIN: Give me four minutes, and if he wants, give him two and cut it that way.

CHAIRMAN CORY: What about all of the others? That's why I have trouble with the cross examination thing trying to deal with it now. What do the Commissioners wish to do?

MR. FALLIN: I'm not asking for cross examination.

CHAIRMAN CORY: You just want more time. If the other people want more time -- I appreciate your concern. It's up to what the Commissioners wish to do. How long do you want to be here and what would you like to do?

MR. McCAUSLAND: It's my firm belief, due to our charge under the statutes and due to our responsibilities as landlords, that it is inappropriate for us to begin asserting ourselves into the determination of what the price of natural gas should be; and I say that because I believe that we have an extremely strong interest in the outcome of that, that probably has to be predominantly oriented towards our role as landlords. I would like my judgment on the matter of price to be determined by a regulatory body who has more expertise in that matter and whose primary mission is to determine fair return so that my fair return is the same as everybody else's fair return.

CHAIRMAN CORY: The question procedurally, though, is I'm trying to ask --

(Thereupon a brief discussion was held off the record.)

CHAIRMAN CORY: Fine. I have the answer from the Commission. Thank you for your offer, Mr.Fallin.

Go ahead, Sid.

MR. FALLIN: I'll write you a letter.

(Laughter.)

MR. McCAUSLAND: Do you want to talk about my concern?

CHAIRMAN CORY: It's the will of the Commission. I think that's where we are.

MR. McCAUSLAND: I have language which I would like to propose in the form of a motion as a substitute to the staff recommendation on this calendar item. I would like to propose that the reasonable market value or current market price of the gas produced and sold from the Rio Vista, Ryer Island, River Island fields for the period in question shall be those prices that are the result of the pending arbitration between PG&E and Texaco, Aminoil and Superior, provided however that should the Public Utilities Commission determine to regulate the price for California-produced gas and impose a ceiling on the price that a California producer may charge, the determination of the State Lands Commission shall be that ceiling price for all time periods in question.

MS. SMITH: Mr. Chairman, I feel that because of my interest in the consumer being protected that that motion probably offers the consumer the most protection that we can offer them and fulfill our responsibilities as Commissioners to the State Lands Commission. I find the staff's recommendation of prices unacceptable, and I find PG&E's position to be one that I cannot accept at this time. Having listened to everything that I've listened to all day, I believe that the motion as worded is acceptable to me and would be acceptable to Lieutenant Governor Dymally and, therefore, I second that motion.

EXECUTIVE OFFICER NORTHROP: Mr. Chairman, I believe that Isleton was left out of that.

MR. McCAUSLAND: That was an inadvertent error. The motion should be amended to include Isleton.

MS. SMITH: That's fine with me. Second the motion.

CHAIRMAN CORY: Is there anything that the Commissioners wish to discuss, or are we at the point where the mind cannot cure what the seat cannot endure?

Do you wish to put any caveat of limitation as to a maximum to which the arbitration, if they came in, should not exceed based upon this record? Do you want the motion to stand where it is?

MR. McCAUSLAND: I made my motion. You can amend it.

CHAIRMAN CORY: We have a motion and seconded. All those in favor signify by saying aye.

(Ayes.)

CHAIRMAN CORY: The ayes have it. The motion is carried. We stand adjourned.

(Thereupon the meeting of the State Lands Commission was adjourned at 8:50 p.m.)

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STATE OF CALIFORNIA)
ss.
COUNTY OF SACRAMENTO)

I, WENDY E. SCHILLER, a Notary Public in and for the County of Sacramento, State of California, duly appointed and commissioned to administer oath, do hereby certify:

That I am a disinterested person herein: that the foregoing Excerpt of the State Lands Commission Meeting was reported in shorthand by me, WENDY E. SCHILLER, a shorthand reporter of the State of California, and thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for any of the parties to said meeting nor in any way interested in the outcome of said meeting.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my official seal of office this 31 day of January, 1978.

Wendy E. Schiller

WENDY E. SCHILLER,
Notary Public in and for the
County of Sacramento,
State of California.