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Fifth Circuit Expands Not Substantially Developed Exception to FERC Jurisdiction under the Natural Gas Act of 1938

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FIFTH CIRCUIT EXPANDS 'NOT SUBSTANTIALLY DEVELOPED' EXCEPTION TO FERC JURISDICTION UNDER THE NATURAL GAS ACT OF 1938

NATURAL GAS—JURISDICTION. The FERC does not have jurisdiction over the sale of leases covering proven reserves of natural gas that lack the imminent ability to produce in commercial quantities. *El Paso Natural Gas Co. v. Sun Oil Co.*, 708 F.2d 1011 (5th Cir. 1983).

INTRODUCTION

The federal government regulates the price of natural gas if the gas was transported or sold in interstate commerce before arriving at the consumer's home.[1] The federally regulated price is normally lower than the prevailing free market price.[2] Because of this gap between the regulated and unregulated prices for natural gas, there is an obvious economic incentive for gas producers to avoid federal regulatory jurisdiction and to sell their gas at the higher, unregulated price.

The Federal Energy Regulatory Commission (FERC), formerly known as the Federal Power Commission (FPC),[3] regulates the price of natural gas coming within its jurisdiction; this power to regulate is derived from the Natural Gas Act of 1938.[4] In passing this act, Congress limited the FERC's regulatory jurisdiction to two areas: (1) interstate transportation or sale of natural gas; and (2) companies engaged in such interstate transportation or sale.[5] The act explicitly excludes the "production and gathering" of natural gas from FERC jurisdiction.[6] One method producers have used to bring their sales into the production and gathering exception and avoid FERC jurisdiction is to sell the leases under which the gas is produced rather than the gas itself.

The Supreme Court initially put its stamp of approval upon this practice in *Panhandle Eastern Pipeline Co. v. Federal Power Comm'n*,[7] noting in passing that "of course leases are an essential part of production,"[8] and

1. The Natural Gas Act of 1938, 15 U.S.C. 717(b) (1982).
2. *See infra* notes 36–38.
3. The functions of the FPC were transferred to the FERC under the Department of Energy Organization Act, 42 U.S.C. 7172 (1982). For simplicity, all references to the FPC (except in case names) have been changed to FERC.
4. 15 U.S.C. 717–717(w) (1982).
5. *Id.* at 717(b).
6. The provisions of the Act "shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas." *Id.*
7. 337 U.S. 498 (1949).
8. *Id.* at 505.

thereby bringing leases within the production and gathering exception to FERC jurisdiction. However, in *United Gas Improvement Co. v. Continental Oil Co.*,[9] commonly referred to as *Rayne Field,* the Supreme Court held that a sale of gas leases which is the economic equivalent of a sale of proven and substantially developed reserves of gas is subject to FERC jurisdiction, even though production and gathering have not been completed.[10]

El Paso Natural Gas Co. v. Sun Oil Co.[11] involved the Fifth Circuit's interpretation of *Rayne Field* and in particular the court's interpretation of the phrase "proven and substantially developed" as a test of FERC jurisdiction under the Natural Gas Act. An interstate pipeline company purchased gas leases from independent producers in the San Juan Basin of northwestern New Mexico.[12] For twenty years preceding this litigation, the parties had treated their transactions as within the "production and gathering" exception, and the pipeline's California customers had paid higher rates for their gas. In 1973, the pipeline company sought to bring the lease purchases within FERC's jurisdiction.[13] If successful, the suit would have forced the producers (and their successors) to accept the lower regulated price for the gas produced from the San Juan Basin, and possibly to refund twenty years' worth of excess payments (payments in excess of the regulated rates over those twenty years).[14]

The Fifth Circuit Court of Appeals held the *El Paso* lease sale was within the "production and gathering" exception to FERC jurisdiction.[15] The court interpreted *Rayne Field* to mean that a lease transfer was only within FERC jurisdiction if the leases were "proven and substantially developed" at the time of transfer. The court interpreted that phrase to require the leasehold be sufficiently developed to have the imminent ability to produce in commercial quantities.[16] The *El Paso* court then held that the ratio of gas wells existing at the time of the lease sale to the number of gas wells expected at full development was too low for the court to find the leasehold had the imminent ability to produce in commercial quantities.[17]

9. 381 U.S. 392 (1965).
10. *Id.* at 401–02.
11. 708 F.2d 1011 (5th Cir 1983).
12. El Paso Natural Gas Co., 6 F.E.R.C. P63,037 at 20 and 39–40. [The opinion is available on LEXIS. Because I am unable to obtain a hardcopy of the administrative law judge's opinion, the page numbers given in reference to 6 F.E.R.C. P63,037 are actually LEXIS screen numbers.]
13. El Paso Natural Gas Co. v. Sun Oil Co., 426 F. Supp. 963, 965 (W.D. Tex. 1977).
14. 6 F.E.R.C. P63,037 at pg. 6.
15. 708 F.2d at 1018.
16. *Id.* at 1017, following Continental Oil Co. v. Federal Power Comm'n, normally referred to as Ship Shoal, 370 F.2d 57 (5th Cir. 1966).
17. 708 F.2d at 1017.

FACTUAL BACKGROUND

The El Paso Natural Gas Company (El Paso) is an interstate pipeline company subject to federal jurisdiction under the Natural Gas Act of 1938. In the mid-1940s, El Paso realized that Southern California demand for its natural gas would outstrip El Paso's supply of casinghead gas[18] from the Permian Basin of western Texas and eastern New Mexico.[19] El Paso sought new gas reserves in the San Juan Basin of northwestern New Mexico. The San Juan Basin was particularly attractive to El Paso because of its proximity to the Southern California market and El Paso's existing gas pipeline.[20]

In August 1947, El Paso filed for FERC certification of a gas pipeline from the San Juan Basin to Southern California, and sought to purchase gas reserves from producers in the San Juan.[21] In May 1948, El Paso entered into a gas purchase agreement with Delhi, an independent gas producer with substantial reserves in the San Juan's Barker Dome formation.[22] The purchase contract would become effective only if El Paso received FERC certification for its California pipeline and if Delhi obtained an FERC determination that the contract would not make Delhi a jurisdictional gas producer under the Natural Gas Act.[23] When Delhi was unable to obtain a definite FERC opinion on the jurisdiction question, El Paso and Delhi sought the advice of former FERC general counsel Charles Shannon. Shannon advised that the FERC would not have jurisdiction over the transaction if Delhi sold El Paso the gas lease itself rather than the gas produced under the lease.[24] El Paso and Delhi then re-wrote their agreement into a gas lease agreement (GLA) under which El Paso undertook to produce and develop the gas covered by the leases.

In 1951, El Paso sought additional gas reserves to maintain its market position as the primary gas supplier to the booming California market.[25] El Paso again approached Delhi, which had San Juan Basin reserves large enough to meet El Paso's supply needs. After several months of negotiations, El Paso and Delhi executed GLA-47 in January 1952.[26] GLA-47 set a standard followed by El Paso in obtaining additional gas reserves

18. "Casinghead gas" is gas produced in connection with the production of oil. Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 674 (1954).
19. 6 F.E.R.C. P63,037 at 19.
20. *Id.* at 20.
21. *Id.*
22. *Id.*
23. *Id.* at 21.
24. *Id.* at 27.
25. *Id.* at 38.
26. *Id.* at 39–40.

in the San Juan.[27] In particular, GLA-47 gave Delhi an overriding royalty payment (override)[28] on all gas produced, setting the override payment for the first ten years and providing for redetermination of the override every five years thereafter. If the parties were unable to agree to the redetermined override, arbitrators were to set the price at the fair market value at the wellhead.[29] GLA-47 also contained both favored nations[30] and take-or-pay clauses.[31]

El Paso and Delhi closed GLA-47 in March 1952. Gas from the leasehold began moving through El Paso's interstate pipeline to California that same month.[32] El Paso acquired an additional thirty-five GLAs from other gas producers in the San Juan, on terms substantially identical to GLA-47.[33] Thirty-five of the thirty-six GLAs acquired by El Paso after 1951 were at issue in this case.[34]

GLA-61 called for redetermination of the override in 1973. El Paso and Sun Oil Company (Sun), the holder of GLA-61, could not agree on the override amount, and they submitted the issue to arbitration per the terms of the contract.[35] The arbitrators awarded Sun an override of \$.40 per Mcf.[36] This rate was below the \$.55–.60 per Mcf rate for wholly intrastate gas[37] and substantially above the regulated interstate rate of \$.24 per Mcf.[38] El Paso's other GLA holders then sought to have their overrides raised to \$.40 per Mcf under the favored nations clauses in their GLAs.[39]

El Paso brought four declaratory actions in the U.S. District Court for the District of Columbia to bring the San Juan area GLAs under the FERC's jurisdiction.[40] If successful, the actions would have forced the GLA holders to obtain FERC approval of override payments in excess

27. *Id.* at 38.

28. An "overriding royalty" is a payment to a third person from the lessee's working interest, free and clear of any expense incident to production and sale of oil or gas produced from the leasehold. DeMik v. Cargill, 485 P.2d 229, 232 (Okla. 1971).

29. 6 F.E.R.C. P63,037 at 41.

30. *Id.* at 41. A "favored nations" clause gives the producer the right to be paid at the highest rate being paid by the purchaser to any other producer in the same field. Texas Gas Transmission Co. v. Shell Oil Co., 363 U.S. 263, 274 (1960).

31. 6 F.E.R.C. P63,037 at 30 n. 40. Under a "take-or-pay" clause, the lessee must pay for a specified minimum volume of gas whether that volume is actually produced or not. *Id.*

32. *Id.* at 44.

33. *Id.* at 45.

34. While 35 of the 36 GLAs were involved in the F.E.R.C. hearing, only 14 GLAs and one PLA (Pacific Lease Agreement, an agreement with Northwest Pipeline Corporation) were involved in the earlier Midland district court decision. See 6 F.E.R.C. P63,037 at 45–46; Brief of appellee at 9, n. 29.

35. El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011, 1014 (5th Cir. 1983).

36. Mcf is an abbreviation for thousand cubic feet. Webster's Third International Dictionary 1397 (1976).

37. Brief of appellees at 18, El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

38. Brief of appellant at 4, n. 4, El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

39. 426 F. Supp. 963, 968 (W.D. Tex. 1977).

40. *Id.* at 965.

of the regulated interstate rate, and possibly to refund part of the payments made under the GLAs to gas consumers in California and the Pacific Northwest.[41]

The cases were consolidated and moved to the Federal District Court for the Western District of Texas at Midland.[42] In June 1974, El Paso filed a complaint with the FERC to begin show-cause proceedings against the GLA holders on the jurisdiction issue. On the same day El Paso moved the Midland court to stay the proceedings pending the FERC's determination on its jurisdiction.[43] Instead, the FERC stayed its proceedings and the district court went forward with the trial.[44] The district court ruled the GLA sales were not *Rayne Field* equivalents to gas sales and that the FERC lacked jurisdiction over the GLA transactions.[45]

In June 1977, the FERC began a show cause proceeding on the jurisdiction question, stating it was not bound by the Midland court's jurisdictional determination.[46] FERC found the GLA transactions equivalent to gas purchases in interstate commerce.[47] Appeals from both the Midland district court and the FERC were consolidated before the Fifth Circuit Court of Appeals. The Fifth Circuit court determined the lease sales were not jurisdictional sales because the leases were not substantially developed at the time of the sale. The Fifth Circuit's opinion is important because the court interpreted the Supreme Court's *Rayne Field* decision in a manner which broadened the "production and gathering" exception to the FERC's jurisdiction. In addition, the record on which the Fifth Circuit reached this decision merits examination when trying to determine what is and what is not within the "production and gathering" exception to the FERC's jurisdiction.

LEGAL BACKGROUND

The earliest Supreme Court decision dealing with FERC jurisdiction over hybrid[48] gas transactions was *Federal Power Comm'n v. Panhandle*

41. 6 F.E.R.C. P63,037 at 6.

42. The transfer was made under the cure of venue defects provisions of 28 U.S.C. 1406(a) (1982). 708 F.2d at 1014.

43. F.P.C. Docket No. 74-314. Brief of Appellant at pg. 5.

44. This case of apparent "reverse primary jurisdiction" arose because the FPC did not want to burden the litigants with dual proceedings. Amicus brief of F.E.R.C. at 10b, El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

45. El Paso Natural Gas Co. v. Sun Oil Co., 426 F. Supp. 963 (W.D. Tex. 1977).

46. Order Instituting Show Cause Proceeding, Ordering Filing of Evidence and Ordering Hearing, El Paso Natural Gas Co., et al., Docket Nos. CP74-314 et al., 58 F.P.C. 2181 (1977). *See* Amicus Brief of the F.E.R.C. at pg. 6, El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

47. El Paso Natural Gas Co., 12 F.E.R.C. P61,297 (1980).

48. "Hybrid" refers to transactions which manifest characteristics of both a normal wellhead sale of gas and of lease transfers. El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d at 1016. FERC has jurisdiction over wellhead sales of gas but its jurisdiction does not extend to cover a normal landowner's lease or its royalty payments. Mobil Oil Co. v. Federal Power Comm'n, 463 F.2d 256 (D.C. Cir. 1972).

Eastern Pipeline Co.[49] Panhandle was an interstate pipeline company which successfully avoided FERC jurisdiction over a sale of its gas reserves. Panhandle formed a subsidiary corporation (Hugoton) and transferred gas leases to Hugoton for all of Hugoton's stock.[50] Hugoton then sold the gas from the leases to Kansas Power and Light. Because the leases covered 97,000 acres entirely within Kansas, and because Hugoton was not a jurisdictional gas company,[51] the deal was entirely intrastate and supposedly outside of FERC jurisdiction.[52]

The Supreme Court agreed with Panhandle. The Court interpreted the Natural Gas Act as supplementary to, and not preemptive of, state regulation of intrastate natural gas.[53] The Court found the FERC lacked jurisdiction over the Panhandle–Hugoton–Kansas Power and Light transaction because the transaction was within the production and gathering exception to the Natural Gas Act. The Court noted that "of course, leases are an essential part of production."[54]

Subsequently, in *Phillips Petroleum Co. v. Wisconsin*[55] (*Phillips* I), the Supreme Court held FERC had jurisdiction to regulate the price at which independent producers sold gas to interstate pipelines for transportation or resale in interstate commerce. Prior to *Phillips* I, the FERC had placed sales by independent producers within the production and gathering exception.[56] The Court expressly rejected the contention that the "production and gathering" exception referred to the business of producing and gathering gas, with a sale an integral part of the business.[57] The Court interpreted the FERC's jurisdiction under the Natural Gas Act to fill the gap in regulation of gas companies caused by court decisions striking down state attempts to regulate interstate transfers of gas.[58] In his concurring opinion, Justice Frankfurter suggested reading into the act that its purpose is to occupy the field where the states cannot constitutionally act.[59] Under *Phillips* I, the FERC's jurisdiction begins where the states' power to regulate ends, and thus any transaction within the "production and gathering" exception should be subject to state regulation.

In *United Gas Improvement Co. v. Continental Oil Co.*,[60] commonly known as the *"Rayne Field"* decision, the essential question was whether

49. 337 U.S. 498 (1949).
50. *Id.* at 500.
51. A jurisdictional company is one subject to the FERC's regulatory jurisdiction under the Natural Gas Act of 1938.
52. 337 U.S. 498, 500 (1949).
53. *Id.* at 502–03.
54. *Id.* at 505.
55. 347 U.S. 672, 677 (1954).
56. *Id.* at 677.
57. *Id.* at 681.
58. *Id.* at 683.
59. *Id.* at 686.
60. 381 U.S. 392 (1965).

Phillips I should be extended to sales of leases covering proven and substantially developed gas reserves to a jurisdictional gas company. The Court found such a lease sale was the economic equivalent of a gas sale jurisdictional under *Phillips* I and held the lease sale was subject to FERC jurisdiction.[61]

In 1957, Texas Eastern, a jurisdictional interstate pipeline company, executed[62] gas purchase contracts with Continental Oil Company and other producers (Continental) to buy gas produced from the Rayne Field in Louisiana. When the Third Circuit Court of Appeals' "Catco" decision[63] appeared to require Texas Eastern to prove that the proposed sale price for its gas was justified by the public's convenience and necessity,[64] Continental withdrew its FERC application to sell Rayne Field gas to Texas Eastern. The parties then reformulated the gas sale into a lease sale to avoid FERC jurisdiction.[65]

At the time of the lease sale, the Rayne Field was well developed.[66] Nineteen wells had been drilled, and seven more were to be drilled.[67] Although estimates of available reserves were possible,[68] the average cost per Mcf of gas could not be accurately determined because the total volume of gas which the lease sale transferred was unknown at the time of sale.[69] Writing for the majority, Justice Harlan noted that federal regulatory statutes were not limited by the meaning which local or common law ascribed to the statute's terminology. Terms in such statutes were to be defined according to the purpose of the Act and the facts involved in the economic relationship at issue.[70] Thus a sale of a lease under state law might still be a sale of natural gas under the Natural Gas Act. Harlan noted that the lease sale was "in most respects, equivalent to conventional sales of natural gas" which "unquestionably" would be subject to the FERC's jurisdiction under *Phillips* I.[71] Moreover, Harlan pointed to the cancelled gas sale contract between the parties, noting that the lease sale

61. *Id.* at 401.

62. The contracts were actually executed by Louisiana Gas Corporation, a Delaware Corporation formed by Texas Eastern to limit its liability in the transaction. *See* "Answering Brief on behalf of intervenors El Paso Natural Gas Company, et al." app. B at 6a, Tenneco Oil Co. v. Federal Energy Regulatory Comm'n *decided with* El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011 (5th Cir. 1983).

63. Public Service Comm'n v. Federal Power Comm'n, 257 F.2d 717 (3rd Cir.) *aff'd sub nom*, Atlantic Refining Co. v. Public Service Comm'n, 360 U.S. 378 (1959).

64. The "public's convenience and necessity" is the standard used in issuing certificates to construct pipelines where FERC has jurisdiction. 15 U.S.C. 717(f) (1982).

65. 381 U.S. 392, 395–96 (1965).

66. *Id.* at 396.

67. 381 U.S. at 396, n.3.

68. Answering Brief of Intervenors El Paso Natural Gas Company, et al., Tenneco Oil Co. v. Federal Energy Regulatory Comm'n, app. A, pg. 7a, citing Opinion 378, 29 F.P.C. 249, 254.

69. Public Service Comm'n v. Federal Power Comm'n, 543 F.2d 757, 783 (D.C. Cir. 1974).

70. 381 U.S. 395, 400 (1965).

71. *Id.* at 401.

was only a change of methods and not of objectives.[72] It was "perfectly clear" that the lease sale "accomplished the transfer of large amounts of natural gas to an interstate pipeline company for resale in other states. That is the significant and determinative economic fact."[73]

Having found the lease sale otherwise jurisdictional, Harlan then examined whether the lease sale came under the "production and gathering" exception of section 1(c) of the Natural Gas Act. He first disposed of the timing question, holding that a sale of gas still in the ground could be a jurisdictional sale of gas under *Phillips I*.[74] The intent of the Natural Gas Act was to protect consumers against exploitive natural gas companies by giving the FERC jurisdiction over all wholesale transfers of gas in interstate commerce.[75] Given this analysis, Harlan logically concluded that the Rayne Field lease sale was not within the production and gathering exception. Production and gathering extended only to physical activities, processes and facilities used in the production and gathering of gas.[76] Harlan suggested that the "production and gathering" exception covered those areas subject to state regulatory power.[77]

Harlan then distinguished *Panhandle* on grounds that the leasehold transferred in *Panhandle* was undeveloped. In contrast, the Rayne Field was substantially developed, with gas from Rayne Field flowing into Texas Eastern's interstate pipeline immediately upon its connection to the field.[78] "The substantiality of development is a relevant consideration, for the more that must be done before the gas begins its interstate journey, the less the transaction resembles the conventional wellhead sale of natural gas in interstate commerce which, as *Phillips* held, the Act affirmatively placed within Commission jurisdiction."[79] Finally, Harlan limited the Court's statement in *Panhandle* that "of course leases are an essential part of production" to the particular facts in *Panhandle*, holding that the statement "should not be considered as embracing each and every transfer that can be put in lease form."[80]

Following *Rayne Field*, the transfer of proven and substantially developed reserves to an interstate gas company for sale in interstate commerce was a transfer subject to FERC jurisdiction under the Natural Gas Act. What was unknown were the parameters of "proven and substantially developed." The leases in *Panhandle Eastern* were undeveloped and

72. *Id.*
73. *Id.*
74. *Id.* at 402.
75. *Id.*
76. *Id.*
77. *Id.* at 403.
78. *Id.*
79. *Id.*
80. *Id.* at 404.

hence within the "production and gathering" exception.[81] The leases in *Rayne Field* were proven and substantially developed, hence equivalent to a *Phillips* I wellhead sale.[82] The Fifth Circuit Court of Appeals articualted a test for when reserves are "proven and substantially developed" in *Continental Oil Co. v. Federal Power Comm'n*,[83] commonly known as the *Ship Shoal* decision.

Ship Shoal is an area off the coast of Louisiana covered by lease interests held by the four Catco companies (Catco). Catco had developed the leasehold to the extent of 17 wells,[84] seven completed[85] as oil wells and only one as a gas well.[86] Drilling on five other gas wells had commenced, but completion had been deferred.[87] In the one completed gas well there were two completions, with gas being found in 46 reservoirs in 39 distinct sand zones.[88] In addition, five sand reservoirs producing oil were also producing gas.[89] The completed gas well had been shut-in and no gas had actually been produced at the time of sale.[90]

In 1960, Catco and Tennessee Gas Supply Company (Tennessee), a jurisdictional interstate pipeline company, entered into a gas lease sale covering Catco's interest in the Ship Shoal area. The parties chose the gas lease sale method because it produced the greatest cash flow for Catco.[91] When Tennessee sought FERC approval for a pipeline to the Ship Shoal area, the FERC sought to bring the lease sale arrangement within its jurisdiction.[92]

On appeal from the FERC's finding of jurisdiction over the lease sale, the Fifth Circuit Court summarized Rayne Field into a three part test:

1. Is the economic effect of the transfer similar to that of a conventional wellhead sale?
2. Is the subject of the transaction "proven and substantially developed" reserves?

81. 337 U.S. 498, 504–05 (1949).

82. 381 U.S. 392, 401 (1965).

83. 370 F.2d 57 (5th Cir. 1966).

84. Brief for Intervenors El Paso Natural Gas Co. et al. in Tenneco Oil Co. v. Federal Energy Regulatory Comm'n stated that the FPC hearing examiner found only twelve wells had been drilled. The brief suggested the error was either a typographical error (7 for 2) or the Court erroneously included the five deferred wells with the twelve actually drilled wells. App. A, at 15a, n.2.

85. The "completion" of a well is the process of inserting casings into the well to protect it from water, earth and sand, and to protect fresh water zones from fluids used and produced in the drilling process. The method used varies with the type of reservoir and formation. For technical discussion, see ENERGY TECHNOLOGY HANDBOOK 3-129 to 133 (D. Consadine ed. 1977).

86.

86. 370 F.2d 57, 59 (5th Cir. 1967).

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 59.

91. *Id.* at 60.

92. *Id.* at 59.

3. Is the transfer for the purpose of interstate transmission and resale?[93]

The court then interpreted "proven and substantially developed" to mean: has the leasehold been sufficiently developed and proven for imminent production of gas in commercial quantities?[94]

The court applied this rewritten test to the *Rayne Field* leases. The court found they passed easily: 19 of 26 wells had been completed at the time of sale, gas began flowing into an interstate pipeline immediately upon connection with the field, and the FERC considered the field "fully developed."[95] Then the court applied the test to the *Ship Shoal* leases. The court found the Ship Shoal field had reached the stage of proof and development necessary to be jurisdictional under Rayne Field.[96] The court listed five factors in reaching its decision:

1. The reserves were sufficiently proven as shown by the faith Tennessee put in its expert estimates of the field. Tennessee invested $97 million on its faith in estimates of the recoverable reserves.[97] Further, Tennessee's readiness to connect its pipeline was a strong indication that Ship Shoal was "substantially developed" at the time of the lease sale.[98]
2. Tennessee relied heavily on the Ship Shoal reserves in making its FERC pipeline application and the FERC normally granted pipeline applications only if gas would begin moving through the line within one year of certification.[99] The adequacy of the Ship Shoal reserves was essential to support Tennessee's application.[100]
3. Ship Shoal had the imminent ability to produce gas in commercial quantities because gas from the one completed well could have been drawn up and produced immediately. Moreover, evidence showed that ten percent of Ship Shoal's reserves could be recovered within four years of the commencement of production.[101]
4. While between thirty-five and forty wells would be necessary to fully develop the leasehold, the number of wells necessary to fully develop was irrelevant to the field's imminent ability to produce.[102] The court's focus appeared to be on whether the field could currently produce gas and not on whether the field was close to full development.[103]

93. *Id.* at 62. The court did not indicate how a court should weigh these factors. *See infra* n.109 and accompanying text.

94. *Id.* at 63–64.

95. *Id.* at 64.

96. *Id.* at 65.

97. *Id.* at 64–65.

98. *Id.* at 65.

99. *Id.*

100. *Id.*

101. *Id.* at 66.

102. *Id.*

103. Compare with the El Paso court's discussion on this issue, 708 F.2d 1011, 1018–19 (5th Cir. 1983).

5. Finally, the substantial economic and "crucial" fact was that the lease sale accomplished the transfer of large quantities of proven reserves of gas to an interstate pipeline company for eventual resale in interstate commerce.[104]

THE COURT'S DECISION

In the *El Paso* decision, the Fifth Circuit saw the Natural Gas Act's limitations on FERC jurisdiction as expressing congressional intent to leave intrastate transactions and production and gathering to state regulation.[105] The court determined that all three parts of the *Ship Shoal* interpretation of *Rayne Field* should be weighed equally.[106] Thus the court found that the administrative law judge and the FERC had misapplied *Rayne Field* by making the "economic effect" criterium, the first part of the *Ship Shoal* test, the determining factor in the jurisdictional analysis.[107]

The court noted that, carried to its logical extreme, the FERC's position would make all transfers of leasehold interests to interstate pipeline companies subject to FERC jurisdiction.[108] "While the Commission's downplaying of the development issue may well foreshadow the next stage in the evolution of the law, for the time being our precedents demand full application of all components of the *Rayne Field* test . . ."[109]

The Court felt the San Juan Basin reserves were proven within the meaning of *Rayne Field*. However, the court found the Basin not substantially developed because of the lack of the imminent ability to produce in commercial quantities, the second criterium in the *Ship Shoal* analysis.[110] The important factors in the court's decision were the limited development of the San Juan Basin at the time of the lease sale, and the "massive efforts" needed to make the Basin commercially productive.[111] Most importantly, the court equated "commercially productive" with the extent to which the Basin had reached *full* development.[112] "Since substantial development turns on whether the acreage is capable of imminent production . . . in commercial quantities . . . it stands to reason that the actual number of wells in comparison to the number needed to complete production . . . is a relevant factor."[113] Using GLA-47 as an example, the court noted that only 26 of 960 wells allowed by state siting laws

104. *Id.*
105. 708 F.2d at 1016.
106. *Id.* at 1017–18.
107. *Id.* at 1018.
108. *Id.* at 1019.
109. *Id.* at 1018.
110. *Id.*
111. *Id.* at 1018–19.
112. *Id.* Contrast with the Court's analysis in *Ship Shoal,* 370 F.2d 57, 65 (5th Cir. 1966). *See infra* nn. 102–03 and accompanying text.
113. 708 F.2d at 1019.

existed at the time of the lease sale.[114] While the court noted that "a few" GLAs showed substantial development, both parties had approached the jurisdiction question on a fieldwide basis rather than an individual lease basis.[115] The fact that El Paso could have tied a few wells into its system shortly after the lease sale did not demonstrate the imminent ability to produce in commercial quantities.[116] Finally, the court noted that the few wells in the ground at the time of the lease sales could not have depleted the formation.[117]

ANALYSIS OF THE COURT'S DECISION

Following the *El Paso* decision, the FERC's jurisdiction over hybrid gas transactions in the Fifth Circuit can be summarized as follows: The FERC has jurisdiction over the sale of leases to an interstate pipeline company where that sale accomplishes the transfer of proven and substantially developed reserves for transportation or sale in interstate commerce.[118] To determine if a lease sale is within FERC jurisdiction, courts should examine three factors, giving all equal weight: (1) Is the economic effect of the transfer similar to that of a conventional wellhead sale? (2) Do the leases cover proven and substantially developed reserves? (3) Is the transfer for the purpose of interstate transportation or sale?[119] In determining the answer to the second factor, courts must examine whether the transferred leasehold has been sufficiently developed and proven for imminent production of gas in commercial quantities to take place.[120] In determining whether the leasehold is capable of production in commercial quantities, courts should examine the ratio of wells drilled at the time of transfer to the number needed to fully develop the leasehold.[121]

The *El Paso* court presumed that all three factors in its three-part *Rayne Field* test should be given equal weight, and the court castigated the FERC for raising the economic effect factor above the other two factors.[122] Yet both the *Rayne Field* and *Ship Shoal* opinions appear to give greater weight to the effect of the transfer than to the substantiality of the development of the leases being transferred. By allowing the amount of

114. *Id.* at 1018. The 960 was computed as follows: 102,400 acres in GLA-47. One well drilling the Mesa Verde formation allowed per 320 acres = 320 allowable wells + One Pictured Cliffs formation well allowed per 160 acres = 640 allowable wells, total of 960. *Id.*

115. *Id.* at 1018–19.

116. *Id.* at 1019.

117. *Id.*

118. United Gas Improvement Co. v. Continental Oil Co. (Rayne Field), 381 U.S. 392 (1965).

119. Continental Oil Co. v. Federal Power Comm'n (Ship Shoal), 370 F.2d 57, 62 (5th Cir. 1966).

120. *Id.* at 63–64.

121. El Paso Natural Gas Co. v. Sun Oil Co., 708 F.2d 1011, 1018 (5th Cir. 1983).

122. *Id.*

development at the time of the lease transfer to negate FERC jurisdiction over the transfer, the *El Paso* court has in effect adopted a "timing of the transaction" test explicitly rejected in *Rayne Field*.[123] The *Rayne Field* court held that "even though a sale of natural gas in interstate commerce occurs before production or gathering is ended, it is nonetheless subject to regulation."[124] The *El Paso* court held that the FERC lacks jurisdiction over a transfer of leases unless the substantiality of development at the time of transfer approaches that in *Rayne Field*. The message to producers wanting to avoid FERC regulation is to schedule the lease sale early in the development of the gas field.

The most striking thing about the *El Paso* decision is the absence of the *Ship Shoal* opinion. While the court dutifully cited to *Ship Shoal*, and used the test set out in that opinion, the court ignored the factual basis on which that opinion was based. The court found the San Juan Basin leases were within the production and gathering exception by comparing their development to the development of the Rayne Field leases. It was *Ship Shoal* which interpreted the meaning of the term "proven and substantially developed," yet the Ship Shoal leases would fail the *El Paso* court's substantiality of development test. The court found the San Juan Basin leases at issue in *El Paso* were within the production and gathering exception by comparing their development to the 73 percent development[125] of the Rayne Field leases. The leasehold covered by GLA-47, the lease specifically mentioned by the *El Paso* court, was 2.8 percent developed at the time of sale.[126] The Ship Shoal leasehold was only 2.5 percent to 2.9 percent developed at the time of sale.[127]

The *El Paso* court's reliance on the wells-drilled ratio is at odds with *Ship Shoal*'s handling of the "imminent ability to produce in commercial quantities" question. The court in *Ship Shoal* found the leasehold sufficiently developed with only one producing well because gas from the two completions in that well could have been drawn up and immediately produced. The *El Paso* and *Ship Shoal* courts disagree on the relevance of how close the leasehold is to full development in determining whether

123. 381 U.S. at 402.

124. *Id.*

125. Calculated as 19 wells at the time of transfer with full development at 26 wells. 381 U.S. 392, 396, n. 3 (1965).

126. Computed as follows: 102,400 acres in the leasehold. One Mesa Verde formation well allowed per 320 acres, or 320 Mesa Verde wells allowed in GLA-47 (320 squared = 102,400). One Pictured Cliffs formation well allowed per 160 acres, or 640 Pictured Cliffs wells allowed, total of 960 wells allowed. There were 27 wells at the time of sale, or 2.8% of total development. 708 F.2d 1011, 1018 (5th Cir. 1983).

127. Comuted as one well at the time of sale with 34 to 40 necessary to determine the volume of the gas field. I presume here that the number of wells necessary to accurately determine the field's volume is "full development," though it seems more than that would be drilled. 370 F.2d 57, 66 (5th Cir. 1966).

the leasehold has the imminent ability to produce in commercial quantities. The *Ship Shoal* court stated that:

> It may well be that Ship Shoal is a 'long way' from being fully developed. Catco anticipated that from 34 to 40 additional completions would be necessary to calculate the final consideration in the seventh year redetermination of reserves. But this problem relates more to determination of final consideration than to imminent ability for production.[128]

The *El Paso* court stated: "Since substantial development turns on whether the acreage is capable of imminent production of natural gas in commercial quantities . . . (citing *Ship Shoal*) it stands to reason that the actual number of wells in comparison to the number needed to complete production from the land is a relevant factor."[129]

The *El Paso* decision opens a vast exception to federal regulation of natural gas prices under the Natural Gas Act. The opinion sets up a situation in which neither state nor federal government can regulate the price at which an interstate pipeline company purchases proven reserves of gas for the express purpose of transporting and selling the gas in other states.[130]

It seems much more logical to define the limits of the "production and gathering" exception in terms of commerce clause and federalism rather than in terms of the number of wells drilled at the time of sale.[131] FERC's jurisdiction under the Natural Gas Act ought to be defined to reach wher-

128. *Id.* at 66.

129. 708 F.2d at 1019.

130. The State of New Mexico lacks the power to regulate the price at which a Texas-based, interstate pipeline company sells New Mexico gas to its California customers. A state's power to regulate the sale price of gas is limited to direct sales to the ultimate consumers in the state. Panhandle Eastern Pipeline Co. v. Public Service Comm'n, 332 U.S. 507, 514–515 (1947). Likewise, the state of California lacks the power to regulate the price at which El Paso acquires the gas it sells to its California customers. Under the Hinshaw Amendment, 15 U.S.C. 717(c) (1982), California may regulate the California distributors of El Paso gas. Michigan Gas Storage Co. v. Michigan Pub. Service Comm'n, 72 Mich. App. 384, 249 N.W.2d 422 (1976) rev'd on other grounds 405 Mich. 376, 275 N.W.2d 457 (1979). However, California cannot regulate the price at which an interstate pipeline sells its gas to a state distributor. Panhandle Eastern Pipeline Co. v. Public Service Comm'n, 332 U.S. 507, 515 (1947). In the *El Paso* situation, neither state can regulate the lease sale: No gas is sold to New Mexico consumers yet California cannot reach out to New Mexico to regulate the lease sale prices.

131. In *Rayne Field,* Justice Harlan explained that the Court's construction of the 'production and gathering' exception "in no way" interfered with "state regulatory power over the physical processes of production or gathering in furtherance of conservation or other legitimate state concerns." 381 U.S. 392, 402–03 (1965). Similarly in *Phillips* I, Justice Minton noted that a great part of the "gap" which the Natural Gas Act was intended to fill was created by cases holding that "the regulation of wholesale rates of gas and electrical energy moving in interstate commerce is beyond the constitutional powers of the States." 347 U.S. 672, 683 (1954), citing Interstate Natural Gas Co. v. Federal Power Comm'n, 331 U.S. 682, 689 (1947). See also Federal Power Comm'n v. Panhandle Eastern Pipeline Co., 337 U.S. 498, 503 (1949).

ever the states's regulatory jurisdiction cannot. Such an interpretation of FERC jurisdiction would further the purpose of the Natural Gas Act: To protect consumers from exploitation by natural gas suppliers by regulating the price at which large quantities of gas are transported and sold in interstate commerce.[132]

DALE EPPLER

132. 381 U.S. 392, 402 (1965).