El Paso
Natural Gas Company

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CHARLES R. JACK, VICE PRESIDENT

BEFORE THE
OIL CONSERVATION COMMISSION
Santa Fe, New Mexico
Case No. 9015 Exhibit No. 2
Submitted by Hartman
Hearing Date March 5, 1987

May 29, 1986

NOTICE TO SELLERS

This Notice is intended to advise you of certain recent developments affecting El Paso Natural Gas Company ("El Paso") and of the resulting effects on El Paso's relationships with those from whom it purchases gas.

I.

As a federally-regulated interstate natural gas pipeline company, El Paso has a legal duty to provide service to its customers at the lowest reasonable rate consistent with maintenance of adequate service. This duty, as declared by the Federal Energy Regulatory Commission ("FERC") and the federal courts, encompasses a continuing obligation to minimize all costs, including the cost of purchased gas, in a reasonable and prudent manner and with due regard for the marketability of the gas being purchased. El Paso's gas purchase agreements are specifically subject to applicable federal laws, orders and regulations.

During the month of May, 1986, in the discharge of its federally-imposed obligations, El Paso has scheduled its takes from the lowest-cost "swing" pools, after taking gas from all "nonswing" sources. As used throughout this Notice, the terms "nonswing gas" and "nonswing sources" include: (1) hardship or emergency gas; (2) casinghead or associated gas; (3) residue gas; (4) certain downhole commingled gas;

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(5) gas received at central points of delivery and which includes casinghead or hardship gas; and (6) gas taken pursuant to certain contractual minimum physical take provisions. The term "swing gas," as used in this Notice, refers to all gas other than "nonswing gas."

You are hereby notified that, in continuing discharge of its duties under federal law, commencing June 1, 1986, and thereafter until further notice, El Paso will extend least-cost scheduling to nonswing sources. El Paso will rank each source of supply by its weighted average cost of gas ("WACOG") and, subject to operational and facility constraints, will schedule gas sequentially from lower-cost to higher-cost sources, including both swing and nonswing sources, to satisfy the demand for gas from El Paso's system supply.

For June, 1986, El Paso believes that sales volumes above 950 BBtu/day cannot be forecast reliably as a basis for production scheduling on a least-cost basis. Given this market, El Paso does not expect to take gas from any source for which the WACOG exceeds $1.50 per MMBtu, inclusive of taxes. As a result, significant volumes of nonswing gas would not be purchased by El Paso under its existing contracts during June because of least-cost scheduling.

El Paso does not desire to precipitate the hardships which might otherwise result from shutting-in these sources. Therefore, during June, 1986, and thereafter until further notice, El Paso will accept without interruption (subject to sufficient market demand) your tender and delivery of such nonswing gas at existing receipt points. Where nonswing Natural Gas Act ("NGA") gas is sold to El Paso under a FERC rate schedule, El Paso will pay the applicable filed rate. Nonswing Natural Gas Policy Act ("NGPA") gas will be taken only at a price which fits within least-cost scheduling. Therefore, the amount El Paso will pay for nonswing NGPA gas in June, 1986, will be $1.50 per MMBtu, inclusive of taxes. The same operating terms and conditions set forth in the pertinent gas purchase agreement will be utilized by El Paso in connection with these purchases.

The price which El Paso can pay for nonswing NGPA gas during periods subsequent to June, 1986 may be higher or lower, depending on changes in market conditions. El Paso will notify its sellers of such gas of any changes prior to the beginning of the applicable month. An affected seller may choose to shut-in its gas rather than sell at the above-described price. In offering to take nonswing NGPA gas at a price which fits least-cost scheduling, El Paso is accommodating both its federal duties and the policies underlying state conservation laws. El Paso does not, however, concede a contractual or statutory duty underlying this offer.

El Paso will not accept gas except in accordance with the production schedule developed to match least-cost sources with available markets. Gas delivered to El Paso in disregard of El Paso's production schedule will be deemed to have been delivered at a sales price equal to the FERC minimum rate of 32.1 cents per MMBtu, inclusive of taxes.

El Paso notes that the production scheduling practices set forth herein will be applicable during June, 1986, and may continue beyond that date. Further changes may be dictated by future events, however. In particular, pending regulatory proceedings may profoundly affect El Paso and all its sellers, and may dictate further revisions in El Paso's production scheduling practices.

II.

Heretofore, by notices dated September 27, 1985 and February 28, 1986, copies of which are appended hereto and made a part hereof for all purposes, El Paso has described certain causes not reasonably within its control which cumulatively threaten El Paso's continuing ability to perform its obligations under many of its gas purchase contracts.

El Paso must now give notice that, since its last notice of February 28, 1986, there have been further events, occurrences, and governmental and court orders, none of which are or have been reasonably within the control of El Paso, and which, singly and collectively, and operating together with the events, occurrences and governmental orders previously described by El Paso in the attached Notices, constitute events of <u>force majeure</u> under El Paso's gas purchase agreements and excuse El Paso from performing its take obligations under certain of its gas purchase agreements. El Paso also hereby notifies you that its performance under the terms of many of its gas purchase agreements has been rendered commercially impracticable within the meaning of applicable state statutes, and under the common law doctrines of impossibility of performance and frustration of purpose. Among these recent events, occurrences and orders are the following:

-- The decision in Office of Consumers' Counsel v. FERC, No. 84-1099 (D.C.C.A.) (referred to on p. 8 of El Paso's February 28th notice) has become final. The parties to that case have announced that rehearing or Supreme Court review will not be sought.

-- El Paso's gas markets are under intense pressure as a consequence of the recent, drastic reduction in prices for residual fuel oil. The price of gas over El Paso's system must be competitive with the prices of alternate fuels available to utility and industrial markets if these markets are to be retained.

-- Beginning in April, 1986, El Paso's second largest customer, Pacific Gas and Electric Company ("PGandE"), reduced purchases from El Paso by 80 million Mcf per day, with PGandE then buying these volumes from its wholly-owned affiliate, Pacific Gas Transmission Company and its Canadian suppliers at spot prices.

-- On March 19, 1986, the Public Utilities Commission of the State of California ("CPUC") in Decision 86-03-057 announced a new and fundamentally altered regulatory framework for the California gas utilities which comprise approximately 80% of El Paso's total market. The CPUC also proposed for comment a number of regulatory changes which, if adopted, will significantly alter the manner in which natural gas is marketed in the State of California.

-- Transwestern Pipeline Company made filings with the FERC which not only produced a decrease in Transwestern's commodity sales rate in California from $2.87 per dekatherm to $2.51 per dekatherm, effective April 1, 1986, but which also sought authorization from the FERC to permit Transwestern to adjust its rates, at its discretion, by giving only a one-day notice. Transwestern may use this authority to further reduce the purchased gas component of its California sales rate, upon one-day prior notice, to permit it to gain competitive advantage over other suppliers, including El Paso. By orders issued March 28 and 31, 1986, FERC gave the requested authorizations and approvals to be effective April 1, 1986.

-- The FERC has refused to grant El Paso's request for immediate authorization to discount selectively its sales rates to meet price competition from fuel oil and other gas supplies. El Paso is seeking a rehearing, but the FERC has not yet acted on this request.

-- The restructuring of El Paso's markets and operations dictated by recent FERC Order Nos. 380 and 436 _et seq._, and the proposed rules advanced by the Department of Energy in FERC Docket No. RM86-3 (ceiling prices; old gas pricing structure and block billing) have continued to create market uncertainty and market loss. Order Nos. 380 _et seq._, were affirmed on appeal by the United States Court of Appeals for the District of Columbia Circuit and petitions for writ of certiorari were recently denied by the Supreme Court of the United States. Order Nos. 436 _et seq._, are now on appeal in the United States Court of Appeals for the District of Columbia. The impact and legality of this latter series of orders will not be finally determined for an indefinite period into the future.

-- Warmer than normal winter and spring temperatures in El Paso's market area, together with higher than normal precipitation (giving rise to availability of abundant supplies of very low-cost hydroelectric power) and the start-up of new nuclear-power facilities, have greatly diminished total gas demand in El Paso's principal markets. The portion of such lost market demand occasioned by the start-up of nuclear-power facilities is permanent.

These events, occurrences and orders have had a significant, adverse impact on El Paso's ability to market the gas committed to it under gas purchase agreements. During January through April, 1986, El Paso sales averaged only 1.5 Bcf/day. By comparison, El Paso's sales in 1985 were approximately 2.45 Bcf/day. Gas available to El Paso for purchase under existing gas purchase agreements during 1986 is approximately 3.5 Bcf/day.

El Paso has continued to exercise due diligence in its efforts to overcome the consequences of these adverse events. Among other things, El Paso has:

-- On April 1, 1986, extended its Spot Market Release Gas Program to sellers in the San Juan Basin in order to provide them alternate market opportunities using El Paso as an open access transporter. This program is now available to all sellers of NGPA gas to El Paso.

-- On May 9, 1986, filed an application with the FERC to secure appropriate blanket abandonment and certificate authorizations so that sellers of all vintages of gas might have access to the natural gas spot market through El Paso's open access transportation system.

-- Participated in every FERC and CPUC proceeding affecting, or potentially affecting, El Paso's market and operation to seek modifications or rejection of regulatory changes which preclude El Paso from performing under its gas purchase agreements.

-- On February 28, 1986, filed a PGA reduction of 38.74¢ per MMBtu.

-- Filed an Offer of Settlement in Docket No. RP86-45 to seek FERC approval of El Paso's open access tariff and rates.

El Paso pledges its continuing efforts to pursue every reasonable opportunity to protect and expand the market which it has traditionally provided for sellers to the El Paso system, and to remedy the <u>force majeure</u> events herein noticed with all reasonable dispatch. Every effort will be made to provide alternate market opportunities for all sellers during this period of time when El Paso is excused from performance of take obligations in certain of its gas purchase agreements. In particular, any seller desiring to obtain a release from its commitment to

El Paso, whether permanent or temporary, total or partial, will be granted expeditious consideration.

III.

This Notice shall further serve to notify those sellers whose contracts with El Paso (1) cover any nonswing gas supplies (as defined herein) and (2) contain an Alternate Price or "market-out" clause exercisable at this time, that El Paso, acting in good faith and in accordance with prudent business practices, has determined that its gas supply and market demand environment indicates a downward change in the value to El Paso of all such nonswing gas for which the current price exceeds \$1.50 per MMBtu, inclusive of "state severance taxes" (as defined in NGPA § 110(c)) and any other applicable adjustments or add-ons. Accordingly, El Paso hereby notifies those sellers of its decision to change the price or prices otherwise payable for such nonswing gas under such contracts to an Alternate Price equal to \$1.50 per MMBtu, inclusive of taxes and any other applicable adjustments or add-ons. Said Alternate Price shall become effective for all sales of nonswing gas from and after June 1, 1986, and, subject to the terms and provisions of such contracts, shall continue until further notice from El Paso.

IV.

El Paso sincerely hopes that all its sellers understand that the measures described herein are necessary and reasonable responses to the prevailing conditions. El Paso urges all its sellers whose gas cannot and will not be taken under the current operating and market conditions to avail themselves of maximum participation in El Paso's ongoing Spot Market Release Program. El Paso further asks that all its sellers support El Paso's requested broadening of the Program to include NGA gas.

In the event you have any questions concerning the implementation of the purchasing practices described herein, you may call El Paso's Gas Purchases Department at (915)541-5408.

Very truly yours,

Charles R. Jack

El Paso
Natural Gas Company

P O BOX 1492
EL PASO, TEXAS 79978
PHONE: 915-541-2600

February 28, 1986

NOTICE TO SELLERS

This notice is intended to advise you of certain recent developments in El Paso Natural Gas Company's ("El Paso") interstate markets, and of El Paso's plans to deal with the increased competition presented by such developments. El Paso's projected sales for 1986 are expected to decline by approximately 20% from the sale levels experienced in 1985, due in large part to the decisions of El Paso's largest customers to purchase low-cost "spot market" gas in lieu of El Paso's system supply. Moreover, with the continuing precipitous decline in oil prices, El Paso's projected 1986 sales are at risk of being diminished further because approximately 30% of the remaining gas load on El Paso's system is capable of switching to fuel oil consumption.

In order to preserve its projected sales levels against loss to alternate fuels and/or alternate sources of gas, El Paso has recently taken action under its market-out clauses, where permitted, to reduce all prices to $2.20 per MMBtu, plus taxes, thereby terminating the payment of the higher market-out prices described in El Paso's letter of September 27, 1985 (received by most, though not all, of El Paso's sellers). El Paso also intends to modify its production-scheduling procedures in a manner that maximizes, to the extent practicable and legally permissible, the purchases of gas from El Paso's lowest cost sources of supply.

I.

As is the case with the natural gas industry in general, El Paso's market has eroded substantially since 1981. The market for natural gas has declined for a number of reasons, including abundance of cheap hydroelectric power, the activation of major nuclear power plants, low levels of economic growth and the increase of conservation. In addition, intense "gas-vs.-gas" competition has developed among the traditional pipeline suppliers to El Paso's two partial-requirements customers in California (Southern California Gas Company ("SoCal") and Pacific Gas & Electric Company ("PGandE") who, together, make up 80% of El Paso's market). Although El Paso has been largely successful in maintaining the competitiveness of its sales price with other traditional long-term suppliers through market-out actions, contract renegotiations, reductions in workforce and other stringent cost control and efficiency measures, El Paso's sales have nevertheless declined from approximately 3,450 MMcf per day in 1981 to approximately 2,400 MMcf per day in 1985.

Until 1985, El Paso's customers did not themselves purchase any gas supplies from short-term non-dedicated sources. In mid-1985, however, the market environment changed radically. Beginning in March, 1985, on an experimental basis, and expanding in July, 1985 to a truly massive scale, SoCal began to displace El Paso's sales gas with low-cost gas purchased on a "spot" basis. Since July, 1985, SoCal's spot purchases have averaged about 680 MMcf per day. PGandE and Southwest Gas Corporation (El Paso's third largest customer) also each make substantial spot gas purchases. The net wellhead price of spot market gas purchased by El Paso's customers has declined from the range of \$1.95 - \$2.25 per MMBtu (inclusive of taxes) in mid-1985 to the range of \$1.45 - \$1.70 per MMBtu (inclusive of taxes) in March, 1986. By comparison, El Paso's equivalent wellhead weighted average cost of gas, inclusive of taxes, was \$2.64 per MMBtu in mid-1985, and \$2.46 per MMBtu in late 1985 and early 1986. Against such competition, El Paso lost substantial sales. This, in turn, forced El Paso to reduce its takes of gas from its suppliers.

The massive displacement of El Paso's sales gas by spot market gas is expected to continue in 1986. El Paso now projects that its 1986 sales will be approximately 1,910 MMcf per day, which represents a decline of approximately 20% from the average-day sales of 2,404 MMcf per day in 1985.

In order to maintain this share of its customers' expected purchases of long-term gas supplies, El Paso must remain competitive with the traditional interstate pipeline suppliers: Transwestern Pipeline Company ("Transwestern") and Pacific Gas Transmission (an affiliate of PGandE). El Paso stands to lose up to 600 MMcf per day of sales unless it keeps its sales rates within a range of the rates of these competitors prescribed by the California Public Utilities Commission ("CPUC").

An additional and immediate threat to El Paso's projected 1986 sales is the potential that major end-user customers of SoCal and PGandE will switch fuels and begin consuming fuel oil. Oil prices have dropped precipitously in recent weeks, to price levels not seen since 1979. As a result, fuel oil is now available at prices below El Paso's current sales rates. In early February, 1986, SoCal narrowly averted the loss of some 600 MMcf per day of sales when an arrangement was worked out with certain of its electric-generation customers to enable those end-users to continue to purchase and consume natural gas, rather than switch to fuel oil. Much of this sales loss would have been borne by El Paso. In approving the arrangement, however, the CPUC limited its term to a period extending only through March 19, 1986. At that time, the CPUC intends to "re-examine market conditions" and review the "actions [that] SoCal's interstate pipeline suppliers take to keep gas rates competitive with declining alternate fuel prices." See CPUC Resolution G-2664, dated February 11, 1986 (copy attached). The CPUC conveyed a clear message that El Paso's sales to California customers may suffer considerable losses unless its rates are "competitive with alternate fuel prices:"

> By allowing this temporary deviation, we are providing SoCal's long-term suppliers with a "grace period" in which to react to the declining fuel oil market and adjust their commodity rates to levels that are competitive with alternate fuel prices. If they succeed, all utility customers will benefit from reduced gas prices. If the pipelines cannot respond, however, some fuel switching may result. Furthermore, there is no reason for California utilities to continue to commit to a 60% purchase level (a level this Commission has never ratified) for long-term supplies unless there is assurance that such gas will be marketable to fuel switching customers.
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> CPUC Resolution G-2664 at p. 2.

Unless El Paso's rates are "competitive with alternate fuel prices," El Paso stands to lose not only its share of the sales retained as a result of the above-described arrangement, but also could lose significant additional sales as a result of other end-users switching to lower-cost fuel oil. El Paso estimates that its gas sales could decline to approximately 1,350 MMcf per day if its prices are not competitive with fuel oil prices. In fact, a substantial amount of sales have already been lost, at least temporarily, as a direct result of the decline in fuel oil prices. PGandE has decreased its purchases of

El Paso's gas by approximately 200 MMcf per day, in favor of purchases of low-cost spot market gas, so as to avoid fuel switching.

II.

In order to maintain its presently-projected sales levels against competition from other gas suppliers as well as alternate fuels, El Paso must take immediate action to reduce its sales rates. El Paso's primary means of accomplishing such reductions in the past has been to decrease gas costs (which account for over 80% of El Paso's sales rate) through market-out actions and contract renegotiations. In this instance, El Paso has determined to effect reductions in its gas costs by again exercising its market-out rights. Alone, however, this further market-out reduction would not be enough. Thus, El Paso also now intends to reduce its gas costs by modifying its production-scheduling procedures in a manner that maximizes, to the extent practicable, purchases of gas from low-cost sources of supply.

1. Market-Out Action

By letter dated September 27, 1985, mailed to most of El Paso's suppliers, El Paso exercised its market-out rights, where permitted, to reduce prevailing prices to $2.20 per MMBtu, plus taxes. This letter further provided, however, that in the event all of an individual seller's contracts with El Paso contained broad market-sensitive pricing provisions, then certain higher market-out prices would apply. These higher market-out prices ranged from $2.30 per MMBtu to $2.60 per MMBtu, depending upon the area in which the gas is located. El Paso has now determined that it is necessary and appropriate, under the existing gas supply and market demand environment, to eliminate these higher market-out prices and to establish a uniform market-out price equal to $2.20 per MMBtu, plus taxes, effective March 1, 1986. The notices implementing this action were mailed this week.

2. Modifications to Production Scheduling Procedures

In order to derive further gas-cost savings without a more drastic market-out action, El Paso has also determined to modify its production-scheduling procedures. In past periods, El Paso attempted to ratably apportion its market demand system-wide to all of its sellers. This policy was predicated on El Paso's belief that no one segment of its supplier community should bear a disproportionate share of the depressed market demand, and its belief that the combination of state conservation laws and regulations, contractual provisions and operational constraints precluded a more aggressive least-cost scheduling program.

Recent judicial decisions, however, constrict El Paso's ability to apportion its market demand in the manner historically followed. In Transcontinental Gas Pipe Line Corporation v. State Oil & Gas Board, No. 84-1076 (January 22, 1985), the Supreme Court of the United States overturned an attempt by a state to regulate the purchasing practices of an interstate pipeline. This decision brings into question the validity of many state conservation laws and regulations, insofar as they require interstate pipelines to take gas without regard to cost or market consequences. In Office of Consumers' Counsel v. Federal Energy Regulatory Commission, No. 84-1099 (February 4, 1986), the District Court of Columbia Circuit Court of Appeals remanded a FERC order respecting an interstate pipeline's purchasing practices, holding, inter alia, that FERC must consider anew the question of whether the pipeline's failure to schedule production on the basis of price was an "abuse" under NGPA § 601(c)(2) or "imprudent" under Section 5 of the Natural Gas Act. CPUC Resolution G-2664 and the increasingly unstable gas market, taken together with the uncertainty created by these judicial decisions, clearly dictate that El Paso modify its scheduling practices so as to reduce gas costs.

Under its new production-scheduling procedures, El Paso expects that it will continue to purchase, without curtailment, its "nonswing" supplies (i.e., gas produced in association with oil and gas produced from hardship or emergency wells). El Paso's remaining sources of supplies will be purchased at varying load factors, depending on average cost of each source of supply and operational considerations. However, El Paso presently anticipates that it will continue to purchase "swing" gas supplies on a ratable basis within discrete common sources of supply.

III.

El Paso is hopeful that the above-described actions will permit it to achieve its projected sales levels for 1986. These actions may not be enough, however. If El Paso's price becomes noncompetitive (as that term may eventually be defined by the CPUC) with other gas supplies or with alternative fuels, El Paso may be forced to take more drastic price actions or to make further modifications to its production-scheduling procedures. We will strive to keep you informed if such actions become necessary.

Very truly yours,

EL PASO NATURAL GAS COMPANY

Charles R. Jack

Charles R. Jack
Vice President

Attachment