*Report of Committee On Natural Gas Liquids Pricing and Allocation**

DECONTROL STEPS

Over the past year DOE has moved step by step toward a loosening of control over NGL markets, although many important controls—particularly over propane—still remain. Much of DOE's direction has stemmed from a desire to encourage NGL use to offset boiler-fuel consumption of imported crude oil-produced products, as well as a recognition of the general surplus condition of the NGL product markets.

As a leading example, butane and natural gasoline, which were subject to the full range of allocation and price controls since the EPAA was first implemented in late 1973—early 1974, were fully decontrolled effective January 1, 1980. This was foreshadowed by ERA's Draft Regulatory Analysis published in March, 1979 which had pointed out that these products were not in general shortage; that their largest market—motor gasoline—was not expected to grow significiantly in the 1980's; that at least one potential market—SNG—was not growing at all; and that another market —petrochemical feedstock—was not significantly expanding either. ERA's Analysis was followed by a public hearing on May 9, 1979 (ERA Docket No. ERA-R-79-14), at which these and similar points were made by most who appeared. The decontrol was finally announced in the December 6, 1979 *Federal Register*.

Paralleling this proceeding has been ERA's longstanding consideration of propane decontrol, on which action has not yet been taken. In February, 1979 ERA published a request for comments in Docket No. ERA-R-79-3; at that time ERA made it clear that it was not proposing deregulation but merely taking a preliminary step to determine whether such a proposal would be appropriate. This announcement produced very extensive comment, most supporting decontrol. Among others, the National LP-Gas Association took a position favoring decontrol generally, although urging continued control and monitoring of certain limited markets such as that for SNG feedstock. Later in 1979, in Docket No. ERA-R-79-3A, ERA published a Draft Regulatory Analysis which generally supported propane decontrol. Among other things, the Analysis pointed out that price decontrol would have relatively little upward effect on prevailing market prices, and that price decontrol would in various ways have a positive effect on competition. As the 1979-80 heating season got under way, however, temporarily rising prices and inventory uncertainties made the decontrol outlook less positive. While the market and inventory situation have long since been considered favorable, ERA's decontrol proposal has as yet not been acted on.

*The Committee acknowledges the efforts of Franklin D. Dodge, Richard T. Williams and Thomas N. Jersild who assembled the material in this Report.

Allocation Matters

Another important event for NGL markets concerned ERA's lifting, effective January 1, 1980, of the formerly-effective use limitations which had in most cases prevented SNG users, utility-injection users, industrial users and petrochemical feedstock users from using more than their "base period use." These actions were taken as part of an overall revision of ERA's NGL allocation regulations which had begun with an initial FEA-proposed version published in August of 1977 (42 *Fed. Reg.* 41242-56). This proposal, never acted on, was referred to FERC after passage of the DOE Reorganization Act, for FERC's consideration under § 404 of that Act, which gives FERC authority to review new ERA rules affecting FERC's natural gas regulation responsibilities. In response, FERC in September, 1978 published proposed revisions of ERA's proposal (43 *Fed Reg.* 36264-81). Following further informal consultations between FERC and ERA, ERA on July 10, 1979 published a further revised version of its overall regulations (44 *Fed. Reg.* 40221-24), which after still further changes (described at 44 *Fed. Reg.* 60638-55) became effective on January 1, 1980. Among the highlights of the new NGL Regulations were:

(a) DOE fully exempted Canadian-source NGLs from the use limitations which had generally prevented SNG, utility-injection, industrial and petrochemical feedstock users from using more than their 1972-73 "base period use."

(b) While DOE did not exempt U.S.-source NGLs from these use limitations, it waived the use limitations for U.S.-source NGLs until further notice.

(c) DOE abolished its former rule that had prohibited utilities from using injection propane while serving interruptible or alternate-fuel equipped customers. This move was obviously designed to further encourage the substitution of propane and other NGLs for imported crude oil-produced products.

(d) The new rule clarified that the ethane content of NGL mixes is not subject to any controls. This had been a matter of some dispute.

(e) The new rule excluded unfractionated NGL mixtures from all allocation control (although their propane content is still separately allocated under certain circumstances).

(f) For industrial and petrochemical feedstock use, exceptions were made to the base period use limitation (which while now waived may be reinstated) for process and plant protection use.

(g) The new rule liberalized the regulations governing termination of base period relationships by providing that a base period purchaser may terminate such a relationship unilaterally without specific ERA approval.

(h) The new rule abolished the old 10-day waiting period during which a supplier in surplus was required to wait before disposing of surplus volumes of which he had notified ERA.

(i) ERA also adopted a new incremental pricing rule under which sales of imported NGLs to SNG, utility, industrial, petrochemical and refinery fuel users must be accounted for separately under the price control rules.

Price Matters

Further regarding price control matters, note should be made of the DOE General Counsel's landmark Interpretation No. 1978-63 (published in the January 15, 1979 *Federal Register*), in which DOE made clear, once and for all, its view that a company having both a gas processing subsidiary and an NGL reseller subsidiary may not treat the two as separate companies as regards transfers from the processing operation to the reseller operation. In other words, in DOE's view a sale of propane from one's gas plant to one's reseller operation is to be disregarded for price control purposes; the first sale on which one may take the allowable margins and mark-ups is the reseller operation's ultimate "resale" to an unaffiliated third party. (There is one long-established exception to this, namely, the case where the intra-firm transfers represent less than 5% of total sales.) The Interpretation has been under continuing challenge by concerned processing-reselling firms ever since it was issued, and is presently the subject not only of many DOE audits but also of court litigation.

Note should also be made of ERA's December, 1979 announcement of its Final Rule increasing allowable non-product costs for small resellers (ERA Docket No. ERA-R-79-33). Under these new rules, which were proposed in July, 1979 (44 *Fed. Reg.* 40324-29), and on which hearings were held on August 8, ERA has:

(a) Increased the allowable increased non-product costs which a propane retailer may pass through if his sales aggregate less than five million gallons per year (except that this increase is not applicable for his sales to utilities or petrochemical users).

(b) Expanded the categories on which such small retailers may calculate their non-product costs, to include such things as owner salaries and other overhead.

(c) Increased the marketing costs which refiners and gas processors may pass through on retaul propane sales (again, except to utilities and petrochemicals).

(d) Amended the equal application rule so not to apply with respect to certain marketing costs of refiners and processors at the retail level.

Interpretation No. 79-14, Crystal Oil Company (June 19, 1979)

Since May 1, 1979, the only Interpretation issued by the DOE with respect to NGLs and NGLPs was issued to Crystal Oil Company. At its Kings Bayou, Louisiana, plant, Crystal extracts NGLs from wet gas supplied by Phillips Petroleum, and other firms. The NGLs are then fractionated into products at Lake Charles, Louisiana.

In its request for interpretation, Crystal asserted that it was processing natural gas for a fee, thereby providing a service, and that it was itself *not* a seller of NGLPs to Phillips, and that its sales to Phillips were not subject to mandatory price controls. To the contrary, Phillips asserted that Crystal is a seller of NGLPs.

Under the contract between Crystal and Phillips, Crystal acquires title to the liquefiable portion of the wet gas stream and to plant fuel gas at the inlet to its Kings Bayou plant and Phillips retained title to residue gas. In consideration for the NGLs, Crystal pays to Phillips a percent of the proceeds from its sale of NGLPs or a percent of the products in kind. The agreement requires Crystal to sell to Phillips, at Phillips' option, all of the NGLPs which Crystal caused to be fractionated from the NGLs extracted at Kings Bayou. If Crystal desires to make sales to third parties, Phillips has an option of matching the highest lawful bid received by Crystal in purchasing NGLPs by paying the bid. If Phillips refuses to meet the bid, Crystal is free to sell to third-party bidders.

DOE determined that Crystal is the seller of all NGLPs that Crystal processes from the gas streams of Phillips at Kings Bayou except for in-kind transfers taken under the contracts by Phillips. Crystal is therefore responsible for compliance with price controls.

DOE concluded the sales of products at the outlet of the Lake Charles plant, following fractionation, represents first sales of NGLPs, and are governed by the maximum lawful price regulations.

DOE rejected Crystal's argument that it was merely providing a service for which it received a processing fee in cash. Crystal conceded that as a matter of form, it was characterized in its contacts as the owner and seller of certain NGLPs, but argued that the underlying economics of the transactions made Phillips the true seller. Crystal relied upon Interpretation No. 1976-2, *Wanda Petroleum Co.* (February 8, 1977). There, Wanda was to lease and operate a gas plant for a specified term for a fixed dollar sum but would have no interest in the NGLs stream to be fractionated nor in the products derived therefrom. DOE distinguished that Interpretation from Crystal's case by observing that Crystal was to be compensated according to the product prices received upon sale rather than a fixed dollar amount.

Crystal went on to argue that in reality it did not have a right to control the disposition of the NGLPs and so should be treated as receiving only a processing fee. DOE commented that "the assertion that Crystal does not possess the full bundle of ownership rights for these NGLPs, even if true, does not mean that under the price regulations Crystal is not the owner and seller of these NGLPs with a responsibility to determine their maximum lawful prices, especially when Crystal was the sole recipient of the sale proceeds. Crystal solicits bids to determine the market value of the NGLPs and Crystal fully bears the financial risk of market price fluctuations."

The Interpretation is susceptible of three conclusions: (1) DOE has freely admitted that the forms of net-back arrangements are varied and that its regulations do not encompass, necessarily, all forms of such arrangements; (2) DOE will therefore not hesitate to impose price controls, retroactively, where it identifies a net-back arrangement which it believes should be encompassed within the regulations; and (3) DOE may be moved more by the form of a transaction than by the economics motivating a transaction to reach the result of coverage under the regulations. (An alternate form for this conclusion might be that in considering the scope of coverage of its regulations, DOE's general tendency is to extend coverage, employing such reasoning as is necessary to jusitfy that conclusion.)

Significant Litigation Developments

Litigation this past year with the DOE regarding NGL and NGLP pricing regulations has continued to wrestle with the Department's attempts at retroactive imposition of regulations and interpretations for the period August, 1973, to January, 1975, and DOE's conflicts with integrated firms which have historically used transfer pricing to value NGLPs manufactured in gas plant operations and turned them over to refiner-marketing entities for ultimate disposition or sale.

It is a truism that pricing regulations issued between August, 1973, and January, 1975, were not geared to regulate the prices of propane, butane, and natural gasoline extracted from natural gas. It was not until 1977 that the Temporary Emergency Court of Appeals determined in *Mobil Oil vs. FEA*, 566 F.2d 87 (1977) that the Emergency Petroleum Allocation Act covered NGLs, and the Court of Appeals continues to wrestle with the meaning of such coverage, remarking in *TwinTech Oil Co. vs. Schlesinger*, 603 F.2d 197 (1979) that "a reading of the refiner regulations raises some doubt as to whether they were specifically designed to apply to natural gas processing plants. These regulations do not, for example, address the unique characteristics of the NGLs extraction process, nor the proper treatment of the different raw material feedstocks . . . thus there was no clearly applicable regulation or precise method by which a gas plant operator could have calculated his maximum allowable level of product prices."

A. *Exxon Corp. et al. v. DOE*

The leading case in the controversy over the validity of regulating gas plant operations under Subparts E and K prior to January 1, 1975, is *Exxon Corp., et al. vs. DOE*, pending in the Northern District of Texas. In July, 1975, Exxon filed this action for injunctive and declaratory relief, broadly attacking the validity of Subpart E as well as Subpart K on both substantive and procedural grounds. Similar actions filed by Dorchester Gas Producing Company and Philllips Petroleum Company and Pennzoil were consolidated with the *Exxon* case. In 1979, Texaco intervened the litigation and more recently Amoco, Cities Service, and Mobil have also sought to intervene. On October 24, 1978, the Court, in essence, granted the plaintiffs' Motion for Discovery with respect to interrogatories and requests for production of documents. In February, 1979, the government responded, producing 250 documents, objecting that an additional 1,400 documents were privileged, and providing limited answers to interrogatories.

In March, 1979, DOE moved to transfer the litigation to the District of Columbia where its action for enforcement of the pricing regulations against Exxon was pending. On June 22, 1979, the Court entered an order denying this motion as well as denying any stay pending final judgment in the District of Columbia cases.

The Court continues to have before it approximately 500 purportedly privileged documents for *in-camera* inspection. There are an additional 950 documents still to be examined for claims of privilege. A United States Magistrate was assigned by the Court to make recommendations with respect to privilege. In sifting through the documents, the Magistrate was to be assisted by one attorney from the plaintiffs and one from DOE to isolate pertinent facts for the consideration of the Magistrate. Those representatives of the parties have not yet been designated. The Magistrate has reported to the Court that it believes counsel for the companies should be restricted in their assistance to the Magistrate to viewing only a few documents, lest problems of privilege be breached. Both the companies and DOE have briefed their views on the Master's report and the Court has not yet rendered any determination. Until solution of the privilege claims and determinations upon the production of documents has been completed, discovery is substantially stalled in this litigation and no trial date has yet been set.

At bottom, the litigation concerns the DOE's identification of "increased product costs" for gas processors. Subpart E, providing for the increased costs of purchasing crude oil to be passed on in a refiner's selling price, had no explicit analogy in 1974 for increased product costs for NGLPs. In the absence of direct guidance, various firms devised their own analogy, noting, for example, that the cost of domestic crude oil purchased by a refiner from an affiliated producer is, for purposes of the regulations, deemed to be the price the refiner would have paid if the transaction had been made at arms length. Using as a measure of current product cost, for NGLs obtained from an affiliated entity the amount that a fractionator of NGLPs might have paid to purchase NGLs from an independent firm has been rejected by DOE.

The Subpart K regulations which became effective on January 1, 1975, identified as an increased product cost the category of "shrinkage," defined to be the reduction in selling price of natural gas processed by a firm which is attributable to the reduction in volume or BTU-value of natural gas resulting from the extraction therefrom of NGLs. This reduction in selling price was to be determined according to the contract for sales of residue gas in effect at the time for which the cost of shrinkage is being measured.

In essence, the government appeared to believe that shrinkage represented an appropriate measure of opportunity cost involved in the extraction of NGLs. This litigation challenges that measurement because DOE has not permitted opportunity costs to include a consideration of the value residue gas would have brought in intrastate sales, not federally regulated until 1978, and because interstate gas sales, prior to the passage of the Natural Gas Policy Act, were often well below the current value of NGLs.

In addition, computational problems under the shrinkage formula are challenged in the litigation since shrinkage cost is not recognized unless residue gas is sold, thereby eliminating the recognition of an opportunity cost in the case of reinjected gas. DOE's formula can also result in "negative shrinkage" which the DOE requires to be deducted from increased product costs, notwithstanding that positive opportunity costs do exist in the same time period.

There are also numerous procedural objections alleged to the promulgation of Subpart K and Rulings 1975 - 6 and 1975 - 18 and the Class Exception issued to natural gas processors on August 29, 1975.

The importation of "shrinkage" into the pricing regulation is not a total surrogate for opportunity cost and its imperfections may exceed its benefits, especially for larger firms. For smaller independent gas processors, however, the litigation must be viewed with equivocation because of the need for these processors to receive in compliance actions some price relief permitting justification of price increases after August 19, 1975, and sustain the competitive viability of this sector of the industry against integrated refiners who can allocate to NGLPs' portions of their purchase product cost increases from the purchase of crude oil for refining operations.

B. *Transfer Pricing Litigation*

In *Amoco Production Company, et al. vs. DOE*, pending in the United States District Court for the District of Delaware, Amoco has commenced a preenforcement action seeking declaratory and injunctive relief to challenge and interpret certain portions of Subpart K of the pricing regulations. Intially launched in October, 1978, just before the November 1 amendments to Subpart K, by Amoco and Northern Natural Gas Company, the litigation has been joined by Exxon, Sun, Mobil, Gulf, Shell, Aminoil, ARCO, Conoco, Texgas Corp., and Allied Chemical Corp.

In 1978 and in January, 1979, Judge Stapleton denied motions for preliminary injunction, notwithstanding that he found that Northern Natural would suffer irreparable harm in the form of revenues foregone if it complied with DOE's view of the regulations. The court thought it unlikely that Northern would prevail on the merits with respect to the prospective invalidity of the November 1, 1978, Subpart K amendments but carefully avoided expressing any opinion on the sustaining of any retroactive interpretations of Subpart K.

In April 1979, Judge Stapleton denied the DOE's Motion to Dismiss or to transfer the litigation to the District of Columbia, and found that venue was proper in Delaware except as to Gulf and ARCO who were dismissed without prejudice.

Four of the plaintiffs moved for an order preventing the government from attempting to assess civil or criminal penalties for pricing actions taken during the course of the litigation based on the doctrine called "constitutional tolling", intended to permit the exercise of the person's right to obtain judicial review without fear that the litigant will be penalized for exercising such a right. On April 30, 1979, Judge Stapleton denied the motion, finding that he could only grant such relief if plaintiffs had satisfied the criteria necessary for the issuance of a preliminary injunction, and further finding there was no showing of immediate and irreparable injury if the motion was denied.

Plaintiffs sought extensive discovery concerning the DOE's contemporaneous construction of the regulations in dispute and to flesh out the administrative record before the Court. DOE moved for protection against the discovery and on May 29, 1979, Judge Stapleton approved extensive discovery, finding that a complete record must contain everything considered by a decisionmaker, whether or not it was relied upon in the reaching of a decision. Discovery was also approved and directed toward the agency's contemporaneous construction of contested regulatory provisions, including the statements and actions of agency personnel with responsibility for implementing and enforcing regulations, even if their views were not approved by the agency and even though they may not be high-ranking officials.

Discovery was also permitted as to the views of agency personnel who participated in developing regulations at the pre-decisional stage; the executive privilege applicable here did not bar all inquiry, the Court found. Discovery was also allowed which was directed to the impact of the amendments upon the industry to determine whether that impact was so substantial as to preclude giving the amendments retroactive effect. This is one of the first instances of DOE discovery against a plaintiff in a preenforcement injunctive action.

While DOE has begun the process of responding to the plaintiffs' discovery, asserting various privileges, specific rulings remain to be made on the production of documents.

In July, 1979, Conoco entered into a stipulation with the DOE under which the company agreed, prospectively and retroactively, to bring itself into conformity with the constructions of Subpart K set forth in Interpretation 1978-29, in return for which the DOE agreed not to recommend or to seek to impose civil or criminal penalties with respect to actions taken heretofore by Conoco that may have been inconsistent with Interpretation 1978-29.

Within the past month, several parties have filed motions for summary judgment, but no schedule for opposition has yet been determined nor has any date been set for hearing. These motions are for partial summary judgment and are restricted to the "first sale" issues as contrasted with the reseller marketing cost issues also present in the case. The Court has heard various motions to compel further discovery from the government by the companies but has not yet ruled thereon.

There are two different controversies relating to transfer pricing being litigated in the Delaware proceedings. Crude oil refiners with affiliated gas processing operations are challenging the DOE's interpretation that the adjusted prices contained in 10 C.F.R. § 212.164 for "first sales" do not apply to intra-firm transfers of NGLPs, whether or not conducted at arms length, either in method or in market effect. Independent gas processors and marketers are challenging (i) the DOE's interpretation concerning "first sales" on the same basis as crude oil refiners with affiliated gas processing operation, and (ii) DOE's interpretation that affiliated marketers cannot utilize the resale regulations under Subpart F to determine resale prices for natural gas liquids.

If Subpart K is construed to bar transfer pricing, the plaintiffs challenge the procedural sufficiency of its adoption, asserting there was not an ample opportunity for public comment on this point, and that such an interpretation is inconsistent with the statutory objectives of the Emergency Petroleum Allocation Act and would be arbitrary and capricious. Retroactive application would be of such impact upon the industry that it should be impermissible.

Next, the litigation raises the question of whether Subpart K, as it stood prior to November 1, 1978, requires that gas processors and reseller affiliates be deemed to constitute a single "firm" with the result that marketing affiliates would determine their maximum permissible selling prices ,under Subpart K rather than Subpart F. Plaintiffs urge that such a construction would be arbitrary and capricious and cannot be imposed retroactively because of its impact on the industry and that such a construction of Subpart K necessarily mean there had not been sufficient opportunity for public comment before its promulgation. Procedural defects are also raised with respect to the prospective definition of a single "firm" in this context after November 1, 1978.

As originally proposed, Subpart K contained no specific reference addressing transfers between affiliated entities, although the preamble to the proposal stated that the new regulation would also apply to refiners "for purposes of determining the appropriate transfer price to the refiner." 39 Fed. Reg. 32718 (September 10, 1974). Subpart K, when adopted, provided that it applied to all sales of NGLs and NGLPs "including transfers between affiliated entities . . . except sales by resellers or retailers which are subject to Subpart F of this part." 39 Fed. Reg. 44408 (December 24, 1974). Subpart K permits the charging of a "first sale" adjusted price for NGLs and NGLPs, defining the term "first sale" to include the "first transfer for value to a class of purchaser for which a fixed price per unit of volume is determined."

An Interpretation issued by the DOE to Conoco, Interpretation No. 78-29 (June 10, 1978), was used as an occasion by the DOE to rule that Subpart K regulations prohibited transfer pricing among affiliated entities and that such transfers did not constitute a "first sale," even though this was not an issue raised by Conoco's request. DOE solicited public comment on the transfer pricing question in addressing an Interpretation request by ARCO and then issued Interpretation 1978-61 (December 8, 1978). Although the comments evidenced the industry's unanimous disagreement with DOE's Conoco decision, the ARCO Interpretation affirmed and was consistent with the Conoco Interpretation.

The DOE also promulgated amendments to Subpart K on September 10, 1978, to become effective November 1, 1978, which would add a new definition of the term "firm" with the effect of applying Subpart K rather than Subpart F to the reseller affiliates of gas processors and which would delete the phrase "including transfers between affiliated entities" from the definition of a first sale. The protests which these changes allows was magnified by the statement by DOE that these amendments merely made explicit that which had always been implicit in Subpart K ever since January 1975. On October 30, 1978, DOE suspended that aspect of the amendments that would have eliminated transfers between affiliated entities from the scope of Subpart K, pending further proceedings, but asserted that this suspension was really of no significance since Subpart K had never permitted the application of adjusted first sale prices to such transfers. DOE continued to adhere to its position that no first sale occurs and transfers between affiliated entities in its Interpretation 1978-63 issued in Northern Natural and Mapco on December 13, 1978.

A survey by the Office of Special Counsel has determined that the transfer pricing issue has an impact of more than $400,000,000 per year if transfer pricing were to be eliminated.

As if the procedural and substantive complexities of this litigation were not sufficient, moments before Exxon filed its Delaware litigation challenging the DOE's construction of transfer pricing, the DOE itself rushed to the District in the District of Columbia and filed *United States vs. Exxon,* among other litigation, seeking declaratory and injunctive relief against violations of challenged practices and an order that each company make restitution in the form of payments to the United States Treasury as well as paying civil penalties and recomputing their maximum allowable selling prices in accordance with the judgment of the Court.

The government complaint alleged pricing violations both under Subpart E and Subpart K and challenged, among other issues, the use of intra-firm transfer prices as well as various shrinkage calculations. Comparable suits were filed against firms other than Exxon, including ARCO, Mobil, Shell, Phillips, Cities Service, Gulf, and Texaco. Several of these defendants filed in 1979 a motion to dismiss alleging lack of subject jurisdiction in the Court because of the abandonment by DOE of its administrative proceedings in favor of a judicial determination of its position.

The Court determined, at 470 F. Supp. 674, that it had subject matter jurisdiction but certified the matter for appeal to the Temporary Emergency Court of Appeals. After a hearing on March 30, 1979, Judge Gesell granted a motion to stay ordering that the District of Columbia actions be stayed until entry of final appealable orders on the merits in the litigation described above pending in Texas and Delaware, unless those actions were earlier transferred to the District of Columbia. The DOE on May 10, 1979, filed in TECA a notice of appeal of the stay order; the defendants filed a motion to dismiss the appeal as not being taken from a final decision ripe for appeal and DOE thereafter moved to withdraw its appeal.

Nonproduct Cost Litigation, Chapter 2

In two actions this past year, DOE's restrictive policies limiting recovery of depreciation expense and restricting the opportunity to recover other operating expenses have been determined in favor of the industry and adverse to DOE.

In *Twin-Tech Oil Co. vs. Schlesinger*, 603 F.2d 197 (TECA 1979), an application for exception relief to permit the pass through of depreciation expense in order to avoid closure of a skid plant had been denied by the DOE. The District Court disagreed and found that the impact of Subpart K regulations was causing serious hardship and gross inequity to the company. 462 F.Supp. 639. The Court remanded the case with instructions to grant substantial exception relief. The decision was affirmed by TECA and required the DOE to grant "meaningful relief, based on a realistic appraisal of all the facts and circumstances of the case." The Court of Appeals found that the different treatment of depreciation expense for crude oil refiners and gas plant operators, both of whom produce NGLs, was arbitrary and discriminatory and that recovery of depreciation cost is entirely consistent with the regulatory program, notwithstanding that it is a non-cash expense.

In *McCulloch Gas Processing Corporation vs. Department of Energy*, an opinion was rendered by Judge Brimmer in the District of Wyoming on October 10, 1979, finding that the DOE's repeated failures to grant exception relief to cover McCulloch's depreciation expense was improper and not based on substantial evidence and was arbitrary and capricious. The agency had simply failed to make "any meaningful analysis of the firm's return on invested capital, cash flow or net profitability."

The Court also determined that portions of the amendments to Subpart K adopted in September, 1978, were invalid as procedurally defective and as lacking in substantial evidence or a rational basis, commenting that "the enactment of these revisions to Subpart K followed an almost incredible process of rulemaking. By their own admission, the draftsmen had no experience in the gas processing field. They proceeded to obtain little, if any, information about gas processing activities from the industry before proposing the new revisions and thereafter they generally disregarded the comments which posed objections to the particular revisions now in issue. Such uninformed tinkering with the gas processing business is arbitrary and capricious and without rational basis." The Court set aside the rulemaking insofar as it restricted the recoupment of depreciation expense to a calculation based upon "units of production" as contrasted with the methods historically and consistently applied by the firm affected. The Court went on to find that various other restrictions upon general and administrative expense and gathering expense were arbitrary and were also not founded upon substantial evidence. The case is presently awaiting formal entry of judgment.

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