Cited as "1 ERA Para. 70,102"

Pac Indonesia LNG Company and Western LNG Terminal Associates (ERA Docket No. 77-001-LNG), September 29, 1978.

Escalator and Currency Adjustor Contract Provisions.

[Opinion and Order]

I. Introduction

A. Summary

In Opinion Number One, the Department of Energy (DOE) conditionally approved a proposed importation of liquefied natural gas (LNG) from Indonesia to the West Coast. Among other things, the DOE disallowed certain escalation and currency adjustment clauses in the LNG purchase contract between the U.S.A. importer (Pac-Indonesia LNG Company, hereinafter "Pac-Indonesia") and the Indonesian supplier (Perusahaan Pertambangan Minyak Dan Gas Bumi Negara, hereinafter "Pertamina"). The DOE also disapproved Pac Indonesia's proposal that its tariff provide for automatic flow-through of any price increases under those clauses. Opinion No. One did indicate, however, that DOE would consider revisions to the escalation and currency adjustment provisions.

Following procedures described below, Pac Indonesia has filed an amendment to its contract with Pertamina, which contains revised escalation provisions, and has requested that flow-through of the cost increases resulting from the new escalator provisions and the currency adjustor provision as originally proposed be approved.

After considering the applications for rehearing, the revisions filed by Pac Indonesia, and the comments filed thereon, the DOE finds that the amended contract escalation clause would not be inconsistent with the public interest in the special circumstances of this proceeding. Moreover, the DOE now withdraws its objections to the currency adjustment clause, and conditionally sanctions the operation of that clause, as explained below.

The DOE will shortly address remaining matters raised by the applications for rehearing of Opinion No. One and then issue the justiciable order under Section 19(b) of the Natural Gas Act.

B. Procedural Background

In reviewing the pricing clauses in the Pertamina-Pac Indonesia contract, we take note of the special history of these proceedings. The first application for permission to import the LNG, filed on November 30, 1973,

with the Federal Power Commission (FPC), reflected Pertamina's September 6, 1973, contract to sell LNG for 63 cents per million Btu (MMBtu) with escalation at 2 percent per year. On January 9, 1975, upon the refusal of the Indonesian government to approve a contract containing an escalator which did not reflect world energy prices, Pertamina and Pac Indonesia's predecessor revised the contract, as follows:

--To set a base price of $1.25 per MMBtu for LNG FOB the tanker at the loading dock in Sumatra;

--To escalate the base price by a formula based on two energy price indicators: (a) 50 percent on changes in the actual average price of exported Indonesian crude oil, and (b) 50 percent on changes in the U.S. Department of Labor, Bureau of Labor Statistics, (BLS) Code 05 Wholesale Price Index for Fuels and Related Products.

On October 28, 1975, the parties again revised the contract to fix a minimum pricing provision designed to cover the amortization of interest on Pertamina's debt as well as its operating costs.

The Administrative Law Judge conditionally approved the import on July 22, 1977. On October 1, 1977, the FPC ceased to exist and its gas import jurisdiction vested in the Secretary of Energy.

The DOE issued Opinion No. One on December 30, 1977. Pac Indonesia and others submitted applications for rehearing within the 30 day period allowed by Section 19(a) of the Natural Gas Act. On February 22, 1978, the Administrator of the DOE's Economic Regulatory Administration held a conference to consider the applications for rehearing. An Order Granting Rehearing for the Purpose of Further Consideration was issued on February 28, 1978.

The Order allowed Pac Indonesia until May 1, 1978, to submit a contract amendment containing revised escalation provisions, and all parties were given 15 days to comment on any submissions. After four extensions of time, Pac Indonesia filed the revised provisions on July 28, 1978. Comments were filed by the staff of the Federal Energy Regulatory Commission (FERC staff) on August 7, 1978, by Hollister Ranch Owners' Association and the Santa Barbara Citizens for Environmental Defense (Hollister) on August 10, 1978, and by San Diego Gas & Electric Company (San Diego) on August 11, 1978. Pac Indonesia filed a limited response to Hollister on August 21, 1978.

C. Economic Background

Opinion No. One explicitly recognized that some escalation provisions might be appropriate in the present LNG contract. We recognize Pertamina's

concerns with respect to revenues over the life of a long-term contract which will not terminate until the next century, 20 years after initial delivery. The necessity for a long-term contract reflects the large capital outlays involved in an LNG venture, including the liquefaction plant, the cryogenic tankers, and the receiving, storage and regasification terminal. Such projects must wed a substantial, dedicated gas supply (over 4 trillion cubic feet of nonassociated gas in this project) to a large, assured market.

These factors support our favorable consideration of appropriate escalation provisions. However, the approval of price provisions in LNG import contracts must also be based upon a careful assessment of the impact of provisions would have on national energy goals as well as a determination of the extent to which the resulting prices in particular projects are justified in terms of national and regional needs for gas.

Domestic natural gas consumption will continue to draw primarily on the conventional supplies obtainable in the contiguous U.S.A. Such natural gas resources are within the reach of drilling technology--on shore and on the continental shelf--at locations near the established pipeline infrastructures. National energy policy recognizes the primacy of these proximate supplies of conventional gas, as enterprise develops them and claims access to U.S.A. markets. Other potential supplies are marginal or at least intramarginal with respect to U.S.A. markets, principally by reasons of remoteness (as reflected in the transportation costs) or uncertain technology. Intramarginal supplies include gas from the Alaskan North Slope, various supplies from advanced technology applied to domestic resources, and overland supplies from neighboring sovereign countries, as mutual benefits may dictate such transactions. Marginal supplies include synthetic natural gas (SNG) from imported petroleum and LNG from abroad.

Even though capital-intensiveness, price, long-term commitment and vulnerability make remote foreign LNG supplies most marginal for U.S.A. markets, there is a place for some such projects. We must take care, however, that decisions taken with respect to LNG imports from remote sources do not discourage the ultimate development of proximate resources, and that only those LNG projects are approved in which the need for the gas cannot be satisfied by more basic sources of supply. In that context, we must also protect the consumer from unacceptable risks of escalation in the price of the gas.

In Opinion No. One, DOE found that the need for this import and its general acceptability as a source of supply did not outweigh the risk to the consumer of unreasonable price increases posed by the contract escalator provisions. Applicants now present us with a revised escalator which we must evaluate with respect to that risk, bearing in mind California's special needs for gas, as discussed in Opinion No. One.

II. Discussion

A. The Revised Price Escalation Provision

In Opinion No. One, DOE disapproved the Pac-Indonesia FOB price escalator provision (based 50 percent on Indonesian crude oil prices and 50 percent on the BLS Wholesale Price Index-Fuels and Related Products) on the grounds that it was tied too directly to future movements in world petroleum prices and that the BLS fuels element would be influenced by future domestic energy pricing policy and by the price of the import itself, thus creating a significant self-compounding effect. DOE did not object, however, to the concept of an escalator provision and suggested, alternatively, the use of an index generally reflecting world or U.S.A. economic conditions in order to provide a more broadly-based means of adjusting prices over the life of the contract.

The applicants submitted an amendment on July 28, 1978, reflecting a revised escalator provision. The revised escalator continues to modify 50 percent of the base price of $1.25/MMBtu on the basis of changes in Indonesian crude oil prices, but with the added constraint of a 15 percent floor and ceiling on annual price fluctuations, which allows any increase above the 15 percent annual limitation and any downward adjustment in excess of 15 percent to be carried forward and applied in future years to the extent permitted by the floor or ceiling. The remaining 50 percent of the revised escalator now reflects a broad-based U.S.A. economic index, the BLS Index of Wholesale Prices--All Commodities (WPI-AC).

In commenting on the filing of the revised escalator, Hollister and the FERC Staff objected to the use of any indicator based on Indonesian prices for crude oil. Hollister further requested formal hearings to explore the operation of the escalator and to develop an evidentiary record. Objections to Hollister's request were filed by Pac Indonesia. San Diego stated that the revised escalator should be approved.

DOE finds that the revised escalator acceptably responds to the objections raised in Opinion No. One, and we will, therefore, approve the flow-through of costs associated therewith. It must be stressed that our conclusion is based on the specific circumstances of this case, including the fact that the escalator provisions in this contract have now been revised twice in an effort to reach terms acceptable to both governments. Our approval in the circumstances of this protracted case, however, should not necessarily be viewed as a precedent for approval of similar contract pricing provisions in proposed import cases involving different circumstances with respect to supply alternatives, market requirements or other salient factors.

While DOE continues to have grave reservations concerning the

acceptability of any LNG supply contract which substantially or totally links the price of gas to cartel-influenced oil prices, there are also features of this contract which tend to mitigate the inclusion of a crude oil-based element in the escalation clause. We note, for example, that the contract generally establishes a fair and symmetrical basis for the relationship between buyer and seller. The contract sets terms for a fixed twenty-year period with no option to reopen. It includes a "most favored nation" clause under which Pac Indonesia would be entitled to a price for LNG no higher, on an FOB equivalent basis, than that paid any other purchaser under any other contract with Pertamina in existence as of January 9, 1975. The escalator provisions do not apply to the full cost of the LNG as imported and delivered to the U.S.A., but only to the price of the LNG in Sumatra near the point of production.

Further, the contract's terms provide symmetrical and countervailing responsibilities and penalties for buyer and seller. Each may terminate the contract if the other fails to meet its obligations. Quantities underlifted by Pac Indonesia will be made up at the contract sales price in effect at the time of actual delivery. Quantities underdelivered by Pertamina will be made up at the price prevailing at the time of Pertamina's failure to deliver. In addition, if Pertamina fails to deliver at least 90 percent of contract requirements and fails to make up those quantities, Pac Indonesia may terminate the contract or require Pertamina to deliver a quantity equivalent to that not delivered previously, at a 10 percent discount from the contract sales price (Article 7.7).

The base price of the LNG is not arbitrarily inflated. Most of the initial FOB price of $1.25 per MMBtu consists of the extensive capitalization expenses necessary for the liquefaction plant. The portion of the base price remaining for production and pipeline transmission to the liquefaction plant is estimated to be in the range of $.20--$.60 per MMBtu. The wellhead portion of the base price, after deducting the pipeline transmission costs, will be somewhat less.

In summary, the contract generally establishes a reasonable base price for the gas and terms which are fair to buyer and seller alike. These generally equitable provisions, when balanced against the provisions of the escalator clause, tend to weigh in favor of acceptance of provisions which otherwise might be found to be unacceptable.

We find the revised escalator formula to be a substantial improvement over the original provision. The escalator provision disapproved in Opinion No. One was linked entirely to energy price movements. The revision limits the direct tie to energy prices, thereby providing greater protection from future increases in world oil prices.

In addition, the 15 percent annual limitation provides some protection against the consequences to gas consumers of a drastic rise in world oil prices. Although any such increases will eventually be reflected in this component, the limitation effectively spreads their impact over time, and would tend to mitigate partially the economic dislocation that could occur in the event of any significant price increases for Indonesian crude oil. Although a lower ceiling may well be essential in other circumstances, we are persuaded that this limitation provides sufficient protection to the consumer when viewed in the context of all the facts in this case.

We also note that the Indonesian crude oil portion of the formula continues to compute increases from the actual sales prices paid for Indonesian exports (as opposed to posted prices), and as such represents a broad and accurate mechanism for measuring changes in actual energy prices. Moreover, the more volatile spot market prices paid for Indonesian crude are excluded from the calculations. The use of such a price quotation mechanism, which appears to reflect the market for the bulk of Indonesian exports, assures greater stability and clarity in this component than would be provided if it were based on commodities with a more volatile and limited market.

We will also approve the use of the WPI-AC for the other 50 percent of the escalator provision in order to provide a broader basis for price adjustments, as called for in Opinion No. One. We note that the contract amendment specifies a procedure for development of an alternative index in the event that BLS ceases to compile and publish the WPI-AC. Indeed, we have been advised by the Department of Labor that its current series of indices is undergoing significant revisions with possible abolishment of some. DOE will direct, therefore, that the applicants submit for approval any new index adopted pursuant to these contract provisions. We suggest that the GNP-deflator published by the United States Department of Commerce would be an acceptable alternative, since it is also a broad-based domestic indicator which avoids any significant self-compounding effect in relation to this project.

Hollister requested further hearings in which to explore the operation of the revised contract provisions. However, the revised escalator formula is clearly defined by the Applicants' filing and information regarding operation of the WPI-AC is readily available to all parties. Therefore, the opportunity given all the parties to comment on the proposal provided an adequate airing of views concerning this issue. Moreover, Hollister has not met its burden of showing that hearings on the subject of the escalator would provide us with additional material information. We note finally that Hollister's intervention in this proceeding was granted for the limited purpose of participation in the siting and environmental aspects. No need has been established for further hearings, and Hollister's request will be denied.

B. The Currency Revaluation Factor

In Opinion No. One, DOE disapproved the automatic flowthrough of costs associated with the currency revaluation factor contained in the sales contract, based upon a finding that the factor did not afford "equitable distribution of currency fluctuation risk between buyer and seller." On rehearing, the applicants argue that DOE's finding is in error, because it is based on conclusions (a) that the contract sales price would never be adjusted downwards in the event of an appreciation of the dollar, and (b) that the 25 percent limitation on adjustments due to dollar depreciation applies quarterly and therefore has no ceiling. Applicants state that neither conclusion is correct, and therefore request that DOE approve the currency revaluation factor as negotiated.

Hollister and the FERC staff oppose the applicants' request. Hollister suggests that DOE should take notice of recent announcements by the Organization of Petroleum Exporting Countries that it intends to adopt a mechanism which will provide for automatic adjustments in crude oil prices to reflect changes in the value of the U.S. dollar. They argue that if DOE accepts an escalator clause which is tied to Indonesian crude oil prices, the adoption of such a mechanism, in conjunction with the currency adjustor, would provide a double adjustment for fluctuations in the value of the dollar. The FERC staff opposes the currency revaluation factor "because its proposed use is satisfied by use of the escalator based on the United States Wholesale Price Index."

DOE has reexamined the currency adjustment provision in light of Pac Indonesia's explanations, and finds that its objections in Opinion No. One were based upon a misconstruction of its operation. Paragraph 9.6 of the amended contract does provide an absolute limit of 25 percent on the amount of adjustment called for by this clause, and further provides for downward adjustment in the event of appreciation of the dollar (although such downward adjustment cannot carry the price below the price on the date of first initial delivery in any quarter when the Calculated Contract Sales Price exceeds the price on the date of initial delivery). Properly understood, the currency revaluation factor, while not perfectly symmetrical in its operation, is not unreasonable in this long-term contract; flow-through of costs associated therewith will thus be approved.

The FERC staff's argument that use of the WPI satisfies the need for a currency adjustor is not persuasive. As stated in Opinion No. One, we do not object to the concept of a currency revaluation factor, per se, as a means by which Indonesia may assure itself of stability of real revenues under this long-term contract.

Hollister's objection would have serious merit if Pertamina were to

adopt a mechanism that adjusted Indonesian crude oil prices to reflect changes in the value of the dollar. However, Pertamina has not taken any such action. Our order will require that if such a mechanism is adopted in the future, appropriate action be taken to remove the potential for duplicative adjustment of the LNG price.

III. Conclusion

The DOE finds that good cause exists to modify Opinion No. One, as described in the body of this Opinion. Upon completion of the DOE's consideration of other matters raised in the applications for rehearing, an appropriate Order shall be issued, reflecting the DOE's findings with respect to such matters as well as those set forth herein.

Issued in Washington, D.C., September 29, 1978.